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Regulation and Competition in Media Markets: the Evolution of Pay-TV in Uk, Australia and Italy

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Abstract

The paper compares recent antitrust and regulatory decisions in pay-tv markets in UK, Australia and Italy. Notwithstanding different initial conditions in these countries, a common model of regulation has emerged based on the principle of incumbents' waiving of exclusivity rights on content distributions for alternative technological platforms and on the creation of a new market for wholesale access to incumbents' contents by downstream competitors. In UK, these results have been obtained by moral suasion exerted by regulator on the dominant satellite operator. In Australia, new market design has been the consequence of undertakings imposed by the Competition commission on the proposed content sharing agreements among the main pay-tv operators. In Italy, the merger between the two satellite operators in pay-tv has been authorized only subject to undertakings concerning removal of exclusivity clauses for content distribution and an obligation to give wholesale access to premium content by new entrants. The regulatory model developed in EU and Australia shows some weaknesses which would certainly require further interventions in order to assure an efficient market design. First of all, the regulatory creation of a new market at the wholesale level, while increasing market competition, it generates also very high transaction costs in terms of definition of internal transfer price within incumbent's division (content broadcasting and distribution) and in terms of accountancy monitoring by regulators. Moreover, one question which seems to emerge in Uk, Australia and Italy, is referred to the definition of content unbundling and pricing at the wholesale level and on the analysis of their impact on the future of media convergence.

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1. Introduction

Media markets are characterized by strong peculiarities (high sunk technological investments, economies of scale and scope, network effects, price and content discrimination, incomplete contracting, intellectual property governance and so on) which often call for long-term exclusivity contracts between content providers and distributors either for vertical or horizontal integration.

The model of Pay-tv business which, in the last decade, has been developed in Europe and in Australia is quite different from the US model; while the former shows a high degree of vertical integration between content rights' holders and technological distributors (satellite or cable operators), the latter is characterized by vertical separation, content unbundling and virtually no-exclusivity provisions for content distribution. The different evolution of pay-tv business models in US, Europe and Australia, which might be explained on the basis of the diversity of initial conditions in technological equipments, has also generated different paths of market competition and alternative systems of regulation.

The paper compares recent regulatory decisions in pay-tv markets in UK, Australia and Italy, showing how, notwithstanding different initial conditions in these countries, a common model of regulation has emerged, based on the principle of incumbents' waiving of exclusivity rights on content distributions for alternative technological platforms and on the creation of a new market for wholesale access to incumbents' contents by downstream competitors.

The above policies are somehow path-breaking with respect to traditional attitudes, at least at the European Commission level, towards the efficiency of long-term exclusivity for premium content distribution through the satellite platform and towards the idea that 'competition for the market' (auctions on premium contents) was the model to be followed in pay-tv markets.

The economic rationale for the new regulatory regime which seems emerging in UK, Australia and Italy will be investigated in the paper in order to point out whether the policy measure which have been so far implemented could somehow be extended in several other media markets, currently characterized by oligopolistic structures both at the production and distribution levels.

An element which is important to stress is that the recent wave of regulatory and antitrust decisions in UK, Italy and Australia has been the result of different legal actions and approaches: in UK, moral suasion by OFT regulator on dominant satellite operator has

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induced BskyB to propose a strong and verifiable commitments not to undertake anticompetitive behaviors against competitors and consumers; in Australia, the Competition Commission has requested strong undertakings in order to authorize an agreement among competitors concerning content sharing among the main pay-tv operators; in Italy, the merger between the two satellite operators in pay-tv has been authorized only subject to undertakings concerning removal of exclusivity clauses for content distribution and an obligation to give wholesale access to premium content to new entrants.

The regulatory model developed in EU and Australia, while representing a Copernican revolution for what concerns the removal of multi-platform exclusivity for premium contents and the creation of a wholesale market, shows however some weaknesses which would certainly require further regulatory interventions in order to assure an efficient market design. First of all, we argue that the regulatory creation of a new market at the wholesale level, while increasing market competition, it might generate also very high transaction costs in terms of definition of internal transfer price within incumbent's division (content broadcasting and distribution) and in terms of accountancy monitoring by regulators, thus calling for the ex-ante definition of clear pricing rule at the wholesale level.

Moreover, another central question is referred to the definition of content unbundling and at the wholesale level. The degree of unbundling and the criteria followed to define wholesale prices will indeed influence the business model and the degree of competition at the market level: we point out the anticompetitive risks associated with the absence of a clear and verifiable pricing rule and of an obligation to promote unbundled wholesale offers together with ban on retail bundling.

The paper finally outlines the need to further regulation aimed at balancing costs and benefits between vertical integration and vertical separation in order to grant the development of new markets and new technologies in the age of media convergence.

The paper proceeds as follows. In section two, we briefly summarize the main features of the pay-tv markets in general, with particular reference to the interdependence existing between the distribution of contents and the nature of technological equipment. In sections three, four and five we briefly recall the main competition issues and policies which have been raised, respectively, in UK, Australia and Italy. In section six, we motivate the need of further

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regulatory interventions in the above pay-tv market in order to grant an appropriate degree of competition, and the full application of the so-called principle of te hnological neutrality.

2. The peculiarities of the Pay-tv market: a brief outline of the evolution of European markets

Pay-Tv industry structure and dynamics are direct consequences of technological innovation[1]. Since its birth as cable TV, in 1947, the industry has followed a continuous path of technological development and change, sharing several common steps with different industries such as the telephone industry and, more recently, the Internet.

Competition Authorities have traditionally[2] distinguished a separate market for pay-TV (distinct from the market for free-to-air television, which is financed by advertising and/or through State contributions), without further declining the technological features concerning the transmission platform employed by operators (terrestrial, satellite, cable or other means of transmission). In this market pay tv operators are mainly financed through subscriptions and, to a lesser extent, through advertising.

The structure of pay tv market differs substantially according to the degree of vertical separation. We can distinguish the following production chain in pay tv

a) production of contents
b) acquisition and ‘assemblage’ of contents into channels
c) programming of channels into packages to be sold to subscribers
d) transmission via technological platform.

Thus, a simplified Pay TV supply chain involves at least three stages: i) the production of programming, that is to say the sale of pay TV broadcast rights to channel suppliers that aggregate the content to create channels and then sale it to pay TV operators or to wholesalers; ii) the retailing of programs to consumers by pay TV operators together with the

[1] See also Nicita and Ramello (2003) “Competition and Exclusivity in Pay-Tv”, forthcoming in *International Journal of the Economics of Business* (n.4, 2005), Routledge, and Armstrong, M (1999). “Competition in the Pay-TV Market”, *Journal of The Japanese and International Economics* 13.

