

The pricing of conditional access services and related issues

A statement by the Director General of
Telecommunications

8 May 2002

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Summary

S.1 This statement of policy follows the consultation document entitled *The pricing of conditional access services and related issues*, 30 October 2001, (available at <http://www.oftel.gov.uk/publications/broadcasting/2001/caco1001.htm>).

S.2 Conditional access and related services provide encryption of broadcast content to digital receivers, to ensure that only those authorised to view the content are able to do so. For example, broadcasters will seek to purchase conditional access to restrict viewing to subscribers, or to people within a defined geographical area.

S.3 This statement outlines Oftel's conclusions on the following areas addressed in the consultation:

- Oftel's approach to regulating conditional access services;
- the structure of tariffs charged for these services; and
- the treatment of public service broadcasting.

S.4 In the UK, conditional access is only relevant to broadcasters using the digital satellite broadcasting route ('the digital satellite platform', operated by BSkyB). It does not apply to the digital cable platform, as with cable transmission, the viewing of content is restricted to defined subscribers with no possibility of overspill. If network capacity were to be made available to third party broadcasters on other platforms, the same regulatory principles would apply.

S.5 Proposals in this document affect the guidelines on conditional access contained in the most recent edition (April 1999 *Digital television and interactive services (statement)* and *The pricing of Conditional Access and access control services (guidelines)* – available at <http://www.oftel.gov.uk/publications/1999/broadcasting/dtv0599.htm>) and outline the approach the Director General would normally take when considering a complaint under the Class Licence for conditional access services. Those guidelines set out Oftel's interpretation at that time of the obligation in the Advanced Television Standards Directive, that conditional access services must be supplied to third parties on a fair, reasonable and non-discriminatory basis. Following from its conclusions set out in this statement, Oftel will consult on a revised version of its guidelines later this year.

S.6 After having considered the consultation responses carefully, Oftel confirms that it does not propose a licence modification to allow the Director General to set ex ante prices for conditional access services. Oftel considers that the current regulatory mechanism combines the advantages of flexibility with valuable scope for incentives. In particular, it allows for negotiation but at the same time offers the safety net of a complaint to Oftel in the event of negotiations failing. Oftel believes that this balanced approach remains the most appropriate way to maximise entry to digital platforms.

S.7 Oftel emphasises that it considers any indicative prices published by conditional access operators to be the starting point for negotiations, rather than rigidly fixed prices. It believes that such indications are useful to the market provided that their status as purely the starting point for negotiations is properly understood.

S.8 Following its consideration of responses, Oftel confirms that it will not prescribe a single methodology for developing a tariff structure for conditional access. However, Oftel wishes there to be clarity about the acceptability of tariffs that would result from any such negotiations, recognising that the bargaining positions of the parties may sometimes be some way from balanced. This will be dealt with in some detail in Oftel's revised guidelines.

S.9 Oftel believes that, in order to maximise entry onto a platform and therefore choice to the consumer, a conditional access supplier, in a competitive market, would take into account the willingness to pay of a rational purchasing broadcaster. In Oftel's view, fair and reasonable charges for conditional access should therefore take account the 'willingness to pay' of the access seeker. In particular, amongst providers of subscription services, Oftel would expect to see a close linkage between willingness to pay for conditional access services and expected retail revenues from selling subscription services.

S.10 A variety of other factors are also relevant and will affect any final negotiated outcome. Platform providers must also avoid discriminating between purchasers in a similar position to one another. Nevertheless, Oftel's view is that it is unlikely to be fair and reasonable for subscription funded retail packages of significantly different retail price to the end user to be charged a similar price for conditional access.

S.11 Oftel does not accept the validity of arguments made by respondents to the consultation that public service broadcasters might be permitted, or required, to receive conditional access services at below the long-run incremental cost or even free of charge. Public service broadcasters should expect to make a reasonable contribution to the costs of provision of conditional access services which are common to all purchasers of those services as they would expect to do for all other services they purchase. However, Oftel considers that the current practice on the digital satellite platform of offering substantial discounts to public service broadcasters compared to the rates expected to be negotiated by pay TV broadcasters is likely in practice to be fair and reasonable, and in line with the conclusions of this statement. Likewise, the nature of individual public service broadcasters should be taken into account when charges are negotiated.

Chapter 1

Introduction

1.1 Oftel is responsible for the regulation of conditional access services needed by broadcasters in order to supply digital television services to those viewers who are authorised to receive them. Conditional access services include encryption services, subscriber authorisation services, subscriber management services and certain other technical services required to display a broadcaster's digitally transmitted services to viewers.

1.2 The obligation to supply conditional access services on a fair, reasonable and non-discriminatory basis (FRND) stems from the Advanced Television Standards Directive (95/47/EC – 'the Directive'). The Directive was implemented in the UK by the Advanced Television Services Regulations 1996 (SI 1996 No. 3151) and the Advanced Television Services (Amendment) Regulations 1996 (SI 1996 No. 3197) (together hereinafter 'the Regulations'). As a result, Oftel regulates the running of telecommunication systems for the provision of conditional access services through a so-called 'class licence' granted by the Secretary of State for Trade and Industry under section 7 of the Telecommunications Act (hereinafter, the 'CAS Class Licence'). That licence was first granted on 7 January 1997, but was recently revoked and an equivalent new class licence granted on 1 August 2001. The European Parliament has recently approved a new conditional access directive as part of the communications directives packages.

1.3 The obligation to supply conditional access services on a fair, reasonable and non-discriminatory (FRND) basis currently applies irrespective of the level of market power in the relevant market. Oftel recognises that the new Access and Interconnection Directive (as adopted by the EU Council on 14 February 2002) may give a greater degree of flexibility for Oftel to withdraw from unnecessary regulation as long as competition or access to public service broadcasts is not adversely affected.

