Matthew Dunning KC | BARRISTER

M E M O R A N D U M

TO: Troy Pilkington and Petra Carey, Russell McVeagh

FROM: Matthew Dunning

DATE: 11 July 2023

SUBJECT: **MICROSOFT/ACTIVISION BLIZZARD; STATEMENT OF ISSUES**

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1. I refer to our discussions regarding the application for clearance from the Commerce Commission for the above transaction.

2. My opinion has been sought regarding aspects of that application, in particular the Commission's Statement of Issues ("**SOI**") dated 20 June 2023 and the appropriate legal tests that should be applied under the Commerce Act 1986 (the "**Act**"). I have been provided all relevant materials, including:

   (a) the application for clearance dated 13 June 2022,

   (b) a number of RFI responses provided on behalf of the applicant,

   (c) the decisions of various overseas regulators regarding the proposed transaction in their jurisdictions, and

   (d) the submission on behalf of the applicant in respect of the SOI, dated 4 July 2023 ("**SOI Response**").

3. In short:

   (a) the proposed transaction plainly raises no issues of horizontal (unilateral, or coordinated) effects or conglomerate effects in any relevant market, and the SOI acknowledges that (at [5] and [81]), but

   (b) the issue is postulated whether, nonetheless, the Commission can be satisfied that a substantial lessening of competition would not be likely to result because of vertical effects, namely by virtue of the merged entity partially or fully foreclosing rivals in respect of gaming consoles and/or cloud gaming services.

4. It is accepted that the concept of foreclosure needs both ability and incentive for it to occur (and even if so, consideration of what the effect could be). In respect of gaming consoles, the evidence appears to be conclusive (and accepted by overseas regulators) that the merged entity would lack incentive because it would not be

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profitable to attempt to foreclose rivals.[1] The SOI also seems to accept that, and you have provided more information to the Commission as requested to confirm the legitimacy of doing so.

5. Given all that, what legitimate basis is there for considering there is a real and substantial risk, nonetheless, that there will be a substantial lessening of competition in a relevant market by virtue of the merged entity foreclosing rivals in the nascent area of cloud gaming services?

6. This is the only issue, in respect of which I address the following aspects:

   (a) being "satisfied" (including the legal test and the weight that can be given to commitments entered into by the applicant as part of its EC filing),

   (b) market definition, and

   (c) vertical restraints/effects.

BEING SATISFIED

7. On the face of it, the test in s66(3)(b) of the Act appears simple: the Commission must give a clearance if it is satisfied that the acquisition would not be likely to have the effect of substantially lessening competition. If it is not satisfied, then it must decline.[2]

8. In *Commerce Commission v Woolworths Ltd*[3] the Court of Appeal declined to engage with a submission that between being satisfied and not being satisfied there was a "gap", and the Court maintained an approach by direct reference to the statutory test, namely, the Commission must grant a clearance only if it is satisfied that a substantial lessening of competition is not likely.[4]

9. The decision to be satisfied (or not), however, "is necessarily to be made on the basis of all the evidence", and the standard of proof is on the balance of probabilities.[5]

10. Unhelpfully, the definition of the latter as a yardstick of evidence also involves a concept of likelihood ("a hypothesis is established on the balance of probabilities if it is more likely than not to be true"[6]), different from the concept of likelihood embraced by caselaw as to whether an effect is likely to occur in the future (a standard of foreseeability: more than "possible" but not "more probable than not": it can be a "real chance" or a "real and substantial risk").

11. For this reason multiplication of likelihoods in articulation of the test under s66(3)(a) is confusing and best avoided: to paraphrase, a clearance should be granted if on the

[1] The evidence also appears conclusive that the merged entity would lack the ability to foreclose rivals for the reasons set out at paragraphs [3.4] to [3.12] of the SOI Response.
[2] An applicant is analogous to a plaintiff in a civil case, who must either prove their case or lose. An applicant can still proceed without a clearance, in which case the onus then shifts to any person challenging the acquisition to prove on the balance of probabilities that the acquisition would be likely to have the effect of substantially lessening competition: *Commerce Commission v Woolworths Ltd* [2008] NZCA 276 at [85] and [101].
[3] *Commerce Commission v Woolworths Ltd* [2008] NZCA 276.
[4] At [95], [101] and [107].
[5] At [101].
[6] At [97].

basis of all the evidence and the balance of probabilities the acquisition would not have a real chance (or a real and substantial risk) of substantially lessening competition.[7]

12. It is important to bear in mind also that in considering the relevant counterfactual, the question, as the Court of Appeal made clear, is “whether there is a real and substantial prospect” of something occurring for it to be accounted for.[8] This is significant to a consideration of Activision content being made available to cloud gaming in a counterfactual [ ].

