

Submission following the report by the Competition Commission on the proposed merger of Carlton Communications PLC and Granada PLC

A report under section 125(4) of the Fair Trading Act 1973 of the Chairman's advice dated 18 September 2003, to the Secretary of State for Trade and Industry under section 86(1) of the Act

In this submission the OFT advises under section 86(1) of the Fair Trading Act 1973 (the Act) on the report by the Competition Commission (CC) on the proposed merger of Carlton Communications PLC (Carlton) and Granada PLC (Granada) (the Report).

The CC has concluded that the merger qualifies for investigation and that it may be expected to operate against the public interest. It recommends that, in order to address the adverse effects of the merger, Carlton and Granada should agree to the set of behavioural undertakings set out at paragraphs 2.137 to 2.139 of the Report (in relation to other ITV regional licences) and paragraphs 2.154 to 2.170 of the Report (in relation to sales of advertising airtime).

RECOMMENDATION

The OFT recommends that you invite us under s88 of the Act to liaise with the Independent Television Commission (the ITC) and the Office for Communications (Ofcom) as appropriate to seek to obtain from Carlton and Granada the CC's recommended remedies concerning regional ITV licensees. We further recommend that you carefully consider the concerns set out below relating to the effectiveness, possible adverse competitive effects and implementation of the CRR remedy when deciding whether to accept the CC's recommendation in relation to the sale of advertising airtime. If you decide to accept the CC's CRR remedy, we advise that you invite us to liaise with the ITC and Ofcom to seek to obtain undertakings giving effect to the CRR remedy. If you decide not to accept the CC's recommendation, you may wish to consider the alternative remedies addressed by the CC.

BACKGROUND

Carlton and Granada are media companies active in the supply of studios and post-production facilities; programme acquisition and supply; distribution of rights for merchandising and licensing of programmes; acquisition of broadcast licences; control of ITV through the ITV network; supply of airtime for TV advertising; and broadcasting. The merger between Carlton and Granada, proposed in October 2002, raised competition concerns in the supply of TV advertising in the UK (together with possible concerns relating to the supply of studios and broadcasting licences). On my recommendation, you referred this merger situation to the CC for investigation on 11 March 2003.

JURISDICTION

The CC concluded that a merger situation qualifying for investigation had been created on the basis of the Act's assets test.

THE CC'S ASSESSMENT

The CC concluded that the merger could be expected to operate against the public interest in relation to (i) the position of the other ITV regional licensees and (ii) future competition for the sale of advertising airtime.

As regards the position of the other ITV regional licensees, the CC concluded that, post-merger, Carlton and Granada would control both the day-to-day and the longer-term strategic decisions of the ITV Network Centre. The other ITV licensees could be vulnerable to the ability of the merged entity to exert its power over the networking arrangements to their detriment. The CC further concluded that the merger would give rise to additional adverse effects since the other ITV licensees would lose a choice as to which sales house to use to sell their TV advertising airtime. Unless the other ITV licensees could continue to sell their airtime through the merged entity's sales house on terms similar to those that they currently enjoy, the proposed merger would have an adverse effect on those licensees.

The CC's major focus was on the effect of the proposed merger on the sale of Carlton's and Granada's advertising airtime. It concluded that the proposed merger would have an adverse effect on future competition for the sale of advertising airtime and so might be expected to operate against the public interest. More specifically, the CC thought that the adverse effects likely to arise would centre on the enhanced market position of Carlton and Granada. This might manifest itself in a number of ways including, in particular, the parties' ability post-merger to:

insist on terms that were generally less attractive to advertisers or media buyers;

enhance the degree of price discrimination; and/or

change the system under which television advertising airtime was sold to the advantage of the merged entity.

The CC identified a number of benefits arising from the proposed merger in terms of broadcasting, programming and competition for viewers. The CC concluded that these benefits did not outweigh the adverse effects identified. Accordingly, the CC found that the merger may be expected to operate against the public interest.

