INPUT FORECLOSURE IN TELECOMS/MEDIA VERTICAL MERGERS: THE *MEO/GMC* CASE

BY ALÍPIO CODINHA, MARIANA COSTA, MARTA RIBEIRO & PEDRO MARQUES[1]

   

1 Alípio Codinha is Deputy Director of the Merger Department. Mariana Costa, Marta Ribeiro and Pedro Marques are economists and were the case handlers in this transaction.

I. INTRODUCTION

In August 2017, MEO – Serviços de Telecomunicações Multimédia S.A.(“MEO”), a wholly-owned subsidiary of Altice Europe N.V., a media and telecoms group announced it would acquire total control of Grupo Media Capital, SGPS, S.A. (“GMC”), the main media and contents company operating in Portugal.

This merger was notified to the Portuguese Competition Authority (“AdC”), which subsequently initiated an in-depth investigation on the potential negative impact the merger would have on competition in the telecom and media markets in Portugal. MEO submitted a set of behavioral remedies which did not adequately addressed the competitive concerns identified by the AdC.

The AdC decided to terminate the merger proceedings as the result of a decision by the notifying party, MEO, to withdraw the notification. Nevertheless, the AdC was able to conclude, in its competitive assessment, that the transaction would ultimately lead to serious impediments to effective competition in the telecom and media markets, with negative impacts on consumers.

II. BACKGROUND

MEO is the former state-owned telecoms company active in all segments of electronic communications services, including the management of the Digital Terrestrial Television network. MEO supplies telecom services (voice, video, data, and internet) supported on both mobile and fixed networks and is active in the retail supply of pay-TV channels through its pay-TV platform and multiple-play services (i.e., bundled services for voice, TV, and internet).

MEO had, in 2016, 39 percent of all pay-TV subscribers and represented 43 percent of multiple-play services revenues in Portugal.

The target, GMC, controls, *inter alia*, the television studio and content producer Plural, Portuguese-speaking TV channels under the TVI brand (TVI, TVI24, TVI Ficção, and TVI Reality), as well as radio stations Comercial, M80, Cidade FM, Smooth FM, and Rádio Vodafone. It also controls the internet portal IOL and the online content platform TVI Player.

TVI channels represented, in 2016, one quarter of average daily share view of all TV channels distributed in Portugal. Moreover, TVI programs (mostly produced by Plural) are consistently in the TOP 10 most viewed programs (first 6 out of 10 most-viewed programs in 2016, excluding football matches).

Advertising in TVI channels represented 40-50 percent of all TV advertising revenues in Portugal in 2016.

MEO and GMC supply few services that directly compete with one another. Their main relationship is that GMC provides TVI channels to MEO that are subsequently distributed to consumers. Therefore, this was primarily a vertical merger, between one of the main players in the telecoms sector, retail distribution of pay-TV services, and multiple-play services on the one hand, and the market leader for the wholesale distribution of audio-visual content and Portuguese-speaking TV channels, including the top-viewing channel (measured in terms of share of audience and advertising revenues), TVI, on the other.

III. INPUT FORECLOSURE ASSESSMENT

In a vertical merger, the possible competitive concerns are that the vertically integrated firm may have the incentive and ability to hamper or eliminate (actual or potential) rivals’ access to supplies or markets thereby reducing their incentive and/or ability to compete in either downstream or upstream markets, thus harming competition and, ultimately, consumers.

Although this transaction involved the assessment of several vertical theories of harm involving a wide range of the parties’ activities, this article focuses solely on foreclosure of GMC’s TVI channels to MEO’s rivals (input foreclosure).

In this context, the AdC's approach assessed the possibility that MEO would prevent rival pay-TV operators from obtaining access to TVI channels or would increase the prices of those channels (carriage fees) in such a way that would result in significant impediments to competition in the provision of pay-TV services (whether or not integrated in multiple-play offers).

A. Exclusion of Rivals (Total Input Foreclosure)

In this first step, the AdC assessed whether the transaction would increase GMC's ability and incentive to deny the provision of TVI channels (namely, TVI main channel and TVI24, a 24h news channel) to MEO's retail competitors, causing them to become less effective competitors.

The AdC concluded that TVI main channel and/or TVI24 are important to MEO's competitors and that there are no good substitutes from other sources that would allow MEO's rivals to implement effective and timely counter-strategies.

Furthermore, the AdC concluded that such strategy would be profitable for the vertically integrated firm.

