OFCOM PAY TV MARKET INVESTIGATION

RESPONSE OF VIRGIN MEDIA TO OFCOM'S SECOND CONSULTATION OF 30 SEPTEMBER 2008

18 DECEMBER 2008

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1. EXECUTIVE SUMMARY

1.1 Virgin Media agrees, subject to the points raised below, that Sky has market power in markets for the wholesale supply of premium sports and movie channels, and that Sky has limited the distribution of those channels to other retailers (either by refusing to supply the relevant channels or by supplying them only on uneconomic terms). Virgin Media also agrees that this competition concern may be capable of being addressed through a mandated wholesale must-offer regime incorporating an *ex ante* pricing mechanism. The effectiveness of any such wholesale must-offer regime will, however, be acutely dependent on its form and scope.

1.2 Virgin Media does not, however, consider that the wholesale must-offer regime proposed by Ofcom is sufficient to address all of the features of the pay TV industry identified by Virgin Media (and BT, Setanta, and Top-Up TV) as having the effect of preventing, restricting or distorting effective competition. In particular, Virgin Media does not consider that the proposed wholesale must-offer remedy will address the significant barriers to entry upstream (i.e. in relation to the purchase of attractive content) or that it will address a range of individual practices in which Sky engages which also have the effect of limiting competition. Accordingly, the proposed wholesale must-offer remedy is, at best, a partial remedy and Virgin Media continues to consider that a market investigation reference to the Competition Commission under the Enterprise Act 2002 may be necessary to resolve the full range of competition problems that have previously been identified by Virgin Media and other interested parties.

1.3 Turning to the supply of premium sports channels, Ofcom has erred by focusing too narrowly on live FAPL content when carrying out its assessment of the relevant market and market power. There is compelling evidence (including new research undertaken for the purpose of this submission) that the value, popularity and resulting importance of the Sky Sports channels do not relate to one particular set of content rights (despite the fact that one specific sports right (i.e. FAPL) may be more popular than other sports rights), but rather to the range of aggregated attractive content rights that Sky has secured and markets in its packages of sports channels. As a result, as currently specified, the proposed wholesale must-offer remedy will not address the adverse effects on competition arising from Sky's market power in the wholesale and retail supply of premium sports channels because the remedy is limited only to the wholesale supply of channels containing live FAPL content.

1.4 If the wholesale must-offer regime is implemented on this basis it will be rendered entirely ineffective by Sky's ability to game the remedy (which will be facilitated by Sky's market power at the retail level). In consequence, the proposed remedy may actually adversely affect the terms on which Sky's premium sports channels are supplied to Virgin Media (by narrowing the scope of the channels supplied). In order to be effective, the scope of the proposed wholesale must-offer obligation must be widened to be consistent with the body of sports content in relation to which Sky derives its market power – i.e. all premium sports channels. This may be achieved in one of two ways:

(a) first, Virgin Media's strongly preferred solution would be for Ofcom to re-visit the approach to market definition and market power to reflect the fact that Sky's market power (at both the wholesale and retail level) in the supply of premium sports channels is derived from the aggregation of a wide range of attractive sports content (both on individual channels and in retail channel packages) and not limited only to the ability to broadcast live FAPL content; or

(b) second, Ofcom modifies the wholesale must-offer regime such that it applies to any sports channel that contains live FAPL content **and** to any sports channel that is bundled at the retail level with any sports channel that contains live FAPL content.

1.5 As regards the supply of premium movie channels, Virgin Media agrees with Ofcom's approach to market definition and market power at the wholesale level. While Virgin Media does not consider that there is any realistic prospect of Sky's market power in relation to these channels changing in the foreseeable future, a very material change in the competitive situation (i.e. the acquisition by an entity other than Sky of the movie output of at least three Major Hollywood Studios) would be required before there could be any reason for Ofcom to re-visit its assessment of market power.

1.6 While Ofcom has dealt with market definition and market power at the wholesale level in some detail it has erred materially in not explicitly addressing the question of market definition and market power in relation to the supply of premium content at the **retail** level. Virgin Media is strongly of the view that in any final decision on its investigation into the pay TV industry, Ofcom must include an assessment of the relevant market definition at the retail level and the degree to which Sky possesses market power in those retail markets. Without such a finding, a key step in the logical construction of Ofcom's case will be missing. Moreover, without a consideration of the dynamics of competition at the retail level on the impact of Sky's dominance, Ofcom cannot fully assess the impact of any proposed remedy.

1.7 As regards the form of any wholesale must-offer regime, Ofcom should specify regulated wholesale prices, through an explicit and unambiguous formula based on certain of Sky's retail prices, rather than merely establishing the framework for price setting and leaving the actual determination of prices to commercial negotiation. In this context, Virgin Media considers that a retail-minus approach together with a cost-plus cross-check would offer a sensible approach which would address the competition concerns arising from the fact that Sky limits the distribution of its premium sports and movie channels to third party retailers. Detailed observations on the way in which both a retail-minus and cost-plus approach should be specified are set out in Section 6.

1.8 The scope of any wholesale must-offer regime must extend, at a minimum, to the supply of the following:

(a) all of Sky's sports channels (i.e. Sky Sports 1, Sky Sports 2, Sky Sports 3 and Sky Sports Xtra and any future premium sports channels) on a "clean feed" basis. In other words, the wholesale must-offer obligation should not be limited only to those channels containing live FAPL content. As an alternative the wholesale must-offer regime should apply to any Sky Sports channel that contains live FAPL content **and** to any sports channel that is bundled at the retail level with any sports channel that contains live FAPL content;

(b) any Sky movie channel containing first-run content from any of the Major Hollywood Studios on a clean feed basis. In addition, Virgin Media agrees with Ofcom that Sky should be obliged to offer a wholesale SVOD service which includes all relevant premium movie content to which Sky has the relevant SVOD rights;

(c) any High Definition versions of Sky's premium sports and movie channels;

(d) any interactive service (of whatever description) that would require control of the intellectual property rights in the relevant content to create or develop;

(e) the relevant premium sports and movie channels to **both** residential customers and to commercial customers. Given that Ofcom acknowledges that Sky has an absolute monopoly over the retailing of premium channels to commercial premises, there is no logical legal or economic reason why there is not at least an equal need to address adverse effects on competition and related supply of the relevant channels to commercial premises as there is to remedy the effects in the residential market. The complete absence of any retail competition in the commercial sector does not reduce, but instead increases, the imperative for regulatory intervention.

1.9 Virgin Media agrees that the wholesale must-offer regime should cover issues relating to security. In this regard, a set of technology and platform agnostic minimum security requirements could be an effective means to address such concerns. However, such arrangements should not enable Sky to subvert the efficacy of the wholesale must-offer regime. Accordingly, Sky should not be permitted to prohibit the use of security technologies which are already successfully being used in the UK or in other parts of the world. In particular, any minimum security requirements should not impose any obligations which go beyond the specification of the current security arrangements used by Virgin Media in relation to Sky's premium channels. In short, any minimum security requirements must be objectively justified, reasonably required to protect the channels, and be consistent with the goal of promoting competition.

1.10 Finally, it is essential that the wholesale must-offer obligation includes a robust and swift dispute resolution process. However carefully specified the wholesale must-offer regime is, it will inevitably give rise to a range of disputes between Sky and rival retailers. If each of these disputes had to be resolved on an ad-hoc basis by Ofcom this would be impracticable, time consuming, resource intensive and would undermine the effectiveness of the regime. Any such dispute resolution must, therefore, apply to any dispute of whatever nature arising from the regime and must, at least, satisfy the following key criteria:

(a) be transparent, fair and independent;

(b) ensure the expeditious resolution of disputes on a very tightly controlled timetable. This is particularly important given the dynamic nature of the pay TV industry and Sky's incentive to draw out any dispute to undermine the efficacy of the regime;

(c) produce a final binding result; and

(d) be cost effective.

2. INTRODUCTION

2.1 This submission (the **"Submission"**) sets out Virgin Media's response to Ofcom's second consultation document in the pay TV market investigation as published on 30 September 2008 (the **"Second Consultation Document"**).[1] This Submission first comments on Ofcom's analysis as regards current competitive conditions in the UK pay TV market and second considers the structure and substance of Ofcom's proposed remedy to address the competitive concerns identified, i.e. the wholesale must-offer obligation (the **"WMO"**).

2.2 In relation to the current competitive conditions in the UK pay TV market, this Submission addresses:

(a) the supply of premium sports: in particular, Virgin Media addresses the importance of a wide range of sports content and why it is inappropriate to consider the supply of premium sports channels, and any corresponding remedy, by reference only to

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1 Ofcom, *Pay TV second consultation – Access to premium content*, 30 September 2008.

live Football Association Premier League (**"FAPL"**) content (**"Core Premium Sports"**);[2]

(b) the supply of premium movies: in particular, Virgin Media addresses why Sky's market power in relation to Core Premium Movies[3] is unlikely to change materially in the foreseeable future; and

(c) the retail market: in particular, Virgin Media addresses why it is important for Ofcom to define retail markets and to assess Sky's market power within these retail markets.

2.3 In relation to the structure and substance of the WMO, this Submission addresses:

(a) general principles which should be followed when determining the price or pricing methodology of the WMO;

(b) the scope of the WMO, i.e. the content subject to the WMO;

(c) security considerations;

(d) technical considerations; and

(e) dispute resolution.

2.4 However, before considering each of these issues in turn, Virgin Media would emphasise that the proposed WMO does not address a large number of the concerns raised by Virgin Media during the course of the pay TV market investigation. In this connection, Ofcom has specifically recognised that:

> "[t]*here may still be some residual concerns which cannot be addressed either using our sectoral powers, or using our Competition Act powers, and which may therefore justify a reference to the Competition Commission.*"[4]

2.5 Virgin Media sets out below a number of the specific concerns that will not be directly addressed by the WMO regime:

(a) the material barriers to entry in relation to the acquisition of content (i.e. at the upstream level). These barriers are expressly recognised by Ofcom;[5]

(b) the range of conduct in which Sky engages that deters the launch of third party High Definition (**"HD"**) channels on competing platforms such as cable (see paragraphs 4.2 to 4.7 of Annex 6 to the Joint Submission to Ofcom dated 3 July 2007[6] (the **"July 2007 Joint Submission"**));

(c) Sky's use of most favoured nation (**"MFN"**) clauses with third party channels which, in combination with Sky's huge subscriber base, has the effect of muting the ability of other platforms to compete with Sky by negotiating more favourable

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2 "Premium sports" refers to the range of pay TV sports channels supplied by Sky and Setanta, consistent with Ofcom's use of the terminology in the Second Consultation Document, see paragraph 3.11. "Core Premium Sports" refers to the subset of premium sports channels which includes FAPL content, i.e. Sky Sports 1 and 2 and Setanta 1.

3 This refers to the wholesale supply of channels which include the first TV subscription window of film content from the Major Hollywood Studios (referring to the Hollywood studios which are members of the Motion Picture Association of America, namely Disney, Paramount, Sony, 20th Century Fox, Universal and Warner Bros).

4 Second Consultation Document, paragraph 1.47.

5 Second Consultation Document, paragraphs 5.71 and 5.72.

6 *Submission to Ofcom on the need for a market investigation into the pay TV industry*, by British Telecommunications plc, Setanta Sports Holdings Limited, Top-Up TV Europe and Virgin Media Limited, 3 July 2007.

channel distribution terms (see paragraphs 4.8 to 4.12 of Annex 6 to the July 2007 Joint Submission); and

(d) Sky's acquisition of ancillary rights to third party channels such as exclusive rights to digital satellite ("DSat") set top boxes, exclusive rights to interactive and enhanced features and the right to carry any new channels as launched by a channel provider (see paragraphs 4.13 to 4.18 of Annex 6 to the July 2007 Joint Submission).

2.6 Virgin Media is concerned that after such a lengthy review by Ofcom the relevant features and behaviour summarised above will remain unaddressed, and reserves its position in relation to those issues. In particular, Virgin Media continues to consider that a market investigation reference to the Competition Commission under the Enterprise Act 2002 may be necessary to resolve the full range of competition problems that have previously been identified by Virgin Media and other interested parties.

3. COMPETITION ISSUES – PREMIUM SPORTS

Introduction

3.1 This Section sets out Virgin Media's position that Ofcom has erred by focusing too narrowly on live FAPL content in relation to its assessment of the relevant market and market power. In consequence, Ofcom's proposed remedy is too narrow in scope. For the reasons set out below, Virgin Media also has significant concerns that a remedy applied on this basis will be rendered entirely ineffective by Sky's gaming behaviour, and that its supply arrangements with Sky for premium content will actually be worse than at present. In order to be effective, the scope of the proposed WMO will need to be widened to be consistent with the body of sports content in relation to which Sky derives its market power – i.e. all premium sports channels.

3.2 Ofcom reaches a view that there is a narrow market for the wholesale of premium sports channels which is defined as being "*channels or packages of channels containing live FAPL matches*".[7] It acknowledges some uncertainty as to the precise boundary of the market, particularly as regards Champions League and certain other football competitions,[8] but since Sky's market share remains high even when these are taken into account, it does not affect Ofcom's finding that Sky has market power[9]. Other sporting events are not considered to form part of the relevant market principally because of Ofcom's survey evidence indicating that they are not individually as important as live FAPL content in driving subscriptions.

3.3 Virgin Media does not dispute the importance of FAPL for subscribers and to retailers of premium sports channels. However, the focus on FAPL leads Ofcom to an assessment of Sky's market power which pays insufficient attention to the market power which arises, not only from Sky's control of FAPL, <u>but its ability to aggregate a body of content (in particular a range of attractive sports) which is highly valued by customers and a key driver of consumer demand</u>. This is despite the fact that Ofcom discusses in some detail the implications of content aggregation and remarks:

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7 Second Consultation Document, paragraph 4.143 and paragraph 5.33.

8 UEFA Cup, the FA Cup and the Carling Cup.

9 Ofcom further acknowledges the uncertainty relating to the market definition exercise in paragraph 4.5 of the Second Consultation Document which states "*We acknowledge that there are arguments both for a slightly narrower market definition (e.g. one that excludes channels such as Sky Sports 2, which contain a small number of live FAPL matches) and for a slightly broader market definition (e.g. one that includes channels which contain a significant volume of other high-quality live sports). These changes would not affect our market power assessment, but they would result in a less precise market definition*."

"[w]*hat would concern us from a competition perspective is the possible existence of market power, created or enhanced by the aggregation of a body of critical content*".[10]

3.4 In short, Virgin Media considers that Ofcom's assessment of market power does not give sufficient weight to the manner in which content aggregation contributes to Sky's dominance, in particular its unique ability to offer attractive bundles comprising live FAPL and other attractive sporting events. Sky's unique position in being able to offer these bundles is critical to understanding its market power and the dampening of competition at both the wholesale and retail levels of the pay TV market.

3.5 The failure by Ofcom to reach any conclusions on the effects of content aggregation by Sky has severe implications as regards Ofcom's proposed remedy and its application to premium sports.[11] Because of the inconsistency between the FAPL-focused market definition and the body of content which Sky is able to aggregate (and from which it derives its market power), the proposed remedy is too narrowly specified in scope. Virgin Media strongly considers that a wholesale remedy limited to live FAPL content will fail to stimulate effective competition in relation to the retailing of premium sports channels, and will very likely lead to a worse position for Virgin Media as regards its supply arrangements with Sky. This is because:

(a) there is a high likelihood that Sky will "game" the arrangement. In particular, if the WMO focuses on live FAPL content, Sky could readily move this content to a single channel to avoid supplying any significant non-FAPL content to rivals. It could charge a high retail price for the single channel in order to disadvantage rivals who will pay a wholesale price based on that retail price (if the retail-minus methodology is adopted). It will then protect its own customer base by offering packages comprising the range of FAPL and non-FAPL content at a low incremental price as compared to the FAPL-only channel; and

(b) rival retailers including Virgin Media will consequently not be able to meet consumer demand for channels covering a range of attractive sports. They will only be supplied by Sky with channels containing live FAPL, and will be unable to put together compelling packages around this content because of the high barriers to entry and expansion in developing rival premium sports channels which cover an appealing portfolio of sports.

3.6 This Section develops the points outlined above, considering:

(a) first, the strength of consumers' preferences for access to premium sports channels which cover a range of attractive sports, and thus the importance to retailers of offering retail packages of channels which cover a range of attractive sports;

(b) second, in light of this consumer demand, the limitations of Ofcom's approach to defining the relevant wholesale market for premium sports channels by reference only to channels including live FAPL content. In particular, this approach does not allow an accurate assessment of the market power enjoyed by Sky (at both wholesale and retail levels) in relation to the supply of premium sports channels; and

(c) third, the implications for Ofcom's proposed remedy if it is specified solely in relation to the supply of FAPL, in particular the high risk that this will be "gamed"

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10 Second Consultation Document, paragraph 5.27.

11 The problem does not arise in relation to premium movies because the body of critical content which Sky aggregates (and from which it derives its market power) is consistent with Ofcom's definition of the relevant market.

by Sky in such a way as to undermine its effectiveness and preserve Sky's position of dominance.

The importance of access to a range of premium sports content

Overview

3.7 Virgin Media considers there to be strong evidence to support the proposition that customers value access to a range of attractive sports and that, therefore, rival retailers must be able to offer attractive portfolios of sporting content in order to compete effectively. In this regard, Virgin Media notes that the categories of channels described by Ofcom as "*'must have' channels, which appeal to large numbers of consumers*", include the following:

> "[p]*remium sports channels, which provide viewers with live access to key sporting events such as live FAPL football, Champions League, or Test cricket*".[12]

3.8 Virgin Media's own experience supports this view. For example, the supply of Sky's premium sports channels on the Virgin Media pay TV service is considered so essential that Virgin Media continues to offer those channels to customers notwithstanding the fact that due to Sky's wholesale prices, Virgin Media earns a lower margin for a pay TV bundle including Sky Sports (i.e. Sky Sports 1, 2, 3 and Xtra) than it does for the equivalent bundles without the Sky Sports channels (i.e. Virgin Media's margins are actually reduced if a subscriber to Virgin Media's XL package of basic channels upgrades to a package containing one or more of Sky's premium channels).[13]

3.9 Virgin Media also agrees with Ofcom's current view that that there are "*two key factors which will determine the value of a particular type of content as a driver of pay TV subscriptions*", namely:

(a) "…*the content must be sufficiently attractive that a large number of viewers are willing to pay a significant amount to watch it*"; and

(b) "…*the content must be available on an exclusive basis to pay TV providers, with limited substitutes available free-to-air*".[14]

3.10 The evidence presented by Ofcom in Section 3 of its Second Consultation Document clearly demonstrates that Sky's sports channels, as a whole, meet those criteria and that they are an important driver of pay TV subscriptions. (In particular, Virgin Media concurs with the conclusion reached by Ofcom at paragraph 5.34 of Annex 6 to the Second Consultation Document which indicates that the number of marginal subscribers to premium sports channels is likely to be low as there are few substitutes for either live FAPL, cricket, rugby league or rugby union.)

3.11 It is apparent from the experience of Virgin Media, the evidence put to Ofcom and the evidence set out in the Second Consultation Document that the value of Sky's premium sports channels to consumers (and their resulting willingness to pay for those channels) is derived from the wide range of attractive sports content broadcast on those channels. This is not to deny that wholesale access to live FAPL matches is essential for competition between pay TV retailers, but that this would be insufficient because there is strong consumer demand for a range of sports, and there are various efficiencies in pay TV retailers offering premium sports channels which cover a range of sports content. There is a range of compelling evidence which supports this conclusion, in particular:

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12 Second Consultation Document, paragraph 3.31.

13 Second Consultation Document, paragraph 6.35.

14 Second Consultation Document, paragraph 3.38.

(a) surveys as to consumers' preferences [**CONFIDENTIAL**];

(b) customer viewing behaviour;

(c) consumers' decisions to subscribe to one or more premium sports channels; and

(d) Sky's investments in acquiring a portfolio of premium sports rights and its active marketing of the fact that it offers consumers access to a range of sports.