THE CC'S RECOMMENDED REMEDIES

The position of other ITV licensees

To address the detriments in relation to the ITV networking arrangements that might adversely affect other ITV regional licensees, the CC recommended that, as a condition of the merger going ahead, Carlton and Granada should agree to a package of safeguards proposed by the ITC – or to any similar measures that the ITC sees fit – and should accept any licence conditions that the ITC chose to propose in relation to them. This package of safeguards is as follows:

the Network Council should be convened at least twice a year to allow the other licensees to register their views and understand the overall direction of the broadcasting and programme strategy;

increases in other licensees' contributions to the network programme budget should be capped at the rate of inflation, save for exceptional events;

Carlton and Granada should not make the commissioning or broadcasting of a programme conditional on using its own licensees for programme compliance (the process which ensures that the programmes screened on ITV conform to the various standards that the ITC has laid down);

the other ITV regional licensees should continue to receive 'clean' broadcast feeds from the network;

if Ulster TV's local programming obligations changed as a result of devolution in Northern Ireland, it should be offered the same opt-out terms as Scottish TV; and

the number of network hours commissioned from the other ITV regional licensees

should be reported annually so that Ofcom would be able to keep the position under review.

To address the adverse effects of the merger in relation to the loss of choice of a sales house through which the other ITV licensees could sell their TV advertising airtime, the CC recommended that Carlton and Granada should undertake that Scottish Media Group (SMG), Ulster TV and Channel TV should have the option to carry forward, for the duration of the companies' respective licences, the terms currently in effect between each of them and Carlton's or Granada's sales houses. The CC also recommended that Carlton and Granada should also agree to accept any licence conditions that the ITC chose to propose in relation to this undertaking.

The sale of advertising airtime

To address the adverse effects of the merger in relation to future competition between Carlton and Granada for the sale of advertising airtime, a majority of the CC recommended a contract rights renewal remedy (the CRR remedy). This remedy is designed to give all advertisers and media buyers that currently have a contract with Carlton and Granada the fallback option of renewing the terms of their 2003 contracts without change for the duration of the remedy, except that where a contract specified a share of broadcast provision, this share would vary in direct proportion to ITV's share of commercial impacts, subject to a cap at the initial share. The revised share of broadcast would be calculated against the base level of impacts in 2002, weighted by the mix of demographics and regions actually purchased. The protection could be rolled forward so that a subsequent year's contract became the base set of contractual terms, subject to mutual agreement. The CC further recommended that the CRR remedy be supplemented by nine additional undertakings:

advertisers would be able to switch between media buyers subject to the merged entity's approval which could not be unreasonably withheld;

lapsed advertisers would have the right to renew the terms of their most recent contract in force since 2000;

rights would not expire if advertisers chose to move away from ITV for a period during the life of the remedy;

line-by-line advertisers acquiring another advertiser would have the choice of applying the acquirer's 2003 terms (subject to any risk of over-trading) or the weighted average of the acquirer's and the acquired's 2003 terms, or of rolling forward separately the acquirer's and the acquired's 2003 terms;

where two media buyers merged, their protected contract would be the weighted average of the two, with the option of rolling forward each contract separately;

the remedy would cover the airtime sale in the 2003 contracts, which included sales on behalf of SMG, Ulster TV and Channel TV, as well as, in some cases, ITV2 and ITV News;

Carlton and Granada are required to accept any changes to their licence conditions stipulated by the ITC relating to the conditional selling of ITV2 or any other channels;

the appointment of a wholly independent adjudicator (or a small panel), selected by the ITC and funded by Carlton and Granada, to resolve certain disputes arising under the remedy; and

Carlton and Granada should undertake to make no material changes to the current airtime sales system, for example by way of a commitment to maintain the use of the Station Average Price (SAP)¹ system for the duration of the remedy and to retain all regions and demographics that the parties currently sell.

Without making detailed recommendations to address the concern, the CC also stated that arrangements for the sale of airtime on channels in which Carlton and Granada did not have an interest, such as S4C, would need to be looked at as part of the detailed implementation of the remedy. The CC recommended that the CRR remedy be in place within 6 months of completion and, ideally, by autumn 2003 (the time at which the next contract negotiation round commences).

