Castalia Commentary on Spark's response to Commerce Commission Questions

5 October 2016

1 Introduction

We have been asked to provide economic commentary on aspects of Spark's response to Commerce Commission questions, particularly as it relates to premium sport as a "must have" and the counterfactual to the Sky-Vodafone combination. The questions asked by the Commission were at least in part prompted by the cross-submissions from Sky and Vodafone, and the NERA Report, which we have also reviewed[1].

We understand from the Commerce Commission's questions that it wants to test the merger against a *status quo* counterfactual (potentially amongst other counterfactuals). Hence, the Commission is seeking Spark's views on the difference in competition that would arise between the scenario with the proposed merger and a scenario without the merger where Sky is likely to resale or wholesale its services to third-parties on a basis that may not be dissimilar to the *status quo*.

2 Premium sports as 'bottleneck" or "must have"

In our earlier report, we used terms such as "must have" and "bottleneck" to refer to the power that control over premium sports content confers to manipulate market outcomes unilaterally. Some of the comments on our report address the substance of the argument—how much power does premium sports content actually confer and how will that power be extended to additional markets following the merger. However, other comments appear to have more to do with the use of the particular terms. To avoid misconception and misuse of language, it is worth re-stating our proposition:

- There are a significant number of consumers—about **[ ]** percent of New Zealand households—with high willingness to pay for premium sports content.
- Their demand is relatively price inelastic

[1] Letter from Buddle Findlay (on behalf of Sky) – full response to submissions 9 September 2016; Vodafone – full response to submissions 11 September 2016; NERA – report for Vodafone and Sky 11 September 2013.

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- Sky has dominant control of premium sports content, and this dominance is persistent and self-reinforcing
- Whoever owns Sky's premium sports content will have the ability to bundle such content with other offerings in a way that extends their market power in the provision of premium sports content into the bundled offerings.

In this context, "must have" does not mean that everyone or most people could not survive without the product. Rather, we use this "plain English' term in the context in which such goods are usually discussed in the literature on "tying": a "tied good" is a good that is demanded by a sufficient number of consumers with strong preferences such that they can be induced into buying other products they otherwise would not have chosen at above-competitive prices in order to gain access to the "must have" good. While it is possible that any product could be "must have" in this sense to a small number of consumers—there are some of us who would do anything for a Big Mac—the critical issue is whether premium sports content is sufficiently "must have" to enough consumers to influence market outcomes. This definition is related to the concept of "tying", which makes the sale of one good conditional on the sale of another good.

This is also the sense in which we used the term "bottleneck": not that the ability to supply premium sports is technically necessary to provide broadband or mobile telephony. Rather, premium sports content is a "bottleneck" in the sense that being unable to supply it on the terms that are similar to those available to the competitors could curtail a firm's ability to operate in the markets for products and services with which sports content may be bundled.

In this sense, premium sports content is not a "bottleneck" at the moment for the provision of telecommunications services, but it would become a "bottleneck" if the Sky-Vodafone merger proceeds.

This use of the term "bottleneck" is consistent with how the economics literature approaches the distinction between "bundling"—a benign term—and "tying" (also referred to as anti-competitive bundling)—an anti-competitive practice.

NERA correctly highlights that product bundling may be pro-competitive in many cases. Indeed, bundling is likely to be anti-competitive—i.e. "tying"—only under certain conditions. Economics literature highlights the following conditions:

- Product bundling is likely to be tying when the components are not separately available even though separate supply is technically possible and is demanded by consumers
- The supplier has market power in one component. That is, one of the components is a "bottleneck".

In our previous report, we used the term "bundling" generically, because we did not want to draw a legal distinction between a lawful market strategy ("bundling") and a violation of the competition law ("tying"). We believe this approach remains analytically justified, as our objective is to consider the outcomes from likely bundling in the factual, rather than to draw any inferences about the legality of the action. In this context, we think NERA's comments drawing on the implied legal meaning of "bundling" to suggest that it is always pro-competitive are somewhat disingenuous and unhelpful to understanding the effects of the proposed merger.