Surveys as to consumers' preferences and viewing behaviour

3.12 Virgin Media does not dispute that access to FAPL is essential for attracting subscriptions to premium sports channels, but it considers there to be strong evidence that other sports are also important to consumers, and that a retail offering limited to FAPL content would be of very limited appeal.

Ofcom survey research

3.13 Figure 17 of Annex 6 to the Second Consultation Document records that 75 per cent of premium sports subscribers who watch sport at least once a week stated that FAPL was *"very important"* to their TV package.[15]

3.14 However, such questions relating to the importance of FAPL do not capture the extent to which:

(a) access to one or more other sports is important to those consumers for whom FAPL is not very important. In this regard, paragraph 5.30 of Annex 6 to the Second Consultation Document indicates that 25 per cent of Sky Sports subscribers do not value FAPL or only weakly value FAPL. Of those, some 40 per cent consider one of either cricket, rugby union or rugby league to be very important;[16] and

(b) other premium sports are also important to those consumers for whom FAPL is "*very important*".

3.15 As regards (b), there is clear evidence that other sports are important to those subscribers for whom FAPL is very important. Paragraph 4.9 of Annex 10 to the Second Consultation Document indicates that, of those pay TV subscribers who watch sports at least weekly, those who are strongly committed to football (i.e. watch three or more times a week) tend also to be avid viewers of other sports. In particular, they tend to be strongly committed (i.e. watch three or more times a week) to boxing (22 per cent), cricket (20 per cent), rugby union (19 per cent), motor sports (19 per cent) and snooker (18 per cent).

3.16 Ofcom observes that there is a "*substantial core that is strongly committed only to football*" (emphasis added) and that this represents "*36% of those strongly committed to football, equating to nearly a quarter (23%) of the total sample*".[17] This supports Virgin Media's view as it indicates that whilst there might be demand amongst a minority of subscribers for a package based just on football (or perhaps even just FAPL), this should not be over-stated since:

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15 Figure 17 of Annex 6 to the Second Consultation Document also indicates that over 70 per cent of Sky Sports subscribers also considered Champions League, international football matches and FA Cup matches to be similarly very important. In addition, Figure 17 shows that there are a further eight sports categories which over 30 per cent of subscribers consider to be "*very important*". Clearly, a channel provider would have to consider very carefully a decision not to offer a sport which a third or more of its subscribers considers to be "very important", but this understates the issue as this does not capture those consumers who consider FAPL and at least one other sport to be very important.

16 Second Consultation Document, Annex 6, paragraph 5.30.

17 Second Consultation Document, Annex 10, paragraph 4.9.

(a) some 64 per cent of those strongly committed to football (not just FAPL) are also strongly committed to other sports; and

(b) across the total sample of subscribers to Sky Sports and Setanta Sports, over three quarters are not strongly committed to football only (not just FAPL).

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3.22 [**CONFIDENTIAL**][19] [**CONFIDENTIAL**]:

(a) [**CONFIDENTIAL**];

(b) [**CONFIDENTIAL**][20] [**CONFIDENTIAL**];

(c) [**CONFIDENTIAL**];

(d) [**CONFIDENTIAL**].[21]

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3.24 [**CONFIDENTIAL**]:

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(ii) [**CONFIDENTIAL**];

(iii) [**CONFIDENTIAL**];

(b) [**CONFIDENTIAL**].[22]

Customer viewing behaviour

3.25 The fact that a large majority of consumers demand access to a range of sports is also clear from consumers' overall viewing patterns:

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(a) paragraph 5.11 and Figure 18 of Annex 6 to the Second Consultation Document indicate that only 14 per cent of subscribers watch only one sport at least once a week. In contrast, 42 per cent of subscribers watch between two and four sports or events each week, and a further 44 per cent watch more than five sports or events per week. Indeed, 24 per cent of subscribers watch more than seven sports or events per week. In total, 72 per cent of subscribers watch three or more sports or events per week;

(b) paragraph 5.14 of Annex 6 to the Second Consultation Document indicates that only about 2 per cent of live programming and less than 0.5 per cent of programming broadcast on Sky Sports channels is accounted for by FAPL programming.

3.26 Virgin Media has undertaken analysis of BARB data, in particular viewing hours[23] for subscribers in relation to Sky's premium sports channels on all platforms where these channels are available over the 12 month period ending 9 November 2008. This indicates that FAPL games (including pre- and post-match commentary) account for only [**CONFIDENTIAL**] per cent of viewing hours for Sky Sports channels. This increases to [**CONFIDENTIAL**] per cent when other FAPL content is included (i.e. preview and review programming). Accordingly, [**CONFIDENTIAL**]per cent of viewing hours for Sky Sports channels are attributable to non-FAPL related content (including other football which accounts for [**CONFIDENTIAL**] per cent of viewing hours (i.e. more than for FAPL matches), cricket which accounts for [**CONFIDENTIAL**] per cent (i.e. the same as for FAPL matches) and golf which accounts for [**CONFIDENTIAL**] per cent).

3.27 Virgin Media has also undertaken an analysis of the reach of football and non-football programming on Sky Sports channels amongst all pay TV subscribers on all platforms in a particular month, namely March 2008[24]. For the purpose of this analysis, individual adult subscribers were counted as having being "reached" if they viewed the broadcast in question for at least 10 consecutive minutes[25]. The figure below shows the proportion of individuals reached in March 2008 who watched only football, only non-football or both. It is significant that of the total number of viewers, only [**CONFIDENTIAL**] per cent viewed football only (of which only a smaller proportion would have been FAPL only viewers). [**CONFIDENTIAL**]per cent watched football and other sports ([**CONFIDENTIAL**] per cent), or only other sports ([**CONFIDENTIAL**] per cent).

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3.28 All the above observations provide strong support for the proposition that the vast majority of subscribers to premium sports channels value and expect a range of attractive sports content, and only a minority are purely interested in a single sport or event.

Consumers' decisions to subscribe to one or more premium sports channels

3.29 The fact that there is wide appeal and consumer demand for channels covering a range of sports, and not just FAPL, is supported by Virgin Media's experience as a retailer of Sky Sports channels. Virgin Media makes Sky Sports channels available in four packages, two of which include all the Sky Sports channels:

(a) Sky Sports 1;

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23 Viewing hours measures the amount of viewing of a given broadcast output as opposed to the proportion of time in the schedule attributable to the broadcast output.

24 The analysis is based on BARB/TNS data.

25 A typical definition of reach (i.e. the net number or percentage of people who have seen a particular piece of broadcast output) is that an individual is required to have viewed the output for at least three consecutive minutes. The use of 10 minutes for the purpose of Virgin Media's analysis is considered, therefore, to be robust.

(b) Sky Sports 2;

(c) Sky Sports 1,2,3 and Xtra (Sky Sports Collection/Mix); and

(d) Sky Sports 1,2,3 and Xtra, and Sky Movies 1 & 2.

3.30 The vast majority of Virgin Media customers purchasing Sky Sports content chose to purchase a package containing the full range of Sky Sports channels (i.e. Sky Sports Mix). For example, Ofcom's willingness to pay survey indicated that, of those Virgin Media subscribers surveyed, 14 per cent receive Sky Sports Mix, but only 3 per cent subscribe to just Sky Sports 1 (see Figure 3 of Annex 10 to the Second Consultation Document).

3.31 Virgin Media's own subscription data for October 2008 indicates that only [**CONFIDENTIAL**] per cent of customers subscribing to premium sports opted for just Sky Sports 1, with approximately [**CONFIDENTIAL**] per cent subscribing to a Sky Sports Collection (Sky Sports 1, 2, 3 and Xtra) and [**CONFIDENTIAL**] per cent subscribing to a Sky Sports Collection as well as a premium movies mix. This is despite the fact that customers with a strong preference for FAPL content could access most of the FAPL games on Sky by subscribing to the cheaper[26] Sky Sports 1.[27] Accordingly, despite customers considering FAPL content to be the most popular and sought after sports content,[28] customers prefer to pay extra for a range of sports content.

3.32 The same tendency is shown on the DSat platform, with the survey referred to at paragraph 3.30 above indicating that 41 per cent of Sky's subscribers receive Sky Sports Mix, 5 per cent receive only Sky Sports 1 and 1 per cent receive just Sky Sports 2.[29]

Sky's investments in acquiring a portfolio of premium sports rights and its active marketing of the fact that it offers consumers access to a range of premium sports

3.33 Apart from the strong consumer demand for access to a range of premium sports rights, there are also various efficiencies associated with access to a range of such rights.

3.34 Whilst strong preferences for certain types of content have been identified in Ofcom's surveys (in particular, FAPL), each customer will have their own differentiated "must have" combination of content. Pay TV retail platforms would wish to respond to this differentiated demand by providing a range of sports content to appeal to customers with different valuations of this content. In this way, customers with different preferences are attracted by the package and this will increase take-up allowing the retailer to recover its fixed costs across a wider revenue base.[30] There may also be a preference amongst customers for purchasing the range of content which they prefer from a single provider which will also encourage the provision of a range of content.

3.35 In pay TV markets, therefore, the products which customers are choosing between are channels of aggregated content which are themselves bundled into retail packages. The willingness of customers to switch to another retail platform on grounds of price/quality will depend on whether their set of preferences (which will reflect their own specific

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26 At present, purchasing just Sky Sports 1 from Virgin Media would cost £2-5 less per month than purchasing Sky Sports Mix, with the price difference depending on the TV package purchased.

27 FAPL content is predominantly broadcast by Sky on Sky Sports 1; only "*relatively few matches are shown on Sky Sports 2*" (Second Consultation Document, paragraph 4.146) and no matches are shown on Sky Sports 3 or Xtra.

28 Second Consultation Document, paragraph 4.113.

29 Sky has chosen not to market to consumers that they do not need to receive Sky Sports Mix (e.g. this possibility is not identified on Sky's website), so that this mix of subscriptions will reflect a combination of consumer demand and Sky's own competitive decision to maximise its revenues and profits by only marketing Sky Sports Mix.

30 The benefits of bundling in this context are outlined by Ofcom in the Second Consultation Document at paragraphs 3.90 and 3.91 albeit in the context of a basic and premium bundle.

valuations of different content elements) can be matched by the rival platform. Given the differentiation described above, rivals must be able to offer comparable bundles in order to be able to attract customers and thereby compete with Sky in the retail market.

3.36 There are also strategic advantages in acquiring a range of premium sports rights as it reduces Sky's dependence on any one sport/event.

3.37 The fact that such competitive advantages are important is confirmed by the considerable sums paid by Sky for non-FAPL sports content, which demonstrates the importance Sky places on having a wide range of attractive content available on its channels. Sky's 2008 results (for the 12 months ended June 2008)[31] indicate that Sky's total sports rights expenditure was £929 million for the year ended June 2008.[32] Of this £929 million, almost £500 million (or just over £492 million i.e. more than half)[33] related to non-FAPL sports rights. It would clearly make no economic sense for Sky to spend the majority of its sports right expenditure on non-FAPL content if it did not think that such content was essential to attract new customers and retain existing customers. In other words, Sky's purchasing behaviour demonstrates its perception that actual and potential customers value a wide range of attractive sports content.

3.38 The importance of offering a range of sports content is supported by public statements made by Sky. When commenting on its 2008 results, Sky highlighted the wide range of sports making up the Sky Sports service, including, in order, golf, FAPL, Champions League football, cricket and rugby.[34] Further, on 14 October 2008, Sky's website promoted Sky Sports with the following description of the service:

> "*Take a Front Row seat at the world's greatest sporting events with Sky Sports Mix*"
>
> *"Sky sports brings you over 100 sporting events across 4 dedicated channels, with exclusive live coverage, including the Barclays Premier league and every England international cricket series."*[35]

3.39 The banner above the introduction to Sky Sports Mix also toggled between a range of sports and sporting events, including the Rugby League World Cup, ATP Masters tennis, American NFL, Coca-Cola Football League and Barclays Premier League, none of which was given more prominence than the other. This demonstrates that Sky places importance on offering a wide range of sporting events as part of its pay TV sports offering.

3.40 It is also clear from Annex 6 to the Second Consultation Document that Sky measures the quality of its Sky Sports offering by reference to the wide range of sports it encompasses. In this regard, Ofcom records that Sky has referred to the following new sports content improving the quality of its offering: darts, snooker, America's Cup sailing, bowls, greyhound racing, hockey, netball, pool, ten pin bowling and volleyball.[36]

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31 See Sky, *Results for the twelve months ended 30 June 2008*, http://media.corporate-ir.net/media_files/irol/10/104016/press/FY_2008_pr.pdf.

32 See Sky, *Results for the twelve months ended 30 June 2008*, http://media.corporate-ir.net/media_files/irol/10/104016/press/FY_2008_pr.pdf, page 10.

33 On the basis that Sky spent approximately £1.3 billion on FAPL rights for a three year period, averaging just under £437 million per annum.

34 See Sky, *Results for the twelve months ended 30 June 2008*, http://media.corporate-ir.net/media_files/irol/10/104016/press/FY_2008_pr.pdf, page 7.

35 http://packages.sky.com/see/SportMix.aspx.

36 Second Consultation Document, Annex 6, paragraphs 3.26-3.28.

3.41 The behaviour of Setanta in purchasing rights also illustrates the need to offer a range of sports content. Although FAPL content makes up a significant foundation of its sports offering, Setanta has found it necessary to offer other sports, such as cricket, rugby, golf, horse racing, boxing and American sports in order to compete with Sky.

Conclusion

3.42 Against this background, Virgin Media considers that there is compelling evidence that the value, popularity and resulting importance of the Sky Sports channels do not relate to one particular set of content rights (despite the fact that one specific sports right (i.e. FAPL) may be more popular than other sports rights), but rather to the range of aggregated attractive content rights that Sky has secured and marketed.

Market definition and market power

3.43 As noted above, the Second Consultation Document focuses on the wholesale market for premium sports channels containing live FAPL matches, i.e. "Core Premium Sports".[37] Ofcom considered that the following channels were captured by this wholesale Core Premium Sports market definition: Sky Sports 1, Sky Sports 2, Setanta Sports 1 and the HD versions of these channels.[38]

3.44 This narrow market definition is a departure from the approach to market definition as adopted by Ofcom in its December 2007 Consultation Document (the **"First Consultation Document"**), where Ofcom defined a premium sports channels market. In the First Consultation Document Ofcom acknowledged the importance of FAPL content in general (see Annex 10 of the First Consultation Document), but it also considered the volume of sports content (i.e. 14,000 hours) available on the Sky Sports service as a whole.[39] On this basis, Ofcom provisionally identified a market for premium sports channels in general, which was defined as "*packages of premium sports that include access to live FAPL matches*" (emphasis added),[40] i.e. Ofcom did not define a market that artificially isolated certain premium sports channels but rather Ofcom focused on packages of premium sports channels in general.

3.45 Virgin Media considers that the Second Consultation Document errs in departing from this approach to market definition and ultimately narrowing its defined relevant market. Such an inappropriately narrow Core Premium Sports market definition fails to take adequate account of the fact that Sky derives its market power at both wholesale and retail level by aggregating a range of attractive content in each of its sports channels and by offering those channels in a range of retail bundles.[41]

3.46 In support of Virgin Media's position, this sub-section considers:

(a) the purpose of market definition; and

(b) the interaction between Ofcom's approach to market definition and its findings on market power.

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37 A stated in footnote 2, in this Submission, "premium sports" refers to the range of pay TV sports channels supplied by Sky and Setanta, consistent with Ofcom's use of the terminology in the Second Consultation Document, see paragraph 3.11. "Core Premium Sports" refers to the subset of premium sports channels which includes FAPL content, i.e. Sky Sports 1 and 2 and Setanta 1.

38 Second Consultation Document, paragraph 4.145.

39 See, for example, First Consultation Document, paragraph 5.30.

40 First Consultation Document, paragraph 5.25.

41 Virgin Media also considers that the absence of any finding as regards Sky's market power in the retail market in the Second Consultation Document is problematic because it weakens the logical construction of Ofcom's arguments particularly as regards the mutually reinforcing effect of market power at the wholesale and retail levels.

3.47 Each of these issues is discussed in turn below.

Approach to market definition

3.48 Before commenting on the market definition adopted in the Second Consultation Document, it is helpful to review the purpose of market definition. The European Commission states that "[m]*arket definition is a tool to identify and define the boundaries of competition between firms. It serves to establish the framework within which competition policy is applied*".[42] This raises two important issues for the present purposes:

(a) first, as Ofcom acknowledges in the Second Consultation Document, market definition is a process undertaken "*with a view to identifying whether any of those firms has market power*."[43] Accordingly, when defining the relevant market, it is important not to lose sight of the purpose of the market definition, i.e. identifying firms with market power; and

(b) second, as Ofcom acknowledges,[44] whilst market definition is a useful starting point for this purpose, it should not be applied too rigidly and should be contextual to the competition issue being considered.

3.49 During any assessment of market definition process, it is important to ensure that the methodology adopted to define the relevant market is consistent with these accepted principles.

Interaction of Ofcom's approach to market definition and market power

3.50 The market definition exercise undertaken in the Second Consultation Document applies the SSNIP[45] framework[46] in order to seek to establish the elements of sports content that customers value most highly, and for which there are few substitutes such that Sky is able to exercise market power. Whilst such an approach serves to indicate that access to live FAPL matches is essential for rival retail platforms to compete against Sky, this conclusion is divorced from the key market realities, and, in particular, that consumers have strong preferences for access to a range of sporting content, which retailers respond to by offering channels covering a range of such content. Accordingly, whilst Virgin Media agrees that there are few substitutes for FAPL, this conclusion is of limited value in assessing Sky's market power which derives from its ability to assemble attractive packages of sports content which appeal to customers.

3.51 As noted above, strong preferences for certain types of content such as FAPL have been identified but this should be understood in the context of differentiated demand which pay TV providers respond to by providing a range of content. Customers choose between channels of aggregated content which are themselves bundled into retail packages. Customers with different preferences can thereby be attracted allowing the retailer to recover its fixed costs across a wider revenue base.[47] The Second Consultation Document examines in some detail the aggregation of content at different points in the value chain, and the use of pricing mechanisms which allow fixed costs to be recovered from

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42 European Commission, C*ommission Notice on the Definition of the Relevant Market for the Purposes of Community Competition Law,* OJ [1997] C372, 9.12. 1997, pages 5-13, paragraph 2.

43 Second Consultation Document, paragraph 4.16.

44 Second Consultation Document, paragraph 4.17.

45 Small but Significant and Non-transitory Increase in Price.

46 Second Consultation Document, paragraph 4.39.

47 The benefits of bundling in this context are outlined by Ofcom in the Second Consultation Document at paragraphs 3.90 and 3.91 albeit in the context of a basic and premium bundle.

consumers in an efficient manner, by for example using various forms of price discrimination.[48]

3.52 Sky undertakes a significant amount of content aggregation in relation to premium sports. It acquires a broad spectrum of sports content rights in relation to football, cricket, golf, rugby union, horse racing, rugby league and other sports from across the world. Sky then aggregates these content rights both on individual channels and when structuring its retail packages (i.e. it only markets a single premium sports package which contains Sky Sports 1, Sky Sports 2, Sky Sports 3 and Sky Sports Xtra, rather than individual sports channels).[49] This is acknowledged by Ofcom.[50] Importantly, Ofcom indicates that there can be competition concerns in relation to aggregation. It states that whether or not bundling and price discrimination are likely to raise competition concerns will depend on the particular circumstances. In particular:

> "[i]*n a situation where the market power can be leveraged into other markets it* [bundling and price discrimination] *is likely to produce additional competition concerns which are likely to outweigh any compensating efficiency benefits*."[51]

3.53 Ofcom also states:

> "[w]*hat would concern us from a competition perspective is the possible existence of market power, created or enhanced by the aggregation of a body of critical content*".[52]

3.54 Ofcom does not, however, appear to investigate this any further. Indeed, having identified that market power exists in relation to the wholesale supply of premium sports channels containing live FAPL content, it does not analyse whether market power is created or enhanced by the aggregation of premium sports content beyond live FAPL content, although this is implied by its statement in footnote 145:

> "*a retailer that supplies channels broadcasting both live FAPL and other (weakly) substitutable content, such as Champions League matches, is likely to dampen competition somewhat.*"[53]

3.55 Virgin Media considers that Sky has a unique ability to aggregate and offer the very wide range of content including the sports (such as FAPL) which most often appear in customers' "must have" bundles, as well as those which appear in some "must have" bundles but not others (such as cricket, rugby, golf, boxing, darts and other sports).