13. The negative position of not being satisfied that the transaction would not have the detrimental effect (as opposed to the positive position of being satisfied that it would not) is not an unprincipled default position to hide suspicions and unease: the discipline is that the Commission must approach that question and decide on the basis of the evidence and the standard of proof, bearing in mind the positive role it has to further society’s interest in efficient mergers.

14. A failure to be satisfied can either be because the applicant simply did not provide enough material (patently not the case here: the application is a comprehensive and well-supported piece of analysis, as are the subsequent RFI responses and the SOI Response), or because other material on the balance of probabilities contradicted or undermined that put forward. If so, that would need to be capable of identification and coherent reasoning by the Commission. In respect of the issue postulated in the SOI, that does not appear to be sustainable.

EC commitments

15. The Commitments that the applicant has entered into as part of its EC filing form part of the material that the Commission is required to assess according to the same standard as the rest of the material supporting the application. On the face of them, they address the concerns they were designed to.[9] Is there any reasonable basis to believe otherwise, that they will not exist for the term stipulated and perform as drafted?

16. The SOI Response on behalf of the applicant identifies a number of features supporting propositions on the balance of probabilities as to the effect of those agreements according to their terms. Nothing appears to have been advanced on the balance of probabilities credibly suggesting otherwise, in which case it is appropriate to place reliance on their existence to remedy the concerns they address. (SOI, [114.2]).

17. As to safeguards for compliance (SOI, [114.1]), it may be a legitimate question to ask ("what if Microsoft breaches the agreements?") but the mere asking does not of itself raise a continuing doubt. The question has been answered. Whether there are sufficient safeguards of compliance is a matter of contractual interpretation, commercial common sense and regulatory (EC) oversight. Analysis with supporting material has been provided in respect of each of these; again, there does not appear to be any contradictory material on the balance of probabilities, from which it could be

[7] At [97].
[8] At [135].
[9] It is not the applicant’s case that the concerns which it alleviated by those commitments were valid and that they were necessary, given its case as to how the markets would operate even without them. With the agreements, however, greater reassurance is provided and that case is significantly reinforced.

determined that a deliberate breach of the agreements would be attempted (applying the contractual doctrine of efficient breach), or could not be prevented (and severely punished), post-merger.

18. The EC plainly thought that in both respects (appropriateness of reliance and safeguards for compliance) the commitments were sufficient.[10] Legally, the commitments would be breached by any failure to perform them according to their terms in respect of New Zealand. Practically, as a matter of fact and commercial common sense there is no basis upon which the applicant could or would treat the New Zealand market differently as to its performance obligations.

MARKET DEFINITION

19. The definition of a market in s3(1A) of the Act is "a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them."

20. Substitutability is not a simple technical exercise:

    (a) there is peril in a formulaic analytical approach of defining markets narrowly to test issues if that leads to tunnel vision. The *ssnip* test is actually an incrementally inclusive approach to find the boundaries of a market in terms of what is required by s3(1A) above, not an incrementally restrictive approach; and

    (b) for this reason, the court in *Brambles New Zealand Ltd v Commerce Commission*[11] warned against being too inflexible in the approach to market definition.

21. Application of "fact and commercial common sense" is an important filter, and has informed the New Zealand approach from the beginning of our competition jurisprudence:[12]

> In delineating the relevant market in any particular case there is a value judgment which must be made which involves, for example, an assessment of pertinent market realities such as technology, distance, cost and price incentives; an assessment of the degree of substitutability of products; an appreciation of the fact that a market is dynamic and that potential competition is relevant; and an evaluation of industry viewpoints and public tastes and attitudes. Particularly important in the process is industry recognition (both by supplier and purchaser) and recognition by the consumer. Ultimately the judgment as to the appropriate market — and its delineation by function, product and area — is a question of fact which must be made on the basis of commercial common sense in the circumstances of each case.

