OFFICE OF COMMUNICATIONS

Market definition and market power in pay TV

Annex 13 to pay TV market investigation consultation

Publication date: 18 December 2007

Contents

Section 1

Introduction

Context

1.1 In this annex[1], we seek to determine the relevant markets for assessing competition issues in the TV industry, and whether there is any evidence that one or more firms have market power.

1.2 Market definition provides an analytical framework for identifying the competitive constraints faced by individual firms. The purpose of defining a market is to identify, in a systematic way, all the products and suppliers that provide a significant constraint on an individual firm. Although it will often not be possible to define the boundaries of the relevant market with precision, the process of identifying competitive constraints is an important first step in assessing whether firms either individually or collectively are likely to possess market power.

1.3 Many of the theories of competitive harm raised in submissions to us rely upon one or more firms having market power. Market definition therefore has an important role to play in assessing the likely validity of these theories of competitive harm. Specifically:

- The submission from the parties focuses on competition within a supposed market for pay TV services, whereas the submission from Sky asserts that pay TV providers participate in a broader market within which they face significant competition from free-to-air television. There is likely to be a particularly close relationship between 'basic-tier' pay TV services and free-to-air services, and we have therefore considered whether at the retail level these should be regarded as being in the same economic market.

- The submission from the parties places a great deal of emphasis on the uniqueness of premium content, and the importance of all broadcasters being able to gain access to it. We have therefore considered whether narrow economic markets exist for specific 'must have' content (premium sport and movies) at both the retail and wholesale level. Sky has not explicitly addressed the issue of whether narrow markets exist for premium content, but has argued that it in any case has an incentive to make its premium content available to other retailers.

- The submission from the Parties claims that Sky's control of the largest pay TV platform and subscriber base allows it to inhibit access by upstream rivals to a sufficient subscriber base. The submission from Sky highlights the rapid and pervasive change which characterises the sector, and which creates various opportunities for market entry and expansion. We have therefore considered whether particular TV platforms should be considered as falling within narrow platform-specific retail markets.

1.4 We have chosen to focus on these three main market definition questions. Although it is not always possible, or even appropriate, to define the precise boundaries of

[1] This is the non-confidential version. Confidential information and data have been redacted. Redactions are indicated by "**[✂]**"

each of these relevant markets, the process of defining the relevant economic market can reveal important information by identifying the extent of the competitive constraints on firms.

1.5 We begin our analysis with an assessment of how other regulators and competition authorities in the UK and elsewhere have approached market definition within the TV industry, and what conclusions were reached. Whilst these precedents are informative, the rapid pace of change, and in particular the emergence of Freeview as a potential substitute for other multi-channel TV offerings, emphasises the importance of examining more current as well as historical evidence on market definition.

1.6 To that end, we have used a range of sources of information to inform our analysis, including:

- Newly commissioned customer research into customer preferences for particular characteristics of free-to-air and pay TV products; and
- Likely consumer responses to a hypothetical increase in the relative price of pay TV services.

1.7 Having defined the relevant markets we then turn to the question as to whether firms (either individually or collectively) have market power in these markets. In markets where most products are sold as part of a bundle, and where different firms bundle products in different ways, it is not possible to provide definitive market share estimates. Instead we have sought to estimate market shares using a range of alternative assumptions.

1.8 In interpreting market shares we have also recognised that products which might technically lie just outside the relevant market may nevertheless impose some competitive constraint on firms.

1.9 In addition to an assessment of market share and market share trends, we have also come to a view on market power by an examination of structural aspects of the market (including vertical integration), customer switching costs, barriers to entry and expansion, countervailing buyer power, and pricing and non-price behaviour.

1.10 The remainder of this annex is structured as follows.

- In chapter 3 we examine the market definition precedents from UK and other regulators and competition authorities, and in particular, their relevance for this market investigation.
- In chapter 4 we set out our approach to defining the relevant market, followed by a discussion of some of the conceptual issues associated with defining the relevant market in the pay TV industry, and how we have addressed them.
- In chapter 5 we examine the available evidence on market definition. For each of our three main focal products (packages containing premium sports, packages containing premium movies, and stand-alone basic TV packages), we consider the available substitutes and whether these impose a sufficient competitive constraint to be included in the relevant market. For premium sports and movies, where there are few providers of wholesale products, we consider the market definition question at both wholesale and retail level. For basic-tier pay TV, however, there are multiple providers of wholesale channels and we would not

expect to find market power regardless of wholesale market definition. We have therefore only considered market definition at the retail level for basic-tier pay TV.

- In section 6 we review the available evidence on whether firms in these content / channel markets individually or collectively have market power in each of the markets we identify.

- In section 7 we present our analysis of platform markets.

Section 2

Market definition precedents

Introduction

2.1 In this chapter we look at the previous investigations into the pay TV market by UK and other regulators and competition authorities. We consider both the approaches used, and the conclusions reached, and comment on their likely relevance for our current market study.

2.2 We recognise the importance of carrying out our own analysis of market definition and market power, particularly in the context of an industry which is extremely fast-moving. However, a review of precedent can suggest important issues which we should consider, and can provide reference points against which to assess the extent of recent changes.

2.3 The issue of market definition in broadcast markets has been considered on a number of recent occasions by both the UK and EU competition authorities. We discuss each in turn.

Recent UK judgements

2.4 Recent UK judgments include the following:

- In 1996, the Director General of Fair Trading conducted a review of the wholesale pay TV market. This concluded that the relevant market for the review was that for pay TV in the UK. The pay TV market could be further subdivided into distinct and separable markets for premium sports and movie channels;
- In April 1999, the Monopolies and Mergers Commission published its report into the proposed merger between Sky and Manchester United Football Club. This report concluded that pay TV is a separate market from free-to-air TV, whilst recognising that the existence of free-to-air broadcasters will place some upper limit on the prices of pay TV broadcasters. It further concluded that the relevant broadcasting market for consideration in the context of this merger was a market for pay TV sports premium channels;
- In 2002, The Office of Fair Trading (OFT) conducted a Competition Act investigation into Sky [case CA98/20/2002]. This investigation concluded that the relevant markets for the investigation were the wholesale and retail supply of channels containing sports content that is unique to pay TV (characterised for the purposes of this investigation as live FA Premier League football) and the wholesale and retail supply of premium film channels, (characterised as first run Category A and Category B films shown on the pay TV Window);
- The Competition Commission (the "CC") published its provisional findings into the acquisition by Sky of a 17.9% stake in ITV on October 5th 2007[2]. Its provisional conclusions were that ITV and Sky operate within a UK market for all-TV which includes both pay TV and free-to-air services, as well as video on demand, but that this all-TV market is highly differentiated. Within this differentiated market the CC suggested that free-to-air services are likely to be a

[2] http://www.mmc.gov.uk/inquiries/ref2007/itv/

closer substitute to packages which include only basic channels than those which include basic and premium channels.

2.5 The UK precedents suggest that there may be separate markets for premium (sport and movie) pay TV channels at both the wholesale and retail level. The UK competition authorities have generally held that pay TV and free-to-air television are in separate markets, although it has been recognised that free-to-air TV imposes some competitive constraint on basic-tier pay TV channels. However, in its draft findings on the Sky/ITV merger, the CC suggests that this competitive constraint is now sufficiently strong for basic-tier pay TV and free-to-air TV to be included in the same relevant market.

Recent judgments at European level

2.6 The EU has consistently found there to be separate markets for pay TV and free-to-air TV at both the wholesale and retail level, for example, Newscorp/Telepiù[3]. The EU has also held there to be separate markets for the supply of premium content, with premium sports and premium movies channels being in separate markets (Newscorp/Telepiù, EU v Football Association Premier League (FAPL)[4]). Pay-per-view has also been consistently deemed to be in a separate market from subscription pay TV services (see for example, Telenor/Canal +/Canal[5]).

2.7 On platform competition, the EU held in Nordic Satellite Distribution that TV supplied by satellite was in a separate market from the cable distribution technology. However, in the more recent Telia/Telenor[6] case, the EU noted that there was significant substitution between platforms, although it left the market definition open.

Implications for our analysis

2.8 It is notable that, with the exception of the CC's Sky/ITV case, the evidence used to define pay TV markets has been primarily based upon what have been regarded as the distinct characteristics of subscription pay TV and free-to-air TV products, including differences in prices and business models.

2.9 In contrast, the CC closely examined evidence of actual substitution between basic-tier pay TV and free-to-air, including churn data and econometric evidence on the probability that customers will take up basic pay TV services. The CC concluded that free-to-air appeared to be a closer substitute for basic-tier pay TV than premium pay TV, and that although there was a substantial amount of product differentiation, basic-tier pay TV and free-to-air were likely to be in the same economic market.

2.10 These precedents generally suggest that free-to-air services provide a growing constraint on basic-tier pay TV services, but that this constraint was not at the time sufficient for these to be in the same market. Precedents also suggest distinct

[3] Commission Decision, Case COMP/M.2876, 2 April 2003, *Newscorp/Telepiù*.

[4] Commission Decision of 23 July 2003 relating to a proceeding pursuant to Article 81 of the EC Treaty and Article 53 of the EEA Agreement (COMP/C.2-37.398 —Joint selling of the commercial rights of the UEFA Champions League)

[5] Commission Decision, Case COMP/C.2.-38.287, 29 December 2003, *Telenor/Canal +/Canal Digital*, paras. 51 et seq

[6] .Commission Decision, 2001/98/EC, *Telia/Telenor* (Case IV/M.1439), [2001] OJ L 40/1, paras. 269 et seq.

narrow markets for premium sport and premium movies at both the retail and wholesale level[7].

[7] The CC's investigation into the Sky/ITV merger did not specifically address this issue

Section 3

Analytical framework

3.1 In this chapter we set out the approach we have taken to defining the relevant markets in this investigation. We begin by outlining our general approach, before turning to a discussion how we have addressed some of the more specific difficulties that we face in defining markets in the pay TV broadcasting industry.

General approach to market definition and sources of data

3.2 The purpose of defining the relevant market is to identify the products and suppliers that impose a significant competitive constraint on individual firms. These constraints can be provided by consumers switching, or threatening to switch, to substitute products (demand-side substitution). Rival firms can also provide a constraint on pricing if they are able to rapidly switch from supplying one product to another in response to a change in relative prices (supply-side substitution).

3.3 The standard approach for assessing whether demand and supply-side substitutes provide a sufficiently strong competitive constraint to be included in the relevant market is the "hypothetical monopolist" test (HMT). This considers whether it would be profitable for a hypothetical monopolist supplying the relevant (focal) product to sustain a small but significant price increase (typically 5-10%) above the competitive level of pricing. This is also commonly known as the 'SSNIP' test (Small but Significant, Non-transitory Increase in Price). If such a price increase would be profitable, then the focal product is the relevant market. Alternatively, if a hypothetical price rise is unprofitable, then we identify the closest substitute to the focal product, add this product to the focal product and repeat the test. Further substitutes are added to the focal product until it would be profitable for a hypothetical monopolist to impose a significant increase in price.

3.4 We have sought evidence on the extent of substitutability from a range of sources. This evidence includes:

- Evidence on the objective characteristics of different TV products;
- Evidence from consumer research on the characteristics that consumers particularly value and which therefore drive demand for pay TV, free-to-air TV and other potential substitutes such as DVDs;
- Evidence from consumer research on the hypothetical behaviour of consumers in response to a sustained increase in prices by a small but significant amount;
- Evidence on the actual behaviour of consumers in response to historic changes in pricing;
- Evidence on the pricing and other strategies of channel wholesalers and retailers; and
- Evidence on the potential for supply-side substitution.

3.5 As part of this exercise we have commissioned an extensive and detailed consumer survey into attitudes to consumers' pay TV purchase decision. The survey was in two parts. First, consumers were asked directly how they would respond to a hypothetical increase in the price of various pay TV products. Secondly, the consumer survey also sought to understand the characteristics of pay TV which were important in driving their demand for pay TV products.

Specific Issues faced when defining markets in broadcasting markets

3.6 In applying the HMT test to pay TV broadcasting markets, there are a number of practical difficulties that we have had to address. Many of these arise in defining markets in other industries, but in combination, they can make the definition of broadcasting markets particularly challenging. In particular, we have considered:

- How to account for the possibility that current prices may be above competitive levels;
- How to account for possible stated preference bias in consumer research;
- How to take account of the two-sided nature of the market;
- How to gauge the substitutability of products which can only be consumed as part of a wider bundle; and
- How to define markets for products which are highly differentiated.

Market definition where pricing is above competitive levels – the "cellophane fallacy[8]"

3.7 The HMT analyses whether it would be profitable for a monopolist to price above the competitive level. TV markets in (common with many other information markets) are characterised by high fixed and low marginal costs of distribution. This means that the competitive price will inevitably be above marginal cost, and that the socially optimal pricing structure may require some form of price discrimination or non-linear pricing. It may therefore be difficult to observe or estimate the 'competitive price' from which to make an assessment on market definition.

3.8 In a non-merger context the appropriate question to ask is whether a hypothetical monopolist could raise prices above the competitive level. However, if a firm is already exercising market power, current prices may already be above the competitive price. If this is the case, then it may not be profitable to raise prices further. Applying the HMT to current prices may therefore suggest that the market definition should (incorrectly) be widened to include substitute products. This is the so called "cellophane fallacy".

3.9 The cellophane fallacy is a recurring problem in non-merger cases, and where there is the possibility that market power is currently being exercised, the results of the HMT must be treated with caution. The resolution of the Cellophane Fallacy usually requires other evidence to be sought such as evidence on the performance of firms and direct measures of market power.

[8] The cellophane fallacy was first highlighted as a competition concern following the controversies which arose as a result of the case involving producers of cellophane *US v Du Pont* 351, U.S. 377 (1956)

Stated preference bias

3.10 It is common when asking consumers hypothetical questions about their potential response to changes in prices to find that consumers overstate the way in which they would react. As with the cellophane fallacy, this means we have to be careful about interpreting switching results – stated preferences may lead markets to be defined too broadly. We have sought to address this issue by looking at the way in which consumption levels have changed historically in response to changes in actual prices.

Two-sided markets

3.11 Markets are two-sided where there are two distinct customer groups, such as viewers and advertisers, whose demands are interdependent. Some broadcasting markets such as channel provision are two-sided because the demand for advertising airtime depends upon both the price of advertising and the number of viewers who watch a particular channel (which in turn depends upon the price charged for viewing).