3.56 In this regard, neither Virgin Media, nor any other competing retailer can aggregate a comparable range of sports. In particular, Sky's stranglehold over the majority of the most popular sports content (and its bidding advantages in relation to the retention of such content's associated rights),[54] is a position that Sky's competitors, such as Setanta, are unable to replicate.[55] In this regard, Virgin Media agrees with the position taken by

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48 Second Consultation Document, paragraphs 5.8 to 5.28.

49 Although Sky makes Sky Sports 1 and Sky Sports 2 available to Virgin Media as single channels, these single channels are not attractive to viewers and, as discussed at paragraph 3.30 above, are not subscribed to by many Virgin Media customers.

50 Second Consultation Document, paragraph 5.26.

51 Second Consultation Document, paragraphs 5.2 and 5.15.

52 Second Consultation Document, paragraph 5.27.

53 Second Consultation Document, footnote 145.

54 Sky's bidding advantages as part of the "*vicious circle*" it enjoys are discussed in detail in the July 2007 Joint Submission. See, for example, Part 3, paragraphs 2.4 to 2.10 of that submission.

55 The fact that Setanta's entry has not materially reduced Sky's substantial dominance at either the retail or wholesale level is self-evident from Sky retaining a very high market share in relation to the retail and wholesale

Ofcom in the First Consultation Document (and summarised in the Second Consultation Document as follows):

> "[o]*ur December Consultation set out a general market definition of "premium sports" and explained that, given that definition, the staggered availability of content rights constituted a barrier to entry. This was because a new entrant would not be able to realise the potential synergies from assembling different rights and would thus likely be outbid by an incumbent with an existing portfolio of rights*".[56]

3.57 In summary, Virgin Media considers that Ofcom's approach to market definition has correctly identified that there are few substitutes for FAPL content, but has incorrectly concluded from this that the relevant market should be limited to sports channels containing live FAPL content and that Sky's market power should be assessed by reference to this market definition. Virgin Media considers that market power arises from Sky's ability to aggregate a compelling portfolio of attractive sports content. Accordingly, a rival retailer unable to offer a comparable bundle would be unable to compete with Sky even if it were to be supplied with channels containing live FAPL content. It is, therefore, essential that any remedy seeking to address Sky's market power should address not only the availability of FAPL but also the range of valued premium sports which is currently available on Sky's premium sports channels.

The implications of Ofcom's approach to market definition and market power and the appropriate scope of remedies

3.58 As a result of the Second Consultation Document adopting an overly narrow approach to wholesale market definition and market power, Ofcom's proposed approach will not effectively address the adverse effects on competition arising from Sky's market power in the wholesale and retail supply of premium sports channels. This is because Ofcom's current approach to remedies and, in particular, the proposed WMO, is directly tied to the wholesale supply of Core Premium Sports channels.[57] As currently envisaged the WMO will extend only to channels carrying live FAPL content. This will be wholly unsuccessful in addressing the detriments identified by Ofcom since it will not engender effective competition in the retailing of premium sports channels, for the reasons set out below.

3.59 Before considering these reasons, Virgin Media considers it uncontroversial that any behavioural remedy needs to be capable of simple implementation and enforcement, comprehensive in dealing with the competition concerns and transparent and predictable as to its application. Only in these circumstances will a remedy provide sufficient confidence to potential new retailers evaluating entry, as well as existing retailers assessing expansion.

General competition law cannot be relied upon to deter Sky from exercising market power as regards non-FAPL content

3.60 First, as a preliminary observation, Virgin Media is currently supplied by Sky with each of Sky's premium sports channels (i.e. Sky Sports 1, Sky Sports 2, Sky Sports 3 and Sky Sports Xtra) albeit, in all cases, at uneconomic rates. Ofcom has also observed that the terms on which Sky supplies those channels limits the ability of Virgin Media to compete with Sky,[58] and that this has adverse effects for consumers.[59] [**CONFIDENTIAL**][60].

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supply of premium channels, but also from the fact that Sky's competitive response to Setanta's entry was not to reduce Sky's prices but to increase them.

56 Second Consultation Document, paragraph 5.57.

57 Second Consultation Document, paragraph 9.17.

58 Second Consultation Document, paragraph 1.29, first bullet point.

59 Second Consultation Document, paragraph 1.32.

3.61 [**CONFIDENTIAL**][61] [**CONFIDENTIAL**]:

(a) [**CONFIDENTIAL**];

(b) [**CONFIDENTIAL**];

(c) [**CONFIDENTIAL**];

(d) [**CONFIDENTIAL**].

3.62 [**CONFIDENTIAL**].

A remedy limited to FAPL would be vulnerable to gaming by Sky

3.63 Second, in the form currently proposed, the WMO regime will be extremely easy for Sky to "game". Sky's ability to game in this way arises from its market power in the retail market (which Ofcom has failed to identify) and therefore Virgin Media believes that the proposed remedies cannot be properly assessed without having proper regard to market power at the retail level.[62]

3.64 As one example (and there are likely to be many options available to Sky), Sky need only transfer all live FAPL content to a single channel (for example, Sky Sports 1) and broadcast all its other attractive sports content on its other premium sports channels which would then be bundled at the retail level by Sky on pricing terms that encouraged uptake of the bundle rather than any single channel. As only the channel containing FAPL content would be subject to the WMO, and having regard to the fact that consumers value a wide range of content (see paragraphs 3.12 to 3.32 above), other retailers would then be placed at a very significant disadvantage to Sky.

3.65 [**CONFIDENTIAL**].

3.66 Absent measures to prevent this, Sky would be free to retail alternative bundled packages containing FAPL at a smaller premium to a FAPL-only channel (say £1 more per month, [**CONFIDENTIAL**]). In such a scenario even fewer subscribers would choose such a FAPL-only package. Such a bundling strategy could be implemented by Sky having multiple sports packages at different prices (some priced close to the FAPL-only price), and/or reducing the prices of basic/movies channels or telephony/broadband services if consumers choose sports packages which are not limited to FAPL.

3.67 In this regard, Virgin Media considers Ofcom's observation that Sky would be unlikely to create a new channel which contains only live FAPL as Sky would not wish to undermine the flagship nature of Sky Sports 1, to be without merit.[63] This is for at least two reasons:

(a) firstly, Sky would not need to create a new channel in order to engage in the gaming behaviour described above. This is because it could simply broadcast all FAPL content on Sky Sports 1 and move the other content to other existing channels. On the basis that Ofcom considers that FAPL content is the most valued by sports channels subscribers, this would preserve a degree of flagship status for Sky Sports 1; and

(b) secondly, Virgin Media does not consider that subscribers are overly concerned with the relevant Sky Sports channel on which their preferred content may be found, so long as they have access to the relevant content on one of the channels in their

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60 [**CONFIDENTIAL**].

61 [**CONFIDENTIAL**].

62 These issues are discussed further in Section 5.

63 Second Consultation Document, paragraph 9.22, first bullet point.

retail package. From the perspective of subscribers, there is no particular loyalty to Sky Sports 1 per se, or to any of the other Sky Sports channels as long as the content which a customer is expecting to be available is provided on the channels which are included in the package. For example, in 2007 Sky chose to broadcast a limited number of Champions League matches on Sky One (a basic pay channel) as well as on Sky Sports Xtra (using the red button functionality). In [**CONFIDENTIAL**][64].

3.68 Accordingly, so long as the content that a subscriber wishes to view from time to time is broadcast on one of the channels in the retail package to which he or she has subscribed, Sky will have very considerable flexibility as to what content is broadcast on what channel.

3.69 Similarly, Virgin Media considers to be misconceived Ofcom's observation that if Sky were to create a new channel, which excluded FAPL content but which aggregated a large number of other rights in a manner that created market power, it ought to be possible at that point to observe the effects of such market power. This is because:

(a) it is very likely that this channel would be bundled at the retail level with a channel or channels containing FAPL content. Assuming that a reasonable proportion of customers subscribed to the bundle rather than individual channels, as is currently the case on both the cable and DSat platforms, Ofcom's assessment would not be able to identify separately the market power of elements of that bundle. Again, from the perspective of the subscriber, demand would be for the range of content offered by the retail package as a whole and not for individual channels;

(b) even if it were possible to carry out an independent market power analysis of a new channel in this way, as indicated above, Ofcom would no doubt need to carry out a full analysis of whether the relevant channel possessed market power before any action was taken. This would be expected to take a considerable amount of time, particularly as a certain time period would need to pass before any data as to consumer reaction and demand for the new channel would be available. Again, during this time the ability of Virgin Media (and other retailers) to compete effectively with Sky at the retail level would be compromised;

(c) if it appeared that Ofcom was, following an investigation, preparing to conclude that a new Sky Sports channel containing a large number of non-FAPL rights possessed market power and should be subject to the WMO regime, Sky could then move content between its existing sports channels, or to new channels (i.e. modify what content could be found where), such that Ofcom's previous analysis of the new channel became redundant and Ofcom had to start its market power assessment again. Given the range of content controlled by Sky, and the range of channels on which it might be offered there would be a large number of permutations open to Sky as regards what content is shown on what channels[65]. Again, Sky could structure its retail packaging strategy to ensure that such behaviour would not adversely affect the availability to subscribers, in their retail package, of the content they wished to view; and

(d) finally, points (b) and (c) above assume that the new channel would be available on a stand-alone basis at the retail level (i.e. not packaged with other premium sports channels). This cannot be assumed. The new channel may be made available by Sky only as part of a bundle with other channels containing FAPL content. This would make it very difficult, or impossible, to evaluate, other than on

64 [**CONFIDENTIAL**].

65 Virgin Media notes in this regard that Sky has been granted a licence by Ofcom in respect of the possible launch of Sky Sports 4.

an entirely hypothetical basis, the degree to which there is stand-alone demand for the new channel.

A remedy limited to FAPL would not be workable

3.70 On the basis that the pricing methodology put in place by Ofcom as part of the WMO regime incorporates some element of a retail-minus approach, the entire regime would be dependent on (i) Sky's premium channels that contain FAPL content and (ii) Sky's premium sports channels that do not contain FAPL content, being made available independently of each other (whether bundled with basic channels or not). This is because:

(a) if Sky's premium sports channels containing FAPL were only to be bundled with channels not containing FAPL content, it would be difficult to determine a retail price from which the relevant "minus" should be deducted. In short, what proportion of the retail price should be allocated to the channel containing FAPL, and what proportion to the channel that contained no FAPL content? Further, how would the price setting methodology reflect changes in the content on the different channels (e.g. certain content switching from one channel to another)?;

(b) conversely, if channels containing no FAPL content were always to be bundled with channels containing FAPL content, then how, as indicated above, could Ofcom determine whether the channels containing no FAPL content possess market power based on stand-alone demand for those channels?

In summary, on the basis of Ofcom's current approach to market definition, Sky could very effectively undermine the proposed WMO regime simply by choosing not to make available some (or all) of its premium sports channels that contain FAPL content independently of those that do not.

3.71 As the above indicates, even a short consideration of the proposed WMO regime set out in the Second Consultation Document, in conjunction with Ofcom's approach to market definition, shows that there would considerable latitude for Sky to "game" the regime such that its effectiveness would be entirely undermined. There would no doubt be many other tactics that Sky could employ to that effect.

3.72 Virgin Media considers that the propensity of the WMO regime to be gamed by Sky stems from the fact that Ofcom has taken an overly narrow approach to the definition of the sports channel market in which Sky possesses market power. In practice, for so long as Ofcom fails to recognise in full the importance of (i) retailers of sports channels being able to offer a wide range of sports content, and (ii) Sky's flexibility to package its sports channels at the retail level as it sees fit, Ofcom's ability to address the features of the market that prevent, restrict or distort competition through the WMO will be compromised.

Conclusions

3.73 In practice, Virgin Media considers that there are two potential solutions to this fundamental concern:

(a) first, Ofcom should revisit the approach to market definition and market power to reflect the fact that Sky's market power (at both the wholesale and retail level) in the supply of premium sports channels is derived from the aggregation of a wide range of attractive sports content (both on individual channels and in retail channel packages) and is not limited only to the ability to broadcast live FAPL content. Accordingly, the WMO remedy should extend to all of Sky's sports channels. This is Virgin Media's strongly preferred solution and the most direct way of addressing Sky's dominance; <u>or</u>

(b) Ofcom recognises that Sky's ability to structure its retail packages as it sees fit means that limiting the WMO regime only to channels containing live FAPL content is unworkable. If, instead, Ofcom were to modify the WMO regime such that it applied to any sports channel that contained live FAPL content and to any premium sports channel that was bundled at the retail level with any sports channel that contained live FAPL content, then Sky's ability to game the regime would be significantly curtailed. This is because Sky would not be able to move content between sports channels (to deny other retailers wholesale access to non-FAPL content) and address the potential impact on consumers at the retail level by packaging channels containing FAPL content together with channels that do not contain FAPL content.

4. COMPETITION ISSUES – PREMIUM MOVIES

Introduction

4.1 Ofcom has reached the view that Sky is currently dominant in the wholesale supply of Core Premium Movies[66] "*and is likely to be dominant in that relevant market for the next three to four years.*"[67] Virgin Media agrees with this finding.

4.2 Virgin Media also notes that Sky's high market share is not significantly altered by taking an alternative view of the relevant market. In particular, Ofcom has examined Sky's share in relation to markets which have been widened to include, respectively, Pay Per View (**"PPV"**) movies, DVD rental subscription packages and over-the-counter DVD rentals. In each case, Ofcom found that Sky's share of the market would remain high or extremely high.[68] In short, Sky has a long-standing position of dominance in the wholesale supply of Core Premium Movies, and it is not constrained by any existing competitors.[69]

4.3 Virgin Media also agrees with Ofcom's finding that Sky's market power in the wholesale supply of Core Premium Movies channels is unlikely to be undermined by potential entrants.[70] Nevertheless, Virgin Media notes that Ofcom reserves the right to review this assessment should the competitive situation change materially.[71] In this regard Virgin Media explains in this Section why there are no reasons for believing that the situation will change materially in the foreseeable future.

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66 This refers to the wholesale supply of channels which include the first TV subscription window of film content from the Major Hollywood Studios (referring to the Hollywood studios which are members of the Motion Picture Association of America, namely Disney, Paramount, Sony, 20th Century Fox, Universal and Warner Bros).

67 Second Consultation Document, paragraph 5.121.

68 Second Consultation Document, paragraph 5.121; Ofcom also indicates such sensitivity testing of market shares will overstate the extent to which Sky's pricing is constrained by these packages because it treats them as if they were within the same relevant market whereas Ofcom has reached the view that they are not.

69 Whilst Virgin Media agrees with Ofcom's market definition in relation to the wholesale supply of Core Premium Movies, and with the finding that Sky has market power, it considers that Ofcom should also have explicitly addressed the question of market definition and market power in the supply of premium movies at the retail level. The evidence assembled by Ofcom to support its wholesale market definition points irrefutably to there being a narrow retail market for premium movie channels. Indeed, Ofcom reached a preliminary conclusion to this effect in its First Consultation Document (paragraph 5.23), and noted that Sky has revenue market shares "(*well over 80%) in the premium movies retail market*" (paragraph 5.54) suggesting that "*Sky is therefore likely to have market power in the retail market for packages containing premium sports or premium movies channels*" (paragraph 5.54). The absence of any finding as regards the retail market in the Second Consultation Document is problematic because it weakens the logical construction of Ofcom's arguments particularly as regards the mutually reinforcing effect of market power at the wholesale and retail levels. It is also inconsistent with the rationale for the WMO remedy which is based in large part on there not being effective competition in the retailing of premium channels with a range of resulting consumer detriments. Finally, Virgin Media believes that the proposed remedies cannot be properly assessed without having proper regard for market power at the retail level. These issues are discussed further in Section 5 of this Submission.

70 Second Consultation Document, paragraph 5.114.

71 Second Consultation Document, paragraph 5.115.

4.4 Virgin Media has assessed the viability of securing premium movie rights in order to challenge Sky's dominance in the wholesale supply of Core Premium Movies on a number of occasions. This direct experience confirms that:

(a) deals with no fewer than three of the major Hollywood studios (the **"Major Hollywood Studios"**) would be required to support a viable competitive offering;[72] and

(b) the barriers facing new entrants are, in Virgin Media's experience, very significant even in relation to the acquisition of rights from one of the six Major Hollywood Studios.

4.5 Accordingly, a very material change in the competitive situation (i.e. the acquisition by an entity other than Sky of the movie output of at least three Major Hollywood Studios) would be required before there could be any reason for Ofcom to revisit its assessment.

Barriers to entry and expansion are extremely high

4.6 Virgin Media has investigated the acquisition of premium movie rights on a number of occasions. It believes that such entry would be welcomed by the Major Hollywood Studios who are currently forced to negotiate with a monopsony buyer. [**CONFIDENTIAL**]. However, on each occasion that Virgin Media has sought to acquire relevant movie rights it has been unsuccessful due to the difficulties of countering Sky's dominant position. [**CONFIDENTIAL**]. These risks arise from the need to assemble rights from a number of studios and the difficulty of achieving this within a reasonable timescale, as discussed further below.

Movie rights from more than one studio would be required to assemble an attractive package

4.7 Virgin Media notes that Sky has argued that a service based on the movie rights of one or two Major Hollywood Studios can be viable.[73] Virgin Media considers that a service based on the movie rights of one studio would not be viable and that, in fact, the rights of no fewer than three studios would be required in order to assemble an appealing package which could be marketed as a mid-priced alternative to Sky Movies (and even in this case, there would be no guarantee of success given Sky's incumbency advantages).[74]

4.8 The movie rights available from a single studio simply do not provide the volumes required to create an appealing package. Depending on its size, a single studio might release in the region of 20 to 25 current movies per annum (i.e. new films from the first pay TV window) of which only a proportion in the region of less than half will be significant titles for which there is a strong demand. A service which might only be able to offer less than one significant title a month is unlikely to attract significant subscribers. Moreover, demand of this nature is also served by PPV movie services, and hence the price of such a low-volume subscription package would be constrained by PPV prices.

4.9 Movie rights from more than one of the studios are required, therefore, to assemble an appealing package. In this sense, the movie rights from each of the studios are not substitutes but are more complementary in nature – i.e. customers who like movies do

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72 Virgin Media, *Consolidated Response to Request for Further Information of 20 December 2007* dated 21 February 2008, paragraph 1.16.

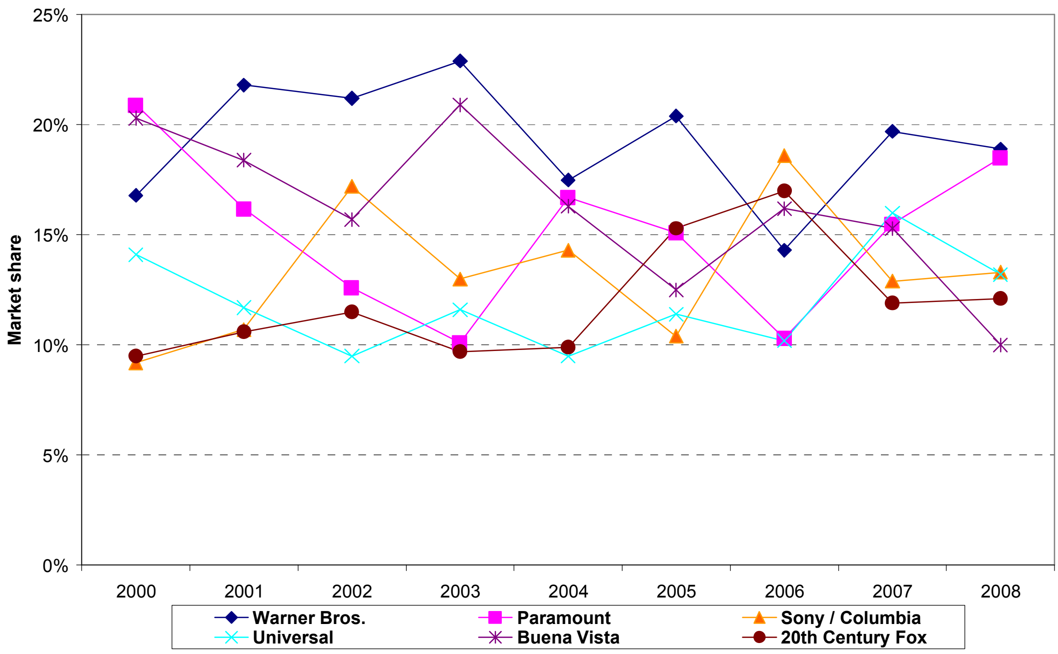
73 Second Consultation Document, paragraph 5.103.

