



Pay TV second consultation

Access to premium content

Consultation

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¹ Annexes 6 to 10 are available as separate documents here:
http://www.ofcom.org.uk/consult/condocs/second_paytv/

Section 1

Summary

Headline summary

- 1.1 We opened our investigation into pay TV in early 2007, following a submission from BT, Setanta, Top Up TV and Virgin Media. Our first consultation, in December 2007, set out some initial concerns relating to the manner in which premium content is distributed. This further consultation explores those concerns in more detail, and sets out for consultation our proposals for addressing them.
- 1.2 Consumers' choice of pay TV service is primarily influenced by the content that is available, rather than by platform features. Some content is of particular importance: live Premier League football and first-run blockbuster movies have an especially wide appeal, and are not available via free-to-air TV. We consult in this document on our view that channels containing these types of content are in their own narrow wholesale markets, and that Sky has market power in those markets.
- 1.3 This market power gives rise to two concerns. First, that Sky is likely to limit the distribution of those channels to other retailers, either reflecting its belief in its own greater efficiency than other retailers or a desire to limit the ability of other retailers to compete effectively; our review of the evidence indicates that distribution of these channels is indeed limited. Second, Sky may be able to set wholesale prices above the competitive level; difficulties with analysing wholesale margins make it difficult to draw firm conclusions on this.
- 1.4 Markets 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.
- 1.5 We propose to address our concerns by requiring Sky to wholesale designated premium channels on regulated terms. In this document we are consulting on the use of our sectoral competition powers under section 316 of the Communications Act to put such an obligation in place.
- 1.6 We may need to return to the question of whether to make a reference to the Competition Commission under the Enterprise Act. This might be appropriate if, for example, we believed there was merit in considering some form of additional intervention into the way in which specific content rights are sold. However, if we proceed with the proposals set out in this document, then it may be premature to consider any further intervention until we can properly assess the effects of our proposed remedy.
- 1.7 We welcome stakeholders' views on the concerns we have expressed and on our proposed remedy.

Introduction

- 1.8 In January 2007 we received a significant submission from BT, Setanta, Top Up TV and Virgin Media (the 'Four Parties'), following which we began an investigation into the UK pay TV sector. In December 2007 we published a first consultation document (the 'December Consultation'), in which we set out our initial views on the operation of the market, and some initial concerns relating to the manner in which premium content is aggregated and distributed, which may restrict competition in the retail market to the detriment of consumers.
- 1.9 We received a wide range of responses to our consultation – 29 in total, 23 of which we published in May 2008 and six of which remain confidential. Views were heavily polarised. Sky and the FAPL disagreed with many aspects of our analysis, including our analysis of market definition and market power, and our associated competition concerns. A number of other respondents expressed support for our concerns, and some suggested we had not gone far enough in our assessment of their magnitude.
- 1.10 In this further consultation we analyse these responses, and review the initial views on the operation of the market that we set out in December in light of this analysis. We set out our current position on competition concerns, and consult on a proposal for addressing those concerns.
- 1.11 In our previous consultation we presented a set of criteria, which we have since refined, for assessing whether the pay TV sector is providing a good set of outcomes for consumers. These focus on three key areas:
- **Consumer choice:** consumers should be able to choose which platform they wish to use as a means of accessing content, and which content they wish to watch on that platform.
 - **Innovation:** consumers should benefit from innovation, both technical innovation in platform services, and retail innovation in service bundling.
 - **Pricing:** prices should provide consumers with good value, and a sufficient variety of price points to allow them to tailor their purchases to meet their preferences.
- 1.12 While respondents broadly agreed with these criteria, several commented that there may be different ways to interpret them. We have therefore set out in this document some more specific characteristics which we believe are likely to be common to most desirable consumer outcomes.
- Firstly, consumer benefits are likely to be maximised if content that consumers value highly is available on all platforms. It is already widely recognised that it would be a poor outcome for viewers of free-to-air services if the main public service broadcasting ('PSB') channels were not available on all platforms. Similarly, it would be a poor outcome for consumers of pay TV services if they were unable to access premium content because of their choice of platform.
 - Secondly, consumer benefits are also likely to be maximised if consumers are able to choose from a broad range of content bundles. A market in which there was effective retail competition might result in different retailers providing services which are optimised for different market segments, including a wide variety of entry-level packages, as well as the ability to purchase specific categories of premium content on a stand-alone basis.

- Thirdly, consumers are likely to benefit if different platforms are able to innovate in a manner that plays to the strengths of the particular distribution technology used by those platforms. Sky's strong history of innovation on its satellite platform is widely recognised, but we also note the potential of emerging IPTV and mobile TV platforms to offer consumers greater convenience and enhanced service flexibility, by allowing them to access content on demand, or when on the move.
- Finally, consumers clearly benefit from a fair deal in terms of pricing. As we discuss later in this document, it is difficult to determine analytically what an appropriate price is for content. In these circumstances we believe it is particularly important that the prices paid by consumers are determined by competition between different suppliers.

The importance of premium content

- 1.13 We continue to believe that consumers' choice of pay TV retailer is primarily influenced by the content bundles which are available from different retailers. Platform-related features may enhance the viewing experience and therefore provide added value to consumers, but they cannot compensate for content that lacks intrinsic appeal. The ability to time-shift a programme, for example, is only of value precisely because consumers want to watch a specific and valued piece of content in the first place.
- 1.14 Our focus in this document is on that content which is likely to be most effective in driving pay TV subscriptions. This content must have two characteristics: a significant appeal to a broad audience, and limited availability via free-to-air TV channels. Content which has a broad appeal, but which is widely available free-to-air, such as some of the UK-originated content available via the public service broadcasters, is unlikely to drive pay TV subscriptions, since consumers are unlikely to pay a significant premium to watch programmes similar to those which they can already watch for free. We identify two types of content which combine broad audience appeal with a high degree of exclusivity to pay TV: live top-flight sports and first-run Hollywood movies².
- 1.15 The importance of these types of content is revealed by a variety of evidence which we have considered here, including:
- Consumer surveys, which show that live top-flight sports and first-run Hollywood movies are among the content genres most valued by consumers. This is consistent with a common-sense observation of the level of interest shown by consumers in live sports and blockbuster movies.
 - Observed consumer behaviour, in particular the high proportion of pay TV subscribers who are willing to pay a substantial premium for bundles which include this content.
 - The observed behaviour of firms, and in particular the high prices which pay TV channel providers are willing to pay for key content rights.
 - The effects on firms and on consumers following substantial changes in the ownership of key content rights. These effects cannot be observed in the UK,

² By "top-flight" sports we mean for example international matches or matches from the top national sports leagues. By "first-run" movies we mean movies that are being shown for the first time on TV.

where the majority of key rights have not changed hands since the early 1990s, but they can be observed in other international markets.

- 1.16 We have considered whether these types of content are likely to continue to be as important in the longer term as we believe them to be now.
- Our view is that live top-flight sports programming is likely to have an enduring appeal, regardless of technical change. Broadcast media are intrinsically well suited to content which is based on mass participation in major live events, and this is unlikely to change in the foreseeable future.
 - The same may not however be true of movie programming, since although blockbuster movies are likely to retain their appeal, the simultaneous broadcast of a small number of movies to a large number of viewers is unlikely to remain the most effective means of distribution in the longer term. It is not difficult to imagine a world in which they are generally accessed more directly, for example via various forms of internet download. Movie download services are already available, though they have yet to be taken up by large numbers of consumers.

Market structure and market definition

- 1.17 We set out an initial view of the structure of the pay TV industry in the December Consultation. We identified four vertical levels at which the market operates: content and production, wholesale channel provision, wholesale platform services provision, and retail service provision. These four levels do not represent a simple linear value chain, but they do provide a conceptual framework for understanding the various types of commercial transaction which take place between different industry players.
- 1.18 The main focus of this document is on wholesale channel provision, and in particular the wholesale markets for premium sports and premium movies. In order to examine potential competition concerns, we need to consider the extent of any market power in such markets. The first stage in that analysis is to establish a set of market definitions. We have based our analysis of market definitions on a wide range of information, including evidence which we published in our December Consultation, responses to that consultation, and further research and analysis carried out since then.
- 1.19 It should be noted however that the process of market definition is a means rather than an end. It provides a useful framework for an analysis of market power, but it would be over-simplistic to assume that products which are within the market all fully constrain each others' prices, while products which are outside the market provide no constraint. This is certainly true for content markets such as those defined here, given the highly differentiated nature of the products being sold in these markets, and the resulting uncertainties in the precise market boundary. Our analysis of market power therefore takes into account the pricing constraint associated with products which lie just outside the market boundary, as well as the constraint associated with products which lie within the market.
- 1.20 We are consulting on our view that there is a narrow economic market for the wholesale of certain premium sports channels, specifically those premium channels which contain live FAPL matches. We use the term 'Core Premium Sports' to refer to these channels, and to distinguish them from other channels which are marketed as premium sports channels, but which we do not include within our market definition. We believe such channels to be significantly differentiated from other channels in their appeal to consumers and therefore their value to wholesalers. We currently

consider the wholesale supply of Sky Sports 1, Sky Sports 2 or Setanta Sports 1 to be included within this market definition.

- 1.21 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 only 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. There is an element of judgement in establishing which channels fall within the market. It is not helpful to have a loose or vague market definition. We would therefore describe 'Core Premium Sports' channels as being those channels which include any live FAPL matches.
- 1.22 We are also consulting on our view that there is a narrow economic market for the wholesale supply of channels which include movies from the major six Hollywood studios, shown in the first pay TV window. We use the term 'Core Premium Movies' to refer to these channels. We acknowledge that there is a growing constraint on such channels from other means of watching movies, but do not believe that the strength of this constraint currently justifies the adoption of a broader market definition.

Content aggregation and market power

- 1.23 We set out in our December Consultation a number of characteristics which we believe to be intrinsic to pay TV markets. We set out a range of evidence for these characteristics. We identified two sets of characteristics which are particularly relevant to premium content markets:
- A set of characteristics which relate to the way in which content is aggregated at different points in the value chain. Specific examples of content aggregation mechanisms include the collective selling of sports rights by bodies such as the FAPL, and the purchase by channel providers such as Sky of movie rights from a number of different studios.
 - A set of characteristics which relate to the way in which the largely fixed costs of producing content are recovered via the pricing structure for downstream services, typically involving a degree of price discrimination inherent in content bundles.
- 1.24 We emphasised that content aggregation and price discrimination are not necessarily a source of concern in and of themselves. Content aggregation is necessary in order to assemble a viable pay TV proposition. Price discrimination allows content to be distributed widely to consumers, while still allowing the recovery of content production and distribution costs. Our level of potential concern with bundling and price discrimination will therefore depend on the particular circumstances:
- In a situation where marginal cost of distribution is low, such practices are likely to offer overall efficiency benefits.
 - If these practices take place in the context of a competitive market, they are likely to promote consumer welfare.
 - In a situation where there is market power, such practices may still result in increased efficiency. However, much of the benefit is likely to accrue to the producer, away from the consumer.

- In a situation where the market power can be leveraged into other markets it is likely to produce additional competition concerns which are likely to outweigh any compensating efficiency benefits.
- 1.25 The extent of any market power is therefore of critical importance. This document consults on a more detailed analysis of market power in the markets for the wholesale supply of Core Premium Sports and Core Premium Movies channels.
- 1.26 Firstly, we are consulting on the conclusion that Sky has market power in the wholesale of Core Premium Sports channels. We base this conclusion on the following:
- Sky has consistently won the rights to televise live FAPL matches since 1992, until the European Commission's intervention ensured that one company could no longer win all the rights in 2006³. We estimate that Sky's market share now stands at [X]%.
 - Sky's market share remains high even if we expand our market definition. In particular, including additional sports rights of similar quality to live FAPL within our market definition makes little difference to our assessment of market power, due to the more limited volume of content associated with these other rights, and the fact that many of these other sports rights are also owned by Sky.
 - Sky has argued for a much broader market definition than we adopt, encompassing free-to-air and pay TV within a single economic market, and has said that if markets were defined in this way Sky would be unlikely to be dominant. We do not however believe that the volume of live high-quality football on free-to-air TV channels is sufficient to constrain the wholesale price of Core Premium Sports channels to the competitive level.
 - There are significant barriers to entry in acquiring the live FAPL rights. We believe that Sky's established subscriber base, coupled with other factors such as its vertical integration and brand strength, means that it can afford to bid a larger amount than any other bidder, and we therefore expect Sky to maintain its market power following the next auction. However, if Sky were to win a significantly smaller set of FAPL rights in the next auction, this would constitute a material change in circumstances and we would need to revisit our assessment of market power.
 - We have said that market boundaries are not clear-cut. To the extent that some other football competitions just outside our stated market represent partial substitutes for FAPL content, it might in theory be possible to assemble some of those into an offer to compete with Core Premium Sports channels. However, no other single competition offers the same volume of highly attractive sport as FAPL, while many of the content rights which would need to be aggregated to create such an offer are already controlled by Sky. The staggered availability of rights is therefore an additional barrier to entry in creating such an offer.
 - The fact that some platforms, notably Virgin's, are closed to other retailers, means that they are more likely to have some countervailing buyer power in dealing with Sky. However, we currently see the commercial balance of the relationships between Sky as a wholesaler of Core Premium channels and other retailers as being strongly in favour of Sky.

³ The details of the European Commission's intervention are described in section 5, paragraph 5.36.

1.27 Secondly, we are consulting on the conclusion that Sky has market power in the wholesale of Core Premium Movies channels. We base this conclusion on the following:

- No company other than Sky has ever won any of the relevant rights from the major Hollywood studios, giving Sky 100% market share.
- Sky's market share remains high even if we expand our market definition slightly, to include for example pay-per-view ('PPV') movies or DVD rental services. Sky has argued for a much broader market definition than we adopt, including free-to-air channels as well as DVD sales, and has stated that if markets were defined in this way Sky would be unlikely to be dominant. While we acknowledge that other means of watching movies, such as the ability to purchase a DVD of a recent movie, or watch an older movie on free-to-air TV, will provide some constraint on the prices which can be charged for Core Premium Movies channels, we do not believe this constraint is likely to be sufficient to ensure prices are at the competitive level.
- Sky's strong position in the market is unlikely to be undermined by potential entrants in the near future. We believe the bidding advantages that we set out above in the context of sport also apply to movie content, and mean that Sky can afford to bid a larger amount than any other bidder for the rights to each individual studio's output. This, in conjunction with the staggered availability of rights, creates a significant barrier to entry.
- There is however the possibility of disruptive change in the way the studios monetise their rights in the future, including in particular new means of distributing individual movies to consumers over the internet. We acknowledge that any major change in the pattern of rights ownership, or in the means by which the studios monetise their rights, would constitute a material change in circumstances and we would need then to revisit our assessment of market power.
- The position with respect to countervailing buyer power is similar to that in sports. We see the balance of power in the relationship between Sky as a wholesaler of Core Premium channels and other retailers as being in favour of Sky.

Competition issues related to Core Premium content

1.28 Market power gives Sky the ability to affect competition. This can result in two kinds of concerns, and we consult in this document on the evidence associated with both of these concerns:

- Firstly, there is a risk that Sky, as a vertically integrated firm, with market power in a key upstream market, will distribute its premium content in a manner that favours its own platform and its own retail business. It might do so either by denying this content to other retailers and / or other platforms, or by making it available on unfavourable terms. The effect of this would be to distort retail competition for the provision of pay TV services. The increased importance of 'triple-play' bundles creates a further risk that this distortion would extend to the other services which are included in such bundles, notably broadband and telephony services.

- Secondly, there is a risk that Sky will set high wholesale prices for its content in order to maximise wholesale profits. This would have the effect of keeping retail prices high without necessarily distorting competition between retail operators.

1.29 In relation to the first of these concerns, we believe that Sky does have the incentive to restrict the supply of its Core Premium channels to other retailers and other platforms, and we further believe there is evidence which suggests that Sky is acting on that incentive:

- Sky's premium content is currently provided on a wholesale basis to Virgin Media. However, the current combination of wholesale charges and incremental retail price makes it unprofitable for Virgin Media to sell premium channels to existing basic subscribers, and Virgin Media therefore has no incentive to do so unless this is absolutely necessary in order to retain a subscriber. There has been a dramatic decline in the number of subscribers to Sky's premium channels via cable in recent years. This is not surprising given the incentives associated with the current charging structure.
- A number of new entrants, seeking to establish new retail businesses and / or new platforms, have sought to purchase access to Sky's premium channels on wholesale terms, but none of these has been successful. We have reviewed the available correspondence between these new entrants and Sky. We have not attempted to reach any conclusions as to the specific reasons why individual negotiations have so far been unsuccessful. We can however reach a more general conclusion that no commercially agreed wholesale deals appear imminent, despite evidence of negotiations going on in some cases since [X].
- We have analysed the incentives we believe Sky faces to wholesale its content to competing retailers and/or on competing platforms. Our conclusion is that there are a number of incentives which may motivate Sky against supplying other retailers at a wholesale price which those other retailers are prepared to pay. This may reflect an unwillingness to wholesale to retailers on other platforms at a price which Sky believes would be lower than the price at which it would need to wholesale to itself on those platforms, but it may also reflect a desire to limit the growth of potential competitors. In either case, the market outcome is similar: Sky's content is not as widely available as it might be, which is likely to limit competition.
- Sky has argued strongly that it is likely to be the most efficient retailer of its own content, and that it believes a satisfactory alternative is for it to retail its content directly over others' platforms. However, it is unlikely that a satisfactory answer to our competition concerns is for Sky to become the only actual or potential retailer of premium content across all platforms. While we recognise that this is likely to improve the availability of Sky's content, and while we also recognise that Sky may have the ability to retail its content as effectively on other platforms as it does over its own platform, we do not believe that it has the incentive to do so. This view is supported by the available evidence, which suggests that where Sky does retail on other platforms, using its 'Sky by Wire' service, the resulting retail offering is of lower quality, is sold at a higher price than similar offerings on its own platform, and that take-up is low.

1.30 The evidence is less clear-cut in relation to the second of these two concerns – possible high wholesale prices – which may be due to a variety of practical difficulties associated with an analysis of wholesale prices for content.

- The costs of producing content are largely fixed, resulting in a marginal cost which is close to zero. It is not therefore appropriate to use the marginal cost of production as a pricing benchmark.
- We have attempted to assess whether wholesale prices are high by analysing the profitability of the part of Sky's business that wholesales premium channels. There are two types of uncertainty involved in this analysis. Firstly, there are practical difficulties associated with a disaggregated profitability analysis of one part of Sky's business, due to uncertainties as to the allocation of common costs and capital employed. Secondly, even if we could obtain an accurate estimate of Sky's profitability, it may under-estimate the total profitability associated with the wholesale of this premium content, since it excludes any rents which are retained by rights owners.
- Nevertheless, we conclude that Sky does appear to be making an operating margin on the wholesale of premium channels of up to [X]% – higher than Sky's 2008 overall operating margin of 15.2%. We have not estimated a return on capital, due to practical difficulties associated with determining the level of capital employed in this part of Sky's business. We further conclude that the gross margins which Sky makes on premium movie content are significantly higher than those which it makes on premium sports. This is as we might expect, given that in the case of movie content it is Sky that is primarily responsible for content aggregation, whereas in the case of sports content much of the aggregation occurs upstream of Sky. We would expect any monopoly rents associated with content aggregation to flow upstream to the entity which is responsible for that aggregation, which in this case is the FAPL.
- We note below that, if we proceed to calculate a price for a wholesale must-offer remedy, then a more detailed analysis of wholesale margins is likely to be one input to that process.

1.31 The concerns set out above relate to the manner in which market power in upstream content markets can be exploited in downstream markets. It has also been suggested that there is a feedback mechanism, by which reduced retail competition reinforces upstream market power, creating what is referred to by the Four Parties as the 'vicious circle'. We acknowledge in our assessment of market power that Sky's established subscriber base is one of the factors associated with high barriers to entry in the markets for the acquisition of key content rights, and this does therefore create a degree of feedback. However, we have also identified other barriers to entry, such as content aggregation and the staggered availability of rights. This feedback mechanism therefore needs to be considered in conjunction with those other barriers to entry, potentially reinforcing them, rather than on a stand-alone basis.

Effects on consumers

- 1.32 As we set out above, we believe that competition in pay TV is likely to be weakened by restricted distribution of Core Premium channels. This results in a lack of choice for consumers, in terms of the content that is available on some platforms, and for some consumers in terms of the platforms that are available to them. Markets where competition is weak, and consumers are unable to exercise a real choice between suppliers, are unlikely to deliver the best outcomes for consumers. This might manifest itself in several ways.
- 1.33 Firstly, there is a risk that consumer choice and retail innovation will be reduced. The most obvious manifestation of reduced consumer choice is the restricted availability

of Sky's premium content on other platforms. We discuss this issue from a competition perspective above, and acknowledge that in this context interpretation of the evidence is complex. From a consumer perspective however the issue is simple: consumers on a number of platforms are currently unable to access the most valuable sport and movie content, and this must be a source of concern.

- 1.34 Even where content is available on a platform, consumer choice may be restricted if that content is only made available via a limited range of content bundles. We do see evidence of this, in that although Sky does offer a wide range of content bundles, the pricing of these encourages consumers to trade up to a small number of 'big mixes'. This pricing structure can be explained in terms of bundling efficiencies, but it may also reflect Sky's commercial incentive to extract the maximum revenue from each subscriber, and the limited competitive constraint from other retailers.
- 1.35 By way of contrast, the entry of Setanta into the market has resulted in the availability of a wider range of entry-level offerings, from a variety of different retailers. These entry-level offerings include, for example, stand-alone premium packages, which eliminate the enforced buy-through which is a characteristic of all Sky's retail offerings. Such entry-level packages are however currently only available for that premium content to which Setanta holds the rights. We believe that consumers would benefit from a wider variety of entry-level packages being more widely available for other premium content. While we acknowledge the economic efficiencies associated with large bundles of different types of content, we believe that consumers would benefit from being able to choose whether they purchase stand-alone premium packages without an enforced buy-through.
- 1.36 Secondly, there is a risk that platform innovation will be reduced. We see some evidence of this, in that while the UK pay TV industry has a strong track record of innovations 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. Innovation in areas less well suited to the Sky platform's strengths might well have proceeded faster if wholesale premium content had been more widely available on other platforms.
- 1.37 As well as looking at consumers' current experience, it is vital to look ahead to the future, particularly given our principal duty under the Communications Act 2003 ('CA03') to further the interests of consumers, where appropriate by promoting competition. This is especially relevant to any discussion of platform innovation. We are at a point in the development of the pay TV sector when new platforms using new distribution technologies, such as IPTV and mobile TV, could offer significant benefits to consumers. The types of innovation which these new platforms might deliver to consumers are of course difficult to predict qualitatively, and even more difficult to quantify. Our general expectation however, as noted above, is that they will offer consumers greater convenience and enhanced service flexibility, by allowing them to access content on demand, or when on the move. We see a real risk that the development of these new platforms could be held back by limited access to premium content, thereby denying consumers the associated benefits.
- 1.38 Finally, there is a risk that prices to consumers will be high, either because of Sky's ability to set high wholesale prices, or because of Sky's ability to leverage upstream market power into downstream retail markets and set high retail margins. We have been presented with a substantial body of evidence on this point, and have carried out our own analysis.

- 1.39 Our analysis of whether retail prices are high remains inconclusive, and this reflects the various practical difficulties associated with such an analysis, such as the lack of a marginal cost which could provide a benchmark for competitive prices. We continue to see difficulties with the sort of international price comparison work presented to us by the Four Parties. Similarly, we believe the difficulties we identified in our December Consultation with drawing conclusions about the market from Sky's overall financial performance still exist.
- 1.40 Nevertheless, in the absence of vigorous competition, we cannot be confident that prices are at the same level that would be delivered by a competitive market.

Remedies

- 1.41 We consult in this document on our conclusion that Sky has market power in the wholesale of Core Premium channels. We further consult on a specific concern, which suggests that Sky, as a vertically integrated firm with market power in a key upstream market, will distribute its premium content in a manner that favours its own platform and its own retail business. We have considered what types of remedies might address this concern, and can identify four broad approaches.
- Despite the existence of the concern, we could deem the risks of intervention too great, and take no further action.
 - Secondly, we might seek to address Sky's market power at source, by intervening to change the way in which key content rights are bought and sold. However, in order for such an intervention to significantly reduce or eliminate the existing market power, it would be necessary to place severe restrictions on the ability of Sky and other firms to aggregate content. Such an intervention would go well beyond the previous intervention by the European Commission into the way FAPL rights are sold. Given the acknowledged benefits to consumers of content aggregation, we are not convinced that this is the best way forward at this stage.
 - Alternatively, we might intervene to eliminate Sky's incentives to exploit this market power in downstream markets. These incentives derive at least in part from Sky's vertical integration, so eliminating them would require a structural remedy which separates Sky's wholesale channel business from its downstream platform and / or retail business. Our view, on which we are consulting, is however that such a remedy would be disproportionate to the level of consumer detriment that we have identified. It would also fail to take into consideration the fact that Sky's current success is based on a historic willingness to invest in what was initially a risky business, and the need to ensure that investment is not deterred in future.
 - Finally, we might eliminate Sky's ability to act on these incentives, by requiring it to provide wholesale access to particular content on regulated terms. Such remedies have been imposed on pay TV providers in several other markets internationally, such as the US and Italy, and are commonly referred to as 'wholesale must-offer' obligations. Such an obligation would enable other operators to develop pay TV offers which include premium content, facilitating choice and innovation. It would do so without having a disruptive effect on the structure of Sky's existing retail and wholesale businesses, and so is a particularly proportionate form of intervention. Indeed, its objective is to replicate the natural outcome of a competitive market, which most interested parties recognise as being one in which content is widely distributed across a range of platforms.

- 1.42 We propose to address our concerns by placing a wholesale must-offer obligation on Sky. In this document we are consulting on the use of our sectoral competition powers under section 316 of the Communications Act to put such an obligation in place.
- 1.43 We believe that this remedy would allow for the strengthening of competition between retailers and between platforms. It would maximise choice for consumers, both in terms of the range of price points and packages available, and in terms of the range of platforms open to them.
- 1.44 We believe that it would be more appropriate to use our sectoral powers under section 316 CA03 than our powers under the Competition Act 1998 ('CA98') to address our concerns. Our principal duty is to further the interests of consumers, where appropriate by promoting competition. This is connected to our duty under section 316 CA03 to ensure "fair and effective competition in the provision of licensed services". This document identifies a lack of incentive for Sky to supply its wholesale Core Premium channels at prices that other retailers can afford. We consider that this has led, and will continue to lead, to reduced competition between retailers and between platforms, which will damage the interest of consumers. Our sectoral powers are well suited to dealing with a concern that competition will not develop in a manner that best serves consumers.
- 1.45 Conversely, we do not believe that it would be appropriate to rely on our powers under CA98 to seek to address the issues we have identified. Depending on the precise form of what we see as the most appropriate remedy, there may be one or more reasons for this.
- The limited wholesale availability of Sky's premium content may simply reflect an unwillingness on Sky's part to wholesale to retailers on other platforms at a price which Sky believes would be lower than the price at which it would need to wholesale to itself on those platforms. If this is the case, a decision not to supply might well not constitute abusive behaviour, and it would not be appropriate to take action under CA98, but our concern as a sectoral competition authority and regulator with a forward-looking duty actively to promote competition would remain.
 - Any wholesale must-offer remedy would need to include a number of detailed conditions governing the terms and conditions of wholesale supply. The most obvious of these conditions is some form of ex ante pricing rule. If we saw fit to set a pricing rule in a way which took account of the lack of scale of potential new entrants, this might imply an approach to cost analysis and therefore a price which could not be imposed under our CA98 powers.
- 1.46 We have also considered a possible reference to the Competition Commission under the Enterprise Act 2002 ('EA02'). While this is an option which remains open, we should consider using our sectoral competition powers first. Given that we believe that the most appropriate way forward is to consult on imposing a wholesale must-offer obligation on Sky, and given that we believe we can achieve this using our sectoral powers, it is not currently appropriate for us to make a Competition Commission reference for this purpose.
- 1.47 There 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. This might be the case if, for example, we believed there was a case for considering a more general intervention

into the way sports and movie rights are sold, which went beyond our powers as a sectoral regulator and competition authority. We have already discussed the possibility of intervening to reduce upstream market power by placing limits on content aggregation, and have noted that we are not currently persuaded of this approach. One alternative might however be to intervene to make rights more contestable, for example by placing specific constraints on contract durations, or the manner in which contracts are renewed. We believe however that the right time to consider such an intervention would be when we are able to review the effectiveness of any intervention resulting from this market investigation process, as well as the previous intervention by the European Commission into the sale of Premier League rights.

Details of a wholesale must-offer remedy

- 1.48 Having considered the most suitable remedy and identified the appropriate legal instrument, we now turn to look at some of the details of a potential wholesale must-offer obligation. We set out and discuss in this document a number of issues which may need to be addressed in such an obligation, and are seeking general feedback on these now. If following this consultation we decide to proceed with a wholesale must-offer obligation, then we would expect to issue a further consultation in which we would propose specific conditions of supply.
- 1.49 The non-price issues which we have considered include the following:
- We would expect the scope of the obligation to cover all Core Premium Sports and Core Premium Movies channels supplied by Sky. We recognise that this could lead to some content being rescheduled to ensure that channels which show a small amount of Core Premium content are not caught within this obligation. In light of this, we believe there may be a role for some limited exemptions, which we would consider on a case-by-case basis as part of our next consultation.
 - We expect the obligation would require Sky to make available its content to retailers supplying residential subscribers. We expect that all retailers on non-Sky platforms would be eligible, but it is less clear that retailers on Sky's own platform(s) should be eligible. Extending eligibility to retailers on Sky's own platform(s) is unlikely to serve our central objective, which is the promotion of competition from retailers on other platforms. It could however have the effect of addressing our concerns about enforced buy-through on Sky's platform(s).
 - We would expect the offer 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.
 - We would expect this content to be provided in the form of a 'clean feed'. This clean feed would not include an undue level of cross-promotion to other Sky channels, which are not included within the wholesale supply obligation. It would also not include any other features which might degrade the viewing experience on other platforms, such as non-functional interactive services.
 - We 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.

- 1.50 We believe it would be necessary to specify an ex ante pricing rule for the channels contained within any wholesale must-offer. We may need to go beyond this and set a specific price, but if we do not do so, then we will certainly need to establish a mechanism for the rapid resolution of pricing disputes. We have not set out a detailed analysis of pricing in this document, but discuss the two broad approaches which are available to us, and would welcome comment on these – in particular the practical difficulties associated with either approach.
- If our only concern is that Sky may price in a manner that discriminates between different retailers, and thereby distorts retail competition, it may be appropriate to set prices on a retail-minus basis. Given that the purpose of our suggested intervention would be to ensure fair and effective competition on a forward-looking basis, the retail margin implied by this pricing rule may need to be set at a level which would support entry into the market by new retailers. The details of this would need to be determined in any subsequent consultation. One of the main practical difficulties however with retail-minus is that it may be possible for the incumbent to game the system of price adjustments over time to its own advantage.
 - If we are also concerned either that Sky may currently be setting high wholesale prices, or that it may respond to this intervention by setting high wholesale prices in the future, it may be appropriate to consider drawing on a cost-based approach. However, setting prices using costs which are determined by content rights auctions could risk artificially depressing future bids for such content, which would clearly be undesirable.
- 1.51 In an attempt to mitigate the likely effects of the various practical difficulties, one method would be to adopt a retail-minus approach, but use a cost-based analysis as a cross-check, noting the need to consider how the value of intangible assets should be considered in that calculation. If this cross-check were to result in a significant discrepancy, providing evidence of excessive wholesale margins, we might consider whether there was a way of bringing prices into line with costs without opening up the difficulties relating to rights auctions.
- 1.52 Finally, we would expect there to be a need to review any obligation after a period of time, perhaps three years from when the obligation comes into force. We recognise that a material change in circumstances, such as a major shift in the ownership of sports or movie rights, might cause us to bring that review forward.

Next steps

- 1.53 We welcome stakeholders' views on all parts of this document, from our analysis of market definition, market power and the importance of premium content, to the concerns we have expressed and the actions we have proposed in order to resolve those concerns.
- 1.54 If following this consultation we decide to proceed with a wholesale must-offer obligation, then we would expect to issue a further consultation in which we would propose specific conditions of supply.

Section 2

Introduction

Summary

- 2.1 In January 2007 we received a significant submission from BT, Setanta, Top Up TV and Virgin Media, following which we began an investigation into the UK pay TV sector. In December 2007 we published a first consultation document, in which we set out our initial views on the operation of the market, and some initial concerns relating to the manner in which premium content is aggregated and distributed, which may restrict competition in the retail market to the detriment of consumers.
- 2.2 We received a wide range of responses to our consultation – 29 in total, 23 of which we published in May 2008 and six of which remain confidential. Views were heavily polarised. Sky and the FAPL disagreed with many aspects of our analysis, including our analysis of market definition and market power, and our associated competition concerns. A number of other respondents expressed support for our concerns, and some suggested we had not gone far enough in our assessment of their magnitude.
- 2.3 In this further consultation we analyse these responses, and review the initial views on the operation of the market that we set out in December in light of this analysis. We set out our current position on competition concerns, and consult on a proposal for addressing those concerns.
- 2.4 In our previous consultation we presented a set of criteria, which we have since refined, for assessing whether the pay TV sector is providing a good set of outcomes for consumers. These focus on three key areas:
- **Consumer choice:** consumers should be able to choose which platform they wish to use as a means of accessing content, and which content they wish to watch on that platform.
 - **Innovation:** consumers should benefit from innovation, both technical innovation in platform services, and retail innovation in service bundling.
 - **Pricing:** prices should provide consumers with good value, and a sufficient variety of price points to allow them to tailor their purchases to meet their preferences.
- 2.5 While respondents broadly agreed with these criteria, several commented that there may be different ways to interpret them. We have therefore set out in this document some more specific characteristics which we believe are likely to be common to most desirable consumer outcomes.
- Firstly, consumer benefits are likely to be maximised if content that consumers value highly is available on all platforms. It is already widely recognised that it would be a poor outcome for viewers of free-to-air services if the main public service broadcasting ('PSB') channels were not available on all platforms. Similarly, it would be a poor outcome for consumers of pay TV services if they were unable to access premium content because of their choice of platform.
 - Secondly, consumer benefits are also likely to be maximised if consumers are able to choose from a broad range of content bundles. A market in which there

was effective retail competition might result in different retailers providing services which are optimised for different market segments, including a wide variety of entry-level packages, as well as the ability to purchase specific categories of premium content on a stand-alone basis.

- Thirdly, consumers are likely to benefit if different platforms are able to innovate in a manner that plays to the strengths of the particular distribution technology used by those platforms. Sky's strong history of innovation on its satellite platform is widely recognised, but we also note the potential of emerging IPTV and mobile TV platforms to offer consumers greater convenience and enhanced service flexibility, by allowing them to access content on demand, or when on the move.
- Finally, consumers clearly benefit from a fair deal in terms of pricing. As we discuss later in this document, it is difficult to determine analytically what an appropriate price is for content. In these circumstances we believe it is particularly important that the prices paid by consumers are determined by competition between different suppliers.

Purpose of this document

- 2.6 We announced the start of our market investigation into pay TV on 20 March 2007. This was prompted by our receipt on 16 January 2007 of a preliminary submission from BT, Setanta, Top Up TV and Virgin Media which alleged that competition in the UK pay TV sector is not working properly, and that Ofcom should refer the industry to the Competition Commission for investigation.
- 2.7 This submission, along with recent changes in the pay TV industry, such as convergence and the emergence of new digital television technologies, convinced us of the need to carry out an investigation to assess the extent of any competition issues in the market.
- 2.8 In our December Consultation, we set out several key concerns. In summary, those concerns were:
- There may be significant barriers to entry into the market for premium wholesale channels.
 - Although a vertically integrated incumbent may supply content to established retail competitors, in order to generate wholesale revenues, it may have the ability and incentive to reduce the quality of what it supplies, in order to strengthen its own retail offering relative to its competitors.
 - A vertically integrated incumbent may have the incentive and ability to foreclose potential new retailers by denying them content.
 - The prevalence of vertical integration between retail and platform operations may cause this problem to extend to foreclosing the possible development of new platforms.
 - The prospects for competition in stand-alone basic packages may be restricted by the existence of buy-through.
- 2.9 Since April of this year, when we received the final responses, we have been reviewing responses to our consultation, and carrying out further research and analysis. This document reflects our views in light of those responses and our own

further work. The responses and our further review have led us to focus in particular on access to premium content, and the effects that restricted access could have on competition in pay TV.

- 2.10 The purpose of this document is to consult on our views on market definition and market power, and the competition issues flowing from that market power. We are also consulting on what we see as the most appropriate remedy to the issues we have identified, which is to use our sectoral powers to put in place a 'wholesale must-offer' remedy in respect of particular content.
- 2.11 This is the non-confidential version of this document. Confidential information and data have been redacted. Redactions are indicated by “[X]”.

The pay TV market investigation to date

- 2.12 Ofcom has published a series of documents on the market investigation already, either produced by Ofcom or by others. In order to provide maximum clarity to readers, we describe these in chronological order below. All of the documents mentioned are available on Ofcom's website via this page <http://www.ofcom.org.uk/tv/paytv/>.
- On 20 March 2007, Ofcom announced that it was opening an investigation into the pay TV industry. The Four Parties had provided Ofcom with a preliminary submission on the pay TV industry on 16 January 2007.
 - On 3 July 2007, the Four Parties made a submission to Ofcom on “the need for a market investigation into the pay TV industry” (the ‘July Submission’).
 - On 30 October 2007, Sky made a submission to Ofcom in response to the July Submission.
 - On 18 December 2007, Ofcom published a first consultation on pay TV.
 - The consultation closed on 26 February 2008. However, we received a number of responses after that date, the last of which was on 11 April, and in non-confidential form on 1 May.
 - On 29 February 2008 the Four Parties made a submission to Ofcom in response to Sky's submission of 30 October 2007.
 - On 13 May 2008, Sky provided Ofcom with a supplement to its previous response.
 - On 1 July 2008, Sky provided two further documents to Ofcom, which it had commissioned from CRA. One was a submission on Sky's incentives to wholesale content, and the other was a further submission on comparing pay TV prices across Europe.
 - On 6 August 2008, the Four Parties made a further submission to Ofcom, responding to Sky's response to our December Consultation.
 - Also on 6 August 2008, BT made a submission to Ofcom entitled “Submission on why a reference to the Competition Commission is fully justified”.

- On 13 August 2008, Sky made a further submission to Ofcom entitled “An examination of LECG’s arguments in relation to pay TV operators’ ability to monetise the acquisition of new content”.
 - On 15 August 2008, Virgin Media made a “supplementary submission” to Ofcom, which focuses on the idea that “UK pay TV consumers can be better served”⁴.
 - On 16 September 2008, Sky made a submission to Ofcom in response to the Four Parties’, BT’s and Virgin’s August submissions.
 - On 22 September 2008, Sky provided a document to Ofcom which it had commissioned from CRA, commenting on the submission from the Four Parties dated 6 August.
 - On 24 September 2008, Sky provided a document to Ofcom entitled “A review of LECG’s critique of PwC’s report on the outcomes for consumers in relation to pay TV in Europe”.
- 2.13 Ofcom has published all these supplementary submissions since May 2008 alongside this consultation document; see <http://www.ofcom.org.uk/tv/paytv/>.
- 2.14 Although the original submission was one of the reasons for beginning this investigation, and there have since been a number of submissions and counter-submissions, all these documents form part of the evidence and arguments we have considered for the purposes of this consultation exercise. The original submission and the counter-submissions have no different status to the other documents in this process.

Work carried out since December

- 2.15 The main work we have undertaken following our December Consultation has been to review the consultation responses and revisit our preliminary conclusions set out in the December Consultation in light of these. We have gathered more evidence from stakeholders and through consumer research, and have carried out further in-depth analysis to continue to assess competition issues.
- 2.16 First, we have issued a number of additional information requests, on a variety of subjects, including:
- Updated subscriber numbers and pricing data.
 - Further information on changes in quality of premium channels over time.
 - Evidence to analyse countervailing buyer power in the wholesale of premium channels.
 - Evidence to help understand pay TV operators’ strategic behaviour in relation to content rights.
- 2.17 Secondly, we have carried out two further pieces of consumer research.

⁴ Ofcom believes that these three August submissions from the Four Parties, BT and Virgin Media do not contain material new evidence.

- A piece of conjoint analysis to understand the relative importance to consumers of different sports and sporting events. This has helped us with our work on market definition in the context of premium sports.
- A piece of research to understand consumers' willingness to pay for a variety of generic packages of content, e.g. basic, sports or movies. This has helped us understand both consumers' demand elasticity for different types of product as well as the extent of any unmet demand resulting from current prices in the market.

2.18 Through the use of this additional research and through further internal analysis, we have continued to develop our assessment of market definitions and market power. The output from these pieces of research is attached at Annex 10.

Ofcom's duties

2.19 Ofcom has a principal duty under section 3(1)(b) CA03 to further the interests of citizens and consumers in relevant markets, where appropriate by promoting competition.

2.20 Other general duties relevant in this context include the requirements under section 3(2) CA03 for Ofcom to secure:

- The optimal use of the electro-magnetic spectrum.
- The availability throughout the UK of a wide variety of electronic communications services.
- The availability throughout the UK of a wide range of TV and radio services of high quality which appeal to a variety of tastes and interests.
- The maintenance of a sufficient plurality of providers of different TV and radio services.

2.21 Section 3(4) CA03 sets out certain other factors to which Ofcom should have regard in performing its principal duty of furthering the interests of citizens and consumers. Those which are most likely to be relevant in this context are:

- The desirability of promoting competition in relevant markets.
- The desirability of encouraging investment and innovation in relevant markets.
- The desirability of promoting the fulfilment of the purposes of PSB in the UK.
- The desirability of encouraging the availability and use of high speed data transfer services throughout the UK.
- The different needs and interests of all users, both current and potential, of the spectrum used for television.
- The opinions of consumers and members of the public.

2.22 Under section 3(5) CA03 Ofcom must also, when performing the duty of furthering the interests of consumers, have regard to the particular interests of those consumers in respect of choice, price, quality of service and value for money.

- 2.23 In relation to the regulation of technical platform services Ofcom must also have regard to its duties to fulfil Community obligations under section 4 CA03.

Legal framework for this document

- 2.24 As noted above, Ofcom has a principal duty under section 3(1)(b) CA03 to further the interests of consumers in relevant markets, where appropriate by promoting competition. This duty to promote competition means that we are required, where appropriate, to take a dynamic and forward-looking view of the effectiveness with which competition is expected to deliver benefits to consumers. In this document we carry out that assessment by reference to the duties described above, the statutory framework and the criteria developed for the assessment of the industry (discussed later in this chapter).
- 2.25 Our principal duty also establishes that if we identify that the interests of consumers are not being, or will not be, furthered by the operation of competition in the relevant markets, we should, where appropriate, act in order to promote competition. In relation to broadcasting markets the duty at section 3(1)(b) to promote competition is connected to Ofcom's sectoral competition functions under sections 316 to 318 CA03, which provide that Ofcom should ensure "fair and effective competition in the provision of licensed services or connected services".
- 2.26 It is important to note that these duties as a sectoral regulator and competition authority may lead us to take action in circumstances where action would not be appropriate under CA98 powers. This is because the primary focus of CA98 is on preventing and remedying anti-competitive behaviour, whereas we must also consider the appropriateness of action to make markets more competitive in the future.
- 2.27 We conducted the December Consultation pursuant to Ofcom's duties under section 3 CA03. We explained that Ofcom would examine whether there were competition issues requiring further action. There are three sets of powers for Ofcom to consider for addressing competition concerns in this context:
- The July Submission argued that Ofcom should exercise its discretion to make a market investigation reference to the Competition Commission pursuant to its powers under EA02.
 - Ofcom also has concurrent jurisdiction with the OFT to exercise CA98 powers in relation to anti-competitive agreements or conduct, or abuses of a dominant position connected with communications matters.
 - The sectoral broadcasting competition regime.
- 2.28 An important step in analysing competition concerns in the context of the above legal instruments is to identify the relevant markets and evaluate whether any participants in the market possess market power. A finding of market power is not in itself a problem warranting intervention. It is rather a step to establishing whether problems with competition may exist. Market power is discussed below in section 5 in light of responses to the December Consultation and additional evidence gathered by Ofcom.
- 2.29 The competition concerns identified in the December Consultation, and commented on by respondents, are then analysed further in section 6. We identify an ongoing concern about limited wholesale access to premium channels and the wholesale

pricing of premium channels. Section 7 then examines how the “interests of consumers in the relevant markets” may be affected by these concerns.

- 2.30 Section 8 then considers which of Ofcom’s competition powers it may be appropriate to use in order to address the competition concerns identified. Before using any of its competition powers Ofcom must also consider whether it may be more appropriate to act under an alternative power. In particular:
- The Office of Fair Trading’s guidelines on market investigation references (to which Ofcom has regard), explain that prior to exercising a discretion to refer, it should be considered whether it is more appropriate to deal with competition issues by applying competition law or sectoral powers⁵.
 - Under section 317(2) CA03 Ofcom is required, before taking action under section 316, to consider “whether a more appropriate way of proceeding in relation to some or all of the matters in question would be under the Competition Act 1998”.

Relationship to Sky’s Picnic proposal

- 2.31 In parallel to the market investigation process into pay TV, Ofcom has been considering an application from National Grid Wireless⁶ and Sky to change Sky’s free-to-air (FTA) channels on DTT to pay channels. As part of that process, Ofcom published a consultation on 4 October 2007, which closed on 14 December 2007. The consultation and responses are available via <http://www.ofcom.org.uk/tv/paytv/>.
- 2.32 While these are two separate processes, they cover much common analytical ground, both in terms of market definition and the nature of any concerns.
- 2.33 Ofcom has therefore released this current consultation alongside a further consultation on DTT licensing, which sets out Ofcom’s views on the NGW / Sky application – <http://www.ofcom.org.uk/consult/condocs/picnic/>.
- 2.34 As that document states, we propose to allow those changes to take place, and allow Sky to broadcast pay TV channels on DTT, but only under conditions which allow for fair and effective competition. We believe those changes can only happen subject to certain conditions, the nature of which is connected with the remedies discussed in section 8 in this document.

Relationship to the market review of wholesale digital platform services

- 2.35 On 10 October 2006, Ofcom announced that it would be carrying out a review of the market for wholesale digital platform services⁷.
- 2.36 Our December Consultation expressly did not attempt to define relevant wholesale platform markets, stating that concerns there would be dealt with in that review. Several respondents to our December Consultation – the BBC in particular – expressed concern that platform issues were not being covered in this investigation.
- 2.37 The market review of wholesale digital platform services is on hold while this investigation is in progress. Issues related to digital platform services, including the

⁵ OFT 511 Market investigation references (March 2006) paragraph 2.1 - http://www.ofcom.gov.uk/shared_ofcom/business_leaflets/enterprise_act/of511.pdf.

⁶ Trading as Arqiva from 22 September 2008.

⁷ <http://www.ofcom.org.uk/tv/ifi/marketreviews/wholesaledtvtb/review.pdf>.

extent to which specific platform characteristics result in platform operators having buyer power in relation to broadcasters, are relevant to this investigation, but any remedy we might propose in relation to a platform market would be proposed as part of that separate project.

Criteria for assessing the pay TV industry

Our views in December

- 2.38 In the December Consultation we invited comments on a more specific set of criteria against which to assess outcomes in the pay TV industry under Ofcom's general duties.
- 2.39 These criteria, which reflect the section 3(5) CA03 requirement (see the further exploration of the legal framework above) to "have regard to the particular interests of those consumers in respect of choice, price, quality of service and value for money", were:
- **Choice of platform and content:**
 - Choice for consumers of platform, and of content once platform selection is made.
 - Switching between retailers and platforms should not be artificially difficult.
 - Generation and availability of a broad range of high-quality content: a variety of content should continue to be generated and made available to consumers on all platforms.
 - **Innovation in platform services:** for example in terms of interactivity, set-top box functionality such as DVR capabilities, or video on demand options.
 - **Pay TV services priced competitively and efficiently:**
 - Prices which give consumers good value and allow efficient producers to earn a reasonable return on their investment.
 - A sufficient variety of price points / bundles to allow consumers to tailor their purchases to meet their preferences.

Respondents' views

- 2.40 Respondents broadly agreed with the criteria identified by Ofcom against which to assess whether the pay TV sector is functioning well in terms of its impact on consumers. However, Setanta, Top Up TV and Virgin Media all emphasised the view that the full consumer benefits of effective competition in pay TV markets can not be judged simply by observing outcomes against these criteria, and that Ofcom must take a dynamic view of the consumer experience of pay TV.
- 2.41 Sky agreed that the criteria "are important factors against which Ofcom should consider the functioning of the pay TV sector". However, it argued that in considering choice of platform and content, switching should not be limited to switching between retailers and platforms, and the ease of switching between channel packages should be included. Sky also argued that whether content is considered 'high-quality' is subjective. Additionally, it believed Ofcom should distinguish between 'platform' and

other services. Sky suggested that consideration of the competitive and efficient pricing of pay TV services should include findings on the levels of consumer satisfaction, levels of pay TV penetration, the quality and nature of content, and that excessive profits are not being made.

- 2.42 Further to this Sky suggested that a number of key developments are absent from Ofcom's overview, including the continued proliferation of the number of channels and amount of content on free and pay TV, significant changes to consumption and distribution of movies (e.g. DVD sales and rentals), and changes in products (e.g. changes in packages). In Sky's view the consultation also failed to consider the importance of quality as a measure of content choice, and services that deliver content over the internet (e.g. iPlayer).
- 2.43 [X] agreed with the criteria insofar as they relate to consumers, but strongly urged Ofcom to consider the relationship between integrated operator / retailers, such as Sky, and third party channel providers as part of the market investigation.
- 2.44 While the ALMR broadly agreed with the criteria, it stated that it would be "important to assess separately the interests of domestic and commercial customers" and that the priority of criteria for commercial customers will potentially be different. There is "no choice for commercial customers – premium sports are exclusively available through one platform and one retailer".
- 2.45 The UK Film Council stated that the dominance of a single significant operator in pay TV has been detrimental to consumer choice and platform growth and has substantially lessened upstream competition for the acquisition of rights to films. Setanta, Top Up TV and BT felt that if premium content was made available at competitive rates on all platforms, consumer choice would be greater (not just in relation to premium content but basic channels also).
- 2.46 Respondents were particularly detailed in their responses regarding innovation. Several points raised regarding the innovation criteria were:
- Sky believed that we should not limit our innovation criterion to "platform services", and stated that it would not categorise HD, interactivity and VoD as "platform services".
 - Tiscali considered that platform innovation should receive particular emphasis as it is an area of vulnerability and offers great potential for positive consumer impact.
 - Virgin Media believed Ofcom should have particular regard for innovation in relation to the supply of HD services.
 - The BBC asked Ofcom to consider whether innovation would have been greater in a more competitive market; to examine the source of innovation to date (can all operators – including channel providers – introduce innovation successfully); and if there is further consolidation, is it a risk to future levels of innovation? Similarly, [X] believed the relevant question is why specific innovation to date has occurred and whether it would have been greater in a truly competitive environment.
 - BT claimed there has been little innovation in content packages, particularly in premium content, and suggested one reason for this is the sale of rights on a cross platform basis.

- 2.47 Setanta and Top Up TV also outlined a number of arguments in relation to innovation in their submission. They stated that Sky has been able to inhibit the launch of HD services by competing broadcasters and that in a more competitive environment, further innovations would find their way to market. They argued that Top Up TV's subscription video on demand (SVoD) service is another example of innovation in the market, but Sky's control of "mutually reinforcing upstream and downstream bottlenecks limits competitors' access to key content, which could form the basis of further innovative services".
- 2.48 In relation to the pricing criterion, it was suggested that Ofcom should expand the concept of "efficient producer" to "efficient market participant", to eliminate any potential confusion with a narrow interpretation referring only to broadcasters.

Our current view

- 2.49 We believe that in light of these responses, the criteria we suggested in December remain broadly the right ones. We agree that what constitutes 'high quality' is inevitably somewhat subjective, which can make it difficult to use this criterion in a transparent manner. That makes it no less relevant. The refinements suggested to how we assess innovation are all helpful – we are very conscious of the important role of platform innovation, and of establishing what we believe the counterfactual would be against which we should judge current and prospective innovation levels.
- 2.50 One refinement we would now make relates to innovation, and relates to the point made by BT about content packaging. Innovation is not limited only to technical platform features. It can also take the form of new types of retail packages – creating new combinations of services, implementing new charging structures for existing content, or bundling content with technical features in new ways. We would therefore amend our innovation criterion to:
- **Choice of platform and content:**
 - Choice for consumers of platform, and of content once platform selection is made.
 - Switching between retailers and platforms should not be artificially difficult.
 - Generation and availability of a broad range of high-quality content: a variety of content should continue to be generated and made available to consumers on all platforms.
 - **Innovation:**
 - In platform services, for example in terms of interactivity, set-top box functionality such as DVR capabilities, or video on demand options.
 - In retail service bundling, packaging and pricing.
 - **Pay TV services priced competitively and efficiently:**
 - Prices which give consumers good value and allow efficient producers to earn a reasonable return on their investment.
 - A sufficient variety of price points / bundles to allow consumers to tailor their purchases to meet their preferences.

- 2.51 Several respondents noted that there may be different ways to interpret some of the criteria on which we consulted. It may therefore be helpful to illustrate in slightly more detail how we expect to interpret them. It is both difficult and inappropriate to predict precisely how a market will develop in the future, but we can identify several specific characteristics that might be expected to be associated with any market outcome which is likely to be regarded as desirable for consumers. We would welcome comment on these.
- 2.52 Firstly, consumer benefits are likely to be maximised if content that consumers value highly is made available on all platforms. It is already widely recognised that it would be a poor outcome for viewers of free-to-air services if the main PSB channels were not available on all platforms. Similarly, consumer benefit is not likely to be maximised if consumers of pay TV services were denied key content because of their choice of platform.
- 2.53 Secondly consumer benefits are also likely to be maximised if consumers have a choice between a broad range of content bundles. A market in which there was effective retail competition might result in different retailers providing services which are optimised for different market segments, including in particular a wide variety of entry-level packages, as well as the ability to purchase specific categories of premium content on a stand-alone basis.
- 2.54 We acknowledge that there is a potential tension between a desire to promote choice, by making available more targeted content bundles, and a desire to reduce prices, by fully exploiting the efficiencies associated with content bundling. We believe that the most appropriate means of resolving this tension is for a wide range of bundles to be made available, priced in a manner which reflects bundling efficiencies, thereby allowing consumers to choose the bundle which represents the best compromise for them.
- 2.55 Thirdly, consumers are likely to benefit if different platforms are able to innovate in a manner that plays to the strengths of the particular distribution technology used by those platforms, specifically:
- We would expect Sky to continue to develop its satellite platform by providing services that either exploit the high capacity of such platforms (e.g. HD) or compensate for their limited ability to deliver content on demand (e.g. DVRs).
 - We would expect new DTT-based platforms to emerge which exploit the ubiquity and low switching costs associated with DTT, but which are commercially viable despite DTT capacity constraints. Live sport is ideally suited to DTT, because it involves a large audience watching the same content at the same time, and we might expect DTT-based platforms as well as some hybrid platforms to exploit this.
 - We see 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. In particular, we might expect to see the development of an increased range of video on demand services.
- 2.56 Finally, consumers clearly benefit from a fair deal in terms of pricing. As we discuss later in this document, it is difficult to determine analytically what an appropriate price is for individual items of content, and it is more difficult still to determine an appropriate price for different content bundles. In these circumstances we believe it is

particularly important that the prices paid by consumers are determined by fair and effective competition between different suppliers.

Structure of this document

2.57 The remainder of this document is structured as follows:

- Section 3: the reasons for the focus of this document on premium content, and why premium content is important to competition in pay TV.
- Section 4: our current views on market definition.
- Section 5: our assessment of market power in the wholesale of premium sports and premium movie channels.
- Section 6: our views on possible problems in access to premium sports and premium movie channels.
- Section 7: the likely effects of these concerns on consumers.
- Section 8: the range of remedies that we might in principle adopt.
- Section 9: issues relating to the details of a possible wholesale must-offer obligation.

2.58 There are 10 annexes to this consultation. Annexes 1 to 5 are appended to this document. Annexes 6 to 10 are available as separate documents.

- Annex 1: responding to this consultation.
- Annex 2: Ofcom's consultation principles.
- Annex 3: consultation response cover sheet.
- Annex 4: summary of consultation questions.
- Annex 5: glossary of terms used in the consultation.

2.59 Annexes 6 onwards are available as separate documents on this page – http://www.ofcom.org.uk/consult/condocs/second_paytv/.

- Annex 6: market definition – support for section 4 of this document.
- Annex 7: market power – support for section 5 of this document.
- Annex 8: competition issues related to Core Premium content – support for section 6 of this document.
- Annex 9: profitability and investor returns analysis.
- Annex 10: consumer research annex.

