E.CA Economics

LGI's acquisition of KBW – effects on competition and bargaining power

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Agenda

- Background
- Effects on Bargaining Power
- Effects on the MDU market
- Conclusions

Cable TV in Germany

Activities

- Cable network operators own infrastructure to transmit TV programmes to homes
- For analogue free-TV transmission a network operator receives feed-in fees from programme providers and subscription fees from households or housing associations (MDUs)
- Cable operators can „onsell" to households (e.g. broadband internet)

Players

- 3 regional cable network operators
  - Kabel Deutschland (KDG); Unity Media (UM) owned by Liberty Global (LGI); Kabel BW (KBW)
- Smaller local (or scattered) operators: Pepcom, NetCologne
- IPTV via fibre networks (Deutsche Telekom)
- Satellite TV
- Terrestrial transmission

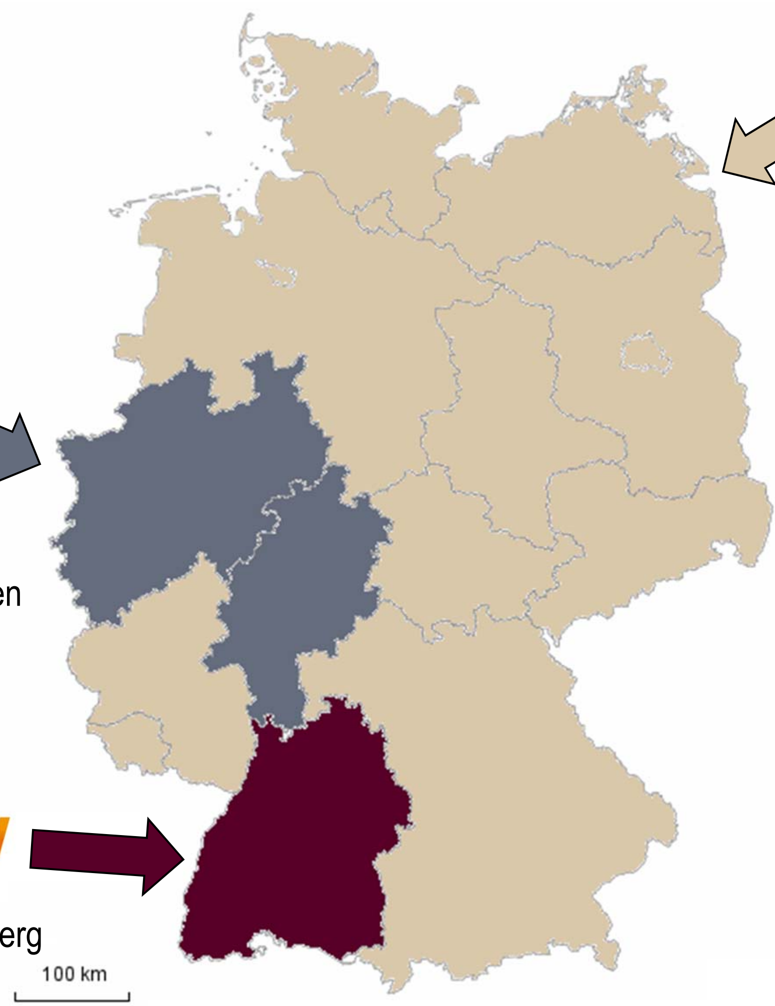
Transaction, time line and key issues

March 11	• **Liberty Global Inc. (LGI)** a large international cable network operator announces acquisition of **Kabel BW** a German regional cabel network operator
April	• Merger notified with the European Commission (EC) due to activities in Germany: LGI ownes regional cabel network operator Unitymedia (UM)
June	• German Federal Cartel Office (FCO) requests scrutiny and EC refers the case to the FCO
Dec	• Transaction cleared with remedies
Jan 12	• Deutsche Telekom files appeal to Higher Regional Court of Düsseldorf

Key issues

- Three large regional operators in Germany: may be perceived as three to two merger
  - Effects on competition in the multi-dwelling unit market (MDU; housing associations)?
  - Effects on bargaining power vis à vis the TV programme providers?
  - Do remedies meet competition concerns?

German Footprints of the three largest German cable operators



Kabel Deutschland

- Bayern
- Berlin
- Brandenburg
- Bremen
- Hamburg
- Mecklenburg-Vorpommern
- Niedersachsen
- Rheinland-Pfalz
- Saarland
- Sachsen
- Sachsen-Anhalt
- Schleswig-Holstein
- Thüringen

LIBERTY GLOBAL – unitymedia

- Hessen
- Nordrhein-Westfalen

Kabel BW – Einfach clever.