In connection with future competition between Carlton and Granada for the sale of advertising airtime, the CC considered three other possible remedies: the prohibition of share deals; the commoditization of airtime; and the divestment of the two sales houses (with the possible variant of divesting only one). The CC rejected the two former remedies. The CC concluded that divestment of both sales houses would be an effective remedy for the adverse effects identified. However, a majority of the CC concluded that the CRR remedy would place a lesser burden on the parties (than the divestment of both sales houses) and believed that the CRR remedy was the more appropriate remedy. The CC concluded that, as effective remedies had been identified, prohibition of the merger would be disproportionate.

¹ SAP is described in Appendix 5.3 of the CC Report. Broadly speaking, SAP is calculated by dividing the total revenue paid each month for a given type of commercial impact by the number of such impacts actually delivered. An increase in revenue for a type of impact would lead to a corresponding increase in SAP.

THE OFT'S ASSESSMENT AND RECOMMENDATION

Although this merger is being considered under the Fair Trading Act, our approach, in the spirit of the Enterprise Act 2002 now in force, is to advise acceptance of CC recommendations provided that those recommendations – in particular as they affect remedies – are capable of transposition into undertakings that can be implemented and monitored effectively so as to remedy the detriment identified.

Other ITV licensees

With this in mind, we recommend acceptance of the CC's recommendations concerning regional ITV licensees. The ITC is well-placed to deal with these issues. We therefore recommend that you invite us under s88 of the Act to liaise with the ITC and/or Ofcom to obtain these remedies from Carlton and Granada.

The CRR remedy

Turning to the sale of advertising airtime, the CC has recommended a complex package of provisions (described above) that together comprise the CRR remedy. Concerns regarding the effectiveness of this remedy have been expressed by most of the media buyers and advertisers that commented on the CRR remedy and by a member of the CC, Mrs. Brown. Most media buyers, advertisers and other commercial channels saw the remedy as introducing an unwelcome degree of rigidity into the market as customers would be reluctant to move away from the protected deal for fear of losing their benefits. Advertisers' requirements are constantly changing with evolving consumer tastes and new product lines, and advertisers feared they would be locked into contracts that did not suit them or that they would have little or no protection if they sought modification. There was also a general concern about the complexity of the remedy and unease about difficulties in implementing it.

These are substantial concerns, and in our view it should be considered carefully whether the CRR remedy: (a) would effectively address the adverse effects identified by the CC; (b) would have adverse effects on competition in other markets not considered by the CC; and (c) is capable of effective implementation and monitoring. We deal with each set of questions in turn.

Effectiveness questions

There is the question of whether the CRR remedy would effectively address the adverse effects of the merger identified by the CC in relation to the sale of advertising airtime. The basic issue here can be simply put. As envisaged by the CC, the CRR remedy grants a right to renew a contract on the same terms as in 2003, but this renewal right

does not relate to the *level* of the price of impacts. Rather, it relates to a particular discount off SAP – i.e. the right is to renew at the same position *relative* to SAP. Therefore, if the merger had the effect of raising SAP, the remedy would not fully address the identified detriment even for those customers who had the renewal right. The remedy does not directly constrain SAP, but indirectly it may constrain it by limiting the ability of the merged entity to increase price discrimination as between customer groups with the renewal right. Further assessment of the risk that SAP could be higher than it would have been absent the merger, despite the CRR, calls for discussion of the following three points.

First, it may be questioned whether the CRR remedy protects adequately the position of a number of categories of customer.

New advertisers might not be able to secure access to airtime under the base contracts of media buyers. If the media buyer can accommodate the new advertiser under its existing contract, it may do so. Although the CRR remedy envisages that new advertisers would be able to obtain protection via existing media buyers' base contracts, on occasion the media buyer may need to change its base contract in order to accommodate the new advertiser. In this circumstance, there is no obligation on Carlton and Granada to agree to grant the new advertiser the benefit of that contract. (This is for a sound reason: Carlton and Granada need to avoid the risk of 'overtrading', which is the term used by the CC to describe entering contractual commitments to deliver more airtime (or commercial impacts) than it is possible for them to do.) In these circumstances, the new advertiser might simply be excluded from advertising on ITV. Alternatively, if the relevant media buyer did seek to negotiate – with Carlton and Granada – changes to its existing contract to accommodate the new advertiser, the media buyer might have no choice but to accept a sub-optimal package of airtime.

