

Sky/Vodafone: The  
Commerce Commission's  
identification of unresolved  
issues

Prepared for Spark

November 2016

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## Executive Summary

In this report, we compare the concerns about the potential harm to competition from the proposed acquisition by Sky of Vodafone New Zealand set out in the Commerce Commission's Letter of Unresolved Issues with those that have led competition authorities in Europe to require structural or behavioural undertakings before approving mergers involving pay TV operators controlling the rights to premium content.

The Commerce Commission is concerned that the merged entity would have an increased incentive to attract customers by offering attractive service bundles including pay TV content and mobile/broadband services and make buying Sky on a stand-alone basis less attractive. It would also have less incentive to provide wholesale access to its premium content to other operators who would therefore be unable to compete in the provision of such bundles. This could have a detrimental impact on competition as these operators would no longer provide an effective constraint in the telecommunications market.

Concerns about the use of control over premium content to foreclose – fully or partially – competition from rivals by denying them wholesale access on terms that would enable them to compete effectively in the provision of service bundles have been apparent in a number of mergers in Europe, and have required merging parties to divest premium content (such as Liberty Global in the Netherlands) or commit to offer wholesale access on appropriate terms to competitors (such as in Spain). The same concerns have been the reason for Ofcom's introduction of a wholesale must-offer obligation on Sky in the UK, covering Sky's two premium sports channels and requiring Sky to sell these to competitors for inclusion in their bundles at a substantial discount from the retail price. These measures were taken in markets where competition in the provision of pay TV services was much more developed, and/or where the party subject to the remedy had less control over premium content than is the case in New Zealand. Against this background, the Commission's concerns are pertinent and entirely justified.

We also consider the extent to which the continued wholesale supply of Sky's content on terms similar to those available at present – which the merging parties have claimed to have an incentive to provide – would be sufficient to address the Commission's concerns. We find that even if the merged entity would continue to offer wholesale access on these terms, for which there is no guarantee, this would be insufficient to permit effective competition in the provision of innovative bundles. Comparing the terms currently on offer with those of the wholesale must-offer obligation designed by

Ofcom explicitly to enable such competition highlights the shortcomings of the current arrangements, both in price and even more so non-price terms.

# 1 Introduction

In its Letter of Unresolved Issues (“the Letter”) of 31 October to Sky Network Television Limited and Vodafone New Zealand Limited, the Commerce Commission (“Commission”) set out its concerns about the impact of the proposed merger between Vodafone and Sky on competition in the provision of telecommunications services.

Specifically, the Commission stated that at this point it was not satisfied that the proposed transaction would not give rise to competition issues in the provision of telecommunications services as a result of vertical and/or conglomerate effects, given that

- *“the merged entity would have substantial market power by virtue of its portfolio of content, including premium content such as live rugby;*
- *the merged entity would have an increased incentive and ability to make buying Sky on a standalone basis relatively less attractive than buying it in a bundle (with mobile and/or broadband) offered by the merged entity, resulting in customers switching to the merged entity;*
- *the merged entity would have less incentive to enter into reselling arrangements than Sky would in the counterfactual, meaning rivals would be unable to offer bundles with Sky and mobile/broadband services or offer bundles as attractive as those offered by the merged entity; and*
- *as a result of the above, one or more rivals may lose customers to such an extent that they no longer provide an effective constraint in a telecommunications market, allowing the merged entity to profitably raise prices of a telecommunications service above levels that would prevail in the counterfactual.”*

These concerns persisted despite arguments put forward by the merging parties that the *“merged entity would continue to be incentivised to offer Sky content to TSPs on a similar basis to what is offered today.”*

We have been asked by Spark to compare the concerns raised by the Commission against those that have led competition authorities and regulatory bodies in other jurisdictions to intervene and clear transactions subject to divestments (such as in the Netherlands) or impose wholesale obligations – either as part of a merger (as in Spain) or under regulatory powers (as in the UK). Such obligations would be capable of addressing concerns about the potential for anti-competitive bundling, while preserving the scope for efficiency and welfare enhancing bundling strategies (by both the merged entity and competitors).

However, we understand that in New Zealand, the Commission does not have the power to impose behavioural obligations on the merging parties as a merger pre-condition<sup>1</sup> (though it could take account of, but not enforce, credible and non-revocable commitments by the merging parties to provide wholesale supply to telecommunication service providers (TSPs) when considering whether the proposed acquisition would lead to a substantial lessening of competition).

In this context, the merging parties have claimed that they would have an incentive to continue to make available Sky content on the wholesale terms that are available at present (though the Commission has – rightly – expressed doubts that this would be the case, as there are reasons for which the merged entity might offer worse terms than Sky does at the moment).

In any case, even if the current wholesale terms were available to TSPs post merger, we do not believe that this would mitigate competition concerns. The terms set out by Sky have not been sufficiently attractive for TSPs other than Vodafone to resell or retransmit Sky's services, and they will be even less suitable for supporting effective competition against a merged entity that is free to design innovative and highly attractive bundle offers.

The shortcomings of the terms that are currently on offer as a basis for effective competition are entirely obvious from a comparison with the wholesale offer remedy imposed by Ofcom in the UK.

The remainder of this report is structured as follows:

- In Section 2, we review a number of cases from other jurisdictions that clearly demonstrate that the Commission's concerns are pertinent and well-reflected in the practice of other competition authorities.
- In Section 3 we consider whether the current wholesale offer – which the parties claim they would continue to provide – would be sufficient to address the Commission's competition concerns; based on comparison with the wholesale must offer remedy designed by Ofcom in the UK, we find that this is not the case, even if the parties were to continue to make available wholesale supply on terms similar to those that are available at present.

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<sup>1</sup> We understand that in New Zealand, the Commerce Act 1986 permits the Commerce Commission to accept only structural undertakings such as the disposal of (tangible or intangible) assets, or of shares.

## 2 Competition concerns identified by the Commission are pertinent

In this section, we look at a number of European merger decisions and Ofcom's UK pay TV market investigation that addressed the same issues that are of concern to the Commission, namely the potential leverage of exclusive control of premium content (in particular high-value sports rights) to restrict competition through bundling.

In all of these cases, there have been structural or behavioural remedies, or direct regulatory obligations (even though the extent of control over premium content was less, and other safeguards to limit concentration of content were available or already in place).

In very general terms, the Commission's concerns are:

- first, that the merged entity would have an incentive to use its exclusive control of programming that is very attractive to its subscribers (premium sports) to offer triple or quadruple play bundles that would make it relatively unattractive to buy Sky's pay TV services on a stand-alone basis (which may be made less attractive); and
- second, that the merged entity would have an incentive not to supply this programming on a wholesale basis to other TSPs on terms that would allow them to compete effectively in the provision of bundled services (which would have to be better than those that are available at present, as we discuss in more detail in the next section).

As a result, competition in the provision of telecommunications services would be distorted or harmed.

Such bundling strategies can in appropriate circumstances have clear benefits for consumers, as the merging parties have pointed out. Nevertheless, it is equally well understood that bundling strategies in circumstances such as these can also have significant anti-competitive effects and result in foreclosure, and as Choi (2008) notes in particular in relation to mergers, "[b]lanket approvals of

*conglomerate mergers with the presumption that bundling is either pro-competitive or competitively neutral are certainly not warranted.*<sup>12</sup>

Therefore, the Commission's concerns are relevant and appropriate. They reflect those that have been expressed by other competition authorities and have formed the basis for both behavioural and structural remedies, or for explicit regulatory obligations to provide wholesale access to premium pay TV content to avoid harm to competition.