- Baden-Würtemberg

The EC's and FCO's concerns

Retail supply of free-TV to housing associations

"While regional cable operators are currently not competing with each other, it cannot be excluded that this is the result of co-ordination among the operators and that the proposed transaction could strengthen such coordinated effects between the three regional operators in Germany." (EC)

Wholesale market concern

"Moreover, the proposed transaction might threaten to affect competition in the national market for the wholesale supply of TV signal transmission services." (EC)

- UM+KBW=greater reach ➔ increases bargaining power ➔ higher access fees ➔ anti-competitive
- Was key concern in previous FCO decisions

Negotiations on feed-in fees

Content

- Cable operators and programme providers negotiate
  - Feed-in fees for analogue programmes (paid to cable operators)
  - Licence fees for rights (paid to programme providers and collecting societies)
  - Signal encryption for free-TV
  - Move to HDTV

Negotiations

- Repeated parallel negotiations with sequential conclusions
- Outcomes are not published but there is some leakage
- Sometimes negotiations are delayed but to date there have been no black-outs

The theory of harm

Theory of harm

- UM controls access to its customers (Monopoly) and this access is indispensable for broadcasters
  - *“According to our investigation free-TV broadcasters [….] depend on distribution through each network“*
- Any addition in reach increases bargaining power
  - *„The bigger the customer base, the more important is the platform for the signal transmission for the access seeking programme providers. Correspondingly higher is the bargaining power of the cable network operator“*
- Increase in bargaining power leads to higher feed-in fees
- Higher feed-in fees are anti-competitive

Testing the theory of harm in a bargaining framework

Two questions

Are these statements consistent?

1. LGI/UM and KBW are essential for programme providers
2. Merger increases bargaining power

What is the expected effect of the merger if actual reach is taken as „critical“ reach?

No effect if negotiations are independent

- Access to individual customer is not affected by the merger – if negotiations are independent, an increase in reach has no effect on the payment per end customer
- In order to have an impact we need to assume that negotiations depend on each other: an agreement between KBW and Broadcaster affects the outcome of negotiations between LGI/UM and the programme provider

A bargaining framework

Framework

- Parallel negotiations between each distribution network and the broadcaster: UM with RTL, KBW with RTL and so on
- Agreement of parallel negotiation is anticipated
- Complete information and similar costs of bargaining / patience
- Compare Nash bargaining solution without merger to solution with merger

Possible linkages between negotiations

- „First“ agreement increases reach above the critical level to induce a shift in advertisment revenue („second“ agreement brings fewer benefits)
- All agreements are essential to get critical reach („second“ agreement bringts big benefits)
- Fix costs of TV programme production recouped in „first“ agreement („second“ agreement brings big benefits)

- Critical for the intuition: In practice (as in the underlying model) each cable operator considers itself being the marginal („second“) negotiating party

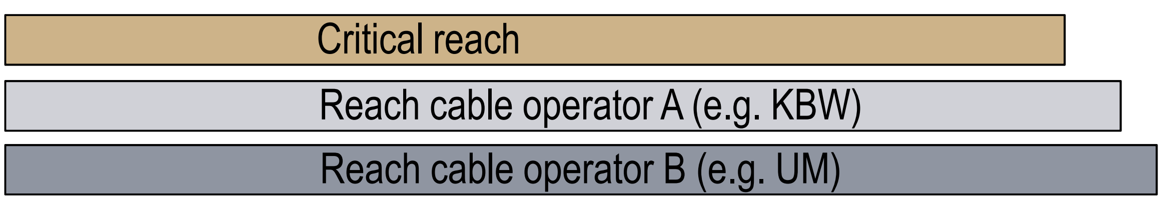
Effects of UM/KBW merger on bargaining power

Economic theory and empirical research question simple link between size and bargaining power

- Bargaining between UM and broadcaster and KBW and broadcaster must be „linked“ – otherwise there is no merger effect
- Link can be due to the fact that broadcaster requires „critical reach“ (a concept used by the FCO)
- If so, the impact becomes an empirical question which depends on the contribution of KBW and UM to the critical reach
- We look at stylised examples to show this (reality is much more complex)