Consultation questions

1. What characteristics should the pay TV sector display in order to serve consumers best?

2. Do you agree with the amendment to our criteria for assessing the pay TV market?

Section 3

The importance of premium content

Summary

- 3.1 We continue to believe that consumers' choice of pay TV retailer is primarily influenced by the content bundles which are available from different retailers. Platform-related features may enhance the viewing experience and therefore provide added value to consumers, but they cannot compensate for content that lacks intrinsic appeal. The ability to time-shift a programme, for example, is only of value precisely because consumers want to watch a specific and valued piece of content in the first place.
- 3.2 Our focus in this document is on that content which is likely to be most effective in driving pay TV subscriptions. This content must have two characteristics: a significant appeal to a broad audience, and limited availability via free-to-air TV channels. Content which has a broad appeal, but which is widely available free-to-air, such as some of the UK-originated content available via the public service broadcasters, is unlikely to drive pay TV subscriptions, since consumers are unlikely to pay a significant premium to watch programmes similar to those which they can already watch for free. We identify two types of content which combine broad audience appeal with a high degree of exclusivity to pay TV: live top-flight sports and first-run Hollywood movies⁸.
- 3.3 The importance of these types of content is revealed by a variety of evidence which we have considered here, including:
- Consumer surveys, which show that live top-flight sports and first-run Hollywood movies are among the content genres most valued by consumers. This is consistent with a common-sense observation of the level of interest shown by consumers in live sports and blockbuster movies.
 - Observed consumer behaviour, in particular the high proportion of pay TV subscribers who are willing to pay a substantial premium for bundles which include this content.
 - The observed behaviour of firms, and in particular the high prices which pay TV channel providers are willing to pay for key content rights.
 - The effects on firms and on consumers following substantial changes in the ownership of key content rights. These effects cannot be observed in the UK, where the majority of key rights have not changed hands since the early 1990s, but they can be observed in other international markets.
- 3.4 We have considered whether these types of content are likely to continue to be as important in the longer term as we believe them to be now.
- Our view is that live top-flight sports programming is likely to have an enduring appeal, regardless of technical change. Broadcast media are intrinsically well

⁸ By "top-flight" sports we mean for example international matches or matches from the top national sports leagues. By "first-run" movies we mean movies that are being shown for the first time on TV.

suited to content which is based on mass participation in major live events, and this is unlikely to change in the foreseeable future.

- The same may not however be true of movie programming, since although blockbuster movies are likely to retain their appeal, the simultaneous broadcast of a small number of movies to a large number of viewers is unlikely to remain the most effective means of distribution in the longer term. It is not difficult to imagine a world in which they are generally accessed more directly, for example via various forms of internet download. Movie download services are already available, though they have yet to be taken up by large numbers of consumers.

Introduction

3.5 Pay TV retailers typically offer consumers a wider range of content than is available free-to-air. Depending on the platform being used, they may also offer various value-added services, such as the ability to view programmes at a time that is convenient to the viewer and a variety of interactive services. This combination of an enhanced choice of content and enhanced platform services has resulted in pay TV growing from almost nothing in the early 1990s to an industry that now serves over 12 million consumers.

3.6 In this chapter we explore what have been the main drivers of this growth. The aim is to recap why the primary focus of our December Consultation was on access to premium content, and why that continues to be our primary focus.

3.7 We also acknowledge that there have been a number of important recent developments, which mean that the future development of the market cannot simply be extrapolated from a view of the past. In such circumstances it is particularly important that our competition analysis takes a forward-looking view, focusing on those characteristics of the market which are most likely to influence its development over the next few years.

3.8 In this chapter:

- We first recap the views we expressed in December, alongside a summary of what respondents said on the issue.
- We then explain the reasons for focusing first on content rather than distribution activities, and on premium rather than basic content. We then proceed to explain the importance of premium content to competition in pay TV.

3.9 The following two chapters analyse in detail whether there are separate economic markets concerning the wholesale supply of premium content and whether there is market power in any such markets

Definition of 'premium'

3.10 The term 'premium' has long been used in the context of pay TV to denote a particular set of channels or packages which command a price premium over 'basic' pay TV packages. Both Sky and Virgin Media refer to "premium mixes" or "premium channels", and Setanta refers to "premium football, cricket, rugby, boxing and motorsport".

3.11 We make use of the term in this document in a number of ways. We talk about 'premium channels', which we use in the same broad way as industry participants.

Under this heading we would include Sky Sports 1, 2, 3 and Xtra, and all the Sky Movies channels. We would also include Setanta's sports channels.

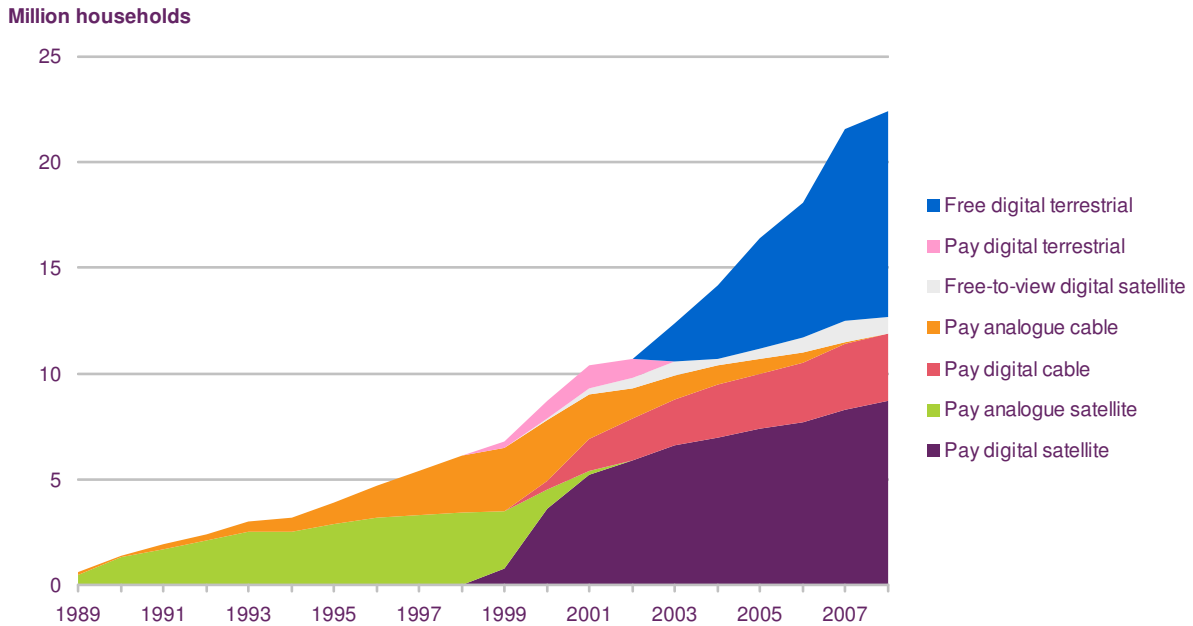
- 3.12 We also talk about 'premium content', by which we mean content which is particularly highly valued by consumers. Much of the content which is on the channels named above falls into this 'premium' category. However, we would not necessarily consider all the content on those channels to be 'premium'. It is quite likely that those channels include content which is of much lower value to consumers. Conversely, there is content on free-to-air channels (or indeed pay TV channels outside the premium channels) which consumers would regard as 'premium'. For whatever reason, that content might be available free-to-air, but if it were available only as part of the premium channels, some consumers might well be prepared to pay a premium in order to view it.
- 3.13 This chapter talks in a broad sense about 'premium' content. However, we go on in the next chapter to identify a more tightly defined set of channels which we consider to be in their own narrow wholesale markets due to their particular importance in pay TV. We refer to those channels as 'Core Premium' to denote their particularly significant appeal.

Our views in December

- 3.14 We explained in our December Consultation how the emergence and growth of pay TV markets in the UK and elsewhere has been driven historically by cable and satellite broadcasters. In the UK the main cable and satellite pay TV operators are:
- Sky, created by the merger of Sky Television and British Satellite Broadcasting in 1990. Sky now has 9.0 million retail subscribers in the UK (subscribers at end of June 2008).
 - Virgin Media, created by a consolidation over 13 years of the cable franchise areas created in 1984, culminating in the merger of NTL and Telewest in 2006, and the subsequent re-branding in 2007 to Virgin Media. Virgin now has 3.5 million subscribers (at end of June 2008).
- 3.15 Pay TV services have also been provided on DTT. ONdigital launched its service in 1998. It re-branded as ITV Digital in 2001, in an attempt to exploit the ITV brand, but went into administration in March 2002, after attempts to renegotiate the terms of its rights deal with the Football League failed. The number of subscribers reached a peak of 1.2 million at the end of 2001.
- 3.16 Freeview was launched in 2002, using the DTT spectrum released following the failure of ITV Digital. It provided a free-to-air alternative for those consumers who wanted multi-channel TV but did not wish to pay the charges set by satellite and cable operators, or could receive neither. There are now 9.3 million Freeview-only households.
- 3.17 The historic growth in these pay TV and free-to-air services is illustrated in Figure 1 below. It is possible to distinguish three fairly distinct periods of growth:
- Steady growth in analogue pay TV services during the 1990s, on both satellite and cable, driven by access to premium content, and in particular the acquisition by Sky in 1992 of exclusive rights to live Premier League football.

- The migration from analogue to digital at the end of the 1990s, greatly increasing the range of content and value-added services that could be delivered to subscribers.
- Over the last five years, continued growth of Sky's satellite service and of Freeview, alongside very limited growth on cable. The key dynamic in recent years has been between Sky, driving growth in pay TV, and Freeview, driving growth in free-to-air multi-channel TV.

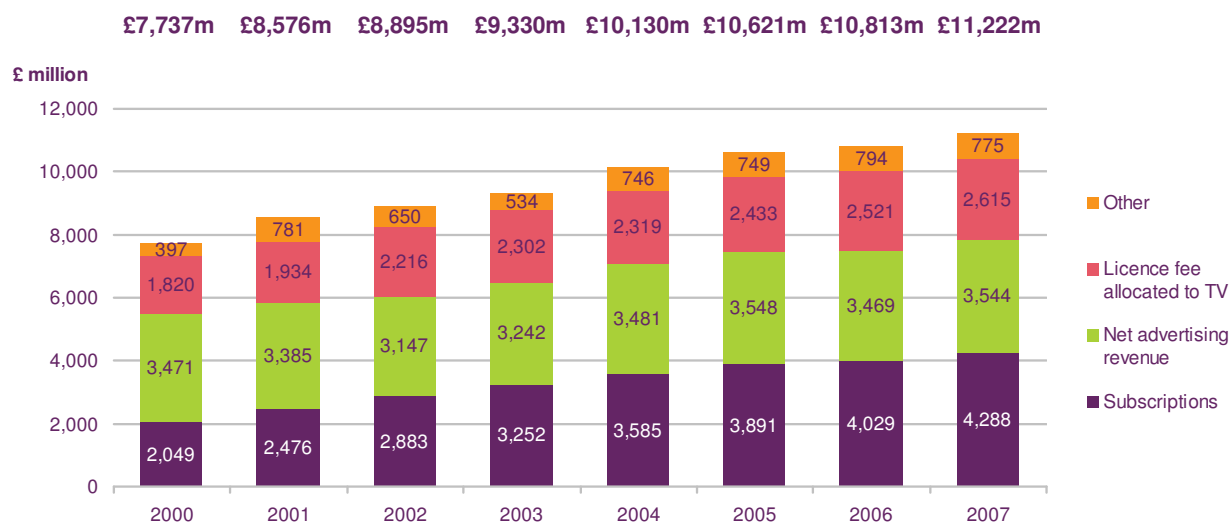
Figure 1 Multi-channel platform penetration (main TV set)



Source: 1989-1996 data from ITC, platform operators and BARB for July of each year; 1997 from Sky and ITC reports; 1998-2006 data from Ofcom estimates, platform operators and GfK research for Q2 of each year.

3.18 We observed that the increased importance of retail pay TV services to consumers has been reflected in a substantial increase in the importance of the associated revenues to industry. Figure 2 below shows that, since 2004, pay TV subscriptions have made up the largest revenue stream within TV broadcasting. In 2007, subscriptions reached £4.3 billion, exceeding the revenue generated by TV advertising (£3.5 billion) and public funding (£2.6 billion).

Figure 2 Total TV industry revenue by sector



Source: Ofcom estimates and broadcasters

Note: figures expressed in nominal terms. 'Subscriptions' includes Ofcom's estimates of BSkyB and Virgin Media television subscriber revenue. 'Other' includes TV shopping, sponsorship, interactive (including premium rate telephony services), programme sales and S4C's grant from the DCMS.

- 3.19 We saw that a variety of technological developments have contributed to innovation in pay TV, including the emergence of new distribution technologies, the digitisation of television signals, the emergence of new video compression techniques, and the falling cost of digital processing and storage. These have enabled new means of content distribution, as well as a variety of new value-added services such as EPGs, DVRs, etc.
- 3.20 We discussed the particular role of content in driving pay TV subscriptions. Unsurprisingly, we found that content is the element of consumers' TV service that is by far most often described as 'must have', both for pay TV and free-to-air consumers.
- 3.21 We discussed the relative importance of different categories of content: premium sport, premium movies and general news and entertainment (often referred to collectively as 'basic content'). We noted that the acquisition of live top division UK football rights by Sky for the period from 1992 to 1997 is widely seen as having been a key driver of subscriptions, a fact that is reflected in the increased value of these rights over the years, as is illustrated in the table below.

Figure 3 1983-2007 summary of sale of live UK top league football rights

Start of rights period	Contract duration (years)	Number of matches per season	Broadcaster	Rights fee (£ million)			
				Total	Per season	Per match	Per subscriber per annum
1983	2	10	BBC/ITV	12	6	0.60	n/a
1985	0.5	6	BBC	3	3	0.50	n/a
1986	2	14	BBC/ITV	12	6	0.40	n/a
1988	4	18	ITV	100	25	1.38	n/a
1992	5	60	Sky	425	85	1.41	n/a
1997	4	60	Sky	832	208	3.46	n/a
2001	3	106	Sky	1,470	490	4.62	[X]
2004	3	138	Sky	1,077	359	2.60	[X]
2007	3	92	Sky	1,314	438	4.76	[X]
	3	46	Setanta	392	131	2.84	[X]

Source: Spectrum Value Partners – see Annex 10 to our December Consultation

Notes:

[X]

Rights fees are expressed in real terms at 2007 / 2008 prices.

In 2001 Sky purchased PPV rights for £60 million. This figure does not include PPV rights.

3.22 Finally, we noted in our December Consultation that there have been a number of important recent developments, including:

- The consolidation and restructuring of the historically fragmented UK cable industry under the Virgin Media brand.
- The emergence of new platforms for delivering pay TV services (BT Vision, Top Up TV, Tiscali / Homechoice) based on new distribution technologies.
- The intervention by the European Commission to change the way in which Premier League football rights are sold. The 2007/8 football season was the first since 1992 for which Sky has not owned these rights exclusively.
- The increasing importance of convergence, and the bundling of pay TV services with broadband and voice services.

3.23 We acknowledged that the future development of the market cannot in these circumstances simply be extrapolated from the past. Our competition analysis must therefore take a forward-looking view, focusing on those characteristics of the market which are most likely to influence its development over the next few years.

Consultation responses

3.24 We received few comments on our account of the development of pay TV; consultation respondents focused more on our definition of premium content and its importance.

3.25 Sky stated that we use the term ‘premium content’ as if the meaning is self-evident, and that its definition plays a key role in our thinking. Sky believed that we were insufficiently clear in our definition of what we meant by ‘premium’ content. As well as questioning Ofcom on the definition of premium content, Sky challenged our view of its importance: it said that it does not agree that access to premium content is essential for effective inter-platform competition. Sky, in its October submission, stated that:

“Pay TV retailers who do not have a wholesale relationship with Sky in respect of Sky’s movies and sports channels are not foreclosed from retailing pay TV services, for the following reasons:

a) Sky’s movies and sports content is not relevant to a very large number of potential subscribers...

b) the customers of such pay TV retailers are able to access Sky’s channels where Sky itself retails its own premium channels on the same platform...”.

3.26 The Four Parties, on the other hand, in their February response to Sky’s October submission, contended that “premium channels are key to pay TV retailers”, and that there “are no substitutes for Sky’s premium movie channels... Setanta’s sports channels are complements to, rather than substitutes for, Sky’s premium channels”.

3.27 The UK Film Council agreed, stating that:

“Even in an era when take-up of digital services is comparatively rapid, it is likely that these new platforms and new services will take a number of years to build critical mass. It is very difficult to build critical mass without access to premium content”.

3.28 Tiscali stated that:

“[Non-discriminatory access to wholesale content owned by aggregators with market power] is key to enabling the development of new platforms and to enabling the technological innovation and service development that will give increased choice and quality to the UK consumer”.

Our current view

3.29 Firstly, we continue to take the view that 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. Sky’s view that we over-stated the importance of premium content seems inconsistent with Sky’s own willingness to spend hundreds of millions of pounds a year on that very content.

3.30 Platform-related services such as Electronic Programme Guides (EPGs) and Digital Video Recorders (DVRs) are also of value to consumers, and may also affect the choice of retailer and / or platform, but this is likely to be a second order effect. This is because these services enhance the way in which consumers view content, but cannot compensate for a lack of desirable content.

3.31 Secondly, we find that there are a small number of channels which are seen as being essential by large numbers of consumers. Consumers have widely varying

preferences for content, and this is demonstrated by the ‘long tail’ of channels which appeal to various minority tastes. The main ‘must have’ channels, which appeal to large numbers of consumers, are:

- The BBC and main commercial PSB channels, which provide viewers with access to most of the first-run basic-tier content which is produced in the UK. There is also some US-produced basic-tier content which is very popular, such as series like *Lost* or *24*.
- Premium movies channels, which provide viewers with access to the most significant category of US-originated content, first pay TV window Hollywood movies.
- Premium sports channels, which provide viewers with live access to key sporting events such as live FAPL football, Champions League, or Test cricket⁹.

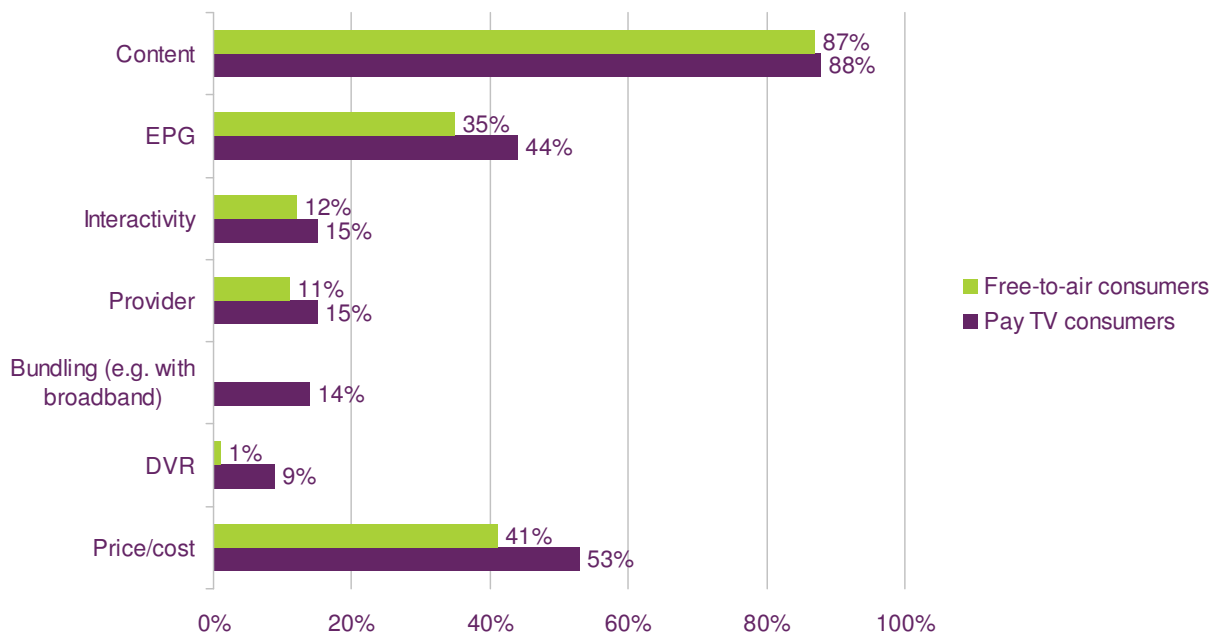
3.32 Thirdly, access to these ‘must have’ channels is of course important for retailers of these categories of content. It is however also important for a wide range of other retail propositions, due to the importance of bundling efficiencies in the provision of retail pay TV services.

3.33 In what follows we set out the evidence associated with each of these conclusions in more detail.

‘Content is king’: the relative importance of content and platform services

3.34 Content is the major driver behind consumers’ selection of their pay TV service. This is evident in their stated reasons for choosing their current service, when asked as part of Ofcom’s consumer research.

Figure 4 Proportion of consumers who cite elements of their TV as ‘must have’



⁹ See December Consultation, Figure 18.

Base: All multi-channel TV household decision-makers (670 free-to-air, 1,338 pay TV)

Source: Ofcom pay TV research, phase one (June / July 2006)

- 3.35 The relative importance of content is also illustrated by the expenditure of different pay TV providers:
- Sky, the most successful pay TV provider, spends 40% of its annual expenditure on programming, and only 13% on “transmission and related functions”¹⁰.
 - Other providers, notably those on cable, have made more substantial investments in their platforms relative to their investments in content, but without this resulting in strong subscriber growth¹¹.
- 3.36 This observed primacy of content over and above platform features is intuitively reasonable. Most platform features are designed to enhance the way in which viewers watch content, by allowing them to select content more efficiently (EPGs), view it at a time of their choice (DVRs, VoD), or enhance its technical quality (HD). However, none of these capabilities can turn undesirable content into desirable content: if a viewer doesn’t want to watch a programme, then this will not be altered by the ability to time-shift the programme, or view it in HD. This is in fact consistent with Sky’s own view, which is that:
- “Sky considers that content choice is what matters to consumers. TV is about delivering content to customers; consumers’ central concern being the ability to watch **what** they want to watch, not **how** they watch it” [Sky’s emphasis]¹².
- 3.37 Pay TV is generally regarded as a relatively innovative industry. However, the innovations which tend to be most commonly cited are the technical platform features listed above, which are unlikely to be as important a determinant of consumer choice as the content that they are able to obtain via a particular service. When we consider innovation, it is important to give sufficient weight to the way content is bundled – innovation in this area is likely to be at least as important as platform features.

The importance of premium content to pay TV

- 3.38 While the importance of content to a pay TV platform is easy to understand, the question of which content is most important is much more complex. There appear to be two key factors which will determine the value of a particular type of content as a driver of pay TV subscriptions:
- Firstly, the content must be sufficiently attractive that a large number of viewers are willing to pay a significant amount to watch it. We discuss in this section which types of content fall into this category.
 - Secondly, the content must be available on an exclusive basis to pay TV providers, with limited substitutes available free-to-air. This is a particularly important consideration given that pay TV in the UK has developed against a

¹⁰ From Sky’s annual report for 2008. It should also be noted that some of the 18% of Sky’s operating expense which is spent on marketing will be attributable to its platform business, but this breakdown is not provided in Sky’s accounts.

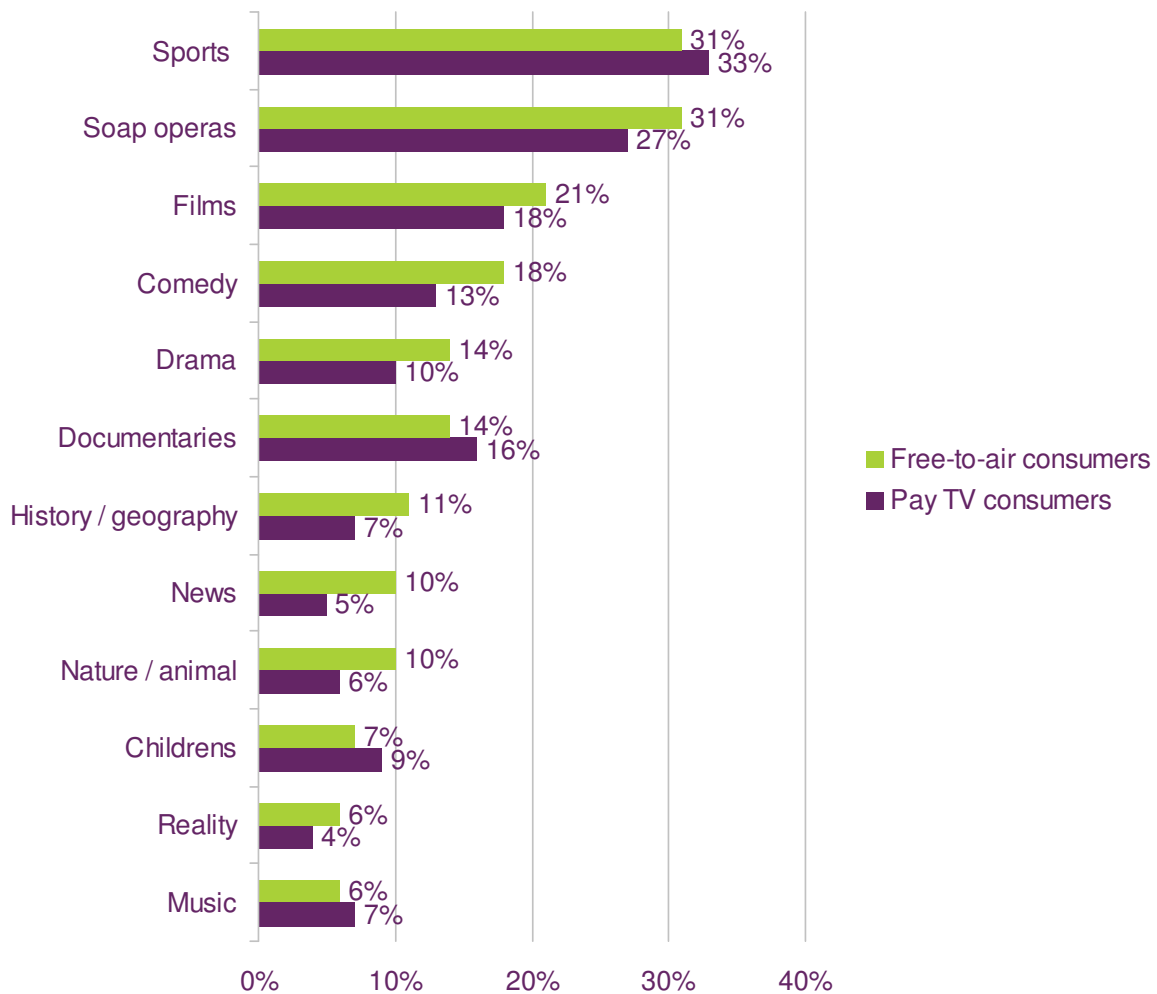
¹¹ Although we would recognise that investment in cable infrastructure has also been for the purpose of providing broadband services, making it difficult to attribute a particular level of infrastructure to TV.

¹² Sky’s consultation response, Part 3, paragraph 5.1.

background where some genres are already well served by the BBC and the commercial PSBs. For example, as noted in our PSB review (http://www.ofcom.org.uk/consult/condocs/psb2_1/consultation.pdf), the BBC and commercial PSBs provide significant levels of UK-originated general entertainment. This content is important to UK viewers, but is already widely available on a free-to-air basis. It is unlikely that pay TV would have been the success it has been unless it had found some additional content, which allowed it to differentiate itself from these.

- 3.39 TV content is an unusual type of product due to its exceptional variety. There are many different types of content: sports, films, documentaries, music, culture, and so on. At the same time, there is an endlessly developing portfolio of content within each type.
- 3.40 Not only is content very varied, but consumers' preferences for that content are equally varied. Every consumer has a different combination of preferences for the various types of content from the next consumer.

Figure 5 Spontaneous mentions of programme genre among those for whom content is 'must have'



Base: All multi-channel TV household decision-makers for whom content is 'must have' (FTA 405, pay TV 947)

Source: Ofcom pay TV research phase one (June / July 2006)

- 3.41 However, the distribution of preferences for content is not even. There are particular types of content which attract strong preferences from a large number of people, as the chart above suggests. Among these types of content, sports and movies are the first and third most mentioned programme genres.
- 3.42 Although Figure 5 illustrates the importance of sport and films to viewers, it also illustrates the importance of other genres. The second most mentioned programme genre is soap operas, while comedy, drama and documentaries all also score highly. However, as we discuss in more detail in our PSB review, the programmes in these genres which are most valued by most UK viewers are those UK-originated programmes which are available free-to-air on the BBC and commercial PSBs. As discussed above, these are therefore unlikely to be important as a driver of pay TV subscriptions.
- 3.43 The importance of premium content can be seen from a number of examples that have played out in the development of the pay TV market, both in this country and in others. The factors we look at here are:
- Consumers' take-up of premium channels in the UK.
 - Prices paid for content by pay TV operators.
 - Statements made by companies operating in pay TV.
 - Parallels from other international pay TV markets.
- 3.44 Industry intelligence enables us to evaluate 'natural experiments' carried out by the market, which provide insight into consumer preferences and can effectively complement hypothetical consumer research.
- 3.45 In the evidence that we have reviewed, there is something of a difference between movies and sports. Particularly when reviewing statements made by pay TV operators, sports are more prominent. One reason for this may be that sport tends to be a more emotive subject than movies. For example, some sports fans will travel substantial distances to support their team, in a way which is harder to imagine with films. There is however a rather broader cross-section of the population which regards a trip to the cinema as a good night out. Total match-day attendances across all four English football leagues in 2006 / 2007 were 29.9 million¹³, compared to 165.3 million cinema attendances in 2007¹⁴.
- 3.46 There is some evidence that these general observations translate into a different pattern of demand for premium sport and premium movies on pay TV, with the demand profile for movies being broader and less peaked. [X]¹⁵.

Consumers' take-up of premium channels in the UK

- 3.47 The importance of sport and movies to pay TV is supported by subscriber data. The table below summarises the premium which subscribers have to pay for different packages including sport and / or movies, and the number of subscribers willing to do

¹³ Deloitte Annual Review of Football Finance 2006 / 2007 -

http://www.deloitte.com/dtt/cda/doc/content/UK_SBG_ARFF2008_Highlights%281%29.pdf

¹⁴ Screen Digest / Carlton Cinema -

http://www.ofcom.org.uk/consult/condocs/market_invest_paytv/annex11.pdf - page 29.

¹⁵ [X].

so. Across all platforms, [X]% of consumers are willing to pay a premium of between £18 and £37 per month to access premium sport or movies content, which is significantly more than the remaining consumers are willing to pay for stand-alone basic content packages. On Sky's platform this figure increases to 65%¹⁶.

Figure 6 Package prices and subscribers

Retailer	Packages	Total package price per month	Implied premium over basic	Subscriber numbers (as at May 2008)	Subscribers as a % of total (as at May 2008)
Sky	Basic only	£17	N/A	[X]	[X]
	Basic + sports	£36 ¹	£19	[X]	[X] ²
	Basic + movies	£34 ¹	£17	[X]	[X] ²
	Basic + both	£43 ¹	£26	[X]	[X] ²
Virgin	Basic only	£11	N/A	[X]	[X] ⁴
	Basic + sports	£37 ³	£26	[X]	[X] ⁴
	Basic + movies	£41 ³	£30	[X]	[X] ⁴
	Basic + both	£48 ³	£37	[X]	[X] ⁴
Setanta Sports	via Sky	£12.99 ⁵	£12.99	[X]	[X] ⁷
	via Virgin	£12.99 ⁵	£12.99	[X] ⁶	[X] ⁷
	via DTT	£10.99 ⁵	£10.99	[X]	[X] ⁷

Source: Sky, Virgin, Setanta

Notes:

1. Based on a Sky entry level basic pay TV package of £17 per month.

(<http://www.sky.com/Assets/PDF/StaticFiles/4396810.pdf>).

2. Based on total DSat subscriber numbers for Sky of 8,311,458.

3. Based on a Virgin Media entry level basic pay TV package (M), which is available free only when taken with a phone line of £11 per month.

(<http://allyours.virginmedia.com/websales/product.do?id=11169>)

(<http://allyours.virginmedia.com/html/dtv/index.html>)

4. Based on total (digital and analogue) subscriber numbers for Virgin of 3,514,900 as published in the Digital Television Update Q1 – 2008.

5. Prices correct as at 18/09/08 (from Setanta website and Virgin Media website).

6. Includes cable subscribers who receive Setanta included in the XL basic package.

7. Based on total subscriber numbers (including IPTV and DTT) for Setanta of [X].

3.48 The figure below shows how this picture is changing with time. It is evident that [X] in recent years. The total number of subscribers to all kinds of premium packages has increased, as has the number of subscribers to basic-only packages.

Figure 7 Numbers of subscribers to different basic and premium packages

[X]

Source: Sky, Virgin Media, Setanta, Tiscali

¹⁶ Sky figure from Sky annual report 2008, page 8. [X].

Notes:

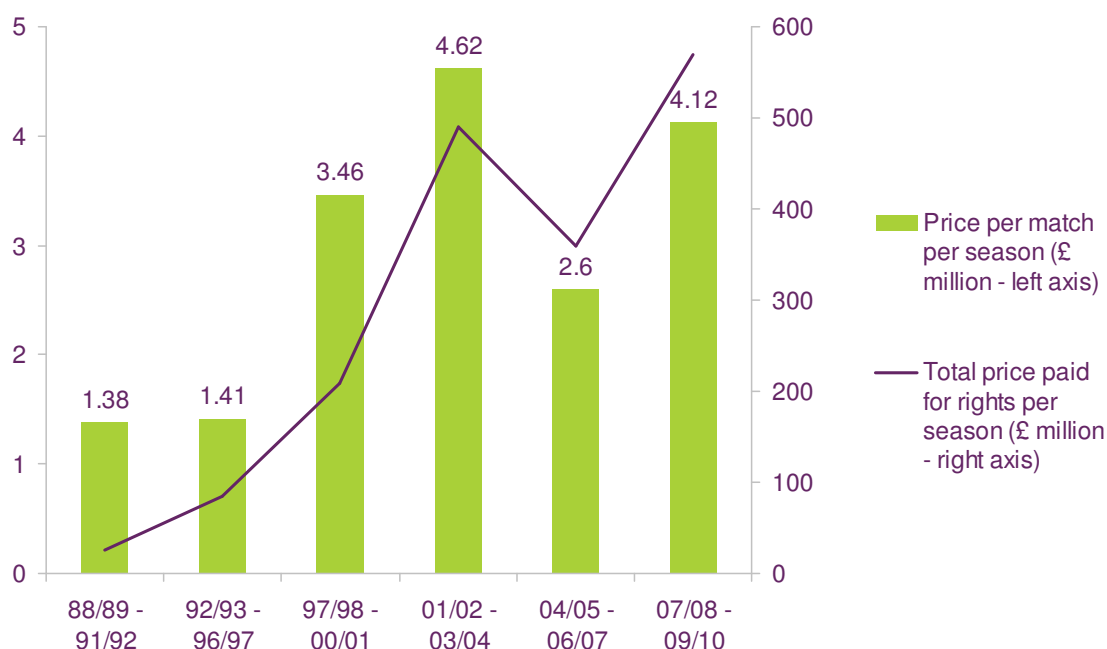
Sports subscriber figures exclude Setanta subscribers; there were [X] Setanta subscribers via satellite in May 2008, [X] subscribers via DTT, and [X] receiving Setanta channels as part of their Virgin Media XL packages. It is not possible to identify unique sports subscribers

CAGR = Compound Annual Growth Rate

Prices paid for content by pay TV operators

- 3.49 Just as the amounts paid by consumers reveal their attraction to premium content, the large amounts consistently paid by pay TV operators for premium content rights is the clearest indicator of the importance they place on that content, and therefore of the value which these operators believe consumers place on it. We have paid particular attention to Sky's expenditure on these rights, given its comment that we have overstated the importance of premium content.
- 3.50 Sports programming alone represents, at 22% of operating expenses, Sky's biggest single cost in 2008 – bigger than its marketing spend (18%)¹⁷. Movies programming comes in at a lower but substantial 7%, which exceeds all news and entertainment programming costs together at 5%, and is the same as all the third party channels that Sky purchases at 7%.
- 3.51 Sky is not unique in paying such substantial sums for rights – Setanta pays £130 million annually for its 46 live FAPL matches. The total paid by Setanta and Sky for live rights over the three years of the current FAPL deal is £1.7 billion. The sums paid for the rights to live FAPL content in particular have increased substantially over the last eight years, as the figure below shows.

Figure 8 Prices paid for FAPL rights since 1992, at real 2007 / 08 prices



¹⁷ From Sky's 2008 annual report - http://media.corporate-ir.net/media_files/irol/10/104016/reports/Annual_Report_2008.pdf - page 31.

Source: Spectrum Value Partners

Notes:

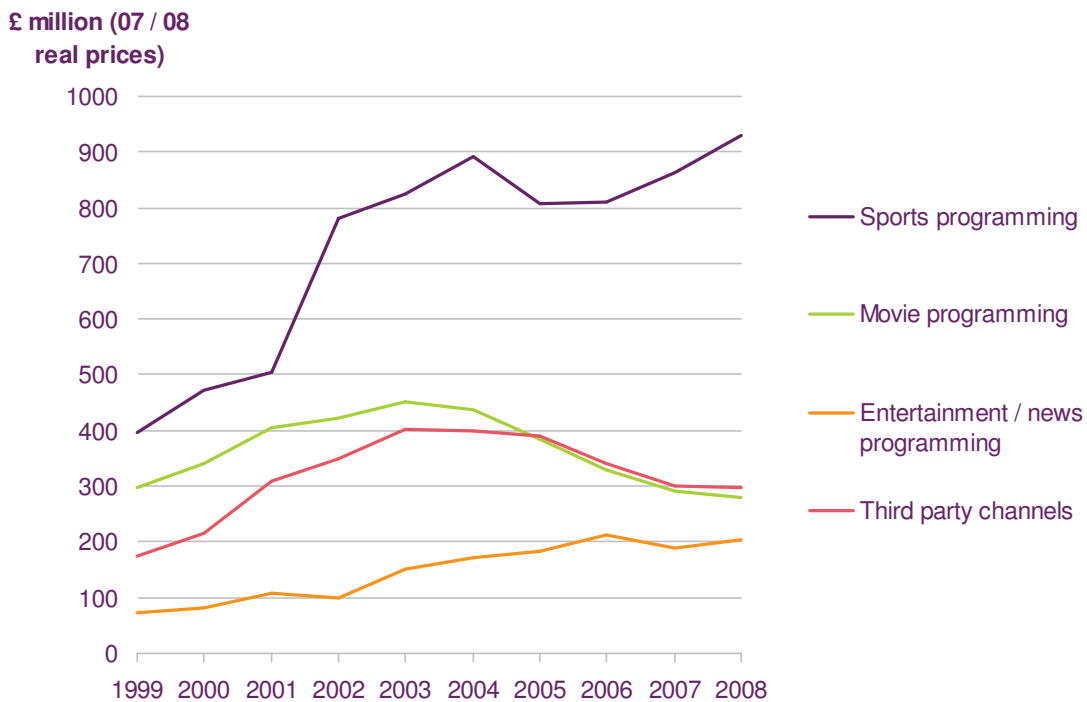
Figures exclude international rights

1992-97 values include highlights rights

2001-04 values include live PPV rights

3.52 Expenditure on movies has not increased, but the amount paid by Sky for the content required for its dozen movie channels has tended to be greater than the cost of news and entertainment programming, and similar to the cost of all the third party channels that Sky purchases, as shown in Figure 9.

Figure 9 Sky's real expenditure by programming type since 1999



Source: Sky annual reports

Statements made by market players

3.53 Market players have on occasion made revealing statements about the importance of particular content to their businesses. Most, but not all, of the comments relate to sport rather than movies. These comments are interesting to us not because of what they tell us about specific companies, but as a way of revealing consumer preferences – the comments tell us what companies think is important to their customers.

3.54 The most well-known of these is Rupert Murdoch's comment at the 1996 AGM of News Corp (a major shareholder in Sky in the UK) that sport would be the "battering

ram” of pay TV. More recently, a quote from Rupert Murdoch in a documentary aired on Sky One in June 2007¹⁸, reveals that:

“In life, if you’re building a company, you’ve got to take risks. And this was certainly, on the face of it, very risky. But I knew from selling newspapers or from television elsewhere that sport is the great, number one common denominator. And, of that, football [is number one]”.

3.55 Sky recounted the role of sports programming in the story of its own development, the “Sky Fact Book”, in 2004:

“Sky Sports has been pushing back the boundaries of televised sport since 1991. It recognised the British public’s insatiable appetite for sport and sparked a viewing revolution that has changed the way people watch it. . . . Right from the start, sport has been a major factor in the growth of multi-channel TV”.

3.56 Trevor East, formerly Deputy MD of Sky Sports, and now at Setanta as Director of Sport, stated in Broadcast on 26 January 2007:

“Sky was on the verge of bankruptcy and it nearly brought the whole of the Murdoch empire down, but winning that Premiership was key to its growth. Hopefully the Premiership and other things we’ve got will do the same for Setanta Sports”.

3.57 These quotes are somewhat historical, in that they refer to the past development of Sky. There is however evidence from information request responses that this also reflects current thinking. For example, a senior executive at Sky ([X]) stated in a letter to the Vice President of Orange Home UK plc, on 8 February 2007, when discussing Orange’s request for wholesale access to Sky Sports channels, that:

“The value of our channels to a platform operator is not simply a function of the subscription that such a platform operator can earn as a distributor of packages of channels that include our channels. The mere availability of our channels on a particular platform has considerable value to the relevant platform operator that is difficult to capture through a per subscriber charging mechanic or the imposition of enforceable marketing obligations”¹⁹.

3.58 The importance of premium sports and movie content to Sky’s platform is also evident from [X].

3.59 [X]²⁰. [X]²¹. [X]²² [X].

3.60 [X]²³.

3.61 These are echoed by various [X]:

¹⁸ Quoted in the Guardian, Friday 22 June 2007, ‘Murdoch warns on football rights’.

¹⁹ Provided by Orange in response to an Ofcom information request under its statutory information-gathering powers of 9 June 2008.

²⁰ [X]. Provided by Sky in response to information request of 14 May 2008.

²¹ [X]. Ibid.

²² [X]. Ibid.

²³ [X]. Ibid.

- [redacted]²⁴. [redacted]²⁵. [redacted]²⁶.
- [redacted]²⁷ [redacted]²⁸. [redacted]²⁹. [redacted]³⁰ [redacted].
- [redacted]³¹. [redacted]³².
- [redacted].

International examples

- 3.62 Some international markets have seen major changes in the ownership of premium sports rights, in particular the rights to live football from the top league in each market (or top-flight football). Responses to these changes in terms of subscriber numbers and market players' activities reveal the importance of that content.
- 3.63 In addition, we examine prices paid by pay TV retailers for content in a number of countries.
- 3.64 We should treat international examples with caution. There are many reasons why TV markets may differ between countries, whether for historical, political or socio-demographic reasons, or simply because some preferences may be different between countries.
- 3.65 That said, examples from other pay TV markets can provide interesting context for the UK, and even provide the sorts of counterfactuals that have never existed in the UK – Sky has never lost the entirety of the live FAPL rights, for example.

France

- 3.66 In France, TPS, one of two now merged satellite operators, lost the rights it held to top-flight football in 2005. This coincided with a loss of subscribers after seven years of consistent growth, and was followed by the merger with Canal Plus.

²⁴ [redacted]. Provided by Virgin Media in response to information request of 23 May 2008.

²⁵ [redacted]. Ibid.

²⁶ [redacted]. Ibid.

²⁷ [redacted]. Ibid.

²⁸ [redacted]. Ibid.

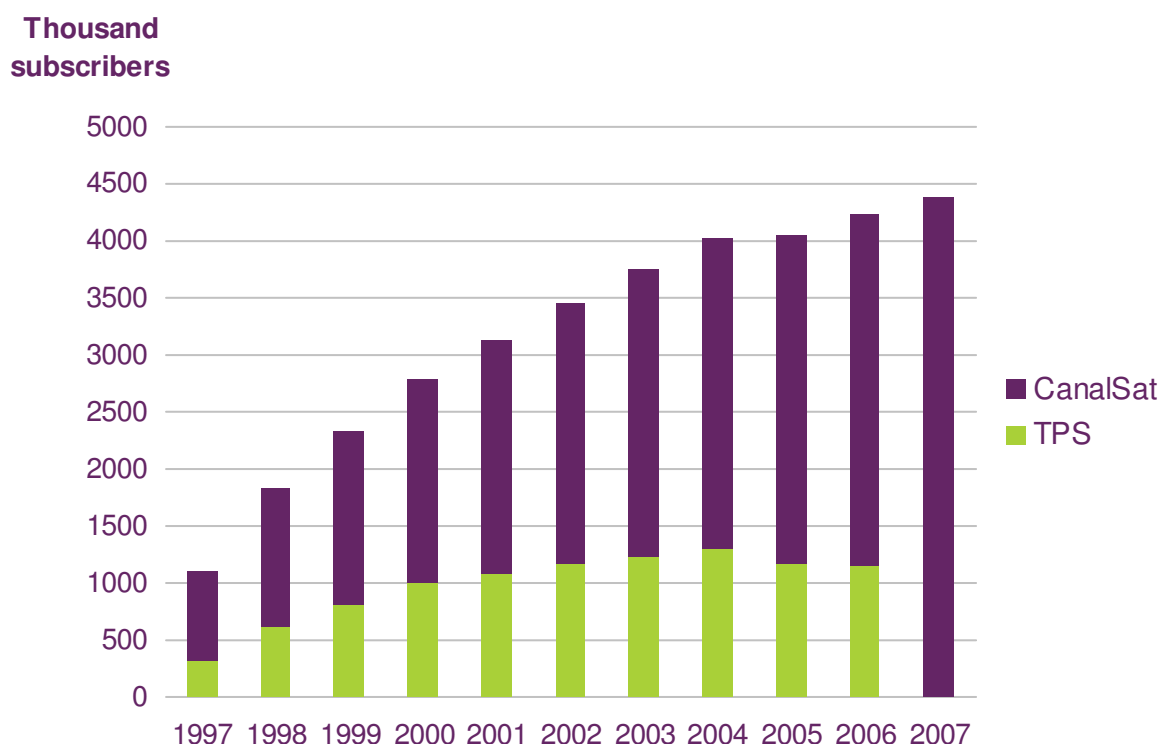
²⁹ [redacted]. Ibid.

³⁰ [redacted]. Ibid.

³¹ [redacted].

³² [redacted].

Figure 10 TPS and CanalSat satellite subscribers



Source: Spectrum Value Partners

- 3.67 From 2001 to 2005, both satellite operators in France, TPS and Canal Plus, won some of the rights to Ligue 1 football rights. Canal Plus paid €289 million per season for its rights, with TPS paying €40 million.
- 3.68 In 2005, Canal Plus won all the live rights exclusively, for an average of €600 million per season, compared to TPS's bid of €327 million. While TPS's subscriber numbers suffered a fall for the first time after seven years of consistent growth, Canal Plus continued to grow its subscriber base from 2.7 million in 2004 to 3.1 million in 2006.
- 3.69 This fall in subscribers in 2005 / 2006, while a reversal of the trend in TPS's subscriber base, might not seem particularly large, at just over 10%. However, TPS in fact only had access to rights worth less than 15% of the value of Canal Plus's rights, which is likely to have reduced the effect of losing the rights relative to a situation where TPS had lost a more significant portion of the rights.
- 3.70 In early 2007, the two companies merged – a move which had been foreseen by some analysts as being related to the ownership of the rights. For example, Enders Analysis believed in December 2004, ahead of the auction, that:

“One constant is the dominant position of Canal+: it has the bulk of the rights today, and the associated revenues...This position would be strengthened if Canal+ were to obtain exclusive rights, advancing the case for a merger with TPS to consolidate the French pay-TV market...”³³.

³³ www.endersanalysis.com/download.axd?id=266

- 3.71 Looking at the deal in retrospect, Deloitte made a similar comment when reflecting on the new rights deal for the 2008 / 2009 season onwards:

“Maintaining the current level of rights fees is a solid achievement for the league given that current deals represented a step change in rights fees (with increased revenues of over €200m (£134.6m) per season) compared to previous deals and accelerated the merger of Canal Plus with TPS, a rival Pay-TV operator and key competitor for Ligue 1 rights”³⁴.

- 3.72 In some respects, with its satellite merger France was following suit with other European countries such as Italy and the UK in the consolidation of its two satellite operators. However, there is a strong correlation between the change in ownership of the rights, the subsequent drop in TPS subscribers and continued growth of Canal Plus, with the merger shortly after.

Germany

- 3.73 The fortunes of Premiere, the German satellite operator, also reinforce the importance of key content, in this case top-flight football.
- 3.74 In a turn of events that has never happened in the UK, Premiere lost all the rights to live pay TV top-flight German football (the Bundesliga) to Unity Media’s Arena. Although the rights were lost at the end of 2005, this was for the 2006 / 2007 season onwards. Premiere immediately went about a campaign to ensure that it was able to offer consumers some form of access to Bundesliga content. This started to bear fruit in May 2006 with an IPTV deal, and continued to be successful in July 2006 with a cable distribution deal with Kabel Deutschland.
- 3.75 The May and July deals meant that there was actually no period in which Premiere had no access to the Bundesliga at all, although until 2007 it could not offer the content throughout the whole of Germany. Premiere reported a 4.4% decrease in subscriber numbers in the year immediately following the loss of the rights, 2006, which was in marked contrast to a 20% compound annual growth rate since 1997³⁵.
- 3.76 In 2007, Premiere agreed a deal with Arena, the new owner of the rights, which effectively restored Premiere to its pre-2006 situation of being able to offer the rights universally via satellite. This was accompanied by a dramatic upturn in subscriber numbers, returning Premiere’s subscriber growth to the sort of overall trajectory it had been on until 2006³⁶.
- 3.77 The chart below shows Premiere’s subscribers since 1997, and a timeline of the various deals related to Bundesliga content.

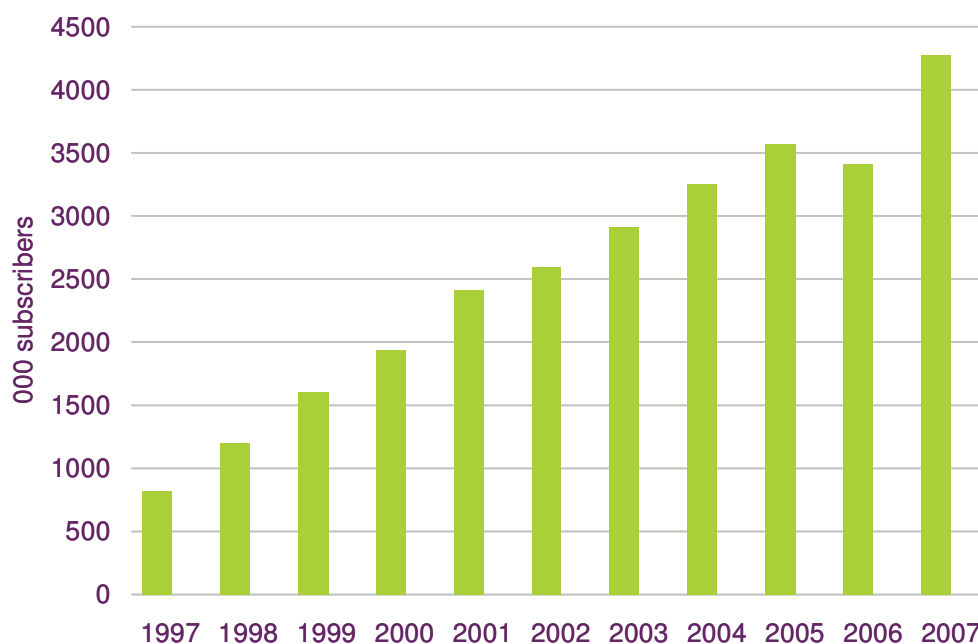
³⁴ “Football Money League”, February 2008

[http://www.deloitte.com/dtt/cda/doc/content/Deloitte%20FML%200607\(4\).pdf](http://www.deloitte.com/dtt/cda/doc/content/Deloitte%20FML%200607(4).pdf)

³⁵ Source: Spectrum Value Partners, Premiere annual reports.

³⁶ Over the course of the first half of 2008, News Corporation acquired 25% of Premiere’s shares - http://www.newscorp.com/news/news_382.html. On 25 June 2008, the European Commission published its decision on the merger, allowing the merger to take place subject to commitments. http://ec.europa.eu/comm/competition/mergers/cases/decisions/m5121_20080625_20212_en.pdf.

Figure 11 Premiere subscribers over time, and 2005-07 timeline showing key Bundesliga-related deals



Dec 05: loses Bundesliga rights for 06/07 season onwards to Unity Media (Arena)
May 06: concludes deal for IPTV supply of Bundesliga matches
Jul 06: concludes deal to supply Arena's Bundesliga coverage in 13 of 16 states via Kabel Deutschland
Feb 07: concludes deal to supply Arena's content throughout Germany via satellite; deal suspended by competition authority
Jul 07: Arena satellite deal allowed by competition authority

Source: Spectrum Value Partners, Premiere annual reports

3.78 The importance that Premiere attached to the rights it purchases can be clearly seen from the CEO's letter to shareholders in its 2005 annual report³⁷:

"Exclusive programming rights are the foundation for successful pay-TV – why else should viewers pay extra for television?"

3.79 The chairman's letter to shareholders in the 2006 annual report³⁸ devotes a good deal of attention to an account of how Premiere had worked itself "back into the game", indicating the importance attached to the content. As further illustration of the importance of Bundesliga programming, the very first words in the entire annual report, over pages 2 and 3, are:

"Premiere is back on track.

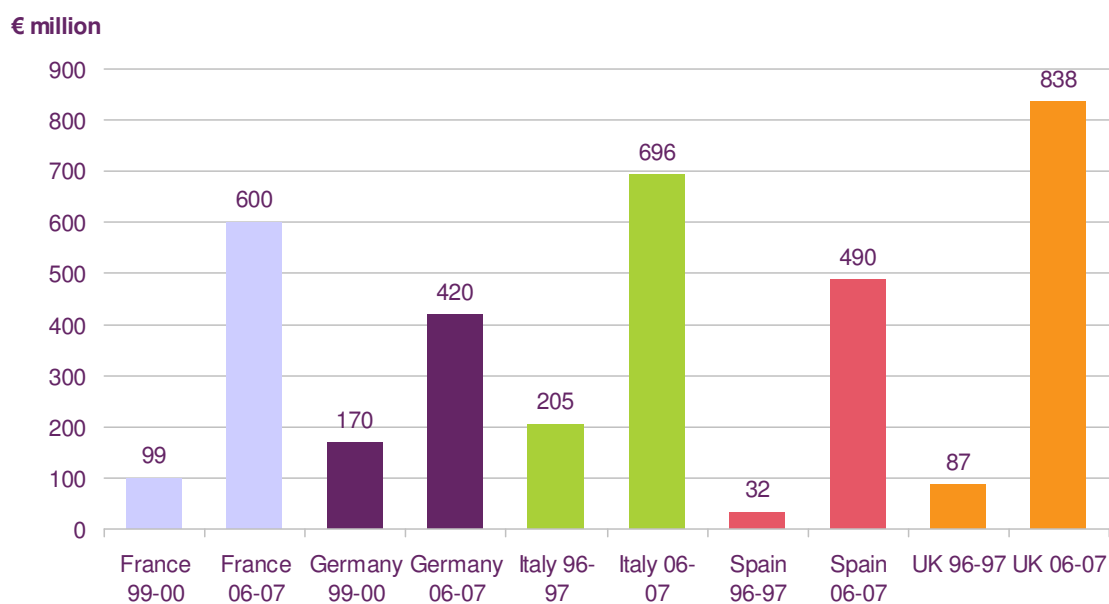
³⁷ http://info.premiere.de/inhalt/static/download/aktie/gj2005/premiere_ag_annual_report_2005.pdf
³⁸ http://info.premiere.de/inhalt/static/download/aktie/gj2006/premiere_ag_annual_report_2006.pdf

2006 was a challenging year for Premiere. After losing the rights to the soccer Bundesliga, Premiere has worked its way back into the game step by step. Today Premiere is a one-stop shop for all the major pay-TV channels from soccer to Hollywood.”

Prices paid for rights

3.80 In a similar way to the UK, pay TV operators abroad have paid large and increasing amounts for pay TV rights to top-flight football.

Figure 12 Value of top-flight football pay TV rights per season in key European markets



Source: Spectrum Value Partners

Note: Not inflation-adjusted.

