Economic Analysis of Proposed Sky/Vodafone Merger

A Report for Fetch TV

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1. Introduction

This report has been prepared by Axiom Economics (Axiom) on behalf of Fetch TV Pty Ltd (Fetch TV). Its purpose is to provide additional information to the Commerce Commission (Commission) on a particular aspect of the proposed merger between Sky Network Television Limited (Sky) and Vodafone New Zealand Limited (Vodafone). Specifically, it addresses three of the key matters raised by the Commission in its Statement of Preliminary Issues (SOPI); namely:[1]

This report addresses three of the key issues raised by the Commission.

- whether Vodafone or Sky would be likely, without the merger, to launch any services that would be in competition to one another;
- whether existing competition in the markets in which any new Vodafone or Sky service would be launched without the merger is currently weak; and
- whether Vodafone or Sky is uniquely positioned to be the potential entrant that would constrain the incumbents in the relevant markets, absent the merger.

Paraphrasing the above slightly, the Commission would appear to be asking the following two fundamental questions:

- would Vodafone and Sky compete with one another in the absence of the proposed transaction?; and
- would the absence of any such potential competition between Vodafone and Sky be meaningful? For example:
  - if barriers to entry are low, such that competition in all of the relevant markets would be strong in the absence of the transaction, then there would be no substantial lessening of competition; but
  - if there *are* significant barriers to entry in at least one of the relevant markets and the proposed transaction would heighten those barriers,[2] then a substantial lessening of competition is likely.

We consider whether Sky and Vodafone would compete in the future, absent the proposed merger.

We address these questions in the remainder of this report. In **section two** we explain why the answer to the first question – i.e., whether Vodafone and Sky would compete, absent the merger – is influenced to a substantial extent by the importance both now and in the future of providers being able to offer a bundle of three or four services to consumers that includes a subscription television product. We explain why, in our opinion, the economics of offering a so-called 'triple-play' (or 'quad-play') are sufficiently compelling that it is highly likely – perhaps even inevitable – that, in the absence of the proposed transaction:

1 Commerce Commission, *Statement of Preliminary Issues, Vodafone Europe B.V. and Sky Network Television Limited*, 14 July 2016 (hereafter: SOPI).

2 This might be because it is harder to compete with the merged firm than with the individual parties (i.e., Sky and Vodafone separately) and/or because Vodafone is no longer available as a prospective partner for other potential entrants, such as Fetch TV.

- Sky would enter the broadband market, in much the same way that BSkyB has done in the UK (with considerable success), and Foxtel has done in Australia as well as a great many other international subscription television providers; and
- as a consequence, Vodafone would be likely to seek to offer subscription television services (i.e., separately from Sky) as most other leading telephony companies have done – in part because Sky would become a direct competitor, thereby seeing an end to the existing collaboration.

We consider whether Sky has vital premium content and the constraint posed by SVOD providers.

In **section three** we describe why the answer to the second question – i.e., whether potential competition between Vodafone and Sky would be of significance – depends, in part, on whether the applicants are correct to contend that Sky does not possess any 'must have' content and faces strong competition from a variety of sources, such as subscription video on demand (SVOD) providers.[3] We explain why, in our opinion, the applicants appear to have overstated the degree of competitive rivalry in the pay-TV market; for example:

- Sky arguably *does* have access to content – often on an exclusive basis – that would be highly desirable to a potential entrant, such as important sport content (e.g., live rugby), key linear channels (Disney, etc.) and serialised dramas such as Game of Thrones; and
- the vast majority of the providers cited by the applicants are unlikely to constitute close economic substitutes for Sky's subscription service – and a number are best viewed as complementary services.

[

Redacted

]

Note that time constraints have prevented us from undertaking a comprehensive assessment of the competitive effects of the proposed transaction. We therefore do not offer a definitive view on this point in this report. The purpose of the analysis set out in the following sections is instead to highlight some of the key issues that we consider the Commission should examine when undertaking its own analysis of the effects of the transaction on competition, so that it can come to a considered view, with the benefit of more time.

[3] Vodafone Europe B.V. Clearance Application (29 June 2016) and Sky Television Limited Clearance Application (29 June 2016) (hereafter: 'Applications'), at §8.2.

2. Potential Benefits of Bundling

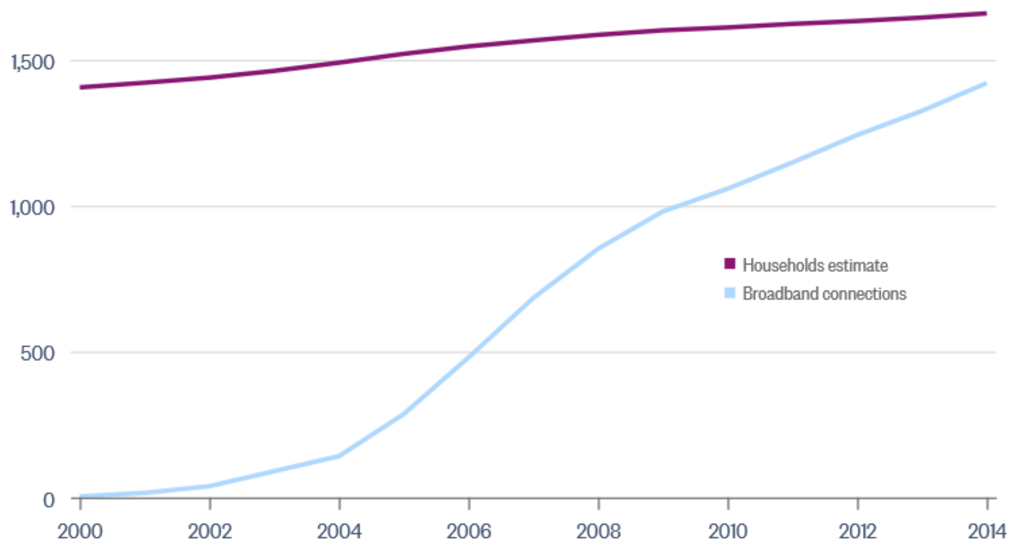
In this section, we highlight the potential 'in principle' benefits on offer to businesses that bundle voice and broadband services with a subscription television product delivered via the same infrastructure. We also highlight a number of international examples of firms engaging in this type of bundling. The economics of offering a bundled service are highly relevant to the Commission's deliberations. They bear directly on the question of whether Vodafone and Sky would be likely to compete with one another if the proposed merger did *not* proceed and on whether barriers to entry would be heightened if the merger *did* proceed.[4]

2.1 Bundling in telecommunications

The 'bundling' of telecommunications products is nothing new. Fifteen years ago, when broadband was in its infancy in New Zealand, many providers began offering the product to customers in addition to traditional voice services – a 'double-play'. The ensuing years saw a proliferation of double-play providers entering the market and the uptake of broadband services was consequently very strong. Today, more than 80 per cent of New Zealand households have access to a broadband service,[5] as Figure 2.1 illustrates.

Figure 2.1: Broadband connection and number of households

The broadband market is fast approaching maturity, so there is now far fewer potential new customers to attract.



Source: Figure.NZ. Available: here.

However, the uptake of broadband by New Zealand households during this period has meant that there are now fewer opportunities to 'grow' the market by signing up more customers. In short, the broadband market is fast approaching maturity.

4 As we noted above, barriers to entry might be raised because it is more difficult to compete with the merged firm than with Sky and Vodafone separately and/or because Vodafone is no longer available as a prospective partner for other potential entrants, such as Fetch TV.

5 Pilcher, P., 'The state of broadband in NZ' *in stuff.co.nz*, 19 May 2016. Available: here.

This means that the 'double-play' marketing strategy, although still widely employed, is not as effective for the simple reason that there are now far fewer new potential broadband customers to attract.

An inflection point in the competitive dynamics has been reached whereby firms are decreasingly competing for *new* customers and are instead striving to gain market share by winning *existing* customers. This is a much less hospitable competitive environment, since firms must typically incur greater acquisition costs per new customer. Meanwhile, churn rates within the subscriber base tend to increase due to the rising percentage off-contract customers and increased competitive activity. Also, margins are compressed due to competitive pressure arising from lower pricing and increased inclusions (e.g., higher bandwidth allowances, faster speeds, more free calls, etc.). The overall effect is strong pressures on portfolio profitability.

A triple-play products with pay-TV can help firms to retain and win existing broadband customers.

This is a trend being seen not only in New Zealand, but throughout the rest of the world. Faced with these challenges, businesses are increasingly turning to the so-called 'triple-play' as a way to increase the appeal of their bundles, arrest churn and improve overall profitability. The potential for service providers to offer a suite of three or four services by bundling voice and broadband services with pay-TV was foreshadowed more than a decade ago by the former Chairman of the Australian Competition and Consumer Commission (ACCC), Graeme Samuel, who observed at the time that:[6]

> *'Increasingly, video and TV services will be provided together with internet and traditional telephone services as part of what the telcos call the "triple play".'*

Nowadays, it is not only *feasible* for businesses to offer a triple-play – the challenges described above mean that it is now fast becoming a commercial *necessity*. As we explain below, the economics of such bundling are sufficiently compelling that it has emerged as a clearly dominant business strategy internationally, with operators seeking to vertically integrate so as to lock-in subscribers and harness the benefits of providing three or four services.

To be sure, a telecommunications provider that decides to supplement its voice and broadband services with a subscription television product will incur additional costs as a consequence ('incremental costs'). For example, if an internet service provider (ISP) decides to offer pay-TV from by purchasing a service from, say, Fetch TV, it will need to:

- fund the set-top box (STB);
- pay a wholesale price to procure the product, i.e., the pay-TV content; and
- modest relative increases in customer support (sales, customer care, tech support, etc.) to cater for incremental customer contacts and potential increases in average handling times.

6 Graeme Samuel, *Check Against Delivery*, *Address to the National Press Club*, 27 April 2005, p.9.

However, because the business would almost certainly already be providing a 'double-play' (i.e., telephony and broadband), there are a number of other costs that it will be able to avoid or minimise. Moreover, bundling three or four products together gives rise to a number of substantial potential benefits that will generally comfortably outweigh any incremental costs. We discuss these benefits below, before providing some international examples.

2.1.1 Marketing and sales benefits – improved acquisition effectiveness

It was not that long ago that almost no New Zealand households had a broadband service. As we noted above, since that time, many providers have entered the market offering broadband – often together with a voice product (a double-play). Almost without exception, the focus of such marketing was on the *broadband* component of the offering since, at the time, this was the new, 'high involvement' product – even though many consumers would ultimately purchase *both* components of the double-play, i.e., buy voice services as well.

