



Fairfax/NZME: review of the draft determination

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Confidential information in this document is identified by square brackets.

1. Introduction and executive summary

1. We have been asked by Russell McVeagh to review the Commerce Commission's draft determination in respect of the proposed Fairfax/NZME merger, dated 8 November 2016. We set out our review in this report.
2. Our key findings are as follows:
 - a) The analysis set out in the draft determination is static and not forward-looking, despite the compelling evidence that news media is being subjected to some very powerful dynamics. The draft determination underestimates the impact of the internet, and does not analyse incentives if the merged entity were to raise price or lower quality.
 - b) The analysis set out in the draft determination is quite structural, and effectively treats news media firms as factories, with their sunk capacity defined by the number of journalists (see, e.g., [481]). But journalists are actually mobile, and expenditure on them is divisible and ongoing (i.e., there is not a sunk investment to any material degree). Therefore news media expansion can be quite incremental. The internet has also dramatically lowered impediments to expansion and entry.
 - c) The analysis in the draft determination does not acknowledge or address the filed evidence of the [], and despite this evidence the draft determination asserts that any assumed merger-induced price increases would lead to functionless supra-competitive rents.
 - d) Underplaying these factors leads the Commission to incorrectly conclude that:
 - i. Print and digital advertising are not substitutes;
 - ii. TVNZ, MediaWorks and RNZ would not expand further into online news if the merged entity attempted to increase prices or lower quality; and
 - iii. [], [].
 - e) The expansion point is perhaps the most critical, as ruling out TVNZ, MediaWorks and RNZ as competitors means the Commission has effectively analysed the merger as a duopoly to monopoly. This is the primary driver for the Commission's conclusions that:
 - i. A paywall would be introduced; and
 - ii. Plurality would be reduced.
 - f) The draft determination does not fully recognise that prohibition of the proposed merger would [], with a consequent loss of consumer value. We return to counterfactual issues below.

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- g) The impact of social media and the internet on plurality is also understated. Implicit in the Commission's analysis is that diversity of opinion largely comes from traditional news organisations. This is an artefact of the Commission's decision to not consider the market for distribution in any detail. Blogs, self-published platforms like Medium,¹ and direct posts on social media are a source of plurality. Plurality is likely to be of much greater concern when distribution is a bottleneck and there is vertical integration between content creation, publishing and distribution. However, the internet means that distribution is now an open access platform, with content creators able to distribute directly to consumers for little incremental cost (e.g., via their own websites) or access the distribution channels of distributors with vast audience reach (e.g., Facebook's Instant Articles) and high dwell times.
- h) The Commission has also overstated the magnitude of any possible quality detriments. The key article it relies on analyses a 1997-2005 dataset, which in terms of internet technology and use, is old. Accordingly, the results of that research will significantly overstate the negative impact of a newspaper merger on quality.
- i) The net benefits calculation can be thought of as an indicator of how material any relevant non-quantifiable detriments need to be for authorisation to be declined (i.e., the net benefit estimate provides the "hurdle" any relevant non-quantifiable detriments must overcome). Our analysis in this report suggests that this hurdle is materially higher in the worst-case scenario than the Commission's assessment.
- j) Against the status quo counterfactual, the Commission estimates the high detriment/low benefits figure to be \$14.1m (five-year net present value). In our view, even if it could be said that (a) the status quo is a relevant counterfactual, and (b) the proposed merger would result in a substantial lessening of competition in the markets identified by the Commission, that figure should be \$118.8m. In Table 1 we set out our adjustments to the Commission's detriment range to show how we have arrived at this figure.

¹ Medium is an open, online publishing platform where people can write articles, which they can then self-distribute, e.g. through social media. Medium also functions as an aggregation/curation service for readers. Use of Medium as a publication is not limited to individual authors either - major traditional publications such as *The Economist* (<https://medium.com/the-economist>) and *The Washington Post* (<https://medium.com/@washingtonpost>) publish articles on Medium. It was also used by Hillary Clinton during the 2016 US presidential election (<https://medium.com/@HillaryClinton>).

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Table 1
Adjustments to the Commission's detriment calculations: assuming status quo counterfactual and a substantial lessening of competition

Category	Commission's range for annual detriments	NERA range for annual detriments ²	NERA rationale for change ³
<u>Allocative efficiency losses</u>			
Community newspaper advertising	[]	[]	Commission uses 5-10% price increases, but community newspaper advertising is constrained by online advertising, so maximum assumed price increase should be 5%
Sunday newspaper advertising	[]	[]	Commission uses 5-10% price increases, but Sunday newspaper advertising is constrained by online advertising, so maximum assumed price increase should be 5%
Premium digital advertising	[]	[]	Commission uses 5-10% price increases, but premium digital advertising is constrained by other online advertising, so maximum assumed

² Our calculations in this column are based on the rounded detriment numbers reported in the Commission's draft determination. We have previously filed our own detriment calculations with the Commission (set out in our report dated 27 May 2016), although we think the Commission's calculations are based on data the Commission has received since 27 May 2016. Accordingly, for our adjustments to the allocative efficiency losses for community newspaper, Sunday newspaper and premium digital advertisers we do not have the underlying data to accurately adjust the top of the range for a 5% price rise. However, we apply a factor of 0.5 to the top of the Commission's range to adjust from a 10% price rise to a 5% price rise. This is broadly similar to the relationship between these detriments based on our own calculations. For example, for Sunday newspaper advertising our analysis filed with the Commission estimates a maximum allocative efficiency loss of [] for a 10% price rise, and [] for a 5% price rise. Our results should therefore be seen as broadly indicative of how the Commission's numbers will change with our adjustments, but may not be perfectly precise. Note also that we make no adjustments to the bottom of the Commission's range (for the community newspaper, Sunday newspaper and premium digital advertising categories), because this is likely to already be associated with a 5% price rise (as was the case with the detriment calculations in our 27 May 2016 report).

³ As noted elsewhere in this report, even the assumption of a 5% price rise is not realistic based on the evidence of the constraint from other digital alternatives.

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Sunday newspaper cover prices	[]	[]	price increase should be 5% Commission already assumes only a 5% price increase, so to be conservative we assume no change to the Commission's figures
Sunday newspaper subscription prices	[]	[]	Commission already assumes only a 5% price increase, so to be conservative we assume no change to the Commission's figures
Paywall	[]	\$0	Detriments are overstated and Commission has not taken into account offsetting benefits, so unlikely to be any net detriments
<u>Productive efficiency losses</u>	\$0 – []	\$0 – []	No change
<u>Dynamic efficiency losses</u>	[]	[]	No change
<u>Wealth transfers</u>	\$6.2m - \$7.8m	\$0	Price rises are functional, not functionless, so wealth transfers are not a detriment
<u>Total annual detriment range</u>	\$7.1m - \$29.2m	\$0.8m - \$4.3m	
<u>Total five-year present value detriment range⁴</u>	\$29.2m - \$122.4m	\$3.5m – \$17.7m	
<u>Total net benefits range (using Commission's quantified benefits of \$136.5m-\$218.7m)</u>	\$14.1m - \$189.5m	\$118.8m - \$215.2m	

⁴ Using a 10% discount rate.

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- k) The Commission has also defined a digital-only (plus the print communities) counterfactual, and finds that the quantified net benefits of the factual against this counterfactual would likely be at least as high as the quantified net benefits against the status quo counterfactual. Fairfax and NZME have filed evidence outlining why this is not a feasible counterfactual.
- l) In fact, the Commission's digital-only + print community counterfactual does not reflect the commercial realities facing the merging parties. In [] the absence of the merger:
- i. []; and
 - ii. []
- m) [] []. [] [].
- n) For the purposes of competition analysis, we think a conservative counterfactual [] []⁵. To illustrate the effect of this counterfactual, we assume it would occur []. The benefits and detriments of this counterfactual are illustrated in Table 2 below.

⁵ []

Table 2

[]

[]^{6,7}

- o) The effect of this analysis is that for the combined quantified and unquantified effects to result in a present value net detriment, [] would need to exceed:
- i. The present value of the quantified net benefits, being []; and
 - ii. The present value of [].

2. The internet and competition in media markets**2.1. Introduction**

3. The internet and other recent technology (e.g., smartphones) have had a profound effect on media markets. They have altered the nature of competition in these markets, the economics of media distribution and publication, consumer behaviour, and the viability of traditional media businesses. These dynamics are strongly evident in New Zealand, as they are globally.
4. We have described these dynamics in our previous reports filed with the Commission. However, we summarise them again in the next section of this report, because:
 - a) They are critical to the competitive effects and benefits of the proposed merger; and
 - b) The Commission has either under-emphasised these dynamics or, in some cases, has not acknowledged the implications in the draft determination.
5. After re-emphasising the impact of the internet, we turn to the implications for the Commission's conclusions.

2.2. The impact of the internet on media markets

6. The internet and other technological change have significantly impacted the viability of traditional print media businesses. In New Zealand, newspaper circulation and readership have been falling across the different categories of newspapers: metropolitan dailies (e.g., *The Dominion Post* and *The New Zealand Herald*), regional newspapers (e.g., *Hawkes Bay Today*), Sunday newspapers and community newspapers.⁸ At the same time, news websites

⁶ As re-estimated by us in this report.

⁷ We use the Commission's assessment of quantified benefits and one-off costs, and assume that all one-off costs occur in year one of the analysis.

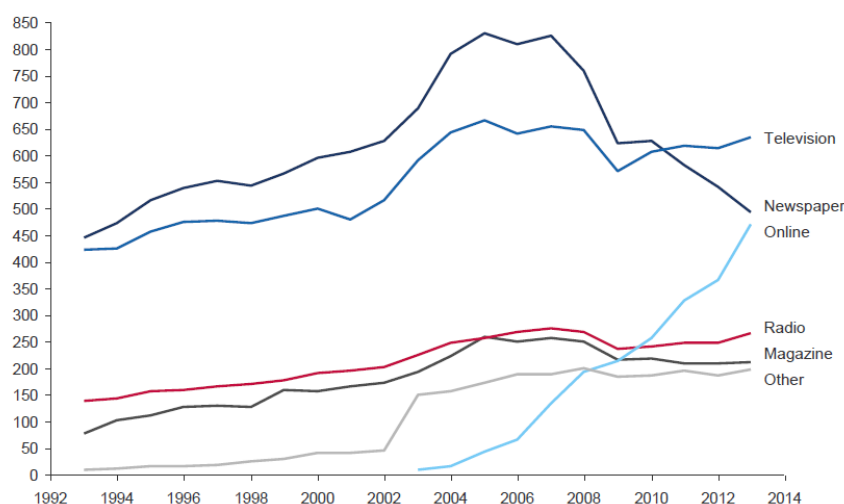
⁸ See Figures 10 and 11 in our 27 May 2016 report filed with the Commission, circulation data available from the New Zealand Audit Bureau of Circulation (<http://newspaper.abc.org.nz/>), and readership data available from Nielsen (<http://www.nielsen.com/content/dam/nielsen-global/nz/docs/newspaperandmagazinecomparatives/newspaper-toplines-q2-2014-q1-2015.pdf>).

