

ANNEX 3: OFCOM'S DISCUSSION OF THE SEABRIGHT REPORT

A. Introduction

- A3.1 At paragraphs 4.167 to 184 of the Consultation Document, Ofcom discusses a study by Professor Paul Seabright and his colleagues, Professors Magnac and Jullien, which considers the extent to which the availability of DTT services affects the demand for Sky's pay TV packages ("**the Seabright Report**", submitted as Annex 5 of Sky's Response to the Second Consultation Document).
- A3.2 Ofcom commissioned an independent review of the Seabright Report by Professor Andrew Chesher. Professor Chesher submitted written questions to Professor Seabright. The issues raised by these questions were discussed in a teleconference on 27 May 2009, and Professors Seabright and Magnac subsequently submitted a written response to the questions ("**the Response to Prof Chesher**"). Following publication of the Third Consultation Document, Professors Seabright and Magnac expressed the wish to write a further response to Ofcom, which is appended to this **Annex 3** of the Response ("**the Seabright and Magnac Report**"), in which they address the most egregious errors and misinterpretations in the Consultation Document.
- A3.3 The Consultation Document misrepresents both the Seabright Report and Professor Chesher's review of it in order to suggest that Ofcom has valid reasons not to accept the results of the study, or that the results are not directly relevant to market definition.
- A3.4 Given Ofcom's acknowledgement that "*the Seabright study provides evidence that there may be substitution between FTA and [packages containing] premium channels*",¹ it is disappointing that Ofcom does not appear to be interested in the strong, new and compelling evidence contained within the Seabright Report. Instead of approaching this evidence with an open mind, Ofcom has instead simply searched for reasons to ignore the Seabright Report. This is not consistent with open-minded, evidence-based regulation.

B. Professor Chesher's comments

- A3.5 Ofcom claims to summarise "*concerns*" raised by Professor Chesher's review.² But Professor Chesher does not characterise these issues as "*concerns*"; rather, he characterises them as "*comments*". Ofcom also fails to acknowledge that, to the extent that Professor Chesher had questions about the Seabright Report, these questions were addressed in the teleconference referred to above, and in Professors Seabright and Magnac's Response to Professor Chesher (neither of which is mentioned by Ofcom in the Consultation Document). Professors Seabright and Magnac explain in their Response to Ofcom that none of these questions casts doubt on the study's claim that the availability of DTT affects the

¹ Paragraph 4.174 of the Third Consultation Document.

² Paragraph 4.179 of the Third Consultation Document.

level of Sky subscriptions; at most they query the precise level of that impact.³ In a study of this kind, it is entirely normal that slightly different formulations would produce slightly different results, but there is no suggestion that the fundamental results of the study are not valid.

- A3.6 Ofcom implies that Professor Chesher’s comments about robustness apply to all types of premium subscriptions. This is not the case, and the impression arises because Ofcom presents the results of the study in a misleading way. The Seabright report looked separately at ‘basic only’ subscribers and ‘premium’ subscribers, and also looked at the results of splitting the latter group into ‘movies only’, ‘sports only’ and ‘sports and movies’. Ofcom presents the results for these latter three groups and for basic, but does not mention the aggregate ‘premium’ group.
- A3.7 Yet Professor Chesher’s comments on the robustness of the results relate to this aggregate ‘premium’ group. Professor Chesher did not comment on the results for “*movies only*” and “*sports only*”, and the comments that he makes about the results for the aggregate ‘premium’ group being “*less robust*”⁴ than the results for the ‘basic only’ group, do not apply to these two sub-groups.
- A3.8 Ofcom itself raises several further issues which were not raised by its appointed expert. For completeness, we explain below why they should be disregarded.

