

Confidential Response to the LOUI on Sky – Vodafone Proposal

Prepared for

2degrees and TVNZ

CONFIDENTIAL

Authorship

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Executive Summary

1. This is our third economic report on competition issues arising from the proposed acquisition of Sky TV by Vodafone. Like our earlier reports, it represents the independent expert views of the authors.
2. We respond to two sets of new information that have become available since our last report:
 - a. [] ; and
 - b. the Letter of Unresolved Issues (LOUI) published by the Commission on 31 October 2016.
3. We share the concerns expressed by the Commission in the LOUI, []

Factual Scenario

4. []
5.
 - a.
 - b.
 - c.[]
6. We consider competition for high value telecommunications customers will be substantially lessened as a consequence of the proposed merger, with flow-on effects that lessen competition for all such customers. []
7. []

8. [

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Counterfactual Scenario

10. [

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11. We continue to believe that genuine wholesaling is a likely counterfactual. Competition often forces firms to do things they would prefer to avoid. In the presence of multiple potential counterfactuals, the Commission must compare the likely effects of the merger against all of the likely counterfactual scenarios, to be satisfied that the proposal will not substantially lessen competition in a market.

Competition Issues

12. We generally agree with the Commission’s analysis of competition issues in the LOUI.

13. [

] When set alongside existing public statements, including in the Grant Samuel report, the weight of evidence indicates that the merged entity will have substantial market power over content, particularly premium sports content.

14. We agree that incentives for the wholesaling of Sky’s content will be materially reduced if the merger proceeds, though our views on this point differ slightly from the LOUI. [

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15. The final concern in the LOUI is that Vodafone’s TSP rivals will lose, or fail to achieve, economic scale and will therefore have less ability to compete. We agree that this is a serious concern [

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1 Introduction

16. Since the application of Sky TV and Vodafone for merger clearance was lodged, we have submitted two independent expert economic reports on competition matters.¹² Both of our previous reports contained a coherent description of the harm to the competitive process that we consider is likely to emerge if the proposed merger is cleared. This theory emerged from our analysis of the current and likely future commercial and competitive dynamics for both the Pay TV and telecommunications sectors in general, and the applicants in particular. We expressed the following concerns.
- a. The merged entity would have strong incentives to expand its share of retail markets for fixed and mobile telecommunications services, while also seeking to expand and protect its Pay TV interests;
 - b. Around one third of New Zealand households have Sky TV but are not fixed line broadband customers of Vodafone, and these are relatively high value customers;
 - c. The merged entity would have the ability to make bundled offers to this one third of New Zealand households that;
 - i. Could not be matched by any other telecommunications service provider (TSP); and
 - ii. Would generate substantial switching away from other TSPs by relatively high value customers.
17. In our view this combination of incentive and ability makes it very likely that the merger would result in a substantial lessening of competition (SLC) in the relevant (telecommunications) markets. That SLC occurs because the merged entity will have substantial market power over premium content and will have the incentive and ability to leverage that market power into retail telecommunications markets. We have explained that this harm would occur relative to the status quo, and relative to the counterfactual scenario that we considered most likely (Sky becoming a genuine wholesaler of content alongside its existing pay TV business).
18. The Commission has identified similar concerns over competition in retail telecommunications markets and we consider that its LOUI correctly articulates the mechanisms involved, namely:
- a. Strategic pricing of stand-alone pay TV and bundles containing both telecommunications and pay TV, such that no other TSP can effectively compete for customers wanting both types of service;

¹ Covec, Economic Analysis of Sky – Vodafone Proposal, 11 August 2016

² Covec, Review of New Material on Sky – Vodafone Proposal, 30 September 2016

- b. Loss of scale as other TSPs lose high value customers and therefore have reduced ability to compete directly with Vodafone and (for the same reason) a greatly reduced opportunity for smaller TSPs to *achieve* scale; and
 - c. Consequently weaker competition in telecommunications markets for all customer types.
19. Our second (September) report responded to information supplied on behalf of the applicants by NERA³ and Buddle Findlay⁴. [

], our overall conclusions have not changed: we still consider that the proposed merger is likely to result in a substantial lessening of competition in retail markets for telecommunications services in New Zealand.

