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Vertical mergers in the technology, media and telecom sector – Note by Mexico

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More documents related to this discussion can be found at

http://www.oecd.org/daf/competition/vertical-mergers-in-the-technology-media-and-telecom-sector.htm

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1. Introduction

1. The Federal Telecommunications Institute (IFT, by its acronym in Spanish) is the Mexican national competition authority and sectorial regulator in telecommunications and broadcasting, which includes electronic media.

2. This contribution summarizes the legal and analytical framework used by the IFT to assess the effects of two relevant cases of vertical mergers in digital media.

2. Legal framework

3. The 2014 Federal Economic Competition Law (LFCE, by its acronym in Spanish) establishes a single merger control regime and general application criteria for all types of transactions. Mandatory previous notification applies to operations that surpass legal thresholds, and the competition authority has the power to investigate consummated mergers and challenge those that have adverse competitive effects.

4. The 2014 Federal Telecommunications and Broadcasting Law (LFTR, by its acronym in Spanish),[1] establishes that mergers involving concessions for commercial or private uses must obtain IFT's authorization before its execution, including those that do not meet LFCE's notification thresholds.[2] In order to assess those and other cases under the LFTR, the IFT uses criteria consistent with competition law and practice.[3] However, Transitory Article 9 of this law provides an exemption from the LFCE's *ex ante* merger review that allows non-preponderant agents[4] to concentrate and present an *ex post* notice to the IFT to assess the transaction's sectorial effects –but not at the relevant market dimension–.[5]

[1] Available at: http://www.ift.org.mx/

[2] This applies to partial or total transfer of rights and obligations established in the concessions (article 110, LFTR), and subscription or sale of shares or equity interest representing 10% or more of a concessionaire's capital stock (article 112, LFTR).

[3] For example, article 110, LFTR states that the Institute may authorize assignments intended to transfer rights and obligations in the concessions to another concessionaire that provides similar services in the same geographic area, after completing an analysis of the effects that such action has or may have on competition in the relevant market.

[4] "Preponderant economic agent (AEP, by its acronym in Spanish)" is a figure established in the Constitution that refers to an economic agent that directly or indirectly holds a 50% share at the sectorial level, measured by the number of users, subscribers, and traffic on its networks or its utilization capacity according to the data available to the IFT.

[5] The *OECD Telecommunication and Broadcasting Review of Mexico 2017* available at: https://www.oecd.org/publications/oecd-telecommunication-and-broadcasting-review-of-mexico-2017-9789264278011-en.htm stressed that: *"(...) those conditions have proven to be inadequate to protect competition, at least in the pay TV market. Nevertheless, the article strips the IFT of its ex ante merger review powers on the premise that doing so will not only lead to greater competition, but do so quickly. Given that the concentration has actually increased in the pay TV market (...). The legal framework should allow the IFT to exercise its authority in all cases, which includes clearing transactions quickly when they obviously pose no*

5. The legal standard for merger review is outlined in articles 58, 59, 61, 63 y 64 of the LFCE, which aims at determining whether the transaction's purpose or effect is to hinder, harm or impede competition and free market access regarding equal, similar or substantially related products or services. Those mergers are unlawful and must be challenged or, when viable, subjected to structural or behavioral remedies.

6. Regarding a concentration or a proposal thereof, the competition authority shall consider the following as indications of an unlawful concentration:

- If it confers or may confer the surviving entity, the acquirer or the economic agent resulting from the concentration, substantial market power in terms of the LFCE, or if it increases or could increase that power, by which free market access and economic competition may be hindered, diminished, harmed or impeded;
- If it has or may have the purpose or effect of imposing barriers to entry, of impeding third parties access to the relevant market, to related markets or to essential facilities or of displacing other economic agents, or
- If its purpose or effect is to substantially facilitate the concentrating parties to incur in practices prohibited under the LFCE and, particularly, in monopolistic practices.

