

APPENDIX A:

**PRINCIPLES FOR THE ANALYSIS OF CONSTRAINTS: A JOINT MEMORANDUM
BY GENESIS ANALYTICS AND CHARLES RIVER & ASSOCIATES**

Please see the attached.



To: ICASA: Subscription Television Inquiry
From: James Hodge (Genesis) and Cristina Caffarra (CRA)
Date: 8 June 2018
Re: **Principles for the analysis of constraints**

Introduction

1. The economists' presentation to the ICASA panel on 11 May 2018 highlighted some important economic principles of market definition and the assessment of competitive constraints¹. The rationale for doing so was that both the ICASA Discussion Document as well as submissions made by third parties (including oral submissions) frequently demonstrated a lack of appreciation of these core principles and their implications in assessing evidence to determine relevant markets and constraints.
2. As the economists' presentation also highlighted, the Discussion Document and multiple other submissions have also used inappropriate shortcuts to a proper constraints assessment, referring to irrelevant product characteristics and conclusions to outdated case precedent in other jurisdictions (rather than principles of analysis).
3. Finally, it was apparent from the ICASA panel's questions that there is also the misconception that the only permissible evidence of competitive constraints bearing on MultiChoice would be a demonstration of large losses of subscribers to alternatives such as OTT or FTA.
4. Given that these three misconceptions seemed to be perpetuated in the question period, we thought it would be appropriate to once more highlight a) the principles relevant to a proper constraints analysis, and their implications for assessing evidence, b) why attempts at short-cuts to by-pass such a rigorous analysis are inappropriate, and c) why firms facing strong competitive constraints may not necessarily lose large numbers of customers.

¹ These principles of market definition were also explained in MultiChoice's submission (paras 229-258)

Four ignored principles relevant in the assessment of constraints

5. As stated by the European Commission's Notice on the Definition of Relevant Market for the Purposes of Community Competition Law, "*Market definition is a tool whose purpose is to identify in a systematic way the competitive constraints that the undertakings involved face.*"² Consistent with this, the hypothetical monopolist test (a conceptual tool used for market definition) applied to the present case would seek to determine whether a candidate market for subscription television would be constrained from profitably increasing price (by a small but significant and non-transitory amount³). The relevant test is therefore one of assessing constraints.
6. In assessing constraints, four principles are of particular relevance to the ICASA Inquiry, given both their relevance to audio-visual services in general, but also the fact that these particular principles seem to not be appreciated in the many submissions made.
7. **First, constraints need to be considered in aggregate, not individually.** In differentiated product markets, such as audio-visual services, it is not uncommon for a candidate product market to have no *single* close substitute but be constrained by a collective of differentiated alternatives. In this context, examining constraints one-by-one to see if they alone constrain the focal product rather than collectively results in incorrect conclusions.
8. As the UK Competition Commission articulated the principle in the Movies on Pay TV Market Investigation, "*[W]hat matters from a market definition perspective is the total strength of the constraint exercised by all substitutes collectively ... where individual products are differentiated, a product may not have any single close substitute but nonetheless may not constitute a separate market if its price is constrained by the collective effect of a number of substitutes, including differentiated products and those offered by smaller suppliers or new entrants.*"⁴ (emphasis added)
9. The implication for this Inquiry is that ICASA needs to determine whether subscription television is constrained by the *collective* of other audio-visual service alternatives (including OTT (paid and free), FTA broadcasters, out of home viewing and pirated content). This is particularly so given the range of bouquets available to subscribers, suggesting each alternative may be more relevant as a constraint with respect to particular groups of subscribers than others (e.g. FTA with respect to lower-priced bouquet subscribers and OTT with respect to subscribers to the higher-priced bouquets).
10. The failure to appreciate this principle in undertaking the analysis and drawing conclusions is evident in ICASA's approach and third party submissions. For instance:
 - 10.1. The ICASA Discussion Document seeks to examine FTA as a sufficient constraint individually and not in combination with other alternatives. In so doing, it dismisses FTA as a constraint in large part because it does not *entirely replicate* the content of higher-priced bouquets. However, this does not rule out FTA constraining lower-

² European Commission, *Notice on the Definition of Relevant Market for the Purposes of Community Competition Law*, 97/C 372/03, OJ EC C 372/5, 9 December 1997, para 2

³ This is the so-called SSNIP test – i.e. is a hypothetical monopolist constrained from profitably imposing a small but significant, non-transitory increase in price

⁴ UKCC, *Movies on Pay TV Market Investigation: A report on the supply and acquisition of subscription pay-TV movie rights and services*, 2 August 2012, para 4.41

priced bouquets directly, and also indirectly constraining higher-priced bouquets (as discussed below, through chains of substitution).