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are being increasingly accessed,⁹ and the decline in print media has been attributed to this shift to online news reading.¹⁰

7. On the advertising side of the market, there has been a similar shift from print media to online. Advertising volumes across the range of different newspapers in New Zealand have experienced substantial falls in recent years.¹¹ The shift of advertising away from print to online is clearly evident in Advertising Standards Authority (ASA) data showing advertising expenditures across the different media. Figure 1 below appeared in our earlier (27 May 2016) report filed with the Commission, and shows that the decline in newspaper advertising expenditure is a reflection of the incline in online advertising expenditure. Falling newspaper advertising prices,¹² even for metropolitan newspapers that face limited geographical competition from other newspapers, also bears out the influence that the internet has had on newspaper advertising.

Figure 1
Advertising expenditures (\$) across different media, 1992-2014



Source: ASA data (sourced from [])

⁹ See Figure 12 in our 27 May 2016 report.

¹⁰ See, for example, Chandra and Kaiser (2016, p.413) who state that “[t]he increased pace of newspaper shutdowns in recent years is no doubt due to stiff competition from online sources” (Ambarish Chandra and Ulrich Kaiser (2016), “Newspapers and Magazines”, in Simon Anderson, David Stromberg and Joel Waldfogel (eds.), *Handbook of Media Economics*, Volume 1A, North Holland).

¹¹ See Figures 1 and 3 in our 27 May 2016 report.

¹² See Figures 2 and 4 in our 27 May 2016 report.

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8. These changes in newspaper circulation and advertising are a global phenomenon.¹³ The result has been that media businesses have struggled to remain profitable: in New Zealand, EBITDA for [] over the past five financial years, and we have found that [] in recent years.¹⁴ Internationally there have also been numerous newspaper closures.¹⁵
9. Against these dynamics in print media, media businesses have not been successful in replacing lost print revenue with online revenue. In the US, between 2005 and 2011 newspapers lost US\$22 in print advertising for every US\$1 increase in online advertising.¹⁶ A similar trend is borne out in New Zealand more recently. [] [], [] [] over this same period. [] [], [] []. In addition, paywalls for general news websites have not been particularly successful at generating revenue from the reader side.¹⁷
10. A key factor underlying these results is the significant competitive threat that has arisen from Google and Facebook. These firms have the largest shares of online agency advertising revenue in New Zealand (at 42% for Google and 19% for Facebook for the year ended August 2016),¹⁸ and this share has been growing – see Figure 2. These firms have several key competitive advantages over traditional media businesses, including their large audience sizes,¹⁹ data about their audiences (which enables them to better target advertising spend), and the dwell time spent by those audiences.²⁰

¹³ See, for example, Shrihari Sridhar and S. Sriram (2015), “Is Online Newspaper Advertising Cannibalizing Print Advertising?”, *Quantitative Marketing and Economics*, 13(4), 283-318; <http://www.pewresearch.org/fact-tank/2015/05/22/the-declining-value-of-u-s-newspapers/>; and “Up against the paywall”, *The Economist*, 21 November 2015, <http://www.economist.com/news/business/21678799-many-publishers-still-see-little-alternative-continual-cutbacks-up-against-paywall>.

¹⁴ See our 27 September 2016 economic profitability analysis report filed with the Commission.

¹⁵ See <http://newspaperdeathwatch.com/>

¹⁶ Shrihari Sridhar and S. Sriram (2015), *op cit*.

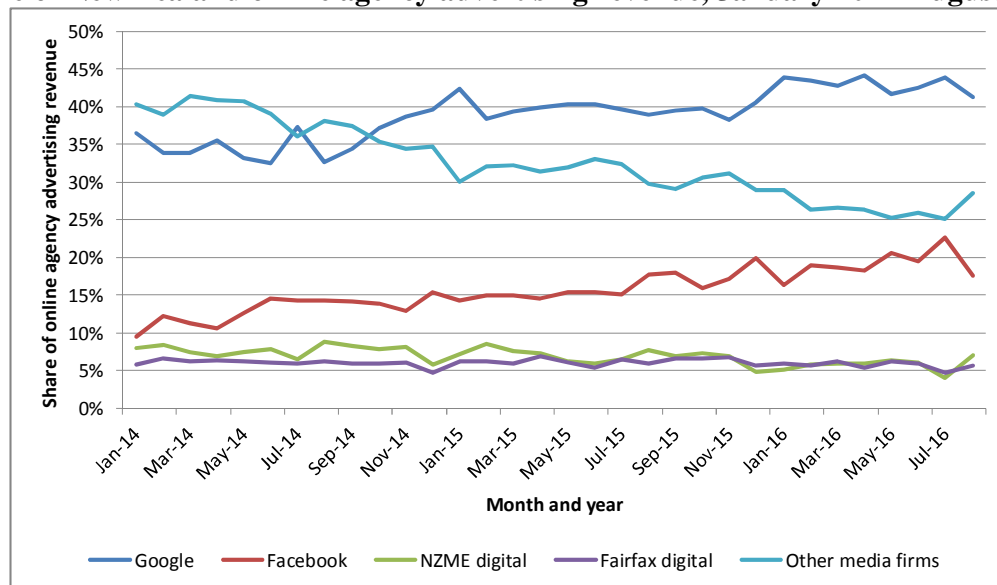
¹⁷ See the evidence noted at paragraph 30 of our 7 October 2016 report (in which we reviewed the Covec report) filed with the Commission.

¹⁸ These shares are calculated based on agency advertising revenue data for New Zealand reported by Standard Media Index (SMI), for the year ended August 2016. We have allocated a share of the “agency trading desk” revenue also recorded in this dataset to Fairfax, NZME, Google, Facebook, TVNZ and MediaWorks in proportion to the (non-agency trading desk) digital revenue shares of these six firms. The shares we have calculated reflect only online advertising i.e., they exclude any advertising revenue for other platforms such as newspapers (e.g., for Fairfax and NZME), television (e.g., for TVNZ and MediaWorks), or radio (e.g., for NZME and MediaWorks).

¹⁹ See Figure 7 of our 27 May 2016 report.

²⁰ See [].

Figure 2²¹
Share of New Zealand online agency advertising revenue, January 2014-August 2016



Source: NERA analysis of SMI data

11. The strength of Google and Facebook makes them a strong competitive constraint in respect of advertising markets. This constraint extends also onto the reader side of the market, because of the nature of media markets as two-sided markets. We have explained this feature in our previous reports,²² but in brief, a two-sided market is characterised by an intermediary or platform serving two different groups of consumers, and in which there is interaction between the demands of the two groups. For media markets, demand by audiences is, in part, related to the amount of advertising shown, while demand for advertising is related to the size of the audience that will ultimately view the advertisement. The interdependency of demand is referred to as a “cross-platform externality”.
12. While Google and Facebook do not create their own content as other news media do,²³ they do compete with news media for advertisers by capturing audiences and “selling” audience attention to advertisers. This competition for advertisers creates pressure on the reader side of the news websites, due to the cross-platform externality. That is, news media compete

²¹ We presented a similar graph in our 27 May 2016 report, which was based on SMI data for the period October 2013-July 2015, disaggregated the “other media firms” category into the different firms making up this category, and included newspaper revenues. That graph showed a similar pattern of increasing share for Google and Facebook.

²² See section 2.2 of our 27 May 2016 report and section 2.1 of our 29 July 2016 report responding to submissions on the Commission’s SOPI.

²³ Although they do distribute news content – a point to which we return below.

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with Google and Facebook to attract audience attention on the reader side of the market, in order to better “sell” that attention to advertisers on the advertising side of the market.

13. The implications for traditional media businesses of competition from Facebook, and indeed other social media platforms such as Twitter, are broader than just the competition for advertisers and audiences. Social media acts as a distribution channel for news content, for example, via content providers or friends posting links to existing news content. The key implications of this are:
 - a) Entry and expansion barriers have been dramatically lowered. Where previously the publication and distribution of news media required substantial fixed (and often sunk) costs of a printing plant and transportation network, the internet has allowed anyone who can set up a webpage the ability to offer both publishing and distribution in respect of news. Moreover, social media essentially allows news media to leverage off the greater audience numbers of Facebook (for example), as compared to what might be achieved from just distributing through a website. Importantly, social media is open access, allowing any publisher to have increased reach for their content without having to make a large investment; and
 - b) Social media is able to attract news reading audiences in particular, when those audiences may have otherwise browsed a news website or app. Indeed, Facebook’s “Instant Articles” product embeds content within Facebook itself, meaning that content created elsewhere (e.g., by a news website) is read via Facebook, rather than the news website.
14. The evidence is supportive of the view that social media is an increasingly important distribution channel for news content. For example, in a 2016 study by Pew Research Center in the U.S., it was found that 62% of U.S. adults obtain at least some of their news from social media.²⁴ Similarly, in our 27 May 2016 report, we presented both overseas (for *The New York Times* website) and New Zealand ([]) evidence showing that news readers are increasingly accessing news websites from social media referrals rather than directly.²⁵ NZME has also filed evidence with the Commission showing that [] of content on nzherald.co.nz is accessed via Facebook.
15. Finally, we note that the internet has lowered the transaction costs of accessing multiple news media (through accessing multiple websites or apps), allowing readers to “unbundle” content and piece together the content they desire from multiple providers. For example, a news reader could read sports news on the stuff.co.nz website, business news from *The National Business Review* website, and world news from the BBC website.
16. Similarly news aggregator services, such as Google News or apps such as Flipboard, allow readers to access multiple news stories from multiple content creators. In a recent paper, Jeon and Nasr (2016) show that news aggregators incentivise news media firms to provide

²⁴ Pew Research Center, “News Use Across Social Media Platforms 2016”, 26 May 2016, available at: <http://www.journalism.org/2016/05/26/news-use-across-social-media-platforms-2016/>

²⁵ See Figures 14 and 15 of our 27 May 2016 report.

high quality content, so as to increase the readership of their articles via news aggregators.²⁶ Jeon and Nasr (2016, p.93) also point to the role that news aggregators have in allowing smaller news media to expand: “In reality, there are many small news sites which have strong incentives to attract traffic from aggregators as they would receive negligible traffic in their absence”.

