Submission to the Commerce Commission in relation to the Sky / Vodafone Letter of Unresolved Issues

11 November 2016

Introduction and executive summary

1. Perpetual is one of Australia's largest independent wealth managers, an expert adviser to high net worth individuals, families and businesses, and a leading provider of corporate trustee services. We are proud to have $24.4 billion in funds under management, $12.7 billion in funds under advice and $620.5 billion in funds under administration.
2. We have significant experience as investors in Media and Telecommunications companies and currently have investments in Alphabet (Google), News Corporation (50% owner of Foxtel), Telstra (50% owner of Foxtel), Twenty First Century Fox, Fairfax, Vocus, Verizon Communications, Viacom, Prime Media, Nine, APN News and Media, and Southern Cross Media.
3. We also own 14.3% of Sky Network Television Limited (Sky).
4. The Commerce Commission has released a Letter of Unresolved Issues (LOUI) in relation to the proposed Vodafone/Sky merger dated 31 October 2016. The Commission expresses the concern that the merger may lessen competition in the national retail markets for residential fixed line broadband and mobile services. In particular, the Commission is concerned that:
    a. the merged entity would be in a powerful position by virtue of its portfolio of content (in particular, live sports);
    b. the merged entity would offer bundles of Sky content and Vodafone broadband and/or mobile that would be more attractive than buying Sky on a stand-alone basis;
    c. the merged entity would be less inclined to enter into reselling arrangements with other broadband/mobile providers; and
    d. as a result of the above, competing broadband/mobile providers may lose customers to such an extent that they no longer provide an effective constraint, allowing the merged entity to profitably raise broadband/mobile prices.
5. In Perpetual's view there is no realistic possibility that the merger would substantially lessen competition in the broadband/mobile markets. While Sky/Vodafone bundles will be attractive to some consumers (as they are today), other broadband/mobile providers will still be able to compete (as they do today). Furthermore, the realities of the content distribution business will require Sky to continue to offer resale arrangements and provide Sky on an attractive standalone basis including through over the top (OTT) services such as Fan Pass and Neon.
6. Bundling by the merged entity would mean the continuation of a positive competitive dynamic. Sky/Vodafone bundling is no doubt attractive to some customers and forces competing telecommunications providers to improve their offerings in response. On its face, this rivalry *increases* competition in mobile/broadband markets and consumers are the winners. The idea that Sky/Vodafone bundling could be so successful that it would monopolise mobile/broadband markets is, in our view, fanciful. Such a strategy would also be inconsistent with Sky's economic imperative as a content aggregator and distributor to maximise its reach across all platforms and communication channels.

7. This view is informed by our experience in New Zealand and a number of other media markets around the world. In this submission we address the following two propositions that should be critical to the Commission's analysis:
   a. Sky does not control "must have" content that would allow the merged entity to colonise the broadband/mobile markets.
   b. The economics of content aggregation and distribution will require Sky to continue to make content available on attractive terms through resale agreements and OTT services.
8. We discuss each proposition in turn.

Proposition 1: Sky does not control "must have" content that would allow the merged entity to colonise the broadband/mobile markets