22. It might seem easy to conclude that the result should be the same, whether an alternative is taken into account as a competitive constraint on operation of a narrowly defined market or whether it is included as part of the market. Of those two options,

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[10] The (appealed) CMA decision was taken prior to the EC decision, and so did not take into account the fact that the three cloud gaming agreements are "underpinned" by the EC Commitments.

[11] *Brambles New Zealand Ltd v Commerce Commission* (2003) 10 TCLR 868 (HC) at [244].

[12] NZCC Decision No. 84 *Edmonds Food Industries Ltd / W F Tucker Co Ltd* (21 June 1984) at [3] and [7].

however, it is the latter that is consistent with both the Act and caselaw, and more likely to avoid distractions that can arise by mis-defining a narrow market in the first instance and then considering competitive constraints through a lens of having already ruled them out of consideration in that initial market definition.

23. Applying these principles:

(a) the SOI acknowledges that the proposed acquisition is unlikely to result in horizontal effects in any relevant market, so it is unclear what significance a definition of separate distribution markets by reference to payment method would have anyway (SOI, [63]). The distinction postulated is not carried through as relevant to a consideration of vertical effects (SOI, [109]).

(b) nonetheless, the way in which businesses, in competition, "slice and dice" their offerings to differentiate themselves is more appropriately an observation of competition in action in a market rather than a basis for division into separate markets. The SOI at [62] acknowledges the point, and in the absence of any reasoned basis to the contrary it is appropriate to define the market as one for digital distribution of video games.[13]

(c) that Microsoft has seen investment in cloud gaming as a potential opportunity[14] for competitive initiatives in competition with other game providers is of itself a very strong indicator,[15] as a matter of fact and commercial common sense, that the market is one.[16] It is difficult to see a realistic basis on which cloud gaming as one distribution platform should be carved out and viewed as a separate market (the SOI also refers to it as a "games distribution" platform in considering the issue of vertical effects, [105]).[17]

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[13] While Microsoft's limited offering in mobile gaming, and the large number of other competitors, obviates the need to consider aggregation per se in that segment (SOI, [56]), the extent to which constraint is provided by mobile gaming in respect of PC and console gaming (and vice versa), now and in the future, is still a relevant consideration in the overall assessment.

[14] [

] That does not make any investment a sure thing. It seems to be generally accepted by all participants that cloud gaming has a way to go yet before it is viable, and that there are difficulties to overcome, but other parties are also positioning themselves for that potential nonetheless. For example, the CEO of Sony has said, in relation to cloud gaming, that the "technical difficulties are high… but we want to take on those challenges". See: (4 June 2023). Sony chief warns technical problems persist for cloud gaming. Financial Times. Retrieved from: https://www.ft.com/content/4b410761-78d8-4bec-a48b-79f1373d42e1

[15] Just as Sony's recent significant investment in 3D virtual reality headsets is presumably seen by it as an opportunity for competitive gain in delivering gaming services too, but not justifying a separate market definition by reference to that specific device.

[16] See also the other evidence in the SOI Response setting out that cloud gaming is not a separate market, as a matter of fact and commercial common sense, at paragraphs [4.4] to [4.26].

[17] Before physical video / DVD rental and purchase stores were driven out by digital distribution and then the latter overtaken by streaming, the differences in access/purchase options could not have been suggested as creating separate markets. While Pay-TV and FTA TV were considered to justify separate markets in NZCC Decision No. 574 *Sky Network Television / Prime Television NZ* (8 February 2006), that was because of their quite different

(d) The Court of Appeal in *Commerce Commission v Woolworths Ltd* took into account business evidence from the nascent competitor in that case, saying "it was not prepared to second-guess the business judgment of the senior management and directors" of it.[18] Here, the evidence from Google to the US District Court when questioned as to who it considered were competitors to Stadia, was consoles and PCs ahead of other cloud service providers,[19] which is also consistent with Microsoft's view, and the views of numerous other industry participants [ ] that cloud gaming forms part of the same market as native gaming.[20]

(e) Observations on the supply side cannot be definitive: development of this nascent distribution technology may be slow, but it is accepted that there is no upstream market power in video game publishing if it does develop and a range of potential relationships able to be formed through existing cloud computing service providers already also positioning themselves for whatever may come.

