COMMERCE COMMISSION NEW ZEALAND
Te Komihana Tauhokohoko

11.04/16008

31 October 2016

To: Sky Network Television Limited and Vodafone New Zealand Limited

Dear Applicants

Letter of Unresolved Issues – Vodafone Europe B.V. / Sky Network Television Limited

1. Vodafone Europe B.V. (Vodafone Group) has sought clearance to acquire up to 51% of the shares in Sky Network Television Limited (Sky). Sky has also sought clearance to acquire up to 100% of the assets and/or shares of Vodafone New Zealand Limited (Vodafone) (together, the proposed merger). As a result of the proposed merger, the merged Sky/Vodafone entity would be controlled by Vodafone Group.

2. The purpose of this letter is to outline the competition concerns that the Commission currently has about the proposed merger and to give Vodafone and Sky (and interested parties) an opportunity to comment.

3. On the basis of information gathered to date, the Commission is not satisfied that the proposed merger will not have, or would not be likely to have, the effect of substantially lessening competition. We continue to have concerns that the proposed merger may give rise to competition issues in the provision of telecommunications services as a result of vertical and/or conglomerate effects. We outline these below.

4. In reaching this view, we have considered a large number of documents and spoken to a wide range of industry participants. The Commission has not yet made a final decision on any issue or on the application for clearance. The views expressed in this letter are therefore preliminary only and could change as the investigation proceeds and more information is provided.

Timeline

5. We intend to publish this letter on our website. We would like to receive any submissions and evidence from you on the issues raised below (and any other issues), by **Friday 11 November 2016**. We will ask third parties to make any submissions on the issues set out in this letter by the same date.

6. You and third parties will then have until **Friday 18 November** for cross submissions. These are to be strictly cross submissions.

7. We are currently due to make a decision on the application on 11 November 2016. However, a further extension of time is required to allow time for the Commission to consider responses to this letter. We intend to discuss this with you further.

8. We are available to discuss any of the matters raised in this letter.

Relevant markets

9. Our focus is on how the proposed merger may directly affect the provision of telecommunications services to consumers (ie, non-business customers). We are, therefore, considering the impact of the proposed merger on the following telecommunications markets:

   9.1 the national retail market for the provision of residential fixed-line broadband services; and

   9.2 the national retail market for the provision of mobile services.

10. Broadcasting markets are also directly relevant to our assessment of the proposed merger. The relevant markets are:

    10.1 the national retail market for the provision of pay TV services; and

    10.2 the national wholesale market for the provision of pay TV services.

11. While some third parties have made submissions relating to the impact of the proposed merger on the provision of free-to-air TV services or on a wider market for the provision of pay TV and free-to-air TV services, we do not currently consider that the proposed merger is likely to substantially lessen competition in any such markets.

The relevant with and without scenarios

12. We consider that both with and without the merger the provision of telecommunications and pay TV services is likely to change. We discuss this below.

With the merger

13. With the merger, Vodafone and Sky would merge their businesses in New Zealand. Vodafone Group would (via a 51% shareholding in Sky) control the merged entity.

14. We consider that a likely scenario with the merger would be one where:

    14.1 the merged entity offers differentiated bundles and content to consumers;

    14.2 there is cross selling of Vodafone services to Sky customers and Sky services to Vodafone customers; and

14.3 the merged entity continues to make Sky services available for resale and retransmission (although as we discuss below, we are not satisfied that these terms would be sufficient to allow rival TSPs to compete against the merged entity).

Without the merger

15. We consider that the likely scenario without the merger would be a continuation or modification to the status quo, where:

15.1 Vodafone continues to resell and retransmit Sky services;

15.2 Vodafone and Sky continue to seek ways to extract efficiencies from their relationship, which may include:

15.2.1 [ ]; and

15.2.2 Vodafone and Sky expanding the range of bundles offered; and

15.3 Sky services continue to be available for resale and retransmission to both Vodafone and third parties on largely the same terms as currently offered by Sky.

16. Even if Sky develops its relationship with Vodafone, it will still be an independent company seeking to maximise its own profits (rather than joint profits as the merged entity would). There is no reason to expect it would give preferential treatment to Vodafone. Sky would be willing to enter into agreements with telecommunication service providers (TSPs) that enable it to increase its own profits.

17. We consider that without the merger there is a real chance that more parties would resell or retransmit Sky services in the future. This is because: [ ].[1] Alternatively, or in addition, Sky may choose to offer their full service as an over-the-top service in the future without the merger, available on all broadband networks.

Competition issues identified

18. At this stage, we are not satisfied that the proposed merger would not give rise to competition issues in the provision of telecommunications services as a result of vertical and/or conglomerate effects.

