# *Public Competition Assessment*

***18 October 2007***

## *Video Ezy Australasia Pty Ltd – proposed acquisition of Blockbuster Australia Pty Ltd*

### Introduction

1. On 18 September 2007, the Australian Competition and Consumer Commission (**ACCC**) announced its decision not to oppose the proposed acquisition of Blockbuster Australia Pty Ltd and the master franchise rights to the Blockbuster business in Australia by Video Ezy Australasia Pty Ltd (**proposed acquisition**), subject to section 87B undertakings accepted by the ACCC on the same day. The ACCC was of the view that the proposed acquisition, in conjunction with the undertakings, would be unlikely to have the effect of substantially lessening competition in the national market for the wholesale purchase of new release DVDs or in any local markets for the rental supply of DVDs to consumers, in contravention of section 50 of the *Trade Practices Act 1974* (the **Act**).

2. The ACCC formed its view on the basis of information provided by the merger parties and information arising from its market inquiries. This Public Competition Assessment outlines the basis on which the ACCC has reached its decision on the proposed acquisition, subject to confidentiality considerations.

### Public Competition Assessment

3. To provide an enhanced level of transparency and procedural fairness in its decision making process, the ACCC issues a Public Competition Assessment for all transaction proposals where:
   - a merger is opposed;
   - a merger is subject to enforceable undertakings;
   - the merger parties seek such disclosure; or
   - a merger is approved but raises important issues that the ACCC considers should be made public.

4. This Public Competition Assessment has been issued because the proposed acquisition is subject to court enforceable undertakings.

5. By issuing Public Competition Assessments, the ACCC aims to provide the market with a better understanding of the ACCC's analysis of various markets and the associated merger and competition issues. It also alerts the market to the circumstances where the ACCC's assessment of the competition conditions in particular markets is changing, or likely to change, because of developments.

6. Each Public Competition Assessment is specific to the particular transaction under review by the ACCC. While some transaction proposals may involve the same or related markets, it should not be assumed that the analysis and decision outlined in one Public Competition Assessment will be conclusive of the ACCC's view in respect of other transaction proposals, as each matter will be considered on its own merits.

7. Many of the ACCC's decisions will involve consideration of both non-confidential and confidential information provided by the merger parties and market participants. In order to maintain the confidentiality of particular information, Public Competition Assessments do not contain any confidential information or its sources. While the ACCC aims to provide an appropriately detailed explanation of the basis for the ACCC decision, where this is not possible, maintaining confidentiality will be the ACCC's paramount concern, and accordingly a Public Competition Assessment may not definitively explain all issues and the ACCC's analysis of such issues.

## The parties

*The acquirer: Video Ezy Australasia Pty Ltd*

8. Video Ezy Australasia Pty Ltd (Video Ezy) is an owner and franchisor of stores in Australia that primarily rent and retail DVDs and games to consumers. At the time of this review, in Australia 517 stores operate under the Video Ezy brand of which 492 are franchisee owned stores, 6 are corporate owned stores and 19 stores are owned by the two major shareholders of Video Ezy.

*The target: Blockbuster Australia Pty Ltd*

9. Blockbuster Australia Pty Ltd (Blockbuster) is also an owner and franchisor of stores in Australia that primarily rent and retail DVDs and games to consumers.

10. Blockbuster is wholly owned by Blockbuster Inc. Blockbuster Inc is listed on the New York Stock Exchange and is a global provider of in-home rental and retail movie and game entertainment.

11. In Australia, at the time of this review 374 stores operate under the Blockbuster brand of which 350 are franchisee owned stores and 24 are corporate owned stores.

*Other industry participants*

12. Other participants in the industry include Civic Video, Network Video, Leading Edge Video, Video 2000, Video Busters, Video City, Local Video and other independent stores.

**The proposed transaction**

13. Video Ezy proposes to acquire Blockbuster and the master franchise rights to the Blockbuster business in Australia. The ACCC understands that the proposed transaction will involve the following elements:

    - Video Ezy, or a wholly owned subsidiary of Video Ezy, will acquire 100 per cent of the issued shares in Blockbuster; and

    - Video Ezy will enter into a master franchise agreement with Blockbuster Inc. The master franchise agreement will run for a 10 year term with the possibility of renewal for a further 10 years.