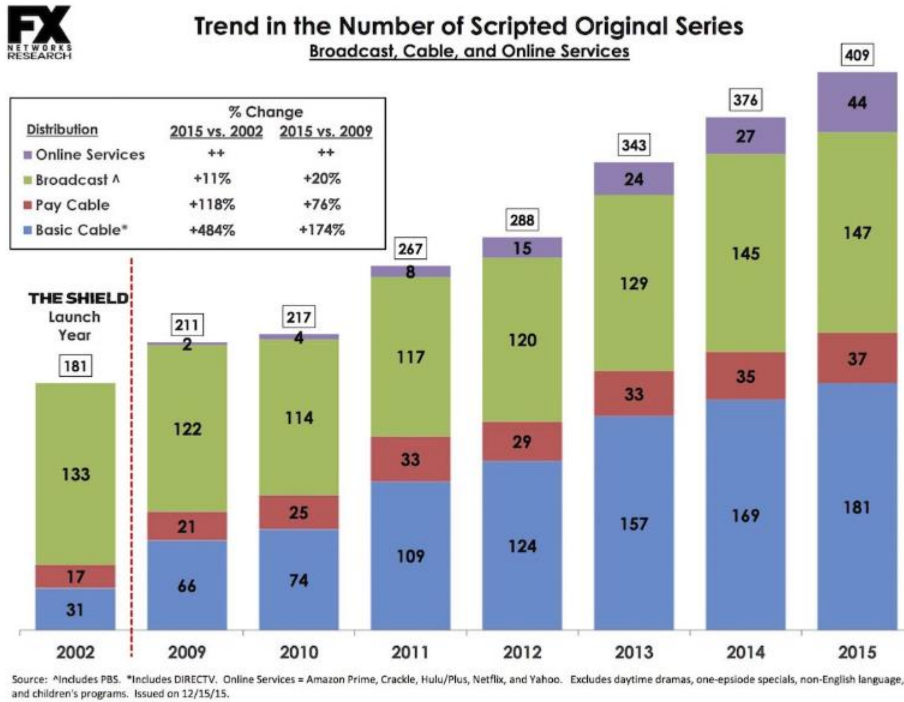
Introduction

9. The Commission's tentative theory of harm is based on the merged entity having substantial market power in the national retail market for pay TV.
10. In our view, the Commission's analysis is not sufficiently sensitive to: the broad range of content that Sky competes with; the content fragmentation trend; the increasing availability of content regardless of the delivery platform; and the contestable nature of Sky's content rights.

Rapid and continuing expansion of content

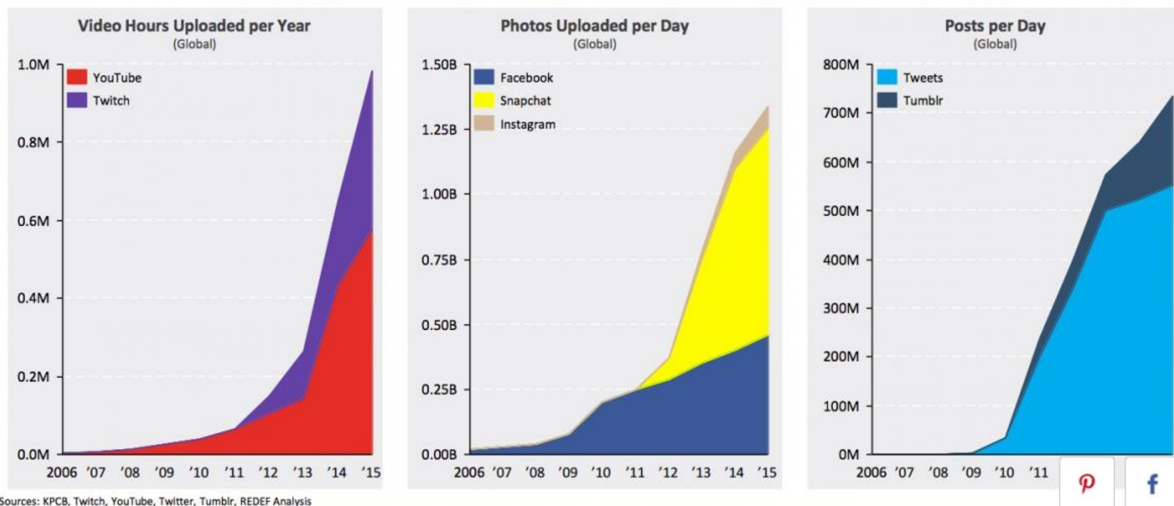
11. Sky's content offering sits alongside a vast array of available programming.
12. The television industry is experiencing a rapid expansion of content, with original scripted TV series in the US nearly doubling in the past 6 years. This is likely to accelerate in the future given existing and new content creators' capital expenditure budgets.
13. For example, Netflix intends to create 1,000hrs of original scripted series at a cost of $6bn in 2017 vs 600hrs in 2016 and zero in 2013:[1]

[1] Netflix Q3 2016 Letter to Shareholders.



14. Many customers treat social media as a substitute for formal programming. By adopting a traditional market definition such as “pay TV services”, the Commission risks losing sight of the true competitive dynamics - for attention - and overstating Sky’s position in “the market”.

15. The following chart shows the explosion in user generated content since 2006:[2]



16. Increasingly consumers are allocating “screen time” between traditional television programming and social media. That is, Facebook, Twitter, and YouTube are also increasingly competitors with Sky.