2.3. Implications for the Commission’s analysis

17. The Commission in its draft determination has significantly under-emphasised the role of the internet and technological change, and this permeates many of its conclusions. The Commission has only made passing references to the shift from print to online news consumption (e.g., at [91]) and the impact of social media (e.g., at [93.2]), and the full implications of these dynamics are not assessed. The Commission has also made only limited reference to the newspaper advertising price declines without drawing out any implications,²⁷ including for metropolitan newspapers that face limited geographical competition from other newspapers. We explain in the following sections the key areas where this impacts the Commission’s findings.

2.3.1. Market definition in advertising

18. The Commission finds that there are separate relevant markets for print advertising and digital advertising (at [153]). However, this ignores the evidence (set out above) of substitution from print to online advertising, and declining newspaper advertising prices (discussed further below). Indeed, as we explain in more detail in section 3.2,²⁸ evidence of substitution is a key consideration in respect of market definition, yet the Commission places no weight on print-to-online substitution.

19. Moreover, the falling newspaper advertising prices, even for metropolitan newspapers that face limited geographical competition from other newspapers, suggests that there must be some constraint aside from other newspapers that is acting on prices. The evidence of substitutability suggests that this constraint is the internet.

20. We note also that a substitutability relationship is supported in the economics literature, although the precise question of market definition in advertising is not resolved by this literature. For example, Evans (2009) states that different methods of online and offline advertising are potentially substitutes for each other.²⁹ Ratliff and Rubinfeld (2010, p.685) go slightly further, noting the shift from offline to online advertising, and concluding that

²⁶ Doh-Shin Jeon and Nikrooz Nasr (2016), “News Aggregators and Competition among Newspapers on the Internet”, *American Economic Journal: Microeconomics*, 8(4), 91-114. The empirical economics literature cited by these authors supports the proposition that news aggregators can expand online news readership.

²⁷ For example, at paragraphs [793] and [794].

²⁸ See also paragraph 27 in our 7 October 2016 report (review of the Covec report) filed with the Commission.

²⁹ David S. Evans (2009), “The Online Advertising Industry: Economics, Evolution and Privacy”, *Journal of Economic Perspectives*, 23(3), 37-60

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“there may no longer be separate markets” for offline and online advertising (but that they are “less confident” of the constraint of offline advertising on online advertising than vice versa).³⁰ Goldfarb and Tucker (2011) address this lack of confidence, and their review of the empirical literature suggests a “default position of substitution”, such that offline advertising does discipline the pricing of online advertising.³¹ In summarising the results from this paper, Goldfarb (2014) states that the Goldfarb and Tucker (2011) paper argues “that there is clear evidence that online and offline advertising markets are substitutes, although the precise degree of cross-elasticity is unclear”.³²

21. The Commission states that the substitutability might be stronger from print to online than vice versa,³³ and this may well be true (although Goldfarb and Tucker (2011) raises doubts about this). But in any case, this is still relevant when assessing competition impacts in respect of newspapers. This applies particularly in respect of the Commission’s analysis of advertising in the Sunday newspapers and the community newspapers, which we discuss in the next two sections respectively.

2.3.1.1. Sunday newspaper advertising

22. The Commission’s findings in respect of Sunday newspaper advertising is that *The Sunday Star-Times* and *Herald on Sunday* are each other’s closest competitors in the North Island ([284]) and that the Sunday papers serve a particular purpose that is not easily replicated by other advertising platforms ([286]).
23. However, advertising volumes of both of these newspapers have been falling – see Figure 3.³⁴ While the volumes for *The Sunday Star-Times* []

Figure 3

[]

[]

[]

24. [] [], [] [] from 2011-2015.

³⁰ James D. Ratliff and Daniel L. Rubinfeld (2010), “Online Advertising: Defining Relevant Markets”, *Journal of Competition Law and Economics*, 6(3), 653-686.

³¹ Avi Goldfarb and Catherine Tucker (2011), “Substitution between offline and online advertising markets”, *Journal of Competition Law and Economics*, 7(1), 37-44.

³² Avi Goldfarb (2014), “What is Different About Online Advertising?”, *Review of Industrial Organization*, 44, 115-129, at p.124.

³³ At [450], albeit that this relates to substitutability on the reader side, but the same point applies on the advertiser side.

³⁴ *The Sunday Star-Times* advertising volumes shown are for all of New Zealand, although the Commission analyses competitive effects in the North Island only. We do not have sufficient data to disaggregated advertising volumes (or prices) into each of the North and South Island.

Figure 4

[]

[]

[]

25. The Commission's analysis of the Sunday newspapers does not explain how [], despite its contention that there are no other constraints acting on these newspapers. In fact, the explanation for [] is that there is another constraint, from substitution to online advertising.

2.3.1.2. Community newspaper advertising

26. In analysing the constraints in respect of community newspaper advertising, the Commission finds that online advertising would not be a sufficient constraint on the merged entity (at [360]). However, [], even for those with no geographic overlap with other community newspapers. Regarding volumes, Figure 5 below shows the average annual percentage change in advertising volumes (measured in column cm) for Fairfax's community newspapers in Auckland and Waikato.³⁵ The green shaded bars are where the Commission has identified an overlapping Fairfax/NZME newspaper, while the blue shaded bars are all other newspapers.³⁶ [].

Figure 5

[]

[]

[]

27. []³⁷

³⁵ We have only analysed volumes for the data we have available, which is for Fairfax's community newspapers in Auckland and Waikato.

³⁶ Note that we have not attempted to identify areas in which there is an overlapping independent publication, as we do not have any comprehensive data on where these publications are based.

³⁷ [] [] [].

Figure 6

[]

[]

[]

Figure 7

[]

[]

[]

28. If Fairfax/NZME publications were placing material constraints on each other, we might expect to see []. However, there is no systematic evidence of this. [] [], this is not consistent across all the set of overlapping papers – in both graphs green features on both the left and right sides of the graphs, as does blue.
29. This evidence suggests there is some other constraint acting on *all* community newspapers (i.e., those with an overlapping newspaper, and those without), the key one of which is likely to be the internet.

2.3.2. Two-sided markets

30. Regarding the two-sided nature of media platforms, the Commission acknowledges the existence of a potential constraint due to the cross-platform externality (at [581]). However, the Commission ultimately dismisses this view, placing no weight on the pressure that platforms such as Facebook place on news websites through this mechanism.
31. The Commission argues that any lost advertising revenue from a reduction in readers may not be sufficiently large to counter the benefits from a paywall or cost savings due to quality reductions ([582-584]). Whether or not this is the case is ultimately an empirical question, but from a conceptual standpoint the evidence suggests that the constraint from the advertiser side of the market on the reader side of the market is relatively strong. In particular:
- a) The primary (and often, only) source of revenue for online news websites is advertising, and gross margins are relatively high to recover (or attempt to recover) the high fixed costs of a news media business.³⁸ Accordingly, online news platforms would be very sensitive to a loss of advertising volumes;
 - b) Fairfax and NZME are clearly concerned with attracting audience attention and providing content that attracts audiences;³⁹

³⁸ See section 2.4 of our 27 May 2016 report, and the associated critical loss analysis that we filed with the Commission.

³⁹ See the evidence set out in section 2.3.3.2.2 of our 27 May 2016 report.

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- c) As highlighted earlier in this report, there is considerable pressure from Facebook, and social media more generally, in terms of attracting audience attention (including attracting audiences seeking news content);
- d) More generally, the economics literature finds that the cross platform externality from the reader side to the advertiser side is relatively strong (i.e., the demand for advertising is strongly affected by the number of readers),⁴⁰ implying that a reduction in reader numbers might result in a large reduction in advertiser numbers; and
- e) Relatedly, the US Court of Appeals for the Second Circuit recently reversed a 2015 decision by a US District Court in a case concerning the market power of American Express, finding that the District Court had overestimated market power by ignoring the two-sided nature of credit card markets. The Second Circuit found that the District Court's erroneous market definition focused only on the merchant side of the market, leading it to incorrectly conclude that American Express had market power. Sidak and Willig (2016) support the Second Circuit's overruling, stating that "a two-sided market analysis is necessary to examine the effects that the challenged conduct has on market competition".⁴¹
32. The strength of the cross-platform externality for news media is further evidenced by the behaviour of newspapers with regional monopolies on the reader side of the market, particularly in the period prior to the growth of the internet. While these newspapers faced few direct constraints on the reader side, they still had an incentive to provide quality content and competitive prices, so as to attract readers, who in turn attract advertisers. This is supported by empirical evidence from Australia showing that, in the 1990s, prices on the reader side for monopoly newspapers were no less constrained than they were for regional newspaper duopolies.⁴²
33. This dynamic is attributed to the cross-platform externality from the reader side to the advertiser side of the market.⁴³ At the time of this analysis, the internet was relatively new and social media platforms such as Facebook did not exist. If anything, with the strength of the internet and the advertising options this provides, the cross-platform externality would likely place an even stronger pressure on news media to attract audience attention.

⁴⁰ Kaiser and Wright (2006) show that (for magazines) advertisers value reaching an extra 1% of readers by approximately 2.5 times more than readers value being able to read an extra 1% of advertisements (Ulrich Kaiser and Julian Wright (2006), "Price structure in two-sided markets: Evidence from the magazine industry", *International Journal of Industrial Organization*, 24, 1-28). Thompson (1989) shows that, for given reader characteristics, advertisers value higher circulation (R. S. Thompson (1989), "Circulation versus Advertiser Appeal in the Newspaper Industry: An Empirical Investigation", *Journal of Industrial Economics*, 37(3), 259-271).