However, as Figure 2.1 above illustrated, the broadband market is now approaching maturity and there are far fewer opportunities to sell a broadband connection to *new* customers. This has rendered the double-play marketing strategy less effective because, simply put, most customers now already have both voice *and* broadband. The latter is no longer a 'high-involvement' product that is simple to market – over time, it has become quite unremarkable and characterised by high inertia. This is particularly true for fixed-line broadband, which is now viewed largely as a commodity or 'dumb pipe'.

A business that that bundles voice and broadband with a pay-TV product can focus its marketing efforts on the latter.

This perception of broadband as a commodity will only intensify due to the rollout of the Ultrafast Broadband network (UFB), which is intended to provide a more level playing-field for all ISPs. This makes the prospect of marketing pay-TV all the more attractive. It *is* a high-involvement product from a marketing perspective, since entertainment can engage, excite, and motivate potential customers.

Specifically, a business that bundled voice and broadband with a pay-TV product at a single price point would be able to focus its marketing efforts on 'Heroing' the latter. Rather than focussing marketing messages for the triple-play on flagfall/call rates, included calls, or broadband data caps and speeds, businesses can emphasis ('Hero') the included content to grab attention and increase consideration. In short, subscription television has the potential to be the new 'high involvement' ('Hero') product for telecommunications companies.

For these reasons, we disagree with the parties' contention that 'pay-TV offerings do not drive substantial changes in broadband shares.'[7] In our opinion, the benefits described in this section, together with the overwhelming weight of international evidence set out in the next, suggests that pay-TV offerings are likely to be a *very important* driver of broadband shares, moving forward. Indeed, we expect that this is one of the key commercial rationales for the transactions.

7 Applications, at §11.13.

Moreover, as we foreshadowed above, the incremental costs associated with marketing/selling three or four products rather than two are likely to be modest, resulting in a reduction in the average acquisition cost per subscriber. For example:

- there is no need to outlay significant costs building brand recognition, since a double-play provider is likely to already have an established brand, e.g., Vodafone is a household name throughout New Zealand;
- there are no incremental media costs associated with marketing a triple-play instead of a double-play, i.e., it can be executed within the same 30-second television spot, print advertisement, etc.;
- there are few, if any incremental creative and/or production costs associated with marketing a triple-play instead of a double-play – the 'creative spend' is essentially the same; and
- the same sales team can sell three products instead of two – the only difference is likely to be a slight increase in average handling time and, perhaps, a modest increase in call centre capacity.

The incremental cost of marketing a triple-play is modest.

Moreover, it should be noted that if those marketing and sales efforts do lead to a significant increase in subscriber numbers, a potential additional advantage is that those customers that are procuring three or four services (as opposed to one or two) may be less inclined to switch suppliers, or 'churn'. This represents yet another conspicuous advantage of offering a triple-play, as we elaborate below.

2.1.2 Churn benefits

A certain level of 'churn' is inevitable in most retail markets as customers migrate for one reason or another to alternative suppliers. The telecommunications and pay-TV markets are no different. Churn has efficiency implications because it increases the costs of supply, i.e., churning customers cause providers to incur additional costs attracting and retaining subscribers. It follows that, if a provider is able to reduce the incidence of churn, this is likely to improve the efficiency of its operations and/or to reduce the volatility of its anticipated revenue stream.

Offering a triple-play may help a business to reduce its level of customer churn in two ways:

- offering a new product – in this case, pay-TV – introduces a new 're-contracting event' that provides businesses with an additional chance to 'lock-in' existing customers for an extended period and across multiple products; and
- once a customer is on-contract and buying three or four different products instead of just one or two, she is much less likely to switch providers (churn) once that contract expires.

In terms of the first benefit, there is no question that 'in contract' customers churn at a much lower rate than 'off contract' customers – often because of the existence of 'early termination fees' (ETFs). It is for this reason that mobile phone retailers commonly offer free – or heavily subsidised – handsets to customers who agree to sign a fixed-term contract, e.g., 24-months. During the intervening period, switching rates are, unsurprisingly, substantially lower – giving rise to a steady and much more predictable revenue stream.

Offering a triple-play provides a 're-contracting' event that can help a firm 'lock-in' its existing customers for longer.

Offering a new pay-TV product presents a business with an opportunity to sign existing broadband customers to a new contract for the provision of the more extensive bundle and extend the term for which they were otherwise committed. This may allow it to retain a greater share of its existing customers for longer than would otherwise have been the case. By way of illustration:

- an existing broadband subscriber may be 'off contract' (e.g., her initial contract may have expired) and be able to switch providers ('churn') without incurring an ETF; and
- if that customer decides to acquire the new pay-TV product, bundled with its existing services, the provider may be able to sign her to a new, 24-month contract for the entire triple-play offering (containing an ETF).

In the fixed line market there is no 'handset equivalent', i.e., customers do not upgrade their modems every one or two years, thereby giving rise to a periodic re-contracting event. In the ordinary course of things, churn therefore tends to happen only when a customer moves house, has a service disruption (or several) or decides to change providers due to price or offer considerations. However, the rollout out of the UFB network throughout the country will provide a one-off 'event' that changes this regular dynamic.

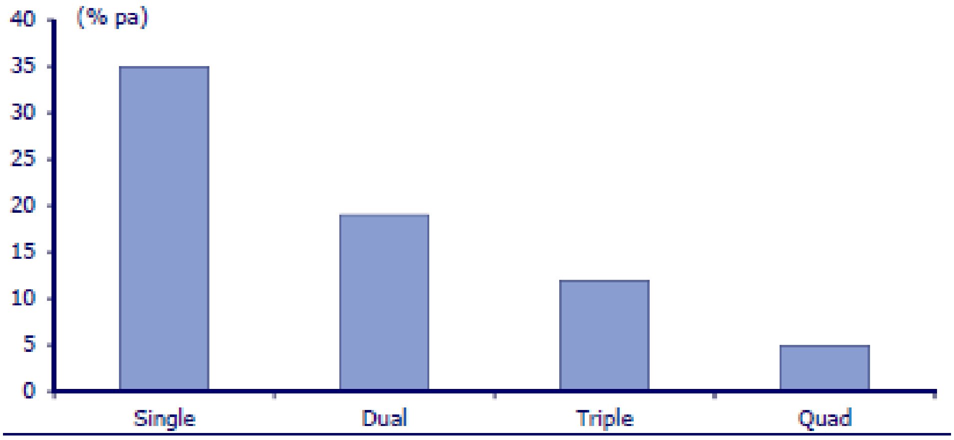
Once a customer has access to the UFB, she will have access to a product not previously available. This introduces a rare 'consideration/re-contracting event' for the entire market of fixed-line customers analogous to, say, the release of Apple's original iphone. ISPs' off-contract customer bases can be expected to be much more susceptible to churning during this UFB migration period.

Put simply, a typical new UFB customer can be expected to find an offer that includes voice, ultra-fast broadband and a pay-TV package with attractive content far more enticing than a simple double-play. In other words, in a world in which customers will be transitioning to fibre, a triple-play bundle provides a business with an opportunity to pro-actively re-contract *existing* customers and to attract *new* customers via their UFB marketing.

Furthermore, as we foreshadowed above, once customers are procuring three or four services, they are typically less inclined to churn than subscribers receiving only one or two products once their contracts expire. To put it colloquially, triple-play customers are 'stickier'. There is compelling market evidence of this phenomenon. For example, UK cable company, Virgin Media, has been offering superfast broadband services for some time and reports considerably lower churn rates for customers buying multiple services, as Figure 2.2 highlights.

Figure 2.2: Virgin Media churn rates by number of services per customer

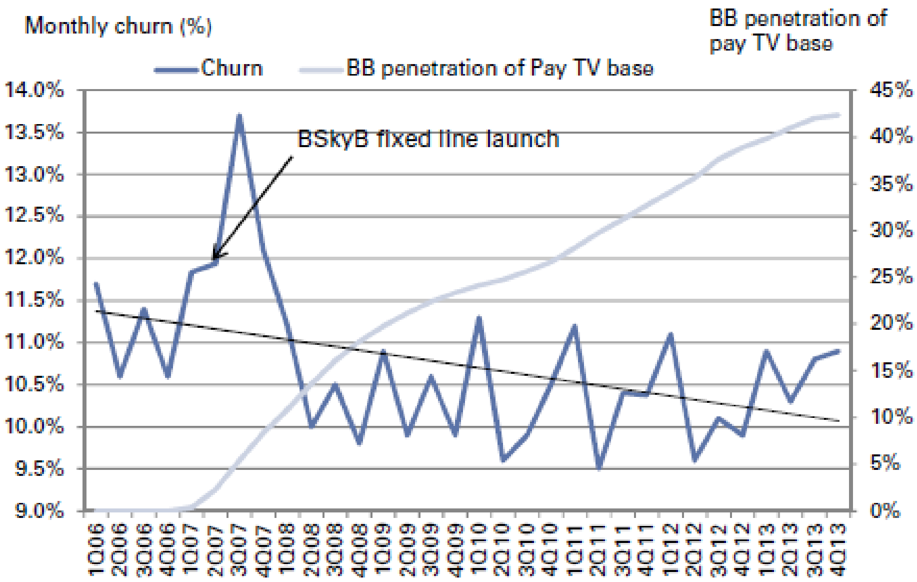
Once customers are buying three or four services, they are less likely to churn than when they are buying only one or two.



Source: CLSA, *Telecoms and media, sector outlook: Stream engines, From Broadcast to broadband*, 25 July 2016, Figure 41, p.17.

In a similar vein, Goldman Sachs has estimated that between the time that BSkyB in the UK started providing a triple-play in 2007 and December 2013, its rate of pay-TV customer churn decreased from 12 per cent p.a. to 10.5 per cent. Figure 2.3 below illustrates this trend (we discuss BSkyB's very successful triple-play offering in more detail in the following section).

Figure 2.3: BSkyB pay-TV churn rate versus broadband uptake, 2006-2013



Source: Goldman Sachs, *Australia Telecom Services: Deep dive into Foxtel Triple Play; A $1bn opportunity for Foxtel*, Exhibit 4, December 9, 2013, p.5.

There are a number of reasons why triple-play customers are less likely to churn – even when their contracts expire. First, if a customer is procuring a larger number of services from a single provider this reduces her 'ongoing contact' with other suppliers. In particular, it consolidates her billing relationships with other companies and, in turn, her exposure to 'below the line' marketing via mediums such as SMS, direct mail, bill inserts, etc. This reduces the customer's opportunities to peruse alternative products.