14. From the information provided to the ACCC, Video Ezy intends, post-acquisition, to operate the Blockbuster brand of stores separately from the Video Ezy brand of stores.

15. The ACCC has been advised by Video Ezy that, under the master franchise agreement to be entered into with Blockbuster Inc, Video Ezy will, among other things, be subject to the following obligations:

    - to maintain a minimum number of Blockbuster stores;
    - to keep all Blockbuster Divisions (which includes any departments and divisions established for the purposes of marketing and general business development) separate and distinct from the Video Ezy Divisions (which also includes any departments and divisions established for the purpose of marketing and general business development);
    - to ensure that there is no information flow between any Blockbuster Division and any Video Ezy Division in connection with Blockbuster's advertising, marketing and promotional programs;
    - to ensure no common ownership by franchisees of Video Ezy and Blockbuster branded stores.

### Timing

16. The following table outlines the timeline of key events in this matter.

| Date | Event |
|---|---|
| 12-Mar-2007 | ACCC commenced review under the Merger Review Process Guidelines. Market inquiries commenced. |
| 26-Mar-2007 | Closing date for submissions from interested parties. |
| 13-Apr-2007 | ACCC requested further information from Video Ezy. ACCC timeline suspended. |
| 21-Apr-2007 | ACCC received further information from Video Ezy. ACCC timeline recommenced. |
| 26-Apr-2007 | ACCC requested further information from Video Ezy. ACCC timeline suspended. |
| 02-May-2007 | ACCC received further information from Video Ezy. ACCC timeline recommenced. |
| 09-May-2007 | ACCC published a Statement of Issues outlining preliminary competition concerns. |
| 23-May-2007 | Closing date for submissions relating to Statement of Issues. |
| 01-Jun-2007 | ACCC announced that it is in discussions with Video Ezy. Proposed date of 6 June 2007 for announcement of ACCC's findings delayed and indicative timeline suspended pending further submission from the parties. |
| 14-Jun-2007 | Draft section 87B undertaking proffered by Video Ezy. Timeline recommenced. |
| 18-Jun-2007 | ACCC commenced market inquiries regarding draft section 87B undertaking. |
| 27-Jun-2007 | Closing date for submissions relating to draft section 87B undertaking. |
| 06-Jul-2007 | ACCC requested further information from Video Ezy. ACCC timeline suspended. |
| 12-Jul-2007 | Former proposed announcement date. ACCC findings delayed until early August to allow for the provision of additional information. |
| 01-Aug-2007 | Video Ezy indicates delays in providing information to ACCC. The timeline remains suspended and the ACCC will announce a revised decision date once the information is received. |
| 10-Sep-2007 | ACCC received further information from Video Ezy. ACCC timeline recommenced. |
| 18-Sep-2007 | ACCC announced it would not oppose the proposed acquisition. |

### Market inquiries

17. The ACCC conducted market inquiries with a range of industry participants, including studios and distributors, competitors, industry associations, DVD retailers, online service providers and franchisees. Submissions were sought in relation to the substantive competition issues and proposed undertakings.

## Market background

*Film distribution and release windows*

18. In Australia, films are released for viewing by consumers in a variety of formats. Some of the forms in which a film may be made available include cinema release, in DVD format through rental or retail stores, on free to air and pay television, through online rental delivery services and through download services.

19. In general, film distributors release films through a series of exclusive windows. A film is released for viewing in a particular form in accordance with a series of timeframes determined by each individual distributor. The table below depicts the formats and the periods of exclusivity that a film title will progress through in the majority of cases, although there are examples of particular film titles or distributors that have deviated from this course.

| Release format | Exclusivity windows |
|---|---|
| 1. Cinema | Exclusive to cinemas for 120 days. |
| 2. Rental and retail channel | Exclusive to rental and retail channels for 90 days after end of cinema's 120 day period. |
| 3. Pay per view and video on demand/download services | Following the rental/retail 90 day window, the film is available to pay per view and video on demand for a further 90 days (at exclusion of pay and free to air television). |
| 4. Pay television | Available to pay television after the expiry of the 90 day window for pay per view and video on demand. |
| 5. Free to air television | A film is generally shown on free to air television 2 years after release at cinema. |

*New releases and back catalogue*

20. In general, there are two categories of DVD titles available at rental and retail stores – new releases and back catalogue. New releases refer to newly released DVD titles (titles that have either recently been released in the Cinema channel, or released by distributors directly to DVD) that generally remain in the new release category for 3 months.