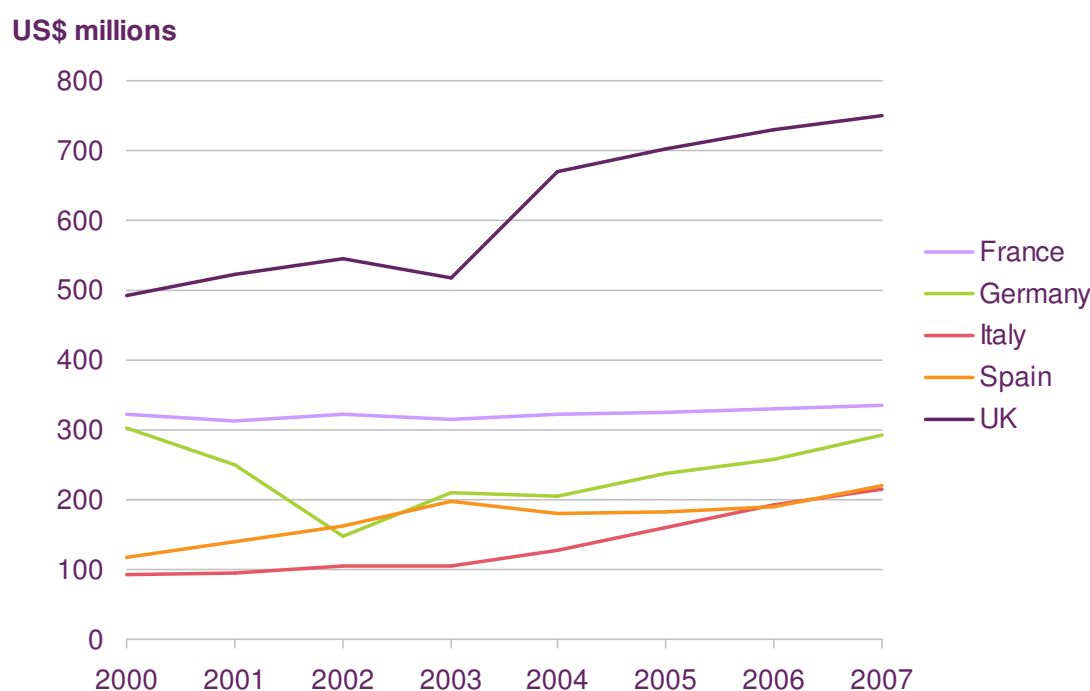
- 3.81 In France, the season value of Ligue 1 is €650 million, over 10 times the value of UEFA Champions League rights, and almost five times the value of the 2006 football World Cup.
- 3.82 In Germany, the price paid for the Bundesliga hit €420 million for the 2006 / 2007 season, well over twice what was paid in 1999 / 2000. This is despite the collapse of the previous owner of the rights, Kirch, and subsequent temporary reduction in the price of the rights. The value of the rights is also arguably lower in Germany than in the UK as a result of the strong FTA offer – sponsorship plays a very important role in German football finance, increasing the importance of the early Saturday evening highlights programme in maximising audiences. The timing of the highlights programme increases the strength of the FTA proposition, because fans do not have to wait long before coverage reaches FTA channels.
- 3.83 In Spain, the rights to La Liga hit €490 million for the 2006 / 2007 season, despite the mandatory existence of one match per week on free-to-air TV. This figure puts La Liga at over four times the amount paid for the next biggest event, the 2006 football

World Cup, and over ten times the per-season value paid for the rights in the late 1990s.

3.84 The picture is very similar in Italy, where Serie A rights cost €696 million in 2006 / 2007, over three times as much as ten years previously.

3.85 Prices paid for movie rights are much less transparent, as they are concluded with several different Hollywood studios rather than a single football league, for example, and do not tend to be reported in the press. The chart below shows Screen Digest's estimates of rights values.

Figure 13 Value of movies pay TV rights in key European markets, as reported by Screen Digest



Source: Screen Digest

3.86 In movies, rights values have been rather steadier. Indeed, movie rights in some countries have dropped in value over the period in the chart above. In some cases, this is largely to do with particular volatility or events in the pay TV market. In Germany in particular, the rights value was affected significantly by the collapse of Kirch Media, the major bidder for the rights.

Premium content may have an impact on the retail of other types of content

3.87 It is possible that premium content is important for retailers who also want to be able to compete successfully in the market for basic-only pay TV content.

3.88 We have identified two potential reasons for this:

- Economies of scope between basic and premium retailing.
- Economies of scale from using premium to acquire more basic subscribers.

- 3.89 There are economies of scope between retailing basic and premium packages. There are certain categories of fixed cost which are shared between these activities – for example some retailing costs. Being able to sell to all 12 million plus pay TV subscribers, rather than just the [X] million who take a basic product only, enables a retailer to spread those fixed costs across a wider subscriber base. This is likely to give the retailer a cost advantage. In particular, there are strong synergies between marketing of basic packages and premium packages, and indeed between content packages and platform-related services.
- 3.90 A potential economy of scale in relation to the retail of basic channels arises from the bundling of basic and premium services. Bundling allows the retailer to attract consumers with a wider range of willingness to pay for basic than would be the case if it were selling basic only on a stand-alone basis. This is based on the point we made in our December Consultation about attracting consumers with different preferences. We said that where two consumers value movies and sport at £10 / £2 and £2 / £10 respectively, setting a price of £12 enables the seller to capture both consumers' willingness to pay for both products. The retailer increases revenues, and both consumers purchase the combined product, rather than the single product they would purchase if the two products were priced separately at £10 each.
- 3.91 We used the example of a sports and movies bundle, but it works in much the same way with a basic and premium bundle. A consumer with a high valuation of the premium element only needs to have a low willingness to pay for the basic content to be happy to pay for the bundle. This has the effect of increasing the number of consumers that take up the basic content. This allows the retailer to recover its fixed costs across a wider revenue base, and is also likely to strengthen its bargaining position when negotiating with third party basic channel providers.

Consultation questions

3. Why do consumers pay for TV services?

4. Do you agree with our assessment of the relative importance of platform features and content?

5. Do you agree with our views on the importance of premium sports and premium movies content for competition in pay TV?

6. Are there any other international examples to which you would draw our attention?

Section 4

Market structure and market definition

Summary

- 4.1 We set out an initial view of the structure of the pay TV industry in the December Consultation. We identified four vertical levels at which the market operates: content and production, wholesale channel provision, wholesale platform services provision, and retail service provision. These four levels do not represent a simple linear value chain, but they do provide a conceptual framework for understanding the various types of commercial transaction which take place between different industry players.
- 4.2 The main focus of this document is on wholesale channel provision, and in particular the wholesale markets for premium sports and premium movies. In order to examine potential competition concerns, we need to consider the extent of any market power in such markets. The first stage in that analysis is to establish a set of market definitions. We have based our analysis of market definitions on a wide range of information, including evidence which we published in our December Consultation, responses to that consultation, and further research and analysis carried out since then.
- 4.3 It should be noted however that the process of market definition is a means rather than an end. It provides a useful framework for an analysis of market power, but it would be over-simplistic to assume that products which are within the market all fully constrain each others' prices, while products which are outside the market provide no constraint. This is certainly true for content markets such as those defined here, given the highly differentiated nature of the products being sold in these markets, and the resulting uncertainties in the precise market boundary. Our analysis of market power therefore takes into account the pricing constraint associated with products which lie just outside the market boundary, as well as the constraint associated with products which lie within the market.
- 4.4 We are consulting on our view that there is a narrow economic market for the wholesale of certain premium sports channels, specifically those premium channels which contain live FAPL matches. We use the term 'Core Premium Sports' to refer to these channels, and to distinguish them from other channels which are marketed as premium sports channels, but which we do not include within our market definition. We believe such channels to be significantly differentiated from other channels in their appeal to consumers and therefore their value to wholesalers. We currently consider the wholesale supply of Sky Sports 1, Sky Sports 2 or Setanta Sports 1 to be included within this market definition.
- 4.5 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 only 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. There is an element of judgement in establishing which channels fall within the market. It is not helpful to have a loose or vague market definition. We would therefore describe 'Core Premium Sports' channels as being those channels which include any live FAPL matches.

- 4.6 We are also consulting on our view that there is a narrow economic market for the wholesale supply of channels which include movies from the major six Hollywood studios, shown in the first pay TV window. We use the term ‘Core Premium Movies’ to refer to these channels. We acknowledge that there is a growing constraint on such channels from other means of watching movies, but do not believe that the strength of this constraint currently justifies the adoption of a broader market definition.

Introduction

- 4.7 The previous section discussed the importance to pay TV consumers of content in general and certain types of premium content in particular. Since that section focused on the importance of content to consumers, the main focus was on retail services and retail markets.

- 4.8 This chapter is structured as follows:

- **Market structure.** We set out an overall view of the structure of the pay TV market, including an overview of the various wholesale markets which underpin the retail provision of services to consumers.
- **Market definition: introduction.** We recap what we said in our December Consultation on market definition and provide a high-level summary of responses to the consultation.
- **Approach to defining markets.** We lay out our analytical approach, as well as setting out how we have addressed some of the specific difficulties associated with analysing markets in broadcasting.
- **Assessment of relevant markets for the wholesaling of premium sports channels.** In this section we set out the various types of analysis we have carried out to come to our conclusions.
 - Indirect constraints on wholesalers of premium sports channels.
 - Wholesale supply side substitution.
 - Direct wholesale demand side substitution.
 - Changes in wholesale prices.
 - Conclusions for consultation.
- **Assessment of relevant markets for the wholesaling of premium movie channels.** In this section we set out the various types of analysis we have carried out to come to our conclusions on wholesale markets for premium movie channels.
 - Film windows.
 - Hollywood ‘major’ studios.
 - Preliminary conclusions of the December Consultation.
 - Indirect constraints on wholesalers of premium movie channels.

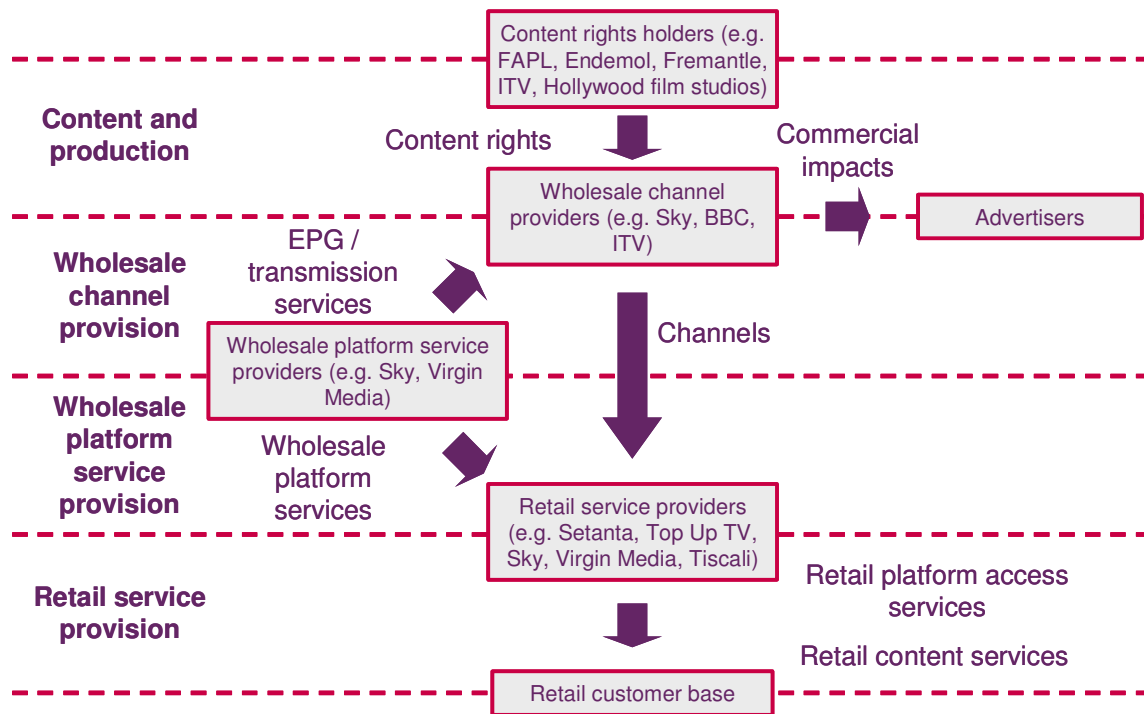
- Changes in wholesale prices.
- Wholesale supply side substitution.
- Wholesale demand side substitution.
- Conclusions for consultation.

Market structure

Our views in December

4.9 In December, we laid out our view of the structure of the pay TV value chain. We suggested a model, illustrated in the figure below, in which the supply chain for the UK broadcasting industry consists of four layers:

- Content production, for example creating and recording content which can be broadcast.
- Wholesale channel provision, which is the aggregation of content to bundle into channels. This could include commissioning content, acquiring rights to broadcast content or licensing content from other providers.
- Wholesale platform service provision, provides services to enable retailers to restrict the supply of content to consumers, or providing Electronic Programme Guide (EPG) services to broadcasters.
- Retail service provision, includes the bundling of channels in to packages to retail to consumers.

Figure 14 Pay TV market structure

Consultation responses

- 4.10 The majority of respondents were broadly comfortable with Ofcom’s view of the pay TV value chain. One confidential respondent highlighted that the value chain does not recognise the role of multiplex operators (in relation to DTT), which are at a similar level to wholesale platform service providers, or the unmediated relationship between the free-to-air channels and the customer base.
- 4.11 Unlike other respondents, Sky did not agree with the analytical framework set out by Ofcom. It stated that Ofcom had failed to address the complexity of the audiovisual sector which it stated does not have a tidy “value chain”. In Sky’s view Ofcom has failed to recognise that the “content and production stage” is a diverse category in its own right. Sky stated that Ofcom is applying a broad label to a variety of highly differentiated activities; that the different ways in which audiovisual services are delivered is not reflected; and that the framework does not include provision of “a la carte” content.
- 4.12 Sky suggested that the value chain is different from those set out in other recent Ofcom publications i.e. the DTT consultation document and Market Impact Assessment of the BBC’s HD proposals.
- 4.13 In Sky’s view the term ‘wholesale’ should not be used in relation to the provision of services such as conditional access. With regards to “wholesale channel provision” it argued that the concept of wholesale supply is only applicable in the context of pay TV channels, and that Ofcom has failed to consider other important activities such as broadcasting and channel marketing within its analytical framework. In addition, Sky stated that the terms “wholesale platform service provision” and “retail service provision” are confusing and not fully explained. However, Sky did not propose an alternative framework.

Our current view

- 4.14 We recognise that the TV sector is complex, and that there are therefore challenges in characterising all the activities involved in a single diagram. However, we believe it is useful to distinguish between the four layers of the market in the manner which we have proposed. These four levels do not represent a simple linear value chain, but they do provide a conceptual framework for understanding the various types of commercial transaction which take place between different industry players. Contrary to Sky's assertion, we believe this framework to be consistent with both the DTT consultation and the Market Impact Assessment of the BBC's HD proposals, the only difference of note being that we have included EPG / transmission services at the wholesale channel provision level.
- 4.15 As far as specific terms go, we believe that 'wholesale platform services' are a widely understood concept in the context of the technical platform services (TPS) regime and our review of wholesale digital television broadcasting platforms, which we announced in the autumn of 2006 but is currently on hold while this wider pay TV investigation is in progress. Similarly, we believe there to be little confusion over the provision of retail services to consumers. However, we have noted the greater complexity and subtleties stressed by Sky, and have sought to take this into account in our more detailed analysis.

Market definition: introduction

- 4.16 Our fundamental reason for considering market boundaries is to be able to assess the extent to which there may be market power, specifically in the wholesale provision of premium sports and movies. Market definition is a tool in that assessment, which allows for a systematic analysis of the constraints that firms face in a market, with a view to identifying whether any of those firms has market power. Its focus is on assessing the range of products likely to lie within the relevant economic market.
- 4.17 The analysis of market power does not depend on the precise boundaries of the relevant markets. Products that lie just outside the relevant market may still exert some competitive constraint on firms; conversely products that lie just inside the market may exert quite a weak constraint on firms. We discuss this further below in section 5. However, the process of defining markets provides the framework to identify and assess the constraints from a range of substitutes. In the context of this investigation, for example, a critical question is the extent to which suppliers of premium sports and movie channels are constrained in their pricing by the availability of a wide range of possible substitutes at different price points, including some that are provided for free; possible substitutes would include FTA TV channels or downloaded content, DVDs or PPV services.
- 4.18 Annex 6 provides supporting evidence and greater detail on some of the issues raised in our assessment of market definition. In particular we consider the impact of the 'cellophane fallacy' on market definition, our approach to defining markets where retail bundling is important, our assessment of subscribers' observed response to price rises, evidence of preferences of premium sports and movie channel subscribers, evidence presented to us by Sky on consumers' likely response to price rises, evidence on wholesale prices of Sky's premium channels and an assessment of sport found on TV.

Our views in December

- 4.19 In the December Consultation Ofcom assessed relevant markets for pay TV for residential subscribers³⁹. Our preliminary conclusions on the likely markets were as follows.
- 4.20 Firstly, we concluded that separate retail and wholesale markets exist for the supply of premium sport and movie channels. We found that consumers were unlikely to find sport on FTA channels a good substitute for sport on premium channels, and that they did not regard other ways of watching films (e.g. DVDs, PPV) as a close substitute for premium movie channels. The price which can be charged for these premium channels is therefore unlikely to be constrained to the competitive level by the availability of other content.
- 4.21 The differentiated nature of content markets means that there is some ambiguity over the precise boundaries of these premium channel markets, and this complicates the process of market definition. Recognising these complications, we proposed the following market definitions:
- Premium sport channels were defined as channels that provided access, often on an exclusive basis, to a set of highly valued sports events, for example live FAPL matches. We found that the sports content that we examined on FTA TV channels or on basic-tier TV channels was unlikely to constrain the pricing of a monopolist wholesaler or retailer of premium sports channels.
 - Premium movie channels were defined as channels that provide access on a subscription basis to first run movies in the first subscription pay TV window from the six Major Hollywood Studios. We considered that other ways of watching films, such as DVDs, PPV film services or films on FTA or basic-tier TV were unlikely to constrain the pricing of a monopolist wholesaler or retailer of premium movie channels to the competitive level.
- 4.22 We also concluded that separate economic markets exist at retail level for basic-tier pay TV and free-to-air TV channels. However, this conclusion was less firm than our conclusion on premium sport and movie channels, since we recognised that the availability of free-to-air services is likely to represent a more significant potential constraint on the price that can be charged for basic-tier pay TV. We also recognised that the strength of this constraint has grown in recent years, due to the growth of free-to-air multi-channel services such as Freeview. However, we did not believe that this constraint was sufficient to constrain prices of basic-tier pay TV services to the competitive level.
- 4.23 Consumers are able to gain access to pay TV and FTA TV content across a number of different ‘platforms’⁴⁰. We therefore analysed whether these retail markets operated across platforms or were specific to particular platforms. On balance, the lack of strong evidence of platform-specific preferences led us to conclude that retail services provided on alternative platforms compete in the same relevant market.

³⁹ Our current investigation is focused on residential subscribers. We have not defined markets for the supply of TV to commercial customers.

⁴⁰ A pay TV platform can be defined as the specific combination of distribution and reception technology and conditional access that enables consumers to receive broadcasts. For example, Sky on DSat, Virgin Media on its cable network, Top Up TV on DTT or BT Vision and Tiscali TV on IPTV.

- 4.24 Our assessment of the wholesale market for basic-tier pay TV indicated that all suppliers had low market shares. Consequently it is unlikely that any firm would be dominant within that market.

Responses to the December Consultation

Retail and wholesale markets for premium channels

- 4.25 Responses to our proposed market definitions for premium channels fell into three broad groups.
- 4.26 Firstly, some respondents argued that premium channels were in broad economic markets. For example:
- Sky considered retail and wholesale markets for premium channels to be broad, encompassing both FTA television and pay TV services (including PPV services), and also (a) DVD sales and rental, and (b) other forms of 'on demand' provision of audiovisual services (regardless of the means of providing those services). It included for example audiovisual content delivered over broadband connections. It argued that if markets were defined in this way Sky would be unlikely to be dominant.
 - FAPL considered that the relevant market for premium sports channels included all TV including pay TV and FTA TV, but not audiovisual content delivered over the internet.
 - [X] considered that there was a high degree of competition between pay TV and FTA channels (both for viewers and advertisers).
- 4.27 Secondly, some respondents agreed with our characterisation of narrow retail and wholesale markets for premium channels.
- The BBC, BT, Virgin Media, [X], [X] and Tiscali all agreed with our proposal to define distinct markets for premium sports and movies channels.
 - [X] agreed that FTA did not provide a competitive constraint on premium movies or sports channels.
- 4.28 Thirdly, some respondents agreed that distinct economic markets for premium channels exist, but argued that we had drawn the boundary incorrectly. For example, Virgin Media and BT agreed that premium sports channels were in a narrow economic market at the retail and wholesale level. However they argued that a key feature of products within that market was not just live FAPL content, but also access to a range of other exclusive content (such as live darts) for which there is no close substitutes on FTA or basic-tier channels. Top Up TV, Setanta, and the Four Parties in a joint submission suggested that wholesale and retail markets for the supply of premium sports channels were narrower than we had defined, and were unlikely to contain Setanta Sports⁴¹.

⁴¹ Joint response of Setanta and TopUp TV paragraph 3.4 et seq and Response of Four Parties' 29 February 2008 paragraph 3.4(e).

Retail and wholesale markets for basic-tier channels

- 4.29 As described above, Sky considered that the market for TV was broad. [X] considered that there was strong competition between pay TV and FTA TV.
- 4.30 Tiscali considered that basic-tier TV and FTA TV are in a single economic market. The BBC and BT both agreed that FTA TV was in a separate market to basic-tier TV but that the distinction between basic-tier TV and FTA TV might diminish over time.
- 4.31 BT and Virgin Media considered that our approach to defining retail markets for basic-tier TV when bought in a bundle with premium channels was wrong, and that our approach considerably understated Sky's market share for the retail supply of basic channels⁴². We 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. However Appendix 2 in Annex 6 sets out the basis of our approach to defining markets which include product bundles.

Platform and distribution technology markets

- 4.32 No party disagreed with Ofcom that pay TV markets operated across platforms; BT and [X] agreed with our assessment⁴³. This therefore continues to be our view.
- 4.33 The BBC, [X], [X] and [X] noted that Ofcom has not considered markets for wholesale platform services as part of its review. They believed Sky has market power in the provision of these services and alleged, for example, that Sky is able to impose unfair contractual terms. As we explained in section 2, our analysis of markets for wholesale platform services is the subject of a separate review.

Arriving at our current view of relevant markets

- 4.34 In the previous section we set out the importance of certain types of content found on premium channels to consumers and hence to channel retailers. As we stated in that section, we believe premium sports and premium movies channels play a major role in driving subscriptions to pay TV. We are looking at wholesale markets for these channels in particular because we believe it is important to understand the extent of access to these channels for pay TV retailers. This is an important determinant of current and future prospects for competition.
- 4.35 In order to assess the role of premium channels in downstream competition, we need to assess whether any undertaking has market power in the wholesale supply of those channels. If no undertaking has market power in the relevant wholesale market, there is unlikely to be the potential for competition to be restricted, as retailers would be able to source alternatives to the premium channels, or consumers would be able to switch to alternative products.
- 4.36 Our 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.
- 4.37 We have reviewed our market definitions in light of the responses we received from stakeholders and new evidence we have gathered. Specifically, we commissioned

⁴² We discuss our approach to defining retail basic-tier TV markets in Appendix 2 in Annex 6.

⁴³ BT response paragraph 88, [X] response page 7.

further survey evidence on consumers' preferences for sport, their valuations of sport, willingness to pay for premium channels and consumption of content from the internet. See Annex 10 for the details of the consumer research we have carried out.

4.38 As in the December Consultation we use the Hypothetical Monopolist (HMT) framework to analyse the competitive constraints faced by undertakings in a systematic way. In line with OFT guidelines on market definition⁴⁴, and in light of the views of respondents, we have considered a range of evidence when assessing the competitive constraints, in order to be able to reach an aggregate view on the constraint that firms face. Our evidence base includes⁴⁵:

- Evidence from the firms active in the markets, for example from their actual behaviour, from internal strategic papers and from market analysis.
- Surveys on consumers' responses to price rises and estimates of price elasticity, including a willingness to pay survey commissioned by Ofcom and [X].
- Survey evidence on customer preferences for products and analysis of product characteristics, including new evidence gathered by Ofcom.
- Patterns in price changes or relative prices.
- Customer reactions to past price changes.
- The impact of the growth of multi-channel FTA services on demand for pay TV services.

Approach to defining markets

4.39 The HMT 'thought experiment' attempts to find the narrowest range of products for which a hypothetical monopolist would be able to sustain prices above their competitive level. We begin by considering a single product or narrow range of products and assess whether a monopolist provider would be able profitably to impose a Small but Significant Non-transitory Increase in Prices (SSNIP) above the competitive level. The monopolist could be prevented from raising prices either by its customers switching to alternative products (*demand side substitution*), or by the entry of alternative suppliers who would be able rapidly and with minimal sunk investment to switch production to the supply of the products under consideration (*supply side substitution*). If the monopolist is constrained from raising prices, we widen the scope of the products under consideration by including the next closest substitute and repeating the thought experiment. We iteratively widen the range of products under consideration until we consider that a monopolist of all the products under consideration would no longer be able to raise prices for a sustained period.

4.40 Additional issues arise when defining wholesale markets: in particular, we need to consider both the direct constraints on the hypothetical monopolist from the retailers it supplies, and the indirect constraints imposed by the final consumers of the retail product that uses the wholesale product as an input. A retailer purchasing from a monopolist faces a number of choices in response to a SSNIP:

⁴⁴ OFT Guidelines on Market Definition, 2004, http://www.ofcom.gov.uk/shared_ofcom/business_leaflets/ca98_guidelines/ofcom403.pdf.

⁴⁵ In section 5 we also consider further evidence relating to our assessment of market power including evidence on profitability, market outcomes, and barriers to entry.

- It can seek to pass on the cost increase to its consumers, some of whom will switch away – this imposes the indirect constraint on the hypothetical monopolist.
- It can seek to absorb the cost increase.
- It can seek to identify alternative wholesale inputs.

4.41 In practice the first of these possible choices tends to mean that wholesale markets will often be defined more narrowly than retail markets. A 10% rise in wholesale input prices – even if fully passed through to retail prices – will entail a less than 10% rise in retail prices because the input cost is likely to be one cost among many. Hence fewer end consumers will substitute away as a result of a 10% wholesale price increase than would in response to a 10% retail price increase. A 10% wholesale price increase is therefore more likely to be profitable, meaning that our definition would settle on a smaller set of products.

Specific additional issues when defining broadcast markets

4.42 In the December Consultation we noted a number of specific practical issues to consider when defining broadcasting markets. These include defining markets which contain differentiated products, the impact of the cellophane fallacy and defining two-sided markets. While these individual characteristics are not unique to broadcasting markets, their combination increases the complexity of the market definition exercise. In the text below, we summarise these features and consider the different responses we received on the relevance of previous findings to our current investigation.

Differentiated products

4.43 In markets which contain a variety of differentiated products, such as some broadcasting markets, there may not be a clear-cut boundary between products that lie just inside the market and products that lie just outside the market. As we stated in paragraph 4.17, the assessment of market power does not rely on the precise drawing of market boundaries, as products just outside the market can exert a competitive constraint. We have therefore tested the sensitivity of our market power assessment to our market definitions by calculating market shares based on a variety of differing assumptions regarding the precise boundary.

4.44 Sky argued that in markets with a range of differentiated products there is a danger that markets could be drawn too narrowly, especially if we rely on assessing product characteristics to define markets. We agree that the presence of a range of differentiated products, each of which may confer some market power, means we need to be careful not to draw markets excessively narrowly. We analyse markets using recent data that are relevant to the specific competition concerns we are examining, and base our current assessment on a range of evidence, as set out in paragraph 4.38.

The impact of the ‘cellophane fallacy’⁴⁶ on market definition

4.45 To understand the scope of the relevant markets, the OFT’s guidelines state that we should perform the HMT with prices at competitive levels⁴⁷. If a firm has already

⁴⁶ The cellophane fallacy was first highlighted as a competition concern following the controversies which arose as a result of the case involving producers of cellophane *US v Du Pont* 351, U.S. 377 (1956).

⁴⁷ OFT Market definition guidelines paragraph 5.4.

raised prices above competitive levels, we would expect to observe higher levels of switching in response to a further price increase, as consumers would switch to other products even though they are relatively poor substitutes. If we were to assess markets based on observed switching in this case, markets would be drawn too broadly. We discuss the impact of the cellophane fallacy on our investigation in more detail in Appendix 1 of Annex 6.

- 4.46 The guidelines also state that “the prices of products outside the hypothetical monopolist’s control are held constant *at their competitive levels*” (emphasis added). Therefore, if upstream input costs are above ‘competitive’ levels⁴⁸, we would again be in danger of drawing markets excessively widely by taking upstream input costs as given in the HMT. This is particularly important since Sky argued that the lack of conclusive evidence that it was earning excessive profits implied that prices must be at competitive levels. We disagree: content aggregation (discussed in more detail in Chapter 5) means that prices may well be above competitive levels with the profits flowing upstream to rights holders.
- 4.47 In broadcasting markets it can often be difficult to identify the competitive price. In economic models, the competitive price is often equated with marginal cost. However, in broadcasting markets, a large proportion of production costs are fixed, and marginal costs are very low. We would therefore expect competitive prices to be well above marginal cost, but it is very difficult to assess just how much higher they will be. Nonetheless it is conceptually correct to conduct market definition at ‘competitive’ prices. Where it is not possible to estimate the ‘competitive’ price, we assess evidence of switching cautiously, as high switching is consistent with both substitution to alternative products at competitive prices or prices being above competitive levels.

Two-sided markets

- 4.48 Broadcasting markets are two-sided, with retail consumers and advertisers both ‘customers’ of broadcasters. In such markets it is not uncommon for one side of the market to pay a high price while the other side pays a low price⁴⁹. For example, many TV channels, such as ITV, Five and Channel 4 are delivered to consumers for free and revenue is derived from advertisers. Wholesale channel providers also operate in two-sided markets. They license their content to channel retailers and they sell advertising and sponsorship to advertisers. For example, the Discovery Channel licenses its channels to retailers such as Sky and Virgin Media and sells advertising space to advertisers.
- 4.49 Two-sided markets present two practical difficulties in applying the standard HMT framework. Firstly, the HMT should attempt to capture the interactions between each side of the market (for example if subscribers switch away and stop viewing a channel, advertising space will be worth less). Secondly, two-sided markets make it even more difficult to identify the competitive price from which to apply the HMT.

⁴⁸ Upstream costs may be above competitive levels for a number of reasons: for example if all substitutable content is sold collectively, as in the case of FAPL rights, the seller may be able to extract an economic rent from the buyer. Economic rents can be distinguished from ‘scarcity rents’ which are associated with unique assets that consumers value highly and which can accrue, for example, to world-class footballers or Hollywood stars.

⁴⁹ In a perfectly competitive market the ‘competitive’ price is set at marginal cost. However, in two-sided markets one group of customers may receive the service at a price below the costs of production, while the other group receives the service above the costs of production.

- 4.50 Our approach to analysing wholesale pay TV markets has been to examine the impact of an increase in the price of licensing the channels, noting that we are likely to over-estimate the profitability of a price rise as consumer switching may lead to lower advertising revenues. We believe this approach effectively examines the competitive constraints on channel wholesalers, with a slight bias towards defining markets too broadly. However, the importance of subscription revenues relative to advertising revenues for premium channels suggests that this effect is likely to be relatively small – see Figure 2 in section 3.

Relevance of previous findings to our current investigation

- 4.51 In our December Consultation we reviewed a number of recent previous findings of other UK and European competition authorities in their investigations into TV markets. We stated that previous decisions can help identify relevant issues, but they do not negate the need for a full review of the relevant markets based on available evidence; this is particularly true in TV markets, which can be subject to rapid change.
- 4.52 Since the December publication another recent finding by the European Commission⁵⁰ has found that the provision of FTA and pay TV services to end users are in distinct product markets in Germany and Austria. The Commission found for example that from a viewer's perspective the "premium" content on pay TV is not substitutable with content found on FTA TV, as it is often broadcast on pay TV before being broadcast on FTA TV.

Views of respondents on other findings

- 4.53 We received differing views on our assessment of the relevance to our investigation of the Competition Commission's market definition conclusions in its investigation into the acquisition by Sky of a 17.9% stake in ITV (the 'Competition Commission's 2007 Findings')⁵¹. The Competition Commission identified a market for all TV including VoD⁵². It also noted that the market was highly differentiated.
- 4.54 Sky and FAPL argued that Ofcom mistakenly "ignores or downplays" the Competition Commission's market definition conclusions⁵³. Sky argued that this is because we believe that current prices are above competitive levels and that the finding would therefore be likely to be different if the inquiry were conducted at 'competitive prices'. However, Sky stated that as we do not provide strong and compelling evidence that current prices are above competitive levels, we should accept the findings as relevant to our current investigation. Sky concluded that this finding is the most relevant to our investigation as it is (i) UK based, (ii) the most recent, and (iii) the only one that considers the impact of Freeview.
- 4.55 Virgin Media⁵⁴ noted that the market definition was specific to the competition issue being addressed, in that case a merger between the leading commercial FTA TV broadcaster and the leading pay TV operator. It highlighted the Competition

⁵⁰ An investigation in relation to a merger between News Corp and Premiere.

COMP/M.5121/NewsCorp/Premiere.

⁵¹ Competition Commission (2007) Investigation into the acquisition by Sky of a 17.9% stake in ITV, <http://www.competition-commission.org.uk/inquiries/ref2007/itv/index.htm>.

⁵² Competition Commission's report to SoS (BERR) 2007 paragraph 4.30.

⁵³ Sky response Annex 2, Appendix 4, Paragraph 4.13; Also see FAPL's response paragraph 3.5 and 7.6.

⁵⁴ Paragraphs 5.6 to 5.10.

Commission's comment that the same market definition might not apply in other competition cases.

- 4.56 Virgin Media and BT also agreed with Ofcom's assessment that the relevance of the Competition Commission's 2007 Findings to the current investigation was limited. They argued that the Competition Commission's analysis was carried out at current prices – as is normal with a merger investigation – whereas our analysis of markets should be performed at 'competitive' prices.

Ofcom's current view of the relevance of other findings

- 4.57 In our view, it is important to carry out the market definition exercise afresh, having regard to the specific concerns that are being investigated and using recent data that are relevant to our investigation. This general approach is consistent with precedent and the relevant OFT guidelines⁵⁵.
- 4.58 Moreover, there are two specific reasons why the Competition Commission's 2007 Findings are of limited relevance to the current investigation.
- First, the Competition Commission was considering a different competition issue and so examined the relevant market for a different focal product. Given the Competition Commission's reference question (a merger between a FTA TV broadcaster and a pay TV broadcaster), the Competition Commission did not (and did not need to) consider the specific question of whether premium sports or premium movie channels are constrained by other pay TV or FTA content.
 - Second, the Competition Commission was considering whether the relevant merger situation gave rise to a substantial lessening of competition. Accordingly, it was appropriate for the Competition Commission to perform the SSNIP test from pre-merger prices. In contrast, for the purposes of the current investigation it is appropriate to conduct the HMT from competitive prices. In Appendix 1 in Annex 6 we discuss evidence that prices may be above 'competitive' levels.

Assessment of relevant markets for the wholesale of premium sports channels

- 4.59 Sport is a genre of programming that is highly valued by consumers⁵⁶. Sports content is broadcast on dedicated sport channels (such as the Sky Sports channels, Setanta Sports channels, Eurosport channels or Extreme Sports) and general entertainment channels (such as BBC1, ITV1 or Sky One). Pay TV channels can be within basic-tier pay bundles or premium channel bundles. Premium sports channels have access to the most valuable sports rights such as live FAPL. However, as we noted in our December Consultation, there is a wide variety of sport available on FTA channels.
- 4.60 The presence of listed events guarantees FTA access to some of the highest valued sports events. 'Listed events' are a limited number of sports events that the UK

⁵⁵ For example *Coca-Cola v Commission* [2000] CMLR 467.

⁵⁶ The high value that consumers place on sport is demonstrated, for example, by consumer surveys which describe the relatively high appeal of sports programming or channels over other genres (for example see the December Consultation, Annex 14, Figures 23, 28, or 29).

Government considers 'key' as they have a "special national resonance"⁵⁷. The Government mandates that these events are provided free-to-air.

- 4.61 FTA broadcasters also hold many other highly valued rights (either exclusively or with pay TV operators) that are not listed events. The growth in the number of FTA digital channels has considerably increased the ability of FTA broadcasters to broadcast a wide range of sport and to cover sporting events in greater depth. Being less capacity constrained may mean FTA channels are able to compete more directly with premium sports channels. FTA broadcasters like the BBC or ITV are now able to devote extended, in depth coverage of a wide variety of sporting events on their digital channels⁵⁸.
- 4.62 The key question for our analysis is to what extent content found on FTA or basic-tier TV channels constrains the pricing of premium sports channels. Given a small but significant increase in the price of a wholesale premium sports channel, would a downstream firm switch to an alternative wholesale input, absorb the price increase or pass the increase onto its subscribers? In the event of the latter, would those subscribers switch to FTA and discontinue their subscriptions to the premium sports channels⁵⁹?

Respondents' views on our assessment of relevant markets

- 4.63 In the December Consultation we assessed retail and wholesale markets for premium sports channels. We provisionally concluded that there were narrow markets for premium sports channels. These markets were unlikely to contain sport found on FTA or basic tier TV channels. We considered that Setanta Sports was the closest substitute for Sky Sports channels, and that the two were likely to be in the same economic market. This was based on the high value that premium sports channel subscribers placed on live FAPL matches (found on both Sky Sports and Setanta Sports channels), and survey evidence that subscribers considered Setanta Sports the closest substitute for Sky Sports⁶⁰.
- 4.64 In response to our consultation, Sky and FAPL considered that markets for sports were broader, encompassing at least FTA channels and basic-tier TV channels. Sky thought that markets were broader still, encompassing audiovisual content from the internet and DVDs.
- 4.65 BT, Setanta, Top Up TV, Virgin Media, the BBC, [X] and [X] all agreed with Ofcom's assessment of markets for premium sports channels. However, BT and

⁵⁷ For information on 'listed events' see for example: http://www.culture.gov.uk/what_we_do/broadcasting/5399.aspx, or http://www.ofcom.org.uk/tv/ifi/codes/code_sprt_lstd_evts/.

⁵⁸ For example last year the BBC Interactive channel offered live coverage of the FIFA Women's World Cup, Moto GP, World Match Play golf, the Snooker Grand Prix, World Championship snooker, the Australian and French Tennis Opens and the Africa Cup of Nations football competition. ITV4 broadcast extensive live coverage of Rugby Union World Cup matches featuring non-UK teams, the Grand Slam of darts and the Tour de France.

⁵⁹ Switching costs from a pay TV product to FTA TV are normally very low and are unlikely to create a barrier to switching. For example, it generally only takes a phone call for subscribers to pay TV services to discontinue their subscription and switch to a FTA service. Sky made the same point at paragraph 3.47 of Annex 2 to its response to our December Consultation.

⁶⁰ For example, our survey of consumers' stated response to hypothetical price rises indicated that Setanta Sports was the closest substitute. For the reasons set out in paragraph 4.86, while we consider that there may be stated preference bias in the survey, we consider that the relative levels of switching responses to alternative products are probably accurate.

Virgin Media considered that our analysis underestimated the importance of other sport on premium sports channels. For example, Virgin Media cited cricket, rugby union, tennis and rugby league as also being important. BT cited darts, noting that a recent match had achieved ratings of over 4.3 million on a Sky Sports channel⁶¹.

- 4.66 BT, Setanta, Top Up TV and Virgin Media all agreed that our market definitions for the wholesale and retail of premium sports channels should not include FTA TV or other basic-tier TV channels. However they considered that markets were in one respect narrower than we had suggested in our consultation. They considered that Setanta Sports was unlikely to constrain the pricing of Sky Sports to any significant degree and was thus in a separate economic retail and wholesale market to Sky Sports channels. They believed that Setanta was more likely to be a complement to Sky Sports rather than a substitute, noting for example that DSat households were likely to take Setanta in addition to (rather than instead of) Sky Sports. Furthermore, they noted that Sky Sports packages had increased in price after Setanta Sports began retailing FAPL matches in August 2007, whereas Setanta Sports had reduced in price⁶². They thought this suggested that though Setanta Sports's pricing may be constrained by Sky Sports, the constraint could be asymmetric: Setanta Sports does not provide a competitive constraint on Sky Sports.

Ofcom's current view

- 4.67 We have considered the responses that we have received, and have analysed a range of new evidence to assess the wholesale markets for premium sports channels.
- 4.68 Our view remains that Setanta Sports is likely to be the closest substitute for Sky Sports and is likely to be within the same relevant market, for the reasons we set out in our December Consultation (paragraphs 5.31 to 5.34). If Sky's channels constrain Setanta's, but not vice versa, our conclusions on market power would be unlikely to change. Conversely, if Sky's channels did not constrain Setanta's, we would be more likely to find Setanta to have market power. We begin our analysis taking Sky Sports channels and Setanta Sports premium channels as the focal premium sports channels for our investigation.
- 4.69 In the following section we first set out a range of evidence on the indirect (retail) constraint that consumers place on channel wholesalers. We then go on to consider evidence of the direct wholesale constraint from retailers substituting to alternative products or from alternative suppliers entering the market.

Indirect constraints on wholesalers of premium sports channels

- 4.70 We have considered a range of evidence to assess the extent of indirect constraints on wholesalers.
- Consumers' estimated responses to price changes.
 - Observed responses to price changes.
 - The popularity of FTA TV.

⁶¹ Virgin Media response paragraph 5.14 and BT response paragraph 67.

⁶² Joint Top Up TV and Setanta response, paragraph 3.4. Sky increased the prices of its premium sports packages by £1 (about 4%) on 1st September 2007; Setanta reduced its price by £5 to £9.99 on DSat in August 2007.

- Survey of consumer preferences and characteristics of premium sports channels.

Consumers' estimated responses to price changes

4.71 In order to assess the likely indirect constraint that consumers place on wholesalers of premium content, we have considered their likely response to a price rise. High levels of switching to other products in response to relatively small increases in prices could indicate that the products were in a broad market. Conversely, low switching could be evidence of narrow markets. Of course, where prices may be above 'competitive' levels we would expect to observe a high level of switching in response to a price rise, and in this case high switching could be consistent with finding narrow markets.

Evidence presented in the December Consultation on consumers' responses to price rises

4.72 In our December Consultation we reported our survey evidence on consumers' stated response to hypothetical price rises. The evidence suggested that although large numbers of subscribers might switch or change their subscription in response to a price rise, many chose to keep the sports element of the package. We stated that such responses might be subject to 'stated preference bias', so they should be interpreted with caution.

Respondents' comments on our evidence

4.73 Sky considered that Ofcom's consumer research into the likely response to a hypothetical price rise is strong evidence that consumers are very price-sensitive. It acknowledged that stated preference bias (where respondents overstate their likely responses to hypothetical questions) can be a problem with this type of research although it argued that it was not sufficient to 'reverse' the findings. In its view, we should accept that the findings indicate consumers are highly price elastic unless we provide evidence on the existence of cellophane fallacy pricing or stated preference bias. Sky believed that Ofcom's assessment of profitability suggests that prices are not excessive and are therefore competitive.

4.74 BT, however, agreed with Ofcom that cellophane fallacy pricing is likely to be a problem when considering the switching responses of consumers.

Ofcom's current view on evidence of consumers' responses to price rises

4.75 We have considered respondents' views on our evidence on consumer switching in response to a small price change, and gathered further evidence on consumers' price sensitivity at current prices.

4.76 We first set out the likely scale of indirect constraints that would constrain a monopolist wholesaler of premium sports channels. We go on to consider evidence of subscribers' price sensitivity.

4.77 Where markets may be narrow and incumbent suppliers have a high market share, prices may already be above competitive levels. For the reasons stated in paragraph 4.47, even though it can be very difficult to observe the competitive price in broadcasting markets, this does not mean we should accept that the current price is at competitive levels. We therefore interpret evidence of switching cautiously and consider it alongside other evidence such as consumer preferences and an assessment of product characteristics.

The scale of the indirect constraint

- 4.78 We first assess the scale of consumer switching that would be likely to constrain a monopolist wholesale channel provider⁶³. Wholesale premium channels are one input to a bundle of goods that a retailer sells to consumers⁶⁴. If the retailer passes through all of a 10% increase in the wholesale price of premium channels to its customers, the retail price will increase by less than 10%. For example the wholesale prices of Sky Sports Mix or Sky Sports and Movies Mix on Virgin Media are £[X] and £[X] respectively. A 10% increase in the wholesale price would be an additional £[X] and £[X]⁶⁵. The products are retailed in bundles costing between £26 and £44.50. Therefore a 10% wholesale price increase, entirely passed on to consumers, would lead to an increase in the *retail* price of between [X]% and [X]% depending on the package taken. This is often described as the “dilution effect” of a wholesale price increase.
- 4.79 The dilution effect means that a relatively strong consumer response to price increases would be needed to constrain a monopolist wholesaler of premium sports channels⁶⁶. The precise figure will depend on the proportion of wholesalers’ costs that varies with numbers of wholesale subscribers⁶⁷.
- 4.80 We can measure the consumer response to a price increase with ‘price elasticities’. Consumers’ price elasticity measures their collective response to a price change. Where price elasticity is greater than 1, a price increase of 10% will lead to a decrease in consumer demand of more than 10%. And where elasticities are less than 1, a 10% price increase will lead to consumer response of less than 10%.
- 4.81 We estimate Sky Sports Mix subscribers’ elasticities would need to be at least [X] (for a Virgin Media M basic subscriber) or [X] (for an XL subscriber) to constrain a wholesale monopolist and that the elasticity of Sky Sports and Movies Mix subscribers would need to be at least [X] to [X] to constrain a monopolist wholesaler⁶⁸.

Evidence on consumer price sensitivity

- 4.82 We have since gathered further evidence to estimate consumers’ responses to price rises. We commissioned a survey of consumers’ willingness to pay for premium sports channels⁶⁹. We also reviewed [X]⁷⁰.
- 4.83 One objective in carrying out this additional research was to minimise the risk of stated preference bias, and we therefore regard this research as removing any

⁶³ When examining constraints on wholesale suppliers of premium channels we consider collectively the indirect constraint from consumer switching and the direct wholesale constraint from retailers switching to alternative wholesale inputs or alternative wholesale suppliers entering the market.

⁶⁴ For example, on Virgin Media, if a consumer wishes to buy Premium Sports channels, he or she must also buy other TV services and can choose to buy a range of other services such as voice or broadband.

⁶⁵ VAT would also be added at 17.5%.

⁶⁶ Appendix 10 to Annex 6 sets out our estimate of the ‘dilution effect’.

⁶⁷ We have assumed that there are no variable costs associated with wholesaling Sky Sports Mix (as all rights are bought on a fixed fee basis) and about £[X] per subscriber per month of variable costs associated with wholesaling the Sky Sports and Sky Movies Mix.

⁶⁸ Appendix 10 to Annex 6 sets out how we derived our estimate of consumer elasticities required to constrain a monopolist.

⁶⁹ See Annex 10 for details.

⁷⁰ See Annex 6, Appendix 4 for details.

significant concerns of such bias. However, all of the studies estimate elasticity at current prices, so they may overstate the level of switching that would occur at competitive prices and therefore raise cellophane fallacy concerns⁷¹.

- 4.84 In the table below we set out our estimates of the minimum consumer elasticity required to constrain a monopolist wholesaler and estimates of elasticity from our research and [X].

Figure 15 Estimates of Sky Sports subscribers' elasticities

	Sky Sports Mix	Sky Sports and Movies Mix
Minimum elasticity to constrain a monopolist Depending on basic package taken	[X]	[X]
Elasticity estimate – Ofcom willingness to pay Given a 10% price increase	1.4	1.1
[X]	[X]	[X]

- 4.85 Overall, the evidence from our willingness to pay survey and [X] appears to suggest that insufficient subscribers would switch to an alternative product to constrain a monopolist wholesaler⁷². We do not therefore think that subscriber switching is likely to place a sufficient constraint on wholesalers of premium sports channels, even at current prices.
- 4.86 Taken together, the evidence from our own survey and [X] suggests that there was significant stated preference bias in our previous survey on consumers' stated response to hypothetical price rises, as is common with this type of survey, and as we stated at the time. However, if prices are above competitive levels we would expect switching to be higher than if they were at competitive levels, so our concerns about the cellophane fallacy remain.

Observed response to price changes

- 4.87 The assessment above is by its nature somewhat theoretical. We have therefore also examined subscribers' responses to actual price rises. If we observed that firms were unwilling to impose price rises on their customers, or that large numbers of consumers would switch in response to price rises, we might infer that firms' pricing was constrained and markets were broad. Of course, as we noted in our December Consultation, it can be difficult to isolate the impact of price changes in dynamic markets where the nature of products is changing over time.

⁷¹ Discussed at paragraphs 4.45 to 4.47, and Appendix 1 to Annex 6.

⁷² The evidence suggests that insufficient retail subscribers would switch away from Sky Sports on Virgin Media to constrain a wholesaler (Sky) from increasing prices. We should therefore consider why Sky does not increase its wholesale price to Virgin Media, as the evidence suggests it could profitably do so if markets were narrow. Sky's vertical integration is important in this respect: Sky will simultaneously seek to set the profit maximising retail and wholesale prices, and this means that the optimal wholesale price may be above or below the profit maximising level that a stand-alone retailer would set, depending on the vertically integrated entity's retail and wholesale costs. (The precise approach to setting the optimal wholesale price is likely to be one which leaves Sky indifferent between wholesaling and retailing.) In addition, [X].

- 4.88 In the December Consultation we found that prices of Sky Sports channels had increased in real terms by on average [X]%⁷³ per year since 2000 (although prices have remained relatively stable in real terms since 2004) and at the same time the number of subscribers to those packages had increased. We noted that it was difficult to interpret the impact of price changes on subscriber numbers because the quality of the packages had changed over time. However, we concluded that on balance the evidence suggested that Sky's pricing was not constrained to the competitive level.

Respondents' comments on our evidence

- 4.89 Sky claimed that our analysis of changes in subscriber numbers, prices and quality was insufficient to draw conclusions on market definitions. It suggested a wide range of factors affect subscriber numbers. These include quality, discounts, subscriber acquisition costs, quality of relevant substitutes, set top box subsidies, charges for related products (e.g. Sky+ or broadband) and marketing spend.
- 4.90 It asserted that our assessment of changes in quality of Sky Sports packages did not consider the fact that there was more live FAPL content, additional channels, additional programming, on-screen and other programming improvements, improvements to basic-tier programming, and other aspects of Sky's product offering such as 'free' broadband.
- 4.91 Virgin Media found our analysis of price changes and subscriber numbers "compelling". It argued that "real increases in prices and growing subscription numbers do not suggest that Sky is subject to any binding constraint"⁷⁴.
- 4.92 BT suggested that any analysis of subscriber numbers and prices is likely to be subject to the problems of cellophane fallacy pricing.

Ofcom's current view on evidence on observed response to price rises and quality changes

- 4.93 We have reassessed the change in quality of packages containing Sky Sports channels over time⁷⁵. It is difficult to quantify quality changes, but we accept that the greater number of FAPL games and additional content introduced to the channels has probably more than offset any reduction in quality resulting from the loss of content.
- 4.94 Since 2006, Sky has reduced the availability of retail discounts, which has had the effect of increasing the effective retail price over the period⁷⁶. Indeed, we understand that in 2006 about [X]% of Sky subscribers had a discount deal, whereas by August 2007, this figure had come down to [X]%⁷⁷. Sky stated that one outcome of [X]. We were unable to quantify the value of the discounts available to subscribers to premium sports channels or premium movie channels. However, the reduced availability of offers is likely to have increased the average price that premium subscribers pay for their service.

⁷³ Depending on the precise package.

⁷⁴ Virgin response to Ofcom consultation paragraph 5.13.

⁷⁵ See Appendix 3 to Annex 6.

⁷⁶ See for example: <http://www.forbes.com/markets/feeds/afx/2007/05/02/afx3675816.html>.

⁷⁷ Third Sky response to Ofcom information request of 29 May 2008, [X].

- 4.95 While it is difficult to identify directly the consumer response to price changes as the quality of the product changes over time, the numbers of retail subscribers to packages containing Sky Sports channels on DSat have increased despite the price increases and reduction in discounts. On its own, this evidence is somewhat ambiguous, and we agree with Sky that there are substantial difficulties in drawing firm conclusions. However, we believe the evidence is consistent with the findings from our consumer research that consumers are unwilling to switch to substitute products despite increases in the price of Sky Sports and the increased availability of sport on FTA channels. At the same time, we recognise that the consumer responses may at least partly reflect an increased willingness to pay for a better quality product.

The popularity of FTA TV

Overview of Ofcom's analysis on the impact of Freeview on numbers of subscribers to Sky Sports

- 4.96 One way to consider whether two products are close substitutes for each other is an 'event analysis' which examines, for example, the impact of the entry or exit of a firm within the markets being assessed. If we observed a strong response from incumbents or from existing consumers when a new product joins the market, this might be evidence that the incumbent's product and the new entrant's product are close substitutes.
- 4.97 The growth of Freeview and a greater number of basic channels featuring sport have increased availability of sports and other programming on FTA and basic tier TV. The number of households which access multi-channel TV on their main set via Freeview has increased rapidly from about one million in 2002 to over nine million now. The entry of Freeview in 2002 enables us to examine the response of other TV providers and of consumers.

Figure 16 DTT and Sky Sports households 2000 – 2008

[X]

Source: Sky⁷⁸, Ofcom digital tracker survey

- 4.98 If sport on Freeview was a close substitute for premium sports channels, we would expect the trend in Sky Sports subscriber numbers to have been impacted by the growth in numbers of Freeview households. The massive growth in popularity of Freeview since 2002 does not seem to have had an impact on growth in Sky Sports subscriber numbers.
- 4.99 It is of course difficult to identify the counterfactual of how numbers of Sky Sports subscribers would have grown were Freeview not available. We reported in the December Consultation that Sky has used an econometric analysis to estimate the demand for its premium sports channels were Freeview not available. It estimates that demand for its premium sports channels would be [X]⁷⁹. In the December Consultation we said that while we agree that this demonstrates that some subscribers might view Freeview and Sky Sports as substitutes, it does not inform us how the pricing of Sky Sports is constrained by the presence of Freeview, and in particular what subscribers would do if the price of their package increased by 10%.

⁷⁸ Sky response to Ofcom information request of 29 May 2008.

⁷⁹ [X] Also Sky confidential response to consultation [X].

Respondents' views on the competitive constraint from FTA TV

- 4.100 Sky and FAPL stated that the range of valuable live sports found on FTA TV meant that it offered a particularly close constraint to premium sports channels. They argued that the constraint had increased as the FTA channels have acquired more broadcasting capacity since the emergence and growth of Freeview.
- 4.101 Virgin Media noted that it “is difficult to envisage a greater market ‘shock’ than the recent substantial expansion of Freeview, both in terms of its channel offering and penetration”. However, it argued that while the FTA channels might to some extent be a substitute for Sky’s premium sports packages, the evidence suggested that Sky did not face a binding competitive constraint from Freeview⁸⁰.
- 4.102 BT argued that the most popular FTA choice, Freeview, only places a limited competitive constraint on pay TV as DTT is currently capacity constrained and cannot therefore match the range and variety of services found on Sky or Virgin Media’s pay TV offerings.

Ofcom’s current assessment of the evidence of the competitive constraint from Freeview

- 4.103 The growth in availability of FTA digital channels and the greater range and quantity of available sport means that FTA TV may now be a closer substitute for premium sports channels than ten years ago when most consumers only had access to five FTA channels. In particular, we observe that the additional digital channels mean that the PSBs are able to broadcast live sporting events in greater depth and there has been enormous growth in numbers of Freeview consumers.
- 4.104 At the same time, some sports that were available FTA – such as live England Test cricket – are now only available on pay TV. This will reduce the extent to which FTA TV is a close substitute for premium sports channels. The recent capacity growth of FTA TV is only relevant to premium sport to the extent that the ownership of key content rights permits this capacity to be exploited.
- 4.105 We recognise that FTA services and premium channels may be substitutes for each other to some extent, as suggested by Sky’s econometric study. However, if Sky were correct to assert that the FTA offering competes closely with premium sports channels, we would expect some of that substantial growth to be attributable to switching away from Sky Sports. In fact Sky Sports numbers have grown since 2000. Although some of this growth may be attributable to changes in the quality of Sky Sports channels, this suggests to us that the very strong growth in popularity of Freeview has not had an observable impact on subscriber numbers to packages containing Sky Sports⁸¹.
- 4.106 This is not conclusive evidence that FTA services and premium sports channels are in distinct economic markets. However we believe that the overall evidence on consumer switching behaviour in response to changes in quality, price and availability of products indicates that premium sports channels are indeed likely to be in a separate economic market. This conclusion is reinforced by our analysis of the characteristics of those channels set out below.

⁸⁰ Virgin Media response, paragraph 5.24.

⁸¹ We discuss the quality of Sky Sports channels in Appendix 3 in Annex 6.

Survey of consumer preferences and characteristics of premium sports channels

4.107 Evidence on estimated price elasticity suggests that at current prices the indirect constraint from final consumers would be insufficient to constrain a monopolist from raising its wholesale prices. This evidence appears consistent with observed responses to price changes. We have also examined evidence on the preferences of consumers to understand whether there are features of premium sports channels that indicate that subscribers would be unwilling to switch to substitutes.

Overview of Ofcom's analysis of consumer preferences in the December Consultation

4.108 In the December Consultation we found that live FAPL was unique among sports shown on TV in that it was a very highly valued sports competition that broadcast a large number of matches (138 per year) throughout each nine month season⁸². Other valued events, such as the football World Cup or the Olympics, tended to broadcast fewer fixtures or were only available for a short period.

Respondents' comments on our evidence

4.109 Both the FAPL and Sky suggested that there are a wide range of rights that could substitute for FAPL, including many currently owned by Setanta and FTA channels. They claimed that Ofcom's consumer survey evidence demonstrates that although FAPL is important to consumers, there are numerous other sports events on TV that are also important to consumers – many of which are broadcast live on FTA TV.

4.110 The FAPL argued that we are wrong to suggest that the highly valued popular sports on FTA TV tend to be relatively short one-off events, giving examples of a range of events that are neither short nor one-off, such as Formula 1, FA Cup, rugby Six Nations and the UEFA Champions League.

4.111 BT, Virgin Media, Top Up TV and Setanta pointed out that although live FAPL is very important, other non-FAPL sports are also important in making Sky Sports channels "must stock" channels for pay TV retailers.

Ofcom's current assessment of consumer preferences

4.112 To shed further light on these issues, we commissioned new consumer research into premium sport channel subscribers' valuation of sport to understand the features that they consider important⁸³. Our analysis is set out in more detail in Appendix 5 to Annex 6.

