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Goodfellas? The European Commission investigates pay-TV film deals

DG Competition's latest probe into the pay-TV industry considers whether contractual terms between major US film studios and Europe's leading pay-TV providers prevent cross-border competition between broadcasters. What is the current impact of these clauses from the perspectives of consumers, pay-TV operators and content producers, and what are the economic concepts in which these issues can be framed?

In January 2014, the European Commission (DG Competition) launched an Article 101 antitrust investigation into the licensing agreements concluded between major US film studios and Europe's leading pay-TV operators.[1] The investigation is focusing on the 'absolute territorial protection' included in many of these contracts, which prevents pay-TV operators from making applicable film content available outside of their home member states.

This probe comes in the wake of the European Court of Justice's recent *Premier League/Murphy* judgment,[2] which considered similar contractual terms embedded within sports rights provisions. While silent on territorial content restrictions, the court's judgment found that additional terms preventing pay-TV providers from supplying decoding devices (i.e. set-top boxes) across territorial boundaries were incompatible with Article 101 TFEU. These terms could, for example, prohibit a European expatriate living in a foreign member state from subscribing to their 'native' pay-TV service, even though this might be technically available via Internet or satellite services. Such terms were deemed to give rise to an 'absolute territorial exclusivity' (along national boundaries) for the broadcast of the relevant sports events, preventing effective competition between pay-TV operators.

In a similar vein, the Commission is specifically considering restrictions in the film rights contracts that prevent passive (i.e. non-solicited) cross-border sales (see the box on the right). Such sales could, for example, result from people travelling within the EU using mobile devices to purchase online content from their home content stores (such as iTunes), or from expatriates purchasing satellite television from their home country providers. The investigation will consider whether such terms afford the major European pay-TV operators similar 'absolute territorial protection', and whether this has an adverse effect on competition.

Passive versus active sales

The Commission and courts have both previously considered the distinction between 'passive' and 'active' sales, includingin-depth treatments in the context of motor vehicle sales and parallel imports of pharmaceutical products.[1] In the case of motor vehicles, it was found that Volkswagen contravened competition rules when it prevented Italian distributors from selling to foreign (particularly German and Austrian) consumers. For pharmaceuticals, these issues arose in the context of GlaxoSmithKline's dual-pricing policies aimed at limiting parallel trade from Spain (where medicinal productsare regulated to prices lower than in other member states). The resulting distinction is now embedded within the Commission's guidelines on vertical restraints, as follows.[2]

Active sales are those that actively target individual customers or groups of customers, through (for example) media or Internet advertising. Also included are advertisements or promotions that are attractive only to potential buyers withina specific territory (irrespective of their broader dissemination).

Passive sales refer to unsolicited requests from individual customers, and include the delivery of goods or servicesto such customers. Also covered is general advertising or promotion that might 'overlap' with another distributor's exclusive territory, as long as this also provides an effectiveway of approaching 'own-territory' customers. The distinction can be made by considering whether the activity would alsobe undertaken absent the spillover into the other exclusive territory.

Note: [1] See Motor Vehicle Block Exemption Regulations (MVBERs), Regulation 1400/2002 and Regulation 330/2010 in the case of motor vehicles; and (among others) joined cases C-501/06 P, C-513/06 P, C-515/06 P and C-519/06 P on GlaxoSmithKlein dual pricing in the case of pharmaceuticals. [2] Commission Notice – Guidelines on Vertical Restraints, OJ C 130, 19.5.2010, p. 13.

Irrespective of the eventual legal outcome, the investigation raises interesting commercial and economic questions from the perspectives of consumers, pay-TV operators and content producers; and in terms of the economic context.

The consumers' perspective

For consumers, the issue of territorial restrictions is brought to the fore by technological developments that allow an ever-increasing range of device and platform options for content consumption. Laptops, tablets and smartphones combined with online catch-up players such as BBC's iPlayer or France TV's Pluzz; live online broadcasts such as Sky's SkyGo or UPC's Horizon services; and over-the-top streaming services such as Netflix, Amazon's LoveFilm and RTL's Videoland provide a growing selection of 'on-the-go' and on-demand viewing options. Mobile consumers with portable devices expect their content to follow them wherever they travel, irrespective of national borders. The prevailing service offerings may therefore lead consumers to ask a number of questions, such as:

- why can't I view online content, that I have already purchased, from anywhere within the European single market?
- why do my European neighbours pay less than me for exactly the same content?
- why can they also obtain *additional* content that I do not have access to—or, if I do have access, why must I wait longer for that same content?

In each case, cross-border restrictions are at least partially responsible for consumers' expectations not being met. Indeed, in his announcement of the probe, Commissioner Joaquín Almunia, Vice President of the European Commission responsible for Competition Policy, stated:[3]

> if I live in Belgium and want to subscribe to a Spanish Pay TV service, I may not be able to subscribe at all if there is absolute territorial exclusivity

It would therefore appear that consumers could be better served if cross-border services were provided, raising the question of why these territorial contract terms persist. It is this question that appears to lie at the heart of the Commission's antitrust concerns in its investigation.