So, if we put the semantics aside, how would we know if premium sports content is "must have" or "bottleneck" in the sense explained above: that it can be used to force consumers who have strong preference for premium sports content to purchase other

products at above-competitive prices to gain access to the sports content? We suggest there are two distinct but related questions that need to be answered:

- First, is there any evidence that premium sports content is currently being used to enforce anti-competitive bundling and to achieve unilateral market power? Of course, for now, there is no single owner that can bundle premium sports content with broadband or mobile telephony. However, there is a single owner—Sky—that can bundle premium sports with other forms of content. We suggest that such bundling and how it is implemented demonstrates the “bottleneck” nature of premium sports. Similarly, Sky’s approach to the wholesaling of its content. We suggest that Sky’s current wholesale strategy is rational only because it can use market power derived from its premium sports content to drive consumer behaviour
- Second, how would we know if the extent to which control over premium sports enables Sky to exercise unilateral market power over other forms of content presages the role that it could play in relation to other telecommunications services once the ownership of content and telecommunications is combined?

2.1 Current pricing structure offered by Sky

As we highlighted in our earlier report, at present Sky requires consumers to purchase a basic content package in order to gain access to sports content (and other premium content packages). In our view, the current bundling strategy used by Sky would not have been possible without premium sports content being a “must have” in the sense explained in the preceding section.

It is clear that there would be a significant number of consumers who would wish to purchase Sky Sports content separately without necessarily wishing to purchase the basic content pack:

- For example, **[ ]**.Most Sky subscribers also have access to Freeview on their TVs. This suggests that customers are able and willing to pull together their own channel combinations. For example, those customers who would have preferred to combine Lightbox with Sky Sports are currently potentially paying twice for the similar (Lightbox – equivalent) content through Sky.
- There is clearly no technical impediment to supplying various channels as stand-alone products.

Buddle Findlay letter on behalf of Sky notes that it would not be rational for Sky to allow competitors to develop alternative pay-TV services that rely on Sky’s most valuable content. In other words, it would not be rational for Sky—as a monopoly provider of premium sports content—to allow competitors to buy only some components of its content and not others, and then to package those components with other offerings. However, in the absence of market power over premium sports content, this is precisely what Sky would have to do. In a competitive market, Sky would not be able to bundle channels in a way that allows it to charge more than the going price for each type of content (obviously, the price of premium sports channels would be higher than the price of gaining access to free-to-air channels), or which ignores consumer demand for unbundled offerings.[2]

[2] The “rational choice” referenced by Buddle Findlay is the choice only available to firms with market power.

The way Sky Sports is bundled with Sky Basic meets the definition of the conditions described in the literature for bundling to have an anti-competitive effect. Consumers may wish to purchase Sky Sports separately and it is technically possible to provide it to them. However, it is only available in a bundle with Sky Basic. Since Sky Basic adds little to what is available through all or combination of Freeview, Lightbox and/or Netflix and others (at much lower prices), a product over which Sky has no market power is compulsorily bundled with a product over which it does.

As we have pointed out in the earlier report, FanPass is the only unbundled Sky Sports offering—available to consumers who only wish to watch through OTT and with limited content. Yet, this standalone product is priced at almost twice the level of the notional price of Sky Sports in the bundle. Again, such price distortions would only be possible if there was material market power.

2.2 Comparison with the Australian market

To observe the market power conferred by the premium sports content, and how it is used today, as an indicator of how it is likely to be used in the future, it is instructive to compare pay-TV pricing and product bundling in New Zealand and in Australia.

While there are obviously many factors that distinguish the Australian and New Zealand content and delivery markets, there also many similarities both in market structure—Foxtel and Sky being single pay-TV providers—and in consumer preferences. However, there is an important difference. In Australia, anti-siphoning rules reserve a significant proportion of premium sports content to free-to-air television channels. Given this, we would expect that Foxtel's sports content would command significantly less market power than we observe in New Zealand with Sky.