3.12 To apply the HMT test to a two-sided market we would theoretically wish to hypothesise both an increase in the price of broadcasting and of advertising. However, the practical assessment of the way in which advertisers would respond to changes in the price of advertising when coupled with viewers responding to an increase in their prices is highly complex and potentially subject to significant error. We have therefore applied the HMT test only to the retail price of pay TV. We recognise that this may have a tendency to overstate the profitability of a price increase (as a reduction in the number of viewers will reduce advertising revenues), but we believe that the magnitude of any such bias to be small.

Market definition with tied and bundled TV products

3.13 Many TV products are sold within a bundle or tied to other products. For example:

- Content is bundled into channels;
- Channels are bundled into retail packages; and
- Retail packages of TV channels are often bundled with other services including, phone lines, broadband, set-top boxes, HD and multi-room.

3.14 Our approach has been, as far as possible, to apply the HMT test to products that individuals actually consume, thereby avoiding attributing notional prices to individual components of bundles. In particular, for premium pay TV services (which are typically sold bundled with basic pay TV channels) we have taken the focal product to be any retail package which contains the relevant type of premium content. To apply the HMT test, we assume the price of the premium package increases, whilst holding the price of basic-tier TV packages constant.

3.15 For Sky's services, we take their focal product to be TV services. We recognise that the price offered to consumers also includes a "free" 2Mbps broadband service for customers within Sky's broadband network. However, we estimate that only about

3%[9] of Sky's UK customers currently take up this 'free' service. We therefore believe that ignoring the cost of providing this "free" service is unlikely to have a material effect on the analysis.

3.16 Virgin only offers a TV product when bundled with telephone or broadband services. However, most cable consumers could self assemble a similar bundle of phone line rental or broadband and TV services at a broadly similar cost to the bundled prices[10]. To reflect this, we have only applied the HMT analysis to pay TV component of the bundle[11].

Switching consumption of TV programmes versus switching to economic substitutes

3.17 Sky and Virgin oblige customers who wish to purchase premium content also to buy basic-tier pay TV content. One implication of this pricing structure is that consumers who respond to an increase in the price of premium packages by trading down to basic-tier packages do not actually switch any of their expenditure to basic-tier pay TV channels – they were purchasing these channels already[12].

3.18 Consumers may switch their TV viewing habits by watching more hours of basic-tier and free-to-air TV. However, this does not imply that these TV services provide an economic substitute for premium pay TV services, as consumers will not necessarily increase their expenditure on pay TV services[13]. We therefore need to consider where consumers switch their expenditure to when they stop consuming premium pay TV services.

3.19 The implication of this is that consumer switching data needs to be interpreted very carefully, to distinguish between genuine switching behaviour and a "stop consumption" decision. Although switching expenditure to economic substitutes is likely to be of more significance than switching viewing habits, the latter may nevertheless be important if it provides basic and free-to-air channels with a strong incentive to compete for premium pay TV subscribers.

Product differentiation

3.20 Markets which contain a variety of differentiated products, such as some broadcast markets, may not have a clear-cut boundary. This can mean that there may not be a unique distinction between products that are in the market and products that are outside it. In such circumstances markets should be defined in the most appropriate manner given the specific competition issue under consideration. Market definition is a tool for analysis and may therefore vary from one investigation to another

[9] Of Sky's 1 million broadband customers, 70% take a paid for upgraded broadband service, with 30% taking the free 2 Mbps broadband service. This equates to approximately 3.7% of Sky's 8.1 million UK subscribers. http://media.corporate-ir.net/media_files/irol/10/104016/ResultsRelease011107.pdf

[10] For example a Virgin 'M' TV package and phone line bundle for a one off cost of £30 and a monthly cost of £11, is similar in characteristics and cost of assembling a BT line rental and Freeview TV package.

[11] We have assumed that the money attributable to the phone line element of the bundle is £11 per month. This is the cost of Virgin's cheapest product, which is, in essence a phone only service.

[12] If there is no such increase in demand, then the products would not be considered to be economic substitutes. Demand could however increase if customers traded up by purchasing more basic-tier channels or larger basic-tier packages.

[13] We note that if consumers watch more hours of basic-tier and free-to-air channels, this could increase the revenues that these channels earn from advertisers and sponsors – however, as noted above this is likely to be a relatively minor effect.

3.21 Indeed, in certain circumstances it can be counter-productive to take a very binary approach to market definition for differentiated markets, dividing products into those which are close substitutes to the product of interest, and those which are not, and only giving detailed consideration to the former. It may be of more value to analyse the level of constraint imposed on the product of interest by a range of other products, including some which are outside the formal market boundary.

3.22 This consideration is particularly relevant to any discussion of the boundary between pay TV and free-to-air services. This boundary issue was thrown into sharp focus by the merger analysis which followed the recent acquisition by Sky of shares in ITV, given that these companies are respectively the UK's major retailer of pay TV services and the UK's leading commercial broadcaster of free-to-air services. We note in this context the recent provisional finding of the Competition Commission that:

> "ITV and Sky compete for viewers within a differentiated product market. This differentiation can be seen in a range of dimensions, such as the amount, type and quality of content provided, the timeliness with which the content is provided (linear or on-demand), the provision of complementary services and equipment (such as EPGs and DVRs), and whether services are available as part of a bundle with other services (for example, telephony and Internet access)" [para. 4.5]
>
> "Our view…is that FTA and pay services compete with one another within a market for 'all-TV', which includes VoD. The all-TV market is highly differentiated, however…" [para. 4.31]

3.23 The CC's draft decision clearly acknowledges that there has been an increase in competition between free-to-air and basic-tier TV. However, the CC emphasised that the question it was seeking to address was whether market power would be increased following the merger, rather than whether any firm had existing market power (which was the focus of previous UK investigations). The CC thus conducted its market power assessment on the basis of current prices, which, as it acknowledges, are not necessarily competitive prices.

Section 4

Preliminary conclusions on content / channel market definitions

Introduction

4.1 The aim of this section is to come to a preliminary view on market definition through a review of all of the available evidence, including market definition precedents, product characteristics, our own primary research, analysis of available data, and evidence provided in submissions to this investigation.

4.2 We focus our attention on three candidate markets in turn, looking at each at the retail and wholesale levels. These are:

1. Packages including premium sports channels ((A) retail and (B) wholesale);

2. Packages including premium movie channels ((A) retail and (B) wholesale); and

3. Packages of basic-tier TV channels when not retailed with premium channels (retail level only).[14]

4.3 For each of these candidate markets we seek to identify what are the closest substitutes, and whether they exert a sufficient competitive constraint to be included in the relevant market.

4.4 When considering retail markets, we look at the following pieces of analysis for each candidate market:

- Package characteristics;
- Research carried out by Ofcom, and where appropriate by stakeholders, into consumers' likely switching behaviour in response to changes in price;
- Actual evidence of the interaction between prices and subscriber numbers[15]; and
- Possible supply-side substitution.

4.5 When considering wholesale markets, we look at the following possible constraints for each candidate market:

- Demand-side substitution;

[14] We have not sought to define the relevant market for the wholesale of basic-tier channels. Even taking the narrowest plausible market definition, the wholesale of basic channels, we observe a highly fragmented market with limited market power for any participant. We have been unable to compile market shares by revenue, but taking viewing figures as a proxy (albeit an imperfect one), we find that no basic-tier channel provider has a share of basic viewing of greater than 20%. With these low market shares, low barriers to entry and relatively powerful buyers in Sky and Virgin Media, it is unlikely that any individual wholesaler could be considered dominant.

[15] In each case we have used data supplied by Sky showing its subscriber numbers on different packages. The reason for selecting these data is unavailability of time-series data for other providers.

- Indirect constraints from retail markets; and
- Supply-side substitution.

1(A) Retail of packages containing premium sports channels

4.6 A 'premium sports' pay TV service is usually defined as one that provides live access, often on an exclusive basis, to a specific set of highly-valued sports events. For the purposes of this work, we have considered packages of premium sports that include access to live Football Association Premier League (FAPL) matches. These packages also contain other sports and Annex 10 lists the key events for which broadcast rights are available in the UK, the current owner of those broadcast rights, and (where available) the price paid for these rights.

4.7 In this section, we seek to establish what are the closest substitutes to pay TV packages containing premium sports channels (the focal product), and whether these substitutes provide a sufficiently strong competitive constraint to be included in the relevant market. To reach our preliminary view on market definition we have considered the characteristics of premium sports pay TV channels, consumer survey evidence on the likely consumer responses to an increase in the price of premium sports packages, evidence on historic pricing, subscription numbers and churn data, and the scope for supply-side substitution.

4.8 Regulators in the UK have held that both the wholesale and retail of premium sports channels are relevant economic markets[16]. In the case of FAPL, the European Commission considered that the joint selling of FAPL required regulatory intervention as this was likely to lead to foreclosure on downstream markets[17]. The FAPL rights are now sold as six independent packages. Currently Sky holds four packages and Setanta two.

Characteristics of packages containing premium sports channels

4.9 The two main premium sports packages in the UK are Sky Sports and Setanta Sports. Setanta Sports is available on all platforms. However, the only two retailers of Sky Sports of any significant scale at present are Sky and Virgin Media.

4.10 Figure 1 below summarises the wide variety of premium sports content that is available on the various TV platforms.

Figure 1: Features of television services containing sports programming

	Product	**Pricing**	**Programming** LR – Live rights, H – Highlights
Sky Sports	Sports Mix (Sky Sports 1-3, Sky Sports Xtra	Available in combination with a basic-tier package either on Sky, Virgin Media or Tiscali[1]. Typical incremental price: Sky - £9-18 pcm	- FAPL (92 matches) – LR - English test match cricket – LR - UEFA Champions League (Shared with ITV) – LR (currently up for negotiation) - Football League matches – LR

[16] See for example OFT 2002 and OFT 1996.
[17] See, EU FAPL, 2006.

	Product	Pricing	Programming LR – Live rights, H – Highlights
		Virgin Media - £15 - £26 pcm	
		Tiscali - £22 - £26.50	
Setanta Sports	Setanta Sports Pack (9 channels on satellite, 7 on cable, 1 on DTT, 3 on Tiscali)	Stand-alone price of £9.99 on satellite, DTT and Tiscali. On Virgin Media bundled into XL pack or available at £8 pcm as a stand-alone package	- FAPL - LR (46 matches) - English home football internationals (2008/09 onwards) – 8 matches over 4 years LR - FA Cup football (2008/09 onwards) – shared with ITV LR
Stand-alone channels	MUTV	£6 pcm	Near live rights to teams' matches
	Chelsea TV	£6 pcm	
Included in Sky basic tier ('News and Event' mix)	'AtTheRaces', British Eurosport, British Eurosport 2, ESPN Classic, Extreme Sports, Sky Sports News	'News and Events' mix has a stand-alone price of £16 pcm, but an incremental price to other basic mixes of £1 pcm	
Included in Virgin basic tier	Virgin L includes 'at the races', British Eurosport, British Eurosport 2.	Virgin L: £11.50 pcm	
	Virgin XL adds Setanta pack.	Virgin XL: £21.50 pcm	
Free-to-air	Sky Sports News on DTT only*, plus sports coverage on general entertainment channels		BBC – FAPL H BBC – Wimbledon BBC / ITV – Rugby League World cup BBC / ITV – FIFA World Cup Finals BBC / ITV – Euro 2008** ITV – England Football internationals – home competitive matches (2008/09 onwards) LR H ITV – UEFA Champions League (shared with Sky) ITV – UEFA cup LR ITV – FA cup (2008/09 onwards) shared with Setanta LR
BT Vision	Sports pack	£4 per month	242 near live FAPL matches
		£12 including Setanta Sports (DTT version)	

	Product	Pricing	**Programming** LR – Live rights, H – Highlights
		PPV £1.99 per near live match	

Source: annex 10 unless otherwise stated.

Correct at December 2007

** Sky is seeking regulatory approval to remove Sky Sports News from the Freeview offering http://www.ofcom.org.uk/consult/condocs/dtv/.*

*** http://www.digitalspy.co.uk/broadcasting/a62069/bbc-itv-agree-joint-euro-2008-deal.html*

4.11 As Figure 1 illustrates sports content is available through both free-to-air and pay TV services. However, although free-to-air channel providers hold some important sports rights, such as the FIFA World Cup and a selection of UEFA Champions League matches, the quantity of live sports coverage on pay TV channels is vastly greater than that available on free-to-air TV.

4.12 Analysis of BARB data for Q3 2007 shows that, of the channels surveyed[18], there were about 16,900 hours of sports programming broadcast in Q3 2007. Subscribers to Sky Sports would have access to about 14,000 hours of sport (the remaining 2,900 hours are largely broadcast on Setanta). If consumers dropped down to a basic package they would have access to 6,600 hours of sport and if they downgrade to a free-to-air service on DSat they would have access to only 1,300 hours. On DTT, Sky Sports News currently broadcasts free-to-air and provides a further 2,100 hours of programming.[19]

4.13 Access to premium sports channels thus provides a substantial increase in the choice and range of sport available. Our own consumer research also found that customers place a high value on the range and choice of high quality sports viewing, with 41% of respondents citing the “whole package” as the primary reason for subscribing to Sky Sports[20].

4.14 Premium sports pay TV channels also provide consumers with access to key content for which there are limited substitutes. In particular the rights to the live broadcast of FAPL football have for a long time been held to be the most important rights for driving customer demand for premium sports pay TV packages in the UK.[21] In 2006 the FAPL rights for the period 2007/8 to 2009/10 were auctioned for a total of £1.7billion. This accounts for around an estimated 40-50% of the total spending on sports rights by Sky and Setanta combined, and also represents an increase of 66% from the period 2004/5 to 2006/7. While there may be a variety of reasons for this increase, it is sufficiently large to suggest that these rights have become, if anything, even more important over the past few years. The annualised figure for FAPL alone is also considerably greater, for example, than Sky’s annual expenditure on movie rights.

4.15 Our own research also highlights the importance of live coverage of FAPL matches. For example, 35% of Sky Sports consumers questioned in a 2005 survey stated

[18] Not all channels subscribe to the BARB service.
[19] Though on Freeview Sky Sports News currently broadcasts free-to-air but as part of a basic channel bundle on DSat.
[20] Ofcom FAPL Omnibus research, March 2005, see Annex 14
[21] OFT 1996, 2002, EC 2006.

(unprompted) that access to live FAPL matches was the main reason for subscribing to Sky Sports[22].