Related to the issue of airtime availability discussed in (a) is the question of price. The new advertiser is protected via the existing contracts of media buyers only if the media buyers' mark-up does not increase. And there is the possibility that a media buyer seeking to negotiate changes to its existing contract might have to pay more, because of the merger, for the desired airtime.

New media buyers seeking to enter the market will have no direct protection by virtue of the remedy and would be in the position of negotiating with the merged Carlton and Granada, whose market power in advertising airtime is likely to be enhanced by the merger. (The terms negotiated by new media buyers and new advertisers are of course a component of SAP.)

Advertisers or media buyers with existing contracts that wish to change their

requirements, or advertisers wishing to switch media buyers may face difficulties similar to those above.

In sum, there may be categories of customers that are not protected fully by the CRR remedy. If this is so, SAP could rise in consequence of the merger, so that even customers enjoying protection under the CRR remedy may pay more for airtime.

Second, the CRR remedy provides for an adjudicator to determine certain disputes. It is not clear that this would be sufficient to protect all the relevant groups of customers discussed in the previous paragraph, and indeed whether it would prevent SAP from being higher with the merger than without. More generally, a large and complex set of issues – of the sort usually settled more or less efficiently by market forces in competitive settings, rather than by adjudication – could fall to the adjudicator.

The adjudicator would deal in the first instance with complaints where incremental changes from a basic fallback contract were claimed to be unfair or where issues of contract enforcement or interpretation arose, as well as with any issues associated with potential 'overtrading'. It is not clear from the Report to which groups of customers this should apply – e.g. in discussing the adjudicator the Report refers to those changing existing contracts or media buyer but not new advertisers (see paragraphs 2.155 and 2.163 to 2.166 of the Report).

The adjudicator must also address 'material changes of circumstances' related to contracts with customers that do not currently have a share of broadcast agreement with either Carlton or Granada. The CC has recommended that any such contract simply be rolled forward in its existing state. Carlton, Granada or the customer concerned would have the option of referring the issue to the adjudicator if there were a material change of circumstance. It is not clear here what issue the adjudicator is intended to address, nor how the issue would be resolved.

Finally, in relation to existing advertisers switching media buyers, the CC recommended that they be able to do so, subject to obtaining the consent of the merged Carlton and Granada to allow the advertiser to be included in the new media buyer's existing umbrella contract. Such consent should not be unreasonably withheld, and any disputes would be referred to the adjudicator. It would appear that on occasion the adjudicator might only be able to resolve the issue by confirming the denial of access to the airtime (in which case the CRR remedy offers the customer no direct protection) or by rationing access to advertising airtime on the part of different customers. If rationing questions did arise, and indeed more generally, there could be difficult issues both procedurally and substantively (e.g. relating to efficiency).

In light of the above it cannot be assumed that the adjudicator, in conjunction with the

CRR remedy, could straightforwardly protect customers against the enhanced market power of the merged entity. (We comment separately below on the practical issues connected with implementation of the adjudicator remedy.)

Third, the CRR remedy in its own terms creates a number of contractual rights to airtime that would not otherwise exist (e.g. advertisers whose contracts have lapsed would have the right to renew the terms of their most recent contract in force since 2000). This in itself creates a risk of 'overtrading' in advertising airtime. Although the adjudicator may be able to address some of these 'overtrading' issues, it would again appear that this would primarily be by way of confirming a denial of access to airtime on grounds of risk of undesirable 'overtrading' or by rationing access to advertising airtime on the part of different customers. The retrospective element of the CRR could therefore heighten the difficulties discussed above.