## 2.1 Ofcom's Pay TV market review and WMO remedy

### Overview

Ofcom's pay TV investigation – taking place over three years with extensive consultations and analysis, and resulting in the imposition of a wholesale must-offer obligation (WMO) on Sky in the UK – was triggered by complaints from BT, Setanta, Top Up TV and Virgin Media that without wholesale supply of Sky's premium content on

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<sup>2</sup> Choi, J P (2008), Mergers with bundling in complementary markets, *Journal of Industrial Economics*, Vol 56; Choi's model shows that "mergers with bundling in systems markets could entail both pro-competitive and anti-competitive effects. In the event of any foreclosure of competitors, however, conglomerate mergers with mixed bundling would be predominantly anti-competitive. Even in the absence of such foreclosure effects, there is no clear-cut answer to how mixed bundling by the merging parties would affect consumer and social welfare. With heterogeneous consumer preferences, some buyers gain and others lose. ... In general, conglomerate mergers would have different implications for competition depending on specific market conditions such as market shares of the merging parties in their individual markets, economies of scale due to avoidable fixed costs, ease of entry, etc. To sort out pro-competitive effects and anti-competitive effects of each conglomerate merger case, the relative magnitudes of these countervailing effects and the likelihood of the foreclosure of one or more competitors need to be assessed." There is a considerable body of literature looking at the potential pro- and anti-competitive effects of bundling, such as Carbajo, J, D De Meza and D Seidman (1990), A Strategic Motivation for Commodity Bundling, *Journal of Industrial Economics*, Vol 38; Bakos, Y and E Brynjolfsson (1999), Bundling Information Goods: Pricing, Profits and Efficiency, *Management Science*, Vol 45; Nalebuff, B (2005), Exclusionary bundling, *The Antitrust Bulletin*, Vol 50; Gans, J S and S P King (2006), Paying for Loyalty: Product Bundling in Oligopoly, *Journal of Industrial Economics*, Vol 54; Rey, P and J Tirole (2007), A Primer on Foreclosure, in Armstrong, M and R Porter (eds), *Handbook of Industrial Organization*, Vol 3; Carlton, D W, P Greenlee and M Waldman (2008), Assessing the anticompetitive effects of multiproduct pricing, *The Antitrust Bulletin*, Vol 53; Choi, J P (2008), Mergers with bundling in complementary markets, *Journal of Industrial Economics*, Vol 56; Peitz, M (2008), Bundling may blockade entry, *International Journal of Industrial Organization*, Vol 26; Mantovani, A (2013), The Strategic Effect of Bundling: A New Perspective, *Review of Industrial Organization*, Vol. 42.



appropriate terms they would not be able to compete effectively with Sky's bundle offers.

The WMO remedy was imposed in spite of the fact that Sky had been providing wholesale services to the cable operators since the 1990s, on the basis of a rate card that had been subject to previous scrutiny by the UK competition authorities.

Based on evidence from various sources (including survey evidence and data on prices paid for broadcasting rights), Ofcom found that sports, soap operas and movies were the most popular and valuable content to consumers,<sup>3</sup> with sports and movies having a high degree of exclusivity to pay TV. Ofcom found that Sky had market power in the wholesale supply of channels that included premium sports and movies.

Ofcom's consumer survey evidence found that sport was the most popular and valuable genre on TV. Football in particular was seen by a substantial majority of Sky's sports customers as a very important part of their sports subscription. Ofcom considered that "Sky's position in sport arises from the unique ability of broadcast TV to reach a large live audience, and Sky's control of the live broadcast rights for many of the most important sports"<sup>4</sup> and that the key sport content was on Sky Sports 1 and Sky Sports 2.<sup>5</sup>

Ofcom's concern was that Sky exploited its market power by restricting wholesale distribution of its premium channels to pay TV competitors who would need such channels in order to put together attractive pay TV bundles (and potentially develop wider service bundles). This is the same concern that has been expressed by the Commission, namely that the merged entity would have an incentive to attract customers by offering service bundles (with mobile and/or broadband) with which other TSPs could not compete effectively because they would not be able to obtain wholesale access to Sky's content on terms that would allow such competition.

For Ofcom, these concerns arose despite the fact that Sky was providing premium content to cable operator Virgin "as a result of a commercial agreement reached in the early 1990s when the

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<sup>3</sup> Ofcom, Pay TV Statement, March 2010 ([https://www.ofcom.org.uk/consultations-and-statements/category-1/third\\_paytv/statement](https://www.ofcom.org.uk/consultations-and-statements/category-1/third_paytv/statement)), Figure 21.

<sup>4</sup> Ofcom Pay TV Statement, paragraph 1.5.

<sup>5</sup> Sky Sports 3 and Sky Sports 4 offered content that was less crucial from a subscriber's perspective and therefore did not consider these two channels as a source of Sky's market power. Ofcom did note that imposing the remedy on Sky Sports 1 and Sky Sports 2 would run the risk that Sky would re-arrange content distribution across channels to undermine the remedy, however, it declared that should Sky do this Ofcom would review the remedy.

*negotiating positions were more evenly balanced, and following the competition case concluded by the Office of Fair Trading in 2002”.*<sup>6</sup>

However, more recent negotiations between Sky and Virgin Media for high definition versions of Sky’s premium channels revealed a pattern of non-supply, preventing fair and effective competition. Ofcom also noted that whilst the rate card prices for Sky’s premium channels might pass a simple ex-post margin squeeze test, this only served to show *“that retailing based on this wholesale price should be profitable at Sky’s scale, and at the level of the entire bundle of basic and premium channels.”*<sup>7</sup> Smaller competitors, or competitors who were not able to replicate Sky’s bundling proposition would not be able to compete effectively on the basis of rate card prices.<sup>8</sup>

More generally, Ofcom reviewed commercial negotiations between Sky and competitors and found that there had been number of attempted negotiations that were *“lengthy and ultimately fruitless”*.<sup>9</sup> Ofcom found patterns in Sky’s behaviour in negotiations that resulted in non-supply of key content and prevention of effective competition. Sky had a strong preference for self-retail and where this option was not available to it Sky appeared to have *“preferred to be absent from the relevant platform rather than to pursue wholesale supply.”*<sup>10</sup> Ofcom considered that Sky’s observed behaviour was driven by strategic incentives *“to protect its retail business on its own satellite platform”* and *“to reduce the risk of stronger competition for content rights”*.<sup>11</sup>

Ofcom considered that Sky’s restriction of distribution limited the ability of customers with a preference for platforms other than satellite or cable to access Sky’s premium channels, and could get these channels on the cable platform only in standard definition and without associated interactive services.

Ofcom also noted that *“[b]undles of TV and telecommunications services are becoming increasingly important .. [but that] if pay TV markets are not effectively competitive, there is a risk that the forms of reduced choice we set out above will extend into these wider bundles. Although there has been considerable innovation in the sector, much of*

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<sup>6</sup> Ofcom Pay TV Statement, paragraph 1.28

<sup>7</sup> Ofcom Pay TV Statement, Paragraph 1.29

<sup>8</sup> Ofcom said that it *“did not believe it to be a reasonable expectation for retailers other than Sky to be prepared to pay the rate card price for Sky’s Core Premium channels, as these prices would not allow them to compete effectively”* (paragraph 1.30, Ofcom Pay TV Statement)

<sup>9</sup> Ofcom Pay TV Statement, paragraph 1.25

<sup>10</sup> Ofcom Pay TV Statement, paragraph 1.26

<sup>11</sup> Ofcom Pay TV Statement, paragraph 1.25

*it has historically been of a type that suits Sky's satellite platform. Sky is unlikely to innovate in ways which are suited to platforms other than its own. This is a particular concern looking forward, given the significant benefits we see for consumers in the effective exploitation of new distribution technologies.*<sup>12</sup>

To address these concerns, Ofcom introduced remedies that obliged Sky to offer Sky Sports 1 and Sky Sports 2 to other pay TV providers at a rate set by Ofcom (and made a reference to the UK Competition Commission in relation to the supply of premium movies channel<sup>13</sup>). The aim of the wholesale must-offer obligation (WMO) was to ensure competitors could "*replicate Sky's broader bundles which contain core premium sports channels, recognising that many consumers now buy TV broadband and telephony as part of a wider bundle.*"<sup>14</sup>