4.16 We also commissioned some more detailed consumer research which sought to identify the key drivers of demand for premium sports channels[23]. The research found that:

- Football is by some distance the most important individual sport for viewers of sport on TV. Of those customers who say that a specific sport is their main reason for watching sport, 60% of respondents (spontaneously) cite football as a ‘must have’, followed by cricket at 20%, and rugby union at 17%[24].

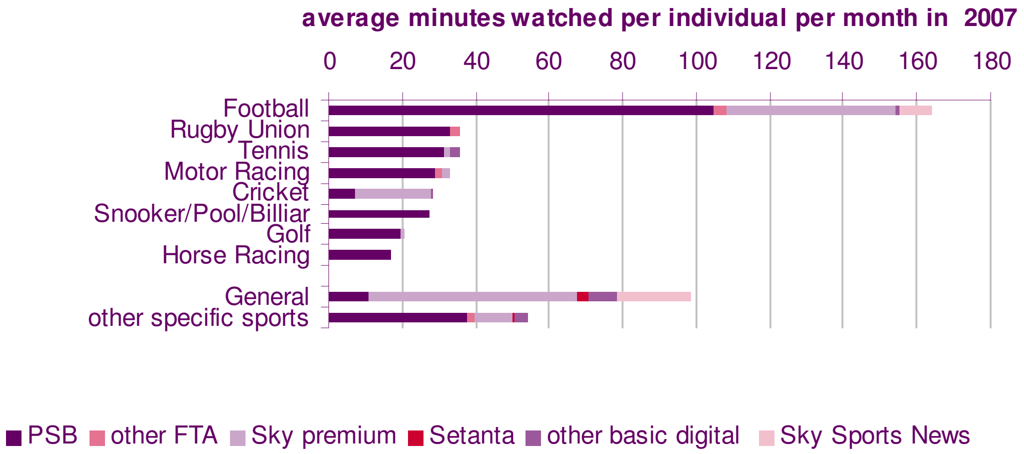
- In 2007, football was by far the biggest single sport watched on TV with viewing hours more than four times as high as rugby union, the next most popular individual sport (see Figure 2 below);

- The five most important individual events cited by consumers are all football events: the FIFA World Cup (55%), FAPL (52%), Champions League (36%), FA Cup 35% and the European Championships (33%). The most important non-football event is Wimbledon, which is cited as ‘must have’ by 29% of our sample[25];

- Subscribers to Sky Sports watch substantially more sport on TV than other viewers (92% of Sky Sports subscribers watch sport at least once a week, compared to 66% of basic pay TV subscribers, and 61% of Freeview viewers).[26]

[22] Ofcom FAPL Omnibus research, March 2005, see Annex 14
[23] Ofcom Phase 3 research, August / September 2007, see Annex 14
[24] Ofcom consumer research, phase 3, see Annex 14 for details.
[25] Customers who regularly watch a specific event were asked to cite (spontaneously) events which they considered to be ’must haves’. Note the analysis was conducted in August and September 2007– the seasonality of sport fixtures may affect the results. Ofcom consumer research, phase 3, see Annex 14 for details.
[26] Ofcom consumer research, phase 3, see Annex 14 for details.

Figure 2: Average time spent watching sport by genre and channel type



Source: BARB 2007 – all individuals, all households.

Note: PSBs include BBC1, BBC2, ITV, Channel 4 and Channel 5. Sky Sports News is a free-to-air channel on DTT but a basic-tier channel on DSat.

4.17 Live FAPL matches are only available on Setanta Sports and Sky Sports, and the live nature of key premium sports programming appears to be an important product characteristic. While there may be a degree of substitutability with delayed programming and highlights, it appears relatively weak:

- On the one hand, survey evidence of football supporters suggests that if a match that they wanted to see was not available, 64% said they would certainly watch, or would be very likely to watch the highlights, and 46% said they would certainly watch, or would be very likely to watch, a near live version of the match[27];

- On the other hand, whilst this suggests some substitutability between different types of rights, it provides no information as to how consumers are likely to respond to a change in the relative prices of different types of sports programming. Furthermore, live rights are clearly more valued by broadcasters and – by assumption – final consumers, compared with delayed rights or highlights. For example, while the live FAPL rights were sold in 2006 for £1.7billion, the delayed rights attracted just £84m, and the highlights £171m[28]. These differences suggest that delayed coverage and highlights of key sports events are unlikely to be close substitutes for live coverage.

4.18 In summary, our analysis of the characteristics of premium sports suggests that:

[27] Source: Ofcom 2005 FAPL survey. Base: 640. All respondents who describe themselves as interested in Premier League Football. Respondents were asked "If a Premiership game, that you wanted to watch, was not shown live on TV, how likely would you be to watch the following if they were available to you?"
[28] See Annex 10

- Access to content (in particular live football), choice and range of sports are the most important characteristics in driving demand for premium sports pay TV channels;
- While attractive sports content is available on free-to-air and basic-tier pay TV channels, premium sports pay TV channels offer a substantially greater amount of programming. They also give exclusive access to content for which there are limited substitutes, in particular live FAPL rights.

4.19 The evidence on characteristics therefore suggests that premium sports pay TV channels do not have any particularly close substitutes, and may therefore be in a separate market to free-to-air and basic-tier pay TV.

Packages containing premium sports channels: evidence on likely consumer responses to price increases

4.20 We have attempted to quantify the extent to which other sports channels, and other TV services, provide a substitute for Sky's premium sports channels, by asking a random sample of Sky Sports consumers how they would be likely to respond to a small but significant non-transitory increase in price (SSNIP) of Sky Sports packages. The prices of basic-tier and premium movie packages were held constant.

4.21 To conduct the SSNIP test, we increased the price of the sports element[29] of the various sports packages by 10%, while holding the price of packages without premium sports constant. This is equivalent to an increase in the overall price of a bundle of channels including Sky Sports of approximately 2-6%.

4.22 Our key findings were that in response to a 10% price increase in the sports element of a bundle[30]:

- 9% of consumers would switch to Setanta (including 3% who would drop their movie channels as well as switching their sport channels);
- 7% of consumers would drop Sports but keep Movies and Basic;
- 5% of consumers would drop Movies, but keep Sports and Basic;
- 4% would drop both Sports and Movies, but keep Basic; and
- 4% would switch to FTA TV.

4.23 If prices are currently at competitive levels, this reported level of switching would be sufficient to make a price rise unprofitable, implying that the relevant market is wider than the retailing of packages containing Sky Sports. Indeed these results suggest that the market is likely to include Setanta's sports programming. They could further imply a market which is wider than all premium sports packages (Sky Sports and Setanta).

4.24 However, as explained in Section 3 above, these results need to be considered in the context of prices that may be above competitive levels and the fact that stated

[29] For the purpose of this exercise we made the simplifying assumption that the sports element of the package was the incremental cost of purchasing sports over the cost of a basic-tier pay TV package.
[30] Source: Ofcom phase 3 consumer research, August / September 2007. Base: 450, all subscribers to Sports and Movie Mix packages.

preference survey results frequently over-estimate actual switching levels. On balance, we believe this evidence suggests that:

- Setanta is a relatively close substitute for Sky Sports;
- Consumers appear to have a strong preference for sports content (only half of the 29% of customers who switch to an alternative package in response to an increase in the price of sports content choose to drop sports); and
- There is some evidence of a binding budget constraint, with some customers responding to an increase in the price of Sky Sports by dropping Sky Movies.

4.25 Taken together the evidence is consistent with consumers having a relatively strong preference to maintain their consumption of premium sports content in the face of price increases, which could point to a premium sports content market definition.

Packages containing premium sports channels: evidence on pricing and subscriber growth

4.26 We have supplemented this assessment with a review of changes in prices and subscriber numbers over the last seven years, based on confidential information provided to us by stakeholders. This suggests that:

- The price of Sky's premium sports, and premium sports and movies packages has risen in real terms since January 2000; and
- During the same period, the number of subscribers has grown, although the growth has slowed in the last two years.

4.27 At the same time, there does not appear to have been a substantial change to the underlying quality of Sky's sports offering – although we recognise that this is a more difficult judgment to make. On a simple measure, although there has been some growth in the overall number of hours broadcast, the number of live FAPL games shown by Sky has actually declined following the 2006 auction.

4.28 A more complex question is the impact of changes to the set of basic channels that are sold with Sky Sports, and of the introduction of Sky+. These represent improvements to the quality of the overall bundle and may therefore provide some explanation of Sky's ability to increase prices and subscriber numbers over the period. However, the changes to the quality of the basic channels is relatively less important to premium sports subscribers than to basic-only subscribers and our consumer research points to premium sports subscribers' strong interest in the sports component of their subscription. These factors suggest that the changes to the quality of basic channels, while relevant, may not be sufficient to account for the increase in the price of premium sports bundles.

4.29 We also note that subscriber numbers and prices have grown despite a number of changes to the market environment that we might expect to strengthen the competitive constraint on premium sports. For example, the launch of sister channels has enabled ITV to show a wider range of UEFA Champions League matches.

4.30 It is of course difficult to draw firm conclusions from these data. In particular, we cannot assess what would have happened in the absence of changes to the market. However, if competition has intensified sufficiently for the market definition to be widened (as compared with previous precedent) then we would expect to see some combination of falling prices, falling subscriber numbers and rising quality. On balance, we believe the evidence presented here suggests that historical precedent with respect to premium sports in the UK is likely to remain relevant.

Packages containing premium sports channels: supply-side substitution

4.31 We have also considered the potential for supply-side substitution. In particular, we have assessed whether an alternative supplier could switch to retailing a package of channels including premium sports channels in a short period of time (less than 12 months) without incurring significant sunk costs.

4.32 In practice, we think supply-side substitution is unlikely to provide a constraint: a supplier would need to acquire sports rights and incur the marketing costs necessary to build a subscriber base. These costs are substantial and acquisition of sufficient rights within a 12 month period is in any case unlikely to be possible.

Packages containing premium sports channels: conclusions

4.33 The key drivers of demand for premium sports pay TV packages are high quality sports content, and live football content in particular, together with the availability of a wide range and choice of attractive live sports content. The characteristics of premium sports pay TV packages appear to be significantly different to those of basic-tier and free-to-air both in terms of the vastly greater number of hours of sport which are available on premium pay TV sports channels, and the quality of that content, in particular, the availability of live Premier League football.

4.34 Our consumer survey evidence on likely consumer responses to a 5-10% hypothetical increase in the price of Sky Sports packages revealed that consumers considered Setanta Sports to be the closest substitute for Sky Sports. We also found evidence that consumers would be prepared to make sacrifices in other areas, in particular dropping Sky Movies, in order to continue taking premium sports content.

4.35 Nonetheless, customer responses indicated a relatively high level of switching away from Sky Sports in response to a SSNIP. This is in part likely to reflect the usual biases inherent in stated preference research and needs to be understood in that context. In addition, since the evidence is consistent both with a wider market (which would include Setanta Sports and basic pay TV programming) and a narrow premium sports market in which prices have already been raised above competitive levels, we need to consider other evidence to reach a judgement as to which of these two possibilities is more likely.

4.36 Previous market investigations and other precedents support a premium sports pay TV market definition. If the market definition has recently widened because of, for example, increased competitive constraints imposed by Freeview, we would expect to see some significant effect on the price (or quality) of Sky Sports and/or the number of subscribers. However, we have observed that the price of Sky Sports has increased in real terms in the last six years, whilst the total number of Sky Sports subscribers has continued to grow.

4.37 We accept that the very real difficulties in estimating the counterfactual mean that we cannot rule out the possibility that the price of Sky Sports has been moderated by increased competition. Furthermore it is too early at this stage to assess the full impact of Setanta’s FAPL offering. We conclude that:

- There is a narrow economic market for premium sports retailing in the UK, which does not include FTA or basic-tier TV channels;
- This is consistent with historical precedent and reflects the fact that the only substantial change to competitive conditions over the past few years within this market is the entry of Setanta;
- It *may* therefore be appropriate to broaden the market beyond Sky's sports channels to include Setanta's offering, although we do not rule out the possibility that the retailing of Sky Sports might be a market in its own right.

1(B) Wholesaling of premium sports channels

4.38 We have approached market definition at wholesale level in a similar way to market definition at retail level. Specifically we have considered whether it would be profitable for a hypothetical monopolist of wholesale premium sports channels to raise prices to retailers by a small, but significant amount.

4.39 However, in addition to the direct constraints imposed on a wholesaler through demand and supply-side substitution, a wholesaler may also be indirectly constrained in its ability to raise prices if final consumers are able to switch to alternative products. For example, if a wholesale price increase is passed on by retailers to final consumers, then this will cause some final consumers to switch to products sold by rival retailers, which in turn may lead to a reduction in demand for the wholesaler's products.

4.40 Indirect constraints can potentially provide a more important competitive constraint than demand and supply-side substitution. We therefore consider all three competitive constraints in our wholesale market definition analysis.

Wholesaling of premium sports channels: demand-side substitution

4.41 If a hypothetical monopoly wholesaler of premium sports channels were to raise its prices there are very limited substitute products for current retailers of premium sports packages. With respect to sports content, there do not appear to be any alternative wholesaler channel providers who offer sufficiently attractive sports content. Reducing the number of channels purchased might be possible, but this would significantly degrade the quality of the product sold to final consumers, and under current pricing structures – would appear unlikely to offer a commensurate cost saving. Alternatively, a retailer could turn to non-sports content but this would effectively amount to adopting a new business model.

4.42 For these reasons, we believe that there are no effective demand-side substitutes for the wholesaling of premium sports pay TV channels.

Wholesaling of premium sports channels: supply-side substitution

4.43 As with retail markets, it is unlikely that a wholesaler of channels other than premium sports channels could switch production to offer premium sports channels within a short period of time due to the exclusivity, staggered availability and contract duration of the necessary content rights. It would therefore not be possible to acquire sufficient rights to assemble a competing channel.

Wholesaling of premium sports channels: indirect constraints

4.44 As noted, the demand of final consumers can place an indirect constraint on wholesalers. This constraint will be greater:

- The higher proportion of a wholesale price increase that is passed on by retailers to consumers;
- The greater the contribution of the relevant wholesale costs to the retail price; and
- The more price sensitive customers are to a change in the price of the product.

4.45 For example, suppose wholesale costs represent 50% of the retail price of premium sports content, and that a retailer passes on 100% of any wholesale price increase to final consumers. This would imply that a 10% increase in the wholesale price of premium sports content would result in a 5% increase in the retail price.