1.4 Oftel published its consultation document entitled *The pricing of conditional access services and related issues* on 30 October 2001.

1.5 That document explained Oftel's initial views on issues concerning the regulatory approach, tariff structure and public service broadcasters.

1.6 Oftel consulted on whether there should be an ex ante price control on conditional access. Oftel also expressed its initial view that the current regime of relying on commercial negotiation within the framework set out in Oftel guidelines, together with Oftel's powers to intervene where negotiations fail, was sufficient.

1.7 A number of different options for tariff structure were considered in the consultation document. Those options were:

- charging a price which varies with the number of channels carried in a retail package;
- charging a price which varies with the retail price of the package of channels; and
- charging a price which does not vary with the number of channels in a retail package, or with the retail cost of that package, but is instead a fixed charge per package of channels.

1.8 Comments were invited on whether a particular tariff structure was likely to better fulfil the obligation of fair, reasonable and non-discriminatory terms.

1.9 The consultation document also discussed whether there were grounds for a price differential for public service broadcasters and suggested a number of factors that might be considered by conditional access providers to justify price differentials.

1.10 Comments were invited from interested parties. Discussions were also held with a number of different parties. Oftel would like to thank all the respondents for their comments. Non-confidential responses are available from Oftel's research and information department. Electronic copies, where received, are available on the Oftel website at www.oftel.gov.uk/publications/responses/2001/cond_accs301001/index.htm. Responses were received from the following:

- BBC;
 - BSkyB (non-confidential version available);
 - BT;
 - Channel 4;
 - Channel 5;
 - Mr W Dyehouse;
 - Energis (confidential);
 - ITC;
 - ITV;
 - Colin Knight;
 - MGT plc;
 - Telewest;
 - Vodafone; and
 - Voice of the Listener and Viewer.
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Chapter 2

The regulatory framework

2.1 Oftel consulted on the question of whether there should be some form of ex ante price control on conditional access services. After having considered the responses carefully, Oftel considers that there are insufficient benefits to justify modifying the current regulatory approach to conditional access for the reasons set out below. Oftel's view is that ex ante price control intervention is not justified in this case on grounds of either necessity or proportionality.

2.2 Oftel is of the view that, at present, it would be a significantly interventionist step to set ex ante price controls for conditional access and that such a step would not be justified. Oftel outlined a number of pros and cons of a price control, as opposed to the current regime, and asked respondents to comment. Following consideration of responses Oftel is of the view that no benefits were described of a sufficient size to lead to the conclusion that a price control was necessary.

2.3 A few respondents disagreed with Oftel's initial views, and they argued that a price control might need to be applied, in particular to the conditional access charge paid by certain public service broadcasters. However Oftel believes that their concerns could instead be adequately addressed through ex post enforcement, and do not require the use of ex ante price controls.

2.4 Oftel considers that flexibility for all parties to pursue negotiations that best serve their business strategies, without prejudicing the underlying objectives, is most likely to be of benefit for the parties involved and for entry of new services into the market.

2.5 Oftel's approach to the interpretation of fair, reasonable and non-discriminatory continues to be informed by the need to allow conditional access operators sufficient flexibility to pursue economically efficient pricing strategies. An efficient pricing strategy is likely to maximise the usage of conditional access operators' systems, whilst at the same time is likely not to have significant adverse effects on downstream markets.

2.6 Oftel will continue to keep the framework set out in the guidelines under review in order to facilitate commercial negotiations. Oftel will monitor the situation closely and, where necessary, it will intervene in the event that negotiations fail to be resolved to the satisfaction of the parties.

2.7 Given the conclusion that further regulatory measures are not needed at this stage, Oftel will not be undertaking a cost-benefit analysis of ex ante price controls.

Chapter 3

Conditional access tariff structures

3.1 The obligation on conditional access providers under the CAS Class Licence is to offer fair, reasonable and non-discriminatory terms to third parties wishing to purchase services regulated under that licence. Oftel's primary consideration is to ensure that intra-platform competition (ie competition on the same platform, as opposed to competition between platforms) between broadcasters is not unduly affected by the terms under which conditional access services are offered on a platform.

3.2 Oftel accepts that the terms for conditional access may have an effect on inter-platform competition. However, it is one of many elements affecting competition between platforms. Oftel only has responsibility for conditional access and is not able to correct any of the other variations that exist between platforms – 'must carry' rules, spectrum allocation etc. Oftel does not consider it is its role, nor would it be appropriate or proportionate, to correct competitive distortions between platforms using the conditional access regime. Hence, Oftel wish only to set out the rules applicable to competition between broadcasters on an individual platform. Oftel would, of course, not add to such variations by imposing terms that would of themselves distort competition between platforms, as all platforms are treated in the same way. If a conditional access service provider is covering their costs and not making excessive profits and platforms are treated in an equivalent manner, competition will not be distorted.

3.3 With a conditional access system most of the actual costs involved in the set up and running of the system do not vary with the number of channels provided. In particular, this is the case where an allowance is made for subsidy of set top boxes to be recovered through conditional access charges. The presence of economies of scale and scope means that the incremental cost of supplying conditional access to one additional channel is likely to be low.

3.4 As the fixed and common costs must be recovered, it is not possible for the supplier of conditional access to charge a price equal to incremental cost to every purchaser. A price equal to the incremental cost of providing conditional access services would cover only the costs specifically associated with providing the service, and would not take account of all those common costs which make it possible for the infrastructure used to offer the service to be built. Oftel would consider it appropriate that all users of the system should pay a charge that is equivalent to incremental cost plus a reasonable contribution to these common costs. In the case of subsidy recovery being allowed through general conditional access charges, this would include a contribution to such subsidies. In general, this is how costs would be recovered in a competitive market.