Foreclosing TVI channels to MEO's rivals entails (i) losing carriage fees from the foreclosed rival pay-TV operators; (ii) losing advertising revenues from reduced viewer reach of these channels; and (iii) losing customer interaction revenues,[2] also from reduced viewer reach of these channels.

In the analysis it was assumed that advertising and customer interaction revenues were directly proportional to the subscriber share of each pay-TV platform prior to foreclosure. Thus, input foreclosure strategy results in a revenue loss corresponding to the pre-transaction advertising revenues of each rival platform reduced by the proportion of subscribers on these platforms that will switch to MEO or other non-foreclosed platforms in order to be able to continue watching TVI channels.

Moreover, it was assumed that a reduction in advertising and customer interaction revenues results in an equal reduction in GMC's profits, given that costs would not change.

The gains from total input foreclosure correspond to the additional profits earned by MEO resulting from new subscribers that will switch to MEO's platform in response to the loss of TVI's channels in the foreclosed platforms.

In order to estimate subscriber switching rates, the AdC had to the determine both the fraction of customers that would decide to leave MEO's rivals (the departure rate) and the fraction of these departing customers that would switch to MEO (diversion rate).

For the diversion rates, historical data collected by pay-TV operators was used. For the departure rate, the AdC conducted a consumer survey with 1,550 interviews where households were asked to qualify (on a scale of 0 to 10, where 10 is "I would switch for sure") the probability of switching in case their current pay-TV service provider would not offer TVI main channel and/or TVI24 in its channels *bouquet*.

The results of the consumer survey showed that a majority of MEO's rivals' subscribers would not switch from their current providers if TVI main channel and/or TVI24 were withdrawn from the channels *bouquet*.

However, a significant number of respondents showed a very high willingness to switch (considering only level 10 of the survey scale). Around 15 percent of respondents in the case of the withdrawal of TVI main channel, 7 percent for TVI24 news channel and 18 percent for both. From this survey it was thus possible to estimate the actual number of subscribers switching to MEO.

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2 Customer interaction revenues are generated from calls made by the viewers in the course of a particular show or TV contest. These revenues are significant for the main Portuguese channels such as TVI, SIC, and RTP.

In order to estimate the incremental profit of each subscriber switching to MEO, the AdC used data provided by the notifying party where it estimated incremental profits *per* type of service.[3] The AdC assumed that subscribers switching to MEO generate a margin equal to MEO's average contribution margin *per* subscriber *per* service on the rival's existing customer base.[4]

The AdC then assessed the incentives for MEO to engage in a number of input foreclosure scenarios involving the permanent withholding of TVI channels from its rivals. It concluded that MEO would have the ability and incentive to: (i) foreclose TVI main channel to the largest of its rivals; (ii) foreclose TVI24 to each one of its rivals; (iii) foreclose both TVI and TVI24 to the largest of its rivals; and (iv) foreclose TVI main channel and/or TVI24 simultaneously to all of its rivals.

In these situations, estimated gains in profits in pay-TV provision more than compensated losses in revenues from advertising and customer interaction services and carriage fees.

B. Raising Rivals' Costs (Partial Input Foreclosure)

Even though some total input foreclosure strategies would be profitable, the AdC also assessed the possibility that the vertically integrated firm would be willing to supply TVI channels to MEO's rivals although at significantly higher prices compared to the pre-transaction scenario, raising rivals' costs and hampering their ability to compete in the provision of pay-TV services.

Given that distribution contracts for TVI channels are negotiated bilaterally between GMC and pay-TV operators, the AdC assessed if the transaction significantly strengthened GMC's bargaining position *vis-à-vis* MEO's rivals.

In this situation, TVI channels would continue to be widely distributed across most or all rival pay-TV platforms increasing, on the one hand, revenues from carriage fees and, on the other hand, holding audience levels constant and, consequently, revenues from advertising and customer interaction services.[5]

For this assessment, the AdC used a Nash bargaining framework, such as the one used by the European Commission in its assessment of the *Liberty Global/Corelio/W&W/De Vijver Media* transaction and by the FCC in its investigation of the *Comcast/NBCU* merger.[6]

The AdC concluded that this transaction substantially increased GMC's bargaining position in negotiations with MEO's rivals over carriage fees for TVI channels in comparison to the pre-merger situation.

This was true for all scenarios taken into consideration (partial foreclosure of TVI main channel and/or TVI24 to each of MEO's rivals), regardless of whether or not total foreclosure was a profitable strategy.

