



RESPONSE BY BRITISH SKY BROADCASTING GROUP PLC TO THE SUBMISSION TO OFCOM ON THE NEED FOR A MARKET INVESTIGATION INTO THE PAY TV INDUSTRY

INTRODUCTION

1. This response (the “**Response**”) is made by British Sky Broadcasting Group plc (“**Sky**”) in response to the complaint made to Ofcom by British Telecommunications plc (“**BT**”), Setanta Sport Holdings Limited (“**Setanta**”), Top Up TV Europe Limited (“**TUTV**”) and Virgin Media Limited (“**Virgin Media**”), (together the “**Complainants**”) on the need for a market investigation into the pay TV industry, dated 3 July 2007 (the “**Complaint**”).

2. Background

2.1. In January 2007, Ofcom received a combined submission from the Complainants, which asked Ofcom to investigate the pay TV industry and to consider whether to make a market reference to the Competition Commission under the Enterprise Act 2002 (the “**Enterprise Act**”).

2.2. **[CONFIDENTIAL]**

2.3. On 20 March 2007, Ofcom announced its decision to initiate an investigation into the “*pay TV market*”.

2.4. Sky made it clear in correspondence with Ofcom that, so long as Sky did not have access to the entire original version of the Complaint, Sky was not in a position to put its case to Ofcom and rebut the allegations made by the Complainants.

2.5. On 3 July 2007, Sky received the Complaint, which purported to be a non-confidential version of the original version but which clearly contained significant new material including references to events since January 2007 and a report by LECG **[CONFIDENTIAL]**.

3. The Response

3.1. This Response focuses on dealing with the specific allegations against Sky in so far as they can be identified from the Complaint. In addition it addresses the Complainants’ arguments for a market reference. However, the Response is not intended at this stage to provide an exhaustive exposition of Sky’s view of the market or the operation of competition. Where relevant, factual

inaccuracies in the Complaint have been corrected but again not exhaustively; any failure to do so in this Response should not be treated as agreement with that aspect of the Complaint.

- 3.2. It remains difficult for Sky to respond to the Complaint as it appears that parts of it that appear to be substantial have yet to be disclosed to Sky, namely four confidential annexes, which it appears from the non-confidential version contain a series of specific allegations against Sky. There is a clear risk of prejudice arising from the failure to afford Sky an opportunity to respond to such allegations. In particular, in the absence of any comments from Sky, Sky submits that it would be unsafe for Ofcom to rely on such material in deciding what steps it should take at the end of its investigation.
- 3.3. In summary, Sky considers that the Complaint contains a number of serious inaccuracies and when properly tested fails to make out a basis for a market reference.
- 3.4. It goes without saying that Sky reserves its right to amend and/or supplement this Response in the event that it receives fuller details of the Complaint, and/or any further allegations from one or more of the Complainants.
- 3.5. Ofcom has previously indicated to Sky that its inquiry is not limited to or defined by the content of the Complaint. Accordingly, Sky looks forward to addressing any additional matters that Ofcom may raise in due course.
- 3.6. The Response is structured in five parts:
 - A. Executive Summary.
 - B. The Complaint misrepresents the context in which pay TV services are provided.
 - C. The “*vicious circle*” theory is fundamentally flawed.
 - D. Allegations regarding Sky’s conduct are factually inaccurate and misleading.
 - E. There is no basis for a market investigation into pay TV in the UK.
- 3.7. This Response incorporates two Annexes prepared by CRA International: **Annex 3**: a report on the average pay TV revenues per subscriber across Europe; a review of the LECG study annexed to the Complaint; and **Annex 4**: a report on Sky’s ‘incentives’ to foreclose competition in the UK pay TV industry.

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PART A: EXECUTIVE SUMMARY**1. Introduction**

- 1.1. This Response addresses the Complainants' arguments for a market reference. It also deals with the specific allegations made against Sky in the Complaint (in so far as they can be identified, given that Sky has not been given access to the Complaint's confidential annexes).
- 1.2. Sky considers that the Complaint contains a number of serious factual inaccuracies and the arguments within it are flawed. When properly tested, the Complaint fails to make out a basis for a market reference.

2. The Complaint misrepresents the context in which pay TV services are provided

- 2.1. The Complaint considers the provision of pay TV services in a context that is entirely divorced from the reality of the current conditions of competition in relation to the provision of pay TV services in the UK. It completely fails to take into account three extremely important elements of the actual context in which pay TV services in the UK are provided:
- (a) competition between pay TV and free to air television services: the provision of pay TV services is treated in the Complaint as though it exists in a hermetically sealed bubble, free from influence from, or interaction with, other services. This is self-evidently incorrect; all providers of pay TV services face significant competition from, in particular, free to air television services;
 - (b) the profound changes that have occurred and continue to occur at almost every level of the media and communications sectors in the UK. These mean that it is unsafe to rely (as the Complaint invites Ofcom to do) on past inquiries in this area as a basis for either market definition or analysis of the current conditions of competition. In evaluating the Complaint, Ofcom will need to take careful account of the dynamic and innovative nature of the UK audiovisual sector, and the changing nature of the constraints that pay TV operators face; and
 - (c) major regulatory interventions which have been in place for less than a year and which, therefore, it would be premature to write off, as the Complaint does, as being either insufficient or ineffectual.
- 2.2. The Complaint fails to point to *any* detriment to consumers – which should be the focus of any competition policy inquiry – let alone providing evidence to substantiate its allegations.
- 2.3. By common consensus, the UK has one of the most dynamic and innovative audiovisual sectors in the world, delivering very significant benefits to consumers. Yet the Complainants seek to present evidence of harm to

consumers in the form of an econometric study by LECG which purportedly shows that consumers in the UK are not well served by the way in which the sector currently operates.

- 2.4. In fact, as shown in a report by CRA and Professor John Van Reenen annexed to this Response, the LECG study suffers from numerous and significant flaws, which render it unfit for purpose. Any one flaw would significantly compromise the reliability of the study. Cumulatively, they mean that no weight at all can be given to its conclusions.

3. The “*vicious circle*” theory is fundamentally flawed

- 3.1. The Complainants advance a theory of a “*vicious circle*”, which they claim results in the prevention, restriction or distortion of the competitive process in the pay TV industry. Its essence appears to be claims that: (i) Sky’s success in attracting subscribers at the downstream level (itself alleged to be a function of its success as a pay TV broadcaster) creates a “*competitive advantage*” at the upstream level; and (ii) Sky’s success as a pay TV broadcaster creates a “*competitive advantage*” for its retail business in attracting pay TV subscribers. As Sky demonstrates in **Part C** of this Response, this theory is fundamentally flawed.

- 3.2. The Complaint attempts to make a case for a reference of the alleged pay TV market for investigation by the Competition Commission under the Enterprise Act and intervention at all levels of the supply chain. A review of the Complaint, however, reveals that in fact it identifies only one “*feature*” said to be capable of justifying a reference to the Competition Commission (or some other regulatory intervention in lieu thereof): the “*vicious circle*”. The notion of a “*vicious circle*” is therefore crucial to the Complainants’ case for reference.

- 3.3. Yet the “*vicious circle*” does not withstand even a cursory analysis. It suffers from fundamental flaws in logic and reasoning and is, in fact, a fictitious circle, invented by the Complainants to sustain their unsubstantiated theories of harm, and to attempt to bolster a case for regulatory intervention at all levels of the supply chain, reflecting their divergent interests in this case. When the circle collapses, so too does the case for regulatory intervention.

- 3.4. A report by CRA and Professor John Van Reenen, provided as **Annex 4** to this Response, supports this conclusion. The report comments specifically on the allegations in the Complaint regarding Sky’s incentive (and ability) to foreclose competition. It shows that the fundamental arguments put forward in the Complaint for the existence of the alleged “*vicious circle*” are flawed:

- (a) there is no downstream foreclosure: due to economies of scale at the broadcasting level and consumer preferences to use different platforms, Sky has strong incentives to make its channels available on other platforms, which may be expected, in both theory and practice, to outweigh any potential gains from foreclosure of other retailers;
- (b) nor is there upstream foreclosure: there are no clear foreclosure effects in the acquisition of content because neither access to the DTH platform

(which is the subject of regulation), nor the current number of subscribers to Sky's retail packages, prevent other broadcasters from bidding for and winning content: any hypothetical advantage developed in the Complaint arises almost entirely from Sky's existing position as a broadcaster rather than any aspect of its vertical integration; and

- (c) the concepts of "*feedback effects*" and "*mutually reinforcing upstream and downstream bottlenecks*", which comprise key elements of the vicious circle theory are also shown to be unfounded.

3.5. The report concludes that the foreclosure mechanisms set out in the Complaint are speculative, and the "*vicious circle*" theory is unsubstantiated.

4. Allegations regarding Sky's conduct are factually inaccurate and misleading

4.1. The Complainants claim that Sky's past conduct vis-à-vis its competitors confirms that Sky has both the incentive and the ability to foreclose competition, both downstream and upstream.

4.2. As Sky demonstrates in **Part D** of this Response, there is no substance to the Complainants' allegations of anti-competitive conduct by Sky: they are, at best, mischaracterisations and, at worst highly misleading.

4.3. Crucially, even if the allegations were, in fact, accurate, the failure on the part of the Complainants to adduce any evidence as to detrimental effects on competition means that those allegations do not demonstrate any ability on Sky's part to foreclose competition, thus undermining any claim that Sky has an incentive to foreclose competition.

4.4. It is also evident that the Complainants perceive regulatory intervention as a viable alternative to engagement in meaningful and genuine commercial negotiations with Sky. The Complainants appear to be using the threat of regulatory intervention to achieve a better commercial outcome and using commercial negotiations to generate 'evidence'. Either way, this is clearly regulatory gaming. Ofcom should, therefore, fundamentally question the credibility and motivation of the Complainants.

5. There is no basis for a market investigation into pay TV in the UK

5.1. Sky submits that:

- (a) Ofcom as the sectoral regulator with specialist knowledge and skills should examine the Complainants' case fully and critically before deciding whether the Complaint discloses "*reasonable grounds*" to justify a reference and, if so, whether any discretion to make a reference should be exercised;
- (b) there are no "*reasonable grounds*" for suspecting that some feature or combination of features of the market prevents, restricts or distorts competition; and

- (c) this is not in any event a case which is suitable for a market investigation.
- 5.2. Furthermore, Ofcom should treat with the utmost scepticism any hypotheses that competition is ineffective, which are inconsistent with the stated competitive strategies and views of the Complainants. Sky believes that the Complainants seek to use the threat of a structural separation of Sky to extract specific commercial benefits in relation to areas of commercial dealings with Sky. Ofcom should be alert to the possibility that a key motivation of the Complainants is simply to disrupt Sky's competitive efforts at a time when it faces ever more aggressive competition.
- 5.3. The sector in question is dynamic and fast-moving and, as such, any intervention runs a greater risk of having unintended consequences, such as might compromise the success of future innovation, for example.
- 5.4. It follows from what is said above that Sky considers that the Complaint fails to make out a sufficient case to justify Ofcom's concluding that there are "*reasonable grounds*" to found a market investigation reference pursuant to Section 131 of the Enterprise Act.
- 5.5. However, even if that is wrong, it is clear that this is not a suitable case for reference. In particular:
- (a) the Complainants fail to recognise the appropriateness of the exercise by Ofcom of its regulatory powers under the Communications Act to address problems that they have allegedly identified; and
 - (b) the Complainants are seeking a market investigation of a single firm which is not the purpose of Section 131 of the Enterprise Act. In essence the Complainants' objection is to the success of Sky as a broadcaster and it is very clear that the purpose of the market investigation regime is not to address the market position of a single firm.
- 5.6. Nor is it otherwise appropriate for Ofcom to exercise its discretion to refer the present case to the Competition Commission.
- 6. Conclusion**
- 6.1. There is no reason to believe that the Complainants' misconceived, exaggerated and cynically self-serving Complaint necessitates a Competition Commission investigation.

PART B: THE COMPLAINT MISREPRESENTS THE CONTEXT IN WHICH PAY TV SERVICES ARE PROVIDED

1. Introduction

- 1.1. The Complaint considers the provision of pay TV services in a context that is entirely divorced from the reality of the current conditions of competition in the UK in relation to pay TV services. In particular, it fails to take into account two extremely important elements of the actual context in which pay TV services in the UK are provided: (i) competition between pay TV and free to air television services; and (ii) significant and ongoing changes at almost every level of the audiovisual sector in the UK.
- 1.2. Furthermore, the Complaint dismisses as inadequate significant recent regulatory interventions in the sector, the effects of which have not yet had an opportunity properly to be seen. It is premature to claim, as the Complainants do, that these interventions are insufficient or will be ineffective.
- 1.3. Finally, in the face of voluminous, readily-available evidence about the dynamism and innovativeness of the UK audiovisual sector, the Complaint seeks to support its claim that consumers are being harmed by the way in which the sector currently operates with an econometric study by LECG that purports to show that: (i) charges for pay TV services in the UK are above the European average for such services; and (ii) this can be ascribed to the structure of the market in the UK. The LECG study, however, is fundamentally flawed and does not support the Complaint's allegations.

2. The importance of free to air television services

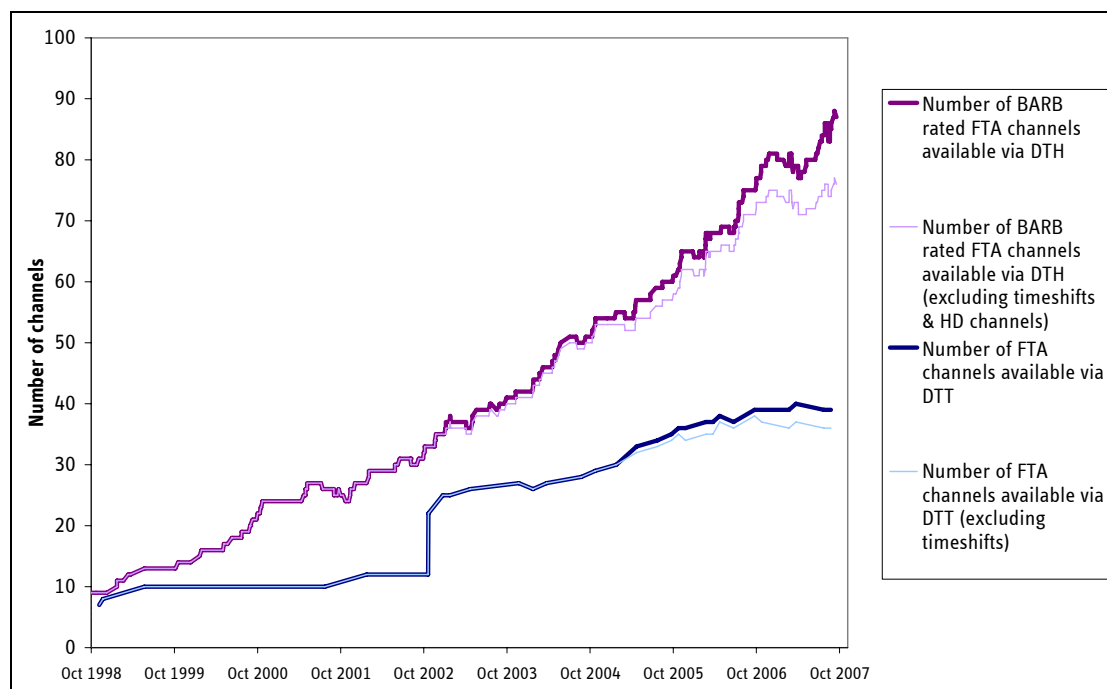
- 2.1. The provision of pay TV services is treated in the Complaint as though it exists in a hermetically sealed bubble, free from influence from, or interaction with, other services, as if the only competition faced by providers of pay TV services is from other providers of pay TV services.
- 2.2. This is self-evidently incorrect. All providers of pay TV services face significant competition from, in particular, free to air television services.¹
- 2.3. Consumers in the UK now have access to a vast range of high quality free to air television services, available via a range of platforms. **Table 1** sets out the current distribution of services and households in relation to free to air television services, while **Chart 1** shows the increase in the number of free to air television services available via DTH and DTT since 1998.

¹ Many also face significant competition from the provision of audiovisual programming on pre-recorded formats – most notably DVDs. This is particularly the case for pay TV operators (at both the channel provider and retailer levels) for whom movies are a significant component of their service. It is less relevant in relation to services such as Sky Sports, or Setanta, whose principal focus is on broadcasting live events.

Table 1: Availability of free to air (“FTA”) television services, by platform, as at October 2007

Platform	No. FTA channels	Number of UK households able to access services
Analogue terrestrial (BBC1, BBC2, ITV1, C4)	4	25.4 million ²
Analogue terrestrial (five)	1	c.20.3 million
Digital terrestrial television (DTT)	39	c.12.9 million ³
Direct to home (DTH)	200+	c. 9 million

Source: Ofcom, Sky data

Chart 1: Increase in number of free to air (“FTA”) TV channels available via DTT and DTH in the UK, 1998 – 2007.⁴

Source: Sky analysis

² Clearly, this number will decline as analogue switch-off progresses.

³ Within this figure, DTT is the sole means of access to free to air multichannel services for around 9.1 million households.

⁴ We have limited the DTH channels included in this chart to BARB rated channels thereby eliminating free to air channels such as home shopping channels, quiz and gaming channels and adult channels.

- 2.4. Competition between pay TV and free to air television derives from the fact that they are economic substitutes – they are both used to satisfy consumers’ demands for audiovisual entertainment, information and education. While this basic interrelationship between the two services can be set out in a more formal way,⁵ the intuition behind it is fairly straightforward.
- 2.5. Competition for viewing is, essentially, a zero sum game. This derives from fixity in the amount of time that people devote to watching TV – people do not tend to expand the time they devote to watching TV the more channels they have available to them.⁶
- 2.6. Clearly, consumers prefer to fulfil as much of their desired TV viewing from ‘free’ channels as possible and, together with the fixity of their total demand for viewing, this means the more they are able to do so, the weaker their demand (or willingness to pay) for pay TV services.⁷ In order to attract and retain subscribers, pay TV retailers must offer consumers a service which offers them programming over and above *the aggregate of that which is available to them free to air*, which they are willing to pay to view.
- 2.7. Once a household chooses to take up a pay TV subscription, subscribers switch some of their viewing to the additional channels that they receive, away from free to air television services. Substitution in viewing, however, is of critical importance to broadcasters of free to air television channels. Audiences are the lifeblood of free to air television, directly determining advertising revenues for commercial channels. Accordingly, households taking up a pay TV subscription, and switching some of their viewing to the additional channels that they then receive, creates additional competition to that which free to air broadcasters already face from other free to air broadcasters.⁸

⁵ See **Annex 1**.

