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To
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Commerce Commission
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From
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By Email
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Dear Susan

SKY/Vodafone: SKY's initial response to submissions

1. In advance of a more comprehensive response to issues raised in submissions, SKY wishes to convey some initial reactions to the main points raised in submissions. SKY requests that these comments be considered by the Division at the time that it considers the submissions.

2. SKY intends to more fully respond to the submissions in due course.

3. The main messages conveyed by the submissions are that:

    (a) TVNZ would prefer to compete with a weakened Prime; and

    (b) telecommunications providers, other than Vodafone, wish to enhance their offerings with SKY's sport content, without paying the full opportunity cost of the content that Vodafone has been willing to pay over the past five years.

4. In the clearance applications, SKY and Vodafone have demonstrated that, consistent with the Commission's previous conclusions, rights to premium sport content are not a "must have" in order to effectively compete. Telecommunications providers have simply asserted that premium sport is a "must have", without providing any evidence that this is actually the case.

5. In this letter, we briefly address the main points covered by the submissions, in particular:

    (a) the counterfactual and the factual;

    (b) the ability of telecommunications providers to compete with Vodafone in residential fixed line broadband and mobile markets, with or without access to premium sports content;

    (c) the wholesaling of premium sport content;

    (d) TVNZ's comments regarding Prime;

(e) the economic reports attached to the submissions;

(f) whether the Commission should hold a conference in relation to the clearance applications.

6. We understand that Vodafone will be addressing matters specific to their expertise, such as net neutrality.

SKY's counterfactual and factual

7. Spark, Trustpower, 2degrees, and Freeview put forward in their submissions:

(a) a factual under which SKY and Vodafone will refuse to provide wholesale access to SKY services, through an outright refusal, or a constructive refusal based on price; and

(b) a counterfactual under which SKY is forced to wholesale sport content:

(i) in a way that allows purchasers, such as telecommunications providers, to choose what sport content they purchase from SKY, and to use the sport content they purchase from SKY to build pay-TV packages that are different from those offered by SKY; and

(ii) on more favourable price terms than the wholesale prices currently offered by SKY.

8. Spark further submits that, under the counterfactual, telecommunications providers will be able to use sports packages to build a large enough revenue base to outbid SKY for rights to premium sport content, when those rights expire and are put to market.

9. Given that SKY currently prices wholesale access to its packages on an ECPR basis (ie, retail price minus avoided costs), under the counterfactual put forward by the submitters, SKY will share the margin it currently earns on its sports packages with its wholesale customers.

10. SKY submits that both the factual and counterfactual put forward by the submitters are unrealistic.

The counterfactual

11. SKY has a reseller arrangement with Vodafone, on terms that are acceptable to both SKY and Vodafone. That arrangement has a term that runs for a further five years, which is also when the content rights for a number of key sports (such as rugby) come up for reallocation. SKY has always made it clear that reseller arrangements on those terms are available to any other telecommunications provider. That continues to be the position. The submissions do not advance any analysis that demonstrates that, in the counterfactual, the current reseller arrangement would break down over the next five years, or that SKY would offer any different arrangement to any other party.

12. If changes in consumer preferences or technology mean that SKY's bundles of services to end users or modes of delivery change, the submissions put forward no convincing reason for concluding that, in the counterfactual, SKY would make those changed offerings available on terms that are different from SKY's current arrangements with Vodafone.

13. In addition, Spark and Trustpower argue that, under the counterfactual, SKY will be forced to wholesale content on an unbundled basis in order to deliver services on an online platform. However, those submitters ignore the fact that SKY has already developed a number of OTT offerings, including SKY GO, NEON, and FanPass. In relation to FanPass, SKY has shown that it can effectively outsource the provision of a platform for those services.