21. Box office hits comprise a small sub-set of new releases. In its Statement of Issues, the ACCC described box-office hits as titles that gross approximately $15 million or more at the Australian box office. Further market inquiries suggested that what may be classed as a box office hit is dependant on the strength of the titles at any particular time and as such it is difficult to describe a hit accurately by reference to its revenue earnings alone.

22. Back catalogue generally refers to those DVD titles where 3 months or more have lapsed since its release to the rental and retail channels.

23. Rental businesses predominantly purchase a wide range of new release titles from wholesale suppliers, while retail businesses have a greater focus on back catalogue and box office hits.

*Franchises and buying groups*

24. The vast majority of rental stores in Australia are operated by either franchisees or operators who are members of a buying group. In addition to the merger parties, other rental store operators in Australia include two buying groups, a franchise system, and several independent chains.

25. Stores compete in localised markets and rental prices are determined at least partly on the basis of local market conditions.

## Statement of Issues

26. The ACCC published its Statement of Issues on 9 May 2007 identifying a number of competition issues. In the Statement of Issues the ACCC considered the ability of the merged entity to purchase a greater range of DVDs on an exclusive basis or subject to a rental window as an issue of concern. **(Increased bargaining power in the national market for the wholesale purchase of new release DVDs)**

27. The ACCC also identified the risk of coordinated conduct post-acquisition between the Video Ezy and Blockbuster networks and their franchisees as an issue that may raise concerns. **(Coordinated effects in local markets for the rental supply of DVDs to consumers)**

## Market definition

*National market for the wholesale purchase of new release DVDs*

28. The ACCC considered the proposed acquisition in the context of the national market for the wholesale purchase of new release DVDs.

29. In relation to the product dimension of the market, the ACCC considered that DVD distributors would be unlikely to be able to substitute to back catalogue DVDs in response to a decrease in the price of new release DVDs offered by rental and retail video chains. Rental stores largely only acquire new release titles from distributors. While retail stores do acquire back catalogue titles, there is no reason to think that the demand by retail stores for back catalogue titles would increase post-acquisition. In this regard, the ACCC considered the following information:

- New releases occupy a separate temporal dimension to back catalogue (ie new releases exist as new releases for 90 days, before they become back catalogue).
- New release DVDs and back catalogue DVDs are subject to different buying patterns between the rental and retail channels. Rental businesses have a much stronger focus on new release titles than on back catalogue titles.
- The wholesale price of a new release DVD title is higher than the price of a back catalogue DVD title. In general, the longer the DVD title has been released, the lower its wholesale price.
- Different marketing strategies are adopted in respect of new release DVDs, with new releases often involving extensive and cooperative advertising between the studio and the rental/retail outlet.

30. In relation to the geographic dimension of the market, the ACCC considered that the majority of DVDs are purchased from seven major movie distributors who each operate a centralised head office for all of Australia. In addition, the distribution of DVDs on a nationwide basis is relatively simple.

*Local markets for the rental supply of DVDs to consumers*

31. The ACCC also considered the proposed acquisition in the context of the local markets for the rental supply of DVDs to consumers.

32. In relation to the product dimension of the market, market inquiries indicated that the retail sale of DVDs, online rental download services (that is, digital distribution where a customer downloads a title) and pay television are not effective substitutes to the rental supply of DVDs. The ACCC took into account the following information obtained during market inquiries:

- The retail price of a single disc new release is approximately $29.95 – $34.95, while the price of a new release rental is approximately $4.20 – $6.95. Given the price difference, the ACCC considers that retail DVDs are unlikely to be a viable substitute to rental DVDs. The ACCC noted that while a number of consumers (eg collectors of certain genres) may consider purchasing DVDs instead of renting, this is not likely to comprise a sufficiently substantial portion of consumers to pose any meaningful constraint on an exercise of market power by the merged entity.

- Technological barriers (download speeds etc) have meant that consumer take-up of online rental download services has not been substantial.
- Consumers are unlikely to wait for a movie to be released on pay television. The ACCC notes that approximately 25 per cent of Australian households currently subscribe to pay television.

