

ANNEX 5

CONTENT AGGREGATION

1 Introduction

- 1.1 In Paragraphs 5.62 to 5.77 and 6.7 to 6.26 of the Consultation Document, Ofcom sets out its thoughts on content aggregation.

2 No evidence that aggregation leads to reduced choice

- 2.1 Ofcom's key observation is that a *"wide variety of content is generated upstream, but is ultimately sold to consumers in a relatively small selection of retail bundles."*¹
- 2.2 Ofcom's proposition that content is sold to consumers in *"a relatively small selection of bundles"* is without merit.
- 2.3 In particular it is important to note that Ofcom's comments relate to the way in which content is offered on a subscription basis as part of a pay TV package. That same content is, however, often available without a pay TV subscription and hence the set of choices available to consumers in terms of how to access a particular type of content is in fact much larger than Ofcom suggests. For example, in the case of movies, the content can be viewed essentially on an à la carte basis by going to the cinema, purchasing or renting a DVD or obtaining the film on a PPV basis through services such as iTunes and 4 On Demand. The DVD sales and rental windows (and, increasingly, windows such as internet download) begin before the pay TV window and carry on through that window. This means that most of the films being shown on pay TV channels are available to view on an à la carte basis via other means of distribution both prior to and during their broadcast on pay TV channels (and, clearly, also after the pay TV window). Increasingly, this is also the case with non-film content such as TV series shown on pay TV channels.
- 2.4 Moreover, even ignoring this and focusing purely on subscription packages, the number of options available to consumers is in fact, at least in respect of Sky's DTH services, very considerable. Far from seeking to limit the range of choices available to consumers, Sky's packages are designed to provide consumers with a manageable menu of options, which can be effectively communicated and understood by customers whilst still providing sufficient choice, such that customers can tailor a package that most closely matches their own preferences.

¹ Paragraph 5.62.

- 2.5 Accordingly, just taking account of Sky's premium channels and the six basic 'Mixes' the number of total bundles from which a customer is able to choose is 1,764.²

3 Aggregation of content at the wholesale level

- 3.1 Having made this observation, Ofcom then goes on to consider the mechanisms by which aggregation of content occurs at different levels of the value chain and the impacts of such aggregation on competition. The following section of this Annex focuses on Ofcom's analysis as it relates to the wholesale level, which is of most relevance to Sky. Aggregation further upstream simply reflects the environment in which Sky and other TV providers have to acquire rights and is something over which Sky has no control.

Ofcom's analysis

- 3.2 Ofcom draws a distinction between (i) aggregation of content that is closely substitutable and (ii) aggregation of content that is not closely substitutable. It uses the bundling of sports with movie content as an illustration of the potential benefits of aggregating content that is not closely substitutable, whereas it asserts that the bundling of sports content within Sky Sports and of movie content within Sky Movies are examples of aggregation of content that is closely substitutable. In what follows, we focus on the aggregation of closely substitutable content, paying particular attention to Ofcom's application of this theory to Sky Movies and Sky Sports.
- 3.3 Ofcom argues that, where a single channel provider is able to aggregate the majority of closely substitutable content, prices are likely to rise above the competitive level. It notes that such aggregation can arise either as a result of a purchaser aggregating a portfolio of rights from different suppliers (i.e., at the wholesale level) or as a result of co-ordination between content suppliers (i.e., in Ofcom's terms at the "*content production level*").
- 3.4 Ofcom suggests that regardless of the particular mechanism for aggregation of closely substitutable content, any monopoly rents are likely to flow upstream rather than to the retailer. It further alleges that this ability to earn monopoly rents creates an incentive for channel providers to seek to aggregate closely substitutable content. Ofcom acknowledges, however, that the extent to which any rents earned by aggregating content at the wholesale level might accrue to the channel provider versus the content producer will depend on their relative bargaining strength.

² Sky offers six different basic 'Mixes'. These can be taken in 63 different combinations. Sky also offers five different premium channels (including Sky Sports Xtra) which can be taken in 28 different combinations. Accordingly Sky's packaging provides for 1,764 combinations (28 * 63).