Interpretation of 'fair, reasonable and non-discriminatory'

3.5 In general, Oftel believes that 'fair and reasonable' terms are those which would be most likely to maximise efficient use of the conditional access system, thereby maximising entry to the platform and choice to the consumer. Such terms would be expected to reflect the willingness of a rational customer to pay for the service. In principle, different terms can be offered to different customers, reflecting the different values of the service to those customers (and, in turn, the value of the service to the end user, who is being served by the customer of the conditional access provider). Overall a conditional access service provider would be expected to recover their costs and make reasonable, but not excessive, profits. This is considered further below.

3.6 Oftel's view is that differentiation of the kind mentioned above should not be allowed if it had a significant adverse effect on competition. However, in practice, by permitting new players to join the platform 'at a discount' when it would have been uneconomic for them to join on more typical terms, it will be pro-competitive. The principle Oftel applies is that comparable service providers purchasing comparable services at broadly similar times should pay comparable prices. Where service providers are not providing directly competing services, then differentiation in pricing is unlikely to have a material adverse effect on competition and should therefore be permitted.

Approach to tariff setting

3.7 Following careful consideration of responses, Oftel confirms that the approach taken in the guidelines to allow for commercial negotiation between operators should remain. Oftel does not intend to be overly prescriptive of the tariff structures that must be used by conditional access operators. Over prescription would not allow flexibility for conditional access providers to take into account the circumstances of the channel when negotiating. Freer negotiations are more likely to result in more channels entering onto a platform as the resulting price should reflect the 'willingness to pay' and hence to result in a more efficient use of each platform.

3.8 However, Oftel clarifies for operators its general presumption on the application of fair, reasonable and non-discriminatory in order to make clear its intended approach to complaints.

3.9 The consultation document set out a number of possible options for how conditional access prices might be structured: price per number of channels, price related to retail charge, price per package of channels. This recognised that there may be a number of different ways of setting a fair, reasonable and non-discriminatory price for conditional access. Oftel is still of the view that it would be impossible to set a uniquely correct tariff structure, or a single correct charge.

3.10 The economics of conditional access are not susceptible to being modelled in any single straightforward fashion. The cost of the actual authorising of a consumer with an additional package of channels is likely to be a relatively small element of the total costs of conditional access and unlikely to vary significantly according to the size of the bundle to be authorised. There are also likely to be varying levels of economy of scale and scope available to different packagers of content and conditional access providers.

3.11 Oftel's conclusion is that there is no need, at the present time, to rigidly define how prices should be structured. An economically efficient outcome in these cases is more likely where prices were negotiated between the conditional access provider and the conditional access customer in order to maximise entry onto the platform. Prices should be above the floor of long run incremental cost and below the ceiling of stand alone cost to ensure that the conditional access service provider is making a reasonable return and that they are not making excessive profits. The conditional access provider is however also under a direct obligation to offer fair, reasonable and non-discriminatory terms. Oftel will give further guidance of how it would interpret fair, reasonable and non-discriminatory and of the factors which it is likely to take into account in case of a dispute between the parties, when it consults on the revised version of its guidelines.

Distribution of common costs

3.12 Oftel would expect that the result of negotiations between conditional access providers and an access seeker is that common costs are likely to be distributed amongst different bundles or single channels at differential levels depending on the overall balance of benefits which would accrue to conditional access provider and access seeker, taking into account the specific circumstances of the transaction. Oftel recognises that there are economies of scale and scope available to both packagers of content and conditional access providers.

3.13 Where there is a retail charge for a channel, Oftel considers that such a charge is a key indicator of 'willingness to pay' and would expect a reasonably close linkage between retail charge and conditional access charge. This is not the only factor to be taken into account, as there would be other attributes a channel or broadcaster might ask to be considered in negotiations. This does not mean that the conditional access charge should be strictly proportional to retail revenues as this would lead to the inappropriate conclusion that free-to-air channels should be entitled to such services free of charge. More generally, Oftel is not suggesting a 'formula' between retail price and conditional access charge, but would expect conditional access agreements taken as a whole to be broadly reflective of the retail charges set by the broadcaster in offering its service to the end user. This conclusion would be inappropriate because it would imply that broadcasters and viewers attached no value to the availability of a free-to-air service on the conditional access platform. This is unlikely to be the case. Another principle is that services should not be provided at rates below the incremental cost of their provision.

3.14 However, there may be other costs and benefits to the channel and the platform that may need to be taken into account in negotiations to reflect the conditional access charge they would be able to bear. Oftel considers that it would be helpful to outline other factors that purchasers and providers of conditional access might take into account in setting prices. This might include on the broadcaster's side:

- increased revenues (advertising/subscriptions/other);
- number of consumers on platform;
- type of service offered;
- costs of rights and content; and
- number of channels in the broadcasters 'package'.

3.15 Oftel would like to make it clear to broadcasters and conditional access providers that negotiations should give consideration to the counterbalancing benefits for the platform, which might include:

- attractiveness of content to current consumers;
- complementarity between access to the platform and channels – attracting new viewers to platform; and
- element of risk for platform including, for instance, length of contract and certainty of income to the platform.

3.16 Oftel does not expect the negotiations to be fixed on these factors, as there are no doubt others that broadcasters may wish to take into account. In particular, it would not expect conditional access providers to require the submission of business plans for detailed analysis, nor should there need to be independent third party verification of statements from broadcasters unless there are genuine disagreements about the plausibility of claims. In addition, Oftel does not expect conditional access providers to develop a formula giving specific numerical weightings for these factors. However, Oftel points to these as guidance on what might inform the judgement as to what is 'fair and reasonable' under the circumstances of the particular negotiation. Proper consideration of these factors will result in the evolution of tariff structures which facilitate retail market entry from broadcasters and which do not unduly discriminate against individual broadcasters' channels or packages of channels.