⁴¹ J. Gregory Sidak and Robert D. Willig (2016), "Two-Sided Market Definition and Competitive Effects for Credit Cards After United States v. American Express", *The Criterion Journal on Innovation*, 1, 1301.

⁴² In particular, prices on the reader side were lower in monopoly markets than in duopoly markets, and prices in the former did not increase when monopoly power was obtained. See Vivek Chaudhri (1998), "Pricing and efficiency of a circulation industry: The case of newspapers", *Information Economics and Policy*, 10, 59-76.

⁴³ See Chaudhri (1998), *op cit.*, who refers to this as the demand interdependency between advertising and circulation.

34. We note also that in the ACCC's recent decision in respect of Seven West Media's (SWM) proposed acquisition of certain assets of News Limited, the ACCC acknowledged the constraint from the two-sided nature of media platforms:⁴⁴

The ACCC also considers that, in the face of growing competition from alternative advertising opportunities, the need for SWM to maintain readership levels in order to ensure advertising revenues would constrain SWM and likely limit its ability to increase prices to consumers or decrease quality as a result of the proposed acquisition.

2.3.3. Sunday newspaper readers

35. The under-emphasis on the role of the internet and technological change extends also to the Commission's analysis of the reader side of the market for Sunday newspapers. In particular, the Commission's analysis does not explain how two key pieces of evidence on reader side pricing fit with its finding that NZME and Fairfax "are each other's closest competitors of Sunday newspapers in the North Island" (at [593]).
36. Firstly, the Commission acknowledges (at [596]) that Fairfax operates a "one-price model" in respect of *The Sunday-Star Times*, where it charges the same cover and subscription price in both the North and South Island, despite there being no overlapping Sunday newspapers in the South Island.
37. This raises the question as to why Fairfax would not charge a higher price to readers in the South Island, relative to readers in the North Island, where (on the Commission's theory) it faces no competition in the former but does in the latter. Indeed, the conditions for such price discrimination are present:⁴⁵ the merged entity could readily identify who it should charge a higher price to, and the ability for those customers to arbitrage the higher price through resale is likely to be limited.
38. The Commission has not explained how this lack of price discrimination is consistent with its findings on the competitive dynamics in respect of Sunday newspapers. An alternative explanation is that the stronger constraint on pricing for *The Sunday Star-Times* comes from substitution to the internet, and this constraint applies nationwide. This would be consistent with Fairfax's approach of following a "one-price model" for this newspaper.
39. Secondly, the Commission observes that ([795]):⁴⁶

The average rates of increase in cover and subscription prices are larger for newspapers that face little to no competition when compared to Sunday newspapers where the Applicants' mastheads compete in the North Island.

⁴⁴ See <http://registers.accc.gov.au/content/index.phtml/itemId/1198464/fromItemId/751046>

⁴⁵ For a discussion of the conditions for price discrimination see, e.g., Dennis W. Carlton and Jeffrey M. Perloff (2005), *Modern Industrial Organization*, Fourth Edition, Pearson-Addison Wesley, at p.294.

⁴⁶ This observation relates to the Commission's detriments analysis, rather than its competition analysis.

40. However, changes in cover prices for the Saturday editions of the metro daily newspapers (which face no competition from other newspapers) are similar to those for the Sunday newspapers. In Figure 8 below we plot the annual average percentage change in cover prices (from 2012-2016) for the weekday and Saturday editions of the metro daily newspapers, and for the Sunday newspapers. Cover prices for the weekday editions have increased, on average, by around [] per annum over this period, while for the Saturday editions and Sunday newspapers the annual average cover price increase has been around [].
41. This data suggests that any constraint acting on the Sunday newspapers is also acting the Saturday editions of the metro daily newspapers, which face no competition from other newspapers. The Commission's theory (that the Sunday newspapers are each other's strongest constraint) is inconsistent with this.

Figure 8

[]

[]

[]

42. In summary, the Commission needs to consider how its finding of a substantial lessening of competition on the reader side for Sunday newspapers is consistent with a lack of price discrimination for *The Sunday Star-Times* between the North and South Islands and similar cover price increases for the Saturday editions of the metro daily newspapers that face no (newspaper) competition. In our view, these features are best explained by the main constraint on the Sunday newspapers of the merged entity coming from substitution to the internet.

2.3.4. Plurality

43. At [893] the Commission notes that plurality is generally used to mean two slightly different things, both of which it believes are relevant for this merger:
- a) "A wide range of information, opinions and perspectives are available" (content plurality); and
 - b) "No individual media owner should be in a position to shape or control the news and political agenda, either by influencing media users through editorial content or by directly leveraging the political process" (media plurality).
44. At [990] – [996] the Commission summarises the six reasons it believes plurality will be reduced by the merger:
- a) Radio and television news typically would not have the range and depth of news coverage of text-based news;
 - b) Television and radio organisations monitor NZME's and Fairfax's websites for news stories. Therefore if the merged entity stopped uncovering as many stories, this would result in stories going uncovered;

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- c) The merged entity’s “dominant position” would not be eroded due to the high costs of entry and expansion;
 - d) Viewership of traditional (linear) television news broadcasts is declining in favour of online, which may jeopardise television as a source of news content;
 - e) Radio has a much smaller reach than the merging parties; and
 - f) Self-regulation via the Press Council will not ensure plurality.
45. Reviewing this list, the Commission’s fundamental concern is that TVNZ, MediaWorks and RNZ would not expand in response to, or otherwise offset, a reduction in plurality by the merged entity. We discuss elsewhere in this report (section 3.3) why we think the Commission incorrectly overestimates the impediments to expansion by these firms. We think the logic for the competition analysis applies equally here, on the basis that if consumers value plurality, a reduction in plurality as a result of the merger will represent a commercial opportunity.
46. The Commission’s list is revealing in that it makes no mention of social media or the internet more broadly. In our view, downplaying the role of social media and the internet in providing plurality has led the Commission to overstate the reduction in plurality caused by the merger.
47. Plurality is likely to be of much greater concern when distribution is a bottleneck and there is vertical integration between content creation, publishing and distribution. This was the case prior to the internet: for a voice to be heard, it essentially needed to be published/distributed by a traditional media firm that owned a printing press or broadcasting license/equipment. In this area, aggregation of distribution platforms would be a particular concern for plurality. However, the internet means that distribution is now an open access platform with content creators able to distribute directly to consumers for little incremental cost (e.g., via their own websites) or access the distribution channels of distributors with vast audience reach (e.g., Facebook’s Instant Articles) and high dwell times.
48. The Levy/Foster report prepared for the Commission⁴⁷ also downplays the impact of Google and Facebook on the basis they do not create their own content (page 18):
- Some have argued that highly successful digital intermediaries in search and social media offer a new source of news plurality. However, while it is the case that they can make it much easier for consumers to access and share the news that they are interested in, as noted above these organisations as yet do not invest significantly in news content – they distribute rather than create.*
49. However, the Levy/Foster report does acknowledge that (page 12):

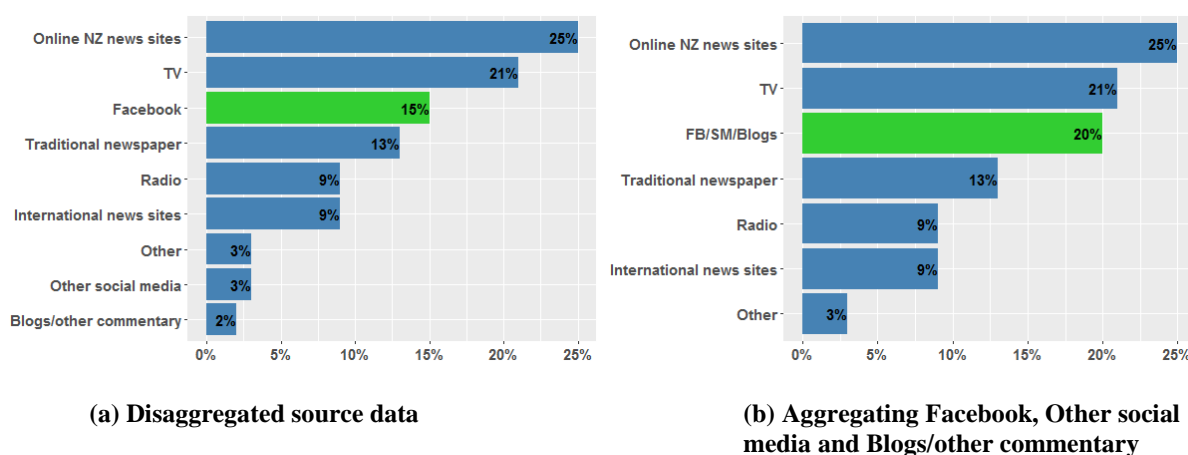
⁴⁷ David Levy and Robin Foster (2016), “Impact of the proposed NZME/Fairfax merger on media plurality in New Zealand: expert review of the Commerce Commission’s Draft Determination Document”, 16 November.

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In the longer term, the aggregate impact on plurality of many smaller suppliers of news (especially in a world in which news stories are increasingly accessed via third party intermediaries or shared via social media) might grow.

50. The latter is our key point – Facebook and Google do not create content, but they make it easier for others to distribute the content they create. The internet and social media provide a disintegrated platform where voices can be heard, and this is not given sufficient weighting in the Commission’s analysis of plurality. This downplaying is illustrated by re-cutting Figure 11 of the draft determination, which aggregates all online forms of news consumption into a single category and therefore masks the impact of social media and blogs. This re-cut graph is shown in Figure 9 below.

Figure 9
Shares of news consumption in a typical week in New Zealand, 2016



Source: NERA analysis of Figure 11 of the Draft Determination, which is based on a Fairfax survey

51. The source data indicates that Facebook has the third greatest share as a source of news consumption. Moreover, if this is combined with “other social media” and blogs to give an “alternative online media” category, this would have a similar share to television, only five percentage points less than online New Zealand news sites.

52. In fact, the Commission appears to view the rise of social media as inhibiting plurality, as it makes it harder for commercial organisations to monetise their content (at [901]):

...the rise of social media and third party aggregators as a major distribution channel, and the difficulty this presents in deriving advertising revenue from online content (as outlined by the Applicants), may make profitable new entry and expansion by commercially-focused organisations more difficult, not less.

53. This ignores that plurality can come from individuals and organisations without a commercial objective, and that social media and aggregators make it easier for these voices to be heard.