7. The statutory criteria includes:[6]

- Defining the relevant and related market(s);
- Identifying the main economic agents that supply the market(s) in question, an analysis of their power in the relevant market(s), and the degree of concentration in said market(s);
- Identifying parties as economic agents, including the dimension of economic groups, considering all the means of influence or control by or over other economic agents or persons. Subsequently, allowing the identification of the relevant and related markets where they participate and understanding the incentives and possible effects of the transaction.
- Assessing the effects of the transaction in the relevant and related market(s), and on competitors, consumers or other economic agents. If risks are identified, economic agents have the right to demonstrate efficiency gains derived from the transaction, and/or propose remedies that overcome the possible anticompetitive effects, which means that it is not the authority, but the law that grants the opportunity to propose mergers. Additionally, because the analysis is prospective, it may include likely future effects.

8. Among the gains in efficiency, the following may be considered:

1. The introduction of new products or services;
2. The use of residual lots, defective or perishable products;

threat to competition, but also includes thoroughly reviewing and, when appropriate, blocking proposed concentrations before they have anticompetitive effects. In short, this exemption to the law is not consistent with the overall goal of the Constitution and the law to promote competition in the telecommunication and broadcasting sectors. On the contrary, it facilitates concentration. Transitory Article 9 should therefore be eliminated."

[6] Articles 61 to 65 and 91 of the LFCE.

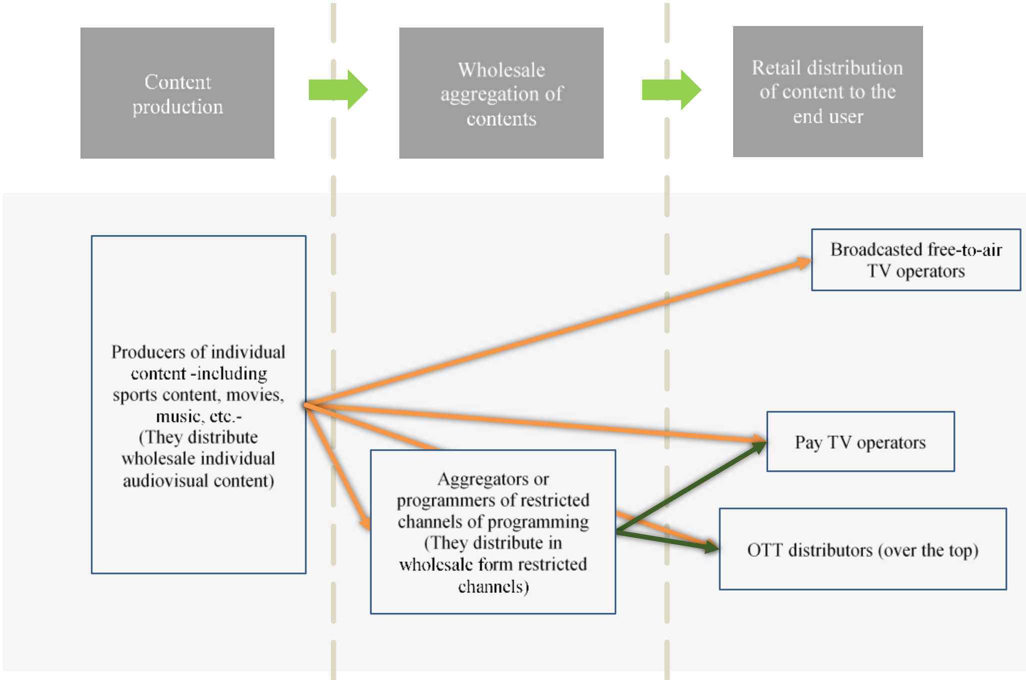
3. The reduction of costs resulting from creating new techniques and production processes, asset integration, increases in the production scale and the production of different products or services using the same production factors;
4. The introduction of technological advances that produce new or improved products or services;
5. The combination of productive assets or investments and their returns, which improve the quality or increase the attributes of the products or services;
6. The improvements in quality, investments and returns, timeliness and service which favorably impact the distribution channel, and
7. Other gains, which are proven to render net contributions to consumer welfare deriving from such practices, which overcome their anticompetitive effects.

