

8 October 2013

John Fellet
Sky Network Television Limited
10 Panorama Road
Mount Wellington
Auckland

Dear Mr Fellet

Commerce Act 1986: Warning

1. During our investigation of the joint venture between TVNZ and Sky Network Television Limited (Sky), we received several complaints about Sky's contracts with telecommunications retail service providers (RSPs) and content providers. At the conclusion of our investigation into the TVNZ/Sky joint venture, we launched an investigation into these complaints under the Commerce Act 1986 (Commerce Act).
2. We have now completed our investigation and are writing to advise you of the outcome. We also enclose our investigation report.

Summary of our conclusions

3. We have concluded that:
 - 3.1 Sky's contracts with content providers are not likely to have breached the Commerce Act;
 - 3.2 'key commitment' provisions in Sky's contracts with RSPs are likely to have previously breached section 27 and were at risk of breaching section 36 of the Commerce Act by hindering competition in the market for pay TV in New Zealand; and
 - 3.3 while their purpose likely remains unchanged, the key commitment provisions in Sky's current contracts with RSPs appear unlikely to continue to have the effect or likely effect of substantially lessening competition, because of market developments.
4. However, only the courts can decide if there has actually been a breach of the Commerce Act.
5. In this case, we have decided to issue a formal warning to Sky rather than issue legal proceedings. In making this decision, we have weighed the historic nature of the conduct likely to be in breach and that the key commitment provisions are unlikely to lead to detriment in the future.

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6. We will, however, continue to monitor Sky's existing or new contracts with RSPs and Sky's conduct in relation to those contracts. This is to ensure that the provisions remain unlikely to have an anti-competitive effect. In particular, we will closely scrutinise Sky's conduct in relation to any requests for exemptions from these provisions.
7. If we consider that there is evidence that competition is, or is likely to be, substantially lessened, we will take the necessary enforcement action to remedy the situation, and ensure that the long-term interests of consumers are protected.
8. In this respect, we reserve the right to draw this warning letter to the attention of a court in any subsequent proceedings against Sky.

Our investigation

9. We assessed whether any provisions of Sky's contracts with content providers, or its contracts with RSPs had the purpose, effect, or likely effect of substantially lessening competition in a New Zealand market in breach of section 27 of the Commerce Act. We also considered whether Sky's conduct either in relation to content, or in relation to the RSP contracts, amounted to it taking advantage of substantial market power for an anti-competitive purpose in breach of section 36 of the Commerce Act.
10. In addition to gathering information from Sky:
 - 10.1 in relation to content, we gathered evidence and information from broadcasters such as TVNZ and Mediaworks on the nature of their current content contracts and the process for acquiring content, potential pay TV entrants on the ease with which they are able to acquire content, and content providers such as movie studios and sports governing bodies; and
 - 10.2 in relation to the RSP contracts, we gathered evidence and information from Telecom, Vodafone, TelstraClear, CallPlus, and Orcon, and current providers of pay TV services in New Zealand such as Quickflix and Coliseum, and potential entrants such as FetchTV, Apple and Netflix.

Conclusions in relation to content contracts

11. For the purpose of investigating Sky's content contracts, we considered the relevant markets to be those for the acquisition of different types of content, such as premium movies in the first subscription pay TV window, and live sports rights.
12. The main theory of harm we considered was whether Sky's content contracts are exclusive, long-term and overlapping such that insufficient content may be available within a reasonable time period for a potential rival to be able to put together an appealing pay TV package.
13. Our view is that Sky's contracts with content providers are unlikely to have breached section 27 or section 36 of the Commerce Act. This is because sufficient content of all types appears to be available outside of Sky's exclusive contracts to enable a rival to

put together an appealing pay TV package. Furthermore, other broadcasters in New Zealand also have contracts with similar exclusivity and duration provisions.

14. What is potentially more of a barrier for a new entrant is the price Sky pays for content, which reflects Sky's large subscriber base. The high cost of content, however, is in itself neither a section 27 nor a section 36 issue.

Our conclusions in relation to Sky's contracts with RSPs

The key commitment provisions

15. Sky has resale and/or retransmission contracts with three of the four largest RSPs in New Zealand. Each of these contracts include 'key commitment' provisions, which:
 - 15.1 restrict the relevant RSPs' ability to source and resell TV content from any party other than Sky; and
 - 15.2 prevent the relevant RSP from providing assistance to other parties who provide or wish to provide services that compete with Sky.
16. Each of Sky's RSP contracts also includes a 'prohibition on bundling' provision. This provision stops the relevant RSP from bundling Sky content with third party content, unless Sky consents.

Pay TV market

17. For the purpose of investigating Sky's contracts with RSPs, we considered the relevant market to be the retail supply of pay TV services in New Zealand (the pay TV market).