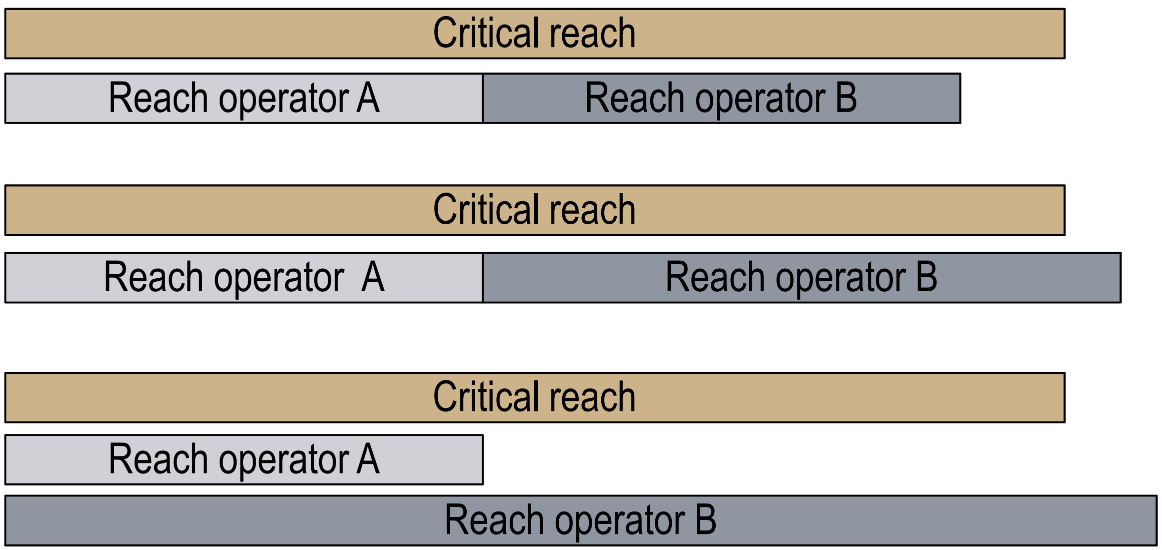
A scenario in which bargaining power does increase

- Suppose both UM and KBW can each individually provide a broadcaster with the incremental increase in viewers to achieve „critical reach“
- Before the merger the broadcaster can trade-off KBW and UM to get a good deal
- After the merger a deal with the combined entity becomes essential – bargaining power increases due to the merger



