

# Review of New Material on Sky-Vodafone Proposal

Prepared for

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2degrees and TVNZ

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# Executive Summary

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1. This is our second report on the proposed merger between Sky TV and Vodafone. It represents the independent expert views of the author and relies on independent examination of a wide range of data and information sources cited below. We comment on material supplied by the Applicants since our first report, particularly a report from NERA and a letter from Buddle Findlay.
2. This new material does not change the conclusions reached in our first report that the proposed transaction is highly likely to substantially lessen competition in the retail markets for fixed and mobile telecommunications services in New Zealand. On the contrary, it raises several new concerns.
3. NERA have not understood the competition problem described in our first report - the merged entity will have strong incentives (and the ability) to use Sky's premium content monopoly to distort competition in the retail telecommunications markets. In this report we explain, among other things, why NERA is wrong to presume that the transaction will benefit consumers.
4. This report also:
  - a. Identifies a group comprising approximately one third of all New Zealand households for whom competition will be directly and substantially lessened;
  - b. Explains that an adverse competitive effect on a significant group of consumers in a market amounts to a substantial lessening of competition in that market;
  - c. Discusses the relatively high value nature of the group of customers at issue, which:
    - i. reinforces the incentives for the merged entity to secure the telecommunications business of this group; and
    - ii. provides evidence that a much wider group of customers is also likely to experience substantially lessened competition; and
  - d. Explains how the proposed transaction will increase the incentives for the merged entity to discriminate in favour of its retail telecommunications business in respect of the terms of access to its monopolised premium content.
5. While the Applicants' views of the appropriate counterfactual remain confidential, NERA has described its own view. The NERA counterfactual helpfully highlights the existing (and proposed future) *two-way* nature of the relationship between Sky and Vodafone. Under the NERA counterfactual and under the status quo, even exactly equivalent wholesaling offers by Sky to Vodafone and all other RSPs could easily have a

discriminatory effect if Sky is rebating value back to Vodafone via the alternative channel (Sky's referral of customers to Vodafone) that NERA expects to only be available to Vodafone.

6. We discuss the revenue synergies expected by the Applicants and inquire into the likelihood of them being realised *without* substantially lessening competition in retail telecommunications markets. We have been unable to discern how the Applicants plan to achieve these twin objectives.
7. Similarly, we have been unable to resolve the puzzle as to why Vodafone is the only RSP currently engaged in wholesale trade with Sky but have identified two further puzzles:
  - a. we cannot understand how Vodafone can currently afford to provide Sky Sports (which must cost Vodafone close to \$30/month) at no charge to broadband customers; and
  - b. if all RSPs have access to equivalent wholesale terms from Sky then it is difficult to explain why 2degrees has been unable to obtain from Sky details of its standard terms and conditions and pricing despite a number of requests.
8. For these reasons and others discussed in the body of this report, we have requested confidential access to the Applicants' redacted information. We anticipate providing an additional report once this is available.
9. In addition, given the significant disagreements between ourselves and NERA (and between other experts and NERA) we believe that a conference would be the most efficient way of properly testing the differing views, both economic and factual, that are evident in the written material.

# 1 Introduction

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10. Following the announcement of a merger proposal by Sky Network Television Limited ('Sky') and Vodafone New Zealand Limited ('Vodafone'), we analysed the proposal from a competition economics perspective.<sup>1</sup> Our report reviewed the market position of the applicants, defined relevant markets, articulated a hypothesis of competitive harm, and tested that hypothesis before reaching the conclusion that the proposal would substantially lessen competition in the retail markets for the provision of fixed and mobile telecommunications services in New Zealand.
11. We agreed with the Applicants that premium content is "a key input into any pay TV service" and noted<sup>2</sup> that Sky TV has a monopoly position, which will continue for the next five years in respect of several forms of premium content.
12. The mechanism by which we expected competition to be substantially lessened was stated in our report as follows (at ¶92).

*The competitive effect will be that Vodafone will have the ability to offer triple- and quad-play bundles that are materially more attractive than any other RSP can commercially afford. This will decisively skew competition in the retail telecommunications markets in Vodafone's favour.*

13. Our report also noted that bundling can be pro-competitive. We cited several current examples of bundled offers in the telecommunications sector and stated (at ¶22) that

*These offers are likely to enhance competition in telecommunications markets **provided that each network has the opportunity to acquire adequate content for their bundles.** (emphasis in original)*

14. Notwithstanding the fact that bundling *can* be pro-competitive, for the reasons described in our earlier report we concluded that the proposed transaction was likely to substantially lessen competition between bundles because Vodafone would have preferential access to Sky's monopolised premium content.
15. In response, NERA claims (at ¶9) that we "treat bundling pejoratively", and (at ¶11) that our "real focus... appears to be the welfare of the merged entity's rivals, rather than that of consumers".<sup>3</sup> The first of these claims is very clearly contradicted by our report. The second claim, as we explain below, is without foundation.
16. It should not need to be said, but conduct that has an anti-competitive effect in a retail telecommunications market in New Zealand, which for the avoidance of doubt means (by definition) that the conduct harms the process of competition in that market, will harm consumers buying from that market *and* the rival firms seeking to compete for the patronage of those consumers. There is consequently an alignment of interests between these two groups. In this context it is not possible to oppose such conduct without simultaneously promoting the interests of the affected consumers and the firms who are being prevented from competing

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<sup>1</sup> Covec, Economic Analysis of Sky – Vodafone Proposal, 11 August 2016.