“1.34 Our initial conclusion is that there is likely to be a strong incentive for firms to aggregate premium content as far up the value chain as is practical, in order to capture the associated benefits of aggregation.

1.35 This suggests that, to the extent that there are any monopoly rents associated with the aggregation of premium content, these will flow upstream.”

- 3.5 Nowhere, however, does Ofcom provide any evidence to support its inference that Sky Movies and Sky Sports aggregate content that is closely substitutable (or that has not already been aggregated by content producers).

Absence of a counterfactual

- 3.6 Ofcom concludes that aggregation of content that is closely substitutable, of which it cites Sky’s premium sports and movie channels as examples, is likely to be bad for overall welfare. Ofcom does not, however, set out the alternative outcome against which such aggregation is being judged. This is very important because in the context of a channel such as Sky Sports such an alternative is not obvious. Clearly inherent in channel production is some concept of content aggregation - in order to create a channel, a broadcaster must engage in a degree of content aggregation since the content it can acquire from a single supplier would not generally be sufficient to sustain a viable channel. So it is unclear whether Ofcom is suggesting that welfare would be enhanced if Sky were to create a channel by supplementing, say, FAPL football with non-sports programming, or whether it is suggesting that welfare would be enhanced if, instead of being assembled into channels, content were offered event by event on a PPV basis.

- 3.7 Ofcom’s failure properly to set out its counterfactual has significantly hindered Sky’s ability adequately to respond to this aspect of the Consultation Document. Without a clear understanding of Ofcom’s benchmark it is not possible properly to assess the pros and cons or whether the relevant outcomes would indeed improve overall welfare.

- 3.8 Even putting this ambiguity to one side, Sky considers that Ofcom’s analysis is far too narrow. Sky would agree that, up to a point, the value of sports rights may increase where they can be combined with other sports rights. However, contrary to Ofcom’s assertion, this increase in value does not arise because of an ability to soften competition and charge monopoly prices. There are several other factors which explain why Sky and other broadcasters seek to aggregate content within a particular genre. Before these are discussed, Sky draws attention to a material inconsistency within the Consultation Document.

Inconsistency with conclusion on the relevant market

- 3.9 Ofcom’s view that sports channels are an example of bundling closely substitutable content is inconsistent with its position on the FAPL. Ofcom’s analysis of the relevant market implies that FAPL rights are a market in and of

themselves and that there is no close substitute for FAPL content.³ Accordingly, we are left in the position where Ofcom must conclude that Sky Sports represents the aggregation of different sports programming that are not closely substitutable for one another. Alternatively, Ofcom must recast its Consultation Document and make it clear that its concerns are much narrower and are limited to the aggregation of FAPL content only.

Bundling efficiency

- 3.10 In Section 6 of the Consultation Document, Ofcom states that the aggregation of content can, by facilitating price discrimination, result in efficiency gains. However, it takes this factor into account only when considering the bundling of sports and movie content and ignores the potential for similar efficiencies to arise in relation to the aggregation of different sports rights or of different movie rights.⁴
- 3.11 In Paragraph 6.9 of the Consultation Document, Ofcom illustrates how the bundling of sports and movies can facilitate price discrimination and increase output where consumers have different preferences for content. The example is based on the fact that the valuations that the two consumers place on sports and movies combined are much closer than their individual valuations of the components. But this same logic applies within sports - i.e., valuations across consumers for a bundle of sports rights may be closer than valuations for individual sports events.⁵
- 3.12 Even accepting Ofcom's assertion that there is a relevant market for premium sports channels, this **does not** imply that all consumers that subscribe to a premium sports service have identical preferences. Within the base of Sky Sports customers there are many different types of subscribers. Some will be football fans that subscribe to the channel because they want to follow a particular football tournament or their team and value the other programming shown on Sky Sports much less. Others will be dedicated followers of cricket or rugby and have only a passing interest in football. Yet others will be generalist sports fans who have no strong preference for any particular event or sports over any other but value being able to follow a variety of sports events.

³ See in particular, Section 4 of Annex 13.