This article first considers the paradoxical position in which pay-TV operators may find themselves as a result of localised market conditions, before asking how this affects the incentives of the ultimate content producers.

Glossary of service types

Live linear broadcast: the traditional terrestrial, cable or satellite 'send-and-receive' model, in which viewers tune into watch their desired content as it is broadcast, at a time scheduled by the broadcaster.

Online catch-up: an increasingly popular offering from traditional broadcasters, such as BBC's iPlayer or FranceTV's Pluzz, allowing viewers to stream recently aired content online to watch at a time of their choosing (typically for a limited period after the live linear broadcast). These services mayalso provide apps for smartphones and tablets.

Over-the-top services: subscription services, such as Netflix, that offer a catalogue of on-demand content available for online streaming to a variety of devices, including computers, tablets, smartphones, and certain smart TVs and set-top boxes.

Live online broadcast: some broadcasters are now offering live online or on-the-go streaming options for viewers, for example Sky's Sky Go and UPC's Horizon service. Unlike with online catch-up and over-the-top services, the viewer does not choose the time of the content they wish to watch, but receives an online stream of the current live linear broadcast.

Download-to-own: an increasing number of online content stores, such as iTunes, Google Play and Amazon Prime, provide viewers with (near) instant access to their desired content which, once paid for, can be both downloaded to local storage for offline viewing, and retained in the cloud for future (free) retrieval.

Market conditions for pay-TV operators

Pay-TV operators can find themselves with conflicting interests when it comes to cross-border service provision. On the one hand, they seek to provide a compelling service to a large number of subscribers in a highly competitive market, for which the provision of cross-border services would be a benefit. On the other hand, they face issues that require a largely localised response, which competing cross-border services could undermine.

On the first point, the rise of over-the-top streaming and download-to-own services puts pressure on pay-TV operators to offer enhanced viewer choice and experience. As the use of mobile devices continues to grow, a principal component of this enhanced choice could be in the form of on-the-go offerings. Additionally, pay-TV operators are driven by an incentive to maximise the return on their content investments, which is achieved by attracting the greatest number of subscribers possible to their platform. Were cross-border supply of premium pay-TV content feasible, it

would therefore seem rational for operators to provide this service. However, that possibility is currently hampered by the territoriality conditions embedded within the content rights contracts.

At the same time, advertising represents an important source of revenue for the pay-TV operator. Cultural preferences and linguistic differences between member states mean that these revenues are generated on a largely national basis. Few advertisers are keen to adopt a pan-European campaign, preferring to address the tastes and fashions of a smaller regional area. In addition, the marketing campaigns run by the pay-TV operators to attract subscribers and promote their content are conducted along cultural and linguistic divides. In order to generate a sufficient return on these (often substantial) promotional and content costs, it is important that pay-TV operators maximise the value of the content they purchase, by ensuring the greatest viewership possible. The exclusive right to show a given film within an advertising and marketing region ensures this revenue maximisation, so pay-TV operators may be willing to pay an additional sum to guarantee such exclusivity.

When combined, these revenue and cost considerations result in the supply side of the European retail pay-TV market becoming segregated along cultural and linguistic divides, for which national boundaries often provide a convenient proxy.

Incentives for content producers

For content producers, the overall aim is simply to maximise the revenues generated from successful content. The production of high-quality content requires a large upfront investment and is inherently highly risky, with only a small fraction of all content going on to become profitable blockbusters. In order to continue to attract the required investment for new content, it is therefore imperative that successful content is fully exploited. To the extent that pay-TV operators are willing to pay more for exclusivity, this alone provides a commercial rationale for content producers to conclude territorially restricted contracts.

Moreover, there are a number of ways in which content producers gain from territorial contracting. First, regional distributors can be an important source of the risk capital needed to finance a new production. By concluding territorially exclusive contracts, a producer may be able to partner with a number of regional distributors simultaneously, raising a larger share of the funds required.

Second, having the content, the producer requires effective local marketing to achieve maximum consumption and revenue generation. Again, the various cultural and linguistic divisions throughout Europe make this most easily achieved by local distributors with local knowledge. However, this significant cost is typically undertaken only in return for exclusive rights to exploit the content within that region.

Third, it is highly likely that, for a given product, pay-TV operators' willingness to pay will differ across Europe according to consumer tastes and income levels. By offering different prices in different regions, the content producer is able to maximise revenues, extracting a greater value from those with the highest willingness to pay, while still supplying the widest possible audience at lower prices.

Taken together, the above factors create a compelling commercial case for content producers to conclude territorial contracts with the pay-TV operators.

An economic framework for assessment

When considering the possible effect of any policy change to contracting terms, it is important to evaluate all relevant aspects in a systematic way. To add some degree of structure to such an assessment, the issues can be framed within the bounds of several core economic concepts, as outlined below.