54. The Commission also downplays the impact of blogs and smaller sites on plurality (at [976]):

Public version

Many of these smaller players, especially blogs, often provide opinion on news content produced by one of the main news organisations rather than original news content. Although there may be occasional isolated instances where smaller players produce news content that has a large impact, this cannot be relied upon to replace the loss in plurality consequent to the merger.

55. The Levy/Foster report acknowledges the impact blogs can have, although still argues that the larger media organisations have the greatest impact on plurality (page 12):

...although online bloggers may appear to be of peripheral impact, they can in some circumstances create specific stories and prompt debates which become much more widely circulated. But we agree that the influence of the main players will be of a larger magnitude and perceived as such by most politicians and institutions as well as consumers for the immediate future and beyond.

56. That being said, the Commission has understated the impact of blogs due to the Commission's implicit assumptions that:

- a) To have an impact on plurality, blogs and smaller sites must *regularly* have a large impact; and
- b) The frequency with which blogs have an impact would not change in the factual if the merger led to a reduction in plurality.

57. If blogs and smaller sites do not frequently have a large impact now, that could merely be evidence that plurality is sufficient today. If the merger were to reduce plurality that would mean there are more opportunities for blogs and smaller sites to have an impact.

58. Furthermore, blogs and individuals may also have non-commercial motives for expanding in response to any perceived reduction in plurality, so it is not sufficient to apply the same commercial lens that is used for assessing TVNZ and MediaWorks.

59. This is not to say that any concerns about plurality can be ignored due to the social media and the internet. Our point is that the concerns are overstated and this should be incorporated into the Commission's balancing exercise, assuming plurality is legally a factor that can be accounted for under the authorisation framework.

3. Application of the competition economics framework

3.1. Introduction

60. Merger analysis in New Zealand, and indeed internationally, is guided by a rigorous analytical framework based on the legislation, case law developments, and a wide body of law and economics literature. This framework is captured in the Commission's *Mergers and Acquisitions Guidelines*, and is intended to be applied by the Commission in its merger assessments. In its draft determination, however, there are some important aspects in respect of which the Commission has not applied the correct analytical framework. Moreover, several of the Commission's findings are based on assertion or claims by market participants, without being supported with any further evidence or tested by analysis. We explain in the following sections the key aspects of the Commission's draft determination where this occurs.

3.2. Premium digital advertising markets

61. The Commission’s approach to defining advertising markets is as follows:

- a) Separate print and online markets are defined, on the basis of the “different methods of engaging with the consumer, advertisers’ views of the relative strengths of the different platforms and the extent to which many different forms of advertising media are selected as part of a wider advertising strategy” ([151]); and
- b) A further “premium digital advertising” segment is defined (homepage takeovers, mobile interstitials and native advertising), based on distinguishing features of this advertising from other forms of digital advertising (e.g., it is “high impact”, limited in supply and sold on a per day basis [163]-[165]).

62. These delineations are based entirely on functional or technical differences between different advertising products. However, the correct approach to defining markets is to assess substitutability between products, rather than functional or technical differences. Motta (2009, p.102) neatly summarises this point as follows:⁴⁸

...whether bananas are to be in a separate market, or not, should not depend on some particular characteristics they may or may not share with other fruits..., but rather on whether there exist other fruits that are substitutable enough to bananas so as to limit the possibility to raise the price of bananas.

63. Indeed, the Commission’s own *Merger and Acquisitions Guidelines* state (at [3.25]):

In assessing the product dimension we look for evidence showing which products customers regard as close substitutes, and whether they would switch sufficient purchases to those products to make a SSNIP unprofitable.

64. The *Guidelines* provide more detail on the application of the SSNIP test – assessing whether a hypothetical monopolist of a group of products could profitably impose a small but significant and non-transitory increase in price. The draft determination refers to this test in respect of the framework that will be applied (at [112]-[113]). However, when it comes to defining markets the main approach taken is to assess functional/technical differences, rather than apply the SSNIP test.

65. As we have previously noted in our 7 October 2016 report (regarding online advertising) filed with the Commission, for there to be a separate antitrust market based on demand-side dynamics, the Commission would need to show that there is a particular type of customer that primarily purchases “premium” online advertising, and that this customer would not have the ability, in the event of a SSNIP by a hypothetical monopolist, to switch its advertising to other ad types, including other forms of online advertising.

66. Moreover, even if there are some customers that would only purchase “premium” online advertising, suppliers to these customers would need to be able to identify and price

⁴⁸ Massimo Motta (2009), *Competition Policy: Theory and Practice*, Cambridge University Press.

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discriminate to these customers. If they could not do so, then these inframarginal customers would be protected from a price rise by marginal customers that would switch their advertising across the different ad types.

67. We note also that the Commission’s analysis appears to be based, in part, on the view that advertisers use a range of different advertising platforms (see, e.g., [151]), and therefore these platforms are in separate product markets. It is correct that advertisers often use the different advertising platforms in a complementary relationship.⁴⁹ That is, an advertiser might find it profitable to spread its advertising budget across multiple media, to maximise the number of eyeballs viewing its advertising. Advertising across multiple media might also serve different functions, e.g., some media might be better for building a brand, while others might be better for promoting immediate sales. Nonetheless, advertisers can also switch expenditure between the different platforms (as the Commission appears to acknowledge at [179]), and it is this substitutability relationship that is the key to defining markets.
68. Indeed, this ability to switch expenditure is highlighted in the Commission’s assessment of “premium” online advertising, where one advertiser is reported as stating that in response to a price increase it “would assess whether it was more efficient to invest the money in other digital advertising types” (at [225]). Another advertiser also gives an example, which the Commission notes “illustrates the comparable effectiveness of the homepage takeover compared to other forms of digital advertising” (at [226]).
69. We note also that the Commission appears to place some weight on the fact that “premium” online advertising is sold on a per day basis (whereas other forms of online advertising are sold on a cost per impression basis) – see [165] of the draft determination. While this results in a different risk allocation, this in itself is not sufficient to define a separate market.⁵⁰ Unless the risk allocation materially affects which agents compete on the demand- or supply-sides, it is hard to see how risk allocation could affect market definition.
70. The failure to apply a rigorous analytical framework extends to the Commission’s competition analysis for “premium” online advertising, where:
- a) The Commission dismisses the constraint offered by TVNZ, MediaWorks and Metservice, without either considering their current market share or properly assessing their ability to expand (which we discuss in more detail in the next section);

⁴⁹ We use the term “complementary” in a loose sense. The strict economic definition of complementary products is where an increase in the price of one product leads to a reduction in the demand for the other product – a common example is the complementarity between DVD players and DVDs. While this might not strictly apply to advertising in different media, the different media are nonetheless complementary in the sense of it being beneficial to an advertiser to spread its budget across multiple media.

⁵⁰ As we noted in our 7 October 2016 report (regarding online advertising), it would be hard to argue, for example, that a house painting fixed price contract and a house painting time and materials contract were in different antitrust markets. Similarly fixed and floating mortgage rates result in different risk allocations, but the Commission has previously defined a single market for mortgages (Commerce Commission (2003), “ANZ Banking Group (New Zealand) Limited and NBNZ Holdings Limited”, Decision No. 507, 25 September).

- b) The Commission’s conclusions appear to be largely based off the concerns raised by a single advertiser (at [238]) for the mobile interstitial product only, without taking in to account that other advertisers either did not express concerns (at [226]) or held a more balanced view (at [225]); and
- c) The Commission dismisses the constraint from Facebook and Google for “premium” online advertising, despite the only evidence on Facebook that is presented suggesting that this was a competitive alternative to homepage takeover advertising (at [226]-[227]).

3.3. Entry and expansion

71. At [511], the Commission states it “does not consider that expansion by existing competitors or entry by new competitors on a sufficient scale would be likely to constrain the merged entity” (in respect of the reader side of the market).

72. However, in reaching this view, the Commission:

- a) Does not apply its own (orthodox) analytical framework;
- b) Mischaracterises the type of expenditure required for expansion; and
- c) Overlooks that TVNZ, MediaWorks, RNZ and others already have reputable brands.

3.3.1. Analytical framework

73. Paragraphs [3.95] and [3.96] of the Commission’s *Mergers and Acquisitions Guidelines* state the following (footnotes omitted):

We assess whether entry by new competitors or expansion by existing competitors is likely to be sufficient in extent in a timely fashion to constrain the merged firm and prevent a substantial lessening of competition. This is referred to as the ‘LET test’.

The LET test is satisfied when entry or expansion in response to a price increase or other exercise of market power is Likely, and sufficient in Extent and Timely enough to constrain the merged firm.

74. As the *Guidelines* correctly identify, the analytical framework involves assessing incentives “in response to a price increase or other exercise of market power”. But the Commission has not applied this framework in its draft determination. [].

75. []

3.3.2. Mischaracterisation of expenditure

76. The Commission emphasises the “significant investment” required to provide online news coverage (e.g., at [512]). However, it appears that most of the “investment” the Commission is considering is in staff, which the Commission refers to as a “sunk cost” ([512]). But this reasoning is wrong:

- a) Staff can be employed incrementally, and can be made redundant – there is not a sunk investment to any material degree; and
- b) Journalists are mobile.