9. Thus, the LFCE provides criteria general enough to review any kind of merger, including vertical ones.

3. Broadcasting and telecommunications sectors in Mexico

10. In these sectors, vertical integrations may occur in any of the links in the value chain illustrated below.

Figure 1. Value chain



Note: Regarding media, the Federal Commission of Economic Competition (COFECE) has analyzed the markets of: i) distribution of films for exhibition in cinemas; ii) licensing of audiovisual content for home entertainment in physical formats and in digital formats for direct acquisition and downloading; iii) licensing of music for home entertainment in physical formats and in digital formats for direct acquisition and download; iv) music licensing by non-digital means; v) live entertainment; vi) licensing of intellectual property rights for books and magazines; and vii) licensing of intellectual property rights for the development of interactive media and video games, which belong to the same chain of value shown in the diagram. See the public version file CNT-126-2018 available in Spanish at: https://www.cofece.mx/CFCResoluciones/docs/Concentraciones/V5963/2/4693359.pdf.
Source: IFT

3.1. Content production

11. This stage comprises the creation of audiovisual content, including preproduction (i.e., preparation of shots, casting and locations, etc.), production (i.e., photography, video production and shooting), and postproduction (i.e., editing, effects specials and sound).

12. These contents are widely heterogeneous (differentiated). Formats include individual events (i.e., football matches), daily or serial programs, movies, contests, news, reality shows, and others. Participants may be independent or vertically integrated producers.

13. These products are offered to aggregators or channel programmers, so that they can be distributed through various means of transmission. In Mexico, the main participants are *Grupo* AT&T (through Time Warner), Disney and Viacom, which are international undertakings, *Grupo* Televisa, which is the main national participant and worldwide producer and distributor, and TV Azteca.

3.2. Aggregation and wholesale distribution of content

14. At this stage, value derives from the aggregation of various programs in a linear sequence. In this activity, the audiovisual contents are associated with targeted audiences, and formatted for a specific transmission medium (i.e., to identify spaces within the content to make advertising insertions in free-to-air and pay TV). At global level, there is usually a strong vertical integration between the content production and its programming.

15. In Mexico, the main players in this market are *Grupo* AT&T (Time Warner), Disney, Viacom, *Grupo* Televisa, TV Azteca, Megacable and MVS. In most cases, there is a strong vertical integration between this stage and the previous one, which means that those with greater production capacity (such as AT&T, Disney and Viacom) also have an important presence in these markets.

3.3. Content distribution to the end user

16. End users can access audiovisual content through different means of transmission that include free-to-air broadcasted TV, online platforms such as OTT, or pay TV networks.

17. Access providers acquire licenses (i.e., specific rights of transmission) for programs, channels, or bundles of channels in order to shape their offers. Sometimes, licenses grant access to more than one transmission mean (i.e., simulcasting). Such amenities may allow a pay TV subscriber to log in into a digital platform or OTT to access the same or additional content (e.g., TV Everywhere). Recent commercial innovations are providing subscribers with ubiquity in accessing the contracted audiovisual content.

18. In particular, commercialization for pay TV is carried out through channel packages offers in exchange for a periodic fee. Usually, fee structure has two parts: a fixed part that depends on the hired package, and a variable part for additional features, such as pay per view (PPV) or video on demand (VOD). In Mexico, the largest participant is *Grupo* Televisa (with more than 60%), followed by participants of a significantly smaller size in terms of subscribers: Megacable and Dish (with around 15% each).

19. In the case of OTT service distributors, such as Netflix, Blim and Claro Video, the distribution is offered through a catalog of content available at any time in exchange for the payment of a –usually monthly– subscription. Although this service reports increasing penetration rates, it potential growth is limited by broadband availability and capacity.