The point of articulating the concerns described above is not to suggest that the CRR remedy is of no effect in addressing the detriment found by the CC. By limiting scope for greater price discrimination, the remedy is indeed likely to result in a lower SAP than in the absence of the remedy. Nevertheless, it seems possible that the merger would SAP increase overall in a way that is not fully prevented by the CRR remedy. Consequently, not only customers without rights under the CRR remedy, but even those with such rights, may pay more for advertising airtime than they would have done absent the merger.

The extent to which any of these risks would occur or influence SAP is a question of degree. The ITC has advised us that it considers that the risk of any of these effects being substantial may be low, but due attention should also be given to the points made by a minority of the CC, Mrs Brown, who rejected the CRR remedy, and by most of the advertisers and media buyers who commented to the CC on the CRR remedy.

On a more general point, the CC noted the expectation, held by the parties and the broadcasting industry in general, that ITV's share of national advertising revenue will continue to decline over the next few years in the face of competition from other commercial broadcasters. This competition might be expected to increase the ability of customers to secure better ITV advertising deals over time. The CRR remedy, which gives rights to renew on past terms, would not fully contain the adverse competitive effect of the merger for those with renewal rights if they could have expected better future terms on account of growing competition.

In sum, there remain questions as to the effectiveness of the CRR remedy, which we recommend that you should carefully consider when deciding whether to accept the CC's recommended remedy.

Other competitive effects

Further issues arise from the possibility that the CRR remedy might result in a particular detriment to some media buyers and advertisers, with possible consequences for competition in other markets. This is because, in so far as the CRR remedy has value to protected media buyers and advertisers, they have an advantage (arising from incumbency) over those without contracts to renew. Potentially, this asymmetry could affect competition adversely in media buying and in a variety of markets for goods and services for which TV advertising is important.

In relation to media buying, the concern is not only that those planning to enter or grow in the market could be at a disadvantage relative to incumbents, but also that competition could be dampened among existing firms.

As noted, in certain circumstances, the only option open to the adjudicator – or even to Carlton and Granada – might be to deny access to TV advertising airtime to certain advertisers. Since TV advertising is one of the primary means in the UK for promoting consumer goods and services, it represents an important way in which firms compete for custom. Accordingly, certain advertisers without rights under the CRR remedy could be constrained (relative to their product market rivals who happened to have those rights) in terms of their access to TV advertising. Potentially, that might lessen competition in some markets for consumer goods and services by limiting an important means of competition to incumbent firms from potential competitors.

Again it is hard to gauge the practical significance of the potential asymmetry – between those with and without renewal rights – that would result from the CRR remedy. We recommend, however, that you have careful regard to this point when considering whether to accept the remedy.

Implementation questions

Certain aspects of the CRR remedy also raise practical issues concerning whether they are capable of transposition into undertakings that can be implemented and monitored effectively.

Some aspects of the CRR remedy are ambiguous in the CC Report: for example, the exact meaning of the phrase 'the terms of their 2003 contracts'², which is fundamental to implementation of the CRR remedy. All such definitional ambiguities

² For the purposes of this advice we have assumed terms refers to the discount from SAP rather than price. It may also cover other elements of the contract such as the position of adverts in the breaks etc.

will need to be resolved before the CRR remedy can be implemented.

The role of the adjudicator would need to be described fully in any undertaking. We would need to define the process to be followed by the adjudicator, the standard to be applied by the adjudicator in determining disputes,³ the scope of possible remedies the adjudicator could impose in any given set of circumstances, and consider the legal implications of trying to impose a binding adjudicator on advertisers and media buyers that were not party to any formal undertakings. In addition, we note a concern raised by Mrs. Brown and a number of the consulted advertisers and media buyers: the contract negotiation round is an intense period, normally around two months, and there is doubt that the adjudicator would be able as a practical matter to engage with all of the contracts and address disputes effectively in the context of that compressed negotiation period.

Without making detailed recommendations to address the concern, the CC also stated that arrangements for the sale of airtime on channels in which Carlton and Granada did not have an interest, such as S4C, would need to be looked at as part of the detailed implementation of the remedy. This would obviously need to be incorporated into any final undertaking.