<sup>2</sup> See fifth paragraph of Executive Summary

<sup>3</sup> NERA, Sky/Vodafone – review of economics reports, 11 September 2016.

effectively for their business. NERA's claim cannot be substantiated on grounds of logic or economics.

17. NERA also make the following claim (¶2):

*“if a merger provides the parties with a competitive advantage, this is on its face a good outcome for consumers”*

18. The existence of many counter-examples to this proposition is the reason why most countries have competition laws that include the ability to block mergers, and specialised competition authorities charged with scrutinising merger proposals. An obvious example is a merger to monopoly. This *“provides the parties with a competitive advantage”* because it extinguishes the competition: the newly formed monopolist is advantaged relative to the competitive position of either of the pre-merger rivals. Few would argue however that *“this is on its face a good outcome for consumers”*.
19. The NERA report, when read in conjunction with other material supplied by the Applicants, raises several additional concerns which we discuss in the body of this report. In particular
- a. In section 2 we consider the market power that the merged entity will possess and its likely effects on competition under the proposed arrangement;
  - b. In section 3, drawing on the Applicants' material and the NERA report we explain why we cannot discern the source of the revenue synergies expected by the Applicants;
  - c. In section 4 we investigate issues arising from the limited information supplied by NERA and Buddle Findlay regarding the Applicants' (confidential) counterfactual scenario; and
  - d. In section 5 we examine current offers by the Applicants which raise further questions which need to be addressed.

## 2 Market Power and Competition

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20. In our first report we reviewed Sky TV's current position in respect of premium content, especially live sport content. We found that, for the future period over which the Commission is assessing the proposed transaction, Sky TV has monopoly control over a very substantial amount of such content. It is the market power resulting from this position that we said would give the merged entity the ability to substantially lessen competition in retail telecommunications markets.
21. NERA agree that market power is a necessary element of the theory of competitive harm that was articulated in our report. NERA does not actually deny that the merged entity will have market power but their report does argue (at ¶10) that "*Sky Sport is not a must-have in New Zealand*" and that "*most households do not buy Sky Sports*". Relying on these and other claims, the NERA report further argues (at ¶11) that the merged entity will lack the "*ability to foreclose and then exercise market power*", and post-merger "*consumers would simply enjoy the benefits of bundling*".
22. We strongly disagree with these claims and consider that NERA have misinterpreted the evidence, including our original report, in reaching them. It is therefore necessary to elaborate on our reasoning in addition to describing our concerns with NERA's report.
23. In this section we begin the explanation of our position by discussing five inter-related issues:
  - a. ECPR pricing strategies as evidence of market power;
  - b. Customer heterogeneity and its implications;
  - c. How competitive harm to a significant group of consumers in a market amounts to a substantial lessening of competition in that market;
  - d. How competition will be substantially lessened; and
  - e. The timing error underlying NERA's interpretation of the "must have" concept.

### 2.1 ECPR Pricing as Evidence of Market Power

24. A well-known benefit of competition is that it tends to drive prices towards the marginal cost of supply. Two things can be inferred from this fact. First, when prices are durably above marginal costs, it is reasonable to infer that competition has not been sufficiently strong to force prices to marginal cost. Second, the size of the mark-up over marginal cost is an indicator of the market power of suppliers.
25. The second point is formalised in the Lerner Index which is the ratio between the mark-up over marginal cost and the price. For a monopolist, the Lerner Index is the inverse of the elasticity of demand.<sup>4</sup> So the relative mark-up over marginal cost is higher, the less elastic is consumer demand. The ability of a firm to mark-up prices above marginal cost is therefore an indicator of the firm's market power.

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<sup>4</sup> Jean Tirole, *The Theory of Industrial Organisation*, 1990, The MIT Press, page 66.



26. Sometimes monopolists supply inputs to their competitors. This can occur for various reasons including a fear of regulation. In such cases, the highest price that can be charged without breaching s36 of the Commerce Act involves setting the price of the input using the efficient component pricing rule (ECPR). The ECPR input price is the monopolist's retail price less the costs the monopolist avoids when a rival supplies the final consumer.
27. ECPR could not survive as a pricing construct if the relevant market for inputs was competitive. In that context, buyers of the input would play one supplier off against another and the input price would be pushed towards marginal cost, just as it is in any competitive market.
28. It is therefore revealing that the NERA report concludes (at ¶17) that "*Sky has already... determined that its existing wholesale pricing approach (based on ECPR) is profit-maximising*". This is compelling evidence of Sky's substantial market power in respect of the pay TV inputs it offers to telecommunications RSPs, which as noted above (¶11) are also "*a key input into any pay TV service*". To explain this point it will be helpful to refer to recent economic research on relevant market structures.
29. In the matter at hand, essential inputs (premium content) into the demand of a significant set of consumers (not necessarily the whole market) are monopolised by Sky TV for the next five to eight years.<sup>5</sup> Sky also imposes restrictions that effectively prevent its rivals from designing new innovative bundles, so under Sky's terms there would be a one-to-one relationship between extra sales of Sky made by an RSP and the consequent payment to Sky.
30. In this context pricing at ECPR is equivalent to what Salop (2010) calls the protected profits benchmark ("PPB").<sup>6</sup> Salop proposed the PPB (ECPR) concept as a way of clarifying, under USA law, whether or not the terms offered by a vertically integrated monopolist (VIM) amount to a refusal to deal or a price squeeze.
31. Three comments were published in a subsequent issue of the same journal. Responding to those comments, Salop (2013) first notes that all three commenters agreed with the above basic analysis, while discussing other more specialised cases. He notes that any price above the PPB/ECPR price would have presumptively anti-competitive effects because "*the VIM would be able to maintain its retail price at the monopoly level, as well as help preserve its input monopoly by reducing the likelihood of future entry there*".<sup>7</sup>
32. None of this recent economic analysis relies on the monopoly being a natural monopoly.<sup>8</sup> It applies fully to Sky's monopoly content rights, which endure beyond the relevant period for scrutinising this transaction. Sky's past and intended future use of ECPR to set wholesale prices shows that Sky has substantial market power over its content.