20. This report aims to assist the Commission by responding directly to the issues raised in the LOUI. To this end, the structure of this report follows the LOUI in addressing:
- a. Relevant markets in section 2;
 - b. The factual scenario in section 3;
 - c. The counterfactual scenario(s) in section 4; and
 - d. Competition issues in section 5.

³ NERA, Sky/Vodafone – review of economics reports, 11 September 2016

⁴ Buddle Findlay letter to Susan Brown, 23 August 2016

2 Relevant Markets

21. We agree with the Commission's assessment that the main impacts of the proposed merger on competition are likely to occur in retail markets for telecommunications services, specifically:
 - a. The national retail market for the provision of residential fixed-line broadband services; and
 - b. The national retail market for the provision of mobile services.
22. We also agree with the Commission that the national retail and wholesale markets for pay TV services are relevant to assessing the competition effects of the proposed merger. As discussed further below, these are markets in which Sky TV currently has substantial market power.
23. In our view, the upstream markets in which television and video content is acquired are also relevant to the competition assessment. As we have previously noted, these markets are likely differentiated by content type, they clear periodically rather than continuously, and they allocate exclusive, multi-year, geographically specific rights. Sky TV currently holds virtually all New Zealand rights to premium sports content and will do so until at least 2020.

3 Factual Scenario

24. Under the factual scenario, a merged Sky/Vodafone will face different incentives to those currently facing each of the applicants. In its LOUI, the Commission describes three types of activity it expects to observe from the merged entity:
- a. Retail offers of differentiated bundles and content to consumers;
 - b. Cross-selling of Vodafone services to Sky customers and vice-versa; and
 - c. The merged entity continues to make Sky services available for resale and retransmission.
25. We share these expectations and offer some further comments on the factual scenario.

3.1 Favouring Vodafone over other TSPs

26. Sky shareholders were informed in the Grant Samuel report's discussion (at page 90) "*the transaction will allow the Combined Group to provide fully integrated bundled quad play and multi-play services (fixed line, broadband, mobile and pay television and/or other digital services such as OTT offerings) and to exploit more effectively the potential of Sky TV's content assets*". It is clear that these fully integrated bundles cannot currently be offered, and will be a consequence of the proposed merger.
27. No other TSP will be able to match these bundles. Buddle Findlay has submitted on behalf of Sky that the merged entity will "*set the price of wholesale access to Sky services on the same ECPR basis as Sky currently offers*".⁵ [

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⁵ Buddle Findlay letter to Susan Brown, 23 August 2016, at paragraph 17.

⁶ []

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31. Buddle Findlay's letter of 9 September 2016 (at ¶21) describes the incentives facing a traditional vertically integrated input monopolist. Sky is in a different situation however: it has no historic property right to a vertically integrated monopoly over telecommunications services, but is instead seeking regulatory consent to vertically integrate into telecommunications markets.
32. While the Commerce Act might allow vertically integrated monopolists to control downstream competition through the application of ECPR access pricing, it places efficient barriers in the path of firms seeking to create a new vertically integrated monopoly by merger.
33. For these reasons, we consider that our original (August) report was correct in making the following statement (at ¶86): *"from its recent experiences, Sky TV now knows with certainty the terms of a wholesale offer that will be unattractive to RSPs without provoking litigation or regulatory intervention. It could therefore be confident that, by continuing to offer those same unattractive terms to other RSPs, only its Vodafone division will have access to its premium content."*
34. In our view, the merged entity will have strong incentives and a clear ability to favour its own TSP division with less restrictive and lower cost access to Sky's premium content than it offers to other TSPs. [] It is also the reason that the proposed transaction would substantially lessen competition in the relevant retail telecommunications markets.