Second, there is additional inconvenience associated with switching. Once a customer is receiving three or four products from the same supplier, discontinuing *one* product may necessitate making alternative procurement arrangements for *all.* This disinclination to switch may be particularly pronounced in the case of pay-TV, because switching providers means:[8]

Switching pay-TV providers is more disruptive than changing phone providers, which makes those customers 'stickier'.

- losing all of the content that a customer has recorded and stored on her STB that she might want to watch again, i.e., an STB is, in effect, a digital library;
- in most cases, the loss of all purchased content (movies, TV shows) – known in the industry as 'electronic sell-through (EST)';
- the loss of all preference settings, including series links, parental controls, reminders and so on; and
- the loss of multi-device configurations/utility, any multi-room functionality and companion applications (phones, tablets, PCs).

A third source of additional inertia is the fact that, if a customer switches suppliers for an individual product this will, in most (if not all) cases, result in the forfeiture of a bundled discount – which can be significant. This can provide a material disincentive for a customer to 'break a bundle', since any benefit of switching a single product to another provider will more than likely be offset by the loss of the 'bundling benefit' on the remaining products. In other words, the bundling benefit acts as both an incentive for new customers, and a barrier to churn for existing subscribers.

2.1.3 Superior product economics

Hitherto, we have focused largely on the advantages that a triple-play can offer telecommunications providers in terms of consolidating their market shares in core broadband and voice products, i.e., the acquisition cost improvements and churn reduction benefits. However, businesses can also make money on the pay TV product itself, i.e., expand their overall margins by adding a third profitable product to the bundle. This can be achieved in large part because of the strong economies of scale and scope associated with providing the larger bundle.

Because the provider would almost certainly already be providing a double-play (i.e., telephony and broadband), there are a number of other costs that it would be able to avoid or minimise. This means that the incremental revenue that the business would need to earn from offering the bundle would not need to be particularly high before it outweighed the additional costs; for example:

8 In comparison, it is not particularly taxing to switch telephony providers – this can be done relatively quickly (e.g., in less than an hour), and a customer can typically keep his or her telephone number as well as all of the content that is stored on the handset (which used to represent an impediment to switching).

- the same DSLAM infrastructure that is already in situ to deliver voice and broadband services could be used to supply subscription television services, i.e., there may be no need to deploy new equipment;
- as we noted above, the incremental marketing and sales costs are likely to be modest, resulting in a potentially significant reduction in the average acquisition cost per subscriber;
- the service and technical support functions can also be undertaken by existing teams – there is likely to be a limited increase in customer service calls and billing inquiries, but these can be managed by leveraging existing capabilities;

Offering a triple-play can help a firm expand its overall margins by harnessing economies of scale and scope.

- there is no incremental billing cost – the additional service can be added to the customer's existing bill – and bad debt recovery/collection costs are also unchanged (or they may even decline);
- there may be no need to acquire additional office or call centre space and there is unlikely to be any significant increase in overheads such as energy costs and operating and maintenance expenses;
- IPTV products such as Fetch TV are 'plug and play' and do not require a 'truck roll' (i.e., a technician to connect the service at the customer's premises), which means that logistics costs would be largely unchanged – the only difference is that a customer would be sent a slightly larger 'package' that contains a STB (for the pay-TV service) as well as a modem; and
- the pay-TV content could be delivered via the telecommunications provider's existing customer delivery network (CDN – i.e., it's 'pipes') – there would be no need to pay potentially costly interconnection fees to hosting companies.

For all of these reasons, the cost of providing pay-TV as part of a triple-play is much less than providing it on a 'stand-alone' basis. A telecommunications provider will have already outlaid many of the costs associated with providing pay-TV, and so there is no need to duplicate them if that additional product is added. The same also applies in reverse. Namely, a pay-TV provider that seeks to offer a triple-play by entering the telephony markets (i.e., to supply voice and broadband services) would experience similar cost advantages.

Because the costs that are common across voice, broadband and pay-TV (of which there are many) can be defrayed over these multiple services, this enables providers to earn higher margins and to pass on some of those cost savings to their customers. In other words, the superior product economics of a triple-play will typically enable suppliers to offer bundled discounts to their customers, whilst achieving margin expansion, i.e., the incremental revenue will tend to exceed the bundled discount.

2.2 International examples

Triple-play competition is now the norm internationally.

There is now a large number of examples from around the world of pay-TV providers beginning to offer telephony services and of telephony businesses starting to offer pay-TV. Such bundling is now self-evidently the dominant business strategy amongst such providers, as they seek to vertically integrated to lock in subscribers and harness the benefits described above.[9] We provide some examples in the following section – but we stress that this is not an exhaustive list.

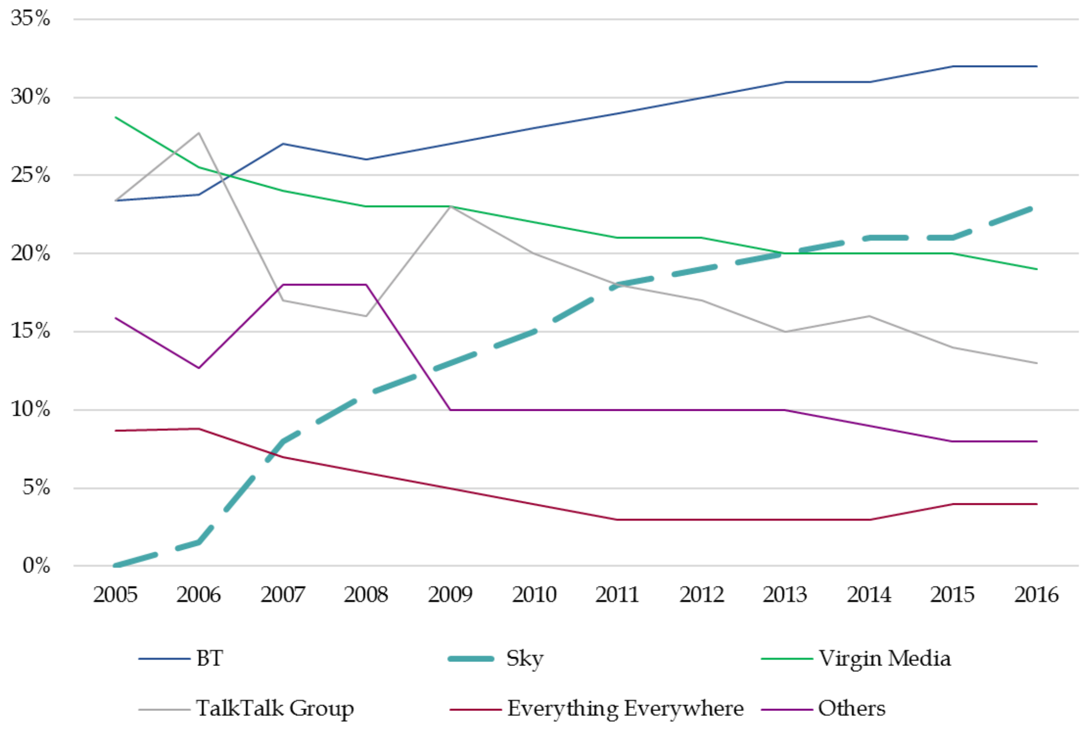
2.2.1 United Kingdom

In the UK in recent years, major pay-TV platform players have sought to extend the range of services they offer beyond TV in response to slowing growth in their core maturing markets and in light of consumer preferences. The most obvious example is BSkyB (Sky). Stagnating growth in standalone pay-TV subscriptions prompted it to invest in broadband in 2006, and to begin targeting the cross-promotion of fixed line and broadband services to core TV subscribers via bundled triple-plays.

This strategy has been an unambiguous success. Since its launch, Sky has been the UK's fastest-growing broadband and telephony provider. Between 2006 and the end of 2015, its market share of the UK fixed broadband market grew from zero to 23 per cent – with it adding more than 5.5 million broadband connections.[10] It is now the second largest broadband provider behind British Telecom (BT) (which had a 32 per cent market share at the end of 2015). Figure 2.4 below illustrates this strong growth.

After launching a triple-play offering in 2007, Sky experienced strong growth in broadband market share and overall profits.

Figure 2.4: UK residential and small business broadband connection shares



Source: Ofcom, *Communications Markets Reports*, 2006-2016.

The adoption of this 'triple play' strategy has been lucrative. For example, in December 2013, Goldman Sachs observed that in the then six years after Sky

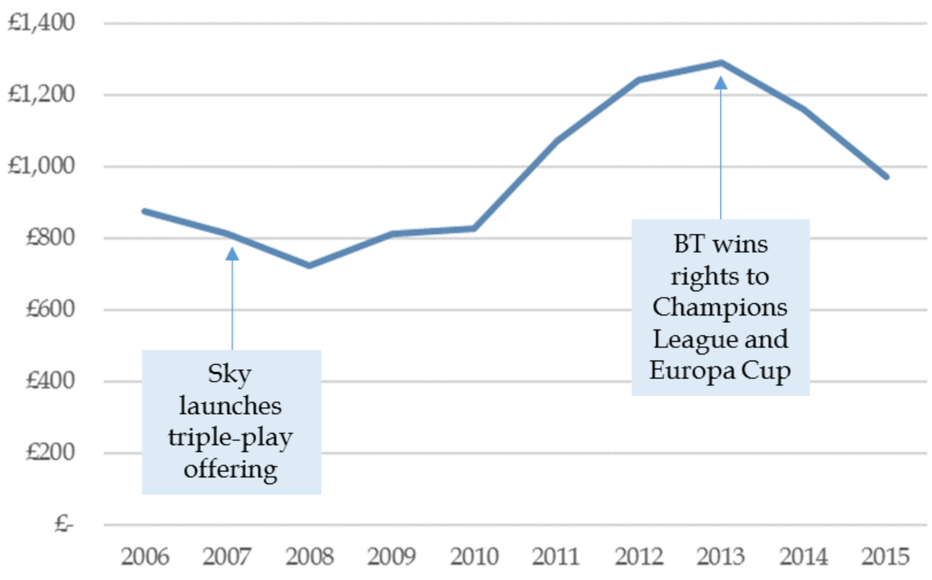
9 *See for example:* Mediatique, *The development of free-to-view television in the UK by 2024*, May 2014, p.2.

10 CMR, *Facts and figures 2016*, available here.

commenced offering a triple-play in 2007 by supplying fixed line services, it had experienced an incremental 15 per cent uplift in revenues and EBITDA. During this window, analysts such as Deutsche Bank consistently maintained a 'buy' recommendation for Sky, noting that broadband and telephony had been the driver of its earnings, despite limited pay-TV growth.