3.17 Oftel recognises that there are different levels of risk in agreements entered into and so would consider it appropriate for conditional access providers to take into account the level of risk for a novel service. In addition, in judging whether discrimination has occurred, Oftel emphasises that an agreement entered into at the launch of a platform, and which hence implicitly or explicitly involved the sharing of risk, could not be considered as being entered into 'at a similar time' as one signed at a much later date, even if the conditional access services provided are similar. This also applies to any rollover agreements in the earlier contract.

3.18 The above approach would ensure, for instance, that a single channel entrant would be able to compete with a similar channel that may be provided as part of a bundle of channels without discriminatory treatment in conditional access price.

3.19 Some conditional access providers publish indicative prices under the obligation to publish the methodology for arriving at charges and other terms and conditions under Condition 14 of the CAS Class Licence. Oftel considers that the publishing of indicative prices that can serve as the starting point for commercial negotiation is helpful for all parties. However, Oftel emphasises that those indicative prices are not set by Oftel and that Oftel would regard them as a starting point in the negotiations between the conditional access provider and the purchaser. Indeed, Oftel would expect such negotiations to take place (as they would be likely to occur in any competitive market).

Market Analysis model

3.20 As part of the consultation the BBC and ITV submitted to Oftel a joint paper written by Market Analysis Ltd. That paper sets out economic arguments on how pricing of conditional access should be worked out. The paper goes into deep level of detail in modelling conditional access bargaining under different scenarios and drawing inferences on consequences at the broader pay TV market level.

3.21 It has been put to Oftel, in the course of the consultation, that parts of the paper, notably those referring to different access pricing rules which have been devised using economic analysis, should be taken into account when setting up the new framework. In particular, some of the respondents argued that conditional access pricing should be based on one specific version of the 'Efficient Component Pricing Rule' by Baumol, and in particular on a model devised by Vickers and Armstrong.

3.22 Oftel has found the paper useful in that it has provided insights upon which to reflect. However Oftel also believes that this model has been developed within a context which suggests that whilst theoretically interesting, it would be inappropriate, and probably impossible, to apply the model in practice.

3.23 A severe difficulty with using the Market Analysis model is that it relies on precise knowledge of a vast number of parameters unlikely to be possible to calculate in practice, eg cross price elasticities of a number of services. If the model were to be used in a regulatory context, it would not be possible to get verifiable objective figures for those parameters. The resulting lengthy theoretical debate would inevitably be inconclusive and would cause a high degree of uncertainty in the market.

3.24 Further, this model is based on the analysis of a vertically integrated firm which is dominant both at the wholesale/upstream and at the retail/downstream level. The model is relevant to a particular context, where a dominant incumbent which has already ubiquitous coverage is regulated in order to allow firms which are at least as efficient as the incumbent downstream to enter the retail market.

3.25 However, this context does not seem to be fully relevant for conditional access. BSkyB, which is likely to be the largest conditional access provider in the UK, has not been found to be dominant in any retail market, and is already subject to a number of obligations both in conditional access and in the broader pay TV market to prevent leverage of dominance from markets in which it has been found dominant. The model does not take account of such other regulatory rules.

3.26 The model also is not appropriate in this case because of its incentive properties. In particular, it does not take into account the importance of providing incentives for building what is an expensive network. This is because the model relates to access to the facilities of an incumbent with a pre-existing ubiquitous national coverage.

3.27 But the real position is that networks providing conditional access services have still to be fully rolled out. Thus, an important consideration in evaluating the suitability of particular charging arrangements is the incentive for rollout under these arrangements. These incentives appear not to be strong under the arrangements suggested by the Market Analysis model. A particular problem is that the costs of additional rollout are not incremental to the number of broadcasters or channels using the platform: these costs are primarily driven by the number of subscribers but, because of the arrangements for set top box subsidy, they are recovered through conditional access charges, rather than directly from subscribers. The Market Analysis model would preclude the conditional access provider from recovering any of these costs from other users of the platform, except if a user of conditional access services were providing a service that was substitute to a conditional access provider's services. If the introduction of the new service had no impact on that conditional access provider's profitability, then it would not be required to make any contribution the costs of network rollout. The result would seem to be that there would be a weaker than appropriate incentive for a platform operator to improve on its network coverage.

3.28 Oftel therefore prefers an alternative approach to this specific version of an efficient pricing rule, based on the analysis of multi-product firms. Such firms set prices to recover a different proportion of common costs from each product according to their demand conditions. But it is reasonable that such pricing structures involve some contribution from all services.

Chapter 4

Public service broadcasters and conditional access

Payment for conditional access services

4.1 As a starting point, Oftel confirms following the consultation that it believes that public service broadcasters should pay a commercially negotiated rate for conditional access services, including an appropriate contribution towards common costs. Oftel considers that it is reasonable that public service broadcasters, as other broadcasters, should pay a charge for services that they are consuming which reflects both the incremental cost of the provision of the service and a reasonable contribution to common costs. This is the basis on which they would expect to pay for any other service which they need to purchase, including other regulated services. This does not necessarily mean that public service broadcasters should pay the same rate as a commercial pay TV supplier or that each public service broadcaster should make the same level of contribution to common costs.

4.2 Some respondents pointed out that currently public service broadcasters purchase conditional access services only on the DSat platform and hence it should be treated differently from any other service they may need to purchase to broadcast digitally. Oftel does not believe that such differential treatment would be justified.

4.3 A number of different funding arrangements, benefits and obligations are in place for public service broadcasting due to legislation and Government policy – ‘must carry’ rules relating to this on cable platform, free spectrum, the BBC licence fee, the digital dividend and so on. Oftel’s obligation is to ensure that public service broadcasters have access to conditional access services on fair, reasonable and non-discriminatory terms. If, due to the costs associated with delivering content on different platforms, the funding arrangements of public service broadcasters need to be addressed to ensure that public service broadcasters are able to fulfil their obligations, then that is a separate public policy issue.