#### Assessment

Though focusing on the market for pay TV services in the first instance, Ofcom's concerns closely mirror those put forward by the Commission:

- Ofcom found that competition in the provision of pay TV services happened over bundles of channels, and that Sky controlled one type of programming without which bundles could not effectively compete against Sky's proposition. This matches the Commission's concerns that Sky's premium TV content would be a key element of any multi-play bundle offered by the merged entity.<sup>15</sup>
- Ofcom found that Sky was reluctant to offer this crucial content on a wholesale basis on terms that would allow the wholesale customers to compete effectively at the retail level, in spite of existing wholesale arrangements that had been scrutinised by competition authorities in the past. Rather, Sky's strategy was to prioritise its own retail operations. This matches the Commission's concern that the merged entity would not be willing to supply access to its key content on wholesale terms that would support effective competition with its own retail offer of bundled services.
- Ofcom considered that effective competition would require that other suppliers should be able to design innovative

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<sup>12</sup> Ofcom Pay TV statement, paragraph 1.31

<sup>13</sup> Ofcom Pay TV Statement, paragraph 1.8

<sup>14</sup> Ofcom Pay TV statement, paragraph 1.67

<sup>15</sup> As noted above, Ofcom was of course aware of the growing importance of multi-play bundles, and considered that the imposed remedy would also benefit the development of a competitive supply of such bundles.

bundle offers rather than having to replicate the packages that were best suited to Sky's platform.

Compared with the case at hand, it is instructive to note that Ofcom decided to intervene in a market where wholesale supply of Sky's programming was available on terms previously reviewed by the UK's competition authorities, where cable had a substantial share of pay TV customers<sup>16</sup>, where other legislation was in place to protect access of free-to-air broadcasters to the rights to key sporting events<sup>17</sup> and where the holders of the most attractive sports rights had committed not to licence the pay TV rights exclusively to a single broadcaster.<sup>18</sup> Concerns about the potential leverage of exclusive premium content should be even stronger in New Zealand where the merged entity would control practically all pay TV subscribers, where wholesale supply is available on terms that are obviously unattractive for all but one TSP, and where no anti-siphoning provisions are in place.

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<sup>16</sup> At the end of 2009, Virgin Media had 3.7 million subscribers compared with Sky's 9.7 million – so more than a quarter of the market. In addition, BT Vision and TalkTalk had around half a million subscribers between them; Top Up TV did not disclose subscriber numbers (see Ofcom, Pay TV Statement, paragraphs 4.38 and 4.39)

<sup>17</sup> The UK Broadcasting Act 1996 empowers the Secretary of State to designate key sporting and other events as 'listed events' with the objective of ensuring that these events are made available to all television viewers, including those who might not be able to afford pay TV subscriptions. Currently, there are two classes of events covered by such a designation – Group A events which may not be covered live on TV on an exclusive basis unless some conditions are met, and Group B events where secondary coverage must be safeguarded. For more detail, see Ofcom, Code on Sports and Other Listed and Designated Events, [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0029/35948/ofcom\\_code\\_on\\_sport.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0029/35948/ofcom_code_on_sport.pdf). Article 14 of The Directive 2010/13/EU of 10 March 2010 on the coordination of certain provisions laid down by law, regulation or administrative action in Member States concerning the provision of audiovisual media services (Audiovisual Media Services Directive) enables Member States to "take measures in accordance with Union law to ensure that broadcasters under its jurisdiction do not broadcast on an exclusive basis events which are regarded by that Member State as being of major importance for society in such a way as to deprive a substantial proportion of the public in that Member State of the possibility of following such events by live coverage or deferred coverage on free television." Such measures are in place in a number of Member States.

<sup>18</sup> The Football Association Premier League gave undertakings in the context of an investigation by the European Commission under Article 81 (now Article 101 TFEU) relating to the sale of broadcasting rights that ensured, amongst others, that no single broadcaster could require all exclusive rights. The commitments can be found at [http://ec.europa.eu/competition/antitrust/cases/dec\\_docs/38173/38173\\_132\\_7.pdf](http://ec.europa.eu/competition/antitrust/cases/dec_docs/38173/38173_132_7.pdf)

## 2.2 Liberty Global/Ziggo merger

### Overview

In October 2014 the European Commission cleared the acquisition of Dutch cable operator Ziggo by Liberty Global, after having received a number of commitments that removed the European Commission's concerns about the competition impact of the transaction, including the merged entity's ability and incentives to foreclose retail competition through refusing to offer wholesale access to its premium film programming on terms that would enable effective competition. This reflects the Commission's concern about the prospect that the combined Sky/Vodafone post-merger would refuse to supply access to its key content in order to limit competition from other TSPs in the provision of service bundles.

Liberty Global, through UPC, owned and operated a cable network. It distributed premium sport and film channels (Sport1, Film1) and had launched as an MVNO. Ziggo also owned and operated a broadband cable network providing digital and analogue cable video, broadband and VoIP services. Ziggo also offered mobile service and, through a joint venture with a subsidiary of Time Warner/Home Box Office, Inc., ("HBO") operated a HBO-branded pay-TV channel and VOD service, which was distributed on a wholesale basis to other retail Pay TV suppliers in the Netherlands.<sup>19</sup>

The European Commission was concerned that the transaction, as notified, raised serious concerns in a number of relevant markets along the value chain for the distribution of audio visual TV content and the provision of telecommunication services in the Netherlands.<sup>20</sup>

Specifically the European Commission was concerned that the merger was likely to "*significantly impede effective competition*" in relation to

- the market for supply and acquisition of Premium Pay-TV channels (supply) in which it identified both horizontal and vertical concerns relating to the wholesale supply and acquisition of Premium Pay TV channels, notably the Premium Pay TV film channels; and
- the market for the supply and acquisition of Basic and Premium Pay TV channels (acquisition side) in which it identified that the merged party would have increased bargaining power vis-à-vis broadcasters and could use this

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<sup>19</sup> European Commission Decision of 10/10/2014, Case M.7000 - LIBERTY GLOBAL / ZIGGO)

<sup>20</sup> The European Commission had rejected the request from the Dutch competition authority to assess the merger not least because there was a "*need to ensure a coherent and consistent approach when assessing mergers in the converging TV-related and telecommunication sectors in different Member States falling under the Commission's competence...*" (European Commission Decision of 10/10/2014, Case M.7000 - LIBERTY GLOBAL / ZIGGO, paragraph 20).

power in a way that would have a detrimental impact on service provision and choice of TV content in the Netherlands, including in relation to OTT VOD services.

The European Commission was concerned that the merged entity would control the only two linear Premium Pay TV film channels in the Netherlands (Film1 and HBO Nederland), potentially allowing it to increase wholesale prices to retail TV operators, virtually all of whom took both Film1 and HBO Nederland.<sup>21</sup>

In addition, the European Commission looked at whether the merged party would have the ability and incentive to engage in partial or total foreclosure of retail competitors by refusing to provide Film1 and/or HBO Nederland or degrading the conditions on which the wholesale service was offered. Whilst HBO Netherlands would be unlikely to be used in such a strategy<sup>22</sup>, the European Commission considered that the merged entity would be able to foreclose competing downstream rivals by refusing to supply Film1, which could be a 'must-have' component of any attractive pay TV offering but in any case would be an important source of product differentiation.<sup>23</sup> The proposed transaction would increase the

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<sup>21</sup> The only exceptions were Vodafone, which did not offer Film1, and CAIW Holding B.V, which did not offer HBO Nederland. The European Commission argued that even though Time Warner/HBO would retain joint control over HBO Nederland and might have the ability and incentive to block HBO Nederland from engaging in any such strategy, Liberty Global would have an incentive to raise the wholesale price of Film1, making a greater margin on wholesale contracts from retained customers and maintaining wholesale revenues from any lost subscribers moving to HBO Nederland. HBO Nederland would then have an incentive to take an advantage of any demand switch by increasing its prices.