Figure 2.5 shows a distinct upward trend in Sky's operating profit[11] in the period following the launch of its 'triple-play' offering in 2007. This is most pronounced in the five-year period from around 2008 to 2013, during which time Sky's operating profit increased by almost 80 per cent overall. This trend has reversed somewhat in recent years. As we explain below, this reduction has corresponded to a period in which BT has invested heavily in its own triple-play offering in competition with Sky, and secured the rights to key premium sporting content.

Figure 2.5: Sky operating profit (£m), 2006-2015



Source: Sky Annual Reports, 2006-2015: available here.

BT responded to Sky's offering by launching its own triple-play product and investing heavily in pay-TV content.

Sky's success in the period following the launch of its broadband service in 2007 encouraged broadband/telephony players to improve their own bundled services by adding audio-visual elements to form triple-play offerings. For example, BT has invested in pay-TV services through 'BT Vision', including in premium sports rights. BT's strategy is essentially aimed at protecting its broadband base – particularly in Sky homes – and taking as many 'greenfield' homes as possible against key competitors Sky, TalkTalk and Virgin – all of which offer competitive triple-play alternatives.

BT's determination to compete vigorously with Sky was evident during last year's auction for the rights to broadcast English Premier League football matches. Seven packages were available in the auction – five with 28 games per season and two

11 Operating profit is equal to revenue *less* operating expenses. Note that the 2010 figure excludes £269m of one-off litigation settlement income.

with 14 games per season. BT won two of these packages[12] – enabling it to expand and improve upon its previous offering.[13] BT paid £738m over three years from 2013-16 for these 38 games per season.[14] In other words, it obtained 114 games at a price of £6,473,684 each.[15]

In addition, two-years' earlier in 2013, BT outbid Sky and ITV to secure the rights to screen UEFA Champions League and Europa Cup matches. BT paid £897m to win the rights to show 350 matches over three seasons, spanning 2015-16 (see here). In other words, in little over three years, BT has spent well in excess of £1.5b securing the rights to premium football coverage in order to provide an attractive alternative triple-play proposition to Sky. As mentioned above, this might be a significant contributor to the decline in Sky's operating profit from 2013 to 2015.

2.2.2 Australia

Just as in the UK, all of the major Australian providers offer a triple-play product.

The story in Australia is much the same as in the UK. All of the chief players in the telecommunications space now offer a triple-play bundle that incorporates some form of audio-visual content. Telstra, for example, resells Foxtel (in which it owns a 50 per cent stake) and also offers an IPTV product called 'Telstra TV' (via a Roku STB – see here). Several of the other ISPs – including Optus, Vocus and TPG (via the iiNet retail brand recently acquired by TPG) have partnered with Fetch TV to offer its IPTV product.

In addition, earlier this year, Optus paid A$189m to secure exclusive Australian broadcast rights to the English Premier League for the next three seasons (see: here). The deal includes live broadcast coverage and digital rights for broadband and mobile. This serves to indicate the willingness of telecommunications businesses to provide compelling triple-play offerings in competition with the largest pay-TV provider – Foxtel. Figure 2.6 summarises Australian telecommunications companies' media offerings.

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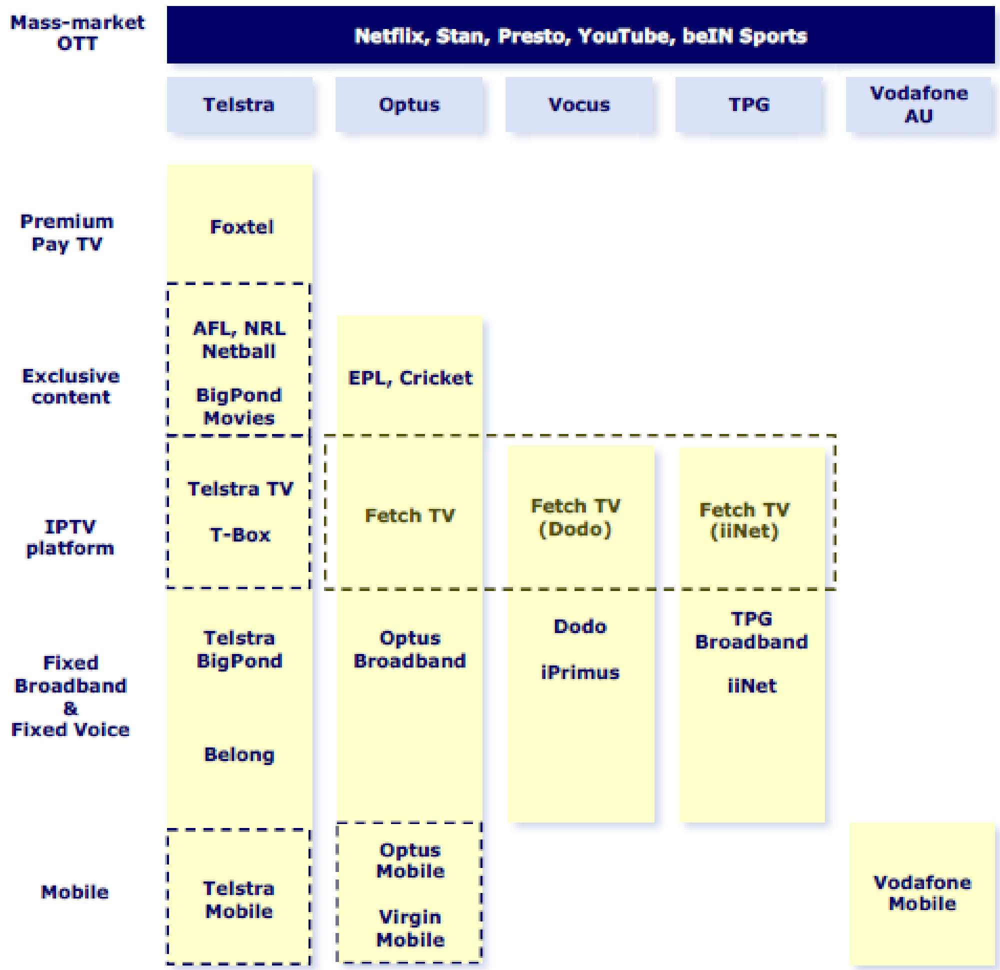
12 Specifically, it won 'package B', which entailed 28 games at tea-time on Saturdays (5.30pm). It also won 'Package F', which had 14 games – a mix of midweek and Saturday games, including three 'first picks'. Sky won the other five packages. See here.

13 The new 5.30pm Saturday slot was held previously by Sky. BT has 'swapped' that new slot with its previous Saturday lunchtime broadcast, which was considered one of the weaker slots.

14 This represented an 18 per cent increase in what it paid three years earlier: see here.

15 In comparison, Sky paid £2.28bn over three years from 2013-16 for 116 games per season or, in other words, it gets 348 games at £6,551,724 each. This was 83 per cent more than it paid at the prior auction: see here.

Figure 2.6: Australian telecommunications companies' media offerings



Source: CLSA, *Telecoms and media, sector outlook: Stream engines, From Broadcast to broadband*, 25 July 2016, Figure 48, p.19.

Much like Sky in the UK, Foxtel has responded by offering its own broadband product (see here), which it launched in early 2015 (see the announcement here). At present, Foxtel's broadband product is delivered over Telstra's ADSL network. However, Foxtel has announced that it also intends to offer broadband and home phone bundles over the National Broadband Network (a similar deployment to the UFB network in New Zealand).

2.2.3 North America

In the US, cable television companies have invested in broadband, and telco providers have invested in pay-TV.

In the US, cable television companies, such as Comcast and Time Warner have invested heavily to build broadband infrastructure and boost speeds in an effort to establish themselves as the broadband providers of choice for consumers. As of the second quarter of 2014, the top US cable companies had more broadband subscribers than cable-TV subscribers - 50.6 million versus 49.6 million. They also had more broadband customers than did the telephone companies with 35.2 million broadband subscribers. Figure 2.7 illustrates.

Figure 2.7: US broadband subscribers end of Q2 2014

US broadband subscribers - end of 2Q14		
Broadband internet cable companies	**Subscribers at end of 2Q14**	**Net adds in 2Q14**
Comcast	21,271,000	203,000
Time Warner	11,965,000	86,000
Charter	4,850,000	62,000
Cablevision	2,779,000	(9,000)
Suddenlink	1,103,300	200
Mediacom	987,000	3,000
WOW (WideOpenWest)	769,600	12,900
Cable ONE	482,725	(1,443)
Other major private cable companies	6,475,000	25,000
Total top cable	**50,682,625**	**381,657**
telephone companies		
AT&T	16,448,000	(55,000)
Verizon	9,077,000	46,000
CenturyLink	6,055,000	(2,000)
Frontier	1,900,500	27,500
Windstream	1,153,800	(16,600)
FairPoint	333,421	1,883
Cincinnati Bell	270,300	300
Total top telephone companies	**35,238,021**	**2,083**
Total broadband	**85,920,646**	**383,740**

Source: CLSA U, *T-Volution, Soap opera in the living room,* 17 December 2014, Figure 27, p.37.

But by the same token, like their counterparts in the UK and Australia, US telecommunications companies have also invested significant resources into pay-TV products to provide their own triple-plays. For example, AT&T has invested in U-Verse TV (see here) and Dish (see here). Verizon has invested in FiOS (see here). Equally, in Canada, Bell also offers pay-TV (see here). In other words, the pattern is the same – vertical integration, followed by triple-play competition.

2.2.4 France

Competition between triple-play providers is also the norm in France.

Competition between triple-play providers is also the norm in France. Telecommunications company Iliad is Europe's largest and the world's fourth-largest IPTV provider. SNL Kagan has estimated that, at the end of 2012, Iliad had 4.2 million IPTV subscribers, translating to a 6 per cent global market share.[16] Iliad's Freebox TV, launched in November 2003, offers more than 400 channels and more than 10,000 VOD titles.[17] Iliad more than doubled its broadband subscribers between the end of 2005 and the end of 2008.[18]

16 SNL Financial, *State of top 20 global IPTV operators*, 16 May 2013, p.2.

17 Its subscribers receive one of the world's most comprehensive programming line-ups, featuring major Western and Eastern European, Asian, Arabic and Hispanic channels, as well as premium Vivendi SA Canal+ and CanalSat channels. Iliad's strategy involves deploying Freebox units to all broadband subs, creating significant triple-play upsell potential. One year after launching Freebox TV, it added HDTV programming, offering more than 50 HD and four 3-D channels by April 2013.