74 Even if commercially viable entry could be achieved in relation to one or maybe two of the premium movie rights packages, Virgin Media strongly agrees with Ofcom's statement that this may still be insufficient to constrain Sky's behaviour: "*it is important to distinguish between the scale of entry that is commercially viable and the scale of entry that would be necessary to undermine any dominant position held by Sky*" (Second Consultation Document, footnote 157).

not just like movies made by, for example, Sony but like a range of movies or movie genres cutting across the studio distinction. Sky's dominance derives from its monopoly of the entire complementary package of movie rights across all six of the Major Hollywood Studios.

4.10 In addition, it is important to have access to movie rights from more than one studio as a risk pooling measure because the success of studios in producing popular titles (and the number of titles) will vary from year to year. The variation in the commercial success of studios is demonstrated by volatility in their market shares on a yearly basis as shown in the chart below.

Figure 1: Market shares of the six Major Hollywood Studios based on gross earnings from theatrical releases in North America



Source: www.boxofficemojo.com/studio (November 2008). Notes: (1) Market shares are based on gross earnings in North America from theatrical releases. (2) Buena Vista was the name of Disney's entertainments division until April 2007.

4.11 In short, in order to constrain Sky, Virgin Media believes that a potential new entrant must aggregate a critical mass of content from different studios. Its own assessment has identified that output agreements with no fewer than three studios would be required in order to assemble an appealing package.

Acquiring critical mass is difficult because of staggered contract lengths

4.12 A new entrant seeking to acquire such a critical mass of content, however, faces significant difficulty because the rights are agreed for varying durations and have different expiry dates. There is also very little transparency as to contract duration as this is negotiated confidentially between Sky and the studios. For example, whilst Virgin Media is aware that the [**CONFIDENTIAL**] contract with Sky is currently under review, the precise duration of the Sony contract which was agreed with Sky in [**CONFIDENTIAL**] is unknown. [**CONFIDENTIAL**]. As a result, a critical mass of content cannot be assembled simultaneously and a new entrant may have to wait a number of years before opportunities to negotiate with the studios arise.

4.13 In the meantime, a new entrant is only able to offer a partial service which limits its ability to attract subscribers. The launch of new premium content typically offers the opportunity to advertise widely in order to stimulate subscriptions (both customers new to premium movies and switchers). Virgin Media considers that this is often a "one-hit" opportunity to influence subscription decisions. A new entrant with only one studio deal, however, would be advertising only a partial service at the outset, and would then need to undertake further marketing in the event that the partial service is subsequently enhanced through the negotiation of later deals with other studios. This is likely to be very confusing for customers and the unique opportunity to launch an appealing new product would be lost.

4.14 The risk of the venture is raised significantly in this context because, despite having sunk investments in the acquisition of movie rights from the first studio, the success of the venture depends on being able to reach agreements with other studios in subsequent negotiations. This will weaken the bargaining position of the new entrant in subsequent negotiations, and make it more vulnerable to aggressive behaviour by Sky.

4.15 Ofcom's position on this barrier to entry is unclear from the statements in paragraph 5.108 of the Second Consultation Document, although the First Consultation Document acknowledged that, due to the staggered nature of rights, it may be a period of months or years before a channel provider has a sufficiently strong package to compete effectively with Sky.[75] In this regard Virgin Media reiterates its view that assembling a portfolio of attractive movie content across the Major Hollywood Studios is essential to compete with Sky Movies and that this cannot be achieved simultaneously due to the staggering of rights contracts which come up for renewal at different times.

Sky has very strong bidding advantages

4.16 The need to secure agreement with several studios and the staggering of rights contracts raise the risks of entry significantly, but this might still be manageable from a commercial perspective if the price which is paid to the studios reflects these risks. This is where Sky's stranglehold on the pay TV market raises the ultimate barrier to entry because Sky will always be able to out-bid Virgin Media in these circumstances.

4.17 Even without the additional risks described above, Virgin Media cannot match the bidding advantage enjoyed by Sky. The reasons for this bidding advantage have been correctly identified by Ofcom.[76] In this regard, Virgin Media highlights the following:

(a) Sky bids in the knowledge that it can "monetise" its expenditure immediately and efficiently across its large subscriber base. It can extract more from its subscriber base by bundling complementary content, and it can extract that value immediately because it does not have to build up a subscriber base. Sky is the dominant retailer on the DSat platform with the largest number of subscribers, and with a large portfolio of other movie rights and other content with which the content in question can be bundled. Sky therefore has an overwhelming competitive advantage;[77]

(b) Virgin Media, on the other hand, is dependent on Sky for gaining access to the large DSat subscriber base. Its bidding strategy is constrained by the uncertainty surrounding the level of wholesale price which would be offered by Sky for the movie content in question even if Virgin Media were to win movie rights from one or more Major Hollywood Studios. Moreover, further uncertainty arises because

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75 Second Consultation Document, paragraph 5.102.

76 Second Consultation Document, paragraphs 5.61 to 5.64 (in relation to premium sports) and paragraphs 5.110 to 5.111 (in relation to premium movies).

77 It should also be noted that Sky forms part of a global entity which has a network of relationships involving the six Major Hollywood Studios which extends beyond the UK. In particular, the Newscorp organisation, which is the parent company of Sky, also encompasses 20th Century Fox. Other entities owned by Newscorp are also important buyers of premium movie rights in other countries, particularly Italy and countries in Asia.

there is no guarantee that Sky would promote the content from a rival entity as actively as the rival would like in order to allow that rival to make a timely return on its content acquisition costs.

4.18 In short, Virgin Media considers that Sky's position of dominance gives a significant bidding advantage over potential rival bidders for movie rights. This reflects its ability to "monetise" its investment thereby reducing bidding risk. New entrants, on the other hand, face significantly higher risks and the prices which they could offer for the movie rights (which reflect these risks) can always be out-bid by Sky (as it does not face the same risks).

Virgin Media has been unable to enter the market despite repeated attempts

4.19 Virgin Media has experienced significant difficulties in securing even a single deal with one of the six Major Hollywood Studios due to its inability to match Sky's offer and still acquire the rights on commercially viable terms. [**CONFIDENTIAL**].

4.20 [**CONFIDENTIAL**].[78]

4.21 [**CONFIDENTIAL**].[79]

4.22 [**CONFIDENTIAL**].[80]

Conclusion

4.23 In summary, Virgin Media concurs with Ofcom's view that Sky's position of dominance in relation to Core Premium Movies channels is likely to continue:

> "*it is likely that Sky will continue to win all, or at least the majority, of the Movie Rights as and when they become available. As a result, Sky's position in the wholesale supply of Core Premium Movies channels is unlikely to be undermined by potential entrants.*"[81]

4.24 As outlined above, Virgin Media has encountered significant difficulties in acquiring a single package of rights from one of the six Major Hollywood Studios. Even had it been successful, Virgin Media does not believe that control of such a package would have been sufficient to launch an appealing new service to customers, and would certainly not have posed any significant challenge to Sky.

4.25 In this regard, Ofcom rightly points to the rather stark history in relation to the exploitation of premium movie rights:

> "*Sky currently has a 100% market share in the wholesale supply of Core Premium Movies channels. Since the early 1990s, Sky has persistently enjoyed an extremely high market share – no other firm has won rights from the Major Hollywood Studios for the first TV subscription window*".[82]

4.26 Virgin Media considers that this observation is consistent with the high barriers to entry[83] which have been described above and which prevent a new entrant gaining even a foothold, let alone a critical mass of content with which to challenge Sky. Virgin Media's

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78 [**CONFIDENTIAL**].

79 [**CONFIDENTIAL**].

80 [**CONFIDENTIAL**].

81 Second Consultation Document, paragraph 5.114.

82 Second Consultation Document, paragraph 5.94.

83 Second Consultation Document, paragraph 5.94.

own experiences provide compelling evidence of the insurmountable difficulties facing new entrants.

4.27 Accordingly, absent regulatory intervention, Virgin Media does not consider that there is any realistic prospect of this changing in the foreseeable future. Further, even if circumstances did change, a very material change in the competitive situation (i.e. the acquisition by an entity other than Sky of the movie output of at least three Major Hollywood Studios) would be required before there could be any reason for Ofcom to revisit its assessment of market power.

5. COMPETITION ISSUES – SKY'S RETAIL MARKET POWER

Introduction

5.1 In Ofcom's First Consultation Document, Ofcom concluded that there were likely to be separate retail and wholesale markets for the supply of premium sports and movie channels.[84] In addition, Ofcom concluded that Sky is likely to have market power in the retail market for packages containing premium sports or premium movie channels. In particular, Ofcom stated:

> "*Sky has revenue market shares of* [redacted] *(well over 70%) in the premium sports retail market and* [redacted] *(well over 80%) in the premium movies retail market, and its market share has increased every year in each of the last five years in both markets. With such a high market share there would normally be a presumption of market power unless there was strong evidence to the contrary, which there does not appear to be. Sky is therefore likely to have market power in the retail market for packages containing premium sports or premium movies channels*".[85]

5.2 Virgin Media agreed with these findings.[86] In the Second Consultation Document, however, Ofcom has not explicitly addressed the question of market definition and market power in relation to the supply of premium content at the retail level. It states that:

> "[o]*ur focus is on wholesale markets. It is not necessary formally to define the downstream markets. However, when defining wholesale markets we take account of the indirect constraint that final consumers place on channel wholesalers as a result of their relationship with retailers.*"[87]

5.3 Virgin Media considers that this approach is problematic for a number of reasons:

(a) analysis of the wholesale market in isolation from the retail market risks understating the manner in which the two are inter-related. Virgin Media considers that Sky's market power at the wholesale level is reinforced by its retail market power and vice versa;

(b) Ofcom is seeking through its proposed remedy to bring about effective competition in retail markets, and a failure to have proper regard to market power at the retail

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84 First Consultation Document, paragraph 5.23, first bullet point.

85 First Consultation Document, paragraph 5.54. This finding was consistent with that of the OFT in 2002 which identified distinct narrow retail and wholesale markets for the sale of premium sports and premium films (see OFT Decision of 17 December 2002 in Case No. CA98/20/2002 *BSkyB Investigation: alleged infringement of the Chapter II prohibition*, paragraphs 169 to 175 and 252 to 257).

86 See Virgin Media's Response of 7 March 2008 to the First Consultation Document (the **"Virgin Media Response"**), paragraph 5.2.

87 Second Consultation Document, paragraph 4.36. Ofcom also states at paragraph 4.31: "[w]*e do not believe it is necessary formally to define the retail market either for basic or for premium channels in order to define wholesale markets for premium channels.*"

level may lead to remedies being proposed that, whilst facilitating access to certain premium content, may not engender effective retail competition; and

(c) the rationale for the WMO remedy is based in large part on there not being effective competition in the retailing of premium channels with a range of resulting consumer detriments. It is not appropriate in this context to disregard the evidence assembled by Ofcom for the purpose of defining the relevant wholesale market which points irrefutably towards there being a separate market for the retailing of premium content, with Sky enjoying a dominant position in that market.

Focus on wholesale markets risks under-stating the interaction with Sky's retail market power

5.4 Virgin Media considers that Sky's position of dominance in the wholesale market for the supply of premium content is a function of its retail market dominance and vice versa. Although this is implicit from much of the analysis in the Second Consultation Document, the lack of a formal finding of market power at the retail level creates a gap in the logical construction of Ofcom's case, and risks understating the effects of Sky's mutually reinforcing market positions.

5.5 For instance, Ofcom provides a compelling description of why Sky is able to out-bid potential rival bidders for premium content rights.[88] In this regard, Virgin Media considers that Sky's market power at the retail level (in particular its control of the largest number of premium channel pay TV subscribers, and its ability to set retail prices to ensure that its investments are "monetised" within a reasonable timescale) means that competing bidding for content is inhibited. Ofcom also appears to reach this conclusion, but without making any reference to retail market power, when it states that Sky is "*vertically integrated with the most effective retail outlet on the pay TV platform with the largest number of likely subscribers*", and to the difficulties of third parties in accessing that outlet.[89]

5.6 Virgin Media also considers that Sky's retail market power is reinforced by its control of premium content at the wholesale level, and this is addressed comprehensively in the Second Consultation Document. In particular, Virgin Media strongly agrees with Ofcom's findings as to the adverse effects of Sky's market power and the lack of retail competition on consumers:

> "[m]*arkets where competition is weak do not deliver the best outcomes for consumers. The limited retail competition that we see in pay TV as a result of limited distribution of premium content is likely to manifest itself in terms of reduced choice, reduced retail innovation, reduced platform innovation or higher prices. For example, consumers on a number of platforms are currently unable to access the most valuable sport and movie content, while even those consumers who can access this content have a limited choice of service bundles. While the UK has a strong track record of technical innovation in areas which play to the strengths of Sky's satellite platform, the same has not historically been true of innovations such as video on demand, which play to the strengths of platforms other than Sky's.*"[90]

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88 Second Consultation Document, paragraphs 5.61-5.64.

89 Second Consultation Document, paragraph 5.63. Ofcom does, however, acknowledge the consistency between its argument and those made in the 2007 Joint Submission. It states: "[t]*he idea that Sky takes an advantage from having the largest number of subscribers is not dissimilar to the 'vicious circle' set out by the Four Parties in their July Submission*" (paragraph 5.64).

90 Second Consultation Document, paragraph 1.4.

5.7 Again, however, there is no explicit recognition by Ofcom that the corollary of the fact that retail competition is weakened by the features identified by Ofcom, is that Sky has retail market power. Virgin Media considers that an explicit recognition of retail market power would give Ofcom's arguments a firmer logical foundation.

Any remedy must be assessed by reference to its impact on competition at the retail level

5.8 In order to assess the efficacy and appropriateness of any remedies imposed to deal with market power at the wholesale level, it is necessary to consider the impact of those remedies at a retail level. This is because, there would be little point in devising remedies to address market power at the wholesale level if those remedies did not satisfactorily address the adverse consequences on consumer benefit at the retail level. In this regard, an assessment of Sky's market power at the retail level is of significant importance in determining whether any particular remedy may be expected to be effective. This is because Sky may use its market power at the retail level to undermine the proposed remedy.

5.9 If, for example, a retail-minus approach is used on its own (i.e. without the cost-plus cross-check) to calculate regulated wholesale prices, Sky could use its retail market power to "game" the regulatory mechanism. Sky might, for example, seek to increase the wholesale price by simply raising its retail price. It is unlikely that rival retailers would be in a position to constrain such a move by Sky given its retail market power. They would also need to ensure that their own retail prices allowed them to recover the higher wholesale price. In addition, adopting only a retail-minus approach to determining the appropriate regulated wholesale price may still allow Sky to earn a significantly greater retail margin than its rivals, which would be likely to distort retail competition.

5.10 In this context, an assessment of Sky's retail market power is directly relevant to whether a retail-minus approach, if applied on its own, would be an adequate remedy. As discussed further in Section 6, Virgin Media considers that a cost-plus cross-check is required to allow the wholesale price to be adjusted if there is evidence of excessive wholesale margins and to ensure that there is not a significant discrepancy in margins thereby allowing rival retailers to compete on a non-discriminatory basis.

5.11 Virgin Media considers that there are also other ways in which the effectiveness of a pricing remedy may be undermined by Sky using its retail market power to "game" the regulatory mechanism. In the case of premium sports, the proposed WMO remedy focuses narrowly on the wholesale supply of channels containing live FAPL matches (as opposed to Ofcom's previous position which focused on channels or packages of channels containing live FAPL matches). In this case, Virgin Media anticipates that gaming by Sky will involve moving premium sports content between channels to avoid supplying any significant non-FAPL content to rival retailers (by, for example, transferring all live FAPL to a single channel, possibly Sky Sports 1, with all other attractive sport content on other premium sports channels).

5.12 Given its retail market power, Sky will be able to influence the relative attractiveness of premium content on different platforms through its pricing decisions with no prospect of being constrained. It could, for example, set a high retail price for Sky Sports 1 which, using the retail-minus approach would yield a high wholesale price, and then set a price for a bundle of channels including Sky Sports 1 which would represent a very small incremental price in relation to the Sky Sports 1 price. Rivals would find it very difficult to compete in these circumstances. Their own retail prices would need to be higher to recover the high wholesale cost and distribution costs, and they would not be able to match the bundle offered by Sky.

5.13 Alternatively, Sky would only offer Sky Sports 1 containing FAPL as part of a bundle with channels not containing FAPL content. In these circumstances, it would be very difficult for the remedy to be applied as there would be no separately observable retail price for the channels containing FAPL content on which to base the retail-minus calculation. The various possibilities for gaming by Sky are discussed further in Section 3.

5.14 In short, Virgin Media considers that an assessment of Sky's market power at the retail level is essential in order to be able to assess whether any WMO pricing remedy would be effective in stimulating competition at the retail level.

The evidence supports a finding that Sky has market power at the retail level

5.15 Lastly, Virgin Media considers that the evidence to support a conclusion that Sky has retail market power has already been presented in the Second Consultation Document albeit under the guise of assessing the indirect constraint that final consumers place on channel wholesalers as a result of their relationship with retailers. Whilst Virgin Media agrees that demand at the wholesale level is a demand which is "derived" from consumer demand and therefore that the preferences and switching behaviour of consumers as regards premium content are relevant to the consideration of wholesale market definition, it also provides the basis for defining retail markets.

5.16 The analysis, which considers a range of evidence in relation to consumers' behaviour and preferences, provides compelling evidence that there is a separate market for the retailing of premium content and that Sky enjoys a position of market power at the retail level. For example, in relation to premium sports Ofcom considered consumers' observed responses to retail price changes and found that consumers of Sky Sports channels were unwilling to switch to substitute products despite increases in the price of Sky Sports and the increased availability of sports on Free-To-Air (**"FTA"**) channels.[91] It also noted that the strong growth in popularity of Freeview had not had an observable impact on subscriber numbers to packages containing Sky Sports.[92] These findings point strongly to a distinct retail market for premium sports channels in relation to which Sky has market power.

5.17 As regards premium movies, Ofcom also found weak responses to price changes, evidence that consumers value access to new films and that products such as DVD rentals are likely to represent weak substitutes for premium movies.[93] Again this evidence also points to a distinct retail market for first-run premium movies in relation to which Sky has market power.

Conclusion

5.18 Virgin Media is strongly of the view that in any final decision on its investigation into the pay TV industry, Ofcom should include an assessment of the relevant market definition at the retail level and the degree to which Sky possesses market power in those retail markets. Without such a finding Virgin Media believes that a key step in the logical construction of Ofcom's case is missing (although it is implicit in much of the arguments which are presented and, indeed, there is direct evidence to support such a finding). Moreover, without a consideration of the dynamics of competition at the retail level and the impact of Sky's dominance, Ofcom cannot fully assess the impact of any proposed remedy. Specifically, Virgin Media considers that Ofcom should restate its previous finding that Sky is dominant in the retailing of packages containing premium sports or premium movie channels.

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91 Second Consultation Document, paragraph 4.95. Ofcom recognised that part of the consumer response may reflect an increased willingness to pay for a better quality product.