<sup>22</sup> This is because the other party in the joint venture, Time Warner/HBO, would have an interest in ensuring a wide distribution of the channel. Even though the merged party could offer to share some of the rents with Time Warner/HBO to align interests, this proposition would have to be offset against any potential reputational damage to Time Warner/HBO's global brand (European Commission Decision of 10/10/2014, Case M.7000 - LIBERTY GLOBAL / ZIGGO, paragraph 217).

<sup>23</sup> European Commission Decision of 10/10/2014, Case M.7000 - LIBERTY GLOBAL / ZIGGO, paragraphs 221-223

profitability of such a strategy, as the merged party would be operating over a larger footprint than Liberty Global alone.<sup>24</sup>

The European Commission was also concerned that, as the merged entity would control access to around 60-70% of the pay TV subscribers in the Netherlands it would have market power as a purchaser of the Basic and Premium TV channels that are included in such Pay TV subscriptions. Although acknowledging that any increased bargaining power could be beneficial for competition (lower input costs that could be passed through to consumers), it might cause harm as the merged entity might stifle innovation and demand terms that put competing pay TV retailers at a disadvantage.

Concerns in this regard focused on strategies to limit the development of OTT propositions, not least because there was some evidence that the merging parties had already sought to impose direct and indirect restrictions on the ability of broadcasters (such as RTL, SBS, Fox, Walt Disney and HBO) to develop OTT propositions.<sup>25</sup>

In order to gain approval, the merging parties committed:

- to divest the Film1 Business on terms of sale approved by the European Commission, not directly or indirectly to acquire or exercise influence over the whole or part of the Film1 Divestment Business for a period of 10 years, and to enter into a carriage agreement for the distribution of Film1 on the merged entity's Pay TV platform in the Netherlands on reasonable commercial conditions;
- not to enter into or renew agreements with TV broadcasters that contain terms which would directly or indirectly restrict the TV broadcasters' ability to offer their channels and associated content via OTT services.

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<sup>24</sup> The European Commission reviewed (and amended) modelling submitted by the Notifying Party, that considered the number of KPN subscribers within the merged party's cable footprint who could reasonably be expected to switch to the merged party's retail offering should they lose access to Film 1. On this basis, it found that the merged party would have a merger-specific incentive to engage in complete foreclosure of Film1 on competing retail Pay TV platforms. The European Commission also considered whether partial foreclosure would be profitable, and found that the resultant increase in the retail price of Film 1 would put downstream competitors at a disadvantage, so that the merged entity could engage in either full or partial foreclosure.

<sup>25</sup> The European Commission found that Ziggo had taken a more accommodating approach than UPC in this regard and was concerned that post-merger there would be a loss of the ability to negotiate less severe restrictions from one party. Moreover, in addition to using contractual terms to stifle OTT innovation the merged entity, providing internet access to around 43% of the Dutch population, could also use technical measures to restrict or degrade the distribution OTT services that included competing content (see European Commission Decision of 10/10/2014, Case M.7000 - LIBERTY GLOBAL / ZIGGO, paragraph).

The European Commission considered that these commitments were suitable to address its concerns, and approved the transaction.

*Assessment*

The European Commission's concerns highlight the importance of premium content – in this case, premium movies – in determining the competitiveness of competing pay TV retailers. The foreclosure analysis shows how merger-specific effects can arise even in relation to strategies that would have been open to one of the parties pre-merger – namely the use of Film 1 to foreclose competing pay TV retailers – because the merger changes the effect of such a strategy. It is also worth noting that the European Commission did maintain its view of the important role played by the merging parties' premium content and did not accept the parties' argument that the premium film channels or Sport 1 were not 'must-have' content.

This confirms that the Commission is right in considering that the merged entity would have a reduced incentive to offer Sky content on a wholesale basis because it faces a different trade-off post merger, gaining retail margin on the bundled services (including the retail margin on telecommunications services) by making wholesale terms less attractive.<sup>26</sup> Compared with the Netherlands, Sky's control over premium content is much stronger in New Zealand, where the merged entity would control only one of the two premium sports channels, and the two premium movie channels, though one of them only through a joint venture with TimeWarner/HBO.

## 2.3 Telefonica/DTS (Canal+) merger

*Overview*

On 22 April 2015, the Spanish Competition Authority CNMC approved the acquisition of DTS<sup>27</sup>, operator of the Canal+ pay TV platform in Spain, by telecoms incumbent Telefónica.<sup>28</sup> The approval decision was based on a number of undertakings extracted from Telefónica over a number of rounds to address the CNMC's concerns.

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<sup>26</sup> See paragraph 31 of the Commission's Letter.

<sup>27</sup> DTS is a media company that operates the pay-TV platform Canal + in Spain and is also active in the acquisition and production of content for pay-TV, in the dissemination of thematic channels (including Canal + 1, Canal + Liga and Canal + Liga2) and the sale of advertising. DTS has [90-100]% of its activities in Spain. [http://ec.europa.eu/competition/mergers/cases/decisions/m7313\\_120\\_2.pdf](http://ec.europa.eu/competition/mergers/cases/decisions/m7313_120_2.pdf) translated

<sup>28</sup> Telefónica, a 100% subsidiary of Telefónica SA, is the parent company of all subsidiaries of Telefónica Group operating in the media, audiovisual and multimedia sectors. Through the pay TV platform Movistar TV, Telefónica Group also offers pay-TV services in Spain. [http://ec.europa.eu/competition/mergers/cases/decisions/m7313\\_120\\_2.pdf](http://ec.europa.eu/competition/mergers/cases/decisions/m7313_120_2.pdf) translated



The CNMC's main concerns were that the concentration would:

- lead to a lessening of competition in the pay TV market, giving the merged entity a market share of 69% by subscribers and 85% by revenues; the CNMC found that the pay-TV market in Spain had been very dynamic during the last years, with the traditional leading player losing market shares and Telefónica playing the role of an aggressive competitor, acquiring premium content to position itself as the closest contender to DTS;
- change the competitive dynamics of the retail markets for electronic communication services, allowing Telefónica to offer service bundles including pay TV content from DTS, considering that the pay-TV component would be the main differentiator factor for bundles and a key driver to capture and retain subscribers in Spain.<sup>29</sup> The CNMC thought that Telefónica would be using its own IPTV platform in areas where it had deployed NGA infrastructure, relying on the stand-alone pay TV offer only in areas where it had no NGA coverage; this implied a service differentiation that made the stand-alone offer relatively less attractive so that it would essentially disappear in areas covered by Telefónica's NGA network;<sup>30</sup>
- affect the wholesale market of audio-visual content, because of the loss of DTS as the main player, with Telefónica's bargaining power for the acquisition of exclusive content rights increasing. This would give the firm the ability and incentive to foreclose the market, which would in turn produce exclusionary vertical effects on the pay-TV market and in the segment of bundled offers including pay-TV and electronic communications services, which would result in a significant competitive advantage for Telefónica;<sup>31</sup> and
- limit the commercial development of competing pay-TV channels, as Telefónica would have the ability and incentive to refuse wholesale access of third parties to thematic pay

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<sup>29</sup> CNMC, Expediente C/0612/14, Report from the Competition Directorate, <https://www.cnmc.es/es-es/competencia/buscadorde/expedientes.aspx?num=C%2f0612%2f14&ambito=Concentraciones&b=DTS&p=0&ambitos=Concentraciones,Recursos,Sancionadores+CCAA,Sancionadores+Ley+30,Vigilancia,Medidas+cautelares,Conductas&estado=0&sector=0&av=0>, paragraph 799.