If our hypothesis about the "must have" nature of premium sports content, and about how control over that content is used to exercise unilateral market power, is correct, we would expect that lower market power in Australia would result in:

- More unbundled product offerings, that is, consumers would be able to exercise more choice over what they buy and what they do not wish to buy
- Lower prices for basic content. If basic content cannot be bundled with a "must have" product, it would be priced at a level reflecting its cost.

In fact, Foxtel went through a significant repricing about a year ago, cutting all its prices by more than 40 percent. At the time, media attributed the need to reprice to loss of market share and an inability to sustain the pricing model without premium sports content.[3]

The comparison between the two countries is set out in the table below.

[3] https://mumbrella.com.au/foxtel-boss-flags-major-changes-tackle-threat-streaming-rivals-249430

Table 2.1: Australia and New Zealand Pay-TV combos

Content combo	Australia		New Zealand	
	Price	Number of channels	Price	Number of channels
Entertainment	AUD 26	45	NZD 49.91	68
Sports	AUD 25	12 (includes beIN channels)	NZD 29.90 (another $8.81 for Rugby Channel)(Another $11.96 for beIN sports)	7 + 1 + 2
Movies	AUD 20	10	NZD 20.93	8
Drama	AUD 20	6		
Entertainment plus	AUD 10	9	NZD 9.99 (SoHo) NZD 11.18 (Rialto)	
Kids	AUD 10	6		
Documentaries	AUD 10	9		

Source: Sky and Foxtel websites

The pricing and packaging structure in Australia is consistent with lower market power over premium sports content:

- The entry price—the basic package that a consumer must purchase in order to have the option of purchasing the Sports combo—is significantly smaller in Australia than in New Zealand. Various channels are split into numerous additional combos in Australia, giving consumers a greater ability to construct their preferred product bundle. In both countries, consumers have to buy the basic combo to access other combos, but in Australia the "entry ticket" is about half of what it is in New Zealand (allowing for the exchange rate)

  It is important to note that the question here is not whether customers value some of the channels that are bundled into the combo required to gain entry to premium sports content. For example, while the basic combo includes free-to-air channels, in New Zealand is also incorporates premium channels such as Disney. Clearly, there would be many customers who would be happy to pay to access Disney content. However, it is the fact that customers have no option but to purchase tied goods at the price at which they are supplied that causes competition concern. In most cases of anti-competitive bundling, the tied goods have some value to consumers

- The Sports combo (including BeIN) is somewhat more expensive in New Zealand than in Australia. In the absence of market power (and hence, without the ability to recover the costs of sports content through a margin on the basic combo), we would expect that the price of the sports combo in Australia would tend towards a level that is consistent with the underlying costs. We would expect that the costs of providing sports content would be somewhat lower in Australia than in New Zealand, since anti-siphoning provisions would discourage Foxtel from bidding up the costs of purchasing exclusive rights.

Overall, our prediction would be that with market power over premium sports content, the profit maximising strategy would be to force consumers to purchase more basic content in order to gain access to the desired premium sports content and to set prices for basic content above what it costs to access such content from alternative service providers.

We observe that in both New Zealand and Australian markets, Pay-TV operators force consumers to pay for an entry ticket to access the desired sports content. However, as expected, with less market power in premium sports, the size of the entry ticket is lower in Australia: consumers are not forced to purchase the entire bundle of entertainment channels, including Kids and documentaries. For example, this means that in Australia, older consumers who may not need access to Kids channels but wish to watch sports are not forced to pay for the content they do not wish to have.

The operation of the anti-siphoning rules, and the effect they have on the price of sports channels is a public policy rather than competition law issue. However, the effect of the market power in premium sports on the price of the entry ticket extracted through forcing consumers to purchase channels they may not wish to have, or may have been able to obtain cheaper from other providers, is an issue for the merger as it indicates likely, future behaviour of a vertically integrated Sky.

