Response to CMA's *Provisional Findings* and *Notice of Possible Remedies* re Vodafone-Three Merger

Stephen Howard, 27 September 2024

The CMA's *Provisional Findings* and *Notice of Possible Remedies* are broadly to be welcomed for taking due note of the benefits that the proposed merger between Three (3UK) and Vodafone (VUK) could bring. In particular, it is reassuring to see real weight being accorded to the parties' considerable investment plans. That said, however, there remain some major concerns with the provisional findings, as well as with the potential remedies that are now being contemplated.

Particularly troubling is that the analysis should posit a false trade-off between investment and pricing. Given the importance of mobile infrastructure as a platform for innovation and productivity growth, this is not merely mistaken but could in fact result in broader economic harm. At a time when recognition of the need to promote and sustain growth has finally reached the top of the national agenda, it is imperative that the UK encourage investment of a kind that can both improve the quality of service and lower the pricing of mobile telecoms. An additional issue is the finding that the merger might put the wholesale market at risk of a substantial lessening of competition (SLC), which strains credibility in view of 3UK's track record in this area.

Retail market price effects

The CMA's merger review includes research into what UK mobile customers themselves prioritise when selecting a service. Not surprisingly, price was identified as the most important parameter of competition. While network quality was also a consideration, it was found to be less prominent a factor. In particular, a majority of customers indicated that they would not be prepared to pay more for either improved speed or reliability.

The way in which these survey findings are presented is highly worrisome, because it suggests the inference that customers want cheaper services rather than investment, as they value inexpensive offerings rather than quality of service. This in turn would imply that there is a risk of over-estimating the importance of investment, because its benefits (such as speed and reliability) might eclipse what is actually most important, namely price. Such an analysis would tend to detract from the benefits of the merger, by downplaying the advantages it could bring in terms of network upgrades.

Yet this would be to fundamentally misunderstand the role of investment. The reality that bears continual restatement is that *investment is pricing*. The quest to minimise the cost of transporting a byte of data to a customer is essentially a quest to maximise the quantity of Moore's Law applied to the network, via efficient capex. So, when customers insist that pricing is the most important factor, far from counting against investment, this should instead be understood as underlining the paramount importance of securing maximal efficient capex.

Happily, this capex will also bring about benefits such as improved speeds and reliability, but what makes it the crucial consideration is that it is easily the most important factor in driving down price. Therefore, far from calling into question the relevance of the would-be merging parties' network investment plans, the survey in fact reinforces their centrality.

It is therefore extremely troubling to read the following. Expressing scepticism about the merging parties' investment programme, the document comments: "We therefore have significant concerns about the impact of the Merger on the large number of consumers who might have to pay more for improvements in network quality they do not value." This underlines that my previously expressed concern about the scope for confusion over the real role of investment in the analysis has, unfortunately, been realised.

In reality, it is investment that drives the price declines on which the CMA is focused. The greater the investment, the greater the price decline.[1] Network quality improvements accompany said price declines. The greater the investment, the greater the price decline *and* the greater the network quality enhancement. So the above quote is fundamentally misguided. What is posited there as a trade off (better investment/network quality or better pricing) is nothing of the sort. Instead, the choice is simply between better investment/network quality/pricing (with the merger) or worse (without the merger).

The pricing analysis employs a GUPPI approach, which – as discussed in my previous submission – is highly unrealistic when sundered from the benefits of dynamic efficiency gains (in the form of the investment that the merger would enable). The *Summary of Provisional Findings* provides us not only with an estimate of the gross price rise without the offsetting dynamic efficiency gains, but also an upper bound sensitivity analysis – without any accompanying lower bound.

Additionally, it is most regrettable that the document should reference in support a recent report from DG COMPETITION that purports to show a linkage between mobile pricing and market concentration. For reasons previously set out at greater length in a dedicated paper, these conclusions are deeply flawed, chiefly (but by no means exclusively) because the research in question neglected to examine actual pricing data, relying instead on a measure of revenue, ARPU.[2]

The CMA is understandably especially concerned about any price rises that might affect those consumers with the lowest disposable incomes. This is also a focal area for Ofcom, which has been constantly active in this space. Given this degree of oversight, though, concerns here should be addressable through behavioural undertakings. Whether or not the merger receives approval, there can be little doubt that these tariffs will remain subject to close monitoring, and doubtless intervention (if necessary) by a vigilant and well-resourced sector regulator.