18 *ibid.*

Incumbent telecommunications operator France Telecom Group-Orange, and Vivendi SA's SFR also both offer a triple-play. SNL Kagan has estimated that these businesses served an estimated 4 million and 2.8 million IPTV customers at the end of 2012, claiming 5.8 per cent and 4 per cent global IPTV market shares, respectively.[19] France Telecom launched its Orange TV-branded IPTV service in 2003.[20] In 2006, it expanded its IPTV deployments beyond France, with the largest secondary market being Poland.

In 2008, Orange launched satellite TV services catering to broadband subscribers unable to access TV over telco DSL and fibre networks. Orange TV France maintained a 13.4 per cent compound quarterly growth rate from the first quarter of 2005 to end-2012 and a 58.7 per cent compound annual growth rate from end-2005 through end-2012.[21]

2.2.5 Asia

In China, China Telecom served an estimated 19.4 million subscribers at year-end 2012, accounting for 94.7 per cent of China's IPTV video subscribers.[22] China's second-largest telco, China Unicom, is also amongst the largest global IPTV operators in terms of total subscriber numbers, despite accounting for only 5.3 per cent of China's IPTV households at year-end 2012. China Telecom and Unicom both offer pay TV services in partnership with broadcasters that hold IPTV business licenses, such as Shanghai Media Group.

Providers in China, Hong Kong and Korea also all offer triple-play products.

In Singapore, telecommunications provider, Singapore Telecom, offers a full service pay-TV product called Singtel TV as part of a triple-play offering (this product was formerly known as Singapore Telecom IPTV and mio TV). Much like BT in the UK and Optus in Australia, it has acquired the exclusive rights to premium sporting content, such as English Premier League football, and is competing strongly with Star World – Asia's largest subscription TV provider.

In a similar vein, Hong Kong Telecom offers a quad-play to its customers in Hong Kong by delivering media content on its fixed-line, broadband Internet access and mobile platforms jointly with its parent company, PCCW Limited. PCCW Media operates the leading pay-TV service in Hong Kong under the Now TV brand, delivering both self-produced and licensed content to its customers using IPTV technology.[23]

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19 SNL Financial, *State of top 20 global IPTV operators*, 16 May 2013, p.2.

20 France Telecom's program offerings include more than 140 linear channels, VOD, SVOD, 3-D and HD TV, and DVR options. It has also secured key premium sports rights including Ligue 1 live football matches.

21 SNL Financial, *State of top 20 global IPTV operators*, 16 May 2013, p.2.

22 *op. cit.*, p.1.

23 Now TV offers more than 180 linear channels of local, Asian and international programming. Its premium content can also be accessed on-demand and on the go via Now Player app. It is also a leading producer of Chinese language news, financial news and sports programming in addition to Asian infotainment content which complements its wide portfolio of licensed movie and international television content. PCCW Media is also engaged in the provision of over-the-top

In Korea, KT – formerly Korea Telecom – launched an IPTV service, MegaTV, in 2004. KT ceased MegaTV operations due to regulatory restrictions in August 2005, before relaunching with an IP-VOD service in June 2007. The Korean Communications Commission awarded it an official IPTV license in September 2008. In April 2009, MegaTV was renamed QOOK TV and then to Olleh in January 2011. At year-end 2012, Olleh TV served 2.3 million linear IPTV subscribers.[24]

In August 2009, via a partnership with direct-to-home (DTH) player Skylife, KT launched QOOK TV Skylife – a hybrid platform integrating DTH-delivered linear channels with QOOK TV's VOD service. Branded as Olleh TV Skylife in 2011, the service's success led to rapid growth, with subscribers increased from 86,000 at the end of 2009 to 1.8 million by the end of 2012. In other words, in Korea, triple-plays are again the dominant strategy.

2.3 Implications

The applicants contend that they do not compete with one another[25] but, instead, offer 'complementary' services. In a very narrow sense, that is true – at least as of *today*. However, for the reasons set out above, it is these complementarities between the parties' respective telephony and pay-TV offerings that are likely to provide the primary impetus for the proposed transaction. Specifically, for the reasons we set out above, by bundling the two service offerings together, the merged firm would be able to:

If the merger did not proceed, the benefits from bundling which are motivating the transaction would be no less compelling to the individual firms.

- attain economies of scope and scale that would enable fixed and common costs to be defrayed over additional products and, potentially, across a larger number of subscribers and, by passing on some of those efficiencies in the form of "bundle benefits", allow it to increase the overall appeal of its offering;
- market the 'high involvement' subscription television product as a 'Hero' in the bundled offering and, in the process, increase the sales/acquisition efficiencies of broadband and voice services, and
- potentially reduce significantly the costs associated with customer churn, consistent with the BSkyB experience in the UK, which would improve the efficiency of their operations and reduce the volatility of revenue streams.

However, it must be remembered that, if the transaction was not to proceed, these potential benefits from bundling which are motivating the merger *would be no less compelling to the individual parties*. There is therefore every reason to think that they would continue to pursue them through other means. In other words, it is very unlikely that the parties would remain a pay-TV provider and a telephony

(OTT) video service under the Viu brand in Hong Kong and other places in the region. In addition, MOOV is a music digital streaming service.

24 Olleh TV offers more than 178 live IPTV channels, HDTV, online education, banking, gaming and 90,000 VOD titles including Hollywood films and television shows from Time Warner Inc.'s Warner Bros., Sony Corp. and Walt Disney Co.

25 Applications at §8.2.

company, respectively, moving forward. With that in mind, what might those parties do in the absence of the transaction?

2.3.1 What might Sky do?

If the proposed merger did not proceed, Sky would still have a strong commercial imperative to enter the broadband market. The BSkyB experience described above – and the myriad other international examples – suggests that such entry is highly probable, if not inevitable. There are a number of potential options at Sky's disposal for entering the market, for example, it might:

If the merger did not proceed, Sky would be likely to enter the broadband market by some other means.

- resell another provider's voice and broadband services to form a triple-play bundle;
- buy the relevant wholesale inputs from Chorus and enter the market itself, e.g., as other providers such as Trustpower have done; or
- buy another ISP, e.g., a smaller provider.

These options are not necessarily mutually exclusive. For example, Sky might enter in the first instance as a reseller, and then seek to acquire another ISP. Although there are several potential 'paths to market', in our opinion, the key point is that it is highly likely that Sky will find a way to enter if the transaction does not proceed. The very large number of examples of pay-TV companies throughout the world doing precisely that supports this conclusion.[26]

2.3.2 What might Vodafone do?

If the proposed transaction did not go ahead and Sky entered the broadband market via other means, then it would become a direct competitor to Vodafone. In those circumstances it would is highly unlikely – probably untenable – that Vodafone would be prepared to continue reselling Sky; unless it was subject to prohibitive contractual restrictions under its existing agreement. Doing so in such circumstances would seem to be quite clearly contrary to its commercial interests, which would render the existing wholesale reselling arrangement unsustainable.

Once faced with a competitor – in Sky – that is offering an integrated triple-play bundle, the most logical response would be for Vodafone to follow the example of a rapidly growing number of telecommunications companies throughout the world and seek to offer *its own* competing pay-TV service. For example, as we noted above, this is precisely how BT responded when BSkyB entered the UK broadband market with great success. It is also consistent with Vodafone's approach overseas, where it has started offering a triple-play in a number of countries, for example:

- in Portugal, Vodafone offer a 'TV-over-fibre' product to its customers which, since July 2015, has been available in 4K (Ultra HD) (see: here and here);

[26] For example, as we noted earlier, as of the second quarter of 2014, the top US cable companies had more broadband subscribers than the 'traditional' telephone companies.

- in Germany, Vodafone offer 'Vodafone TV' and, in December last year, it commenced offering its broadband customers a new STB to access its IPTV and VOD services (see: here); and
- in Spain, in March, Vodafone has also launched a new 4K Ultra HD STB aimed at its broadband subscriber base (see: here).

A potentially compelling proposition would be for Vodafone to offer a pay-TV service by partnering with a provider such as Fetch TV – potentially as part of a coalition of other ISPs. This is precisely what has happened in Australia, where Fetch TV's IPTV product is now offered as part of 'triple-play' bundles by all three of the major 'non-Telstra' ISPs, including Optus, Vocus and TPG (via iiNet).

Optus in particular is a potentially instructive case study here. Prior to 2002, it was a vigorous competitor in the pay-TV market, supplying a service in direct competition with Foxtel over its own HFC cable network. However, it eventually entered into a content sharing agreement with Foxtel and became a mere reseller (i.e., 'Optus TV featuring Foxtel'). In other words, it was in an analogous position to Vodafone's current situation with Sky.

If the merger did not proceed, Vodafone would be likely to find another way to offer a pay-TV product.

However, those market dynamics changed dramatically when Foxtel announced its intention to enter the broadband market and, to a lesser extent, when Telstra announced its intention to launch its 'T-box' product (which has since been replaced with its 'Telstra TV' offering). Optus responded to those respective triple-play threats launching its own pay-TV service. It chose to do so by offering Fetch TV's IPTV product to its customers and, as we noted above, more recently it also acquired the exclusive rights to the next three seasons of English Premier League football.

Optus' alternative to partnering with Fetch TV (a 'buy' solution) was to invest in its own pay-TV product offering, e.g., invest in the necessary infrastructure, procure a portfolio of content, etc. (a 'build' solution). However, in smaller markets like Australia and New Zealand the 'buy'/'partner' option is often the more attractive. In particular, it enabled Optus to offer an 'off-the-shelf' (or 'turnkey') solution at a relatively attractive price-point, with high-quality content (given Fetch TV's relationships with content providers), modest risk and a quick speed to market.