⁶ See the chart at **Annex 2**. There is a strong seasonal pattern in the amount of time spent watching TV. In his speech to the 2007 Edinburgh International TV Festival, Kevin Lygo said: “In 1997 people watched 25 hours of television a week. In 2006 this figure was almost identical.” See: <http://image.guardian.co.uk/sys-files/Media/documents/2007/08/24/KLspeech.pdf>. Particularly among younger population groups other activities – notably online activities and playing video games – appear to be competing with television viewing time. See, for example, BBC research at: <http://www.bbc.co.uk/commissioning/marketresearch/audiencegroup2.shtml> and Ofcom’s reports “The Communications Market 2006” at p.257 and “The Communications Market 2007”, at pp.163-4. If this is the case, it increases the competitive pressure on providers of all television services.

⁷ Clearly, this substitutability is of direct relevance at the retail level of the market. However, it also acts indirectly at the wholesale upstream (channel provider) level of the market. (The observation that such a constraint is indirect should not be taken to mean that it is weak.)

⁸ Clear evidence of this switching arises from comparing viewing shares of free to air channels in DTT households with the viewing shares of the same channels in cable and pay DTH households where consumers have a greater choice of television services available to them. Viewing shares for free to air channels are substantially higher in DTT homes than in cable and pay DTH homes. Broadcasters like ITV make no secret of their preference for households adopting DTT rather than cable or DTH for this reason. See, for example, Charles Allen’s comments to the House of Lords Select Committee on the BBC Charter Review, at p.29 of <http://www.publications.parliament.uk/pa/ld200506/ldselect/ldbbsc/999/bbc0712.pdf>.

- 2.8. Free to air broadcasters have two main competitive weapons in their fight for audiences: creating more channels and creating better channels; both types of investments serve to undermine the attractiveness of pay TV. This, in turn, requires pay TV retailers to compete harder for subscribers – through better offers, keener pricing, innovative services, new packages and, most importantly, better content – which in turn leads to increased competition to free to air broadcasters, and so on.⁹
- 2.9. Competition inquiries in the past have accepted this interplay between the two types of service, but have generally concluded that the interaction is not sufficient to regard them as being supplied within a single relevant market.^{10,11} In Sky's view, in light of the very significant growth in the number of households which receive free to air multichannel television (now over 70%¹² of UK households and increasing rapidly), and an enormous growth in the range of free to air television services available to consumers (see Chart 1 above), such a conclusion is no longer sustainable.
- 2.10. Pay TV and free to air broadcasters also compete upstream, for example in relation to the acquisition of content and managerial and on-screen talent, and (in the case of commercially funded broadcasters) compete with each other in relation to advertising airtime sales.

Free provision of content via the internet

- 2.11. There is also a substantial and rapidly increasing range of audiovisual programming provided (legally) for free via the internet. It includes a large range of types of content – from news and sports clips, through to movies and whole television series. (There is also a large and increasing range of 'user-generated content' available – notably via sites like YouTube, Yahoo! Video and Current TV). Such content is provided: (i) via entirely new internet-based free 'television' services, such as Joost and Babelgum; (ii) via 'on demand' services which enable specific content – the majority of which has also been broadcast via linear television services – to be downloaded or streamed by users; and (iii) by 'simulcasting' of television channels via the internet.

⁹ This competitive dynamic was set out by ITV in its main submission to the Competition Commission in the inquiry into Sky's stake in ITV. See Paragraphs 7.13 – 7.19 in ITV's Main Submission, available at: http://www.competition-commission.org.uk/inquiries/ref2007/itv/pdf/main_party_submission_itv_competition.pdf.

¹⁰ See, for example, Paragraph 161 of the *BSkyB Investigation, alleged infringement of the Chapter II prohibition*, OFT, 17 December 2002, which stated: "...the Director does not contest (and has never contested) the view that free-to-air channels constrain the prices of pay TV channel packages to some extent". If this was the OFT's conclusion before the advent of Freeview, the effect of Freeview must now be sufficient to place the two type of service in the same market.

¹¹ It is Sky's view that such conclusions typically amounted to assertions in the past as they were not adequately supported by relevant evidence.

¹² This figure excludes subscribers on digital television platforms other than DTH and DTT (notably cable subscribers) as the concept of free to air television services does not apply to these platforms.

- 2.12. A very substantial range of broadcasters now offer such services. In the UK the terrestrial broadcasters are at the forefront of such developments with sites and services which provide content on a free basis, such as ITV.com, the BBC's iPlayer and Channel 4's '4OD' service in which they are investing heavily¹³ and promoting extensively from their linear channels.¹⁴
- 2.13. Over 10 million UK households have broadband internet access, which enables them to use these video services.
- 2.14. Again, these developments expand the range of 'free' programming available to consumers, diminishing their willingness to subscribe to pay TV services.¹⁵ Currently, the extent of substitutability of such services with mainstream television services is limited by the fact that they are delivered predominantly to computer screens rather than television sets. However, consumers' use of such services is being facilitated by the development of digital media adaptors ("DMAs") – most notably Microsoft's Xbox and Apple TV¹⁶ – which enable video downloaded from the internet to be viewed on television sets, and which with increasing take-up will further increase the competitive constraint free services place on pay TV services.¹⁷ In the medium term, it will become less and less relevant how content is delivered into the home.¹⁸

3. The extent of change in the sector

- 3.1. The Complaint does not take into account at all the profound changes that have occurred and continue to occur in the media and communications sectors. The nature and significance of such changes will be very familiar to

¹³ For example the development of ITV.com, from which ITV aims to earn £150m by 2010, is central to ITV's recently announced strategy – see <http://www.itvplc.com/itv/news/releases/pr2007/2007-09-12>. For evidence of the importance placed on internet distribution of content by the BBC see speech by Ashley Highfield, at the FT New Media and Technology conference in 2004, available at: http://www.bbc.co.uk/pressoffice/speeches/stories/highfield_ft.shtml.

¹⁴ Many pay TV broadcasters also offer programming for free via their web sites (for example, UKTV's site at <http://uktv.co.uk/uktv/videoatoz/sid/5000>) and many broadcasters (both pay and free to air, including Sky and the BBC) also upload content to sites such as YouTube.

¹⁵ Some evidence of this substitutability has been found by the BBC. See: <http://news.bbc.co.uk/1/hi/entertainment/6168950.stm>.

¹⁶ For a description of Apply TV see: http://store.apple.com/Apple/WebObjects/ukstore/?family=AppleTV&cid=OAS-EMEA-KW-UK-TV-UK&aosid=p202&esvt=GOUKE100819837_&esvadt=999999-0-1014022-1&esvid=100619.

¹⁷ See Paragraph 1.31 in Ofcom's Market Impact Assessment of the BBC's on demand proposals which stated: "*Initially, most of the substitution [caused by the introduction of the BBC's service] is likely to be away from other internet services, such as streamed and downloaded video-on-demand (VOD), and from DVDs. Over time, as home hubs (i.e. devices that enable viewers to watch internet content on their TVs) become more popular, there is likely to be a growing amount of substitution away from broadcast, cable and satellite TV services, and from PVRs.*" Ofcom, January 2006. Available at: http://www.ofcom.org.uk/research/tv/bbcmias/ondemand/bbc_ondemand/bbc_ondemand.pdf.

¹⁸ Ofcom itself has stated that "*for the last four years there have been signs that use of the internet may be starting to substitute to some extent for broadcast media.*" Communications Market Report, Ofcom, 23 August 2007, p.17.

Ofcom, as there is hardly an Ofcom publication that does not cite them. For example:

Ofcom's 2007 'Communications Market' report, which stated:

"In recognition of the changing shape of the communications sector, we have altered the structure of this year's Communications Market Report. More and more operators are providing services which cross the traditional boundaries of communications; for example telecommunications operators are offering content over their infrastructure, and broadcasters are using the internet and mobile platforms for distribution. And consumption habits are changing too. We believe that this calls for a new approach on how Ofcom reports market developments."

Ed Richards' comments at Ofcom's inaugural analysts' briefing:

"It is a very good time to be talking about broadcasting from where we sit, because obviously the sector is undergoing tremendous change. Digital television is now in well over 80% of homes and that number is steadily rising.... Convergence in broadcasting is now steadily taking shape with the launch of IPTV, mobile TV, the growth of on demand programming and of course the use of increasingly powerful digital video recorders (DVRs)."

And Ed Richards' comments in the introduction to Ofcom's publication entitled 'Communications, the Next Decade':

"The reality of convergence - and the sweeping transition, from analogue to digital technologies - is radically changing the communications sector.

*New corporations, which have come into being over the past decade, are already global, multibillion pound businesses. They're offering new services over new platforms to meet previously hidden demand, requiring longer-established players to reassess and adapt their business models to meet consumer demands in today's rapidly changing marketplace."*¹⁹

3.2. Although numerous other such views on the same lines could be cited, we cite here one other representative example:

"It is doubtful that, with the exception of TV's first ten years ... any decade has seen such rapid shifts in broadcasting as this last one. Ten years ago, remember, there were only five terrestrial channels. When I first joined C4 ten years ago special permission was needed to gain access to the internet. In 1997 BBC1 and ITV took almost 62% of the available audience.....Nine years on, the share of BBC1 and ITV1 combined had fallen to 43%.

With the emergence of new platforms, the established broadcasters have responded by creating new channels and by seeking other sources of revenue....

¹⁹

"Communications, the Next Decade", Ofcom, November 2006.

.... everyone in television knows that the audience is more demanding than ever. A new kind of audience has emerged. Home ownership of PCs, broadband internet, DVDs, digital cameras and ipods have created a sense of immediacy and entitlement that is new. The audience knows what it wants, is technologically literate enough to be able to find it, and expects it on-demand.”²⁰

- 3.3. Such rapid and pervasive change is important in the context of an assessment of the Complaint for two reasons.
- 3.4. First, it argues for a cautious approach to the Complaint. In sectors that are subject to significant ongoing change there is generally less need for regulatory intervention – let alone the extensive intervention of the type called for by the Complainants. Change creates opportunities for new entry and expansion, and means that even firms with well-established positions must continue to strive to serve consumers well and stay ahead of their actual and potential competitors, the set of which is likely to be increasing.²¹ Furthermore, the potential detriments to consumers from unintended consequences of intervention in fast-moving sectors can be very significant²² – for example it can result in increased costs, slower innovation and/or slower diffusion of innovations.²³
- 3.5. Second, such changes mean that it is unsafe to rely on past inquiries in this area as a basis for either market definition or analysis of the current conditions of competition in the relevant sectors.
- 3.6. This is the case even in relation to the OFT’s decision, “BSkyB investigation: alleged infringement of the Chapter II prohibition”, which was published in December 2002 (the “**OFT Decision**”). While the investigation that led to the OFT Decision ran from March 2000 to December 2002, its focus was the period between January 1998 and December 2001.²⁴ The rapid pace and pervasiveness of change in the sectors in which Sky operates means that, although this period is now just under six years ago, it has little or no

²⁰ Speech by Kevin Lygo, *op. cit.*

²¹ “Over the last year players from historically different parts of the communications industry have joined forces to take advantage of converging markets. These ranged from straightforward acquisitions, to exclusive partnerships, to the bundling of products and services from different parts of the value chain: content and rights, packaging, distribution, device, navigation and consumption.” Communications Market Report, Ofcom, 23 August 2007, pp.20-21.

²² See, for example, J.A. Hausman, “Valuing the Effect of Regulation on New Services in Telecommunications”, Brookings Papers on Economic Activity, Microeconomics, 1997. Hausman found that the cost to consumers of regulatory interventions which delayed the introduction of mobile telephony services in the U.S. was close to \$100 billion.

²³ In common with all sectors, whether fast-moving or otherwise, undue attention by regulators to self-serving complaints also encourages firms to devote resources to seeking commercial advantage through regulation, rather than focusing their efforts on competing on the merits and serving consumers well, which can also lead to significant economic detriment.

²⁴ See the chart at Paragraph 543 of the OFT Decision.

relevance to the conditions of competition that exist today either in pay TV, or the audiovisual sector in the UK more generally.²⁵

- 3.7. Some of the most prominent changes in these sectors that have occurred since 2001 are:
- (a) the launch of Freeview and the rapid take-up of use of DTT services by UK households – Freeview did not exist in the period examined by the OFT. It is now in nearly 13 million UK homes, and the principal source of television for over 9 million homes;
 - (b) rapid growth in the DTH platform;²⁶
 - (c) continued proliferation in the number of television channels available in the UK, both free and pay.²⁷ In particular, the period since 2002 has seen the adoption by ITV, Channel 4 and five of a strategy of developing a portfolio of channels in order to minimise the loss in their viewing share to competing services. UK consumers can now receive a range of high quality, well-funded and heavily promoted new free to air channels, such as E4, More4, Film 4, ITV2, ITV3, ITV4, five life and five US;²⁸
 - (d) exit of ITV and Channel 4 from the supply of pay TV channels to focus entirely on providing free to air services;
 - (e) the emergence of Setanta as a pay TV sports broadcaster whose channels include, from August 2007, broadcasts of live Premier League football matches, together with a wide range of other sports events including the US PGA Tour golf and, from next year, FA Cup and England international football matches (and whose channels are positioned as basic channels in Virgin Media’s pay TV packages);²⁹

²⁵ In this context, the Complainants’ credibility is undermined by their failure to advance any positive arguments as to why inquiries which pre-date the OFT Decision, cited by them at Part 3, Paragraph 2.2 of the Complaint – including inquiries as far back as 1996 – remain relevant given the very substantial changes that have since occurred. Similarly, it is Sky’s view that simply to cite past cases which relate to pay TV in other countries (as the Complaint does), without consideration of whether the facts of each case make them relevant precedent in light of the conditions of competition that are found in the UK today, is equally flawed. In Sky’s view the fact that the majority of these cases are old in addition to the fact that they relate to different countries means that it is entirely unsafe to rely on them in any way in assessing the Complaint.

²⁶ At the end of 2001, there were approximately 5.5 million households on the DTH platform. There are now over 9 million households on the platform.

²⁷ See Chart 1 above in relation to the number of free to air television channels.

²⁸ For a commentary on the success of this strategy see Section 4.1.1 (“Strong performance by networks’ spin-off channels”), in ‘The Communications Market’, Ofcom, August 2006. Channel 4 also converted Film 4 into a free to air television service in July 2006.

²⁹ This fact alone undermines the relevance of the market definitions adopted in the OFT Decision, in which the OFT found a separate market for premium sports channels on the basis that certain

- (f) very significant changes to the distribution and consumption of movies, including:
- a huge expansion in the number of movies available on free to air channels;³⁰
 - a massive expansion in the take-up and use of DVDs (both via purchase and rental) by consumers with the price of DVDs falling very considerably;^{31,32}
 - proliferation in DVD sales and rental options, notably via online services, with many online rental services comprising subscription services;³³
 - an increasing number of ‘true’ video on demand (“**VOD**”) movie services (notably those provided by Filmflex³⁴ on Virgin Media’s network, BT Vision on BT’s IPTV network and both Picturebox³⁵ and Tiscali on Tiscali’s IPTV network); and
 - an increasing number of download-to-own and download-to-rent services provided via the internet;³⁶

content “*is unique to premium sports pay TV channels*”, of which the Director General identified only live FAPL football (see Paragraph 37, for example, of the OFT Decision.

³⁰ In 2001, there were 3,126 screenings of movies on free to air channels tracked by BARB. In 2006, there were 21,936 screenings on such channels. This includes Film4 only after it became free to air in July 2006. Figures exclude timeshift channels and second screenings of the same movie on the same day on the same channel.

³¹ Between 2002 and the end of 2006 penetration of DVD hardware rose from 25% to 80% of UK households, DVD sales increased by 150% in volume and 75% in value, and DVD rentals approximately doubled in both volume and value. The difference between DVD sales as measured by value and volume reflects very significant falls in the retail prices of DVDs.

³² The OFT Decision cites Sky as submitting that “*more recently, films have also become available to rent (and purchase) on DVDs*”, which again indicates that the evidence presented during that investigation is now significantly out of date. See Paragraph 194 of that decision.

³³ There are currently more than 20 UK online DVD rental sites, including: Lovefilm which launched in May 2002, and has over 60,000 movies and television shows available, with 340,000 UK subscribers in Q1 2007); Amazon (which launched its service in December 2004 and offers 40,000 titles); Blockbuster (which introduced its online rental service in September 2002, and offers 50,000 titles); Mymoviestream (launched early 2005, offering 40,000 titles) and Cinema Paradiso (launched 2003, with 35,000 titles). Lovefilm also provides a white label service for other brands including Tesco, WH Smith, easyCinema and Odeon Direct.

³⁴ Filmflex is a joint venture between Sony, Disney and the ONDemand Group.

³⁵ Picturebox is a VOD movie service provided by Universal. Picturebox also provides a subscription ‘push VOD’ service (where movies are downloaded to a PVR) on the DTT platform.

³⁶ These include Lovefilm (which launched its movie download service in November 2005), Movies Now (launched May 2007), Wippit (movie download service launched July 2006), Vizumi (launched August 2007), Empire Movie Downloads and 4 On Demand (4OD). Sky also enables its subscribers to packages including its movie channels to download movies in the pay TV window.

