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Taking control

THE COMPETITIVE IMPLICATIONS OF PARTIAL OWNERSHIP

If a company acquires a shareholding in a competitor, without taking full ownership, the transaction may nevertheless be subject to scrutiny by the competition authorities – somewhat counter-intuitively, the competitive effects may even be greater. In this bulletin, we explain the standard economic framework for assessing the competitive implications of partial ownership. Using the BSkyB/ITV merger case in the UK as an illustration, we go on to give some pointers to the treatment of future cases.

In 2006, the UK's largest pay-TV broadcaster and retailer, British Sky Broadcasting Group plc (BSkyB), announced that it had acquired 17.9 per cent of the issued share capital in the UK's largest commercial free-to-air TV broadcaster, ITV plc. The acquisition took place without prior consultation of ITV, shortly after a rival, Virgin Media Inc, had approached ITV with an indicative cash and share offer for the whole of the company.

The transaction was referred to the Competition Commission (CC), which decided that it would lead to a significant lessening of competition (SLC), as



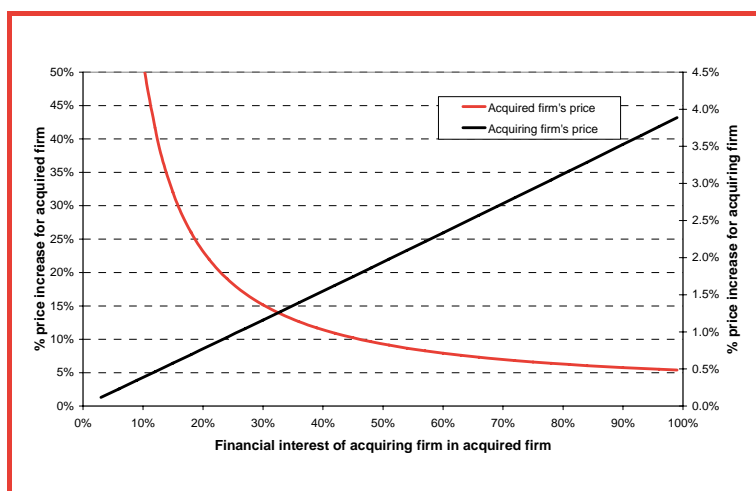
BSkyB would be able and incentivised to influence ITV and weaken the competition that it posed to BSkyB. The CC concluded that BSkyB should reduce its ITV shareholding to below 7.5%. BSkyB appealed the decision before the Competition Appeal Tribunal (CAT), without success, and the CAT's judgment is now being contested before the Court of Appeal. Considerable attention was devoted to the question of whether a 17.9% shareholding would give BSkyB "material influence" on ITV's policy. This bulletin focuses on the equally important question of whether BSkyB would have the incentive to do anything with that influence to impair ITV's offering.

ECONOMIC FRAMEWORK

It is essential to distinguish between the acquisition of a financial interest (giving entitlement to a share of the profits), and the acquisition of corporate control (giving influence over decision-making). Let's call the acquiring firm A and the acquired firm B:

- The acquisition of a **financial interest** may affect A's incentives to compete. Initiatives such as price-cutting will become less attractive, if stealing business from rivals will in part involve stealing business from one's self. Price increases will become more attractive to A, if A will recapture a share of the profits on any sales diverted to B.
- The acquisition of **corporate control** may affect B's incentives to compete. A will want to raise B's prices, if some profit on sales lost by B will be recaptured by A. While the first round effect is to reduce B's profits, and so diminish the value of A's shareholding in B, the value of A's shares may rise.

A transaction which raises one of these competition concerns will not necessarily raise the other. Any incentive for A to raise its prices will stem directly from its financial interest in B, and does not require that it gains influence or control over B; although unless it has "material influence" (UK merger regime) or "decisive influence" (EU merger regime), the competition authorities would not have the right to intervene under the merger control rules. Similarly, any incentive for A to raise B's prices will stem from its control over B, and does not require a financial interest in B.



Impact of silent financial interest and control at differing levels of financial interest

Source: Frontier illustration. Assumes Bertrand competition with differentiated products, with diversion ratios between the two firms of 25%, gross profit margins of 30%, and linear demand curves.

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However, these effects are inter-related, as illustrated in the above figure. This shows that A's incentive to raise its prices increases with the size of its shareholding in B, and is greatest in a full merger. However, if A has a large financial interest in B, then its incentive to raise B's prices will be limited by the losses B will suffer. So the effect on incentives of gaining control will be greater if A were to acquire only a small financial interest in B, and greater than in a full merger. Of course, the outcome will depend not just on A's incentives but on its ability to influence B – and so not just on the size of A's shareholding, but on such factors as the governance structure and the other shareholders of B.