⁴ This is in sharp contrast to Ofcom's analysis of barriers to entry where it asserts that there are barriers to entry in the provision of premium movie and premium sports channels because of bundling efficiencies. For example, Paragraph 6.64 states: *"By aggregating content into channels, wholesale channel providers can increase the collective value of the content above its stand-alone value. This means that a channel provider that already has the rights to a significant range of content can potentially extract more value from the next set of rights to come available than could a new entrant. It will therefore be able to pay more for those rights."*

⁵ A similar case can be made in relation to movies, for example bundling of block-busters and independent films, or action films and comedy.

3.13 The variety of tastes and preferences within the Sky Sports customer base is clearly demonstrated by [CONFIDENTIAL].⁶ [CONFIDENTIAL].⁷ [CONFIDENTIAL]

3.14 Given this significant variety of preferences, the bundling efficiency that Ofcom acknowledges applies in bundling sports with movie content is also relevant when considering the aggregation of sports content within Sky Sports (and of movie content within Sky Movies).

Channels that offer a series of matches and a variety of sports may be more valuable to some consumers

3.15 Ofcom also ignores the fact that Sky has an incentive to assemble a portfolio of rights because, in so doing, it is able to increase the underlying value of its proposition to certain consumers and expand its subscriber base.

3.16 A consumer's valuation of the ability to watch a particular sports event is not independent of the other programming provided on a channel. A channel can create additional value by placing the sports event in the context of the tournament or season of which it is a part. The ability to tell the story of the tournament or follow the overall progress of a particular team or sports star adds to the enjoyment that a viewer may gain from watching a particular sports event. For example, by aggregating different FAPL matches, a channel provider is able to add incremental value such that, for some viewers, their willingness to pay exceeds the sum of their valuations for each individual match.⁸

3.17 Similarly, as referred to above, there are consumers who are not fans of any particular sport but instead are interested in sports in general (and particularly the big, talked-about events). This type of customer is only interested in subscribing to a channel which offers a depth of different content across a range of different sports including events such as the big FAPL matches between the top teams, the Ashes series, international football, the autumn internationals, big golf events etc. In order to serve the demands of this type of consumer a channel provider has to aggregate different sports content and is thus able to expand the overall appeal of its service to include a broader group of consumers.

⁶ [CONFIDENTIAL].

⁷ Note that this variety of preferences is also evident from Ofcom's own research. See Figure 37 of the research conducted by Ofcom on FAPL during the course of 2004-2005 as part of the European Commission's investigation into competition issues relating to the collective selling of FAPL ("Premier League Football: Research into viewing trends, stadium attendance, fans' preferences and behaviour, and the commercial market. Analysis advising the Commission of the European Communities relating to a proceeding under Article 81 of the EC Treaty in case COMP/C/38.173 – FAPL").

⁸ Note that this does not imply that, to be successful, a broadcaster would need to show a huge number of live matches. For example, the BBC is able to tell the story of the FAPL competition on *Match of the Day* through highlights, and Setanta is able to do the same through a combination of live and highlight rights.

- 3.18 In essence, what both of these examples are alluding to is the fact that, for certain viewers, different sports events may be complementary, such that the value of having one component might be increased if they are also able to consume the other. The complementary nature of some sports programming for some consumers gives rise to a further issue. If complementary sports programming is fragmented across a number of channel providers then there may be a risk that prices will actually be higher than when they are sold by a single supplier. This is because where programmes are complementary for some viewers, a change in the price charged to subscribers for a given programme service will affect not merely the demand for that programme but also the demand for complementary programme services (amongst those viewers for whom the programmes are complementary). Where these services are offered by different suppliers, the supplier making the price change will not take this externality into account. A channel provider which supplies only an element of the complementary programme would fail to take account of the fact that an increase in the price of his service would not just reduce the demand for his event but, amongst a certain group of viewers, may also reduce demand for other events thus potentially leading to higher prices than if the services were offered by a single supplier able to internalise this externality.⁹

Information and transaction costs

- 3.19 Another flaw in Ofcom's analysis is that it fails to acknowledge the very significant information and transaction costs associated with selling content on a very disaggregated basis.
- 3.20 If channel providers did not aggregate sports content (or movie content) and instead different sports events (or movies) were fragmented across a range of suppliers and offered to retailers on an event by event basis then the cost of service would increase.¹⁰ Retailers would have to make significant capital investments if they were to offer individual events on an unbundled basis. There would be an additional cost of billing customers for content which could be large relative to the cost of an event. For example, the transaction cost where the customer calls to order a Sky Box Office movie is in the order of [CONFIDENTIAL].

