

23 November 2016

To

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Copy to





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From

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By email

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-  Information confidential from Vodafone and the public
-  Information confidential from all parties (including SKY) and the public (but may be seen by specified SKY personnel)
-  Information confidential from the public

Dear Susan

SKY/Vodafone: SKY cross-submission on the letter of unresolved issues

1. Thank you for giving us the opportunity to respond to third party submissions on the Commission's letter of unresolved issues, dated 31 October 2016.
2. In our view, parties who have filed submissions in opposition to the proposed transactions have not raised any matters that detract from, or rebut, the points made in SKY's submission of 11 November 2016:
 - (a) In assessing whether or not the proposed transactions are likely to have the effect of substantially lessening competition, the Commission must consider whether there will be any substantial change in the effectiveness of the constraint collectively provided by competitors of the merged entity. The legal test is not merely whether there is a risk that, if a competitor of the merged entity does not take steps to respond to the offerings of the merged entity, that competitor may lose some market share.
 - (b) Undermining stand-alone SKY would be too risky, and not a rational strategy for the merged entity to pursue.

- (c) The merged entity will have the same incentive to wholesale as SKY currently has, and on the same terms. The merged entity's competitors in telecommunications markets will continue to provide an effective constraint on the merged entity, whether or not they offer bundles of telecommunications services and SKY services. There are a range of offers that telecommunications customers find attractive, including stand-alone "no frills" telecommunications offers, and bundles of telecommunications services and other non-SKY services.
- (d) Rival TSPs will continue to be able to provide an effective competitive constraint on the merged entity after the possible unbundling of fibre in 2020.
- (e) In any case, key content rights for premium live sport will expire around the same time that it is proposed that fibre unbundling takes place. Spark and other TSPs are well-placed to start preparing now for the proposed unbundling of fibre and expiry of key content rights.
- (f) The content most likely to be consumed over mobile networks is general entertainment content and content from social networks. There are a number of sources for that content other than SKY, and those sources are often backed by large multinational companies. As a result, future increases in the consumption of content over mobile networks will not increase the likelihood of the proposed transactions substantially lessening competition in the market for mobile services.

3. In this cross-submission, we address:

- (a) why the "enthusiastic wholesaler" counterfactual remains unrealistic, despite submitters having renamed it as the "genuine wholesaler" counterfactual as a consequence of that counterfactual having already been rejected by the Commission; and
- (b) submissions about the merged entity's incentives to wholesale; and
- (c) why premium live sport is not a "must have" input required for effective participation in either of the markets that the Commission has identified; and
- (d) why high ARPU customers will be no more likely to switch from their current TSPs to the merged entity; and
- (e) submissions regarding the zero-rating of video content over mobile networks; and
- (f) the absence of any link between legal action by SKY to protect the rights SKY has paid for, and the legal test the Commission is required to apply; and
- (g) the allegations made by Wigley + Company Solicitors against SKY, Buddle Findlay, and NERA in its submission on behalf of Trustpower, Blue Reach, and InternetNZ.

Rejection of the "enthusiastic"/"genuine" wholesaler counterfactual

4. Third party submitters have attempted to use the latest round of submissions to revive the "enthusiastic wholesaler" counterfactual that the Commission has already rejected. It is clear from the submissions that the "genuine wholesaler" counterfactual being put forward by Covec,

2degrees, and Spark is simply the "enthusiastic wholesaler" counterfactual renamed. This is presumably so that the counterfactual the submitters are putting forward appears less irrational than it actually is. For example:

- (a) Covec's report for 2degrees and TVNZ uses the "enthusiastic wholesaler" and "genuine wholesaler" labels interchangeably. For instance, paragraph 58 of Covec's submission refers to "enthusiastic wholesaling" in the first sentence, and "genuine wholesaling" in the second sentence; and
 - (b) 2degrees refers to an email from the Commission stating "that it does not consider the "genuine wholesaler" counterfactual to be a likely scenario without the merger"; and
 - (c) in the section of its submission on the "genuine wholesaler" counterfactual, Spark submits that the counterfactual "that Spark initially proposed ... is more likely than not to occur".
5. The submissions point to no new information that could lead the Commission to depart from its view that, in the counterfactual, SKY is likely to continue its current approach to wholesaling.
6. As we explained in our submission in response to the statement of preliminary issues, dated 9 September 2016, the enthusiastic wholesaler counterfactual involves SKY acting irrationally, by deciding to:
- (a) share its margin with other entities, knowing that those entities will use SKY's forgone margin to develop alternative pay-TV products to compete with SKY's, including to outbid SKY for content; and
 - (b) allow other entities to develop alternative pay-TV services that contain SKY's most valuable content plus any other content, devaluing SKY's own pay-TV services.
7. As was the case in their submissions on the statement of preliminary issues, submissions on the letter of unresolved issues do not explain why, in response to consumers' increasing demand for OTT and on-demand services:
- (a) SKY would need to wholesale on the terms they describe, to deliver those services; or
 - (b) SKY could not provide those services on its own (as it already does), or continue its current approach to wholesaling.
8. In both the factual and the counterfactual, like any other business, SKY's approach to wholesaling will be to ensure that it recovers the opportunity cost of selling SKY services directly to consumers. Submitters have not identified how changes in the way consumers prefer to view content could lead to SKY departing from that approach.
9. 2degrees has submitted that its recent negotiations with SKY regarding [**REDACTED**] demonstrate that SKY has been, and in the counterfactual will be, willing to negotiate wholesale arrangements with TSPs on a different basis from that set out in SKY's submissions, and that SKY's approach to wholesaling changed as a result of the proposed transactions. SKY rejects that submission:

(a) [REDACTED

]

(i) [REDACTED

]

(ii) [REDACTED

]

(b) [REDACTED

].

(c) [REDACTED

]

(d) [REDACTED

]

10. SKY also rejects any implication from the "genuine wholesaler" label that SKY's current attempts to negotiate wholesale agreements for its services are not genuine. SKY has provided adequate information to the Commission regarding its need to find as many outlets for its services as possible, subject to maintaining the viability of stand-alone SKY. In particular:

(a) The barriers to entry for parties who wish to deliver video content are lowering. As a result, a number of new providers are entering retail pay-TV markets in New Zealand and overseas. They include content creators, including studios (in overseas markets) and sports bodies and organisations, as well as a number of other well-resourced multinational companies, such as Netflix and Apple. [REDACTED

]. In the past week, Amazon launched its Amazon Prime Video Service in Australia, and there are media reports of the entry of Amazon Prime Video in New Zealand.¹

(b) The entry of well-resourced participants in the retail pay-TV market is increasing competition in the upstream markets for the acquisition of content, driving up SKY's content costs. At the same time, SKY is losing subscribers.

¹ <http://www.stuff.co.nz/business/industries/86673441/amazon-prime-video-adds-more-colour-to-the-internet-tv-jungle>

- (c) This means that, in order to meet the increasing cost of content, SKY needs to maximise its revenue base. SKY does this by finding the optimal balance between subscriber numbers, and the prices of SKY services.
- (d) To help it reach that optimal point, SKY sells its services in the retail market, and also wholesales its services on a retail minus avoided cost basis, while offering extra margin to wholesale partners for "new to SKY" customers. That approach ensures that SKY reaches as broad a customer base as possible, including customers that SKY may not reach on its own, without compromising SKY's ARPU.

The merged entity's incentives to wholesale

11. There is no difference between the merged entity's incentives to wholesale in the factual, and SKY's incentives to wholesale in the counterfactual. In particular, like SKY, the merged entity will continue to need to wholesale SKY services so that it has as close to the optimal number of subscribers as possible. This is because the cost of content is rising, and is mostly fixed – ie, it will continue to rise even as SKY's subscriber numbers decrease. In order to meet the rising cost of content, the merged entity will need to maximise its SKY subscriber and revenue base.
12. As Perpetual points out in its submission, in Australia, Foxtel and Telstra have attempted to restrict bundles of Foxtel and telecommunications services to Telstra customers. That strategy has been extremely unsuccessful:
 - (a) Foxtel is present in just 30% of Australian households; and
 - (b) if anything, the strategy may have accelerated the uptake of alternative pay-TV services, and contributed to the loss of content rights.
13. The case study in Perpetual's submission supports SKY's submissions that it would be irrational, and contrary to the merged entity's needs and incentives, for the merged entity to refuse to provide wholesale terms to other TSPs through an outright or constructive refusal to deal.
14. In relation to submissions about the price that Vodafone will pay SKY for SKY services under the factual, and the price that other TSPs will pay the merged entity for those same services, SKY refers the Commission to the accompanying NERA report. As NERA points out, submissions that assert that Vodafone will pay SKY an internal transfer price of zero, while other TSPs pay the merged entity an ECPR-based price, fail to recognise the difference between the internal allocation of accounting costs, and factors that contribute to the final retail price. The internal transfer price will have absolutely no effect on the profit-maximising retail price of a SKY/telecommunications bundle sold by the merged entity, or the costs that the merged entity will avoid (and the discount that a wholesale partner will receive) under a wholesale arrangement for SKY services.
15. In addition, references in [