Free-riding

With experience goods such as films, marketing and advertising form an important part of the value generation chain. A consumer knows the true value of a product only once they have consumed (and paid for) the experience. Therefore, marketing (which sets an expectation for what is to be experienced) is an important source of information for consumers to help them prevent purchases that they might regret. However, the marketing required to promote a film is a costly activity for local distributors, and only undertaken with an expectation of a reasonable return. If foreign pay-TV providers, supplying across borders at reduced prices, are able to free-ride on these marketing investments, the continued provision of this value-creating activity could be undermined.

Price discrimination

In an industry characterised by a high commercial failure rate, the full exploitation of successful films is an important driver of continued investment spending. Firms with some degree of market power may therefore use price discrimination to extract a greater share of the available value from their products, by charging a higher price to those consumers with the greatest willingness to pay.[4] In the pay-TV sector, this discrimination is currently conducted along largely national boundaries as a reasonable approximation for the cultural, linguistic and income differences across Europe.

As a result, consumers in countries with the highest willingness and ability to pay for content are, in some sense, subsidising lower-valuation consumers.[5] However, in the extreme alternative, if a single European price were set, this

might have consequences for consumers' access to pay-TV content. Under this scenario, smaller pay-TV operators might be unable to bid competitively for these pan-European content rights, forcing consumers in smaller countries to adopt services from cross-border providers, or go without.

It is clear that the Commission is *not* seeking pan-European pricing in this investigation; rather, its focus is on improving cross-border portability and unsolicited sales. This would, however, mean that terms preventing *active* cross-border sales could still be included in film rights contracts. In this eventuality, there is a possibility that passive sales 'leakages' might force content wholesalers to adopt (at least close to) a uniform European price (thus excluding the smaller TV operators), while *active* sales restrictions might still prevent the larger retailers from directing low-priced promotions at consumers from outside their home country.

With price differentiation between territories disincentivised at the wholesale level, and contractually prohibited at the retail level, there is a risk that this could be a lose–lose scenario for the consumer. With only a single price for content, consumers in countries where viewers have less disposable income could be priced out of the market.

Investment incentives and long-run dynamic effects

It is also important to consider the long-run dynamic effects of any change to contracting terms. While it might be attractive to both regulators and consumers to boost access to the existing stock of content by removing territorial limitations, in the long run the value of that content will be depleted without continuous investment. For example, which has a greater entertainment value and cultural significance today: a modern blockbuster such as *The Hunger Games*, or a top-grossing film from the 1920s such as *The Jazz Singer*? While the widest possible access to the existing stock of works is undoubtedly good (*The Jazz Singer* in this example), it is unlikely to be generally considered a substitute for the creation of further new titles (*The Hunger Games*). However, in order to stimulate the required investments, there must be a substantial return on successful titles to compensate for the inevitable flops. As discussed above, territorial exploitation (or, more generally, price discrimination) plays an important role in achieving these rewards.

A future without borders?

Whatever the eventual outcome of the Commission's investigation, it has the potential to have wide-reaching impacts on the workings of the film industry. This might be of particular importance to those member states with strong or growing creative industries of their own.

If the Commission does proceed to reduce the territorial segmentation options available to pay-TV operators, perhaps it is time for the industry (at both the wholesale content and retail service levels) to consider alternative attributes that identify consumers with the greatest valuations for films. The advent of ever higher-quality technologies such as high-definition, blu-ray, 3D and 4K may already provide such a differentiator. While customers with a greater willingness and ability to pay self-select the best-quality media to enjoy the fullest experience, consumers with lower willingness to pay can continue to enjoy standard-definition versions at lower prices. Alternatively, a greater reliance on price discrimination might arise through 'windowing'[6] (perhaps in combination with technology used, as is the case with the staggered release of hard- and paperback versions of books) to differentiate between consumers.

[1] European Commission (2011), 'Antitrust: Commission investigates restrictions affecting cross border provision of pay TV services', press release, IP/14/15, 13 January, accessed 20 March 2014.

[2] Joined cases C-403/08 and C-429/08.

[3] European Commission (2014), 'Statement on opening of investigation into Pay TV services', statement by Joaquín Almunia, speech/14/13, 13 January, accessed 20 March 2014.

[4] A supplier is said to be able to 'price-discriminate' if they are able to increase profitability by charging different prices to different consumers within the same market, according to the consumers' willingness to pay. In the context of this analysis, each producer may be considered to enjoy a limited monopoly over the supply of their particular work. This provides them with some limited degree of market power that may be used to enact such a price-discrimination strategy. This, however, requires some mechanism for the supplier to separate high-value from low-value consumers.

[5] See Oxera (2011), 'Fares fair? The economics of setting ticket prices', *Agenda*, June, p. 4 for a concise treatment of Ramsey pricing, whereby products with the most inelastic demand are given the highest price–cost mark-up.

[6] Windowing describes the process by which media content is released in multiple formats at different times and at different prices in order to maximise total revenues. For example, by releasing a film at the cinema first and releasing it on DVD only later, the content-owner reduces the number of viewers who choose to avoid the cost of going to cinema by watching the film on DVD.