4.4 In Oftel’s previous guidance, it stated that free-to-air television could be treated as a separate category to pay television, but that the general presumption would be that there should not be any discrimination between broadcasters within those categories unless it was as the result of demonstrable cost savings. Oftel is still of the view that public service broadcasters, whilst having specific characteristics, are not a homogenous group, and it does not consider that there are convincing reasons for concluding that they are in a separate market from other free-to-air broadcasters. The majority of respondents did not dispute this. Instead, they concentrated on the different markets between basic pay television and public service broadcasters.

4.5 Whilst Ofcom does not consider that it would be appropriate for public service broadcasters to be treated as a 'special' category from the point of view of conditional access provision, there are factors that are particular to public service broadcasters that should be taken into account by conditional access providers and are likely to lead to pricing differentials between commercial and non-commercial broadcasters. This might lead conditional access suppliers to offer terms that are more favourable to certain public service broadcasters depending on the nature of the broadcaster.

Setting tariffs for public service broadcasters

4.6 Ofcom considers it appropriate that, as part of commercial negotiations, conditional access providers may consider the nature of the channel in arriving at a reasonable charge. This follows on from the section on tariff structure and Ofcom's view that negotiations are likely to arrive at a price that reflects the benefits to the platform and the benefits to the channel.

4.7 Negotiations are likely to consider the benefits to the platform of carriage of popular content that is provided by the public service channels which are still the most watched, even in multi-channel households, and also the benefits of carriage to the broadcaster of the channel. The differing characteristics of individual public service broadcasters themselves may be taken into account, as should the competitive effects of differentiation.

4.8 By way of example, the willingness of the public service broadcaster to pay for conditional access is related to the commercial or other benefits from carriage on the platform. These might be considered to include: accessibility for digital only channels; increased audience for channel; 'tied deals' with non-service broadcaster content from the same company; and higher revenues available to the channel (including, for instance, digital dividend and advertising).

4.9 These factors would not be likely to hold equal worth in every set of negotiations. Ofcom considers that willingness to pay for niche, non-commercial public service broadcasting channels is likely to be less than for the commercially owned companies which attract the possibility of greater revenues for shareholders.

4.10 Some respondents argued that the broadcasting of public service channels on a platform will add to the benefit of other channels by, for instance, increasing take up, rather than by competing with channels as substitutes for viewers. However, it is not clear going forward that the addition of new public service broadcasting channels on digital platforms is in itself likely to have a significant impact on take up of services. It might have been the case at the time of the launch of digital services that the existence of public service broadcasters on digital platforms aided take up of such services.

4.11 It can be seen quite simply from the audience share statistics that channels are competing for viewers. The launch of new channels tends to change viewing patterns rather than significantly increasing the total viewing. Viewing figures since the launch of multi-channel television show that the hours spent watching public service broadcasters is decreasing. As such, it seems difficult to argue that the public service broadcasters are complementary to other free-to-air channels on digital platforms. Hence, although there may be an argument to be made that the channel is complementary to the platform, there is strong evidence to conclude that they are not complementary to the other channels.

4.12 Oftel's view is that, in order to fulfil obligations of non-discrimination, similar prices should be charged for similar services at similar times. It is likely that a number of different outcomes can be expected from the negotiations. Oftel would not, therefore, consider that two broadcasters within the free-to-air category paying different prices would in itself be evidence of discrimination. For this reason, charges negotiated at the time of the launch of platforms might be quite different from those negotiated when there is significant take up of services.

4.13 A respondent pointed to the appreciable value to ITV companies of digital satellite carriage (ie access to the BSkyB platform), particularly in the receipt of the financial incentives offered by the Government in the form of the digital dividend. As this is a financial incentive that is directly linked to subscribers, and therefore the number of Sky set top boxes in use, it would seem that ITV's contribution to set top box subsidy creates a directly clear financial benefit to them. As an illustration of this, in the preliminary results of Granada of 28 November 2001, they state that the digital dividend is worth £37m to them. After transponders/uplink costs of £8m and conditional access contribution of £7m, Granada claim an annual net benefit of £22m. On a simple analysis this would seem to demonstrate that the benefits of satellite carriage outweigh the costs significantly.

4.14 However, there is an alternative way of looking at the digital dividend. It could be argued, as it was by some respondents, that it is a form of compensation to ITV companies for the inevitable loss of advertising revenue that will result from the move to digital and multi-channel broadcasting. It is unclear whether this view is more appropriate than the view that the digital dividend is a payment to ITV as an incentive to increase the take up of digital television. Given this uncertainty, the digital dividend does not appear to give clear guidance as to whether ITV contribution to the recovery of set box subsidies in the charges it pays for conditional access should be different from that of other public service broadcasters.

4.15 However, whichever view is taken of the digital dividend, the ITV companies, when they bid for their franchises, would have had every incentive to take into account the consequences of the move to digital and the expected loss of market share. Some reasonable amount for conditional access on platforms that they did not own is already taken into account in the franchise prices, and it would be appropriate to reflect this in the actual payments for conditional access services.

4.16 Oftel considered in the consultation document whether it might be appropriate for the level of public service broadcasting commitments to be taken into account in the price of conditional access. However, where a company has bid for a licence to provide such services, it is expected that such levels of commitment have been taken into account by the companies when bidding for the licence. As such, Oftel's view is that it would not expect that companies should be compensated twice for the same obligations.

4.17 Given the comparable service offered on digital platforms by commercial public service broadcasters, Oftel considers that significantly differential pricing between free-to-air commercial channels and the commercially owned public service broadcasters for conditional access may have an adverse effect on competition.

4.18 Oftel considers that, where conditional access services are purchased solely to protect commercial interests in the rest of the footprint of the transmission network, it may be inappropriate to offer differential prices to other commercial services. This is likely to occur if a service is provided free-to-air on satellite in the UK, but is a pay TV service in the rest of Europe. The nature of the totality of services offered within the conditional access agreement should be considered by the conditional access service provider.