C. Direct evidence that DTT availability is a constraint on prices

- A3.9 Ofcom claims that the study “*effectively reports the impact on demand for Sky’s premium channels following an infinite increase in the price of DTT services*” for all consumers in an area.⁵ This is simply not correct, as Professors Seabright and Magnac explain in their Response to Ofcom.⁶

D. The constraint on packages containing both sports and movie channels

- A3.10 Ofcom notes that that “*the relationship between DTT availability and demand for [packages containing both Sky Sports and Sky Movies] is not statistically significant [at the 10% level] after correcting for spatial correlation*”.⁷ This is true, but it is not clear what implication can be drawn from this.
- A3.11 As the Seabright Report notes, “*The measured effects for sports-only and movies-only packages remain statistically significant at well under one per cent even when spatial correlation is taken into account*.”⁸ As a matter of economics, the finding of a strong constraint from DTT on packages containing Sky’s sports channels and packages containing Sky’s movie channels is itself enough to have

³ Paragraphs 3 to 6 of the Seabright and Magnac Report.

⁴ But not, as Ofcom claims at paragraph 4.179, “*not robust*”.

⁵ Paragraph 4.175 of the Consultation Document, emphasis in original.

⁶ Paragraph 8 of the Seabright and Magnac Report.

⁷ Paragraph 4.176 and footnote 155 of the Consultation Document.

⁸ Paragraph 29 of the Seabright Report.

important implications for market definition, since those packages are within the relevant retail markets that Ofcom has defined and, by implication, therefore impose a strong constraint on packages containing both Sky's sports and movie channels. Hence although the *direct* constraint from DTT on packages containing both Sky's sports and movie channels appears to be weaker than the constraint on packages containing only one type of premium channel, there is a further indirect constraint.

E. The Cellophane fallacy

A3.12 Ofcom suggests that "*If Sky's current prices are above competitive prices we would expect that the magnitude of substitution between Sky Premium and DTT would be exaggerated*".⁹ As Sky discusses in **Section 5** of this Response, there is no reliable evidence to indicate that Sky's prices are above 'competitive prices'.

A3.13 Even if Sky's current prices were above competitive prices (which Sky denies), Ofcom's assertion is not a simple one and is not adequately explained. Careful consideration reveals its flaws. The Seabright Report effectively seeks to compare the propensity of households to take Sky's pay TV packages in areas where DTT is not available with areas where it is available. If Sky's prices were above the 'competitive level', elasticities of demand for Sky's pay TV packages would be higher than at 'competitive prices' *in both areas*. It is possible in theory that the level of prices could have some effect on the *magnitude* of the effect of DTT availability found in the study, but it is not plausible that it could generate a DTT effect where one did not exist.

F. Effect of Setanta

A3.14 Ofcom suggests that the results of the study could be entirely due to the availability of Setanta via DTT.¹⁰ This would be highly implausible given the small number of DTT subscribers Setanta had.¹¹ Moreover, it is not possible to make such a claim on the basis of the study. The Report considers subscription data at two points in time, both prior to and after Setanta's launch on DTT in August 2007, and its conclusions in respect of both points in time are virtually identical. Professor Seabright and his colleagues found that data for February 2007 gave "*results that are virtually identical to those from February 2008. The conclusions that we draw from the data for 2008 would therefore be unchanged on the basis of data from the earlier year.*"¹² If Ofcom had considered the Seabright Report properly, it could not have concluded that the results of the study could have been due to the availability of Setanta on DTT.

⁹ Paragraph 4.177 of the Consultation Document.

¹⁰ Paragraph 4.178 of the Consultation Document.

¹¹ Sky estimates that Setanta had fewer than 200,000 subscribers via DTT.

¹² Paragraph 23 of the Seabright Report.