3.2 Lessening Competition for High Value Customers

35. In our second (September) report (at ¶33 – 45) we used a Venn diagram to characterise around one third of New Zealand households as being high value customers, currently buying Sky services, but not subscribing to Vodafone's fixed line services. []

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⁷ []

⁸ []

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40. [

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3.2.1 Incentives

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a.

⁹ Prior to 2013, the Commission's monitoring reports used a different method and focused on fixed lines rather than fixed broadband lines.

b.

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3.2.2 Revenue vs Connections

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a.

b.

45.

]

3.3 Mobile

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47.

48.

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4 Counterfactual Scenarios

49. Because the applicants' submissions on the counterfactual scenario(s) were redacted, our first report drew inference from the limited information available at that time in defining the counterfactual scenario. Despite being sceptical of its veracity, we relied on the applicants' claim that *"pay TV offerings do not drive substantial changes in broadband share"* (application at ¶11.13) to infer that cross-selling Sky services to Vodafone customers was an important source of gain for the merged entity. We then used the very limited financial data available at the time to show that genuine wholesaling of Sky's content would deliver financial benefits to Sky.

50. [

a.

b.

c.

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4.1 Multiple Options

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] For the reasons described in our first (August) report we consider that Sky is most urgently in need of new opportunities. Combined with Sky's commanding position in respect of premium content, it is therefore appropriate to focus considerable attention on Sky in defining the relevant counterfactual(s) and assessing the proposed transaction.

55. [

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57. It is not possible to be satisfied that the proposal would not substantially lessen competition without comparing the likely effects of the proposal against all of the likely counterfactual scenarios.

58. Despite the claims in Buddle Findlay's letter of 23 August 2016 that enthusiastic wholesaling is a "*completely fanciful*" (¶14) and "*unrealistic*" (¶10) alternative strategy, we consider that it does remain a likely (and we would say the most likely) counterfactual. We accept that Sky might instinctively dislike the idea (perhaps to the point of not having seriously considered it) but we do not agree that from commercial and economic standpoints genuine wholesaling is fanciful or unrealistic.

59. On the contrary, wholesaling can be thought of as an economically rational form of price discrimination in which Sky receives lower per-customer revenues in return for additional customers. Sky would continue to sell directly to its own customers and give TSPs incentives to expand the market for Sky's content.

60. The rationality of this strategy cannot be discredited merely by attaching pejorative labels to it. Nor is the past, in which Sky has been able to grow continuously without wholesaling, a reliable guide to a more competitive future with open access to broadband infrastructure.

5 Competition Issues

61. We agree with the competition concerns identified in the LOUI and comment briefly on each in this section.

5.1 Substantial Market Power over Content

62. For the reasons described in our first (August) report (at section 3) we consider that there are distinct upstream markets for the acquisition of content. We also noted that the markets for premium content allocate geographically exclusive rights that endure for several years. These are “winner-takes-all” markets and Sky is currently the “winner” in respect of the most compelling of premium content: live premium sports.

63. [

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64. The important role of premium sports rights was also featured in the Grant Samuel report for Sky’s investors, such as in this passage (from p27) where it is characterised as a valuable defence against competitors.

The availability of exclusive premium content is likely to be a further driver of differences in the impact of OTT services across markets. In particular, the availability of exclusive sports programming may be a powerful defensive opportunity for pay television operators. In some markets (such as Australia) government mandated access to sports programming via free-to-air television (“anti-siphoning legislation”) limits the ability of pay television operators to secure exclusive rights over the most attractive programming. However, in other markets, such as the United Kingdom for soccer and New Zealand for rugby, exclusive sporting rights fundamentally underpin the content offerings of the incumbent pay television operators and are a driver of subscriber loyalty. Moreover, they help to support advertising revenues and can provide the basis for the incumbent pay television operators’ own OTT offerings”.