[2] See for instance, for the European Commission, the following cases: Case COMP JV 37 *BskyB/Kirch Pay TV*, case IV M. 993 *Bertelsmann/Kirch/Première*, case COMP M.2211 *Universal Studio Networks/De Facto 829 (NTL) Studio Channel Ltd*, case COMP JV 57-TPS, Case COMP M. 2845 *Sogecable/Canalsatélite Digital/Vía Digital*, Case COMP M.2876 *Newscorp/Telepiu’*.

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possible wholesaling (or resale) to competitors; iii) the distribution of Pay TV services to consumers through infrastructure such as satellite and cable.

While in US we have registered the evolution of a competitive structure for each of the above levels of activities within the pay tv market, the European markets (as the Australian one) tend to be vertically integrated with a monopolistic either, at most, a duopolistic structure. In UK, for instance, BskyB is almost the only operator in b) and c), due also to exclusivity arrangements with content rights holders and to its own production of the most diffused channels, and it is also the monopolistic operator over the satellite platform. As Nolan (1997)[3] has outlined the above levels of the production chain in pay tv could represent substantial bottlenecks for new operators.

The production of contents can be realised inside the pay TV firms in case of vertical integration (this happens especially for the 'basic' contents) or outside the firm. The latter occurs mostly for the *premium* contents. They are subscription driver contents which have been usually represented by key sporting events and blockbuster movies, but which in reality include any event which is able to attract a separate demand for pay tv[4].

The delivery process can be operated by wireline or wireless network, in the form of terrestrial transmission (analogical or digital), of satellite transmission (*point-to-point*, *point-to-multipoint*, or *direct broadcast*), of cable transmission (here the scenario is even more confused due the next possibility to use digital telephone lines such as ISDN, ADSL e xDSL)[5]. According to the initial conditions in a given country, the degree of competition in the segment of delivery process will be strictly affected by the actual level of diffusion of alternative platforms. In Europe, there are typically some countries, such as UK, Netherlands, Belgium, France, Germany which registered significant percentage of cable diffusion (prior to the satellite introduction), while some other countries (such as Italy, Spain and Greece) had, until recently, a virtually non-existent activities in cable.

In addition, as delivery systems are essentially networks, they are characterised by important network effects that are generated when the global value of the network increases with the

[3] Nolan, Dermot (1997) Bottlenecks in Pay Television: Impact on Market Development in Europe. *Telecommunications Policy* 21.

[4] See European Commission DG Competition COMP M.2876 *NewsCorp/Telepiu'*.

[5] For a technical survey see Parsons P.R. and Freiden R.M. (1998), The Cable and Satellite Television Industries, Allyn and Bacon, Boston.

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number of consumers that use it, and when the marginal value of access to the network by single users grows with the growth of the number of users hooked up to it. This fact implies that who start first in realizing a technological platform enjoys a comparative advantage in having already built up its network[6]: on one hand it is able to pay more for obtaining exclusive access to rights for premium events[7]; on the other hand, it is favoured by high switching costs of consumers, generated both by the technological lock-in coming from the system already adopted - which at the present occurs mostly when the competing delivery systems belong to different domain (for instance, think about cable vs. satellite)[8]- and by path dependency or loyalty phenomena (such as target rebates on subscription renewal, one stop shop behaviour and so on). In contrast to the sectors in which these effects are absent, entry costs for newcomers in pay TV markets do not depend solely on the components that characterise the supply side, but also on the dimensions of *switch* costs to the potential clients and users that characterise the demand side; in this case the new entrants have even to sustain the entire cost of users' *switching* (in addition to the costs of premium events) to contend credibly the market (Klemperer, 1987)[9].

The consequence of this mechanism is that when there are strong network effects, potential competitors who are more efficient than the incumbent on the supply side, can, in any case, be pushed out of the market where increased efficiency cannot compensate for the switch cost of customers. This fact can commit the technological change with perverse consequences on innovation race.

At the same time we observe a typical chicken-egg problem which may characterize (and that actually has characterized at least in Europe) the pay tv market, given by the circumstance that vertically integrated operators might be induced to increase their overall efficiency by cross financing their respective investments sustained both in building a delivery platform for content distribution and in buying valuable contents for their transmission to final customers[10].

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[6] See Economides and White (1994); Katz and Shapiro (1985).

[7] In presence of network externalities, the value of premiums events also for the operator is increasing function in the number of its subscribers.

[8] It is worth noting that this doesn't contradict what asserted about the technological convergence. The differences at the present, just in perspective of such a convergence, can be used to acquire a dominant position in the future.

[9] Klemperer P. (1987) 'Markets with Consumers' Swiching costs', Quarterly Journal of Economics, 102, 375-394

[10] See Parsons and Frieden (1998).

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In this respect, acquiring contents without having already reached a critical mass of customers, either investing in building a distribution platform without having the certainty to gain ex-post access to valuable content are both very risky strategies and a rational operator will not commit him self to sunk and risky investments unless he faces a strong competitive structure in one level of the market (content production either content distribution via alternative platforms) which may, in principle, alter providers' incentives to vertically integrate, monopolizing the market.

However the above argument implies quite automatically the existence of strong incentives for first comers to market monopolization and foreclosure by vertically integrating the levels of rights acquisition and that of building the transmission platform at the national level (of course satellite operators enjoy in this a competitive advantage with respect to cable operators which generally may only gain, at most, local monopoly in a given served area).

1) The evolution of pay tv market structure in European markets has thus been characterised by monopolistic or duopolistic satellite operators backward integrated upstream in the (exclusive) acquisition of content and channel assembling.

3. The rise and thefall of regulatory inter ventions in the UK pay-tv market

The first case of Copernican revolution which we analyze is the OFT 'induced' regulation of Uk Pay tv market. We define it an 'induced' regulation since its actual shape has been in fact determined by moral suasion over BskyB's undertaking in response to a formal investigation issuedby OFT in 1994 and subsequently reviewed in 1996[11].

In 1996 BskyB has officially undertaken a series of commitments regarding: (a)the obligation to make a non-discriminatory wholesale offer to downstream competitors; (b) the commitment to avoid any discount either pricing mechanism aimed at decreasing the profitability of downstream competitors.

In 2002, the OFT has concluded its investigation[12] on whether BSkyB has acted in breach of the Competition Act 1998, following several complaints issued by cable companies NTL and Telewest and the (now insolvent) DTT broadcaster ITV Digital. At the moment of the new

[11] A series of informal undertakings in relation to wholesale pricing practices had been given by BSkyB in March 1995. See OFT, "The Director General's Review of BSkyB's Position in the Wholesale Pay TV Market", December 1996.