[2] http://www.businessinsider.com/future-of-video-2016-10/?r=AU&IR=T/#-16

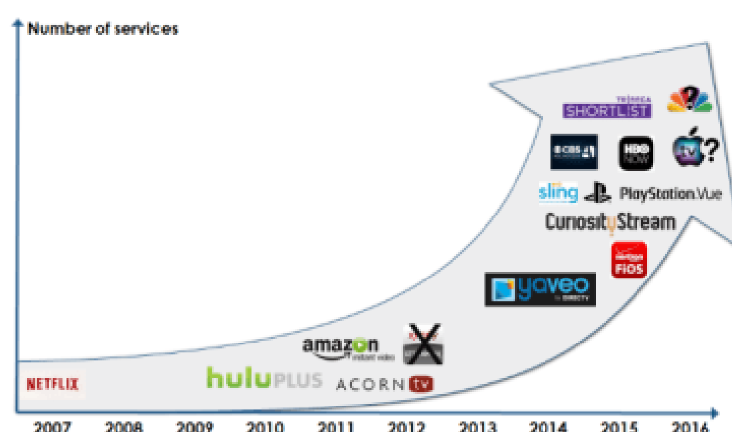
Global trends: fragmentation, diversity and multi-platform delivery

17. Content delivery has undergone massive change over the last few years.

18. One of the key trends has been the disaggregation of content libraries to unlock economic value. For example, when Netflix started it realised economic value from content libraries, which were conventionally regarded as largely worthless, through its platform. This catalysed the fragmentation and revaluation of content and thus contracts into different value tranches such as first window, second window, library and digital. We expect this fragmentation to continue according to differing levels of definition (SD, HD, UHD etc), length (short-run etc), delay etc. What drives this fragmentation? As we discuss further below, the economics of content creation and distribution require maximising reach across platforms and targeting of value through audience customisation.

19. While Netflix led the OTT charge, the market is evolving and the disrupter is starting to be disrupted as niche platforms successfully segment consumer tastes. Curiosity stream for documentary lovers for example. This is much like what happened to magazines in the 1980-90's as mass market titles were picked off by targeted niche publications.

20. The following chart shows the growth of OTT providers:[3]



21. Content creators are also increasingly seeking direct access to their customers across non-proprietary delivery mechanisms (HBO-Go, Showtime, NY Yankee's, Chelsea FC etc). This has been facilitated by the movement of the user interface (how and what you watch and transition between programming) from proprietary set-top-boxes, to applications that reside on a television or device such as Apple TV.

22. Outside of OTT, VOD, and direct content, there are multiple internet based video delivery platforms including streams (Youtube, Vimeo), social (Facebook, Snapchat) etc.

[3] http://go.ooyala.com/rs/447-EQK-225/images/Ooyala-and-Vindicia-MTM-whitepaper.pdf

23. The means by which content are delivered will continue to evolve, but two trends seem clear:
    a. content offerings will continue to fragment as economies of scope diminish and we will increasingly see social and identity based feeds (Stab Cinema for surfers for example) replacing one-size-fits-all programming; and
    b. consumers will increasingly demand to watch content where, when and how they desire.
24. This all highlights that Sky is competing with more than just NZ based companies as content, content rights and platforms are increasingly fragmented, niche and global. The market is broader and more diverse than the Commission has described and evolving at an ever increasing pace, leaving Sky competing for content (and more aptly – attention) from domestic and increasingly global peers and suppliers (content creators going direct).

Sky sports is not "must have" content

25. Against this background, we are very surprised by the suggestion that Sky sports would put the merged entity in a position to dramatically change the competitive dynamics in the mobile/broadband market using its alleged market power in pay TV.
26. While Sky sports may be attractive to some broadband/mobile customers, it is only one of a number of relevant factors that such customers will take into account including: user experience and interface; price; service; and the bundling of other services (such as Spark/Lightbox/Spotify bundling).
27. The "nice to have" (not "need to have") nature of Sky content is illustrated by the present situation. In particular, most New Zealand households do not subscribe to Sky sports,[4] and Vodafone resells Sky, but this does not put it in a specially privileged position in the broadband/mobile markets.
28. For a small fraction of customers, access to a particular sport or collection of sports will be very important. However:
    a. Sky sports content is no different from other desirable content: for the vast majority it will be a nice to have feature, no different from access to other forms of programming and user-generated content that they wish to watch.
    b. As well as content fragmentation, we are seeing diversification in telecommunications offerings, from no-frills to premium offers. Consumers are demanding products to suit their needs, whether this is bundles or increasingly tailored niche and differentiated offerings. i.e. less mass market, more fragmentation. This fragmentation limits the ability to leverage a particular point of difference across a broad segment of customers.
    c. At the same time we are seeing customers demanding ubiquitous access to content over multiple platforms and regardless of the provider of those communications links.
29. We consider that Sky has a good content mix, but that it does not give it power to dramatically change the nature of competition in the mobile/broadband markets. That is, while Sky sport may be critical for some customers (in the same way that Game of Thrones will be for others), for the vast majority it is just one factor that will get