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<sup>5</sup> See figure 1 in TVNZ submission, 12 August 2016.

<sup>6</sup> Steven C. Salop, 2010, Refusals to Deal and Price Squeezes by an Unregulated, Vertically Integrated Monopolist, *Antitrust Law Journal*, 76, pp. 709 – 740.

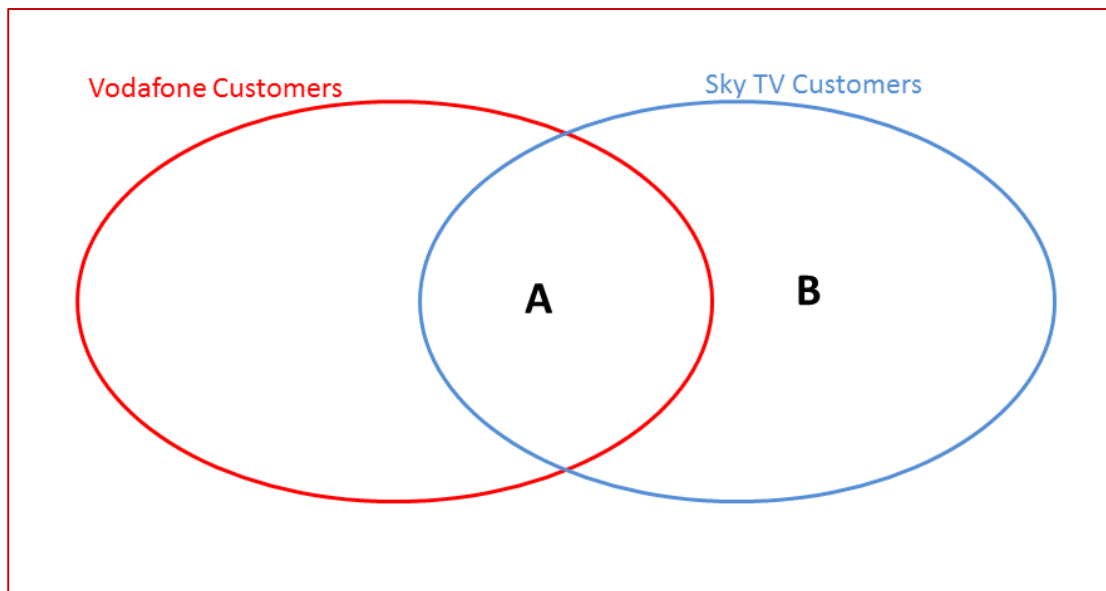
<sup>7</sup> Steven C. Salop, 2013, The Protected Profits Benchmark: Response to Comments, *Antitrust Law Journal*, 79, pp. 701 – 714.

<sup>8</sup> This makes it more general than the vertically integrated *natural* monopoly (VINM) context that is familiar to policy analysts in New Zealand since at least 1995.

## 2.2 Customer Heterogeneity

33. The telecommunications and broadcasting industries both serve mass markets: virtually all New Zealanders take some services from each of these industries. As a consequence, the retail markets being served are extremely diverse, including in respect of the ability and willingness of customers to pay for high value services. Other things being equal, retailers in these industries would prefer to serve high value customers rather than low value customers.
34. Sky TV is a high value service, costing \$50/month for the basic package with various add-ons available such as SOHO for an extra \$10 and Sports for an extra \$30. A customer buying the full premium Sky package would be paying around \$140/month.
35. Using data from the Commerce Commission's telecommunications monitoring reports and Sky TV's annual reports, we estimate that the monthly average revenue per user (ARPU) is around \$12 for pre-pay mobile customers, and \$50 for on-account and business mobile customers. Our own analysis estimates a monthly ARPU of \$80 - \$90 for Sky TV subscribers.<sup>9</sup> We can therefore safely assume that households that subscribe to Sky TV have the *ability* to pay more than other households for premium content. This helps to explain the difference in penetration rates: whereas mobile penetration is well over 100%, only around 50% of New Zealand households subscribe to Sky TV.
36. It follows that, in retail telecommunications markets, an RSP that had preferential access to Sky TV's content would have preferential access to high value customers. At present, as represented in Figure 1, Vodafone supplies telecommunications services to some but not all Sky subscribers.

Figure 1: Current Distribution of Customers



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<sup>9</sup> The higher figure results from dividing Sky's reported revenue by its reported subscriber numbers; it is possible that Sky's sales of FanPass and similar services are included in its revenue figures but not in its subscriber figures.