VERTICAL EFFECTS

24. The essence of the issue would seem to be that while these markets are dynamic and innovation may occur in the factual ("with or without the merger"), firms could have more incentives to invest and innovate in a counterfactual (SOI, [79]). But the caution by the Court of Appeal, as noted above, is "whether there is a real and substantial prospect" of something occurring in the counterfactual for it to be accounted for.[21]

25. What is the basis for this suggested disparity? Given the absence of horizontal effects and therefore market power, the presence of large, well-resourced competitors both in gaming services and in cloud computing, and a nascent but potentially growing and dynamic gaming distribution technology, why would incentives to innovate and invest in competitive response to the merged entity (ie, dynamic efficiency) be any the less?[22] It is important to bear in mind the axiom under our law that the concern is only with potential harm to competition, not harm to competitors (even assuming there is a financial impact on Sony, Amazon Luna, NVIDIA, or others, that is not avoided by their own initiatives and competitive responses).

26. The theory of harm comprises two elements: whether Activision content (primarily, *Call of Duty* ("***COD***")) would be an essential input for rivals of the merged entity to be able to compete effectively in the supply of video game consoles and cloud gaming services (SOI, [83.1]), and whether the merged entity would have the incentive and ability to withhold that content (SOI, [83.2] and [86.1]). This theory cannot be made out in the absence of either.

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business models whereby the latter relied on advertising (raising two-sided market concepts) and the former relied on subscription. Nonetheless, they were still considered to exercise competitive constraint on each other.

[18] At [142].

[19] SOI Response, at [4.11].

[20] SOI Response, at [4.8].

[21] *Commerce Commission v Woolworths Ltd* at [135].

[22] And not even by direct competitors, such as Sony, Nintendo, Google and Amazon: Apple has every incentive to protect the revenues it makes, if necessary: [
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27. Even if *COD* was an essential input which the merged entity had the incentive to withhold, it is also a question whether the effect would be likely to substantially lessen competition in a market.[23]

Essential input?

28. The SOI acknowledges that there would have to be "limited or no good substitutes available" to *COD* for it to be an essential input (in other words, market power, which is also how it is formulated in the Mergers and Acquisition Guidelines regarding vertical effects).

29. As Professor George Yarrow once observed,[24] an ounce of empirical data is worth a ton of theory.

30. What the material establishes to be important is a range of content (not unlike the music industry, e.g. *Tru Tone Ltd v Festival Records Retail Marketing Ltd*[25]), and that the merged entity will be unable to prevent ongoing access by competitors to their own content from a number of parties.

31. The empirical market data provided from various sources including IGEA as to trends in popularity, and in particular as to whether *COD* (or Activision content generally) is an essential input, is telling. The answer would seem to be that it is not. While having an attractive range of popular titles in an offering is important, the market evidence also demonstrates that that does not have to be Activision content (there is more than sufficient alternative popular content to compete with *COD*). All of this is consistent with a finding that the merger would not cause horizontal effects (i.e. market power) in the video game publishing market (conversely, it would be inconsistent with that finding if it was determined that *COD* or some broader Activision content was "essential").

32. The inference seems to be, however, that because of network effects there would be a race to scale, and (like platforms such as TradeMe and eBay), the first to get their nose ahead, stays ahead (i.e. "tipping" a market), and even though the merged entity is considered unlikely to have that incentive in respect of other distribution technologies (PC / consoles), and no such "tipping" has been seen to occur in relation to those distribution technologies.[26]

33. The SOI (perhaps picking up on the CMA[27]) appears to support this distinction for cloud gaming by its reference to what are said to be the applicant's "significant