G. Conclusion

- A3.15 Ofcom's attempts to undermine the Seabright Report are based on misrepresentation and misunderstandings of both the Seabright Report and Professor Chesher's comments. Ofcom's criticisms are largely without merit and have failed to demonstrate that a lack of confidence in the conclusions of Professor Seabright and his colleagues is justified.
- A3.16 The study by Professor Seabright and his colleagues was the result of a very considerable level of effort, and was conducted by academics with significant expertise and standing, acting on an independent basis. It presented strong and compelling new evidence relevant to Ofcom's investigation. But, instead of assessing this evidence with an open mind and a genuine desire to understand the implications of the study for competition and market definition, Ofcom has instead simply sought (unsuccessfully) to undermine the conclusions of the study.

The Effect of DTT Availability on the Demand for Sky

A Response to Ofcom

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17th September 2009

1. In January 2009, at the request of BSkyB's external legal advisers, we submitted to Ofcom a paper, co-authored with our colleague Professor Bruno Jullien of the Toulouse School of Economics. This paper reported an econometric study we had conducted to estimate the impact of the availability of Freeview on households' willingness to subscribe to Sky. On 26 June 2009 Ofcom published a consultation document, entitled *Pay TV Phase Three Document - Proposed Remedies*, that made several references to our study (see paragraphs 4.167-4.184, 4.217, 4.246, 4.309 and 4.321), and referred also to a review of that study conducted by Professor Andrew Chesher, which was reproduced as Annex 7 to the Ofcom document (hereafter the "Chesher Review"). We are submitting this present note in response to the consultation because Ofcom's document misrepresents our study (and the conclusions that could be appropriately drawn from it) in several important ways. Furthermore, it does so in ways that are not supported by anything to be found in the Chesher Review. The effect of these misrepresentations is to cast doubt on the reliability of our study. We reject these imputations and are disturbed that Ofcom should imply that they are in any way supported by the Chesher Review.

2. In our view the Cheshier Review of our study is a thoroughly professional document with whose main points we have no disagreement. It proposes some alternative specifications of our estimating equations and points out that these make some difference to the parameter estimates, but it does not offer (and does not claim to offer) conclusive reasons for preferring these specifications to our own. While we have small disagreements on points of detail and of emphasis, these lie well within the area of normal scientific discussion, and there is no need for us to discuss them here. Had we received the document as part of the peer review process in the course of submission of our study to a scientific journal, we would have been glad of its constructive suggestions.

3. The Ofcom document states that the Cheshier Review “raised a number of concerns about the study’s methodology” (paragraph 4.179). We note that the word “concerns” (which implies that there is something unsatisfactory about the procedure we have used) does not appear in the Cheshier Review; this is entirely Ofcom’s coinage. These “concerns” are stated to be threefold:
 - a. “The estimate of the relationship between DTT availability and demand for Sky premium channels is not robust to changes in model specification”.
 - b. “The instrument chosen to treat the endogeneity of availability of DTT may be invalid as it has a role in determining demand”.
 - c. “The study ignores the potential problem of endogeneity of access to cable. Without treating this problem we cannot be sure that any of the estimated coefficients are not biased”.

4. Each of these statements misrepresents both our study and the Cheshier Review. On the first, the Cheshier Review specifically stated that the “The magnitudes of the estimated coefficients on DTT availability in equations for Sky basic package subscriptions are found to be generally robust to these changes in specification”. It then goes on to note that (as discussed in our study) “there is less robustness in the magnitude of the estimated coefficients on DTT availability in equations for Sky premium packages estimated using the 2SLS procedure”. Professor Cheshier does not write that our premium results are not robust; he writes that a *subset* of our premium results (those using 2SLS) are *less* robust than the basic results. Indeed, he writes that “Plausible model reformulations lead to estimates of the effect of DTT availability on the demand for Sky premium services of the order of one half of the value headlined in the study”. Professor Cheshier does not write that these reformulations amount to *no* effect of DTT on demand for Sky premium services, and he does not assert that they are clearly to be preferred to our own.
5. On the second point, Professor Cheshier does not claim that our chosen instrument has a role to play in determining demand, only that it may have. He discusses, in terms with which we have no significant disagreement, the issues that might arise in determining whether there might be better ways to treat the possible endogeneity of DTT availability. His alternative specifications still show that DTT availability has a statistically significant effect on demand for Sky Premium, albeit one that is not as large as the one in our report.
6. On the third point, our study did not “ignore” the problem of the endogeneity of cable. Both Ofcom and Professor Cheshier know (since we discussed this with them at length