65. The benefits to Sky of premium sports content are not limited to defensive motives. We note that the Grant Samuel modelling (at p. 45) includes the following assumption for the future outlook:

“ARPU increase for Big Sky customers of 2.8% per year on average over the period FY16 to FY20 driven by changes in the penetration of sports packages (up), movie packages (down) and moderate price increases”.

66. Later, in assessing the value of Sky’s business, Grant Samuel report notes (at p.56) that

“there are no anti siphoning laws in New Zealand and Sky TV has a strong lock on the key sporting rights that are significant drivers of customer attraction and retention

And that

“Sky TV’s sports rights holdings provide a critical competitive advantage both in terms of its core subscription service and its OTT offerings

67. These observations are consistent with the view that Sky has substantial market power over content, []

68. We agree with the Commission’s view in the LOUI (¶22) that the competitive relevance of triple- and quad-play bundles is likely to increase dramatically in the near term. []

]

69. We consider that triple- and quad-play bundling will also increase under the counterfactual for reasons outlined above (¶58 - 59).

5.2 Inducing Customers to Switch

70. We consider that the Commission’s views are sound concerning customer switching under the factual, as expressed in the LOUI (at ¶23 – 28). As a vertically integrated monopolist of premium content, the merged entity would have several ways of inducing telecommunications customers to switch to its triple- or quad-play bundles. As noted in the LOUI (at ¶23), this could be achieved through pricing, either by increasing the price of Sky as a stand-alone service or by decreasing the price of bundles of Sky content and telecommunications services.

71. A similar effect could be achieved by differentiating the quality of service available from the merged entity relative to stand-alone TSPs, as noted in the LOUI (at ¶23.2). Examples include:

- a. Ensuring that the merged entity can offer better broadcast quality (e.g. HD vs SD) than any stand-alone TSP buying wholesale inputs from the merged entity; and

- b. Ensuring that interactive capabilities¹⁰ are only available from the merged entity rather than from all TSPs.
72. We consider that the Commission is right to consider the impact of the UFB and RBI projects, both of which provide significant increased ability to transmit video content directly to end users, and the associated role of mobile broadband. These are technological advances that allow customers to bypass the traditional channels through which broadcast/video content is delivered. By reducing the physical and economic barriers between broadcasters and customers, they create the potential for materially enhanced competition.
73. While these deployments in New Zealand have the potential to disrupt established business models, Sky's lock on premium content gives it an opportunity to skew the impending disruption in its favour. Under the factual, the merged entity would have a strong initial position in the fixed and mobile delivery channels, along with the capability of taking much larger shares of these markets, through the strategic use of its premium content. The merged entity will use its premium content to gather up extra market share, particularly the most valuable customers, in the retail markets for fixed and mobile services, by favouring its own telecommunications division.

5.3 Wholesaling Incentives Reduced

74. The applicants claim that the merged entity will have unchanged incentives to wholesale Sky's content to other TSPs, but this claim does not withstand scrutiny.
75. First, it seems likely that Vodafone is *already* being favoured by Sky. On this point we refer to section 5 of our second (September) report, which analyses Vodafone's current market offers. Among other things we noted (at ¶95) NERA's comment to the effect that Sky is helping Vodafone to fund the bundle discount that Vodafone currently offers.
76. More generally, there are some margins available in the relevant retail telecommunications markets. Sky has no prospect of gaining a share of those margins unless it owns (or part-owns) a TSP. If Sky was to wholesale its content it could further exploit the market power arising from its lock on premium content, but even then, it would not capture any margins available in the relevant retail telecommunications markets.¹¹
77. We therefore consider that the trade-off discussed in the LOUI (from ¶32) is slightly inaccurate. [

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¹⁰ Such as predictions/betting and competitions

¹¹ There is only one monopoly profit available from Sky's content, as discussed in our second (September) report at ¶47 and ¶67.

5.4 Scale Issues

78. We agree with the LOUI about the mechanism by which competition will be reduced under the factual. Existing suppliers will have their growth prospects constrained and potential entrants will be deterred.

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