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[23] Although from the way the enquiry is framed, positive findings on the two pre-conditions would likely mean that the answer was foregone: if there was a positive finding that the input was essential to rivals competing effectively, then precluding that input would, by definition, lessen competition. Hence, consideration of whether an input is essential must meet a high standard, in just the same way that considering whether exclusive dealing contravenes the Act requires the presence of unconstrained market power: *Simpson Appliances (NZ) Ltd v Fisher & Paykel Ltd* [1990] 2 NZLR 731.
[24] To the Commission, which he was advising regarding Orion's CPP application under Part 4 of the Act in 2013.
[25] *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [1998] 2 NZLR 352.
[26] I also note that, to the extent there are network effects in this industry, they occur at the game title level (gamers want to play the same game with their friends), not in relation to the distribution technology used – see further at [34(d)] below.
[27] Which vaguely refers to the applicant's "other assets" and its "strengths".

advantages", namely, as a provider of cloud computing services and as a developer and publisher of games. Yet:

(a) it has already been determined that no horizontal effects / market power arise in respect of the latter, and there is no shortage of other content providers and competing developers and publishers of games (and no "tipping" has occurred in console / PC gaming), and

(b) providers of cloud computing services already include Google and Amazon (and many others), plus the applicant does not use Azure for its cloud gaming services.

34. This sounds more like a theory of conglomerate effects, even though that has already rightly been ruled out. Moreover:

(a) having strengths or advantages is not a legitimate objection in New Zealand merger law. There are competitive constraints at every level and, in the absence of evidence to the contrary, there is no reason to suppose that further and ongoing competitive responses will not occur. Sony is an integrated / cross-media global entertainment group that has "music, TV, films, video games: things that everyone [else] wants, but only Sony actually does at scale and in a joined-up way", which puts it in a "uniquely powerful position"[28] (with all the advantages that brings to its gaming range),

(b) the SOI at [103] acknowledges the point that there are substantial competitors already in cloud computing services (such as Google and Amazon), and entry by cloud gaming providers could occur by partnering with such cloud computer providers,

(c) the counterfactual assumes that Activision content would likely be made available to cloud gaming service providers, [ ] and the factual assumes that the applicant will make it exclusive. Neither of those assumptions are supported on the evidence,

(d) in fact, the evidence is consistent, both from current behaviour and of future intentions, reinforced by the Commitments, that the applicant is motivated to operate more like a publisher with content distributed as widely as possible on multiple platforms. Equally, Activision's approach has been to ensure that to the extent there are network effects, those occur at game level, and are not device-specific (for example, by having its content available across multiple devices and enabling gamer ID logon through any device, so that it is the game that provides those benefits independent of any device or distribution channel it is played on). This means that cloud gaming foreclosure is not credible,

(e) the theory also seems to assume that the applicant "would hit the ground running" with exclusive Activision content, which of itself would give a lead in the race to scale, and that lead would not be competed for vigorously with content available on other cloud gaming services delivered by or in partnership with other cloud computing providers,

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[28] (17 January 2022). Has Sony become the entertainment group it always wanted to be? Financial Times. Retrieved from: https://www.ft.com/content/70877521-29f6-406f-ae13-b1fdfc837eed

(f) if, as the evidence supporting market definition indicates above, PCs and consoles compete with cloud gaming services in the same market and it is accepted that there will be no foreclosure of PCs and consoles, then it is theoretically unsound to consider there could be foreclosure in relation to cloud gaming, and

(g) in any event (without accepting the concerns being realistic), the Commitments entered into by the applicant (along with submissions from the likes of rivals such as NVIDIA in support of the transaction) reinforce the unlikelihood of any of that occurring and of a substantial lessening of competition being the outcome.

35. As a forward-looking exercise involving predictions of future behaviour, uncertainty is inherent in application of the clearance test. Uncertainty of prediction per se, in a nascent, but technologically fast-changing and dynamic, industry segment should not necessarily or automatically count against the applicant and does not justify a default position of not being satisfied. To the contrary, the Court of Appeal has said that acquisitions "should be permitted unless there is a good reason to prevent them", including as they "can increase efficiency and benefit the public".[29]

36. If the extensive material and propositions provided, without more, are accepted as established on the balance of probabilities, then the conclusion should be that there is not a real or substantial risk of the effect of the merger being to substantially lessen competition. A contrary conclusion would require that there is more, and that the material and/or propositions are deficient on the evidential standard. There is no reliable indication of that.

Matthew Dunning KC
Barrister/Arbitrator

[29] *Commerce Commission v Woolworths Ltd* at [76]. [emphasis added]