⁹ We note that this is inconsistent with Ofcom's analysis of complementary rights at Footnote 62 of Annex 13 of the Consultation Document. Ofcom states that, where rights may be complementary, a wholesaler that provides both can charge **more** for them than if the rights were sold on an individual basis (by two wholesalers). Ofcom's analysis is based on the assumption that (i) the two rights are highly complementary and (ii) that where rights are sold on an individual basis the wholesaler has no market power (in the sense of being able to charge above marginal cost). Neither of these is likely to hold in practice. Very few rights are likely to be highly complementary (other than perhaps the first and second half of a match) and a wholesaler selling only one of the rights is nevertheless still likely to have some degree of market power due to the highly differentiated nature of sports content in general.

¹⁰ As set out above, it is not clear from the Consultation Document whether offering programming on a PPV basis is the type of counterfactual that Ofcom had in mind when it noted that aggregation of closely substitutable content at the wholesale level reduces consumer welfare.

- 3.21 If programming were sold on a PPV basis, it would also be very costly to market the availability and prices of individual sports events (or movies). Retailers and wholesalers would have to market the availability of every event/movie to persuade subscribers into repeated purchase. Packaging sports or movie content into a channel results in a significant economy of marketing. The marketing challenge is simplified by building awareness for a channel (rather than an event) and promoting the availability of a range of sports/movies to drive subscriptions. Subscribers are then retained by continuing to offer them access to a range of content which they continue to value.

Product differentiation

- 3.22 Ofcom's analysis also fails to take account of the fact that the most appropriate benchmark for the wholesale provision of channels is not perfect competition but differentiated competition. The key feature of the differentiated competition paradigm is that prices for differentiated products lie above marginal cost and that this is necessary to allow fixed costs to be recovered.
- 3.23 Because of the large fixed costs associated with sports right, broadcasters must have a degree of market power, in the sense of being able to raise price above the marginal cost in order to survive; if prices were depressed to marginal cost, channels would exit the industry and further entry would be deterred.
- 3.24 Simple economic models predict that price competition between identical products even where there are only two firms can result in both firms charging a price equal to marginal cost. This happens because each firm has an incentive to undercut the other. The problem with this kind of price competition in wholesale provision of pay TV channels is that fixed costs are typically very high in relation to marginal costs – this is particularly the case in relation to sports channels. If channels were to set their prices at marginal cost, the fixed costs of production could not be covered. Hence because unrestrained price competition leads to prices that cannot be maintained channels try to differentiate themselves from their competitors. Channels therefore compete with one another based on differences in the products that they sell as well as on price.¹¹
- 3.25 Given the necessity for channels to be differentiated it is not clear that less aggregation of sports content, for example, would lead to lower prices, particularly for the same combinations of sports rights. Channel providers would still need to ensure that their channels were sufficiently differentiated

¹¹ This was recognised in the judgment of the Restrictive Practices Court in the Premier League case. The Court stated: “We conclude that pay-TV broadcasters compete primarily on the differentiated characteristics of their channel content, and only secondarily on price. This is true of many other commercial markets where competitors strive to differentiate themselves. Prices must always be a factor, but not the over-riding factor if the supplier can offer a product that differs in essentials from that of competitors.” See Paragraph 276 of the judgment of the Restrictive Practices Court, of 28 July 1999 in the Premier League case, 28 July 1999.

and outcomes in which there were a number of different channels which were almost identical and where competition was based purely on price would not be sustainable.