- (g) introduction and take-up of new technologies, such as:
- delivery of audiovisual programming over the internet;
 - personal video recorders (“PVRs”);
 - high definition (“HD”) television; and
 - mobile TV.
- (h) consolidation through mergers of ITV and cable, with ntl/Telewest subsequently merging with Virgin Mobile, and being rebranded as Virgin Media, and the restructuring of cable’s balance sheet which has strengthened its financial position;
- (i) adoption by ntl and subsequently Virgin Media of an ‘off-net’ strategy – *i.e.*, offering services to consumers outside cable areas via LLU;
- (j) Sky’s transformation to become a multi-product business operating in both the television and communications sectors, via its purchase of Easynet and subsequent investments in local loop unbundling;
- (k) the development and launch of BT’s hybrid Freeview/IPTV platform;
- (l) changes in products offered to consumers, such as:
- changes in pay TV packages;³⁷
 - an increasing range of VOD services;
 - introduction of ‘catch-up TV’ services;
 - an increasing prevalence of the provision of television services as part of a package of services, notably communications services such as telephony and broadband services (as pioneered by cable). Such packages are now provided by Sky, BT and Tiscali, with Virgin Media extending also into the provision of mobile telephony services;³⁸ and
- (m) changing consumer demands, with increasing demands for control, flexibility and mobility with respect to consumption of audiovisual

³⁷ In particular, in 2005 Sky undertook a very significant repackaging and re-pricing of its basic channel packages in order better to compete with free to air services. This involved (a) a move to genre-based “Mixes”, and (b) the introduction of a range of attractive price-points below the charge for its all-inclusive Six Mix/ Big Basic package.

³⁸ The rapid convergence of the television and communications sectors is resulting in significant increases in competitive pressure, in both directions. Sky’s 2 Mix basic package, including Sky’s Base 2Mb/s broadband package for £17 a month, now costs less than using Freeview and taking a 2MB/s broadband service from BT (at £17.99 a month). This highlights the danger that would arise from examining, for example, charges for pay TV services in isolation, without adequate consideration of the competitive context in which such services are now provided.

services, consumption of increasingly high bandwidth services, and involvement in content production.³⁹

- 3.8. Accordingly, in light of such substantial changes, past inquiries – particularly those from the last century cited by the Complainants – are now of historic interest only and should not form any part in an analysis of either issues concerning market definition or the current conditions of competition in relation to the provision of pay TV services.
- 3.9. Moreover, it is evident that the pace of change shows no signs of slowing. In particular, there is ongoing expansion in the means of distribution of content to end-users, with Tiscali rolling out a nation-wide IPTV network, the BBC and ITV launching an additional DTH platform, and the prospect of major investments in ‘Next Generation Access’ which would significantly boost the already rapidly expanding capability of the internet as a mode of distribution for video services.
- 3.10. Indeed, expansion in the use of the internet as a means of distributing audiovisual programming to end users appears likely to give rise to very significant changes in the sector. This view is encapsulated in a contribution to Ofcom’s recent symposium on changes in the sector in the next decade – itself motivated by recognition of the profound changes currently occurring, as evidenced in the quote from Ed Richards’ introduction, cited above – which stated:

“Life after broadcasting

The problem is that the business model that supports broadcast is based on its ability to attract and hold mass audiences. Once audiences become fragmented, the commercial logic changes. And, to compound the difficulty, new technologies have emerged such as Personal Video Recorders (PVRs), which record onto hard drives rather than tape and are much easier to programme. They’re enabling viewers to determine their own viewing schedules and – more significantly – to avoid advertisements.

Note that when I say that broadcast TV is declining, I am not saying that it will disappear. That’s what the computer scientist John Seely Brown calls ‘endism’, and it’s not the way ecologists think. Broadcast will continue to exist, for the simple and very good reason that some things are best covered using a few-to-many technology. Only a broadcast model can deal with something such as a World Cup final or news of a major terrorist attack – when the attention of the world is focused on a single event or a single place. But broadcast will lose its dominant position in the ecosystem, and that is the change that I think will have really profound consequences for us all.

What will replace it? Simple: the ubiquitous internet.”⁴⁰

³⁹ See the speech by Ed Richards on 17 October 2007 for a summary of these trends. Available at: <http://www.ofcom.org.uk/media/speeches/2007/10/annuallecture>.

- 3.11. Robin Foster, in his report to the Secretary of State for Culture, Media and Sport on future broadcasting regulation reaches similar views on the growth in the importance of the internet.⁴¹
- 3.12. It is important to emphasise, however, that this is not arriving at some point in the distant future; as described above, broadcasters are making substantial investments today in delivery of content to end users over the internet, and the number of services (legally) providing audiovisual content over the internet is already substantial and increasing rapidly.
- 3.13. A particular strength of services that provide audiovisual programming via the internet, and hybrid Freeview/IPTV services such as BT Vision, is that they enable consumers to mix and match paid for content on an on demand basis, with a wide range of free content. Augmenting this with PVR technology – enabling viewers to store libraries of content which they can also turn to if there is nothing being broadcast which they want to watch – creates a highly marketable alternative to a pay TV subscription.
- 3.14. Accordingly, in evaluating the Complaint, Ofcom will need to take careful account of the dynamic and innovative nature of the UK audiovisual sector, and the changing nature of the constraints that pay TV operators face.

4. Recent regulatory interventions

- 4.1. Whilst the Complaint ignores free to air television services and the significant changes occurring in the sector, it does acknowledge the fact that there have been several recent major regulatory interventions in relation to pay TV, most notably (i) Ofcom’s extensive review of Sky’s terms for the provision of services such as conditional access, which resulted in a new, prescriptive approach to regulation; and (ii) the European Commission’s requirement that the FAPL sell packages of rights to broadcast live Premier League matches to more than one broadcaster.
- 4.2. The Complaint, however, claims that the former intervention is “*insufficient*”,⁴² and dismisses the latter as not solving the alleged “*problem*” of the alleged “*vicious circle*”.⁴³

⁴⁰ John Naughton, “Our changing media ecosystem”, in Section 1: Trends and Challenges in ‘Communications, the Next Decade’, Ofcom, November 2006.

⁴¹ *Future Broadcasting Regulation, An independent report by Robin Foster commissioned by the Department for Culture, Media and Sport*. DCMS, January 2007. Available at: <http://www.culture.gov.uk/NR/rdonlyres/A86E7A41-52F2-452B-B9BF-EB08B5E0EFFF/0/FutureBroadcastingRegulation.pdf>.

⁴² Criticism by Virgin Media of Ofcom’s regulation of Sky’s charges for ‘Technical Platform Services’ is particularly ironic, in view of the fact that Virgin Media operates a closed platform and therefore, unlike Sky, does not make such services available to third parties on any terms.

⁴³ See, for example, Part 5, Paragraph 2.8 and Part 6, Paragraph 3.12 of the Complaint. Sky notes that allegations about the flaws in such regulation are contained only in confidential annexes to the Complaint.

- 4.3. The former intervention took effect in January 2007, while the latter took effect from the start of the 2007 football season, in August 2007. Accordingly, both these interventions have been in place for less than a year.⁴⁴ In such circumstances, it would be entirely premature to write off these interventions as being either insufficient or ineffectual.

5. Effective competition within the pay TV sector

- 5.1. While it is essential to a proper assessment of the Complaint to examine it within an appropriate context, it is Sky's view that the Complaint's central allegation - that other firms within the narrow pay TV sector are unable to compete effectively with Sky on the merits - does not bear scrutiny. In particular, the Complainants' claim (for the purposes of the Complaint) that there is not effective competition at every level of the supply chain in pay TV, is belied by actual evidence. For example:

- (a) while Setanta likes to portray itself as an "*embryonic*"⁴⁵ (and therefore weak) competitor, this is clearly false. Setanta is an experienced, well funded pay TV sports broadcaster, operating at an international level.⁴⁶ In the UK, where it has operated as a sports broadcaster for over five years, it now has a well established brand and a subscriber base for its channels which is likely to be over 2 million households across a range of platforms. It is vertically integrated into pay TV retailing and is the only pay TV sports broadcaster currently permitted to offer services on the DTT platform. Allegations about difficulties in competing with Sky for sports rights are at odds with its attractive (and expanding) portfolio of sports rights;
- (b) in the case of Virgin Media, there are almost daily statements by its management about its competitive advantages in competing with Sky. For example, during the call with analysts about Virgin Media's second quarter 2007 results, Virgin Media's management stated:

"We have now, in my opinion, the most superior pay-TV basic service in the UK. For avid sports fans, Virgin Media is the only place that [they] can watch all the 138 Premier League games through one single provider."

"I just want to repeat one thing I said: remember, 20Mbps broadband, 50Mbps broadband and 100Mbps broadband, which only cable can do, will become more important every day as we build the

⁴⁴ Sky notes that the Complainants submitted the original version of the Complaint to Ofcom some eight months before the latter intervention was even set to affect the market. Further, it would appear that one of the Complainants, Setanta, concluded that the intervention was insufficient before it had even broadcast FAPL content in which it had invested £392 million (over three years).

⁴⁵ See Paragraph 8 of the summary of Setanta's hearing at the Competition Commission in relation to the Competition Commission's inquiry into Sky's purchase of a stake in ITV. Available at: http://www.competition-commission.org.uk/inquiries/ref2007/itv/hearing_summaries.htm.

⁴⁶ Setanta is backed by very large private equity firms.

content that goes through those pipes. That's why we're focused so strongly on that in terms of getting that content into the customers' homes across the multiple platforms – across the Mobile platform, across the broadband platform, and across the pay-TV platform. We are uniquely positioned to capitalise on that, which is why Sky has spent so much money defending their space on broadband and telephony, and basically giving those products away.”

“If I now turn to the V+ box, the second TV product success, this is simply the best DVR in the market and has been labelled as such by Consumer magazine.... the V+ box improves ARPU and reduces churn and, in combination with our VOD service and enhanced content, makes our TV platform more attractive than it's ever been as we enter the second half of 2007.”

“I don't think this should be surprising to anyone who's used Virgin Media's on-demand services, as I think, once you try them, you will not want to move to any other TV platform.”

Such statements are also found regularly in the press. For example:

“He [Mr Wall] thinks the combination of content (deals have been completed for 2,700 hours of VoD, while thousands more are in the pipeline) and Virgin's delivery mechanism will prove an irresistible proposition to subscribers. “Sky may have more linear channels than we do,” he says. “But we've got all the most viewed channels. Linear channels are declining. It's notable how the Sky Movies channels have declined;”⁴⁷

To the extent that, in spite of the types of competitive advantages cited above, Virgin Media has had difficulty in attracting and retaining pay TV subscribers, it is evident that (in keeping with its predecessors) Virgin Media is seeking to blame Sky for the result of its own shortcomings – most notably in customer service – for which it is notorious – as well as other difficulties facing its business (such as the distraction of integrating formerly separate businesses, and merging with Virgin Mobile). Neither Sky, nor fictitious “*structural features*” in the sector, can be held responsible for such shortcomings.

- (c) BT Vision has indicated that it expects to gain significant number of subscribers. It announces at regular intervals new content deals. A typical example is the announcement of BT's deal with NBC Universal in which Dan Marks said:

“This is a very exciting deal that breaks new ground in the entertainment industry. Customers increasingly expect to enjoy entertainment when, where and how they want it and this agreement will help to make that possible. We are delighted to have concluded

⁴⁷

Broadcast, 2 March 2007.

this groundbreaking deal with NBC Universal that enables BT customers to watch some of the world's best entertainment titles through their TV, PC or portable player and choose whether to own or rent. They can also receive a DVD in the post as part of the package!"⁴⁸

In relation to sports content specifically, BT Vision's web site says:

"There is a huge range of sport on BT Vision. For the 2007/08 football season there are 46 Barclays Premier League games available live through Setanta Sports and a further 242 matches available On Demand just hours after kick off.

There are also 60 live Clydesdale Bank Premier League games from Scotland on Setanta Sports, plus 125 matches from the Football League and Carling Cup available On Demand. All this plus a huge range of live sport on Setanta Sports, from US PGA Tour golf to world-class boxing; a huge library of classic sport available On Demand; and all the sport available on Freeview."

6. Lack of evidence of consumer harm

6.1. In Part 4 of the Complaint, the Complainants seek to present evidence of harm to consumers arising from the way in which the sector currently operates. Such a task is extremely difficult in light of the fact that, by common consensus, the UK has one of the most dynamic and innovative audiovisual sectors in the world, delivering very significant benefits to consumers. Evidence of the sector delivering real benefits to consumers in the UK includes:

- (a) a wide and increasing choice of high quality television channels, both pay and free to air, with the quality and value for money of pay TV services reflected in a very high penetration of such services;⁴⁹
- (b) a wide and increasing choice of ways of receiving audiovisual programming, including analogue terrestrial broadcasting, digital terrestrial broadcasting, DTH, cable, IPTV networks, the internet, mobile TV, online DVD rental and so on; and
- (c) advanced new services, such as PVR technology and HD television provided in user-friendly ways at prices that have encouraged very significant rates of take-up.

⁴⁸ See: <http://www.btplc.com/News/Articles/Showarticle.cfm?ArticleID=e275988e-b0be-43cd-a663-cf5e66416344>.

⁴⁹ Despite the growth of Freeview, and a large expansion in the range of free to air services available, pay TV penetration in the UK increased from around 39% in 2002 to around 45% in 2007. Sources: ITC Multichannel Quarterly, September 2002; 'The Communications Market, Digital Progress Report, Digital TV Q2 2007', Ofcom.

- 6.2. Such evidence is highly supportive of a view that the sector is producing outcomes which provide very significant benefits to consumers.
- 6.3. The Complainants have attempted to overcome this difficulty by commissioning a report, which purportedly shows that consumers in the UK are not well served by the way in which the sector currently operates.⁵⁰ This is an econometric study prepared by LECG which seeks to demonstrate that (i) charges for pay TV services in the UK are above the average in 15 European countries (after taking into account differences between those countries); and (ii) the reason for this can be attributed to the Complaint's alleged "*vicious circle*".
- 6.4. In fact, the LECG study suffers from numerous and significant flaws, which render it unfit for the purpose to which it is put in the Complaint. These flaws are set out fully in the attached report by CRA and Professor John Van Reenen (attached as **Annex 3**). We summarise a number of the study's central flaws below.⁵¹
- 6.5. Most fundamentally, the LECG study fails to deal adequately with quality differences in pay TV services among countries. Clearly, when comparing the prices of two services it is necessary to ensure that like-for-like comparisons are made, for example in terms of the quality of services. The LECG study attempts to control for quality differences between pay TV services delivered in different countries by using spending on content by pay TV channel providers as the control variable. The data used by LECG, however, is not fit for this purpose because it consists only of payments by premium movie

⁵⁰ The Complaint also cites "*less choice and diminished innovation*" as additional consumer detriments (Part 4, Paragraph 5). These allegations largely consist of (a) a restatement of false allegations about Sky's behaviour, which are addressed in **Part D** of this Response; or (b) allegations of detriments to Sky's competitors, not consumers. In view of the facts set out above, the Complainants have failed to make out their case that the UK audiovisual sector delivers inadequate choice or innovation to consumers. Finally, the Complaint also alleges that the cost of "*access to live coverage of top football leagues*" is higher in the UK than in Italy, France, Spain, Germany and the Netherlands (Part 4, Paragraphs 4.1 - 4.2). It is notable, however, that the Complaint makes no attempt to take into account any country-specific factors that might give rise to differences in such charges between countries (in contrast to the (failed) attempt to take such factors into account in relation to differences in charges for pay TV services between countries in Europe) or of what else is included in relevant packages. As a result, no weight can be placed on the Complaint's allegation in this respect.

⁵¹ As set out in Professor Van Reenen and CRA's paper, LECG's only evidence to support their claim that market structure affects price is the positive correlation between the "*market share of the largest DTH supplier*" and "*Average Revenue Per Subscriber*". Due to the issue of the provision of free to air services via cable being treated as "pay TV" in LECG's data, and there being no adequate control for quality of pay TV services in LECG study, this correlation can be explained by the fact that DTH services contain on average a greater true pay TV component than cable services. Furthermore, LECG justify their use of the variable "*market share of the largest DTH supplier*" as a measure of competitiveness on the basis that ScreenDigest data do not allow them to calculate standard measures of market concentration. This is incorrect. When Professor Van Reenen and CRA calculate such indices (using ScreenDigest data) they find that "*market share of largest DTH supplier*" is uncorrelated with market concentration. Hence there is no reason to believe that "*market share of largest DTH supplier*" is a good indicator of the competitiveness of a market.

channel providers for pay TV movie rights. As such it excludes *all other types of spending* on content for pay TV services, notably all spending on sports programming and all spending on programming for basic channels. As a result, the study fails entirely to control for differences in quality of pay TV services among the countries in the study, leading to serious omitted variable bias.

- 6.6. This problem is exacerbated by the combination of the facts that (a) in many European countries in the study cable is used to a significant extent to deliver free to air television services for a relatively low access charge, and (b) payments for such services are treated as “pay TV” revenues in the data used by LECG, which enormously increases the variation in LECG’s dependent variable (“Average Revenue Per Subscriber”).
- 6.7. LECG’s analysis also appears to suffer⁵² from other data errors in addition to those described above, and these errors appear to have a significant effect on the results.
- 6.8. Finally, their analysis contains many technical errors: as a result of a basic error,⁵³ both their estimation and forecasting techniques are incorrect; their reliance on fixed effects estimation exacerbates the problems caused by the poor quality of their data on programme expenditure; and the econometric model they use suffers from endogeneity in the right-hand-side variables and fails to control for serial correlation in the errors. These lead to biased estimates and faulty inference, rendering their results entirely unreliable.
- 6.9. Any one of these issues alone would significantly compromise the reliability of the conclusions drawn from LECG’s study. Cumulatively, they mean that no weight at all can be given to the study’s conclusions.
- 6.10. As a result, Sky submits that the Complaint fails to point to *any* detriment to consumers – which should be the focus of any competition policy inquiry – let alone providing evidence to substantiate its allegations.

⁵² As set out in Professor Van Rensen and CRA’s report (at **Annex 3**), it is not possible to replicate exactly the data used by LECG due to changes in the ScreenDigest database.

⁵³ See Paragraphs 78-80, *ibid.*

PART C: THE “VICIOUS CIRCLE” THEORY IS FUNDAMENTALLY FLAWED

1. Introduction

- 1.1. In this **Part C**, Sky demonstrates why the Complainants’ theory of a “*vicious circle*”, which they claim results in the prevention, restriction or distortion of the competitive process in the pay TV industry,⁵⁴ is fundamentally flawed. Since the “*vicious circle*” is central to the Complainants’ argument for the need for a market reference, that case founders fatally with its dismissal.