'Must offer'

4.19 There are proposals from the Government to create a 'must offer' obligation on public service broadcasters to ensure that they are provided to consumers on relevant digital platforms. Such proposals may compel public service broadcasters to broadcast free-to-air and may lead to a need for public service broadcasters to purchase conditional access services in order to fulfil this obligation whilst protecting rights. Oftel does not propose, at present, that any changes to the conditional access regulatory regime as a result of any future 'must offer' requirement would be necessary. Regardless of this requirement, conditional access providers will not be able to charge above levels that are fair, reasonable or non-discriminatory. All purchasers of conditional access, including public service broadcasters, are able to ask Oftel to enforce this requirement if they regard it as being breached. It would also be possible to make a complaint under the Competition Act 1998.

Annex

Summary of responses to the consultation questions

Question 1: Do respondents agree that these are the relevant pros and cons that need to be considered for the purposes of assessing Ofstel's regulatory approach?

A.1 Although the majority of respondents were in favour of the Ofstel approach as set out in the consultation, a few did disagree and suggested that there needed to be an ex ante regime.

A.2 ITV disagreed with the pros outlined for the ex post approach. ITV argued that BSkyB has no effective competition, that it is an essential monopoly and that the flexibility afforded to CA providers is at the cost of channel providers. Ofstel disagree with this as the flexibility is afforded to CA providers in order to ensure that content services with differing characteristics are able to be launched on digital platforms. A rigid approach to tariff setting is likely to have the potential to be a barrier to the launch of new services.

Question 2: Do respondents agree with Ofstel's provisional conclusion that there should not be an ex ante price control set by Ofstel?

A.3 ITV stated that Ofstel should see how the CA market develops and that there may be a need for a price control in the future. They called for Ofstel to require BSkyB to publicly disclose any information they claim is confidential. Ofstel consider that the onus is on the conditional access supplier to ensure that they are compliant with the regime and it is the regulator's role to adjudicate whether a price is unfair, unreasonable or discriminatory through considered analysis of confidential information. Such disclosure may not add to this process but is potentially damaging to commercial companies supplying conditional access as it would expose commercially confidential information to competitors and potential competitors. However, Ofstel will keep the issue under review and take steps to ensure that it, as the regulator, has full access to all the information it needs in order to resolve disputes.

A.4 ITV also stated that at present CA prices discriminate between ITV and the other PSBs. The principle Ofstel applies is that comparable service providers purchasing comparable services at broadly similar times should pay comparable prices. Where service providers are not providing directly competing services, then differentiation in pricing is unlikely to have a material adverse effect on competition and should not be prevented. Ofstel dispute that there is a homogenous category that is 'public service broadcasting' and also points out that that there are different levels of risk in agreements entered into. As such, an agreement entered into at the launch of a platform, and which hence implicitly involved the sharing of risk,

could not be considered as being entered into 'at a similar time' as one signed at a later date, even if the conditional access services provided are similar.

A.5 ITV also stated that Oftel should establish what the actual costs of CA are. Oftel does indeed need to do so in the event of a complaint but the value of continuous interventions has not been established.

A.6 MTG stated that Oftel needs to develop ex ante pricing based on a fixed revenue share across all CA users. Oftel is of the view that the revised approach outlined in this statement is based on a similar concept, through the 'willingness to pay' principle, and would reach a similar outcome. This should recognise that there would be a distribution of common costs between operators based on expected revenues to those operators. Oftel considers that those best placed to make a judgement on willingness to pay would be the parties to the agreement rather than Oftel as it requires assumptions on behalf of commercial operators purchasing the conditional access that are rightly the responsibility of those operators.

A.7 Other respondents agreed that there was no need for ex ante price setting and that the conditional access regime and competition law provides adequate redress against abusive behaviour. Oftel agrees with these respondents.

A.8 NTL agreed with Oftel's conclusions but was disappointed with the lack of a market analysis. Oftel did not consider such an analysis as appropriate or necessary as the regime mandated by the Advanced Television Standards Directive applies to all operators regardless of market power. Oftel will, however, conduct a market review as part of the process of implementing the new European Directives and will review the market regularly thereafter.

Question 3: If the current approach is confirmed, is there a need for greater detail or precision in any area of the guidelines and, if so, what detail or precision do respondents find necessary?

A.9 BSkyB and BT disagreed with this in their responses, believing that more detailed guidelines are not necessary as the current system is working well. Oftel's consideration of the responses from broadcasters purchasing conditional access suggested that further clarity within the guidelines would be useful to broadcasters. It has therefore set out an additional level of clarity within the statement and will review its guidelines later this year.

A.10 The ITC, ITV, the BBC, Teletext and VLV agreed that Oftel should set out precise, objective and transparent pricing rules within guidance. Oftel agree that the guidelines need to indicate more precisely what FRND means in practice and intend to consult on revised guidelines implementing the policy outlined in this statement. Oftel does not, however, want to go as far as giving inflexible prescriptive advice but wishes to retain the flexibility for commercial negotiation

within a set of guidelines that aids both conditional access providers and operators in arriving at a price.

Question 4: Do respondents believe that one particular tariff structure for the provision of conditional access services in Option A to C is more likely than others to be fair, responsible and non-discriminatory and if so why? If this is the case should Oftel set out in the form of a future set of guidelines what this tariff structure is likely to be?

A.11 B SkyB, BT and Channel 5 were not in favour of setting a tariff structure as the factors involved in arriving at a price are more complex than stated in the consultation and should be arrived at by a commercial negotiation. Oftel agrees that it does not wish to be prescriptive in setting a tariff structure but considers that the responses justify a greater explanation from Oftel of what it would expect to see as a result of commercial negotiation.