In fact, the bargaining model showed that post-merger, GMC and MEO's rivals would always have an incentive to reach an agreement (i.e., total surplus from reaching an agreement was strictly positive in all situations). The vertically integrated firm would be able to obtain an increase in carriage fees at least as high as the increase in profits from total foreclosure. As for MEO's rivals, their losses from higher carriage fees would be lower than the ones resulting from lost subscriber revenues.

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3 From 2-play to quintuple play bundles that included pay-TV.

4 For example, if a rival's subscriber base is composed of 40 percent triple-play customers and 60 percent quadruple-play customers, than, the average subscriber switching from that rival to MEO will contribute to MEO's profits taking into account 40 percent of MEO's incremental profit in triple-play services and 60 percent in quadruple-play services (Incremental profit of a subscriber switching from the rival = (0.4 x MEO incremental profit in triple-play services) + (0.6 x MEO incremental profit in quadruple play)).

5 For a more in-depth discussion, please refer to, e.g., Helen Weeds (2016), *TV Wars: Exclusive Content and Platform Competition in Pay TV*, The Economics Journal, August 2016, Volume 126, Issue 594.

6 *See* Baker, Jonathan B., Comcast/NBCU: The FCC Provides a Roadmap for Vertical Merger Analysis (February 5, 2011). Antitrust, Vol. 25, No. 2. Spring 2011; Rogerson, William (2012): Vertical mergers in the video programming and distribution industry: The case of Comcast-NBCU, CSIO Working Paper, No. 0116, Center for the Study of Industrial Organization at Northwestern Univ., Evanston, Ill.

Even when total foreclosure was not a profitable strategy, GMC was able to extract higher carriage fees because failure to reach an agreement with MEO's rival post-transaction would harm GMC less than absent the transaction (because post-transaction, GMC internalized the profits of MEO).

The Nash equilibria post-transaction predicted several fold increases in carriage fees that amounted to substantial increases in total content acquisition costs for MEO's rivals.

The AdC therefore concluded not only that post-transaction the new entity would have an improved bargaining position in negotiations of carriage fees with MEO's rivals, but also that partial foreclosure would be the most likely result of this transaction, given that it would result in higher profits for the vertically integrated firm.

C. Effects

The AdC concluded that the merged firm would have the ability and incentive to implement total and partial foreclosure strategies attaching a higher probability to a partial foreclosure outcome.

Higher carriage fees for TVI channels would result in significant overall increases in content acquisition costs to MEO's rivals which would have to increase subscriber fees. Furthermore, MEO's rivals' ability to acquire competitive content would also be negatively affected.

In both cases, MEO's rivals would become less effective competitors, thus increasing the ability of the merged entity to increase prices to final consumers and/or decreasing pressures for high-quality content acquisition/production.

Furthermore, the AdC concluded that the transaction would raise barriers to entry, with particular emphasis to potential alternative low-cost online providers as these providers either would not have access to TVI channels or would have access at less favorable terms than absent the merger.

IV. CONCLUSIONS

The notifying party decided to withdraw its notification during the course of the in-depth investigation. For this reason, the AdC's final decision is limited to the termination of the procedure and detailed results cannot be reported here.

The Transaction relates to all the levels of the TV value chain and raised competitive concerns in several different vertically-related markets.

The most relevant anticompetitive effect identified by the AdC concerned the possibility of foreclosing GMC's TVI channels to MEO's rivals in the provision of pay-TV services.

This type of anti-competitive effect has been previously identified, for example, by the FCC in the *Comcast/NBCU* merger and by the EC, in the *Liberty Global/Corelio/W&W/De Vijver Media* transaction.

The AdC's assessment used a similar analytical framework to infer about the ability and incentive of the merged entity to engage in total or partial input foreclosure.

The results from the consumer survey allowed the AdC to quantify, precisely, subscriber departure rates in case TVI channels were withheld by the merged entity. These results confirmed that both TVI channels are important inputs for pay-TV operators to compete in the provision of pay-TV services.

Departure rates were sufficiently high to allow the merged entity either to profitably withhold TVI channels to MEO's rivals or to credibly threaten to do so, therefore strengthening GMC's bargaining position *vis-à-vis* MEO's rivals post-transaction.

The bilateral bargaining framework further showed that GMC's bargaining position would still be strengthened even in those situations where total input foreclosure was not a profitable strategy for the merged entity.

The AdC therefore concluded that partial input foreclosure, through higher carriage fees, would be the most likely result of this transaction. This would cause a significant increase in content acquisition costs, hampering MEO's rivals' ability to be effective competitors in the provision of pay-TV services, ultimately leading to higher consumer prices and/or decreased service quality.

These results would most likely be sufficient, on their own, to justify an opposition decision by the AdC.