37. Given the value-based differences in customers (as discussed in ¶34 above), the customers who currently buy services from both Vodafone and Sky TV (i.e. those located in group 'A' of Figure 1) are likely to be among Vodafone's most valuable (i.e. high ARPU) customers. The customers in group B are Sky customers but not Vodafone customers. It is this group of customers that the merged entity intends to target through "*enhanced cross marketing...*" (Vodafone application at ¶4.2b).
38. If the merged entity provides its premium content to its telecommunications business on terms materially better than the terms on which it makes that content available to other RSPs, competition for customer group B will be substantially lessened as discussed further in section 2.4. Although on the one hand, this group will be offered (according to the Applicants) innovative, new and engaging digital products that are not currently available, no equally efficient rival of Vodafone could match Vodafone's terms (including pricing) for bundles that include Sky TV's premium content.
39. Customer group B (estimated to be approximately one third of New Zealand households – see paragraph 44 below) has revealed a willingness to pay for Sky. Unless all RSPs have access to equivalent terms for including Sky's content in bundles, the merged entity's telecommunications business will be readily able to acquire these customers with offers its competitors cannot match (even if other RSPs have more attractive offers in other dimensions such as customer service and the pricing of broadband). The proposed merger will grant one RSP a durable advantage over its rivals in respect of group B customers.
40. This outcome is likely to create knock-on effects for a wider group of telecommunications customers. As the substantial lessening of competition for group B customers will materially reduce the prospects of Vodafone's rivals attracting and retaining high-value customers, they will be severely weakened, which will make it more costly for them to compete strongly for all other customers.<sup>10</sup>

### 2.3 All Consumers are Entitled to Benefits of Competition

41. Customer group B is a significant subset of the relevant retail market. Let us assume (contrary to the discussion in ¶40) that there will be no subsequent lessening of competition for any other customers. Under this assumption, would a substantial lessening of competition affecting only customer group B amount to a substantial lessening of competition in the market?
42. There is some case law on this point from Australia which has broadly similar competition law as it pertains to this matter. In *Dandy Power Equipment v Mercury Marine Pty Ltd*,<sup>11</sup> Smithers J said:

*To my mind one must look at the relevant significant portion of the market, ask oneself how and to what extent there would have been competition therein but for the conduct, assess what is left and*

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<sup>10</sup> It is rational for RSPs to offer a menu of bundles from which consumers self-select, but the terms associated with each item on the menu need to cover total costs after consumers have made their choices. The fewer high-ARPU customers are available, the less attractive are the terms that can be offered for the lower-valued bundles on the menu.

<sup>11</sup> *Dandy Power Equipment Pty Ltd v Mercury Marine Pty Ltd* (1982) 64 FLR 238 at 259 – 260.

*determine whether what has been lost in relation to what would have been, is seen to be a substantial lessening of competition. ... [I]t is the degree to which competition has been lessened which is critical, not the proportion of that lessening to the whole of the competition which exists in the total market. Thus a lessening in a significant section of the market, if a substantial lessening of otherwise active competition may, according to circumstances, be a substantial lessening of competition in a market.*

43. This approach has been adopted by New Zealand courts, for example in *Fisher & Paykel Ltd v Commerce Commission* (1990).<sup>12</sup> It is also consistent with an economic analysis of the matter: when competition is substantially lessened for a significant group of customers in a market, that group suffers from the absence of robust competition by being denied real choice across all of the dimensions on which services are specified and differentiated by competing firms. If Vodafone is the only RSP offering a \$30 discount off a bundle that includes Sky Sports, customers that attach sufficient value to Sky Sports will choose Vodafone even if, for example its customer service and billing accuracy were materially lower than another RSP.
44. The group of customers located in group 'B' of Figure 1 does indeed comprise a significant section of the relevant market in this particular case. Vodafone supplies around 29% of fixed-line broadband connections in New Zealand.<sup>13</sup> If the distribution of Sky TV customers across fixed-line broadband suppliers was uniform, Vodafone customers would therefore also represent around 29% of Sky TV customers. To be more generous to the Applicants, let us assume that 35% of Sky TV customers are already Vodafone customers. That implies that group B customers are around 65% of Sky TV customers which represents approximately one third of all New Zealand households.<sup>14</sup>
45. One third is "a significant section of the market" in purely numerical terms. It is all the more significant when one considers that Sky TV subscribers are very likely to be relatively high value customers as discussed above (¶34).

## **2.4 How Competition will be Substantially Lessened**

46. The theory of harm articulated in our first report is predicated on the view that, under the proposed transaction, Sky's telecommunications division (Vodafone) will have preferential access to its premium content. As discussed below (in sections 3 and 5) there is evidence to suggest that preferential access may already be in place. Disregarding that evidence for now, we consider how the process of competition would be compromised by preferential access.
47. The process is fairly simple, relying on incentives and ability. We focus here on the pursuit of commercial advantage in the telecommunications sector because doing so is sufficient to demonstrate our point and also because (as discussed below at ¶67 ) there is only one monopoly

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<sup>12</sup> *Fisher & Paykel Ltd v Commerce Commission* [1990] 2 NZLR 731, 759.

<sup>13</sup> Commerce Commission, Annual Telecommunications Monitoring Report, 2015, Figure 12.

<sup>14</sup> As at December 2015, Sky TV's subscriber numbers were 51% of the total number of households in New Zealand according to Statistics NZ. The 65% of these households that are not with Vodafone therefore represents 33% of all households.

profit available from Sky's premium content rights and both NERA and Buddle Findlay believe that Sky is already gaining maximum commercial advantage from its monopoly rights.<sup>15</sup>