Effects of UM/KBW merger on bargaining power

There are many situations in which there is no increase in bargaining power



Critical reach not attainable to begin with

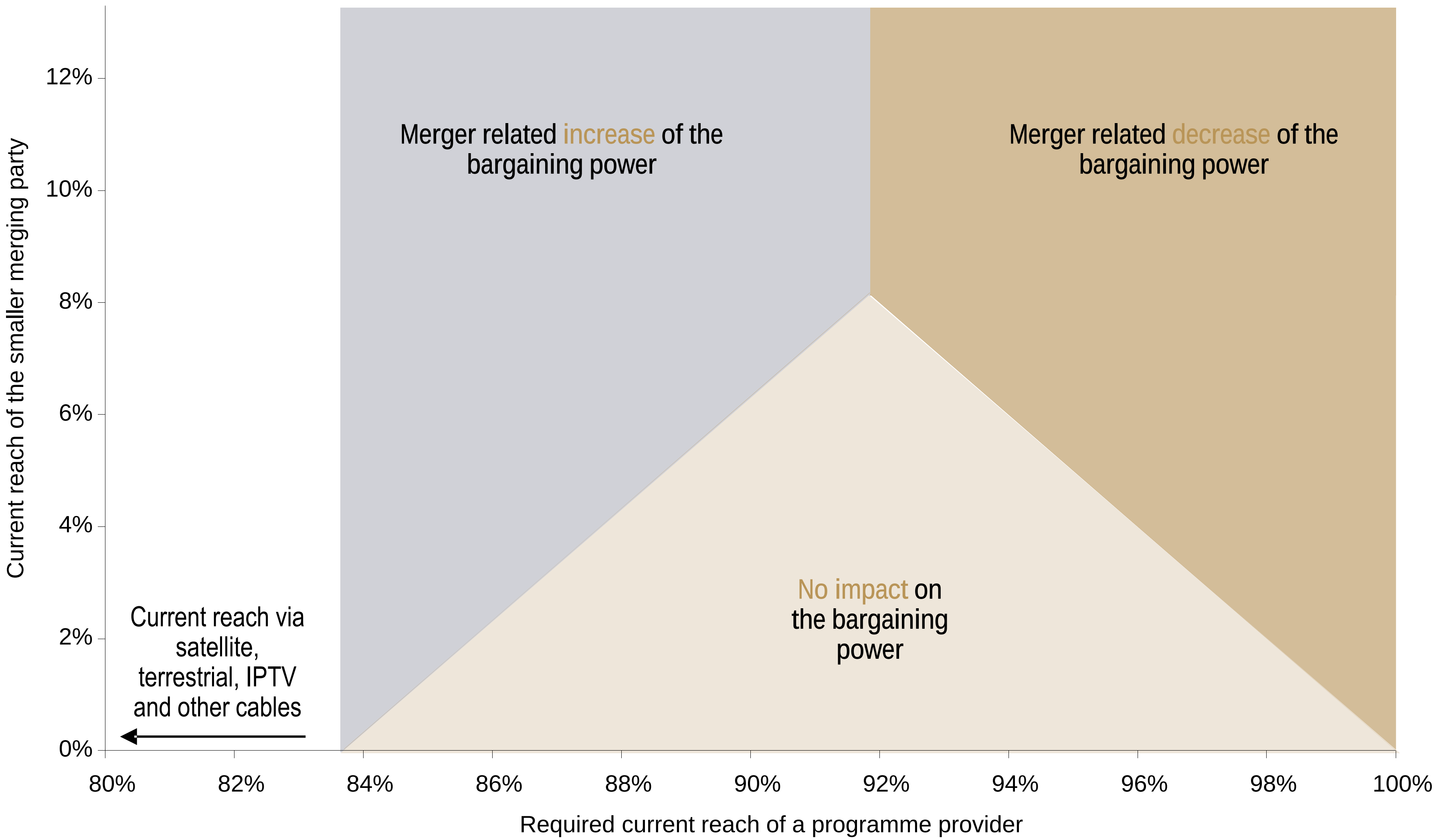
Both operators are required to attain critical reach, merger removes one necessary negotiation (complementary goods)

Operator A never had a critical bargaining position to begin with

Theory suggests that the impact on bargaining power is an empirical question

- Compare the cable network operators‘ actual reach to the respective required critical reaches of the programme provider
- Idea: take current reach of programme providers as approximation of critical required reach