[12] OFT, Decision CA98/20/2002, 17 December 2002.

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investigation BskyB was the main supplier of satellite television channels to the UK. Its channels were broadcasted via the Astra satellite system and received by UK households by means of satellite dishes. NTL was the main cable operator in UK with 2.8 million residential cable television customers in 2001, whereas Telewest Communications was operating on cable serving over one million of subscribers.

The UK Pay TV structure was composed, at the upstream level, by content rights providers and by providers of other program inputs. At this level, BSkyB[13] was the main operator, since it had exclusive rights over the most valuable premium contents, such as movies and sport programs. Some of the channels created by further 'assemblage' of contents included most BSkyB's own made programs. At the "downstream" level, channels were sold to distributors, who often bundled channels together into packages, and sold them to final consumers.

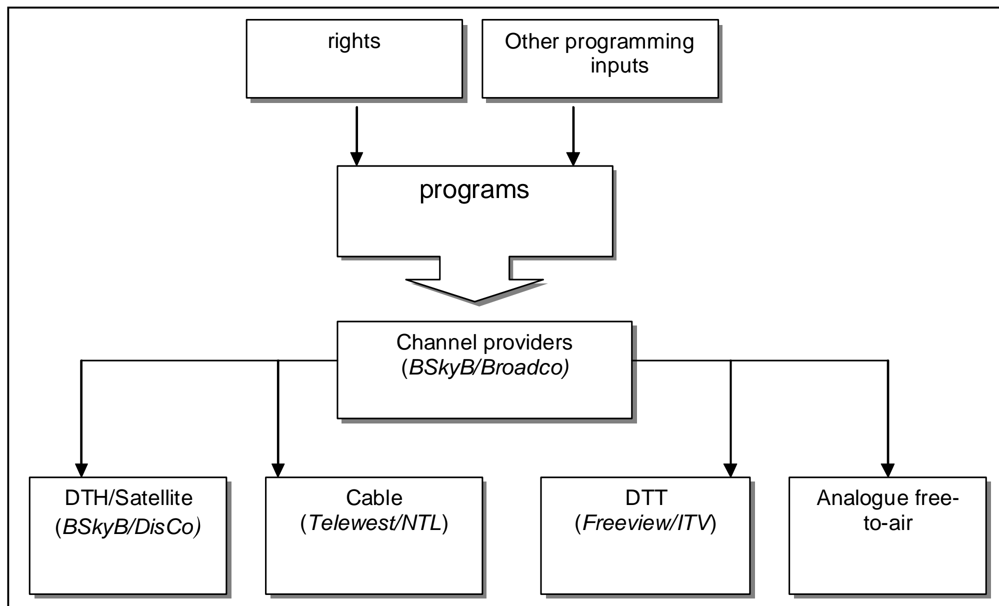

fig.1 - Vertical relationships in the UK Market

The pay TV system was mainly supported by DTH[14]/Satellite system (operated by BSkyB), cable (operated principally by Telewest and NTL) and DTT[15] (operated by Freeview and ITV). Satellite covers still today about 60% of the market, while cable covers about 30% of

[13] British Sky Broadcasting is a provider of sports, movies, entertainment and news. Its channels are received by over 10 million households in the UK and Eire. In 1998, it launched the country's first digital television platform, broadcasting over 200 channels.
[14] Direct To Home is a technology which delivers television channels directly to consumers via satellite.
[15] Digital Terrestrial Television is based on a technology which receives digital television.

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the market. The remaining part is actually occupied by DTT, while only 0.1% is actually covered by ADSL. Thus at the moment of the investigation, BSkyB was involved in both channel provision and distribution of pay TV contents. Such vertical integration and the ownership of pay TV programming rights was the main source of concerns about its conduct. In particular, it was alleged that BSkyB was abusing of its dominance position in the supply of premium Pay TV contents to distort competition against its competitors in favour of its DTH distribution system. BSkyB had substantial market shares in two sub-markets: *i)* in the retail-distribution market it had around 66% of pay-TV subscribers in the UK; *ii)* in the wholesale market for the supply of premium channels it was (and still is) the only supplier of premium sports and movies (although there are other 'niche' premium channels) and the only wholesale supplier for channels that are key driver of the pay-TV market. In other words, companies wishing to compete with Sky in the retail market must have obtained programming from Sky's wholesale operation.

One of the main issues concerning BskyB position was its two-sided nature of being both the only wholesaler and the main retailer of premium programmes. In such respect, the OFT distinguished two clear separate relevant markets: the retail and the wholesale market.

In such a framework, pay tv companies in UK were competing against BskyB to acquire the the rights to broadcast programming and selling them to subscribers. Such programmes were however different in terms of attractiveness with respect to those offered by BskyB. In the UK, BskyB, as the first entrant in Pay-TV market, acquired soon the broadcasting rights to several Hollywood first-run movies and to the main sport events available to Pay TV. The possession of large market shares, the existence of substantial barriers to entry, and the ownership of premium programming rights in a vertical integration context, lead the OFT to recognize the dominant position of BskyB in the UK pay-TV market.

OFT investigation's main purpose was thus to respond to competitors complains such as: (a) the allegation that BSkyB was abusing a dominant position by exercising a margin squeeze in relation to its premium channels, Sky Sports 1, Sky MovieMax and Sky Premier against rival distributors of pay TV; (b) the allegation that BSkyB was abusing a dominant position by pricing its channels in the form of anti-competitive 'mixed bundling'; (c) the allegation that BSkyB was abusing a dominant position by giving anti-competitive discounts to distributors.

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With respect to alleged margin squeeze, that squeeze exists when the dominant vertically integrated company wholesales a product to distributors at a price that allows an insufficient margin for them to make a profit even if they are as efficient as the vertically integrated company's own downstream distribution business. As a consequence OFT has tested whether BSkyB had set its wholesale prices at a level that would prevent a distributor earning a normal return on the distribution of BSkyB's premium channels, even if it were as efficient in distribution as BSkyB. In order to properly assess the test OFT has assumed that BskyB was formed by two vertically separate firms – a broadcasting firm responsible for channel production ('Broadco') and a distribution firm ('Disco') responsible for bundling channels and selling those channels to the final consumers. As the OFT recognizes, "the result of the analysis was borderline. For some of the period examined (and also for a while before the Competition Act came into force) Disco made a loss, albeit a relatively small one. But during the period loss turned to profit", as a consequence OFT concluded not to have sufficient elements to clearly assess whether a margin squeeze applied.