4.113 We found that FAPL is the most valued sport shown on TV. For example:

- 75% of premium sport channels subscribers with an interest in sport consider FAPL to be *very important*.
- 71% of Sky Sports subscribers with an interest in sport said live FAPL was one of the top three most important sports events within their package.

⁸² An assessment of live sport shown on TV is found at Appendices 9 and 10 to Annex 6.

⁸³ Ofcom sports conjoint research – see Appendix 10 in Annex 6 for details. Survey of all Sky Sports and Setanta subscribers who watch sport at least once per week. We reported in our December consultation that approximately 92% of subscribers to Sky Sports channels watch sport at least once a week (December Consultation, Annex 14 Figure 33).

4.114 UEFA Champions League and the FA Cup are also very important to premium sports channel subscribers. Matches often feature FAPL teams. These competitions include some matches shown on FTA channels. For example:

- 72% of premium sport channels subscribers consider UEFA Champions League to be *very important* (including 57% who consider it *extremely important*).
- 71% of premium sport channels subscribers consider the FA Cup to be *very important* (including 54% who consider it *extremely important*).

4.115 Lower leagues are less highly valued than competitions featuring Premier League teams. For example, only 9% of subscribers to premium sports channels who regularly watch sport on TV considered that access to Football League football was one of the most important sports events in their decision to subscribe to the channels. This compared with 71% of subscribers who considered FAPL important in their decision to subscribe.

4.116 In order to assess whether consumers who highly value FAPL would consider other events to be substitutes, we have examined the characteristics of FAPL and other football competitions on TV. There are four other competitions which feature Premier League teams and are played throughout the season.

4.117 The table below sets out the number of football fixtures broadcast live last season. FAPL offers far more games featuring top UK teams each season. Other competitions feature fewer games which include Premier League teams. The UEFA Champions League featured 130 games of which only 44 included one of four FAPL teams.

Figure 17 Live football featuring Premier League teams on TV (2007/08 season)

Competition	Total number of matches broadcast	Number of broadcast matches featuring FAPL teams	Number of matches broadcast on FTA featuring FAPL teams	Number of matches broadcast on premium channels featuring FAPL teams	Number of unique occasions to watch FAPL teams	
					FTA	Premium
FAPL	138	138	0	138	0	136
Champions League						
- Qualifying	10	4	2	2	2	2
- Post qualifying live matches	125	43	22*	22*	13	14
FA Cup	28	19	14*	6*	14	6
UEFA Cup	49	28	25	3	19	3
Carling Cup	15	13	0	13	0	13
Total	365	245	63	184	48	174

Source: TV Times

Note: * Includes simulcast of final on both FTA and pay TV

4.118 We believe that the extent to which a pay TV retailer would see alternative competitions as a substitute for live FAPL in assembling a consumer proposition is determined by four (closely related) factors:

- The attractiveness of each individual match to consumers.

- The frequency with which the competition takes place – i.e. annual, every four years, etc.
- The spread of matches over the season.
- The total number of matches.

4.119 We have assessed the characteristics of other live football on TV to determine whether it would be likely to be viewed as a close substitute for live FAPL. Figure 17 indicates that in the last football season there were 63 games featuring FAPL teams broadcast on FTA TV. However, as some of these games were broadcast simultaneously there were only 48 separate occasions (just over one per week) when a consumer could watch a match featuring an FAPL team on FTA TV, compared with 174 occasions on premium sports channels. Importantly these matches are not evenly spread through the season. In fact between August and May there were 11 weeks where no live football featuring FAPL teams was broadcast on FTA TV.

4.120 We therefore consider that while some other football events found on FTA TV might be comparable to live FAPL in terms of the attractiveness of each individual match, they cannot match programming found on premium sports channels in terms of quantity and regular availability of matches throughout the season, even when considered in aggregate. The constraint from live football featuring FAPL teams on FTA TV is weak – it is likely to lie outside the relevant economic market.

4.121 However, we do not preclude the possibility that these individual matches lie just within the market. The UEFA Champions League appears particularly relevant in this respect. In the following chapter, we therefore assess market shares both including and excluding these matches from the relevant market.

4.122 We have also assessed the potential for substitution to non-FAPL live football featured on FTA TV, but consider these events are less good substitutes:

- Events that only take place episodically; for example, the UEFA European Football Championship cup finals or FIFA World Cup finals, though highly valued, are each only held every four years for a period of about three weeks and therefore will only be considered a weak substitute for FAPL featured on premium sports channels for those consumers who regularly watch football.
- There are also a small number of England international matches played throughout the season broadcast on FTA channels. These are also considered important by consumers; for example 71% of premium sport channels subscribers consider England international matches to be *very important* (including 55% who consider it *extremely* important). However, in the last year only 12 matches featuring England were broadcast, just six of which were on FTA TV. We therefore consider that these would be a weak substitute for content found on premium sports channels.

4.123 There are a number of other UK leagues whose football is broadcast throughout the year⁸⁴. All are broadcast on premium sports channels. However, matches that do not feature Premier League football teams are likely to be more distant substitutes for subscribers who consider FAPL very important. Competitions with lower ranking teams are likely to be more distant substitutes than competitions featuring higher

⁸⁴ For example the Coca Cola Championship, the Football League Divisions one and two, the Blue Square football.

ranking teams (for example Coca Cola League football is likely to be a closer substitute for FAPL than Blue Square Conference football is)⁸⁵.

Conclusion on key features of premium sports channels

- 4.124 Overall, our survey data and analysis of product characteristics indicate that matches featuring FAPL teams are very important to subscribers. While there are a number of competitions that subscribers consider important, including four that feature FAPL teams, FAPL itself is the most important competition, since it features FAPL teams playing matches regularly through the season. It is possible that other football competitions featuring FAPL teams where matches are scheduled regularly though the season may be considered a substitute for FAPL. For example, consumers place a high value on the UEFA Champions League, which includes matches shown on premium sports channels as well as FTA.
- 4.125 A critical question for us, however, is whether the football matches featuring FAPL teams on FTA TV are a sufficiently strong substitute for premium sports channels. On balance we consider the relatively low number of matches featuring FAPL teams featured on FTA TV mean that it is likely to be regarded as a weak substitute for live football featuring FAPL teams on premium sports channels.
- 4.126 We therefore conclude that live FAPL games played regularly throughout the season represent a distinctive characteristic of premium sports channels. However, we recognise that the market could be somewhat broader, including all competitive games featuring FAPL teams (including matches on FTA TV from either UEFA Champions League UEFA Cup, or the FA Cup) and we consider the implications of this broader definition in our assessment of market power in the next chapter.

Wholesale supply side substitution

- 4.127 Supply side substitution may occur where an undertaking would be incentivised to enter the market following a small but significant price rise. It is standard practice when assessing supply side substitution to consider entry that can take place within a short space of time (about a year) and that does not incur significant sunk costs⁸⁶.

Ofcom's assessment of supply side substitution in the December Consultation

- 4.128 In the December Consultation we concluded that wholesale supply side substitution within a year without significant sunk costs was unlikely, as broadcasters would have to acquire rights and incur start up costs for their channel, both of which would incur significant costs.

Respondents' views on supply side substitution

- 4.129 Sky stated that the threat of competitive entry exists at the wholesale channel provider level. It argued that Ofcom adopted an unreasonable entry benchmark, i.e.

⁸⁵ This is evidenced by average viewing. The average audience for Coca Cola Football League coverage (broadcast live on Sky) between Q2 2007 and Q1 2008 was approximately 337,500, while the average audience for Blue Square football (broadcast on Setanta) was just 28,000 in the same period. This compares with the average audience for an FAPL match on Sky Sports of 1,035,500 (Q2 2007 to Q1 2008).

⁸⁶ The OFT considers supply side substitution a special case of entry that occurs "quickly (e.g. less than one year), effectively (e.g. on a scale large enough to affect prices), and without the need for substantial sunk investments".

rapid and direct replication of Sky's sports channels in order to constrain Sky's pricing. Sky argued that other modes of entry are possible, including gradual or targeted entry, or entry through differentiated content. Sky also argues that rapid entry is possible because rights to access content become available on a staggered basis and are fully contestable.

- 4.130 Sky further argued that, although significant financial outlay would be involved in acquiring rights, many entities would have access to such funding, such as Disney / ESPN, or BT. It stated that a new entrant could limit initial investment by incrementally building subscribers. Sky suggested that Setanta's entry into the market is evidence that entry is possible.
- 4.131 UKTV said that it had considered entering the market to supply a sports channel but concluded that although it would be able to acquire rights to "less well known" sports, it would not be economically feasible to operate a channel based on these "less popular" sports⁸⁷.

Ofcom's current assessment of supply side substitution

- 4.132 We agree that a new entrant would not have to replicate existing channels in order to compete for the same consumers. However, our evidence on consumer preferences indicates that FAPL or a significant number of matches featuring FAPL teams is a key characteristic needed to compete with premium sports channels. UKTV for example decided that it could not compete providing a sports channel showing other less popular sports.
- 4.133 Press reports indicate that Setanta has incurred losses of €100 million from 2005 to 2007. Setanta's director of corporate development said that "when you're launching and expanding, you typically incur the costs before you get any money from your subscriber base"⁸⁸. The scale of Setanta's losses and UKTV's assessment of entry into the market are both evidence that entry within a year without sunk costs is unlikely.
- 4.134 As set out in our December Consultation, we consider that in the relatively short term it would be unlikely that a new entrant could enter the market without incurring sunk costs in acquiring content and customers. This is illustrated by the losses Setanta incurred, and Setanta's assessment that significant investment is required over a long period to attract subscribers. For this reason we do not consider supply side substitution to be sufficient to widen markets. This view is strengthened by our subsequent review of barriers to entry in the context of market power in section 5.

Direct wholesale demand side substitution

- 4.135 In the event of a price rise on wholesale premium sports channels a retailer could in theory substitute to alternative inputs to use in its retail packages. For example, after Virgin Media and Sky were unable to agree a price for the carriage of Sky basic channels Virgin Media, informed its customers that it intended to supply alternative programming⁸⁹.

⁸⁷ For example UKTV cited swimming, hockey, table tennis and sailing.

⁸⁸ <http://www.independent.ie/business/irish/expansion-sees-setanta-losses-head-for-8364100m-1088013.html>.

⁸⁹ For example see: <http://www.digitalspy.co.uk/cable/a43320/in-full-virgins-statement-to-customers.html>. Sky and Virgin Media are reported to have since been in negotiations to for Virgin

- 4.136 Given that wholesale demand is derived from consumer demand, products that consumers would find weak substitutes (such as non-football content or football from foreign leagues) are also likely to be relatively weak substitutes at the wholesale level.
- 4.137 Our analysis of the indirect retail constraint indicates that there are no close substitutes for FAPL content found on premium sports channels⁹⁰. We do not consider therefore that there are likely to be any wholesale products that a retailer could substitute to in the event of a small but significant increase in the carriage fee.
- 4.138 Furthermore, we observe that retailers (i.e. cable companies) have not previously dropped Sky Sports channels even when the wholesale price has increased. Our conclusion is therefore that wholesale demand side substitution is unlikely to be a significant constraint.

Changes in wholesale prices

Sky's assessment of the change in wholesale prices

- 4.139 In response to our December Consultation, Sky argued that flat or falling wholesale carriage prices for its premium channels are strongly suggestive that it does not have market power to set prices above competitive levels⁹¹. It also argued that "given the very significant increases in rights costs, particularly in the case of sports channels, the obvious implication is that margins between costs and prices have narrowed in relation to Sky's channels at the wholesale level over the period".

Ofcom's assessment of changes in wholesale prices

- 4.140 We have analysed changes in wholesale prices of the most popular wholesale premium sports channel mixes^{92,93}. The wholesale price of the Sky Sports and Movies Mix has decreased in real terms since 2005 but is still [X] than it was in 2002. The price of Sky Sports Mix has [X] since 2002 and is now [X] than it was in 2002.
- 4.141 We have also examined the wholesale mark-up over programming costs. While the relationship between input costs and wholesale prices is complex, our analysis suggests a widening wholesale margin over costs.
- 4.142 We therefore consider that the fall in wholesale prices of packages containing Sports and Movies Mix since 2005 does not necessarily imply a binding competitive wholesale constraint. In fact, the widening gap between average wholesale costs and prices could indicate increasing market power.

Media to carry the channels. See: <http://www.digitalspy.co.uk/digitaltv/a117562/sky-virgin-still-in-carriage-negotiations.html>.

⁹⁰ Appendix 9 to Annex 6 describes alternative sport channels. These include niche a la carte channels such as MUTV or Chelsea TV; channels that are either provided FTA such as Fight Network or sportsXchange; channels contained within a basic tier subscription such as Eurosport, Motors TV, Attheraces.

⁹¹ Annex 2 to Sky's non-confidential response to our consultation 3.131-2.

⁹² Sky Sports Mix and Sky Sports and Movies Mix are taken by [X]% of wholesale subscribers to Sky Sports channels.

⁹³ Our full analysis is contained in Annex 6, Appendix 6.

Conclusion on the market for the wholesale of premium sports channels

- 4.143 The evidence is indicative of a narrow market for the wholesale of premium sports channels, which we define as being channels or packages of channels containing live FAPL matches. Evidence on subscribers' price sensitivity indicates that insufficient numbers of subscribers would switch to constrain a monopolist wholesaler of premium sports channels, even at current prices. Our research indicates that FAPL content is sufficiently important to a large enough number of consumers that the constraint from FTA channels is relatively weak.
- 4.144 The characteristics of other sports competitions render them also inadequate substitutes for live FAPL content – in particular we considered Champions League, which we believe to be just outside the market. The lack of demand-side substitutes for subscribers means it is unlikely that a retailer could switch to an alternative channel. New entrants would have to make significant investments in content and acquiring subscribers to supply a channel so we do not consider that supply side substitution would broaden the markets. Increasing wholesale prices for sports channels suggest that prices are not constrained to the competitive level.
- 4.145 Our current view is that the relevant wholesale market is for premium sports channels containing live FAPL matches. We consider the wholesale supply of Sky Sports 1, Sky Sports 2 or Setanta Sports 1, as well as HD versions of these channels, to be included within this definition. In the remainder of the document we will refer to these channels as 'Core Premium Sports' channels.
- 4.146 As is often the case with market definition, the precise boundaries of this relevant market are difficult to determine with certainty. We have included Sky Sports 2 in the relevant market on the basis that it includes a number of FAPL matches. While this avoids ambiguity, we recognise that, in practice, relatively few matches are shown on Sky Sports 2. It could be argued that this means that the market should be narrowed to exclude Sky Sports 2. On the other hand though, as we have observed, it is conceivable that the market should be broadened to include for example Champions League matches. In any case, as we explain in section 5, our market power assessment is unaffected by the inclusion or exclusion of Sky Sports 2 in the relevant market.

Assessment of markets for the wholesale of premium movie channels

- 4.147 Films are an important genre of programming for consumers. Films have different characteristics to sport in that they are not viewed 'live' as they are produced. This means they can be retailed to consumers in many different formats. They can be watched on traditional linear TV channels including Sky Movies channels and other basic or FTA channels. Alternatively, they can be downloaded via the open internet, bought or rented on DVD, or watched on an on-demand service.
- 4.148 Some of the available formats have only relatively recently become widely available to consumers, such as internet downloading services and VoD services. There are new retailers of films, such as BlinkBox (an internet retailer) which started operating at the end of October 2007, and Apple (via Apple TV) which began offering films for rental or purchase by UK consumers in 2008⁹⁴. The dynamic nature of these markets makes it difficult to consider the constraint imposed by new products on wholesalers of premium movies channels.

⁹⁴ Apple launched its Apple TV console in 2007 but UK consumers were only able to rent or buy films from 2008.

- 4.149 Sky wholesales a range of packages that contain its premium movies channels. It also retails the same channels to its DSat subscribers in a range of packages which can also include premium sports channels and basic-tier TV channels. In addition, Sky Movies subscribers can download films shown on Sky Movies channels via the Sky Anytime application to their PCs. Sky Movies channels contain a mix of new films from the first pay TV window and older library films.
- 4.150 In this section we set out our view of the wholesale market for premium movies channels such as Sky Movies. We consider the extent to which other movie formats are likely to constrain a hypothetical monopolist wholesaler of premium film channels. We also consider whether older films found on FTA TV might constrain the wholesale prices of premium movie channels to competitive levels.
- 4.151 We begin by describing two important features of film content, the film ‘windows’ and the role of the biggest Hollywood studios. We then summarise the preliminary conclusions on markets for premium movie channels that we reached in our December Consultation. We go on to set out the responses we received on our assessment of relevant markets and assess new evidence on which we base our current view of the relevant markets.

Film windows

- 4.152 Annex 11 to our December Consultation described how film content is commercially exploited in a number of different ways. The timed availability of films across different formats (known as ‘film windows’) is controlled so as to exploit consumers’ different willingness to pay for content in order to maximise revenues and recover the fixed costs of production and marketing.
- 4.153 New films are often valued more highly by consumers than older films. This is in part because significant marketing occurs around the time of the initial cinema release which increases the awareness of a film. The value of this marketing will diminish over time. Once a consumer views a film in an earlier window its value to that consumer in later windows is likely to be diminished. Viewing a film in the cinema is often considered a more special experience than watching the film at home. The table below sets out the available film windows.

Figure 18 Summary of movie windows in the UK

Window	Time of start of window (after cinema release)
Cinema release	N/A
DVD rental	4 months
DVD retail	4 months
VoD / PPV	6 to 7.5 months
Internet download	6 to 7.5 months
Pay TV subscription channels	12 months
FTA channels	24 to 27 months

Source: Screen Digest – see Annex 11 to December Consultation, Figure 2

‘Major’ Hollywood studios

4.154 The term ‘major’ studio is used to refer to the Hollywood studios which are members of the Motion Picture Association of America. At present the following six Hollywood studio groups are considered to be the ‘major’ studios⁹⁵. These are:

- Disney.
- Paramount.
- Sony.
- 20th Century Fox.
- Universal.
- Warner Bros.

4.155 Screen Digest estimates that the films produced by the six Major Hollywood Studios typically account for around 35% of films released at UK cinemas and 80% of UK box office revenues. Sky has had exclusive agreements with the current six Major Hollywood Studios to exploit their films in the pay TV window since [X]⁹⁶.

Preliminary conclusion of the December Consultation and responses

- 4.156 In the December Consultation we assessed retail and wholesale markets for premium movies channels. We concluded that there were narrow retail markets for premium movies channels at the retail and wholesale levels.
- 4.157 Sky considered that markets are broader, encompassing at least FTA channels, basic tier TV channels, audiovisual content from the internet and DVDs. In particular, it stated that there are now many more potential substitutes for Sky Movies than there were ten years ago⁹⁷. Sky reported that the aggregate constraint from DVD rental and retail, VoD and an increasing number of films on basic and FTA TV was “having a major impact on TV retailers’ ability to attract subscribers to packages that included premium movie channels”⁹⁸. It stated that despite flat inflation-adjusted prices since 2001 the number of subscribers to the channels was declining. Furthermore, fewer new subscribers tended to take Sky Movies.
- 4.158 BT, Setanta, Top Up TV, Virgin Media, BBC, [X] and [X] all agreed with Ofcom’s assessment of markets for premium movies channels.
- 4.159 We have considered the responses that we received and have analysed a range of new evidence to assess the relevant markets.

⁹⁵ See for example: <http://www.mpa.org/AboutUsMembers.asp>.

⁹⁶ [X] Source: Sky response to information request of 20 December 2007. Note however that Disney premieres its animated films on its Disney Cinemagic channel, before they are shown on Sky Movies (see for example http://media247.co.uk/skydigital/newsarchive/2006/02/sky_launch_conf.php).

⁹⁷ Sky response Annex 2 paragraph 3.73 – 3.81.

⁹⁸ Sky response paragraph 6.36.

- We begin by assessing the indirect constraint that subscribers place on wholesalers of premium movie channels, including evidence presented to us by stakeholders about their view on the likely constraints.
- We then go on to consider evidence of the direct wholesale constraint from retailers substituting to alternative products or from alternative suppliers entering the market.

Indirect constraints on wholesalers of premium movie channels

4.160 In considering indirect constraints, we have examined the following evidence:

- Firms' views on likely substitutes.
- Consumers' estimated response to price changes.
- Consumers' observed response to price changes.
- Consumer preferences and features of premium movie packages.
- The potential constraint from DVDs.
- The potential constraint from content downloaded from the internet.

Firms' views on likely substitutes

4.161 We have gathered views of firms in the market in order to identify close substitutes for the product under consideration.

4.162 Sky clearly views other movie products as competitors to its premium movie channels. Sky supplied to Ofcom the results of an analysis it had commissioned of consumer views of its premium movie channels. The analysis described the increasing number of alternatives available to consumers and noted that Sky faces competition from a growing range of products. These included movies shown in the cinema, on DVD via retail and rental, PPV, new film subscription services and movies on FTA TV. This is set out in Figure 19 below.

Figure 19 Slide from Sky presentation on Sky Movies

[X]

Source: Sky

4.163 Sky supplied us with a number of internal papers where it noted that the growth in the retail of DVDs and increased availability of films (from later windows) on digital channels were partly responsible for declining numbers of movie subscribers⁹⁹. [X]

4.164 [X]¹⁰⁰ [X]:

"[X]".

4.165 [X]¹⁰¹.

⁹⁹ Sky's third response to Ofcom information request of 29 May 2008.

¹⁰⁰ Sky's third response to Ofcom information request of 29 May 2008.

- 4.166 We agree that there are a wide and growing variety of potential substitutes for Sky Movies channels. The key question for our analysis is whether these potential substitutes sufficiently constrain a monopolist wholesaler of premium movie channels from imposing a price rise above competitive levels.
- 4.167 We have therefore examined evidence on prices and subscriber numbers, consumer preferences and characteristics of products over time, to consider how likely consumers be to would switch to alternative products in the event of a price rise.

Consumers' estimated response to price changes

Evidence presented in the December Consultation on consumers' response to price rises

- 4.168 In the December Consultation we reported the results of Ofcom research into consumers' response to hypothetical price rises. We interpret evidence of stated responses to hypothetical price rises cautiously, as they could be susceptible to stated preference bias. Furthermore, if prices were above competitive levels we would expect the switching response to be greater than if prices were at competitive levels.

Respondents' comments on our evidence

- 4.169 Sky believed that our survey evidence on consumers' stated response to hypothetical price rises was strong evidence that consumers were price elastic. It stated that, unless there was strong and compelling evidence that prices were above competitive levels, we should accept that the results indicate that consumers are very price-sensitive.
- 4.170 BT stated that the high level of switching indicated by the results could be as a result of cellophane fallacy pricing, and that therefore by relying on this data we might draw excessively broad markets.

Ofcom's current view on evidence of consumers' response to price rises

- 4.171 We have estimated the minimum consumer elasticity that would be required to constrain a monopolist wholesaler from increasing prices above current levels. In order to calculate likely elasticity, we commissioned a willingness to pay survey and [~~X~~]. The results are shown in the table below.

¹⁰¹ Virgin Media response to Ofcom information request of 15 May 2007 [~~X~~].

Figure 20 Estimates of Sky Movies subscribers' elasticities¹⁰²

	Sky Movies Mix	Sky Sports and Movies Mix
Minimum elasticity to constrain a monopolist Depending on basic package taken	[∞]	[∞]
Elasticity estimate – Ofcom willingness to pay Given a 10% price increase	N/A Low sample size (40)	1.1
[∞]	[∞]	[∞]

- 4.172 Our analysis shows that insufficient Sky Sports and Movies Mix subscribers would be willing to switch to alternatives if the price of their subscription increased by a small amount to constrain a monopolist wholesaler of these channels.
- 4.173 The evidence suggests that Sky as a wholesaler of premium movie channels could profitably increase its prices from current levels. As set out in footnote 72 in relation to premium sports channels, we consider the reason that it does not increase prices from current levels may be because wholesale prices are set with reference to their retail prices. The derived wholesale price may be above or below the profit maximising level and may be above the competitive level.
- 4.174 Our estimates of elasticities for Sky Movies subscribers are less conclusive than for Sky Sports as [∞], and there was a small sample size in our willingness to pay experiment. However, it would take a strong consumer response to constrain a monopolist wholesaler of premium movie channels, and the results indicate a weak constraint on premium movie channels.

Consumers' observed response to price changes

- 4.175 We have also examined growth in numbers of movie subscribers over time to assess subscribers' responses to price changes. Falling subscriber numbers despite constant prices might indicate that markets are broad, because this might indicate that consumers were switching to alternative products. However, we need to consider the impact of subscribers' responses to price changes with caution, firstly because changes in quality may affect demand (for example an increase in the number of basic-tier channels within the package or the offer of 'free' or competitively priced broadband packages) and secondly because prices may be above 'competitive' levels.
- 4.176 In the December Consultation we found that the number of Sky Movies subscribers was flat in the period 2004-2006 and had fallen in 2007. There is some seasonality in the subscriber numbers, but even taking a three month rolling average, current numbers of movie subscribers, though higher than in 2000, are [∞]% lower than their peak in 2004. We also found that prices had increased in real terms since 2000.

¹⁰² See Appendix 10 in Annex 6 for a derivation of these figures.

Respondents' comments on our evidence

- 4.177 Sky stated that the price of the Movies Mix package has remained relatively constant in real terms since 2001¹⁰³, and the price of the 'top tier'¹⁰⁴ package has remained relatively constant since 2004. Sky cited this as evidence that its prices are constrained.
- 4.178 Moreover, Sky stated that recent joiners to its service were much less likely to take premium movie channels than previously; and those that did were much more likely to churn than previously.

Ofcom's current view on evidence on observed response to price rises¹⁰⁵

- 4.179 Sky recently announced an increase in the price of its premium Sky Sports packages (including those that contain Sky Movies) by £2 from September 2008. However, it did not change the price of its packages containing only Sky Movies (but not Sky Sports), which remain at the same (nominal) level as they have been since September 2007. This could suggest that the current price may be constrained.
- 4.180 However, as we set out in paragraph 4.94, Sky has had a policy of [X]. Sky supplied to Ofcom a document¹⁰⁶ reporting that in 2006 about [X]% of Sky subscribers had a discount deal, whereas by August 2007, this figure had dropped to only [X]%. Sky stated that the [X].
- 4.181 We have also analysed movie programming costs. Changes in per subscriber programming costs may reflect one of a number of different factors, such as a shift in the recovery of common costs, changes in the per subscriber costs of other inputs such as basic-tier programming or customer services. However, other things being equal, if the price of Sky Movies were strongly constrained, we would expect the retail mark-up over programming costs (the difference between input costs and retail prices) to have fallen or remained constant¹⁰⁷.
- 4.182 As the chart below shows, the average movie programming cost per subscriber has fallen by about [X]% in real terms. The real price of Sky Sports and Sky Movies has increased by about [X]% each year since 2002. This indicates that the retail mark-up over programming cost has grown since 2002 and may be evidence that retail prices are unconstrained.

Figure 21 Per subscriber programming costs for Sky Movies

[X]

*Source: Sky annual reports, real prices at 2008 levels**Note: Programming cost each year to end June, divided by Sky and cable subscribers*

- 4.183 Furthermore, as discussed in Annex 9, we have also examined margins on the wholesale supply of premium sports and movie channels. This analysis suggests that, depending on assumptions we make about allocating common costs, gross margins could be in the region of [X]% for Sky Movies channels. This figure

¹⁰³ Sky consultation response Annex 2 paragraph 3.64.

¹⁰⁴ I.e. Sports Mix and Movies Mix.

¹⁰⁵ Our full analysis of observed response to price changes is contained in Appendix 3 in Annex 6.

¹⁰⁶ Third Sky response to Ofcom's questions of 29th May 2008 [X].

¹⁰⁷ Sky made a similar point in reference to its input costs and wholesale prices. See Sky's consultation response Annex 2, paragraph 3.132.

appears potentially high for an asset-light wholesale channel business and could indicate that falling subscriber numbers could be consistent with high switching as a result of pricing above the competitive level.

4.184 Overall, it is not clear to us that the decline in subscriber numbers is evidence of a binding competitive constraint from other products. This is because:

- Falling numbers of subscribers to premium channels are partly explained by [redacted]¹⁰⁸. [redacted].
- The growing mark-up over programming costs indicates that the competitive constraint from other products may be weak.
- The relatively high margin we observe in Sky's notional wholesale channel business indicates that price may already be above competitive levels¹⁰⁹.

4.185 We have therefore considered a range of other evidence to assess whether the wholesale supply of premium movie channels is likely to be competitively constrained by the availability of other ways of watching movies.

Consumer preferences and features of premium movie packages

4.186 We have analysed consumers' preferences for premium movie packages to consider the features that they value. This can help identify which products might be relatively close substitutes for premium movie channels.

4.187 In the December Consultation we presented the results of a survey on the preferences of subscribers to premium movie channels. The research suggested that there were several features of premium movie channels that consumers value including the ability to pay monthly, access to a wide range of films, access to new films and the convenience of not having to rent a DVD.

Respondents' comments on our evidence

4.188 Sky argued that our analysis focused on the preferences of average subscribers, rather than those most likely to switch in response to a price rise ('marginal subscribers')¹¹⁰.

Ofcom's current view on evidence on consumer preferences

4.189 We have analysed consumer research sent to us from stakeholders and reassessed Ofcom research to consider preferences of marginal subscribers. Access to new Hollywood blockbusters is a particularly important feature for consumers of movies. As an example, a survey carried out for Virgin Media asked its subscribers for which genre of content they would consider paying more than their current subscription. [redacted]¹¹¹.

¹⁰⁸ Third Sky response to Ofcom's questions of 29th May 2008 [redacted].

¹⁰⁹ As we discuss in Appendix 1 of Annex 6, the absence of excessive profits for the wholesale business is not necessarily evidence that prices are at competitive levels.

¹¹⁰ We consider this in paragraph 4.89 and Appendix 7 in Annex 6.

¹¹¹ Virgin Media response to information request of 15 May 2007 [redacted].

4.190 Internal research supplied to us by Sky¹¹², used when considering how to package its movie channels, noted that although consumers were often not aware of the windowing of films, the “[X]”. It is notable that when Sky re-branded its Sky Movies channels in April 2007 it introduced two Sky Premiere channels showing the newest films which are only available to consumers who buy the more expensive movie bundles. In its marketing of Sky Movies to consumers Sky describes the Sky Premiere channels (containing the newest films) as one of the main reasons to choose Sky Movies, stating for example that Sky Premiere has:

“5 brand new movies every week, 1 year before any other terrestrial or subscription TV channel will show them. If you are talking about movies on TV, there is simply nowhere else that compares”¹¹³.

4.191 Packages showing films from the library window, including films on FTA and basic channels are likely to be a relatively weak substitute for packages containing newer films.

4.192 We have further analysed the responses to our own consumer research to identify the features that price-sensitive subscribers consider important to their subscriptions¹¹⁴. We found that price-sensitive subscribers placed a lower value on features of premium movie channels than less price-sensitive subscribers. Nonetheless, a significant proportion of price-sensitive subscribers considered access to a range of films (81%), films on at all times (70%) and access to new movies (68%), as either ‘nice to have’ or ‘must have’ features of their package¹¹⁵. This suggests that older library movies (or non-movie content) found on FTA or basic-tier TV are likely to be a less good substitute for the consumers who value access to new movies.

4.193 The evidence on the importance of paying a monthly fixed subscription is somewhat more mixed. Of price-sensitive subscribers, 57% consider the ability to pay monthly a useful feature of their package, but for the 43% of price-sensitive subscribers who do not, PPV VoD may be a convenient substitute.

4.194 Virgin Media research into preferences of subscribers who were interested in a subscription Virgin Movies channel asked which features of the proposed service were ‘key drivers of interest’. [X]¹¹⁶.

4.195 In conclusion, the evidence from consumer surveys points to consumers valuing a subscription service with access to a wide range of films including new movies. However, the evidence suggests that PPV offers a close substitute for some price-sensitive subscribers as it offers convenient access to a wide range of new movies. Other content found on TV is likely to be a weaker substitute for the broad range of movies, including new movies, found on premium movie channels.

The potential constraint from DVDs

4.196 In our December Consultation we noted that the product characteristics of retail or rental DVDs indicate that these products could be substitutes for some premium

¹¹² Sky’s third response to Ofcom’s questions of 29 May 2008 [X].

¹¹³ For example, www.skymovies.com/skymovies/article/0,,80000-1298507,00.html, quoted at 19 September 2008

¹¹⁴ Ofcom pay TV consumer research, phase 2, November 2006. See Appendix 7 in Annex 6 for details.

¹¹⁵ Full details of the analysis of preferences are found in Appendix 7 to Annex 6.

¹¹⁶ Virgin Media response to Ofcom information request of 15 May 2007 [X].

movie subscribers who value access to new movies and do not mind the inconvenience of going to a video shop. Movies become available on DVDs up to a year before they become available on pay subscription movie channels.

Respondents' comments on our evidence

- 4.197 Sky considered the aggregate constraint from substitutes including DVD retail and rental to be strong, and noted that the reduction in price of retail DVDs reduces the attractiveness of premium movie channels. [X]¹¹⁷.
- 4.198 Sky also provided details of consumer research which suggested that retail DVDs are attractive to consumers as they offer “the benefits of permanent ownership of an extremely popular delivery mechanism”¹¹⁸.
- 4.199 Internal documents supplied to us by Sky also noted that by the time a film becomes available in the pay TV window, the retail price of the DVD format can have fallen from the level when it was initially released around twelve months previously¹¹⁹. [X]. For example, the document quotes a popular film whose DVD’s recommended retail price was £24.99, but was being sold by internet retailers for £5.47 plus postage by the time the film was available to view on Sky Movies channels.

Ofcom's current view on evidence on the constraint from DVD sales

- 4.200 DVDs could in theory be considered a substitute for Sky Movies packages by consumers, though the products’ characteristics are very different. Consumers purchase DVDs in order to obtain permanent access to a small number of specific favourite films within a film library of their own. Consumers subscribe to a movie channel in order to gain access to a wider choice of movies to be viewed on a one-off basis. DVD purchases are made with a specific movie in mind, whereas the purchase of a movie channel subscription allows a spontaneous choice between a range of different movies.
- 4.201 The option of purchasing a DVD of a movie is available to consumers before the option of watching it on television. Many consumers who wish to buy a movie on a DVD will therefore already have done so by the time it appears on television. The price of the DVD option does decline with time, but purchasing a DVD of a movie that is currently being shown within the ‘pay TV’ window is still likely to be more expensive than watching it on television. Indeed, the entire point of the various movie windows is to extract the maximum willingness to pay from consumers, for example by ensuring that those consumers who are willing to pay for a DVD do so. Those consumers who have already demonstrated by their behaviour that they do not wish to purchase a DVD of a movie are unlikely to regard a DVD purchase as a close substitute when that movie appears on television.
- 4.202 We have analysed retail prices and sales of DVDs and premium movie subscriptions. Similar patterns of price changes between both products would be consistent with them being substitutes; conversely, price divergence without substitution is consistent with the two products being in separate markets.
- 4.203 Our analysis of total retail sales of DVDs (and videos) shows total sales volume has grown significantly since 2000. Over the same period the price of DVDs / videos has

¹¹⁷ Sky confidential consultation response [X].

¹¹⁸ Sky’s third response to Ofcom’s questions of 29 May 2008 [X].

¹¹⁹ Sky’s third response to Ofcom’s questions of 29 May 2008 [X].

fallen by 33% / 43% whereas the price of premium movie subscriptions increased from 2000 to 2002 and since remained relatively constant in real terms¹²⁰. If DVD sales strongly constrained retailers of premium movie channels we would expect the growth in volume and the reduction in prices of DVD / video sales to have had an impact on Sky Movies subscriptions. Although not conclusive, the widening price differential without significant switching is evidence that retail DVDs and premium movies packages are in separate markets.

- 4.204 The evidence on price divergence between DVD retail and premium movie subscriptions suggests DVD retail is a relatively weak constraint on the price of premium movie channels.

Ofcom's current view on evidence on the constraint from DVD rentals

- 4.205 DVD rentals provide an alternative to a DVD purchase. Two main types of rental services are available:

- Traditional over-the-counter DVD rental services, typically charged on a PPV basis.
- Services which allow consumers to rent DVDs by ordering over the internet, typically charged on a subscription basis.

- 4.206 It is possible to imagine other types of service, such as over-the-counter subscription services, but these are not currently widely available.

- 4.207 Over-the-counter DVD rental services may be closer substitutes to Sky Movies packages than DVD sales, since they provide consumers with a similarly wide choice of films, to be viewed on one-off basis. However, these rental services do not share other product characteristics with Sky Movies packages, such as the convenience with which films can be chosen, and the certainty of a fixed monthly subscription.

- 4.208 Services which allow consumers to rent DVDs by ordering over the internet may be an even closer substitute to Sky Movies packages, since they provide the same certainty of a fixed monthly subscription, as well as a convenient means of choosing films. They do not however provide the same degree of convenience as a pay TV service, since however straightforward the ordering process is, a consumer cannot view a movie until it has been delivered in the post. Consumers therefore need to be willing to plan their viewing several days in advance to be able to make effective use of such a service.

- 4.209 We have examined trends in DVD rentals, shown in the chart below.

¹²⁰ The price of 'Top Tier' has increased in real terms up to 2004 and has since remained constant.

Figure 22 Total value of DVD rentals¹²¹



Source: British Video Association

4.210 Figure 22 suggests that while there has been significant growth in the volume of DVD rental subscription packages, this has been at the expense of over-the-counter rentals.

4.211 Our view is that while DVD rentals are a closer substitute to Sky Movies packages than DVD sales are, they are not in the same market. Note however that our conclusions on market power do not depend on this conclusion, since expanding our market definition to include DVD rentals does not materially change our assessment of market power (see paragraph 5.96 below).

The potential constraint from content downloaded over the internet

Respondents' comments on the constraint from content downloaded over the internet

4.212 Sky stated that we did not fully take into account emerging constraints from VoD, or content accessed over broadband (Joost, Blinkbox, iPlayer, etc.). It asserted that this is a strong and increasing constraint. It claimed that "a very significant number" of consumers are capable of receiving audiovisual services via broadband whose quality is at least as good as normal TV, and that quality can only increase over time. The BBC, in contrast, suggested that we may have overstated the constraint from emerging platforms.

Ofcom's view on the constraint from content downloaded over the internet

4.213 We agree that downloading content to watch from the internet offers consumers a wide range of content that can be accessed relatively easily and viewed at their convenience.

¹²¹ Over-the-counter rentals are mostly one-off rather than subscription-based. On-line services are predominantly subscription-based.

- 4.214 We also commissioned a survey to understand the current level of consumption of content delivered via the internet. Our survey indicates that relatively few consumers currently download content, and that the constraint is therefore relatively weak. For example, only 13% of Sky's premium subscribers had downloaded content from the internet in the last month.
- 4.215 This is supported by [X]¹²² [X].
- 4.216 On the other hand, Sky's decision to invest in offering content over broadband (and to renegotiate rights contracts where necessary) could be a competitive response to the potential for increasing demand for downloading movie content, which would support the view that downloading content is a growing constraint.
- 4.217 We have also considered the impact of illegal file downloading using applications such as Bit Torrent (file sharing) as a constraint on providers of premium movie channels. A recent study¹²³ found that 4% of the population had illegally downloaded content from the internet in the last three months. However, this group was overwhelmingly biased towards students; 48% of all illegal downloaders were students (either at school or in further education). From these figures, it appears likely that only a small proportion of actual or potential premium channel subscribers engage in illegal downloading.
- 4.218 Given the relatively small numbers of subscribers who are likely to have illegally downloaded content, we do not think that the constraint is likely to be strong. Furthermore, it is not currently known whether the constraint is likely to diminish over time as rights holders take action to protect their copyrights¹²⁴.
- 4.219 Downloading content could be a significant constraint in the future as popularity of downloads increase and capacity to download grows, but analysis of current consumption suggests that the current indirect constraint is relatively weak. The scale of the constraint is likely to grow as more homes have broadband internet connections and the average connection speed increases.

Wholesale supply side substitution

- 4.220 As with premium sports, we have considered the likelihood that a new entrant could enter the market within a short space of time, without incurring significant sunk costs, if the wholesale price of Sky Movies increased by a small but significant amount¹²⁵. A new entrant would not need precisely to replicate Sky Movies channels and could enter with a differentiated product, for example showing films from just one Hollywood studio.

¹²² Sky response to Ofcom information request of 29 May 2008 [X].

¹²³ British Video Association Yearbook 2008, page 112. The study found that 8.1 million people or 17% of the population had downloaded content in the last month, of which a quarter (or 4.25% of the population) had downloaded content illegally.

¹²⁴ For example the BPI, the British Film Industry, major internet service providers (ISPs) and government have signed a memorandum of understanding which aims to significantly reduce the amount of illegal file sharing in the next three years.

http://www.bpi.co.uk/index.asp?Page=news/press/news_content_file_1152.shtml

¹²⁵ As noted above, the OFT regards supply side substitution as a special case of entry. Effectively, to broaden markets another supplier needs to be able to 'switch production' to supply the product without incurring sunk costs, within a year.

- 4.221 Our analysis suggests that an entrant would need to invest a significant amount to create a channel containing movies from the pay TV window of just one of the six Hollywood majors. For example, [X]¹²⁶ [X].
- 4.222 The multi-million pound investment needed to acquire rights to show films from the pay TV window from only one studio means that we should not widen the market to include potential entry from other premium movie channel suppliers as a case of supply side substitution.
- 4.223 In the section on market power we consider whether threat of entry might provide a competitive constraint on Sky in its wholesale of premium movies channels.

Wholesale demand side substitution

- 4.224 Given that wholesale demand is derived from consumer demand, products that consumers would find relatively weak substitutes (such as film channels that only contain older library films beyond the first TV window) are also likely to be relatively weak substitutes at the wholesale level.
- 4.225 Our analysis of the indirect retail constraint indicates that there are no close substitutes for channels including films in the first pay TV window from the Major Hollywood Studios that a retailer would switch to. It does not appear therefore that there are likely to be any wholesale products to which a retailer could substitute in the event of a small but significant increase in the carriage fee.
- 4.226 In particular, the constraint from providers of older films seems relatively weak as few subscribers would be willing to switch to a service with fewer films or only older films. For example, Picturebox offers a film subscription service for a narrower range of older films on the Tiscali, DTT and BT Vision platforms, but it only has about [X] subscribers on Top Up TV and Tiscali¹²⁷, less than [X]% of Sky Movies' subscriber base.
- 4.227 We therefore conclude that demand side substitution is unlikely to be sufficiently significant to broaden our market definition.

Changes in wholesale prices

Sky's assessment of the change in wholesale prices

- 4.228 In its response to our December Consultation, Sky argued that flat or falling wholesale carriage prices for its premium channels are strongly suggestive that it does not have market power to set prices above competitive levels, and by implication that markets should be defined broadly¹²⁸. Sky argued that the per subscriber wholesale carriage fees for its packages had been flat in real terms since 2004 and that the price of single sports and Movies Mix has declined.
- 4.229 Furthermore it argued that "given the very significant increases in rights costs, ..., the obvious implication is that margins between costs and prices have narrowed in relation to Sky's channels at the wholesale level over the period".

¹²⁶ [X].

¹²⁷ It is now also retailed on BT Vision. [X].

¹²⁸ Annex 2 to Sky's non-confidential response to our consultation, paragraphs 3.131-2.

Ofcom's assessment of changes in wholesale prices

- 4.230 We have analysed changes in wholesale prices of the most popular wholesale Movie channel mixes over time^{129,130}. The wholesale price of the Sky Sports and Movies Mix has [X] since 2005 but is still [X]% [X] than it was in 2002. The price of Sky Movies Mix has [X] and is now [X] in real terms than it was in 2002.
- 4.231 Falling wholesale prices for Sky Movies Mix channels could be evidence that wholesalers face an increasing competitive constraint from other substitutes, although it is not clear that this would be sufficient to reduce prices to competitive levels.
- 4.232 We have also examined the wholesale mark-up over programming costs. While the relationship between input costs and wholesale prices is complex, our analysis suggests a widening wholesale margin over costs.
- 4.233 We therefore consider that the fall in wholesale prices of packages containing Movies Mix and Sports and Movies Mix does not necessarily imply a binding competitive wholesale constraint. In fact, the widening gap between average wholesale costs and prices could indicate increasing market power.

Conclusion on relevant market for wholesale premium movie channels

- 4.234 The evidence on premium movie channels is harder to judge than for premium sports channels. We have reviewed a wide range of evidence, from which we take somewhat conflicting conclusions.
- We can see a growing number of potential substitutes which some consumers find attractive: PPV VoD, DVD rental, online downloads, and greater number of films on FTA TV.
 - Our analysis of elasticity evidence suggests a weak response to price changes, particularly for top tier subscribers, which is insufficient to constrain a hypothetical monopolist, indicating that consumers' price sensitivity would not constrain a hypothetical wholesaler's prices to the competitive level.
 - Numbers of subscribers to Sky Movies have declined somewhat despite falling real prices. Offsetting this apparent fall in prices is a reduced availability of discounts, which is likely to have increased the effective price to consumers. Our evidence on consumers' observed response to price changes could be consistent with a binding competitive constraint or switching in response to cellophane fallacy prices.
 - Our evidence on pricing of DVDs and the growth of DVD rentals indicates that these are likely to represent relatively weak substitutes for premium movies. Similarly, although downloading films may become a more important factor, relatively few consumers currently use it.
 - Our consumer survey evidence suggests that access to new films is an important feature of premium movie channels, and that channels containing older films or other film content are likely to be a weak substitute.

¹²⁹ Sky Movies Mix and Sky Sports and Movies Mix are taken by [X]% of wholesale subscribers to Sky Movies channels.

¹³⁰ Our full analysis is contained in Annex 6, Appendix 6.

- We have seen programming costs decline in real terms, but wholesale prices decline to a lesser extent. This appears inconsistent with a view that the constraint on wholesale prices has been increasing.
 - As with premium sports, the aggregation of movies content suggests that retail prices may well be above competitive levels, and we therefore need to interpret consumer switching behaviour with care: high switching rates at competitive prices could indicate a need to broaden the relevant market, but high switching rates at higher prices would be consistent with a narrow market.
- 4.235 On balance, we believe it likely that the wholesale supply of channels including first-run movies from the Major Hollywood Studios in the first pay TV window lies within its own market at present, but we observe that the constraint from other ways of watching films is growing and may grow further in the future.
- 4.236 The market is likely therefore currently to include the following channels: Sky Movies Action & Thriller, Sky Movies Comedy, Sky Movies Drama, Sky Movies Family, Sky Movies Premiere, Sky Movies Premiere HD, Sky Movies Premiere+1, Sky Movies SciFi & Horror, Sky Movies Screen 1, Sky Movies Screen 2, Sky Movies Screen 1 HD, Sky Movies Screen 2 HD. In the remainder of the document, we will refer to these channels as ‘Core Premium Movies’ channels.

Consultation questions

7. Do you agree with our overall approach to market definition analysis?

8. Do you agree with our definition of the market for Core Premium Sports channels or do you believe it to be narrower or wider than we have suggested? If so, what specific evidence do you have to support your view?

9. Do you agree with our definition of the market for Core Premium Movies channels or do you believe it to be narrower or wider than we have suggested? If so, what specific evidence do you have to support your view?

10. How would you see the future development of consumers’ viewing habits for sports and movies, and of the ways movies will be delivered to them? How would this affect market definition?

Section 5

Content aggregation and market power

Summary

- 5.1 We set out in our December Consultation a number of characteristics which we believe to be intrinsic to pay TV markets. We set out a range of evidence for these characteristics. We identified two sets of characteristics which are particularly relevant to premium content markets:
- A set of characteristics which relate to the way in which content is aggregated at different points in the value chain. Specific examples of content aggregation mechanisms include the collective selling of sports rights by bodies such as the FAPL, and the purchase by channel providers such as Sky of movie rights from a number of different studios.
 - A set of characteristics which relate to the way in which the largely fixed costs of producing content are recovered via the pricing structure for downstream services, typically involving a degree of price discrimination inherent in content bundles.
- 5.2 We emphasised that content aggregation and price discrimination are not necessarily a source of concern in and of themselves. Content aggregation is necessary in order to assemble a viable pay TV proposition. Price discrimination allows content to be distributed widely to consumers, while still allowing the recovery of content production and distribution costs. Our level of potential concern with bundling and price discrimination will therefore depend on the particular circumstances:
- In a situation where marginal cost of distribution is low, such practices are likely to offer overall efficiency benefits.
 - If these practices take place in the context of a competitive market, they are likely to promote consumer welfare.
 - In a situation where there is market power, such practices may still result in increased efficiency. However, much of the benefit is likely to accrue to the producer, away from the consumer.
 - In a situation where the market power can be leveraged into other markets it is likely to produce additional competition concerns which are likely to outweigh any compensating efficiency benefits.
- 5.3 The extent of any market power is therefore of critical importance. This document consults on a more detailed analysis of market power in the markets for the wholesale supply of Core Premium Sports and Core Premium Movies channels.
- 5.4 Firstly, we are consulting on the conclusion that Sky has market power in the wholesale of Core Premium Sports channels. We base this conclusion on the following:
- Sky has consistently won the rights to televise live FAPL matches since 1992, until the European Commission's intervention ensured that one company could

no longer win all the rights in 2006¹³¹. We estimate that Sky's market share now stands at [X]%.

- Sky's market share remains high even if we expand our market definition. In particular, including additional sports rights of similar quality to live FAPL within our market definition makes little difference to our assessment of market power, due to the more limited volume of content associated with these other rights, and the fact that many of these other sports rights are also owned by Sky.
- Sky has argued for a much broader market definition than we adopt, encompassing free-to-air and pay TV within a single economic market, and has said that if markets were defined in this way Sky would be unlikely to be dominant. We do not however believe that the volume of live high-quality football on free-to-air TV channels is sufficient to constrain the wholesale price of Core Premium Sports channels to the competitive level.
- There are significant barriers to entry in acquiring the live FAPL rights. We believe that Sky's established subscriber base, coupled with other factors such as its vertical integration and brand strength, means that it can afford to bid a larger amount than any other bidder, and we therefore expect Sky to maintain its market power following the next auction. However, if Sky were to win a significantly smaller set of FAPL rights in the next auction, this would constitute a material change in circumstances and we would need to revisit our assessment of market power.
- We have said that market boundaries are not clear-cut. To the extent that some other football competitions just outside our stated market represent partial substitutes for FAPL content, it might in theory be possible to assemble some of those into an offer to compete with Core Premium Sports channels. However, no other single competition offers the same volume of highly attractive sport as FAPL, while many of the content rights which would need to be aggregated to create such an offer are already controlled by Sky. The staggered availability of rights is therefore an additional barrier to entry in creating such an offer.
- The fact that some platforms, notably Virgin's, are closed to other retailers, means that they are more likely to have some countervailing buyer power in dealing with Sky. However, we currently see the commercial balance of the relationships between Sky as a wholesaler of Core Premium channels and other retailers as being strongly in favour of Sky.

5.5 Secondly, we are consulting on the conclusion that Sky has market power in the wholesale of Core Premium Movies channels. We base this conclusion on the following:

- No company other than Sky has ever won any of the relevant rights from the Major Hollywood Studios, giving Sky 100% market share.
- Sky's market share remains high even if we expand our market definition slightly, to include for example pay-per-view ('PPV') movies or DVD rental services. Sky has argued for a much broader market definition than we adopt, including free-to-air channels as well as DVD sales, and has stated that if markets were defined in this way Sky would be unlikely to be dominant. While we acknowledge that other means of watching movies, such as the ability to purchase a DVD of a recent

¹³¹ The details of the European Commission's intervention are described in paragraph 5.36.

movie, or watch an older movie on free-to-air TV, will provide some constraint on the prices which can be charged for Core Premium Movies channels, we do not believe this constraint is likely to be sufficient to ensure prices are at the competitive level.

- Sky's strong position in the market is unlikely to be undermined by potential entrants in the near future. We believe the bidding advantages that we set out above in the context of sport also apply to movie content, and mean that Sky can afford to bid a larger amount than any other bidder for the rights to each individual studio's output. This, in conjunction with the staggered availability of rights, creates a significant barrier to entry.
- There is however the possibility of disruptive change in the way the studios monetise their rights in the future, including in particular new means of distributing individual movies to consumers over the internet. We acknowledge that any major change in the pattern of rights ownership, or in the means by which the studios monetise their rights, would constitute a material change in circumstances and we would need then to revisit our assessment of market power.
- The position with respect to countervailing buyer power is similar to that in sports. We see the balance of power in the relationship between Sky as a wholesaler of Core Premium channels and other retailers as being in favour of Sky.

Introduction

- 5.6 We start this chapter by discussing those characteristics of the pay TV market which relate to content aggregation. Content is aggregated via a range of different mechanisms, at different points in the value chain, and it is this process that allows a commercially viable retail offering to be generated from a disparate set of underlying content providers.
- 5.7 Although content aggregation may be beneficial for consumers, it also has the potential to create market power, especially where it takes place within a narrow economic market. This may give rise to competition concerns. We therefore also set out in this chapter those markets where we believe market power to exist.

Content aggregation

Our views in the December Consultation

- 5.8 We set out in our December Consultation a number of characteristics which we believe to be intrinsic to pay TV markets, and the evidence for their existence. We identified two sets of characteristics which are particularly relevant to the content markets which are the primary focus of this document:
- A set of characteristics which relate to the way in which content is aggregated at different points in the value chain.
 - A set of characteristics which relate to the way in which the largely fixed costs of producing content are recovered via the pricing structure for downstream services.
- 5.9 Content aggregation is significant because consumers have widely differing content preferences. We observe a limited amount of content which is highly valued by large

groups of consumers, plus a long tail of content that is attractive to some individual consumers, but not to others. In such circumstances content aggregation is likely to be necessary in order to assemble a credible pay TV proposition.

5.10 Content is aggregated at different points in the value chain (as is shown in the figure below).

Figure 23 Mechanisms for content aggregation

Level of value chain	Mechanism for content aggregation
Content and production	<ul style="list-style-type: none"> • Collective selling by the owners of sports rights • Selling on a staggered basis and for a fixed duration of key content rights
Wholesale channel provision	<ul style="list-style-type: none"> • Aggregation of content into wholesale channels and 'bouquets' of channels
Retail service provision	<ul style="list-style-type: none"> • Retail bundling of wholesale basic entertainment channels into tiered basic entertainment packs • Buy-through as a mechanism for bundling of basic and premium content • Mixed bundling of sports and movies as a mechanism to encourage the purchase of both forms of premium content

5.11 Our initial conclusion was 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. We observed that most aggregation of premium content occurs at the content production and wholesale channel provision levels of the value chain, for example by FAPL, and by wholesale channel providers such as Sky.

5.12 We commented that, to the extent that there are any monopoly rents associated with the aggregation of premium content, these are likely to flow upstream, at least to where the content is aggregated. Although they may affect wholesale and retail pricing, they will not necessarily result in excessive profits being generated by retail pay TV providers. Depending on where the aggregation takes place and the balance of negotiating power in the relevant commercial relationships, they may not result in excessive profits at the wholesale channel level either.

5.13 We noted that aggregation of basic content is also likely to take place, but is less likely to lead to the creation of market power. Wholesale markets for basic content are relatively broad, making it considerably more difficult for one wholesale channel provider to aggregate all the basic content which might be regarded as substitutable.

5.14 We also identified a number of pricing mechanisms for the aggregated content produced at different levels of the value chain. These allow the fixed price of content production to be recovered from consumers in an efficient manner, by for example exploiting various forms of price discrimination, as shown in the figure below.

Figure 24 Pricing mechanisms

Level of value chain	Pricing mechanisms
Content and production	<ul style="list-style-type: none"> • Production costs are high but do not scale with the number of viewers • Content rights are typically sold for a fixed fee, and on an exclusive cross-platform basis
Wholesale channel provision	<ul style="list-style-type: none"> • Channels are usually licensed for a per subscriber fee, often with platform-specific exclusivity clauses
Retail service provision	<ul style="list-style-type: none"> • Bundling and buy-through provide mechanisms for price discriminating among consumers with widely varying content preferences

5.15 We emphasised that content aggregation / bundling and price discrimination are not necessarily a source of concern. Indeed, some form of price discrimination is almost certainly necessary in order to allow content to be distributed widely to consumers, while still allowing the recovery of content production and distribution costs. Our level of potential concern with bundling and price discrimination will therefore depend on the particular circumstances:

- In a situation where marginal cost of distribution is low, such practices are likely to offer overall efficiency benefits.
- If these practices take place in the context of a competitive market, they are likely to promote consumer welfare.
- In a situation where there is market power, such practices may still result in increased efficiency. However, much of the benefit is likely to accrue to the producer, away from the consumer.
- In a situation where the market power can be leveraged into other markets it is likely to produce additional competition concerns without any compensating efficiency benefits.

Respondents' views

5.16 Sky took the view that there is no evidence that the aggregation of content reduces choice. Content with pay TV packages is often available without a pay TV subscription (through cinema, DVD, PPV etc.) and Sky stated that it offers a total of 1,764 different combinations of pay TV services, which can be tailored according to customers' preferences.

5.17 Further, Sky argued that it is not proven that it aggregates substitutable content or generates market power at the wholesale channel provider level. Specifically it argued that:

- The December Consultation failed to provide any evidence that Sky Movies and Sky Sports aggregate content that is closely substitutable (or that has not already been aggregated by content producers).
- The December Consultation did not set out the alternative outcome or counterfactual against which such aggregation is being judged. Sky suggested that the absence of a counterfactual restricted its response. It also referred to

Ofcom's observation that available rents may in any case flow upstream to rights holders.

- Substitutability between Sky Sports content is inconsistent with a narrow market for FAPL rights (which we consider to have no adequate substitute).