20. In Mexico, the main competitor in broadcasted TV is *Grupo* Televisa with a 59.16% share in terms of audience, followed by TV Azteca with 31.14% and Grupo Imagen.

3.4. Market definition in competition cases

21. These characteristics affect the behavior of the economic agents involved in mergers and, therefore, they are taken into account in the resolutions issued by the IFT. In this regard, the IFT has identified and analyzed the following activities:

- Provision and licensing of audiovisual content (programming channels and programs) to pay TV providers;
- Provision and licensing of audiovisual content (programs) to aggregators (programmers) of pay TV channels;

- Provision and licensing of audiovisual contents (programs) to free-to-air broadcasted TV providers;
- Provision and licensing of audiovisual contents (programming channels and programs) to providers of Internet distribution service (OTT) of audiovisual content;
- Provision and licensing of audio (musical) contents to providers of OTT distribution service of audio content;
- Provision and sale of times or spaces for commercial messages or advertising on pay TV channels;
- Provision and sale of spaces for commercial messages or advertising by internet platforms dedicated to the provision of audiovisual content;
- Provision and licensing of audio content for radio audio broadcasting stations;
- Licensing of intellectual property for radio audio broadcasting stations;
- Provision of OTT distribution service of audiovisual content, by subscription (or online video distribution, OVD);
- Production of audiovisual content (programs) for third-party providers of the services of free-to-air TV, pay TV and OTT distribution of audiovisual content; or for any other third party programmers who add content that is distributed on free-to-air TV, pay TV and/or Internet platforms;
- Acquisition of rights for the transmission of sporting events.

22. Regarding the *provision and licensing of audiovisual content (programming channels) to pay TV providers*, the IFT has considered that different categories of programming channels are not substitutes, so each category constitutes a different relevant market, based on the following considerations:

- In order to offer a competitive service, pay TV providers need to transmit different programmatic signal categories in their programming packages to attract a larger number of customers;
- Each of the programmatic signal category seeks to attract a certain type of viewer and, accordingly, it selects the contents that make up the channel packages offered to its subscribers;
- In order to attract different types of customers, pay TV service providers must offer the widest variety of programmatic categories available;
- There is no substitution between programmatic categories for a given moment and for specific taste. A viewer will not stop watching a program to observe another from a different category (it is not possible for a user who wishes to watch a sports content to replace it with a cultural or a kids' content).

4. Analytical framework

23. Within its five-year practice, the IFT has analyzed the effects of vertical integration on AT&T/Time Warner and Disney/Fox mergers, in 2016 and 2018, respectively. These cases were not purely vertical mergers, but main concerns arose from their non-horizontal

effects such as capacity and incentives of the resulting entity for coordination, exclusion (foreclosure), and barriers to entry. Pursuant article 64, paragraph II of the LFCE, any of these likely effects alone is sufficient to challenge the merger.

24. The IFT has identified foreclosure risks in either or both upstream (input) and downstream (output) market:

- Input foreclosure: when it was likely proven that the integrated economic agent would acquire or reinforce its incentives and capacity to cease to provide the input to competitors in downstream markets, or would continue input provision at higher costs either throughout direct price increases and/or indirectly, by offering adverse conditions of performance, availability, diversity or other non-price features. Rising rivals' costs may be a strategy either to squeeze the margins of the downstream competitors, or to make them lose customers that the integrated economic agent can capture in upstream markets.
- Customer foreclosure: when the integrated economic agent in the downstream market stops using other input providers from the upstream market, relying instead solely on the economic agent that belongs to its economic group, then reducing either rivals' capacity to exercise competitive restraints or the likelihood of entry.

25. In both cases, post-merger anticompetitive foreclosure risks are likely to exist when the integrated economic agent's losses resulting from hampering or limiting access to upstream or downstream are lower than the profits resulting from the exclusionary behavior. The analysis uses both, quantitative and non-quantitative tools.