4.46 The implied retail price increase will therefore almost always be less than the wholesale price increase. This means that the wholesale market is unlikely to be defined more widely than the retail market (unless there are significant demand- or supply-side constraints). So, whilst an increase in wholesale price may lead to some switching by final consumers, the indirect competitive constraint this imposes is likely to be limited given our conclusion that the retailing of premium pay TV sports packages is likely to be the relevant market.

Wholesaling of premium sports channels: conclusions

4.47 Demand and supply-side substitution possibilities are extremely limited, so that the only realistic constraint on a hypothetical monopoly wholesaler of premium sports pay TV channels is likely to come from the indirect competitive constraint imposed by final customers switching away from premium sports packages to substitute products.

4.48 However, given our conclusion that the retailing of premium pay TV channels is likely to be a relevant market, this indirect constraint is likely to be too weak to prevent a hypothetical monopoly wholesaler of premium sports pay TV rights from raising prices above competitive levels. Consequently, the relevant market is likely to be no wider than the wholesaling of premium sport pay TV channels.

2(A) Retail of packages containing premium movies channels

4.49 In this section we consider whether the supply of subscription pay TV packages containing premium movies (the focal product) is a relevant market. We follow the same approach to that for premium sports.

4.50 The retailing of premium movies has been considered on a number of occasions by economic regulators in the UK. The consistent conclusion of those investigations has been that there is a separate market (both at the retail and wholesale level) for the provision of premium movie rights[31].

[31] See for example, OFT 2002 and 1996.

Characteristics of packages containing premium movie channels

4.51 Hollywood movies are distributed in a number of viewing “windows”, beginning with theatrical release and followed most immediately by release on DVD. For the purposes of this analysis, we have defined the focal product as the retailing of subscriptions to view channels broadcasting major Hollywood films[32] during the first TV window (which begins about twelve months after initial theatrical release).

4.52 At present, Sky Movies is the only means by which consumers can subscribe to major Hollywood movies within the first TV window[33]. Sky retails Sky Movies itself on DSat and Tiscali’s IPTV platform, and also wholesales its channels to Virgin Media, which retails them on cable.

4.53 Figure 3 below summarises the different ways in which individuals are able to view movies on TV.

[32] From the six major Hollywood studios: Buena Vista (Walt Disney), Paramount, Sony, Twentieth Century Fox, Universal and Warner Bros

[33] However, the same movies can be accessed by consumers both earlier (at the cinema, on DVD, or pay per view), and later (on free-to-air TV) than on subscription pay TV channels.

Figure 3 Pay TV packages containing premium movie channels

	Product	Pricing	Programming
Sky Premium Movies	Movies Mix (Sky Movies Premiere / Classics / Family / Modern Greats / Indie / SciFi / Action / Drama, Sky Movies, Disney Cinemagic)	Available in combination with a basic-tier package either on Sky, Virgin or Tiscali[1]. Typical incremental price: Sky - £9-18 pcm Virgin - £15 - £26 pcm Tiscali[34] - £22 pcm	All movies from the six major Hollywood studios in the fist subscription (pay TV) window
Picturebox	Available on Top Up TV or Tiscali's platform.	£5 - £7 per month	Movies from the Universal studio, (although Ofcom understands it does not include those from the first pay TV window).
Pay-per-view / VoD		£1.99 - £4 per view	Movies from the VoD window
DVD rental		£1.99 - £4 per view or available on subscription packages.	Movies from the DVD rental window
DVD retail			Movies from the DVD retail window
Basic-Tier Pay TV	TCM, TCM2, Movies24, Movies on general entertainment channels	£10 (eg for Virgin's L package) - £21 for Sky 6 mix	Movies from the free-to-air and library windows
Free-to-air	Film4, Movies on general entertainment channels		Movies from the free-to-air and library windows

Source: company websites. Correct at December 2007

4.54 Although there are a number of alternative means of accessing the content that is available on subscription pay TV channels, this does not necessarily imply that these alternatives provide effective substitutes for consumers. Rather, what matters is whether these alternatives provide the characteristics that customers particularly value.

4.55 To obtain a better understanding of the characteristics that are important in driving consumer demand we commissioned a consumer research survey which asked Sky Movie consumers about the characteristics of the product that they particularly value[35]. The key conclusions of that research are:

- Access to a wide range of films was the most important characteristic (cited by 83% of subscribers as 'must have' or 'nice to have');

[34] On Tiscali, Sky Sports channels are retailed by Sky under the Sky by Wire brand.
[35] Ofcom pay TV research, phase 2, see Annex 14

- This was closely followed by having films available at all times, and access to new releases (cited by 70% and 72% of subscribers respectively);

- Consumers also value not having to pay each time they watch a film, and the convenience of not having to rent a DVD (respectively cited by 63% and 65% of consumers as either 'must have' or 'nice to have' features).

4.56 These findings, and in particular, the convenience aspect of having a wide range of films available, at home, and free at the point of consumption, suggests that for many consumers DVD rental, pay per view, and seeing films at the cinema may not provide particularly effective substitutes.

4.57 Online subscription DVD rental services may appeal to those consumers who value the convenience of paying monthly or not having to go to a DVD shop. However, they currently represent only 13% of the DVD rental market[36].

4.58 There is also a growing availability of movies on basic-tier pay TV and free-to-air TV channels which premium movie consumers might find attractive. However, these channels are unable to provide the latest releases or to match the range of movies that are available on subscription pay TV premium movie channels.

4.59 Our characteristics assessment suggests that there is no one product which is likely to provide a particularly close substitute to subscription pay TV premium movie channels. This may suggest that subscription pay TV premium movie channels are in a separate market. The relevant market definition could however be wider than this if the collective constraint imposed by a number of weaker substitutes was relatively strong.

Packages containing premium movie channels: evidence on likely consumer responses to price increases

4.60 We have attempted to determine the extent to which other products are likely to provide substitutes for subscription premium movie channels by asking a random sample of Sky Movies consumers how they would be likely to respond to a small but significant increase in the price of Sky Movie packages[37]. The prices of basic-tier, and premium sports packages were held constant.

4.61 To conduct the SSNIP test, we increased the price of the movie element of the various movie packages by 10%[38]. This is equivalent to an increase in the overall price of a Sky Movies bundle of approximately 2-6%.

4.62 We have focused our attention on the responses from consumers who take the sports and movies package[39]. Of those customers:

- 18% reported that they would drop Movies from their bundle (i.e. switch to a Sport and Basic bundle)

---

[36] Screen Digest, 2006, see annex 11

[37] Source: Ofcom phase 3 consumer research, August / September 2007. Base: 450, all subscribers to Sports and Movie Mix packages.

[38] For the purpose of this exercise we have made the simplifying assumption that the movie element of the package was the incremental cost of purchasing movies over the cost of a basic-tier pay TV package.

[39] There are comparatively few customers who only take the movies package.

- 7% would switch to basic pay TV packages (drop Sport and Movies);
- 3% would switch to FTA (drop Sport, Movies and Basic);
- 4% would drop Sports, keep Movies and Basic;
- 1% would switch to pay-per-view movies.

4.63 Taken at face value, these results would suggest that it would not be profitable for a hypothetical monopoly retailer of Sky Movies packages to raise prices.

4.64 There also appears to be some evidence that premium movie customers might be more price sensitive than premium sports consumers. For consumers who purchase packages containing both Sky Movies and Sky Sports, 29% report that they would switch to a non-movies product were the price of the movies element of the package to increase, whereas only 15% of consumers would switch to a non-sports product were the price of the sports element of the package to increase.

4.65 However, as set out in paragraphs 3.7 to 3.10 the magnitude of these results should be treated with caution due to potential concerns that prices may have already been raised above competitive levels and the risk of stated preference bias.

4.66 The “Cellophane Fallacy” may be a particular concern when considering premium movie channels on account of the very high market shares at both the wholesale and retail level, and the fact that Sky Movies is retailed at the same price as Sky Sports despite the considerably lower cost of obtaining the content rights.

4.67 To obtain a better understanding of the likely competitive constraint offered by potential substitutes we asked consumers which film products they would be likely to substitute to if they dropped Sky Movies from their package[40] in response to a price increase. The survey suggested that there is no single product that provides a particularly close substitute to the Sky Movie packages[41]:

- 9% of consumers would consume more pay-per-view movies;
- 17% would rent more DVDs;
- 18% would watch more films at the cinema; and
- 28% would watch more films on free-to-air TV.

4.68 We note in particular the relatively low level of switching to pay-per-view and DVD rental. These alternatives did not exist to anything like the same extent during the OFT’s previous review, so high levels of switching to DVDs and pay-per-view might represent a change in competitive conditions. The evidence presented here however suggests that they do not impose a strong constraint

4.69 Taken together, our analysis of customer switching behaviour suggests that:

[40] Consumers who said they would drop Sky Movies from their package in response to Ofcom consumer research.
[41] Source: Ofcom 2007 Broadcasting Consumer Research. Base: 179. Customers who reported that they would drop Sky Movies following a price increase.

- A small increase in the price of premium movies would appear to cause a relatively large number of consumers to drop the movie element of their package;
- Premium movies appear to be more price sensitive than premium sports;
- Consumers who drop Sky Movies switch to a wide range of movie and non-movie products.

4.70 At face value the stated level of switching suggests that the market may be wider than the retailing of subscription pay TV packages. However, the evidence is also consistent with a narrowly defined market for the retailing of Sky Movies packages, where the high level of switching results from prices having been raised above competitive level.

Packages containing premium movie channels: evidence on pricing and subscriber growth and churn

4.71 To help distinguish between whether the high levels of stated switching are consistent with a highly competitive market, or one in which market power is currently being exercised, we have looked at changes in prices and subscriber numbers for packages containing Sky movie products. We find that:

- The price of packages containing premium Movies products has increased in real terms since 2000; and
- The numbers of subscribers have grown during the same period– although subscriber numbers have levelled off since 2004, and fell slightly in 2007.

4.72 There does not appear to have been a significant change in the quality of the Movie package products over the period. In particular, the number of films broadcast on Sky Movie channels has remained relatively stable since 2001, although the addition of other services, such as free broadband on Sky or greater on-demand services on Virgin Media and Sky could be viewed as a quality change.

4.73 We also note that the concurrent increase in retail prices and subscriber numbers has taken place despite apparent changes in competitive conditions, which might be expected to have increased the competitive constraint on Sky Movies. For example, the growth of Freeview and the repositioning of Film Four as a FTA channel means that consumers have greater choice for viewing films.

4.74 Furthermore, between 2001 and 2006 the retail price of DVDs has fallen in real terms by 43% while expenditure on retail DVDs has tripled over the period.[42]

4.75 As stated above, it is difficult to draw firm conclusions from such data. However, it is notable that the price of Sky Movies has grown at approximately the same rate as that of Sky Sports, despite what appear to be a greater array of potential substitutes. In particular, the growth in popularity of renting and purchasing DVDs does not appear to have had a constraining impact on the price of Sky Movies.

Packages containing premium movie channels: supply-side substitution

4.76 We have also considered supply-side substitution. In particular we have considered whether an alternative supplier could switch to retailing a package of channels

[42] Source: Screen Digest, see annex 11

including premium movie channels within a relatively short period of time without incurring significant sunk costs.

4.77 As with premium Sports channels we consider it unlikely that a supply-side substitution is likely to provide a constraint. In particular, there are no alternative wholesalers of subscription premium movies as a result of Sky's exclusive contracts with the six major studios.

Packages containing premium movie channels: conclusions

4.78 The key driver of demand for subscription pay TV premium movie packages appears to be the very wide choice of first run Hollywood films that are always available and accessible to consumers at a zero marginal cost. Whilst similar or even higher quality content is available on pay-per-view and DVD, these characteristics appear to be of secondary importance to consumers of subscription premium movie channels.

4.79 Consumer research evidence indicated that a high proportion of customers would switch away from Sky Movies were the price to increase by a small but significant amount. This is consistent with a relatively wide product market definition in which premium subscription movies compete with other premium and non-premium pay TV content and possibly free-to-air TV as well. However, it is equally plausible that prices have already been raised above competitive levels, and that this is primarily responsible for the high level of reported switching.

4.80 The consumer survey also suggested that there was no particularly close substitute to Sky Movies. If consumers stop their subscription to Sky Movies they spend their money on a wide variety of products. Perhaps surprisingly, there was very limited reported switching to DVD (retail or rental) or pay-per-view TV, suggesting that these are relatively weak substitutes. The absence of a particularly close substitute is consistent with a narrow subscription pay TV premium movies market.

4.81 Since January 2000, sales of premium movie subscription pay TV packages have increased, and prices have increased in real terms, despite the rapid growth of DVD sales, and increased competition from Freeview, pay-per-view and VoD. As quality has not notably increased, this tends to suggest that the competition from these potential substitute products is limited.

4.82 We therefore consider that premium movie bundles are likely to be in a separate economic market.

2(B) Wholesaling of premium movies channels

4.83 In assessing the relevant wholesale market we have adopted the same approach as in our analysis of the premium sports pay TV wholesale market. We first examine the competitive constraints imposed by demand and supply-side substitution and then the indirect competitive constraints imposed by the potential for final consumers to switch away from premium movie subscription pay TV channels to substitute products.

Wholesaling of premium movies channels: demand-side substitution

4.84 Our analysis presented above suggested that there are only weak substitutes for premium subscription movies. As a result, it appears that a retailer faced with a SSNIP on wholesale premium subscription movies would struggle to find a sufficiently compelling alternative wholesale product. While a retailer could in principle reduce the number of subscription movies that it offers and increase the quantity of pay-per-view movies, our consumer survey and other evidence suggested that pay-per-view movies were not an effective substitute for subscription movies. Moreover, switching to retailing pay-per-view movies would possibly also require the adoption of a new business model.

4.85 As with premium sports, reducing the number of channels purchased might be possible, but is likely to be financially unattractive as it would significantly reduce the quality of the product sold to final consumers, whilst appearing unlikely to offer a commensurate cost saving.

4.86 For these reasons, we believe that there are no effective demand-side substitutes for the wholesaling of subscription premium movie channels.

Wholesaling of premium movies channels: supply-side substitution

4.87 It is unlikely that a wholesaler of channels other than subscription premium movies channels could switch production to offer premium movies channels within a short period of time due to the exclusivity, staggered availability and contract duration of the necessary content rights. Supply-side substitution is therefore unlikely to provide an effective competitive constraint.