5.18 Sky argued that content aggregation generates benefits for consumers that should be offset against any costs, specifically:

- There are efficiency gains from aggregation with Sky Sports and Sky Movies (e.g. sports customers have very varied tastes, so there is a benefit to aggregating different sports).
- An aggregated channel offers additional value by placing an event in the context of a tournament or season, or by grouping a range of high-profile events.
- Rights packages may be complementary, so prices may rise if provided by different wholesale channel providers.
- Retailers and consumers face information and transaction costs in trading disaggregated content; it is therefore more efficient to market a channel than an event.
- The benchmark is competition with differentiated products; high fixed costs mean that competition purely on price is not sustainable in the long run. The imperative to differentiate products may mean that competition on price fails to emerge even if control of rights becomes fragmented.

5.19 The FAPL responded by saying that Ofcom should not be using its consultation to review issues such as content aggregation or collective selling. In its view these issues have been considered and accepted by the Commission, therefore the FAPL's sale of rights in compliance with the Commitments will not foreclose any broadcast markets, and cannot create a barrier to entry.

5.20 Further to this, the FAPL argued that Ofcom has failed to recognise that the collective selling of football rights gives rise to inherent efficiencies that benefit broadcasters, consumers and football itself. These benefits include:

- Scheduling efficiency.
- Quality efficiency (broadcasters have a better choice of attractive games).
- Investment in talent.
- Revenue redistribution.
- Promotion of the FAPL and football in general.
- Investment in safe stadia and high quality facilities.
- Investment in good causes at home and abroad, including grass roots football, training etc.

5.21 The FAPL noted that the Commission has acknowledged that collective selling is necessary to provide these efficiencies and benefits. In the FAPL's view collective

selling is inevitable, and some sort of aggregation will inevitably occur; it is just a question of where in the supply chain this will happen. In addition, the FAPL disputed Ofcom's belief that rights being available on a staggered basis creates a barrier to entry, arguing that this theory runs counter to all available evidence, in particular the launch of Setanta, a new premium sports channel. The FAPL also stated that: "Wholesale pricing decisions are determined by marginal cost. Since the marginal cost of the PL rights does not vary with the overall valuation of those rights, the amount paid for PL rights does not affect the optimal wholesale price of premium sports channels. Put simply, a decrease in the price paid to secure PL rights will not feed through to a decrease in the wholesale or retail price of premium sports channels that show PL matches".

- 5.22 The ALMR agreed that content aggregation "can be used as a means of monopolising certain categories of content and believe this to be the case in respect of premium sports broadcasting to commercial customers". The BBC also agreed that the aggregation of premium content can and has created market power in relation to sports and movies.
- 5.23 BT noted that content aggregation "may not always result in result in output expansion" and cautioned Ofcom to take care to "avoid inapplicable extrapolations of the conclusions arising from its stylised example". BT also stated that there is a threshold for efficiencies that can be gained from bundling content and that a "situation of competition between smaller bundles at the retail level may still be preferable from a consumer perspective".
- 5.24 [X] agreed with Ofcom's concerns regarding content aggregation and also with the potential of the aggregator to leverage that market power into other markets, such as those for other communications services bundled with pay TV.

Ofcom's current view on content aggregation

- 5.25 As we would expect, content aggregation is widespread in pay TV. At one level, collective selling of FAPL football matches is a clear example of aggregation of a body of critical content for which there are no close substitutes in the hands of one seller – in this case the FA Premier League. The other example of an aggregation of a body of critical content in the hands of one firm is premium movies, where Sky purchases the rights to blockbusters in the first pay TV subscription window from all six Major Hollywood Studios. Implicit in our market definition for premium movies is a view that this represents the aggregation of substitutable content.
- 5.26 At another level, we also see aggregation of different types of content in the hands of companies, particularly wholesale channel providers. Setanta and Sky both do this, aggregating different sports and sporting events into channels and bundles of channels.
- 5.27 We have acknowledged that aggregation is not necessarily a cause for concern, and that it may deliver efficiency benefits to consumers. Furthermore, in the case of FAPL, for example, the potential benefits of collective selling to football have been documented by various competition authorities around Europe. What 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.
- 5.28 The rest of this section moves on to consider whether market power exists in the wholesale supply of Core Premium Sports and Core Premium Movies.

Approach to market power assessment

- 5.29 This section assesses the extent to which any party holds market power in each of the relevant markets defined in section 4 above.
- 5.30 As discussed in section 2 there are a number of legal instruments which Ofcom might deploy in the event that competition issues are identified. Under all of these instruments it will be relevant to consider the extent to which undertakings possess market power in the relevant markets. In order to gauge the extent of any market power we assess below Sky's and Setanta's positions by reference to the concept of dominance, as used in section 18 CA98. We have used this standard for the purposes of using a well-established and widely understood concept. It has no bearing on the legal instrument, if any, that we might seek to use in this process.
- 5.31 We make our assessment by reference to both existing circumstances and likely future outcomes. We thus consider whether any firm is currently dominant in the relevant markets and whether any firm is likely to be dominant in the relevant markets for the next three to four years.
- 5.32 Ofcom's analysis is set out in full in Annex 7 and is summarised in the remainder of this chapter. Consultation respondents made a number of detailed technical comments on our analysis; we respond to these in Annex 7. Below we summarise our assessment of market power in relation to each of the two markets we defined in section 4, namely the wholesale supply of Core Premium Sports channels and Core Premium Movie channels.

Assessment of market power in relation to the wholesale supply of Core Premium Sports channels

Factual background

- 5.33 For the reasons given in section 4, we consider that the relevant market is the wholesale supply of channels or packages of channels containing live FAPL matches. For ease of reading, we refer to these as 'Core Premium Sports channels'.
- 5.34 Currently three channels include live FAPL matches, namely Sky Sports 1, Sky Sports 2 and Setanta Sports 1. There are thus two firms active in the relevant market: Sky and Setanta. In the 2007/08 season, 138 live FAPL matches were broadcast on TV. Of these, Sky Sports 1 featured 87 matches (63% of the total), Sky Sports 2 featured five matches¹³² (4% of the total) and Setanta Sports 1 featured 46 matches (33% of the total).
- 5.35 If, contrary to the market definition set out in section 4, live Champions League matches including FAPL teams were included in the relevant market, then the equivalent figures would be as follows. In 2007/08 181 matches featuring FAPL teams were televised (138 live FAPL matches plus 43 unique live Champions League matches). Of these, 114 were broadcast by Sky (92 FAPL matches and 22 Champions League matches) (64% of the total), 46 were broadcast by Setanta (all of which were FAPL matches) (25% of the total) and 22 were broadcast by ITV (all of which were Champions League matches) (12% of the total)¹³³. Of the 22 live

¹³² We understand that live FAPL matches are currently only broadcast on Sky Sports 2 when they are displaced by other sporting events (e.g. a cricket or golf tournament).

¹³³ The Champions League final was broadcast live on both Sky and ITV1. It is thus included in both Sky and ITV's total.

Champions League matches broadcast by Sky, two were broadcast on Sky Sports 1, 13 on Sky Sports 2, one on Sky Sports 3, three on Sky Sports Xtra and three on Sky One.

- 5.36 The Live FAPL Rights¹³⁴ are sold by the FAPL. Until the 2007/08 FAPL season, all the available Live FAPL Rights had been won by Sky since the early 1990s. However, in March 2006, the European Commission adopted a decision (the “Commitments Decision”) to accept binding commitments (the “Commitments”) from the FAPL concerning the sale of various media rights, including the Live FAPL Rights. The Commitments require six packages of live rights, each for 23 matches, to be made available. The Commitments set transparency and non-discrimination conditions for the bidding process. No one bidder is allowed to acquire all six packages and packages must be bid for on a stand-alone basis i.e. the amount bid cannot be conditional on the number of packages a bidder wins. The Commitments apply for the six seasons from 2007/08 onwards, or two rounds of bidding.
- 5.37 The December Consultation stated that Sky was likely to be dominant in the “wholesaling of premium sports content” and that it was unlikely that Setanta could challenge Sky’s dominance in this market in the short to medium term¹³⁵.
- 5.38 We have reviewed the position in the December Consultation in light of the consultation responses that we have received. In doing so, we have considered evidence on:
- Existing competitors (such as market shares).
 - Potential competitors (specifically, barriers to entry and expansion).
 - Countervailing buyer power (‘CBP’). Our views on each of these issues are set out in turn below.

Existing competitors

- 5.39 While market shares are not conclusive evidence, the European Court of Justice has stated, in the context of Article 82 of the EC Treaty, that dominance can be presumed in the absence of evidence to the contrary if an undertaking has a market share persistently above 50%¹³⁶. The OFT’s guidelines (the “OFT Market Power Guidelines”) state that it is generally unlikely that an undertaking will be individually dominant if its share of the relevant market is below 40%, although there may be exceptions¹³⁷.
- 5.40 As explained above, there are two firms currently active in the relevant market: Sky and Setanta. As explained in Annex 7 we consider that Setanta’s Core Premium Sports channels are a substitute for Sky’s channels.
- 5.41 Virgin Media and Setanta / Top Up TV stated that, while Setanta’s sports channels might be the closest substitute to Sky’s sports channels, the degree of substitution is

¹³⁴ I.e. rights to show live footage of Football Association Premier League matches in the UK.

¹³⁵ Note that the definition of the relevant market in the December Consultation was not as precise as the definition adopted in this document. It referred to a “specific set of highly-valued sports events” (Annex 13, paragraph 4.5) but did not precisely list which events these were.

¹³⁶ Case C62/86 *AKZO Chemie BV v Commission* [1991] ECR I-3359.

¹³⁷ *Assessment of market power*, OFT, December 2004, paragraph 2.12 available at http://oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft415.pdf

nonetheless limited (Virgin Media also noted that Freeview may constrain Sky's pricing to a limited degree). Setanta / Top Up TV argued that the number of live FAPL matches and the amounts paid for the rights to those matches provide evidence that Setanta's sports channels are substantially differentiated from Sky's sports channels. Virgin Media and Setanta / Top Up TV also argued that increases in Sky's retail prices are evidence of its market power. In addition, the FAPL matches that are broadcast by Setanta are typically less attractive than those broadcast by Sky¹³⁸ (Annex 7, paragraph 2.24).

- 5.42 We have considered a range of approaches to calculating market shares. As explained above, live FAPL matches are broadcast on Sky Sports 1, Sky Sports 2 and Setanta Sports 1. However, the calculation of market shares is complicated by a number of factors. First, Sky Sports and Setanta Sports 1 are not only sold on a stand-alone basis e.g. Sky Sports is also bundled with Sky's movie channels and Setanta Sports 1 is bundled with other Setanta Sports channels. Second, Sky Sports and Setanta Sports feature (i.e. bundle) other sporting content, as well as the live FAPL matches that we have focused on in our market definition. The main measure of market shares that we have used is an estimate of the wholesale revenues earned by Sky and Setanta from the sale of the channels in question. However we have also used the amounts paid for the Live FAPL Rights by Sky and Setanta as a cross-check. Further details of our calculations are set out in Annex 7.
- 5.43 We have calculated market shares as a proportion of the revenues from the wholesale supply of Core Premium Sports channels. Since August 2007, we estimate that Sky's share of revenues has averaged approximately [X]%. Setanta accounts for the remainder (Annex 7, paragraph 2.21; these figures include self-supply of channels to Sky and Setanta's retail businesses).
- 5.44 Paragraph 4.3 of the OFT Market Power Guidelines states that: "the history of the market shares of all undertakings within the relevant market is often more informative than considering market shares at a single point in time, partly because such a snapshot might not reveal the dynamic nature of a market". Prior to August 2007, Setanta did not broadcast live FAPL matches on its channels and thus was not active in the relevant market. Thus, not only does Sky enjoy a high market share in 2008, from the moment it first acquired the rights in 1992, no other firm succeeded in acquiring any Live FAPL Rights until Setanta in 2007. In the 2006 auction, Sky was no longer able to acquire 100% of the Live FAPL Rights due to the European Commission's intervention (i.e. the Commitments). Until August 2007, however, Sky maintained a 100% market share for a 15-year period.
- 5.45 An alternative – although imprecise – approach to assessing market shares is to use the amounts paid for Live FAPL Rights by Sky and Setanta, as a cross-check on the previous method. For the Live FAPL Rights to the 2007/08-2009/10 seasons, Setanta paid £130m per annum (£2.8m per game) whereas Sky paid £438m per annum (£4.8m per game). Using this measure Sky's market share is thus 77%; Setanta's market share is 23%.

¹³⁸ Different packages of Live FAPL Rights allow a first, second, third and/or fourth pick of the available matches. Clearly a first pick match is likely to be more attractive to final consumers than a fourth pick match. Sky generally has an earlier pick of matches than Setanta. For example, Sky has all the first pick matches.

5.46 We have also considered a range of measures of market shares¹³⁹ under two alternative market definitions. We provide greater detail on the calculation of market share under these measures in Annex 7. Both of the alternative market definitions include some top-flight football broadcast on FTA channels. This provides an upper estimate for the strength of the competitive constraint that may be exercised by products that lie slightly outside of the relevant market but that may nonetheless act as (imperfect) substitutes:

- The first alternative market definition includes live Champions League matches shown on FTA as well as on pay TV channels. It therefore includes those matches shown by ITV as well as those shown by Sky. In order to exclude the broad range of other programming also shown on channels such as ITV, we have just focused on the football matches in question. For example, we have estimated market shares by estimating Sky, ITV and Setanta's share of the audiences for these matches (i.e. excluding the audiences for any other programmes screened on their channels). Similarly we have estimated these companies' shares of the amounts paid for the live rights to these matches and the proportion of these matches broadcast by each company. For the 2007/8 season, Sky's market share on all of the measures we considered exceeds 50%. For the 2009/10 season onwards, Sky's market share using this definition would be higher (in excess of 60%) because Sky has won a greater share of the Champions League rights.
- The second alternative market definition is even broader and includes channels featuring a range of additional football competitions¹⁴⁰. Again, when calculating market shares we only took these football competitions into account, rather than the broad range of other programming also shown on the relevant channels. While Sky's market share is lower under this alternative definition, it nonetheless remains high¹⁴¹.

5.47 In summary:

- In light of Setanta's market share (particularly in comparison to that of Sky), our current view is that Setanta is unlikely to possess a dominant position in the wholesale supply of Core Premium Sports channels.
- In contrast, our view is that Sky's market shares are a strong indication of it possessing a dominant position in the wholesale supply of Core Premium Sports channels.
- This view is supported by the observation that Sky's market share generally remains high even under plausible alternative market definitions. Moreover we recognise that these alternative market share figures will overstate the strength of the competitive constraint exercised by 'out of market' products and thus understate the extent of Sky's market power.

¹³⁹ Direct assessment of revenues is complicated by the challenge of disaggregating advertising revenues for the relevant matches, so we have used a range of alternative measures, namely the number of matches shown, audience share and the amounts paid for rights.

¹⁴⁰ In addition to FAPL and Champions League matches, this definition includes the UEFA Cup, the FA Cup and the Carling Cup.

¹⁴¹ The measures used were: (i) broadcasters' share of the total audience for all these matches, (ii) the number of matches, and (iii) the number of matches featuring FAPL clubs. Under (i), Sky's share for these matches was 37%. Sky's market share under (ii) and (iii) was significantly higher at 62% and 55%.

- 5.48 In the analysis of entry and expansion barriers and CBP that follows, we therefore focus on the position of Sky.

Potential competitors: barriers to entry and expansion

- 5.49 Where entry barriers are low, it may not be profitable to sustain prices above competitive levels because this would attract new entry which would then drive the price down, at least in the long term¹⁴². In the following pages we explain why we believe that there are, and, in the absence of further regulatory intervention will remain, important barriers to entry in this market. The analysis of these barriers is relevant both to our assessment of market power in this chapter, and also to our discussion of potential consumer detriment and possible remedies in subsequent chapters.

Sale process for the Live FAPL Rights

- 5.50 In order to wholesale a channel or packages of channels containing live FAPL matches it is essential to possess Live FAPL Rights¹⁴³. These rights are sold by the FAPL (see paragraph 5.36 above).
- 5.51 Until the 2007/08 FAPL season, all the available Live FAPL Rights had been won by Sky since the early 1990s. In spring 2006, the Live FAPL Rights for the 2007/08 to 2009/10 seasons were sold. That sale was subject to the Commitments. Sky won four of the six available packages of Live FAPL Rights, with Setanta winning the remaining two.
- 5.52 In the first half of 2009, it is expected that the Live FAPL Rights for the 2010/11 to 2012/13 seasons will be sold (that sale will also be subject to the Commitments). In principle, this might allow new entrant(s) to acquire a sufficiently large proportion of those rights to undermine any dominant position possessed by Sky. However, as explained below, our current view is that this is unlikely to occur in practice.

An overview of the December Consultation and the responses on the likely outcome of the next Live FAPL Rights auction

- 5.53 In the December Consultation, we argued that Sky is likely to retain its strong position in the wholesale of premium sports on the basis of its advantages when bidding for the rights to those sports.
- 5.54 Sky criticised Ofcom's analysis in the December Consultation for a number of reasons. For example, Sky argued that Ofcom adopted an unreasonable entry benchmark, namely rapid and direct replication of Sky's sports and movie channels. Sky argued that other modes of entry are possible, including gradual or targeted

¹⁴² *Assessment of market power*, OFT, December 2004, paragraph 3.3, second bullet.

¹⁴³ The available evidence suggests that a large number of consumers have extremely strong preferences for live FAPL, Champions League, international and FA Cup matches (all these events were rated 6 or 7 (out of 7) in importance by over 70% of premium sports subscribers who have an active interest in sports – see Figure 18 in Annex 6. Other sporting events were markedly less attractive (the next highest being Football League matches with 50% and Rugby Union with 37%). For the reasons given in paragraphs 4.118 to 4.123 we consider that the constraint from live football featuring FAPL teams on FTA TV to be weak so that it is likely to lie outside the relevant economic market. We thus consider that it is unlikely that a party that won a minority of the Live FAPL rights (two of the six available packages, say) and supplemented that content with other sporting events would be able to displace any dominant position held by Sky. Accordingly, it is not necessary to consider whether there are barriers to acquiring other (non-FAPL) sports rights.

entry. Further, Sky argued that the conclusion in the December Consultation was inconsistent with the observed market outcomes. For example, in 2006 Sky won only four of the five packages of Live FAPL Rights that it could have won. Similarly, the price of sports rights has significantly increased, which is inconsistent with the view that competition for those rights is weak. Sky also advanced a number of other arguments, which are set out in Annex 7.

- 5.55 The FAPL stated that these issues had already been considered by the European Commission and that its sale of the Live FAPL Rights in compliance with the Commitments will not foreclose any broadcast markets or create a barrier to entry.
- 5.56 The Four Parties identified a wide range of factors that they considered act as entry barriers. For example, Setanta/Top Up TV referred to the effects of bundling of content by retailers. Setanta/Top Up TV and Virgin Media referred to the impact of incumbent retailers' subscriber bases when those retailers bid for upstream content rights. Virgin Media argued that rights to "key content" only become available on a staggered basis, creating an obstacle to assembling sufficient rights. These responses are discussed in further detail in Annex 7.

Ofcom's view on the likely outcome of the next Live FAPL Rights auction

- 5.57 Our 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.
- 5.58 The more precise market definition set out above focuses on live FAPL matches. Clearly in this context, the staggered availability of content rights is not directly relevant because the Live FAPL Rights are all made available simultaneously (although see footnote 150 below). However, we remain of the view that it is likely that Sky will win the majority of the Live FAPL Rights when they next become available. We agree with Sky that gradual entry may be viable. However 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. Put simply, a small entrant may be able to operate a viable and profitable business but may nonetheless be too small to prevent Sky enjoying a dominant position. In the light of Sky's current high market share, we do not consider that entry on a smaller scale, as Setanta has sought to achieve, would be sufficient to undermine Sky's dominant position.
- 5.59 In the following pages we set out in more detail our thinking on barriers to entry. However, a forward-looking assessment of this sort can never be entirely certain. We believe that Sky is unlikely to be constrained by the threat of entry, but in the event that Sky did not win the majority of the Live FAPL Rights in a future auction, this would clearly constitute a material change of circumstances, and we would need to revisit our assessment of its market power.
- 5.60 In the 2006 FAPL auction, we understand that there was an initial round of sealed bidding. In light of those bids, the FAPL chose to award three packages of Live FAPL Rights to Sky and to hold a second round of bidding for the remaining three packages. Following that second round, the FAPL awarded a fourth package of Live FAPL Rights to Sky and two packages to Setanta (rather than holding any further rounds of bidding). We believe that Sky enjoys two advantages over potential rival

bidders for the Live FAPL Rights, which are likely to allow it to outbid other firms¹⁴⁴. Since we believe that the FAPL is likely to sell the Live FAPL Rights to the buyer that bids the greatest amount for those rights (subject to the overarching requirement that no single bidder can win all six packages) this implies that Sky is likely to win the majority of these rights.

First advantage enjoyed by Sky: more efficient access to a greater number of subscribers

5.61 First, Sky is the most effective retail outlet on the platform with the largest number of likely subscribers, and third parties are unable to access that outlet as efficiently. As a result of this efficiency advantage, Sky is likely to be able to outbid potential rival bidders for the Live FAPL Rights. There are two steps which lead us to this conclusion (our evidence on these points and the consultation responses that we have received are set out in Annex 7):

- **Step 1: the importance of dealing with the leading retailer on each platform.** On most platforms, we observe a leading retailer (e.g. Virgin Media on cable, Sky on its DSat platform) that retails the vast majority or all of the channels available on that platform. In principle, a firm that successfully bid for the Live FAPL Rights and created a channel containing live FAPL matches could either directly retail that channel on a particular platform or wholesale that channel to a third party retailer on that platform. Crucially, greater total industry profits are likely to be generated when that channel is distributed by the leading retailer on each platform. This is for three reasons (our evidence on each of these points is set out in Annex 7):
 - On closed platforms, rather obviously, there is no alternative but to deal with the leading retailer.
 - Even on open platforms, the leading retailer is likely to be able to generate greater revenue by aggregating that channel with other content and services. For example, aggregation of content in the hands of one retailer facilitates bundling at the retail level. Bundling of content that is not closely-substitutable can allow retailers to sell more content, at different price points, to a wider range of consumers. For example, bundling can effectively allow a retailer to charge a high incremental price for content to a consumer that has a high willingness to pay but a low incremental price to a consumer that has a low willingness to pay¹⁴⁵.
 - On open platforms and where the leading retailer was the previous incumbent supplier of the channel, a new entrant is likely to suffer a delay in building up its subscriber base to match that of the former incumbent.

¹⁴⁴ We are not suggesting that Sky's advantages are necessarily illegitimate or detrimental for either consumers' or society's welfare. Indeed, the advantages we identify generally stem from Sky's greater efficiency. Rather, the context for this discussion is to explain the basis for our preliminary conclusion that other parties are unlikely to win the majority of these rights.

¹⁴⁵ Furthermore, as we have explained above, we consider that there is some uncertainty about the precise boundary of the relevant market. There is likely to be a degree of substitutability between a Core Premium Sports Channel and programs such as live Champions League matches, although this degree of substitutability is probably insufficient to place such programs within the same relevant market. Nonetheless, a retailer that supplies channels broadcasting both live FAPL matches and other (weakly) substitutable content, such as Champions League matches, is likely to dampen competition somewhat. Where the leading retailer on a platform already supplies such substitutable content, it provides an additional reason to distribute a Core Premium Sports channel via that retailer.

- **Step 2: vertical integration allows certain bidders to access the leading retailer on certain platforms more efficiently.** A third party channel provider cannot obtain access to the leading retailer on a platform as efficiently as a wholesale channel provider that is vertically integrated with that retailer. This is for two reasons that we refer to as the “access disadvantages” (our evidence on each of these points is set out in Annex 7):
 - Uncertainty about the level of the wholesale price at the time the rights are bid for. In contrast, for a vertically integrated retailer-wholesaler the ‘wholesale price’ of a channel is simply an internal transfer.
 - Difficulties in aligning the retailer’s and wholesaler’s incentives. Wholesale prices are typically structured as a price per subscriber. As a result, relative to a vertically integrated retailer, a vertically separate retailer has a diminished incentive to attract additional subscribers by engaging in marketing/advertising or by dropping retail prices (this latter effect is known as “double marginalisation”). In contrast, the incentives of a vertically integrated firm’s retail and wholesale arms are likely to be better aligned.

5.62 Steps 1 and 2 have the following consequences:

- An entirely independent bidder faces the access disadvantages on all platforms. A bidder that is vertically integrated with the leading retailer on one platform avoids the access disadvantages on that platform but faces the access disadvantages on all other platforms. An entirely independent bidder will thus be at a disadvantage compared to vertically integrated bidders.
- When assessing whether one vertically integrated wholesaler-retailer is in a relatively stronger position than another, the relative size of those firms’ subscriber bases is crucial. The effect of the access disadvantages is larger on platforms with more subscribers to the content in question. Since a vertically integrated wholesaler-retailer avoids the access disadvantages on ‘its’ platform, this implies that the leading retailer on the platform with the largest number of subscribers to live FAPL matches is least affected. It is thus likely to be able to outbid vertically integrated retailers on other (smaller) platforms for the Live FAPL Rights.

5.63 Sky is the leading retailer on the platform with the largest number of likely subscribers to channels containing live FAPL matches. In June 2007, Sky retailed its sports channels to [X] subscribers as compared to Virgin Media’s [X] subscribers to those channels. We therefore consider that Sky is vertically integrated with the most effective retail outlet on the pay TV platform with the largest number of likely subscribers (Step 1) and third parties are unable to access that outlet as efficiently (Step 2). Our view is therefore that Sky is likely to generate greater value from the Live FAPL Rights than other potential bidders. As a result, Sky is always likely to be able to outbid rival bidders for those rights.

5.64 The 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. The Four Parties stated in Figure 2 in that document that “Sky’s control of the biggest base of pay TV subscribers and the largest pay TV platform inhibits competitive bids from third parties for content”.

Second advantage enjoyed by Sky: branding

5.65 Second, Sky enjoys a branding advantage over other potential bidders. Analysis of the results of an April 2008 Ofcom survey indicates that, were all the 138 FAPL matches that are screened live available from Setanta, then on average consumers would value that content at £42 per month. If that same content were available from Sky, consumers would value it at £57.50 per month (Annex 7, paragraph 2.127). Possible explanations for this increased consumer willingness to pay is a preference for Sky's coverage (such as match analysis and commentary) and/or the brand that Sky has established over the course of several years. These potential explanations are supported by [X] and the relative amounts spent on advertising (Annex 7, paragraph 2.128). Since consumers are willing to pay more for content when it is included within a Sky branded channel, Sky is likely to be able to outbid rival bidders for the Live FAPL Rights.

The actual outcome of the 2006 Live FAPL Rights auction

5.66 The logic of the two advantages we set out above is consistent with the outcome when the Live FAPL Rights were sold prior to 2006. As highlighted by Sky, we recognise that Sky did not in fact win as many packs as it could have done under the Commitments. One reading of the advantages expressed above would be that Sky should have won the maximum five packs available to a single bidder and that Virgin Media (the firm vertically integrated with the most effective retail outlet on the pay TV platform with the second largest number of likely subscribers) should have been the second most successful bidder, rather than Setanta. However, these discrepancies are explained by two factors as follows.

5.67 **Why Sky won four rather than five packs of Live FAPL Rights:** The main conclusion we draw from our analysis of barriers to entry is that Sky was likely to win the majority of packs of Live FAPL Rights. This was precisely what happened in reality – indeed Sky not only won four packs, but they were the four most attractive packs, based on the pick mechanism. Beyond winning the majority of packs, there was a question as to whether it would win four or five packs (as the Commitments prevented it winning all six). It is quite possible that Sky was sufficiently indifferent as to the choice between these two outcomes not to want to make a significant outlay on ensuring that Setanta did not win two packs. Alternatively, it is possible that it slightly underestimated the amount that Setanta was willing to pay, and simply lost the auction for the fifth pack. Either way, in arriving at one of these two outcomes, it had avoided what we would expect it to regard as the really undesirable results, which were [X].

- This view is supported by [X].
- [X]¹⁴⁶.

5.68 **Why Setanta won rather than Virgin Media:** we understand that [X].

Sky and the FAPL's consultation responses

5.69 The FAPL referred to the European Commission's analysis and the effects of the Commitments. The Commitments Decision states that the Commitments "considerably improve the scope for ex ante competition for the rights... [The] increase in the number of live TV rights packages... will permit greater competition in

¹⁴⁶ [X]. Provided on 13 June 2007 in response to information request of 14 May 2008.

the acquisition of those rights... The ban on conditional bidding makes a further contribution to levelling the playing field...” (paragraph 40). However we do not regard our current view (namely that Sky is likely to outbid rivals and acquire the majority of the Live FAPL Rights) as being inconsistent with the European Commission’s position. The advantages that Sky enjoys over potential rival bidders mean that total industry profits are likely to be greater if Sky wins the Live FAPL Rights. Such a bidder would be expected to win in a competitive auction/bidding process. Thus, in our view, there is no inconsistency between the European Commission’s view that the Commitments increase competition for the Live FAPL Rights and our view that Sky (i.e. the bidder that generates the most value for suppliers) is likely to win the majority of those rights.

- 5.70 We have carefully considered Sky’s observation that the increase in the price of the Live FAPL Rights is inconsistent with the view that these rights are not “contestable”. Figure 25 below sets out the amounts paid for these rights the last four times that they were sold. It has been suggested that competition between bidders was relatively weak in 2003 (when the Live FAPL Rights for the 2004/05 to 2006/07 seasons were sold), in particular due to the collapse of ITV Digital in May 2002. The much larger amounts paid in 2006 (for the Live FAPL Rights to the 2007/08 to 2010/11 seasons) is likely to reflect fiercer competition between bidders than in 2003. However the average amount paid per game in 2006 is very similar to the amount paid in 2000 (for the Live FAPL Rights to the 2001/02 to 2003/04 seasons), namely £4.12 million compared to £4.06 million. Sky won all the Live FAPL Rights in 2000. Even though competition was stronger in 2006 than in 2003, this does not imply that all bidders were on an equal footing in 2006. Rather, for the reasons summarised above and discussed in Annex 7, we consider that Sky enjoys a number of advantages over rival bidders. These advantages have allowed Sky persistently to outbid rivals for the Live FAPL Rights, even when competition between bidders has been relatively strong. In other words, even though other firms bid for the Live FAPL Rights (and thereby drive up the price of those rights), they are unlikely actually to outbid Sky and win a large proportion of those rights.

Figure 25 Amounts paid for the Live FAPL Rights

FAPL Seasons	Total amount paid per season	Number of live FAPL matches	Average price per match
1997/98 to 2000/01	£168m	60	£2.8m
2001/02 to 2003/04	£430m	106	£4.06m
2004/05 to 2006/07	£341m	138	£2.47m
2007/08 to 2009/10	£596m	138	£4.12m

Source: December 2007 Consultation, Annex 10, page 19

Ofcom’s current view of barriers to entry and expansion

- 5.71 In conclusion, our view is that it is likely that Sky will win the majority of the Live FAPL Rights when they next become available. This reflects a number of advantages that Sky is likely to enjoy when bidding for these rights – these advantages constitute barriers to entry and expansion from the perspective of competitors seeking to acquire the Live FAPL Rights and enter the market.

- 5.72 Nonetheless, we recognise that there is inevitably a degree of uncertainty in predicting the outcome of future auctions. While our current view is that Sky is likely to win the majority of the live FAPL Rights and therefore maintain its market power, we would clearly need to reconsider our market power assessment if there were a materially different outcome in the next FAPL auction.

Countervailing buyer power

- 5.73 The only major independent purchaser of Sky Sports 1 and 2 is Virgin Media, while a number of other parties have sought to acquire these channels in recent years. We have considered whether these actual and potential buyers are likely to exert sufficient CBP to offset Sky's seller power over the next three to four years.
- 5.74 In the December Consultation we indicated that, on balance, Virgin Media does have a degree of countervailing buyer power but that it is unlikely to be sufficient to constrain Sky's ability to exercise market power.

Responses to the December Consultation

- 5.75 In its response to the December Consultation, Sky noted that certain platforms, such as those of Virgin Media and BT, are closed. Sky argued that this gives rise to a potentially significant 'hold-up' problem. Specifically, a wholesale channel provider is less able to recoup its expenditure in content and acquire customers for its channel unless it can agree terms to access platforms. In respect of closed platforms, a channel provider, including Sky, faces the risk that an agreement to supply a channel to customers on that platform will not be agreed (or will only be agreed on unfavourable terms).
- 5.76 In its response to the December Consultation, Virgin Media stated that Ofcom has erred in concluding that Virgin has some countervailing buyer power, stating that it does not have any buyer power in its relationship with Sky. In particular, Virgin argued that its dealings with Sky cannot reasonably be described as 'negotiations', as revealed by the wholesale prices and the terms and conditions imposed by Sky. In particular, Virgin referred to Sky "refusing to supply" high definition programming, interactive services and related content.
- 5.77 Virgin stated that the strength of its bargaining position depends on the attractiveness of acquiring Sky's content relative to not acquiring that content. Virgin asserted that Sky has a major influence over both these issues since: "Sky's retail and wholesale margins from premium packages are determined by Sky. As a result, Sky can choose to set its retail and wholesale prices such that Virgin Media makes a very low retail margin or a loss on selling Sky's premium channels." In its response, Virgin Media stated that the margin on its XL package of basic channels is greater than the margin when it supplies a subscriber with that XL package plus Sky Sports and/or Sky Movies.

Responses to our July 2008 information request

- 5.78 In July 2008 we asked Virgin Media and Sky a number of detailed questions regarding negotiations between the two parties over the supply of Sky Sports and Sky Movies by Sky to Virgin Media. We asked the parties about the extent of their dependence on one another and about the commercial relationship between the companies in respect of Sky's premium channels.
- 5.79 [X].

5.80 [X].

5.81 [X].

5.82 [X].

Our assessment of countervailing buyer power

5.83 The OFT Market Power Guidelines set out four conditions that are relevant to the assessment of CBP. Three of these conditions are particularly relevant to our analysis¹⁴⁷:

- The buyer is well informed about alternative sources of supply and could readily, and at little cost to itself, switch substantial purchases from one supplier to another while continuing to meet its needs.
- The buyer could commence production of the item itself or ‘sponsor’ new entry by another supplier (e.g. through a long-term contract) relatively quickly and without incurring substantial sunk costs.
- The buyer is an important outlet for the seller (i.e. the seller would be willing to cede better terms to the buyer in order to retain the opportunity to sell to that buyer).

5.84 We have been mindful of these conditions in assessing whether retailers of pay TV services possess CBP in respect of Sky. Most importantly, we believe that if Sky suffers few (or no) detrimental effects if a buyer declines to purchase Sky’s channels, then that buyer does not possess sufficient CBP to offset Sky’s seller power.

5.85 We retain our view that Virgin Media has a degree of countervailing buyer power in relation to the licensing of Sky Sports and Sky Movies. Virgin Media is the UK’s second largest retailer of pay TV services, and is likely to provide Sky with access to some subscribers it otherwise could not reach. We believe that the closed nature of the cable platform increases Virgin Media’s buyer power to some extent, as it affords broadcasters no outside option for accessing the cable customer base (beyond serving these households through other platforms). We also consider that Virgin Media is a well-informed buyer, likely to be aware of any alternative options available to it.

5.86 However, we also retain our view that Virgin Media’s buyer power in relation to Sky’s premium channels is limited. In coming to this view, we have been mindful of the following considerations:

- **The importance of Sky’s Core Premium content to consumers.** We believe that Virgin Media is under significant commercial pressure to offer its customers a content offering that is competitive with that of Sky. This reality conveys a degree of seller power on channel providers with attractive content – power which increases in line with the content’s desirability. As stated in sections 3 and 4, we believe that Sky Sports 1 and 2 are important drivers of the take-up of premium pay TV services. Virgin Media does not have available adequate alternative sources of supply to replace Sky Sports while continuing to meet its customers’ needs. As we set out in paragraphs 5.49 to 5.72 above, we believe that there are

¹⁴⁷ The remaining condition is that “the buyer can intensify competition among suppliers through establishing a procurement auction or purchasing through a competitive tender”.

substantial barriers to entry upstream, such that Virgin Media cannot achieve or sponsor entry quickly or without substantial sunk costs. This vulnerability leaves Virgin Media in a comparatively weak position with respect to Sky.

- [X]. Sky has stated [X]. Sky states that its wholesale prices are set at a level at which no margin squeeze can occur (according to the test set out in the OFT's 2002 decision), but does not acknowledge that a *range* of such prices exists. Meaningful negotiation with the cable operators might be expected to place a degree of downward pressure on Sky's wholesale rates, and it is clear that Sky would not expect *lower* wholesale prices to contravene margin squeeze rules¹⁴⁸. We accept that the regulatory environment may affect Sky's wholesale pricing *structure*, and the upper *limit* of its rates, [X]¹⁴⁹.
- **Evidence from Virgin Media [X].** We would expect the creation of Virgin Media from the merger of NTL and Telewest to have somewhat increased cable's buyer power with respect to Sky. However, we do not believe that the merger has fundamentally improved Virgin Media's negotiating position, not least as it has not directly addressed Virgin's reliance on content controlled by Sky.
- **Analysis of Sky's incentives.** Analysis carried out by CRA for Sky suggests that Sky has the incentive to wholesale its content to Virgin Media at current wholesale prices. Our own calculations indicate (again, at current wholesale prices), that it would be profitable for Sky to cease its wholesale relationship with Virgin Media if it considered its pay-off over an extended period – see paragraphs 6.100 to 6.106. By contrast, evidence presented by both Sky and Virgin Media suggests that Virgin Media has been keen to down-sell from premium channels as it struggles to make a positive incremental margin on the sale of Sky's channels. Our view is that this indicates that Sky's wholesale charges have not been effectively constrained by the buyer power of Virgin Media.

5.87 Virgin Media has argued that its failure to secure the supply of Sky's basic channels is evidence of a lack of buyer power on Virgin Media's part. However, our focus here is on Sky's premium channels. In any case, the fact that Virgin Media can choose from a considerably wider range of basic channels than premium channels suggests that we should not seek to draw strong parallels between basic and premium channels. Virgin Media's failure to purchase Sky's basic channels does not affect our view that Virgin Media lacks sufficient CBP to constrain Sky's ability to exercise market power in relation to Core Premium Sports channels.

5.88 In relation to retailers other than those on cable, we are aware of several retailers that have sought wholesale access to Sky Sports and Sky Movies but have not been able to reach commercial agreements. This contrasts with the example of Setanta, which has very quickly agreed wholesale deals with Virgin Media, BT Vision, Tiscali and more recently Top Up TV¹⁵⁰. We set out the evidence we have reviewed on these negotiations in the next section. We 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,

¹⁴⁸ A lower bound on Sky's wholesale charges may exist for the avoidance of prices that might breach predation rules.

¹⁴⁹ [X] the bargaining process between Setanta and Virgin Media for cable carriage of Setanta's channels, documents relating to which have been provided to Ofcom. The documents show that the two parties put forward proposals and counter-proposals, eventually reaching a negotiated settlement on pricing and packaging which satisfied both parties.

¹⁵⁰ Setanta also has an exclusive wholesale agreement with Sky in respect of commercial customers.

we do not believe that these retailers are able to exercise any significant buyer power with respect to Sky.

Conclusion on countervailing buyer power

5.89 In summary, our view is that Virgin Media is the most likely retailer to exercise CBP over Sky. However, we believe that, while Virgin Media is a significant outlet for Sky, the commercial balance of the relationship appears to be strongly in favour of Sky. This relationship may be further influenced by Sky's desire to strengthen its position of power in both downstream and upstream markets. We therefore believe that no party exercises sufficient buyer power to counter Sky's seller power in the context of Core Premium Sports channels.

Conclusion in relation to the wholesale supply of Core Premium Sports channels

5.90 In conclusion, our view for consultation in relation to the wholesale supply of Core Premium Sports channels is that Sky is currently dominant and is likely to be dominant in that relevant market for the next three to four years.

5.91 Our analysis suggests that entry barriers are such that market power is likely to persist. However, if the rights ownership situation were to change significantly in the future, we would in any case revisit our assessment of market power. In particular, while we think it is unlikely that Sky will win fewer than four packages of Live FAPL Rights in the next auction, if this were to happen we would need to reassess our finding of market power.

Assessment of market power in relation to the wholesale supply of Core Premium Movies channels

5.92 For the reasons set out in paragraphs 4.147 to 4.235 above, we propose defining the wholesale supply of channels or packages of channels which include the first TV subscription window of film content from the Major Hollywood Studios as a relevant market. Currently only the Sky Movies suite of channels includes such content. We thus only assess Sky's position within this relevant market. For ease of reading, we refer to these channels / packages as 'Core Premium Movies channels'.

5.93 The December Consultation stated that Sky was likely to be dominant in the wholesale supply of "premium movies". We have revisited that position in the light of the consultation responses that we received. In doing so, we have considered evidence on the following factors (our views on each of these issues are set out in turn below):

- Existing competitors (such as market shares).
- Potential competitors (specifically, barriers to entry and expansion).
- Countervailing buyer power.

Existing competitors

5.94 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 to films from the Major Hollywood Studios for the first TV subscription window.

- 5.95 We observe in paragraph 4.195 that PPV movies may offer a reasonably close substitute for some consumers. If we were to recalculate Sky's market share taking these into account, then Sky's market share would remain extremely high – specifically, [X]%¹⁵¹.
- 5.96 DVD rental subscription packages may also offer a close substitute for some consumers, though they lack the convenience associated with both subscription and PPV TV services. If we were to recalculate Sky's market share taking DVD rental subscription packages into account, Sky's market share would remain extremely high – specifically, in the region of [X]% albeit declining¹⁵². Even if we assume that the 15% rate of annual growth in subscription DVD rentals is maintained over the next three to four years, Sky's market share only falls by approximately [X]% per annum and thus remains high. If we were to recalculate Sky's market share, also taking over-the-counter DVD rentals into account, Sky's market share would also remain high, in the region of [X]%.
- 5.97 Legal movie downloads (to rent or own) are currently a nascent sector. Including them therefore has an immaterial effect on Sky's market share¹⁵³.
- 5.98 Note that the figures cited above effectively treat these products as if there were all within the same relevant market; they therefore overstate the extent to which Sky's pricing is constrained by these packages.
- 5.99 Our view is that Sky's market shares are a strong indication of it possessing a dominant position in the wholesale supply of Core Premium Movies channels.

Potential competitors: barriers to entry and expansion

Sale process for the Movie Rights

- 5.100 In order to wholesale a channel including films in the first TV subscription window from the Major Hollywood Studios it is essential to possess the rights to those films (the 'Movie Rights')¹⁵⁴. The Movie Rights are currently supplied on an exclusive basis to Sky by the six Major Hollywood Studios, namely Disney, Fox, Paramount, Sony, Universal and Warner.

¹⁵¹ Although PPV movies are growing in popularity, they remain small in relative terms with a current annual turnover of under £100 million in 2006 (including VAT). It was estimated that Sky accounted for some 56% of this revenue in 2006 with Virgin Media accounting for approximately 42% (December Consultation, Annex 11, paragraph 27 and Figure 98 on page 69). The precise market share depends on how the revenue from wholesale sports and movies bundles is attributed when calculating Sky's market share.

¹⁵² The value of online DVD rental services was estimated as £67 million in 2006 and £77 million in 2007 i.e. growth of 15% (Source: *BVA Yearbook 2008*, British Video Association, page 89). The precise market share depends on how the revenue of wholesale sports and movies bundles is attributed when calculating Sky's market share.

¹⁵³ It is estimated that UK consumers spent only £0.5 million on internet-based VoD in 2006. However this sector is expected to grow rapidly. One forecast of annual digital rental spending in 2011 is £7 million plus a further £76 million on digital retail (download to own). December Consultation, Annex 11, paragraph 33. Even using the higher 2011 aggregate rental and retail figures, Sky's market share would be in the region of [X]%.

¹⁵⁴ As explained in section 4, linear and/or subscription VoD rights to first run movies from the Major Hollywood Studios are crucial inputs for entry into this market and thus fall within the definition of the Movie Rights. The PPV rights do not allow entry into this relevant market and are thus excluded from the definition of the Movie Rights.

5.101 The Movie Rights are sold following negotiations between interested parties and each individual Major Hollywood Studio. Such negotiations may take place before the current agreement to licence the Movie Rights expires. This contrasts with the more formalised and collective way in which the FAPL sells its rights. Clearly a Major Hollywood Studio is likely to sell the Movie Rights to the buyer that pays the greatest amount for those rights.

An overview of the December Consultation and the responses on the likely outcome when the Movie Rights are next sold

5.102 The December Consultation stated that constructing a “compelling film package” is likely to require rights packages from more than one studio, in order to be able to offer a critical mass of content to consumers. Further, due to the varying durations and different expiry dates of rights contracts, it may be a period of months or years before the channel provider has a sufficiently strong package to compete effectively with Sky Movies.

5.103 In general, respondents made the same arguments with respect to the Movie Rights as they did with the Live FAPL Rights (see paragraph 5.56 above). For example, the Four Parties repeated their arguments that the staggered expiry of rights agreements and Sky’s existing subscriber base act as barriers to entry. Similarly, Sky argued that Ofcom adopted an unreasonable entry benchmark and that the experience in the US indicates a service based on the Movie Rights of one or two Major Hollywood Studios can be viable.

5.104 Sky also provided evidence on the alignment in the dates at which its contracts with the Major Hollywood Studios become available for renewal.

Ofcom’s view on the likely outcome when the Movie Rights are next sold

5.105 In principle, as Sky’s current contracts with the Major Hollywood Studios expire, this might allow a new entrant to acquire a sufficiently large proportion of those rights to undermine any dominant position possessed by Sky. For this to be possible there are three conditions which would need to be met:

- The rights for individual studios must be sufficiently contestable that they can realistically be acquired by a new entrant.
- The rights for the different studios must be available in a manner that permits a new entrant to acquire a critical mass of content on a practical timescale.
- The incumbency advantage that Sky has because of its existing retail subscriber base must not give it too great a bidding advantage over other firms.

5.106 In relation to the contestability of individual rights, Sky has stated that Ofcom overlooked the fact that bundling efficiencies enjoyed by an incumbent broadcaster may be exhausted fairly quickly, and that rights may be worth more to an entrant with a small portfolio of rights than to a broadcaster with a large existing portfolio. Further to this Sky argued that “the ease of participating and the fact that rights are normally awarded in advance of commencement dates encourages prospective new entrants to compete for rights”.

5.107 We have not carried out a detailed investigation of the way in which individual movie rights were awarded. Clearly, these awards are not subject to the same degree of transparency as the auction of FAPL rights, and this makes it difficult to judge without

a detailed investigation how contestable the individual rights are in practice. Sky stated in the confidential version of its consultation response that: [REDACTED]. However, [REDACTED].

- 5.108 In relation to the ability of a new entrant to aggregate a critical mass of content from different studios, we have reconsidered our views on the staggering of rights. As noted above, [REDACTED]. Furthermore, there is some evidence that a viable channel could be developed using the output from a limited number of studios. For example, Disney offers its own channel, Cinemagic, although only animated Disney films are shown before the library window on this channel. Documents provided by Virgin Media following that consultation indicate that [REDACTED]¹⁵⁵. However, [REDACTED]¹⁵⁶.
- 5.109 However, our view remains that new entrants are unlikely to acquire a sufficiently large proportion of the Movie Rights in practice. It would require an extremely large shift from the status quo to undermine Sky's position materially¹⁵⁷. For example, even if a new entrant acquired the rights from one or perhaps two Major Hollywood Studios, then this might only reduce Sky's market share by some 10-40% (Annex 7, paragraph 3.36). Thus, even if entry on this scale were viable it is unlikely to be sufficient to undermine any dominant position possessed by Sky. Moreover such a shift is without precedent – Sky has historically acquired all of the Movie Rights from the Major Hollywood Studios since the early 1990s.
- 5.110 Furthermore – and regardless of the staggering issue – we remain of the view that it is likely that Sky will win the majority of the Movie Rights when they next become available. This is because we believe that Sky enjoys advantages over potential rival bidders for the Movie Rights, which are likely to allow it to outbid other firms¹⁵⁸. These advantages are similar to the ones we set out in paragraphs 5.61 to 5.65 above as part of our assessment of market power in Core Premium Sports channels and relate to Sky's large subscriber base and its vertical integration¹⁵⁹. As a result, our current view is that it is likely that Sky will continue to win the Movie Rights as and when they become available.
- 5.111 Sky is the leading retailer on the platform with the largest number of likely subscribers to channels containing movies from the first TV subscription window. In June 2007 Sky retailed its movie channels to [REDACTED] subscribers as compared to Virgin Media's [REDACTED] subscribers. Sky is the retail outlet with the largest number of likely subscribers and third parties are unable to access that outlet as efficiently. As a result of this advantage, our view is that Sky is likely to generate greater value from the Movie Rights than other potential bidders. As a result, Sky is likely to be able to outbid rival bidders for those rights.
- 5.112 Further evidence that new entrants are not in a position to outbid Sky is provided in internal documents. [REDACTED]¹⁶⁰.
- 5.113 A further possibility that we have considered is that Sky might not lose the Movie Rights to another bidder, but that a Major Hollywood Studio may decide to exploit its

¹⁵⁵ [REDACTED]. Provided in Virgin Media's information request response dated 21 February 2008 [REDACTED].

¹⁵⁶ [REDACTED]. Provided in Virgin Media's information request response dated 21 February 2008 [REDACTED].

¹⁵⁷ As noted above, 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.

¹⁵⁸ As set out in footnote 144 above, we are not suggesting that Sky's advantages are necessarily illegitimate or detrimental for either consumers' or society's welfare.

¹⁵⁹ See Annex 7 for further detail.

¹⁶⁰ Virgin Media information request response of 18 July, [REDACTED]. Similarly, [REDACTED]. Provided in Virgin Media information request response, 21 February 2008. [REDACTED].

rights directly, by for example developing its own movie channel. We believe that this is a possible outcome, but that it also has barriers to entry associated with it.

- In the short term any studio that chose to develop its own channel would be giving up the additional revenues currently generated from accessing Sky's retail subscriber base more efficiently. As described in paragraphs 5.61 to 5.64 (in the context of Core Premium Sports channels), this retail subscriber base gives Sky an advantage over the Major Hollywood Studios similar to that which it enjoys over other types of potential retailer.
- A single Major Hollywood Studio that chose to develop its own channel would have much less content than Sky. In order to be successful it would probably need to be included within a large retail bundle, as is the case for example with the Disney Cinemagic channels. This would be unlikely to erode Sky's market power.
- The Major Hollywood Studios might be able to develop a more compelling proposition if they combined their content, but this is made difficult by the staggering of their contracts with Sky. Any agreement which they did reach to sell their content jointly may also be subject to review under competition law.

Ofcom's current view on barriers to entry and expansion

5.114 In conclusion, our current view is that 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.

5.115 As with our conclusion on Core Premium Sports channels, we recognise that a forward-looking assessment cannot ever be entirely certain – although there is a very extensive history of Sky's enduring ability to win all of the Movie Rights. Should the position with respect to the Movie Rights change materially, we would of course need to review our assessment.

Countervailing buyer power

5.116 The only major independent purchaser of Sky Movies channels is Virgin Media, although a number of other parties have sought to acquire these channels. As with premium sport, we have considered whether these buyers (actual and potential) are likely to exert sufficient CBP to offset Sky's seller power over the next three to four years.

5.117 In the December Consultation we concluded that Sky is in a very powerful bargaining position as regards retailers. We indicated that, while Virgin Media is likely to have some CBP, this is likely to be limited.

5.118 The responses to our December Consultation on CBP did not draw a distinction between premium sport and premium movies. As a result, the points set out in paragraphs 5.73 to 5.89 above apply equally here. Similarly, our overall position on CBP with respect to movies is the same as that for sport.

5.119 However, we have also been mindful of one additional consideration: [redacted]¹⁶¹. [redacted].

¹⁶¹ [redacted]. Provided in Virgin Media information request response, 21 February 2008. [redacted].

Conclusion on countervailing buyer power

5.120 In summary, our view is that Virgin Media is the most likely retailer to exercise CBP over Sky. However, we believe that, while Virgin Media is a significant outlet for Sky, the commercial balance of the relationship is strongly in favour of Sky. We therefore believe that no party exercises sufficient buyer power to counter Sky's seller power in the relevant wholesale market.

Conclusion in relation to the wholesale supply of Core Premium Movies channels

5.121 In conclusion, our view for consultation in relation to the wholesale supply of Core Premium Movies channels is that: when dealing with other buyers (actual and potential), Sky is currently dominant and is likely to be dominant in that relevant market for the next three to four years.

Consultation questions

11. Does Sky have market power in the wholesale of Core Premium pay TV channels?

12. Do you agree with our conclusion that Sky has market power in the wholesale of Core Premium Sports channels? What specific evidence would you provide to support your view?

13. Do you agree with our conclusion that Sky has market power in the wholesale of Core Premium Movies channels? What specific evidence would you provide to support your view?

Section 6

Competition issues related to Core Premium content

Summary

6.1 Market power gives Sky the ability to affect competition. This can result in two kinds of concerns, and we consult in this document on the evidence associated with both of these concerns:

- Firstly, there is a risk that Sky, as a vertically integrated firm, with market power in a key upstream market, will distribute its premium content in a manner that favours its own platform and its own retail business. It might do so either by denying this content to other retailers and / or other platforms, or by making it available on unfavourable terms. The effect of this would be to distort retail competition for the provision of pay TV services. The increased importance of 'triple-play' bundles creates a further risk that this distortion would extend to the other services which are included in such bundles, notably broadband and telephony services.
- Secondly, there is a risk that Sky will set high wholesale prices for its content in order to maximise wholesale profits. This would have the effect of keeping retail prices high without necessarily distorting competition between retail operators.

6.2 In relation to the first of these concerns, we believe that Sky does have the incentive to restrict the supply of its Core Premium channels to other retailers and other platforms, and we further believe there is evidence which suggests that Sky is acting on that incentive:

- Sky's premium content is currently provided on a wholesale basis to Virgin Media. However, the current combination of wholesale charges and incremental retail price makes it unprofitable for Virgin Media to sell premium channels to existing basic subscribers, and Virgin Media therefore has no incentive to do so unless this is absolutely necessary in order to retain a subscriber. There has been a dramatic decline in the number of subscribers to Sky's premium channels via cable in recent years. This is not surprising given the incentives associated with the current charging structure.
- A number of new entrants, seeking to establish new retail businesses and / or new platforms, have sought to purchase access to Sky's premium channels on wholesale terms, but none of these has been successful. We have reviewed the available correspondence between these new entrants and Sky. We have not attempted to reach any conclusions as to the specific reasons why individual negotiations have so far been unsuccessful. We can however reach a more general conclusion that no commercially agreed wholesale deals appear imminent, despite evidence of negotiations going on in some cases since [X].
- We have analysed the incentives we believe Sky faces to wholesale its content to competing retailers and/or on competing platforms. Our conclusion is that there are a number of incentives which may motivate Sky against supplying other retailers at a wholesale price which those other retailers are prepared to pay. This

may reflect an unwillingness to wholesale to retailers on other platforms at a price which Sky believes would be lower than the price at which it would need to wholesale to itself on those platforms, but it may also reflect a desire to limit the growth of potential competitors. In either case, the market outcome is similar: Sky's content is not as widely available as it might be, which is likely to limit competition.

- Sky has argued strongly that it is likely to be the most efficient retailer of its own content, and that it believes a satisfactory alternative is for it to retail its content directly over others' platforms. However, it is unlikely that a satisfactory answer to our competition concerns is for Sky to become the only actual or potential retailer of premium content across all platforms. While we recognise that this is likely to improve the availability of Sky's content, and while we also recognise that Sky may have the ability to retail its content as effectively on other platforms as it does over its own platform, we do not believe that it has the incentive to do so. This view is supported by the available evidence, which suggests that where Sky does retail on other platforms, using its 'Sky by Wire' service, the resulting retail offering is of lower quality, is sold at a higher price than similar offerings on its own platform, and that take-up is low.

6.3 The evidence is less clear-cut in relation to the second of these two concerns – possible high wholesale prices – which may be due to a variety of practical difficulties associated with an analysis of wholesale prices for content.

- The costs of producing content are largely fixed, resulting in a marginal cost which is close to zero. It is not therefore appropriate to use the marginal cost of production as a pricing benchmark.
- We have attempted to assess whether wholesale prices are high by analysing the profitability of the part of Sky's business that wholesales premium channels. There are two types of uncertainty involved in this analysis. Firstly, there are practical difficulties associated with a disaggregated profitability analysis of one part of Sky's business, due to uncertainties as to the allocation of common costs and capital employed. Secondly, even if we could obtain an accurate estimate of Sky's profitability, it may under-estimate the total profitability associated with the wholesale of this premium content, since it excludes any rents which are retained by rights owners.
- Nevertheless, we conclude that Sky does appear to be making an operating margin on the wholesale of premium channels of up to [X]% – higher than Sky's 2008 overall operating margin of 15.2%. We have not estimated a return on capital, due to practical difficulties associated with determining the level of capital employed in this part of Sky's business. We further conclude that the gross margins which Sky makes on premium movie content are significantly higher than those which it makes on premium sports. This is as we might expect, given that in the case of movie content it is Sky that is primarily responsible for content aggregation, whereas in the case of sports content much of the aggregation occurs upstream of Sky. We would expect any monopoly rents associated with content aggregation to flow upstream to the entity which is responsible for that aggregation, which in this case is the FAPL.
- We note below that, if we proceed to calculate a price for a wholesale must-offer remedy, then a more detailed analysis of wholesale margins is likely to be one input to that process.