2. The Complaint’s allegations

- 2.1. Sky notes at the outset that, as set out in **Part B** of this Response, the Complaint is set in a context that is divorced from reality, and, in particular, adopts an approach to market definition which is unduly narrow considering the conditions of competition currently found in the UK television sector. Nevertheless, for the remainder of this **Part C**, we evaluate the Complaint’s allegations based on the Complainants’ own narrow market definition. Even within this erroneous framework of analysis, the “*vicious circle*” theory fails.
- 2.2. The lack of clarity in the exposition of the Complaint presents considerable difficulties in responding to it.⁵⁵ The allegations being made by the Complainants are not expressed (or explained) clearly, and are put differently in different parts of the Complaint.⁵⁶ This places Sky in the invidious position of having to attempt to work out what it is that the Complainants are trying to allege before it is able to respond to those allegations.
- 2.3. The Complaint attempts to make a case for a reference of the alleged pay TV market for investigation by the Competition Commission under the Enterprise Act and for intervention at all levels of the supply chain.⁵⁷ The statutory test that must be met for Ofcom to make a reference is that Ofcom “*has reasonable grounds for suspecting that any feature, or combination of features, of a market in the United Kingdom for goods or services, prevents, restricts, or distorts*

⁵⁴ Part 4, Paragraph 1.2.

⁵⁵ The overall lack of clarity is compounded by a considerable degree of confusion about the different vertical stages of the industry, which is critical given the Complaint’s emphasis on issues concerning vertical integration.

⁵⁶ To cite but one example, the Complaint refers to the existence of “*bottlenecks*” at various stages in the vertical supply chain. The text of Paragraph 10 of the Executive Summary refers to Sky’s control over the most attractive pay TV content, the largest pay TV platform and the largest base of pay TV subscribers as “*bottlenecks*”, while the diagram at Paragraph 10 of the Executive Summary as well as in Part 3 refers to Sky’s control over “*key content*”, its selective distribution of key content and its control of the biggest base of pay TV subscribers.

⁵⁷ “*Intervention is needed at all horizontal levels of the supply chain. Downstream regulation without upstream intervention will not lead to effective competition in retail distribution. Likewise, measures aimed at generating a level playing field for content acquisition will fail in the absence of effective regulation downstream.*” (see Part 5, Paragraph 1.2).

*competition.*⁵⁸ The Complaint appears to attempt to meet this test by identifying a number of highly selective “*distinctive features of the pay TV industry*”⁵⁹ and by outlining the effects of Sky’s vertical integration and alleged conduct, said to give rise to a “*vicious circle*”.

2.4. A review of the Complaint, however, reveals that in fact it identifies only one “*feature*” said to be capable of justifying a reference to the Competition Commission (or some other regulatory intervention in lieu thereof): the “*vicious circle*”. Of the selective “*distinctive features of the pay industry*” alighted on by the Complainants:

- (a) two of them are features of the alleged “*vicious circle*” itself: “(v) *economies of scale in distribution of content*” and “(vi) *feedback effects*” are factors which are alleged to give rise to the alleged “*vicious circle*” and are not therefore significant in their own right;
- (b) “(iv) *exclusive licensing and selective distribution of key content*”⁶⁰ conflates an alleged feature of the upstream market with allegations regarding Sky’s conduct.⁶¹ Selective distribution of key content is only capable of having any effect to the extent such content is licensed on an exclusive basis. And such selective distribution is again a factor which is alleged by the Complainants to give rise to the alleged “*vicious circle*”;⁶² and
- (c) the remaining three features – “(i) *finite pool of content*”; “(ii) *limited duration of certain contracts from key content*”; and “(iii) *staggered*”

⁵⁸ Section 131 of the Enterprise Act 2002 and Paragraph 1.6 of OFT 511 (Market investigation references).

⁵⁹ The Complaint also refers to these selected features as being significant contributors to barriers to entry to the three different levels of the alleged pay TV market (see, for example, Paragraph 8 of the Executive Summary). It is clear, however, that in order properly to assess barriers to entry to these areas, it would be necessary to take into account many other features of the market – for example, among other things, technological change, the effect of existing regulatory intervention, and changes in programming rights over time – in addition to the small and highly selective number of features identified in the Complaint.

⁶⁰ The Complainants use the term “*key content*” throughout the Complaint without providing an adequate definition of what they mean by it. It is evident from the Complaint that they regard rights to broadcast live FAPL matches and subscription television rights to movies from Hollywood studios as falling within their definition of “*key content*” (see, for example, Paragraphs 8 and 14 of the Executive Summary). In general, however, the Complaint uses a series of vague formulations – including formulations as vague as “*key content*” comprising “*high quality sports and movies*” (Part 3, Paragraph 2.2) or even just “*sports rights*” (Part 1, Paragraph 1.3). In Sky’s view, given the centrality of this issue to the Complaint, it is incumbent on the Complainants to specify properly what they mean by the term.

⁶¹ Matters of Sky’s alleged conduct and therefore concerning the allegation of selective distribution, are considered in **Part D** below.

⁶² For example, under Part 3, Paragraph 2.10(iv) “*exclusive licensing and selective distribution*”, the Complaint states that “*in the context of UK pay TV, this problem is significantly increased by Sky’s position as both broadcaster and distributor – Sky the broadcaster acquires content on an exclusive basis and, to promote the success of Sky the distributor it has an incentive to distribute such content on a selective basis at the wholesale level*” (emphasis added) (see Part 3, Paragraph 2.10).

availability of key content” - relate entirely to the upstream market and cannot therefore support a case for intervention at all levels of the supply chain. These factors are also only of significance in as far as they compound the “*vicious circle*”.⁶³

- 2.5. Accordingly, other than the issues of vertical integration and the alleged “*vicious circle*”, which are addressed in the following sections, the so-called “*distinctive features of the pay TV industry*” are highly selective and either: (i) are allegations as to Sky’s conduct;⁶⁴ or (ii) relate entirely to the upstream market and hence cannot support the Complainants’ case for intervention at all levels of the supply chain; or (iii) are only significant in the sense that they are claimed either to contribute to, or to compound, the alleged “*vicious circle*” (itself a concept which we show below to be fundamentally flawed).
- 2.6. The notion of a “*vicious circle*” is therefore crucial to the Complainants’ case for reference. The fact that the Complainants’ case for a reference to the Competition Commission hangs on the existence or otherwise of the alleged “*vicious circle*” is recognised by the Complainants when they describe it as the “*core issue*” in the UK pay TV industry.⁶⁵ Its importance to the Complainants’ case is further underlined in the discussion of remedies which indicates that were the “*vicious circle*” to be broken (or found not to exist in the first place) the market would be contestable and Sky would have no ability adversely to impact competition.⁶⁶
- 2.7. The problem for the “*vicious circle*” argument, however, is that in order for there to be a “*circle*”, it needs to be complete. If any part of the argument fails there is no “*circle*”. As is readily apparent from the paragraphs which follow, the “*vicious circle*” does not withstand even a cursory analysis. It suffers from fundamental flaws in logic and reasoning and is, in fact, a fictitious circle, invented by the Complainants to sustain their unsubstantiated theories of harm, and to attempt to bolster a case for regulatory intervention at all levels of the supply chain, reflecting their divergent interests in this case. When the circle, and the Complainants’ own case, collapses, so too does the case for regulatory intervention of the kind called for. All that is left is a series of isolated allegations about behaviour, which is, in reality, all the Complaint amounts to.

⁶³ For example, under Part 3, Paragraph 2.4(ii) “*limited duration of certain contracts for key content*”, the potential concern is described that “*where there is a period of only three years in which to recoup a content investment, it would not be commercially rational to bid very aggressively (even for valuable exclusive content) without access to a pre-existing subscriber base*” (emphasis added).

⁶⁴ The OFT’s guidance indicates that single firm conduct, absent any other features, is unlikely to justify a reference (OFT 511, Paragraph 2.7).

⁶⁵ See Paragraph 9 of the Executive Summary of the Complaint.

⁶⁶ Part 6, Paragraph 2.10 of the Complaint states “*It is only if the pay TV supply chain becomes contestable both upstream and downstream that the “vicious circle” will collapse and with it Sky’s ability to exclude or marginalise competitors.*”

3. The alleged “vicious circle”

- 3.1. The essence of the Complaint’s alleged “vicious circle” appears to be its claims that: (i) Sky’s success in attracting subscribers at the downstream level (itself alleged to be a function of its success as a pay TV broadcaster) creates a “competitive advantage” at the upstream level (we address this claim in **Section 4** of this **Part C** below); and (ii) Sky’s success as a pay TV broadcaster creates a “competitive advantage” for its retail business in attracting pay TV subscribers (we address this claim in **Section 5** of this **Part C** below).

4. The alleged advantages that Sky’s position as a leading pay TV retailer confers on its broadcasting business

- 4.1. The Complaint’s proposition that success downstream gives rise to competitive advantages upstream for a vertically integrated operator is based on the assertion that the size of Sky’s base of retail subscribers produces two advantages for its broadcasting business:

- (a) it is alleged to give rise to significant reductions in Sky’s content acquisition costs per subscriber, thereby enabling it perpetually to outbid rivals with smaller existing subscriber bases for “key content”;⁶⁷ and
- (b) it is alleged to enable Sky more swiftly and more efficiently to achieve a return on investment in content rights as compared with its rivals, which must build their own subscriber base.⁶⁸

We discuss each of these below.

Alleged bidding advantages arising from economies of scale

- 4.2. The confusion in the Complainants’ case is exemplified by their discussion of the role of economies of scale in the alleged “vicious circle”. The Complainants state:

“The pay TV industry exhibits economies of scale in the distribution of content. A large subscriber base enables a broadcaster to reduce its

⁶⁷ See Part 3, Paragraph 2.11: “A larger subscriber base enables a broadcaster to reduce its average content acquisition costs. This downstream advantage provides it with an ability to outbid its rivals in the competition for key content.”

⁶⁸ See Part 3, Paragraph 3.3: “it provides Sky with access to a large base of subscribers to whom content can be sold immediately upon the rights becoming available”; Part 3, Paragraph 2.5: “An incumbent vertically-integrated firm with a sizeable established subscriber base is able to monetise its content investment faster, and more efficiently, than a firm without a subscriber base”; and Part 3, Paragraph 3.4: “Sky’s competitors would need to build a subscriber base for any new premium channels in order to be able to exploit the rights that they acquire which would be a time consuming activity. In contrast, Sky can rely on the immediate demand for its substantial and pre-existing subscriber base.”

*average content acquisition costs. This downstream advantage provides it with an ability to outbid its rivals in the competition for key content.*⁶⁹

- 4.3. This argument is confusing for two reasons. First, it begins by talking about economies of scale at the downstream (distribution) level, yet in the next sentence refers to reductions in the average costs at the upstream (broadcaster) level. Second, the term “*content acquisition costs*” is ambiguous. The last sentence would appear to suggest that it refers to content acquisition at the upstream (broadcaster) level, while the first sentence seems to suggest that it refers to reductions in the cost to retailers of licensing premium channels from pay TV channel providers.
- 4.4. Such an incoherent analysis is indicative of the meagre basis for the “*vicious circle*” construct.
- 4.5. The most likely explanation, given the main thrust of the Complaint, is that use of the term “*broadcaster*” in the argument above is erroneous. The Complainants intended to argue that having a larger subscriber base enables a *retailer* to reduce its per subscriber costs associated with the premium channels carried in its packages and that, if the retailer is vertically integrated, this (somehow) provides its upstream broadcaster business with a competitive advantage when bidding for “*key content*”.⁷⁰
- 4.6. If this is the Complaint’s argument, then it is wrong. It is simply not the case that there are significant economies of scale at the retail level in relation to licensing of channels for distribution to subscribers which give rise to lower per subscriber costs for key content as subscriber numbers increase.⁷¹ This is for the simple reason that the predominant model in the pay TV industry for such arrangements (indeed an industry-wide feature conveniently overlooked by the Complainants) is that channels (both basic and premium) are licensed on the basis of per subscriber fees, with little use made of non-linear tariffs (for example contracted for reductions in per-subscriber fees as the number of subscribers increases). Average per subscriber “*content costs*” (in the sense of payments to channel providers under such licences) do not fall significantly as the number of subscribers increase, and any argument about advantages for bidding for rights based on the presence of such an economy of scale at the retail level therefore fails.

⁶⁹ Part 3, Paragraph 2.11.

⁷⁰ This interpretation is partially supported by the formulation at Part 3, Paragraph 3.3, which states that “*Sky’s downstream leadership confers upon Sky...significant economies of scale which reduce its (content and other) costs per subscriber*”, though again the phrase “*content and other costs*” is ambiguous given that it could equally be referring to either a retailer’s content costs, or a broadcaster’s.

⁷¹ It may be the case that a retailer that offers access to a very large subscriber base will be able to secure lower per subscriber fees when negotiating with third party basic channels than a smaller retailer. However, to the extent that this is the case, it is entirely unclear how this would translate into a bidding advantage for ‘key content’.

- 4.7. If, on the other hand, the Complaint's argument is that there are economies of scale in terms of per subscriber content costs at the upstream (broadcaster) level, then it is trite. It is clearly the case that there are economies of scale at this level as there are many types of content rights that are purchased on a fixed cost basis. It necessarily follows that the more subscribers to a broadcaster's channel comprising fixed cost content, the lower will be the broadcaster's average per subscriber costs for that channel.⁷²
- 4.8. If this is the point that the Complainants seek to make, it has nothing to do with vertical integration and, accordingly, it can play no role in the "vicious circle" allegation.⁷³ It has nothing to do with vertical integration for two reasons:
- (a) such scale economies exist equally for integrated and non-integrated broadcasters. For example, even were Sky's retail business to be separated from its broadcasting business, the broadcasting business would still continue to enjoy the same economies of scale;⁷⁴ and
 - (b) the denominator in the cost per subscriber in the context of a broadcaster's business is the total number of subscribers to its channel(s) *across all retailers* not just the subscribers to the channel via an integrated downstream retail business (if there is one). By way of example, Setanta's per subscriber content cost fell significantly overnight when it reached agreement with Virgin Media for Virgin Media to retail Setanta Sports to an estimated additional 1.36 million households.⁷⁵

Alleged bidding advantages arising from the supposed ability to make a return on the cost of rights more quickly and efficiently

- 4.9. An argument that Sky's retail presence increases its ability to make a return on the cost of rights more quickly and efficiently than actual or potential competitors is equally defective. It makes the same fundamental error, as above, of attributing advantages enjoyed by Sky's broadcasting business to its position at the retail level when they are in fact attributable to its position at the broadcaster level.

⁷² This is a key feature of television broadcasting in general and is not restricted to the production of pay television channels.

⁷³ Furthermore, if the Complaint's argument relates to economies of scale at the broadcaster level it is entirely unclear how having a low cost per subscriber today benefits a broadcaster in a competition for content rights covering a period in the future. In this sense, economies of scale in broadcasting are dissimilar to scale economies associated with incurring fixed and sunk costs in relation to long-lived assets in other industries.

⁷⁴ In fact, economies of scale in broadcasting are exactly what drive wide distribution of content. This undermines the existence of the "vicious circle" and Sky's alleged incentive to distribute content selectively (see Section 4 of the CRA report at **Annex 3**).

⁷⁵ Merrill Lynch, "Virgin's free kick from football", Company Update: Virgin Media Inc., 20 July 2007.

- 4.10. When any broadcaster, including Sky, acquires new content rights there are two main ways that it can exploit them:
- (a) it can include programming based on the rights that have been acquired on an existing television channel; or
 - (b) it can include such programming on a new television channel.

Inclusion of new content on existing channels

- 4.11. In the first scenario – inclusion of programming on an existing channel – the subscribers who receive that programming are subscribers to that channel *across all retailers* not just the subscribers to the channel via an integrated downstream retail business (if there is one). For example, when Sky purchased the live rights to domestic cricket Test matches, and began broadcasting those matches on its Sky Sports channels, all households that received the Sky Sports channels were then able to view those matches – including subscribers to Sky’s own retail packages (whether via DTH or Sky by Wire) and to Virgin Media’s retail service.
- 4.12. Were Sky’s retail business to be separated from its broadcasting business, the broadcasting business would continue to be able immediately to supply any new content acquired to all households which subscribe to a pay TV service that includes the channel on which the new content is broadcast.
- 4.13. An additional flaw in the argument is that it appears to assume, by quoting Sky’s DTH subscriber figures of 7.8 million in 2006,⁷⁶ that Sky is immediately able to monetise new content to which it has acquired the rights to *all* its own retail subscribers, whether or not they subscribe to a package that includes the channel on which the new content is broadcast. This is clearly erroneous.
- 4.14. Accordingly, for both these reasons, this argument also has nothing to do with vertical integration and therefore contributes nothing to the “*vicious circle*” allegation. It is an argument about the position of different operators at the upstream (broadcaster) level only.

Creation of new channels

- 4.15. In the second scenario – inclusion of programming on a new channel – the claim, that Sky can, by virtue of its large existing retail subscriber base, immediately monetise the investment in additional content, is wrong.
- 4.16. For example, consider a scenario in which Sky purchases a set of cricket rights with the objective of starting a dedicated cricket channel which it intends to offer to subscribers for an incremental charge. In these circumstances Sky would *not* be able automatically to recover the incremental charge from all of its existing sports subscribers by adding the service to their subscription entitlement.

⁷⁶ Footnote 55 of the Complaint.

- 4.17. Sky would only be able to generate additional revenue from customers who chose to add the new channel to their existing subscription package.⁷⁷ Sky would need to market the availability of the new service, thereby encouraging its existing subscribers to contact Sky and change their subscription package so as to include the new service.
- 4.18. Accordingly, despite being vertically integrated, Sky is not immediately able to realise additional subscription revenue by automatically including a new premium channel as part of the package to which its existing customers subscribe.