With respect to the anticompetitive mixed bundling (which is in fact in our case an asymmetric mixed bundling given that only the basic package is sold on a stand alone basis), the OFT has assessed that mixed bundling at the retail levels *per se* not only it is not necessarily anticompetitive, rather it could have beneficial effects for customers. The test followed in this case was aimed at verifying whether, in the case in which the implicit discount generated by mixed bundling was determined by an incremental price lower than incremental costs for bundling, such discount would have created a substantial market foreclosure (which was not the case according to OFT).

Finally, the OFT also verified complaints related to BskyB eventually abusing its dominant position by offering anticompetitive discounts, such as the pay-to-basic ratio (PBR) discount[16], the volume discount and the basic penetration discount offered by BSkyB to its distributors. The anticompetitive impact of those discounts would have been mainly suffered bycompeting channel providers, given that distributors would have strong incentives to sell BSkyB

[16] Oft (2002): "The pay-to-basic discount is based on the sales of premium BSkyB channels relative to the total number of basic channel cable subscribers. Volume discounts relate to numbers of basic subscribers to BSkyB channels. Basic penetration discounts are based on the sales of basic BSkyB channel packages relative to the number of homes which have a TV cable running down the street outside".

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channels with the purpose to obtain higher discounts. Even in this case, the OFT rejected the compliant on the basis of insufficient evidence.

What is the main lesson to be drawn from the UK case? The most important lesson is related to the idea of forcing dominant vertically integrated operators to provide a wholesale offer, thus creating a new relevant market for wholesale offer and decreasing the anticompetitive effects of exclusivity. The limits of the regulatory approach followed by OFT, which accepted undertakings by BskyB rather than forcing it to face a final decision, is that it definitively legitimates the existence of a monopoly at the wholesale level, thus inhibiting in fact any potential competition at the upstream level by downstream competitors, who will act as merely distributors of the vertically integrated dominant firm. With respect to this approach, which however was an ex-post approach, the recent ex-ante approaches followed by the Australian Competition and Consumers Commission (ACCC) and the European Commission have introduced several new disciplining rules against the vertically integrated dominant operator, such as those of recognising the removal of holdback exclusivity and the possibility of unbundled wholesale offer to competitors.

4. Beyond smoke-filled rooms: cartelizing pay-tv in Australia

The Australian pay-tv industry was launched in 1995. At its very beginning the sector underwent some years of turbulence and in the 1998 Australis, one of the major operators, was drop out of the market. However by the 1999 the things turned to a better point and the sector reached 1.44 million of subscriber by the start of 2003 with a rate of penetration of the 22% of Australian household[17]. The major retail pay TV operators in Australia are Foxtel, Austar and Optus Television but there exist even limited niche and/or regional players[18].

[17] It is worth remarking that despite the growth started in 1999 the rate of penetration remains quite low if compared to other OECD countries. The OECD average is approximately 52 per cent, in 1999 and penetration rates in the United States, United Kingdom and New Zealand are approximately 69, 44 and 43 per cent respectively (*source*: the Australian Competition and Consumer Commission : Report to senator Alstrom June 2003).

[18] There are smaller operators: Television & Radio Broadcasting Services Australia (TARBS), TransACT, Neighborhood Cable and Bright. See Australian Competition and Consumer Commission (2003), *Report to Senator Alston, Minister for Communications, Information Technology and the Arts, on Emerging Market Structures in the Communications Sector*.

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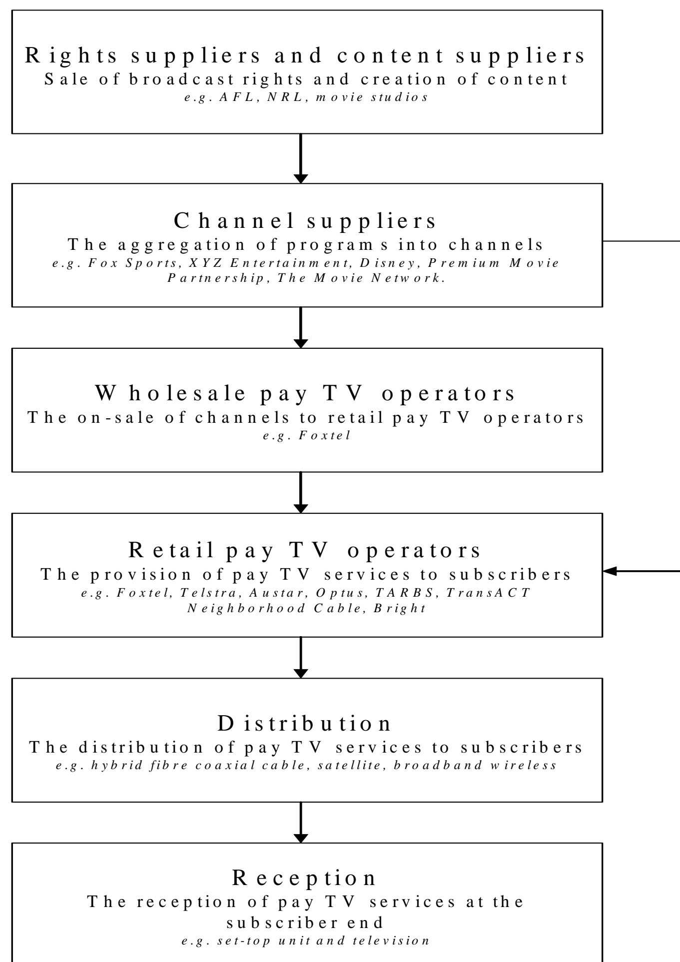

fig.2 – Vertical relationships in the Australian Market

In terms of subscriber numbers Foxtel is the most successful operator, with 800,000 households receiving its service as at June 2003. Its availability increased substantially in March 1999 when it launched services via satellite and satellite customers now account for more than 35 per cent of its subscriber base.

Austar is the second supplier of retail pay-tv services and reached 406,000 subscriber in March 2003. It is worth noting that Austar operates as a virtual monopoly in regional and rural Australia. Indeed Austar generally competes in a different geographical area to Foxtel and Optus. The regions in which Austar and Foxtel operate were decided through programming arrangements entered into by Austar and Australis, which Foxtel inherited. These agreements divided Australia into 'Austar' and 'non-Austar' areas and restricted the abilities of Austar and Foxtel to provide pay TV services by MDS and satellite in those areas.