[4] NERA report, 11 September 2016, para 10.

weighed up in the mix, together with service performance, user interface, price, brand loyalty, and other bundled offers. A recent Ampere Analysis poll of 32,000 people in Europe found that only 11% of 18-24 year olds chose sport as their favourite media genre.[5]

30. If Sky's content could give the merged entity the sort of market power suggested in the LOUI, then this begs the question why Sky has not exploited such power to date? That is, if the Commission's concerns were valid, then we would expect Sky to have already leveraged its Pay-TV content into the mobile and broadband markets by partnering with telecommunications providers and dominating those markets. And, if that was possible in telecommunications, then we would expect Sky to have also leveraged its content to dominate electricity retailing and other markets. The fact that Sky has not done so, is very strong evidence that its content does not give it such power and that it will likewise be unable to leverage its content in the way suggested in the LOUI if the merger proceeds.

Sky does not "own" or otherwise have indefinite rights to sports content

31. Finally, we note that leasing rights to sports content regularly come up for auction and can be bid for on an open basis. In recent years, for example, rights to the English Premier League and Professional Golf Association have changed hands – including to telecommunication providers (Optus/Spark) – and been modified in contested processes. As an example of the competition Sky will face for content in the future, we note that Twitter has recently won rights to stream NFL games.[6] Sky has no certainty of holding such rights beyond its present contractual terms, and increasingly sports organisations are considering direct distribution.

Proposition 2: The economics of content aggregation and distribution will require Sky to continue to make content available on attractive terms through resale agreements and OTT services

Introduction

32. The Commission is concerned that the merged entity will leverage market power in relation to Sky content by bundling Sky content with Vodafone mobile/broadband offerings. The Commission is then concerned that the merged entity will undermine other channels to access Sky content in order to boost the Vodafone mobile/ broadband side of the business. We consider that this is inconsistent with the economic imperative for content providers to maximise reach.

Reach will remain key for the merged entity

33. As a content aggregator, Sky's business model is based on reach.

34. Content is expensive and for the most part a fixed cost, hence the economics of distribution requires maximising reach across platforms and providers. This imperative is evidenced by Sky's past behaviour of offering wholesale content,

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[5] https://www.ft.com/content/0985a8a0-a4dc-11e6-8898-79a99e2a4de6 ("Sports rights: The fight to keep the fans on side", 9 November 2016).

[6] https://nflcommunications.com/Pages/National-Football-League-and-Twitter-Announce-Streaming-Partnership-for-Thursday-Night-Football.aspx

providing OTT and VOD services including Pay-Per-View (daily, weekly, monthly Fan Pass).

35. There are two sure ways to damage a content distributors business. One is to charge excessively, reducing reach and triggering an economic death spiral. The second is to attempt vertical integration into a specific distribution network and again reduce reach and therefore gross monetisation.

36. The business model and economics of distribution ensure that reach is the main objective. The strategy of buying content and keeping it on the in-house platform would be a forlorn strategy. Suggesting Sky would profit from withholding or constraining wholesale access is like suggesting it would be viable for HBO to reduce cable coverage in an attempt to capture the entire value chain through HBO-Go. We are unaware of any operator successfully pursuing such a strategy. To the contrary, the ubiquitous approach is to maximise reach. For example, ESPN now reaches 80% of US households (98m) and 200 countries (Neilsen June 2016 coverage estimates).

37. We are seeing content fragmentation to target niche audience segments drawn from a global pool, but the entire industry trend is against using content to capture customers on a particular communications platform.

38. In the case of Sky, its potential customers use a diverse set of access platforms, use a wide range of access providers, and expect to be able to pick-and-mix content. While its content may be able to sway a small percentage to Vodafone (as occurs today), Sky’s priority will be to maximise reach not to constrain it.