REDACTED

]. Those changes include a number of well-resourced, multinational pay-TV providers entering New Zealand's pay-TV market, including a number of content creators. SKY needs access to revenue in order to continue to purchase key content. Any suggestion that [

REDACTED

].

SKY's content, including premium live sport, is not a "must have" input

16. A number of submitters point to extracts from SKY's Explanatory Memorandum and Grant Samuel's report on the proposed transactions, and quotes from senior SKY personnel, as evidence that SKY's content is a "must have" input required for effective participation in either or both of:
 - (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.
17. Those extracts and quotes show that SKY and Grant Samuel agree with the proposition that premium live sport content is valuable content for a pay-TV provider to have. However, those extracts and quotes are not relevant to whether premium live sport, or any other content to which SKY holds the rights, is a "must have" input required for effective participation in telecommunications markets.
18. The submission from Bronwyn Howell and Dr Petrus Potgieter refers to the fact that TSPs compete by differentiating the range of products and services that they add on to homogenous internet access, available to all broadband providers on equivalent terms. They do not compete on the basis of homogenous offerings (such as stand-alone internet access, or a bundle of SKY content and internet access). As outlined in the clearance applications, and in SKY's and Vodafone's submissions, the differentiation described in the Howell/Potgieter submission is clearly observable in telecommunications markets today.
19. This is illustrated by the fact that, over recent years, SKY has been open to, and has pursued wholesale arrangements with, other TSPs. Those TSPs have decided that they do not want or require wholesale arrangements with SKY. The most obvious example is Spark, who decided to end its wholesale arrangements with SKY in order to develop its own differentiated offering. In Spark's current negotiations with SKY, [

REDACTED

]. This is consistent with the submission by Howell/Potgieter that, "if rivals to the merged SKY/Vodafone firm get access to SKY content, it will not be to simply gain market share by reselling identical services".
20. The central thesis of the Howell/Potgieter submission perhaps explains the lack of enthusiasm on the part of TSPs for wholesaling/retransmission deals with SKY, after Vodafone had established itself as the TSP offering SKY in its bundles. SKY is indisputably a good thing to offer in a TSP's bundle but, according to the analysis set out by Howell/Potgieter, once a TSP has it, it becomes

less attractive to the others in the market, who then seek alternative differentiating elements (Spotify, free Wi-fi, alternative video offerings, electricity, etc).

21. The effect described above could also justify SKY's developing scepticism about the extent to which the recent (ie, after the announcement of the proposed transactions) flurry of interest by TSPs in pursuing wholesale/retransmission, will actually result in those TSPs signing up to offer SKY in their bundles.
22. SKY stands ready to sign up TSPs on the same basis as Vodafone, but the Howell/Potgieter submission suggests the real reason for those TSPs to be less enthusiastic than they claim to have suddenly become.
23. SKY's scepticism about the likelihood of entering into new retransmission agreements may be even further justified, when the high upfront cost to retransmission partners of building retransmission infrastructure is taken into account.
24. Again, no submitters have pointed to any reason why, in the future, TSPs would compete on a different basis than they do today, with or without the proposed transactions.
25. [

REDACTED

].

High ARPU customers no more likely to switch to the merged entity

26. Trustpower, Link Economics for Blue Reach, 2degrees, Covec for 2degrees and TVNZ, and Spark have merely asserted, and have not provided any evidence, that SKY subscribers tend to be higher ARPU telecommunications customers. Mosaic analysis from April 2015² shows that³:
 - (a) **[REDACTED]** of all SKY subscriptions were for households in Mosaic groups with below average incomes; and
 - (b) **[REDACTED]** of SKY Sport subscriptions were for households in Mosaic groups with below average incomes.
27. For evidence as to why submitters' assertions on this point are incorrect, SKY refers the Commission to the accompanying report from NERA.

² This is the most recent Mosaic analysis that SKY has available.

³ Using Mosaic's descriptions of the average incomes of different Mosaic groups.