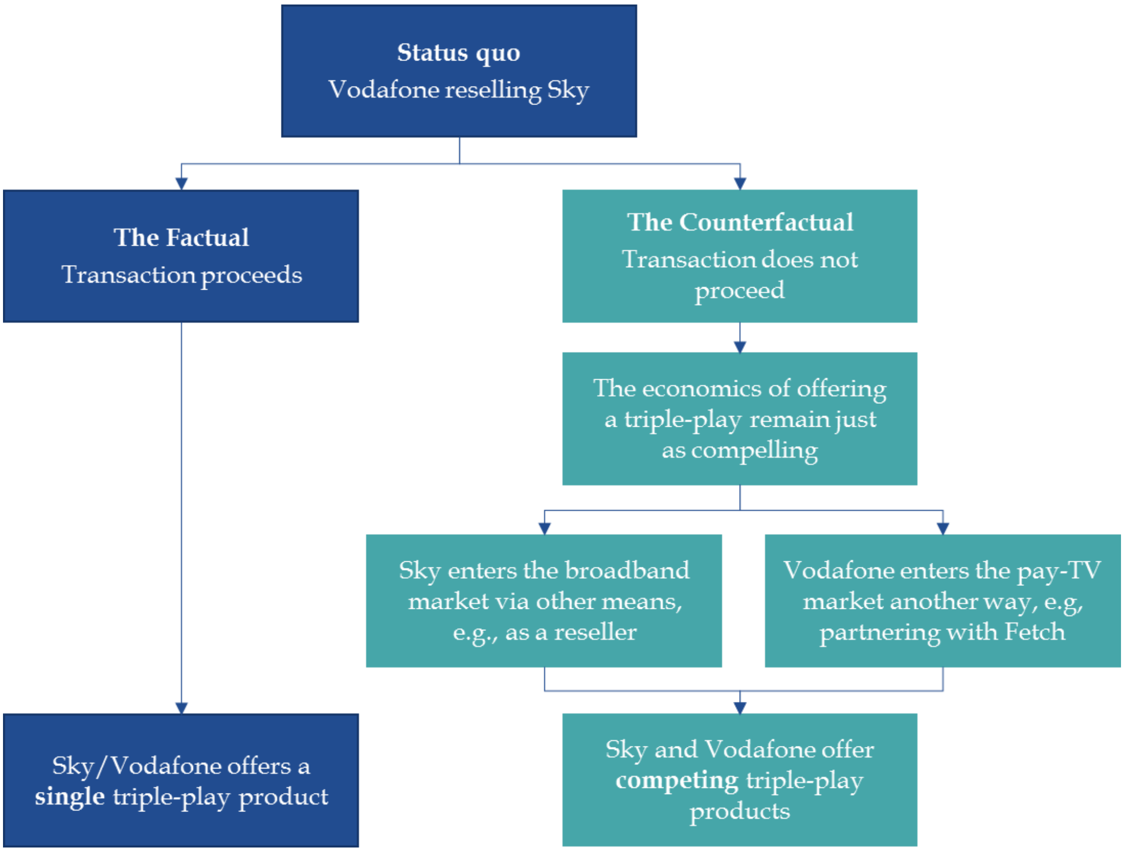
In our opinion, there is every reason to think that a similar scenario would play out in New Zealand in the absence of the proposed transaction. Namely, that Vodafone would find another way to offer pay-TV content to its customers to address the competitive threat likely to be posed by Sky, e.g., by partnering with Fetch TV – perhaps in conjunction with other ISPs. Again, the large – and growing – number of examples of telecommunications providers across the globe adopting this strategy supports this conclusion.

2.3.3 Summary

The most likely and appropriate counterfactual against which the Commission should assess the potential competitive effects of the proposed merger is one in which *both* Sky and Vodafone augment their existing stable of services by providing triple-play offerings. In contrast, the economics of bundling described above are likely to mean that the status quo is simply not an appropriate reference point against which to assess the proposal. Figure 2.8 below summarises.

The most likely counterfactual is one in which the two parties provide competing triple-play products.

Figure 2.8: The counterfactual



In other words, the answer to the Commission's question of whether the parties would be likely, without the merger, to launch any services that would be in competition to one another is, in our opinion: yes, they would. It follows that the lack of overlap between the services offered by the two parties *today* should not be relied upon to discount the potential for the proposed merger to give rise to adverse unilateral effects in *the future*, relative to the counterfactual.

3. Competitors to Sky

In their applications, the parties submit that the pay-TV market is becoming increasingly competitive and imply that Sky does not currently possess a significant degree of market power.[27] This key contention rests, in turn, on two separate – but related – propositions:

- that Sky does not have any premium content that would limit rivals' ability to compete and, by extension, neither would the merged firm; and
- that Sky is facing (and the merged firm would face) strong competition from a variety of sources, such as subscription video on demand (SVOD) providers.

If these propositions are correct, then this would diminish the importance of any potential future rivalry between Vodafone and Sky. It would also assuage any concerns relating to potential vertical foreclosure. However, for the reasons we set out below, we are not persuaded by these submissions.

3.1 The importance of premium content

The parties contend that they would not have any premium content that would limit rival providers' ability to compete in any market. To support this contention, they point to the wide variety of content that is now available from alternative sources – including from SVOD providers (which we explore in more detail in the following sections) – and the fact that only Vodafone chose to take up Sky's resale offering. We do not find this reasoning compelling.

3.1.1 Sky possesses a great deal of premium content – often exclusively

There is no doubt that there is a wealth of content available from a wide variety of sources. But it is the quality of that content that matters.

There is no doubt that there is a wealth of content available from a wide variety of sources. But, by the same token, there are also many different places that one might watch a game of live rugby. It does not follow from this that the price a local rugby club charges for admission (if anything) to watch its first XV play has an influence on the prices charged for tickets to All Blacks matches. It is the *quality* of the content that matters. A local club game would not be a comparable product to an All Blacks test in the eyes of many (or any) prospective consumers.

The key question, therefore, is whether the content that is provided by the myriad providers cited by the parties in their applications represents a close economic substitute for Sky's offerings, i.e., whether it would place a constraint on the price that Sky can charge for them. Former ACCC Chairman, Graeme Samuel, highlighted the importance of high quality content to the potential success of pay-TV providers as early as 2005, when he stated that:[28]

> *'Crucial to the success of any ventures using these new technologies will be content rights, and control of premium sporting content, such as AFL, rugby, rugby league, cricket and tennis, could be pivotal. It is vital therefore that no single network*

[27] Applications at §11.10 and §12.2.

[28] Graeme Samuel, *Check Against Delivery*, Address to the National Press Club, 27 April 2005, p.9.

owner acquires exclusive rights to all that content and effectively locks out the potential competition … I like to put it this way: if you can't control the arteries, what you do is get hold of the blood.'

In this respect, we note that Sky holds the rights to some very important content, including virtually all live rugby (e.g., All Blacks tests, super rugby, the Mitre 10 cup) and NRL, the Olympic Games and the current seasons of many hit shows such as Game of Thrones and Fear the Walking Dead. In our opinion, if this content does not fall under the moniker of 'premium content' – particularly live rugby – it is not altogether clear what would. If live rugby was no longer on Sky, intuitively, we would expect its subscriber numbers to decline significantly – perhaps even substantially.

In our opinion, and as we explain in more detail in the following section, this is likely to be one of the reasons why the emergence of alternative content providers such as Netflix and the many other SVOD firms cited by the parties appears not to have had a substantial impact on 'traditional' pay-TV platforms. CLSA U reported recently that, in the US market:[29]

> *'Nearly 85% of consumers who own a connected TV still subscribe to platform based, pay-TV subscription (satellite or cable or IPTV) … cable television still has an edge over internet TV in the USA, with TV viewers maintaining their platform-based, pay-TV subscription likely because streaming services such as Netflix and Hulu Plus,* ***still do not offer the quality, timeliness of release, and range of content they want: namely, live sports, the current seasons of hit cable-TV shows, or the latest content on top cable channels such as ESPN and HBO****.'* [emphasis added]

The merged firm would have access to a lot of premium content – often on an exclusive basis.

In other words, although *some* of the content that is offered by SVOD providers is 'nice to have' and may compete with Sky's offering at the margin (e.g., movies), this does not detract from the fact that the merged firm would have core content that is 'vital to have'.[30] A useful thought experiment to highlight this point is to imagine how a typical customer might react if a Vodafone broadband product was bundled with Sky's offering or a SVOD firm's offering, respectively. For example:

- if a customer needed to purchase a broadband product from Vodafone in order to see All Blacks and Super Rugby games live in HD, then it is quite plausible that she would be willing to switch broadband providers – particularly if bundled discounts are offered; but
- if the same customer needed to purchase a broadband product from Vodafone in order to view much of the other content cited by the applicants – e.g., NBL matches, domestic cricket or even Netflix – it is harder to imagine that she would be willing to do so, even if bundled discounts are provided.

The challenges that a prospective competitor to Sky face are exacerbated considerably by the fact that a significant quantity of the premium content that Sky

[29] CLSA U, *T-Volution, Soap opera in the living room,* 17 December 2014, p.37.

[30] In this respect, we find the contention that the music streaming application Spotify is somehow comparable to premium sport content such as, say, live All Blacks matches very difficult to accept. *See:* Buddle Findlay, *Sky/Vodafone: Sky's Initial response to submissions,* 23 August 2016, p.4.

possesses currently is held *on an exclusive basis*. Some of the exclusivity periods are very lengthy, which means that certain premium content will be unavailable - in some cases for many years. Appendix A provides a confidential overview of the content rights that Fetch TV understands Sky possesses on an exclusive basis. It reveals that these rights encompass core premium sports content (e.g., live rugby), key 'tier 1' linear channels (e.g., Disney, Discovery, etc.) and, in some cases, prominent linear channel brands (e.g., the "History Channel").

As Fetch TV explained in its summary submission, access to well-recognised linear channels such as Disney and Discovery is crucial to supplying a competitive pay-TV platform. When compared with the alternative of, say, building a new channel from scratch, offering a 'known-quantity' with a high-level of existing brand-appeal offers a number of compelling advantages – particularly in smaller market such as New Zealand. These benefits include the following:

Sky's exclusive rights to premium content creates significant barriers to entry.

- the licence to distribute a linear channel carries with it the right to use and to market the channel brands – many of which have extremely strong name recognition, e.g., Disney, Discovery, etc.;
- linear channels have a substantial advantage over steaming services in the provision of the all-important first run content, which will be available between 1 and 3 years before it is offered on SVOD services;
- linear channels offer the pay-TV platform the ability to effectively provide an 'on-demand' service to the customer, i.e., it can be recorded to the subscriber's hard drive, recorded to the cloud or offered as part of an in-house catch-up service for a 7- to 14-day period; and
- they are far more attractive from a cost perspective, e.g., they are generally offered on a variable (per subscriber) basis and not on the basis of the fixed cost licensing required by providers of content to an SVOD service – this reduces greatly the risk associated with content acquisition.

The fact that Sky has exclusive access to such a significant number of high-profile linear channels – not to mention premium sports rights – creates significant barriers to entry for potential competitors. For example, Spark could, in principle, launch its own pay-TV product by, say, partnering with Fetch TV. However, even if the parties could reach mutually acceptable terms (which is by no means assured), could Spark/Fetch TV offer customers a compelling alternative to Sky/Vodafone, given the content that Sky has tied up? In our view, that is far from clear.

In other words, even if a prospective entrant had a *theoretical* path to market in the absence of the transaction, it may be illusory *in practice* if Sky has pre-emptively tied-up a substantial amount of premium content so as to foreclose that potential competitive threat. Moreover, with the additional scale provided to the merged firm through Vodafone's customer base and the various other benefits set out in section 2.1, it is conceivable that no other firm would be in a position to challenge the merged entity when those exclusive rights expire.

