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Assessing the proposed merger between Sky and Vodafone NZ: a response to the Commerce Commission and NERA

A report for 2degrees and TVNZ

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1 Introduction

Vodafone New Zealand ('Vodafone') and Sky Network Television Limited ('Sky') propose to merge and have applied to the Commerce Commission for clearance. Should the Commission clear the merger, or should it decline clearance on the grounds that it is not satisfied that the merger will not be likely to have the effect of substantial lessening competition when compared with likely counterfactuals?

2degrees and TVNZ engaged Plum Consulting to undertake a study of the likely outcome and effects should the proposed merger proceed. Plum provided its report in August 2016[1]. Our conclusion was that on balance, the merger would lead to a substantial lessening of competition in both the retail fixed broadband market and the mobile services market in New Zealand.

Following the submission of our report the Commerce Commission invited 2degrees[2] to provide it with an additional submission as to the likely counterfactual. In response 2degrees engaged Plum to provide additional analysis on the likely counterfactual and to comment on the views expressed by NERA in its Report[3] to Bell Gully and Buddle Findlay, now filed with the Commission. We therefore set out below in:

- **Chapter 2** – a more detailed analysis of what constitutes the most likely counterfactual against which to judge the proposed merger
- **Chapter 3** – analysis of the impact of the proposed merger on competition if the likely counterfactual were one in which Sky operated in a manner not dissimilar to the status quo; and
- **Chapter 4** – comments on the NERA report of 11 September.

[1] Plum Consulting, Assessing the proposed merger between Sky and Vodafone NZ, A report for 2degrees and TVNZ, August 2016, (Plum Report) http://plumconsulting.co.uk/assessing-proposed-merger-sky-nz-vodafone-nz/

[2] Susan Brown, NZCC, email to NIcko Waymouth, 2degrees, 21 September 2016.

[3] *Sky/Vodafone – Review of Economics Reports,* NERA, 11 September 2016

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2 Response to the Commission's view of the counterfactual

2.1 Introduction

In its email[4], the Commerce Commission notes that 2degrees and others submit that "*absent the proposed merger, Sky would be incentivised to wholesale on a markedly different basis that* [sic] *is currently the case (e.g. by unbundling its content).*" The Commission goes on to advise that currently the Commission does "*not consider this to be a likely scenario without the merger*" and invites 2degrees to provide its views "*on the difference in competition that would arise between the scenario with the proposed merger and a scenario without the merger where Sky is likely to resell or wholesale its services to third-parties on a basis that may not be dissimilar to the status quo*."

In this chapter we provide additional analysis and clarification on what we consider the most likely counterfactual to be and the extent to which it differs from the status quo. In our analysis:

- we assume that Sky NZ is a rational, profit maximising, company which, in the absence of a merger, would distribute its premium content in a profit maximising way. This is consistent with the approach taken by NERA in its report of 11 September;
- we observe that the development and take-up of high-speed broadband services is fundamentally changing the dynamics of the pay TV and telecommunications markets. These changes:
  - are recognised in the application for merger clearance by Sky and Vodafone. For example Paragraph 11.21 of the application states that "*the Transaction will allow the Combined Group to better serve customers' evolving preferences by enhancing the delivery of content across multiple devices and via multiple distribution technologies, including satellite, broadband (UFB and fixed wireless (rural)) and mobile*";
  - are also recognised by the Ministry of Business, Innovation and Employment. In its discussion paper *Exploring Digital Convergence* it notes that "*convergence is changing competition dynamics within the TIME [telecommunications, information, media and entertainment] sectors*", and that '*the business models of both content creators and content distributors are changing at pace*"[5]; and
  - are discussed at length by Plum in Chapter 3 of our previous report; and
- we draw on observed behaviour in the UK pay TV market over the past five years. Back in 2010 Sky UK was in a similar position to that of Sky NZ today – having a very strong hold on premium content in the UK, relying heavily on distribution of content by DTH satellite, and strongly restricting conditions on use of this premium content by rivals. So the recent behaviour of Sky UK offers useful empirical evidence on how Sky NZ is likely to behave in the absence of a merger with Vodafone.