Wholesaling of premium movies channels: indirect constraints

4.88 As noted in the discussion of the wholesale market for premium sports channels above, whilst there is likely to be some indirect competitive constraint imposed by the ability of final customers to switch from subscription premium movie packages to various substitute products, this constraint is unlikely to be as great as the competitive constraint at the retail level. Given our conclusion that the retailing of subscription premium movies was likely to be a relevant market, the indirect competitive constraint that potential customer switching has on wholesalers is unlikely to be sufficient, on its own, to prevent a hypothetical monopoly supplier of wholesale subscription premium movie channels from raising prices.

Wholesaling of premium movies channels: conclusions

4.89 Demand and supply-side substitution possibilities are extremely limited, so that the only realistic constraint on a hypothetical monopoly wholesaler of premium subscription movies pay TV channels is likely to come from the indirect competitive constraint imposed by final customers switching away from premium subscription movie packages to substitute products.

4.90 However, given our conclusion that the retailing of subscription premium movie channels is likely to be a relevant market, this indirect constraint is likely to be too weak to prevent a hypothetical monopoly wholesaler of premium subscription movie channels from raising prices above competitive levels. Consequently, the relevant market is likely to be no wider than the wholesaling of subscription premium movie pay TV channels.

3 Retail of packages of stand-alone basic-tier channels

4.91 In this section we seek to determine what is the closest substitute to bundles of stand-alone basic-tier pay TV channels (the focal product), and, in particular, whether the price of stand-alone basic-tier TV is constrained by free-to-air TV. As with sports and movies, our analysis is based on evidence on product characteristics, consumer survey evidence on likely consumer switching behaviour, evidence on prices, subscriber numbers and churn, and supply-side substitution. We look at each of these individual pieces of evidence in turn, before drawing our conclusions on market definition.

4.92 We focus here on basic-tier channels when they are sold on a stand-alone basis. We acknowledge that the basic-tier pay TV service is an entry level product, which consumers often need to purchase in order to obtain the possibility of purchasing premium pay TV content. The demand for basic pay TV services more generally is thus, in part at least, derived from the demand for premium pay TV content. Basic-tier pay TV is often bundled with internet and telephony as well

Characteristics of stand-alone basic-tier TV packages

4.93 The table below summarises some of the key characteristics of the basic-tier pay TV services offered by Sky and by Virgin and, for comparison, the Freeview free-to-air service.

Figure 4 Basic-tier TV packages

	Product	Pricing
Sky basic packs	6 mixes of basic channels, each containing ~15 to ~35 channels which are not available on free-to-air services, and which can be purchased in any combination. Total number of channels across all 6 mixes is ~120	Stand-alone price for 1 mix is £16 pcm. Further mixes can be added for an incremental price of £1pcm. All 6 mixes can be purchased for £21pcm
Virgin Media basic packages	3 basic packages marketed as size M, L and XL. These contain ~35, ~85, and ~140 channels respectively. Some additional channels available separately. XL includes Setanta's premium sports channels. Channels in the M bundle are similar to those found on Freeview. Additional channels on the L or XL bundle are not available on free-to-air services.	M: Free with phone L: £11.50 pcm XL: £21.50 pcm
Freeview	~40 channels available free-to-air	No subscription. Set-top-box purchase required (~£20-£30)

Source: company websites. Correct at December 2007

4.94 Basic-tier TV products all contain a bundle of channels with a range of general entertainment or themed channels. Although the content of these channels is similar to those that are available free-to-air, basic-tier pay TV offers customers a much greater range and choice of channels. In addition to those channels which are available free-to-air basic-tier TV offers consumers up to 120 further channels.

4.95 Generally the content is provided linearly, but it may also be provided via VoD or push VoD (e.g. Sky Anytime, BT Vision or Virgin TV on Demand). In addition, consumers purchasing basic-tier TV packages receive EPG and interactive services and potentially DVRs and replay options.

4.96 These product characteristics suggest that the most likely substitutes for basic-tier pay TV services are likely to be Freeview, Freesat and BT Vision. Freeview offers a range of channels – albeit a more limited one than is available on pay TV – and DVR services are now also available. Freesat offers a range of channels including most of those available on Freeview. BT Vision supplements the Freeview offering with on demand content. Finally, analogue television may also be a substitute for some consumers, although it offers a considerably smaller range of channels.

4.97 To assess the extent of substitutability, we commissioned some wider ranging consumer research[43] into the primary drivers of customer demand for basic pay TV services. We have also drawn on stakeholders' own market research.

4.98 The results of our research suggested that access to content was a key factor in the take up of a TV service, but access to other services such as the EPG, interactivity, DVR or a bundled telephony product were less likely to be cited as reasons take-up. When consumers were asked to specify which elements of content were key to their take-up of TV service, preferences appeared to be spread across a wide variety of specific channels, programmes and genres.

4.99 Evidence on whether basic subscribers value a range of content or specific content was more mixed. Ofcom research into what consumers value in their existing package suggested that access to specific channels such as Sky One, UK TVGold and Discovery was the primary motivating factor for take up of a basic-tier TV package, with the range and choice of content an important, but secondary factor – cited by a quarter of respondents. In contrast, research provided to us by stakeholders suggests that the main motivating reason for taking out a subscription to a basic-tier service was to gain access to a greater choice of content (for example in one survey provided by a stakeholder, over half of respondents cited range of channels as their primary reason for taking up a basic-tier pay TV package). In practice, these two pieces of evidence may reflect the preferences of multiple individuals within a household, so that both specific channels and a wide range are important.

4.100 Surveys conducted by stakeholders (undertaken during 2007) also indicated a greater importance being placed on access to DVRs than Ofcom's research suggested in 2005.

4.101 Our analysis of product characteristics suggests that:

- Access to a wide range and choice of TV channels is a key characteristic driving demand for basic-tier pay TV packages. Some consumers also value access to specific channels;
- Although free-to-air channels, and Freeview in particular, share some of the characteristics of basic-tier pay TV packages, basic-tier pay TV packages offer a substantially greater number and range of channels than are available on Freeview;
- There is also some more recent evidence that access to DVRs (e.g. Sky+) is an important driver of customer demand;
- Increasing availability of DVRs on Freeview may close some of the perceived gap between Freeview and basic-tier pay TV.

[43] Ofcom pay TV research, phase 1, see Annex 14

4.102 The evidence therefore suggests that there are important differences in the characteristics of free-to-air and basic-tier pay TV. However, it is unclear whether these differences are sufficient for basic-tier pay TV packages to be in a different market to free-to-air TV.

Stand-alone basic-tier packages: evidence on likely consumer responses to price increases

4.103 We have attempted to assess the substitutability of basic-tier pay TV services with other TV and non-TV products, by asking a random sample of basic-tier consumers how they would respond to a 10% increase in the price of basic-tier TV packages, while keeping the prices of other products the same[44].

4.104 Our survey research into consumers' response to a 10% price increase found[45]:

- 73% would continue to purchase a basic-tier pay TV package;
- 17% would switch to free-to-air TV;
- 10% don't know or would not say.

4.105 The research appears to confirm the assessment set out above that consumers consider free-to-air TV, and Freeview in particular, to be the closest substitute to basic-tier pay TV packages.

4.106 At face value, this evidence also implies that it would not be profitable for a hypothetical monopoly supplier of basic-tier pay TV services to raise prices, and that the relevant market should therefore include free-to-air as well as basic-tier TV services. However, as with our assessment of premium sports and movies, this finding needs to be considered in the context of stated preference bias and the dangers of prices being above competitive levels.

4.107 In addition to using our own analysis, we have also received the results of a survey carried out by a stakeholder into the consumer response to a price increase, although we have not seen the underlying data from the survey. It used a different approach to our own and suggested somewhat lower switching rates. In particular it suggested that price increase of around **[✂]** would lead to a **[✂]**% reduction in basic-tier subscriptions. On the assumption that cost savings from supplying fewer customers are likely to be negligible (as most costs are fixed) our analysis of these results suggests that a price rise may be (just) profitable, and that basic-tier pay TV packages may therefore be in a market on their own.

4.108 Taken together the evidence from the two surveys suggests that:

- basic-tier TV and free-to-air TV are relatively close substitutes;
- the reported levels of consumer switching are significant in both surveys, but are not of sufficient magnitude to draw any firm conclusions on market definition.

[44] Ofcom consumer research phase 3, 2007
[45] Ofcom consumer research phase 3, 2007

Stand-alone basic-tier packages: evidence on average prices and subscriber numbers

4.109 We have examined the changes in prices and subscriber numbers of Sky's basic-tier pay TV packages to see whether this provides any evidence on how consumers have responded to changes in the relative prices of basic-tier pay TV and free-to-air service, as well as how Sky has adapted its pricing strategy to changes in competitive conditions. As with premium sports and movies, we recognise that Sky is only one of a number of retailers of basic-tier pay TV; however, its subscriber numbers are an important indicator of the way the market has developed.

4.110 Figure 5 below shows the price charged for Sky's different basic-tier pay TV packages in the period January 2000 to October 20007, as well as the total number of subscribers to each package. Prior to September 2005, most of Sky's basic-tier subscribers purchased the full range of available channels (equivalent to the current 6-mix). In September 2005 Sky introduced a new pricing structure which introduced an entry price 2-mix package[46], as well as the full 6 mix package and a number of intermediate priced packages.

Figure 5 Sky basic-only subscribers and real price changes (base year of 2006 Q3)

[✂]

Source: Sky

4.111 As Figure 5 shows Sky has been able to sustain a growth in the number of residential basic-tier subscribers over the period, despite real increases in headline prices through most of the period, although the average prices paid by basic-tier customers have declined more recently following the change in pricing in September 2005. Specifically:

- The real price of Sky's most popular 6-mix package increased by an average of **[✂]** in real terms over the period;
- Subscriber numbers to Sky's basic package have grown **[✂]**
- Since September 2005, the average real price[47] paid by basic-tier pay TV subscribers has fallen, reflecting constant nominal prices and changes in the distribution of consumers among the different basic packages.

4.112 As with sports and movies, the combination of rising prices and subscriber numbers – at least in the period to September 2005 – may suggest that Sky faced limited competitive constraints in the provision of basic-tier pay TV. However, once again, we need to consider the impact of quality changes.

4.113 In particular, there has been a year on year increase in the number of channels offered to consumers. For example in 2002 the top tier basic package (Family) contained **[✂]** channels and a further **[✂]** time shifted channels. By 2007 the equivalent package (6 mix) contained **[✂]** channels and **[✂]** time shifts. Consumers also now have access to Sky's and Virgin's DVR services. In particular,

---

[46] Consumers are able to purchase anywhere between 2 and 6 mixes. The incremental price of a mix is £1.
[47] Weighted by subscriber numbers.

there has been a year on year increase in the number of channels offered to consumers.

4.114 The introduction of Sky's new tariff in September 2005 is also important since it has led to a reduction in the average real price paid by basic-tier customers, as customers have traded down from the full 6-mix to cheaper, lower-quality packages. It is possible that one of the motivations for the new pricing tariff was the competitive threat posed by Virgin Media and Freeview.

4.115 Since the launch of Freeview, the number of Sky's basic-tier pay TV subscribers has continued to rise, suggesting that Freeview customers have predominantly come from analogue TV customers trading up, rather than basic-tier pay TV customers trading down.

4.116 Of course, it could be that what we have witnessed is in fact a significant fall in the number of basic-tier pay TV subscribers relative to a counterfactual in which Freeview did not enter the market. **[✂]**

4.117 Sky has submitted evidence based on an econometric study that if Freeview were not available, the current number of Sky basic-tier subscribers would be significantly higher, and that the number of subscribers to Sky premium tiers would also be higher.

4.118 We accept that basic-tier pay TV services may have been higher in a counterfactual where there was no Freeview. In particular, we think that it is plausible that the entry of Freeview may have had a market expansion effect. Evidence for this is that the entry of Freeview has led to a net increase in the total number of customers taking multi-channel TV of over 7 million.

Figure 6 Sky basic-only subscribers and real published and average price changes

[✂]

Source: Data supplied by Sky

4.119 While it is possible that the entry of Freeview may have increased the competitive constraint on basic-tier pay TV, this does not necessarily mean that Freeview exerts a sufficiently strong competitive constraint to be included in the same relevant market as basic-tier pay TV.

Stand-alone basic-tier packages: supply-side substitution

4.120 To begin providing a package of basic-tier channels, a retailer would need access to (1) transmission and broadcasting capacity and (2) sufficient content to create an attractive retail proposition.

4.121 Supply-side substitution on the cable platform is not possible as it is a closed platform, while capacity constraints on the DTT platform would also severely limit the ability of a supplier to provide a new basic-tier pay TV service on that platform.

4.122 Supply-side substitution is potentially more feasible on Sky's satellite platform, which is open and not subject to capacity constraints. There may also be some capacity to transmit on IPTV networks. For example Tiscali has mooted wholesaling its IPTV network on a white label basis[48], and Orange has stated that it may develop an IPTV offering.

4.123 However, there are a number of barriers and costs which in our view would severely limit the potential for supply-side substitution. In particular:

- There are significant difficulties in potential retailers obtaining rapid access to content, due to existing exclusive deals for distributing third-party basic channels over particular distribution technologies;
- There are significant marketing and other costs that would need to be sunk to establish a customer base of minimum efficient scale within a short timescale.

4.124 For these reasons we consider it unlikely that supply-side substitution into the provision of basic-tier TV packages would provide a sufficiently strong competitive constraint to warrant inclusion in the relevant market.

Retail of stand-alone basic-tier packages: conclusions

4.125 Consumer survey evidence points clearly to free-to-air services being the closest competitive constraint to the retailing of basic pay TV packages. However, the products remain differentiated in some important respects. In particular, basic-tier pay TV offers consumers both valuable content which is not available elsewhere (eg Sky One, UK TV Gold and Discovery) and a substantially greater number and choice of channels. This product differentiation is reflected in the very significant price differences, with basic-tier TV packages commanding a premium of £11 to £21 per month over free-to-air TV – although these price differences do not necessarily imply that the two products are in separate markets.

4.126 There is some evidence that customers would switch from basic-tier pay TV to free-to-air TV in response to a 5-10% increase in prices. However, it is unclear whether customers would switch in sufficient numbers to make a price rise unprofitable. Whereas our stated preference consumer evidence suggested that sufficient numbers of customers would switch to defeat a price rise, the evidence from stakeholders is much more ambiguous.