Alleged advantage over other broadcasters deriving from DTH subscriber base

- 4.19. Furthermore, the Complaint appears to assume that new entrant broadcasters (or existing broadcasters seeking to expand their business) are not able to sell their new channels to Sky DTH subscribers and therefore are at a disadvantage compared to Sky (which is allegedly able to encourage existing subscribers to sign up to a new channel that it offers) when bidding for rights.
- 4.20. This is also wrong as it ignores the open nature of the DTH platform. Such an entrant would be able to reach Sky DTH subscribers (which comprise the vast majority of Sky's existing retail base) in one of two ways:
- (a) by entering into a wholesale arrangement with Sky. Sky has every incentive to enter into wholesale arrangements to supplement its retail offering by adding attractive content, provided of course that sensible commercial terms can be agreed. Examples where Sky has retailed channels that are in the same genre as its own channels are: the retail of Film Four on behalf of Channel 4 (prior to it switching to free to air distribution); the retail of MUTV and Chelsea TV; and the retail of Setanta channels to Sky's commercial customers;⁷⁸ or
 - (b) by directly retailing that content to DTH households (whether Sky subscribers or not) by purchasing conditional access and EPG services from Sky on regulated FRND terms, and undertaking its own marketing and subscriber management.⁷⁹ In this context, it is important to note

⁷⁷ Alternatively, Sky would have the choice to immediately include this new channel as a bonus channel to one of its existing premium sports packages (or alternatively position it as a basic service). In these cases, however, the scenarios become analogous to the first option set out above, in which the new content is included in an existing service and all the same arguments apply. In addition, positioning of the new channel as a bonus channel would only give rise to additional revenue to the extent that it attracted additional subscribers to the premium tier or reduced subscriber churn. The profitability of increasing the price of Sky's premium tiers is limited by the risk that customers will churn from Sky to competing services (including free to air) or will spin down to cheaper packages.

⁷⁸ **[CONFIDENTIAL]**

⁷⁹ Sky notes that the Complainants have alleged that such an option is not effective, though their reasons for such an allegation have been kept secret. It is difficult to conceive what those reasons might be, given that Ofcom has only recently concluded a detailed review of this regulation which resulted in new prescriptive guidelines to improve certainty and transparency as to the terms of access.

that a new entrant wanting to sell its content directly to Sky's DTH subscribers does not need to persuade those customers to drop their Sky subscription. Customers *can* choose to switch completely from Sky, but they can also down-grade their Sky package to accommodate an additional subscription, or they can simply take a new service *in addition* to their existing Sky package. Indeed, this is consistent with the view recently expressed by Setanta as to its own strategy to New Media Markets:

*"We do not see Setanta as a replacement to Sky. We certainly do not view customers' intentions to purchase Setanta in addition to Sky as a conflict to our growth targets in terms of subscribers or distribution platforms."*⁸⁰

- 4.21. It is also worth noting that the provision by Sky of access to the DTH platform on transparent terms facilitates competitive bidding for content rights and thereby new entry. In this sense, Sky's success at the retail level in developing a large scale subscriber base, together with open access regulation, facilitates rather than forecloses entry upstream.
- 4.22. By comparison, a broadcaster contemplating bidding for content cannot rely on access to the customers of Virgin Media, or any of the IPTV platform operators (including Tiscali and BT Vision), since it first has to agree commercial terms with the platform operator. This gives rise to a potentially significant 'hold-up' problem where the broadcaster has made a fixed and potentially substantial investment in content but is unable to recoup that investment and acquire customers for its channel unless it can agree commercial terms with the platform operator. The platform operator will be interested in distributing attractive content as a means of acquiring new subscribers, but unless contracts are agreed in advance, the platform operator knows that the investment the broadcaster has made in content is sunk and the only threat available to the broadcaster is to withhold supply, pending agreement of acceptable terms.
- 4.23. Where the broadcaster is a new entrant and the closed platform provider controls access to a large number of customers (for example in the case of Virgin Media), the threat by the broadcaster not to supply its new channel may not be credible. Accordingly, in respect of closed platforms a broadcaster, including Sky, must take into account when bidding for content the risk that an agreement pursuant to which the channel is supplied to customers on that platform will not be agreed (or will be agreed only on unfavourable terms).

⁸⁰ New Media Markets, 7 September 2007. In that report, Setanta is also reported as having said that 6-7% of UK satellite homes - about 600,000 households - had subscribed to Setanta, while 1% of digital-terrestrial homes - about 85,000 households - had taken out a subscription in the last three months. Research by Citigroup analysts also acknowledges that "*some consumers may have [simply paid extra] and / or dropped their second Sky Sports stream, or spun down to a lower tier basic offer*". See "*UK Television: Meteoric Changes at a Glacial Pace*", 28 September 2007, Citigroup Global Markets Equity Research.

- 4.24. Since this ‘hold-up’ problem does not arise in respect of the open DTH platform, the larger the number of DTH homes readily accessible relative to the number of customers of the various platform operators that are not readily accessible, the lower the risk faced by the entrant broadcaster.
- 4.25. In fact, if any platform operator is to gain an advantage from this ‘hold-up’ problem it would be Virgin Media, whose closed platform enables it to bid for content with guaranteed access to not only the 9 million DTH households available to Sky and any other broadcaster, but also a further 3.4 million of its own subscribers.

5. The alleged advantages that Sky’s position as a leading broadcaster of “premium content” confers on its downstream retail business

- 5.1. Even if the first part of the argument held (which it does not), completion of the “*vicious circle*” would require some feature of the market which meant that holding a leading position upstream conferred benefits on an operator’s downstream retail business. As Sky explains below, no such feature exists, and the “*vicious circle*” theory therefore fails on two bases.
- 5.2. The mechanism by which the Complaint seeks to establish the link between upstream position and downstream benefit is not a structural feature of the market, but an allegation about Sky’s incentives and conduct – that Sky has the incentive to foreclose downstream retail competition and does this through “*selective distribution*” of its sports and movie channels. The Complaint asserts:

*“Sky’s past conduct vis-à-vis its competitors confirms that Sky has both the incentive and ability to foreclose downstream competition. For example, Sky is able to use its leading position in the acquisition of content upstream to deny key content to competing pay TV retailers and thereby restrict downstream competition for its own retail business”;*⁸¹

while the Complaint’s diagram of the alleged “*vicious circle*” states:

*“Sky holds the rights to key content and either refuses to supply it to competing pay TV operators or offers it on uneconomic terms.”*⁸²

- 5.3. This theory of an incentive for Sky to foreclose downstream retail competition as a result of its vertical integration is shown, in **Annex 4**, to be flawed, while the allegations about Sky’s past conduct are addressed in **Part D** of this Response, where they are shown to be either false or mischaracterisations of Sky’s actions.
- 5.4. Furthermore, and crucially, as Sky explains in the paragraphs below, even if Sky’s channels were not wholesaled to third party retailers, this would not foreclose downstream retail competitors. Pay TV retailers who do not have a

⁸¹ Paragraph 11 of the Executive Summary.

⁸² See the diagram following Paragraph 10 of the Executive Summary.

wholesale relationship with Sky in respect of Sky's movies and sports channels are not foreclosed from retailing pay TV services, for the following reasons:

- (a) Sky's movies and sports content is not relevant to a very large number of potential subscribers, the significance of which is overlooked by the Complaint (*i.e.*, it is not "*key content*" – assuming that, by this term, the Complainants mean content that is vital in some sense for a pay TV retailer to attract subscribers); a pay TV retailer is able to establish a customer base regardless of the availability or otherwise of Sky's content; and
- (b) the customers of such pay TV retailers are able to access Sky's channels where Sky itself retails its own premium channels on the same platform (whether the DTH platform or a third party platform with which Sky has an access arrangement). Therefore, even if it were the case, as the Complainants allege, that Sky's premium channels constitute "*key content*", a pay TV retailer, which does not itself retail Sky's content, can nevertheless establish a customer base by retailing other content either (i) on a platform other than DTH where Sky's channels are available via 'Sky by Wire'; or (ii) on the DTH platform, where customers also have access to Sky's DTH subscription service.

Sky's sports and movie channels are not relevant to a very large number of potential pay TV subscribers

- 5.5. There are many existing and potential pay TV subscribers who have no interest in Sky's sports and movie channels, which therefore comprise a significant target market for a pay TV service that does not include these channels. Some [CONFIDENTIAL]% of Sky's UK subscribers, and over [CONFIDENTIAL]% of Virgin Media's subscribers do not take any of Sky's premium channels.⁸³ Accordingly, even assuming that a retailer was able to attract only pay TV customers that do not currently subscribe to Sky Movies or Sky Sports, its pool of potential customers would, at a minimum, include these [CONFIDENTIAL] existing basic pay TV subscribers.

A pay TV retailer can build a customer base by retailing other content alongside Sky retailed content

- 5.6. It is wrong to suggest that where Sky does not wholesale its premium channels to a pay TV retailer, the retailer's subscribers are unable to access these channels, or indeed that the retailer is foreclosed from selling other pay TV channels and services to customers if it does not itself retail Sky's premium channels.

⁸³

As at August 2007.

On non-DTH platforms

- 5.7. As set out in **Annex 4**, Sky has an incentive to supply its channels on all available platforms (provided that they are not susceptible to piracy). In general, however, Sky's preference is to retail its premium channels directly to consumers on all platforms, and it has made substantial efforts to engage with the operators of closed platforms so that it can retail its channels directly to customers of those operators.⁸⁴
- 5.8. Where Sky is able to secure such access so that it can retail its premium channels directly, the platform operator can then include the availability of those channels in its marketing messages. Hence, the platform operator is able to attract customers to its platform based on the combination of services that it retails itself and those that are retailed by Sky. Accordingly, the platform's potential subscriber base is not confined to those homes who are not interested in Sky's sports and movie channels.
- 5.9. There is no reason why subscribers need to purchase all services delivered over a single platform from one retailer. Tiscali's customers, for example, can take basic TV (including Sky's basic channels), telephony and broadband from Tiscali along with Sky's premium channels by contracting directly with Sky; while on TUTV's DTT platform there are two retailers – TUTV and Setanta. By analogy, BT also seems to have little difficulty with the concept of shared customer ownership as it retains its customer relationships through line rental on the Blue Bill with numerous customers who take their telephony services and broadband services from other suppliers (including both Sky Talk and Sky Broadband).⁸⁵

On the DTH platform

- 5.10. The Complaint takes an unduly narrow view of what is required to establish a base of retail customers by appearing to suggest that the only way for a competing retailer to establish a large customer base is to operate its own platform and offer a service which customers might take instead of Sky's DTH service.⁸⁶
- 5.11. The scale of the DTH platform, together with regulated open access to it, however, means that another retailer is able to establish a large customer base on that platform.

⁸⁴ Sky's preference for retail arrangements over wholesale arrangements is explained in detail in **Part D** of this Response (**Paragraph 4.16** onwards).

⁸⁵ In fact, many DTH households already have subscriptions to multiple pay TV retailers' services.

⁸⁶ See for example, the statement at Part 3, Paragraph 2.13 that: "*leading market positions become entrenched because consumers will not subscribe to new entrants unless their content offerings are sufficiently attractive and existing subscribers are unlikely to switch to alternative providers unless they can obtain a more attractive price quality offer. But this is not likely because new entrants will face the handicap of having to compete for subscribers with inferior content.*"

- 5.12. Furthermore, as set out above,⁸⁷ another DTH-based retail offering need not necessarily involve services which are wholly substitutable with Sky's DTH services. A new retailer could sell a pay TV service, for example, directly to Sky's existing customers either as an add-on to their existing Sky package or as a replacement for some element of the service that they currently take from Sky.
- 5.13. This is exactly the strategy being adopted by Setanta. Setanta was able to mount a competitive bid for FAPL rights and indeed other significant rights such as the FA Cup, England internationals and US PGA Tour golf based on a business model that does not seek to replicate the whole of Sky's content offer or establish its own platform. Rather Setanta's approach has involved a mixture of routes to market, retailing its channels directly via the TUTV DTT platform and DTH (which it acknowledges is likely to account for the majority of its revenues), and entering into wholesale supply arrangements with Virgin Media on the cable platform and BT for the BT Vision platform. The fact that it did not have a significant base of existing retail customers and had no prospect of securing a base of retail customers in respect of the cable platform did not prevent Setanta from outbidding Sky for FAPL content (Setanta secured two packages whereas Sky was only prevented from acquiring one), the FA rights or the US PGA Tour golf rights. Similarly, the fact that Setanta's DTH retail offer is limited to nine sports channels will not prevent it from establishing its own retail base of customers on the DTH platform.

6. Conclusion

- 6.1. It is evident, even from this cursory analysis, that the Complaint's "*vicious circle*" theory is fundamentally flawed. Not only is the circle incomplete, no element of its circumference exists. The circle is, in fact, a fictitious one.
- 6.2. The failure of the Complainants' "*vicious circle*" theory fatally undermines the Complaint and, specifically, the Complainants' case for a reference to the Competition Commission.

⁸⁷

See **Paragraph 4.20(b)** of this **Part C** above.

PART D: ALLEGATIONS REGARDING SKY'S CONDUCT ARE FACTUALLY INACCURATE AND MISLEADING

1. Introduction

- 1.1. The Complainants claim that Sky's past conduct vis-à-vis its competitors confirms that Sky has both the incentives and the ability to foreclose competition, both downstream and upstream.
- 1.2. The details of Sky's alleged conduct are apparently set out in detail in the confidential annexes to the Complaint. Sky has not, despite requests to Ofcom, been provided with copies of those confidential annexes (nor is it clear to Sky why Annexes which purport to document facts as to Sky's conduct cannot be shared with Sky, with any information which would not be in Sky's knowledge and which is commercially sensitive redacted as appropriate).
- 1.3. Ofcom cannot, in any circumstance, rely on accounts of Sky's conduct which have not been put to Sky. Furthermore, as this **Part D** demonstrates, the Complainants' versions of events are inaccurate.
- 1.4. Given that Sky has not seen the confidential annexes which purport to provide details of conduct on Sky's part which has foreclosed competition, Sky cannot be sure of the full extent of the allegations made against it, nor of the details. Notwithstanding these limitations, Sky seeks to respond below to what it suspects to be the main thrust of the Complainants' allegations and to correct the misleading impressions that these might otherwise give Ofcom. This Response, and Sky's view of the Complainants' approach, is based on (i) what appears in the main body of the Complaint; (ii) the content of submissions made by the Complainants to the Competition Commission in the context of its investigation of Sky's acquisition of a stake in ITV; and (iii) the (revisionist) correspondence that Sky has received from the Complainants in recent months.
- 1.5. Much of the material provided by Sky for this purpose is confidential and/or commercially sensitive, and has therefore been placed in a separate, confidential **Annex 5** (the "**Confidential Annex**"). The Confidential Annex is divided into free-standing sub-annexes, each of which contains details specifically on Sky's relationship and dealings with each different Complainant. Each of the sub-annexes may be disclosed to the particular Complainant to which it relates, but only to that Complainant.
- 1.6. Sky believes that the Complainants have pursued a concerted and cynical strategy which seeks to bolster, through correspondence, what the Complainants realise is ultimately a very weak case. Sky has seen a pattern of behaviour emerge over the last few months in which the Complainants have, individually, addressed correspondence to Sky which inaccurately summarises previous discussions and dealings between the parties with regard to the issues raised in the Complaint, which misportrays Sky's position and the current state of play on those issues, and which seeks to elicit particular

statements from Sky which would support the claims as to Sky's conduct made in the Complaint. In some cases, the matters discussed in this correspondence were last raised by the Complainant many months, if not a matter of years, ago. (Examples of this type of correspondence are given in the context of Sky's responses to individual allegations against it.) It is surely no coincidence that the first of these attempts at revisionism was received around the time when the Complainants would have been working up their revised Complaint.

- 1.7. The allegations as to Sky's conduct are misleading in a range of ways. In certain instances, the Complaint claims that Sky has refused to supply a service when the opposite is the case and Sky has in fact offered to supply the service in question. In other cases, where the Complaint claims that Sky has refused to make services available, either discussions between the parties are ongoing (and it is clear that no conclusion has yet been reached) or the Complainant has chosen not to actively pursue discussions with Sky. In yet other cases, the Complaint presents as hard fact what is simply the Complainants' own position on issues which are already the subject of legal proceedings between Sky and Virgin Media (and which, in each case, Sky rejects in its entirety).
- 1.8. It is important to appreciate that the types of relationships and commercial arrangements, to which reference is made and which the Complaint alleges Sky refused to enter into, are complicated. They require committed and intensive engagement from both sides over a period, and the negotiation and resolution of myriad commercial issues. Reaching agreement in respect of these types of services is never a matter of simple offer and acceptance. The complicated nature of the terms that need to be agreed, and the level of engagement that this necessitates, mean that the fact that no agreement has been reached cannot be taken as evidence of a refusal to supply.
- 1.9. The Complainants' current intervention makes productive engagement of the kind that is a pre-requisite to establishing viable commercial arrangements even more difficult than was already the case. This is particularly so given that, as described above, the Complainants have recently been attempting to turn every piece of correspondence with Sky on these matters into a potential piece of evidence for the Complaint, rather than meaningfully addressing or progressing the issues contained in that correspondence.
- 1.10. There is no substance to the Complainants' allegations of anti-competitive conduct by Sky. Rather, the Complaint represents a cynical attempt to convince Ofcom of the existence of problematic features of the market - features which, the Complainants claim, are borne out by Sky's conduct, which forecloses or hinders competition. Ofcom should, therefore, fundamentally question the credibility and motivation of the Complainants.
- 1.11. Crucially, the Complainants do not adduce any meaningful evidence of foreclosure of competition nor, through it, of consumer harm arising from Sky's alleged conduct. Furthermore, in several instances, the lack of interest demonstrated and effort applied by the Complainants towards getting a deal done with Sky clearly indicates that there would be no effect on competition

even if Sky were to refuse to supply (which it has not); if the supply of the services in question was material to the ability of the Complainants (and others) to compete with Sky, they would surely have pursued their goals, commercially, with some vigour.

- 1.12. It is also evident that the Complainants perceive regulatory intervention as a viable alternative to engagement in meaningful and genuine commercial negotiations with Sky. The Complainants appear to be using the threat of regulatory intervention to achieve a better commercial outcome and using commercial negotiations to generate ‘evidence’. Either way, this is clearly regulatory gaming. Ofcom should, therefore, fundamentally question the credibility and motivation of the Complainants.

2. The conduct allegations

- 2.1. The Complaint makes allegations concerning Sky’s conduct at all levels of the pay TV supply chain:

- (a) at the level of the acquisition of content;
- (b) at the level of the wholesale supply of channels/content services;
- (c) at the level of the retailing of pay TV services; and
- (d) at the level of platform operation.

- 2.2. Sky outlines briefly below the inaccuracies in the allegations made at each level. Further (commercially sensitive) details are provided in the **Confidential Annex**.