<sup>30</sup> Ibid., paragraph 789

<sup>31</sup> Ibid., paragraph 797

channels produced by the merged entity, and could threaten to limit access to its broadcast/transmission platforms.<sup>32</sup>

These concerns are reflective of the same concerns raised by the Commerce Commission in the Sky/Vodafone merger. In particular, the potential damage to competition arising from the ability of the merged entity to offer service bundles with which others would be unable to compete effectively without having adequate access to the premium content controlled by the merged entity is at the heart of the concerns expressed in the Commission's Letter.

The CNMC eventually cleared the acquisition on the grounds that the remedies proposed by Telefónica would adequately address the competition problems identified.<sup>33</sup> In addition to commitments that Telefónica would not block or restrict access of competing internet-based pay TV operators to its network and to its customers<sup>34</sup> and commitments to reduce switching impediments in the pay TV market<sup>35</sup>, the merging parties also agreed to offer premium programming on a wholesale basis.

Specifically, Telefónica committed to offering third party pay TV operators wholesale access to a maximum of 50% of its premium channels at a price that would be set to "*ensure that Telefónica's retail offers are replicable and must prevent situations of margin squeeze.*"<sup>36</sup> Premium channels were defined as being "*those showing previously unseen, exclusive content from the major film and television*

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<sup>32</sup> Ibid., paragraph 802

<sup>33</sup> <http://merlin.obs.coe.int/iris/2015/6/article13.en.html>

<sup>34</sup> Specifically, Telefónica undertook to provide third-party operators with access to its Internet network in Spain with sufficient capacity and quality; not to use network and traffic management techniques in Spain that could discriminatorily degrade the flow of third-party video or similar data, and to negotiate interconnection agreements for the delivery of audiovisual content to its fixed or mobile broadband end users, on equitable, reasonable, transparent, objective and non-discriminatory terms. (CNMC, 22 April 2015, 'SUMMARY OF MERGER C/0612/14 TELEFÓNICA/DTS' pp2-3 <https://www.cnmc.es/es-es/competencia/buscadorde/expedientes.aspx?num=C%2fo612%2f14&ambito=Concentraciones&b=DTS&p=0&ambitos=Concentraciones,Recursos,Sancionadores+CCAA,Sancionadores+Ley+30,Vigilancia,Medidas+cautelares,Conductas&estado=0&sector=0&av=0http://merlin.obs.coe.int/iris/2015/6/article13.en.html>)

<sup>35</sup> Specifically, Telefónica committed to processing requests from its customers to end their subscription within a limited period of time (e.g. a maximum of 15 days for customers with unbundled services); waived the requirement for, and application of, minimum term clauses under certain circumstances; and undertook not to try to win back certain types of customers for a period of two months from the day when they had requested to end their service. Telefónica also undertook to maintain wholesale agreements for DTS services and not to try actively to sell to customers who were receiving DTS services from another provider.

<sup>36</sup> CNMC, 22 April 2015, 'SUMMARY OF MERGER C/0612/14 TELEFÓNICA/DTS'

*producers or live sporting events including first division football (Liga de Primera División), Spanish championship football (Copa de Su Majestad el Rey), the Champions League, the Europa League, the World Cup, the Basketball World Cup, Formula 1, Moto GP and the Olympic Games.*<sup>37</sup> The third party pay TV operator would have full discretion to choose which premium channels it would like to be included in the wholesale offer. This is obviously very different from the case of New Zealand, where Sky to date has offered essentially wholesale terms under which competitors would only be able to resell Sky's offer (on terms that are not commercially attractive) rather than to develop their own service bundles to compete with Sky.

Under the terms of the commitments, Telefónica would also not be allowed to acquire exclusive content in relation to some windows, such as video on demand for films and series, and would only be able for a maximum period of two years to acquire exclusive content with the total contract length limited to a maximum three-year period and not acquire exclusive transmission rights which it was not going to use; Telefónica would also waive any rights of first refusal relating to content it currently had.

In March 2016, Vodafone claimed that Telefónica had violated these commitments because it refused wholesale access to the Moto GP and Formula 1 feeds for the season tournament.<sup>38</sup> According to Vodafone Spain's Legal Director Pedro Peña the merger should have been banned and would have been in most EU countries. Furthermore, Mr Peña considers that the remedies are "*not only weak, lax and benevolent' but also 'unenforced'. As proof, he cited a similar situation with first division football, considering this to be a dark spot for the pay TV industry.*"<sup>39</sup> Mr Peña also raised concerns that Telefonica's share of the pay TV market, which had been growing slightly following the acquisition, could reach 100% "*in a couple of years.*"<sup>40</sup>

#### Assessment

The CNMC's concerns very closely reflect those expressed by the Commission: the combination of a strong player in the pay TV

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<sup>37</sup> CNMC, 22 April 2015, 'SUMMARY OF MERGER C/0612/14 TELEFÓNICA/DTS'

<sup>38</sup> CPI Journal Article, 22 March 2016, 'Spain: Vodafone accuses Telefonica of refusing access to motor sports feed'  
<https://www.competitionpolicyinternational.com/spain-vodafone-accuses-telefonica-of-refusing-access-to-motor-sports-feed/>

<sup>39</sup> CPI Journal Article, 22 March 2016, 'Spain: Vodafone accuses Telefonica of refusing access to motor sports feed'  
<https://www.competitionpolicyinternational.com/spain-vodafone-accuses-telefonica-of-refusing-access-to-motor-sports-feed/>

<sup>40</sup> MARCA News Article  
<http://www.marca.com/motor/2016/03/17/56eaa26c22601dfa5e8b4653.html>  
translated

market, controlling premium content, with a strong telecoms operator could substantially harm competition in the telecommunications market and in the provision of bundled services. The merged entity could offer bundles of pay TV and telecoms services that other competitors would be unable to replicate, given DTS's and Telefónica's control of premium content, with the stand-alone pay TV offer remaining only a fall-back option in areas where the merged entity lacked NGA coverage to supply the modified service over IPTV. These concerns could only be addressed through commitments that guaranteed competitors wholesale access to premium content on an unbundled basis and on terms that would pass a margin squeeze test. In addition, the undertakings that the merging parties had to offer in order to gain approval included commitments not to acquire specific types of content and to limit the duration of rights.

Even so, these commitments appear to have been not fully enforceable and thus not fully effective.

Comparing this case with the case at hand, it is instructive to note that the CNMC was concerned about potential anti-competitive bundling in a more competitive pay TV market than exists in New Zealand.

About a year earlier, the European Commission had approved the acquisition of ONO by Vodafone in Spain (notified on 23 May 2014)<sup>41</sup> with no competition concerns. The transaction combined Vodafone's and ONO's complementary mobile and fixed networks in Spain, where Vodafone provided fixed and mobile services but did not have a pay TV offer and ONO provided pay TV, fixed and mobile services, but as an MVNO. Considering that the proposed transaction could raise horizontal competition concerns, the European Commission looked in detail at the retail supply of fixed Internet services, mobile telecommunications services and fixed voice services, but found no issues, given that the merged entity would continue to be subject to effective competitive constraints.<sup>42</sup>

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<sup>41</sup> Vodafone Group Plc ("Vodafone", UK) would take control of the whole firm *Grupo Corporativo ONO S.A.* ("ONO", Spain), by purchase of shares. Considering the turnover of the involved parties, the operation was considered to have a European Union dimension so the case was handled at EU level. European Commission, Decision of 2 July 2014, VODAFONE/ONO, Case M.7231, paragraph 802, [http://ec.europa.eu/competition/mergers/cases/decisions/m7231\\_20140702\\_20310\\_4002660\\_EN.pdf](http://ec.europa.eu/competition/mergers/cases/decisions/m7231_20140702_20310_4002660_EN.pdf)

<sup>42</sup> According to the European Commission, the retailed fixed voice services market was analysed because the combined Market share of both parties in the residential segment was close to 20% in 2013 and above 20% in 2012. See paragraph 85, *Ibid.* The European Commission also looked at a number of wholesale markets but identified no competition concerns.

