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Agenda

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New powers for telecoms and media regulators? Part 2: convergence and regulation

Vertical integration between network operators and content providers, and growing consumer demand for bundles including premium TV content, are creating new challenges for regulators and antitrust enforcers. Is the European telecoms regulatory framework fit to deal with the convergence challenge?

On 8 July 2015, Oxera held a round-table event in Brussels to discuss the new challenges faced by regulators in the telecoms and media space. Operating under the Chatham House rule, it was a lively and engaging debate attended by senior representatives from the European Commission (DG Connect and DG Competition), national telecoms regulators, lawyers, and major telecoms and media operators.

Part one of this two-part *Agenda* article covered the first of two themes discussed at the round-table: the challenges that regulators are facing as a result of more concentrated oligopolistic markets.[1] This article focuses on the challenges posed by the vertical integration and convergence of network operators and content providers.

The convergence trend

The increased use of the Internet protocol (IP) in the core network, alongside the growth of network capacity in the access network (e.g. fibre roll-outs), has enabled traditional telecoms operators to deliver an ever-increasing array of innovative content-based services (including linear broadcast TV and on-demand services) over their existing network infrastructure. At the same time, technological advances have allowed cable networks—previously designed for one-way-only broadcast use—to provide two-way voice and data offerings, at speeds rivalling the current copper-fibre hybrid technologies.

The result has been a convergence in the traditional media broadcast and voice/data network industries, with both the traditional telecoms and traditional pay-TV operators now offering consumers a range of bundled service packages of voice, broadband, pay-TV and/or mobile.

In addition, an increasing number of operators are opting to bolster their core capabilities by acquiring adjacent service providers. This includes transactions that combine fixed-line operators with mobile operators; network operators with channel providers; and/or network operators with content producers. Similarly, while some operators are choosing to acquire established media businesses (such as Telenet's acquisition of the Flemish channels, Vier and Vijf[2]), others are opting to buy key content rights (e.g. live football rights) and to invest in developing their own content businesses.

In response to these changing offers, consumers' preferences over electronic communication services are evolving, with 44% of EU consumers now purchasing their broadband and/or pay-TV service as part of a bundled offer.[3] Their motivations for being connected are also changing. Whereas data services previously provided users with predominantly text-based informational materials, their take-up is now being driven by a range of rich media content and over-the-top (OTT) services[4]—and the availability of these is becoming a central factor when selecting a network provider.[5]

Is content susceptible to ex ante regulation?

The existing EU regulatory framework for electronic communications services does not cover content—from a broadcasting standards aspect, this is dealt with in the Audiovisual Media Services Directive.[6] As a result, most of the regulatory discussion around content focuses on the nature of the material, rather than competition aspects.

However, in 2002, when the ex ante regulatory framework was introduced, it was already recognised that the convergence of technologies could have a significant effect on the regulatory landscape. As services delivered over different network technologies (copper, fibre, cable and mobile) were converging (in terms of their functionality), the need for horizontal regulation that considered the constraints

posed by all infrastructure types—not just the traditional telecommunications networks—became apparent. As such, the 2002 framework was not limited to 'traditional' public switched telecommunications network (PSTN) networks and services alone, but covered all electronic communications networks and services.

Whereas the convergence considered by the 2002 Directive was between network technologies, this might now reasonably include certain premium content, as well as OTT services. Against the backdrop of significant growth in the sale of bundled communications and media services, the practical implication of content being outside the scope of the framework becomes clear. Of the typical triple-and/or quad-play bundle elements, only content/pay-TV stands alone as a completely unregulated element.

At first glance, content would appear to have very different economic characteristics to telecoms and cable networks. Whereas the latter involve substantial sums being invested in physical networks that are largely sunk and long-lived, investment in content has a shorter life owing to the bidding nature of certain core rights markets. As a result, the perceived wisdom has been that enduring economic bottlenecks in pay-TV and content markets are far less common. Indeed, the incentives on independent content producers and channel providers are such that they would generally wish to seek the widest possible distribution for their output—meaning that refusal to supply has not been a major issue faced by competition authorities.

However, recent developments may be challenging these perceptions. Core content has remained far more concentrated in the hands of a few large distributors than might have been expected, many of which are also vertically integrated into the assets needed to supply bundles of communications services. Similarly, as discussed below, vertical integration might be changing the incentives to maximise distribution of content and channels.