3.1.2 Why do broadband providers not bundle SVOD services?

There are a number of additional factors that serve to further discourage broadband providers from bundling a SVOD service. The first is that, even if the content on offer was comparable to Foxtel/Sky (which is questionable), a business would not create any meaningful barriers to churn by bundling a ubiquitous SVOD product. For example, if a customer was purchasing a bundle that included say, Quickflix, from Vodafone and switched to Spark, her username and password would still work. In short, there would be no real inconvenience created at all, i.e., none of the barriers to churn described in section 2.1.2 would apply.

There are many reasons why broadband providers have not bundled their services with SVOD offerings, such as Netflix.

In the case of Netflix – by far the most popular SVOD provider – there is the further problem that it will not allow its service to be offered as part of a 'hard bundle'. For example, Vodafone could not bundle Netflix with any of its existing products and market it to customers at a single price, on a single consolidated bill. Rather, Netflix requires its service to be purchased and billed separately, and to be cancellable independent of any other product. A telecommunications provider might be permitted to offer the customer 3-6 months of the service for free (while paying Netflix out of 'its own pocket') – but no longer than that. This serves to remove many of the advantages of the triple-play strategy described earlier, for example:

- it compromises the 'product economics' benefits described in section 2.1.3, because Netflix must be priced separately; and
- it undermines the 'customer churn' benefits set out in section 2.1.2, since a customer must be able to cancel the bespoke Netflix component of any bundle.

Furthermore, irrespective of the type of SVOD service that a broadband provider was seeking to incorporate into its existing offering – e.g., Netflix, Stan, Presto, etc. – none would provide access to the so-called 'HDMI 1' portal. As we explain in more detail subsequently, this makes OTT and SVOD providers significantly less attractive potential partners than the likes of Sky or Fetch TV, which *would* be in control the primary platform that customers utilise to acquire and view pay-TV content (i.e., the 'HDMI 1' interface) and all the benefits that entails.

3.1.3 Why does no other broadband provider resell Sky?

It is worth touching finally on the question of why no other broadband company has taken up Sky's resale offer if it has such attractive content. In their application, the parties contend that this must mean that Sky *does not have* any vital content.[31] A similar line of inferential reasoning featured in a memorable scene from *the Simpsons*, in which Homer is reflecting on the supposed success of the neighbourhood 'Bear Patrol' – formed at great expense by the residents of Springfield:

> *Homer: Not a bear in sight. The Bear Patrol's working like a charm.*
> *Lisa: That's specious reasoning, dad.*
> *Homer: Thank you, dear.*
> *Lisa: By your logic I could claim that this rock keeps tigers away.*

[31] Applications at §11.42.2.

Homer: Oh, how does it work?
Lisa: It doesn't work.
Homer: Uh-huh.
Lisa: It's just a stupid rock. But I don't see any tigers around, do you?

Just as there was an alternative (and far more plausible) explanation for the lack of 'bear sightings' in Springfield following the inception of the 'Bear Patrol', so too is there a number of other potential reasons why broadband providers have been unwilling to resell Sky, despite ostensibly having the option to do so. These were highlighted by Fetch TV in its summary submission of 12 August 2016 but, by way of brief recap:

The fact that no other broadband suppliers chose to resell Sky does not mean that it does not have a large volume of vital content.

- by wholesaling the Sky service, an operator would be allowing Sky full access to its customer base, which would provide it with a strategic advantage if it chose itself to become a provider of broadband[32] – which, for the reasons we set out in the previous section, is highly likely in the absence of the transaction; and
- we have been instructed by Fetch TV that the financial terms offered by Sky in respect of such wholesale access are not commercially attractive, do not offer sustainable margins for distributors and contain unfavourable non-price terms of conditions of supply.

We are therefore unconvinced by the parties' submissions that Sky does not have access to decisive premium content that would limit rivals' ability to compete in the pay-TV market. Rather, Sky continues to hold the rights to vital content – such as live rugby games – often on an exclusive basis, as Fetch TV highlighted in its summary submission. Moreover, as we explain below, the content that is provided by the likes of SVOD providers might, in most cases, best be characterised as *complementary* to Sky's offering, rather than a *substitute* for it – and many of those suppliers may not exist in the future in any event.

3.2 Substitutes or complements?

In addition to being by far the largest provider of subscription television services in New Zealand, Sky also has a virtual monopoly over the primary platform that customers utilise to acquire and view pay-TV content – the 'HDMI 1' portal. As Fetch TV outlined in its summary submission, in practice this means that Sky will typically have:

OTT and SVOD have not sought to control the 'HDMI 1' portal – they have instead been happy to be a tier on existing platforms.

- control over the remote control primarily used by the consumer to access television content and the consumer's user interface when she switches on her television;
- a primary billing relationship with the consumer; and
- the ability to act as a platform for the hosting of third party services (including over-the-top (OTT) and other SVOD services, such as Netflix.

32 Sky would not only have customers billing information but, via advertising insertion, a very low cost yet highly effective means to market to them in high frequency.

OTT and SVOD services have not sought to provide their customers with access to a similar platform, i.e., to control the 'HDMI 1' portal. They instead seem to be prepared to be a 'tier' on an existing pay-TV platform, rather than supply a competing platform. Moreover, as we foreshadowed above, although some providers – such as Netflix – offer some undeniably attractive content, it is highly debatable whether it constitutes a close economic substitute for Sky's offering – particularly in light of its (often exclusive) rights to other premium content.

It is consequently unclear how many of the providers cited by the parties in their application will ultimately survive in the longer-term – recent international experience suggests that it may not be many. Furthermore, it not at all obvious that those providers that do survive – Netflix being an obvious candidate – would be offering a close *substitute* that would enable large numbers of customers to cancel or 'downsize' their Sky subscriptions. Instead, they may simply *complement* the content a customer is already purchasing from Sky. We elaborate below.

3.2.1 Significant challenges faced by OTT and SVOD providers

OTT and SVOD providers are undoubtedly attracting an audience. But that does not mean that they are profitable, or affecting materially the growth and ongoing viability of platform providers such Sky. Simply put, SVOD and OTT services constitute an infinitesimal share of total pay-TV revenues and profit pools, globally. Indeed, an analyst recently observed that no OTT provider is generating meaningful free cash flow or EBITDA – including YouTube and Netflix.[33]

Few SVOD providers have remained financially viable on a sustained basis.

Indeed, despite earning revenues of more than $6b globally last year and having 100 times as many subscribers, Netflix is significantly less profitable than Sky – a fact that the Chief Executive of Sky, John Fellet, sought to emphasise recently:[34]

> *'Netflix, which has almost 100 times as many subscribers as Sky around the world, was "significantly less" profitable than Sky with a profit margin of just 1.9 per cent, he said. Last year Netflix made an annual profit of US$122m (NZ$167m) – not much different to Sky – on revenues of more than $6b. Its last quarterly profit was US$41m (NZ$56m).'*

Aside from major global players (such as Netflix), SVOD services have had considerable difficultly remaining economically viable. As Fetch TV described in its summary submission, the Australian pay-TV market has seen many SVOD and other players fail or struggle to achieve the scale required to build a business able to compete with Foxtel. By way of brief recap:

- Netflix dominates with around 75 per cent of the SVOD market share;
- the shareholders of the SVOD service Stan (Nine Entertainment and Fairfax Media) have signalled that the service will require additional capital of circa $50m, despite around A$110 million having already been invested;

33 Media Partners Asia Research and Consulting, *The Route, Issue 2*, 21 July 2015, p.5.

34 Pullar-Strecker., T, 'Sky profit falls 14% as revenue flat lines' in *stuff.co.nz*, 26 August 2016. Available: here.

- the third main SVOD service in Australia, Presto (owned by Foxtel and Seven West Media), is reported to be facing considerable challenges in building market share and revenue, and speculation is mounting that Seven will exit the Joint Venture and that Foxtel will discontinue by merging the service with its existing Foxtel Play service;
- Quickflix, an early SVOD provider, is in administration; and
- EzyFlix shut down its operations in 2015, less than two years after it had launched its SVOD service.

To put it colloquially, Australia has become something of a 'graveyard' of failed SVOD providers. The challenges faced by OTT and SVOD providers are exacerbated by their relatively modest purchasing power when it comes to premium content. In short, their capacity to purchase a suite of content that is comparable to Foxtel's offering in Australia (or Sky's in New Zealand) is limited. As Venture Insights (2015) observed recently in relation to the Australian market:[35]

> *'If we assume that the SVOD operators invest 50% in programming then this equates to A$211m of programming investment in FY16 with Netflix contributing roughly half of this. By FY20, this increases to A$424m. Importantly,* ***this pales in comparison to broadcasters (FTA and Pay-TV) which invest around A$3.5b pa in programming****.'* [emphasis added]

Overall, this experience and the challenges that such operators face suggests there is cause to be very sceptical about whether many of the providers identified by the parties in their application will ever become profitable going concerns. Moreover, it is unclear whether those firms that do continue to exist in the long-term would constitute a serious competitive threat to Sky, or affect materially its ongoing profitability. We consider why in the following section.

3.2.2 Consumers see the services as largely complementary

The likely extent of the effect of OTT and SVOD providers should be kept in perspective.

It would be wrong to suggest that OTT and SVOD providers will have *no effect* on the competitive landscape, moving forward. In all likelihood, they will. However, as Venture Insights observed recently, it is important to keep the likely extent of that effect in perspective. It stated that the revenue risk posed by SVOD providers in Australia relates only to certain content such as movies.[36] It foresaw no material change in customers' appetite to pay for, say, premium sport content. It consequently saw SVOD providers a competitive threat only at 'the edges'.[37]

This conclusion was reinforced by a survey undertaken by Venture Insights of 5,300 Foxtel consumers on their attitudes and intentions towards SVOD providers. Of the 5,300 customers surveyed, 65 per cent said that they had not even considered

35 Venture Insights, *Pay-TV Market Outlook – the growing importance of Pay-lite*, 2 October 2015, pp.5-6.

36 *op. cit.*, p.2.