48. Once Vodafone PLC owns Sky and Sky acquires the Vodafone New Zealand telecommunications business, it will be natural for the combined entity to design retail telecommunications products and services which give it a competitive advantage over its rivals. This *incentive* arises from the opportunity for the combined entity to secure the telecommunications business of the (approximately) one third of New Zealand households that have Sky TV but are not Vodafone customers. There are margins available to telecommunications RSPs (which is why there are more than 80 RSPs); they are higher on more affluent customers; and Sky TV subscribers have revealed themselves to be relatively affluent (see also the discussion in section 3.1 below).
49. The merged entity will have the *ability* to capture customer group B:
  - a. Firstly, all of these customers will already be customers of the merged entity's pay TV business and cross-selling is one the Applicants' expected strategies; and
  - b. Secondly, by ensuring that no other RSP can gain access to its monopolised premium content on terms that would allow them to offer equivalent retail terms to the merged entity's telecommunications business.
50. By providing discriminatory benefits to its own telecommunications business, the combined entity can therefore expect to secure most customer group B, all of whom are expected to be of high value, with bundled offers no other RSP can match.
51. NERA says (at ¶11) that, under the factual, these consumers will "*simply enjoy the benefits of bundling*". The customers at issue are, in all likelihood, eager to "*enjoy the benefits of bundling*" but under the factual they will not enjoy the *benefits of competition* between competing bundles that include premium content, and especially live sports events (see also ¶43 above).
52. The telecommunications industry in New Zealand is familiar with the "healthy dwarf" strategy, where an incumbent ensures the ongoing presence of several smaller rivals, none of whom have reasonable prospects of growth; as explained below it can be better to marginalise one's rivals than to foreclose them.
53. On this point, Salop (2013) argues persuasively that price squeezes of this type are more damaging to competition than predation.<sup>16</sup>

*Conduct that raises rivals' costs by charging high input prices raises greater antitrust concerns than does charging low output prices that allegedly are predatory. Predatory pricing allegations raise fewer concerns for several reasons: because consumers benefit from the alleged exclusionary conduct during the predatory phase; because the conduct sacrifices profits during the predatory*

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<sup>15</sup> See NERA at ¶17 and Buddle Findlay (9 September 2016) at ¶21.

<sup>16</sup> Steven C. Salop, 2013, The Protected Profits Benchmark: Response to Comments, *Antitrust Law Journal*, 79, at p. 703.

*phase; and, because the firm may be unable to recoup these losses during the predatory phase, in that the victim may not exit the market or other firms will expand when it tries to raise price.*

*In contrast, exclusionary conduct that raises the costs of competitors is more likely to succeed and consumers are more likely to be harmed for several reasons: because conduct that raises rivals' costs will lead to higher prices immediately, so that recoupment will occur simultaneously with the exclusionary phase; because the victim firm will raise price even if it does not exit, so that the conduct can lead to market power even in the absence of exit; and, because consumers will be harmed from those higher prices immediately, so there are no inherent short-term consumer benefits, as there are in predatory pricing. Because of these significant differences, raising rivals' costs and predatory pricing represent two distinct paradigms for the antitrust treatment of exclusionary conduct.*

## **2.5 The “Must Have” Concept**

54. The Applicants and NERA rely on a view that Sky Sports is not a “must have” component in any bundle, but their evidence for this view is entirely backward-looking. The NERA report (at ¶10) points to the fact that RSPs generally (i.e. with the sole exception of Vodafone) do not resell Sky Sport as indicating it is not a “must have” component in any bundle.
55. By contrast, the Commerce Commission is obliged to look forward, to compare the likely future worlds with and without the proposed transaction. If, as many analysts and industry participants (including Vodafone) predict, competition in triple- and quad-play bundles is the relevant (i.e. the future) playing field, then it is extremely important for competition that all RSPs have access to premium broadcast content on equivalent terms. The competition concern with the proposed transaction is that the merged entity will favour its own telecommunications business at the expense of other RSPs *in the factual scenario*.

### 3 Source of Revenue Synergies

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56. As noted in our first report, the Applicants expect “revenue synergies” of \$435m from the proposed transaction. We assume that these “revenue synergies” are extra earnings for the combined group, relative to the sum of the counterfactual earnings expected by each applicant. The timing of these extra earnings is however unclear, as we observed in our first report (for example at ¶76).
57. In this section we review the Applicants’ statements about competition and explain why we cannot reconcile those statements with their anticipation of substantial revenue gains.
58. The statements at issue are:
- a. under the factual scenario the merged entity “will continue to have an incentive to provide wholesale access to Sky services on the same terms” as the current terms (Buddle Findlay letter to Commission, 23 August 2016, at ¶16); and
  - b. “In the factual, the merged entity will set the price of wholesale access to Sky services on the same ECPR basis as Sky currently offers” (Buddle Findlay letter to Commission, 23 August 2016, at ¶17).
59. We interpret these statements as suggesting that:
- a. Sky currently offers Vodafone the same wholesale terms as are on offer to all other RSPs; and
  - b. Sky will continue to offer the same terms to all RSPs under the factual scenario.
60. The Applicants seem to be implying that Vodafone does not currently receive preferential terms of access to Sky’s content and will not receive preferential terms of access (compared with their current standard offer) if the transaction proceeds. If these claims were correct, we cannot understand how the Applicants could expect, as a consequence of the transaction, to earn an extra \$435m in revenue. There are only three possible ways of earning extra revenue:
- a. capturing more market share, but (since Sky is already optimising, as discussed at ¶47 above) that market share gain must mainly occur in telecommunications markets and the application (at ¶11.13) argues that “Pay TV offerings do not drive substantial changes in broadband market share”;
  - b. increasing retail prices, but there is limited scope for this given that Sky is already setting profit-maximising prices and Vodafone supplies workably competitive retail markets; and/or
  - c. up-selling existing customers to higher-value bundled products; but since Sky says that all RSPs will receive the same terms there is no need for an equity transaction to achieve this outcome.
61. We are left with a puzzle. If Sky is currently optimising its pricing and offering the same wholesale terms to all telecommunications RSPs, and will continue post-transaction to offer these

same terms including to its own telecommunications RSP division, we do not think it is possible for the merged entity to earn an extra \$435m relative to its un-merged components.