4.127 Because of concerns about the Cellophane Fallacy and other potential difficulties in the interpretation of consumer survey data, we have considered whether the stated customer preferences are supported by actual switching behaviour. Here, we observe that the basic pay TV subscriber base has continued to rise despite real price increases and the very significant entry of Freeview. However, there have also been increases in the number of basic channels and this clearly represents an improvement in quality.

4.128 Although we accept that prices and subscriber numbers might have grown more rapidly in the absence of Freeview, our view is that the evidence points to the main effect of the entry of Freeview as being to expand the multi-channel TV market (at the expense of analogue TV), with a relatively modest impact on the demand for basic pay TV.

4.129 Overall, we regard the evidence on stand-alone basic-tier pay TV as mixed. There appears to be a growing constraint from Freeview, but it is not yet clear that that constraint is sufficient to argue that free-to-air and stand-alone basic-tier pay TV are

[48] http://www.tiscali.co.uk/presscentre/press_release/2006/august/081206videonetworks.html

in the same market. We conclude that stand-alone basic-tier pay TV is likely to be in a separate market, but note that this conclusion is considerably weaker than those for premium sports and movies.

Section 5

Preliminary conclusions on content / channel market power

5.1 In this chapter we consider whether any firms are likely to possess market power, either individually or collectively, in the relevant markets that we considered above, namely the supply of basic pay TV, premium sports, and premium movie packages at both the retail and wholesale levels[49].

5.2 As noted above, several of the theories of competitive harm put to us by third parties rely upon one or more firms having a high degree of market power. An assessment of market power is therefore critical to our overall analysis of whether and the extent to which there are likely to be competition issues in the pay TV industry.

Definition of market power

5.3 Market power can be defined as, “the ability profitably to sustain prices above competitive levels or restrict output or quality below competitive levels. An undertaking with market power might also have the ability to harm the process of competition in other ways; for example, by weakening existing competition, raising entry barriers or slowing innovation”[50].

5.4 Market power therefore captures two separate notions; the ability to raise prices above competitive levels, and possibly, the ability to distort the competitive process through, for example, engaging in anti-competitive conduct.

5.5 Competition issues are unlikely to arise unless a firm (or firms) have such a high degree of market power that they can be said to be dominant in the market. The European court has defined dominance as “a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant economic market by affording it the power to behave to an appreciable extent independently of its competitors, customers, and ultimately of consumers”.[51] A single firm can be dominant, or firms might collectively be dominant.

The criteria for assessing dominance

5.6 In effect, a firm is dominant where it faces only limited competitive constraints upon its pricing and other strategic decisions (including quality of product, innovation and customer service). There are three main types of competitive constraints faced by firms:

- Competition from existing competitors
- Competition from potential competitors

[49] Note that in the market definition chapter above we also considered whether there might be separate platform market definitions at the retail level. Our finding that all platforms are likely to compete in the same economic market implies that the only markets we need to consider are the supply of different types of pay TV packages, i.e. basic-tier, premium sports and premium movies.
[50] OFT “assessment of market power”, December 2004,http://oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft415.pdf
[51] Case 27/76 United Brands v European Commission [1978] ECR 207, para. 65 of the judgment.

- Countervailing buyer power

5.7 Market shares can be an important indicator of market power as they provide a measure of the competitive constraint imposed by existing firms in the market that produce substitute products. Firms with relatively low market shares (less than 25%) are very unlikely to be dominant, and it is relatively rare for firms to enjoy a position of dominance with market shares of less than 35-40% in a properly defined economic market.

5.8 Whilst market shares in excess of 40-50% might provide prima facie evidence of dominance, high market share are not sufficient in themselves to demonstrate the existence of dominance. In particular, high market shares may result from a firm being more efficient, more innovative, or pricing more competitively than its rivals. High market shares may also be a relatively temporary phenomenon[52], and a firm will only be deemed to have dominance where it can sustain prices above competitive levels for a significant period of time without attracting entry.

5.9 Market shares are not the only measure of the likely competitive constraints imposed by existing competitors. For example, competition between firms in a market might be more intense if products are relatively homogeneous and customer switching costs are low. Firms with relatively low market shares might also provide a significant competitive constraint if, for example, they have an innovative business model or are adopting an aggressive pricing policy.

5.10 The likely competitive constraint from potential competitors is greater the lower are the barriers to market entry and expansion. The competitive constraint is also likely to be greater in dynamic markets, particularly where new entrants are likely to emerge with technological advances or more attractive business models which would allow them to quickly win market share and put competitive pressure on incumbent suppliers.

5.11 Buyer power can also provide an important competitive constraint on suppliers, most particularly where buyers negotiate individually with suppliers and have credible alternative sources of supply.

5.12 In making our assessment as to whether one or more firms enjoy a position of market dominance we have looked at several criteria which together seek to measure the effectiveness of competition in the market. These include:

- market shares (and market share history);
- rivalry between retailers (including structural features of the market which might dampen or strengthen the price responsiveness of competitors e.g. product differentiation and vertical integration);
- price responsiveness of consumers, including customers' search and switching costs;
- evidence of actual consumer switching behaviour;
- evidence of active price or non-price competition between rivals;

[52] For example, in a market where contracts are awarded by competitive tender, market shares may be temporary if it is relatively easy for rivals to contest future contracts.

- barriers to entry and expansion; and
- the extent of countervailing buying power.

5.13 In addition, evidence that the market definition boundaries have widened or narrowed since previous studies can provide evidence of changes in dominance.

5.14 In the sections below we apply these criteria to each of the relevant economic content / channel markets in this investigation:

- 1(A) Retail of packages containing premium sports channels;
- 1(B) Wholesale of premium sports channels;
- 2(A) Retail of packages containing premium movie channels;
- 2(B) Wholesale of premium movie channels; and
- 3 Retail of stand-alone basic-tier TV packages.

1(A) Retail of packages containing premium sports channels

5.15 In defining retail markets we concluded that there was likely to be a separate market for the retailing of pay TV packages containing premium sports content, and that this market included Sky's premium sports channels and potentially also Setanta Sports. In what follows, we consider the broader version of this market – namely one including both Setanta and Sky Sports.

5.16 By way of background, Sky and Virgin Media are currently the only firms that retail the Sky Sports channels[53]. However, Setanta is a growing provider of premium sports channels, retailing its channels directly to customers served by the DSat and DTT platforms, and wholesaling its channels to Virgin Media and BT Vision for inclusion in their respective retail services.

Market shares

5.17 Estimating market shares on a revenue basis is complicated by the fact that Sky Sports is retailed as part of a package which includes basic channels and often also includes premium movie content. In recognition of these difficulties, we present retail market shares on three different bases.

- On the first basis, we include the full retail package price, irrespective of whether a portion of these revenues is associated with payments for premium movies;
- On the second basis, we attempt to identify more closely the revenues associated with payments for premium sports packages, by stripping away incremental payments for premium movie channels[54]; and
- Finally on a third basis, to isolate the estimated value of premium sports packages when bought in a bundle with basic-tier channels, we use the

[53] Sky Sports is also available to customers of Tiscali and other small IPTV providers, but the service is retailed directly by Sky.
[54] For example, where Sky Sports is bought in a bundle with Sky Movies

wholesale prices charged by Sky and Setanta to estimate the contribution of premium sports channels to a consumer's bundle.

5.18 However, we note that our results are not particularly sensitive to these alternative assumptions.

5.19 We apply the same assumptions on packages containing both premium sports and premium movies to Virgin Media. In respect of Virgin Media's channel bundles that contain Setanta Sports (i.e. the 'XL' package), we include a contribution for each subscriber based on an estimate of the wholesale price paid by Virgin Media to Setanta.

Figure 7 Market share estimates for the retail of premium sports packages (share of revenues)

[✂]

Sources: Data provided by relevant parties; company web sites

Figure 8 Market share estimates for the retail of premium sports packages (share of subscribers)

[✂]

Sources: Data provided by relevant parties; company web sites

5.20 The fact that Sky has very high market shares, of over 70% of revenues and over 50% of subscribers, provides strong prima facie evidence of dominance. Revenue market shares are likely to provide the more reliable guide to market power in this instance as Virgin Media's share of sports subscribers is arguably inflated through interpreting all subscribers to its XL package as subscribers to sports packages (regardless of the value these subscribers place on Setanta Sports).

Constraint from free-to-air services

5.21 While our initial conclusion is that free-to-air services are in a separate relevant market from premium sports packages, we accept that there is likely to be some degree of a constraint from free-to-air television. In particular, live sport events screened by the large free-to-air broadcasters, which include live Champions League football, Formula One motor racing and the Wimbledon tennis championships, are likely to restrict the premium achieved by pay TV broadcasters.

5.22 However, our view is that the availability of sports programming free-to-air is insufficient in itself to counter the market power of a dominant pay TV operator. The large majority of the most attractive live sports is still only available through Sky's retail packages. For example, the availability of the World Cup or European Championships on the BBC or ITV from time to time does not effectively restrict the pricing of packages containing live Premiership football each week of the season.

Rivalry between retailers

5.23 Premium sports channels are retailed in a variety of ways. For example, Virgin Media offers Sky Sports and Setanta channels only as part of a bundle which also includes telephony and basic pay TV content. Sky offers Sky Sports as part of a bundle including basic pay TV content, whilst Setanta offers its own premium sports channels as a stand-alone product.

5.24 There also appear to have been important historical differences in the business models of the leading two retailers. While **[✂]**% of Sky's customers take a premium sports package, the comparable figure for Virgin Media is only **[✂]**%. This might be because historically, customers were attracted to cable companies primarily by the offer of a telephony/pay TV bundle, and to Sky by the offer of premium channels.

5.25 Although there is some evidence that the retail offerings and business models of Sky and Virgin Media are becoming less differentiated – both firms now offer a triple play product for example – significant differences remain, which may suggest that competitive rivalry is not particularly intense.

5.26 Sky's relatively high retail market share may arise through certain advantages that it enjoys through being vertically integrated into the supply of wholesale content. For example, our consumer survey found that many customers think of Sky as the most natural retailer from which to buy Sky Sports channels, perhaps due to association of the 'Sky' and 'Sky Sports' brands, which comes from vertical integration. It is notable that only 19% of DSat Sky subscribers interested in football were aware that Sky Sports was available on Virgin Media[55].

5.27 In addition we are not yet in a position to judge whether Setanta Sports, which currently features one-third of live Premiership football matches, is likely to provide a strong competitive constraint at the retail level. Our survey research into consumer responses to a hypothesised increase in the price of Sky Sports suggested that a significant number of customers would switch to Setanta Sports, but we do not currently have sufficient information to judge whether Setanta Sports acts primarily as a substitute or as a complement to Sky's premium sports channels.

Switching costs

5.28 Where customer switching costs are high, this can weaken the incentives for rival retailers to compete aggressively with each other to win new customers, particularly in markets where there is limited market growth.[56]

5.29 Most pay TV customers receive services through a single broadcasting platform and, furthermore, through a single retailer on that platform. Our research indicates that there are significant real or perceived switching costs in moving to an alternative platform. These costs include set-top box costs, installation costs, the possible inconvenience associated with the installation process and unfamiliarity with alternative platforms. Although churn rates have historically run at **[✂]**, according to our research, 75% of Virgin Media customers and 80% of Sky subscribers claim never to have switched service provider[57]. In consideration of alternative retailers on the same platform, consumers may consider that there is an inconvenience cost associated with switching between retailers or transacting with more than one retailer.

5.30 In addition, premium sports TV packages are often only one element of the bundle of services purchased from a retail service provider, which might also include (for example) telephony and broadband. Therefore, if a retailer attempted to raise the

[55] Ofcom pay TV consumer research phase 3, see Annex 14

[56] In rapidly growing markets, high switching costs might lead to more intensive competition to win new customers, as it becomes more feasible to spend money in acquiring customers if subsequently they can be "locked in".

[57] Ofcom pay TV consumer research phase 3, see Annex 14

price of premium sports packages above competitive levels, in order to switch to an alternative service provider, customers would either have to:

- purchase different services from different retailers, incurring the costs of purchasing from multiple suppliers, or
- purchase all services from a single alternative supplier, regardless of whether that retailer is the preferred supplier of each component of the service bundle.

5.31 For DSat households, the possibility of switching to Virgin Media only exists where their homes are in cabled areas; similar limitations also apply to services provided by Top Up TV and Tiscali.

Barriers to entry and expansion

5.32 There have been two types of entry into the premium sports retailing market in recent times. Firstly, firms such as Tiscali and BT have entered through the development of new distribution and technology channels. Secondly, Setanta Sports has entered the retailing market by acquiring rights to live sports, in particular, two packages of FAPL rights as a result of the FAPL remedy.

5.33 The former type of entry has yet to make any significant impression on the retail market and both Tiscali and BT Vision have struggled to attract significant numbers of premium customers to their services. Indeed, in the case of Tiscali, Sky retails its sports packages directly to consumers, so they have no genuine presence in the retailing of premium sports rights.

5.34 In contrast, Setanta's retail operation has grown quickly from a small base. Setanta has been able to market directly to consumers without sinking any significant costs in the development of a new distribution channel. However, there are important barriers to further expansion – namely the difficult of acquiring additional attractive sports rights within a reasonably short period of time.

5.35 Although there have been promising signs of entry into the retail market, we believe that there remain significant barriers to entry and expansion. New entrants can either launch a new platform, in which case they incur the very significant costs in platform development, but are likely to find it easier to secure premium content (as Sky and Setanta generally have incentives to ensure that their content is available on all distribution technologies). Alternatively, they can largely avoid the sunk costs of developing a new distribution technology by using the DSat platform, and attempt to secure their own content. Although Setanta has shown that it is possible to obtain premium sports content, to do so takes time, and involves significant sunk costs. Bundling benefits may also mean that it is necessary for a retailer to obtain a substantial portfolio of channels in order to provide a genuine alternative to the retail products currently offered by Sky and Virgin Media.

Countervailing buyer power

5.36 Customers are final consumers and do not have any significant countervailing buyer power.

Conclusions on market power in retail of packages containing premium sports channels

5.37 Sky has a market share in excess of 70% of the premium sports retailing market. Although high market shares alone do not confer dominance, the other structural and behavioural features of the market support the supposition that Sky does not face very significant competitive constraints in the retailing of premium sports content. In particular, rivalry between Sky and Virgin Media is limited by a number of factors including high customer switching costs, the dependence of Virgin Media on Sky for the supply of content, and the lack of customer awareness that Virgin Media is a supplier of Sky Sports. Despite the entry of Setanta, there remain very significant barriers to entry and expansion – in particular, the ability to secure sufficient premium sports content to be able to offer an attractive bundle of channels which would serve as an effective substitute to the packages provided by Sky and Virgin Media. There is also no significant countervailing buyer power, as buyers are individual consumers.