A.12 ITV stated that conditional access pricing should take away the per broadcaster's link and a version of conditional access pricing related to retail price should be introduced. The ITC also agreed that of the options the retail price methodology would be the most appropriate. Oftel agrees with ITV that the number of channels is not a cost driver but would not go as far as prescribing what the tariff structure would be. Oftel would, however, agree that where there is a retail price this is a good indicator of willingness to pay. So whilst we would expect broadcasters providing packages of significantly different retail price to be paying significantly different conditional access prices we would not expect the relationship to give rise to a rigid formula between conditional access price and retail price.

A.13 The BBC disagreed, stating that there was likely to be a wider range of acceptable pricing structures. They also fundamentally disagreed that retail price should have a direct influence on CA price. Oftel agrees that there are likely to be a range of acceptable prices and that the retail price is not relevant in all situations, nor should it be the only consideration.

Question 5: Do respondents agree with Oftel's preliminary conclusion that an economically efficient outcome is more likely where a greater degree of flexibility over pricing is retained by the conditional access supplier?

A.14 B SkyB, Vodafone and BT agreed with Oftel's preliminary conclusion. They argued that CA providers have taken risk and the assessment of that risk is only possible by those companies.

A.15 ITV disagreed, arguing that flexibility does not deal with potential over recovery or questions of vertical integration. Oftel does not agree that flexibility leads inevitably to over recovery and notes that conditional access providers are prohibited from over recovering their costs by the regulatory regime. Oftel's primary responsibility in this case is to consider the regulation of conditional

access as it affects intra-platform competition between broadcasters. Oftel considers that its remit is not to correct other distortions through the use of the conditional access regime.

Question 6: Do respondents believe that the current structures of conditional access charges need to be altered in order to facilitate entry by independent retail bundles of channels, or is competition in the relevant market sufficiently effective? If so, what should the new structure be?

A.16 BSkyB, Telewest and BT disagreed that the structures of tariffs needed to be altered. Oftel agrees that there are a number of factors that need to be taken into account when setting a charge for conditional access and that these might not necessarily be related to the number of channels in a package. Following the consultation Oftel is not convinced of the need to have a prescriptive structure but would like to give more guidance to broadcasters and conditional access providers on the interpretation of fair, reasonable and non-discriminatory tariffs.

A.17 ITV agreed that current tariff structures need to be altered and the VLV agreed that CA charges need to change to reflect the distinction between entry and running costs, and the different types of information service provided. Oftel believes that this level of detail would be more appropriate for a commercial negotiation rather than its guidelines.

Question 7: Do public service broadcasters merit special treatment for conditional access purposes?

A.18 BSkyB disagreed, stating that the concept of PSB is nebulous and cannot be used to underpin any proportionate rule. Oftel agrees with BSkyB to the extent that it is not appropriate for conditional access providers to identify a homogenous category of 'public service broadcaster' as such broadcasters have differing characteristics. However, the characteristics of each individual broadcaster should be taken into account within the negotiation on price. Public service broadcasters are likely, by their nature, to receive a lesser charge than pay television channels and this is reflected in current conditional access tariffs. This is likely to hold even more true according to the principles outlined in this statement.

A.19 ITV disagreed with Oftel's contention that there is no distinct category for public service broadcasters for conditional access purposes. Oftel is not of the view that there are grounds for creating such a category due to the diverse nature of the broadcasters themselves and the fact that there is clearly some degree of competition with other channels in the free-to-air category, for instance for viewers and advertising revenue.

A.20 The BBC stated in its response that it does not merit 'special treatment' and agrees with Oftel that public service broadcasters should pay an appropriate rate for services they acquire. However, the BBC argued that they did not derive additional value from being on digital platforms nor did they contribute to the cost

of such services on other platforms on which they broadcast. Oftel disagrees with this as they at the very least would want to ensure that there was access to their digital only channels and points out that the BBC does not contribute to the conditional access on the cable and digital terrestrial platforms because it does not purchase such services on those platforms.

A.21 VLV explained in detail the differences between the public service broadcasters. Oftel notes these differences but infer from this that it is not possible to treat public service broadcasting as a single homogenous good. Oftel believes that there may well be differential prices that are charged to broadcasters that may still not be discriminatory but give discounts according to the nature and characteristics of the individual broadcasters.

A.22 The ITC stated that public service broadcasters should pay a lower rate as they only needed conditional access services because of the need to protect intellectual property rights and earn less incremental revenue with no ability to recover costs. They also benefited platforms who have no risk in carrying them and therefore gain a stable income. Oftel does not agree that public service broadcasters need conditional access services only for property rights - they are also sometimes purchased for commercial reasons unrelated to the public service remit. Also, Oftel does not agree that there is no incremental revenue benefit to the commercial channels in launching on digital platforms. However, Oftel does agree that there are likely to be benefits to platforms from the carriage of some public service channels and believes that these would be taken into account within a commercial negotiation.

A.23 Teletext's response stated that they did not agree that public service broadcasters should make any contribution to common costs. Oftel does not agree. Public service broadcasters would expect to pay a contribution to the common costs of any commercial service that they may purchase and conditional access services should be treated like any other service supplied to them in this regard.

Question 8: Should conditional access suppliers be able to consider the characteristics of a public service channel in constructing its tariff?

A.24 BT, BSkyB, ITC and BBC agreed that conditional access suppliers should consider arguments raised by broadcasters about their unique features within a negotiation. However, they disagreed in the outcome that this is likely to have. Oftel agrees that all broadcasters should negotiate on the basis of their characteristics and that this is likely to conclude in public service broadcasters paying significantly less than, for instance, pay television operations but that there should be a contribution that covers at least incremental cost and a contribution to common costs.