Looking at potential conglomerate effects<sup>43</sup>, the European Commission considered that even though the transaction would eliminate a competitor from the multi-player segment, there were several alternative operators that would continue to offer bundles. It found that *"the merged entity would not have the ability to foreclose competitors from offering elements of fixed or mobile telecommunications services to create multiple play bundles"*<sup>44</sup> and that the acquisition in fact create a stronger competitor to Telefónica.

## 2.4 Vodafone/Liberty Global

### Overview

In August 2016, the European Commission cleared a proposed joint venture under which Vodafone Netherlands and Liberty Global subsidiary Ziggo would merge their operating businesses after having received a commitment that the merged entity would divest Vodafone's fixed line business in the Netherlands. This commitment was given to address the European Commission's concerns that otherwise the merger would pose a danger to competition by removing a new entrant who could play an important role in the provision of innovative service bundles. The Commission has expressed similar concerns in relation to the potential threat to the development of innovative service bundles and the loss of smaller TSPs, albeit not as a direct result of the merger but rather as a consequence of foreclosure strategies that would prevent them from achieving efficient scale.

The joint venture between Vodafone, which provided retail fixed line telephony, broadband internet and TV services in addition to its mobile communications service in the Netherlands, and cable operator Ziggo, which owned and operated a cable network, provided fixed telephony, broadband internet and TV services over cable, and mobile service as a mobile virtual network operator, had been announced in February and notified to the European Commission given the turnover of the parties involved.

The European Commission considered<sup>45</sup> that Vodafone had the potential to become a strong competitor in the provision of fixed line and fixed-mobile multiple play services and that the proposed

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<sup>43</sup> European Commission, Decision of 2 July 2014, VODAFONE/ONO, Case M.7231 paragraph 167

<sup>44</sup> European Commission, Decision of 2 July 2014, VODAFONE/ONO, Case M.7231, paragraph 181.

<sup>45</sup> As in the Liberty Global/Ziggo case, the Commission had rejected a request from the Dutch competition authority to be allowed to assess the merger, arguing that *"given its extensive experience in assessing cases in the telecommunications sector, and the need to ensure consistency in the application of merger control rules in this sector across the European Economic Area (EEA), it was better placed to deal with this case."*

transaction would eliminate the benefits from these developments. The full decision has not yet been published, so detailed information about the European Commission's reasoning is not available. The press release however states that the European Commission *"assessed the transaction against the backdrop of current access obligations in the Netherlands and had concerns that the merger, as initially notified, would have reduced competition in the markets for fixed multiple play services and for fixed-mobile multiple play services in the Netherlands. The merger would have removed Vodafone as a player with the potential to exercise a strong competitive constraint in these markets. This would likely have led to higher prices and reduced competition on the markets."*<sup>46</sup>

However, the proposed divestment of Vodafone's consumer fixed business in the Netherlands<sup>47</sup>, which accounted for a very small share (1-2%) of Dutch broadband subscribers<sup>48</sup> addressed these concerns. The transaction was cleared conditional upon this divestment as the European Commission considered that the divestment of the fixed business would allow the purchaser of the divested assets to play a competitive role similar to that of Vodafone before the merger: *"The divestment entirely removes the overlap between the activities of Vodafone and Liberty Global in the markets for the provision of fixed and fixed-mobile multiple play bundles and so addresses the identified competition concerns."*<sup>49</sup>

In the wake of the decision, the Dutch telecoms regulator launched a consultation asking for industry input as it considered that the merger would change competition in the telecoms sector and might require a new market analysis to be conducted early.<sup>50</sup>

#### Assessment

The concerns expressed by the European Commission indicate the importance of multi-play bundles in the electronic communications sector and suggest that even small competitors are an important element of such competition.

This confirms the Commission's concerns about the potential impact on competition in the provision of telecommunications services in the case that some of the smaller TSPs would not be able to compete effectively with the merged entity owing to customers

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<sup>46</sup>European Commission - Press release, 3 August 2016

<sup>47</sup> European Commission - Press release, 3 August 2016. Available at: [http://europa.eu/rapid/press-release\\_IP-16-2711\\_en.htm](http://europa.eu/rapid/press-release_IP-16-2711_en.htm);

<sup>48</sup> See <https://technology.ihc.com/573399/vodafone-and-liberty-combine-to-create-netherlands-quad-play-giant>; subscriber numbers at the sale were reported to be around 150,000 (<http://www.totaltele.com/view.aspx?ID=495460>)

<sup>49</sup>European Commission - Press release, 3 August 2016

<sup>50</sup> "ACM vraagt input van de markt bij vooronderzoek marktanalyse telecom", 19 September 2016 (<https://www.acm.nl/nl/publicaties/publicatie/16308/ACM-vraagt-input-van-de-markt-bij-vooronderzoek-marktanalyse-telecom/>)

being attracted by multi-play offers including premium pay TV programming that such competitors would be unable to replicate.

## 2.5 Summary

In this section, we have reviewed a number of structural and behavioural remedies in merger case and Ofcom's intervention in the pay TV market that were aimed at supporting effective competition in the provision of innovative service bundles by removing the risk that suppliers controlling key inputs into such bundles – premium pay TV content – could stifle such competition by refusing to supply such content to competitors, or setting terms that would not enable them to compete effectively. These are precisely the concerns that the Commission has identified in its Letter.

Undertakings were required and obligations were imposed in markets with a more competitive pay TV supply and/or less complete control over key content than is the case in New Zealand, and where other safeguards potentially limiting the acquisition of exclusive broadcasting rights to key events were available or in place.

- In the UK, Ofcom imposed a wholesale must-offer obligation and set a wholesale charge level to address concerns about Sky exploiting its control of premium sports programming in a way that would prevent competitors from establishing attractive service bundles, in spite of the fact that the existing wholesale supply arrangements had allowed Virgin media to gain more than a quarter of pay TV subscribers.
- The Spanish competition authority cleared the acquisition of DTS by Telefónica only after the merged entity had committed to provide wholesale access to at least half of its premium channels on an unbundled basis, with wholesale customers free to decide what content they wanted, and on terms that would ensure that they could earn a sufficient margin, even though the merged entity would have less than 70% of subscribers (albeit 85% of pay TV revenues, reflecting its control of premium programming); even so, there have been complaints about non-compliance with these undertakings; In this regard, it is worth mentioning that similar undertakings given by Canal Plus/TPS in order to obtain clearance of their merger from the French competition authority in 2006 were not honoured, resulting in a fine of €30 million and a revocation of the merger authorisation by the authority in 2011.<sup>51</sup>
- The European Commission approved the merger of Liberty Global and Ziggo only after the merged entity had

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<sup>51</sup> Canal Plus fined €30 million for TPS merger, <http://www.digitaltveurope.net/15372/canal-plus-fined-e30-million-for-tps-merger/>

committed to divest one of its two premium movie channels, even though the merged entity would have controlled only one of the two premium sports channels; control of the remaining premium movie channel was through a joint venture with TimeWarner/HBO, and the merged entity controlled access to no more than 70% of pay TV subscribers in the Netherlands.

- The tie-up between Vodafone and Liberty Global was approved only subject to the divestment of Vodafone's fixed line business, given concerns about the potential damage to competition in the development of innovative service bundles, even though Vodafone had only a very small share of Dutch broadband subscribers.

These comparisons suggest that the Commission's concerns about potential harm to competition in New Zealand, where Sky's market position in the provision of pay TV services and its control over key content rights are much stronger, are pertinent and entirely justified.