Retail market network quality effects

The provisional findings recognise certain of the benefits that the joint business plan (JBP) and joint network plan (JNP) would bring, but question the likelihood that these would be fully implemented. Fortunately, it ought to be possible to address such concerns through behavioural remedy commitments.

The CMA states that, "the Parties' quantitative modelling of the claimed network capacity and quality impacts of the Merger… include the claim of a market-wide welfare gain of £1.8 billion per year. We have a number of serious concerns about the robustness and predictive value of these models, and therefore we do not put any weight on these models or their claims." While it is entirely appropriate that those

[1] A formal exploration of the relationship between investment and pricing can be found in, for example, François Jeanjean, "Static and dynamic causes of the decline in the price of mobile telecommunication services", *24th European Regional Conference of the International Telecommunications Society*, 2013.

[2] For the full analysis, see: *https://www.commcham.com/pubs/2024/9/27/a-critique-of-protecting-competition-in-a-changing-world.html*

reviewing a merger should query such projections, the fact remains that these positive impacts are a substantial and integral aspect of the merger and ought not to be disregarded.

As things stand at present, the situation resembles a concern raised in my previous submission: "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." There may be a case for disputing the estimated magnitude of these benefits, but nevertheless an evaluation of their size will be needed if the assessment is to be a fair and balanced one.

The document also questions the value to customers of certain of the improvements in network quality that the parties argue the merger will deliver: "we therefore consider that the value to customers of some of these technical improvements (especially speed and latency) is likely to depend to a significant extent on the emergence and adoption of new applications that require very high speeds and low latencies."

In part, the response to this – as in any technological field – ought to be that "'twas ever thus". The assertion quoted above has been readily applicable throughout the history of the mobile industry. This does not mean it is necessarily wrong, but certainly in the past, hopes that fresh services would emerge to utilise platforms' new capabilities have generally been fulfilled, at least in the medium term. Moreover, we can be fairly clear that new services will not emerge if the infrastructure required to underpin them is either absent in the first place or deployed to an insufficient degree.

It is to be welcomed that the provisional findings do recognise the likelihood that the network quality improvements resulting from the merger would engender a competitive response. As discussed above, network investment brings both capacity benefits (hence price declines) and network quality enhancements. These improvements would plainly be rivalry enhancing, forcing competitors to respond – and thereby having a positive impact across the entire marketplace.

This should be so even without taking into account Beacon 4.1. Given VMO2's relative lack of spectrum, the transfer of frequencies to this close competitor (on the CMA's own assessment) would very plainly enhance its ability to compete in both retail and wholesale segments.

Wholesale market effects

In the wholesale market, as in the retail market, the precise question before the CMA is whether or not the combination creates the expectation, defined as a greater than 50% chance, that there will be a substantial lessening of competition (SLC). It is difficult to understand how the proposed merger could have these odds of seriously reducing competition in the wholesale arena when 3UK has only one significant MVNO customer, representing c.1% of the mobile market, and has not won a major new MVNO contract in more than half a decade.

A primary piece of evidence offered in support of the provisional finding that there is scope for a SLC in the wholesale market is that the MVNOs themselves said as much. In view of the potential remedies in prospect – perhaps the ringfencing of spectrum or even direct price controls – there is very obviously a considerable incentive in play. This is not to blame the MVNOs: regulatory arbitrage has, alas, long been

one of the most important skill sets in the telecoms industry. However, the CMA should consider whether such claims meet the test of reasonableness.

In this context, it is worth noting what the CMA itself considers robust and reliable when evaluating statements from the would-be merging parties. This might be summarised as follows: talk is cheap/put your money where your mouth is. It is not sufficient that the companies have tabled intricate post-merger business and network plans. As the CMA emphasises, this provides no guarantee that the merged operator will actually follow through on these pledges. Hence the interest in securing commitments on network investment.