Possible issues with content and networks convergence

Being able to give subscribers access to core, high-value content is increasingly an important competitive differentiator for platforms. In combination with the growing convergence of content and network owners, this may give rise to three broad competition problems:

- **input foreclosure**: if key high-value content is acquired exclusively by an incumbent network operator, this could be used to cement a dominant position at the network level despite increasing competition from alternative network technologies (such as cable or long-term evolution (LTE) mobile);
- **customer foreclosure**: as network operators extend their reach into new retail services and content provision, they could leverage their existing market power into upstream/adjacent markets—for example, by favouring their own emergent services over competitors' services (including those provided by OTTs, an issue closely related to the net neutrality debate);
- **hampering new technologies**: combining aspects of both input foreclosure and customer foreclosure, vertically integrated network operators might have both contractual and technical tools at their disposal to hinder emerging technologies (such as OTT)—for example, by limiting their access to the best content or preventing their transmission over the operator's IP network.

These concerns could arise from the vertical integration occurring within the value chain, as operators go from providing retail network access to providing (and in some cases producing) the content distributed by those networks. In this case, any firm enjoying sufficient market power at one level might find that it has the ability and incentive to leverage that power into other parts of the value chain through foreclosure strategies.

Input foreclosure

A principal concern arising from the convergence of content owners and network operators is the incentive for those firms to leverage their content advantage to drive subscribers to their communications networks. This might harm consumer welfare by creating or strengthening a dominant position for the vertically integrated retailer, as well as potentially restricting choice and variety for consumers, who might be forced to choose between the content they want and the platform they prefer.

The expected efficacy and consumer impact of such a strategy would depend on the **type of content**, which must be sufficiently compelling to drive consumers to switch (ideally, across the entire multi-play bundle rather than just pay-TV). In practice, this is likely to mean premium content such as sports, films or high-quality entertainment. However, other important content (such as niche local language content) could also be considered sufficiently 'must have' to harm a competitor's pay-TV offer if withheld.

In addition to considering a complete foreclosure strategy, the vertically integrated operator might find it has the ability and incentive to engage in a partial foreclosure, in which the channel is still provided as an input to rivals, but on worsened terms. As a result, it may be able to raise its rivals' costs (and thus soften downstream competition at the bundle level) to the detriment of consumers.

Customer foreclosure

Under this strategy, the vertically integrated platform operator might opt to deny rival channels access to its retail TV platform, preventing them from reaching a proportion of potential viewers. The vertically integrated operator could gain, as consumers who might otherwise have watched another channel are pushed onto the captive channels—driving subscription revenue (in the case of

premium pay services) or 'eyeballs' (in the case of channels funded by advertising). Consumers could be harmed as, once again, they might be forced to choose between the content they want and the platform they prefer.

Again, an alternative scenario would be that the vertically integrated provider opts for a partial customer foreclosure strategy, in which it continues to carry the rival channels but on worsened terms. Although this would not mean that consumers necessarily lose access to the channels they want, the worsened terms of the channel providers could be expected to feed through into the quality of programming presented by the channel. This could be particularly significant for smaller channels in local languages that are more reliant on the vertically integrated platform for their audience.

The question remains as to how likely this form of foreclosure would be in many cases. The same incentives that drive the vertically integrated operator to consider an *input* foreclosure strategy could act *against* a customer foreclosure strategy. Any subscribers lost as a result of desirable content being missing from the platform are likely to also switch a number of lucrative bundled services—such as voice or data. Therefore, the cost to the platform of being incomplete (or at least being perceived as such) could outweigh the potential benefits on offer.

Hampering new technologies (OTTs)

There is also the risk that a vertically integrated platform operator could have both the ability and incentive to hinder the development of emergent technologies. OTT entertainment services (such as Netflix) are becoming a significant competitive threat to traditional pay-TV retailers. With considerable revenues still being derived from the provision of pay-TV, vertically integrated platforms might have an incentive to act to protect their position.

One means for platform operators to do this would be through technological restrictions, akin to customer foreclosure. Given the trend for bundled service provision, an increasing number of people receive their broadband Internet from the same provider as their pay-TV service. In principle, this means that the network operator can protect its position by interfering with the transmission of the OTT content across the broadband network.

However, the likelihood of such a strategy is questionable, given the potential for unilateral harm to the quality of service offered by the network operator, and its ongoing reputation. On top of this, in October 2015 the European Parliament passed the EU-wide net-neutrality rules intended to prevent network operators discriminating against any online service provider.[7]

As an alternative, powerful platform operators may be able to use contractual means to universally prevent top content from being distributed OTT. With rights holders seeking to maximise their exposure (to generate both carriage and advertising revenues), the incumbent pay-TV platforms remain an important business partner. However, these platforms—running a subscription TV model—are unlikely to pay top prices for content that is widely (even freely) available OTT.