5.38 We therefore conclude that it is likely that Sky is dominant in the retailing of premium sports packages.

1(B) Wholesale of premium sports channels

5.39 Our initial analysis suggests that the wholesaling of premium sports channels is likely to be a relevant economic market.

5.40 There are currently only two wholesale providers of premium sports content, Sky and Setanta. Sky provides a wide range of premium sports content including football (most live FAPL football, the Football League and UEFA Champions League), cricket, golf, rugby, tennis and athletics. Setanta Sports is a relatively new entrant with a more limited range of sports, but it does include two FAPL packages, the Scottish Premier League and the US PGA golf tour.

Market shares

5.41 Estimating market shares on a revenue basis is complicated by the fact that Sky and Setanta are both vertically integrated[58]. However, we do have information on the wholesale charges made by Sky and Setanta to Virgin Media (which is the largest independent customer for both Sky and Setanta). To estimate wholesale market shares we have assumed that these prices can be applied to all sales, including sales to the vertically integrated business[59].

Figure 9 Market share estimates for the wholesale of premium sports packages (including self-supply)

[✂]

Sources: Data provided by relevant parties; company web sites

[58] A vertically integrated wholesaler could choose to earn profits at the wholesale or retail level, or both. Transfer prices may not therefore be a reliable guide to the value of the wholesale service provided.

[59] Strictly, all that we have assumed is that the ratio of Sky's price to Setanta's price is constant across different customer groups and equal to the observed relative prices charged to Virgin Media.

5.42 Sky's market share of revenues, the more reliable estimate for market power[60], has declined following the entry of Setanta Sports, though is still well in excess of 70%. Its market share continues to be exceptionally high, providing prima facie evidence that they continue to be dominant in the wholesaling of premium sports rights.

Indirect constraints from free to air

5.43 The potential for consumers to substitute between free-to-air and premium sport pay TV channels may provide an indirect competitive constraint on the ability of a wholesaler of premium sports rights to exercise market power. However, as noted in the discussion of market definition above, in our view free-to-air programming only provides a limited constraint on premium sports pay TV services at the retail level. We therefore believe that the indirect constraint provided by free-to-air broadcasting is unlikely to be sufficient to prevent the exercise of market power in the wholesaling of premium sports rights.

Rivalry between Sky and Setanta

5.44 Our consumer survey evidence suggested that Setanta Sports was viewed by consumers as the closest substitute to Sky Sports.

5.45 In addition, although Setanta has been successful in building a portfolio of premium sports rights, it currently cannot match the quantity and quality of Sky's portfolio. It is notable, in this respect, that Virgin Media offers Setanta Sports as part of its top tier (XL) basic package, rather than being bundled with Sky Sports in its premium packages, whilst Tiscali and Setanta itself offer Setanta as a stand-alone product.[61] The wholesale prices of Setanta are also significantly lower than those of Sky Sports. This suggests that Setanta is primarily regarded either as an "entry level" sports package, or as an optional add on to an existing subscriber of Sky Sports, rather than as a direct competitor to Sky Sports.

5.46 Taken together, the evidence suggests that Setanta does not provide a direct substitute to retailers for Sky Sports. In particular, it is unlikely to be credible for a retailer of premium sports packages to switch from Sky Sports to Setanta Sports, and Sky Sports therefore continues to be a 'must have' product.

Barriers to entry and expansion

5.47 The key barrier to entry and expansion is in obtaining access to a portfolio of premium sports rights. One of the main historical problems potential rival wholesale channel providers have had in challenging Sky's incumbent position has been that the sale of sports rights has been staggered. This gives Sky two related incumbency advantages. The first is that the value of premium rights is typically greater to a wholesaler that already holds a portfolio of rights than one with few or no rights[62]. The second is that it puts a new entrant in a relatively weak bargaining position against retailers, as whilst Sky Sports is likely to be a 'must have' product, it may well

[60] Setanta's share of subscribers is inflated by our assumption that all purchasers of Virgin Media's XL package are purchasing a premium sports package.
[61] Setanta Sports is also available as a stand-alone product to subscribers to Virgin Media's 'M' and 'L' television packages.
[62] There are a number of reasons for this. Rights may be complementary, in which case a wholesaler can charge more for (say) two complementary rights, than rights sold on an individual basis. Where rights are substitutes, there may be a strategic advantage to the incumbent in securing rights by reducing the threat of wholesale competition. The most important reason however is the nature of consumer preferences and the resulting efficiencies associated with the bundling of rights.

be credible for a retailer not to contract with a new entrant who owns a very limited portfolio of rights. This potentially makes it difficult for a new entrant to obtain full value for its rights.

5.48 Despite the entry of Setanta, we believe that there remain very significant barriers to entry and expansion into the wholesaling of premium sports rights, and that the threat of entry is therefore unlikely to act as a significant constraint on Sky Sport's wholesale prices.

Countervailing buyer power

5.49 The main independent purchaser of Sky Sports is Virgin Media. Although Sky Sports is almost certain to be a 'must have' product for Virgin Media, conversely, Virgin Media provides the only means of Sky Sports selling to customers on the cable distribution technology.

5.50 However, Sky Sports is likely to be in a relatively strong bargaining position as, were no agreement to be reached with Virgin, some customers would be likely to switch to alternative platforms to maintain their Sky Sports subscription (those with low switching costs and/or high valuations of Sky Sports), whilst Virgin Media does not have any real credible alternative to Sky Sports.

5.51 On balance, we consider that Virgin Media does have a degree of countervailing buyer power but that it is unlikely to be sufficient to constrain Sky's ability to exercise market power.

Conclusions on market power in the wholesale of premium sports channels

5.52 Sky's very high and sustained market shares, together with the existence of high barriers to entry and limited countervailing buyer power, strongly suggest that Sky is likely to be dominant in the wholesaling of premium sports content. Although Setanta has gained a foothold in this market, it is not currently able to provide a product which is an effective substitute for the Sky Sports channels from a retailer's perspective. Although it is plausible that Setanta could grow to become a more significant constraint on Sky, the difficulties in acquiring sports rights and establishing a competing retail offering make it unlikely that Setanta can challenge Sky's dominance in this market in the short to medium term.

2(A) Retail of packages containing premium movie channels

5.53 The market structure and conditions of competition in the retail premium movies markets are very similar to those prevailing in the premium sports markets. Indeed, Sky has arguably a stronger position as regards content, as it has exclusive rights to first-run releases in the subscription pay TV window with all six major Hollywood Studios. This means that retailers need to access Sky movie channels in order to compete in the relevant economic market. There are currently only two main retailers of premium movie channels, Virgin Media, and Sky itself. Certain Sky Movies channels are also available to Tiscali customers, retailed by Sky.[63]

[63] Tiscali, Top Up TV and BT Vision do provide some video on demand services, but we believe that these lie outside the relevant economic market.

Market shares

5.54 Market shares have been estimated in a similar way as for premium sports packages (see paragraph 5.17 above).

5.55 Sky has an estimated market in excess of 70% of the premium movies retail market. Market shares of this magnitude, together with the fact that market shares have not moved significantly over time, provide strong prima facie evidence of dominance.

Constraint from other film services

5.56 A potentially important difference between premium movies and premium sports is that customers can access premium film content earlier than the subscription TV window by visiting a cinema, renting a DVD, or through pay-per-view. In particular, pay-per-view services are widely available through multiple platforms, by consequence of the non-exclusive nature of rights in the pay-per-view window. However, our consumer evidence and market definition analysis show that these alternative viewing modes provide only a limited competitive constraint. It is also notable that subscription pay TV revenues have remained stable over time despite windowing changes made by the studios.[64] Free-to-air movies are also unlikely to provide a significant competitive constraint – our consumer survey evidence indicated that two of the most important properties of Sky Movies are a wide range of films and access to new releases, properties which cannot be adequately replicated by films available free-to-air.

Rivalry between retailers

5.57 Sky and Virgin Media retail Sky Movies in broadly the same way, offering them as part of either a basic/movies, or basic/sports/movies package. The main difference between the retail products offered is that Virgin Media also provides a telephony service as part of the bundle.

5.58 However, as with premium sports, significantly fewer of Virgin Media's customers choose to take a premium movie package (only **[✂]**% compared to **[✂]**% for Sky). This may result from differences in the business model of the two retailers, for example, because cable operators have primarily focused on selling a pay TV telephony bundle.

5.59 In addition to being differentiated by business model and branding, Virgin Media and Sky are also differentiated geographically, with Virgin Media only being available in 47% of UK households, compared with 98% for Sky. Such product differentiation, and, in particular, Virgin Media's apparent disadvantages in terms of both customer reach and customer awareness, suggest that rivalry in the retailing of Sky Movies may not be particularly intense.

Switching costs

5.60 As noted at paragraphs 5.28 to 5.31 above, there are significant customer switching costs in moving to an alternative retail platform. Such switching costs can weaken the incentives for rival retailers to compete vigorously with each other to win new customers, particularly in markets where there is limited market growth. We observe that switching costs to DTT services may be lower than those for cable services, as

[64] For example, the DVD rental window has been abolished, with titles now being released on DVD for retail and rental simultaneously.

many households already have DTT reception equipment installed. Since premium movies are not available on DTT – unlike premium sports, in the form of Setanta Sports – switching costs for premium movies may be even greater than those for premium sports.

Barriers to entry and expansion

5.61 As with the retailing of premium sports packages, obtaining access to a significant portfolio of premium content is the most significant entry barrier. The difficulties faced by a potential new entrant are arguably higher for premium movies than premium sports, as all the premium content is controlled by one wholesaler (Sky).

Countervailing buyer power

5.62 Customers are final consumers and do not have any significant countervailing buyer power.

Conclusions on market power in retail of packages containing premium movie channels

5.63 Sky has an estimated market share in excess of 70% of the premium movies retailing market. As with the premium sports pay TV market, the very high and sustained market shares, the limited incentives of Virgin Media to engage in aggressive price competition, the barriers to entry and expansion, and the absence of countervailing buyer power suggest that Sky remains dominant in this market.

2(B) Wholesale of premium movies channels

Market shares

5.64 Currently Sky has a 100% market share of the wholesale market for premium movie content.

Indirect constraints

5.65 Although Sky Movies is likely to be a 'must have' product for any retailer of premium movie subscription pay TV services, it is possible that Sky might be constrained in the price that it can charge retailers if retailers are unable to pass on higher wholesale prices to consumers without inducing significant switching to alternative products such as pay-per-view and free-to-air TV. However, both of these services have consistently been held to be in a separate retail market from subscription pay TV services, a finding confirmed by our own market definition assessment. This implies that such indirect constraints are unlikely to be significant.

5.66 Pay-per-view movies, although growing in popularity, remain small in relative terms with a current annual turnover of £80 million. Screen digest estimate that Sky account for over 50% of income generated by pay-per-view movies[65] (with most of the remainder generated by Virgin Media), even if pay-per-view is included in the relevant market, Sky's market share would not be materially reduced.

[65] See Annex 11

Barriers to entry and expansion

5.67 Sky's contracts with the six major Hollywood studios cover the large majority of the most popular films distributed on UK television. These contracts, which are exclusive to Sky, amount to a significant barrier to entry to the wholesale market. In particular, in order to construct a compelling film package, of adequate volume and variety, an alternative wholesale channel provider may require rights packages from more than one studio. Due to the varying durations and different expiry dates of rights contracts, it may be a period of months or years before the channel provider has a sufficiently strong package to compete effectively with Sky Movies[66].

Countervailing buyer power

5.68 Sky Movies is a 'must have' product for any retailer seeking to provide a premium movie pay TV subscription service, and so Sky is in a very powerful bargaining position as regards retailers. However, Virgin Media is likely to have some limited countervailing buyer power, as it provides the only means of accessing customers on the cable platform. This countervailing buyer power is however likely to be relatively weak, as whilst a retailer has no alternative but to source from Sky, if Virgin Media dropped Sky Movies, our customer research suggests that significant numbers would leave the cable platform and purchase from Sky instead.

Conclusions on market power in the wholesale of premium movie channels

5.69 Sky is the sole supplier within the wholesale market for premium movies. There are significant barriers to entry to this market, with very limited indirect competitive constraints from pay-per-view and free-to-air TV, and only a limited degree of countervailing buyer power. We therefore consider that Sky is likely to be dominant in the relevant market.

3 Retail of stand-alone basic-tier packages

5.70 In defining retail markets we sought to identify the extent to which stand-alone basic pay TV services were constrained by competition from free-to-air television. We found that the existence of high quality free-to-air services, in particular, the continuing growth of Freeview, was likely to provide some competitive constraint on such basic pay TV services. However, we concluded that this constraint was insufficiently strong to imply that stand-alone basic-tier free-to-air should be included in the same relevant market as basic-tier pay TV services.

Market shares

5.71 Our initial definition of the relevant market is for subscriptions to TV packages containing only basic channels (i.e. without the purchase of additional stand-alone channels). We acknowledge that charges for these packages often include implicit or explicit payments for additional services, such as telephony, broadband and, in some cases, an implied set-top box subsidy.

5.72 The market structure is essentially one of a duopoly between Sky and Virgin Media, with a small, but growing, competitive fringe (which includes Top-Up TV and Tiscali).

[66] This problem would also be faced by the Hollywood studios themselves should they attempt to 'go downstream' and enter the wholesale channel market. It is not clear that one studio alone would be capable of attracting enough subscribers to construct a sufficiently attractive retail package.

With such a duopolistic market structure it is possible, but unlikely, that Sky or Virgin would individually be considered to be dominant.

Constraint from free-to-air TV

5.73 The Competition Commission's preliminary view in consideration of Sky's shareholding in ITV is that free-to-air services currently provide an effective constraint on the pricing of basic pay TV packages. This assessment was based on current prices and so does not necessarily imply that the constraint is sufficient to ensure that current prices are at competitive levels.