14. SKY submits that the counterfactual put forward by the submitters is completely fanciful, because it requires that SKY engage in behaviour that is not rational. Under the counterfactual:

    (a) SKY would not agree that wholesale purchasers could choose what individual sports rights they purchase/sub-licence from SKY, or to combine sports rights acquired from SKY with rights the purchasers acquire on an exclusive basis without also sharing those rights with SKY. Allowing others to bundle SKY services with other TV services would devalue stand-alone SKY services. As the Commission has previously recognised, without provisions that prevent (for example) RSPs bundling other pay-TV products with SKY services, SKY would not enter into wholesale or reseller contracts; and

    (b) SKY would not provide wholesale access to SKY services on terms that result in SKY sharing its margin with wholesale purchasers to any greater degree than it does now. This would not be commercially rational, because SKY sells SKY services directly to consumers. Pricing terms such as those put forward by the submitters would require SKY to decide to sell SKY services in a way that produces a smaller margin for SKY than if SKY sells its services on its own. In particular, it is not rational for SKY to share margin with other entities so that they could use SKY's foregone margin to develop alternative products and services to compete with those offered by SKY.

15. In that context, under the counterfactual, SKY will continue to provide wholesale access to third parties as follows:

    (a) over the next five years, SKY will continue to offer wholesale access to SKY sport services to any interested third parties, on the same terms as those currently offered to Vodafone; and

    (b) beyond the next five years, there is no guarantee that SKY will continue to hold the rights to premium sport content that is currently broadcast by SKY. Other pay-TV providers will have the opportunity to bid for the rights to premium sport content. As outlined in the clearance applications, rival pay-TV providers can achieve the scale necessary to successfully bid for rights to premium sport content in a number of different ways, and do not need to rely on revenue from a pre-existing domestic pay-TV subscriber base.

The factual

16. Under the factual, as set out in the clearance applications, SKY and Vodafone will continue to have an incentive to provide wholesale access to SKY services on the same term as discussed above. This is because:

(a) the cost of content is increasing (as recognised by a number of submitters). SKY and Vodafone will have an incentive to ensure that their revenue base is as broad as possible, in order to cover those costs and make a margin on their business activities; and

(b) consumer reaction, and associated loss of subscriptions, that would result from requiring SKY customers to purchase telecommunications services from Vodafone in order to view live sport, is likely to far outweigh any increased revenue from the sale of bundles of SKY and Vodafone services.

17. In the factual, the merged entity will set the price of wholesale access to SKY services on the same ECPR basis as SKY currently offers, the retail price for SKY services, minus avoided costs.

18. SKY is also likely to continue to develop new sports offerings, to meet consumer demand. For example, as outlined in the clearance applications, SKY has developed FanPass, a stand-alone sport OTT offering, in response to demand from consumers for a live sport offering that does not require them to also purchase SKY Basic.

19. In any event, as discussed in the clearance applications and in the following section, rights to premium sports content are not a "must have" input required to effectively compete in telecommunications markets.

The ability of telecommunications providers to compete with Vodafone: rights to premium sport content are not a "must have"

20. Spark, Trustpower, and 2degrees argue that, without rights to premium sport content, they will be unable to effectively compete with Vodafone in telecommunications markets. They argue that, after the proposed transactions, SKY and Vodafone would deny other telecommunications providers access to premium sport content in a way that forecloses competition in telecommunications markets.

21. However, those submitters have simply asserted, and failed to produce any evidence, that rights to live sport content are a "must have" input to compete in telecommunications markets.

22. As outlined in the clearance applications, rights to premium sport content are not a "must have" in order to compete in telecommunications markets. Rather, providers of telecommunications services face a competitive environment in which they need to differentiate their offerings, by bundling telecommunications services with other "value-adds", offered at a discount as compared with purchasing each service in the bundle separately. Live sport is simply one of many possible discounted value-adds.

23. **[REDACTED]**. The clearance applications list multiple examples of alternative value-adds, including Spark's bundle of mobile services with the extremely popular Spotify music streaming service, and Spark's offers of free access to Lightbox for its residential broadband customers, and free WiFi for its mobile

customers. Despite Vodafone having access to SKY's sports services, Spark continues to be a strong competitor in both residential broadband and mobile markets.

Wholesaling of premium sport content

24. In light of the factors set out above, there is no case for SKY to divest rights to premium sport content in order to prevent the proposed transactions from substantially lessening competition in telecommunications markets.