26. A quantitative tool utilized to assess incentives and capacity of the resulting economic agent consists on simplified *vertical arithmetic*. For example, in an input foreclosure case it considers the incentives and the ability of the post-merger economic agent in dealing with its downstream rivals. If the integrated economic agent refuses to supply rivals, it would incur in losses that are estimated considering the portion of the downstream market it supplies under pre-merger conditions and its capacity to capture the sales diverted from the disadvantaged rivals.

27. If the post-merger economic agent has no possibilities to divert rivals' sales (e.g., due to the existence of input supply alternatives or competitors' capacity to vertically integrate) or to capture them (e.g., because rivals have the capacity to absorb input foreclosure's effects without passing them to their customers), it would result in an unprofitable strategy and thus making it less likely to happen. On the other hand, if the post-merger economic agent can capture a portion of the sales lost by its rivals, big enough to compensate the losses caused by input foreclosure, then its decision would be a profitable strategy and thus making it likely to occur. In cases of rising rivals' costs, the arithmetic considers incomes from increasing input prices. Once the risks are identified, it falls on the merging parties to prove efficiencies of the proposed merger and whether they are likely to outweigh the loss of competition.

28. The analysis of vertical effects also takes into consideration if the post-merger economic agent, as input provider or customer, can access to information that could facilitate anticompetitive practices (article 64, section III of the LFCE), specially collusion.

29. Anticompetitive foreclosure is likely to occur when the vertically integrated economic agent has a dominant position in one of the markets and has the incentives and the ability to leverage its position to other stage of the value chain, harming competition and, ultimately, consumers in terms of price, quality, availability or diversity.

30. According to the LFCE, when a merger poses anticompetitive risks, the IFT must inform them in writing to merging parties, before the issuance of the Board's final decision. This allows them to exercise their right to present its efficiency defense and/or propose remedies. Based on the overall assessment of those elements (i.e., risks, efficiencies and remedies) the IFT may object the operation or impose conditions aiming at outweighing anticompetitive effects.

31. Regarding remedies, statutory provisions state that the IFT can only impose or accept those that are directly related and proportional to correcting merger's anticompetitive effects. They also state that remedies could be: (i) behavioral conditions; (ii) divestiture commitments of assets, rights, shares (structural) or social shares, or (iii) any other to serve the purpose set forth.

32. The main theory of harm that was considered in both cases was input foreclosure, in which the merged entity would potentially restrict access to an essential input to its downstream competitors, thereby raising its downstream rivals' costs and increasing the price charged to consumers. In particular, it was considered whether the integrated company would increase prices or degrade the quality of the input supplied to its downstream competitors in a way that may harm end users.

33. A full analysis of the competitive effects of a vertical merger would examine the potential competitive benefits and harms in order to predict the likely net competitive effect on consumers and competition. The fact that multiple markets are normally affected makes the analysis more complex. It also raises legal and policy issues when competition is harmed in one market but benefited in another market.

34. The decisions therefore highlight the importance of using qualitative arguments in conjunction with the empirical exercise, as any model will only reflect part of the market reality. In these cases, the likelihood that the upstream competitor would increase the price by more than the critical price increase has to be measured against market characteristics such as the reaction of potential entrants. Taken in a vacuum, i.e., without reference to the specifics of the market, the critical price increase would not be informative.

35. Finally, it is important to stress that the likelihood of an input foreclosure will also depend on the merged entity's ability to commit to stop competing in the upstream market. Indeed, the integrated company may be tempted to re-enter the upstream market by slightly undercutting its rival, as this would allow it to gain upstream sales with only a marginal effect on the downstream market. However, since the two mergers were cleared, the question as to whether the merged entity could commit to stop competing upstream (i.e., through technical means) might be left open.