33. The ACCC also considered that online rental services by postal delivery (that is, where a customer orders a DVD online and has it delivered by post) may be considered in the same market, but noted that they do not currently make up a significant proportion of the market.

34. Regarding the geographic dimension of the market, the ACCC considered that the local markets were likely to exist, and extend between a two and five kilometre radius of a rental store (although this may be wider in rural areas).

## Competition analysis

### Increased bargaining power in the national market for the wholesale purchase of new release DVDs

*Potential competitive harm*

35. As expressed in the Statement of Issues, the ACCC was concerned that the proposed acquisition may provide the merged firm with the bargaining power to gain **exclusive** access to a greater range of new release DVDs from suppliers. In turn, this may have had the effect of lessening competition in local markets for the rental supply of DVDs to consumers.

36. DVD rental stores compete on, among other things, their DVD title range (especially their range of new release DVDs). If other DVD rental stores are unable to gain access to a broad range of new release DVDs, the competitive constraint they impose on the merged firm is likely to diminish.

*Bargaining power of the merged firm in the national market for the wholesale purchase of new release DVDs*

37. A key issue in determining whether the above mentioned competitive harm was a likely outcome of the proposed acquisition, was the degree to which the merged firm was able to take advantage of any increase in bargaining power in the national market for the wholesale purchase of new release DVDs.

38. The purchasers of wholesale DVDs fall into two main groups – retailers of DVDs (the retail channel) and DVD rental franchisees or buying groups (the rental channel).

39. Post-acquisition, the merged firm will purchase the major share of wholesale DVDs for the rental channel. Within this channel, the merged firm is likely to have considerable bargaining power with DVD distributors.

40. A potential constraint on the bargaining power of the merged firm is the option for DVD distributors to sell to the retail channel.

41. Market inquiries indicated that DVD titles purchased for the rental channel are largely made up of new release titles. By contrast, the retail channel tends to focus on box office hit new releases (a small subset of the overall range of new release DVD titles), and back catalogue titles. Market inquiries also suggested that some new release titles are specifically aimed at the DVD rental market.

42. The ACCC considered that the merged entity may have been able to exercise bargaining power in a number of ways, including threatening to boycott or reduce purchases from wholesale DVD suppliers. Where the new release DVD title in question was suited to the rental channel, the bargaining power of the merged firm would be significantly increased. In such cases, the ACCC considered that the merged entity may be able to secure more new release DVD titles suited to the rental channel on an exclusive basis.

*Conclusion*

43. The ACCC considered that, post-acquisition, the merged entity was likely to have an increased degree of bargaining power in the wholesale market for the acquisition of new release DVD titles. The ACCC considered that the merged entity was likely to be able to take advantage of that power by entering into exclusive purchase agreements for a greater number of new release DVD titles than either Blockbuster or Video Ezy were able to secure without the acquisition. Access to a greater range of new release DVD titles on an exclusive basis was likely to lessen the extent to which competitors of the merged firm were able act as a constraint on the merged entity in downstream markets for the supply of rental DVDs.

44. Consequently, the ACCC considered that the merged entity may be able to use its bargaining power to sustain a price rise at the consumer level, and that the proposed acquisition may lead to a substantial lessening of competition in the local markets for the rental supply of DVDs to consumers.

*Impact of the Undertaking*

45. Under the undertaking offered by Video Ezy, and accepted by the ACCC on 18 September 2007, Video Ezy and Blockbuster cannot purchase new release DVD titles on a rental exclusive basis, either for the networks separately, or for the joint benefit of both networks for a period of five years.

46. The ACCC considered that the undertaking adequately addressed its concerns regarding the wholesale market for the purchase of new release DVDs. The undertaking removes the potential competition concern arising from the merged entity's increased bargaining power. Consequently, from the information provided by Video Ezy, and on the basis of the court enforceable undertakings, the ACCC did not consider that the proposed acquisition would lead to a substantial lessening of competition in this market.

*Rental windows*

47. Rental windows are arrangements whereby a title is exclusive to the rental channel (all rental businesses) for a limited period of time prior to its retail release. A premium is generally charged by distributors for rental window titles.

48. In its Statement of Issues, the ACCC expressed concern that the merged entity would have an increased ability to secure rental windows and, given its buying power, could obtain DVD titles subject to rental windows at a lower price than its competitors.