The merged entity would not rationally risk its content business to grow its telecommunications business

39. The Commission’s theory of harm posits the merged entity prioritising the competitive position of its mobile/broadband offering over maximising content reach.

40. We consider that this would not be a rational business strategy for the merged entity for two reasons.

41. First, telecommunication offerings are becoming commoditised through greater network availability. We know that voice and text have lost their value in offerings with unlimited now the standard. Data is following the same trajectory. The following chart illustrates these trends: [7]

[7] Commerce Commission New Zealand, Annual Telecommunications Monitoring Report May 2016.

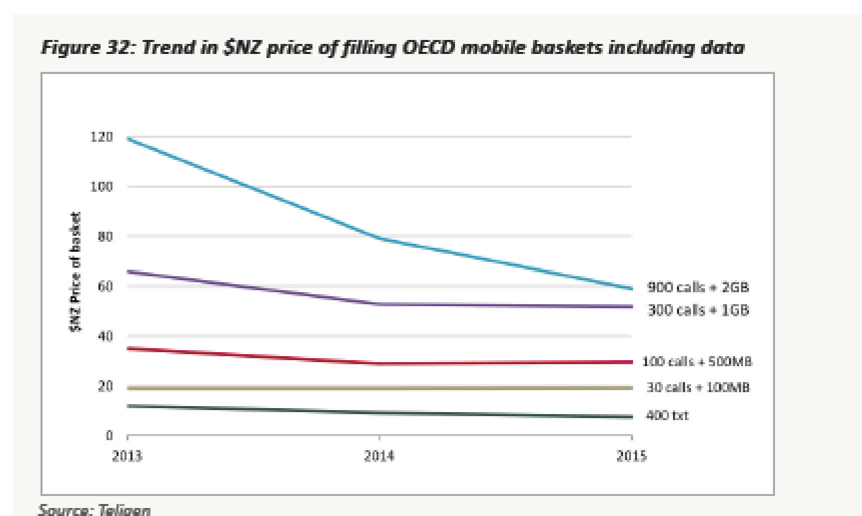


Figure 32: Trend in $NZ price of filling OECD mobile baskets including data

Source: Teligen

42. Furthermore, the telecommunications markets face low barriers to entry, particularly in relation to fixed line copper and fibre broadband where there is mandated access at regulated prices.

43. In these circumstances, it would be very surprising for the merged entity to prioritise mobile/broadband take up ahead of maximising the value of its content.

44. Secondly, the relatively small broadband and mobile market share (30%, 40% respectively) of the merged entity would make this an even less viable option. That is, the merged entity would be risking the sale of its content to 70% of broadband and 60% of mobile customers by attempting to make these channels less attractive than they are today.

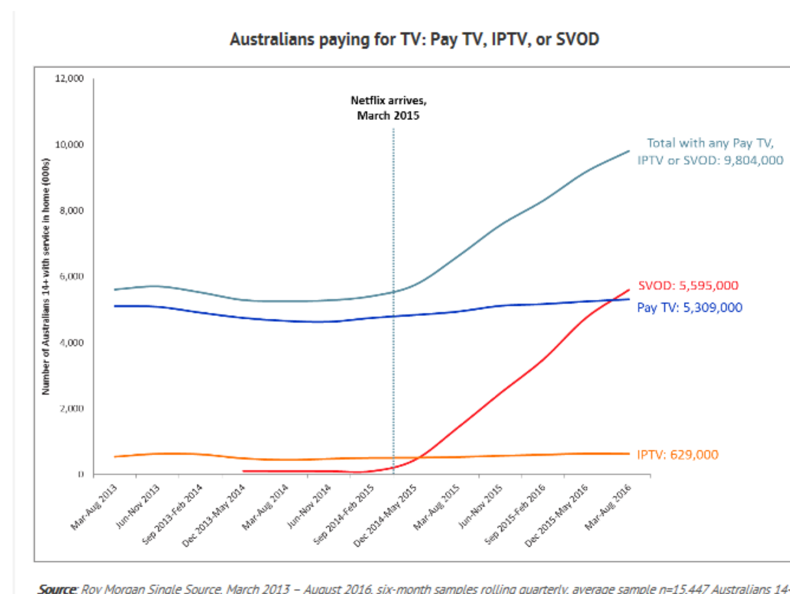
45. Overall, a strategy of the sort proposed by the Commission in the LOUI would be short-lived and value destructive. Sky's potential return on content would be much lower than an aggregator who intends to use all available platforms and providers – and they could with wholesale UFB and in-TV ecosystem or a relatively inexpensive puck (Apple TV for example). Sky would not be able to compete and win future content against such a distributor.