2.3 Wholesale Pricing of Sky

Sky has announced that it sets its wholesale price at its calculation of efficient component pricing rule (ECPR). Of course, we cannot verify Sky's calculations. Apart from Vodafone (which has special circumstances due to re-transmission agreement for the cable), no RSP resells Sky.

It is unlikely that RSP's downstream (retail) component costs are higher than Sky's. It is also unlikely that RSP reselling of Sky would one-for-one cannibalise the existing customer base. In most markets, wholesale service providers who also undertake their own retail tend to increase their marketing reach through wholesaling. For example, by making wholesale content available to RSPs, Sky may be able to reach customers who have no or low propensity to subscribe to pay-TV services.

A useful illustration is the 2013 launch in the UK of the Now-TV OTT service. The service is available to watch via a Now TV branded box, computer, various mobile devices, some game consoles and set-top boxes (Freeview UK). The service is operated by but is not viewable via Sky's digital satellite television service, or through the Sky Go service. The service is deliberately designed to provide a more limited service to a demographic that would not normally purchase pay-TV.

While the UK example is itself delivered by Sky, the same results could be achieved through wholesale supply. The fact that this innovation, or indeed much wholesaling, is not happening in New Zealand suggests that:

- Sky's calculation of ECPR is wrong, and it has no incentive to get it right
- Sky gets more value from tight control over the pricing and bundling of the overall package, than it would from extending its content into different demographics.

To use Buddle Findlay's terminology, this represents a rational choice only if premium sports content is a "must have" product, which enables Sky to extract monopoly rent from other forms of content when bundled with them.

2.4 Ability to use premium sports to leverage market power into telecommunications

Vertical integration between Sky and Vodafone creates both the incentive and the opportunity to extend the use of market power derived from premium sports content into the provision of telecommunication services (both broadband and mobile telephony). The incentive on Sky-Vodafone as a joint entity will be to use the "must have" characteristic of premium sports content to a significant proportion of New Zealand households to induce those households to pay the entry ticket for gaining access to the content they desire not only through the purchase of basic channels they may not wish to have, but also through the purchase of broadband and mobile telephony services they may not have wished to purchase (or may not have wished to purchase from Vodafone).

In the extreme, one could imagine Sky-Vodafone making premium sports content only available to customers who purchase their broadband and mobile from the same company. This would be qualitatively and in terms of commercial strategy no different to what Sky is currently doing with respect to basic content.

In practice, we do not expect such explicit "tying":

- Sky has indicated that it will continue to make its content available wholesale (albeit possibly at unrealistic ECPR)
- Concern about inducing a regulatory response, including the introduction of anti-siphoning rules in New Zealand, would likely prevent Sky-Vodafone from explicitly refusing to serve customers of other RSPs and mobile providers
- Sky-Vodafone would be concerned about losing those Sky customers who have a strong preference for staying with other RSPs and may not value premium sports content sufficiently highly.

However, Sky-Vodafone would be able to achieve substantially the same result by manipulating Sky standalone, Sky wholesale and bundle prices so that consumers are induced to switch towards a Sky-Vodafone triple play bundle. More importantly, the merger would allow Sky-Vodafone as a joint company to delay the effect of OTT-based competition from undermining Sky's market position in pay-TV.

The emergence and growth of OTT services, the growing demand for skinny bundles associated with consumers having a greater ability to construct their own bundles and to view content on demand, and the emergence of alternative content providers, such as Lightbox, is increasing price elasticity of demand for traditional Pay-TV services. The recent repricing in Australia discussed above is an example of the effect that this changing price elasticity is having.

In our previous report, we focused on the effect of OTT services on Sky's incentive to wholesale. However, if we put that aside, even if Sky does not choose to wholesale more

actively and continues with the *status quo*, it will need to contend with growing competition from the OTT services. The merger with Vodafone would:

- Reduce competitive pressure by taking out one potential significant competitive provider of OTT content
- Create the threat of Sky-Vodafone developing their own OTT platform with access to unique premium content. This would discourage and delay the development of alternative platforms, such as Lightbox, Netflix and others, which are already fighting to gain traction.
- Use price and non-price mechanisms to encourage Sky customers who do not currently use Vodafone to switch away from their existing RSPs and mobile operators. This may result in a short term gain for consumers who switch, but a medium-term loss in competition and therefore detriment to consumers. More limited competition will force some emerging competitors to withdraw—as Coliseum did—and allow the merged entity to increase prices of the bundle after the initial offer term has expired.