Given this evidence we think it unlikely that, in the absence of a merger, Sky will continue to use a business model for distribution of content which is similar to the status quo.

[4] ibid

[5] Ministry of Business Innovation & Employment, Exploring Digital Convergence, 2015 page 11, http://convergencediscussion.nz/wp-content/uploads/2015/08/Exploring-Digital-Convergence-Issues-for-Policy-and-Legislation-2015-08-27.pdf

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2.2 Sky's options in the absence of a merger

Faced with the disruption to the pay TV markets which broadband services are now generating, Sky has three main options for how it responds (in the absence of a merger with Vodafone):

- Option A – it pursues a hybrid strategy in which it continues to retail its traditional broadcast pay TV services, offers retail OTT services to broadband customers in New Zealand and offers genuine wholesale products to retail service providers – both fixed and mobile;
- Option B – it pursues a strategy of minimal change from the status quo in which it continues to retail its traditional broadcast pay TV services, offers retail OTT services to broadband customers in New Zealand and continues to resell its retail pay TV bundles on its current commercial terms; and
- Option C – it enters the retail fixed broadband and mobile services markets on its own in order to deliver video-on-demand services.

Which of these options is likely to be profit maximising and therefore the most likely counterfactual? To answer this question we compare Option A with Option B in Section 2.3 and Option A with Option C in Section 2.4.

2.3 Option A versus Option B

Figure 2-1 compares Options A and B.

Figure 2-1: the characteristics of Options A and B compared

Distribution activity by Sky	Option A - hybrid distribution	Option B - minimal change from the status quo
Retail traditional bundles of TV channels via satellite	Yes	Yes
Resell these bundles to fixed broadband RSPs on current supply terms	No	Yes
Wholesale selected content to fixed broadband RSPs on commercial terms	Yes	No
Retail OTT products for fixed and mobile broadband delivery	Yes	Yes
Wholesale OTT products for mobile broadband delivery	Yes	No

The two options are the same in that:

- both involve Sky continuing to retail traditional bundles of TV channels via satellite; and
- both involve Sky retailing OTT products over the fixed and mobile broadband networks of RSPs. However it is important to note here that we expect OTT products for fixed and mobile broadband delivery to be very different – given that the incremental cost of delivering a GB of video over a 4G mobile network is many times greater than over a fixed broadband network. This means that it would not make sense for Sky to resell its current bundles of TV channels to mobile broadband

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RSPs. Such a product would create very high conveyance costs for the mobile RSPs (and very high prices for end-users).

But the two options differ in two important respects:

- under Option A Sky would wholesale selected content to fixed broadband RSPs rather than require the RSPs to resell Sky's existing retail bundles of TV channels. This is likely to mean allowing the RSP to choose selected channels from the retail bundles and to aggregate them with video content from other sources to create differentiated video offerings. This contrasts with Option B where RSPs simply resell the full retail bundles of Sky's video content and are not permitted to add content from other sources; and
- under Option A Sky would wholesale OTT products for mobile broadband delivery so as to allow mobile RSPs to build differentiated video products as part of their overall mobile service offerings.

We believe that Option A is a more likely counterfactual than Option B because it is more likely to maximise Sky's long-term profits. Our reasons are as follows:

- Option A is more likely to expand the market for Sky's content. There are clearly different segments to the New Zealand pay TV market. For example keen sports fans may be happy to pay well in excess of $100 per month for Sky's existing bundles of TV channels. But the majority of households do not fall into this category. They have a lower willingness to pay for premium video content which could be captured if they were offered a range of video-on-demand services from competing RSPs. Sky could capture a substantial proportion of these additional revenues under Option A at low cost. It could not do this under Option B;
- Option A would allow Sky to exploit the competition between RSPs of broadband services. Competing RSPs are keen to minimise customer churn and an effective way to do that is to add video to the bundle of services offered. (See for example Section 3.2 of Plum's August report). This willingness to pay for churn reduction by RSPs would help raise the wholesale prices which Sky could charge for its unbundled content. This opportunity is unlikely to be realised under Option B where Vodafone is currently the only reseller of Sky's retail bundles; and
- we observe that, over the last five years, Sky UK has followed Option A rather than Option B in response to the development of broadband video services. As evidence we note that Sky UK now wholesales its premium content through multiple providers using different distribution platforms. This includes Virgin Media's cable network and the IPTV platforms of BT and TalkTalk. Sky UK claims that over time it has wholesaled its premium channels to 37 different DTT, Cable, and IPTV platforms and to have made it available on 43 different OTT and mobile services. In all cases the retailers have a choice as to which of Sky UK's wholesale channels they purchase and how they combine them in developing distinct and differentiated retail propositions for their subscribers. The retailers are also able to source content at wholesale from a range of other content providers as well as Sky UK. For example Virgin Media has three TV bundles – one offering 130 TV channels; one offering 230 channels plus BT Sports; and a third offering 245 channels plus BT and Sky Sports channels and Sky Movies.

2.4 Option A versus Option C

Under Option C Sky would, in the absence of the proposed merger, enter the retail fixed and mobile broadband markets itself. Option C is, in our view, less likely to be profit maximising for Sky than Option A for the following reasons:

- Option C would require Sky to become an MVNO. Establishing an MVNO and building a substantial market share would take time. As a result, Option C would not give Sky significant access to mobile distribution channels for its premium content over the next few years – a period when distribution of video content over mobile broadband will become increasingly important. At the same time it is uncertain whether Sky's MVNO venture would generate significant profits. In contrast Option A would give Sky access to all mobile broadband RSPs immediately and at low cost;
- Option C would restrict the fixed broadband delivery of Sky content to a modest proportion of households. Market entry into the fixed broadband market in New Zealand is now relatively straightforward given the open access requirements on Chorus and the local fibre companies. But Sky would be building its fixed broadband customer base from scratch against strong competition from other RSPs. Option A is not limited in this way; and
- Option A would help Sky to expand the market for its premium content and to exploit competition between RSPs at low cost (as discussed in Section 2.3 above). Option C would not.

2.5 Conclusions on the most likely counterfactual

Based on the analysis set out above we conclude that Option A is more likely to maximise profits than Options B or C in the absence of the proposed merger. It is therefore the most likely counterfactual. Using Option A as the likely counterfactual we reach the same conclusion about the effect of the merger as we did in our report of August 2016.

First in relation to the **mobile services market**, the merger would lead to a substantial lessening of competition relative to the counterfactual of Option A. There are two main effects:

- with access to Sky's premium content on preferred terms, Vodafone would be able to increase its share of the retail mobile market, currently 50% by revenues, as the take up of its 4G data services increases; and
- Vodafone would also be able to cross sell into the Sky customer base in a way not available to its two mobile rivals.

These effects would not exist under the counterfactual.

Second in relation to the **fixed broadband market** the merger would lead to a substantial lessening of competition when compared with the counterfactual of Option A. Again there are two effects:

- Vodafone would have access to premium content on substantially better terms than rivals. This would enable the merged entity to create more attractive triple and quadruple play bundles than rivals, to grow its fixed broadband customer base and to reduce customer churn; and
- again there would be an opportunity for the merged entity to cross sell to Sky customers, This effect is likely to be significant given Sky's large customer base in New Zealand.

Under the counterfactual all RSPs of fixed broadband would have access to Sky's content on comparable terms and there would be no cross-selling effects. It is therefore likely that the overall effect of the merger would be a substantial lessening of competition in the fixed broadband market.

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3 The impact of the merger with Option B as the counterfactual

We set out in Chapter 2 why we consider that Option A is a more likely counterfactual than Option B. In this chapter we briefly consider the impact of the proposed merger on the assumption (in our view unlikely) that Option B is the **only** likely counterfactual. This is in response to the Commission's email of 21 September in which it asks for views on "*the difference in competition that would arise between the scenario with the proposed merger and a scenario without the merger where Sky is likely to resale or wholesale its services to third-parties on a basis that may not be dissimilar to the status quo*".