- 10.2. Similarly, Cell C's oral presentation erroneously concludes that OTT players are not a substitute because they do not constitute a competitive threat "*for the majority of viewers*".⁵ This is erroneous because OTT players need only be a substitute for *some* of the viewers in order to contribute to overall constraints and warrant inclusion in the market.
- 10.3. This type of thinking is reflective of the general fallacy that pervaded the public hearings, namely that only a *complete replica* of the MultiChoice service offering (i.e. a single player offering a set of bouquets similar to each of the DStv bouquets) was capable of constraining MultiChoice. That conclusion is reflective of erroneous one-by-one constraint thinking.
11. **Second, what matters are marginal not average customers.** As the hypothetical monopolist test recognises, it is not necessary that the majority of subscribers are willing to switch in the face of a price increase, but only that enough subscribers are willing to switch to make such an increase unprofitable. In services with a fair proportion of fixed costs – a characteristic of audio-visual services – even a small proportion of customers switching can make price increases unprofitable.
12. What matters therefore is the proportion of marginal subscribers (i.e. those that just value the product enough to buy it and would consider switching) out of all subscribers, and the propensity of those marginal subscribers to switch in response to a SSNIP, not the propensity to switch of infra-marginal subscribers (i.e. those that value the product highly and are unlikely to switch regardless of price) or the average subscriber. Furthermore, what matters are the alternatives available for marginal subscribers of the product in question, not whether consumers more generally (including consumers that do not even subscribe to the product) have alternatives.
13. The failure to appreciate this principle is primarily evident in the discussion around broadband access and the constraint exerted by OTT on subscription television.
 - 13.1. For instance, Kwesé's submission sought to examine broadband penetration with reference to the entire population (or all TV households) in order to draw conclusions on OTT as a constraint on subscription television, notwithstanding that the entire population does not subscribe to TV, let alone to subscription TV bouquets for which OTT is likely to be a close substitute.⁶ Similar flawed thinking was reflected in questions from the panel.
 - 13.2. Not only does this approach fail to narrow the analysis to subscription television customers only (it is irrelevant whether consumers generally, including those that do not subscribe to TV, have access to broadband), but it also fails to focus on the marginal subscribers to subscription television and the fundamental question of whether a sufficient group of marginal subscribers would switch to alternatives in response to a SSNIP.

⁵ Cell C oral presentation, slide 15

⁶ For instance, Kwesé's oral presentation, slides 33-34, and 43

- 13.3. Furthermore, given the first principles outlined above, when it comes to OTT as a constraint, it is also relevant to consider only marginal customers for higher-priced bouquets, since other alternatives (e.g. FTA including OTT FTA services and zero-rated data offers by the OTT services of telcos) may act as constraints on lower-priced bouquets.
14. **Third, constraints may operate through a chain of substitution.** Where price differences reflect differences in quality, it is common for consumers to make trade-offs between these two dimensions of competition – as a result of which more expensive or cheaper products still exert constraints on a focal product. In cases where there is a clear ladder of products at different quality and price points, then it is also not uncommon to see a chain of substitution whereby an alternative priced at one end of the ladder exerts a constraint on more distant products up the chain. Such chains are even more likely if there are alternatives operating at both ends of a chain.
15. This is particularly relevant in the context of a tiered bouquet structure such as that offered by MultiChoice, whereby each bouquet tier includes all the channels of the tier below, and the additional price is clearly linked to the additional channels present on that bouquet relative to the bouquet one tier down.
- 15.1. In such cases, it is entirely transparent to customers what the price and quality trade-offs are. In addition, if one bouquet tier is constrained and has to reduce its price (or offer more content), then this will upset that relative trade-off causing marginal subscribers to the higher-priced bouquet to downgrade unless the relative price and quality is restored (through more channels or a lower price for the higher-priced bouquet too).
- 15.2. In this way, constraints on a bouquet at one end of the “chain” may constrain other bouquets throughout the chain. And it follows that constraints on each bouquet in the chain should be viewed “in the round” as part of the aggregate constraints on each and every bouquet in the chain.
16. The general failure of ICASA and third parties to contemplate chains of substitution is reflected in the thinking that an alternative needs to replicate the entire bouquet structure of MultiChoice to be an effective constraint, or the flip side of the same fallacy, namely that an alternative is not a constraint if it only competes with part of the product offering.
17. **Fourth, two-sided markets require consideration of both sides.** In two-sided markets, such as audio-visual services, it is important to consider both sides of the market when assessing constraints. In the current market inquiry context this has two important implications.
- 17.1. The profitability impact from a loss in subscribers is likely to be exacerbated for a subscription service such as MultiChoice which also earns revenue from the other side of the market, namely advertising. Simply put, a loss of subscribers will reduce both subscription and advertising revenues. This means any alternative for subscribers is likely to have a heightened constraint on the subscription service. This consideration seems to not have entered the debate during the hearings.