28. Even if the proposed transactions did result in the merged entity achieving a market share gain in the broadband market of between [REDACTED] and [REDACTED], and all of the customers that switch to the merged entity are the highest ARPU customers, that would not involve a large enough diversion of revenue to lead to a substantial lessening of competition. This is because, as NERA pointed out in its report of 11 November 2016:
- (a) the question is whether, in the factual, other TSPs will face higher forward-looking costs to win customers from the merged entity, than they would to win customers from Vodafone in the counterfactual, and whether that difference is large enough to constitute a substantial lessening of competition; and
 - (b) many of the relevant fixed costs that TSPs face are sunk, or, in other words, not forward-looking costs; and
 - (c) the non-sunk fixed costs that TSPs face are relatively minor; and
 - (d) the major variable cost for TSP in the broadband market is what the TSP pays to Chorus. Scale is not relevant to the Chorus variable charge.
29. The submissions implicitly acknowledge that a market share gain of between [REDACTED] and [REDACTED] would not constitute a substantial lessening of competition, by continuing to advocate for the already rejected "enthusiastic wholesaler" counterfactual. They would not need to advocate for that counterfactual, if a substantial lessening of competition was possible simply as a result of high ARPU customers switching to the merged entity.

Zero-rating of video content over mobile networks: a strategy available to all mobile providers

30. In both the factual and the counterfactual, any mobile operator will be able to zero-rate any content that they choose. That includes both SKY content, and non-SKY content.
31. This means that, if the merged entity attempted to zero-rate the delivery of SKY content over mobile networks, but not any other content, the merged entity's competitors in the market for mobile services will be able to respond by:
- (a) zero-rating SKY content, and/or
 - (b) zero-rating other content.
32. Zero-rating other content is likely to be an effective response to any strategy by the merged entity that is based on zero-rating SKY content. For example, as set out in SKY's and Vodafone's submissions in response to the letter of unresolved issues:
- (a) the consumers most likely to view content over mobile networks are millennials. However, millennials are also the least likely consumers to subscribe to SKY and/or SKY Sport; and
 - (b) according to AC Nielsen's *New Zealand Connected Consumers Report*, [REDACTED] as many 15-24 year olds, and more than [REDACTED] as many 25-34 year olds, used Netflix than used SKY Go in the four weeks before the survey; and

- (c) according to AC Nielsen's *New Zealand Connected Consumers Report*, [REDACTED] as many 15-24 year olds, and [REDACTED] as many 25-34 year olds, used YouTube than used SKY GO in the four weeks before the survey; and
- (d) according to NZ On Air's *Where are the Audiences? 2016* report, online video sites like YouTube and Facebook now reach more than six in ten New Zealanders each week. This can be compared with the [REDACTED] in ten households that had a SKY subscription over the same period of NZ ON Air's survey.
33. This means that any strategy to foreclose the market for mobile services by zero-rating SKY content, but nothing else, could not succeed.
34. Some submitters have also pointed to references in SKY's clearance application, and in the EM, to the merged entity being in a position to more efficiently monetise the delivery of content over mobile networks, as an indication that the merged entity is likely to pursue some sort of foreclosure strategy.
35. However, those submitters have drawn incorrect conclusions based on a misunderstanding of the relevant references.
36. When SKY refers to the more efficient monetisation of the delivery of content over mobile networks, SKY is referring to the fact that, as a number of submitters have recognised, the consumption of video content over mobile networks is driving increased usage of data over those networks. However, without an ownership or equity stake in a mobile provider, it would be extremely difficult for SKY to [**REDACTED**] benefit from the consumption of its content over mobile networks. Instead, the benefit from increased data usage and associated increases in revenue from mobile customers sits entirely with providers of mobile services. This is at a time when SKY's content costs are increasing, making efficient monetisation of the content rights currently held by SKY even more important.

No link between SKY's action to protect rights SKY has paid for, and the legal test the Commission is required to apply

37. TVNZ has attempted to characterise legal action taken by SKY to protect the rights that SKY has paid for, as an example of SKY abusing market power, and a reason for the Commission to require SKY to divest Prime as a condition of granting clearance. However, TVNZ has grossly mischaracterised the legal action taken by SKY to protect its considerable investment in those rights.