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Optus is the operator with smallest number of subscribers: 270,000 at June 2002. Optus is not a pure pay-tv services supplier indeed it does not sell pay-TV as a standalone product but bundles it with high-speed Internet and local telephone services. The Australian pay TV industry has been covering the same path of other countries, the common features are: a highly concentrated retail market, the presence of a vertically integrated major player and the problem of premium program resale. The pay TV industry in Australia is converging to a highly concentrated and partially vertically integrated model as in other countries. The current structure is apparently that of a oligopoly with three major player. Nevertheless as we pointed out above the structure is slightly different, since the industrial structure is that of a local monopoly of Austar in the rural areas and of a duopoly, with minor competitors, in the rest of the country. Furthermore it is worth remarking that Foxtel, the major pay TV operator, is 50% owned by the major telecommunication company Telstra creating a kind of vertical integrated operator in all the supply chain[19].

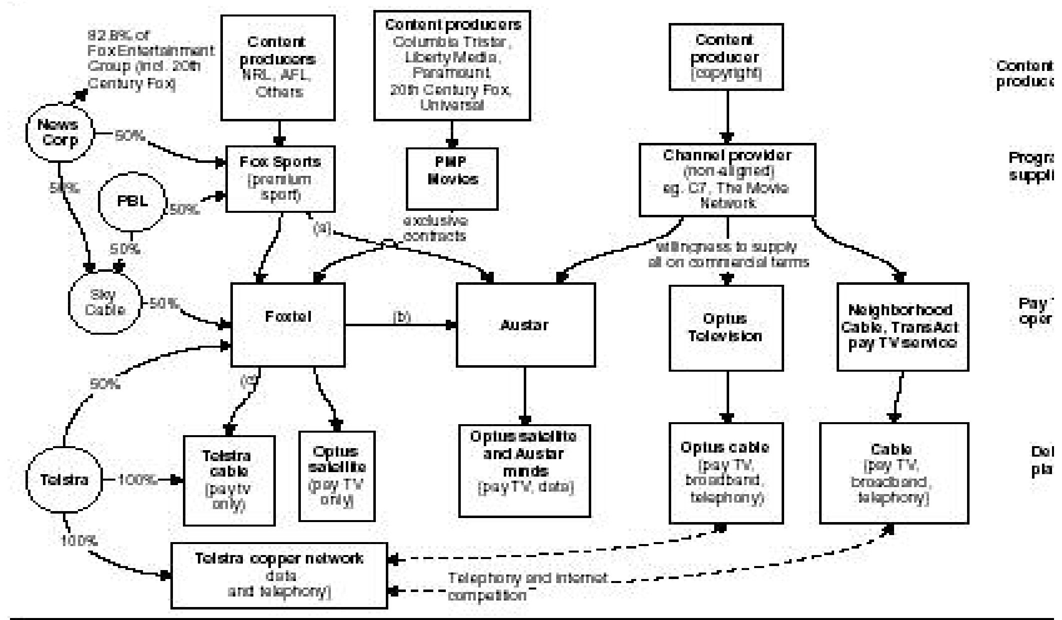

fig.3 – Vertical relationships and cross ownership in the Australian Market (ACCC, 2002)

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[19] Foxtel indeed partly distributes its programs through Telstra delivery systems and Telstra resale Foxtel programs to 100.000 of its customers.

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Given the high sunk costs of distribution networks the participation of Telstra in Optus can act as a barrier to entry for small operators. Thus, establishing a distribution network capable of delivering pay TV services involves considerable sunk costs, such as launching a satellite or deploying a cable network.

As these sunk costs are irrevocably committed, the risk of entry is increased. In such a contest the negotiation of access to existing distribution networks and the regulation of entry constitutes a fundamental point in order to lower barriers to entry. Access regulation can provide for third party access to pay TV distribution networks but as the Australian Competition and Consumers Commission (ACCC) recently pointed out[20] the regulation seems still too ineffective in Australia[21].

The third and crucial feature is the presence of exclusive vertical contracts on premium programming. As we pointed out the presence of exclusive contracts can lead to a market which takes on 'winner-takes-all type characteristics. Therefore retail pay TV operators have an incentive to purchase premium content on an exclusive basis. While the costs of obtaining such content may be high, the longer term remuneration for doing so may be higher.

In particular, the pay TV operator may strengthen its own position while simultaneously weakening the position of its competitors that cannot obtain premium content, which decreases their ability to attract a large number of subscribers.

The most important recent event faced by the Australian pay TV sector is strictly related to its high concentration and to the presence of exclusive contracts.

On March 2002, Foxtel and Optus approached the ACCC in order to obtain clearance of a proposal relating to the supply of Foxtel content to Optus governed by a content supply agreement. On June 2002 the commission rejected the proposal stating that the proposed arrangements between Foxtel and Optus raised if implemented were likely to breach the Trade Practice Act.[22] Subsequently to the ACCC response an agreement between Foxtel and Austar was also submitted to the Commission for consideration. The agreement provided for the

[20] See Australian Competition and Consumer Commission : Report to senator Alstrom June 2003.
[21] The recent long-running legal dispute of the small operator Seven with Foxtel and Telstra over access to Telstra's cable network for Seven's C7 channels confirm the difficulties of third party access to distribution network when the network owner has interest in the supply of services.
[22] Source: ACCC, *Foxtel/Optus proposal likely to breach Trade Practices Act*, media release, 21 June 2002.

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supply of certain pay TV rights to Austar. In this context Foxtel, Optus, Telstra[23] and Austar submitted to the Commission some undertakings designed in order to address the competition concerns that the Commission had identified[24].On November 2002 the ACCC announced that it believed the undertakings finally offered addressed the competition concerns that it had identified[25].

We do not enter in depth the contents of the agreements nevertheless it is worth remarking that they have the characteristic of an horizontal agreement between the major players of the market with two main consequences.

First, the Foxtel/Optus agreement may have the effect of an horizontal integration. The supply of contents by Foxtel to Optus may cause a decrease in the variety of programs available for consumers. Indeed under the content supply agreement the incentive to Optus to acquire programming may be weakened and furthermore under the agreement even if Optus continues to acquire contents it would faces restrictions about how the channels it acquires can be positioned and packaged. This reduction in content-based competition between the parties would likely lead to less competitive tension for the acquisition of content. It would considerably enhance Foxtel's negotiating power in the acquisition of content especially for premium one. This raised the issue of whether new pay TV operators would be able to establish themselves as viable competitors given that access to contents (especially to premium contents) is a key determinant of competition[26].

Second, the presence of exclusive vertical contracts, together with a content supply agreement have the effect to legitimate the main operator to act as a supplier of the key contents to its competitors. Under the content supply agreement Foxtel acts as a content reseller, it buys rights under exclusive contracts and then it sells it to its downstream competitor. The problem of the resale of contents (especially of premium programs) in the presence of exclusive contracts has been analyzed by Armstrong (1999) and Harbord and Ottaviani

[23] Telstra is the main Australian telecomunication company owing the 50% of Foxtel.