92 Second Consultation Document, paragraph 4.105.

93 Second Consultation Document, paragraph 4.234.

6. WHOLESALE MUST-OFFER OBLIGATION - PRICING

Introduction

6.1 This Section considers the appropriate approach to setting wholesale prices as part of the WMO. Virgin Media agrees with Ofcom that "*the price of any wholesale must-offer is clearly a central feature of the offer*",[94] and it will be of vital importance in determining whether or not the remedy will be effective in addressing the distortions to competition (both at the retail and wholesale levels of the pay TV market) and the adverse effects on consumers which have been identified by Ofcom. In this regard, Virgin Media considers the key pricing issues to be as follows:

(a) the role of Ofcom – Virgin Media considers that Ofcom should specify regulated wholesale prices, through an explicit and unambiguous formula based on certain of Sky's retail prices (see further below), rather than merely establishing the framework for price setting and leaving the actual determination of prices to commercial negotiation. Sky has no incentive to engage in constructive and timely commercial negotiations, and can be expected to adopt every strategy at its disposal to delay and limit the development of retail competition;

(b) the retail-minus approach coupled with a cost-plus cross-check offers a sensible approach which would address the main competition problems highlighted by Ofcom;

(c) the retail cost base for establishing the "minus" under the retail-minus approach should be informed by the costs incurred by Sky's retail competitors in providing a comparable package of services (including broadband and telephony services);

(d) a single wholesale rate-card should be set which would apply to all existing retailers (across different platforms), as well as to new entrants seeking access to Sky's premium content. In addition, where Sky retails comparable bundles containing premium content across different platforms, the retail-minus approach should be applied to the bundles on different platforms, and the wholesale price should be based on the lowest price which emerges from this exercise;

(e) additional regulatory measures will be required to address the risk of regulatory "gaming" by Sky, in particular independent verification of cost estimates submitted by Sky;

(f) the mechanism for adjusting prices going forward should provide retailers with security as regards wholesale prices and their ability to compete; and

(g) it is not sufficient to control price in isolation from quality and functionality. The price control will need detailed specification of what features Sky is obliged to supply in particular as regards HD format and interactive services (as discussed further in Section 7 below).

6.2 These issues are discussed in turn in the sections below.

The role of Ofcom

6.3 Ofcom requests views on its regulatory role and in particular whether:

(a) its role should be limited to that of specifying a high-level statement on how prices should be derived, leaving the detail of actual price levels to commercial negotiations; or

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[94] Second Consultation Document, paragraph 9.51.

(b) it should specify price levels based on a detailed regulatory assessment of allowable costs and rates of return.[95]

6.4 As regards the first option, Ofcom observes that the regime could be established more quickly but might be subject to commercial disputes which would in any event, require Ofcom to take a view on appropriate prices.[96] In the latter case, setting the regulated prices could be time-consuming but "*might reduce the total time taken to provide sufficient certainty for alternative retailers to launch*".[97]

6.5 Virgin Media strongly believes that it will not suffice for Ofcom to limit itself to establishing guidance on price-setting. This will be entirely ineffective given Sky's market power and the resulting asymmetric bargaining positions of Sky and third parties. Indeed, this has been the problem at the root of the limited distribution of premium content across alternative platforms which has prevailed to date. Ofcom has confirmed this in its finding that no party exercises sufficient buyer power to constrain Sky's position as a wholesale supplier of core premium content.[98]

6.6 Even with detailed guidance on price-setting from Ofcom, Virgin Media considers that commercial negotiations will inevitably result in deadlock and protracted disputes, with Sky having no incentive to engage in constructive and timely negotiations. The task of mediating such disputes and determining whether or not there has been compliance with the pricing rules would inevitably fall to Ofcom, and would be tantamount to setting prices in the first place.

6.7 In addition, Virgin Media considers that such a "light-handed" regulatory approach would create significant uncertainties for new entrants and existing retailers which may dis-incentivise market entry and/or investment. In particular, rival retailers would need to assess, on the basis of Ofcom's guidance as to the appropriate wholesale pricing methodology, whether the terms being offered to them by Sky would be considered by Ofcom to be compliant with the general principles in the event of a complaint or dispute. It is essential, in Virgin Media's view, that the WMO remedy provides a predictable and transparent approach to pricing enabling potential providers of pay TV to assess their risks prior to entering, and for existing retailers to assess the risks of expansion. Any lack of clarity arising from the guidelines will increase the risks of investment and/or market entry.

6.8 Virgin Media also notes that when Ofcom set specific Asynchronous Transfer Mode (**"ATM"**) interconnection prices in the context of wholesale broadband access in 2004, this replaced a regime which had used a "no margin squeeze" pricing rule. This regime had resulted in protracted investigations which Ofcom considered had had a "*chilling effect*" on competition.[99] The new regime involved Ofcom setting an actual margin to

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95 Second Consultation Document, paragraphs 9.52-9.54.

96 As envisaged by Ofcom in the Second Consultation Document, paragraph 9.53.

97 Second Consultation Document, paragraph 9.54.

98 Second Consultation Document, paragraphs 5.88 and 5.89. Commenting on the difficulties that several retailers have experienced in seeking wholesale access to Sky Sports and Sky Movies, Ofcom remarks: "[w]e *believe that the successive instances where commercial agreements have not been reached are at least indications that Sky does not consider these retailers to be essential outlets for its content. As such, we do not believe that these retailers exercise any significant buyer power*" (paragraph 5.88). Commenting on the position of Virgin Media, Ofcom states that "*while Virgin Media is a significant outlet for Sky, the commercial balance of the relationship appears to be strongly in favour of Sky. The relationship may be further influenced by Sky's desire to strengthen its position of power in both downstream and upstream markets*" (paragraph 5.89).

99 "*Ofcom is conscious that in order to make investment decisions, Altnets require stability and certainty in deciding whether or not to enter this market. The resource intensive investigation following the April 2003 price changes to IPStream and the ensuing uncertainty highlighted the "chilling" effects of the current arrangements on Altnets, i.e. the investigation discouraged Altnets from taking investment decisions in relation to intermediate services*", Ofcom, *Direction Setting the Margin between IPStream and ATM interconnection Prices,* 26 August 2004, paragraph 1.8.

ensure that there was no price squeeze between BT's ATM interconnection charges and its prices for the relevant downstream services.

6.9 In summary, Virgin Media considers that Sky's market power in relation to premium content at both the retail and wholesale levels is such that there can be no confidence that commercial negotiations would give rise to fair, reasonable and non-discriminatory prices even if the negotiations were to be constrained by detailed *ex ante* pricing rules. Indeed, although Ofcom indicates that, in such circumstances, it would need to establish a "*mechanism for the rapid resolution of pricing disputes*",[100] Virgin Media considers that disputes would be the norm rather than the exception, and that the resolution of these disputes would be anything but rapid.

6.10 Virgin Media considers that setting a specific price formula is imperative in order to foster competition in the provision of premium content services. Ofcom can review on an ongoing basis whether this remains appropriate in the light of changing market conditions, but given the current scale of Sky's dominance in relation to premium sports and movies, a light-handed approach is very unlikely to be appropriate for some time to come.

Retail-minus with a cost-plus cross-check is a sensible approach

6.11 Virgin Media considers that a retail-minus approach to calculating regulated wholesale prices, coupled with a cost-plus cross-check offers a pragmatic approach which is responsive to the key competition problems identified by Ofcom. In particular, Ofcom has identified a number of incentives which may motivate Sky against supplying its premium content to rival retailers at wholesale prices which would ensure effective competition in the retail supply of premium sports and movie channels. The object of the WMO is to eliminate Sky's ability to act on these incentives, thereby enabling other operators to develop competitive pay TV offers which include premium content. Ofcom is seeking to replicate the natural outcome of a competitive retail market by facilitating access to content on regulated terms, thereby allowing additional innovative retailers and platforms to emerge and expand, to offer greater customer choice, and to put competitive pressure on pay TV retail prices.

6.12 In this regard, Virgin Media agrees that the retail-minus methodology, which focuses on whether the wholesale price is sufficiently low to enable rivals to compete on price (as well as quality and innovation) with the retail arm of their wholesale supplier (Sky), is the correct approach to adopt. This is vital to Virgin Media because, as Ofcom is aware, the existing wholesale pricing arrangements create an incentive for Virgin Media not to retail Sky's premium channels at all (unless this would lead to Virgin Media foregoing customers who would otherwise subscribe to its basic pay TV and other services). This environment is self-evidently not one in which Sky will face effective competition in the retailing of premium sports and movie channels, and will result in the distortion of competition in basic pay TV and other services.

6.13 A regulated wholesale pricing arrangement which allows Virgin Media to recover its efficiently incurred costs as well as a reasonable margin would give Virgin Media and other retail competitors both the ability and the incentive to compete on price with Sky, and to undertake greater promotion and investment in packages containing premium channels. If Ofcom wishes to engender effective price and non-price competition in the retailing of premium sports and movie channels, then the prevailing situation in which Virgin Media has no ability or incentive to compete with Sky on price or quality must be addressed.

6.14 Ofcom will need, however, to give careful consideration to the application of the pricing arrangement in order to meet these objectives. In particular:

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[100] Second Consultation Document, paragraph 9.3.

(a) the cost-plus cross-check is important to ensure that Sky is not able to earn a significantly greater retail margin than its rivals;

(b) in order to ensure a level playing field between different retailers regulated wholesale prices should be set which apply to all actual and potential retailers of premium content – i.e. there should not be different prices for different retailers; and

(c) the retail-minus approach will need to accommodate the fact that Sky may retail premium content across different platforms. The wholesale price will need to be set in such a way that it allows third parties to compete effectively with Sky whether it is retailing premium content in packages on DSat or on other platforms.

The importance of the cost-plus cross-check

6.15 Given the aim of Ofcom to promote fair and effective competition between retailers, Virgin Media is concerned that a retail-minus approach should not be applied in such a way that it allows Sky to earn a significantly greater retail margin than its rivals. The retail-minus approach might, for example yield a wholesale price which allows rival retailers to cover their retail costs including a reasonable margin but is still significantly in excess of Sky's wholesale costs. Each premium subscriber attracted or retained by Sky would be significantly more profitable for Sky as compared to rivals, and this would provide both the incentive and ability for Sky to invest in improving and advertising its offer (for example investments in marketing and new technology). The ability of rival retailers to compete through making comparable investments would be compromised because their gross retail margin per new subscriber won would be lower than that of Sky.

6.16 The cost-plus cross-check which is proposed by Ofcom is important, therefore, to ensure that there is not a significant discrepancy in margins and that rival retailers can compete on a non-discriminatory basis. If a significant discrepancy were to be identified, the wholesale price derived using the retail-minus approach would need to be adjusted downwards. Accordingly, Virgin Media agrees with Ofcom that the "*two pieces of analysis would have to be carried out in parallel*".[101]

Setting a wholesale price to apply to all retailers

6.17 Virgin Media considers that regulated wholesale prices should be set which apply to all actual and potential retailers of premium content – i.e. there should not be different prices for different retailers. This approach is justified on the ground of pragmatism - i.e. the regulatory task of setting prices for different categories of retailers would be prohibitively complicated – but also on the ground that it is important to preserve a level playing field amongst rival retailers.

Setting a platform neutral wholesale price

6.18 The retail-minus approach will also have to allow for the fact that Sky may increasingly retail its premium content on platforms other than DSat, in particular Digital Terrestrial Television (**"DTT"**) in the event that the "Picnic" proposal is authorised.[102] It will therefore be necessary to apply the retail-minus calculation to <u>all</u> packages of channels which include premium content across the different platforms, and to set the regulated wholesale price on the basis of the <u>lowest</u> price for comparable packages which emerges from this exercise. This is important in order to enable third parties to compete

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[101] Second Consultation Document, paragraph 9.58.

[102] As set out in Virgin Media's response to Ofcom's *Proposed BSkyB Digital Terrestrial Television Services - Second Consultation on Sky's "Picnic" proposal* of 30 September 2008 (submitted on 18 December 2008), Virgin Media strongly considers Ofcom should not consent to the "Picnic" proposal.

effectively with Sky's retail bundles on DSat, as well as, potentially, DTT and any other platform where Sky launches a retail service which includes premium content.

Practical issues associated with retail-minus and cost-plus cross-check

6.19 As regards the practical issues raised by this approach, Virgin Media considers that:

(a) a retail-minus approach should take Sky's actual current (and future) retail prices as the starting point;

(b) it should deduct costs which reflect the reasonably efficiently incurred cost base of Sky's competitors (including new entrants); and

(c) in calculating the cost-plus cross-check, a detailed analysis of Sky's wholesale cost base will be required in conjunction with additional regulatory measures to address gaming by Sky.

Determining the appropriate retail price

6.20 Ofcom has identified a potential complexity in applying the retail-minus approach, namely, determining the appropriate measure of retail price. It states:

> "[o]*ne potential complexity is that the product for which we may wish to determine a wholesale charge is normally retailed in bundles including a range of other products, and this may make it difficult to set a stand-alone* *__retail__* *price for that product*".[103] (emphasis added)

6.21 Virgin Media considers that the bundling of products by Sky raises two issues as regards the identification of the appropriate retail price, namely that:

(a) the bundles may include different combinations of premium elements; and

(b) the bundles may include different combinations of basic channels, telephony and broadband. For example, Sky currently offers six basic entertainment packs amongst which customers can choose. It then offers different tiers of broadband (namely Sky Broadband Base, Mid and Max), as well as different tiers of telephony (including Sky Talk Freetime and Sky Talk Unlimited).

6.22 As regards the first point, Virgin Media considers that Ofcom should set regulated wholesale prices by applying the retail-minus approach to all possible retail bundles of Sky's premium channels. At present, Virgin Media understands that the following premium combinations are available to Sky subscribers (provided they also subscribe to basic content):

(a) Sky Movies Pack;

(b) Sky Sports 1 (although this is not advertised by Sky);

(c) Sky Sports 1 and Movies Pack (comprising a number of premium movie channels);

(d) Sky Sports Pack (comprising Sky Sports 1, 2, 3 and Sky Sports Xtra); and

(e) Sky Sports Pack and Movies Pack.

6.23 As regards the second point, Virgin Media considers that the retail-minus methodology should be calculated for each of the bundles of premium channels outlined above (and any others which Sky introduces in the future) where they are supplied within entry-level

[103] Second Consultation Document, paragraph 9.69.

"triple-play" packages (i.e. in combination with telephony and broadband). Customers are increasingly opting for triple-play packages (as acknowledged by Ofcom[104]), and it is essential that the regulated wholesale price for premium content is set at a level which allows rival retailers to assemble comparable bundles to those offered by Sky. In this regard, Virgin Media notes that Ofcom is concerned as to the possible effects on the broadband market of limited distribution by Sky of premium content.[105] Virgin Media considers that setting wholesale prices in relation to Sky's triple-play bundles, thereby allowing rivals to make a reasonable retail margin in supplying comparable bundles, will assist in reducing this risk.

6.24 Having said this, it would be impractical to set regulated prices in relation to all possible triple-play bundles. Virgin Media considers, therefore, that the retail-minus methodology should be calculated in relation to the price of retail bundles containing the premium elements described in paragraph 6.22 above where the non-premium elements (i.e. basic, telephony and broadband) are supplied by Sky at their lowest tier. For example, the Sky Sports Pack is made available by Sky within a retail bundle which includes one basic entertainment pack (i.e. the lowest level of basic content), and the lowest tiers of broadband (Sky Broadband Base) and telephony (Sky Talk Freetime).[106] This bundle should be used to calculate a wholesale price for the Sky Sports Pack[107] as opposed to a retail bundle which includes further basic packs and a higher tier of broadband and telephony. Similarly, where Sky supplies the Sky Sports Pack together with the Movies Pack in a bundle with the lowest tiers of basic content, broadband and telephony, this should provide the basis for the calculation of a regulated wholesale price for the combined sports and movies elements of the package rather than a bundle featuring these premium elements together with higher tiers of basic content, broadband and telephony.

6.25 As noted above, this will allow rival retailers to compete effectively by offering comparable bundles to those of Sky. In particular, rival retailers could combine their own basic, telephony and broadband offers with the core premium content supplied under regulated terms by Sky. The retail prices which Sky charges for packages of channels will reflect, in part, the bundling efficiencies available to Sky from assembling these bundles. By applying the retail-minus calculation to bundled prices, efficiencies will also be reflected, to some extent, in the regulated wholesale price, and rival retailers will be able to compete on a level playing field in pricing their own bundles to reflect these efficiencies. Virgin Media also considers that this approach will limit Sky's ability to game the wholesale prices of premium channels because the wholesale prices will be directly linked to the retail packages which are likely to be the most competitively priced.

6.26 By linking the retail-minus calculation to prices which exist in the market, Ofcom also avoids the problem of having to identify a stand-alone retail price, which might involve Ofcom requiring Sky to offer the relevant channel(s) to retail customers on a stand-alone basis. In those circumstances, Virgin Media considers there to be a high likelihood of gaming behaviour by Sky which might necessitate an extension of the regulatory regime to encompass retail prices. For example, if Sky was required to offer Sky Sports 1 on a

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104 Second Consultation Document, paragraph 7.105.

105 Second Consultation Document, paragraph 7.106: "*Although there are limits to the parallels between broadband and premium content – for example, the barriers to entry are very different – we see risks to the strength of competition between tripe-play operators if distribution of premium content remains limited. We would be concerned if the effects we have identified of limited distribution of premium content were to be extended to other markets such as broadband*".

106 Sky markets this bundle as containing one Entertainment Pack and the Sports Pack for £36 with the broadband and telephony elements supplied with no extra charge.

107 This is consistent with Virgin Media's position that the WMO should apply to all individual channels retailed to customers containing live FAPL content (in this case Sky Sports 1 and Sky Sports 2), as well as to any premium sports channel that was bundled at the retail level with a sports channel containing live FAPL content (in this case Sky Sports 3). See Section 3 of this Submission.

stand-alone basis, it might set a retail price of £27.99 per subscriber a month as compared to a price of £28.00 for a bundle of Sky Sports 1, basic channels (one mix), telephony and broadband. Sky could thereby ensure that the retail price used to calculate the wholesale price was as high as possible whilst ensuring that its customers are incentivised to choose the bundle and thereby avoid the high retail price. In order to address this problem, Ofcom would need to establish pricing rules relating to retail prices which would introduce an additional level of complexity to the regulatory regime.[108]

In setting the "minus" Ofcom should have regard to competitors' costs

6.27 Ofcom has asked for views on whether, in applying a possible retail-minus methodology, it should have regard to the costs of an efficient large-scale operator, or whether it should set a price based on a forward-looking view of a new entrant's costs.[109]

6.28 Given the objective of promoting retail competition, Virgin Media considers that Ofcom should use a cost benchmark that is not solely based on Sky's retail costs to determine the "minus". In particular, Virgin Media considers that Sky, as the incumbent operator with the largest pay TV subscriber base, has a significant advantage both in terms of its large subscriber base and the range of products and services over which common costs can be recovered (i.e. it benefits from significant economies of scale and scope). In this regard, smaller rivals and new entrants may be efficient operators given their size, but they cannot yet replicate the economies of scale and scope available to Sky which would require a product portfolio and subscriber base equivalent to that which Sky has developed over many years. An approach which reflects the costs of smaller scale operators promotes competition as it allows rival retailers to recover efficiently incurred distribution costs, notwithstanding that they cannot yet achieve the economies of scale and scope available to Sky.

6.29 More generally, in calculating the "minus" from a bundled retail price, Ofcom will need to deduct the costs that would be incurred by rival pay TV retailers when offering Sky's premium channels in competition with Sky's retail services. In particular, the following will need to be deducted:

(a) VAT on Sky's retail price for the bundle;

(b) the wholesale costs of the non-premium elements of the package (e.g. basic channels);

(c) the net costs of all other services included in Sky's retail bundle (e.g. broadband and telephony);

(d) subscriber acquisition costs;

(e) subscriber management costs;

(f) conditional access and electronic programme guide costs;

(g) network costs;

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108 Ofcom would also need to implement a well-defined audit regime (as acknowledged in paragraph 9.93 of the Second Consultation Document). In this connection, Virgin Media envisages significant implementation issues with Ofcom's option (i) for an audit regime (i.e. Sky negotiates reporting and auditing procedures with each retailer) as it may lead to prolonged negotiations and potential disputes. Ofcom's option (ii) (i.e. Sky defines generic reporting and audit procedures to be used by all retailers) may be workable if Sky is required to consult with industry and appoints an independent firm to implement the audit. However, in any event it may result in prolonged negotiations and potential disputes. If option (ii) was invoked (i.e. Ofcom designs the audit scheme and appoints an independent audit firm), Virgin Media would expect to be consulted on the generic principles.