38. In particular, in relation to SKY's application for an interim injunction against Fairfax in response to Fairfax's coverage of the Rio Olympics,⁴ although Fogarty J did not grant the interim injunction sought by SKY:
- (a) Fogarty J accepted that SKY had a reasonable argument that Fairfax had infringed SKY's rights to broadcast the Rio Olympics; and
 - (b) Fogarty J observed that Fairfax had moderated its conduct, but that, if Fairfax had not changed its conduct in that way, he would have ordered an injunction as sought by SKY; and
 - (c) Fogarty J invited SKY to apply to the court again if Fairfax repeated its previous conduct; and
 - (d) TVNZ, Mediaworks, NZME, and Fairfax were all able to successfully report on the Rio Olympics as a current event, including by using SKY's Rio footage on their websites.
39. It is clear from the court's findings that there is a genuine question to be tried regarding the ambit of the "fair dealing" defence for reporting current events. Different media outlets also use different amounts of video footage when reporting on sports events, and use it in different ways. SKY's most recent legal action is aimed at receiving clear guidance from the court as to what does and does not constitute fair dealing under the Copyright Act 1994. Those questions are completely unrelated to the proposed transactions, are reasonable questions to take to a court, and cannot rationally be attributed to whether or not SKY has market power in any particular markets.
40. Turning to what SKY submits is the real reason for the legal action, the Copyright Act 1994 was enacted before the internet became what it is today. TVNZ, NZME, and other media organisations are relying on the vagueness of the Act to use copyrighted video content, for free, to increase advertising revenue and/or sponsorship revenue. This occurs when viewers click through to those media organisations' commercially driven online platforms in order to watch the copyrighted video content. SKY has paid very substantial amounts to win content rights in competitive processes, on an even playing field with TVNZ and other media organisations. SKY has also made a huge investment to provide coverage of sports events such as the Olympic Games and All Blacks matches. To give a sense of scale, SKY has spent over \$NZ1 billion on covering sports over the last 10 years.
41. SKY accepts and embraces the statutory recognition of fair dealing for reporting current events. However, SKY simply does not accept that fair dealing allows its investment to be gutted by TVNZ, or by anyone else. As a result, it has asked the court to determine what constitutes "fair dealing" in the current environment.
42. Finally, as a further example of how TVNZ has mischaracterised SKY's legal action, SKY made extra video footage of the Rio Olympics available to TVNZ, at TVNZ's request and at no cost to TVNZ, so that TVNZ's Te Karere programme could support its news reporting on the Rio Olympics with video content. Likewise, SKY made Rio Olympics video footage available to the New Zealand

⁴ *Sky Network Television Ltd v Fairfax New Zealand Ltd* [2016] NZHC 1883.

Olympic Committee, so that NZOC could supplement Rio updates on its website with video content. Those actions are hardly consistent with SKY attempting to restrict press freedom in New Zealand.

43. TVNZ appears to be attempting to use the Commission's clearance process to support its position in an unrelated legal dispute. There is no connection between legal action taken by SKY to protect its rights, SKY's ownership of Prime, and the proposed transactions. It is clear that, as set out in SKY's initial response to submissions on the statement of preliminary issues, TVNZ's concerns relate solely to TVNZ's desire to weaken Prime. TVNZ's submission, and TVNZ's request that SKY be required to divest Prime, are wholly irrelevant to the proposed transactions,

Wigley + Company's allegations

44. [REDACTED]

45. [REDACTED]

46. [REDACTED]

47. [REDACTED]

48. [REDACTED]

Concluding remarks

49. Third party submissions in opposition to the proposed transactions are, as SKY submitted in August, related to protecting their own commercial interests. They do not relate to any genuine concerns about how the transaction may affect the effectiveness of competition in any markets.

The submissions rely entirely on unsupported assertions of fact, and draw conclusions without any proper analysis of incentives, or of cause and effect.

50. We therefore submit, as set out above and in our previous submissions, that there is sufficient evidence for the Commission to be satisfied that the proposed transactions will not substantially lessen competition in any market, and the Commission should grant the clearances sought.

Confidentiality

51. Confidentiality is sought for the information in this letter that is highlighted and in square brackets. We are also providing you with a public version of this letter.
52. We request that we be notified of any request made under the Official Information Act for the information, and be given the opportunity to be consulted as to whether the information remains commercially sensitive at the time that the request is made.
53. These requests for confidentiality are made because the information is commercially sensitive, and disclosure would be likely to unreasonably prejudice SKY's commercial position.

Yours sincerely



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