[24] This procedure is compliant with the Section 87B of the Trade Practice Act providing that the Commission may accept a written undertaking in connection with a matter in relation to which the Commission has a power or function under the Act itself. Undertakings are court enforceable.

[25] It is worth noting important that the developed undertakings are designed in order to deal with the concerns raised by the ACCC as a result of the submitted pay-TV agreements and they are not designed in order to address pre-existing competition concerns.

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(2001). Harbord and Ottaviani (2001) show, in particular, that resale of premium programming for per subscriber fees relaxes downstream competition and provides incentives for both downstream firms to increase prices. The profits initially created are captured by the reselling firm and then transferred to the rights monopolist. As a consequence the apparently beneficial transfer of rights hold under an exclusive contract may have detrimental effects for competition and for consumers welfare[27].

This analysis suggest the necessity of some regulatory control and intervention. In particular the resale price of premium programs may be monitored and regulated in order to divide the surplus created by premium programming between firms and consumers. Furthermore, as Armstrong (1999), Harbord and Ottaviani (2001) and Nicita and Ramello (2003) point out, the very crucial issue for competition policy is the presence of exclusive vertical contracts such as the most effective remedy for competition would be a ban of such contracts that would transfer the surplus of premium programming from firms to consumer through an intensification of downstream competition[28].

Third, as recently pointed out by ACCC[29], the wholesale offers made by incumbent to small cable operators should be fully public and transparent so as to avoid any discrimination at the downstream level. Moreover, the wholesale offer should enable downstream rivals to compete against incumbents by providing an alternative offer. Thus means that downstream operators should be given with th right to have access to an unbundled wholesale offer without simply accepting the bundling strategies made by incumbents.

The centrality of an unbundled wholesale offer as a policy tool against dominant position has been outlined in 2003 by the European Commission, following the authorization of the Italian merger between *Newscorp and Telepiu'*.

[27] Harbord, D., Ottaviani, M. (2001), "Contracts and Competition in the Pay-TV Market", London Business School, mimeo, show that in the aggregate consumers may be better off in the absence of contents reselling even if some are deprived of premium programming.

[28] The ACCC has recently pointed out the necessity of non exclusivity measures, e.g. "*…a non-exclusivity measure is likely to operate closer to the source of the access to content concerns (the barriers to entry created by exclusive content agreements) than the access to content measure."* Australian Competition and Consumer Commission : Report to senator Alstrom June 2003. pag. 123.

[29] ACCC (2003) "Emerging market structures in the communication sector". A report to Minister for Communications.

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5. The *NewsCorp/Telepiu'* merger

In 2003 the European Competition Commission has authorized the merger between the two satellite pay tv operators in Italy Stream (NewsCorp) and Telepiu' (CanalPlus). The merger was the conclusion of a five years of battles in the market, in which the acquisition costs of premium contents raised enormously (more than 500% in soccer) together with the financial losses of the two operators. According to merging parties the rationale for the merger was simply the idea that, given the high costs of premium content and the actual aggregate demand for them, the market would have efficiently allowed only one operator in the market. The Commission rapidly rejected the above argument raising serious concerns over a merger which would have been created a monopoly in the Italian market for pay tv[30]. The battle has thus been concentrated on undertarkings. The Commission has finally authorized the merger under several conditions concerning, among the others, the removal of holdback exclusivity clauses, a mandatory wholesale on unbundled basis and following the retail minus principle.

As regards access to contents, the scope and duration of exclusivity rights held by the combined platform has been extensively reduced to allow such rights to be contested on a frequent (in the case of DTH rights) or permanent (in the case of non-DTH rights) basis. Furthermore, premium contents to be broadcasted via DTH by the combined platform have been made fully available to non-DTH platforms at wholesale prices via the provision of an wholesale offer. In addition Newscorp will not acquire, through future contracts or renegotiations of the terms of the existing contracts, any protection or black-out right with respect to DTH. The wholesale offer "is intended to allow competitors of the new entity on platforms other than DTH to subsist or to enter in the Italian pay-TV market. The underlying idea is that such wholesale offer will lower barriers to entry in the pay-TV market by allowing non-DTH pay-TV operators to access premium contents which would otherwise be too costly for them to purchase directly or which are locked away by means of long-duration exclusivity agreements entered into by the incumbent players with the content providers. Some types of content (mainly, but not exclusively, football and films) are considered to be subscription-drivers". In this respect, the starting point for the calculation of the Wholesale Price pursuant to the retail minus principle is the effective retail price charged by the Sky to its customers for

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[30] COMP M.2876, *NewsCorp/Telepiu'*.

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the premium package, minus a quota concerning the avoidable costs and the costs of basic package plus a reasonable margin.