- 6.4 The concerns set out above relate to the manner in which market power in upstream content markets can be exploited in downstream markets. It has also been suggested that there is a feedback mechanism, by which reduced retail competition reinforces upstream market power, creating what is referred to by the Four Parties as the ‘vicious circle’. We acknowledge in our assessment of market power that Sky’s established subscriber base is one of the factors associated with high barriers to entry in the markets for the acquisition of key content rights, and this does therefore create a degree of feedback. However, we have also identified other barriers to entry, such as content aggregation and the staggered availability of rights. This feedback mechanism therefore needs to be considered in conjunction with those other barriers to entry, potentially reinforcing them, rather than on a stand-alone basis.

Introduction

- 6.5 The previous chapter set out our assessment of the relationship between content aggregation and market power, and the extent of market power in the markets for the wholesaling for Core Premium Sports and Movies channels. In this chapter we set out the concerns that might flow from the existence of that market power.

- 6.6 There are two broad issues that might cause us concern.

- **Distribution of Core Premium channels:** where market power is exercised in a way that restricts the distribution of wholesale content to retailers, for whatever reason, we might be concerned about the distorting effects on retail markets.
- **Wholesale pricing of Core Premium channels:** one effect of aggregating a set of critical content, and concentrating that content in the hands of a single seller, might be to result in a high price for that content, even if it were distributed widely.

- 6.7 We address the two issues set out above in turn in the rest of this chapter.

Distribution of Core Premium channels

Introduction

Our views in December

- 6.8 In our December Consultation we outlined four primary concerns which could flow from the leverage of market power:
- We argued that a vertically integrated operator might have an incentive not to supply a potential new retailer, on the grounds that that operator could present a threat to its own retail operation; this could risk dynamic foreclosure of new retailers.
 - We noted that this might extend to the foreclosure of new platforms, due to the widespread vertical integration of platforms and retailers. This caused us to be concerned about the prospects for inter-platform competition – the availability of a range of different platforms, all offering a range of content.
 - We noted that Sky does make its content available to the major existing retailer, Virgin Media, on a platform where Sky itself is not present. We believed that even in this situation, Sky might have an incentive to reduce the quality of what it supplies, in the hope of diverting some customers to its own retail business.

- We considered that prospects for competition in stand-alone basic pay TV on a given platform might be restricted by the existence of buy-through.

6.9 We address the first three of these further in this section. We address buy-through in the following section on the consumer experience.

Consultation responses

- 6.10 There was a mix of views from consultation respondents on the issue of distribution of content. Analysis carried out for Sky by CRA concluded that Sky always has an incentive to supply third parties with its premium content. On the basis of this assessment, Sky denied that it has an incentive to refuse to supply, and criticised Ofcom for presenting no empirical evidence that Sky has withheld its content from customers on other platforms. Sky further argued that if it has an incentive to supply content at all, then it would have no incentive to reduce the quality of what it supplies.
- 6.11 Sky also believed that traditional foreclosure arguments are of little relevance in the TV sector, and that Ofcom's approach to foreclosure was too hypothetical and narrow. CRA criticised Ofcom's theory of dynamic foreclosure. CRA / Sky argued that dynamic foreclosure requires a mechanism such as network effects to link a practice in one period to lost market share in another and that such a mechanism does not exist in pay TV.
- 6.12 Others, notably [X], Virgin Media, Top Up TV and Setanta, argued strongly that Sky does have an incentive to exclude other retailers by refusing to supply content. BT, supported by NERA, put forward the prospect that new entrants may be particularly vulnerable to foreclosure strategies, especially as incumbents are uncertain as to the level of risk presented by a new entrant.
- 6.13 Tiscali attributed a current lack of success for IPTV to a lack of access to premium content.
- 6.14 Virgin Media used its assessment of Sky's actual behaviour as supporting evidence for the existence of an incentive to foreclose competition. Virgin argued that Sky supplies it on uneconomic terms, and that Sky refuses to supply enhanced and interactive services.
- 6.15 BT stated that a withdrawal of supply from cable operators might constitute an abuse of a dominant position, which would be contrary to CA98 and/or Article 82 EC Treaty, given that different considerations may apply to a withdrawal of supply from an existing customer as opposed to a refusal to commence supply to a new customer¹⁶².
- 6.16 The BBC stated that vertical integration can change the incentives of a channel provider to offer premium channels on all distribution platforms.
- 6.17 The UK Film Council believed that "given Sky's current position where it retains exclusive rights to film product, its willingness to license film channels beyond its own retail platform cannot logically be taken for granted".

Our current view

- 6.18 It is clear from the responses to our December Consultation that there is a strong divergence of views between Sky, as a wholesaler of premium content, and retailers

¹⁶² BT March 2008 response, paragraph 116.

such as Virgin Media, Top Up TV etc. as (potential) purchasers of that content. There are two broad possible explanations for this divergence.

- **The suggestions by retailers that Sky intentionally withholds its premium channels.** On this argument, Sky withholds supply to other platforms in order to divert subscribers to its own retail business and potentially to undermine its competitors.
- **Sky considers that it is a more effective retailer than its competitors, and the failure to agree terms merely reflects this.** Sky would therefore prefer to retail on other platforms rather than wholesale. Sky has said that it has made “substantial efforts to engage with the operators of closed platforms” in order to retail its channels directly. Sky’s response stated that no operator has been able to come up with wholesale terms that would alleviate its concerns about the wholesale model (failure of cable to sell premium effectively; marketing expertise and incentives; investment incentives; customer retention). Sky argued that the ‘Sky By Wire’ scenario (which it said Ofcom failed to include in the December Consultation as a means of content distribution) would allow it access to the greatest number of subscribers and would address issues around access to content¹⁶³.

- 6.19 It may be important to distinguish between these two explanations if we are concerned about the effect of poor access to content on retail prices. If Sky were withholding supply in order to undermine its retail competitors, that could create a concern in relation to retail pricing. However, if the failure to agree terms reflects Sky’s belief that it is a more efficient retailer, then this is less likely to create such a concern.
- 6.20 If however our primary concern is the foreclosure of competition from new platforms, and the resulting loss of innovation, then this remains a concern under either explanation.
- 6.21 In the remainder of this section we discuss:
- **Current distribution of Sky’s channels:** we set out the factual position with respect to the current distribution of Sky’s premium content on a wholesale and a retail basis.
 - **Sky’s incentives to wholesale its content to third party retailers:** we describe the incentives Sky faces with respect to the wholesaling of its premium content to other retailers.
 - **An indicative assessment of the financial effect on Sky of refusing / withdrawing wholesale supply:** we attempt to quantify the effects of the various incentives to supply that we have identified.
 - **Relative merits of Sky retailing its premium channels on other platforms versus wholesaling to other retailers:** we describe the incentives Sky faces with respect to the retailing of its premium content on platforms other than its own.

¹⁶³ See Part D of Sky’s “Response to the Complaint” (October 2007) and paragraphs 9.7 and 9.8 Part 2 of Sky’s consultation response.

Current distribution of Sky's channels

6.22 Sky's premium channels are currently available through three routes:

- Directly from Sky as a retailer on DSat.
- On cable via retailers Virgin Media, Wight Cable and Smallworld.
- On Tiscali's IPTV network, but retailed by Sky.

6.23 Figure 26 below shows the various major platforms and retailers, where Sky premium channels are available and through which retailers. Figure 27 below that shows the same information for Setanta's premium channels. As the figures show, Sky's premium channels are available through two major retailers, whereas Setanta's channels are available through five different major retailers.

Figure 26 Distribution of Sky premium channels

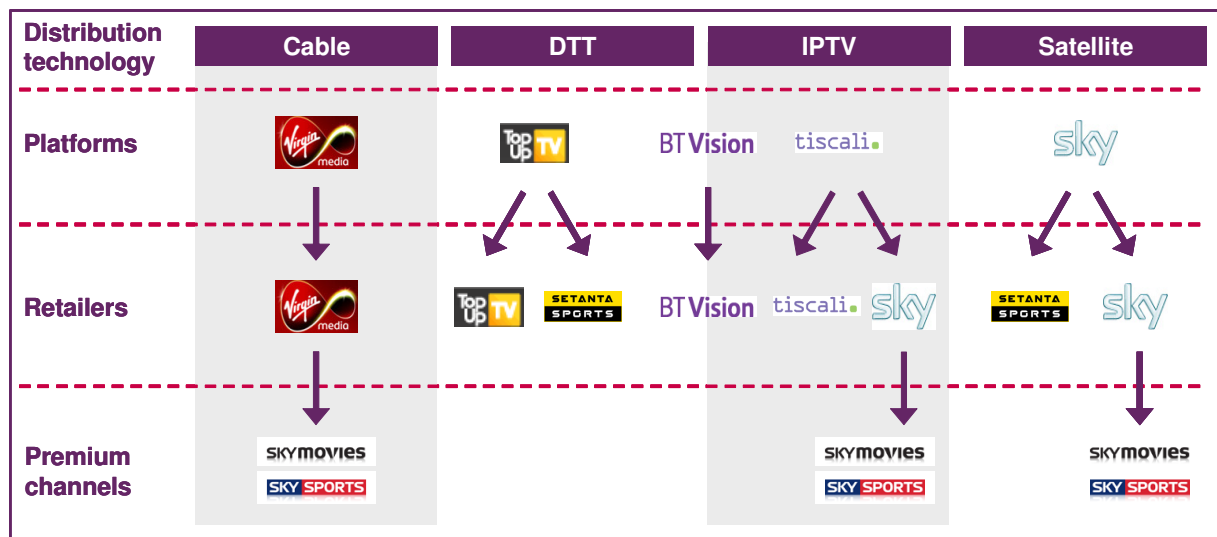
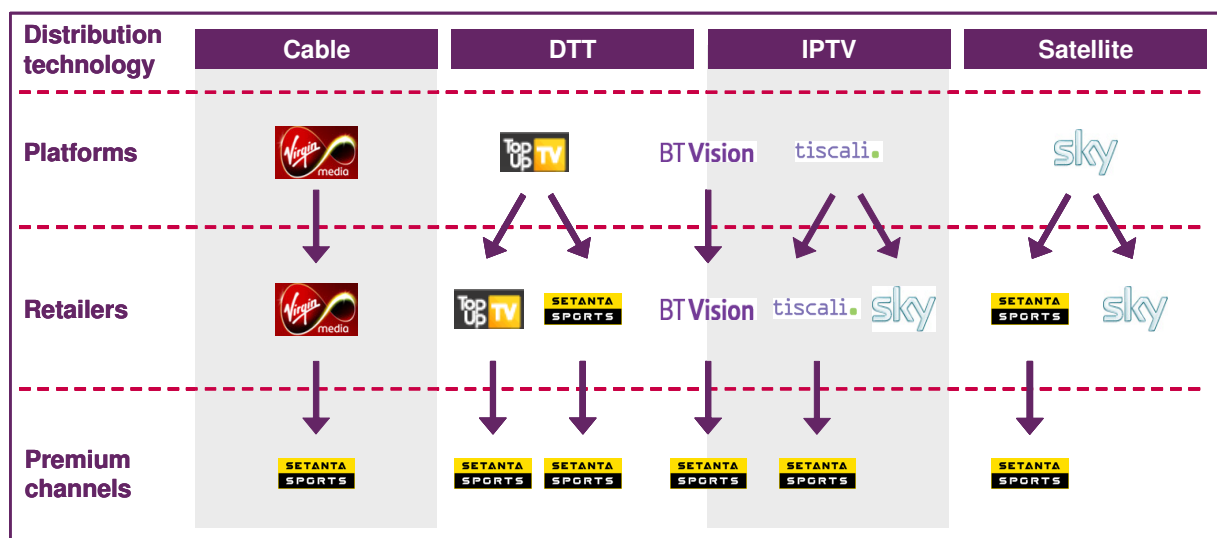


Figure 27 Distribution of Setanta premium channels



- 6.24 Ofcom is aware of six examples of mainstream companies either purchasing wholesale premium channels from Sky, or attempting to do so. These are: Virgin Media, BT Vision, Orange, Setanta, Tiscali and Top Up TV. These companies all have rather different histories in relation to premium channels. Virgin Media has a long history of taking supply from Sky, and has an established subscriber base, which at times in the past has been approximately equal to Sky's own. The others are all much newer entrants to the pay TV market with smaller subscriber bases, or in some cases have not yet entered.
- 6.25 Here we document the situation between Sky and Virgin Media, before going on to look at the relationships between Sky and other potential wholesale customers. We finish by contrasting the wholesale availability of Sky's content with that of Setanta.

Virgin Media

- 6.26 Virgin Media purchases wholesale premium sports and movie channels from Sky, and it or its predecessor companies have done so since the early 1990s. It has made various complaints to the regulatory authorities about the terms of the supply, most recently in a margin squeeze case which the OFT concluded in 2002. From 1996 to 2002, the supply of premium content by Sky to cable operators was the subject of non-statutory undertakings given by Sky to the OFT / Director General of Fair Trading ('DGFT') (the '1996 Undertakings').
- 6.27 The key elements of the 1996 Undertakings were as follows.
- Sky would supply certain channels separately, and publish a rate-card showing its wholesale prices for cable companies, with a discount structure approved in advance by the OFT. Absolute price levels were not approved.
 - Sky would detail the terms on which it granted broadcasters access to its analogue encryption services.
 - Sky would submit accounts separated between its wholesale and retail businesses (dubbed 'BroadCo' and 'Disco', respectively). In particular, Sky agreed to show in the accounts a notional charge for the supply of its channels to Disco, to allow the Director to determine if Disco made a reasonable profit when 'purchasing' channels on the terms of the rate-card.
- 6.28 The 1996 Undertakings were amended in February 1999, with retrospective effect from October 1998. The amendments principally reflected the Director's agreement to the removal from the wholesale rate-card of four of Sky's basic channels, which were considered not to have or to confer market power on Sky (Sky News, Sky Soap, Sky Travel and [redacted])¹⁶⁴.
- 6.29 The DGFT began a further review in 2000. The DGFT's first issues paper indicated that the review might lead to further investigation or action under CA98. As a result of the comments the DGFT received, it accepted that Sky need no longer observe certain undertakings. These included Sky's scope to impose minimum carriage requirements ('MCRs') on cable companies (from December 2000), and removal of Sky One from the rate-card.

¹⁶⁴ For further details on previous competition cases involving pay TV, please see Annex 7 of our December Consultation.

- 6.30 The responses to the 2000 review gave the OFT reasonable grounds under section 25 of the CA98 to suspect that Sky had infringed the Chapter I and Chapter II prohibitions, and an investigation was opened in December 2000. The investigation was into conduct falling both within and outside the scope of the 1996 Undertakings. In particular, the OFT investigated the terms on which Sky supplied its premium sports and film channels, namely Sky Sports 1, Sky Sports 2, Sky Premiere, and Sky Moviemax, for the period from 1 March 2000 until 30 June 2001.
- 6.31 On 17 December 2001 the OFT issued a Rule 14 notice to Sky, in which it proposed to find that three elements of Sky's wholesale pricing of its premium sports and film channels infringed the Chapter II prohibition of CA98:
- i) Sky had exercised a margin squeeze on its premium channel distributors. The margin offered between the prices charged to distributors and the retail price charged to subscribers was not enough for a normal profit to be made had the distributors been as efficient as Sky's own distribution business.
 - ii) Sky's mixed bundling had been applied to an abusive extent.
 - iii) Sky had offered discounts to its distributors on its pay to basic rate-card, which either foreclosed or had the potential to foreclose entry to other providers of the premium channels, and distort the competitive conduct of these distributors.
- 6.32 Sky informed the OFT on 11 January 2002 that it intended to amend its wholesale pricing of its premium channels having completed a preliminary review of the Rule 14 notice.
- 6.33 The OFT found that Sky was dominant in two markets, namely the wholesale provision of TV channels carrying sports content that only appear on premium pay TV sports channels (identified as live FAPL football) and premium pay TV film channels. It considered that there were insufficient grounds to find that Sky had abused its dominant position by exercising a margin squeeze on its premium channel distributors, or by practising anti-competitive mixed bundling in the wholesale provision of such channels. Further, Sky was found not to have infringed CA98 by offering the discounts set out in its pay to basic or premium pay unit rate-card¹⁶⁵.
- 6.34 During the 1990s a substantial proportion of Virgin's subscriber base subscribed to Sky's premium channels; this proportion has halved since 2000. The equivalent proportion on satellite has also declined, but much less slowly and remains at 65%. In absolute terms, Sky's premium subscribers have continued to increase, while Virgin's decline.

Figure 28 Number and penetration of subscribers to Sky's premium channels on satellite and cable

[✕]

Source: Sky, Virgin Media

- 6.35 Virgin Media suggested that the wholesale pricing arrangements create an incentive for it to avoid retailing Sky's premium channels to its XL subscribers. If it matches Sky's retail pricing (£46 for 6 entertainment mixes plus Sky Movies and Sky Sports), then its margin from an XL-only subscriber who currently pays £19.50 for an XL package is greater than its margin from a subscriber taking the XL package and

¹⁶⁵ http://www.of.gov.uk/shared_of/ca98_public_register/decisions/bskybfinal1.pdf

Sky's premium channels who pays an additional £26 for Dual Movies and Dual Sports. Given that Sky's premium wholesale rate-card charge from 1 September 2008 is £[X] for Dual Movies and Dual Sports, Virgin's argument that it achieves a higher margin on an XL only subscriber appears plausible. Virgin Media also argues that the unavailability of interactive services for Sky's premium channels on cable exacerbates the impact of Sky's wholesale prices on its ability and incentive to attract and retain premium subscribers.

- 6.36 The OFT has not previously accepted Virgin Media's argument that looking at the incremental price is an appropriate basis for examining competition issues concerning supply to Virgin Media in the context of a CA98 margin squeeze analysis, and we would be likely to adopt the same position. However, we do believe that from a commercial perspective, the current combination of wholesale charges and incremental retail price for the premium channels does not create the incentive for Virgin Media to attempt to sell premium channels to existing basic subscribers. Indeed, it may even result in Virgin Media being quite content to stop selling premium channels to its customers as long as they keep subscribing to a basic package. This view is supported by evidence which has been provided by [X].
- 6.37 We should of course exercise caution about drawing too direct a causal link between the price charged and subscriber numbers since there may well be other factors at play. However, the fact that the number of subscribers to Sky premium channels via the various cable operators has declined dramatically in recent years is not surprising given the apparent incentives faced by Virgin.

Other potential wholesale customers

- 6.38 The Four Parties alleged in their July Submission that Sky had, among other things,
- “... refused to supply its premium channels to certain other third party pay TV retailers and platforms”¹⁶⁶.
- 6.39 In its response to the December Consultation Sky argued that it has not refused to consider supplying its content on wholesale terms to other retailers. However, Sky has expressed a strong preference for retailing its premium content directly over third party platforms, as set out in the 'Response to the Complaint' (October 2007):
- Sky argued that its reason for pursuing a retail deal arises from its experience on cable and its desire to distribute to the greatest number of subscribers by using its expertise in marketing its own products.
 - It also argued that a third party platform operator does not have the incentives to invest in marketing Sky's channels and this could be exacerbated where the third party has higher margin products such as telephony and broadband.
 - Sky also asserted that a third party platform provider would not have the incentive to keep customers on premium subscriptions, leading to higher churn.
- 6.40 Ofcom has carried out a review of correspondence and meeting notes relating to the commercial discussions between Sky and several other parties for the distribution of Sky's basic and premium content. This information has been provided informally to Ofcom on a confidential basis by the parties to the discussions and in response to

¹⁶⁶ July Submission, part 3 paragraph 4.5.

formal information requests to specific actual or potential pay TV operators under the Enterprise Act.

- 6.41 The documents we have reviewed provide further insight into Sky's reasons for preferring retail rather than wholesale deals, [X].
- 6.42 It is apparent that despite Sky's assertion that it has an incentive to supply its content on a wholesale basis, and despite the stated preferences of the other parties to the discussions for a wholesale deal, no such deal has been done. It is clear that each party that has entered into negotiations with Sky has preferred, and in most cases sought from Sky in writing, a wholesale deal for premium content, but that Sky has typically responded by attempting to negotiate arrangements under which it would be the retailer. We are aware of no case in which Sky has formally refused to enter into some form of dialogue, but there are a number of instances where negotiations have continued for several years without any resolution and / or are ongoing.

Figure 29 Length of time that negotiations have been continuing with BT, Orange, Tiscali and Top Up TV

[X]

Source: BT, Orange, Sky, Tiscali, Top Up TV

Setanta as a supplier of wholesale content

- 6.43 We have described the availability of Sky's premium content via other retailers. It is instructive to compare this to the availability of Setanta's content via other retailers.
- 6.44 Since the auction in 2006 for rights to FAPL coverage for three seasons from 2007 / 2008, Setanta owns the rights to one third of the available live FAPL matches. It is the second player in the market for the wholesale of Core Premium Sports channels.
- 6.45 There are several reasons why we might expect Setanta to retail in a more platform-neutral manner than Sky:
- Setanta does not have the same degree of vertical integration as Sky, in that it does not operate its own platform.
 - Setanta is vertically integrated to some extent, in that it operates both as a wholesale supplier of premium content and as a retailer of that content. However, it is less likely than Sky to have market power at the wholesale channel, and is therefore less likely to be able to exploit any such market power by favouring its own retail business.
 - Moreover, Setanta does not retail the same range of additional services as Sky. This suggests that the additional retail margin Setanta owns by diverting subscribers to its retail business may be lower than that earned by Sky.
- 6.46 This expectation is supported by the evidence. Unlike Sky's content, Setanta's content is available very widely. Not only does Setanta itself retail over a number of platforms (Sky's DSat platform and Top Up TV's DTT platform), but it has also concluded a number of wholesale deals, with Virgin, Tiscali, BT Vision and Top Up TV, and has done so within a relatively short period of time.
- 6.47 The wider availability of Setanta's content is however insufficient to assuage our concerns about the availability of Sky's content. Setanta can only offer one third of

available live FAPL matches, and often the less attractive matches at that – as we have already observed, Sky’s four packages of live FAPL matches include all the first “pick” matches, and over three quarters of the second pick matches, making it far more significant when looked at in value terms than in volume alone.

Sky’s incentives to wholesale its content

- 6.48 As noted above, there may be a variety of explanations for the current distribution of Sky’s channels on a wholesale basis. In the following paragraphs we describe those alternative explanations.
- 6.49 We first consider the interplay of the incentives we believe Sky faces in deciding where it supplies wholesale content, before exploring the particular role of vertical integration. We then lay out an example of the likely effect of these incentives in terms of financial impact, based on a format that Sky referred to as ‘vertical arithmetic’.
- 6.50 There are two types of decision that we believe Sky faces with respect to wholesaling: first, whether to start supplying a company that is seeking supply of Sky’s wholesale channels, and second, whether to continue to supply a company to which it already supplies a product. The incentives Sky faces in both cases depend on the interplay of several different factors. These factors influence the price at which Sky would be prepared to wholesale as well as Sky’s willingness to wholesale at all:
- The margin that Sky can earn from retailing – both its premium channels and other products.
 - The propensity of subscribers to switch retailers.
 - Advertising revenues.
 - Longer-term issues relating to the extent to which other retailers may be able to establish themselves as more effective rivals to Sky both at retail level and in other parts of the value chain.
- 6.51 We discuss each of these factors in turn, and then present some indicative calculations to give an idea of the approximate scale of Sky’s incentives.

Retail margins

- 6.52 At the simplest level, Sky’s incentive to wholesale to other retailers is driven by a straightforward trade-off between wholesale and retail margins:
- If Sky does not wholesale to other retailers, then all subscribers that wish to view premium channels are obliged to purchase those channels from Sky. This has the potential to increase Sky’s retail revenues.
 - On the other hand, if Sky does wholesale to an alternative retailer, then some of Sky’s retail subscribers may choose the alternative retailer. Sky loses any retail margin from those subscribers, but earns wholesale revenues from the alternative retailer.
- 6.53 In addition, if the alternative retailer can access premium subscribers that Sky could not otherwise access itself, then Sky will earn extra wholesale revenues because of a

market growth effect. We discuss the impact of this effect below under switching costs.

- 6.54 The wholesale price is clearly an essential driver of the wholesale / retail trade-off. Sky would maximise its profits by setting a wholesale price that leaves it indifferent between wholesaling and retailing. A downstream retailer can then only succeed if it is at least as efficient as Sky's own retail business. On this argument, the absence of a wholesale deal could in part reflect a world in which Sky is more efficient than its retail rivals¹⁶⁷.
- 6.55 At a more detailed level, it is important to consider the drivers of Sky's retail margins and the way in which these influence its incentives. These drivers include:
- Sky's retail costs. To the extent that Sky's retail costs are lower than its rivals – for example because of economies of scale – it will prefer to distribute via its own retail business than via rival retailers. In response to a July 2007 information request on the costs involved in providing a retail service, Sky stated that [X]% of its total £[X] of relevant costs in 2006 / 07 were fixed. This suggests that economies of scale are likely to be significant.
 - Sky's retail prices for premium content. If Sky were able to charge a higher retail price than its rivals, other things being equal, it would again prefer to retail than to wholesale.
 - Sky's margins from other products that it sells jointly with premium content. There is, for example, a significant difference for Sky between a customer on DSat and one on Virgin's cable platform. On DSat, Sky not only sells premium content to a customer, but it also sells basic content – the use of buy-through makes this a certainty. In addition, although Sky does not sell all of these services to every premium customer, there are a number of other products and services on which it may generate margin. These include HD channels, Multiroom, Sky+ boxes, broadband and telephony, and any ancillary services such as Sky Bet¹⁶⁸. The overall point is that if Sky is more effective than its rivals at assembling attractive retail bundles, then its retail margin per subscriber across all of the products within those bundles is likely to be higher. This strengthens the incentive for Sky to retail rather than wholesale.
- 6.56 All three of these factors relate to Sky's effectiveness as a retailer. To reiterate the point above, Sky's wholesale market power would in principle enable it to set wholesale prices at which it were indifferent between retailing and wholesaling. If other retailers were unwilling to purchase Sky's wholesale channels at those prices, that would reflect their inability to assemble as compelling a retail offering as Sky's retail business. Nonetheless, and as we explain below, this would not necessarily be a good outcome for the longer-term evolution of competition or for consumers.

Switching costs

- 6.57 If Sky's retail competitors are able to access subscribers that Sky cannot readily access – or they can access those subscribers more efficiently, then Sky's incentive

¹⁶⁷ This is the logic of the Efficient Component Pricing Rule (ECPR) whereby a wholesale price is set with reference to retail prices and incremental retail costs in order to make a vertically integrated firm indifferent between selling to its own downstream business and a rival downstream business.

¹⁶⁸ We recognise that it is possible to gain access to Sky Bet other than through Sky's premium channels.

to wholesale is increased. These additional subscribers might, for example, be on a different platform and face switching costs to move to Sky's platform.

- 6.58 The opportunity to access these customers – albeit indirectly – could in turn imply that Sky would be prepared to accept a somewhat lower wholesale price. However, the precise trade-off is complex: a lower wholesale price might encourage the alternative retailer to reduce its retail price to subscribers that might otherwise switch to Sky. This would increase the competitive pressure on Sky's retail business and therefore dampen the incentive for Sky to reduce the wholesale price below the level suggested by the no-market-growth case¹⁶⁹.
- 6.59 In more general terms, where switching costs are low, there is little to prevent consumers switching from Sky to the alternative retailer. If switching costs were extremely high, it would be very unlikely that consumers would switch away from Sky to the alternative retailer. Sky would therefore be more likely to supply that retailer with a wholesale product – or equivalently would be prepared to accept a lower wholesale price.
- 6.60 The reality is that switching costs vary considerably, but in very few cases are they likely to be so high as entirely to deter switching. It is important to recognise that the costs will vary depending on which platform a customer is switching to. We laid out our views on the likely levels of switching costs or barriers in the December Consultation. We stated that barriers to switching are lowest for consumers switching between different retailers on the same pay TV platform. For instance, switching from Sky to Setanta on DSat requires no hardware changes. The second lowest type of switching barrier is switching between platforms on the same distribution technology – for example between two different DTT-based platforms.
- 6.61 In comparison, changing platforms and distribution technologies, for example to platforms on either cable or satellite, requires a new set-top box, a satellite dish or potentially new cabling to the home, plus in all likelihood internal rewiring in the home.
- 6.62 Some of the newer platforms offer the prospect of somewhat lower switching costs. Although changing to any new platform requires a new set-top box, and may involve dealing with whatever contractual terms bind the customer to their current provider, IPTV or DTT-based platforms involve reduced additional changes in hardware to cable and satellite. IPTV-based platforms use the existing telephone line, and DTT-based platforms the existing aerial.
- 6.63 Although some newer platforms offer lower switching costs, the increased prevalence of bundling TV with other services such as telephony and broadband may increase the inconvenience to the customer of switching. A triple-play customer may need to switch not just their TV service, but also their telephone and broadband services.
- 6.64 Sky acknowledges that switching costs are at their lowest when switching between retailers on a platform, and recognises that this makes distribution of content to multiple retailers on the same platform unlikely. In a report prepared for Sky by CRA and submitted to Ofcom on 1 July 2008, CRA says:

¹⁶⁹ The incentives are further complicated by the potential for price discrimination at both wholesale and retail level. For example if retail price discrimination is possible, then Sky may be able to sustain a higher overall wholesale price because the alternative retailer can extract more consumer surplus from those subscribers that would not switch to Sky, or that face higher switching costs.

“We have indeed acknowledged that, when downstream substitution is especially strong, as in the case where the downstream competitors operate on the same platform, content is unlikely to be licensed broadly”.

- 6.65 Switching costs do not apply in quite the same way when Sky is considering potential new pay TV consumers. Such consumers incur costs of signing up to whatever service they choose, although those costs vary by platform in a similar way to the description of different platforms above.
- 6.66 The extent of switching barriers from Virgin to Sky has a significant bearing on the extent of Sky’s incentive to maintain supply. If barriers to switching are very high, a withdrawal of content from Virgin’s platform would result in relatively few Virgin premium customers switching to follow the premium content, making withdrawal of supply less likely. Conversely, the lower the barriers to switching are, the more likely it is that sufficient customers would follow the content and switch to a Sky retail service, increasing the incentive on Sky to withdraw supply.

Advertising revenue

- 6.67 As we discussed in the section on market definition, pay TV is a two-sided market, where Sky sells impacts to advertisers as well as selling services to consumers. Sky should be able to maximise advertising revenues by ensuring that its channels are available to the maximum number of people.
- 6.68 If by selling via wholesale, Sky increases the total number of people that consume its premium channels, it should be able to increase the amount of revenue it can generate from advertisers. Offsetting this is the foregone advertising revenue resulting from decreased viewing of its owned basic channels, e.g. Sky One, Sky News and Sky Sports News, where these are not available via the other operator’s service.

Longer-term factors

- 6.69 The factors described above relate to Sky’s short term incentives. In practice, Sky’s decision about whether to wholesale to other retailers will reflect a longer term view of the market. Two longer term factors are of particular relevance:
- Subscriber churn.
 - The longer-term pay TV landscape, including the relative strength of different platforms.

Subscriber churn

- 6.70 The existence of regular subscriber churn means that the incentives to withdraw are not the same on day one as over a period of months or years. Churn is a natural process of attrition from a retailer’s subscriber base. Sky put its churn level at 10.4% for 2008¹⁷⁰. Virgin Media’s churn was somewhat higher – Virgin reported its churn for the fourth quarter of its financial year as 1.4% per month¹⁷¹. Although some of these churning subscribers may be giving up subscribing to pay TV entirely, this means

¹⁷⁰ http://media.corporate-ir.net/media_files/irol/10/104016/reports/Annual_Report_2008.pdf, page 8.

¹⁷¹ <http://library.corporate-ir.net/library/13/135/135485/items/287050/2007AnnualReportFinal.pdf>, page 60.

that in the space of a year, towards a fifth of Virgin's subscriber base becomes available in the market.

- 6.71 From the perspective of Sky's wholesaling incentives, two types of churn are relevant: customers who churn away from Sky in order to change to another provider, such as Virgin Media, and others who move away from Sky and cease purchasing premium content altogether.
- 6.72 Minimising churn is an important driver of success in pay TV, particularly given the high cost of replacing customers once some have churned away (Sky put its subscriber acquisition costs at over £250 per subscriber in 2008¹⁷²). Anything Sky can do with its content to keep churn down would therefore be desirable. If Sky could create an environment in which it was the only retailer of premium content, it would make it less likely that premium customers would churn away from its service, since there would only be one place for premium customers to get premium channels.
- 6.73 On the other hand, where Sky's sale of premium content to a competing retailer enables that retailer to become a stronger competitor, with an offer that is more compelling for consumers, there is a greater likelihood that customers may churn away to that competitor. This decreases the incentive for Sky to supply the competing retailer.

The longer-term pay TV landscape

- 6.74 The other critical determinant of Sky's incentives to wholesale its premium channels is the way in which those channels can enable alternative retailers to strengthen their competitive position both in the retail market and in other related markets. We have argued above that premium content is an essential driver of subscriber numbers, and also that subscriber numbers are an important driver of Sky's wholesale market power and the value of its platform business. On this argument, Sky would prefer to avoid a situation in which competing retailers are able to challenge that market power.
- 6.75 The strategic value of the Sky premium channels to platforms is clearly revealed by a comment made by a senior Sky executive – see paragraph 3.57 above.
- 6.76 Sky was making that point to explain its dislike of a wholesale model, but it clearly illustrates Sky's own view on the importance of premium content, and Sky's premium content in particular, to platform operators.
- 6.77 This point underlines the role that Sky's premium channels play in increasing the chances of a rival retailer and / or platform operator succeeding. The arguments and evidence we set out in section 3 reinforce this view. When considering supplying a new or emerging retailer or retailer / platform operator in particular, Sky only stands to gain a relatively small amount of wholesale revenue, particularly while the prospective customer has a relatively small base of subscribers. On the other hand, based on a static decision, Sky would only stand to gain a small number of retail subscribers in the short term by not supplying the rival retailer.
- 6.78 However, at the point where a rival retailer is still in the early stages of its development, still with a small subscriber base, it is unclear how much of a threat it represents in the long term. The new retailer might offer a consumer proposition which proves to be very strong in the longer term, based partly on the wholesale Core Premium content supplied by Sky. Over that longer term, it could develop into a

¹⁷² http://media.corporate-ir.net/media_files/irol/10/104016/reports/Annual_Review_2008.pdf, page 23.

potential threat to Sky's position of power in the wholesale channel markets. Therefore even where supplying may have a positive financial impact in the short term, the unquantifiable future threat may be regarded as outweighing the short-term benefit.

- 6.79 This effect is magnified where the rival retailer also operates a platform. Sky derives revenues not only from selling its channels, but also from its satellite platform, which is currently by some distance the largest pay TV platform in the UK. In deciding whether to wholesale its premium channels to another combined retailer / platform operator, Sky has at its disposal a major lever for determining whether that other platform emerges to challenge the position of its satellite platform. The effectiveness of this lever is borne out by the quote from [X] in section 3.
- 6.80 There is also a more specific long-term strategic reason why Sky is likely to have an interest in keeping rival retailers suppressed. We described in our section on market power the role played by owning a large subscriber base in raising barriers to entry in the acquisition of content rights. By controlling the supply of wholesale content, Sky can contribute to the retail subscriber bases of rivals remaining lower than if those rivals had access to the content, thereby constraining their ability to compete with Sky for rights.
- 6.81 In practice, the strategic threat perceived by Sky will of course be different depending on the identity of the company in question and its role in the competitive landscape. The nature of the threat posed by an alternative downstream retailer depends on a number of factors: the size of the retailer, the platform on which it is retailing or proposing to retail, and the nature of the existing relationship with Sky.
- 6.82 As noted above, we are aware of a number of examples of major companies who either currently purchase wholesale premium channels from Sky or have attempted to do so at some point: Virgin Media, BT Vision, Orange, Tiscali and Top Up TV. Each of these individually is likely to have a strong incentive to conclude a deal with Sky, given the advantages that Sky's channels can confer on any retailer or platform that is able to offer them.
- 6.83 In the case of Virgin Media, Sky already supplies its wholesale channels, and receives wholesale revenues for over half a million premium customers on Virgin's cable platform. Virgin's cable platform has been stable for several years at around 3.5 million subscribers in a period when Sky has consistently grown its subscriber base.
- 6.84 We set out a concern in December that even where a company supplies others with wholesale content, it may have an incentive to reduce the quality of what it supplies. This is precisely what Virgin alleges is taking place in this case. It alleges that the non-supply of interactive services to Virgin is an example of Sky intentionally reducing the quality of what it supplies, whereas Sky both disputes the importance of interactive content and asserts that there are sound technical reasons why it is unable to supply that content. Sky also argues that if it has the incentive to supply the underlying content, it also has an incentive to supply the additional features. Apart from any possible technical reasons for non-supply, we can see two reasons why Sky might not supply additional features. One is that the incremental cost to Sky of supplying the additional features is greater than the benefit those features would generate. On the other hand, it is possible to imagine that if Sky is supplying the channels themselves primarily because of prior competition law cases and the threat of further such cases, it would have little incentive to enhance the quality of what it supplies.

- 6.85 Tiscali also has an existing relationship with Sky, but of a different nature. Sky has a quasi-retail relationship with customers via Tiscali's IPTV platform, setting prices while Tiscali operates approximately like a retail agency for Sky. Tiscali, in its previous incarnation of Homechoice / Video Networks, would have preferred to purchase the channels on a wholesale basis, but such a deal was never concluded.
- 6.86 What Tiscali shares, however, with BT Vision and Top Up TV for example is that they all operate platforms and have retail offers on distribution technologies where Sky itself has indicated an intention to set up its own operations – DTT and IPTV. We have already referred in this document to Sky's proposed Picnic service on DTT. Sky is reportedly considering launching a Picnic IPTV service if Ofcom does not consent to its DTT proposal¹⁷³.
- 6.87 Not only therefore do these retailers potentially threaten Sky's position in the retail of pay TV in a general way, but they also specifically threaten to displace Sky's intended platform offerings on those particular distribution technologies.

The role of vertical integration

- 6.88 In our December Consultation, we made frequent reference to the fact that these incentives relate particularly to a vertically integrated operator. Sky expressed the view that licensing content exclusively to one retailer on a platform is the rational strategy of wholesale channel provider, whether vertically integrated or not.
- 6.89 Vertical integration is not a necessary condition for incentives not to supply to exist. If there were no ownership link between Sky's wholesale business and a particular downstream retailer, it might well still be in the interests of one downstream retailer to seek to conclude an exclusive deal with Sky for the supply of the content. The exclusivity premium that retailer would pay for the acquisition of a competitive advantage in the retail market through sole access to the content would give Sky the incentive to conclude agreements.
- 6.90 However, vertical integration removes the need to enter into a contract in order for this incentive to come into force. Vertical integration is also likely to be particularly relevant in relation to the long term or strategic effects of exclusivity, the benefits of which are particularly difficult to capture in a fixed term supply agreement.
- 6.91 It may even be somewhat artificial in this situation to make the distinction between Sky's wholesale business and its retail arm. In reality, both of these nominal entities are part of the same company. Sky's decision on whether or not to supply at the wholesale level is inextricably linked with the fortunes of its core retail business.

Indicative assessment of the financial effect on Sky of not supplying / ceasing supply

Introduction

- 6.92 Precise quantification of the various effects described above would be a highly complex task requiring a wide range of detailed assumptions which are difficult to estimate. However, to provide some indication of the sorts of effects at play, we have undertaken some illustrative calculations of the financial impact on Sky of a decision not to wholesale its premium channels. We do not in any sense regard this analysis

¹⁷³ For example, "Sky seeks to revive Picnic value brand", Marketing Week 29 May 2008, "Sky explores IPTV launch for Picnic", Broadcast, 23 April 2008.

as definitive, but it gives a high-level indication of the circumstances in which it may be profitable for Sky to refuse to supply new wholesale customers and / or withdraw supply from existing customers.

- 6.93 CRA, in its paper accompanying Sky's October 2007 submission, was the first to present this kind of model during this process, calling it an exercise in 'vertical arithmetic'. It acknowledged the difficulties with using this kind of model again in its submission to Ofcom in July 2008:

"Vertical arithmetic is a very crude methodology. The only point of the exercise is to get an idea of the order of magnitude of the effects involved".

- 6.94 We agree with CRA's caution in using this kind of analysis. However, we also believe that it is useful to carry out this kind of analysis in order to weigh up the various forces that we believe influence Sky's decision on whether or not to wholesale its premium content.
- 6.95 It is important to note one particular limitation of this kind of analysis: such a set of calculations cannot hope to incorporate all the incentives we have laid out in the preceding paragraphs. It can attempt to balance the short- to medium-term financial impact of trading off one set of margins against another. However, it cannot capture the longer-term, strategic incentives to do with the competitive landscape. If anything, therefore, it is likely to overstate the incentive to supply.

Summary of findings

- 6.96 Our calculations accord with the incentives we identified above. They suggest that at current wholesale prices, a withdrawal of supply from Virgin might be profitable after seven or eight years. As the caveats set out above indicate, we should not expect to attach particular weight to the precise number of years we mention here. Instead it should be regarded as being in the right order of magnitude.
- 6.97 The profitability of refusing to supply a new customer on DTT is very subject to assumptions, and is particularly dependent on price. However, given the small (or non-existent) existing subscriber base of a potential new customer, and the lower switching costs to new platforms, particularly those on DTT, failing to supply new retailers is likely to be profitable within a significantly shorter time period than is the case with Virgin Media.
- 6.98 Below we present some of our key considerations in carrying out this modelling, and a summary of the results. For a greater level of detail, please see Annex 8.

Analytical approach

- 6.99 Our analysis considers consumers' product choices, where these choices are likely to depend on the availability of Sky's premium content through other pay TV retailers. We assess the impact of these effects on Sky's profitability, and hence Sky's decision whether to make its content available to other retailers. The various effects are summarised in the table below.

Figure 30 Effects concerning consumers' choices¹⁷⁴

Effect	Explanation
a. Immediate switching of current Virgin Media premium subscribers	Our consumer research suggests that a substantial proportion of current Virgin Media premium customers would leave the platform if Sky's premium channels were no longer available on cable, and that the majority of these would be likely to choose a Sky package
b. Delayed switching of current Virgin Media premium subscribers	A proportion of cable customers would remain with Virgin Media after the loss of Sky's premium channels. However, as time progresses, it is likely that this group would be more likely to churn away from cable, and, in that event, be more likely to choose a Sky package (due to the unavailability of premium content through other providers)
c. Reduced churn of Sky's own premium subscribers	Over time, Sky's own premium customers face natural decision points (such as home moves) at which they may consider alternative providers. At these points an increased proportion of Sky's customers may be persuaded to remain with Sky if premium content is unavailable through other providers. This factor is particularly important in considering Sky's incentives to wholesale to existing and potential DTT retailers
d. Choices of 'new' consumers	The number of households interested in packages containing premium channels is likely to increase in size over time. Sky can expect to benefit from an increased proportion of these 'new' premium subscribers (and households re-entering the market) if it is the only retailer of Sky Sports and Sky Movies. This factor is particularly important in considering Sky's incentives to wholesale to existing and potential DTT retailers

Financial effect on Sky of not supplying / ceasing supply – Virgin Media

- 6.100 We first consider Sky's incentives in respect of Virgin Media, Sky's principal wholesale customer¹⁷⁵. The table above suggests that Sky's incentives to wholesale its content will vary according to the time horizon over which these incentives are measured, as churning subscribers and new customers come into play. Indeed, our analysis suggests that, if we only consider immediate switching from Virgin Media to Sky's retail packages (effect **a** in the table), it is unlikely at current wholesale prices to be profitable for Sky to cease to supply Virgin Media. This is because the wholesale profits Sky sacrifices (for those premium retail customers who do not switch to Sky) are likely to be greater than the additional retail profits Sky gains (for those premium retail customers who do switch to Sky).
- 6.101 However, Sky's incentives are likely to change if we consider a longer time horizon. This is because of the effects **b** to **d** in the table. In each case, to a greater or lesser extent, sections of consumers are faced with decision points at which switching costs are less important than for consumers already receiving a premium service (without disruption to the continuity of that service). For these consumers, unimpeded by switching costs, decisions are more likely to be based on differences in content between providers. For these cohorts of consumers, Sky is likely to sacrifice few wholesale customers relative to the increase in retail customers it is able to attract through its content advantage. This is especially likely to be the case for retailers

¹⁷⁴ As part of our consumer research, we asked cable customers how they would respond to the loss of certain channels from their packages. See Annex 10 for more detail on this consumer research.

¹⁷⁵ Sky also supplies Smallworld and Wight Cable.

whose products are not strongly differentiated from Sky's, such as retailers on platforms or distribution technologies on which Sky operates.

- 6.102 Our calculations indicate that Sky's profitability is particularly sensitive to churn, so Sky may choose to incur substantial costs to secure just a small percentage point reduction in customer disconnections. This factor, in particular, leads us to conclude that, considered over a number of years, Sky's incentive is to ensure that it is the only retailer of its premium channels.
- 6.103 Our analysis suggests that a decision to stop wholesaling to Virgin Media would be unprofitable to Sky in the near term, but subsequently profitable; specifically the decision not to wholesale would be profitable when considered over a period of seven or eight years.

Key sensitivities

- 6.104 The results of our model are sensitive to some important assumptions, several of which are presented in the table below. Here, for alternative assumption values, we indicate the 'payback' period over which the cumulative discounted profits from withdrawing supply to Virgin Media pass through break-even. These payback periods should be compared with the payback period of the eighth year for our present assumptions. The assumptions are considered here independently of one another.

Figure 31 Sensitivities to payback period of decision not to wholesale to Virgin Media

Assumption	Current value for assumption	Alternative value for assumption	Payback period given alternative value
Responses to consumer survey: level of stated preference bias (see Note 1)	10%	0%	7 years
		20%	9 years
Responses to consumer survey: confidence intervals (at 95% confidence level)	As per consumer responses	High case: maximum switching to Sky (implied by limit of confidence interval)	4 years
		Low case: minimum switching to Sky (implied by limit of confidence interval)	13 years
Growth rate in premium cable subscribers in Base Case (where Sky continues to wholesale)	For Sky: 4.2% for Y1 to Y6, 2.1% thereafter. For VM: 0% throughout	For Sky: 5.3% for Y1 to Y6, 2.7% thereafter. For VM: -4.1% for Y1 to Y6, -2.1% thereafter.	8 years
		For Sky: 0% throughout For VM: -4.1% throughout	8 years
In Alternative Case, proportion of cable ex-premium cohort who churn each year, over and above Base Case churn (see Note 2)	Y1: 20% Y2: 15% Y3: 10% Y4: 5% Y5 onwards: 0%	Half these values for Y1 to Y4, and 0% thereafter	9 years
		0%	10 years
Proportion of people who, in the Base Case, would switch to cable to take premium channels, and still do switch to cable in the Alternative Case despite absence of premium channels (see Note 3)	10%	0%	7 years
		20%	10 years
Discount rate (nominal, pre-tax) applied to Sky's future profits	10.75%	10%	8 years
		11.5%	8 years
Inflation rate applied to Sky's future revenues and costs	2.5%	0.0%	8 years
		5.0%	7 years
Sky's wholesale charges to Virgin Media for Sky Sports and Sky Movies	As per current cable rate-card	5% lower than cable rate-card	6 years
		10% lower than cable rate-card	5 years

Notes:

1. Our survey responses may be subject to stated preference bias, in that respondents may have exaggerated the likelihood of switching to alternative providers following the loss of Sky's premium channels. In the sensitivity test, we adjust the number stating an intention to switch by 0% or 20%, with the number remaining with Virgin Media increasing respectively.

2. We believe that Virgin Media's premium subscribers who do not switch to Sky immediately are more likely than other cable customers to disconnect from Virgin Media at a time in the future. For example, in Year 1 we assume the churn rate for this cohort will be 20 percentage points above the normal Virgin Media rate of churn. In the sensitivity test, we first reduce these proportions, and then assume that churn will not be above the normal Virgin Media rate of churn.

3. Our model takes account of churn between providers. In the Base Case (where Sky does wholesale to Virgin Media), a number of Sky subscribers switches to Virgin Media each year to take premium channels. In the Alternative Case, when premium channels are no longer available on Virgin Media, we assume that 10% of switchers still choose Virgin Media (because of preferences for other service aspects). In the sensitivity test, we alter this proportion downwards or upwards.

Other factors not quantified

6.105 Our calculations do not take account of certain factors that can be expected to alter Sky's incentives to wholesale its content. These include, for example:

- Sky's greater strength at the retail level resulting in increased strength at the wholesale level – as explained in section 5 on market power, we believe that there is a relationship between retail subscribers and wholesale market power. Therefore, if Sky expands its retail base, it will strengthen its advantage in content rights acquisition and channel provision.
- Sky's advertising income for its basic channels – Sky's basic channels, most notably Sky One, are presently available to Sky's customers but not to those of Virgin Media. If Sky is able to attract Virgin Media subscribers to its own retail packages, this may raise audiences for Sky's basic channels, increasing their associated advertising income.

Conclusion on results of our indicative calculations – Virgin Media

6.106 As noted, our analysis suggests that it is in Sky's shorter-term interest at current wholesale prices to continue supplying its wholesale premium channels to Virgin Media. However, over a longer time horizon Sky might benefit from withdrawing supply, both because of the longer-term impact on customer choices, and because of the potential softening effect this could have on competition (although we have not sought to quantify this second effect).

Financial effect on Sky of not supplying / ceasing supply – DTT retailers

6.107 Sky has applied to Ofcom to replace its three existing free-to-air channels on the DTT distribution technology with five different pay TV channels. Sky intends to market these channels in 'Picnic'-branded packages, for which consumers would pay a monthly subscription charge. As detailed in our parallel consultation, <http://www.ofcom.org.uk/consult/condocs/picnic/>, Picnic would offer several basic channels and the opportunity to trade up to versions of Sky Sports 1 and Sky Movies 1. Our research suggests that premium content is the most important driver of take-up of pay TV services, and as such is likely to be important to the success of Picnic. We believe that Sky's incentive to wholesale Sky Sports and Sky Movies to other DTT retailers would be likely to be affected if it did become a retailer and platform operator on DTT. In addition, quite straightforwardly, Sky's incentive is likely to be highly contingent on its wholesale price.

6.108 Some illustrative calculations, similar in nature to the basic 'vertical arithmetic' exercise undertaken by CRA, show the pay-offs facing Sky in its decision whether to wholesale to other DTT retailers. Sky faces a trade-off, familiar from the analysis above, between wholesale profits if it chooses to wholesale and greater retail profits if it does not.

Main assumptions

6.109 Our calculations, which attempt to quantify in broad terms the trade-offs that would face Sky, use some central assumptions about the nature of competition between pay TV services on DTT to help understand Sky's incentives. Figure 32 below sets out the most important assumptions.

Figure 32 Assumptions underlying calculations

Variable	Central assumption	Note	Significance of assumption
Number of DTT retailers of Sky's premium channels	3 including Sky	1	Additional retailers are likely to expand the overall size of the market, delivering incremental (wholesale) revenues to Sky, but may attract customers who would otherwise have chosen Picnic
Size of pool of 'contestable' customers	700,000	1	This figure represents customers that are willing to choose between different retailers. These customers will consider alternative retailers of Sky's premium channels.
Sky's share of contestable customers	Sky attracts 40% of 'contestable' customers	1	If Sky can expect to attract a large proportion of 'contestable' customers, it has less to lose from wholesaling to other DTT retailers
Product differentiation and market expansion effect	Each additional retailer expands size of market by a further 10%	1	If each additional retailer significantly expands the DTT market, serving customers that are "out of reach" of Picnic, this elevates Sky's incentives to wholesale to additional retailers
Sky's profit margin from DTT retail customers	[✕]	2	If Sky's retail margin is high relative to its wholesale margin, this heightens Sky's incentive to attract potential customers to Picnic rather than serve customers through its wholesale product
Sky's profit margin from DTT wholesale customers	[✕]	3	
Proportion of DTT pay TV customers diverted from Sky's DSat packages	20%	1	For those pay DTT customers who would otherwise have chosen a premium package from Sky on DSat, Sky sacrifices retail profits from DSat
Sky's gross profit margin from premium DSat retail customers	[✕]	4	If Sky's retail profit margin on DSat is high relative to its margin on DTT, it would prefer to serve customers through its DSat packages, and suffers when customers are diverted from DSat to pay-DTT.

Notes:

1. The assumptions for these variables are based on one view of how the market will develop. There could of course be alternative credible forecasts.

2. [✕].

3. [✕].

4. [✕].

Indicative results

6.110 Our calculations are highly simplified, and reflect a 'steady-state', mature market scenario¹⁷⁶. They are unlikely precisely to reflect competitive conditions. Such analysis is not able to model the impact of long-term strategic factors affecting Sky, such as those discussed at paragraphs 6.69 to 6.87. Nevertheless, we believe that the arithmetic provides some important messages. At a wholesale price of £17.50 per month, these basic calculations indicate that Sky would have the incentive to wholesale to other DTT retailers. While Sky would sacrifice substantial DTT and DSat retail profits, it is more than compensated by an increase in its DTT wholesale profits.

¹⁷⁶ Factoring in the years of market growth would only generate different results if we assumed different growth rates for different operators.

Figure 33 Impact of decision to wholesale premium channels to other DTT retailers, at a wholesale charge of £[X] per subscriber per month

	Base Case: Sky does not wholesale	Alternative Case: Sky does wholesale	Net impact of decision to wholesale
Total number of subscribers to Sky's premium channels (all retailers)	770,000	910,000	140,000
Sky's subscribers to Sky's premium channels	770,000	350,000	(420,000)
Other retailers' subscribers to Sky's premium channels	0	560,000	560,000
Sky's DTT retail profits	[X]	[X]	[X]
Sky's DTT wholesale profits	[X]	[X]	[X]
Sky's lost DSat profits	[X]	[X]	[X]
Sky's total profits	[X]	[X]	[X]

Note:

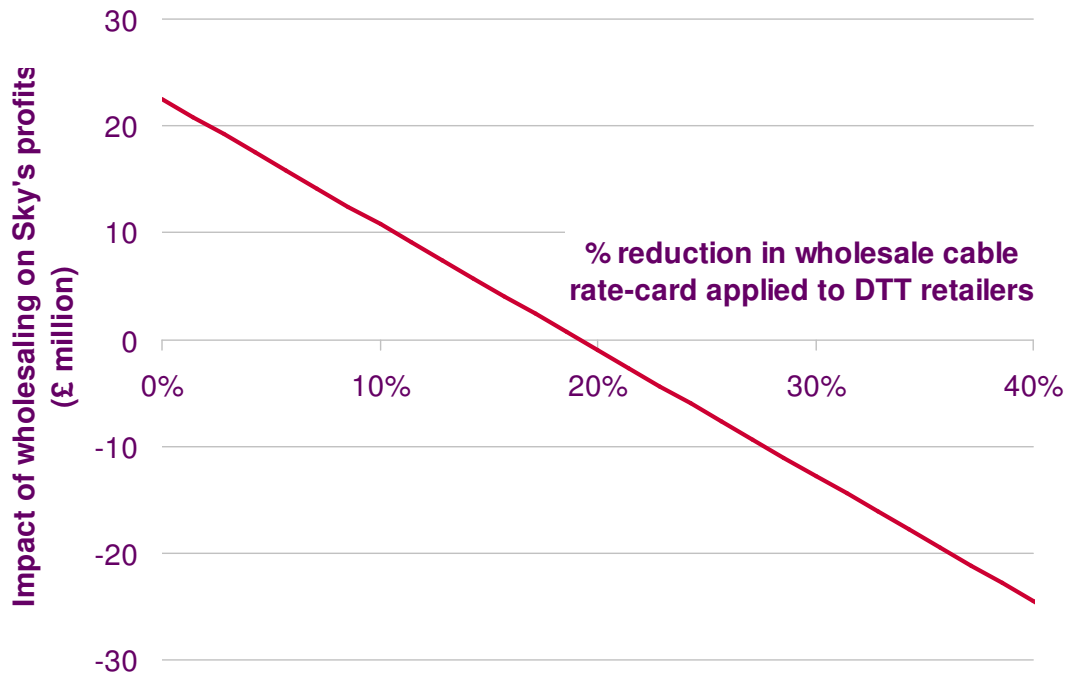
Subscriber numbers are rounded to the nearest thousand. Profit figures are rounded to the nearest million. Due to rounding, the net impact may not precisely equal the difference between the Base Case and the Alternative Case.

- 6.111 As we would expect, Sky's incentives are highly sensitive to its wholesale price. While wholesaling to other DTT retailers would be profitable to Sky at wholesale rates higher than just over £[X], below this level wholesaling is unprofitable to Sky. Therefore, as an indicative calculation, we would not expect Sky voluntarily to wholesale its premium channels with charges at anything below this level.
- 6.112 The results of these calculations are purely indicative. However, it seems likely that Sky would have an incentive to supply DTT retailers at the cable rate-card price for Single Sports and Single Movies. The picture is clouded somewhat by the fact that Single Movies might well not be the appropriate product for DTT retailers, since DTT capacity constraints make it likely that they could not accommodate that many channels. It would appear that If Sky has offered that price to DTT retailers, they were unable to generate a sufficient retail margin on the basis of that price.
- 6.113 This analysis sets out the incentives that might apply in a steady-state model, in for example five years' time, if Sky and others had entered on DTT. It excludes the effects of those longer-term strategic factors described earlier in this section. These are likely to be particularly relevant at the present time, when various companies are making decisions about their entry strategy on DTT. It is not realistic to expect to be able to model the effect of those longer-term factors, given the number of assumptions which would have to be made, but they are likely to increase the level of incentive not to supply content over the level that is implied by the steady-state model.