on 27 May 2009, and addressed it in our note which was provided to Ofcom on 1 June 2009, prior to the issue of the Ofcom document) that we did in fact give considerable consideration to the question of the possible endogeneity of cable but were unable to find suitable instrumental variables. This is not a shortcoming of our methodology but a limitation of the available data. Furthermore, Professor Chesher writes that “it is not possible to determine the direction of any bias resulting from the endogeneity of cable availability”. Nor is there any reason to think that there would be any effect on the estimates of DTT availability, which is the study’s variable of interest. Professor Chesher did not describe this as a “concern about the study’s methodology” and it is misleading of Ofcom to claim that he did.

7. In paragraph 4.181 Ofcom also states that our study “does not model the effect of a price increase” in the price of Sky packages on the demand for FTA. This is correct since, for reasons we explain at length in the study, the data do not permit such an exercise. However, contrary to what Ofcom goes on to assert, it is not correct to state that “it does not provide direct evidence that Freeview is a constraint on the prices of premium sports channels”, since we provide evidence of such a constraint in a different way. We estimate, using a procedure that is clearly explained and whose merits or otherwise Ofcom chose not to address, the impact of the availability of DTT on the average willingness of viewers to pay for various Sky channels. This is precisely a “constraint on the prices of premium sports channels”, since a change in such willingness to pay will change what price Sky can charge. We do not claim that these estimates are the only reasonable ones that could be constructed, but it is incorrect for Ofcom to assert that we do not provide direct evidence of the constraint provided by Freeview.

8. Contrary to what is stated by Ofcom (in paragraph 4.175), our method of estimating the impact of Freeview is not equivalent to estimating the effect of an infinite increase in its price for all consumers. A marginal change in the extent of availability of DTT affects only the consumers at the margin. Since their weight is zero there is nothing implausible about the finite change in demand resulting from the infinite change in price for these consumers. We use this demand effect to make estimates, to which Ofcom make no reference, of the implied reduction in willingness to pay for Sky packages. These are large for basic packages and smaller but still substantial for premium packages. While none of these estimates settle the question whether free to air and pay TV are in the same relevant market, they provide a serious challenge to the view expressed by Ofcom in paragraph 4.184 that “the growth of FTA channels has not sufficiently constrained Sky’s pricing of Sky Sports for FTA channels to be included in the same market”.

9. Overall, we took great care to ensure that our study was conducted in a transparent and scientific manner, using available data to address an important economic question and being open about the limitations on what the data allow us to say. We have repeatedly tested our estimates for robustness in order to explore fully the possible reservations about the findings. Contrary to what Ofcom asserts, reporting the extent to which such tests of robustness modify the parameter estimates is not a weakness of the scientific method but a strength. We have not claimed that the study definitively settles the issues at stake, but it has shown the presence of significant demand interdependencies that no previous study has been in a position to investigate. Professor Chesher’s Review responded in exactly this spirit and at no point cast any doubt on the rigor or

professionalism of our methods. Importantly, it did not dispute the strong and robust effect of DTT availability on demand for Sky basic packages, and the questions it raised about premium packages did not lead Professor Chesher to conclude that there was no significant effect of DTT availability on demand for them. He has suggested that this effect on demand may be smaller than we have estimated. We and he accept that we are in a zone of legitimate scientific uncertainty. However, he has not suggested that the effect of DTT availability is small enough to ignore completely, still less that our own estimates are unreasonable or the result of a less than rigorous methodology. Ofcom's document misrepresents the views of its own expert as well as our report.