5. Relevant cases

5.1. Case 1: AT&T/ Time Warner

36. In August 2017, the IFT authorized the AT&T/Time Warner merger subject to remedies aimed at overweighting non-horizontal effects (i.e., vertical foreclosure and coordination). AT&T and Time Warner participate in few common markets but mainly in separate markets of telecommunications and audiovisual content provision, respectively.

37. In Mexico, AT&T is a mobile carrier that holds a minority share (41.3%) in Sky Mexico, the main satellite pay TV service provider, whose majority shareholder is *Grupo*

Televisa (GTV), which, among other businesses in media and telecommunications, provides services like free-to-air TV, pay TV, OTT distribution and wholesale and retail provision of audiovisual content. Time Warner supplies audiovisual content (linear programmed channels and programs) throughout several business divisions (Turner, HBO and Warner). In particular, through HBO Latin America Group (LAG), it acts as an intermediary to license access to content provided by itself and other groups.

5.1.1. Vertical effects

38. This operation was not a complete vertical concentration, as AT&T has a minority shareholding in Sky Mexico (the largest satellite pay TV operator), but it entailed vertical effects because of that participation and because Time Warner is a provider of audiovisual content for pay TV operators.

39. In this sense, IFT's evaluation of the merger's vertical effects focused on the capacity and the incentives that the economic agent resulting from the AT&T/Time Warner operation would have in order to implement upstream and downstream foreclosure in which these economic agents participated, considering AT&T's minority shareholding in Sky Mexico. The IFT, as a result of knowing information from its non-integrated competitors, to which it did not previously have access, also assessed whether vertical integration could facilitate that agent's collusive conduct.

5.1.2. Other effects of the operation

40. Horizontal effects: AT&T and Time Warner coincided as competitors in the provision and licensing of programming channels to pay TV suppliers. Risks to competition were ruled out because the restricted channel of AT&T (Golf Channel) had a marginal participation and a specific audience.

41. Coordinated effects: These effects resulted from the structural link that AT&T had with Sky Mexico and the fact that, after the transaction, AT&T/Time Warner and GTV, which is the other shareholder of Sky Mexico, are competitors in various markets for the provision and licensing of audiovisual content, where they could coordinate their actions.

5.1.3. Identified risks and imposed remedies

42. Vertical risks and remedies: in the upstream market (i.e., access to programming channels), the operation would:

- Create incentives for the resulting economic entity AT&T/Time Warner to practice foreclosure to third-party pay TV operators, other than Sky Mexico and other GTV's cable carriers, with the object or effect of establishing barriers to entry and displacing them in the provision of pay TV service;
- Allow Sky Mexico to have access to sensitive information from the competitors that purchase Time Warner content, in the provision of pay TV.

43. In order to address such risks, the IFT imposed remedies to:

- Ensure that AT&T/Time Warner attends all requests for access to its restricted television channels by third-party providers of pay TV service, offering similar terms and conditions in the negotiation of comparable requests; and

- Maintain independence, in terms of decision-making and information flow, between Sky Mexico and Time Warner; and between HBO LAG and the rest of AT&T/Time Warner's interest group.

44. Coordinated effects and remedies: the operation would facilitate collusive conducts by AT&T/Time Warner and GTV in the provision and licensing of programming channels to pay TV providers. Regarding vertical effects risks, the elements taken into account were the existence of AT&T/Time Warner's ability and incentives to discriminate and displace other pay TV providers (other than GTV) regarding prices and terms and conditions.

45. Assessing markets' structure, the IFT considered Time Warner's and GTV's position as providers of channels for pay TV operators; the fact that GTV is the largest pay TV provider that holds a 61% market share; and the shareholding of AT&T in Sky México. Likewise, the IFT implemented a numerical model considering the following assumptions:

- AT&T raises the price from Time Warner content (channels) to all pay TV providers except Sky Mexico and GTV.
- The price increase in the licensing of Time Warner channels would cause an increase in the rates of the packages offered to final consumers (subscribers), since not all pay TV service providers would have the capacity to absorb the extra cost.
- Once the price increases, a percentage of the subscribers will look for a better alternative –choosing a lower price or packages that given the new relative prices, are now more attractive–, where the options would only be Sky Mexico or GTV, because they could maintain their prices.