Merger effect on bargaining power depending on critical reach



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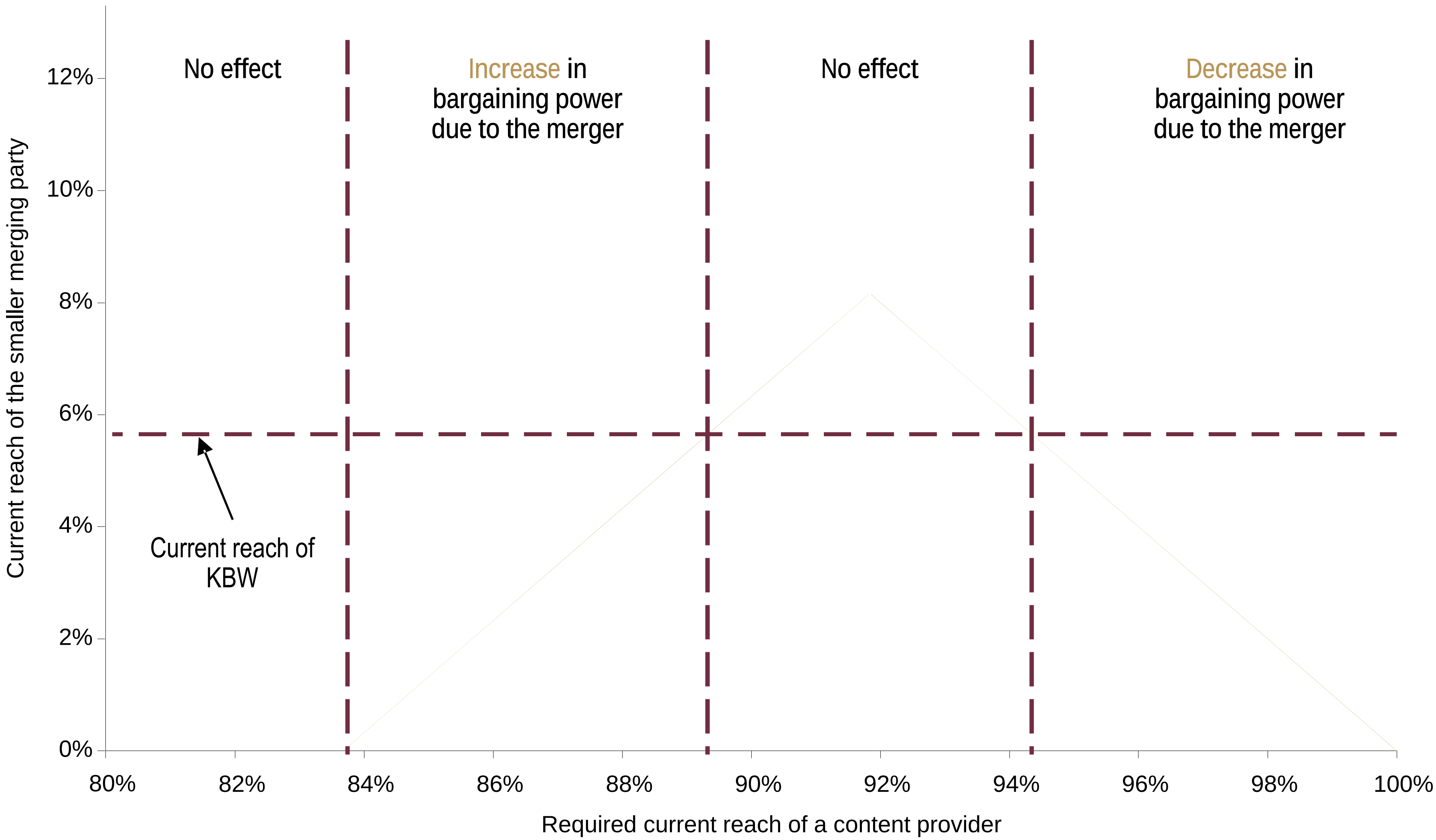
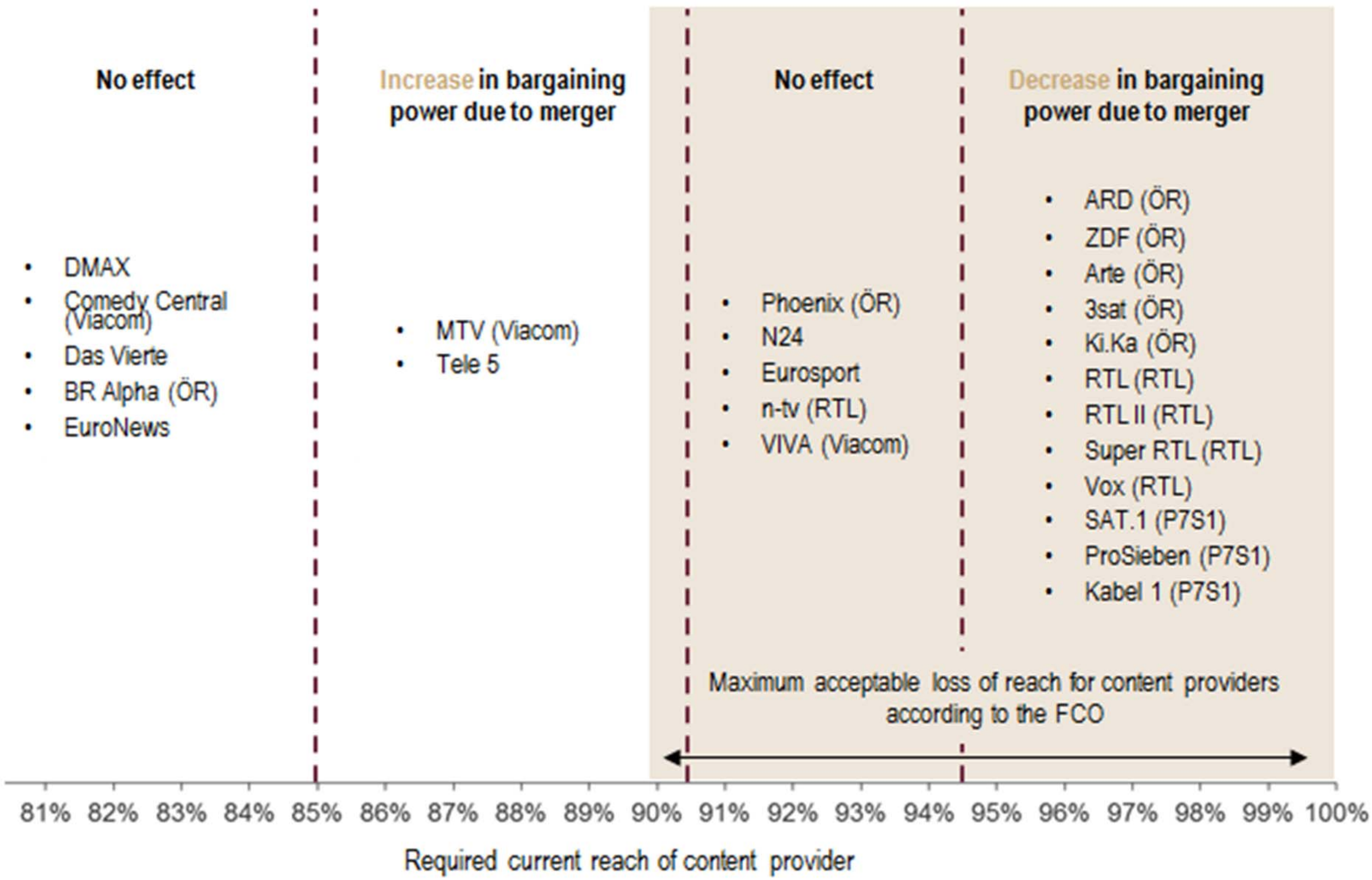
Effect of merger between KBW and UM on bargaining power