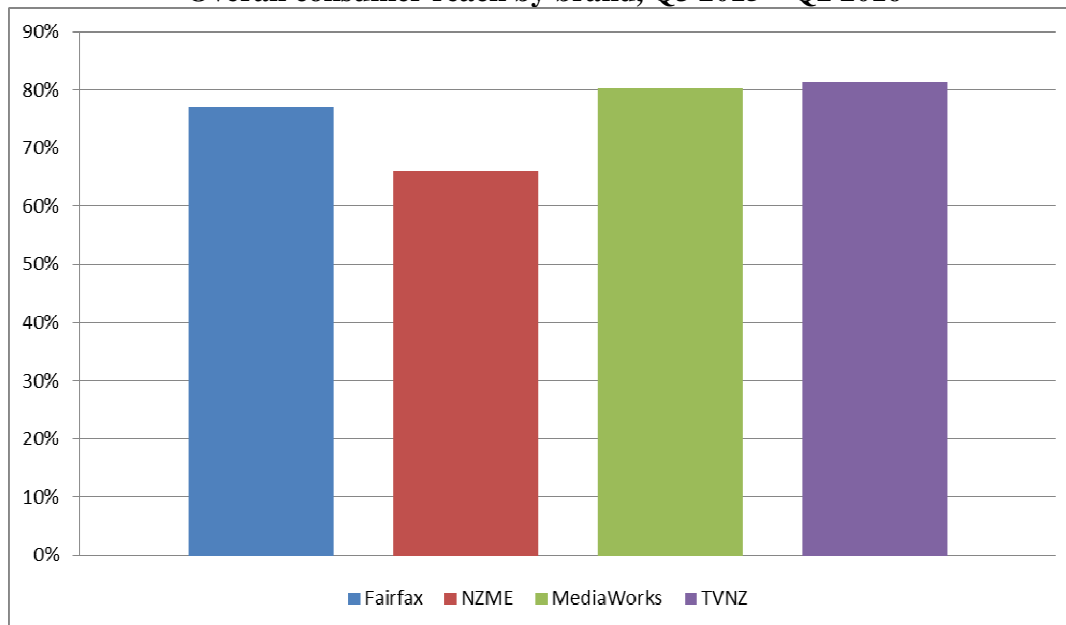
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77. The implications of this are that expansion can be quite incremental: because journalists are mobile, and expenditure on them is divisible and ongoing, an online news provider can readily employ additional journalists to expand its content in response to a price increase/quality decrease by the merged entity. The Commission's analysis here is structural, and effectively treats news media firms as factories, with their sunk capacity defined by the number of journalists (see, e.g., [481]).
78. In fact, we query whether other providers such as TVNZ, MediaWorks and RNZ would need to expand their output *per se*. These firms already provide a broad range of New Zealand content that is likely to be attractive to consumers. The key issue then is whether there are any barriers to consumers switching providers. Given that the internet lowers the transaction costs of accessing different media providers, there are no impediments to consumers accessing news content through the likes of TVNZ, MediaWorks and RNZ rather than the merged entity.

3.3.3. Brand

79. Finally, the Commission refers to the need for "investment in brand development". We agree that this type of investment is sunk. However, TVNZ, MediaWorks and RNZ already have established, reputable brands.
80. Furthermore, each of these firms has economies of scope, as they have built their online news businesses on the back of other news businesses (television and radio). If provided with an incentive to expand their online businesses, they are able to do so incrementally and accordingly in a relatively low risk way.
81. The prominence of TVNZ's and MediaWorks' existing branding is illustrated in the underlying Nielsen data from the draft determination's Table 18. Figure 10 below displays the overall reach to consumers by each brand (Fairfax, NZME, TVNZ and MediaWorks) when including all forms of their media output. As is visible, both TVNZ and MediaWorks have an overall higher reach to consumers than Fairfax and NZME – evidence that both of these companies already are in control of well-established branding.

Figure 10
Overall consumer reach by brand, Q3 2015 – Q2 2016



Source: Nielsen CMI Q3 2015 - Q2 2016, August TV/Online Fused.
 Note: Values are percentage of reach to total consumer count of 3,974,000.

4. Benefits and detriments

4.1. Introduction

82. The Commission’s quantification yields net benefits, even in the “worst-case” (high detriment/low benefit) scenario, where a figure of \$14.1m (in present value terms, over five-years) is estimated ([999]). However, the Commission’s overall view is influenced by its qualitative assessment, in which the detriments associated with quality, varying forms of paywalls (other than that modelled) and plurality are considered to outweigh the quantified net benefits.
83. We make a number of comments on the Commission’s benefits/detriments analysis in the following sections. The net quantifiable benefits calculation can be thought of as an indicator of how material any non-quantifiable detriments, assuming they are relevant, need to be for authorisation to be declined (i.e., the net benefit estimate provides the “hurdle” any relevant non-quantifiable detriments must overcome). Our analysis in this report suggests that this hurdle is materially higher in the worst-case scenario than the Commission’s assessment.
84. In particular, we find that the high detriment/low benefit scenario is likely to yield net benefits of approximately \$118.8m (five-year present value, assessed against the status quo counterfactual), based on the adjustments described in Table 3 below.

Table 3
Adjustments to the Commission's detriment calculations: assuming status quo counterfactual and a substantial lessening of competition

Category	Commission's range for annual detriments	NERA range for annual detriments ⁵¹	NERA rationale for change ⁵²
<u>Allocative efficiency losses</u>			
Community newspaper advertising	[]	[]	Commission uses 5-10% price increases, but community newspaper advertising is constrained by online advertising, so maximum assumed price increase should be 5%
Sunday newspaper advertising	[]	[]	Commission uses 5-10% price increases, but Sunday newspaper advertising is constrained by online advertising, so maximum assumed price increase should be 5%
Premium digital advertising	[]	[]	Commission uses 5-10% price increases, but premium digital advertising is constrained by other online advertising, so maximum assumed

⁵¹ Our calculations in this column are based on the rounded detriment numbers reported in the Commission's draft determination. We have previously filed our own detriment calculations with the Commission (set out in our report dated 27 May 2016), although we think the Commission's calculations are based on data the Commission has received since 27 May 2016. Accordingly, for our adjustments to the allocative efficiency losses for community newspaper, Sunday newspaper and premium digital advertisers we do not have the underlying data to accurately adjust the top of the range for a 5% price rise. However, we apply a factor of 0.5 to the top of the Commission's range to adjust from a 10% price rise to a 5% price rise. This is broadly similar to the relationship between these detriments based on our own calculations. For example, for Sunday newspaper advertising our analysis filed with the Commission estimates a maximum allocative efficiency loss of [] for a 10% price rise, and [] for a 5% price rise. Our results should therefore be seen as broadly indicative of how the Commission's numbers will change with our adjustments, but may not be perfectly precise. Note also that we make no adjustments to the bottom of the Commission's range (for the community newspaper, Sunday newspaper and premium digital advertising categories), because this is likely to already be associated with a 5% price rise (as was the case with the detriment calculations in our 27 May 2016 report).

⁵² As noted elsewhere in this report, even the assumption of a 5% price is not realistic based on the evidence of the constraint from other digital alternatives.

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Sunday newspaper cover prices	[]	[]	price increase should be 5% Commission already assumes only a 5% price increase, so to be conservative we assume no change to the Commission's figures
Sunday newspaper subscription prices	[]	[]	Commission already assumes only a 5% price increase, so to be conservative we assume no change to the Commission's figures
Paywall	[]	\$0	Detriments are overstated and Commission has not taken into account offsetting benefits, so unlikely to be any net detriments
<u>Productive efficiency losses</u>	\$0 – []	\$0 – []	No change
<u>Dynamic efficiency losses</u>	[]	[]	No change
<u>Wealth transfers</u>	\$6.2m - \$7.8m	\$0	Price rises are functional, not functionless, so wealth transfers are not a detriment
<u>Total annual detriment range</u>	\$7.1m - \$29.2m	\$0.8m - \$4.3m	
<u>Total five-year present value detriment range⁵³</u>	\$29.2m - \$122.4m	\$3.5m – \$17.7m	
<u>Total net benefits range (using Commission's quantified benefits of \$136.5m-\$218.7m)</u>	\$14.1m - \$189.5m	\$118.8m - \$215.2m	

85. We elaborate on the views in this table in the following sections (4.2 to 4.4). We also comment on quality, and then finally we discuss the counterfactual.

⁵³ Using a 10% discount rate.

4.2. Price increases

86. The Commission's estimates of the allocative efficiency loss require an estimate of the likely price increase that would result from the merger. For community newspaper advertising ([781]), Sunday newspaper advertising ([785]), and premium digital advertising, the Commission has used a range of 5%-10% for the price increase ([789]). For Sunday newspaper readers the Commission has used a price increase of 5% ([799]).
87. For the reasons discussed in section 2.3.1 of this report, we think that newspaper advertising and online advertising are in the same market. Accordingly, we do not think there would be any material price increase in newspaper advertising prices post-merger. At the very worst, the price increases should be assumed to be no higher than 5%, as per our merger simulation findings.
88. We have previously submitted merger simulation modelling to the Commission (which the Commission refers to at [778]) showing that, on the advertiser side of the market, the simulated price effects of the merger are generally for a price increase of 5% or lower.⁵⁴ We noted also the limitations in applying merger simulation to the present case, and that accordingly the models will overstate merger-induced price increases. Reiterating these limitations:
- a) The merger simulation models we use were designed to apply to one-sided markets, and do not take account of the cross-platform externality between the advertising and reader sides of the market;
 - b) A significant proportion of ad inventory is sold by auction (e.g., via KPEX or Google AdWords), and neither of the merger simulation models we used are auction models;
 - c) The models do not fully capture the competitive pressure imposed by firms such as Google and Facebook, who continue to gain share from longer-standing platforms, and have significant audience and data advantages. Indeed, our 23 June 2016 report was based on SMI data for the year to April 2016, for which Google and Facebook had shares of 33% and 15% respectively. Using more recent data for the year to August 2016 (for agency advertising across both online and newspapers), these shares have increased to 36% and 16%; and
 - d) Even if other offline platforms such as television are not technically in the same antitrust market, there is likely to be some constraint from them.
89. To be conservative for present purposes, we will assume 5% is an appropriate price increase to use, but we think this is an overstatement – in reality we doubt there would be any material price increase in newspaper advertising prices post-merger.

⁵⁴ Report dated 23 June 2016. We also presented merger simulation analysis in our first report filed with the Commission, dated 27 May 2016.

4.3. Wealth transfers

90. The Commission’s analysis treats transfers from New Zealanders to foreigners as a detriment if they are “supra-competitive returns”. The Commission defines supra-competitive returns at [832]:

Supra-competitive returns are those returns which are over and above those needed to incentivise efficient investment. They may arise from the exploitation of market power. These can be distinguished from competitive returns to capital that are necessary to incentivise efficient investment.

91. The Commission’s assessment of whether the transfer resulting from assumed price increases is supra-competitive differs depending on whether the “status quo” or “digital only + print community” counterfactual is adopted:

- a) For the status quo, the Commission assumes that current prices are “more than sufficient to incentivise investment”, and so the entire transfer (to foreigners) is a detriment ([835.1]); and
- b) For the “digital only + print community” counterfactual, the Commission assumes price increases are necessary to meet the unavoidable costs that were previously met by print ([835.2]). Therefore, transfers (to foreigners) related to premium digital advertising and the paywall are not treated as detriments.