## 3 Sky's current wholesale offer would not address competition concerns

In this section, we consider whether wholesale supply of Sky's programming on terms similar to those available today – which the merging parties claimed they would have an incentive to continue to supply – could address the Commission's concerns and enable effective competition from other TSPs. Comparing the terms of the current wholesale offer with those of the WMO designed by Ofcom with the express purpose of supporting competition in the provision of innovative service bundles, we concluded that this is not the case. Rather, the current offer would limit TSPs to replicate Sky's stand-alone offer, on terms that are not commercially attractive even at present. As the merged entity would have the full flexibility of designing innovative service bundles and adjust Sky's standalone offer in order to cater for those customers who are not attracted by such bundles, allowing TSPs to resell or retransmit Sky's standalone packages without modification will not enable them to compete effectively with the merged entity.

*Continuing availability of Sky New Zealand's current wholesale offer*

The merging parties have stated that they would continue to make Sky programming available on a wholesale basis on the same, or similar, conditions as those that are available at the moment. They argue that these conditions allow commercially rational TSPs (such as Vodafone) profitably to resell Sky's services. The merging parties assert these terms are commercially attractive, and stress the fact that Vodafone is the only TSP to make use of this wholesale supply at present only shows that access to Sky's programming is not essential for TSPs to compete effectively. The implication is that continued supply of Sky's services on the same or similar wholesale terms, would be sufficient to protect competition.

However, these arguments ignore a number of crucial facts:

- the current wholesale terms are insufficient to provide effective competition to Sky at the retail level;
- the competitive landscape will change with the merged entity having complete flexibility in the design and pricing of service bundles that other TSPs would not be able to replicate on the basis of the current wholesale offer (let alone replicate profitably); and
- the current wholesale offer is tied closely to Sky's stand-alone proposition rather than providing unbundled access to core content, and would thus be affected by changes that the merged entity might make to this in combination with its design of bundled offers.

This means that even if the merged entity would continue to make available Sky's content on the terms currently on offer – for which



bundle provided by the merged entity rather than ceasing to purchase television services (or purchase them from another TSP via a resale/retransmission arrangement).

*Comparison between the Sky/Vodafone offer and Ofcom's WMO remedy*

It is instructive to compare this wholesale offer against the wholesale must-offer obligation (WMO) that Ofcom in the UK designed specifically in order to allow competitors to compete with Sky's retail bundles.

- The WMO covered Sky's core premium sports channels (Sky Sports 1 (SS1) and Sky Sports 2 (SS2), both individually and as a package) for inclusion into bundles over which the wholesale customer had complete flexibility;
- Sky was required to produce a Reference Offer which would be available to any customer who met a set of minimum qualifying criteria; though Sky could negotiate bespoke terms, the Reference Offer would have to be capable of working as a supply agreement without the need for negotiation bespoke terms;
- As part of the qualifying criteria, Sky could set technology-agnostic minimum security requirements in order to protect its content (rather than having to agree to specific solutions that the wholesale customer might implement for encryption and protection).
- The Reference Offer would have to specify details of the technical and operational arrangements for interconnecting with Sky, such as the interfaces that Sky would present to retailers to allow them to take delivery of the programming and associated data feeds and arrangements for possible equipment co-location and operational processes.
- Whilst the Reference Offer might include rules governing the editing, re-sizing or overlay of interactive and other content (e.g. because Sky may have obligations to upstream rights holders), such rule would have to be fair, reasonable and non-discriminatory, and be set out clearly in the Reference Offer (not least because Ofcom considered that overlay of interactive content is a key for innovation).
- The price of the wholesale supply was determined by Ofcom using a retail-minus methodology in order to establish a retail margin (in absolute terms) that would have to be subtracted from the corresponding retail price, which in turn was derived from the retail prices of channel bundles that included Sky's core premium sports channels.

Leaving aside the restrictive conditions of the current wholesale terms offered by Sky in New Zealand, the wholesale price itself is unlikely to be set at a level that would permit effective competition from other TSPs.

Sky claims to have determined its wholesale prices using the Efficient Component Pricing Rule (ECPR). Broadly speaking, this

involves subtracting the cost that Sky would save if a customer were served by one of its wholesale customers rather than directly by itself. Put differently, the ECPR price is obtained by subtracting the avoided/incremental retail costs from the retail price of the service.

We are obviously not in a position to establish the level of Sky's avoided retail cost, but note that the magnitude of these costs as a proportion of the retail price that is implied by the offer appears to be [ ] with the avoided retail costs established by Ofcom as the result of a detailed cost modelling exercise.

Specifically, the retail margins established through Ofcom's analysis are between 55% (for the bundle of SS1 and SS2) and 61% (for SS1 or SS2 on a standalone basis) off the retail price of Sky's premium sports channels in the UK.

Although these results are clearly not directly applicable to Sky's New Zealand business, [ ]

*Ofcom's approach to establishing the retail margin*

Ofcom aimed at providing competitors with wholesale access to the two prime sports channels on an unbundled basis (i.e. without having to acquire other programming typically sold by Sky in packages including the two sports channels). This necessarily implies differences in the approach taken, as the incremental cost associated with offering the channels as part of wider retail packages rather than as stand-alone wholesale channels are difficult to establish.

Ofcom started from an imputed retail price for SS1 and SS2, by calculating a subscriber-weighted average retail price<sup>53</sup> of packages that included the relevant Core Premium Sports product and no other Core Premium channels or non-pay TV products.<sup>54</sup> It then aimed to calculate what would essentially be 'ex-factory' prices, for

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<sup>53</sup> To capture the fact that consumers often do not pay the headline published prices for a given retail package, Ofcom applied Sky's average customer discount (assuming that Sky's total discounts as per its management accounts were spread equally across its subscriber base).

<sup>54</sup> Ofcom noted that although the intention of the wholesale must-offer remedy was to allow other retailers access to Sky's Core Premium Sports packages to enable them to compete with Sky's retail bundles, it has not made any allowance for the costs and revenues of other services that Sky bundles with Core Premium Sports packages. There was, therefore, a risk that competitors might not be able to replicate Sky's broader bundles (e.g. 'triple play' offers including TV, broadband and telephony). Ofcom would be concerned if the incremental price of an additional product in Sky's bundles were below its long run incremental cost, and would test for this if potential exclusionary bundling by Sky would become an issue in the future. Ofcom proposed to adjust wholesale prices by subtracting the amount by which incremental costs exceeded the incremental price if a bundled product priced in such a manner was sold to a material number of subscribers (for example, 5% of Sky's retail subscriber base).

SS1 and SS2 by deducting the costs that Sky would avoid by offering SS1 and SS2 on a wholesale basis compared with offering them as part of a retail channel package.<sup>55</sup> In doing so, Ofcom had to engage in a number of cost allocation exercises:

- First, it had to allocate costs incurred by Sky across the UK and Ireland to the UK business. No such allocation would be required when looking at the cost avoided by Sky New Zealand;
- Second, given the choice of establishing prices for SS1 and SS2, Ofcom had to allocate some retail costs that were common across the different elements of the service bundles offered by Sky to SS1 and SS2 specifically (for example, customer acquisition and transmission costs). When looking at Sky New Zealand's wholesale offer, which covers the full channel package offered by Sky to its retail customers, no such allocation would be necessary.
- Third, Ofcom also allocated some costs that were common across Sky's retail, wholesale and platform business to the respective business units.

This means that Ofcom essentially used a retail-minus methodology on a Fully Allocated Cost (FAC) basis, including an allocation of costs between Sky's retail, wholesale<sup>56</sup> and platform functions, rather than a strict ECPR approach using only incremental cost.