Despite this, the question remains whether the potential for both contractual and technical foreclosure issues as a result of vertical integration strengthens the case for bringing pay-TV/content within scope of an ex ante regulatory framework.

How have these foreclosure issues been tackled?

Issues around the control of content have been handled recently in the following ways.

Merger remedies

The foreclosure issues discussed above featured prominently in two recent European Commission Phase II merger assessments: *Liberty Global/Ziggo* in the Netherlands, and *Liberty Global/Corellio/W&W/De Vijver Media* in Belgium.[8] In both cases, the Commission raised the concern that, following the transaction, certain key content would become vertically integrated. Additionally, in *Liberty Global/Ziggo*, the Commission considered whether the enlarged platform operator might also have both the ability and incentive to hinder the growth of OTTs by technical means, restricting their access to the merged parties' broadband network.

Ultimately, in both cases the Commission's concerns were allayed with the adoption of commitments from the parties. In the case of *Liberty Global/Ziggo*, this included the divestment of one of the premium film channels owned by the merged parties; a commitment not to hamper the uptake of OTT services by including restrictive clauses in carriage contracts with channel providers that prevented their content being supplied via OTT (either own or third-party); and a commitment not to hinder the transmission of OTT services onto and over the merged entity's network.

In the case of *De Vijver Media*, the main commitment was to continue to grant rival pay-TV retailers access, on a FRAND[9] basis, to the key local-language content channels, Vier and Vijf. This included a commitment to provide 'ancillary' rights (e.g. catch-up and online rights), as well as anti-circumvention measures to prevent the parties from lowering the quality of the FRAND channel offer by moving the most compelling content to an alternative channel.

Similar issues featured in the recent Spanish competition authority case concerning the acquisition by Telefónica of leading pay-TV platform, DTS. Again, the authority accepted commitments from the parties before clearing the transaction at Phase II. In this case, the commitments included maintaining the contracts that DTS had in place

with rival platform operators, and not impeding switching by subscribers; providing competitors with a wholesale offer that includes all premium channels; and guaranteeing interconnection capacity for OTT providers.[10]

Ofcom pay-TV investigation

In 2007, Ofcom, the UK communications regulator, initiated an investigation into the UK pay-TV market to consider the effect of the vertical integration between the Sky platform and the premium Sky channels (Sports and Movies) on competition between pay-TV retailers.

Despite having concurrent competition powers under the UK's 1998 Competition Act, Ofcom chose to use its sectoral oversight powers under the 2003 Communications Act to initiate the investigation and ultimately impose remedies.

Ofcom chose this legal instrument on the grounds that its ex ante powers as a sectoral regulator allow for a more timely and comprehensive intervention into the market to ensure effective competition. By contrast, its competition powers allow for only an ex post evaluation of an actual abuse. In its discussion of the appropriate legal framework, Ofcom cites several shortcomings with a Competition Act approach:[11]

> following the finding of an infringement, the powers under the Act are limited to the imposition of financial penalties or directions only such as required to bring that infringement to an end;
>
> the imposition of *ex post* remedies may not be as effective as an *ex ante* licence condition;
>
> even if an intervention under the Competition Act were to resolve the issues in question (pricing of standard definition channels), it is likely that a series of further complaints would need to follow to address issues around high-definition, minimum security requirements, etc.

Overall, Ofcom determined that, by using its sectoral regulatory powers, it would be better able to consider how competition across the markets concerned could be opened up to be fair and effective; put in place a remedy that was appropriate to the competitive conditions; and provide greater certainty to the pay-TV retailers that would be relying on the remedy.

The aim of its intervention was to ensure effective competition at the retail level for pay-TV bundles that include premium sports content. To achieve this, it imposed a wholesale must-offer obligation on the Sky Sports 1 and 2 channels. However, a more recent decision has lifted this obligation on the basis that Sky has shown to be a willing wholesaler of its Sky Sports channels on commercial terms that Ofcom considers do not impede fair and effective competition.[12]

Ofcom's assessment of BT's VULA margin

In the UK, BT has invested significant sums of money in premium sports rights (including for English Premier League and Champions League matches), and in creating sports channels (under the BT Sport brand) to broadcast this content. Its strategy has been to bundle these channels with the sale of its broadband services, offering them free of charge or at a considerable discount to the prices paid by non-BT broadband customers.