49. Market inquiries conducted with distributors revealed that, in some circumstances, distributors decided to instigate a rental window on a new release DVD title where it considered that the title was particularly suited to the rental market. Further, market inquiries indicated that this was not done at the prompting of rental networks, but for commercial reasons by the distributor.

50. Some distributors noted that restricting rental windows may diminish their bargaining position. The ACCC also considered the views of many franchisees, which were generally in favour of rental window titles.

51. In addition, only a small number of titles are released subject to rental windows, and this is unlikely to increase to any great extent post-acquisition. Therefore, the ACCC considered that rental windows were unlikely to have a detrimental impact post-acquisition.

52. Also, when a title is released subject to a rental window a distributor generally invests in extensive marketing of that title, the benefits of which were likely to flow to the entire rental channel.

53. Ultimately, the ACCC did not form the view that competition concerns were likely to arise in relation to rental windows.

**Coordinated effects in local markets for the rental supply of DVDs to consumers**

*Potential competitive harm*

54. The ACCC was also concerned that if Video Ezy and Blockbuster stores were to coordinate their prices in areas where they face little competition, the price paid by consumers would be higher. The ACCC considered that, pre-acquisition, Blockbuster stores in these areas were likely to place a constraint on the pricing decisions of Video Ezy and vice versa. The ACCC was concerned that the removal of this competitive tension, by way of any increased risk of coordinated conduct resulting from the proposed acquisition, may lead to a lessening of competition.

*Competition analysis*

55. The ACCC was concerned that there would be an increased chance of coordination on price and other services between the Video Ezy and Blockbuster networks post-acquisition. Of particular concern were local markets where only Video Ezy and Blockbuster stores operate. The ACCC identified 17 such markets in its Statement of Issues. Based on market inquiries conducted following the Statement of Issues, the ACCC refined this to the 14 local markets listed in the table below.

| **Market** | |
|---|---|
| **NSW** | |
| Murwillumbah | Muswellbrook |
| Springwood | Dubbo |
| Cessnock | |
| **Queensland** | |
| Bribie Island | Noosa Heads/Noosaville |
| **South Australia** | |
| Gawler | Mt Barker |
| Port Augusta | Port Lincoln |
| **Victoria** | |
| Mornington East | |
| **Western Australia** | |
| South Lakes | Warnbro |

56. Post-acquisition, Video Ezy and Blockbuster franchise stores are able to make individual decisions regarding price based on local conditions. Video Ezy and Blockbuster franchisees can continue to be in competition with one another at the local level. Under the sales agreement with Blockbuster Inc, Video Ezy is required to operate the networks separately, and restrict information flows between the networks and not allow common ownership of stores across the networks.

57. In the context of the proposed acquisition, the ACCC considered that there were two possible ways that coordinated conduct could be facilitated. These would be either at the franchisor level, or at the franchisee level. Facilitation at the franchisor level would entail the merged entity influencing pricing and other decisions of franchisees to limit the extent to which Video Ezy and Blockbuster franchisees compete with each other in markets where they face little competition. Facilitation at the franchisee level would involve franchisees of Video Ezy and Blockbuster coordinating their conduct to limit the extent to which they compete with each other in local markets.

*Potential for new entrants to constrain the merged entity or its franchisees*

58. In determining the likelihood that such competitive harm may occur, the ACCC considered the extent to which the threat of new entry in local markets (identified above) would constrain the merged entity. The ACCC considered what barriers to entry might exist for other suppliers of rental DVDs wishing to enter markets where Video Ezy and Blockbuster face little competition.

59. The ACCC considered that the barriers to entry in these markets were likely to be high. Market inquiries conducted by the ACCC indicated that a new entrant seeking to enter one of these markets would likely face the following barriers to entry:

- Risks involved in the entry into a mature industry with emerging technologies
- Insufficient demand to sustain additional DVD rental stores in the market (one store requires 5000 households per store in a relevant area. 12,000 – 15,000 households would support two stores)
- Availability of suitable premises
- Availability of suitable franchisees / buying group members
- Threat of a strong competitive reaction of incumbent businesses
- High sunk costs relative to expected rates of return available to video store owners.