We have reviewed the analysis set out in Chapter 6 of our report of August 2016 while substituting Option B for Option A as the counterfactual. We conclude that:

- the merger would continue to lead to a substantial lessening of competition in the retail mobile services market given that the merger would substantially strengthen Vodafone's already strong position in this market through both cross selling and access to premium content on preferential terms; and
- the merger would also continue to lead to a substantial lessening of competition in the retail fixed broadband market. Again the merger would strengthen Vodafone's position in this market through preferred access to premium content and cross selling – competitive advantages which rivals would struggle to match.

Overall we conclude that the merger would lead to a substantial lessening of competition in the retail broadband markets of New Zealand whether Option A or Option B were chosen as the likely counterfactual. We reach this conclusion under either option because, in our view, the merger would create an entity which has a dominant position in the pay TV market and which is, through its Vodafone business, able to leverage that dominance into the fixed and mobile broadband markets at a time when the ability to offer attractive video content in these markets is becoming increasingly important.

4 Response to NERA's critique of Plum's analysis

4.1 NERA ignores the current market power of the parties to the proposed merger

In its executive summary (page 1) the NERA report sets out arguments which ignore the fact that Sky is clearly dominant in the pay TV market while Vodafone has the strongest market position in the retail mobile market with a 50% market share by revenues. (We also note that the report does not consider the current market power of the parties to the proposed merger in any way).

Were the proposed merger between less powerful players, then we might agree that there could be consumer benefits from the merger. But, as we demonstrated in our report of August 2016, the merged entity would have such a degree of market power that it would find it profitable to leverage its dominance from the pay TV market into the retail fixed and mobile broadband markets. This would result in a substantial lessening of competition, especially given the substantial barriers to acquisition of premium content by Sky's rivals.

4.2 NERA misrepresents the counterfactual proposed by Plum

The NERA report argues that the counterfactual used in the Plum report is "*unlikely*" (page 1). But it then misrepresents the Plum counterfactual in order to support this assertion. For example its states (page 6) that:

> *"It is unclear why vertically integrating and wholesaling to RSPs (whether fixed or mobile) should be considered mutually exclusive".*

This is a misrepresentation of our counterfactual. We do not make this argument. Plum's counterfactual does not, as NERA assumes, have Sky acting as a pure wholesaler but as a player employing a hybrid distribution strategy in which it:

- continues to retail its traditional broadcast pay TV services;
- offers retail OTT services to broadband customers in New Zealand; and
- offers wholesale products to retail service providers – both fixed and mobile.

It is this counterfactual which we believe, in the absence of the proposed merger, would be profit maximising for Sky, and therefore the most *likely* counterfactual. The third element of this counterfactual is important if Sky is to access the emerging video-on-demand markets, and especially the mobile video-on-demand markets, in a profitable manner.

4.3 NERA argues that the merger and Sky entering broadband markets on its own are close substitutes

NERA questions Plum's rejection of a counterfactual in which, in the absence of the merger, Sky would vertically integrate on its own into the broadband markets. It argues (page 6) as follows:

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"From Sky's perspective, the merger is simply an accelerated form of developing its own broadband offering, and the fact that Sky has pursued a merger deal with Vodafone reveals that Sky expects this strategy to be more profitable than the counterfactual posited by Plum".

This argument appears to assume that Sky's merger with Vodafone, and Sky vertically integrating into retail broadband markets on its own, are equivalent. They are not. The merged entity would be the Number 1 mobile broadband operator and Number 2 fixed broadband operator in New Zealand as well as being the dominant pay TV supplier, from day one. In contrast, if it followed Plum's Option C counterfactual, Sky would be starting from scratch in entering the fixed and mobile broadband markets. Nor, in putting these arguments does the NERA report explain how Sky might, in the absence of a merger, vertically integrate profitably into the mobile broadband market. We argue here that Sky would generate greater profits from wholesaling or retailing its content to/over all three mobile operators rather than becoming an MVNO for one of them.