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If you won't pay them, buy them!: Merger Mania in Distribution and Content Markets

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ABSTRACT

Structural changes in TV markets are resulting in carriage disputes that have spread from the United States to Europe. A carriage dispute refers to a disagreement between a pay-TV operator and a broadcaster over the right to 'carry' a broadcaster's channel. TV broadcasters are demanding ever increasing payments from pay-TV operators that complain about lower-profit margins due to spiralling programming costs. This article discusses vertical mergers between distributors and broadcasters as a possible way to reduce retransmission payments and to secure cheap and privileged access to programming in today's hypercompetitive video markets.

KEYWORDS
pay-TV
vertical merger
retransmission payments
programming costs
business model
cable industry

GROWING NUMBER OF RETRANSMISSION BATTLES

Carriage disputes between pay-TV operators and TV broadcasters have become increasingly public in recent years. A carriage dispute refers to a disagreement over the right to 'carry', or retransmit, a broadcaster's channel. Some of these disputes have taken the form of epic battles, dominating policy forums and heating up public debate for months. In August 2013, for example, Time Warner Cable (TWC) dropped major network CBS in eight large US markets after TWC and CBS failed to agree on a new retransmission contract – accusing each other of grandstanding and punitive conduct. Additionally, TWC demanded CBS' exclusive rights so as to prevent over-the-top (OTT) competitors from obtaining the live rights to CBS programmes. Although industry watchers expected that this fight would cost CBS some $400,000 a day, TWC's third-quarter earnings (Q3, 2013) revealed that the cable operator had lost no less than 306,000 subscribers following the month-long CBS blackout (CBS also blocked TWC broadband subscribers from watching programmes online on CBS.com). Against all odds, CBS was able to negotiate a substantial increase in retransmission fees (from about 50 cent to around $2 per subscriber per month) and to maintain its digital rights that it could sell to Netflix, Amazon and others (Stock 2013).

Although the mechanisms of retransmission payments are strongly rooted in historical and structural patterns of the US media system, market-driven compensations, on top of existing copyright provisions, are also making inroads into European TV markets. Some pay-TV operators, mainly cable operators, have been paying TV broadcasters retransmission fees for decades, but since the mid-2000s European TV broadcasters have put retransmission fees back on the industry and policy agenda. Free-to-air broadcasters in the United Kingdom, Germany, Belgium, the Netherlands and other countries started seeking after (higher) retransmission payments and complained about distributors' unfair economic practices (Evens and Donders 2013). In the United Kingdom, for example, terrestrial broadcasters BBC, ITV, Channel Four and Channel Five stated they were paying leading pay-TV platform BSkyB £24.4 million per year to have access to the satellite platform. Following public controversy about the high access charges, in February 2014, the BBC, ITV and BSkyB reached an agreement that reduces the BBC and ITV's payments for platform services to zero. Instead of charging free-to-air broadcasters, Mediatique (2012) calculated BSkyB should pay the channels retransmission fees between £190 and 220 million. Hence, ITV announced its intention to push for BSkyB to pay US-style retransmission fees to carry the commercial channel, which could provide an additional income source. ITV argues that its investment in programming – about £1 billion per year – is justification for the payment of retransmission fees by BSkyB and Virgin.

HIGHER PROGRAMMING COSTS, LOWER PROFIT MARGINS

Having more alternatives for distribution, broadcasters can now play pay-TV operators off against each other and bargain more favourable deals than in previously monopolistic markets. Structural market changes due to digital TV distribution and competitive entry in distribution have allowed broadcasters to demand higher retransmission fees, resulting in an increasing number of negotiating impasses between pay-TV operators and broadcasters (O'Reilly 2008). Moreover, the high dependence on advertising income and the competitive pressure on these revenues following commercial skipping and on-demand viewing urge TV broadcasters to diversify their revenue base. Indeed, changing economic conditions call for alternative and possibly more stable income sources. Whereas advertising investments tightly correspondent to economic conjuncture, subscriptions for premium cable and satellite services have proved quite persistent during economic downturns (Picard 2011). Even more, consumer expenses have been on the rise for years. The development of digital TV was accompanied with a shift towards subscription services, changing the function of free-to-air broadcasters into showrooms for premium channels and on-demand platforms. Therefore, it is no surprise that TV broadcasters started bargaining for higher retransmission payments from pay-TV operators, and want to benefit from the spectacular growth of pay-TV, following the completion of digital switchover, in most parts of the world (Evens 2013).