Effect of merger between KBW and UM on bargaining power



Results from academic research

Chipty and Snyder (1999)

- Average value function of programme provider is convex
- In the absence of up- and/or downstream efficiencies, a merger leads to lower payments by programme providers

Raskovich (2001)

- Pivotal buyer is „on the hook“ to ensure that a supplier‘s cost are covered
- Becoming pivotal due to a merger leads to lower payments by programme providers

Adilov and Alexander (2002 and 2003)

- If the Nash bargaining solution changes as a result of the merger, the intuition derived above may not hold
- Suppose the merger leads to better information, a more skilled bargaining team, lower risk aversion or more patience then the resulting change in the Nash bargaining solution could overcompensate the otherwise expected merger effect of lower prices

FCO Decision

Generally, a price increase is a possible result of a merger

- FCO references Adilov and Alexander (2002 and 2003)
- However, no specific evidence suggesting that bargaining power should increase

Empirical evidence for general price increase insufficient

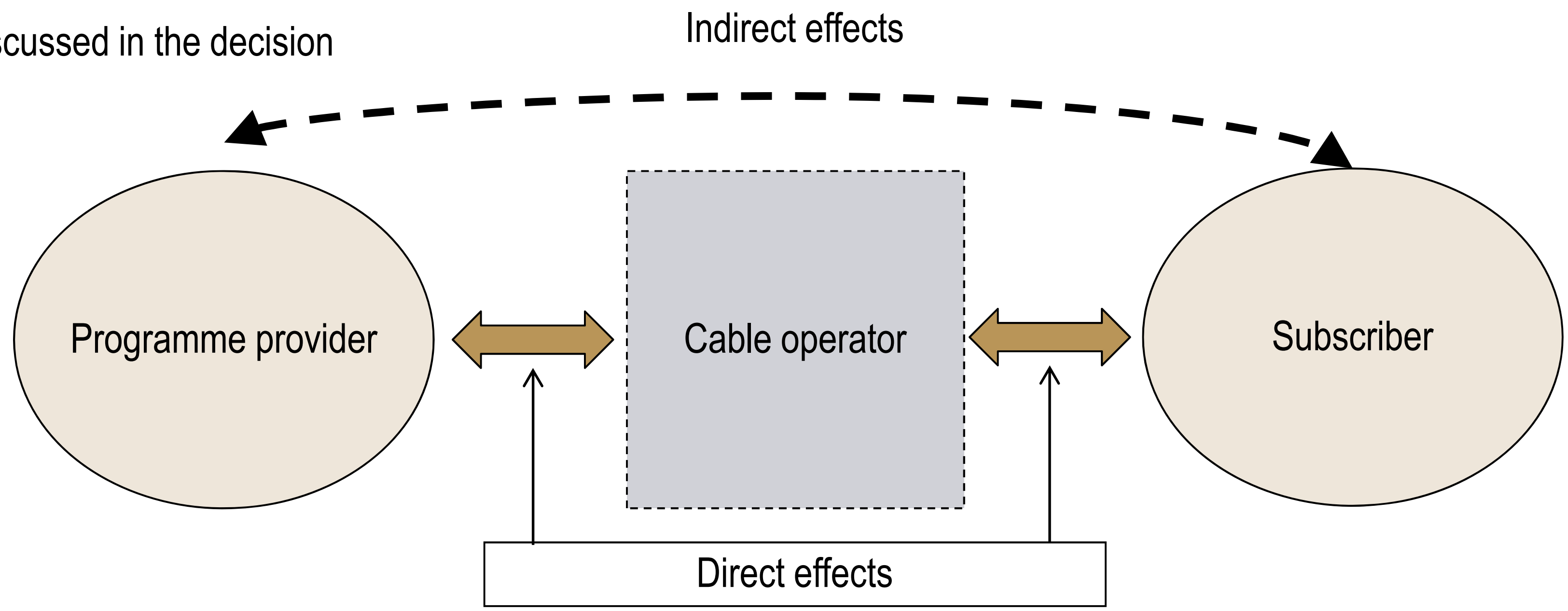
- Majority of programme providers considered the larger size of KDG as irrelevant
- Merger that created KDG did not lead to an increase in prices
- Only concern left: potential introduction of encrypted signals in KBW‘s footprint