Time is pressing: the next negotiation round for the sale of advertising airtime commences on or around 1 November 2003. Negotiating undertakings giving effect to the complex CRR remedy would be a complex task for the OFT, the ITC, Ofcom and, indeed, for the parties themselves. There is no guarantee that these undertakings can be negotiated quickly enough for the parties and their customers to absorb their implications by 1 November.

We recommend that you should carefully consider the above practical issues when deciding whether to accept the CC's recommended CRR remedy.

Alternative remedies

If you consider that in light of concerns regarding the CRR remedy you cannot accept the CC's recommendation, you may wish to consider alternative remedies for the adverse public interest detriments identified by the CC in relation to the sale of advertising airtime. We therefore address below the effectiveness and practicability of the other four remedies for the adverse effects on future competition in the sale of

³ The CC Report refers to 'fair and reasonable' and 'material change of circumstances' being the appropriate standard for the adjudicator when determining particular types of complaint. Neither term is defined or explained in the CC Report. We consider that any formal undertaking giving effect to the CRR remedy would need to make specific provision for these definitions to avoid later uncertainty.

advertising airtime that were considered by the CC: the prohibition of share deals, the commoditization of airtime, the divestment of the two sales houses (with the possible variant of divesting only one), and prohibition of the merger.

The CC considered and unanimously rejected both the prohibition of share deals and the commoditization of airtime. We agree with their conclusion since neither proposal appears likely to address effectively the adverse public interest effects of the proposed merger, nor would either remedy in our view be capable of transposition into undertakings that can be implemented and monitored effectively.

As noted above, the CC unanimously concluded that divestment of each of the parties' advertising airtime sales houses (to two separate buyers) was a potentially effective remedy, rejecting the argument that only one sales house need be divested. The CC saw both advantages and disadvantages with this remedy. It would preserve the pre-merger market structure in advertising sales and not rely on other types of intervention to mitigate the adverse effects of the merger. The CC also thought that it would be possible to devise incentives to encourage the two sales houses to compete with one another and to maintain an adequate level of performance. They were concerned, however, with ensuring that the merged Carlton and Granada would not be able to exert excessive influence or a degree of control over the independent sales houses. They also shared some of Carlton's and Granada's concerns about divorcing the broadcasting company from its principal source of income, and that this could result in dysfunctionality due to the differing commercial incentives of the broadcaster and the two sales houses, thus reducing one of the benefits of the merger. This point needs to be weighed against the questions raised above regarding the effectiveness, implementation and competitive consequences of the CRR remedy. In the judgement of one member of the CC, Mrs. Brown, the balance of advantage lay with the sales house divestment remedy.⁴

The sales house divestment remedy would indeed need to ensure the two independent sales houses could be satisfactorily incentivised to compete with each other. There would undoubtedly be challenges associated with this remedy. However, we note that this remedy would steer clear of some of the difficulties of the CRR remedy discussed above.

Finally, prohibition would be an effective remedy but the CC considered it to be disproportionate in light of their view as to the effectiveness of the CRR remedy. If, however, you favoured prohibition of the merger now, that would of course not

⁴ We note that Mrs Brown felt that divestment of the two sales houses could not be completed prior to this autumn and that therefore the CRR would be required in the interim. We note that, alternatively, the completion of the merger could be delayed until the divestment of the sales house a hold-separate trustee could ensure that the status quo continued in the interim.

preclude the possibility of the merger taking place at some later date, if competition develops as expected by the parties and the CC.

CONCLUSION

We recommend that you invite us under s88 of the Act to liaise with the ITC and Ofcom to seek to obtain from Carlton and Granada the CC's recommended remedies concerning regional ITV licensees. We further recommend that you carefully consider the above concerns relating to the effectiveness, possible adverse competitive effects, and implementation of the CRR remedy when deciding whether to accept the CC's recommendation in relation to the sale of advertising airtime. If you decide to accept the CC's CRR remedy, we advise that you invite us to liaise with the ITC and Ofcom to seek to obtain undertakings giving effect to the CRR remedy. If you decide not to accept the CC's recommendation, you may wish to consider the alternative remedies addressed by the CC.