17.2. The fact that some audio-visual services earn their revenues from the advertising side of the market and not the subscriber side (such as FTA or ad-based OTT services), does not necessarily weaken these alternative business models as constraints. This is because in order to generate advertising revenues, these alternatives will still need to compete with other services for viewers in much the same way that subscription services do (i.e. through acquiring or commissioning, and then broadcasting attractive content). This was recognised quite clearly by the FTA services presenting at the public hearing. However, despite this logic, the Discussion Document and other submissions seem to see differences in business models as a basis for concluding a lack of constraint, but incorrectly so. Constraints matter, regardless of the business model or differences in prices or platforms, etc. (see below for more on this).

Attempted short-cuts to conclusions are inappropriate

18. It would seem that rather than engaging in an evidence-based inquiry as to constraints currently operating in South Africa today, the Discussion Document and many third party submissions have sought to find a short-cut to conclusions on constraints by reference to differences in product characteristics, business models, platforms, licence categories, etc. and outdated case precedent. As explained in the hearing itself, this is inappropriate, especially for an industry which is clearly undergoing dramatic technological disruption.

19. **First, outdated case conclusions from other jurisdictions are not informative.** Conclusions as to constraints in cases and inquiries are ultimately based on the application of economic principles as outlined above to a set of specific facts present at the time. It is therefore relevant to draw on the principles applied, but less informative to simply adopt the conclusions in a new inquiry as the facts of the case are likely to differ.

19.1. For instance, Cell C's written submission fairly "*cautions against reliance on these documents [international cases and sources] as exemplifying best practice in circumstances that are very different from those that subsisted when those international cases were decided. The decisions and reasoning for those decisions can best be regarded as informative, rather than determinative in the South African context*".⁷

19.2. This is particularly the case where an industry has undergone massive technological disruption such that the basis for competition and range of alternatives in the market differ materially to the circumstances present in those dated cases. In such instances these cases are not even informative at all.

20. It is also not appropriate for ICASA to justify its reliance on precedents from other jurisdictions by alleging, as it did at the hearing, that a single aspect – namely broadband penetration in the UK or other European countries at the time - may be similar to that of South Africa today. In addition to this premise itself being factually incorrect (e.g. smartphone/tablet penetration and OTT and IPTV services were in their infancy globally ten years ago), there are many other aspects which ultimately affect the conclusions on constraints aside from broadband access. This would include changes in the quality and sophistication of the OTT services themselves since those cases were decided, as well as

⁷ Cell C submission, 4 December 2017, para 4

changes in consumer behaviour (especially with respect to consumption of audio-visual services on mobile devices).