19. Our concern arises from the following factors:

19.1 the merged entity would have substantial market power by virtue of its portfolio of content, including premium content such as live rugby;

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1 Sky “FY16 business plan” (2nd sub, May 2015) at 69; interview with Sky (19 September 2016).

19.2 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;

19.3 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

19.4 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.

20. We discuss each of these factors below.

The merged entity would have substantial market power for content

21. We consider that Sky has substantial market power by virtue of its ownership of key content. Sky has the rights to a large proportion of the most important live sports including rugby, cricket, NRL and netball, the rights of which are secured for several years. Approximately [ ]% of fixed broadband customers are prepared to pay a premium over the cost of 'Basic' Sky to access this content. Vodafone's internal documents also [ ].[2]

22. We recognise that other competitors do not currently offer bundles containing Sky and instead compete using other types of add-ons, for example Spark/Spotify. However, TSPs have suggested that this is not because Sky content is not valuable, but because it has not been offered on sufficiently attractive terms. This may not have mattered in the past because, by purchasing Sky standalone, consumers can create their own bundles with rival TSP telecommunication services at a similar price and with similar content compared to Vodafone's bundle. As we discuss further below, we are concerned that in future the merged entity will make standalone Sky relatively less attractive. The availability of standalone Sky would then not be sufficient to prevent customers switching to the merged entity.

The merged entity could make buying Sky standalone relatively less attractive, leading to customers switching

23. We are concerned that the merged entity could make buying Sky on a standalone basis relatively less attractive than purchasing it in a bundle, leading to current Sky customers that are not also Vodafone customers switching to a Sky/Vodafone bundle. Although we consider a "hard tie" (that is, forcing customers who want Sky

2 [ ]

to also take Vodafone) is unlikely, we consider there may be other ways that the merged entity could achieve a similar purpose. For example, the merged entity could:

23.1 increase the price or lower the quality of the standalone Sky service; and/or

23.2 decrease the price or increase the quality of Sky in a bundle with Vodafone telecommunication services.

24. This could lead to significant numbers of non-Vodafone customers switching to the merged entity. The merged entity could potentially capture the proportion of broadband customers that currently subscribe to a Sky package that includes sport (around [ ]% of broadband customers). While Vodafone internal documents [ ]

25. In addition, as UFB is rolled out, the opportunity to retransmit Sky over fibre will increase. To the extent this is a lower cost means to distribute Sky and leads to lower prices, Sky's subscriber base could increase. This would increase the scope for the merged entity to attract more broadband customers and foreclose more of the market through bundling.

26. The number of mobile connections in New Zealand is much higher than the number of broadband connections, and so the number of Sky account holders relative to the number of mobile connections is lower than the comparable figure for broadband. Furthermore, only a small proportion of mobile data is used to view Sky content. However, there has been a rise in the consumption of mobile data as consumers view more content on mobile networks. If viewing content on mobile devices and the data consumption associated with it becomes an important revenue stream for TSPs in future, then this would increase the potential for the merged entity to foreclose competitors through bundling content with its mobile service in a way that rivals cannot match.

27. We recognise that few customers in New Zealand currently purchase multi-play bundles (that is, bundles of telecommunications and entertainment products). However, a change in the relative price between purchasing products on a standalone basis and purchasing them in a bundle may drive an increased uptake of bundles. Any change in consumer preferences towards multi-play bundles in future would further increase the ability and incentive of the merged entity to engage in bundling to reduce competition in telecommunication services. The roll-out of UFB could support such a shift as there will be a greater opportunity for customers to view Sky content online, and the process of switching to UFB may present an opportunity for the TSP to offer the customer a multi-play bundle.

28. Finally, simply looking at the number of subscribers that may switch to the merged entity could underestimate the impact of such switching, if a significant number of these are high average revenue per user (ARPU) customers. Concerns have been raised that the broadband and mobile customers most likely to switch to a Sky

bundle are high ARPU customers. The loss of high ARPU customers could have a disproportionate impact on the competitors that lose them.

The merged entity may have less incentive to enter into reselling agreements

29. You have submitted that the merged entity would continue to be incentivised to offer Sky content to TSPs on a similar basis to what is offered today.

30. At this stage, we consider that in the factual the merged entity would be less incentivised to offer content on terms that would allow TSPs to compete effectively with the bundle offered by the merged entity. Although the merged entity may not go so far as to outright refuse to supply, it could instead make the terms sufficiently unattractive to ensure there was no take up.

31. In deciding whether to offer Sky content for reselling, the merged entity faces a trade-off. On the one hand, it would gain from offering Sky on a resale basis via wholesale margins on Sky sales from TSPs. On the other hand, it would lose retail margin for telecommunication services from those customers that purchase from rival TSPs that would otherwise buy from Vodafone.