92. For the status quo scenario, the Commission offers no justification for its assumption that current prices “are more than sufficient to incentivize investment”. The Commission’s only discussion of this assumption is at [845]:

We consider that in the status quo, current prices are sufficient to maintain incentives for efficient investment in the markets of concern. Any likely post-merger increases in prices, particularly when coupled with a reduction in costs, would suggest that shareholders would be deriving supra-competitive returns.

93. However, this assumption cannot be justified, in light of the following evidence that we have previously filed with the Commission:⁵⁵

- a) [];
- b) The share prices of each firm’s parent company has not recovered since the GFC,⁵⁶ despite share markets in general experiencing a recovery;
- c) []⁵⁷ []; and

⁵⁵ See our report dated 27 September 2016 filed with the Commission.

⁵⁶ Or ex-parent company in the case of NZME.

⁵⁷ Note that the NZME analysis covered the period 2010-2015 and the Fairfax analysis covered the period 2011-2016.

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- d) More generally, news media businesses globally have been struggling to remain profitable in the face of online competition, as discussed earlier in this report.
94. Accordingly, any assumed post-merger price increases should better be regarded as simply enabling the merged entity to have a better shot at covering its costs and being able to invest, i.e., any rents would be functional, not functionless. We made this point in our 27 September 2016 report, but the Commission has not acknowledged our analysis or rebutted it.
95. Turning to the “digital only + print community” counterfactual:
- a) As noted, the Commission assumes that price increases for premium digital advertising and revenue from the paywall would meet unavoidable costs previously met by print revenues;
 - b) This implies that, in the counterfactual, print revenues were making a contribution towards unavoidable costs, yet the merging firms’ print operations were nonetheless shut down;
 - c) But such a shut down decision would be irrational. It would only make sense to shut down the print division if the incremental revenues from print are less than the *avoidable* costs of the print division. In other words, print would only be shut down when it no longer makes a contribution to the *unavoidable* costs of the business.
96. To put this another way, in the “digital only + print community” counterfactual, the daily newspaper print operations of Fairfax and NZME would be shut down, despite (on the Commission’s assumption) these print operations being profitable. But these would be irrational decisions.
97. We note also the Commission’s “digital only + print community” counterfactual assumes the merged entity would continue printing its community newspapers, but shut down print operations for its daily newspapers. This is contrary to evidence filed by Fairfax and NZME outlining why this is not a feasible counterfactual.
98. The use of a digital-only counterfactual could be helpful conceptually, although as we discuss in section 4.6 of this report, even that counterfactual is not likely. But assuming for the moment the use of such a counterfactual, we agree with the Commission’s concern that on the face of it, current prices would not be sufficient to cover content costs. Accordingly, we agree that any merger-induced price increases should be assumed to be functional as against the digital-only counterfactual.
99. However, this also implies that the same treatment should be applied to any merger-induced price increases as against the status quo counterfactual. If current prices are not sufficient to cover unavoidable costs in the “digital-only + print community” counterfactual, then they cannot be sufficient to cover unavoidable costs in the status quo counterfactual. That is, in both scenarios the merged entity would be earning below a competitive return on its capital, so that any transfers due to price increases should not be treated as supra-competitive rents.

4.4. Paywall

4.4.1. Detriments

100. The Commission has calculated an allocative efficiency detriment for a paywall in the range of \$0 to [] per annum. It is useful to step back and consider the materiality of the upper end of this range. Previously when we have calculated allocative efficiency detriments (as per our 27 May 2016 report) we have sought to “sanity check” them, by calculating the detriment as a percentage of revenue in the relevant market segment for which the detriment is calculated. In our 27 May 2016 report we showed that the allocative efficiency detriments were typically in the range of [] of revenue.

101. However, for the Commission’s paywall detriment, the estimated annual revenue from the paywall is [].⁵⁸ This implies that the allocative efficiency detriment as a percentage of revenue is approximately []. This is clearly a material detriment, and must raise questions about the Commission’s approach.

102. In particular, there are two methodological problems with the Commission’s allocative efficiency detriment calculation for paywalls:

- a) The calculation assumes a linear demand curve, when in fact the demand curve is likely to be “L” shaped or kinked; and
- b) The calculation treats the residual demand curve faced by nzherald.co.nz as the market demand curve, and therefore implicitly assumes that readers who switch away from nzherald.co.nz in response to a paywall obtain zero consumer surplus from stuff.co.nz or stop reading online news sites.

103. As we now discuss, these methodological problems mean that the Commission’s calculation materially overstates the loss in surplus.

4.4.1.1. Non-linear demand curve

104. As the Commission notes, estimating allocative efficiency detriments when the counterfactual price of online news is zero is difficult (see footnote 415).

105. The Commission proposes two extremes in place of this, specifically focusing on the group of users who would encounter the paywall, but would not have been assumed to subscribe [].⁵⁹ At one extreme, no readers in this group value viewing [], therefore resulting in zero allocative efficiency loss.

106. On the other end of the spectrum, the Commission considers that if the paywall subscription price had been lower, more readers in this group would have chosen to subscribe and view

⁵⁸ Calculated by multiplying the annual paywall price in the Commission’s analysis, of [], by the number of users that subscribe to the paywall, [].

⁵⁹ []

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the website more than the []. For this extreme, the Commission constructs a linear demand curve, based on two price-quantity coordinates:

- a) For the price of zero, the number of existing unique browsers (as estimated by the Commission), discounted to those who would be affected by the paywall [], with the ultimate quantity calculated as [] users, year to date September 2016; and
- b) A price of [], constructed from []. The relevant quantity point is then [].

107. The resulting calculation of allocative efficiency detriment using this extreme scenario is \$[] per year. Therefore the annual range is from \$0 to \$[] per year.

108. The first feature of the Commission’s analysis that results in the high point being too extreme is the assumption of a linear demand curve, when the literature points out that demand in this instance is likely to have more of an “L-shape”. The Commission notes this in footnote 418 – demand is likely to be horizontal for a portion of readers who would switch when faced with a paywall, no matter the price. We note that this portion is likely to be large, as both of the studies noted by the Commission in footnote 418 recognize the low willingness to pay for online news among consumers.⁶⁰ Also, the estimated number of subscribers to the paywall is not only a function of the set price, but a reflection of consumers’ recognized aversion to paying any non-zero price for online news.

109. We illustrate the difference in demand curves in Figure 11 below. The demand curve as set out by the Commission is represented by the line AB, assuming linear demand. However, the true demand is likely to follow along the line ACB, as there is a group of consumers who would stop viewing as soon as the price moves above zero (we do not know where the line ACB would be – our diagram is stylistic, but illustrates the point). The Commission assesses the detriment in terms of the triangle ABD, but to be accurate it should be the area of triangle ACD.

Figure 11

[]

[]

110. The Commission recognizes that its “estimated dead weight loss under the assumed linear demand may consequently overstate the true allocative efficiency loss” (footnote 418) and “the use of a linear demand curve may also overestimate the true allocative efficiency loss should there be a subset of readers who do not have a positive willingness to pay regardless of the subscription price” (footnote 425). Our point is that this overstatement is potentially very significant.

⁶⁰ Hsiang Iris Chyi (2005), “Willingness to Pay for Online News: An Empirical Study on the Viability of the Subscription Model”, *Journal of Media Economics*, 18(2), 131-142, and Manuel Goyanes (2014), “An empirical study of factors that influence the willingness to pay for online news”, *Journalism Practice*, 8(6), 742-757.

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111. Overall, the Commission notes multiple times within footnotes that the parameters used in its analysis could be overstating the true values⁶¹ – estimating the significantly inflated detriment of [], which impacts the ultimate benefit/detriment analysis.
112. As we now discuss, even if the [] is the correct calculation, the Commission is incorrect to treat the entire amount as the detriment of the merger.
- 4.4.1.2. Market versus residual demand curve
113. The Commission’s calculation is based on a theory that a paywall would be implemented for nzherald.co.nz but not for stuff.co.nz.⁶² The calculation the Commission has conducted focuses on the price charged for a paywall on nzherald.co.nz and how this affects demand for the paywalled website. Therefore the calculation is using the residual demand curve faced by nzherald.co.nz, rather than a market demand curve for “online news”. This is crucial as it has implications for how the lost surplus is interpreted.
114. The Commission has calculated the lost surplus for consumers who stop reading nzherald.co.nz once the paywall has been implemented, but does not take into account that those customers may switch to stuff.co.nz (or another news website), which will give them surplus.
115. Indeed, the Commission’s calculation would only be a valid measure of the allocative efficiency detriment if those readers leaving nzherald.co.nz gain zero surplus from using stuff.co.nz or other news websites. Put another way, the Commission’s calculation implicitly assumes that these customers drop out of the market, which is inconsistent with the Commission’s logic for assuming that a paywall would only be put on one website, explained at [537] of the draft determination:
- The Commission considers that if the merger were to proceed, other online news providers would not constrain the merged entity from implementing a paywall. In addition, if the merged entity chose to leave one of its websites (either stuff.co.nz or nzherald.co.nz) open for free access it would reduce the risk of losing advertising revenue by implementing a paywall on its other website. This is because its ‘free’ website would be able to capture a number of users who decide to switch away from the website with the paywall.*
116. It may be that nzherald.co.nz and stuff.co.nz (or other news websites) are not perfect substitutes, and therefore the surplus gained from reading another news website may not perfectly offset the surplus lost from not consuming nzherald.co.nz. However, to the extent that these news websites are relatively close in product space the difference is not likely to be material.

⁶¹ See footnotes 418, 419 and 425.

⁶² E.g., [539].

4.4.2. Benefits

117. Given the Commission's predominant concerns with the proposed merger relate to quality and plurality, it would be appropriate for the Commission to explore further the potential benefits of a paywall. The Commission does note at [540] "that paywalls are not necessarily detrimental, and faced with a continuing decline in print revenues, media firms may seek to rely on paywalls for revenue". However, the Commission does not discuss the issues any further.

118. There are two main benefits of paywalls.

119. Firstly, as the Commission notes, they can help to fund the costs of creating content. Online news is a two-sided platform, and the optimal balance of prices on both sides is still unclear. Indeed, as we set out in our 7 October 2016 report filed with the Commission (in which we reviewed the Covec report), while many news media globally do have some form of paywall, it is less clear whether these paywalls, particularly for general news websites, are considered to be successful.