In its recent decision on the wholesale local access market review, Ofcom imposed an ex ante margin squeeze remedy on BT's provision of wholesale fibre access (or virtual unbundled local access, VULA).[13] A key question for Ofcom was whether to include the cost of sports rights and TV channel production in the test, or whether such issues were best dealt with under competition law.

Indeed, Ofcom had recently conducted—and ultimately closed down—a competition law investigation into an alleged margin squeeze abuse in fibre-based broadband.[14] BT argued that this showed that competition law could be effective at dealing with these issues, particularly for bundled sales that include content where relatively complex effects-based analysis would be required in order to demonstrate consumer harm. Rejecting these claims, Ofcom proceeded to design a test that included the cost of BT Sport in the calculation. It argued that BT's bundling strategy might have the effect of strengthening its market power in the provision of wholesale fibre access, which was ultimately the focus of the review.

In its comments letter to Ofcom, the European Commission agreed in principle with the inclusion of BT Sport in the test, but warned that the methodology proposed by Ofcom unduly limited BT's commercial flexibility in the non-regulated pay-TV market, where BT does not hold a dominant position. It therefore asked Ofcom to remain vigilant that the application of the test would not have unintended consequences in markets where competition law would be sufficient.[15]

Key points raised in the Oxera round-table discussion

The above issues were considered in detail in the Oxera round-table discussion.

The discussion started by considering whether content markets could have economic characteristics that warrant ex ante regulation. It was noted that rights for premium content were typically licensed for a specific period of time, either via an auction or as the outcome of commercial negotiations. Hence, content rights that could give rise to market power are, in principle, contestable and can change

hands in a relatively short period of time.[16] This makes content markets fundamentally different from physical network assets that have been subject to ex ante regulation.

Nevertheless, it was also noted that, in order to be able to justify the significant cost of content acquisition and make a positive return on investment during the licensing period, platforms and channels needed a large customer base from which to extract value (via subscriptions and advertising). For potential entrants in the market, the lack of an established customer base from which to monetise the investment can therefore be a significant barrier to entry. As a result, it is not surprising to observe that premium content changes hands infrequently, which could give rise to concerns about market power and leverage of this power to adjacent markets such as broadband (for example, through bundling practices, margin squeeze or refusal to supply).

Despite this, some participants did not consider that this observation was enough to warrant the inclusion of content markets within the ex ante regulatory regime for electronic communications, for three main reasons.

- Not all content is equal; therefore, defining what constitutes ‘premium’ content that could give rise to market power could be fraught with problems. This was seen as particularly problematic in the context of the European Commission’s goal of greater harmonisation of national regulatory decisions.
- Content strategies can be a source for differentiation among firms, thereby enhancing competition. It was therefore argued that a regulatory outcome that required all premium content to be granted to rivals would lead to a symmetric market structure and eliminate an important source of competition from the market.[17]
- Competition law can be an effective tool to deal with any concerns of market power in relation to content, should they arise.

This was not a unanimous position held by all round-table participants. Those in favour of a more proactive ex ante approach highlighted that defining what constituted premium content was not insurmountable, given the available competition and regulatory precedent. Similarly, it was noted that a case-by-case approach, depending on national circumstances, could actually be seen as a strength of the regime. In relation to content being a strategic differentiator, it was observed that the same could conceivably be said about different access technologies (copper, fibre, cable, LTE) but that, nevertheless, ex ante regulation of physical bottlenecks was still going strong.

Finally, in relation to the role of competition policy, given the need to demonstrate an abuse of dominance rather than intervene pre-emptively, some round-table participants noted that competition authorities could be too slow to react—an issue that could be particularly problematic in countries where the regulator does not have concurrent competition powers.

Concluding remarks

Whether content will be brought within the scope of the electronic communications regulatory framework in Europe is uncertain. What is more certain is that ‘convergence’ is finally here, and regulators and competition authorities will need to step up their game to keep up with these developments.

As ever, the regulator’s job is to ensure that it intervenes only to improve market outcomes for consumers. However, in a converged market of network and content operators with prevalent bundling practices, identifying where the sources of market failure lie will be increasingly complex.

The regulators that are best placed to address this challenge will be those with converged skills in telecoms and media that are able to use a mix of ex ante and ex post enforcement powers, adapting to situations on a case-by-case basis. This does not (yet) necessarily require a change in the European regulatory framework. However, short of granting national regulatory authorities concurrent competition powers, it will require a very close working relationship between regulators and competition authorities in each member state.