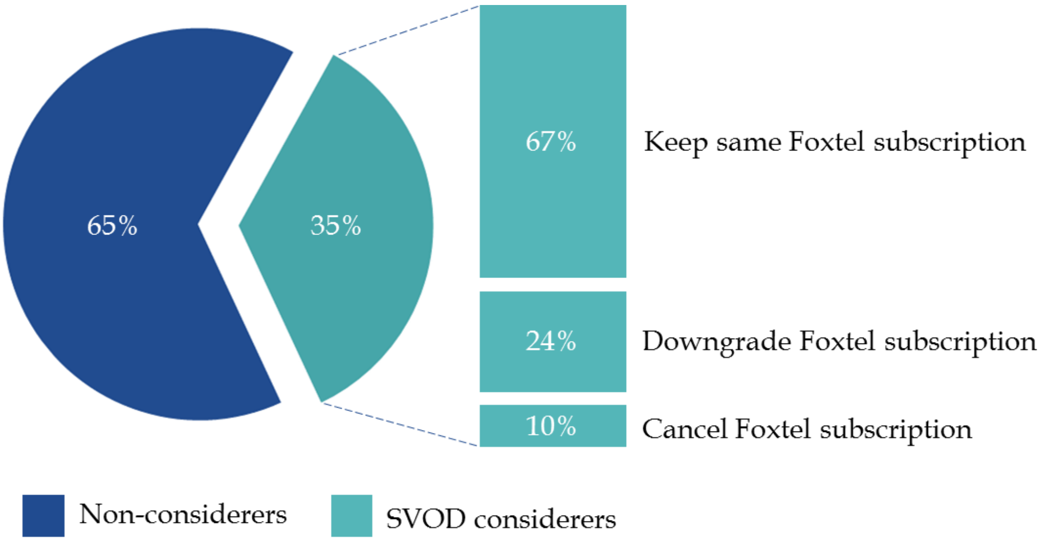
37 *op. cit.*, p.6.

purchasing a SVOD service. Furthermore, of those 35 per cent of customers that *had* considered purchasing a SVOD service:[38]

- only 10 per cent said that they would cancel their Foxtel subscription;
- 24 per cent responded that they would downgrade their Foxtel package; and
- 67 per cent said that they would consume the SVOD service *in addition* to Foxtel

The results of this survey are summarised in Figure 3.1 below.

Figure 3.1: Foxtel subscriber intentions



Source: Venture Insights, *Pay-TV Market Outlook – the growing importance of Pay-lite,* 2 October 2015, p.2.

Put another way, Figure 3.1 implies that:

Most customers were not even considering purchasing SVOD services and, of those who were, most saw those services as complementary to Foxtel.

- **88.5 per cent** (i.e., 65% + 35% x 67%) of the customers surveyed said that they would continue to buy the same service from Foxtel, irrespective of whether they were considering purchasing a SVOD service;
- **8.4 per cent** of the customers surveyed indicated that they might downgrade their service (e.g., cease purchasing a movies package), but would still continue to take buy Foxtel (e.g., the basic package plus sports); and
- only **3 per cent** of customers who responded indicated that they would countenance cancelling their Foxtel subscription entirely, i.e., 'cutting the cord' and switching to a SVOD provider for all their viewing needs.

The results indicate that most of the customers surveyed were *not even considering* purchasing SVOD services and, of those who were, most saw those services as *complementary* to Foxtel's offering, i.e., they would buy *both*. In our view, there is no obvious reason to think that New Zealand customers would see things any differently. If anything, they may be even *more reluctant* to switch away from Sky, since much of the premium sports content that is available only on Sky in New

38 Venture Insights, *Pay-TV Market Outlook – the growing importance of Pay-lite,* 2 October 2015, p.3.

Zealand is broadcast on Free-to-air (FTA) television in Australia on account of the anti-siphoning legislation.

In many – if not most – cases, purchasing Sky and, say, Netflix is not an 'either/or' proposition; customers can and do buy both.

This implies that in many – if not most – cases, purchasing Sky and, say, Netflix is not an 'either/or' proposition; customers can and do buy both. As a number of commentators have observed, 'doubling up' on pay-TV subscriptions is increasingly becoming the means by which subscribers can get all the content they want, when they want it and how they want it. CLSA U reported recently that this is precisely what is happening in the US market:[39]

> *'There has been some speculation about the impact which internet-TV content aggregators and their original content has had on premium cable subscriptions but, according to SNL Kagan, it has been minimal … Premium cable subscriptions have remained stable or have increased minimally as premium content, like HBO, has remained attractive enough that even "cord-cutters" still wish to retain access to premium content - namely, their favourite TV shows.'*

This is also wholly consistent with the recent remarks of the Chief Executive Officer of Sky in the UK, Jeremy Darroch. Mr Darroch stated that 45 per cent of Sky's customers also use Netflix. He observed that:[40]

> *'Netflix has been in the UK for a few years now and both [of us] have continued to grow well. It would be wrong to characterise [Sky v Netflix] as an either/or [choice]. What we are doing in terms of box-sets and the Now TV proposition we have built up is strong. I can't see why we won't continue to grow strongly and others will as well. It is not about dividing up the pie, it is about growing the pie.'*

Moreover, it is not only *consumers* that would seem to view pay-TV platform providers and SVOD services as being largely complementary. There is also compelling evidence to suggest that this is also the way in which the providers of the two services perceive *one another*. As we explain below, this has been the case for some time, and this view is becoming even more entrenched.

3.2.3 The suppliers themselves see the services as largely complementary

Pay-TV platform providers and SVOD services also appear to view each other's services as being largely complementary.

The largely complementary relationship between SVOD providers and pay-TV platforms is illustrated starkly by the fact that, in December 2007, Netflix was poised to release its own STB that would stream movies and TV from its then-nascent 'Watch Now' catalogue. However, at the last minute, Chief Executive Officer, Reed Hastings, cancelled the project. The Netflix player was eventually spun out to Roku (see here), and subsequently launched by (amongst others) Sky UK and Telstra.

According to *Fast Company* (see here), Reed Hasting's rationale was that, if the company released its own hardware, it would be seen as a competitor to the very companies with which it was hoping to partner. One high-level source was reported as saying that:[41]

39 CLSA U, *T-Volution, Soap opera in the living room,* 17 December 2014, p.38.

40 As reported in: Media Partners Asia Research and Consulting, *The Route, Issue 2,* 21 July 2015, p.9.

41 Carr, A., 'Inside Netflix's Project Griffin: The Forgotten History Of Roku Under Reed Hastings', 23 January 2013. Available: here.

> *'Reed said to me one day, "I want to be able to call Steve Jobs and talk to him about putting Netflix on Apple TV," … "But if I'm making my own hardware, Steve's not going to take my call."'*

This reasoning proved prescient. Nowadays, increasing numbers of pay-TV providers are offering SVOD services as part of their platforms – and, consistent with the sentiments expressed by its CEO in 2007, Netflix is willing to collaborate with them. For example, a recent report by IHS Technologies observed that Netflix has partnerships in place with 25 pay-TV providers (e.g., Netflix is available on Fetch TV – the first platform upon which it was available in Australia), and this number seems poised to grow, for example:

- in July this year, US cable TV giant Comcast announced that it would Netflix onto its X1 platform (see here); and
- in Australia, Foxtel is reportedly considering including Netflix in the company's own version of an on-demand streaming service (see here).

SVOD services being offered as a tier on an existing pay-TV platform is clearly viewed as a 'win-win', highlighting the complementary relationship.

The IHS report also included a survey based on interviews with executives from companies across the pay TV value chain, including operators and their technology partners. The results generally support the view that third-party video-steaming services positively impact pay-TV operators' performance and serve to *complement* traditional channels and VoD offerings. For example, when Virgin Media decided to allows its customers to access Netflix from its TiVo STBs the arrangement was widely viewed as mutually beneficial (see here):

- it enabled Netflix to grow its existing base of paid subscribers; and
- it allowed Virgin Media to expand the value of its TiVo STBs and also kept subscribers locked into its platform, which in turn:
  - maintained viewership figures, which made its customers more likely to explore its live TV and on-demand offerings; and
  - increasing the likelihood that its customers would continue to renew their subscriptions, i.e., reduce churn.

In other words, OTT and SVOD services have consciously eschewed from seeking to control the aforementioned 'HDMI 1' portal – in Netflix' case, even abandoning such a strategy at the last minute. They instead seem happy to be a 'tier' on an existing pay-TV platform. Perhaps largely for that reason, those providers are increasingly being embraced by pay-TV platforms and being presented as part of their own offerings. This is clearly viewed as a 'win-win', highlighting the symbiotic relationship between the two services.

It is therefore far from clear that OTT and SVOD providers are close substitutes for pay-TV platform services such as Sky.

In other words, from an economic perspective, it is far from clear that OTT and SVOD providers are close economic *substitutes* for pay-TV platform services such as those offered by Sky. To be sure, there may be some limited substitution at the margin ('cord shaving') – e.g., some customers might cancel their 'Sky movies' package and rely on Netflix. However, the material set out above suggests strongly that the vast majority of customers that are countenancing buying a SVOD product will see it as *complementary* to Sky.[42]

3.3 Implications

In their applications, the parties submit that the pay-TV market is becoming increasingly competitive and imply that Sky does not currently possess a significant degree of market power. They claim that the merged firm would not have any vital premium content, and that there would be a wide array of substitute services available from alternative providers – such as SVOD players. For the reasons set out above, we do not find these contentions persuasive because:

- Sky does appear to have access to a significant amount of premium content (such as the rights to live rugby and 'tier 1' linear channel) – often on exclusive terms – that would limit rivals' ability to compete with the merged firm;
- very few, if any, of the providers cited by the parties in their application – including the plethora of SVOD suppliers – constitute obvious close economic rivals to Sky for a number of reasons, including:
  - international experience suggests that many, if not most, of these providers will not become profitable going concerns and will exit the market in the longer-term; and
  - those providers that do survive will not necessarily be supplying a *substitute* service to Sky's offering – it seems more likely that most customers will continue to buy Sky, with some supplementing their viewing with content obtained from other providers, i.e., the services may be *complements* rather than *close economic substitutes*.

The applicants' contention that there is strong competition in the pay-TV market from the likes of SVOD providers should be viewed with scepticism.

It is likewise important to note that:

- SVOD providers have not, hitherto, competed for premium sports rights (e.g., live rugby matches) and there is no obvious reason to think that this would change in the future (or that they would be successful in the event that they did decide to compete for such rights); and
- for the reasons we set out in the previous section, SVOD providers are unlikely to have any material bearing on competition in the broadband market, e.g., bundling Netflix with a Vodafone product would be a far less effective strategy than pairing it with premium Sky content such as live rugby.

For these reasons, we consider that the Commission should view the applicants' contention that there is strong competition in the pay-TV market from the likes of SVOD providers with scepticism. In our view, the mere fact that there is a large number of firms supplying content cannot be relied upon to discount the possibility that the merged firm might attempt to engage in an anticompetitive vertical foreclosure strategy if the transaction proceeds.

42 In other words, most customers would continue to buy Sky to access its premium content and may then simply supplement their viewing with content obtained from other providers.

Appendix A Confidential Material

[Redacted]