60. The ACCC considered that, while alternatives to bricks and mortar rental networks currently operate, such as video download and online mail delivery services, these were of a scale that was unlikely to constrain the activities of the established participants in the rental stream due to limited take-up and coverage, and technical limitations.

61. Consequently, the ACCC considered that the merged entity was unlikely to be significantly constrained by the threat of new entry in markets where its franchise and corporate stores face little competition.

62. The ACCC then considered whether coordinated conduct was likely to occur in the relevant markets, and whether such coordination would be franchisor facilitated, or occur between franchisees of the merged entity.

*Franchisor facilitated coordination*

63. In order to determine whether the franchisor was likely to coordinate the conduct of its franchisees, the ACCC considered whether the merged entity would have the ability to direct the practices of franchisees, and whether a sufficient incentive was likely to exist to justify such coordination.

*Ability of the franchisor to facilitate coordination*

64. The ACCC considered that the merged entity (as franchisor of both networks) was likely to have the ability to coordinate the conduct of franchisees through the control that it exercises over aspects of the network such as stock purchasing decisions and marketing, combined with the access to information from both networks.

65. The ACCC considered that Video Ezy and Blockbuster were likely to be in a position to control the marketing activities of their networks. The ACCC also considered that franchisees were likely to participate in marketing initiatives where they are strongly promoted.

66. The ACCC considered that this was likely to give the merged entity the ability to exercise a level of influence over the competitive, independent decision making of its franchisees.

67. The ACCC considered that control of the marketing decisions of the networks was likely to give the merged entity an avenue to control the level and frequency of discounting carried out by franchisees.

*Is there sufficient incentive for the franchisor to facilitate coordinated conduct?*

68. The ACCC considered whether sufficient incentive existed to prompt the merged entity to facilitate coordination. In determining whether this incentive existed and its relative strength, the ACCC considered in detail the financial structure of both franchise groups, in particular the various payments made by franchisees to the franchisor. This was necessary because, on the face of it, any benefits from coordination flow directly to franchisees and not the franchisor.

69. Based on the current structure of franchise arrangements only a small amount of any increase in revenues resulting from coordinated conduct among franchisees would be received by the franchisor.[1]

70. Moreover, facilitating such conduct would not be without cost for the merged entity. To implement the conduct, the merged entity would have to adopt a different marketing program in some local markets to that implemented in markets where it faces significant competition. The implementation of a separate marketing program, which would be structured to take advantage of the lack of competitive constraint in certain local markets, would likely require additional resources to those currently in place.

71. The ACCC formed the view that the financial incentives for the franchisor to facilitate coordination at the franchisee level were unlikely to be sufficient for it to seek to facilitate such coordination.

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[1] It is possible that the merged entity may alter the structure of the franchise agreements. While this is possible it would take a considerable period of time and would likely to be opposed by franchisees.

*Coordinated conduct by franchisees*

72. At the franchisee level, market inquiries suggested that some franchisees were of the view that price fixing between franchisees post-acquisition was not illegal. Market inquiries also indicated that the acquisition may facilitate increased interaction between Video Ezy and Blockbuster franchisees.

73. The ACCC considered that a competition concern arose from the potential for franchisees to coordinate their conduct in certain local markets post-acquisition.

*Impact of the Undertaking*

74. The undertaking requires that Video Ezy implement a compliance program whereby Video Ezy and Blockbuster staff, and their franchisees, would receive trade practices compliance training. The training focuses on Part IV of the *Trade Practices Act* 1974.

75. The undertaking also places restrictions on the extent to which confidential information could be transferred between the Video Ezy and Blockbuster networks. The ACCC considered that restricting the flow of such information was likely to ensure the separate operation of the two networks and reduce the extent to which they are likely to coordinate post-acquisition. As part of the undertaking, Video Ezy and Blockbuster staff and franchisees will also receive training on the confidential information obligations in the undertaking. The ACCC was satisfied the compliance program and confidentiality regime would adequately address its competition concerns regarding local rental markets.

## Conclusion

76. On the basis of the above, including taking into account the undertakings, the ACCC formed the view that the proposed acquisition of Blockbuster Australia Pty Ltd by Video Ezy Australasia Pty Ltd would not be likely to result in a substantial lessening of competition in the national market for the wholesale purchase of new release DVDs or in the local markets for the rental supply of DVDs to consumers, in contravention of section 50 of the Act.