Summary: aggregation at the wholesale level

- 3.26 In summary, Ofcom's analysis of aggregation at the wholesale level is incomplete and overly narrow. Whilst it accepts that bundling sports with movie content can be efficient, its discussion of the welfare effects of the aggregation of sports content (or the aggregation of movie content) suggests that such aggregation results in market power without off-setting efficiency gains. In fact, a more thorough analysis shows that there are likely to be efficiency gains from aggregating sports content or movie content at the wholesale level.¹² In ignoring these efficiency benefits Ofcom has not made the appropriate trade-off between efficiency and possible competition problems.

4 Aggregation at the retail level

- 4.1 Ofcom also sets out theories on content aggregation at the retail level and, in particular, its impact on competition.
- 4.2 Ofcom's key observation relates to the hypothesis that there is a "*tendency for one retailer to emerge as the primary retailer*"¹³ on any given platform. Ofcom considers that a single retailer will emerge (irrespective of the availability of premium content)¹⁴ because a retailer which already has a portfolio of basic content will, by virtue of the efficiency of channel bundling, be able to offer a channel provider more favourable terms.
- 4.3 Essentially, Ofcom alleges that a retailer that is able to offer a new channel in various combinations with other basic content will have more scope to price discriminate between customers and therefore will be able to earn more from the inclusion of a channel as part of its retail offering than a rival that has fewer channels.

Some general observations

- 4.4 Sky agrees that, looking at UK platforms, there is a tendency for a single retailer to emerge on a platform. This tendency does not, however, arise for

¹² Sky notes, however, that the mere existence of such efficiency benefits does not imply that there are significant barriers to entry into the wholesale provision of premium sports and movie channels. This is because, as set out in **Annex 3** (Barriers to entry), where rights are obtained by a new entrant the efficiency benefits may be realised at the retail level and shared with the wholesale channel provider. In addition several of the efficiencies arise in particular when compared to a PPV alternative and are potentially exhausted once a relatively small number of programmes are assembled into a channel.

¹³ Paragraph 6.17.

¹⁴ Ofcom notes that competition at the retail level is likely to be strongly influenced by content aggregation even "*where premium content is made available to all retailers on each platform*" (Paragraph 6.17).

the reasons set out by Ofcom. Rather, there is only one retailer on cable and BT Vision because these platforms are closed and other retailers are excluded from retailing pay TV services over them.

- 4.5 Ofcom's analysis fails to recognise the distinction between the DTH platform on the one hand and cable and BT Vision on the other. It fails to recognise that there is no intra-platform competition in respect of cable or BT Vision. Ofcom's analysis of content aggregation on intra-platform competition is therefore entirely focused on DTH. It is disproportionate for Ofcom to allocate time and resources to consideration of the efficacy of intra-platform competition purely in relation to DTH. Ofcom has made no attempt to justify why intervention to address alleged 'tipping' in respect of the DTH platform is even on the policy agenda when in fact DTH is the only significant platform in the UK where there is any degree of intra-platform competition and where a number of different retailers already operate, with platform services provided to them on regulated terms. If Ofcom has concerns about the strength of intra-platform competition then surely it is incumbent on Ofcom to focus first on closed platforms.

Ofcom's theory is flawed

- 4.6 Furthermore, Ofcom's theory as to why a single retailer is likely to emerge on the DTH platform is flawed and, in common with many other parts of Ofcom's analysis, pays scant regard to the reality of retailing pay TV services.
- 4.7 In particular, it assumes that a retailer's pricing and packaging structure is totally dictated by the economics of bundling and has no regard to any other factor. This is clear from Paragraph 6.19 where Ofcom considers the scale of the advantage that bundling is likely to confer by reference to the point at which bundling efficiencies might theoretically be exhausted. Ofcom offers no evidence to support its assertion that retailers design packages which in fact exhaust bundling efficiencies. A cursory review of the evidence shows that they clearly do not. To fully exploit the bundling efficiencies described by Ofcom would require a retailer to offer an extremely complex matrix of channel combinations, potentially with a price for every permutation of channels. This would result in an extraordinary number of packages. For example, a retailer which offered 50 different basic channels might need to offer consumers the option of subscribing to over a trillion different packages.
- 4.8 In reality pay TV retailers will take into account a number of factors in designing their pricing and packaging strategy. Probably the most important factor, which Ofcom has entirely ignored, is simplicity and the ability to convey the different packaging options to potential subscribers.¹⁵ The need for simplicity will significantly limit the extent to which a retailer is able to exploit the theoretical efficiency associated with bundling. For example, Virgin Media offers only three different basic tiers - M, L and XL - where M is