It seems only balanced to follow a similar approach when considering the position of the MVNOs. How many major MVNOs have actually been prepared to put their money where their mouth is and switch to a wholesale contract with 3UK? So far this decade, precisely zero.

Despite their lack of willingness to sign up with 3UK, MVNOs have apparently noticed the improvement in its network proposition. By contrast, VMO2 is regarded as capacity constrained and, as a consequence, has been able to pursue MVNO opportunities only selectively. Beacon 4.1, though, will leave this competitor much better positioned to win additional wholesale business. The proposed merger would therefore result in not one but two players having greatly augmented network capacity to clear – and, in the case of VMO2, that capacity in the hands of an operator with an established track record of successfully wholesaling to MVNOs.

On a separate point, the provisional findings mention that, were MVNOs less able to compete as a result of the merger, this would have further negative consequences for retail prices. Yet it is notable that elsewhere the document concludes that "the constraint from MVNOs is limited".

Given the paramount importance of the potential investment by the merging parties, whether through the lens of pricing or quality of service, it is very much to be hoped that misguided concerns about the impact on the wholesale market do not derail the merger. If the merging parties provide undertakings to implement the JBP and JNP, perhaps complemented by limited-term pricing commitments on social tariffs or similar, it would be a travesty were the merger's advantages to be lost on the basis of the supposed impact on the wholesale market.

Structural remedy options

The document proposes two potential structural remedies, namely a prohibition or a partial divestiture. To opt for the first of these would simply be to abandon the powerful benefits that the merger would bring in terms of investment, and therefore also capacity, speeds, reliability and pricing. For the reasons set out in my earlier submission, the parlous state of returns in the mobile market mean that operators will struggle to justify even the rates of investment that have been committed to date. The merger, on the other hand, creates the opportunity to lock in the capex on which positive outcomes depend, and should therefore be embraced.

The second structural remedy under consideration is one of partial divestiture. Here the CMA is correct to adopt a highly sceptical stance, in particular for the reasons cited relating to economies of scale. The purpose of the proposed combination is to create an operator with the scale to invest successfully over the longer term. Artificially carving out an additional MNO from its operations would not only undermine

the scale benefits accruing to the merged operator (and thereby compromise its ability to invest), but would also create an entity that – being smaller scale than today's third and fourth players – would struggle.

Efforts elsewhere to arbitrarily create scope for a fourth player where none exists economically have led to deeply counter-productive measures such as mandating access for the new entrant to others' network and spectrum. This undermines the investment incentives not merely of the merging operators but of all market participants, so impairing the very process that powers ongoing pricing and quality of service improvements.

Behavioural remedy options

While recognising that the CMA has a preference for structural remedies, it should be acknowledged that one of the potential disadvantages of behavioural remedies is much ameliorated in a market subject to such active and ubiquitous regulation as telecoms.

The benefits of the merger would primarily comprise of the investments that it will unleash. If the CMA has concerns that the combining parties might not fully implement their tabled JNP and JBP, then a behavioural remedy to guarantee that progress is made with these would seem the most appropriate option.

However, the CMA also suggests – owing to the time taken for investments to be made and for their benefits to flow through to customers – that it may be appropriate, in addition, to institute shorter-term retail market protections. An example cited is a commitment by the parties to protect social tariff terms and conditions.

It always bears repeating that, ultimately, investment is pricing. Operators investing more will provide better quality, lower priced services. Nevertheless, if there are concerns about the speed of the transmission mechanism involved, a time-limited retail market protection might be appropriate. Note, though, that this should incorporate linkage to CPI or RPI to allow for input cost changes that are beyond the operators' control, as has been witnessed during the recent inflation spike.

Turning to the wholesale market, neither remedies ringfencing capacity nor introducing price controls would be justified. This is primarily for the reasons already discussed above. In summary, the theory that the merger of 3UK (which has not won a significant new MVNO contract this decade) with a rival would result in a serious diminution of wholesale competition lacks plausibility.