25. In addition, there are a number of problems with Spark's submission that the Commission should decline to grant clearance unless SKY divests rights to premium sport:

    (a) the sports bodies that create and sell rights to live sport content have decided that the most profitable way for them to sell rights to that content is on an exclusive basis. If they were of the view that they could better monetise their content by selling it to multiple pay-TV providers (in a similar manner to the wholesale model described in Spark's submission), they would already be doing so;

    (b) Spark envisages that a premium sport wholesaler would wholesale sports rights at prices that are lower than currently apply. Such a business model is likely to be quite unprofitable both for the wholesaler, and ultimately for any sporting body that sells rights to it in future. The rights that SKY would be required to divest under Spark's proposal, or that SKY would wholesale under Spark's counterfactual, have a limited life. Once those rights expire, because the sports rights wholesaler (the divested business, or SKY under Spark's counterfactual) would be selling rights at a discounted rate, as Spark argues in its own submission, it is difficult to see how the wholesaler would have sufficient revenue to win those rights again. At that point, the "slice and dice" wholesaling that Spark seeks is likely to come to an end;

    (c) in the interim, rights to premium sport will become available. However, the Commission has no ability to ensure that those rights will be purchased by the divested wholesale business; and

    (d) Spark has not identified who would own the premium sport wholesaler. This means that assertions as to what that business's incentives are likely to lack any foundation.

TVNZ's comments regarding Prime

26. TVNZ submits that the Commission should decline to grant clearance for the proposed transactions, unless SKY divests Prime.

27. TVNZ's submission appears directed at criticising the Commission's decision in 2006 granting SKY clearance to acquire Prime and relitigating submissions TVNZ made during the RSP investigation, rather than any real concerns about the effect of the proposed transactions on competition in any markets.

28. In its submission, TVNZ establishes no link between the proposed transaction and FTA providers' ability to compete in markets for the acquisition of rights to premium sport content. TVNZ suggests

that the proposed transactions will put SKY in a position to purchase bundles of rights to premium sport content that include free-to-air rights, subscription pay-tv rights, and VOD rights. However, that is already the basis upon which SKY is able to purchase rights.

29. TVNZ also makes a number of spurious claims in its submission, for example:

(a) TVNZ aired 800 hours of FTA coverage of the Beijing Olympics, compared with SKY's broadcast of 240 hours of FTA coverage of the Rio Olympics on Prime. TVNZ omits to disclose that the vast majority of TVNZ's hours were broadcast on the TVNZ Sports Extra channel on the Freeview platform, which, at the time, was available to just 10% of New Zealand households; and

(b) SKY has used its acquisition of Prime to purchase bundles of pay-TV and FTA rights to premium content, in a way that makes it uneconomic for stand-alone FTA providers to continue to acquire rights to premium content, monetise them, and create local content. In fact, not only is TVNZ's share of the FTA audience almost ten times that of Prime's (41.9% of the all day audience aged 5+ for 2016 to date, compared with Prime's 4.6%), but in June 2016, SKY subscribers spent 41.2% of their SKY viewing hours watching FTA channels on the SKY platform. In particular, SKY subscribers spent almost a third of all SKY viewing hours watching TVNZ's channels. This demonstrates that, even amongst SKY subscribers, TVNZ continues to be able to offer compelling packages of content.

Economic reports

30. We may wish to provide a more detailed rebuttal of the economic reports provided by Plum, Covec, and Castalia. At this stage, we wish to record that we consider that the economic reports do not address competition issues arising from the proposed transactions in a way that can assist the Commission.

31. In summary, none of the three reports apply an antitrust economics test for anticompetitive bundling, instead assuming that any advantage to a competitor accruing from bundling results in a substantial lessening of competition. This clearly contradicts conventional antitrust economic analysis, and the Commission's previous conclusions that bundling is generally pro-competitive and efficient. In particular, the fact that bundling occurs in both the factual and counterfactual is given insufficient emphasis.

Requests for a conference

32. Given what we have said above about the submissions made, and the information we have already provided to the Commission, we do not consider that there is any need to hold the conference requested by TVNZ, 2degrees, and Blue Reach. The affected parties' views may be fully examined through written submissions, and meetings with the Commission.

Confidentiality

33. Confidentiality is sought for the information in this letter that is highlighted and in square brackets. We are also providing you with a public version of this letter.

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34. We request that we be notified of any request made under the Official Information Act for the information, and be given the opportunity to be consulted as to whether the information remains commercially sensitive at the time that the request is made.

35. These requests for confidentiality are made because the information is commercially sensitive, and disclosure would be likely to unreasonably prejudice SKY's commercial position.

Yours faithfully
Buddle Findlay

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