109 Second Consultation Document, paragraphs 9.56 and 9.60.

(h) an appropriate allocation of general overheads; and

(i) an allowance should be made for a reasonable profit margin on retail activities.

The cost–plus cross-check will require careful analysis of Sky's wholesale costs and additional regulatory measures will be required to address gaming by Sky

6.30 As noted above, the cost-plus cross-check is important to ensure that the gross retail margin which is earned by Sky is not significantly different from that of other retailers. The assessment will require information from Sky on its wholesale costs. The most significant of these will be rights expenditure, and there will need to be an assessment of the appropriate basis for allocating these costs between different premium channels. The inclusion of overhead costs will need to be scrutinised to ensure that this reflects only those costs associated with Sky's wholesale business and not those relating to the operation of Sky's pay TV platforms and the retailing of pay TV services. A reasonable wholesale margin should also be included.

6.31 Having established the total relevant wholesale costs on the basis of these components, Ofcom will then need to deduct relevant non-residential pay TV revenues including advertising and commercial subscriptions (again apportioned between the relevant Sky premium channels). The resulting (net) cost figure represents the sum that could be recovered from wholesale pay TV revenues which should be apportioned over all premium subscribers to establish the cost-based cross-check of the per subscriber wholesale price calculated using the retail-minus methodology.

6.32 It will be vital to verify the cost information submitted by Sky for this purpose in order to counter any gaming by Sky – in particular, any over-statement of wholesale costs. Virgin Media considers that independent assessment of the cost information will be required, and any such review cannot be confined to the pay TV business but will also need to examine how cost and revenues are allocated between Sky's other businesses. In short, accounting separation between Sky's different businesses will be required to allow verification of the information submitted by Sky, as well as transparency in relation to cost and revenue allocations. Such accounting separation is far from novel. Indeed, it has been applied to Sky in the past. Accounting separation was applied to Sky's broadcasting and distribution business between 1995 and 2002 following Sky's undertaking to the OFT to prepare separate accounts for its broadcasting entity (**"BroadCo"**) and its distribution entity (**"DisCo"**).[110]

6.33 Given the scope for Sky to allocate costs and revenues in ways which serve its interests, the items which Sky chooses to include and exclude should be set out in detail, reasons should be given as to the basis of any allocations, and if the results are particularly sensitive to any assumptions then these should be subject to close scrutiny. This process will be most effective if such matters can be disclosed to Virgin Media (and other relevant retailers) and they can comment on the validity of any such modelling assumptions applied by Sky.

6.34 Virgin Media notes, in this regard, that despite a lengthy Market Investigation which commenced in March 2007, Ofcom has been unable to reach a definitive view on whether Sky has made excessive profits (either in relation to the premium content wholesale business, or for the Sky business overall). This is attributed to difficulties and ambiguities relating to the financial information (in particular cost and revenue allocations and asset valuations). Overcoming these difficulties will be paramount in the success of any price control regime, and a tightly supervised audit process, and one in which Virgin Media (and other relevant retailers) can provide their input, is therefore essential.[111]

110 Accounting separation is currently only applied in respect of Sky's Technical Platform Services (**"TPS"**) activities.

111 Virgin Media acknowledges that Ofcom will need to balance its (Virgin Media's) wishes for greater transparency with

6.35 Ofcom indicates that accounting separation may be required as part of the wholesale regime "*to ensure that internal transfers are also charged at rate-card prices*".[112] Virgin Media agrees with this proposal. Accounting separation will increase transparency and facilitate enforcement of the wholesale remedy. It needs, however to be independently audited to tight audit standards and reconciled to statutory accounts.

The mechanism for adjusting prices going forward should give security in relation to wholesale prices

6.36 The Second Consultation Document highlights the benefits to pay TV operators of a WMO remedy which increases rival retailers' confidence as regards their ability to secure wholesale access to premium content on competitive terms. It states:

> "[t]*he existence of such an obligation, with defined terms of supply, in particular with respect to price, should also add to the level of confidence retailers have around access to premium content. This should enable them to develop long-term strategies which involve premium content, rather than facing the uncertainty of not knowing how negotiations with Sky might turn out, or how long they might take*."[113]

6.37 Virgin Media considers such confidence to be vital in promoting effective competition between rival retailers. In particular, in order to make investment decisions relating to customer acquisition or technology improvements, pay TV operators require stability and certainty as regards wholesale prices and indeed other features of the WMO including channels, HD, interactive features, security specifications and technical considerations.

6.38 Accordingly, Virgin Media considers that the price adjustment mechanism should take the form of a regular assessment of retail costs (based on historic costs) which would be deducted from Sky's prevailing retail price to give the regulated wholesale price. The deduction would be tied to the retail price such that if Sky attempted to flex its own retail prices in order to affect the retail margin available to its competitors, then the allowed wholesale price would be adjusted in line with the changes to the retail price as follows:

(a) if Sky lowers its retail price then the retail-minus deduction should be performed in relation to the new retail price and the new wholesale price should be introduced immediately in order to allow rival pay TV retailers to be able to compete directly with Sky's new retail price; and

(b) if Sky increases its retail price, then this should also, in due course, generate a correspondingly higher wholesale price. In this case, however, Virgin Media considers that competing retailers should be given a reasonable period of notice in respect of such an increase (for example not less than 90 days). This notice period is required because rival retailers will set their own retail prices partly on the basis of their wholesale costs, and will therefore need a reasonable period within which to consider their pricing strategy, and effect any changes that might be required. In relation to non-price terms, in order to provide sufficient security of supply (such as notifying customers), Virgin Media would expect 12 months' advance notice of any change.

6.39 In short, Virgin Media favours an approach which fixes the retail margin on a regular basis.

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the need to respect Sky's commercial confidentiality. It may therefore be helpful to use an independent body to review the analysis and to publish the conclusions of the independent body on the validity of the cost assessment exercise.

112 Second Consultation Document, paragraph 9.52, third bullet point.

113 Second Consultation Document, paragraph 8.84.

A constraint on price is insufficient on its own and must be accompanied by regulatory direction as regards important non-price elements of supply

6.40 As acknowledged by Ofcom, a regime which specifies wholesale prices is not sufficient on its own. The wholesale regime will also need clarity as to the specific products and services and key elements of product quality which Sky will be obliged to supply on a fair, reasonable and non-discriminatory basis. The non-price issues are discussed in the remaining Sections of this Submission.

7. WHOLESALE MUST-OFFER OBLIGATION – SCOPE OF REGULATED SERVICE

Introduction

7.1 This Section considers the range of content that the WMO should regulate. In particular, this Section discusses in turn:

(a) premium sports channels;

(b) premium movie channels (linear service);

(c) SVOD movie rights;

(d) HD channels;

(e) interactive features; and

(f) commercial premises.

Premium sports

7.2 Virgin Media has set out in detail in Section 3 above the importance of access to a range of premium sports content. In this context, Virgin Media has referred to a wide range of evidence supporting its view that the value of Sky's premium sports channels to consumers (and their resulting willingness to pay for those channels) is derived from the wide range of attractive sports content broadcast on those channels. This evidence demonstrates that the value, popularity and resulting importance of the Sky Sports channels do not relate to one particular set of content rights, but rather to the range of aggregated content rights that Sky has secured and marketed.

7.3 Further, it is clear that Sky's market power arises from Sky's ability to aggregate a compelling portfolio of sports content and that a rival retailer unable to offer a comparable bundle would be unable to compete with Sky, even if it were to be supplied with channels containing live FAPL content. It is therefore essential that any remedy seeking to address Sky's market dominance should address not only the availability of FAPL content but also the range of premium sports which are currently available on Sky's sports channels.

7.4 Accordingly, Virgin Media is of the strong view that it would be entirely inappropriate for Ofcom to limit the WMO to Core Premium Sports only. As discussed in paragraphs 3.58 to 3.72 above, if the WMO was limited to Core Premium Sports, Virgin Media considers that:

(a) first, the adverse effects on competition arising from Sky's market power in the wholesale and retail supply of premium sports channels, and the resulting consumer harm, would not be addressed; and

(b) second, Sky would be well placed to undertake a variety of gaming strategies that would enable it to undermine entirely the efficiency of the WMO regime.

7.5 Against this background, Virgin Media considers that there are two potential solutions to these fundamental concerns (as set out in paragraph 3.73 above), namely:

(a) first, the WMO remedy should extend to all of Sky's sports channels (this is Virgin Media's preferred solution and the most direct way of addressing Sky's dominance); or

(b) second, the WMO regime should apply to any sports channel that contains live FAPL content **and** to any premium sports channel that is bundled at the retail level with any sports channel that contained live FAPL content.[114]

7.6 Virgin Media discusses the extent to which the WMO should apply to HD sports services from paragraph 7.30 below and certain interactive services related to sports from paragraphs 7.43 below.

Premium movies (linear)

7.7 Virgin Media agrees with Ofcom that the WMO must extend to the Core Premium Movies, i.e. the linear Sky Movies service, as identified by Ofcom. However Virgin Media notes that, despite Ofcom's acknowledgement that it reserves the right to review its assessment of Sky's market power in the wholesale supply of Core Premium Movies channels, there are no reasons for believing that the situation will change materially in the foreseeable future. Further, even if circumstances did change, a very material change in the competitive situation (i.e. the acquisition by an entity other than Sky of the movie output of at least three Major Hollywood Studios) would be required before there was any reason for Ofcom to revisit its assessment of market power. This is discussed in detail in Section 4 above.

7.8 Virgin Media discusses the extent to which the WMO should apply to wholesale SVOD movies from paragraph 7.9 below. Virgin Media discusses the extent to which the WMO should apply to HD movie services from paragraph 7.30 below and certain interactive services related to movies from paragraph 7.43 below.

Wholesale SVOD movies service

7.9 Ofcom has indicated that it may be appropriate to require Sky to launch a wholesale Subscription Video On Demand (**"SVOD"**) service[115] which includes all relevant premium movies to which it has relevant SVOD rights.[116] Virgin Media fully supports this proposal, which is entirely consistent with Virgin Media's observations that the offer of an SVOD movie service in the UK is materially constrained by Sky's exclusivity in the first pay TV subscription window.[117]

7.10 In this context, Virgin Media addresses below:

(a) why the proposed WMO regime should require Sky to offer a wholesale SVOD product; and

(b) why such an approach is consistent with Ofcom's past regulatory practice.

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114 In this context, bundling must include "mixed bundling". As recognised by the OFT,"[m]*ixed bundling refers to the situation where two or more products are offered as unbundled (i.e., undiscounted) products and simultaneously offered together at a price less than the sum of the individual product prices (i.e., discounted)*" (Office of Fair Trading, Case No. CA98/20/2002, *Decision of the Director of Fair Trading – BSkyB investigation: alleged infringement of the Chapter II prohibition*, 17 December 2002, paragraph 548).

115 Virgin Media has not addressed, at this stage, the form of such a wholesale SVOD product. For example, it will need to be considered whether Sky would create a branded service or simply provide the relevant movie content to be packaged by the relevant retailer.

116 Second Consultation Document, paragraphs 9.49-9.50.

117 See, in particular, Virgin Media's Supplementary Submission, Section 5.

Why Sky must be required to launch a wholesale SVOD product

7.11 In Section 5 of its Supplementary Submission of 15 August 2008 (the **"Supplementary Submission"**), Virgin Media sets out *inter alia* the importance of Video On Demand (**"VOD"**) services and, in particular, of SVOD movie services. In summary, there is clear evidence of a shift in demand away from linear television content and traditional fixed time viewing to VOD services generally. The major limiting factor of a linear broadcast from a viewer's perspective is that viewers do not have flexibility as to when they watch individual programmes since individual programmes are only available at the time slots determined by the broadcaster. However, consumers are increasingly demanding the ability to choose what content they wish to view and at what time they watch it. They also seek to control the way content is viewed (e.g. they wish to be able to pause it, rewind it, etc.). VOD services increase the choice and flexibility of entertainment options available to consumers.

7.12 In particular, there is a strong demand for SVOD as customers in the UK show a clear preference for subscription services over PPV services. An SVOD movie service would be an extremely compelling proposition by enabling customers to watch a movie of their choice at their convenience and without paying an additional specific fee per movie. This is shown by the following points, amongst others:

(a) [**CONFIDENTIAL**];

(b) [**CONFIDENTIAL**];

(c) [**CONFIDENTIAL**].

7.13 The above points are reinforced by the importance of SVOD in the other EU Member States, in particular France and Germany, and in the US, where all three major pay movie networks (HBO, Showtime and Starz!/Encore) provide SVOD movie services.

7.14 As demonstrated in paragraphs 5.30 to 5.44 of Virgin Media's Supplementary Submission, Sky has sought to overcome the inherent limitations of its own VOD offering through exerting its purchasing power with the movie studios to deprive its competitors of attractive content for VOD services. Specifically, the exclusive rights secured by Sky from the Major Hollywood Studios in the first pay TV window prevent simultaneous SVOD exploitation by any other broadcaster or platform. As a result, Virgin Media is able to access, and offer to consumers, new release VOD movies only on a PPV (transactional model) basis.

7.15 Separately, in many instances, Sky may not possess SVOD rights but, instead, has "holdbacks" in respect of such rights which prevent the relevant Major Hollywood Studios from licensing SVOD rights to third parties. In these circumstances, third parties will not be able to acquire the relevant SVOD rights. Nor, however, would Sky be able to provide an SVOD service (whether wholesale or retail) which includes the content subject to the holdback. Sky's holdback provisions therefore prevent the development of SVOD services, thereby restricting the choice of services available to consumers, and insulate its own existing linear movie services from competition.

7.16 As Ofcom observes,[118] Sky is in any event technologically constrained from being able to offer the most flexible form of VOD ("true" TV VOD service which would *inter alia* allow viewers to watch whatever movies they want when they want). The DSat platform does not have the necessary "return path" to offer true VOD. In addition, even Sky's proposed VOD service via Sky Broadband will have several limitations. For instance, if a customer lives more than a few miles from the exchange, he or she may not be able to receive the

118 Second Consultation Document, paragraph 9.50.

service. As Ofcom also points out, in addition to being unable to offer a true retail SVOD service, Sky would have limited incentives to offer a wholesale SVOD service.[119]

7.17 As a consequence, in the absence of intervention by Ofcom, there is a real prospect that UK viewers will be denied access to the type of SVOD movie service for which there is a clear demand and which Virgin Media would be able and willing to provide in the UK (in contrast to Sky, Virgin Media offers true VOD through its hybrid coaxial (or HFC) cable).

7.18 In order to ensure that this detriment does not occur, Ofcom should require Sky to launch an SVOD service which includes all relevant premium movies to which it has relevant SVOD rights. This service should be made available to all pay TV retailers and all platforms capable of supporting an SVOD service (including cable, DTT, Internet Protocol Television (**"IPTV"**), and PC website-based services). In addition, in order to prevent Sky from circumventing the obligation to provide an SVOD service, it will be necessary for Ofcom to address Sky's holdback provisions addressed at paragraph 7.15 above.

Ofcom has previously mandated the offer of wholesale products in the past

7.19 The proposal that Ofcom should require an electronic communications provider to provide a new wholesale product is of course far from novel. In this respect, Ofcom and Oftel have required BT to provide new wholesale products which BT was unwilling to provide on a voluntary basis and which BT did not require in order to provide its own retail services. By way of example, Oftel has required BT to provide *inter alia* the following products or services which BT did not previously provide:

(a) a new Wholesale Line Rental (**"WLR"**) product;

(b) Local Loop Unbundling (**"LLU"**); and

(c) Partial Private Circuits (**"PPCs"**).

Wholesale Line Rental products[120]

7.20 In August 2002, Oftel modified BT's licence to require it to provide a new WLR product which would stimulate competition by allowing alternative providers to rent access lines on wholesale terms (with charges set by Oftel) from BT, and to resell the access lines to the end user, enabling alternative suppliers to provide a single bill covering both line rental and telephone calls. Oftel's determination resulted from its finding in June 2002 following its review of the fixed telephony market that BT had significant market power (**"SMP"**) in the provision of both calls and access.[121]

7.21 BT had been unwilling to provide such a wholesale product and the product which it did provide was of poor quality. Specifically, BT had first launched a "Calls and Access" resale product in October 1998 (partly under pressure from Oftel). However, uptake of this product was found by Oftel to be very limited, primarily due to the product's high price and poor in-life processing. Calls and Access failed to attract any major branded service providers to the market and a number of issues were raised with Oftel in the year following its introduction. As late as 2002, BT maintained that issues such as ensuring scalability on this product could be dealt with by co-operation and without the need for regulatory action.

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[119] Second Consultation Document, paragraph 9.50.

[120] See Ofcom, *Consultation on undertakings offered by British Telecommunications plc in lieu of a reference under Part 4 of the Enterprise Act 2002*, 30 June 2005, Annex G *An Analysis of the deployment of Wholesale Line Rental (WLR).*

[121] One of the reasons for this was that BT could provide a bundled calls and access service, which gave it a significant competitive advantage over other service providers.

7.22 These issues continued even after the mandated introduction of the new WLR product and Ofcom's Strategic Review of Telecommunications (the **"SRT"**) found in 2005, amongst other problems with the WLR product, that BT continued to supply an inferior product to alternative providers.[122] Specifically, Ofcom noted in the SRT that the combination of BT's enduring upstream market power and vertical integration had not given BT the incentive to develop a fit-for-purpose WLR product. As such, this was one of the factors which led to the requirement in BT's 2005 undertakings that BT must *inter alia* apply equivalence of inputs to various WLR products.

Local Loop Unbundling[123]

7.23 Following a consultation period in 1998-99, Oftel imposed a requirement on BT in November 1999 to offer LLU.[124] Oftel's aim was to ensure that BT should make its local loops available to other operators in order to allow them to compete directly with BT in providing higher bandwidth access.

7.24 Due to its vertically integrated structure, BT did not require an LLU product in order to supply wholesale broadband services to its own retail divisions (it supplied these divisions with a downstream, end-to-end product called "IPStream"). As with WLR, BT had been unwilling to provide LLU and did not provide LLU until it was mandated to do so, seeking instead to supply alternative providers with a wholesale end-to-end broadband product managed by BT.

7.25 Ofcom's SRT found in 2005 that there were substantial delays in the provision of LLU in part as a result of the breakdown of commercial negotiations to resolve the technical issues involved in supplying LLU.[125] Specifically, Ofcom noted in the SRT that the combination of BT's enduring upstream market power and vertical integration had not given BT the incentive to introduce LLU and to resolve the significant technical issues that had arisen as a result of its introduction. As such, this was one of the factors which led to the requirement in BT's undertakings in 2005 that BT must *inter alia* apply equivalence of inputs to various LLU products including Metallic Path Facility and Shared Metallic Path Facility.

Partial Private Circuits[126]

7.26 In December 2000, Oftel issued a statement and draft direction regarding national leased lines in which it directed BT to negotiate with industry the terms and conditions of supply for a range of PPC wholesale products. The statement and draft direction of December 2000 were followed by a permanent direction in March 2001 and, subsequent to negotiations between BT and the alternative network operators, wholesale PPCs were introduced in August 2001.[127]

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122 Ofcom, *Consultation on undertakings offered by British Telecommunications plc in lieu of a reference under Part 4 of the Enterprise Act 2002*, 30 June 2005, pages 76-79.

123 See Ofcom, *Consultation on undertakings offered by British Telecommunications plc in lieu of a reference under Part 4 of the Enterprise Act 2002*, 30 June 2005, Annex I, *An Analysis of the deployment of Local Loop Unbundling (LLU)*

124 Oftel, Policy Statement 11/99, *Access to Bandwidth: Delivering Competition for the Information Age*, November 1999.

125 Ofcom, *Consultation on undertakings offered by British Telecommunications plc in lieu of a reference under Part 4 of the Enterprise Act 2002*, 30 June 2005, Annex I, *An Analysis of the deployment of Local Loop Unbundling (LLU)* pages 92-96.