62. The Applicants argue that Sky's premium content is not a "must have" because all but one of the 80 plus RSPs in New Zealand have opted not to resell Sky's content.<sup>17</sup> We have explained the logical error in this analysis in section 2.5 above and we discuss at section 5.1 a more likely explanation for this very unusual situation.
63. Without access to the Applicant's redacted material, we can only deduce that the merged entity's pay-TV division will provide its telecommunications business with content on more advantageous terms than it offers to other RSPs, and through this arbitrage seek to obtain an advantage for its telecommunications business in the retail market

### 3.1 Incentives for the Merged Entity

64. The factual scenario would create a vertically integrated firm that holds an upstream monopoly over premium content for the time period relevant to competition analysis. This structure weakens and reduces the incentives for non-discriminatory wholesaling of the monopolised content.
65. If Sky wanted to be an active and non-discriminatory wholesaler of its monopolised content, it would have been readily able to do so without the proposed transaction. As our original report noted (at ¶50), under this model, Sky would be "*effectively recruiting a competitive layer of RSPs, each of whom would gain some benefit from selling Sky's content to their own customers*". This model is popular and successful in the payment card industry, where the international card networks that have recruited a layer of competing banks as their agents (e.g. Visa and MasterCard) have been materially more successful than card networks that do not use this model (e.g. Diners Club). As noted in the Plum report, this is also the model adopted by Sky in the UK.
66. Once merged, the incentive for this strategy of non-discriminatory wholesaling is severely weakened. The reason is that the upstream monopolist now has a second source of profit, namely profit from selling telecommunications services.
67. It is well known that in any vertical chain of production there is only one monopoly profit available: irrespective of where in the vertical chain that monopoly profit is collected, it cannot be increased because its size ultimately depends on the willingness of final consumers to pay for the products that embody the monopolised inputs. Thus, since NERA and Buddle Findlay claim that Sky TV is already optimising its pricing to fully exploit its premium content monopoly through its ECPR wholesale pricing and its retail pricing,<sup>18</sup> merging with Vodafone is unlikely to materially increase the monopoly rent accruing to that content.
68. However the merged entity does have the ability and the incentive to use its premium content monopoly in a way that is designed to increase its retail telecommunications market share, particularly in respect of high ARPU customers.

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<sup>17</sup> Application at 11.11 (a)

<sup>18</sup> See footnote 15 above. We also note that NERA concedes at ¶21 that Sky's pricing already includes monopoly rents.



## 4 Counterfactual Scenarios

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69. In our original report we considered a counterfactual in which Sky becomes a genuine (or enthusiastic) wholesaler of content. We developed a quantitative estimate of the value of such a strategy, based in part on the Applicants' argument that *"pay TV offerings do not drive substantial changes in broadband share"* (application at ¶11.13). However the NERA report, relying on redacted information, says (footnote 21) that the Applicants do not expect to gain most of the extra \$435m of revenue by upselling Sky to Vodafone's existing customer base. As discussed above (at ¶60) there are only a few ways in which extra revenue can be earned. If the expected revenue gains are not mainly from selling more pay TV services, or from selling more telecommunications services (because *"pay TV offerings do not drive substantial changes in broadband share"*) and the relevant telecommunications markets are competitive so prices cannot increase, then it is difficult to see how Grant Samuel could have forecast any material revenue gains.
70. NERA also consider (at ¶17) that Sky will not *"drop its wholesale prices and expand its wholesale business"* under the counterfactual because if that strategy was profitable *"it would have done so already"*. This ignores the role of new information and the fact that many markets do not adjust instantaneously. It brings to mind the old joke about the economist and a non-economist friend walking together; the friend points to a \$10 bill on the ground and the economist denies its existence because *"if there really was \$10 there, someone would have already picked it up"*. On NERA's logic, the timing of the proposed transaction itself is questionable: if the transaction is profitable, why did it not happen last year or in 2014?
71. The answer of course, as our original report made clear (see section 2.2.1), is that market developments have recently forced Sky TV to consider alternative strategies. The proposed transaction is one alternative strategy, but it is not the only one. If the transaction does not proceed, Sky TV will still be in need of a new source of growth. Recent history shows that a continuation of offering ECPR pricing to the 80+ RSPs that do not currently buy Sky's wholesale content is very unlikely to result in such growth.
72. This is also why we doubt that NERA's preferred counterfactual (NERA, ¶25), which is essentially business as usual, is likely to occur. The telecommunications and broadcasting sectors are both being constantly disrupted by technological advances; indeed, such advances are the reason that convergence is occurring. Business as usual is not likely to be an option except for firms that have substantial market power. As noted in the Minister's forward to the government's recent work on Convergence:<sup>19</sup>
- "...convergence provides businesses with the opportunity to expand into new services and products and new markets. In New Zealand we are seeing increasing competition across the sectors, and companies expanding into new areas. The increasingly global marketplace is seeing international barriers crumble as both providers and consumers find new and innovative ways of doing business."*
73. Indeed, any suggestion that a likely counterfactual is the status quo, or may not be dis-similar to the status quo, is unrealistic, and ignores the impact of convergence across the

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<sup>19</sup> Ministry for Business Innovation and Employment and Ministry for Culture and Heritage, Exploring Digital Convergence: Issues for Policy and Legislation, 2015.

telecommunications, information, media and entertainment sectors. As the Convergence Report notes:<sup>20</sup>