Overall, the merger is likely to reduce the rate at which demand for traditional pay-TV services is becoming increasingly more price elastic, limiting market growth and innovation, while also creating an opportunity for Sky-Vodafone to make purchase of its broadband and mobile products an entry ticket to gaining access to premium sports content, increasing prices across the market.

As we discuss below, apart from OTT services, Freeview provides the only potential competition to Sky in linear viewing. However, the existing market for linear viewing is segmented, with low-value price-sensitive customers opting for Freeview and higher-value, less price sensitive customers opting for Sky. Vertical integration between Sky and Vodafone would likely carry that segmentation into the broadband and possibly mobile telecommunications markets, with Sky-Vodafone gaining customer lock-in and market power in the higher-value segment, while other RSPs compete for the lower value customers.

3 Counterfactual

The counterfactual where Sky becomes an active wholesaler was based on the significant transition to OTT viewing and use of multiple devices. The Commerce Commission wants to test the merger against a *status quo* counterfactual (potentially amongst other counterfactuals). We interpret this as the Commission wanting to focus on the near future, where a significant proportion of consumers continue to prefer linear viewing of content via TVs receiving a terrestrial or satellite broadcast. The following analysis proceeds on that basis. However, given the proposed merger would result in a permanent structural change to the market, it is not clear to us why it would be appropriate to look only to the short term. In particular, there is strong evidence to support the likely significant transition to OTT viewing in the medium term, even if the precise time period over which that will occur is uncertain.

To understand the *status quo* counterfactual, we need to unpack the current pricing model and see how it is likely to continue evolving. At present, Sky provides four services:

- Delivery channel (satellite)
- Product aggregation
- Own non-premium channels

– Original premium content

Outside of the OTT technologies, Freeview is the only alternative delivery channel for linear television viewing. In effect, Freeview provides three of the four services. Potentially, Freeview could compete with Sky in providing pay-TV channels. However, this would require Freeview to set up a subscription system along-side its free offering. Since Freeview is essentially a cooperative of New Zealand free-to-air channels set up to deliver their products, such an enhancement may take time to reach agreement on.

Over time, more channels that rely on advertising or sponsorship may choose to switch to Freeview (e.g. Freeview already carried Al Jazeera). Freeview currently also provides access to On Demand with Freeview Plus. These OTT video on demand catch-up services are available to consumers at no charge as they operate via an advertising funded model (AVOD).

Given its advertising funded model, it seems likely that Freeview's customer base is weighted toward the most price sensitive end of the consumer spectrum, making subscription offers harder to sell through the Freeview customer base than a customer base like Sky or Vodafone's, where customers are accustomed to paying monthly or annual subscription fees for higher end services.

However, regardless of how Freeview evolves in the near term, we expect that under the *status quo* counterfactual, Sky will continue to have market power in aggregating content to be delivered via satellite. Hence, Sky will have no incentive to unbundle its offering (this is confirmed in their submission).

As explained above, Sky will continue to have a lock in on premium sports content.

At the margin, Sky will continue to be under pressure from OTT service providers (such as Lightbox and Netflix). However, without significant transition to OTT, Sky is likely to continue a business model built around:

- Preference for linear viewing
- Use of TV sets in preference to other devices
- Core customers group who demand premium sports

This business model will look a lot like the *status quo*.

A key aspect of this counterfactual (as compared to the factual) is that the continued exercise of market power by Sky (derived from its control over premium sports and over the satellite distribution channel) will not be extended into broadband or mobile telecommunications markets.