¹⁵ A further relevant factor is that consumers have bounded rationality. There are limits to a consumer's ability to formulate and solve complex problems and to process information. Faced with a large number of different channel combinations and prices, consumers may be unable to determine which option maximises their consumer surplus.

a sub-set of L and L is a sub-set of XL. This falls a long way short of the number of options that would be required for bundling efficiencies to become exhausted.

- 4.9 Sky notes that these other factors that a retailer takes into account in determining its packaging strategy were explained in some detail in Sky's response to Question 14 of Ofcom's Request of 18 July 2007. As in many other cases, Ofcom has completely failed to have due regard to the information provided by Sky, in spite of the very considerable effort that Sky has taken in responding to such information requests.
- 4.10 Pay TV retailers also have very incomplete information about the willingness of actual and potential subscribers to pay for various channels or combinations of channels. Hence a retailer's ability to exploit the bundling efficiencies on which Ofcom places so much weight will be very imperfect.
- 4.11 Accordingly, it is not correct to assert that a retailer with an existing portfolio of basic channels will be able to extract more value from additional basic channels than a rival that has fewer channels. The scale of the advantage conferred on a particular retailer by bundling efficiencies is much smaller than Ofcom suggests.
- 4.12 Pay TV customers are very diverse in their demands and, taking into account the need for simplicity and the paucity of information on underlying demands, it would be extremely difficult for a single retailer to design its packaging in a way that appealed to all.
- 4.13 For example, Sky bundles basic pay TV channels into six mutually exclusive genre "mixes" which customers can then purchase in any combination. Whilst this strategy caters, for example, to subscribers who want a wide range of documentary channels but do not want to purchase kids programming or music channels, it is less effective at meeting the requirements of consumers who want only a small number of pay TV channels across a range of genres.
- 4.14 If a new documentary channel were launched, it is by no means certain that Sky would be able to earn more from that channel than any other retailer on the satellite platform. Within its existing structure, the value to Sky might be quite limited. Sky already offers a deep range of documentary channels which are offered as part of its Knowledge Mix. The Knowledge Mix is offered at a stand-alone price of £16 (or can be added to other Mixes to form a broader basic offering for an incremental £1 on the price of the overall subscription package). A new documentary channel is unlikely to provide Sky with the opportunity to increase the price of this Mix, particularly given the desirability of prices at integer values. Hence, any value to Sky would derive from driving subscribers to add the Knowledge Mix to their subscription package, which might also be quite limited given the number of similar channels already offered by Sky.
- 4.15 A retailer with a much smaller portfolio, however, may see significant value in a new documentary channel. The retailer might consider including the channel in a small, low-priced basic tier to cater to those subscribers that

want only a limited degree of choice.¹⁶ Another retailer, by packaging the new channel in a different way, may in fact be able to target a different audience, which the retailer with the more inclusive offering may not easily be able to accommodate without undermining its existing package structure.

Summary: aggregation at the retail level

- 4.16 Ofcom's analysis fails to take into account the other various factors that a pay TV retailer takes into account in devising its package structure. These other factors and the limited information on underlying channel demands significantly limit the extent to which a pay TV retailer is in fact able to benefit from bundling efficiencies. A pay TV retailer will not be able to approach exhaustion of the theoretical potential to exploit bundling efficiencies under conditions of perfect information. Hence the scale of the advantage available to a retailer with a portfolio of channels in terms of obtaining new channels is much smaller than Ofcom suggests. Given Ofcom's reliance on the economics of bundling, its assertion that the DTH platform may be prone to tipping must be equally flawed.

¹⁶

Note that a consistent theme in [CONFIDENTIAL].