5.74 Our consumer survey also found evidence that free-to-air provides some constraint on basic-tier pay TV services, with 17% of respondents stating that they would be prepared to switch away from basic pay TV services to free-to-air in response to a 10% increase in the price of basic pay TV services.[67]

5.75 As we acknowledged in our market definition assessment it is clear that free-to-air provides an important and possibly growing constraint on the pricing of basic-tier pay TV services, although, in our view, the constraint is not yet sufficient for free-to-air to be included in the relevant market.

5.76 In making an assessment of market power it matters less whether free-to-air technically lies just inside or just outside the relevant market, and more on how close a competitive constraint substitute products provide. Our view is that free-to-air is likely to provide an increasing competitive constraint on the price of basic services, particularly as the number and quality of freely available channels increase. However, although this in principle should have a constraining effect on basic pay TV prices, we have yet to see any firm evidence of such an effect. Indeed, Sky's price of basic packages has remained constant in real terms since January 2003, whilst the number of basic and total subscribers continues to grow.

Rivalry between Sky and Virgin Media

5.77 The content of Sky and Virgin Media's products is similar, suggesting that they are close substitutes for consumers.[68] There are also similarities with Tiscali's packages and, to a lesser extent, those provided by Top Up TV.

5.78 Such product homogeneity is often associated with a high degree of rivalry between competitors. However, there are important differences between the product offerings of Sky and Virgin Media. Not only are they provided on different platforms, with associated costs of switching between suppliers, but the two companies have historically followed very different business models, with Sky focusing on premium content, and Virgin Media on offering a bundle of telephony and pay TV.

5.79 More recently such differences have reduced with Sky heavily marketing a bundle of communications services, with substantial take-up of telephony and broadband services. However, it may still be the case that a Virgin Media customer may not be motivated to switch to Sky solely to obtain an alternative basic TV package.

---

[67] Ofcom pay TV consumer research phase 3. For reasons set out in paragraphs 3.7 to 3.10, we have reservations about this statistic on account of the problem of the prevailing price being above the competitive level, and the difficulties in interpreting consumers' stated responses.

[68] The main differences between the basic packages of Sky and Virgin Media are that (a) Sky's basic channels are unavailable to Virgin Media's subscribers, and (b) the Setanta Sports suite is available at no extra charge to subscribers to Virgin Media's XL package.

Switching costs

5.80 As noted at paragraphs 5.28 to 5.31 above, there are significant customer switching costs in moving to an alternative retail platform. Such switching costs may weaken the incentives for rival retailers to compete vigorously with each other to win new customers, particularly in markets where there is limited market growth.

Barriers to entry and expansion

5.81 Although several firms have sought to enter the retail market by establishing their own platforms and services (for example, Tiscali and BT), other retailers have successfully entered using the DSat and DTT platforms, suggesting that platform access does not represent the most substantial significant barrier to entry. (It will, however, remain a barrier to retail on closed platforms such as cable.) The wholesale market for basic channels is relatively unconcentrated; content is widely distributed and the number of channels is growing rapidly each year, with most basic channels made available to most retailers.

5.82 However, entrants have a number of difficulties in establishing a retail bundle capable of attracting a large body of consumers. Firstly, wholesale channel providers often engage in exclusive platform-specific contracts with retailers. These may limit intra-platform competition for basic packages: an alternative retailer to the platform incumbent is unable to distribute the content of channel providers with an exclusive supply contract. Other contractual terms may in effect restrict the terms of distribution through alternative retailers. Secondly, extant carriage contracts are likely to expire at intervals over a period of years, which obstructs an entrant's construction of a channel bundle sufficiently attractive to persuade consumers to switch from existing providers. Thirdly, large existing retailers may benefit from economies of scale in service provision (for example, in marketing and subscriber management), a cost differential that may make competition on price difficult for entrants.

5.83 Retailers of basic pay TV may also face significant barriers to expansion. One reason for this is the existence of customer switching costs and consumers' preferences for receiving services through a single broadcasting platform (as described in paragraph 5.80 above). This makes it difficult for retailers to adopt a strategy of mimicking the mass market strategies of the incumbents, and indeed, most entry has been aimed at identifying market niches.

Prices

5.84 Price comparisons are complicated by the fact that the number of channels available through both Freeview and basic pay TV packages has increased significantly over time, implying a growth in the quality of both sets of services. However, for example, it is clear that the unadjusted prices for Sky's basic channels have remained approximately constant in real terms since 2003, despite the growth in availability and take-up of free-to-air services. This could suggest that free-to-air services have not been an effective constraint on the pricing of basic pay TV packages. However, it is not possible to draw firm conclusions from this evidence due to difficulties in establishing the appropriate counterfactual.

Vertical integration

5.85 Both Sky and Virgin Media are vertically integrated into wholesale channel provision. Sky controls a suite of basic channels including Sky One, and has equity stakes in other several other channel providers. Virgin Media also controls a suite of basic channels including Living TV, as well as a stake in the UKTV joint venture with the BBC. Security of carriage of these channels is likely to increase the respective retail market power of Sky and Virgin Media, although only to the extent that these channels are important in the relevant wholesale market. The degree of influence of Sky and Virgin Media over their joint venture channels may be limited, depending on the strategy of their respective venture partners.

Countervailing buyer power

5.86 The buyers here are individuals consumers and consequently do not have not have any significant countervailing buyer power.

Conclusions on market power in retail of stand-alone basic-tier packages

5.87 The market for basic pay TV services is essentially a duopoly between Sky and Virgin Media with a growing competitive fringe which includes, amongst others, Top-up TV and Tiscali. Although competition between Virgin Media and Sky may not have been particularly intense historically (the price of basic has not been the primary focus of competition and there are significant barriers to switching between retailers), it is likely to be sufficient to ensure that no firm is individually dominant.

5.88 In addition to competition from each other, Sky and Virgin Media are also facing growing competition from Freeview. We therefore believe that it is likely that neither Sky nor Virgin Media has significant market power in the market for stand-alone basic pay TV services.

Section 6

Platform markets

Introduction

6.1 In this section we address the question of whether retail markets may be differentiated by platform, such as Virgin's cable platform and Sky's satellite platform.

6.2 We have not addressed here the question of wholesale platform markets since this is the subject of the separate TV platform market review.[69]

6.3 When examining market definitions for platforms, we refer to the term "platform" as being the set of conditional access technology used to deliver pay TV services to consumers. Often a "platform" will include the consumer equipment used to receive programming as well, as in the case of Virgin or Sky. However, this is not always the case – consumers can receive channels encrypted using Top Up TV's conditional access platform on a box provided by BT Vision.

6.4 The reality of UK pay TV at the moment is that among "distribution technologies" (i.e. DTT / cable / satellite), IPTV is the only one with more than one platform:

- Sky on satellite;
- Top Up TV on DTT
- Virgin on cable; and
- Tiscali and BT Vision on IPTV.

However, we distinguish between the two terms because this situation could change in future.

Retail platform market definitions

6.5 To assess the substitutability of platforms, we have carried out a variety of pieces of analysis:

- We commissioned consumer research into the characteristics which drive demand for particular distribution technologies;
- We have reviewed factors that might limit substitutability in practice such as perceived switching costs;
- We asked consumers how they would be likely to respond to a SSNIP on the relative prices of pay TV packages on alternative platforms;
- We have also considered evidence on actual switching behaviour, including marketing evidence provided to us by third parties; and
- We have considered the role of possible supply-side substitution.

[69] See http://www.ofcom.org.uk/tv/ifi/marketreviews/wholesaledtvb/review.pdf

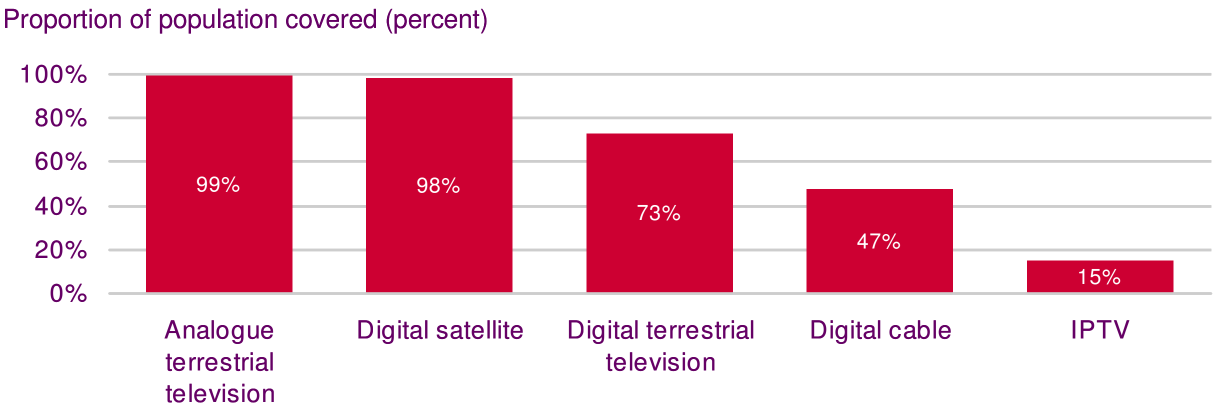
6.6 We examine each of these pieces of analysis in turn.

Characteristics of different platforms

6.7 The pay TV products retailed on different distribution technologies, though not identical, share similar characteristics in terms of both content and features. As regards content, Freeview, Setanta and pay-per-view channels are retailed across all platforms, although Sky Movies and Sky Sports are currently only available on DSat, cable and Tiscali's IPTV platforms. Value added pay TV services such as EPG's and time-shifting are also very similar on the different platforms. Whilst cable and IPTV offer true VoD, the near VoD offered on the satellite and DTT distribution technologies may provide a relatively close substitute. Retailers on all platforms also offer triple play services including broadband and telephony.

6.8 There are however important differences in the availability, and the quality of reception, of the different technologies in different parts of the country. See Figure 10 below for a summary of this.

Figure 10 Availability of distribution technologies UK 2007



Source: The UK Communications Market 2007, Ofcom

6.9 Our consumer research found that for existing consumers, content was the most important characteristic of their current service, across all distribution technologies.[70] Other features such as EPG, interactivity or DVRs were less frequently cited as important. The importance of content and features, which are broadly similar across the different distribution technologies, suggests that, subject to availability, the different retail distribution channels provide relatively close substitutes.

Switching costs

6.10 Although similar products may be offered on different platforms consumers may be resistant to changing platforms (in response to a change in relative prices) if they face switching costs. Such switching costs might be real e.g. the cost of equipment and installation costs, and search and shopping costs, or perceived, e.g. a lack of awareness about the availability of rival suppliers, or of the products that they offer.

[70] Ofcom pay TV research, phase 1, see Annex 14

6.11 Switching costs are likely to be higher when moving between platforms (where consumers might face costs of installation of new reception technology) than when moving between retailers on the same platform.

6.12 The greater is the numbers of customers with relatively low switching costs, and the more that competition is orientated to winning new uncommitted customers (as opposed to encouraging existing customers to switch), the more likely it is that the alternative distribution technologies compete in the same relevant market.

Consumer survey evidence on the likelihood of switching in response to changes in the relative prices on different platforms

6.13 To assess the extent to which different platforms are substitutes for one another, we asked a sample of existing Sky and Virgin Media consumers how they would be likely to respond if the price of all packages on their current platform were increased by 10%, with all prices on rival platforms held constant.[71]

6.14 For Sky consumers, 11% reported that they would switch to free-to-air, and 7% to Virgin Media and 3% to other pay TV retailers. Reported switching of Virgin Media customers was much greater, with 15% reporting that they would switch to free-to-air and 10% switching to Sky and 2% to other pay TV retailers.

6.15 These reported switching figures need to be treated with some caution. In addition to the “cellophane fallacy” and stated preference bias alluded to earlier, customers were made aware that products on alternative platforms were held constant. We would anticipate that this would overstate actual switching given that evidence from previous consumer surveys showed relatively low levels of awareness of alternative products. It is also possible that some customers may have expressed a preference to switch to cable where cable is not available in their area.

6.16 Nonetheless, if stated preferences reflect actual preferences, and if current prices are at competitive levels (i.e. the “cellophane fallacy” does not apply), then the consumer survey evidence would suggest that Virgin and Sky’s platforms compete in the same relevant market.

Evidence on actual customer switching

6.17 Our consumer survey found very limited evidence of consumers switching between different distribution technologies. For current Virgin Media customers, 75% reported that they had never switched multichannel service, and for Sky the equivalent figure was higher at 80%.

6.18 The actual churn rate for Sky’s pay TV packages is about **[✂]**% per year, and **[✂]%** per year on Virgin Media’s platform[72]. It could be the case that a minority of customers frequently churns from one pay TV service to another and our measure of churn includes consumers who leave and then rejoin their provider. This may reconcile retailers’ relatively high reported churn rates with the large proportions of current pay TV customers that claim not to have switched from one multichannel service to another.

---

[71] Ofcom consumer research phase 3, 2007

[72] Source: Sky Virgin Media. Defined as cancellations plus terminations. Note this may not be the definition used by stakeholders

6.19 It is important to recall that the relevant question for market definition purposes is the extent to which customers would be prompted to switch by a change in the relative price of two competing products. If the two products do constrain each other, so that prices rarely, if ever, move significantly out of line, then we would expect to see very limited switching.

Supply-side substitution

6.20 Evidence regarding demand-side substitution may be indicative of cross-platform markets: at the retail level we do not observe separate relevant markets for each distribution technology or platform. Our view is that there is little prospect of supply-side substitution widening this market further. The establishment of a new broadcasting platform requires very substantial investment, regardless of whether it exploits an existing distribution technology (for example, unused satellite transponder capacity) or is created alongside a new distribution technology (for example, a proprietary IPTV network). Such costs are likely to be incurred both in the capital expenditure associated with the deployment of bespoke platform technology, and the very substantial marketing costs required to build a retail presence. These investment costs and the delay in entry prevent the market being broadened through supply-side substitution.

Conclusions

6.21 The characteristics of alternative distribution technologies are very similar, particularly those that consumers most value, namely the content currently supplied on the platform and technological features. Our consumer research suggested that consumers would be prepared to switch platforms in response to a SSNIP. Virgin Media’s consumers in particular appeared to be relatively price-elastic. However, we need to be careful in interpreting such consumer survey evidence, particularly in the light of evidence of actual switching behaviour which appears to be considerably less extensive. Lack of actual switching may be the result of competitive prices, but it can also reflect real and perceived switching costs. On balance, the lack of strong evidence of platform-specific preferences leads us to conclude that the alternative retail platforms compete in the same relevant market.