3. Allegations regarding Sky’s conduct at the level of the acquisition of content

- 3.1. The Complaint portrays Sky as pursuing a strategy in its acquisition of content which seeks to foreclose its competitors downstream. It alleges that:

- (a) *“Sky has... acquired exclusive rights to content not only for the satellite platform but also for other distribution platforms which it has then warehoused”*;⁸⁸ and
- (b) *“[t]hrough the bundled acquisition of ancillary rights (including rights such as DSL) on an exclusive basis, Sky denies such rights to innovative new entrants such as BT Vision whilst not fully exploiting these ancillary rights itself. Because of the exclusivity provisions, these rights are not available directly from content owners”*.⁸⁹

- 3.2. The above allegations are misleading, both in their portrayal of the manner in which content rights are sold and their characterisation of Sky’s conduct and motivation:

⁸⁸ Part 3, Paragraph 4.5(d).

⁸⁹ Part 4, Paragraph 5.5(b).

(a) “*Warehousing*” implies a deliberate policy of acquisition (and non-exploitation) of specific rights in relation to specific platforms in order to avoid or restrict competition from those platforms. Sky does not warehouse content; Sky is not simply a vertically integrated satellite operator but, in fact, seeks to exploit its content rights as fully as practicable. Sky distributes and makes its content available (primarily as part of its linear TV channels) over a number of platforms: DTH, cable DTT, IPTV, mobile, the internet. It should be noted, however, that there are factors beyond Sky’s control which restrict Sky’s ability (or counter its incentives) to distribute its services in certain circumstances or to use certain technologies. Such factors include:

- regulatory restrictions on Sky’s ability to broadcast pay TV channels on DTT. It is notable that, following Ofcom’s announcement, in April 2006, that it had concluded that the FTA requirement in multiplex licences could be removed and that it was minded to remove the requirement on request from licensees, Sky has acted promptly with a view to making certain of its pay TV channels available on the DTT platform;
- the fact that Sky may not have the rights in question;⁹⁰
- movie studios’ requirements regarding content protection (such as the use of copy protection technology); and
- the susceptibility of platforms to piracy (and the unwillingness of certain platform operators to take adequate steps to prevent piracy and to commit to restore security in the event of a breach).

Accordingly, where Sky is unable or unwilling to distribute its services on other platforms this cannot and should not be characterised as “*warehousing*” of the rights to the content included in those services.

(b) “*Bundled acquisition*” implies that the sale of rights allowing exploitation across a number of platforms is Sky’s doing, whereas very often, particularly in the case of high profile sports rights, it is the rights owners who dictate how rights are packaged (*e.g.*, in invitations to tender (“**ITTs**”)) and Sky is simply responding to what it is offered. Sky notes that Ofcom recognises, in its recently published consultation on “*Proposed BSkyB digital terrestrial television services*”, that content rights tend not to be sold on a platform specific basis.⁹¹ Where rights are not delineated by distribution technology, there is no meaningful concept of a ‘DSL right’, for example.

⁹⁰ This was the case when ONdigital launched a pay TV service on the DTH platform. Whilst Sky had exclusive rights to movie content from a number of Hollywood studios in the pay TV window, it did not have the right to exploit that content via DTT from all those studios.

⁹¹ See Paragraph 3.38 of the Ofcom consultation document “*Proposed BSkyB digital terrestrial television services*,” dated 4 October 2007.

(c) Similarly, exclusivity is a *sine qua non* for content differentiation, which is in turn a key aspect of competition in broadcasting. Sky's acquisition of rights on an exclusive basis is a function of the nature of competition between broadcasters (including free to air broadcasters) and cannot be characterised as behaviour whose aim is to foreclose competitors.

3.3. It is unclear why the Complainants describe DSL rights as "*ancillary rights*". These are core rights for Sky, given that its channels are distributed over DSL. This approach would also seem to undermine the Complaint's "*warehousing*" argument, which implies that all rights are created equal.

4. Allegations regarding Sky's conduct at the level of wholesale supply of channels

4.1. A number of the allegations regarding Sky's conduct as a broadcaster could be loosely grouped under the heading of 'refusal to supply': according to the Complainants, Sky has (i) refused to supply its HD channels and its enhanced/interactive services to cable; and (ii) refused to supply its premium channels to certain other third party pay TV retailers and platforms, including pay TV retailers on the DTT platform.

4.2. In making these allegations, the Complainants have deliberately mischaracterised Sky's position in a number of commercial negotiations as a refusal to supply, when in fact negotiations either have not been pursued by the relevant third parties or are ongoing.

Sky has not refused to supply HD channels

4.3. The Complaint alleges that Sky has withheld its HD services from cable.

4.4. Contrary to what is implied in the Complaint, however, Virgin Media has not been pressing for supply of Sky's HD channels. Nor is it the case that Sky has refused to supply those channels to Virgin Media.

4.5. Details of the nature of discussions between cable and Sky regarding supply of Sky's premium HD channels, including copies of relevant correspondence, are provided in the **Confidential Annex**.

4.6. Sky notes, in this regard, that Virgin Media does not carry any HD pay TV channels and that its linear HD offering is currently limited to the BBC HD channel. Sky understands that this is explained, in large part, by capacity limitations which will not be resolved unless and until its analogue cable service is switched off. This supports Sky's point that Virgin Media has not been pressing for the supply of Sky's HD channels.

4.7. Sky also notes that, tellingly, Steve Burch (then CEO of Virgin Media) was publicly vocal in ascribing very little value to HD services; indeed, at the IEA conference earlier this year,⁹² he was highly dismissive of the attractiveness of HD sport, questioning how much value could really be attributed to a few

⁹² IEA 5th Annual Conference "The Future of Broadcasting", 27-28 June 2007.

“beads of sweat”. This public position is hardly consistent with the proposition that Virgin Media is keen to carry Sky’s HD channels, but *is*, on the other hand, consistent with cable’s lack of interest in pursuing discussions.

Sky has not refused to supply enhanced and interactive services

- 4.8. With regard to the supply of enhanced and interactive services to Virgin Media, there have in fact been extensive discussions between Sky and cable in the past with a view to establishing the appropriate technical means by which cable could distribute the relevant services. Details of those discussions are provided in the **Confidential Annex**.
- 4.9. There are significant technical hurdles to be overcome in order for Sky to supply its enhanced and interactive services to Virgin Media. Sky needs to be assured that the cable platform is capable of supporting an identical interactive service without impairing Sky’s editorial control and, especially, Sky’s control of the ‘look and feel’ and integrity of those services. A key consideration is the extent to which supplying (and continuing to supply) rapidly changing and evolving enhanced services in a form compatible with Virgin Media’s cable platform would hinder the pace at which Sky can develop and innovate in relation to those services generally.
- 4.10. Whilst Sky has not ruled out the possibility of supplying its enhanced and interactive services, Virgin Media has not confirmed that its platform is capable of meeting Sky’s reasonable requirements and that the efforts that Sky would need to make would be justified through additional revenue.

Sky’s distribution of its premium channels

- 4.11. The Complainants make a number of allegations regarding Sky’s strategy for distribution of its premium channels on platforms other than the DTH platform:
- (a) *“Sky has... refused to supply its premium channels to certain other third party pay TV retailers and platforms”;*⁹³
- (b) *“Sky’s refusal to wholesale its premium channels to certain pay TV retailers on the DTT platform means that consumers on those platforms are denied the ability to choose to subscribe to those channels. The fact that Sky does not wholesale its channels to DSL providers (instead, insisting on retailing direct to customers via ‘Sky by Wire’) denies those platforms the ability, among other things, to offer bundled or discounted offerings including premium content to their customers”.*⁹⁴

⁹³ Part 3, Paragraph 4.5.

⁹⁴ Part 4, Paragraph 5.3(a).

'Sky by Wire' does not have the object of foreclosing Sky's pay TV competitors - nor does it have the ability to do so

- 4.12. It is true that, all things being equal, Sky has a preference for arrangements whereby it gains access to the closed platforms of others and is able to retail its premium channels itself, directly to consumers on those platforms. The Complainants, however, seek to portray Sky's preference for retail deals as an example of a strategy by which Sky seeks to marginalise or foreclose its downstream competitors (*i.e.*, at the retail level). But the Complainants' account of events is highly selective and misleading.
- 4.13. Any consideration of Sky's 'Sky by Wire' strategy must be underpinned by a proper understanding of Sky's reasons for pursuing that strategy.
- 4.14. In light of the high and increasing fixed costs of acquiring content and the inherent economies of scale at the channel supply level, Sky considers that its interests are best served by distribution to the largest possible number of subscribers.
- 4.15. Sky believes that the best way to achieve this is by ensuring that its premium channels are available across as many different platforms (provided they are adequately secure) as possible (and CRA, at **Annex 4**, demonstrates that it has incentives to do so).
- 4.16. Sky's preference for retailing its premium channels stems from its experience with cable. On Virgin Media's cable platform, less than **[CONFIDENTIAL]**% of subscribers take one or more of Sky's premium channels, compared with some **[CONFIDENTIAL]**% where Sky is the retailer; if the rate of penetration of Sky's premium channels on Virgin Media's cable platform were equivalent to that on DTH, incremental contribution for Sky could be as much as some £**[CONFIDENTIAL]** per annum.⁹⁵
- 4.17. Sky considers that several factors contribute to Sky's relative success in retailing its premium packages:
- (a) Sky has proven marketing expertise in communicating the value of its premium sports and movies channels to prospective and existing basic customers and, more generally, the know-how and expertise in marketing television services is one of its core strengths. Cable and the IPTV providers' core strengths on the other hand tend to lie in different areas, in particular in the sale of telephony and broadband;
 - (b) third party retailers do not have the same incentives as Sky to market Sky's channels. Whereas Sky has very low marginal costs (since many of its rights costs are largely fixed), third party retailers must bear a marginal cost (namely the wholesale price). This is inherent in wholesale distribution, as there is a marginal cost whatever the supply price (unless it is zero). Sky has tried on a number of occasions to

⁹⁵

As at September 2007.

improve the incentives available to retailers to sell its premium channels, for instance working with cable on non-linear discount structures from the wholesale ratecard prices. These efforts had to be abandoned however **[CONFIDENTIAL]**;

- (c) Sky believes cable's poor performance in selling Sky's premium channels to date is exacerbated by the fact that greater incentives lie elsewhere. For Virgin Media, whose core strengths lie in telephony and broadband⁹⁶ (where marginal costs are very low as costs are largely sunk in the network), their potential margins - and therefore incentives - to sell such products are greater than in the case of Sky's premium channels. The same can be said of other platform operators (such as BT Vision). Understandably, such platform operators tend to prioritise their marketing efforts on selling telephony and broadband services, at the expense of marketing and selling Sky's premium channels.
- (d) Sky also believes that, if a customer who is taking Sky's channels calls to cancel his subscription, a third party retailer's incentive is to focus on making sure that customer is retained as a customer of its pay TV and/or other services, and that the subscription to Sky's channels would be sacrificed if necessary to secure that objective. In order to 'save' a potential churner, the retailer might suggest that the customer moves to a lower priced proposition, dropping one or more Sky channels in the process.⁹⁷ This has long been a problem with regard to the cable wholesale relationship. Sky has greater incentives than third party retailers to persuade the customer to retain his subscription to a Sky channel, and greater experience of successfully doing so.

4.18. Not only, as set out in the preceding paragraphs, is the 'Sky by Wire' strategy not motivated by a desire to foreclose Sky's competitors at the retail level, but it also does not have the potential to do so. This is because (as already discussed in **Part C** above),⁹⁸ even if it were the case (which it is not) that, in order to build a viable subscriber base, a pay TV retailer needs to be able to offer access to Sky's premium channels, the availability of Sky's premium channels on the same platform for purchase directly from Sky satisfies such a requirement.

4.19. Turning specifically to the section of the Complaint quoted in **Paragraph 4.11(b)** of this **Part D** above, it is inappropriate to talk, as the Complainants do, in terms of a *platform* having the ability to offer bundled or discounted offerings and, as discussed in **Part C** of this Response, there is no imperative for consumers accessing a particular platform to be able to acquire all their TV

⁹⁶ See the comments of Virgin's acting chief executive Neil Berkett, "*Despite our technical advantage we are still not really standing out from the crowd,*" admitted Mr. Berkett. "*I really do want to re-focus our energies onto the broadband platform*". Guardian, 22 October 2007. <http://business.guardian.co.uk/story/0,,2196476,00.html>.

⁹⁷ For example, it might be suggested that the customer cease subscribing to Sky Movies channels and instead buy movies from the retailer's on-demand service as and when they want to.

⁹⁸ See from **Part C, Paragraph 5.7** onwards.

services from the same provider.⁹⁹ Nor is it clear what is intended by the phrase “*bundled ... offerings including premium content*”; if this means no more than packages which include both “*premium*” and non-“*premium*” content, a few facts should be acknowledged: first, there are premium services other than Sky’s premium channels (e.g., Setanta’s services, Universal’s ‘PictureBox’ and Sony/Disney’s JV FilmFlex premium movie services), so that it cannot be the case that any action by Sky can cause a particular situation with respect to all “*premium content*”; second, Setanta retails its channels directly to subscribers on TUTV’s DTT platform, who, to the extent that they subscribe to basic channels, buy these from TUTV; and third, to the extent that a ‘bundled offer’ requires a consumer to subscribe to one service in order to be able to receive another, it should be noted that platform operators with whom Sky has entered into a ‘Sky by Wire’ arrangement have been able to require, as a condition of access to their platform, that Sky retails its premium channels only to consumers who have already subscribed to channels retailed by the platform operator (i.e., Sky premium channels are available only as a buy-through from a package retailed by the platform operator). The platform operator has therefore been able to procure that, in effect, Sky’s premium channels are only available if bundled with its own TV offering.

- 4.20. It should be noted that, in addition, Sky offers to wholesale its basic channels to platform operators, rather than including them in its ‘Sky by Wire’ offering, so that those basic channels are sold as part of the operators’ packs .
- 4.21. As far as the reference to “*discounted offerings*” is concerned, it is open to platform operators with whom Sky has ‘Sky by Wire’ arrangements, in their capacity as retailers of TV services, to discount their basic channel packages (or any other packages of services) to those of their subscribers who also subscribe to one or more premium channels from Sky. They are also free to discuss any other joint marketing arrangements which would benefit both parties.
- 4.22. For these reasons, it is wholly misleading to portray Sky’s policy as designed to restrict or refuse supply of its premium channels. Despite technical obstacles, and contrary to the allegations made, Sky has made substantial efforts to engage with the operators of closed platforms so that it can make its channels available to customers of those distribution networks. Platform operators have not been foreclosed from retailing other pay TV channels and services in the process.

Sky has not refused to wholesale its premium channels

- 4.23. The section of the Complaint quoted in **Paragraph 4.11(b)** of this **Part D** above implies that Sky would never contemplate wholesaling its premium channels to retailers on DSL platforms, which is not the case. Sky has explained its reasons for preferring retail over wholesale arrangements and has invited DSL operators to suggest arrangements which might alleviate Sky’s concerns. To

⁹⁹ *Ibid.*

date, no operator has done so, and Sky has negotiated agreements for access to DSL platforms.

- 4.24. The Complainants also claim that Sky has refused to wholesale its premium channels to certain pay TV retailers on the DTT platform. Sky assumes that the pay TV retailers in question are TUTV and BT. As evidenced in the **Confidential Annex**, Sky has not refused to wholesale its premium channels in either case.
- 4.25. It is also worth noting that there is no certainty that Sky will be able to launch new channels (including its sports or movies channels) on the DTT platform (Sky's proposals to launch such channels being the subject of an Ofcom consultation).

Sky's basic channels

- 4.26. The Complaint also claims that Sky has constructively refused to supply its basic channels to Virgin Media, thus depriving customers on the cable platform of access to those channels.
- 4.27. This, in effect, repeats the allegations made by Virgin Media in the proceedings which it has launched in the High Court against Sky, alleging that Sky has constructively refused to supply its basic channels to Virgin Media, thereby abusing a dominant market position to Virgin Media's detriment.
- 4.28. Sky has fully set out its arguments as to why it has not refused to supply its basic channels to Virgin Media, whether constructively or otherwise in its defence to Virgin Media's claim, which it has served.

Wholesale rates for Sky's premium channels

- 4.29. The Complaint claims that Sky does not supply its premium channels on commercially viable wholesale terms. Ofcom is of course aware that the OFT investigated Sky's wholesale pricing of its premium channels in the UK under the Competition Act 1998. In the OFT Decision, the OFT concluded that Sky had not exercised a margin squeeze on third party distributors. Sky is, as Ofcom would expect, very much alive to the issue of margin squeeze when setting its wholesale prices for its premium channels and its retail prices for its channel packages, and takes care to ensure that it continues to satisfy the OFT's margin squeeze test. Sky's pricing is wholly consistent with the OFT Decision; Sky's own notional retail pay TV business is profitable and yet pays notional wholesale prices for Sky's premium channels which are the same as those paid by Virgin Media.
- 4.30. Unless the Complainants are suggesting that the OFT margin squeeze test is wrong, there is nothing more to be said in response to this claim.¹⁰⁰

¹⁰⁰ Whilst Sky considers that (to the extent that it was ever correct, which Sky disputes) the dominance finding in the OFT Decision can no longer be relied upon, there is no reason why the margin squeeze test set out in that decision would no longer be the appropriate test to determine whether a margin squeeze has been exerted on third party distributors.

Sky has not failed to offer any security of contract in relation to the terms of supply of premium channels

- 4.31. Sky finds this a strange allegation for the Complainants to make. Sky's wholesale customers for its premium channels, including Virgin Media, are able to derive considerable comfort as to the future availability and pricing of Sky's premium channels from previous regulatory pronouncements, including the OFT Decision. By contrast, Sky has no such comfort as to the continued carriage of its channels on networks such as cable.
- 4.32. Sky has strong incentives, therefore, to negotiate longer term contracts for the supply of its premium channels in order to gain security of carriage for a reasonable period (and security as to the length and terms of that carriage).
- 4.33. It should be appreciated, however, that negotiation of a longer term agreement is a difficult task, since it involves agreeing terms in relation to issues which are likely to become more complicated as the term of the agreement increases, such as future wholesale prices and content commitments. It is disingenuous of the Complaint not to acknowledge this fact, and even more so given that cable has pressed for the scope of discussion in relation to potential longer term wholesale supply agreements for Sky's premium channels to extend to a yet wider range of issues.
- 4.34. The fact that, in the past, longer term agreements with cable for the wholesale supply of Sky's premium channels for carriage on the cable platform have either not been reached, or have been agreed but not implemented, cannot be blamed on Sky. These attempts to agree longer term (and more sophisticated) wholesale agreements have been frustrated in part by vacillation on the part of cable operators and in part by the unwillingness of regulators to provide Sky with the legal comfort it needs before entering into arrangements of this nature.
- 4.35. However, as illustrated by the contents of the **Confidential Annex** (which provides details of past and ongoing attempts to negotiate longer-term wholesale agreements between Sky and cable), the above is not to say that Sky has written off the possibility of reaching a longer term agreement of this type.