126 See Ofcom, *Consultation on undertakings offered by British Telecommunications plc in lieu of a reference under Part 4 of the Enterprise Act 2002*, 30 June 2005, Annex K *An Analysis of the deployment of Partial Private Circuits (PPCs)*.

127 Oftel, statement and draft direction, *National Leased Lines*, December 2000; Oftel, *Direction under Condition 45.2 of the Public Telecommunications Licence granted to British Telecommunications plc*, March 2001.

7.27 BT did not provide wholesale PPCs before it was mandated to do so as a regulatory remedy. The rapid take-up of PPCs once they were introduced (at all bandwidths) illustrated the strength of demand for such a product.

7.28 Further, Ofcom noted in the SRT that the combination of BT's enduring upstream market power and vertical integration had not given BT the incentive to resolve the outstanding issues with PPC products.[128] Although Ofcom considered it impractical to require equivalence of input to be applied to these products (as they were likely to be replaced over time by Ethernet-based products), BT's undertakings of 2005 required BT to increase the level of transparency regarding the network inputs that it supplied to its own downstream divisions.[129]

7.29 In summary, as demonstrated above, where (as in this case) Ofcom and its predecessors have concluded that a vertically integrated operator has market power and no, or limited, incentive to make a wholesale product available to downstream competitors, they have been willing to mandate that the vertically integrated operator make available a wholesale product to rival retailers. This has been the case even where the vertically integrated operator does not need an equivalent to the wholesale product in order to supply retail customers. In short, there is ample precedent to justify Ofcom imposing a requirement on Sky to supply a wholesale SVOD movie service.

HD content

7.30 Ofcom has reached the view in the Second Consultation Document that it "*would expect the* [WMO] *to include high definition ('HD') versions of channels*".[130] In this regard, Ofcom specifically comments:

> "[a]*ny wholesale must-offer obligation would be likely to require Sky to make available all channels containing specified content, including some form of non-discrimination provision. If the technical quality of the channels which Sky makes available to others were lower than the technical quality of the channels which it made available to itself, this would be likely to constitute discrimination. On this basis it would not be appropriate for Sky to make channels available to itself in HD, and others only in SD.*"[131]

7.31 Virgin Media agrees with Ofcom's observation that the WMO should extend to HD versions of the content provided under the WMO, i.e. in relation to both premium sports and premium movies content channels. In this regard, in support of Ofcom's view, this Section of the Submission:

(a) summarises why HD content is important and why HD content should be included in the WMO; and

(b) explains why there are no technical or other issues which prohibit the inclusion of HD services in the WMO.

7.32 Each of these issues are considered in turn below.

Importance of HD content and why it must be included in the WMO

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128 Ofcom, *Consultation on undertakings offered by British Telecommunications plc in lieu of a reference under Part 4 of the Enterprise Act 2002*, 30 June 2005, Annex K *An analysis of the deployment of Partial Private Circuits (PPCs),* page 104.

129 Ofcom, *Consultation on undertakings offered by British Telecommunications plc in lieu of a reference under Part 4 of the Enterprise Act 2002*, 30 June 2005, page 20.

130 Second Consultation Document, paragraph 1.49, third bullet point.

131 Second Consultation Document, paragraph 9.40.

7.33 HD channels are an important component of a pay TV service and are becoming more important as HD TV sets, and HD TV technology become increasingly ubiquitous across the UK.[132] Virgin Media understands that currently there are approximately 15 million HD-ready TV sets in the UK, and that 80 per cent of these sets are primary sets. Virgin Media expects this HD TV sets penetration to increase as HD TV sets continue to reduce in price.[133] The importance of HD is also consistent with Sky's behaviour, in particular the fact that it heavily promotes its HD services, both via large-scale marketing campaigns and reductions in the cost of its Sky+HD set top box.[134]

7.34 Against that background, consumers will always gravitate towards platforms and services which offer the most advanced viewing experience, and HD services are an effective means by which consumers are able to distinguish dated services from forward-looking future-proofed services. Accordingly, in order to be able to attract and maintain subscribers it is important, and will become more important, for pay TV retailers to offer HD services. This is particularly so given that Virgin Media can envisage that, at some point in the future when HD TV sets have reached sufficient penetration, Sky may offer some content in HD format only. Accordingly, pay TV retailers without access to Sky's HD services will not only suffer from a lack of access to HD versions of Sky's premium channels, but may also lack access to certain content. Against this background, if pay TV retailers are to be able to compete effectively with Sky at the retail level, it is essential that relevant HD content be provided as part of the WMO regime.

7.35 [**CONFIDENTIAL**].

7.36 [**CONFIDENTIAL**]:

(a) [**CONFIDENTIAL**];

(b) [**CONFIDENTIAL**].[135]

7.37 [**CONFIDENTIAL**][136] [**CONFIDENTIAL**]:

(a) [**CONFIDENTIAL**];

(b) [**CONFIDENTIAL**];

(c) [**CONFIDENTIAL**];

(d) [**CONFIDENTIAL**];

(e) [**CONFIDENTIAL**].

7.38 [**CONFIDENTIAL**].[137] [**CONFIDENTIAL**].

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132 Ofcom has recognised "*the increasing popularity of high-definition (HD) services, backed by rising take-up of HD-ready sets …*[and] *increasing numbers of HD subscribers*". See Ofcom, *The Communications Market 2008,* August 2008, page 158.

133 As noted by Ofcom, "[p]*rices of Digital and HD-ready sets have also come down significantly in recent years, providing a boost to sales*". See Ofcom, *The Communications Market 2008*, August 2008, page 213. Indeed, at page 116 (Figure 2.65) of that report, Ofcom records that since 2003 the average price of a HD TV set has reduced from almost £6000 to approximately £500.

134 Indeed, Ofcom's records that Sky's HD subscribers more than doubled from Quarter 4 in 2006 to Quarter 4 in 2007. See Ofcom, *The Communications Market 2008*, August 2008, Figure 3.2.

135 [**CONFIDENTIAL**].

136 [**CONFIDENTIAL**].

137 [**CONFIDENTIAL**].

Supply of HD content is feasible

7.39 There are no technical or other issues which would prevent the inclusion of HD services in the WMO. In this connection, Virgin Media already currently successfully offers a number of HD linear and HD VOD services on its platform, including a linear service from the BBC and VOD HD services from Filmflex, HBO Warners, BBC (iPlayer) and Channel 4 (4oD). [**CONFIDENTIAL**]. Against this background, Virgin Media is confident that there are no insurmountable technical or capacity constraints to providing further HD services under the WMO regime.

7.40 By way of background technical information, Virgin Media uses MPEG-2 video compression for all its SDTV and HDTV services (including VOD content). This differs from Sky which uses MPEG-4 video compression for all of its HD channels and generally MPEG-2 video compression for Standard Definition (**"SD"**) channels. MPEG-4 was developed a decade after the MPEG-2 system and it offers approximately 30 to 50 per cent increased efficiency over MPEG-2. The fact that MPEG-4 is a more efficient compression system does not, however, give Sky's HD services better picture quality.

7.41 The difference between Sky's MPEG-4 technology and Virgin Media's use of MPEG-2 technology does, however, affect how Virgin Media needs to receive the broadcast feed to ensure an equivalent picture quality to that provided by Sky. In relation to SDTV channels carried on Virgin Media, these are acquired via DSat in MPEG-2 without any need for repurposing the video (i.e. re-encoding the video signal). If HD channels were to be acquired via DSat it would be necessary for Virgin Media to re-encode the channels from MPEG-4 to MPEG-2, [**CONFIDENTIAL**], HD content supplied by Sky to Virgin Media would need to be acquired uncompressed at the "factory gate". This would require delivery of uncompressed HD channels by Sky over fibre from a play-out centre (this is currently how the BBC supplies HD channels to Virgin Media). Virgin Media would arrange the compression of this uncompressed feed. This would allow Virgin Media to display HD content with a picture quality at least equal to that offered by Sky on DSat. Virgin Media has previously taken Sky's SD channels from Sky at the "factory gate", demonstrating that supply at the "factory gate" is practical.

7.42 Given the increasing importance of HD to consumers, and as a consequence of the Virgin Media pay TV business, Virgin Media has invested, and will continue to invest over the next few years, in increasing its ability to offer HD content. [**CONFIDENTIAL**].

Interactive features

7.43 Before setting out Virgin Media's views on which interactive services should be included as part of the WMO, it is necessary to clarify what is meant by "interactive services". "Interactive services" is a broad term that can be used to refer to different types of services. In this connection, Virgin Media broadly agrees with the distinction made by Ofcom between **"Primary Interactive Content"** and **"Editorial Interactive Content"**:

> "[w]*e see a broad distinction in this content between primary content and editorial content. By primary content we mean live footage where being able to show that footage is dependent on ownership of the rights in question. By editorial content we mean additional content which could in principle be generated by any other retailers.*"[138]

7.44 By way of illustrative example, there is a significant amount of Primary Interactive Content that forms part of the Sky Sports packages that is made available on Sky's DSat service. For example, it is common for certain Champions League games only to be available via the red button. In these circumstances, the red button actually routes customers to a separate linear broadcast stream. This Primary Interactive Content is

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138 Second Consultation Document, paragraph 9.43.

actually not a true interactive service, which typically use a two-way path between the viewer and broadcaster/TV platform, but instead merely enables customers to access hidden content. This type of service is used to access sporting events via the red button but is also used by Sky to offer its multi-start movie service. Sky currently only makes available this Primary Interactive Content on its Sky Sports and Sky Movies service on its own proprietary DSat service.

7.45 In contrast, Editorial Interactive Content includes access to services such as betting and purchase of additional services. Such services enable two-way interaction between the viewer and either the broadcaster/TV platform or third party.

7.46 It is clear that Ofcom considers that Primary Interactive Services, and not Editorial Interactive Services, should be included as part of the WMO. In this connection, at paragraph 1.49 of the Second Consultation Document, Ofcom states:

> "[w]*e would expect the* [WMO] *to include high definition ('HD') versions of channels as well as interactive ('red button') services where this is the means by which viewers can gain access to primary content. Interactive services which provide editorial content which could be replicated by other retailers would not have to be included*".

7.47 Further, at paragraph 9.44 of the Second Consultation Document Ofcom states that:

> "[c]*ontent requiring access to the primary rights should form part of any wholesale offer. For example:*
>
> - *Where two different live FAPL matches are shown at the same time, one on a premium channel, and one behind the red button on the same premium channel, then subscribers of all retailers must be able to view both matches, subject to any capacity constraints on some platforms.*
>
> - *Where one live FAPL match is being shown, and viewers are able to use the red button to access information about the teams, or place a bet on the result, then it is not necessary for subscribers of all retailers to do so.*"

7.48 Virgin Media considers that, at the very least, the WMO must be extended to include all services or features which enable viewers to access primary content, i.e. Primary Interactive Content.[139] However, Virgin Media also considers it essential that it is able to access Editorial Interactive Services where it would be unable to recreate or develop equivalent interactive services itself, e.g. because of a lack of the appropriate rights. This is consistent with Ofcom's observation that it should not require the provision of interactive services where those interactive services can be replicated by retailers.[140] In support of Virgin Media's view, this Section sets out:

(a) why it is essential for such interactive services to be included as part of the WMO regime;

(b) why there are no insurmountable technical or other issues which would prohibit the inclusion of such interactive content in the WMO; and

(c) what is Virgin Media's preferred technical solution to providing interactive services.

Interactive services must be included as part of the WMO

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139 A large amount of the Editorial Interactive Content available on, for example, Sky Sports is interactive content that primarily cross-sells and promotes Sky's products in general (for example HD channels and Sky's Sky+ set top box). Such content should not be included in the channels supplied by Sky under a WMO regime.

140 Second Consultation Document, paragraph 1.49, third bullet point.

7.49 As a starting point, Virgin Media considers it essential that Primary Interactive Content forms part of the WMO regime. As set out by Ofcom at paragraph 3.34 of the Second Consultation Document, content is the "*major driver behind consumers' selection of their pay TV service*". Further, "*the primary reason why consumers choose a particular retailer or a particular platform for their pay TV service is the choice of content that is available from that retailer, or on that platform*".[141] Further, Ofcom acknowledges that premium sports and movies content is particularly important in driving pay TV.[142] [**CONFIDENTIAL**].

7.50 If Primary Interactive Content is hidden behind a red button and not made available to third parties, third party retailers will be at a distinct disadvantage vis-à-vis Sky's DSat premium sports and movie services. Sky currently exploits this competitive disadvantage by heavily cross-promoting its enhanced and interactive services on the linear streams of its channels which it supplies to Virgin Media. [**CONFIDENTIAL**].

7.51 Sky's refusal to supply its interactive services to cable is clearly detrimental to customers. Subscribers to Sky premium sports and movies on the cable platform are deprived of access to the full service [**CONFIDENTIAL**]. As an obvious example, the lack of interactivity available to Sky Sports subscribers on the cable platform has enabled Sky to shift certain Champions League games behind the red button, therefore depriving Virgin Media customers of the ability to watch those matches.[143]

7.52 Further, Sky's behaviour has hindered the development of interactive services by denying third party platforms the ability to develop their own interactive services. Increased innovation and development of interactive features are likely to occur if access to the key content is provided under the WMO regime. As Ofcom states at paragraph 2.55 of the Second Consultation Document there is "*potential value for consumers in a wider range of broadcast packages which make use of the interactive capabilities of certain platforms, especially those based on cable or IPTV technology*".

7.53 [**CONFIDENTIAL**].

7.54 Against this background, it would be entirely inappropriate to leave the supply of Primary Interactive Content to commercial negotiations between Sky and other pay TV retailers – it is very unlikely that economic arrangements for the supply of Primary Interactive Content will be reached. This is a direct result of the clear disparity in bargaining power between Sky and competing pay TV retailers[144] and of Sky's incentive and ability, as a vertically integrated platform owner and content provider, to limit the quality and attractiveness of its channels to competing downstream platforms.[145]

7.55 Turning to the question of what Primary Interactive Content should be subject to the WMO regime, as highlighted in paragraph 7.48, Virgin Media's preferred solution and the most direct way of addressing Sky's dominance is that the WMO regime should be extended to all Primary Interactive Content linked to channels/packages subject to the WMO. This specifically includes Sky Sports channels including any sporting content hidden behind the red button or made available only to Sky's subscribers via any other interactive or quasi-interactive application. Likewise, the WMO regime must also apply to any Sky service

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141 Second consultation Document, paragraph 3.29.

142 Second Consultation Document, paragraph 3.31.

143 Virgin Media has provided Ofcom with copious evidence demonstrating the difficulties it has in relation to Primary Interactive Content. Sky/Virgin Media correspondence on this and related issues was submitted to Ofcom on 21 February 2008 in response to Ofcom's *Request for Further Information of 20 December 2007* (see Annex 8).

144 Ofcom has acknowledged the disparity in market power, see for example Second Consultation Document, paragraphs 5.88 to 5.89.

145 See July 2007 Joint Submission paragraphs 2.16 to 2.25 of Annex 6 and Virgin Media's *Consolidated Response to Ofcom's Request for Further Information of 20 December 2007* dated 21 February 2008, Part II, paragraphs 4.1 to 4.11.

containing content from one of the six Major Hollywood Studios and any movie from those studios hidden behind the red button (or via another quasi-interactive application).

7.56 Virgin Media sets out below the types of interactive services, as an absolute minimum, which it considers must form part of the WMO:

(a) Football First – this is Sky's highlights programme for FAPL matches which is first broadcast on Saturday evenings. All the FAPL matches which take place during each Saturday are included in Football First and can be accessed on satellite via an interactive application. Sky has historically refused to supply this interactive application and the additional audio/video streams to Virgin Media, so that Virgin Media's subscribers to Sky Sports are only able to access the one match which is shown on the linear stream of Football First that Sky supplies to Virgin Media;

(b) Champions League – Sky's live coverage of Champions League football includes every match other than the one or two matches which ITV shows in relevant weeks. As a consequence, on some days Sky broadcasts eight Champions League matches live more or less simultaneously. Sky satellite subscribers are able to choose which match to watch and can access it via an interactive application. As with Football First, Virgin Media is only supplied with the linear components of the channel and thus Virgin Media's subscribers to Sky Sports can only see the match which Sky broadcasts on the linear stream and are denied access to other Champions League matches which Sky broadcasts at the same time.

(c) other live sports event that Sky may in future hide behind a red button functionality. In this regard, Virgin Media is aware that, for example, in December 2008 certain European Rugby Cup (Heineken Cup), cricket and American football matches have been hidden behind the red-button.

(d) certain movies – Ofcom needs to exercise caution about the structure of the WMO in relation to interactive services in order to limit Sky's ability to undermine the efficacy of the WMO. Sky could undermine the WMO by, for example, premiering first-run pay TV movies on a Movie Multistart or other quasi-interactive service and then only later make these movies available on its standard linear Sky Movies channels. Under current market conditions, if Sky were to take this action, Sky Movies subscribers on the cable platform would not be able to access these movies until they became available on Sky's linear channels and, as a result, would not be able to access high-profile new releases until after DSat Sky Movies subscribers. The WMO must ensure that competing pay TV retailers such as Virgin Media can provide the full range of first-run movies to their subscribers at the same time as Sky's DSat subscribers are able to access this content. Where Sky supplies these rights first on a Multistart basis, Virgin Media must be able to provide this content to its Sky Movies subscribers on a similar basis at the same time. In short, third party retailers should be supplied with any premium movie subject to the WMO regime in the same window as Sky first shows this content regardless of whether it is shown on one of Sky's linear movies channels, behind the red button or to Sky Anytime subscribers.

7.57 Further, to the extent that Editorial Interactive Services cannot be replicated by Virgin Media (for example, as a result of rights restrictions) and Virgin Media desires to provide such services to its consumers, the relevant Editorial Interactive Services should be provided under the WMO. Such services, for example, player interviews and highlights of previous matches, can be very attractive to viewers and the lack of access to such services would undermine the overall Virgin Media offering relative to Sky's offering.

7.58 In conclusion, given the importance of content in driving pay TV, the WMO regime needs to ensure that the full range of premium sports and premium movies content available on the packages/channels that form part of the WMO are available to third party retailers.

No insurmountable technical issues/preferred technical solution

7.59 Paragraph 1.51 of Ofcom's First Consultation Document observes that: "*premium channels supplied by Sky to Virgin Media do not support the interactive capabilities of the equivalent satellite channels, and are not available in high definition. We acknowledge however that there may also be technical reasons (e.g. technical inter-operability, limitations on platform capabilities) why it may not be straightforward to supply certain enhanced content or value-added services to other platforms, and that this may at least in part explain the reduced capabilities of the channels which Sky supplies to Virgin Media*".

7.60 Virgin Media also notes Ofcom's observations at paragraphs 9.87 to 9.92 in the Second Consultation Document in relation to implementing a wholesale distribution of interactive content. Nevertheless, Virgin Media is confident that the cable platform is technically able to carry Sky's interactive and enhanced services. This is confirmed by Virgin Media's experience in providing interactive functionality on the cable platform.

7.61 As a preliminary observation, Virgin Media notes that the technical delivery issues as regards Primary Interactive Content are very limited. As discussed above, Primary Interactive Content is not true interactive content but merely access to a hidden broadcast stream via the red-button. A similar system could easily be implemented on the cable platform. The simplest and most cost effective way of ensuring access to the full range of content subject to the WMO regime for downstream pay TV retailers is for Sky to supply the raw feeds of the content hidden behind the interactive feed, or on other applications. Virgin Media, in this instance, could ensure that the red-button, linked to a channel tuning application, would direct viewers to an alternative broadcast stream for that content. The advantage of this option is that it will be easy to set up, manage and regulate. Competing platforms would be able to receive the content subject to the WMO regime with a limited ability for Sky to game the process by creating unnecessary technical hurdles. Competing platforms would then be able to develop their own interactive features around the key content.

7.62 Further, even where a channel offers true interactive features (i.e. requiring the development of platform specific applications) Virgin Media has been able, with the co-operation of the relevant content provider, successfully to offer a number of interactive services supplied by those third party content providers (such as BBC, ITV, Five, Cartoon Network, Euronews and AttheRaces). The BBC's interactive service on the cable platform is the most comprehensive with multi-screen applications, games services, news and text based information and voting systems.