*The relationship between content creation and content distribution, which was previously close, is all but gone. Distribution is no longer a significant barrier for content creators. At the same time, consumers have more options for accessing desired content, thereby reducing the influence of distributors. The evolution of this relationship means that the business models of both content creators and content distributors are changing at pace.*

*For consumers, convergence means greater choice and lower cost. No longer bound to an individual provider for a specific service, today's consumers can select the devices that best suit their lifestyles and connect them to one or more network providers to access the services and content of their choice. New Zealand consumers can increasingly choose between either subscribing to a triple or quadruple play package (voice, video, data and mobile) from a single provider or mixing and matching service offerings from multiple different sources. Consumers are also increasingly at the centre of content service delivery, controlling not only what they view, but also when, where and how they view it.*

*For policy-makers and regulators, the emergency of new, converged services challenges existing policy and regulatory regimes. Rapid changes in technology create the risk that New Zealand's regulatory regimes may fall out of tune with changing business models and consumer expectations. It is important for regulators and policy-makers to enact legislation and policies that recognise ongoing convergence in the TIME sectors.*

74. Bearing in mind that NERA has access to the Applicants' confidential information (see NERA, footnote 13), there are further aspects of the counterfactual NERA describes on which comment is required.

#### **4.1 Reciprocal Arrangement?**

75. The NERA report and Buddle Findlay's letter of 9 September 2016 (at ¶25) state that Sky's wholesale pricing is based on ECPR. Buddle Findlay also claims that "*the terms that Sky offers to any other party interested in wholesale access to Sky services*" is the same as it offers to Vodafone.
76. Yet there seems to be a *two-way* arrangement in place between Sky and Vodafone: Vodafone is not merely a reseller of Sky, it is also being promoted by Sky in a referral arrangement that might be "*slightly altered*" (NERA, footnote 25) if the transaction does not proceed. The two-way nature of the relationship envisaged between Sky and Vodafone (under both the factual and counterfactual scenarios) raises barriers to Sky offering the *same terms* to any other RSP. These difficulties may not be insurmountable<sup>21</sup> but they do exist and it is surprising that NERA does not consider them.
77. From our external perspective, without any access to redacted information, it seems possible that even if Sky currently offers all RSPs the same terms as Vodafone for wholesale access to its

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<sup>20</sup> Page 4 of the Convergence Report.

<sup>21</sup> For example, it might be that Sky's website would be programmed to randomly re-order the list of RSPs that Sky resells so that none received an advantage by always being at the top of the list.

content, Sky then rebates some value back to Vodafone through the terms on which Sky refers customers to Vodafone, which terms are not offered to all RSPs.

## 4.2 Attitude to Wholesaling

78. The main difference between our views of the counterfactual scenario and NERA's view is that NERA believes that Sky will continue its stated strict adherence to the ECPR concept for setting the terms of access to its premium content, even though only one RSP currently finds these terms acceptable. Buddle Findlay expects the same continuation of ECPR terms.<sup>22</sup> The Applicants therefore see the current terms of access to Sky's content as sound predictors of the future terms of access under both the factual and counterfactual scenarios.
79. There is however a question whether the Applicants' claim that "*the terms Sky offers to any other party interested in wholesale access to Sky's services*" are the same as the existing arrangements with Vodafone, or indeed whether any such open offer exists at all. Our understanding is that 2degrees has not been able to obtain a copy of Sky's standard terms and conditions or prices. If these terms are indeed standard for all RSPs, we would expect them to be publicly available similar to a reference offer.
80. However, even relative to the status quo or near equivalent (such as NERA's counterfactual), the proposed transaction would substantially lessen competition by enabling and strengthening the incentives for the merged entity to provide its Vodafone division with access to its monopolised premium content on more favourable terms than it offers to other RSPs.
81. Evidence for this proposition includes the *absence*, in all of the material submitted by the Applicants, of any assurance that all RSPs could trade with Sky *on equivalent terms to Vodafone* now, and more importantly post-merger when the merged entity's incentives to benefit its telecommunications business will be much stronger (as discussed in section 3.1 above).
82. Instead, focusing on the current arrangements, we are told that:
- a. "*Sky's reseller arrangement with Vodafone, and the terms that Sky offers to any other party interested in wholesale access to Sky services, is priced on an ECPR basis*"<sup>23</sup>; and that
  - b. Under the counterfactual<sup>24</sup> "*Sky will continue to offer wholesale access to its pay-TV services at Sky's retail price, minus avoided cost, including restrictions on bundling Sky's pay-TV services with other pay-TV services, and restrictions on the acquisition of other content exclusive from Sky*".
83. The first quote omits reference to the benefits that Sky currently grants to Vodafone through its referral arrangement. The second quote suggests there will be no change under the counterfactual ("*...Sky will continue to offer...*") while also omitting reference to the benefits that Sky currently grants to Vodafone through its referral arrangement.

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<sup>22</sup> Buddle Findlay letter to Commerce Commission, 9 September 2016, paragraph 23.

<sup>23</sup> Buddle Findlay letter to Commerce Commission, 9 September 2016, paragraph 25(a).

<sup>24</sup> Buddle Findlay letter to Commerce Commission, 9 September 2016, paragraph 23.