Remedy

- Long term commitment not to encrypt Free-TV programmes

Potential effects on consumers?

- What if access prices increased?
- Each customer becomes more valuable
- To the extent that prices are set by cable network operators, this should lower the price for end customers (absent dynamic foreclosure concerns)
- Not discussed in the decision



Conclusions

Big step

- Moving away from the immediate and non-questionable link between reach and bargaining power is an important step forward
- References to conceptual discussion are helpful (but detailed and careful discussion is still missing)

Research questions

- Reasons why larger firms should get a larger part of the pie?
- Role of efficiencies and potential for downstream entry?
- More evidence on
  - split of the pie?
  - effects of mergers on access price?

Background

Effects on Bargaining Power

Effects on the MDU market

Conclusions

The FCO concern

Theory of harm

- Regional cable operators are currently not competing
- This is the result of co-ordination among the operators
- The proposed transaction could strengthen such coordinated effects

Counter arguments

- Incumbents with established networks can undercut entrants
- Entry unlikely absent the merger

The economics of entry

Costs of building a network infrastructure out of footprint decisive

- No access scenario
- Overbuild scenario leads to cost asymmetries (incumbent petter placed)
- Winning probability out of footprint minimal
- Submission of offers costly

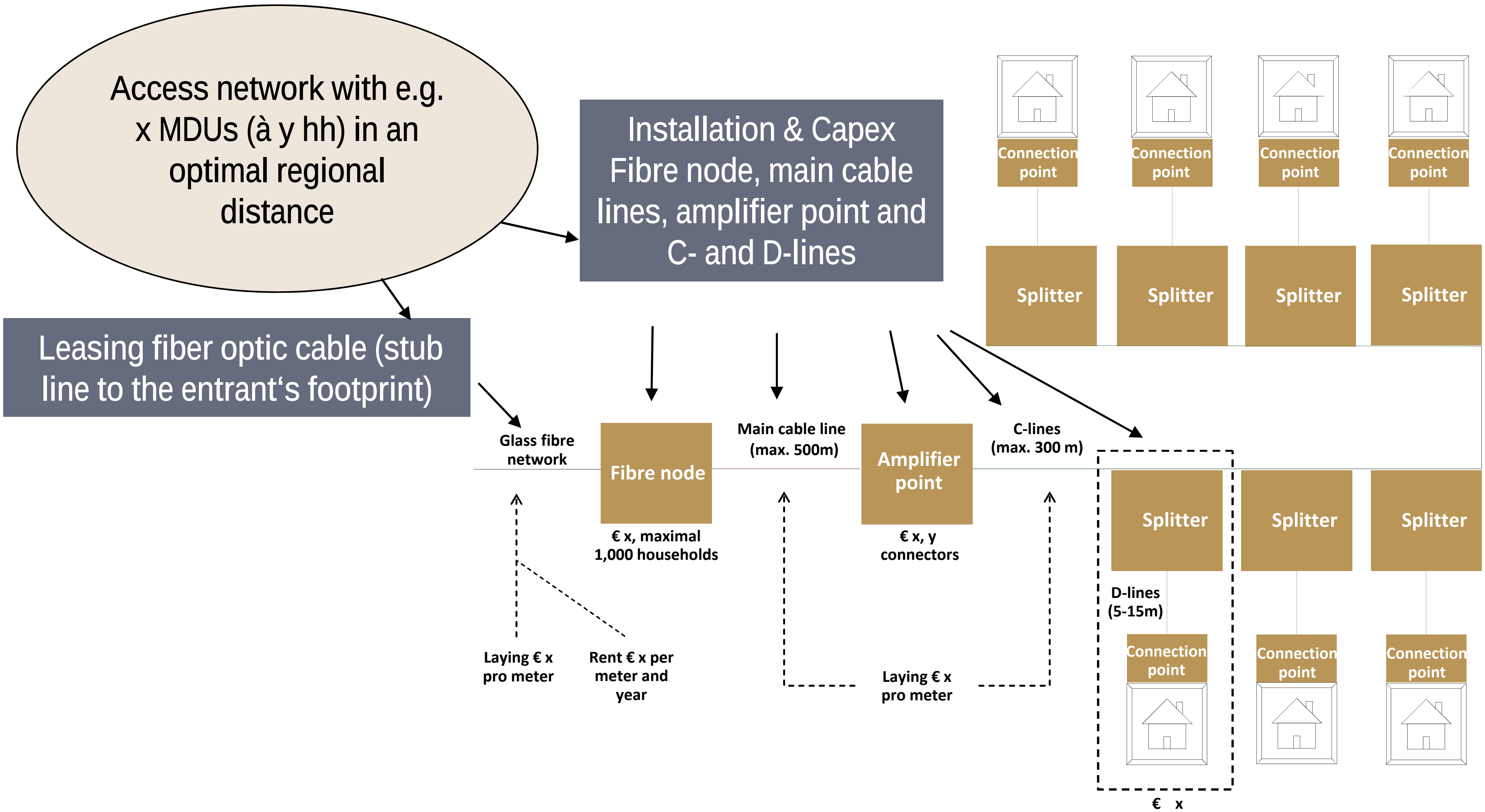
No overbuilding expected

Idea: simulation

- Important cost drivers
  - Regional distribution of MDUs
  - Customers per unit
  - Distance to network (backbone)

Cost simulation model

Analysis of an entrant’s additional avoidable costs – approach of the model



Profitability of an entrance

Model results and scenarios [data omitted]

Increasing contract periods implies longer times of amortization and fewer costs per hh / month

more hh or objects implies fewer costs per hh / month

Table 1: Costs of investment per hh and month, leasing glass fibre network (in €)

Amount households	1 year	2 years	3 years	4 years	5 years	10 years	15 years
10							
50							
100							
500							
1,000							
5,000							
10,000							

Source:E.CA

Marked area reflects typical contract conditions and MDU characteristics,

Conclusion regarding the economics of entry

No implicit market sharing

- Given minimal winning probability and costs for submitting offers: no entry expected in the absence of the merger
- Without incentive to enter there can be no implicit market sharing

No strengthening of alleged collusion

- Merger does not change any of the economics above
- No strengthening of alleged collusion as a result of the merger

Additional arguments

- Limited investment funds
- Investment within footprint more attractive than outside footprint

Activities of smaller rivals

What can we learn from scattered footprints?

- Smaller cabel network operators invest within own Footprint
- Footprints scattered due to historical reasons
- Very few true incidences of competition
  - Overlapping networks
  - Reasons independent of attractiveness of the offers
- In future cases other bidders more likely
  - Smaller operators with overlap
  - Smaller operators with more complex models of cooperation
  - DTAG

Change of business model of LGI (UM) or KBW to place selected offers unlikely

FCO decision

How robust are results?

- Assumed costs may be too high
- Isolated price cutting vs contagion of other contracts by low prices
- Entrant may be more efficient (lower costs, better service, more onselling opportunities)

FCO assumes market sharing collusion (before the merger) and anti-competitive effects

- Given alleged existing collusion there are extremely low standards for merger effects
- Entry in next five years not likely but need to take long-term view
- Removal of potential entrant harmful

Remedies

- Exeptional right to give notice for the 50 (UM) and 17 (KBW) largests contracts with housing associations
- Removal of exclusivity rights for house cabeling

Conclusions

Effect on bargaining power

- Tension between empirical finding and hesitation to present a full bargaining model
- Big step to consider that an increase in reach must not always lead to an increase in bargaining power
- Effect on consumers in case of higher access prices not considered

Effect on MDU market

- Forward looking approach required
- Opening of existing contracts designed to reduce collusion concerns