7.63 Each of these content suppliers currently authors the individual applications and then re-configures the applications (sometimes with the help of a third party, with experience in cross-platform development) for different platforms. Although there can be slight differences in look and feel between the different platforms, these differences are minimal and do not affect the user experience. It is clear therefore that the technological issues relating to offering interactive services on different platforms can be addressed successfully. Indeed, in this regard there are third party providers of cross-platform development tools that could be used to develop interactive features. It is Virgin Media's understanding that these third party providers are able to develop software that enables content creators to write applications once, using a common language and then deploy them across several interactive TV platforms.

7.64 It should, however, be emphasised that the success in developing interactive applications on the cable platform requires co-operation from the relevant content supplier. This is normally not a barrier as content providers such as the BBC, ITV, Five, Cartoon Network, etc, have an incentive to develop such applications. Sky may not, however, have the same incentive to develop the necessary application interfaces in a timely and effective manner. Ofcom would, therefore, need to stipulate precisely the levels of co-operation expected of Sky and the timeframe within which the software development should take place. Ofcom will also need to put in place a fast and effective dispute resolution mechanism in the event that Sky chooses not to co-operate as required.

7.65 In summary, irrespective of the type of interactive service offered by Sky, Virgin Media has the technological capability to replicate those services on the cable platform. Whilst this may require a certain degree of co-operation on the part of Sky (which will vary depending on the type of interactive services), there are no technological reasons why the WMO regime should not extend to all Primary Interactive Content.

The scope of the remedy should extend to the commercial market

7.66 The Second Consultation Document acknowledges that Sky has an absolute monopoly position in the retailing of premium pay TV channels to commercial premises, which it (correctly) distinguishes from the retail residential market.[146] Notwithstanding this observation, Ofcom proposes to take no remedial action whatsoever in relation to this market on the ground that "*it is likely to be difficult to apply the same remedy to commercial customers as residential customers in a way which results in a positive outcome*".[147]

7.67 Ofcom advances two reasons for this provisional view. First:

> "[p]*ricing is not transparent, and varies significantly across the customer base. One type of customer is likely to be very different to another – for example a large hotel chain and a small pub. This would make any kind of determination of the price of a wholesale obligation, either on a 'retail-minus' or 'cost-plus' method, exceptionally difficult.*" [148]

7.68 Virgin Media does not share this view. Virgin Media understands that Sky's retail prices to commercial premises are based on premises' rateable values, although Sky might well choose to "flex" these prices for certain commercial customers (reflecting that even a complete monopolist, such as Sky, might want to optimise the premium which it can charge). There is no reason why a retail-minus methodology could not function by reference to a rate-card based on rateable values.

7.69 Secondly, Ofcom suggests that a "WMO" remedy might be less effective at engendering retail competition as regards the retailing of premium channels to commercial premises:

> "[t]*he challenges in the commercial sector exist not just at the wholesale level in terms of access to content, but also in terms of the route to market. We can see this in the fact that on acquiring the rights to its two packs of live FAPL matches, Setanta promptly chose to make a deal with Sky for the distribution of those matches in the commercial retail market. The contrast between residential and commercial is that in the residential sector, there are at least other viable competitors besides Sky – in the commercial sector, that is not the case. This raises the possibility that a wholesale obligation, even at a set price, would have no effect on retail prices, unless we were to contemplate the very interventionist prospect of retail price controls.*" [149]

7.70 Virgin Media considers that the absence of retail competitors in relation to the commercial market is driven in large part as a consequence of Sky foreclosing retail competition in the residential market. If a thriving and viable market in the retailing of premium pay TV channels were to be established in the larger residential market through an effective WMO, it would then be viable for pay TV retailers also to penetrate the retail market for

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146 Second Consultation Document, paragraph 9.16, second bullet point.

147 Second Consultation Document, paragraph 9.16.

148 Second Consultation Document, paragraph 9.16, first bullet point.

149 Second Consultation Document, paragraph 9.16, second bullet point.

commercial premises at relatively low incremental costs. Of course, such an outcome depends on the WMO remedy extending to commercial premises. The fact that Setanta has not chosen to compete independently as regards commercial premises must be judged by reference to the fact that:

(a) there are no retail competitors active in the commercial premises market so that in this market currently Setanta's sole route to market is through Sky, whereas this is not the case in the residential market; and

(b) it will be particularly important for commercial premises to have access to the most popular premium sports – which Setanta's channels, with their narrower portfolio of premium sports content, cannot deliver on their own. Setanta would, therefore, find it extremely challenging to offer a stand-alone retail service in the commercial premises market.

7.71 Virgin Media does not believe that Setanta's current inability to compete independently of Sky in the commercial premises market provides any evidence that retail competition cannot exist in this market. Instead it is the inevitable consequence of Sky's dominance and anti-competitive behaviour across both the residential and commercial premises markets.

7.72 Ofcom also observes that the concerns raised by the AMLR in relation to commercial premises related to high prices and not to a reduction in innovation and choice.[150] To the extent that, in making this observation, Ofcom is implying, or suggesting, that higher prices are either not a concern that should be addressed, or cannot be addressed through a wholesale remedy, this is misconceived:

(a) first, it is no surprise that the ALMR is concerned that Sky's market power has resulted in higher prices. High prices are arguably the most obvious manifestation of the exercise of market power. This does not, however, mean that such market power has not also resulted in a reduction in innovation and choice. To the contrary, in circumstances in which there is a single monopoly supplier of a service within a relevant market, there will clearly be no choice of supplier and it must be expected that there will be a reduction in innovation. Further, as regards innovation it may be difficult for ALMR and its members to identify what types of service they might expect in the presence of greater competition. On the other hand, when considering the residential market (in which there are either actual or potential competitors to Sky) those competitors are better placed to highlight and point out the lack of innovation and choice that has arisen from Sky's behaviour;

(b) higher prices are of equal concern in terms of consumer harm to a reduction in choice and innovation; and

(c) in any event, as the objective of a WMO regime is to introduce greater retail competition, such competition should be expected (if achieved) to deliver not only innovation and choice but also lower prices. In other words, a WMO regime should be expected to be equally effective in addressing high prices as in addressing a loss of innovation and choice.

7.73 Quite apart from the above observations, Ofcom has provisionally concluded that Sky's market power in the wholesale supply of Core Premium Sports and Core Premium Movies channels has led to a reduction of competition in the residential market in which there exists some (albeit very limited) retail competition. Even greater adverse effects on competition must be expected in retail markets in which Sky faces no retail competition. There is, therefore, no logical legal or economic reason why there is not at least an equal need to address adverse effects on competition in relation to the supply of the relevant

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150 Second Consultation Document, paragraph 9.16.

channels to commercial premises as there is to remedy the effects in the residential market.

7.74 Virgin Media considers that it would be an extraordinary outcome if Ofcom made no effort to engender some competition in the commercial premises sector. The complete absence of any retail competition in this sector does not reduce, but instead increases, the imperative for regulatory intervention. Extending the WMO remedy to this sector would be a proportionate response which should be pursued before Ofcom contemplates a greater level of regulatory intervention.

8. WHOLESALE MUST-OFFER OBLIGATION – SECURITY ISSUES

8.1 At paragraph 1.49 of the Second Consultation Document, Ofcom states:

> "[w]*e would expect Sky to be able to impose conditions on other retailers to ensure that the platforms being used to retail that content are secure, and that adequate processes are in place to protect against content piracy. We would need however to ensure that security is not used as a pretext to withhold content from specific retailers, and it may therefore be necessary to establish some form of dispute resolution process*".

8.2 In this regard, Ofcom suggests that:

> "[o]*ne approach to ensure consistency of security measures across the industry would be for each retailer to ensure that its chosen CA system complied with a defined set of Minimum Security Requirements (MSRs) and was incentivised to maintain the integrity of its chosen CA system. …the MSRs could form the basis of an agreement between Sky and each retailer for the supply of wholesale must-offer channels".*[151]

8.3 Virgin Media agrees with Ofcom's approach in principle. Providing for a proportionate approach to determining a set of Minimum Security Requirements (**"MSRs"**) will assist in preventing Sky, as it has in the past, from using security as a pretext for withholding content. In this regard, Ofcom sets out, at paragraph 9.82 of the Second Consultation Document, three different options as to how such MSRs could be defined.

8.4 The first option is that Sky defines the MSR by reference to a particular Conditional Access (**"CA"**) technology. In this scenario Sky would be fully responsible for the integrity of the CA system and would also be liable for any breaches. Virgin Media agrees with Ofcom that this would not be a preferred option.[152] In particular, and as noted by Ofcom, Virgin Media has heavily invested in its existing CA technology and it would be economically unviable for Virgin Media to swap out its incumbent system to Sky's NDA system. In addition, Sky has been prepared to supply premium channels to Virgin Media on the basis of its existing security arrangements for a number of years. It would, therefore, be wholly disproportionate to require those arrangements to be replaced.

8.5 The second option proposed by Ofcom would allow Sky to negotiate with each prospective retailer as to the terms of any MSR. Virgin Media considers that this option would be overly time-consuming and would inevitably allow Sky to use protracted negotiations on security arrangements to delay the wholesale supply of the relevant channels and undermine the efficacy of the WMO regime. Ofcom has already anticipated this concern.[153]

8.6 Ofcom's third option is that Sky defines a set of technology and platform agnostic MSRs and the retailers select a CA technology which they consider best fulfils these

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151 Second Consultation Document, paragraph 9.81.

152 Second Consultation Document, paragraph 9.83.

153 Second Consultation Document, paragraph 9.84.

requirements. Virgin Media considers that such an arrangement whereby a set of technology and platform agnostic MSRs are defined could be effective subject to a number of important caveats:

(a) contrary to Ofcom's suggestion, Sky should not be able to impose any MSRs which it simply considers "*necessary*".[154] Rather, the MSRs should be defined by Sky, relevant retailers (including Virgin Media) and Ofcom together as part of the creation and operation of the WMO so as to ensure that the MSRs are objectively justified, reasonable and proportionate. Such MSRs will not be objectively justified, reasonable and proportionate if they are defined by Sky alone;

(b) the MSRs should not impose any obligations which go beyond the specification of the current security arrangements used by Virgin Media in relation to Sky's premium channels; and

(c) Ofcom should be involved in formulating a robust dispute resolution mechanism to avoid Sky using the MSRs as a pretext to circumventing a WMO regime.

8.7 Virgin Media currently operates a CA system provided by Nagra and has experience of dealing with Sky’s security requirements and is, therefore, well placed to consider what principles the MSRs should cover. Virgin Media considers that the MSRs should be based on the following broad technical and procedural criteria:

(a) the technical solution should not be restricted to any particular form of security technology (e.g. smart card) or CA technology but could be any solution that is capable of fulfilling the basic principle of protecting the content from unauthorised viewing or recording. If the MSRs were set by reference to a specific technological requirement this could quickly become outdated;

(b) a technical solution should protect the content from its point of distribution to its point of delivery to the customer, where validation is in place to ensure that the customer is an authorised customer (paying or otherwise) of the platform. This protection should prevent interception of the content whilst on the platform; and

(c) a proactive program of activities should be designed to protect and maintain the security of the system being operated. These should be proportionate and should not inhibit retailers or providers from sharing threat information or intelligence.

9. WHOLESALE MUST-OFFER OBLIGATION – TECHNICAL CONSIDERATIONS

9.1 This Section considers two technical issues:

(a) first, the requirement to provide channels under the WMO on a "clean feed" basis; and

(b) second, the technical delivery of channels under the WMO.

9.2 Each of the above issues is addressed in turn below.

Clean feed

9.3 In paragraph 9.32 of the Second Consultation Document, Ofcom sets out its proposal to require Sky to make available a "clean feed" to other retailers, i.e. Ofcom proposes to require Sky to comply with a set of rules governing advertising and cross-promotion. Ofcom suggests that there should be:

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154 Second Consultation Document, paragraph 9.85.

"[n]*o cross-promotion of specific channels which are not included within the supply obligation....*"

"*No cross-promotion of specific retail propositions.*"

"*To the extent that advertising minutage is used to promote other channels or other retail offerings, this advertising minutage must be available to all retailers on a non-discriminatory basis or the retailer must be able to insert its own advertising into pre-defined ad breaks with the clean feed prior to onward transmission to their own subscribers*".

9.4 Virgin Media agrees that Sky should be prohibited from cross-promoting, on channels subject to the WMO regime, channels which are not included within the regime or specific retail propositions (i.e. enhanced features) that are not available on platforms other than the DSat platform. In light of Virgin Media's experience with Sky, it considers such cross-promotion restrictions to be necessary. [**CONFIDENTIAL**].

9.5 Second, it would be insufficient to rely on Ofcom's other regulatory powers to address this concern. By way of example, [**CONFIDENTIAL**] Sky ran a series of cross promotions aimed specifically at Virgin Media's customers following the companies' failure to agree commercial terms for the carriage of Sky's basic channels on the cable platform. Ofcom found Sky in breach of Ofcom's Cross-Promotion Code in relation to three specific broadcast promotions. These promotions were aimed at damaging Virgin Media's relationship with its customers and attracting Virgin Media subscribers to the Sky platform. After an appeal by Sky, the finding of breach took Ofcom over 18 months to finalise. Therefore, given that Sky has been willing in the past to use its airtime to aggressively promote its retail packages on alternative platforms and the difficulty of getting a swift resolution, Virgin Media considers it is imperative that the channels subject to the WMO do not include such harmful promotions.

Technical delivery

9.6 In paragraph 9.34 of the Second Consultation Document, Ofcom sets out three ways in which a channel can be distributed in real time to different platforms. Alternative retailers can pick up the channel either:

(a) "*at the factory gates*";

(b) from Sky's satellite transmission; or

(c) via the use of simulcrypt.

9.7 Ofcom states that its starting position is that "*a wholesale obligation would require delivery "at the factory gates". This is on the basis that distribution is in general not a bottleneck, so where Sky does provide distribution beyond the factory gates, it should do so on commercial terms, and be able to negotiate recovery of any additional costs which it incurs on a commercial basis*".[155]

9.8 Virgin Media understands that a channel picked up "*at the factory gates*" would entail the signal being taken from Sky's play-out centre, via a fixed landline to the retailer's own distribution network (e.g. to the cable head-end).

9.9 As regards the fixed landline required in order to obtain channels from Sky at the factory gate, Virgin Media already has this core infrastructure in place, i.e. Virgin Media has fixed

155 Second Consultation Document, paragraph 9.35.

landlines from Sky's play-out centre to Virgin Media's cable head-end. [**CONFIDENTIAL**][156] [**CONFIDENTIAL**].[157]

9.10 Virgin Media considers that in relation to HD channels, picking up the relevant channel broadcast at the factory gate is the most efficient means by which retailers can access and broadcast these channels. As set out in more detail in paragraphs 7.39 to 7.42 above, supply at the factory gate would enable Virgin Media to compress the raw feed straight into MPEG-2 format, which is the compression standard used on the cable platform. This would enable Virgin Media to display HD content with a picture quality at least equal to that offered by Sky on DSat.[158] Indeed, Virgin Media currently picks up BBC's HD channel "at the factory gate" illustrating that delivery of HD channels at the factory gate is practical.

9.11 Currently, all of Sky's SD channels (and also channels from other broadcasters such as BBC) are provided to Virgin Media via DSat transmission in MPEG-2. Given that the signal is received in the MPEG-2 format used by Virgin Media on the cable platform, Virgin Media does not need to repurpose the video (i.e. does not need to re-encode the video signal). If Virgin Media were to receive SD channels at the factory gate in uncompressed format, it would need to encode the signal into MPEG-2 and transmit it via fixed landline to the cable head-end. In this regard, Virgin Media estimates that taking the SD feeds from the factory gates would be at [**CONFIDENTIAL**]. Therefore, it is more efficient and cost effective, and accordingly Virgin Media's broad preference, for Virgin Media to receive SD channels via DSat signal.

9.12 However it must be considered whether it will continue to be practical to receive SD channels via DSat signal in light of the requirement to provide channels on a clean feed basis (a requirement strongly supported by Virgin Media). This is because Sky may either be unwilling to provide a clean feed signal via DSat or only willing to do so on terms that are not economically viable. In light of Ofcom's observation that Sky may recover costs of delivery associated with not delivering at the factory gate,[159] the question of whether it is commercially and economically viable for retailers such as Virgin Media to receive a clean feed of Sky's SD channels via the DSat signal will, ultimately, depend on the costs charged by Sky to deliver a clean feed this way. In part, it may also depend on whether other third party retailers will also want to receive the same SD channels via DSat signal (and therefore the costs may be divided across a number of retailers[160]).

9.13 In any event, if the SD channels are delivered to Virgin Media (and other retailers) via the DSat signal on a clean feed basis (i.e. not at the factory gate), and Sky charges for this service, Sky's costs for delivering the channels on such a basis would need to be subject to review by Ofcom in order to ensure that Sky does not seek to undermine the WMO by charging unjustifiably high prices.

10. WHOLESALE MUST-OFFER OBLIGATION - DISPUTE RESOLUTION

10.1 This Section sets out Virgin Media's comments on Ofcom's proposal that it may be necessary to establish processes for the resolution of WMO disputes between Sky and qualifying retailers. Specifically, Ofcom raises the need for some form of dispute resolution process relating to:

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156 [**CONFIDENTIAL**].

157 [**CONFIDENTIAL**].

158 If Virgin Media were to pick up the signal from Sky's DSat transmission, it would need to decompress the MPEG-4 coded transmission and then compress to cable's MPEG-2 standard.

159 Second Consultation Document, paragraph 9.35.

160 Such an approach may also result in other retailers avoiding having to invest in the infrastructure required to receive channels from the factory gate, thereby leading to cost savings and efficiencies.

(a) pricing issues where Ofcom does not set a specific price in the WMO;[161]

(b) security issues;[162] and

(c) matters relating to subscriber numbers and service theft.[163]

10.2 Virgin Media agrees that it is essential for the WMO to include a dispute resolution process. Without such a process, qualifying retailers may have no option but to bring every disagreement between themselves and Sky in relation to the WMO regime to Ofcom for resolution, whatever its nature and whatever its size. This is likely to prove impractical, time-consuming and resource intensive and would undermine the effectiveness of the WMO regime. A dispute resolution process is therefore necessary to ensure the swift and effective resolution of such issues.

10.3 Virgin Media does not, however, agree with Ofcom's proposals set out at paragraph 10.1 above that a dispute resolution process should be limited to pricing, security and subscriber audit issues. By way of example, Virgin Media can anticipate disputes arising in respect of nearly all aspects of the regime, including:

(a) the scope of content that must be provided under the regime. In particular, it may be necessary to settle disputes as to which channels, interactive services and so forth should be subject to the regime;

(b) the way in which content is delivered and changes to those arrangements; and

(c) co-operation between Sky and retailers on technological issues (e.g. to ensure that interactive functions are able to work on different platforms).

10.4 There does not appear to be an obvious reason why certain disputes between Sky and qualifying retailers should be capable of being dealt with through a dispute resolution process and not others. Accordingly, Virgin Media considers that any dispute resolution process should apply to any dispute arising out of the implementation and operation of the WMO.

10.5 Virgin Media has yet to consider the form of a potential dispute resolution process in detail, but, in any event, observes that any dispute resolution process should:

(a) resolve matters in a way that is transparent, fair and independent;

(b) ensure the expeditious resolution of disputes, including a tightly controlled timetable. This is particularly important given the dynamic nature of the pay TV industry, the incentive of Sky to draw out any dispute resolution procedure, and the fact that disputes between Sky and Virgin Media have invariably been protracted;

(c) provide certainty for parties to a dispute, i.e. that the process should produce a final binding result; and

(d) have a clear focus on controlling costs.

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161 Second Consultation Document, paragraphs 1.50, 9.3, and 9.53.

162 Second Consultation Document, paragraphs 1.49 (fifth bullet point), 9.2 (fifth bullet point), and 9.84.

163 Second Consultation Document, paragraph 9.98.

Annexes

1. Responses to Ofcom's Questions
2. [**CONFIDENTIAL**]