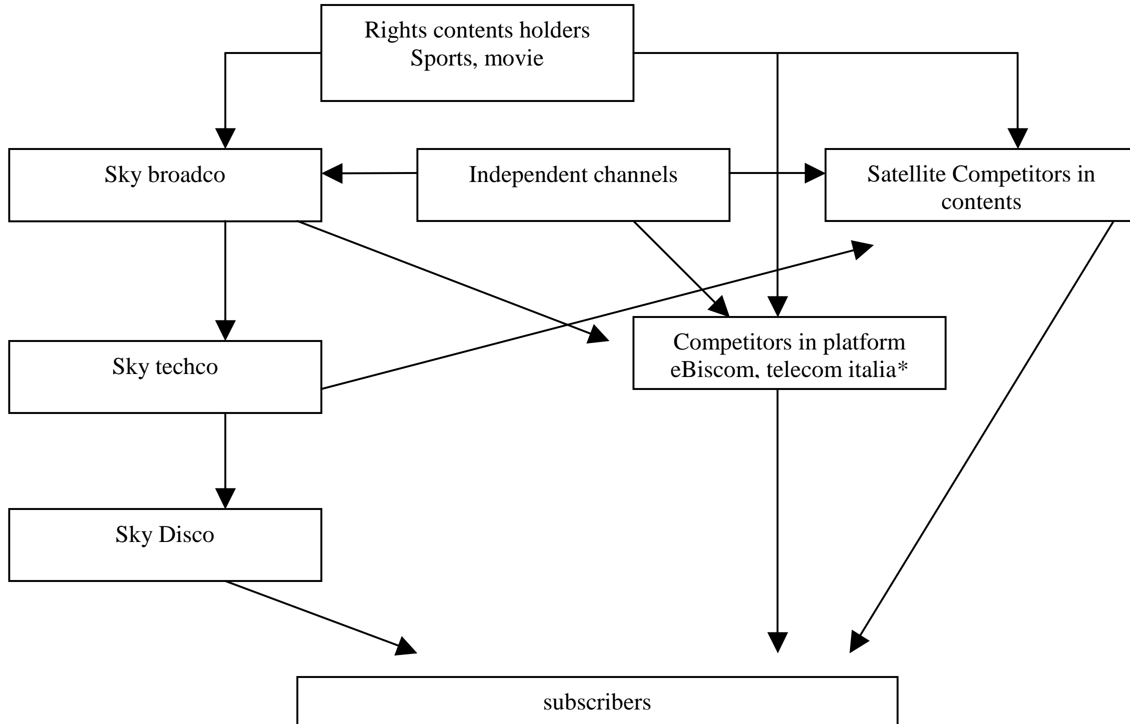

fig.4 – Vertical relationships in the Italian Market

The post-merger scenario is thus that depicted in fig.4. The vertically integrated operator, Sky, will allow wholesale access to contents for non DTH competitors (such as eBiscom, a new cable operator) and will allow DTH competitors to access to its own platform (Sky Techco) at non discriminatory price.

Notwithstanding the above undertakings, after one year the market is far from being competitive. Competitors have requested formal investigation by the Italian Communication Authority in order to verify the potential anticompetitive impact of contractual terms imposed by Sky both a the wholesale level and with reference to access to platform. Whereas Sky ha rapidly reached 3 millions of subscribers (starting from a basis of 2 million), competitors reaction is far from being really challenging. According to competitors comments reported in

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newsapers, the major problems refer to the pricing criteria applied by Sky and to an insufficient degree of unbundling in the wholesale offer.

6. In whose interest? The way ahead for regulatory reforms

In the previous sections we have briefly outlined recent regulatory evolution in UK, Australia and Italy. Notwithstanding the different nature of the regulatory and antitrust interventions (an alleged abuse of dominant position in UK, an anticompetitive agreement in Australia and an anticompetitive merger in Italy), and the heterogeneous structural conditions in the market, the different competition and regulatory Authorities raised analogous issues from an anticompetitive point of view and outlined similar remedies. In terms of the nature and the impact of remedies the Italian case appears to be the strongest for three reasons:

1. an effective removal of exclusivity clauses on premium contents at least for their transmission on alternative platforms (DTT and cable);
2. an effective reduction in the duration of exclusivity on the satellite platform with counterparts (i.e. soccer teams and majors) having the right to breach contractual terms in advance;
3. an effective obligation, upon the incumbent, to supply an unbundled wholesale offer following the retail minus principle, determined according to avoidable costs and international best practice.

In approving the above conditions, the European Competition Commission has completely changed its traditional approach toward exclusivity and vertical integration in media markets.
The European Commission in the past years has never questioned the exclusive acquisition neither as the main driver of costs increase nor as an anti-competitive market foreclosure strategy adopted by incumbent against the new entrant.
According to the Commission, having access to valuable content was considered a necessary condition to recover sunk investments in technological platform, while exclusivity was considered as a way of keeping the value of very costly contents. The position of the

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Commission could be illustrated with the words of A.M. Wachtmeister[31], of the EU Media Unit: "the sale of exclusive rights to broadcast sports events is an accepted commercial practice. For sports organisers, the sale of exclusive rights is a way of ensuring the maximum short-term profitability of the event organised, the price paid for the exclusivity by one broadcaster probably being higher than the sum of the amounts which would be paid by several broadcasters for non-exclusive rights. For the broadcaster, sports programmes are considered as particularly suited to attracting a large number of viewers. For them, it can be said that exclusivity represents:

a) the only way to guarantee the value of a given sports programme;
b) the broadcasting company may get more value from the rights if it can sub-license to competitors;
c) a way to build up audience, in the short as well as in the long term (consolidation of audience base, fostering loyalty, improvement of image);
d) a substantial increase in advertising or sponsorship revenue as sports programmes are a means of targeting a specific audience, often in large numbers;
e) a degree of prestige in being the only broadcaster showing a particularly popular sport;
f) for pay-TV channels, exclusivity of rights to very popular sports events is fundamental in order to attract new subscribers; this is especially true for sports theme channels: persuading viewers with specialised tastes to pay for specialised channels is the only way that many such channels could be financed, since the number of interested viewers would be too small to attract enough advertising revenue;
g) it may also be vital to re-coup investment in infrastructure; the revenue may be needed by a broadcasting company which wants to invest in cable, decoders and/or satellites".

According to the above quotation, content exclusivity was viewed as the only way to guarantee the value of a given program, to attract subscribers, to recover initial investments and so on. As a consequence the only concern related to exclusivity was that of its duration which in any case should have to be 'not excessive' in length or scope.

The increase in premium content prices induced by 'competition for the market' in content acquisition has induced a recent wave of vertical and horizontal integration in Europe and in

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[31] A.-M. Wachtmeister, (1998) "Broadcasting Of Sports Events And Competition Law", *Competition Policy Newsletter* 1998 - number 2 - June

Australia. In Italy and in Spain the two satellite operators decided to merge, in Australia main competitors in cable and satellite signed an agreement to share their premium content and their technological equipments following a rule of reciprocity. While the operators have motivated their decision to horizontally merge either to sign a sharing agreement on contents on the basis of 'natural monopoly' and 'failing firm defence' explanations, the Competition authorities who authorized under conditions, respectively, the proposed mergers in Italy (*NewsCorp/Telepiu'*) and in Spain (*Sogecable/ViaDigital*) and the content sharing agreement in Australia, have made a Copernican revolution in their valuation of exclusivity clauses, imposing now limits on the duration of exclusivity, the removal of any 'holdback' clause and an obligation to promote a wholesale offer to competitors as the one actually provided by BskyB in UK.

We call the above new attitude a 'Copernican revolution' since it reverses the traditional approach previously followed in pay tv market, now explicitly admitting:

(a) that it is the exclusivity request which increases the cost of acquisition, and not vice-versa, i.e. that the high cost of rights obliges purchasers of those rights to ask exclusivity as a way to defend the value of those right; as a consequence, the economic value of rights is recognized not to be exogenous but determined by the competition race and the market foreclosure strategies adopted by incumbents;

(b) that it is possible in pay tv market to sustain a new competition model based not on 'competition for the market' strategies, through exclusive access to premium contents, rather on 'facility-based competition' which enhances the quality of transmission, the degree of (un)bundling to final customers, the possibility of providing customized offers and so on.