5. Allegations regarding Sky's conduct as a pay TV retailer

- 5.1. The Complainants claim that Sky has leveraged its position as the primary pay TV retailer on the DTH platform into other platforms and technologies.¹⁰¹ This appears to link in with Part 4, Paragraph 5.4(f) of the Complaint:

"Sky imposes onerous obligations, including most favoured nation clauses, on third party broadcasters in its agreements with them for satellite distribution of their channels. These MFN clauses result in either restricted access to content for competitors seeking to use new platforms and

¹⁰¹ See Part 3, Paragraph 4.5(e).

technologies or the imposition upon such competitors of commercial terms which are appropriate for more traditional linear broadcast services. Thus, these MFN clauses inhibit the development of innovative services over new platforms and technologies.”

- 5.2. Although Sky does not have the benefit of specific examples where Sky’s arrangements with third party channel providers are alleged to have these effects, it is nonetheless able to make the following points.
- 5.3. Whilst MFN provisions are included in **[CONFIDENTIAL]** the DTH distribution agreements into which Sky has entered with broadcasters whose channels Sky retails on the DTH platform, Sky does not impose those provisions. Rather, they are negotiated as a legitimate ‘quid pro quo’ for channel providers’ desire for longer term distribution agreements. The provisions are designed to protect Sky’s legitimate interest in ensuring that other pay TV retailers will not free-ride on the licence fees paid by Sky to channel providers. The scope for free-riding in these circumstances is potentially extreme because of the nature of broadcasters’ cost structures (under which the incremental cost of wholesaling (linear or non-linear) content to another pay TV retailer is potentially close to zero). The MFN provisions that Sky negotiates with broadcasters tend to seek to encompass situations where the broadcaster licenses to a third party (whether for inclusion in linear or non-linear services) content which is of equivalent value, from a retailer’s perspective, as the channel supplied to Sky.
- 5.4. MFN provisions also function as a means by which Sky can mitigate risks that it would otherwise face in entering into distribution agreements of any significant duration (or of any duration, in the case of entirely new channels) associated with uncertainty as to whether the value of the channel might decline over the term of the contract.
- 5.5. If broadcasters were unwilling to commit to MFN provisions, so that Sky would need to assume high levels of risk with regard to possible free-riding by competitors and possible diminution in value of channels, the result would be that Sky would either significantly reduce the duration of the contracts into which it was willing to enter or significantly reduce the level of wholesale payments that it offered to broadcasters. Both courses of action would have a detrimental impact on broadcasters: the former would reduce the security enjoyed by broadcasters and, as a result, reduce their ability to plan ahead and invest in content; the latter, by reducing broadcasters’ revenues, would also have a long-run impact on the level of their programme investment. In both cases, the quality of channels provided to consumers would suffer.
- 5.6. It also seems that these allegations link in with Part 4, Paragraph 5.6(c) of the Complaint: *“the ability to impose restrictive terms in relation to the supply by channel providers of programmes to the DTH platform (and, in particular the imposition of restrictions as to the availability of such content on other platforms) again reduces the ability of affected broadcasters to innovate in terms of the use of content and overall strategy”*. Sky does not impose restrictions (whether in DTH distribution agreements or elsewhere) which prevent content being made

available on other platforms. Neither the MFNs nor any other provisions in Sky's DTH distribution agreements prevent the channel providers from agreeing to license their channels to other platforms, although, clearly, the terms of an agreement with another retailer (whether in respect of a 'traditional' linear channel or a non-linear service) might trigger a right for Sky to benefit from more favourable financial terms. Clearly, however, it is no more legitimate for retailers of newer, non-linear services to expect to free ride on the licence fees paid by Sky to channel providers than it is for retailers of linear services to do so.

- 5.7. The Complaint does not specify how the MFN clauses are alleged to "*inhibit the development of innovative services over new platforms and technologies*"; nor does it adduce evidence of any resulting foreclosure of competition. Indeed, the recent launches of Channel 4's 4oD VOD service **[CONFIDENTIAL]** and of the BT Vision VOD service would seem to contradict the Complainants' portrayal of the situation and claims as to the difficulties faced by new services, and non-linear services in particular.

6. Allegations regarding Sky's conduct as the operator of the DTH platform

Sky is not inhibiting Setanta's launch of HD channels.

- 6.1. The Complaint claims:

"Sky has refused to provide conditional access services to Setanta for a new HD channel. It has, however, indicated that it may be willing to retail a Setanta HD sports channel on the satellite platform to its subscribers – an arrangement which would eliminate retail price competition between such a channel and Sky's own channels (including its existing HD sports channels). Sky is, therefore, inhibiting Setanta's ability to introduce better quality broadcasts for its viewers".¹⁰²

- 6.2. Details of the correspondence between Sky and Setanta regarding Sky's provision of conditional access services for a Setanta HD channel, **[CONFIDENTIAL]** are provided in the **Confidential Annex**.

- 6.3. Ofcom will appreciate from the material in the **Confidential Annex** that:

- (a) discussions between Sky and Setanta concerning the provision of conditional access services for HD channels must be viewed as ongoing; and
- (b) Sky is not "*inhibiting Setanta's ability to introduce better quality broadcasts for its viewers*";¹⁰³ rather, **[CONFIDENTIAL]**.

¹⁰² Part 4, Paragraph 5.4 (d).

¹⁰³ Part 4, Paragraph 5.4(d).

- 6.4. Further, Sky notes that Paragraph 11 of the summary of Setanta’s hearing with the Competition Commission on 4 July 2007 in relation to its investigation into Sky’s acquisition of a 17.9% stake in ITV¹⁰⁴ states:

*“Setanta said that high definition was currently primarily a digital satellite application and it could add value to live sport. BSkyB had two high definition channels. **Setanta had not yet reached agreement with Sky to make conditional access technology available to Setanta for a high definition channel.** Nevertheless, Setanta was arranging for its games to be filmed using high definition compatible technology.”* (emphasis added).

- 6.5. Ofcom should question why, if Setanta believes that Sky has refused to supply and feels aggrieved at this, it did not choose to present the facts in this way to the Competition Commission, rather than as a case of continuing negotiations. It is particularly pertinent that Setanta gave this evidence to the Competition Commission only one day after the submission to Ofcom of the version of the Complaint of which Sky has been provided with a (partial) copy, in which Sky’s position is categorically described as a refusal to supply.

Sky’s conditional access charges for packages including live FAPL coverage

- 6.6. The Complaint alleges that certain prospective entrants were deterred from “*competing vigorously*” for live FAPL rights when they were auctioned in April/May 2006 as a result of Sky’s “*published CA charge*” of “*£3.20 per month for subscription CA services for a package of channels containing live FAPL coverage.*”¹⁰⁵
- 6.7. It is not clear to Sky who it is alleged was deterred from “*competing vigorously*” or why. In particular, the Complaint fails to account for the fact that Setanta was not deterred from bidding for, and ultimately winning, two packages of live FAPL rights. The reason for this is straightforward.
- 6.8. The approach to determining conditional access charges that applied at the time was based on commercial negotiation between Sky and third parties.¹⁰⁶ The figure of £3.20 referred to in the Complaint was included in a document that Sky was required to publish setting out its approach to such negotiations.¹⁰⁷ The figure of £3.20, however, was clearly indicated to be a starting point for negotiations, not the charge that would automatically apply to any package containing live FAPL football.¹⁰⁸

¹⁰⁴ Available on the Competition Commission’s website at http://www.competition-commission.gov.uk/inquiries/ref2007/itv/hearing_summaries.htm.

¹⁰⁵ Footnote 62 of the Complaint.

¹⁰⁶ Following the publication in 2006 of revised guidance on how Ofcom would examine complaints about Sky’s charges for such services, this approach has been replaced by the publication of a deterministic ratecard.

¹⁰⁷ “Method for Establishing Conditional Access Charges”, August 2003.

¹⁰⁸ Sky had been encouraged by Oftel to include such indicative charges in its publication setting out how it would approach negotiations in relation to conditional access charges. For example, Oftel’s May 2002 Statement on the pricing of conditional access services stated: “*Oftel considers*

- 6.9. [CONFIDENTIAL]. Negotiations between Sky and Setanta culminated, [CONFIDENTIAL], in an agreement as to the level of conditional access charge that Setanta would pay in the event that it won one or more packages of live FAPL rights, which was £[CONFIDENTIAL] per subscriber - [CONFIDENTIAL]. There is no reason why other potential bidders would not have been able to reach a similar position.

7. Conclusion

- 7.1. The allegations regarding Sky's conduct are, at best, mischaracterisations and, at worst highly misleading.
- 7.2. Furthermore, even if the allegations were, in fact, accurate, the failure on the part of the Complainants to adduce any evidence as to detrimental effect on competition means that those allegations do not demonstrate that competition has been foreclosed.

that the publishing of indicative prices that can serve as the starting point for commercial negotiation is helpful for all parties.” See Paragraph 3.19. Available at: <http://www.ofcom.org.uk/static/archive/oftel/publications/broadcasting/2002/cast0502.htm>.

PART E: THERE IS NO BASIS FOR A MARKET INVESTIGATION INTO PAY TV IN THE UK

1. Introduction

1.1. The Complainants argue that they have provided sufficient evidence to justify Ofcom concluding that:

- (a) there are reasonable grounds for suspecting that some feature, or combination of features, of the markets in which Sky operates in the United Kingdom prevents, restricts or distorts competition; and
- (b) Ofcom should exercise its discretion to refer the matter to the Competition Commission pursuant to Section 131 of the Enterprise Act.

1.2. Sky contests both these assertions. It is to be noted that whilst, conceptually, the two issues are distinct, there is a real risk that if (as Sky contends) the Complainants have wrongly identified a supposed ‘problem’ in the market, any assessment of whether that supposed problem can best be addressed by a market investigation is also likely to be erroneous. It is only if a problem is correctly identified that a true assessment can be made as to whether it is likely to be effectively addressed via a market investigation reference. Sky shows below that, by wrongly characterising the supposed problems afflicting the markets in which Sky operates, the Complainants have also misled themselves into believing that such problems are apt to be addressed via a market investigation reference.

1.3. It is Sky’s submission for the reasons more fully developed below that:

- (a) Ofcom as the sectoral regulator with specialist knowledge and skills should examine the Complainants’ case fully and critically before deciding whether the Complaint discloses “*reasonable grounds*” to justify a reference and, if so, whether any discretion to make a reference should be exercised;
- (b) there are no “*reasonable grounds*” for suspecting that some feature or combination of features of the market prevents, restricts or distorts competition; and
- (c) this is not, in any event, a case suitable for a market investigation.

2. The role of Ofcom

2.1. One of the functions of Section 131 is to enable the OFT (or, in regulated sectors, a regulator exercising concurrent powers with the OFT) to call a halt to its own preliminary investigation, without having to reach definitive conclusions, and to hand the matter over to the Competition Commission for a fuller investigation. In order to avoid unnecessary duplication of effort by the OFT and the Competition Commission, the point at which the OFT is entitled to

initiate a full Competition Commission investigation may come at a relatively early stage in the process, where there are sufficient grounds to justify a full investigation, but before the OFT has itself conducted a full investigation. But the OFT must, at the least, conduct enough of an inquiry to ascertain what appears to be the ‘problem’ in a particular market, so that it can at least decide whether the problem is likely to be sufficiently material to justify further competition law review, and, if so, whether it is likely to be best addressed via a market investigation rather than via some other kind of competition law or consumer protection law intervention.¹⁰⁹ In short, Section 131 seeks to strike a balance between having an unnecessarily long inquiry at the OFT stage, on the one hand, and having cases referred prematurely and unnecessarily to the Competition Commission, on the other.

- 2.2. What kind of inquiry the OFT should conduct before deciding to make a market investigation reference will vary from one case to another, according to how complex the market is and how readily potentially relevant features can be identified. In some cases, even if the firms who are under investigation call into question whether the OFT’s identification of relevant features is correct, or whether the identified features are likely to be restrictive of competition, the OFT may decide that it need not probe such explanations in detail, and that its own preliminary assessment of the case justifies a reference to the Competition Commission. In other cases, such an approach would be irresponsible, and would give rise to substantial costs and burdens for the Competition Commission and affected private parties, which might have been avoided altogether by a more thorough investigation of the facts by the OFT. Thus, in such a case, the OFT may judge it appropriate to conduct a fuller investigation of the facts before deciding whether, in the light of all the evidence, there are “*reasonable grounds*” sufficient to justify a reference.
- 2.3. Sky submits that this is such a case where it is appropriate for Ofcom to conduct a rather more thorough examination of the facts and issues than the Complainants wish to see. There are several reasons why Ofcom should examine the facts and matters very thoroughly before deciding whether the evidence discloses “*reasonable grounds*” for a reference. They are as follow:
- (a) as a sectoral regulator with specialist knowledge, Ofcom can be expected to apply its specialist knowledge to decide whether the Complainants’ case withstands scrutiny. Ofcom is in a position to do this, and can bring its own extensive knowledge and skills to bear on the issues, whereas the OFT’s knowledge of a market is likely to be more limited given that it may not have had cause to investigate it previously;
 - (b) the role of Ofcom in assessing the Complaint is all the more important since the Complaint is presented in a way which ignores important elements of the context in which pay TV is provided in the UK, with which Ofcom will be familiar. It is submitted these missing elements have an important bearing on the decision whether to make a reference;

¹⁰⁹ See Paragraphs 3.34 – 3.41 of OFT 519 (Market studies) and Paragraph 2.1 of OFT 511 (Market investigation references).

- (c) the Complainants have put together a very lengthy document, which invites scrutiny as to whether it is well-founded in fact, and well-reasoned. Faced with such a lengthy document from the Complainants, it is clearly appropriate for Ofcom to weigh what the Complainants say against what Sky itself says in reply, and what Ofcom knows from its own experience of the sector. In particular, Ofcom should treat with the utmost scepticism hypotheses that competition is ineffective which are inconsistent with the stated competitive strategies and views of the Complainants;
- (d) Ofcom should take into account the motivations of the Complainants in bringing the Complaint and (in light of those motivations) the credibility of the case that they seek to make. Sky has previously submitted evidence to Ofcom that it is part of the Complainants' strategy to use the ill-founded and unwarranted threat of a structural separation of Sky to seek to extract specific commercial benefits in relation to areas of commercial dealings with Sky. Ofcom should be alert to the possibility that a key motivation of the Complainants is simply to disrupt Sky's competitive efforts at a time when it faces ever more aggressive competition;
- (e) one of the Complainants, Virgin Media, has launched proceedings in the High Court against Sky, alleging that Sky has abused a dominant market position to Virgin Media's detriment. In short, it is raising some of the issues which appear in the Complaint in separate litigation. Ofcom should therefore also be alert to the possibility that the Complaint is a tactical device in that litigation;
- (f) Ofcom is conducting its own review of the terms on which Sky offers third party access to its TV distribution platform.¹¹⁰ Ofcom should therefore assess thoroughly whether all or part of the Complaint can be effectively addressed via *that* review;
- (g) if there were any substance in any part of the Complainants' case (which is disputed), it would raise serious questions as to whether the relevant issues would be better addressed via the Competition Act 1998 and/or Articles 81 and 82 EC, or by the exercise of Ofcom's sectoral powers. This is a more complex judgment than the judgment required to be made in many cases, because of the more extensive powers available to Ofcom than to the OFT in other sectors. In order to decide whether a Competition Commission reference is appropriate in the present case, Ofcom needs to reach a well-informed view as to what, if any, problems there might be in respect of competition in the markets in which Sky operates, and how they might best be addressed;¹¹¹

¹¹⁰ Ofcom's "Review of Wholesale Digital Television Broadcasting Platforms" (commenced in July 2006).

¹¹¹ The OFT Guidelines highlight the importance of considering the powers and remedies available to the OFT and its responsibility to exercise those powers and remedies where they are

- (h) the sector in question is dynamic and fast-moving and, as such, any intervention runs a greater risk of having unintended consequences, such as affecting the success of any future innovation; and
- (i) there is no urgent need to refer the matter to the Competition Commission immediately or in short order.

2.4. In summary, Sky therefore urges Ofcom to examine the Complainants' case fully and critically before deciding whether it discloses "reasonable grounds" to justify a Competition Commission reference, and, if it finds there are reasonable grounds, before deciding whether to exercise any discretion to make such a reference. Ofcom should be mindful of its own statement that:

*"The option of not intervening... should always be seriously considered. Sometimes the fact that a market is working imperfectly is used to justify taking action. But no market ever works perfectly, while the effects of... regulation and its unintended consequences, may be worse than the effects of the imperfect market."*¹¹²

3. There are no reasonable grounds for suspecting that some feature or combination of features of the market prevents, restricts, or distorts competition.

The Complainants' case

3.1. The Complainants argue, in effect, that Sky's role in the provision of pay TV (and premium pay TV) services gives rise to a "vicious circle", in which Sky's alleged competitive advantages at one level of the supply chain reinforce its alleged advantages at other levels of the supply chain. They argue that Sky's conduct demonstrates that it has the incentive and ability to foreclose competitors both upstream and downstream.¹¹³ The Complainants argue that piecemeal intervention to prevent particular kinds of abusive conduct at one level of the supply chain will not address the "vicious circle" effects. They argue that, whilst there may be scope for dispute as to whether the "features" which they have identified are properly to be regarded as "structural" or "behavioural", the question is of no significance and, either way, their evidence discloses "reasonable grounds" sufficient to enable Ofcom to make a market investigation and they propose such a market investigation as being appropriate, in order to open up the possibility of both "behavioural remedies" (e.g., FRND access to certain 'bottlenecks') and "structural remedies" (e.g., operational separation of Sky's upstream and downstream activities). The Complainants draw analogies with the OFT's reference to the Competition Commission of the UK airports market, where the reference is perceived as being designed to address structural features of the market arising from BAA's common ownership of several major airports.

appropriate to address the competition problem which has been identified: see Paragraph 2.3 of OFT 511 and Paragraph 3.37 of OFT 519.