Figure 34 Sensitivity of Sky’s profitability to wholesale charges (assuming no change to retail prices)

[X]

Figure 35 Sensitivity of Sky’s profitability to percentage change to current wholesale charges (assuming no change to retail prices)



Relative merits of Sky retailing its premium channels on other platforms versus wholesaling to other retailers

6.114 In principle, there are two ways in which content could reach consumers through a given platform. To take the example of live FAPL coverage: first, a retailer on that platform (for example the owner of the platform) can retail FAPL matches to consumers by purchasing from a channel provider. Second, Sky, as the wholesale channel operator that has bought the rights to that content, could supply to itself in order to retail over that platform.

6.115 Sky contends that retailing over others’ platforms itself amounts to the same thing in terms of the effect on that platform’s chances of success as wholesaling content to the platform operator and allowing it to retail the content. It stated in paragraph 9.8 of part 2 of its consultation response that:

“To the extent that the attractiveness of a platform depends on the content available on that platform, it does not matter whether that content is wholesaled or retailed”.

6.116 It is important for several different retailers to have the opportunity to retail premium content, for several reasons which we explore below.

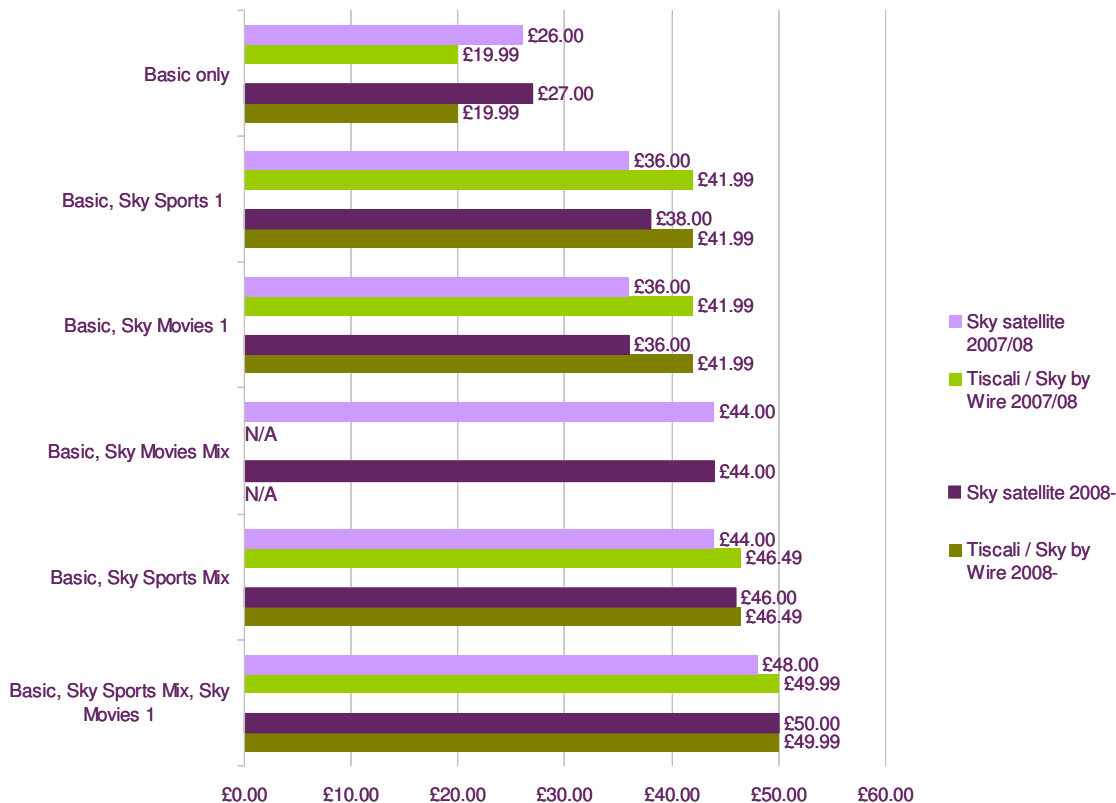
Pressure on retail costs

- 6.117 The most important reason relates to a simple question of longer-term retail competition. If Sky were the only retailer of a particular type of content over all platforms, there would be minimal pressure on retailing costs for that content.
- 6.118 To put it another way, it would seem undesirable for Sky to be the only retailer of premium content across cable, satellite, IPTV and DTT, able to manage retailing across all these distribution technologies in a relatively unconstrained manner.
- 6.119 There are however additional reasons, which we explore in the following paragraphs.

Softening of retail efforts on platforms owned by competing operators

- 6.120 We believe that where Sky retails via other operators' platforms, it has an incentive to weaken its retail offering, in order to increase the likelihood of customers selecting to take up that content via its retail offer on its own platform. The reasons for this incentive are similar to the reasons described earlier in this chapter for Sky's preference to retail to its own customers rather than wholesaling to another operator.
- 6.121 Sky's probable absolute preference is likely to be retail via its own platform. However, there is still likely to be some incentive for Sky to sell to customers via others' platforms, particularly where there are consumers who are unable to use a satellite dish, whether for planning reasons or because they are rental tenants. Retailing via others' platforms potentially allows Sky the best of both worlds, in that it can drive some consumers to its own satellite platform, while charging a high price to those that would be unable to switch to satellite. Even if Sky would in principle be a more efficient retailer than the platform operator, which is a possibility we raised earlier in this chapter, it is likely that it has an incentive not to retail with maximum effectiveness, in the interests of encouraging consumers to its own platform.
- 6.122 The existence of this incentive is supported by the case of Tiscali. On Tiscali's IPTV platform, there is an arrangement between Sky and Tiscali which is akin to an agency set-up. Sky sets retail prices and determines how its Sky Sports and Movies product may be sold, and it pays Tiscali a fee in return for Tiscali providing transmission, retail service and billing.
- 6.123 A simple comparison of the pricing of Sky's product on DSat with its product on Tiscali is illuminating. Basic-only packages from Tiscali are cheaper, but particularly on packages including just one sports or movies channel, the package via Tiscali / Sky by Wire is considerably more expensive than that via Sky on satellite. The comparative prices are shown in the table below.

Figure 36 Summary of total package prices of bundles including Sky Sports and Sky Movies via Sky on satellite and Sky by Wire



Source: <http://packages.sky.com/buy/> and <http://www.tiscali.co.uk/products/tv/sky-by-wire.html>

Notes:

All prices include line rental and entry-level broadband; line rental via Sky costs £10 (in Sky LLU areas)

2007-08 prices correct at 6 August 2008; 2008- prices correct at 19 September 2008

- 6.124 It could perhaps be argued that all these comparisons would change if Tiscali's basic package were priced lower. However, it would appear that Tiscali's basic package is already keenly priced, including as it does broadband, line rental and some basic pay TV for £20. As the chart shows, despite Tiscali's entry-level offering being £7 cheaper than Sky's, all of the Tiscali / Sky by Wire bundles including premium content are at least as expensive, and in some cases significantly more expensive, than the equivalent Sky DSat bundles.
- 6.125 Although the headline price gap is smaller on mixes than on packages including single premium channels, the gap expands somewhat once quality is taken into account: no Sky by Wire package includes interactive services. Although it is unclear exactly how much value these add for consumers, and therefore how much of a difference this makes to the perceived quality of Sky by Wire, Sky must attach some value to interactive services or it would not offer them via its own platform.
- 6.126 For a keen sports or movie fan who is unable to use satellite or cable, leaving IPTV as the only option, Sky by Wire may be a viable alternative. However, for the

consumer who has that choice, it is very apparent that the DSat offer is more attractive.

- 6.127 This disparity between the attractiveness of Sky by Wire and Sky's products on satellite is borne out in subscriber numbers to Tiscali's platform. Of a total [X] Tiscali TV subscribers in June 2008, only [X]% take the Sky by Wire product¹⁷⁷. This compares to 65% of Sky DSat customers that take Sky Sports or Movies¹⁷⁸, and around [X]% of Virgin customers¹⁷⁹.

Owning the customer relationship

- 6.128 An additional potential problem with Sky being the retailer via another's platform is that by retailing its channels rather than wholesaling, Sky maintains the customer relationship and owns the customer data. While there may be restrictions on the use of those data during the course of Sky's relationship with the retailer / platform operator, those restrictions would typically cease to apply if Sky stopped retailing its channels over the platform. This could potentially put the platform operator at a disadvantage even in its basic business, as Sky would have an opportunity to try to migrate customers to its satellite platform in the event that it stopped retailing on the alternative platform.

Flexibility

- 6.129 If Sky retails premium sport and movies on another's platform, this deprives the platform operator of some of the pricing flexibility that Sky is able to take advantage of on its own DSat platform.
- 6.130 For example, on Tiscali's platform, Sky sets the retail prices for Sky Sports and Sky Movies. That prevents Tiscali from being able to set bundle prices as it chooses, in combination with other products or stand-alone. Tiscali's freedom to market the Sky by Wire product is also constrained by the nature of the agreement with Sky. The Sky by Wire price must always be quoted as a stand-alone add-on to Tiscali's basic offering. [X]:

"[X]".

Customer base-related barriers to entry to wholesale channel provider market

- 6.131 In our section on market power in wholesale channel provision markets, we set out our view that, because Sky is the leading retail outlet on the largest platform and third parties are unable to gain access to that outlet as efficiently, there is a barrier to entry. It is important for a wholesale channel provider to deal with the leading retailer on each platform. Since Sky's wholesale channel business is vertically integrated with its own leading retail presence, it benefits from improved access to the leading retailer on its own DSat platform.
- 6.132 Having a number of operators able to retail premium content, rather than one single retailer, increases the chances that more viable bidders may build up retail subscriber bases in premium content. This is likely to reduce the barriers to them being able to bid successfully for content at the wholesale channel provider level.

¹⁷⁷ From confidential information provided by Tiscali.

¹⁷⁸ http://media.corporate-ir.net/media_files/irol/10/104016/reports/Annual_Report_2008.pdf, page 8.

¹⁷⁹ [X] Virgin premium customers at end of June 2008, from information provided by Virgin; from Virgin Media's Q2 2008 results, 3,538,800 TV customers for the three months ending 30 June 2008.

This could reduce the extent of one of the barriers to entry that we identified in our market power assessment, thereby eroding market power to some extent. That market power is the foundation for the issues which cause us concern in pay TV.

Wholesale pricing of Core Premium channels

- 6.133 When a seller of a product is in a position of market power, it can potentially set prices above competitive levels. In the case of Core Premium channels, the situations of sport and movies are subtly different.
- In sports, as we explained when discussing content aggregation in our chapter on market power, there are different levels of aggregation taking place. In the first instance in the case of the primary important content we have identified, FAPL, the FAPL itself aggregates content through collective selling. Sky and Setanta then carry out further aggregation by assembling channels containing a number of different sporting events.
 - In movies, Sky aggregates content by purchasing rights from all six Major Hollywood Studios.
- 6.134 It is not always entirely clear who is likely to be the main beneficiary of the aggregation process. As we set out in the December Consultation, it is likely that many of the rents will flow upstream to where the aggregation takes place – although it is always difficult to distinguish monopoly rents from scarcity rents, such as the value placed on footballing talent.
- 6.135 As we explained, if there is a fully competitive market for the purchase of the FAPL rights then we would expect the aggregation benefits to flow entirely upstream to the FAPL itself. To the extent that there is insufficient competition between purchasers for the rights, then the purchasers may extract some of the rents. Indeed evidence from [X]. The benefits from aggregation of the FAPL rights are constrained to some extent at least by the European Commission’s remedy.
- 6.136 In the case of movies, Sky is likely to benefit from its role as aggregator and the fact that there appears to be less intense competition for the movie rights, but it is also likely that the Major Hollywood Studios can extract some of the benefit from aggregation in their individual negotiations with Sky. We have not directly assessed the balance of negotiating power between Sky and the Major Hollywood Studios.
- 6.137 In our December Consultation we attempted to carry out some analysis of the profitability of the whole of Sky, for want of useful information on the industry as a whole, as a way of attempting to establish whether consumers were suffering from high prices. That analysis was inconclusive. We revisit it in light of consultation responses in the next chapter.
- 6.138 In the following paragraphs we summarise our attempt to establish the profitability of the part of Sky’s business which wholesales premium channels, among them the Core Premium Channels that we identified as being where Sky has market power. Clearly the idea of “Sky’s wholesale premium channel business” is somewhat notional, as many of its sales are made to Sky’s own retail arm. However, we can identify a price – the Virgin Media wholesale rate-card – and can attempt to allocate relevant costs to this part of Sky.

Sky's wholesale margins

6.139 An outline of the analysis is attached to this document at Annex 9. In summary however:

- In order to assess wholesale margins, we consider a hypothetical business – PremiumChannelCo. Sky's retail DSat offering is assumed to be a separate retail business. PremiumChannelCo is assumed to purchase content, package it into channels and supply to wholesale customers, primarily Virgin Media and Sky Retail. It earns revenues from selling these products on the same wholesale ratecard to both Virgin Media and Sky Retail, from advertising, and from direct sales to commercial premises.
- We first calculate the gross margin earned by PremiumChannelCo. There are various difficulties with attempting to disaggregate different parts of Sky's business. However, our attempts to establish the gross margin for wholesaling premium sports channels suggest it lies between [X]% and [X]%. The wholesaling of premium movies channels, on the other hand, appears to generate a gross margin of between [X]% and [X]%. Details of these calculations are provided in Annex 9.
- We next consider how the gross margin might translate into an operating margin. Allocation issues become even more acute when trying to calculate an operating margin, due to problems with allocation of common costs. However, there are good reasons to believe that a wholesale premium channel business would be likely to have only modest overheads when compared to the direct costs associated with premium content acquisition.
- Sky has indicated to Ofcom the level of operating costs that it considers could reasonably be attributed to a business involved in the wholesale of premium content¹⁸⁰. Ofcom has not established the reasonableness or otherwise of that estimate, and therefore it must be used with caution. However, even using this estimate suggests that operating margins for PremiumChannelCo would be approximately [X]%. This is higher than both Sky's overall operating margin (15.2% in for the year to June 2008) and the operating margin it earns on pay TV (20.7%, according to its most recent results announcement).

6.140 There are so many uncertainties with establishing the level of capital in PremiumChannelCo that calculating a return on capital is not possible without a great deal of disaggregated cost data. In general, we would not expect this part of the business to be very capital-intensive, although there are complexities associated with the level of intangible assets, and their allocation to particular parts of Sky's business. Of the two types of channels, it is likely that movies is making a greater return for Sky than sports, given the differences in gross margins. This seems consistent with what we observe above about content aggregation and the likely destination of rents.

6.141 The margins in PremiumChannelCo need to be seen in the context of the whole business. If we were to establish that profitability for the whole of Sky were high, we might see that as evidence of a competition problem in one of the areas in which is Sky is active. Establishing strong margins in movies might lead us to believe that we had identified the main area where such a problem existed. If on the other hand, we were to establish that Sky was unlikely to be making excessive profits in aggregate,

¹⁸⁰ [X].

we would be somewhat less concerned about margins in movies. In the absence of excessive profits overall, variations in margins on different products would reflect a particular method of recovering overall costs, which might not be a cause for concern.

- 6.142 However, as we go on to explain in the following section, we did not find it possible in our December Consultation to come to either of those conclusions, as we found the assessment of overall profitability to be inconclusive. This remains the position, although we will continue to consider this question.

Consultation questions

14. Can retailers and / or platform operators get sufficient access to Sky's Core Premium channels?

15. Have we presented a factually correct picture of current distribution of premium sports and premium movie channels?

16. Do you agree with the list of factors we present as being relevant when Sky considers whether to supply?

17. Do you agree with our presentation of the longer-term factors in Sky's decisions to supply?

18. Do you agree with our discussion of the role of vertical integration?

19. Do you agree with the figures we have presented to illustrate the playing-out of incentives to supply?

20. Do you agree with our proposal that it is important for multiple operators to have wholesale access to Core Premium content, rather than Sky retailing on others' platforms?

21. Do you agree with our analysis of the profitability of Sky's wholesale premium business?

Section 7

Effects on consumers

Summary

- 7.1 As we set out above, we believe that competition in pay TV is likely to be weakened by restricted distribution of Core Premium channels. This results in a lack of choice for consumers, in terms of the content that is available on some platforms, and for some consumers in terms of the platforms that are available to them. Markets where competition is weak, and consumers are unable to exercise a real choice between suppliers, are unlikely to deliver the best outcomes for consumers. This might manifest itself in several ways.
- 7.2 Firstly, there is a risk that consumer choice and retail innovation will be reduced. The most obvious manifestation of reduced consumer choice is the restricted availability of Sky's premium content on other platforms. We discuss this issue from a competition perspective above, and acknowledge that in this context interpretation of the evidence is complex. From a consumer perspective however the issue is simple: consumers on a number of platforms are currently unable to access the most valuable sport and movie content, and this must be a source of concern.
- 7.3 Even where content is available on a platform, consumer choice may be restricted if that content is only made available via a limited range of content bundles. We do see evidence of this, in that although Sky does offer a wide range of content bundles, the pricing of these encourages consumers to trade up to a small number of 'big mixes'. This pricing structure can be explained in terms of bundling efficiencies, but it may also reflect Sky's commercial incentive to extract the maximum revenue from each subscriber, and the limited competitive constraint from other retailers.
- 7.4 By way of contrast, the entry of Setanta into the market has resulted in the availability of a wider range of entry-level offerings, from a variety of different retailers. These entry-level offerings include, for example, stand-alone premium packages, which eliminate the enforced buy-through which is a characteristic of all Sky's retail offerings. Such entry-level packages are however currently only available for that premium content to which Setanta holds the rights. We believe that consumers would benefit from a wider variety of entry-level packages being more widely available for other premium content. While we acknowledge the economic efficiencies associated with large bundles of different types of content, we believe that consumers would benefit from being able to choose whether they purchase stand-alone premium packages without an enforced buy-through.
- 7.5 Secondly, there is a risk that platform innovation will be reduced. We see some evidence of this, in that while the UK pay TV industry has a strong track record of innovations 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. Innovation in areas less well suited to the Sky platform's strengths might well have proceeded faster if wholesale premium content had been more widely available on other platforms.
- 7.6 As well as looking at consumers' current experience, it is vital to look ahead to the future, particularly given our principal duty under CA03 to further the interests of consumers, where appropriate by promoting competition. This is especially relevant to any discussion of platform innovation. We are at a point in the development of the

pay TV sector when new platforms using new distribution technologies, such as IPTV and mobile TV, could offer significant benefits to consumers. The types of innovation which these new platforms might deliver to consumers are of course difficult to predict qualitatively, and even more difficult to quantify. Our general expectation however, as noted above, is that they will offer consumers greater convenience and enhanced service flexibility, by allowing them to access content on demand, or when on the move. We see a real risk that the development of these new platforms could be held back by limited access to premium content, thereby denying consumers the associated benefits.

- 7.7 Finally, there is a risk that prices to consumers will be high, either because of Sky's ability to set high wholesale prices, or because of Sky's ability to leverage upstream market power into downstream retail markets and set high retail margins. We have been presented with a substantial body of evidence on this point, and have carried out our own analysis.
- 7.8 Our analysis of whether retail prices are high remains inconclusive, and this reflects the various practical difficulties associated with such an analysis, such as the lack of a marginal cost which could provide a benchmark for competitive prices. We continue to see difficulties with the sort of international price comparison work presented to us by the Four Parties. Similarly, we believe the difficulties we identified in our December Consultation with drawing conclusions about the market from Sky's overall financial performance still exist.
- 7.9 Nevertheless, in the absence of vigorous competition, we cannot be confident that prices are at the same level that would be delivered by a competitive market.

Introduction

- 7.10 In this section we assess the likely effects on consumers of the competition concerns we identified in the previous section.
- 7.11 We start by revisiting the criteria we established in December, and analysing consumers' current experience of pay TV. We look at price, choice, innovation and satisfaction in turn. As part of this, we review the evidence and analysis presented to us in consultation responses, as well as presenting further work that we have carried out since December.
- 7.12 We look forward to the possible future development of pay TV, in terms of competition and its benefits for consumers. We then review the likely effects of the competition issues we have identified.

The importance of competition

- 7.13 One of Ofcom's principal duties is "to further the interests of consumers in relevant markets, where appropriate by promoting competition". Strong competition is a vital tool for delivering good outcomes for consumers. The OFT, in its introductory document "Competing fairly"¹⁸¹, sets out why by stating that:

"Open and vigorous competition is good for consumers because it results in lower prices, new products of a better quality and more choice. It is also good for fair-dealing businesses, which flourish when markets are competitive".

¹⁸¹ http://www.ofcom.gov.uk/shared_ofcom/business_leaflets/ca98_mini_guides/oft447.pdf

- 7.14 The benefits of stronger competition are often difficult to quantify. Some of those benefits are somewhat intangible, such as “new products of a better quality” or “more choice”, which the OFT cites. Even the degree to which competition can lower prices can be difficult to assess, because it is not possible to establish a counterfactual against which to judge the current situation, either in the UK or elsewhere in the world. Where we see competition as weaker than it could be, we find ourselves trying to compare the tangible situation that exists in reality with an alternative world where competition is stronger.
- 7.15 Competition is likely to be particularly important where a market is moving from a market expansion phase to a phase of greater consolidation. Even where competition between firms is weak, it is possible that as a market expands, consumers will see many benefits from innovation, for example, as firms attempt to attract new customers into the market. However, as the market saturates and it becomes impossible to attract new consumers to the market at such a high rate, firms are likely to become more concerned with maximising returns from their existing customers. This is of relevance in pay TV because recent years have seen strong growth in the multi-channel pay and FTA markets. It is likely that as the total number of consumers with multi-channel TV services reaches 100% of households, pay TV retailers will become less able to attract new customers, and will have to focus to a greater extent on making the most of their existing subscriber bases.
- 7.16 However, although we may not always be able to predict exactly what the benefits might be, to the extent that benefits can be quantified, we should attempt to do so.

The current situation

- 7.17 The current situation, as laid out in the December Consultation, is one where pay TV has appeared to serve consumers reasonably well. However, there are also concerns in many of the measures of the consumer experience.
- 7.18 In section 2 we discussed our criteria for assessing the pay TV market. We have amended them slightly since the December Consultation, resulting in an updated set of criteria as follows:
- **Choice of platform and content:**
 - Choice for consumers of platform, and of content once platform selection is made.
 - Switching between retailers and platforms should not be artificially difficult.
 - Generation and availability of a broad range of high-quality content: a variety of content should continue to be generated and made available to consumers on all platforms.
 - **Innovation:**
 - In platform services, for example in terms of interactivity, set-top box functionality such as DVR capabilities, or video on demand options.
 - In retail service bundling, packaging and pricing.
 - **Pay TV services priced competitively and efficiently:**

- Prices which give consumers good value and allow efficient producers to earn a reasonable return on their investment.
- A sufficient variety of price points / bundles to allow consumers to tailor their purchases to meet their preferences.

7.19 We revisit our assessment against each of these criteria here, as well as providing a summary of overall satisfaction measurements.

Choice of platform and content

7.20 We said in our December Consultation that levels of choice of content compared well to other countries. However, we also observed that some channels, particularly premium channels and some basic channels, were unavailable on some platforms, and that the actual level of choice available to some consumers might therefore be lower, depending on which platforms they had access to.

7.21 We also observed that just under half of consumers had a choice between the established cable and satellite platforms, that three quarters of the population could gain access to pay DTT, and that an increasing number of consumers could also now gain access to IPTV-based pay TV services. However, this still left some consumers without any actual choice of platform.

Respondents' views

7.22 Sky believed Ofcom should assess whether the pay TV sector is functioning well for consumers against penetration levels, and cites a report provided to it by PwC (the "PwC report") and submitted as part of Sky's consultation response. PwC studied the UK's pay TV sector in light of 14 other European markets. Sky has interpreted the results of PwC's study as demonstrating that the UK's pay TV market is delivering positive outcomes for consumers.

7.23 In particular, Sky highlighted the high levels of digital pay TV penetration as indicating the health of the UK's pay TV market. Sky also evaluated the UK strongly in terms of choice and innovation, based respectively on the number of channels available and the introduction date / penetration of various devices and services, such as DVRs.

7.24 Sky considered that content choice is what matters most to consumers, rather than which platform they watch that content on. In commenting on levels of platform choice Sky believed that Ofcom has given little consideration to significant future platform developments (e.g. the growth in IPTV networks), internet to the TV, the launch of BBC Freesat, and the effect of digital switchover, which will result in DTT coverage being extended to 98.5% of the population.

7.25 Sky suggested Ofcom has understated content choice in the UK and emphasised the availability of content on all platforms. In Sky's view any assessment of content on different platforms should give due consideration to the effects of closed platforms, capacity constraints, and the impact of regulatory restrictions. It believes that consumers are served very well in terms of content and choice both in terms of range of channels, and quality of programming carried on those channels.

7.26 Sky argued that Ofcom should consider the number of packaging structures available to consumers. It stated that there are 1,764 different bundle combinations of its basic

pay TV and premium channels mixes available, and that Sky does not require a customer to buy a large basic TV package in order to access premium channels.

- 7.27 Virgin Media highlighted the lack of choice of suppliers of premium content for customers outside cable areas. Other confidential respondents also highlighted geographic limitations: less than 50% of UK customers can choose between satellite and cable, there is limited access to premium content on DTT, and only 15% of households have access to IPTV.
- 7.28 The ALMR (Association of Licensed Multiple Retailers) pointed out that there is no choice available for commercial customers as premium sports content is exclusively available through one platform and one retailer. It identified that it is not possible to source Setanta via a route other than Sky.

Ofcom's current view

- 7.29 Ofcom has reviewed the PwC report alongside other evidence – in particular work carried out for us on the international context by Spectrum Value Partners for the December Consultation. While we have identified some gaps in the range of measures used, we broadly agree that pay TV penetration in the UK is relatively high compared to other European markets, although it is lower than in the US. However, the relatively high level of penetration in itself is not sufficient to assume that the competitive conditions in the market are working such that there is no consumer detriment. In Ofcom's view it is necessary to look at the choice of content and platform, as well as penetration, in order to assess whether the market is working well for consumers.
- 7.30 With regards to choice of content, Ofcom recognises that Sky offers a large amount of content and a large number of combinations of content aggregated into packages. However, Ofcom has identified that the PwC methodology on choice has only taken into account those packages that are modelled on a variant of buy-through, and has not included a la carte and PPV models that are not directly comparable to the way content is packaged in the UK market.
- 7.31 We would highlight the particular importance of choice between different platforms and retailers. The range of packages and channels offered by one operator on a given platform represents one level of choice, but this is a choice that is constrained by the commercial strategy of that operator. We place particular importance on consumers being able to choose between the different types of offers from different operators, all providing diverse platform characteristics. One of the criteria we have set out for assessing the pay TV market was the existence of a choice of content available across all platforms. Put another way, we see it as beneficial for consumers' choice of premium content not to be unduly restricted by their platform choice.
- 7.32 In this context, the most obvious manifestation of reduced consumer choice is the restricted availability of Sky's premium content on other platforms. We discuss this issue from a competition perspective in section 6 above, and acknowledge that in this context interpretation of the evidence is complex. From a consumer perspective however the issue is simple: consumers on a number of platforms are currently unable to access the most valuable sport and movie content, and this must be a source of concern.
- 7.33 Even where content is available on a platform, consumer choice may be restricted if that content is only made available via a limited range of content bundles. We do see

evidence of this, in that although Sky does offer a wide range of content bundles, the pricing of these encourages consumers to trade up to a small number of ‘big mixes’. This pricing structure can be explained in terms of bundling efficiencies, but it may also reflect Sky’s commercial incentive to extract the maximum revenue from each subscriber, and the limited competitive constraint from other retailers. By way of contrast, the entry of Setanta into the market has resulted in the availability of a wider range of entry-level offerings, from a variety of different retailers.

- 7.34 These entry-level offerings include, for example, stand-alone premium packages, which eliminate the enforced buy-through which is a characteristic of all Sky’s retail offerings. Such entry-level packages are however currently only available for that premium content to which Setanta holds the rights. We believe that consumers would benefit from a wider variety of entry-level packages being more widely available for other premium content. Additionally, while we acknowledge the economic efficiencies associated with large bundles of different types of content, we believe that consumers should be able to choose whether to purchase stand-alone premium packages without an enforced buy-through.

Innovation

- 7.35 Strong innovation is one of the positive effects we would expect to see from vigorous competition. This is particularly the case in a market in which technological change plays a strong role, such as in pay TV.
- 7.36 We would point to two major types of innovation:
- **Platform enhancements:** first, there is the type of innovation that is enabled by new technology, such as new equipment or new features of existing equipment. This is the type of innovation that tends to come to mind most obviously in the context of pay TV.
 - **Retail packaging innovation:** innovation can also take the form of new types of services, new ways of packaging or pricing existing services, or bundling different services together.
- 7.37 We said in December that innovation in UK pay TV seemed to offer benefits for consumers, noting in particular such products and services as DVRs, HD and interactivity.

Respondents’ views

- 7.38 Sky criticised Ofcom for not including any analysis of the benefit of innovations, or the impact of innovations, on the development of pay TV. It believes the UK and Sky, in particular, are innovation leaders and that the PwC report supports a conclusion that UK innovation levels are high, and deliver significant benefits to consumers. The PwC report proposed an innovation index based on the introduction and current take up of digital TV, DVRs, and HD.
- 7.39 BT acknowledged that there has been a degree of platform innovation, but claims that there has been little innovation in content packages, particularly in premium content, and suggests one reason for this is the sale of rights on a cross-platform basis.
- 7.40 Other confidential respondents suggested that Ofcom should consider whether more innovation would have occurred if the market had been more competitive; whether all

operators are able to innovate, vertically integrated or not; and, whether there is a risk that further consolidation could decrease future levels of innovation. There is a belief amongst some respondents that the dominance, or further dominance, of one operator could stifle innovation; that Ofcom should look more critically at the role of vertically integrated platform operators and Sky in particular, in driving, enabling or obstructing innovation.

- 7.41 Another confidential respondent argued that the UK television industry might have seen greater levels of competition had rivals been able to offer equivalent content packages or had equivalent access to platform services; and, that innovation is driven most aggressively by new entrants with no legacy business models to protect. In its view Sky has innovated only in a self-serving way to protect its existing market position and innovates only on its own terms.
- 7.42 The ALMR stressed that the development of HD services and PPV are important for its members; it currently sees no appetite at the wholesale or retail level to offer PPV for premium sporting events.

Ofcom's current view

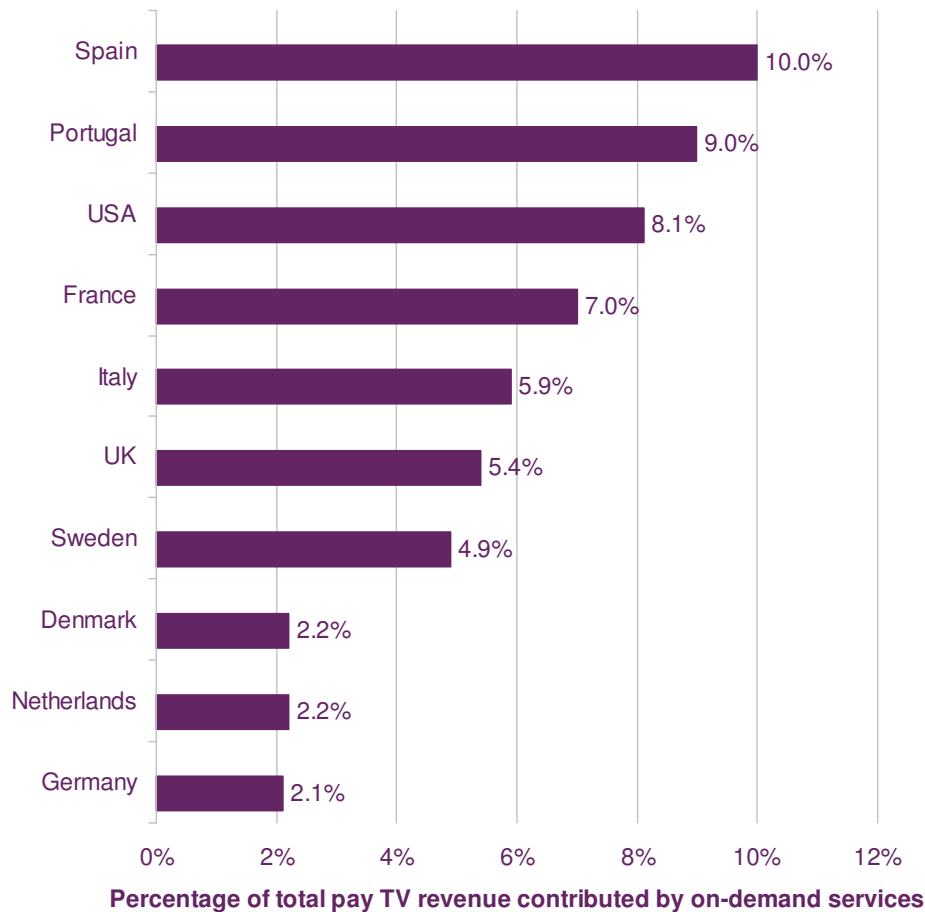
- 7.43 As described above, we would divide the broad heading of innovation into two types: one which relates to platform enhancements, and another which relates to retail packages.

Innovation in platform enhancements

- 7.44 On platform enhancements, the record of innovation in the UK is fairly strong, particularly on Sky's satellite platform, an aspect of the market that has been stressed by Sky in particular. Although innovations such as DVRs have taken a strong hold in the UK, there are other areas where the UK's record is not as positive.
- 7.45 What is noticeable overall about the PwC index is that the types of innovation that it includes are those that are well suited to satellite: HD, which can take advantage of satellite's large capacity; digital TV itself; and DVRs, which allow satellite to get round the difficulties of offering VoD services by offering near VoD services via hard disk storage on the DVR.
- 7.46 On these measures, Sky has indeed performed strongly, and we would emphasise again that we are fully aware of the role it has played in advancing those innovations. It was the first to convert its customer base fully to digital; it owns the platform with the strongest HD offer; and it was the first pay TV retailer to embrace DVRs, brand them successfully and roll them out to a wide audience in a way that has meant they are now a major part of how UK consumers watch TV.
- 7.47 In contrast, we have seen much less strong development in the UK of the kinds of platform enhancements that are better suited to non-satellite platforms – especially those interactive services which play to the strengths of IPTV and cable networks. This is unsurprising, since Sky has had little incentive to develop such services, and other platforms have lacked effective access to the content necessary to exploit such services. Video on demand services are excluded from PwC's innovation index, an omission which significantly reduces its value. Some other markets appear to be leading the UK in the development of VoD services, as illustrated for example by the availability over ComCast's US cable network of its day-and-date service. In early 2007, Ovum put the US as representing almost 80% of total VoD revenue, with Western Europe at 15% but forecast to grow much more slowly than China / India

and Asia-Pacific to 2010¹⁸². Further, as the figure below shows, according to Screen Digest the UK lags behind Spain, the US, France and to a lesser extent Italy in the proportion of pay TV revenues coming from on-demand services.

Figure 37 On-demand revenue as a proportion of total pay TV revenue in the top 10 Western European / US pay TV markets



Source: Screen Digest

Notes:

Total pay TV revenue includes linear subscription and on-demand revenues.

On-demand revenues include the following services: transactional nVoD (including PPV sports), transaction true VoD, subscription on-demand, VoD access fees (where applicable), sports season tickets and DVR subscriptions.

Innovation in retail packaging

7.48 Sky rightly stressed the important role it has played in advancing platform enhancement innovations. However, we would argue that the record of the UK pay TV industry has been less strong in relation to retail packaging innovation, particularly in relation to premium content – an aspect of innovation which was

¹⁸² Journal of the Communications Network, Volume 6 Part 1, January-March 2007.

excluded from PwC's innovation index. One example of this is the continued prevalence of enforced buy-through, at least as far as Sky's Core Premium channels are concerned, which was one of the concerns we identified in our December Consultation.

7.49 Over the last few years, access to premium content has followed a standard pattern in the UK: a subscription package, only available as part of a buy-through, at a regular monthly price. While a wide range of bundles do indeed appear to be available, they are priced in such a way as to encourage consumers to concentrate on a small number of larger bundles. This is reflected in subscriber numbers: [X]% of Sky subscribers taking basic only take [X]; of all the package combinations, [X] as many people ([X]% of total Sky subscribers) take [X] as the next biggest combination (which is [X] at [X]% of the total)¹⁸³. There have been a small number of exceptions to these relatively similar offerings, such as Sky's Prem Plus offer, as well as PPV movies from various operators.

7.50 The entry of Setanta into the market has seen some significant innovation in retail packaging.

- First, subscription premium sports channels are available on a stand-alone basis for the first time, eliminating enforced buy-through from that premium content controlled by Setanta.
- Second, premium channels have for the first time been available as part of a 'basic' offer – Setanta's channels are available at no extra charge to subscribers to Virgin Media's 'XL' package. This is a significant departure from the standard model of premium sports channel subscription.
- Thirdly, and as yet untested, Setanta and Top Up TV have recently announced that consumers can obtain "free" access to Setanta's live FAPL matches for an entire football season when they purchase a Top Up TV PVR and sign up to a trial of Top Up TV's Anytime service¹⁸⁴.

7.51 The availability of Setanta's channels on a stand-alone basis is relevant to the concern we expressed in our December Consultation on buy-through. We considered whether the practice of buy-through, whereby consumers are required to buy a basic package before they can buy a premium package, could restrict competition in the provision of basic retail services. We noted that buy-through may be a perfectly rational strategy for a retail provider, but that it may also have an exclusionary effect.

7.52 There was a range of views on this in response to our consultation:

- BT suggested in response to this that buy-through allows Sky to use its market power in premium content to its advantage in basic-only (also deriving market power in basic because of this), which may allow it to set prices above the competitive level for basic pay TV.
- Various channel providers presented arguments in favour of the retention of buy-through, on the basis that its removal would threaten the existence of some channels, reducing choice for consumers. The BBC agreed that buy-through can have efficiency benefits, but it also stated that care must be taken to assess the

¹⁸³ Data based on Sky's confidential 13 June 2008 response to an Ofcom information request. Data are for the month of May 2008.

¹⁸⁴ <http://www.digitalspy.co.uk/digitaltv/a118941/free-setanta-for-new-top-up-customers.html>

true effects of this practice, as it could encourage inefficient entry of basic channels.

- Sky pointed to buy-through being prevalent in most countries, and specifically to the fact that buy-through exists to some extent in all 15 countries of PwC's survey, with varying degrees of buy-through obligation. Sky believed consumers are satisfied and that buy-through may benefit consumers. Further, Ofcom should not assume that consumers should have unlimited choice and says Sky's packages provide consumers with a manageable menu. In Sky's view most consumers are happy with their service, suggesting needs are being met.

7.53 In fact, European operators are increasingly launching services which differ from the traditional pay TV buy-through-only model – a fact which was not fully reflected in PwC's report for Sky. Examples of this are set out below:

- “Pay TV light” – premium content is available in a small single package offer (e.g. Mediaset Premium Gallery in Italy)
- “A la carte premium” – premium content and channels are available on an a la carte or PPV basis (e.g. Cartapiu in Italy)
- “A la carte basic” – Basic channels and content are available on an a la carte or PPV basis (e.g. Premiere Flex in Germany)

7.54 We agree that buy-through may indeed be an efficient way of pricing basic and premium. However, unless the incremental costs of basic content are zero, there is still likely to be some difference between the optimal price of a stand-alone premium package and that of a bundle of premium and basic content. We believe that consumers should be able to choose, based on this price difference, the retail product that best serves their needs. The current situation, in which most current pay TV consumers are denied this choice, cannot be regarded as being good from a consumer perspective.

7.55 We see some likely benefit in a stand-alone premium package being available alongside the basic / premium bundle, as is now the case for the premium content controlled by Setanta.

Pay TV services priced competitively and efficiently

7.56 We would be concerned about consumer detriment if we established that the prices that consumers were paying were substantially and consistently above the competitive level.

7.57 Establishing the ‘competitive level’ for content-based products such as TV packages, for which the marginal cost may be low or zero, is particularly difficult. That is why we look at international price comparisons in an attempt to establish a benchmark for whether UK prices are high. Additionally, we can attempt to assess the profitability of firms in the market to see whether high prices are being revealed in significant margins.

7.58 As we will demonstrate, however, despite considerable amounts of work carried out by ourselves, and by the Four Parties and Sky, we do not believe that we are in a position to draw strong conclusions from either type of analysis.

- 7.59 Where we find it difficult to be conclusive from analysing actual price levels in the market, we would want to be confident that competition is sufficiently vigorous that there is downward pressure on prices.
- 7.60 As we set out in the December Consultation, we find it difficult to feel that confidence in the context of Sky's Core Premium channels. The contrast with Setanta's channels is again instructive. Setanta's channels are available via three different retailers on DTT – Setanta itself, BT Vision and Top Up TV, with a variety of package types – via Virgin Media on cable, via Tiscali on IPTV, and via Setanta itself through Sky's satellite platform. In other words, Setanta's channels are available via a wide variety of retailers (and platforms).
- 7.61 In contrast, retail competition in Sky's Core Premium channels is much more modest: they are available through only two mainstream retailers – Sky itself on its own platform and in the form of Sky by Wire on Tiscali's platform, and via Virgin Media on cable. Even that modest level of competition may be compromised by higher levels of switching costs between retailers on satellite and cable, and the somewhat limited commercial incentives Virgin Media faces to sell Sky's premium channels.
- 7.62 The contrasting levels of retail competition mean that we do not feel confident that competition is sufficiently rigorous to put downward pressure on Sky's retail prices.

International price comparisons

- 7.63 We have been provided with a great deal of evidence on international price comparisons, both by the Four Parties, supported by LECG, and by Sky, supported by PwC. Such evidence is always hard to interpret. Differences between countries mean that comparing a price in one country with a price in another country is fraught with difficulties. Such differences can take many forms:
- Historical: differences in the development of markets.
 - Political: these influences are particularly relevant as broadcasting tends to have attracted considerable attention from governments, such as in the form of public service broadcasting.
 - Preferences: different nationalities may have very varying preferences for content, for example for one sport over another.
 - Socio-demographic.
- 7.64 In their July Submission the Four Parties, supported by LECG, argued that competition in pay TV was not functioning effectively, and that prices in the UK were high compared to other countries. Sky provided a response to this analysis, supported by CRA, in October 2007.
- 7.65 We reviewed the original analysis, alongside Sky's October response, in the December Consultation. We were supported by Professor Andrew Chesher in carrying out our analysis. We concluded that there were problems with both the base data used by LECG and the analysis, which together meant that the data provided did not support the arguments the Four Parties had made.
- 7.66 In February 2008 the Four Parties / LECG provided a response to Sky's October response. Further to this, in April 2008, Sky / CRA provided further information on this matter as part of Sky's response to the December Consultation.

- 7.67 Also in its consultation response Sky argued that any assessment of pricing should take into account profitability, plus high levels of consumer satisfaction and high levels of digital pay TV penetration. Sky suggested there was an inconsistency between Ofcom's assessment that there is no evidence of excessive pricing, and references to the possibility that prices may be above the competitive levels. It believed that the LECG report, which was criticised by Sky previously in its October 2007 submission to Ofcom, and critiqued by Professor Chesher in the consultation document, is flawed and should not be taken as indicative evidence that UK prices are high compared to other countries.
- 7.68 At the beginning of July 2008, Sky / CRA provided a further rebuttal of the analysis presented by LECG in February.
- 7.69 Our further review of the analysis in light of both LECG's and CRA's responses on the subject since December, has not significantly changed our view: that the analysis provided by LECG does not support the conclusions drawn. In particular:
- Data definition issues, particularly regarding the measurement of service and programme quality, continue to hinder interpretation of the LECG results. Additional submissions provided by the Four Parties do not remove concerns in this area.
 - In a mature market with a long history of pay TV provision, demand for high-quality high-cost programming may develop. Where large firms operate it may be economic to satisfy that demand. A relationship between an average price of the sort calculated by LECG and a market share variable may arise but without there necessarily being any consumer harm. The case for consumer harm would be stronger if there were evidence for higher prices in the UK relative to other countries for TV packages of similar quality.
 - It remains the case that much of the variation in important explanatory variables is at the country level. The data comes from a relatively small number of countries across which there are many differences not captured in the explanatory variables employed. The interpretation placed on the results by LECG is one of many that could be advanced and it is not safe to conclude, as LECG proposes, that differences in retail pay TV prices are "due in large part to certain differences in market structure".
- 7.70 Sky also argued in its consultation response that the PwC report demonstrated that Ofcom should not have any concerns about prices in the UK being high relative to other countries. Sky argued that unlike LECG, the PwC methodology had compared services that are actually provided on a like-for-like basis.
- 7.71 However, the PwC report provides only a partial comparison of prices with other countries as it does not cover lower priced entry packages from DTT providers, for example. In some markets prices can in fact be seen to be much lower – such as Italy (Mediaset), Germany (Premiere Flex), and Sweden (Boxer).

Aggregate profitability analysis

- 7.72 Further detail on this analysis is provided at Annex 9 to this document.
- 7.73 In our December Consultation, we also reviewed information on the profitability of Sky. We would have preferred to review the profitability of all the players in the market, but Sky was the only player in the market whose published accounts were

primarily relevant to UK pay TV. We found that it would be possible to conclude that Sky's profits were high for certain periods, although they did not appear to be high for other periods. Overall, it was difficult to be definitive as to whether Sky had made excessive profits, particularly due to problems determining the appropriate asset base for a business so light on tangible assets.

- 7.74 Sky noted that Ofcom's analysis only looked at Sky's profitability, rather than the industry in general, and stated that pricing at both the wholesale and retail level is broadly reflective of underlying input cost.
- 7.75 In their joint response to Ofcom, Setanta / Top Up TV considered that Ofcom's financial analysis and assessment of Sky's profitability was cursory and insufficient. They argued that total shareholder returns (TSR) is not an appropriate measure for assessing a company's financial strength in the context of a competition inquiry and pointed out that the OFT advocates the use of Internal Rate of Return (IRR) as a profitability measure. Further to this, they stated that the truncated IRR methodology advocated by the OFT discloses an IRR for Sky of approximately 40% over the financial years 2003 to 2007. They argued that Sky's operating margin, profitability per subscriber, return on capital employed (ROCE) and return on equity (ROE) are also all substantially higher than those of comparable companies.
- 7.76 Virgin Media suggested that fluctuating profitability levels may reflect investment to protect Sky's dominant position in the longer term. Similarly Tiscali in its response suggested that Sky's profits are currently being invested in growth and excessive profits will follow later.
- 7.77 Ofcom has continued to review its analysis of Sky's aggregate pay TV profitability, and in particular has continued to probe the possibility of carrying out an IRR analysis. However, the concerns that we expressed in our December Consultation remain valid. We also consider these concerns to be entirely consistent with the paper on profitability written by Oxera for the OFT¹⁸⁵. Ofcom believes there is considerable uncertainty relating to some estimates utilised in the IRR calculations provided by respondents and that adjusting these estimates leads to significantly different potential views of Sky's profitability.
- The OFT / Oxera paper highlights that "to the extent that disaggregated data is poor and the cost- and revenue-allocation exercise is difficult... the resulting cash flow data may be poor". We believe this issue to exist in Sky's case, with several of its activities not relating to its UK pay TV business (broadband, for example).
 - The paper states that "where MEA [modern equivalent asset] values are difficult to determine, it will also be difficult to obtain a robust and meaningful estimate of the IRR". It also says that "typical sectors where this may be the case include those characterised by rapid technological change, such as information technology. Sectors with high levels of intangible assets, relative to fixed assets, that are difficult to value could also fall into this category". It seems likely that both of these situations are applicable to Sky.
- 7.78 The OFT / Oxera paper suggests that a next step for a competition authority which considers that a meaningful estimate of the IRR is difficult to obtain is to consider "ROS, gross margins and market valuations". The analysis of aggregate profitability that we carried out for our December Consultation used market valuations. The use

¹⁸⁵ "Assessing profitability in competition policy analysis", http://www.of.gov.uk/shared_of/reports/comp_policy/oft657.pdf.

of comparative profitability assessments based on return on sales (ROS) or gross margin analysis is unlikely to yield a robust result due to differences in making comparisons with similar companies, not least because of the issues set out above regarding the difficulty of making international comparisons. We have, however, carried out an initial analysis of gross margins of the premium channel wholesaling part of Sky's business for this document, as set out in section 6 and Annex 9.

7.79 We remain of the view that:

- Sky is the only pay TV company for which we can obtain meaningful data specifically on the financial performance of its pay TV business.
- It is not possible to draw strong conclusions from a review of Sky's financial performance, due to ambiguities primarily relating to cost and revenue allocation, time periods, and asset valuations.

Satisfaction

7.80 We found in December that levels of customer satisfaction with multi-channel TV were fairly high, with slightly higher levels of satisfaction for Sky than for Virgin Media. We expressed caution about using such satisfaction data, due to the difficulty of establishing a suitable benchmark, and the fact that only those that already participate in the market can express a view.

Respondents' views

7.81 Sky's view is that high levels of consumer satisfaction constitute prima facie evidence that the sector is working well for consumers and disagrees with Ofcom that evidence on consumer satisfaction levels is hard to interpret. Sky argues that further analysis of Ofcom's research shows that multi-channel TV performed similarly against other communications services on the ease of making quality service comparisons.

7.82 Other respondents did agree with Ofcom's view that evidence on consumer satisfaction is hard to interpret, and there were calls from other pay TV retailers for further research. Virgin Media suggested an alternative review of consumer harm which analyses what the consumer experience would be, absent the market features that have been identified. BT called on Ofcom to conduct further research with consumers who take pay TV on DTT in addition to Freeview, Sky and cable, suggesting that consumers to these newer platforms (BT Vision, Top Up TV) may be experiencing greater consumer detriment than those on other platforms. BT also pointed out that the consumer research did not include the views of the large percentage of the population who do not currently subscribe to pay TV services.

Ofcom's current view

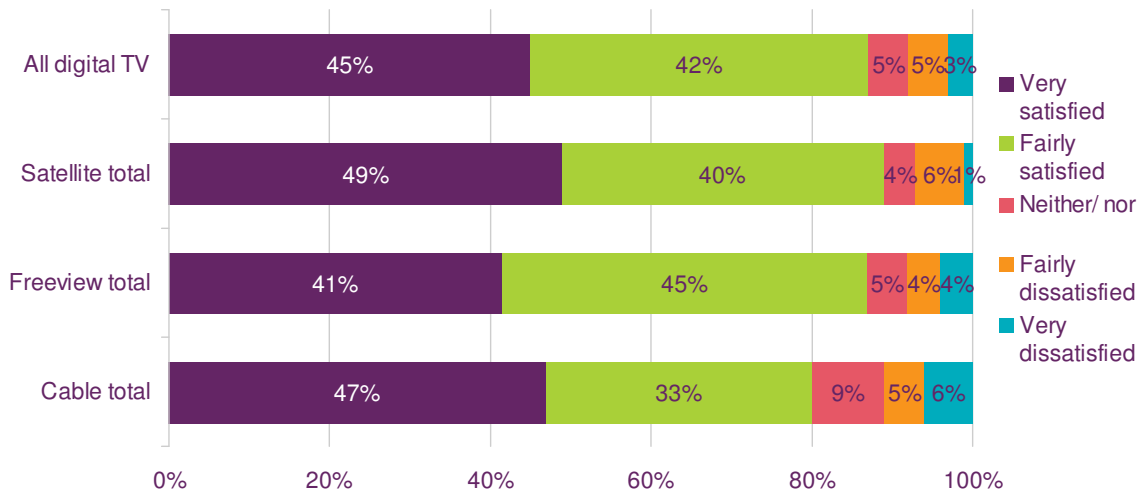
7.83 On consumer satisfaction, we placed a caveat on the relatively high levels of satisfaction expressed by consumers, and that caveat continues to hold. While many of those expressing a view in response to Ofcom consumer research questions professed themselves satisfied, the questions only pick up those people who actually take pay TV services already. For this to be a problem, we would have to believe one of two things:

- That prices were too high, and that consumers were therefore being excluded.

- That the choice of package combinations was insufficient to allow certain customers to purchase a package that reflected their willingness to pay.
- 7.84 The first could be the case if retail prices are above competitive levels. As we have explained above, the aggregation of premium content suggests that this may be the case, even if it is not clear whether Sky itself earns excessive profits. The second could be true if there were consumers that were keen to purchase stand-alone premium products from Sky, but were not willing to pay the extra required for them to take the buy-through basic / premium combination.
- 7.85 In their submission of August 2008, the Four Parties referred to a survey carried out by YouGov for USwitch which aimed to understand consumers' satisfaction levels with pay TV¹⁸⁶. This showed lower satisfaction levels than were indicated by the data we published in our December Consultation. Although overall satisfaction with Sky was 76%, value for money was rated at 57%. Equivalent figures for Virgin Media were 68% and 66%. Both companies scored only 59% on customer service.
- 7.86 There are differences in research methodology between the data provided in our December Consultation and in the USwitch survey. Most importantly, the USwitch survey used an online panel, whereas our survey results were collected face-to-face. Results from face-to-face and online surveys can be very different, as the sampling can vary significantly between the two.
- 7.87 We have since carried out an updated survey to gather similar data. The results of this (see the two charts below) show that overall satisfaction is highest for satellite customers, but that satisfaction with value for money is much lower, with only 26% of satellite customers professing themselves "very satisfied" with value for money. On satellite and cable, 21% and 24% respectively say they are "fairly dissatisfied" or "very dissatisfied" with value for money. Unsurprisingly, satisfaction with value for money is much higher for the service with no monthly subscription – Freeview. We should be generally wary when looking at value for money figures in relation to TV broadcasting, since consumers' attitudes have been informed by a history of receiving TV services free at the point of use, funded by public subsidy.
- 7.88 These figures compare with combined "very" / "fairly" satisfied figures for mobile telephone services of 94%, and satisfaction with value for money of 89% (48% very, 41% fairly satisfied).

¹⁸⁶ <http://www.netimperative.com/news/2008/may/12/digital-tv-2018disappointing2019-customers>

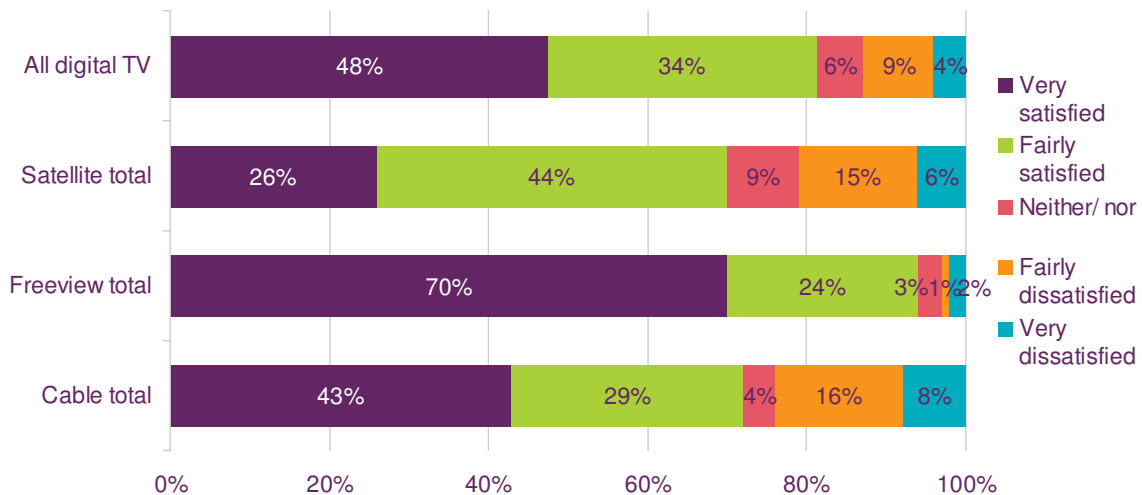
Figure 38 Overall satisfaction with TV services



Source: Ofcom Decision Making Survey 2008

Base: All adults who are decision makers for digital TV, not in a bundle of services, who expressed an opinion (891), with satellite (435), with Freeview (401), with cable (55) – low base size for cable.

Figure 39 Satisfaction with value for money of TV services



Source: Ofcom Decision Making Survey 2008

Base: All adults who are decision makers for digital TV, not in a bundle of services who expressed an opinion (876), with satellite (432), with Freeview (390), with cable (54) – low base size for cable.

A forward look

7.89 The first ten years of the pay TV industry’s existence in the UK were characterised by a simple choice for consumers between satellite and cable, or for the 50% of households in non-cabled areas, between satellite and nothing at all.

7.90 Recent years have seen the emergence of new distribution technologies, in particular in the form of IPTV and DTT, and also potentially mobile TV. These new technologies offer the possibility of new pay TV platforms emerging, as indeed they have started to in the form of Tiscali, Top Up TV and BT Vision.