21. For conclusions in respect of other alternatives such as FTA, clearly there are a multitude of South Africa-specific factors that would impact on conclusions drawn from the application of economic principles. This would include, amongst others, the service offering of both FTA and subscription services, their target markets, and the type of content consumed and valued locally.
22. **Second, constraints cannot be concluded from product characteristics alone.** The Discussion Document and third parties have similarly sought to find a short-cut through reference to product characteristics rather than testing constraints.
23. The first problem with this approach is that it again reflects an underlying assumption that products need to be identical in order to constrain each other. However, in most markets, and especially audio-visual services, differentiation is the very basis for competition and hence alternatives are not identical and yet pose constraints.
24. The second problem with this approach is that whilst some characteristics may influence the strength of the constraint imposed, this cannot be assumed. Instead, it needs to be properly tested. This was aptly illustrated in the question session where a member of the panel argued that the UK Competition Commission Inquiry into Movies on Pay TV made mention of product characteristic differences between Pay TV and OTT services. However, as noted in reply, this decision still found that OTT competed with Pay TV services despite these differences in characteristics as this excerpt from the decision indicates.

*"We also noted that there were some significant differences between the OTT services of LOVEFiLM and Netflix and Sky Movies (including Sky Movies on Now TV), such as in relation to price, the number of films and the extent of FSPTW content... However, it appeared to us that Sky's launch of Sky Movies as the first content available on Now TV was at least in part a response to the perceived competitive threat from LOVEFiLM and Netflix. Moreover, other evidence supported there being some competitive interaction between these services. Overall, we found that there was sufficient rivalry between the OTT services of LOVEFiLM and Netflix and traditional pay TV to include them in the pay-TV retail market."*⁸ (emphasis added)

25. It is also the case that many characteristics may have no influence on consumer demand and constraint levels. Indeed, the economic literature specifically warns against the risk of simply trying to find points of difference based on arbitrary or subjective characteristics and concluding falsely on narrow markets. Illustrative of this point are some of the characteristics cited by ICASA and third parties. Two examples are:

- 25.1. Licence categories is cited as one characteristic used to exclude FTA (and seemingly OTT). However, licence categories have no influence on consumer demand behaviour which informs constraints, even if it may prevent an FTA broadcaster from providing a paid-for service.⁹

⁸ UKCC, *Movies on Pay TV Market Investigation*, 2 August 2012, paras 4.67-4.69

⁹ For instance, Kwesé's oral presentation, slide 28

25.2. Distribution technology was similarly used in the Discussion Document to distinguish FTA from subscription television on DTH. Aside from the fact that FTA is broadcast on DTH too (OpenViewHD), consumers are generally indifferent as to platform as their demand focus is generally on the content provided, not the means of provision.

Subscriber losses are not the only evidence of constraints

26. From the direction of questioning, the ICASA panel seemed to be under the impression that unless MultiChoice had experienced a material loss of customers to OTT providers (or FTA providers) then these alternatives cannot possibly be claimed to constitute effective constraints. In a similar fashion, the e.tv oral presentation also focused on financial performance whilst acknowledging the rise of OTT and FTA interaction with Pay TV.¹⁰ This is plainly incorrect – as a matter of economic, and business logic – as it would effectively imply that only those firms that are weakened and hemorrhaging customers are deemed effectively constrained.
27. In the real world, no efficient firm waits to lose customers, revenue and profits before it responds competitively. Efficient firms will seek to *retain* as well as build their customer base through multiple mitigating initiatives when they are under threat. The fact that they can be successful in doing so (i.e. that they succeed in stemming or slowing customer losses through various inducements) does *not* imply they are not facing constraints from actual or potential competitors. This is especially true in markets that are simultaneously expanding.
28. Rather, it is the quality of their competitors and the threat they pose of rapidly taking share that is going to be determinative of the extent and effectiveness of competition. The practice of technology, media and telecommunications industries which rely strongly on managing churn for their performance is to pay close attention to churn indicators and seek to actively mitigate customer losses by means of multiple initiatives. MultiChoice is no exception: it seeks actively to mitigate and prevent customer losses by making attractive competitive offers to subscribers to entice them to stay and not switch to alternatives. It would be entirely incorrect to assume that only evidence of material losses can “prove” one is exposed to active competition: in fact lack of evidence of these losses says *nothing* about competition because it is equally consistent with strong mitigation activities *driven* by competition (which MultiChoice is indeed actively undertaking). Indeed, the economics literature considers that in certain circumstances the mere threat of potential entry is able to effectively constrain an incumbent, i.e. at a point where the incumbent has not even lost any sales. This is also widely accepted in competition law where potential entry is considered amongst the competitive constraints that need to be assessed.

¹⁰ e.tv oral presentation, slides 10-13