Basically, it all boils down to the question of who actually benefits from whose investments. Discussions between free-to-air broadcasters and distributors are captured by the tension between maximizing own revenues while not jeopardizing a long-lasting contractual relation. Broadcasters argue that relations with distributors are (no longer) economically 'fair' (Donders and Evens 2014). Although free-to-air broadcasters in Denmark, the Netherlands and Belgium receive substantial retransmission payments, they contend that this fee is too low in comparison with the popularity of their programming which is driving pay-TV adoption. Broadcasters claim that they carry the bulk of investments in quality content, whereas distributors take a disproportional share of the pie, without significantly contributing to the financing and production of that content. Waterman and Han (2010) provide an empirical basis for such claims, demonstrating that pay-TV operators have been able to take far greater economic advantage of the digital switchover than broadcasters. According to Ofcom (2012), in 2010, UK public service broadcasters spent 27% of their revenues on domestic first-run productions (£1.868 billion) compared to only 2% spent by pay-TV operators (£215 million). However, profits are unevenly shared among the TV industry. Ernst & Young (2013) found that cable operators, partly fuelled by high-margin bundling strategies, overall have cash flow (EBITDA) profit margins of 41%, outperforming satellite operators (25%) and TV broadcasters (19%).

However, network operators argue that these margins are becoming under severe pressure due to spiralling programming and network costs. The popularity of online video and the subsequent increase in data traffic is placing an extra burden on the network's performance (Netflix, e.g., accounts for about a third of total broadband usage in the United States), urging additional investments in network optimization (without significant return). Moreover, pay-TV operators report an enduring pressure on video margins from continued high programming cost growth. According to SNL Kagan (2013) retransmission fees in the United States grew from $215 million to $762 million between 2006 and 2009, and they are projected to exceed $6 billion in 2018. Pay-TV operators' programming expenses (as a proportion of total revenues) have risen from 33.3 per cent to 39.7 per cent between 2004 and 2013, and are likely to further erode pay-TV operators' margins. Finally, the saturation of digital TV penetration in most Western European countries is slowing down revenue growth. Due to intense platform competition in the pay-TV market, there is a continuous pressure to offer enticing programming bundles and price promotions. As the long-term sustainability of the current pay-TV business model is questioned, the industry is looking for new growth strategies.

TRENDING: HORIZONTAL AND VERTICAL MERGERS

Pay-TV markets, both in Europe and in the United States, have seen an acceleration of merger and acquisition activity since 2013. The New Wave of mergers and acquisitions is characterized by far-going consolidation in distribution markets and concentration among content providers and distributors. Vodafone's acquisition of Ono and Kabel Deutschland in Spain and Germany, as well as Liberty Global's acquisition of cable infrastructure in the United Kingdom (Virgin) and the Netherlands (Ziggo) are exemplary for further horizontal concentration. In the United States, cable operators Comcast and TWC are expected to merge, as well as IPTV operator AT&T and satellite provider DirecTV. Liberty Global's interest in vertical integration has become apparent through its purchase of shares (all in 2014) in production company all3media, free-to-air broadcaster ITV and De Vijver Media, a Belgian production and free-to-air television company. Liberty Global, which earns over 90 per cent of its revenues in the twelve European markets it is active in (Austria, Belgium, Czech Republic, Germany, Hungary, Ireland, the Netherlands, Poland, Romania, Slovakia, Switzerland and the United Kingdom), has been unequivocal about its strategy of vertical integration with OTT, television production and free-to-air television. In an interview with the Wall Street Journal, CEO Mike Fries said such a strategy is a means to overcome competition from players such as Netflix and to avoid transmission fees for broadcasters reaching US levels (Schechner and Zekaria 2014).

It is expected that the horizontal and vertical strategy undertaken by Liberty Global will act as blueprint for further industry consolidation in distribution and content markets. In effect, consolidation lies at the heart of the future pay-TV business model. Horizontal partnerships give the merging parties more scale and leverage in programming negotiations; larger pay-TV operators are typically able to negotiate lower retransmission fees per subscriber than smaller firms (Adilov and Alexander 2006). The purchase of a free-to-air broadcaster allows cable operators to sit on both sides during carriage negotiations, and indirectly control the spiralling retransmission fees that broadcasters receive. Research shows that, apart from possible market foreclosure and discriminatory conduct, vertical integration leads to operational efficiency in bilateral contracting and reduces transaction costs (Waterman and Choi 2011). Paying lower retransmission fees to affiliated broadcasters will automatically temper fees paid to competing broadcast networks, and bring retransmission payments, especially in the United States, back to normal levels. This is not a counterproductive development per se since US broadcasters have gained a competitive advantage vis-à-vis pay-TV operators, but this evolution is not welcomed in Europe, where monopolistic cable operators still control most national markets. In such a market structure, there is a concern that lower retransmission payments will ultimately result in lower investments in original content commissioning and thus negatively affect the development of a robust, innovative European content ecosystem.

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