¹¹² "Better Policy Making – Ofcom's approach to Impact Assessment" (21 July 2005), Paragraph 1.1.

¹¹³ Although it should be noted that it appears much of the detail of the Complaint in this regard is contained in confidential Annexes which have not been disclosed to Sky.

3.2. Sky takes issue with each and every such element of the Complainants' case.

The Complaint misrepresents the context in which pay TV services are provided

3.3. Sky has already explained in **Part B** of this Response that the Complaint ignores three very important elements of the context in which pay TV services in the UK are provided:

- (a) competition between pay TV and other audiovisual services;
- (b) the significant and rapid changes in the audiovisual sector in the UK; and
- (c) the fact that the regulatory interventions dismissed by the Complainants as inadequate are only recent.

3.4. This has important consequences for Ofcom's assessment of the Complaint. First, the Complaint has to be assessed in the wider context set out in **Part B** of this Response; in particular, any consideration of whether reasonable grounds for a reference exist and whether a reference would be proportionate must take into account the competitive constraints on pay TV that other audiovisual services impose. Second, given the rapid change in the audiovisual sector, Ofcom cannot rely on past inquiries as the basis for its analysis. The OFT's last investigation was completed in 2002 and focussed on the period between 1998 and 2001. Given the current competitive dynamics of the sector, neither this nor older decisions remain relevant. Third, any attempt to assess the effectiveness of recent regulatory interventions is premature and Ofcom should examine the Complaint critically in this regard. Finally, given the rapid pace of change Ofcom should make a dynamic assessment of the Complaint having regard to, for example, the opportunities for new entry and expansion that are enhanced by innovation and the likely impact of recent regulatory interventions.

3.5. However, even if one adopts the narrow approach of the Complaint, there are no reasonable grounds for a reference.

There is no such 'vicious circle' as the Complainants allege, a fact which is fatal to the Complainants' case for reference

3.6. Sky has explained in **Part C** of this Response that there is no "vicious circle" such as the Complainants allege. The theory advanced by the Complainants suffers from fundamental flaws in logic and reasoning.

3.7. Sky has also shown how the notion of a "vicious circle" is crucial to the Complainants' case for reference. When the theory of the circle is deconstructed, the Complainants' case for regulatory intervention via a market reference collapses.

No evidence has been disclosed which demonstrates that Sky has either the incentive or the ability to foreclose competitors, or that it has done so

- 3.8. The CRA report at **Annex 4** demonstrates that there is no basis for the argument in the Complaint that Sky has the incentive or the ability to foreclose competitors either upstream or downstream.
- 3.9. In **Part D** of this Response, Sky has shown that there is no basis for the allegations that it has acted to foreclose or hinder competition. Indeed the Complaint is seriously misleading in its account of Sky's conduct and dealings with the Complainants and others in the industry. Sky considers that the Complainants have engaged in concerted strategy of seeking through recent correspondence to bolster what is ultimately an extremely weak case. Ofcom should rigorously test these allegations.
- 3.10. Importantly, the Complainants do not allege or adduce evidence to the effect that there has been any impact on competition arising from Sky's alleged conduct.
- 3.11. In summary, Sky has not engaged in conduct (nor does it have the incentive or ability to do so) which prevents, restricts or distorts competition.
- 3.12. Sky submits that, if Ofcom subjects the Complaint to critical scrutiny, it will conclude that it discloses no reasonable grounds to suspect that there are features of the market (whether alone or in combination with conduct on Sky's part) which prevent, restrict or distort competition.

4. This is not a case which is suitable for a market investigation

As a consequence, the arguments put forward by the Complainants to justify a market investigation are erroneous

- 4.1. It follows from what is said above that Sky considers that the Complaint fails to make out a sufficient case to justify Ofcom's concluding that there are "*reasonable grounds*" to found a market investigation reference pursuant to Section 131 of the Enterprise Act.
- 4.2. However, even if that is wrong, it is clear that the Complainants' errors in characterising the competition problems which they have allegedly identified have skewed the Complainants' assessment of the suitability of the case for reference to the Competition Commission by way of market investigation. In particular:
- (a) the Complainants fail to recognise that, if there is a problem for new retailers in accessing the market, it is best addressed by the exercise by Ofcom of its regulatory powers under the Communications Act to ensure fair access for third party retailers on reasonable terms to existing distribution networks – both Sky's satellite distribution platform and Virgin Media's cable platform. The Complaint distracts attention from this issue, by focusing instead on the retail market, and thereby obscures the fact that Ofcom has available to it powers to regulate

access to the platforms which are an essential input into any retail TV offering;

- (b) by their false line of reasoning, the Complainants suggest that serious problems at the retail and upstream (content procurement) levels of the market are mutually reinforcing. They infer from this that there is a need for major structural remedies, or wholly new kinds of semi-structural rules, which would go beyond Ofcom's powers as a sectoral regulator. But there is no such problem as the Complainants posit, and therefore a market reference cannot be justified.

4.3. In addition, the Complainants are seeking a market investigation of a single firm which they acknowledge is not the purpose of Section 131. The Complaint fails to meet the higher hurdle (which the Complainants accept)¹¹⁴ for a reference, namely that there are both single firm conduct and structural features of the market which prevent, distort or restrict competition. In essence the Complainants objection is to the success of Sky as a broadcaster and it is very clear that the purpose of the market investigation regime is not to address the market position of a single firm.

4.4. Furthermore, at the core of the Complainant's "*vicious circle*" theory is Sky's vertical integration. The OFT's guidance indicates, however, that the vertical integration of a single firm is not a feature that is appropriately the subject of a market investigation reference. It is only if "*a number of firms in a market are vertically integrated and they engage in some form of anti-competitive conduct*" that a market investigation reference "*might be appropriate*".¹¹⁵ No case is made in the Complaint that there are structural issues arising from a number of vertically integrated players.

The analogy with BAA is a false one

4.5. The Complainants present the problems they identify as being essentially structural, but suggest that the precise characterisation does not matter. Sky agrees that Section 131 of the Enterprise Act recognises no distinction between structural and behavioural problems. But, by characterising the problems as essentially structural, the Complainants go on to draw a false analogy with the case of BAA and the market investigation of the airports sector.

4.6. In the BAA case, the OFT was quite clear in its reasoning, to the effect that, if there is ultimately found to be a structural problem in a market for the supply of airport services in the south east of England, that problem is likely to arise, in substantial part, from the very fact of the common ownership of Heathrow, Gatwick and Stansted airports by BAA. BAA owns the freehold property on which the airports operate, and all the airport assets, and nothing short of a divestment order will be effective to alter that. Thus, if there is a structural

¹¹⁴ Part 6, Paragraph 2.5.

¹¹⁵ Paragraph 5.9 of OFT 511 (Market investigation references).

problem requiring structural remedy, the only likely remedy is an order that BAA divest its entire interest in one or more of its airport undertakings.

- 4.7. In contrast, even on the Complainants' case, Sky's supposed structural advantages arise, at most, from a series of contracts between Sky and third parties (content providers, platform operators, channel providers, and customers), and the advantages which that network of contracts is alleged to confer on Sky in winning future contracts for important content or distribution opportunities. Sky does not, in any sense, own unique infrastructure or other tangible assets (and even the 'Sky platform' is merely a construct of contracts with satellite operators, technology providers, and suppliers of reception and decoding equipment). Thus, even on the Complainants' case, this is not a situation where Sky owns outright unique assets or infrastructure.

It follows that, if (contrary to Sky's case) Ofcom were to conclude that there are "*reasonable grounds*" sufficient to enable it to make a market reference to the Competition Commission, it would be erroneous to do so on the basis that any structural remedies required in the present case could be achieved only via a divestment order following a market investigation.

- 4.8. It is important to recognise that the case of BAA is materially different from the present case in other respects also. In deciding to refer the airports case to the Competition Commission, the OFT identified several issues which it considered could best be addressed by the Competition Commission via a market investigation reference. As well as the issue of common ownership, it identified issues as to whether the regulatory regime applicable to airports was restrictive of competition, and as to whether the planning regime is restrictive of airport development and, hence, of competition.
- 4.9. It is notable that neither of these matters is capable of being addressed via other forms of competition law intervention, and both are subjects in respect of which the Competition Commission is likely to be well-placed to investigate and report in exercise of its market investigation functions.
- 4.10. In addition the OFT was concerned about BAA's capital investment plans, levels of charges and service quality. As Sky has shown in **Part B** of this Response, it has led the development of the industry through its innovation and investment. The CRA Report at **Annex 3** shows that there is no basis for the allegations of consumer detriment made by the Complainants; the LECG report on which they rely is deeply flawed.

Nor is it otherwise appropriate for Ofcom to exercise its discretion to refer the present case to the Competition Commission

- 4.11. The Complainants cite a number of other reasons which, in their view, make the present case suitable for reference to the Competition Commission. Sky takes issue with the Complainants' account of these factors.
- 4.12. Generally, competition authorities favour structural remedies (subject to considerations of their proportionality in any particular case), because they offer a once and for all solution, thereby obviating the need for constant

monitoring and supervision. But the Complainants do not suggest that their proposed remedies would achieve this. They apparently envisage that Sky should be subject to continuing obligations to maintain operational independence for its retailing/platform functions from its channel supply functions. And they also envisage that Sky should be subject to continuing obligations to deal on FRND terms in supplying various services to third parties. It is clear that Ofcom, rather than the Competition Commission, is better placed to devise and oversee the observance of such obligations via the exercise of its sectoral regulatory powers where they are relevant (*e.g.*, in respect of the supply of platform access services to third parties).

- 4.13. It is also to be noted (as Ofcom's own current consideration of digital TV broadcasting platforms recognises)¹¹⁶ that there may well be a case for regulating not only Sky's DTH platform, but also other delivery platforms (*e.g.*, Virgin Media's platform). It would therefore be wrong to accept the Complainants' characterisation of the issues as relating exclusively to Sky and its alleged competitive advantages, and as being unrelated to the subject matter of Ofcom's sectoral regulatory functions.
- 4.14. Finally, Sky does not contest that there is an important public interest in ensuring the competitive functioning of the pay TV sector (and the wider market within which it exists). But it is, nonetheless, important to keep a sense of proportion. As set out in **Part B** of this Response, this is not a market where competition is ineffective. There is an excellent record of innovation in every sense – in technical modes of delivery of services, in the range and quality of content available, and in the methods by which services are marketed to consumers. There is a wide range of suppliers active in the market at all levels, with numerous channel suppliers, retailers/free to air distributors and platform operators which benefits consumers. Importantly, as set out in **Annex 3**, there is no evidence of consumer detriment. There is therefore no reason to believe that the Complainants' misconceived, exaggerated and cynically self-serving Complaint necessitates a Competition Commission investigation.

Sky

October 2007

¹¹⁶ Ofcom's "Review of Wholesale Digital Television Broadcasting Platforms" ("Statement", dated 10 October 2006), Paragraph 3.7.

ANNEX 1: THE STANDARD ECONOMIC MODEL OF SUBSTITUTABILITY BETWEEN PAY TV AND FREE TO AIR TELEVISION SERVICES

1. The standard economic analysis of the way in which free to air television affects the demand for pay TV may be demonstrated by way of an example.¹¹⁷ Initially, we assume that there is only one free to air channel and one pay TV service, each of which broadcast over the same three-hour period in a day. **Table 1** below shows the assumed value to a representative viewer of the programming provided by each service.

Table 1: Value of Programming to Viewer by Service: single free to air channel

	Value placed on programming		
	Hour 1	Hour 2	Hour 3
Free to air channel	£5	£7	£8
Pay TV service	£7	£6	£13

2. If the free to air channel was not present, the consumer would be willing to pay as much as £26 for the pay TV service, since that would be the value to her of the programming it offers. But the free channel offers programming in hour 2 that the consumer prefers to the programming carried by the pay TV service exhibited in that hour. As a result, if the consumer subscribed to the pay TV service she would watch programmes on its channels only in hours 1 and 3 and in those hours would gain an incremental value over the free programming of £2 in hour 1 and £5 in hour 3, for an aggregate gain of £7. The maximum that the consumer would be willing to pay for the pay service is, therefore, £7 since any greater payment would exceed the value of the pay TV service to her. Absent the free to air channel, the consumer would have been willing to pay £26 for the pay TV service so competition from the free to air channel reduces the price the consumer would be willing to pay for the pay TV service from £26 to £7. It is clear, therefore, that the existence of free to air channels represents a competitive constraint on the prices that can be charged for pay TV services.
3. The existence of additional free to air channels will, for a given quality of programming carried by pay TV services, diminish further the amount that can be charged for a pay TV package, by increasing the likelihood that the further

¹¹⁷ See pp 101-106 in B. Owen, and R. Wildman, "Video Economics", Harvard University Press, 1992. This constraint has been recognised by competition authorities in the past. For example, the Monopolies and Mergers Commission stated: "We agree that there is a degree of price constraint [from free to air television] – people have to be persuaded that pay TV is worth buying at all..." Paragraph 2.38, *British Broadcasting Group plc and Manchester United PLC, A report on the proposed merger*, Monopolies and Mergers Commission, April 1999. Cm 4305.

free to air channels will provide some programming that the consumer values more highly than that on the pay TV service. **Table 2** below adds the values the consumer attaches to the programming of a second free to air channel.

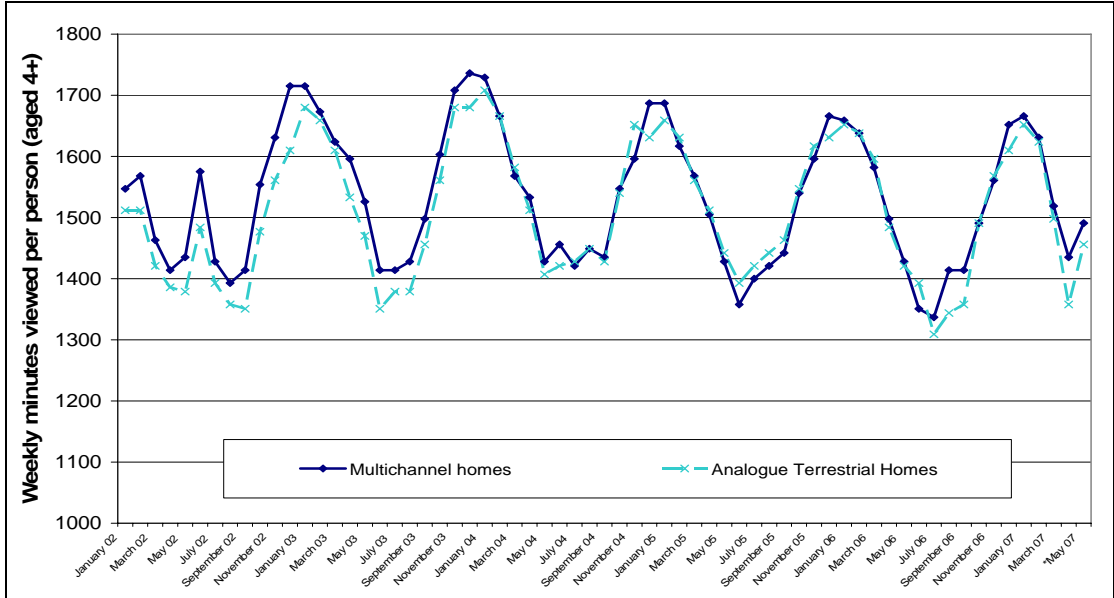
Table 2: Value of Programming to Viewer by Service: multiple free to air channels

	Value placed on programming		
	Hour 1	Hour 2	Hour 3
Free to air channel 1	£5	£7	£8
Free to air channel 2	£8	£5	£7
Pay TV service	£7	£6	£13

4. In this example the consumer now prefers programmes on the free to air channels in both hours 1 and 2. If she subscribed to the pay TV service she would watch it only in hour 3 and the incremental value to her over the best programming offered by free to air television would be £5. The addition of a second free to air television channel has, therefore, reduced the price that the consumer would be willing to pay for the pay TV service from £7 to £5. This is particularly important in the context of the recent very substantial increase in the number of free to air channels available in the UK.
5. A number of implications arise from this standard analysis:
 - The availability of free to air television services diminishes consumers' willingness to pay for subscription television services (and thereby the prices that retailers can charge for pay TV packages);
 - Programming on the free to air channel need not be a "close substitute", in the sense of being the same type (or genre) of programming, to that carried on channels in the pay TV service for the free to air channel to be a very effective constraint on the prices that may be charged for the pay TV service. The programming shown in a particular hour on each channel in the examples above might be completely different;
 - The greater the number of free to air television channels available the more likely that consumers will be able to satisfy an increasing amount of their desired viewing with free to air programming and the lower will be their willingness to pay for subscription television services; and
 - An improvement in the quality of free to air television services will diminish consumers' willingness to pay for pay TV services. Again, an improvement in the quality of free to air services increases the likelihood that consumers will be able to satisfy an increasing amount of their desired viewing with programming that is free at the point of delivery.

ANNEX 2: MINUTES OF TELEVISION VIEWING PER WEEK

Table 1: Analogue terrestrial v. multi-channel households



Source: BARB/Infosys data, Sky analysis

ANNEX 3: CRA PAPER: A COMPARISON OF AVERAGE PAY TV REVENUE PER SUBSCRIBER ACROSS EUROPEAN COUNTRIES

ANNEX 4: CRA PAPER: SKY'S "INCENTIVES" TO FORECLOSE COMPETITION IN THE UK PAY TV INDUSTRY

ANNEX 5: FURTHER DETAILS OF SKY'S COMMERCIAL DEALINGS WITH THE COMPLAINANTS

CONFIDENTIAL ANNEX 5

Confidential Sub-Annex 1 – Virgin Media

[CONFIDENTIAL]

CONFIDENTIAL ANNEX 5

Confidential Sub-Annex 2 – TUTV

[CONFIDENTIAL]

CONFIDENTIAL ANNEX 5

Confidential Sub-Annex 3 – BT

[CONFIDENTIAL]

CONFIDENTIAL ANNEX 5

Confidential Sub-Annex 4 – Setanta

[CONFIDENTIAL]