46. We consider that Foxtel in Australia illustrates the problems with the proposed strategy. Foxtel is 50% owned by Telstra. Importantly Telstra is the incumbent telecommunications provider in Australia with $6.3Bn of EBIT to protect. The Telstra telecommunications business is 20x their share of Foxtel EBIT (~$300m). This leads to the telco business model – and incentives – dominating and suffocating the aggregator business model and economics. Telstra limits Foxtel's reach by restricting access by bundling exclusively across Telstra's own network. Despite Telstra's market share, this has had an adverse effect on Foxtel's content business:

    a. Foxtel has saturated at ~30% penetration – reach is poor.

    b. Given dissatisfaction between the content/platform tie, the Australian market was ripe for the entry of OTT providers. OTT now covers over 5.5m people in Australia, already exceeding Foxtel's user base. Australia has been one of Netflix's most successful launches with ~23% penetration after 14 months and Stan (Nine OTT) announced at its recent investor day that it has 1.5m active users. Others including Amazon Prime are rumoured to be looking to launch in Australia. In a sign of things to come, earlier this year Foxtel lost key

content (Showtime) to Stan. The following chart shows the growth of SVOD in Australia:



c. Foxtel has had to reprice its offering of its basic package from $49 to $25 per month and they intend to reduce pricing for Foxtel Play (OTT) from $25 to $10-15 per month.

d. Morgan Stanley Media analysts recently wrote off $3bn from its Foxtel valuation.

47. Consumers are demanding to watch 'their' content when and how they want and increasing internet capability will only accelerate this dynamic. The content capture business model does not work; demonstrated by Foxtel. We believe the 50:50 nature of Sky and Vodafone (at the EBIT level; ~$230m for Sky and ~$250m for Vodafone – after allowing for normalised D&A of $200m vs $334m actual) aligns incentives with aggregator economics.

Summary

48. While content may be used as an attractive point of difference for telecommunications services, it is quite another thing to suggest that a content aggregator will deliberately seek to weaken its other channels to market.

49. We strongly believe that the merged entity would continue its present behaviour of maximising reach through offering wholesale content, and providing OTT and VOD services including Pay-Per View.

50. Finally, we note that while we have used "reach" in our discussion, to be specific it is value-adjusted-reach that matters. This means balancing reach to maximise monetisation. The 'enthusiastic wholesaler' argument proposed by competitors is false as providing incremental content (reach) to the detriment of the existing user base only reduces total monetisation in the medium term. Likewise, overpricing incremental content and reducing value-adjusted-reach is equally as detrimental. Hence, it is a balance with the goal of maximising monetisation. Sky's recent offerings to the market are the best evidence of what it would offer in the future with or without the merger.

Conclusion

51. We believe that the content and aggregator market is broader, more diverse and evolving at a faster pace than the Commission appears to have appreciated in the LOUI. It will continue to change in ways currently unimaginable but will follow the bedrock of the content business model – reach. Thus it will fragment along niches according to changing demographics and tastes, but will be delivered on globalised platforms that facilitate and enhance the viewing experience and do not restrict users to particular communications technologies. The days of aggregator monopoly behaviour from delivery/network limitations are dead.

52. We also strongly believe that in-housing content to corner the market would be a very short term and value destructive strategy as it would not maximise returns on content and would see a new distribution model being deployed. Such a strategy would not be followed by the merged entity and, if it was, it would fail.

53. For these reasons, we support the merger of Sky and Vodafone. Together, with local and worldwide experience, they should be able to curate relevant content, delivered across technologically superior platforms, to a unique, diverse and demanding consumer base. We believe this will be additive to innovation/competition of both content and delivery ultimately benefitting the New Zealand consumer who will experience a broader set of differentiated and tailored options. With the proliferation of content and platforms, combined with increasing network availability, the companies who do this best will win. We simply cannot envision a situation whereby the catch-all, vertically integrated, mass market strategy would be followed by the merged entity as it is a failed strategy.