As set forth in the documents, potential remedies must be examined from the perspective of the potential market distortions that they might introduce, as well as the extent to which they would impair the relevant customer benefits (RCBs) that the merger would bring.

Any wholesale remedy would fall foul of both of these considerations. For the reasons detailed in my previous submission, while the existence of the wholesale market does provide certain benefits, specifically in terms of addressing market niches that larger operators might otherwise struggle to reach, it also comes at a significant cost. 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.

It should therefore be understood that the wholesale market represents a trade-off: a greater balance in favour of wholesale as opposed to retail means less investment. This is not to deny that the wholesale market results in increased price competition; but where returns fail to meet the cost of capital, short-term benefits in this regard will come at the price of reduced longer-term network investment, and thus ultimately inferior quality of service and pricing outcomes. As it is investment that ultimately drives quality of service and pricing, the CMA should be extremely wary of imposing wholesale remedies, given that these will undermine the case for investment and thus the RCBs.

Furthermore, wholesale remedies – whether pre-agreed access terms or capacity ring-fencing – risk fundamentally distorting the wholesale market, by in effect pre-ordaining its dimensions. This is plainly not the job for a regulator but for the market itself. MNOs need to clear their capacity – and the more investment they make, the more capacity they will have to clear. MVNOs will thrive to the extent that they can assist with this process, by focusing on market segments with which the MNOs might otherwise struggle, or by giving access to established, valuable customer bases. However, the parameters of price and volume here are surely for the market to determine.

Relevant customer benefits (RCBs)

The additional network investment that will be underpinned by the merger can credibly be expected to meet the CMA's requirements that RCBs result in lower prices and higher quality of service, including both increased choice and greater innovation, to the benefit of both customers and the broader UK economy.

In a telecoms context, improvements boil down to declines in unit price, since it is lower unit prices (specifically the price per GB) that enhance the value for money of existing services, while enabling the provision of entirely new ones. Social media offerings, for example, or video calls/conferencing, have only been possible because of the progressive collapse in the cost of conveying packets of data over telecoms networks. These declines in unit pricing are, in turn, driven by network investment. The proposed merger provides a way to improve returns and thus network investment viability, paid for out of operating efficiency gains.

The parties' claims that combining mobile spectrum and assets in a single network will yield substantial efficiencies is highly plausible. Financial analysts, when presented with operators' efficiency programmes, are wont to display healthy scepticism about their feasibility. However, the idea that efficiency gains can be realised by reducing network duplication is precisely the type of saving upon which an analyst would place a high degree of confidence. The archetypal example is that of 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 – or to extend coverage to areas currently without it.

As ever, the primary driver of better outcomes is simply network investment. Capex translates into newer, more efficient equipment, capable of delivering more capacity for less. It is 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. Network investment committed today will focus on the latest generation of mobile technologies, namely 5G. This platform brings certain entirely new

capabilities, in addition to further progressing the vitally important work of reducing the cost of conveying a data packet to a customer.

The merger, together with the economies it should yield, will enable more extensive investment (and therefore 5G deployment) than would otherwise be possible. Conversely, though, an alternative scenario, in which the merger does not take place, will entail less (as well as less efficient) investment. The simple reality here is that 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 it cannot be prevented. The best option is to permit those initiatives, such as this merger, that can provide improved returns – and so justify and sustain longer term investment – through cost savings.

Conclusion

In conclusion, it is encouraging to see the CMA undertake a balanced assessment of the implications of the proposed merger, and in particular one that pays greater attention to the investment dimension than has been the case for those combinations reviewed in Brussels. Nevertheless, significant concerns remain:

- The provisional analysis identifies a trade-off between investment and price. In fact, there is no such trade-off. Investment is precisely what drives pricing downwards. With growth at the top of the national agenda, this type of misunderstanding (which inevitably carries with it the risk of underestimating the benefits of investment) is frankly the last thing the country needs.
- Given major MVNOs' long-standing reluctance to give 3UK new business, it looks highly improbable that the merger would qualify as a substantial lessening of competition. Moreover, the suggested wholesale remedies risk acting as market distortions.