Potential ways the key commitments could harm competition

18. We have considered three related ways in which the key commitment provisions could harm competition in the pay TV market:
 - 18.1 by Sky leveraging its market power to prevent or hinder RSPs from assisting or developing rival pay TV products that may have in time become an effective competitor to Sky;
 - 18.2 by denying rival pay TV wholesalers to Sky viable scale in New Zealand by limiting access to RSPs; and
 - 18.3 by Sky paying RSPs not to enter into the pay TV market and/or not to support a new entrant into that market.
19. In assessing the effect and likely effect of these provisions on competition, we have considered the aggregate effect and likely effect of the key commitments in each contract between Sky and an RSP under section 3(5) of the Commerce Act.

Key commitments likely to have breached section 27 historically

20. Our view is that the key commitment provisions are likely to have breached the Commerce Act in the past.
21. In relation to section 27 we consider that on their face these provisions appear aimed to hinder competition, despite Sky's purported rationale for the key commitment provisions. This is supported by Sky's internal contemporaneous documents, which indicate support for a conclusion that Sky's subjective purpose was to limit competition from RSPs, especially in relation to content.
22. We also consider that, historically, the key commitment provisions have had the effect of substantially lessening competition in the pay TV market because:
 - 22.1 Sky is a near monopoly in the supply of pay TV in New Zealand, such that any new entry were it to occur would have significant benefits for New Zealand consumers;
 - 22.2 [];
 - 22.3 the key commitment provisions alone (or in aggregate) increased barriers to entry to the RSPs, some of the most likely entrants into the pay TV market; and
 - 22.4 there is some evidence that RSPs were deterred by the key commitment from considering entry into the pay TV market provisions and where RSPs attempted to enter (or considered entry) they were prevented from doing so by Sky enforcing the key commitment provisions.
23. For similar reasons we consider that Sky's conduct in imposing the key commitment provisions may have also breached section 36 of the Commerce Act.

Key commitments are unlikely to continue to have the effect or likely effect of substantially lessening competition, because of market developments

24. We consider that the key commitment provisions in Sky's current contracts with RSPs appear unlikely to continue to have the effect or likely effect of substantially lessening competition. This is because, in no particular order:
 - 24.1 Telecom is not currently offering Sky's services to new customers and as such has a reduced incentive to remain with Sky when its contract ends;
 - 24.2 Telecom was recently granted an exception to the key commitment provisions by Sky so that it can offer an alternative pay TV product; and
 - 24.3 entry by other pay TV operators is more likely than it has been in the past.

Prohibition on bundling unlikely to breach the Commerce Act

25. In our view, Sky is entitled to prevent RSPs from bundling competing TV products with Sky's to protect its brand. If Sky could not prevent an RSP from bundling its products with other pay TV products, the RSP could enter by free-riding on Sky's product. This may reduce incentives for firms to invest in a similar fashion in future and reduce competition.
26. We consider the prohibition of bundling provision facilitates Sky supplying its product. Therefore we consider that these provisions do not have the effect or likely effect of substantially lessening competition in breach of section 27. For similar reasons to those stated above the Commission also considers that Sky has not breached section 36, as we consider a competitive firm would likely include a similar clause.
27. However, despite Sky's submissions to the contrary, we do not consider the 'free-riding' argument above also justifies the key commitment provisions. In that case, Sky is not seeking to protect its investment, but seeking to preserve its market power by limiting competition from RSPs.

Further action by the Commission or by other parties

28. As stated above, while we have decided not to issue legal proceedings against Sky in this instance, we reserve the right to do so should new evidence that competition is, or is likely to be, substantially lessened come to light.
29. The court can impose penalties where it finds the law has been broken. An individual can be fined a maximum of \$500,000 and/or be prohibited from being a company director. A body corporate can be fined the greater of \$10 million, or three times the commercial gain from the breach (if this cannot be easily established, 10% of turnover). Every separate breach of the Act may incur a penalty.
30. You should be aware that our decision to issue this warning letter does not prevent any other person or entity (for example, an RSP or another pay TV operator or potential operator) from taking private action through the courts.

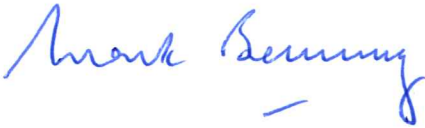
Publication

31. This warning letter and the enclosed investigation report are public information and will be published on our website. We intend to make public comment including via issuing a media release and making comment to media.

Further information

32. Please contact [] on [] or by email at [] if you have any questions about this letter.

Yours sincerely



Dr Mark Berry
Chairman
Commerce Commission

cc: Buddle Findlay