*Ofcom had considered that deducting only incremental costs "would be broadly equivalent to implementing the Efficient Component Pricing Rule (ECPR) which aims to ensure (under some relatively strict assumptions) that a vertically integrated wholesaler/retailer is indifferent between supplying its own retail arm and a competing retailer. Under this approach, if a large proportion of retailing costs were common (for example common across retail and wholesale businesses) then we would only make a relatively small deduction for retailing costs. However, adopting the ECPR approach would mean that a competing retailer paying the resulting wholesale price would only be able to recover a small proportion of its retailing costs if it were to match Sky's retail prices, making it unviable unless it recovered all its common costs from other lines of business. We do not believe that this approach would meet our objective of ensuring fair and effective competition."<sup>57</sup>*

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<sup>55</sup> Ofcom took Sky's own costs as the best available proxy for an efficient competitor, but made a scale adjustment, which looked at the number of subscribers a competitor to Sky might be able to realistically gain, with smaller scale implying higher retail costs per subscriber and therefore lower wholesale prices.

<sup>56</sup> Sky had offered wholesale programming to cable operators for more than two decades on the basis of a rate card that was scrutinised by the UK competition authorities on a number of occasions.

<sup>57</sup> Ofcom Pay TV Statement, paragraph 10.124, p 540

By contrast, a methodology that takes into account both incremental costs and a portion of common costs would encourage entry where a pure ECPR approach would not, and would also increase the incentives of competitors to innovate and invest. Ofcom noted that that the OFT had also allowed for an allocation of common costs across Sky's retail and wholesale function to the retail activity in its 2002 margin squeeze case, and *"that Sky does not appear to disagree with the approach of allocating a proportion of common costs. The key question remaining is therefore not whether common costs should be taken into account, but the amount to be recovered from Core Premium Sports packages."*<sup>58</sup>

In any case, it is not obvious what impact the allocation of common costs across the retail, wholesale and platform business would have on a similar analysis of Sky in New Zealand. Given the rather limited scale of its wholesale operation or platform business (allowing third party pay TV providers to operate through its infrastructure), many of the costs that would have been considered 'common' in the UK case would be attributable to Sky's retail activity in New Zealand.<sup>59</sup>

It is worth emphasising that Ofcom established an absolute retail margin, which was subtracted from the (imputed) retail price to yield the wholesale charge that Sky was permitted to levy. The imputed retail price included the discounts that Sky's retail customers were effectively enjoying. By contrast, the current Sky New Zealand offer does appear to be based on the undiscounted headline price. Whilst under the UK system increases in the effective discount offered to retail customers would translate into reductions in the wholesale price, there would appear to be no such effect in New Zealand. If this were the case, Sky could increase headline prices, and thus wholesale prices, whilst offering discounts to its customers, putting wholesale customers at a further disadvantage.

In terms of avoided costs, Ofcom considered:

- programming costs, incurred in licensing and producing channels which were not provided on a wholesale basis, but

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<sup>58</sup> Ofcom Pay TV Statement, paragraph 10.126-127, p 541

<sup>59</sup> At present, the large majority of Sky's pay TV customers in New Zealand are direct retail subscribers: according to digitaltvnews.net, at the end of 2014 around 120,000 of Sky's 860,000 subscribers – or around 14% - were wholesale subscribers through Vodafone and – then – Spark (see <http://www.digitaltvnews.net/?p=25573>). (see footnote **Error! Bookmark not defined.**). Sky's annual report shows a revenue line titled "Other revenues", which include commercial revenue earned from SKY subscriptions at hotels, motels, restaurants and bars throughout New Zealand, revenue derived from transmission of programming for third parties and revenue from other subscription services such as NEON, FAN PASS and IGLOO, which accounts for around 8.5% of total revenues in 2015/16. This suggests at best a very small scale platform business.

included in the retail packages used for establishing the relevant retail price; however, given that these costs related to basic programming only, their contribution to avoided retail costs were small;<sup>60</sup>

- marketing costs, which were allocated to retail, wholesale and platform functions;
- subscriber management costs, covering the cost of operating call centres and subscriber management IT systems as well as technical platform services (e.g. conditional access and electronic programme guide charges); and
- transmission costs, incurred in the delivery of the service to customers (e.g. satellite transponder costs); and
- administration costs, which depend (amongst other things) on the scale of the retail business.

Given that at a high level the cost structures of Sky's business in the UK and Ireland (as used in Ofcom's analysis) and in New Zealand appear to be broadly similar (see Annex A) there is no obvious reason to expect that the level of discount from the retail price that allowed TSPs in New Zealand to compete effectively would be substantially different.

In summary the current wholesale offer does not appear to support effective competition from other TSPs in the provision of innovative service bundles on the basis of its price terms, and even less on the basis of the non-price terms.

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<sup>60</sup> Ofcom Pay TV Statement, Figure 138 and accompanying text.

## Annex A Sky's costs in the UK and in New Zealand

The tables below show the breakdown of Sky's operating costs from Sky's annual reports for the UK and Ireland for 2008 – 2010, and for New Zealand for 2014 – 2016 respectively.

Table 1: Sky UK and Ireland Operating Costs (GBPm)

	2008	2009	2010	% of total (average)
Programming	1,713	1,750	1,902	39%
Subscriber management and supply chain	700	662	655	15%
Transmission, technology and networks*	542	726	892	16%
Marketing	743	907	1,118	20%
Administration*	530	501	518	11%
Total	4,228	4,546	5,085	

\* "Administration costs include depreciation, channel management, facilities, other central operational overheads and the expense recognised for awards granted under our employee share option schemes."

Source: Sky UK & Ireland Annual Reports

Table 2: Sky New Zealand Operating Costs (NZ\$m)

	2014	2015	2016	% of total (average)
Programming	280	296.6	331.1	45%
Subscriber related costs	104.7	107.1	106.3	16%
Broadcasting and infrastructure	88.5	91.2	96	14%
Other costs*	56.8	52.9	69.5	9%
Depreciation, amortisation and impairment	126.1	119.2	100.2	17%
Total	656.1	667	703.1	

\* Other costs include advertising costs, the overhead costs relating to corporate management and the affiliated businesses such as IGL00 and FATSO. These costs increased in 2016 due mainly to the professional fees of \$13.4 million in relation to the planned acquisition of Vodafone NZ

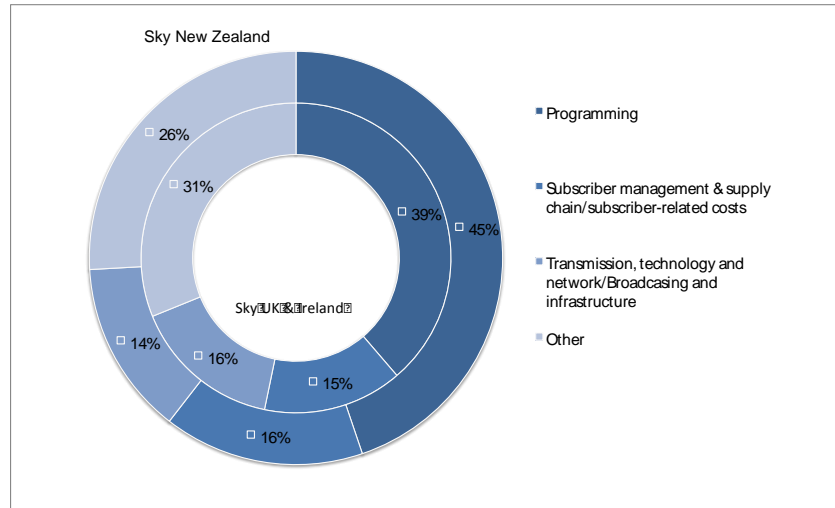
Source: Sky New Zealand Annual Reports

Although the cost categories cannot be matched up exactly, and in particular the breakdown of costs other than those related to



programming, subscriber management and broadcast transmission is not directly aligned, the overall structure looks broadly comparable, as Figure 1 suggests.

Figure 1: Comparison of cost structures for Sky New Zealand and Sky UK & Ireland



A somewhat greater proportion of Sky's cost in New Zealand are accounted for by programming, and a correspondingly smaller proportion falls into the 'Other' cost categories (which includes marketing and advertising costs), with the proportion of operating expenditure accounted for by subscriber management and transmission being fairly similar.