A.25 VLV stated that the guidelines need to ensure public service broadcasters are not subsidising non-public service broadcasters. This seems to be a

misunderstanding of conditional access in that public service broadcasters are not 'subsidising' non public service broadcasters by paying for conditional access but are purchasing a service from a platform provider as they would any other service in order to broadcast.

Question 9: What evidence can respondents give of the benefits and cost to a public service broadcaster of being on digital platforms?

A.26 Little evidence was given in responses of the costs and benefits to broadcasters of being on the platform. ITV and BBC argued that there is little or no benefit, which Of tel does not find to be plausible. Of tel considers that a rational commercial negotiation is likely to give rise to a more realistic appraisal of the costs and benefits to public service broadcasters. Some respondents pointed to the additional revenue streams and also to the increased viewing from being on digital platforms and also the public policy benefits. Of tel is of the view that there are benefits to public service broadcasters from being on digital platforms but that the benefits are not uniform across public service channels, as they are not across any other type of broadcast channel.

Question 10: Should a differentiation be made between advertising funded commercial channels and the 'not for profit' channels?

A.27 ITV disagreed that a differentiation should be made. ITV's position was that the public service obligations apply to all such broadcasters. Of tel observes that whilst obligations may apply to all public service broadcasters they are not uniform and concludes that the financial benefit for commercial channels to gain carriage on digital platforms is likely to be greater than from not-for-profit channels for instance through the digital dividend. Of tel does not wish to define 'sub markets' of free-to-air broadcasting but recognises that the characteristics of commercial channels is likely to conclude in a greater 'willingness to pay' during a commercial negotiation. The benefits to the platform and the benefits to the broadcaster would, however, have to be considered as part of any such negotiation.

A.28 The BBC and BSkyB agreed that different public service broadcasters have different characteristics. The BBC pointed out that not-for-profit broadcasters would see a 'quality-adjust' in programming, ie a reduction in perceived quality or production values, by having to pay conditional access charges. Of tel's view is that it is likely that the differing nature of broadcasters is likely to impact on willingness to pay as the benefits are likely to be different for each channel. Also, given the cost compared to the overall budget of a broadcaster it is unlikely that any significant 'quality adjust' could be attributed to conditional access charges.

Question 11: Is there any reason to link the charge for conditional access to the imposition of a 'must offer' obligation and if so what level of adjustment is appropriate?

A.29 Oftel agrees with BSkyB and BT that there is already a requirement on conditional access service providers to provide such services on fair, reasonable and non-discriminatory terms and that this is unaltered by any additional obligations that may be imposed upon public service broadcasters. In any event, such obligations are weighed up by commercial companies against the benefits of being a public service broadcaster in bidding for the licence.

A.30 ITV and Channel 5 said that 'must offer' should be linked to a corresponding 'must carry' obligation. Oftel observes that there is already an obligation under the Conditional Access Services Class Licence to provide conditional access services to third parties ensuring that they can gain carriage on reasonable terms.

A.31 The BBC stated that the 'must offer' requirement would restrict public service broadcaster's bargaining power, and this asymmetry needs to be recognised. Oftel's view is that any such obligation does not add or subtract from the requirement already on conditional access service providers to provide fair, reasonable and non-discriminatory terms but that it should be a factor to be taken into account in negotiations. The guidance that Oftel issues on conditional access pricing should be sufficient to ease such concerns.

A.32 BT stated that regardless of 'must offer', public service broadcasters are a resource drain for the conditional access service provider. Oftel agrees that there should be an appropriate charge and that there should be the flexibility to set tariffs that continue to recognise the benefits to the broadcaster, bearing in mind the individual circumstances, and the corresponding requirement of non discrimination between different purchasers of conditional access services.

Question 12: If there is, should the Guidelines only be changed in respect of the 'must offer' channels in the event that legislation creates such an obligation?

A.33 Given the responses to previous questions, Oftel considers that there would not be a need to change the guidelines in respect of 'must offer' channels in the event that legislation creates such an obligation. Most respondents gave views that there should be some revision of the guidelines and Oftel considers that the guidelines following on from this statement should be sufficient to deal with any of the problems that 'must offer' channels may face in negotiating with conditional access services providers.

Question 13: Is it appropriate for non-public service channels to benefit from any differential pricing offered to public service channels?

A.34 No respondents agreed with this. Oftel is of the view, however, that there are different circumstances for different services. Public service broadcasters may wish to bundle other services in with their offering and these should be treated as with any other negotiation for conditional access services along the principles contained in this document.

Question 14: Should the nature of public service obligations on a channel be taken into account in setting the price for conditional access?

A.35 Given the responses to this and previous questions, Oftel confirms that the nature of the obligations is one of many factors that is likely to be taken into account in setting conditional access charges.

Question 15: Would differential pricing for public service broadcasters impact to the detriment of competition in the free-to-air category?

A.36 BSkyB stated that in order to argue for differential rates, the public service broadcaster would need to argue that the detriment to choice and the burden upon other broadcasters would be justified. Oftel's view is that comparable service providers buying comparable services at similar times should be charged comparable prices.

A.37 ITV's and BBC's responses, including the economic paper submitted, stated that the relevant issue is opportunity cost. Oftel is not convinced by the economic paper for reasons outlined above in Chapter 3.

Question 16: Is there any justification for exempting broadcasters from contributing to the common costs of the conditional access system?

A.38 All respondents who commented on this question, apart from two, agreed that broadcasters should pay towards the common costs of the conditional access system.

A.39 Oftel's view is that the common costs of a conditional access service provider should not fall on one particular broadcaster but that they should be spread equitably between broadcasters recognising that the broadcasters themselves benefit from the investment in a digital platform and increased take up from consumers. As such Oftel continues to be of the opinion that the service provided by conditional access providers should be supplied on the same terms as any other service commercially provided to broadcasters – with a charge that reflects marginal cost of providing the service and some contribution to common costs.