However, the key question is the longevity of the *status quo* counterfactual. Foxtel's experience in Australia, the experience in a number of other countries, and the commentary in the Explanatory Memorandum suggest that the pressure from the OTT alternatives on Sky is building up. While in New Zealand, Sky's control over the premium sports bundle gives it a greater ability to defend its current business model, such defence is unlikely to be viable in the medium term. Eventually, we are likely to see the kind of re-pricing and re-structuring observed in Australia.

The proposed merger would likely extend Sky's ability to defend its business model, as well as extend its reach into the telecommunications markets. In the counterfactual, however, indefinite longevity of the *status quo* cannot be assumed.

With transition to OTT, absent the merger, Sky will also likely develop new and additional services, including better performing and more diverse OTT services that

operate over broadband networks as complements to its traditional subscription services. In order to stem the current trend of customer losses, Sky may review its pricing and channel package structure (as Foxtel did) and will likely continue to partner or co-promote a bundle of Sky TV services and broadband, just as it is currently doing with Vodafone. Absent the merger, there would be little reason to provide Vodafone with access to content on highly favourable terms or limit access to its content to a single broadband operator or mobile operator. Spark itself will have the incentive to invest in a more comprehensive content platform as a means of differentiating and adding value to its broadband products. Ultimately, OTT viewers in New Zealand will have access to more content choices. And as competing content platforms gain in popularity, the incentive for Sky to make their OTT products available on those platforms will also increase.

Spark itself will have the incentive to invest in a more comprehensive content platform as a means of differentiating and adding value to its broadband products. That is likely to lead, as Spark describes has happened in the UK, to mutually beneficial content sharing agreements between content owners, expanding the range of content available on the different platforms, providing more consumer choice and more competition. Ultimately, OTT viewers in New Zealand will have access to more content choices. It seems clear that as competing content platforms gain in popularity, the incentive for Sky to make their OTT products available on those platforms will also increase.

In other words, in the absence of the merger, competition for value-added services (potentially including some mobile-only sports rights) would promote the development of the RSP OTT platforms, which in turn will encourage more active wholesaling and reduced bundling of content. By contrast, in the factual, the best way to defend the existing business model and to delay the evolution of the *status quo* would be to deter the development of competing platforms via control of one of the main mobile carriers and RSPs.

While the Commission has made it clear that it wishes primarily to consider a counterfactual that does not involve wholesaling by Sky beyond the ECPR based deal with Vodafone (and any other RSP prepared to buy content at ECPR under Sky's restrictive terms), given the clear direction of travel, it is worth considering what Sky would likely do in the OTT world in the absence of the merger.

Given an increasing range of OTT content and the increasing availability of low cost OTT devices which enable ready access to content (like Apple TV, Roku streaming sticks and smart TVs), in such a counterfactual Sky would likely:

- Either set up its own OTT channels, which could be accessed via an increasing range of devices over broadband provided by any RSP's; and / or
- Wholesale its channels to RSPs which in turn can invest in the platforms and devices to bring the content to their customers. This will increase innovation and the quality of competitive responses in broadband.

In essence, in a medium-term counterfactual, Sky, not dissimilar to Netflix, would see greater value in partnering with RSPs since:

- as a content owner with limited control over OTT platforms it would have difficulty controlling access to its services and risk revenue dilution arising from issues like password sharing. It is highly attractive to pass that risk to RSPs, which collect monthly fees from the broadband subscribers and would pay the wholesale margin directly to Sky. This is demonstrated by Netflix's

business practices worldwide where they have increasingly partnered with RSPs

- By increasing wholesale offerings, Sky will reduce the incentives for RSPs to develop product aggregation services which exclude and differentiate the Sky branded channels and content, and hence retain some of the existing value.

Again, regardless of whether Sky pursues its own OTT channel or wholesales, in this OTT-based counterfactual Sky's market power in pay TV and premium content will continue to erode, consumers will have greater content choices and prices for access to content (including, in the medium term, premium sporting content) will likely reduce.

Overall, Sky would have less market power and would not be able to extend the residual market power into broadband and mobile telecommunications.