46. Based on this quantitative estimation, the IFT concluded that AT&T/Time Warner would have the incentives to perform upstream foreclosure, since in most of the proposed scenarios, this practice would have been profitable to them, as the net gains derived from the behavior were positive.

47. On the other hand, regarding risks due to coordinated effects, the IFT considered that:

- Sky Mexico is a structural link and an important business for AT&T and for GTV, since it represents a significant source of income for both.
- Time Warner and GTV are competitors and, as a whole, they would have an important participation in the provision and licensing of programming channels for pay TV providers.

48. Therefore, there were risks of coordinated effects, after the operation, between AT&T/Time Warner and GTV (the other shareholder of Sky Mexico) in the provision and licensing of programming channels for pay TV providers.

5.2. Case 2: Disney-Fox

49. In March 2019, the IFT Board approved the merger by which The Walt Disney Company (Disney) acquired assets of Twenty-First Century Fox, Inc. (Fox), subject to conditions.

50. Disney and Fox participate in businesses related to the provision and licensing of audiovisual content (programming channels and programs, including movies and series) to providers of pay TV services, free-to-air broadcasted TV and OTT content distribution. Disney has 50% of the share capital of A&E Television Networks, LLC and its subsidiaries

(Group A&E), which provides and licenses, through a distribution contract with HBO LAG, factual channels (the A&E Channels).

5.2.1. Identified risks and imposed remedies

51. Dealing with the merger of two direct competitors that coincided in the same value chains of provision and licensing of audiovisual content, the analysis focused mainly on horizontal effects. However, the IFT also considered the existence of risks associated with vertical effects.

52. The IFT determined that, in Mexico, the merger could generate risks due to horizontal effects with respect to the markets of:

- Provision and licensing of sports channels to pay TV providers; and
- Provision and licensing of factual channels (i.e., documentary and realities) to pay TV providers.

53. In sports channels, the proposed merger would have generated an economic agent with substantial market power, in which the resulting economic agent, Disney (ESPN)/Fox (Fox Sports), would have accumulated together close to 80% share in this market, measured in terms of audience.

54. In the factual category, the merger would have given the A&E Channels of Disney and Fox a joint share greater than 40% of the market, measured in terms of audience, and would have allowed the number reduction of important competitors from three to two (Disney/Fox and Discovery), which would have generated coordination risks between those two competitors.

55. One of the elements considered by the IFT to identify risks to competition in sports channels was the vertical effects of the operation. The evaluation of these vertical effects considered the acquisition of rights for the transmission of national and international sports events, by Disney (ESPN) and Fox (Fox Sports), which was analyzed as a related upstream market, regarding the downstream relevant market of provision and licensing of sports channels to pay TV providers.

56. In this regard, the IFT considered that the high participation that the economic agent Disney/Fox would obtain in the acquisition of international audiovisual sports content would also affect the conditions of competition in the downstream market of the provision and licensing of sports channels to pay TV providers.

57. To authorize the merger, the IFT imposed the following main conditions (structural and behavioral):

- In sports channels: the divestment of the Fox Sports Business, which includes all the necessary assets to keep it as a viable business, independent from the parties. Divestment period is limited, and ring fencing and hold-and-separate orders protect the divestment process. The selling of Fox Sports and the compliance of related remedies are entrusted to three independent figures: an administrator, a divestment agent, and an auditor.
- In factual channels: the preservation of independence, in terms of decision-making and the flow of information, between Disney/Fox and Group A&E. Imposed remedies prohibit to the resulting economic agent the distribution of Fox's factual channels through the same means used by Group A&E.