120. To a degree the Commission recognizes this benefit, although in the negative sense – rather than treating the portion of rectangle 0EAD in Figure 11 above that results in a transfer to overseas owners as a detriment, the Commission treats this neutrally as against the digital-only counterfactual [852.3]. However, as against the status quo counterfactual, the Commission treats this transfer as a detriment (Table 11 of the draft determination). For the reasons set out in section 4.3 of this report, we think this is inappropriate, and instead it should be assumed that these rents would be functional, as they would fund content.

121. Secondly, the report filed with the Commission by Professor Randal Picker described how paywalls can result in higher quality content as valued by readers, rather than advertisers.⁶³

122. Indeed, as well as funding quality, a paywall might fund content diversity, as also discussed by Professor Picker. We made a similar point in section 3.1 of our 27 May 2016 report, where we stated (footnotes omitted):

This latter point can be conceptualised in a Hotelling-type framework with no price competition (on the reader side). The websites under independent ownership may locate close to each other in order to maximise share of audience – a shift away in product space by, say, Stuff might result in a sufficient number of readers switching to nzherald.co.nz to make the shift unprofitable. However, that effect would be internalised under merged ownership, allowing the websites to be separated in product space. (Of course, for the reasons we have described in this report, the merged entity and its platforms would continue to face competition from other firms.)

123. We note the Commission has in mind a paywall on just one of stuff.co.nz or nzherald.co.nz ([539]). It is possible that paywall funding for one website would result in efficient product differentiation between the two websites, with one offering the higher quality content that could be in part funded by a paywall, and the other being purely advertising funded.

⁶³ Randal C. Picker (2016), "Commentary on News Media Quality Issues in Fairfax/NZME Proposed Acquisition", 15 October.

4.4.3. Conclusion

124. For the reasons set out in section 4.4.1, we do not think there is likely to be any material detriment from a paywall on one of stuff.co.nz or nzherald.co.nz. If there would be a detriment, it would likely be at least offset by the benefits explained in section 4.4.2. Therefore as a practical matter we suggest the Commission treats the paywall detriment as being zero.

4.5. Quality

125. The Commission's view is that a reduction in quality as a result of the merger would likely lead to "a significant impact on total welfare" ([880]). This view is based on a recent paper by Fan (2013),⁶⁴ in which it is shown that a merger between two local newspapers in the US would reduce quality⁶⁵ and this would have an adverse impact on total welfare. The Commission states that ([881]):

...where there is evidence of likely detrimental impacts on quality, the recent research discussed above [i.e., Fan (2013)] indicates that there is potential for detrimental welfare effects to be relevant.

126. However, Fan (2013)'s results are based on a dataset for US daily newspapers between 1997 and 2005. Since 2005 the media industry dynamics have changed considerably: for example, social media has become established and grown considerably, and smartphones and tablets have been developed and their use as tools to go online has increased materially.⁶⁶ Given these material changes in dynamics, we expect that Fan's results from the merger simulation significantly overstate the negative impact of a newspaper merger on quality in a market today.⁶⁷

127. Furthermore, we emphasise again the other quality pressures that would operate on the merged entity:

- a) The pressure that platforms such as Facebook place on news websites through the nature of the two-sided platform;
- b) The pressure that news aggregators more generally (such as Google News and Flipboard) place on news media to provide high quality articles, consistent with the economics literature discussed earlier; and

⁶⁴ Ying Fan (2013), "Ownership Consolidation and Product Characteristics: A Study of the US Daily Newspaper Market", *American Economic Review*, 103(5), 1598-1628.

⁶⁵ Fan (2013) measures quality in three ways: news content quality (based on non-advertising space, number of staff for opinion pieces, and total number of journalists); local news ratio, measured by local news staff divided by total staff; and content variety, which is a measure based on the share of staff across different sections of the newspaper.

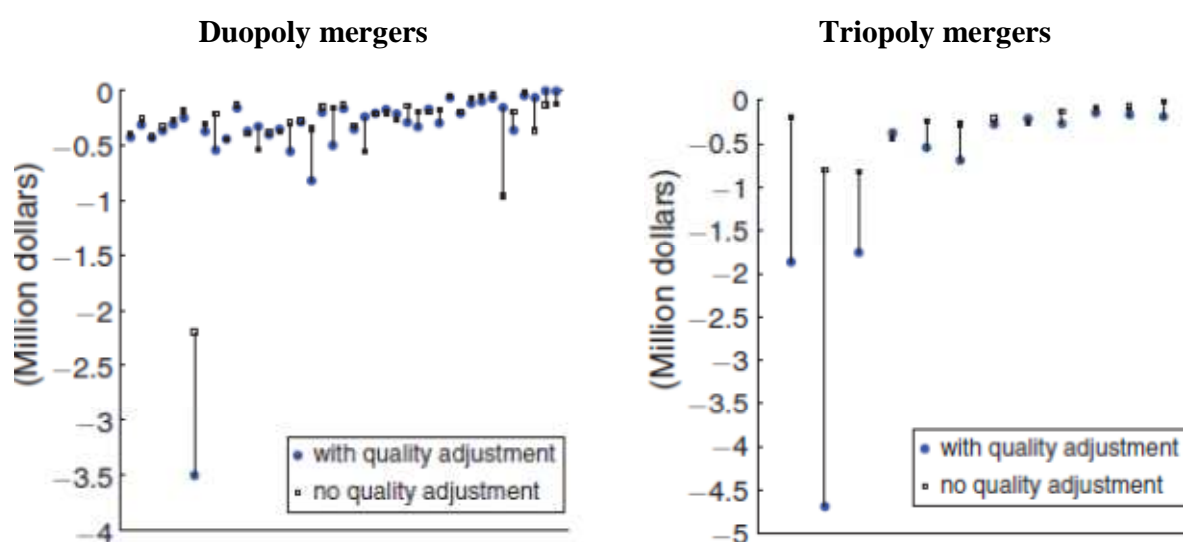
⁶⁶ We set out some of these dynamics in our report dated 7 October 2016 (reviewing the Covec report) filed with the Commission.

⁶⁷ Fan accounts for the development of online news as "utility from outside choice" as a time trend in her analysis, which shows utility from newspaper subscriptions decreasing over time.

- c) The ability of firms such as TVNZ, MediaWorks, RNZ, Bauer, NZ Newswire and others to expand.

128. Moreover, while Fan's results do show there can be an impact of quality on welfare for one specific market,⁶⁸ when her model is applied to a range of different markets, the effect of quality on welfare varies. In Figure 12 below we show the graphs depicting change in total reader surplus from Figures 4 and 5 of Fan (2013) for "duopoly" and "triopoly" mergers.⁶⁹ The squares show change in total reader surplus when quality effects are not captured, while the dots show where quality effects are captured. The difference between the squares and dots (i.e., the impact of quality effects on the change in reader surplus) is relatively variable, and depends on the particular market being assessed. In some cases, there is only a relatively small effect of quality change on welfare (i.e., where the squares and the dots are close together).

Figure 12
Fan (2013) analysis of change in reader surplus with and without quality impacts



Source: Fan (2013)

129. In summary, Fan's paper (i) does not capture the recent material changes in media industry dynamics; and (ii) does not unambiguously show that quality has a significant impact on

⁶⁸ As per section IV.A of Fan (2013).

⁶⁹ Fan (2013, p.1620) defines a duopoly merger as where "the publisher of one newspaper buys the other and becomes a monopolist in the market", while a triopoly merger is where there is "consolidation of the two largest newspapers in a game with three player newspapers".

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welfare. Accordingly, this paper does not provide a strong basis with which to conclude, as the Commission does, that any reduction in quality from the proposed merger would lead to a significant impact on total welfare.

4.6. Alternative counterfactual/Prolonging the life of print

130. One of the Commission’s counterfactuals is a “digital-only + print community” one. Because this counterfactual involves closing all newspapers other than communities, the Commission commensurately reduces the quantified detriments of the merger against this counterfactual (at [823]). Of course, unquantified detriments should also be reduced.
131. The Commission also comments that the factual cost savings would be lower as against the digital-only counterfactual, although does not quantify the reduced benefits.
132. These are both reasonable adjustments to make, assuming the veracity of the digital-only + print community counterfactual. However, the Commission overlooks another benefit of the factual against the digital-only counterfactual, being the prolonged life of print.
133. Despite many newspapers having a positive reader side price compared to “free” online news, a number of consumers continue to buy newspapers. Therefore there is still a consumer value arising from newspapers.
134. This value would be lost if newspapers were shut down. And any shut-down would effectively be irreversible – the probability of a news firm re-entering and setting up a new print plant in the future after shutting one down is low, given the dynamics already described in this report.
135. In this sense, the present transaction presents the Commission with quite a different decision than that in say the Warehouse Extra case.⁷⁰ In that case, the decision to allow the merger would effectively be irreversible. Given uncertainty about the competitiveness of the counterfactual (the success of the Warehouse Extra concept), the Commission (upheld by the Court of Appeal) exercised a “free (delay) option” to decline clearance.
136. In the present case, there is not a free (delay) option – declining the merger would likely result in the irreversible demise of newspapers, and the associated consumer value.
137. In fact, the Commission’s digital-only + print community counterfactual does not reflect the commercial realities facing the merging parties. In [] the absence of the merger:
- a) []; and
 - b) []
138. [][]. [][].

⁷⁰ Commerce Commission Decision Nos. 606 & 607, 8 June 2007; and *Commerce Commission v Woolworths Limited and Ors*, CA, CA55/2008 [1 August 2008].

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139. For the purposes of competition analysis, we think a conservative counterfactual [] []⁷¹. To illustrate the effect of this counterfactual, we assume it would occur []. The benefits and detriments of this counterfactual are illustrated in Table 4 below.

Table 4

[]

[]^{72, 73},

140. The effect of this analysis is that for the combined quantified and unquantified effects to result in a present value net detriment, the present value of [] would need to exceed:

- a) The present value of the quantified net benefits, being []; and
- b) The present value of [].

⁷¹ []

⁷² As re-estimated by us in this report.

⁷³ We use the Commission's assessment of quantified benefits and one-off costs, and assume that all one-off costs occur in year one of the analysis.

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