32. The incentive for the merged entity to resell would be stronger where wholesale margins for Sky content are high compared with retail margins for telecommunication services, and where a high number of customers have a strong preference to purchase Sky through a TSP other than Vodafone or purchase it as a standalone product (so that the rival TSP generates "new-to-Sky" customers that the merged entity would not have otherwise obtained).

33. You have submitted that wholesale margins for Sky content are high relative to retail margins for telecommunication services, and therefore it would be worthwhile for the merged entity to offer Sky for resale even if a high proportion of a rival TSP's Sky bundle customers would otherwise buy Sky from Vodafone or on a standalone basis. While this may be true, the proportion could be lower if, for example, the merged entity were to capture not only a broadband margin but the margin of one or two mobile accounts as well.

34. At this stage, it is unclear how many Sky bundle customers of rival TSPs would otherwise purchase Sky through Vodafone or on a standalone basis.[3] It is therefore unclear where the merged entity's incentives will lie, and we are concerned that the merged entity may consider that it is better off not offering terms to TSPs for its content that would allow TSPs to compete effectively with the bundle offered by the merged entity.

35. Further, even if the merged entity would make greater profit by offering Sky content for resale, the merged entity may still not be prepared to do so. The merged entity may be prepared to incur short terms losses (and lose actual or potential

[3] Indeed, we recognise the difficulties inherent in making such a determination.

subscribers) with the knowledge that rival TSPs' inability to offer a competitive bundle will mean the merged entity could raise margins on telecommunications services once the competitive constraint from these TSPs is diminished.

36. An additional incentive for the merged entity to not offer its content on a resale basis is to maintain control over the customer relationship. [ ] Sky may be more willing to overlook this cost of reselling if it was not able to gain those customers through its standalone services. With the merger, it can weigh this cost more heavily since it would have the option of selling through the merged entity.

One or more rivals could lose or fail to achieve scale and so would provide a materially weaker constraint leading to an SLC

37. We are concerned that, due to the loss of customers, rival broadband suppliers could lose scale in the factual and become less competitively effective. Although the supply of broadband has a large component of variable costs, there are some fixed costs. For example, some broadband suppliers make fixed cost investments including active network assets within exchanges and through owning core network assets (ie, backhaul networks). There are also fixed costs associated with marketing and support staff.

38. We are concerned that smaller broadband suppliers who have invested in those assets (and those that are planning to) may not be able to achieve scale in the factual to recoup their investment. Those suppliers may then leave the market or become forced to retrench. Rivals may find it difficult to grow again if they are unable to match the merged entity's bundled offerings. Although customers may initially benefit from the bundle offers, we are concerned that once those rivals are at a reduced scale, the merged entity may be able to raise prices for broadband services relative to the counterfactual.

39. We are also concerned that, due to the loss of customers, rival mobile suppliers could also lose or fail to achieve scale in the factual and become less competitively effective. We recognise that the proportion of mobile accounts that are affected by the merged entity's conduct at present may be lower than the comparable number for broadband accounts. However, we continue to have concerns because:

39.1 there has been a shift to consumption of video content on mobile which (as noted earlier) increases the potential for the merged entity to foreclose competitors through bundling content with mobile services; and

39.2 fixed costs comprise a large proportion of the costs associated with offering a mobile service, which means a loss of subscribers is more likely to affect scale economies.

40. The merged entity's bundles could lead to a rival losing a significant proportion of subscribers or preventing a rival from growing, resulting in that rival not achieving a

competitively effective scale. Rivals may find it difficult to grow again if they are unable to compete with the merged entity's bundle. Although customers may initially benefit from the bundled offers, we are concerned that once those rivals are at, or are maintained at, a reduced scale, the merged entity would be able to raise prices for mobile services relative to the counterfactual.

41. As noted earlier, we understand that the subscribers that are most likely to switch are high ARPU customers, which means the loss of subscribers will have a disproportionate impact on the finances of those competitors that lose them. We are concerned that this may have a material impact on the competitiveness of rival TSPs.

42. As noted earlier, we consider that there is a real chance that, absent the merger, Sky would resell to more TSPs. To the extent that this creates stronger competition for bundles, the adverse impact from the bundling strategy is compounded. In the event that more TSPs resell Sky without the merger, there may be greater like-for-like bundle competition between the TSPs, driving the price of bundles containing Sky content down.

43. If the merged entity did not offer Sky on terms that would allow TSPs to compete effectively with the bundle offered by the merged entity, the price for bundles containing Sky content may not be as low. This may be the case even if rival TSPs can offer bundles with other types of content (such as music), since there would be less like-for-like competition for bundles containing Sky content.

Conclusion

44. As set out above, the Commission has not reached any final views on any of the above matters, and the purpose of this letter is to give you an opportunity to respond to these concerns. Nevertheless, at this stage, we are not satisfied that the proposed merger would not substantially lessen competition in one or more of the relevant markets.

Yours sincerely

Katie Rusbatch
Competition Manager