84. Moreover, according to Buddle Findlay<sup>25</sup>, “*Sky’s incentives to provide wholesale access to Sky services are the same under the factual as under the status quo, and under the [redacted] counterfactual*”.
85. None of these statements, nor any others we have reviewed, contains any assurance that the merged entity would offer telecommunications RSPs equivalent terms to those it offers its own RSP division (i.e. Vodafone). The statements are clear that (under both the factual or counterfactual scenarios) Sky intends to continue to offer the unchanged terms to the 80+ RSPs which the Applicants say have opted not to resell Sky services. However, they are silent on how the merged entity’s pay TV and telecommunications businesses will deal with each other under the factual.
86. Based on currently available information, we are unable to determine whether the existing two-way relationship between Sky and Vodafone amounts, in substance, to strict ECPR pricing of Sky’s premium content on terms equivalent to those offered to Vodafone’s RSP rivals (see ¶77 above and section 5 below). We will comment further on this point when we have had access to the redacted material.
87. All of the counterfactual scenarios presented publically would be more competitive than the factual.

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<sup>25</sup> Buddle Findlay letter to Commerce Commission, 9 September 2016, paragraph 28.

## 5 Current Market Offers

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88. In this section we discuss:
- a. Sky's current resale offer to RSPs; and
  - b. the existing arrangements between Vodafone and Sky.
89. As already noted, there is insufficient information available to determine whether Sky is currently offering the same terms to all RSPs.

### 5.1 Sky's ECPR Resale Offer

90. Both NERA and Buddle Findlay state that Sky's current arrangements with Vodafone, and standing resale offers to RSPs are priced "*on an ECPR basis*", also described<sup>26</sup> as "*a retail minus avoided cost basis*". NERA (at ¶17) asserts that Sky's "*existing wholesale pricing approach (based on ECPR) is profit-maximising.*"
91. One of the mysteries of the status quo is that Sky's resale offer has been accepted by only one of more than 80+ potential RSPs customers. The Applicants claim this proves Sky premium content is not "*must have*"; while as NERA notes (at footnote 9) "*the four economic reports all make the claim that the fact only Vodafone resells SKY implies that SKY's wholesale pricing is too high*".
92. This raises the question whether SKY's retail discount does in fact equal the costs it avoids when the end customer is supplied by an RSP. The costs avoided would include customer acquisition costs, billing functions, satellite delivery costs and some proportion of call centre support.
93. We have not yet seen the redacted material, but anecdotal evidence suggests that the retail discount is very small. For the purposes of this report, we assume a retail discount in the order of \$5, which might well be less than Sky's avoided costs. This would be a complete explanation for other RSPs deciding not to accept the offer, as an equally efficient access seeker could not supply the service profitably on that basis. Vodafone for its part, given its size and scale, may have been prepared to bear that loss in order to achieve a wider strategic objective (such as a close partnering relationship with, and ultimate acquisition of, Sky).
94. We will provide a further report on this issue once we have been provided with access to the redacted information.

### 5.2 Cost Sharing Between Sky and Vodafone

95. NERA describes (at ¶5) as "*the existing arrangements between Sky and Vodafone, i.e., Vodafone resells Sky and Sky resells Vodafone*". We note that "*to be accurate*" NERA qualifies this statement in footnote 5 which says that "*the upshot is a bundle discount for customers, funded by both companies*" (emphasis added).
96. This joint funding of a bundle discount is inconsistent with the Applicants' claim that Sky offers the same ECPR-based terms to all RSPs. Under ECPR, the price offered to access seekers is the

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<sup>26</sup> Buddle Findlay letter of 9 September 2016 at paragraph 25(a) and 26(c).

highest possible price permitted under New Zealand law. If Sky is helping Vodafone to fund a bundle discount, it is not setting an ECPR price for Vodafone.

### 5.3 Vodafone's Free Sky Offer

97. Vodafone is currently<sup>27</sup> offering a very attractive bundle of Sky TV and telecommunications services that appears to be targeted at the customers of other fixed-line broadband RSPs who already have, or are willing to purchase the basic Sky TV package. The offer requires that customers

*“sign up for our Unlimited Broadband Data and Home Phone plan on a 12 month term, and have SKY Basic”*

98. In return Vodafone will provide either Sky Sports or SoHo without charge.

*“Get an all-access pass to the best the sporting world has to offer, right in the comfort of your living room. So whether you’re a rugby fan, love athletics or even keen on synchronised swimming, we have all the sport you can handle and more.*

*Or if watching the latest shows and movies is your thing, choose SKY SoHo instead.”*

99. To enjoy either of the offers above, customers need to sign up for Vodafone’s Unlimited Broadband Data and Home Phone plan on a 12 month term, and have SKY Basic. Vodafone also states the following.

*With this **exclusive** offer, we’ll also throw in MY SKY for the life of your plan, a brand new ADSL, VDSL or Fibre modem\* and free calling to five NZ mobile numbers^.*

*All up, you’ll save well over \$500^^ in 12 months through this deal. (emphasis added)*

100. Vodafone’s “unlimited broadband data and home phone” plan is priced at \$105/month. From our experience we understand that the profit margin for a plan of this type is around 20% of revenue once all RSP costs are included, so we assume a margin of \$21.

101. Once a customer has purchased the Sky basic package, Sky Sports can be purchased for an extra \$30/month. Assuming ECPR-based pricing, the wholesale cost of that Sky Sports component to Vodafone will therefore be around \$25/month. It is therefore likely that:

- a. Vodafone is losing money on this offer; or
- b. The offer is being “funded by both companies” as NERA suggest.

102. To the extent that this offer is a pre-view of the Applicants’ plans post-transaction, it raises the question whether Sky is offering the same terms to all RSPs, so that all RSPs can benefit from the joint funding of bundle discounts.

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<sup>27</sup> <http://www.vodafone.co.nz/freesky/>

103. Uptake rates on this offer, and the proportion of those taking the offer who choose Sky Sport rather than SoHo would provide the Commission with valuable insights.