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[1] Oxera (2015), ‘New powers for telecoms and media regulators? Part 1: the rise of oligopolists’, *Agenda*, August, http://www.oxera.com/Latest-Thinking/Agenda/2015/New-powers-for-telecoms-and-media-regulators-Part.aspx.

[2] For details of the European Commission’s investigation into Liberty Global’s (Telenet’s controlling shareholder) acquisition of De Vijver Media (operator of Vier and Vijf), see European Commission (2015), ‘Mergers: Commission clears Liberty Global’s acquisition of controlling stake in De Vijver Media, subject to commitments’, press release, 24 February, http://europa.eu/rapid/press-release_IP-15-4481_en.htm.

[3] Eurobarometer (2014), ‘E-Communications and Telecom Single Market Household Survey’, Special Eurobarometer 414, March, p. 69.

[4] OTT refers to a host of content and communication services (e.g. Netflix, BBC iPlayer, WhatsApp, Skype) that are now provided over the Internet using IP data networks rather than traditional communication or distribution infrastructure (i.e. broadcast infrastructure such as digital terrestrial, cable or satellite; and communications infrastructure such as wireline and cellular networks).

[5] Ofcom (2015), ‘The Communications Market Report’, 6 August, p. 289, http://stakeholders.ofcom.org.uk/binaries/research/cmr/cmr15/CMR_UK_2015.pdf.

[6] Directive 2010/13/EU, OJ L 95, 15.4.2010. European Commission (2010), ‘Audiovisual Media Services Directive (AVMSD)’, https://ec.europa.eu/digital-agenda/en/audiovisual-media-services-directive-avmsd.

[7] European Commission, 'Our commitment to Net Neutrality', https://ec.europa.eu/digital-agenda/en/eu-actions.

[8] Oxera advised Liberty Global in both of these cases. European Commission (2014), 'Mergers: Commission clears acquisition of Dutch cable TV operator Ziggo by Liberty Global, subject to conditions', press release, 10 October, http://europa.eu/rapid/press-release_IP-14-1123_en.htm. European Commission (2015), 'Mergers: Commission clears Liberty Global's acquisition of controlling stake in De Vijver Media, subject to commitments', press release, 24 February, http://europa.eu/rapid/press-release_IP-15-4481_en.htm.

[9] Fair, reasonable and non-discriminatory: a frequently used pricing principle where mandated access to an input is required by law.

[10] Comisión Nacional de los Mercados y la Competencia (CNMC) (2015), 'La CNMC aprueba la operación de concentración Telefónica y DTS con compromisos sometidos a vigilancia', press release, 23 April, http://cnmc.es/CNMC/Prensa/TabId/254/ArtMID/6629/ArticleID/1211/La-CNMC-aprueba-la-operaci243n-de-concentraci243n-Telef243nica-y-DTS-con-compromisos-sometidos-a-vigilancia.aspx.

[11] Ofcom (2010), 'Pay TV Statement', 31 March, paras 9.114–9.121.

[12] Ofcom (2015), 'Review of the pay TV wholesale must-offer obligation', 19 November, para. 1.33, http://stakeholders.ofcom.org.uk/binaries/consultations/wholesale-must-offer/statement/review_of_wmo_sStatement.pdf.

[13] Oxera advised BT on various aspects of this case. Ofcom (2015), 'Fixed Access Market Reviews: Approach to the VULA Margin, Statement', March.

[14] Ofcom (2013), 'Complaint from TalkTalk Group against BT about alleged margin squeeze in relation to superfast broadband pricing', CW/1103/03/13.

[15] European Commission (2015), 'Commission decision concerning Case UK/2015/1692: Wholesale local access provided at a fixed location in the United Kingdom – Remedies – Comments pursuant to Article 7(3) of Directive 2002/21/EC', C(2015) 992 final.

[16] This is the case with the rights to broadcast national football leagues across Europe (Premier League, La Liga, Serie A, Ligue 1, Bundesliga, Champions League), as well as first-run pay-TV rights for audio-visual content (e.g. Hollywood films).

[17] An example was provided in relation to a decision by the Belgian Competition Authority where an obligation to supply basic TV channels was not extended to premium channels, in order to provide incentives for firms to invest in differentiated strategies. Conseil de la Concurrence (2008), 'Décision n° 2008-C/C-57 du 31 octobre 2008: Affaire CONC-C/C-08/0023 TECTEO - BETV / ACM', 31 October, paras 8 and 70–4, http://economie.fgov.be/fr/binaries/Decision_n_2008-C_C-57_du_31_octobre_2008_tcm326-67447.pdf.