The new approach followed by OFT in UK, European Commission and Australian Commission acknowledges that in sectors characterized by network effects, competition can only manifest itself through the introduction of new technological paradigms whose increased efficiency is so great as to make it convenient to abandon the incumbent. Given the network effects, exclusivity clauses only serve thus to reinforce the cost of *switching* to the customers and users, thus increasing costs for new operators. On this point some authors are quite

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explicit[23]: *" exclusive contracts (...) can be particularly insidious in the network industries, with the danger of, even for new more efficient technologies, the impossibility of reaching the critical mass of users necessary to launch a competitive challenge to the market leaders".*

The removal of holdback exclusivity and the obligation for incumbent to provide wholesale offers to new entrants, from one side increase short run entry by limited scale entrants ("splintering"), from the other it induces powerful incentives to invest in new technologies (such as DTT and fibre optic networks) and to compete on the quality of the service provided rather than on the kind of content sold.

This is a path-breaking result because it applies not only to pay tv but to all media markets characterized by a high rate of technological innovation.

This new approach however could be undermined by a series of regulatory problems such as:

- the economic criterion to be applied to determine an wholesale price;
- the pricing mechanism to be identified in order to provide a non-distorted unbundled wholesale offer when the retail price is referred to a bundle;
- the accounting separation to be implemented to verify any ex-post price squeeze by the incumbent vertically integrated operator;
- the design of asymmetric regulatory measures to favour new entrants investments in new technology.

The first question to be posed in order to solve the above problems is: in whose interest to proceed? The answer differs from one case to another, since while the OFT is testing a possible abuse of dominant position and not the creation of a dominant position either an anticompetitive agreement. Moreover, while the OFT investigation does not question the internal growth of BskyB, the European Commission has questioned whether, through the *NewsCorp/Telepiu'* merger, the new monopolistic entity would be able to neutralize any potential competition, thus harming in the longer term, consumers welfare.

The European Commission has somehow imposed some asymmetric measures on Sky, which recall indeed the asymmetric regulation in telecommunications: Sky's undertakings are

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[23] C.Shapiro (1999) "Exclusivity in Network Industries*" George Mason Law Review 7 (3):1-11.On the same argument see also* D.Baltho *(1999)* "Networks and Exclusivity:Antitrust Analysis Promote Network Competition" 7 *George Mason Law Review.* See also Nicita and Ramello (2003).

supposed not only not to discriminate between its own retail division (Disco) and equally efficient downstream competitors but, furthermore, they are supposed to encourage entry even by competitors with limited infrastructural capacity in transmission, in order to give them a short term access to contents while completing their platform.

The main purpose followed by the European Commission is that of allowing investors in alternative platforms (fiber optic, ADSL, DTT) to be able to complete their investments so as to reach a concrete competitive structure at least at the transmission level, while respecting the principle of 'technological neutrality' often invoked by the European Commission.

In this respect, it should be pointed out the clear trade-off which does emerge between incumbent's bundling strategies at the retail level and the obligation of an unbundled offer at the wholesale level. Price discrimination via bundling at the retail level is efficient as long as a mandatory wholesale offer does affect incumbent's consumers incentives to buy at the given price and bundle.

In the UK and in the Australian case, regulatory and competition authorities have clearly assessed that bundling (between basic and premium channels) at the retail level could be beneficial to final customers, as long as it reduces any deadweight loss, as any other price discrimination strategy would do. In a sense, the implicit argument in those cases is that the wholesale offer (both in terms of prices and of content) follows the retail offer. As a consequence, competitors will not be allowed to have such margins to produce their own bundled offer different from that established by the incumbent. That means that under the UK and the Australian framework, competitors are merely resellers of the incumbent product, and do not use that product as an intermediate good in order to build an original and competitive offer towards final customers.

On the opposite side, the *NewsCorp/Telepiu'* decision is rather different. What is important there is to discipline market power of the new entity through competitors' ability to enter the market and replicate the dominant's offers. This means that, at least in the Italian case, the bundling strategy of the incumbent should follow the wholesale offer and not vice-versa. This outcome, may of course reduce in the short term overall efficiency, since it affects incumbent's ability to adopt its bundling strategy at the retail level as if there was not a mandatory unbundled wholesale offer. Some customers thus may not be captured by incumbent bundling as long as the competitors are not able to provide their own retail offer.

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However, the eventually negative impact of a mandatory unbundled wholesale offer should be compared with the positive impact that a reduction in incumbent's ability to bundle may generate by inhibiting incumbent to build an anticompetitive bundling (Nalebuff, 1999)[32], i.e. a bundling which reduces entrants' expected market share, deterring entry.

As Nalebuff observes, there are many cases in which, via bundling, an incumbent operator may actually reduces profitability for new entrants. This is a very sophisticated argument since while bundling per se is not anticompetitive, some forms of bundling, which increase rivals' costs either increase consumers' switching costs from the incumbent's offer, may have an anticompetitive impact. It is very difficult, however, to distinguish ex-ante anticompetitive from efficient bundling.

In this context, while a generalized ban on bundling may actually reduce the overall efficiency and consumers welfare by inhibiting both anti-competitive and efficient bundling, a mandatory unbundled wholesale offer could reach the desirable result of preserving efficient bundling (competitors unbundled access make it possible for new entrants to propose their own bundling strategies) while preventing any deterrence effect against competitors through inefficient unbundling.

Thus the regulatory choice has to answers preliminary to the question: in whose interests applying a mandatory obligation to wholesale? If the main purpose is to give actual consumers with a higher overall welfare, thus incumbents should be free to decide first their retail bundling and pricing strategies and than to residually apply a discount to competitors. However, when the main aim to be implemented is that of increasing actual competition than priorities should be inverted and incumbent's retail bundling and pricing strategies should be constrained by an obligation to unbundled wholesale offer.

In other terms the existence of a mandatory wholesale unbundled offer produces several effects: it allows immediate access to contents giving investors with resource sufficient to reach a minimal critical mass necessary to complete their infrastructural capacity in alternative platform; it constrains incumbent's ability to generate anticompetitive bundling.

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[32] See Nalebuff (1999), Bundling, Yale Icf Papers no. 99-14.

Of course, consumers may suffer in the very short term, since some of them might be excludedfrom access to bundled good, while they could obtain, in the longer term, a reduction in prices and/or an increase in variety and quality of the retail offer.

In this respect, what is important is the temporal horizon over which the obligation should be adopted.

The following conclusions could somehow be extended to other media markets, every time potential competition in these markets could be inhibited by anticompetitive bundling and/or by exclusivity clauses. The creation of a wholesale market and the obligation to provide competitors with an unbundled wholesale offer will increase potential competition by granting immediate access to contents and by constraining incumbent’s ability to promote anticompetitive bundling.

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