THE BSKYB/ITV MERGER CASE

In its analysis of the BSKyB/ITV merger, the CC found that a SLC would be expected in the “all-TV” market for audiovisual services. This transaction could have raised either of two competition issues:

- The potential incentive for BSKyB to increase its pay-TV prices and/or advertising rates due to the acquisition of financial interest in ITV - if viewers and/or advertisers switched from BSKyB to ITV, increasing ITV's advertising revenues, BSKyB would receive 17.9% of additional ITV advertising profit.
- The potential incentive for BSKyB to weaken the competitiveness of ITV's offer due to the acquisition of corporate control - if viewers and/or advertisers switched from ITV to BSKyB, BSKyB would receive additional pay TV subscriptions and/or advertising revenues.

The CC concerns related to the acquisition of corporate control, but not to financial interest; with only 17.9% of the shares, BSKyB would benefit from only a small share of any uplift in ITV's profits. Without board representation, BSKyB would not have been able to influence ITV's day-to-day management decisions, such as its negotiations of advertising rates with media buyers. Hence, the CC's theory of harm was focused on BSKyB's ability to influence ITV's strategy, particularly in relation to future investments or transactions.

The CC found the “all-TV” market to include both free-to-air (FTA) and pay-TV services. Using customer switching data provided by BSKyB, the CC concluded that all pay-TV services should be in the same relevant market, and that there is a chain of demand-side substitution linking FTA services, basic pay-TV packages and those containing both premium and basic channels. BSKyB, ITV, the BBC and Virgin Media were identified as the major competitors in the “all-TV” market. Whilst Virgin Media was the closest competitor to BSKyB, FTA services (within which BBC and ITV were key) exerted a constraint on BSKyB's conduct.

The economic framework outlined above supports the CC's view that the incentive for BSKyB to worsen the quality of ITV's offer might be strong, even if the consequent diversion of revenues from ITV were modest. With only 17.9% of the company, BSKyB would suffer little from ITV's lost profit. The critical question was whether BSKyB would have the ability to exert material influence over ITV's strategy, or be held back by ITV's other shareholders. The CC concluded that, by blocking special resolutions at general meetings, BSKyB could limit ITV's ability to raise funds – a serious restriction, given the CC's belief that

the ITV board might wish to make investments requiring external funding (notably, perhaps a non-pre-emptive rights issue) in the next two to three years.

POINTERS TO THE FUTURE

The economic framework shows that the acquisition of a small shareholding in a competitor could be particularly damaging if this were to allow influence over decision-making. In the BSkyB/ITV merger case, the key issue was whether the acquiring firm would have the ability to influence the competitive behaviour of the firm in which shares were acquired. This raises the question of the appropriate definition of corporate control, on which the UK and the EU regimes differ. The EC test requires “decisive influence” that can block significant management and/or shareholder decisions, whilst the UK test only requires “material influence” on the direction of decisions looked at in the round. So while it is unlikely that a shareholding of less than 25% will meet the EC test, in the UK a relatively small shareholding may do so.

The economic framework also demonstrates how the acquisition of a passive or silent financial interest in a competitor could raise competition concerns, albeit less likely if the shareholding is small. This raises the question of whether there is an enforcement gap under the current UK and EU merger control regimes, as both only apply in situations where the acquiring firm has gained either “material” or “decisive” influence.

There are issues that follow regarding the appropriate standard of proof that should be required of the authorities. The acquisition of a small shareholding in a competitor could entail a relatively small probability of large detrimental effects; e.g., if such a shareholding provided the acquiring firm the possibility to influence the strategic decisions of the acquired firm, if the opportunities to do so were infrequent and uncertain, but the competitive implications were large. This raises the question of whether the standard of proof that is currently required in these circumstances (a balance of probabilities test – the need to form an expectation) is optimal.

Finally, the economic framework has implications for the effectiveness of remedies. If the SLC concern arises from the acquisition of financial interest, then removing control over decision-making may not eliminate the acquiring firm’s incentive to increase its price. And if the concern arises from the acquisition of corporate control, then reducing the size of the shareholding may not eliminate the problem and could indeed be counter-productive, by increasing the incentive to raise the acquired firm’s price, unless the ability to influence its actions is thereby removed.

Frontier Economics Europe advised ITV in relation to this transaction.

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