- 7.91 New platforms offer the possibility of greater choice for consumers. In particular, pay DTT could offer the possibility of a second, near-ubiquitous pay TV option to rival satellite in a way that cable has not done, albeit with a somewhat limited range of channels due to capacity constraints. DTT offers particular advantages for the short- to medium-term expansion of pay TV and diversification of available services, because of the large installed base of terrestrial consumers. This stems from the fact that a large proportion of UK households already have much of the requisite hardware in place – namely a TV aerial.
- 7.92 In the longer term it seems possible that other technologies may become better suited than DTT to providing sophisticated pay TV services. As HD services become more widespread, and particularly if HD becomes the de facto consumer standard, capacity constraints on DTT will bite sooner.
- 7.93 In the near to medium term, hybrid IPTV / DTT models offer the prospect of making use of DTT's ubiquity with the ability of IPTV to provide interactivity and widespread on-demand services.
- 7.94 The prospect of full IPTV services taking over from more established technologies may be somewhat farther off. Widespread availability of IPTV depends on significant infrastructure investment, particularly in more rural areas or in areas which are distant from the exchange. However, the development of IPTV will be assisted by the roll-out of next generation access (NGA). IPTV is already present in the market in the shape of Tiscali's TV / broadband / voice bundles. IPTV-based models have made quicker progress in some other markets. In particular, France has seen IPTV being much more successful, with 2.5 million subscribers in 2007.
- 7.95 The emergence of new distribution technologies, and new platforms using those distribution technologies, offers significant potential benefits to consumers.
- First, it offers the possibility of more platform operators entering the market, increasing competition and giving consumers more choice of platform, particularly for those consumers that have been used to having a single option for pay TV, in the form of satellite.
 - New platforms offer potentially attractive generic features to consumers, such as the ability to get pay TV without any additional cabling to their home or the addition of a satellite dish.
 - Mobile TV offers the possibility of a new way of watching TV, with consumers no longer restricted to watching live sport, for example, from their home or in pubs.
 - Subject to attractive content being available, some of the newer technologies offer the prospect of more widespread on-demand services and more highly developed interactive propositions.

Effects of competition issues

- 7.96 The attractive picture we presented in the preceding paragraphs, where several retailers have access to premium content, and different platforms thrive as a result, is likely to be endangered if Core Premium channels are not more widely available than is currently the case.
- 7.97 As we explained in chapter 3, we see premium content as being an important enabling factor for competition in pay TV. Enhanced access to premium content

would allow for a strengthening of competition in pay TV. As we explained above, competition is one of the main drivers behind consumers benefiting from a market. The benefits of competition could take many forms, such as in terms of innovation, choice and efficiency.

- 7.98 Sky stated in its consultation response that the concerns we expressed in our December Consultation were purely hypothetical. We would acknowledge that our concerns are to some extent forward-looking and somewhat hypothetical. However, this is an inevitable consequence of many of the difficulties we set out earlier in this chapter about the benefits of competition being difficult to quantify, the lack of a benchmark competitive market, and the effects of technological change.

Innovation

- 7.99 One of the most important, but hardest to quantify, types of detriment to consumers resulting from lack of widespread access to content relates to innovation. Lack of access to premium content reduces the likelihood that new platforms will emerge successfully and be able to compete effectively with existing platforms. This reduces the potential for consumers to obtain the potential benefits offered by those platforms, except to the extent that those platforms are pursued by the incumbent owner of premium content.
- 7.100 As well as potentially restricting the development of services from new entrants, a reduction in the strength of competition relative to the counterfactual is likely to result in less pressure on existing operators to innovate.
- 7.101 It is in the nature of innovation that it is not possible for us to predict accurately what new types of service might emerge, or to quantify what benefits consumers might realise as a result. However, benefits could include newly flexible services such as subscription VoD, the on-the-go benefits of mobile TV, or innovative interactive features on IPTV, or more widespread on-demand services via IPTV.

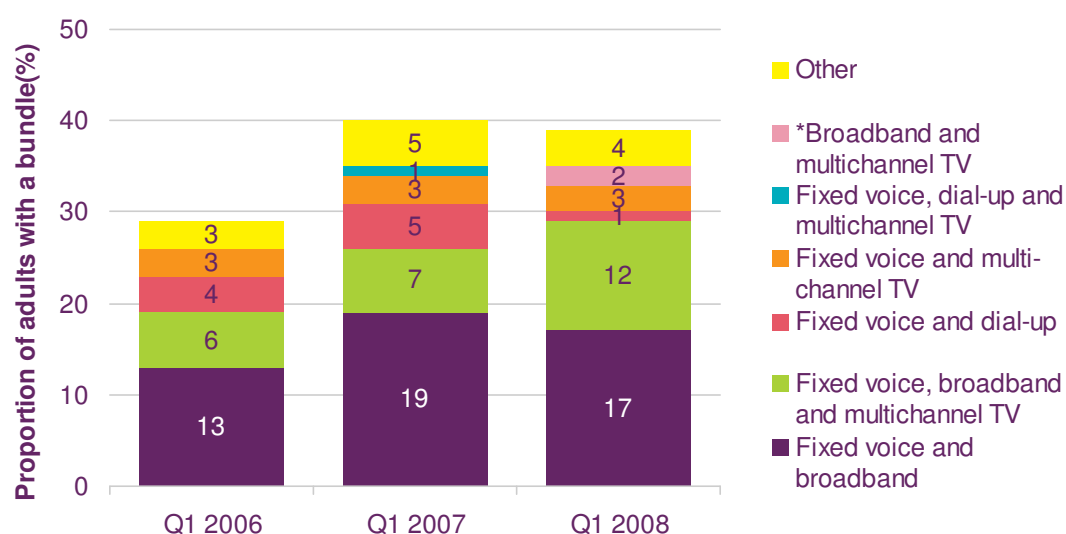
Choice

- 7.102 Having a reduced number of retailers with access to Core Premium content reduces the range of price points on premium and reduces the range of bundles of premium products with other products. More simply, decreased competition in the provision of premium content reduces pressure on retail costs relative to the counterfactual.
- 7.103 Not only does a reduction in the number of viable retailers reduce choice in an absolute sense, it may also force consumers to make choices that are in effect 'wrong' for them. For instance, if a consumer particularly valued the set of features offered by Top Up TV's DTT platform relative to Sky's satellite platform, but valued the ability to watch all available live FAPL matches even more highly, he or she would be likely to choose satellite. This would in effect be the wrong choice for that consumer's set of preferences.
- 7.104 More fundamentally, lack of access to content is likely to hold back the development of platforms. Platforms may develop more slowly than if they had access to premium content. It is possible that platforms may not even get off the ground at all, if they conclude that their launch depends on access to premium content. Either outcome would reduce consumers' choice of platforms.
- 7.105 Consumers have increasingly been taking packages of TV with other services, such as broadband or telephony, as Figure 40 below shows. It seems likely that this trend

will continue, and consumers will increasingly take advantage of the convenience and cost-effectiveness of taking all their fixed-line communications services from one provider. Ofcom has already intervened in one bottleneck – fixed telecoms – to ensure that competition is able to thrive. It is the action we have taken in that market that has allowed several operators, notably Sky and Tiscali, to offer triple-play services.

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 triple-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.

Figure 40 Take-up of triple-play bundles



Source: Ofcom consumer research

Notes:

A bundled service is defined to be two or more services taken from a single provider, with or without a price discount

* Previously included in 'other' category

Efficiency

7.107 One simple benefit of enhanced competition in pay TV as a result of better access to wholesale content would be the greater pressure that would place on productive efficiency. Lack of access to premium content is likely to restrict the number of viable retailers and the number of viable platforms, leading to reduced pressure on costs in both areas.

Consultation questions

22. What is the effect on consumers of the current situation with regard to access to premium content, now and in the future?

23. Do you agree with our analysis of the current situation with regard to choice, innovation, pricing and consumer satisfaction?

24. How would you see differently the future of pay TV as outlined in our “forward look”?

25. Would you agree with our analysis of the likely effects of restricted distribution of Core Premium content on consumers?

Section 8

Remedies

Summary

- 8.1 We consult in this document on our conclusion that Sky has market power in the wholesale of Core Premium channels. We further consult on a specific concern, which suggests that Sky, as a vertically integrated firm with market power in a key upstream market, will distribute its premium content in a manner that favours its own platform and its own retail business. We have considered what types of remedies might address this concern, and can identify four broad approaches.
- Despite the existence of the concern, we could deem the risks of intervention too great, and take no further action.
 - Secondly, we might seek to address Sky's market power at source, by intervening to change the way in which key content rights are bought and sold. However, in order for such an intervention to significantly reduce or eliminate the existing market power, it would be necessary to place severe restrictions on the ability of Sky and other firms to aggregate content. Such an intervention would go well beyond the previous intervention by the European Commission into the way FAPL rights are sold. Given the acknowledged benefits to consumers of content aggregation, we are not convinced that this is the best way forward at this stage.
 - Alternatively, we might intervene to eliminate Sky's incentives to exploit this market power in downstream markets. These incentives derive at least in part from Sky's vertical integration, so eliminating them would require a structural remedy which separates Sky's wholesale channel business from its downstream platform and / or retail business. Our view, on which we are consulting, is however that such a remedy would be disproportionate to the level of consumer detriment that we have identified. It would also fail to take into consideration the fact that Sky's current success is based on a historic willingness to invest in what was initially a risky business, and the need to ensure that investment is not deterred in future.
 - Finally, we might eliminate Sky's ability to act on these incentives, by requiring it to provide wholesale access to particular content on regulated terms. Such remedies have been imposed on pay TV providers in several other markets internationally, such as the US and Italy, and are commonly referred to as 'wholesale must-offer' obligations. Such an obligation would enable other operators to develop pay TV offers which include premium content, facilitating choice and innovation. It would do so without having a disruptive effect on the structure of Sky's existing retail and wholesale businesses, and so is a particularly proportionate form of intervention. Indeed, its objective is to replicate the natural outcome of a competitive market, which most interested parties recognise as being one in which content is widely distributed across a range of platforms.
- 8.2 We propose to address our concerns by placing a wholesale must-offer obligation on Sky. In this document we are consulting on the use of our sectoral competition powers under section 316 CA03 to put such an obligation in place.

- 8.3 We believe that this remedy would allow for the strengthening of competition between retailers and between platforms. It would maximise choice for consumers, both in terms of the range of price points and packages available, and in terms of the range of platforms open to them.
- 8.4 We believe that it would be more appropriate to use our sectoral powers under section 316 CA03 than our powers under CA98 to address our concerns. Our principal duty is to further the interests of consumers, where appropriate by promoting competition. This is connected to our duty under section 316 CA03 to ensure “fair and effective competition in the provision of licensed services”. This document identifies a lack of incentive for Sky to supply its wholesale Core Premium channels at prices that other retailers can afford. We consider that this has led, and will continue to lead, to reduced competition between retailers and between platforms, which will damage the interest of consumers. Our sectoral powers are well suited to dealing with a concern that competition will not develop in a manner that best serves consumers.
- 8.5 Conversely, we do not believe that it would be appropriate to rely on our powers under CA98 to seek to address the issues we have identified. Depending on the precise form of what we see as the most appropriate remedy, there may be one or more reasons for this.
- The limited wholesale availability of Sky’s premium content may simply reflect an unwillingness on Sky’s part to wholesale to retailers on other platforms at a price which Sky believes would be lower than the price at which it would need to wholesale to itself on those platforms. If this is the case, a decision not to supply might well not constitute abusive behaviour, and it would not be appropriate to take action under CA98, but our concern as a sectoral competition authority and regulator with a forward-looking duty actively to promote competition would remain.
 - Any wholesale must-offer remedy would need to include a number of detailed conditions governing the terms and conditions of wholesale supply. The most obvious of these conditions is some form of ex ante pricing rule. If we saw fit to set a pricing rule in a way which took account of the lack of scale of potential new entrants, this might imply an approach to cost analysis and therefore a price which could not be imposed under our CA98 powers.
- 8.6 We have also considered a possible reference to the Competition Commission under EA02. While this is an option which remains open, we should consider using our sectoral competition powers first. Given that we believe that the most appropriate way forward is to consult on imposing a wholesale must-offer obligation on Sky, and given that we believe we can achieve this using our sectoral powers, it is not currently appropriate for us to make a Competition Commission reference for this purpose.
- 8.7 There may still be some residual concerns which cannot be addressed either using our sectoral powers, or using our CA98 powers, and which may therefore justify a reference to the Competition Commission. This might be the case if, for example, we believed there was a case for considering a more general intervention into the way sports and movie rights are sold, which went beyond our powers as a sectoral regulator and competition authority. We have already discussed the possibility of intervening to reduce upstream market power by placing limits on content aggregation, and have noted that we are not currently persuaded of this approach. One alternative might however be to intervene to make rights more contestable, for

example by placing specific constraints on contract durations, or the manner in which contracts are renewed. We believe however that the right time to consider such an intervention would be when we are able to review the effectiveness of any intervention resulting from this market investigation process, as well as the previous intervention by the European Commission into the sale of Premier League rights.

Introduction

- 8.8 Section 4 identified for further consultation preliminary conclusions on relevant markets for the wholesale of Core Premium Sports and Movies channels. Section 5 reached a view that Sky has a dominant position in those markets and that this dominant position is expected to persist over the next three to four years.
- 8.9 Sections 6 and 7 identified our competition concern: that Sky lacks the incentive to supply its wholesale Core Premium channels at prices that competitors can afford, leading to reduced competition between retailers and between platforms, with detrimental effects on consumers.
- 8.10 In this section we consider potential responses to this concern, taking into account our statutory duties and the criteria for the assessment of outcomes in the pay TV industry as described in section 2. We first set out in general terms what we would hope to achieve through some form of regulatory action. We note how similar objectives have been achieved in other countries, albeit within different economic circumstances and different regulatory frameworks. We then consider in more detail the options open to us, given the specific legal instruments which are available.

Objectives of any remedies

- 8.11 As noted above, the core competition concern we have identified relates to Sky's lack of incentive to supply premium content to retailers other than itself at affordable prices, and the consumer detriment to which we consider this is likely to give rise. We could respond to this in one of several ways:
- **Take no further action:** despite the existence of the concern, we could deem the risks of intervention too great, and take no further action.
 - **Intervene to eliminate market power:** we could attempt to remedy this competition concern at source, by seeking to reduce (or eliminate) the upstream market power that we have identified to a level at which Sky no longer has the ability to distort downstream competition. The specific object of such an intervention would be to change the way in which content rights are bought and sold, in order to ensure that content aggregation, and the other barriers to entry which we have identified, do not result in the creation of market power.
 - **Intervene to eliminate the incentives to exploit upstream market power:** the specific object of such an intervention would be to address those structural features of the market, notably Sky's vertical integration, which provide Sky with the incentive to restrict the distribution of its Core Premium channels.
 - **Intervene to reduce the ability to act on these incentives:** finally, we could reduce Sky's ability to act on those incentives. The specific object of such an intervention would be to establish behavioural rules which prevented Sky from exploiting its ability to distort downstream competition.

- 8.12 The central objective of any remedy should be to promote long-term competition by reducing the ability of firms to benefit from their market power to the detriment of consumers, in line with our section 3 CA03 duties. We see those duties as being to consider ways of increasing levels of competition in the markets we regulate – for example by reducing barriers to entry for new firms. This does not mean that we should seek to protect specific new entrants, but it does imply potentially going beyond simply defending the competitive process by punishing actual anti-competitive behaviour, as we would do under our CA98 powers.
- 8.13 In considering whether to adopt any remedy and if so which type of remedy to adopt, we must also recognise the benefits that the current market structure has delivered to consumers. As discussed in section 3, the pay TV industry has grown from almost nothing in the early 1990s to one that now provides services to over 12 million consumers, and is characterised by technical innovation as well as delivering reasonable levels of consumer satisfaction. We do have concerns about the current market structure, as set out in this document, but we also acknowledge that in many respects the development of pay TV has been a success story. Furthermore, it is a success story that can largely be attributed to Sky, and its willingness to invest private capital in what was initially a highly risky business. Our consideration of possible remedies needs to take this into account.
- 8.14 Below we consider each of the four possible routes listed above in turn, before addressing the legal instruments open to us.

Take no further action

- 8.15 Any regulatory intervention carries risks with it. These risks are the reason why, having identified a problem, taking action to remedy it should not be an automatic next step.
- 8.16 As we note in our document “Better policy making: Ofcom’s approach to impact assessment”, quoting the Better Regulation Task Force¹⁸⁷:
- “No market ever works perfectly, while the effects of...regulation and its unintended consequences, may be worse than the effects of the imperfect market”.
- 8.17 Any type of regulatory action entails specific risks, and those are assessed below as we consider each possible type of action in turn. However, there are more general risks which apply to any intervention.
- 8.18 The clearest risk in this case is in the uncertainty of assessing the extent of a future risk to competition. We have identified concerns around the foreclosure of competition due to lack of access to content, and the effects that is likely to have on innovation and choice.
- 8.19 All of these are forward-looking concerns, and are difficult to quantify, particularly in the case of innovation. These forward-looking concerns have to be looked at in the context of a market that is changing, as Ofcom has noted on a number of previous occasions. For example, in the foreword to our annual plan for 2008-09¹⁸⁸, we stated:

¹⁸⁷ http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf

¹⁸⁸ http://www.ofcom.org.uk/about/accoun/reports_plans/annual_plan0809/statement/annplan0809.pdf

“Convergence is also bringing sweeping changes to the structures of our communications markets, fuelling new patterns of demand and changing traditional business models”.

8.20 Alongside this, we stated in that same foreword that:

“There will continue to be a role for Ofcom to intervene decisively to protect people from actual or potential harm whenever this proves necessary”.

8.21 Sky has argued that our concerns are entirely speculative. It argued in its consultation response that in a market which is rapidly changing, such speculative concerns cannot provide the basis for regulatory action. We recognise that our concerns are primarily forward-looking, although we are concerned about the limited availability of Sky’s premium content today as well. We set out in sections 5, 6 and 7 an explanation of why we consider these concerns are likely to persist over the next three to four years. The fact that our concerns are primarily forward-looking means that we have to be particularly careful in identifying a remedy and ensuring that it is proportionate.

8.22 We acknowledge the particular importance of acting in a proportionate manner in circumstances where, as discussed above, Sky’s current market position reflects its willingness to invest private capital in what was initially a highly risky business. We recognise the need to ensure that investment is not deterred in future.

8.23 However, to discount the possibility of taking action would be to ignore the real concerns we have in relation to the future of competition. Doing this would be out of keeping with our duty to further the interests of citizens and consumers. If we were not to take any further action, not only might existing platforms be at risk, but new platforms based on technologies such as IPTV, pay DTT and mobile will not flourish as they otherwise might. This likely detriment outweighs the risks of intervention.

8.24 The option to take no further action remains open following this consultation, but we believe we should continue to investigate the possibility of reaching an appropriate and proportionate solution. A particular concern at the moment relates to the future of DTT; we can see consumer benefits in premium content being available on DTT, but would be concerned about this coming about solely through Sky’s Picnic proposal.

Intervene to eliminate upstream market power

8.25 In theory we could attempt to address the existence of market power at source, by changing the way in which rights are sold at the content layer, so as to ensure that no one provider has market power. There are broadly two types of intervention which might achieve this.

8.26 Firstly, it might be possible to ensure that no one provider has market power by placing specific restrictions on the aggregation of content. The current intervention into the sale of live FAPL rights permits one wholesale channel provider to obtain five of the six available packs. In order to eliminate market power, a more extreme form of intervention would be required, for example:

- A behavioural rule which prevents FAPL selling more than two of its six packages of rights to any one wholesale channel provider; and / or

- A behavioural rule which prevents any one wholesale channel provider from purchasing the rights to the output of more than two of the six Major Hollywood Studios.
- 8.27 However, as we set out at the beginning of section 5, content aggregation also has positive effects. Any remedy which prevents or restricts aggregation to the extent that would be necessary to eliminate market power is also likely to risk sacrificing some of these benefits. This might result in some consumers paying higher prices, due to a reduction in the efficiencies associated with content bundling. It may also result in reduced convenience for some consumers, who may have to take multiple subscriptions or purchase multiple set-top boxes to get the content they want.
- 8.28 Secondly, it might be possible to reduce barriers to entry, and thereby reduce market power, by placing specific restrictions on the way content rights are sold to make them more contestable. This is the primary focus of the current intervention into the sale of live FAPL rights, which seeks to make these rights more contestable by limiting their duration, and ensuring that there is an open bidding process for their renewal. Our view is that there is clearly merit in reducing barriers to entry by ensuring that key content rights are more contestable. The risk of perverse consequences for consumers associated with this type of intervention is also relatively low. However, the resulting reduction in barriers to entry has been insufficient to eliminate the market power associated with live FAPL rights. This is because, as discussed in more detail in section 5, these barriers to entry are not the only source of market power.
- 8.29 In addition to the substantive reasons why each of these two approaches is not likely to be suitable at this point in time, there are also specific practical reasons why this is not likely to be the best way to proceed at this moment.
- In relation to live FAPL rights, there is already a remedy in place, imposed by the European Commission. That remedy has played a key role in enabling market entry by Setanta. The remedy applies for six football seasons, and we are only now starting the second of those six. The second rights auction to be governed by this remedy is expected to take place early next year. Our current view is that it would be most appropriate to review this remedy towards the end of the current six-year period, at which point sufficient evidence should be available to allow a proper assessment. Even ahead of such a review, we can see that the remedy does not appear to have eliminated upstream market power, as section 5 indicates, but a review later in the six-year period would allow us to understand the extent of any other benefits. An earlier review might of course be appropriate if there is a material change in circumstances, such as a major shift in the competitive landscape following the forthcoming auction.
 - In relation to the sale of other live sports rights, to the extent there is merit in reviewing these, such a review should take place at the same time as any review of the existing FAPL remedy.
 - In relation to the sale of movie rights, we have already noted that there is the possibility in the medium-term future of disruptive changes in the way movie content is distributed. For example, there is the possibility that the studios might take advantage of new technologies to gain access to consumers directly. This means that now might not be the right time for a regulator to attempt to set detailed behavioural rules governing the sale of movie content rights.

Intervene to eliminate the incentives to exploit upstream market power

- 8.30 Sky's incentives to exploit its upstream market power derive from a variety of market characteristics, and in particular from the fact that it is a vertically integrated business which wholesales channels, operates a platform, and retails to consumers. One approach to changing Sky's incentives would be to address this.
- 8.31 One means of doing so would be to separate Sky, either operationally or structurally, so as to eliminate the incentives associated with vertical integration. The Four Parties have argued that one of the remedies which should be considered, in order to address the "structural" features of the market underlying the "vicious circle", is operational separation of Sky's channel and distribution businesses.
- 8.32 However, this would be a draconian remedy, especially since operational separation is unlikely to change the incentives faced by Sky unless it was part of a wider structural solution which included a substantial divestment of assets. Such a structural solution would be complex in nature given the interwoven nature of the different areas of Sky's business.
- 8.33 Our view is that such a remedy would not be a proportionate one, for two reasons.
- The level of benefits currently being delivered by Sky to consumers, and the possibility that these might be put at risk by disruptive structural changes to Sky's business.
 - The fact that Sky's current market position reflects its willingness to invest private capital in what was initially a highly risky business, and the need to ensure that investment is not deterred in future.
- 8.34 We also note that while some form of structural separation is likely to be necessary to address our concerns regarding Sky's incentives, it may not be sufficient. We observed in section 6 that although vertical integration makes it more likely that there will be an incentive not to supply, vertical integration is not a necessary, nor indeed the only, condition for this incentive to exist. It is therefore not certain that removing vertical integration would eliminate the incentives we have identified.

Intervene to reduce the ability to act on these incentives

The possible application of a 'wholesale must-offer' obligation to Sky

- 8.35 The remaining alternative is to attempt to remove Sky's ability to act on its incentives. The normal means by which this is achieved in relation to vertically integrated firms is to place an obligation on the firm to supply the same product it supplies to itself to others, and to do so in a manner that does not unduly discriminate. Such an obligation, in the context of wholesale channels, is usually referred to as a 'wholesale must-offer' obligation. The most targeted remedy would be to set a requirement for Sky to supply a defined set of content to other retailers on a wholesale basis on regulated terms.
- 8.36 In order to address our concern about the lack of stand-alone premium packages, it should be sufficient to make a stand-alone premium package available at the wholesale level; particularly as we see different platforms as being in the same retail market, this should tackle the retail-level concern.

The possible application of a wholesale must-offer obligation to other firms

- 8.37 Much of the discussion above relates to Sky, and this is appropriate given its market position. However, we do also need to consider whether a wholesale must-offer obligation should apply to Setanta, given that is currently the only other wholesaler of premium content. It may also be helpful to provide some guidance as to whether we would consider applying a similar obligation to other firms, if they are successful in winning key content rights in the future.
- 8.38 One reason why it might not be appropriate to apply a wholesale must-offer obligation to Setanta is that we have not found Setanta to have market power in the supply of premium sports channels. We acknowledge however that we have not ruled out the possibility that the market for Core Premium Sports content is narrower than we set out in section 4, and in particular that every live FAPL match is in its own narrow economic market. If this were the case, we would be likely to believe that Setanta did have market power.
- 8.39 However, even if we did believe Setanta to have market power, this would not necessarily lead us to extend a wholesale must-offer obligation to Setanta as well as Sky. There are two main reasons for this:
- Setanta does not face the same incentives to restrict supply of its content as does Sky. In particular, does not have the same degree of vertical integration as Sky, since it does not operate its own platform. It is therefore more likely to retail in a platform-neutral manner.
 - We are aware of no evidence that Setanta is restricting supply of its content. Indeed, although Setanta has been a wholesaler of premium content for a much shorter period than Sky, its content is already available widely on a wholesale basis, as well as being available via retail on Sky's DSat platform (see section 6). We acknowledge that Sky does not currently retail Setanta's content, but there are a variety of possible interpretations of this, and we do not currently see it as evidence of Setanta restricting supply of its content.
- 8.40 It is possible that at some point in the future some other firm will win content rights which enable it to supply Core Premium channels. We would then have to consider whether any wholesale must-offer obligation should apply to that firm. In such circumstances we would expect to apply similar criteria to those which we have applied to Setanta, i.e. we would consider whether that firm had market power, the extent to which it had an incentive to act on that market power, and the availability of any actual evidence that it was doing so.

Examples of wholesale must-offer obligations in other countries

- 8.41 Wholesale must-offer obligations have been imposed in a number of other countries, in response to similar concerns to those we have set out here. Examples are set out at Annex 16 of our December Consultation, and include:
- Conditions imposed in France as a result of the Canal+ / TPS and Tele2 / SFR mergers. These limited the duration and degree of exclusivity of rights agreements, and established obligations on the merged parties to wholesale their channels to other retailers on non-discriminatory terms.
 - Conditions imposed in Italy as a result of the Newscorp / Telepiu merger, which resulted in the creation of Sky Italia. These conditions unwound Sky Italia's

exclusivity in relation to various existing content rights, limited the duration and exclusivity of future content deals, and committed Sky Italia to offer premium channels (and basic channels containing premium content) on a non-exclusive, non-discriminatory and unbundled basis to third parties, for distribution on platforms other than its own DSat platform.

- Conditions imposed in Spain as a result of the Canal Satellite Digital / Sogecable / Via Digital merger. These limited the duration and exclusivity of Sogecable's premium rights agreements, and required Sogecable to wholesale premium channels to other retailers.
- In 1992 a review of the US pay TV industry led to the introduction of the Cable Television Consumer Protection and Competition Act 1992. The United States Congress found that there was limited competition in the cable-dominated pay TV market. The Federal Communications Commission (FCC) was therefore mandated to put into effect measures to foster the development of a more competitive market. These included a set of 'program access rules' which prohibited vertically integrated cable operators from¹⁸⁹:
 - Significantly "hindering or prohibiting" a competing retailer from making programming available to subscribers or consumers;
 - Discriminating in the prices, terms, and conditions of sale or delivery of channels to competing retailers; or
 - Entering into exclusive contracts with cable retailers unless the FCC finds the exclusivity to be in the public interest.

8.42 Other than the US Cable Act, the example remedies shown above were implemented as part of merger processes. Although the concerns which led to the remedies were to some extent similar to the concerns we have identified in the UK, the legal instruments under which they were applied are not available in this situation.

8.43 In what follows we consider in more detail the specific legal instruments that are available.

Legal framework for remedies

8.44 In section 2 we identified the legal instruments available for Ofcom to address competition concerns. Before using any of its powers, Ofcom must identify the most appropriate legal instrument, if any, under which to take action to address the competition concern identified. Against that framework we address below the following potential routes for responding to the concerns identified:

- We could rely on the use of ex post action under CA98.
- We could pursue a remedy under our sectoral competition powers.
- If we were not satisfied that the competition concern could be adequately addressed through ex post action under CA98 or through ex ante action under our sectoral competition powers, we could pursue a reference to the Competition Commission under EA02. This approach would be relevant in particular if we

¹⁸⁹ The rules have recently been reviewed; the text of the most recent FCC document is available at http://fjallfoss.fcc.gov/edocs_public/attachmatch/FCC-07-169A1.pdf.

considered that a structural remedy needed to be considered, or a behavioural remedy which could not be implemented using our sectoral powers.

8.45 We assess below which of these routes it is likely to be most appropriate to take.

Rely on the use of ex post powers under CA98

8.46 We have set out above that we believe that our competition concern merits taking action, and that we believe the best way of doing this is to tackle the effects of Sky's incentives on the distribution of its premium channels. The next question to address in assessing the best route for responding to this concern is whether we should rely on ex post powers under CA98 and take action against any abusive conduct by Sky arising from this incentive under the Chapter II prohibition if and when such conduct arises, or whether it is more appropriate to use our sectoral powers under section 316 CA03. This is an analysis which Ofcom is required to undertake pursuant to section 317 CA03 if it is considering the potential use of its sectoral competition powers.

8.47 In section 5 we reached the view that Sky holds a dominant position in the markets for the supply of Core Premium Sports and Movies channels. In section 6 we reached the view that Sky has an incentive not to supply those Core Premium channels to its retail competitors. To the extent that Sky does have an incentive not to supply retail competitors, it could be argued that the types of behaviour with which Ofcom should be concerned are in principle susceptible to action under the Chapter II prohibition, which prohibits conduct that amounts to abuse of a dominant position. For example, the following types of conduct have previously been found to be an abuse of a dominant position:

- Refusal to supply existing and potential customers.
- Offering to supply on unacceptable terms may constitute a constructive refusal to supply.
- A price squeeze on a retail competitor's margins.

8.48 The concern identified might therefore in principle be addressed to some extent by opening CA98 cases to investigate abuses if and when they are alleged to have occurred. Given the sanctions available under CA98, Sky should in theory be under a strong incentive not to commit such abuses.

8.49 We have reviewed evidence concerning Sky's recent negotiations for the wholesale supply of premium channels with several existing and potential pay TV retailers, including Top Up TV and BT Vision, Tiscali and Orange. A summary of that review is set out above at section 6. Although we have established that no wholesale deals have been concluded despite negotiations between Sky and a number of retailers, we have not carried out a CA98 investigation to establish whether Sky has refused to supply its premium channels in the sense set out in CA98¹⁹⁰. Nor have we investigated whether the issues raised by Sky in the context of these negotiations are not objectively justified, or whether the course of negotiation might be regarded as a constructive refusal to supply.

8.50 We believe that it would be more appropriate to use our sectoral powers under section 316 CA03 than our powers under CA98 to address our concerns. Our

¹⁹⁰ Nor have we received complaints alleging a breach of CA98.

principal duty is to further the interests of consumers, where appropriate by promoting competition. This is connected to our duty under section 316 CA03 to ensure “fair and effective competition in the provision of licensed services”. This document identifies a lack of incentive for Sky to supply its wholesale Core Premium channels at prices that other retailers can afford. We consider that this has led, and will continue to lead, to reduced competition between retailers and between platforms, which will damage the interest of consumers. Our sectoral powers are better suited to dealing with a concern that competition will not develop in a manner that best serves consumers.

8.51 Conversely, there are several reasons why we do not believe that relying on our CA98 powers would be an appropriate response to our competition concern.

- **We would still see a competition problem even absent a finding of anti-competitive behaviour.** One of the potential reasons we identified for Sky’s lack of incentive to supply was possible differences in efficiency between Sky and other retailers. If that were the case, an abuse might well not have taken place, but the negative impact on competition and consumers that we have identified would still exist. If we were to rely on our powers under CA98, we would not be able to address this competition problem absent an actual finding of anti-competitive behaviour.
- **Some types of remedy would not be available under CA98.** Even if it were demonstrated that Sky had committed a breach of the Chapter II prohibition, the remedies available under CA98 might not be able properly to address the concerns we have identified. The imposition of a fine would not in itself secure supply of the wholesale product. It would be necessary for Ofcom to issue directions under section 33 CA98. In advance of any particular breach occurring it is not possible to determine what scope of directions might be justified in the particular circumstances. There is therefore a material risk that it may not be possible to remedy a refusal to supply under CA98 through an obligation on Sky to enter into a wholesale arrangement. In particular, one possible component of a remedy to address the problem we have identified is to impose an ex ante pricing rule on wholesale channels. It is probably not possible to introduce this under CA98. Further, if we saw fit to determine a wholesale price designed to facilitate entry, that price would be based on different cost data from a test of whether Sky was applying a CA98 margin squeeze. Specifically, a remedy intended to promote competition might seek to reflect the lack of scale economies of a new entrant. The CA98 margin squeeze test is more focused on an equally efficient operator. It might therefore generate a different result and in this case be less effective at promoting the dynamic benefits of competition.
- **Even if anti-competitive behaviour were taking place, under a CA98 process it might take a considerable amount of time for this to become apparent.** If we were to carry out an external analysis of Sky’s conduct, it would be exceptionally difficult to determine whether a failure to reach an agreement on supply was attributable to (a) the difficulty of reaching agreement on these complex commercial issues (b) an inability to agree a price satisfactory to both parties or (c) an incentive to restrict supply in order to distort competition. It is at least very likely, given the evidence available to date on the duration of wholesale discussions, that a substantial period of time may have to have passed before Ofcom could be satisfied that any failure to reach agreement is attributable to the difficulty of reaching agreement rather than an incentive not to supply. In the meantime the negative impact on consumers of a failure to agree terms for wholesale supply, as described above at section 7, will persist. In our view there

may be a risk that damage to the market would occur during that period because potential new retailers will not be able to take advantage of technological changes to enter the market. We do not consider that this situation would be consistent either with Ofcom's principal duty to further the interests of consumers, where appropriate by promoting competition, or with the concept of ensuring "fair and effective competition" under section 316 CA03.

- 8.52 Our current conclusion is therefore that it would be more appropriate for Ofcom to use its sectoral competition powers under section 316 CA03 in order to deal with the competition concerns we have identified.

Pursue a remedy under our sectoral competition powers

- 8.53 Our current assessment is that the likely problems associated with taking no action are greater than the risks of intervening. Our current assessment is also that we should not rely on our ex post competition powers to remedy the competition concern we have identified.
- 8.54 A more appropriate way of pursuing the remedy that we have put forward – a wholesale must-offer obligation on a given set of channels – would be through our ex ante powers. We could propose a condition or direction pursuant to our sectoral competition powers.
- 8.55 Ofcom's sectoral competition powers are contained in sections 316 to 318 CA03. In particular, section 316 states:

"Conditions relating to competition matters

(1) The regulatory regime for every licensed service includes the conditions (if any) that OFCOM consider appropriate for ensuring fair and effective competition in the provision of licensed services or of connected services.

(2) Those conditions must include the conditions (if any) that OFCOM consider appropriate for securing that the provider of the service does not—

(a) enter into or maintain any arrangements, or

(b) engage in any practice,

which OFCOM consider, or would consider, to be prejudicial to fair and effective competition in the provision of licensed services or of connected services.

(3) A condition imposed under this section may require a licence holder to comply with one or both of the following—

(a) a code for the time being approved by OFCOM for the purposes of the conditions; and

(b) directions given to him by OFCOM for those purposes.

(4) In this section—

“connected services”, in relation to licensed services, means the provision of programmes for inclusion in licensed services and any other services provided for purposes connected with, or with the provision of, licensed services; and

“licensed service” means a service licensed by a Broadcasting Act licence.”

- 8.56 In the broadcasting sector there is a relationship between the principal duty at section 3(1)(b) CA03 (to further the interests of consumers, where appropriate by promoting competition) and the concept of “ensuring fair and effective competition” pursuant to s316.
- 8.57 Section 316 allows Ofcom to intervene on an ex ante basis to ensure fair and effective competition, where appropriate, either by inserting new conditions into Broadcasting Act licences pursuant to section 316(1), or by taking action under section 316(3) in relation to an existing licence condition.
- 8.58 Sky holds television licensable content service licences under the Broadcasting Act 1990 for its premium sports and movie channels. These channels are therefore “licensed services” for the purpose of section 316 CA03. Ofcom can therefore consider appropriate action under section 316 to ensure fair and effective competition in the provision of those channels, and any services provided for purposes connected with those channels.
- 8.59 In addition to the possibility of new licence conditions, there are existing licence conditions which are relevant in this context. Pursuant to section 316 CA03 the licences for the channels, in common with all Broadcasting Act licences, contain a standard fair and effective competition licence condition. The provision can be found at Condition 14 of the licences and provides that Sky shall:
- “(a) not enter into or maintain any arrangement, or engage in any practice, which is prejudicial to fair and effective competition in the provision of licensed services or of connected services; and
 - (b) comply with any code or guidance for the time being approved by Ofcom for the purpose of ensuring fair and effective competition in the provision of licensed services or of connected services; and
 - (c) comply with any direction given by Ofcom to the Licensee for that purpose.”
- 8.60 Section 4 above reaches the view that at the wholesale level there are separate markets for the supply of the Core Premium Sports and Movies channels which are the subject of these licences. This section identifies markets which are relevant to a consideration by Ofcom of fair and effective competition in the provision of the licensed services. In section 5 we conclude that Sky is in a dominant position in those markets¹⁹¹.

¹⁹¹ It should be noted that although in this instance Ofcom is using the CA98 concept of dominance to assess the extent of market power, this does not have any bearing on the conditions for the use of section 316 in other cases.

- 8.61 Section 6 above reaches views on concerns over the incentive and ability for Sky's actions to restrict competition in pay TV retail markets through its approach to the wholesale of Core Premium Sports and Movies channels. Ofcom has a concern that fair and effective competition in the provision of the licensed services is being and will be restricted in respect of Sky's wholesaling of channels subject to Broadcasting Act licences. It may therefore be necessary to intervene in the wholesale of Core Premium channels to ensure fair and effective competition in:
- The retail provision of the Core Premium Sports and Core Premium Movies channels which are "licensed services", and services connected to the provision of those services.
 - The retail provision of licensed services in the relevant markets which are affected by the terms on which the Core Premium channels are supplied, and services connected to the provision of those services.
- 8.62 Following the analysis of consultation responses on sections 3 to 7 we therefore propose to consider further the imposition of a remedy under section 316 CA03 through a licence condition or direction on Sky in the form of a wholesale must-offer obligation.
- 8.63 Following this consultation, and subject to the responses received, we would expect to issue a further consultation which would respond to submissions on this consultation, and would propose the detailed form of a remedy. Any such detailed proposals would include further work on the price of a wholesale offer – we raise some of the issues related to price in the next section. A final decision on a remedy would follow the subsequent consultation if appropriate.

Consider a reference under EA02

- 8.64 The Four Parties have argued that Ofcom should, in the absence of Sky offering acceptable undertakings, make a market investigation reference to the Competition Commission under EA02 in respect of the pay TV industry¹⁹². They not only argued this in their original July Submission, but have since reinforced this view in their responses to our December Consultation, and in three further submissions in August 2008, from BT, Virgin and jointly from the Four Parties.
- 8.65 The Four Parties have argued for such a reference in order to address the "structural" features of the market underlying the "vicious circle" through "operationally separating" Sky's channel and distribution businesses. Operational separation of this kind is not a remedy which Ofcom has the power to impose. This is one of the reasons why the Four Parties therefore advocate a market investigation reference to the Competition Commission.
- 8.66 The OFT's guidelines on market investigation references (to which Ofcom has regard), explain that prior to exercising a discretion to refer, Ofcom should consider whether it is more appropriate to deal with competition issues by applying competition law or sectoral powers¹⁹³. In other words, before making such a reference we must consider not only what we wish to achieve, but also satisfy ourselves that this is the most appropriate means of doing so.

¹⁹² Part 5, section 3 and Part 6 of the July Submission.

¹⁹³ OFT 511 Market investigation references (March 2006) paragraph 2.1.

- 8.67 If we had concluded that a structural remedy would be the most appropriate way of tackling the concern we have identified, then a reference to the Competition Commission might indeed be the best way of moving forward at this point. However, we have not reached such a conclusion. Our current view is that such a remedy would not be a proportionate means of addressing our competition concerns, and it would not therefore be appropriate to make a reference for this purpose.
- 8.68 Our primary competition concern is a lack of an incentive for Sky to wholesale Core Premium Sports and Movies channels (section 6). As we discuss above, our preliminary conclusion is that this is an issue which could satisfactorily be addressed through our sectoral competition powers, by requiring particular content to be the subject of a wholesale must-offer obligation. If this is the case, then it would not be appropriate to make a reference for this purpose.
- 8.69 If we had concluded that an intervention into the way in which rights were sold was the most appropriate way forward, then to the extent that such an intervention was not possible via the application of competition law or sectoral powers, a reference to the Competition Commission might be appropriate. However, we have not reached such a conclusion. Our current view is that for an intervention into the way in which rights are sold to be an effective means of addressing our primary competition concerns, it would have to apply draconian restrictions on the aggregation of content, which are likely to have adverse consequences for consumers. If this is the case, then it would not be appropriate to make a reference for this purpose.
- 8.70 We have acknowledged that there may be merit in interventions into the way in which rights are sold which make them more contestable. However, in the case of live FAPL rights, such an intervention has already taken place under competition law. If this use of competition law proves to be effective, then it would not be appropriate to make a reference for the same purpose. There may be merit in considering the application of similar principles to other content rights, but we believe we should review their effectiveness in relation to live FAPL content before considering any extension to other content. Unless there is a material change of circumstances, the most appropriate time to review the effectiveness of the current FAPL remedy is towards the end of the six-season period which it covers.

Preliminary conclusions on remedy options

- 8.71 We are therefore consulting on the following preliminary conclusions on responses to the competition concerns identified:
- The competition concerns identified merit further consideration. A wholesale must-offer obligation is the remedy which is most likely to succeed without undue risk of unforeseen detrimental results.
 - It is more appropriate to use our sectoral competition powers under section 316 CA03 to address the competition concerns identified.
 - We therefore do not consider at this point that it would be appropriate to consult on a market investigation reference.
- 8.72 In the next section we consider in more detail how a wholesale must-offer obligation might help to ensure fair and effective competition by considering the potential impact on consumers and stakeholders.

Potential impact on consumers and stakeholders

- 8.73 In the previous chapter we expressed concern about the prospects for new retailers and platforms to emerge if wholesale premium content were not supplied. As we said, it is possible that one possible reason for content not being supplied is differences in efficiency between Sky and other potential retailers.
- 8.74 Our proposal of a wholesale must-offer obligation would seek to facilitate the emergence of new retailers and platforms. It is possible that where the non-supply of content results from differences in efficiency, putting in place this kind of remedy might reduce overall efficiency in the short term. However, this would be to the benefit of long-term dynamic efficiency and consumer outcomes, promoted by the emergence of new retailers and platforms.
- 8.75 The analysis presented in the whole of this document represents an impact assessment, as defined in section 7 CA03. Here we draw out some of the main issues.

Impact on consumers

- 8.76 As we discussed in section 8, foreclosure of retail competition due to restricted access to premium content can have a number of detrimental effects on consumers. Relative to the counterfactual, these were:
- Reduced innovation.
 - Possible higher prices.
 - Reduced choice of platform due to premium content only being available via a limited number of retailers.
- 8.77 We believe that facilitating wholesale access to Core Premium content would have a positive impact for consumers, because it should allow additional innovative retailers and platforms to emerge, making use of Core Premium content. It should also increase the level of choice for consumers, because Core Premium content would be available via a number of different retailers and platforms.

Impact on Sky

- 8.78 We recognised in the December Consultation, and continue to do so today, that Sky has played a pivotal role in the development of the pay TV industry, largely to the benefit of consumers.
- 8.79 However, Sky's success has at least to some extent been built on its access to Core Premium content, and it has sustained a position of market power in that content. Sky itself has argued that it has no incentive not to supply its content more widely. We therefore consider that a remedy which sets out the terms on which we would expect content to be available is not very intrusive. Having said that, the price of the wholesale offer does significantly affect the extent to which the obligation might be regarded as intrusive.
- 8.80 Moreover, we would in setting the scope of such an obligation continue to restrict the scope of the remedy to what is proportionate in order to respond to the concern identified.

Impact on other pay TV operators

- 8.81 We explained in section 3 why access to premium content is important to competition in pay TV. We went further in section 6 to explain why it is important for other pay TV operators to have wholesale access to premium content, rather than Sky itself retailing on others' platforms.
- 8.82 A wholesale must-offer remedy would address very directly both of these concerns. Being able to sell premium content would enable retailers to increase the attractiveness of their retail packages. It would also allow platform operators to enhance the attractiveness of their platforms to consumers.
- 8.83 Ensuring widespread access to premium content would enable potential new entrants to start with the nucleus of premium content, and build a compelling pay TV offer around it. It would also encourage the development of new platforms, which without premium content on the platform would struggle to develop sufficient scale.
- 8.84 The 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. The extent to which this is in fact the case depends on the precise terms which are associated with the obligation.
- 8.85 We acknowledge the concern expressed by some channel providers that without buy-through the demand for some channels could be reduced, and that this may even result in some channels going out of business. However, we believe that this is unlikely to be a high risk in practice, since the price differential between stand-alone premium content and premium / basic bundles is likely to be small. It is in any case not a risk which should be addressed by forcing consumers to purchase access to channels which they do not wish to purchase.

Impact on rights holders

- 8.86 We should also consider the impact beyond the immediate players in the pay TV market. In particular, rights holders are an important stakeholder group, because any damage to their ability to generate attractive content would have a detrimental effect on consumers.
- 8.87 A wholesale must-offer obligation would not be intended to have an impact on rights holders – its focus is further down the value chain. However, whether it works as intended depends on the precise terms of the obligation. In particular, the impact on rights holders of such a remedy is very dependent on how we go about setting prices.
- 8.88 As we have not set prices at this point, the precise impact on rights holders is difficult to quantify. However, the possible impact on rights holders does underline the need for an awareness of the upstream impact if and when we come to carry out that analysis.

Consultation questions

26. What should we do, if anything, to tackle the problem we have identified relating to Core Premium content?

27. What would you see as the key objectives of any remedy in pay TV?

28. Do you believe we have identified the right list of regulatory options?

29. Have we made a suitable assessment of the option of taking no further action?

30. Have we made a suitable assessment that it would be more appropriate to use our sectoral competition powers than to rely on ex post action under CA98?

31. Have we made a suitable assessment of the option of pursuing a process under our sectoral competition powers?

32. Have we made a suitable assessment of the option of pursuing a reference to the Competition Commission?

33. Do you agree with our discussion of the legal framework for a wholesale must-offer remedy?

34. Have we captured the potential impact on consumers and stakeholders in our preliminary impact assessment?

Section 9

Details of a wholesale must-offer remedy

Summary

- 9.1 Having considered the most suitable remedy and identified the appropriate legal instrument, we now turn to look at some of the details of a potential wholesale must-offer obligation. We set out and discuss in this document a number of issues which may need to be addressed in such an obligation, and are seeking general feedback on these now. If following this consultation we decide to proceed with a wholesale must-offer obligation, then we would expect to issue a further consultation in which we would propose specific conditions of supply.
- 9.2 The non-price issues which we have considered include the following:
- We would expect the scope of the obligation to cover all Core Premium Sports and Core Premium Movies channels supplied by Sky. We recognise that this could lead to some content being rescheduled to ensure that channels which show a small amount of Core Premium content are not caught within this obligation. In light of this, we believe there may be a role for some limited exemptions, which we would consider on a case-by-case basis as part of our next consultation.
 - We expect the obligation would require Sky to make available its content to retailers supplying residential subscribers. We expect that all retailers on non-Sky platforms would be eligible, but it is less clear that retailers on Sky's own platform(s) should be eligible. Extending eligibility to retailers on Sky's own platform(s) is unlikely to serve our central objective, which is the promotion of competition from retailers on other platforms. It could however have the effect of addressing our concerns about enforced buy-through on Sky's platform(s).
 - We would expect the offer 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.
 - We would expect this content to be provided in the form of a 'clean feed'. This clean feed would not include an undue level of cross-promotion to other Sky channels, which are not included within the wholesale supply obligation. It would also not include any other features which might degrade the viewing experience on other platforms, such as non-functional interactive services.
 - We 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.
- 9.3 We believe it would be necessary to specify an ex ante pricing rule for the channels contained within any wholesale must-offer. We may need to go beyond this and set a specific price, but if we do not do so, then we will certainly need to establish a

mechanism for the rapid resolution of pricing disputes. We have not set out a detailed analysis of pricing in this document, but discuss the two broad approaches which are available to us, and would welcome comment on these – in particular the practical difficulties associated with either approach.

- If our only concern is that Sky may price in a manner that discriminates between different retailers, and thereby distorts retail competition, it may be appropriate to set prices on a retail-minus basis. Given that the purpose of our suggested intervention would be to ensure fair and effective competition on a forward-looking basis, the retail margin implied by this pricing rule may need to be set at a level which would support entry into the market by new retailers. The details of this would need to be determined in any subsequent consultation. One of the main practical difficulties however with retail-minus is that it may be possible for the incumbent to game the system of price adjustments over time to its own advantage.
- If we are also concerned either that Sky may currently be setting high wholesale prices, or that it may respond to this intervention by setting high wholesale prices in the future, it may be appropriate to consider drawing on a cost-based approach. However, setting prices using costs which are determined by content rights auctions could risk artificially depressing future bids for such content, which would clearly be undesirable.

9.4 In an attempt to mitigate the likely effects of the various practical difficulties, one method would be to adopt a retail-minus approach, but use a cost-based analysis as a cross-check, noting the need to consider how the value of intangible assets should be considered in that calculation. If this cross-check were to result in a significant discrepancy, providing evidence of excessive wholesale margins, we might consider whether there was a way of bringing prices into line with costs without opening up the difficulties relating to rights auctions.

9.5 Finally, we would expect there to be a need to review any obligation after a period of time, perhaps three years from when the obligation comes into force. We recognise that a material change in circumstances, such as a major shift in the ownership of sports or movie rights, might cause us to bring that review forward.

Introduction

9.6 In the previous section, we explained that we intend to consider a requirement for Sky to make available wholesale access to particular content on regulated terms.

9.7 In this section we set out and discuss a number of issues which may need to be addressed as part of such an obligation, and are seeking feedback on these now. We consider the following issues:

- **Eligible retailers:** which retailers should be eligible to purchase a wholesale product?
- **Residential and commercial subscribers:** should an obligation cover all end customers, or should it be focused on particular types of subscribers?
- **Content and channels covered by an obligation:** what specific premium content should be included within a wholesale supply obligation? Given that a practical wholesale supply obligation must relate to a specific set of channels,

rather than discrete items of content, how do we determine which channels are included?

- **Product definition:** what are the technical characteristics of a wholesale product? Under what circumstances might the technical characteristics of the product supplied to other retailers be different to the technical characteristics of the product which Sky supplies to itself? What formats should be covered by an obligation?
- **Pricing:** would it be necessary for us to set prices for a wholesale product, and if so what factors should we consider in doing this?
- **Commercial terms:** what are the commercial terms on which a product would be supplied?
- **Review provisions:** what should be the term of an obligation, and under what circumstances should we review it?

9.8 On all of these issues, we have laid out options, and in each case our current view of the appropriate way forward, but we recognise that this is the first time we have consulted on the potential content of a wholesale must-offer, and that the effectiveness of any wholesale supply obligation depends on getting the detail right. We therefore particularly welcome stakeholders' views on these issues.

9.9 Having exposed some of the broad issues in this document, subject to consultation responses, we would expect to set out the specific details of any proposed remedy designed to ensure fair and effective competition in a subsequent consultation.

Qualifying retailers

9.10 It should not necessarily be taken for granted that all retailers would qualify for a wholesale offer.

9.11 Our key competition concern is that Sky has an incentive not to supply content to other retailers on other platforms, and that this might foreclose competition from other platforms. If this was our only concern, then it might be appropriate to limit eligibility to retailers on platforms other than those operated by Sky. Extending eligibility to multiple retailers on Sky's platform would result in a model of resale competition which may do little to promote inter-platform competition. It could conceivably even be counter-productive, since it might reduce the incentive to develop new platforms.

9.12 A particular reason to extend an obligation to provide the wholesale offer to all retailers, including those on Sky's own platform, would be to assuage the concerns we expressed in section 7 about buy-through. Retailers on Sky's platform would in theory be able to sell a stand-alone premium package.

Residential and commercial customers

9.13 As we indicated in our December Consultation, we are well aware that residential consumers are not the only customers of pay TV. There are also several tens of thousands of commercial enterprises that purchase pay TV services, from pubs to health clubs to offices.

9.14 The remedy that we are proposing would only apply to channels as retailed to residential customers. We recognise the importance of the commercial sector, and

this came through in certain responses to our consultation – particularly from the ALMR.

- 9.15 The concerns expressed by the ALMR relate to a rather different issue than the main one we have identified in this document. We have expressed a concern that restricted availability of Core Premium channels is likely to restrict retail competition in pay TV, with particular consequences in terms of innovation and choice. ALMR's main concern is that retail prices for commercial subscribers are too high.
- 9.16 We recognise the strength of the concerns that have been expressed. However, there are very different challenges in the commercial market which mean 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.
- Pricing 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.
 - The 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.

Content and channels covered by the obligation

- 9.17 The competition concern which we are proposing to remedy arises from Sky's market power in the following markets:
- The wholesale supply of Core Premium Sports channels.
 - The wholesale supply of Core Premium Movies channels.
- 9.18 We have defined these markets in terms of specific types of content. This is because it is consumers' preferences for this content which are the primary driver of consumer demand, and therefore the primary determinant of market power.
- 9.19 We have considered whether a wholesale supply obligation might apply at the level of individual pieces of content (i.e. an individual football match or movie), an entire linear channel, or a bundle of channels.
- We do not believe it would be appropriate to apply the remedy to an individual football match or movie. This would amount to an obligation on Sky to sub-license its rights to this content on a non-exclusive basis. This would undermine the basis on which Sky had originally contracted for this content in a way that would break up the process of Sky assembling channels from various content.

- We believe it would be appropriate to apply the remedy to those linear channels broadcast by Sky which contain this content, since this is currently the principal means by which consumers view this content, and is the normal means by which broadcasters supply content to retailers.
- We have considered whether it would be appropriate to apply the remedy to the most popular bundles of channels containing premium content. This might for example result in the remedy being applied to all the channels within the 'Sky Sports Mix' or the 'Sky Movies Mix'. We do not believe this would be appropriate, since as long as a competing retailer had access to the content associated with market power, it should be possible to combine this with other content to create competing bundles. We do however need to address some issues associated with bundling, such as the level of cross-promotion between channels in a bundle, and we return to these issues below.

9.20 We therefore propose that any remedy should apply to a specific set of channels. The channels which we currently consider would be caught are:

- Sky Sports 1 and Sky Sports 2, and HD versions of both channels.
- Sky Movies Action & Thriller, Sky Movies Comedy, Sky Movies Drama, Sky Movies Family, Sky Movies Premiere, Sky Movies Premiere HD, Sky Movies Premiere+1, Sky Movies SciFi & Horror, Sky Movies Screen 1, Sky Movies Screen 2, Sky Movies Screen 1 HD, Sky Movies Screen 2 HD.

9.21 One issue we would face in defining the scope of a remedy relates to the uncertainties discussed in section 4 regarding the market definition for premium sport (the same issue does not arise for premium movies). This focuses on live FAPL, because of the quality of this content, coupled with the fact that it provides sufficient volume to sustain a subscription service. We did however recognise that some other sporting events (e.g. Champions League) provide content of a similar quality to live FAPL, albeit in lower volumes, and that it might be appropriate to expand the market definition to include this. Our conclusions on market power did not depend on whether Champions League was in or out of the market. It is not currently possible to observe the demand for the majority of Champions League coverage separately from the demand for FAPL, because they are mainly shown on the same channels.

9.22 There is therefore a risk that our current market definition analysis may result in a remedy which is too narrow in scope. We do not however believe this to be too great a risk in practice, for the following reasons:

- Since a remedy would relate to a channel rather than to a specific item of content, it would capture more content than would be implied by a very narrow interpretation of the market definition. Sky Sports 1 contains live FAPL, but also contains a variety of other sport. It is possible in principle that Sky might create a new channel which contains only live FAPL, but we believe this to be unlikely. Sky Sports 1 is currently Sky's flagship channel, and it seems unlikely that Sky would wish to undermine this position.
- If Sky did create a new set of channels, which excluded FAPL, but which aggregated a large number of other rights in a manner that created market power, then it ought to be possible at that point to observe the effects of this market power, in a manner that is not possible at present. In such circumstances it might be appropriate to consider extending any supply obligation to include

these other channels, and it would be possible to base this consideration on evidence of the stand-alone demand for this content.

- Sky already supplies some premium channels to Virgin Media which would not be included within our definition of ‘Core Premium Sports’ – specifically Sky Sports 3 and Sky Sports Xtra. These channels were previously included within the scope of the non-statutory commitments which Sky gave to the Director General of Fair Trading in 1996. If Sky were to withdraw these channels from Virgin, following the introduction of a wholesale must-offer obligation, the manner in which that withdrawal occurred might provide evidence as to the existence of any market power associated with these channels. In such circumstances it might be appropriate to consider extending any supply obligation to include these other channels. Additionally, if the manner in which this withdrawal occurred provided evidence of some form of anti-competitive conduct, it might be appropriate to consider some form of action under CA98.

9.23 One option for implementing a wholesale must-offer obligation would be for us to apply a remedy in the form of a licence condition associated with each of these channels¹⁹⁴. This may however be too inflexible to be effective over a period of time. There are various reasons why a greater degree of flexibility might be required:

- Some of the channels which would currently be caught by a supply obligation only contain a small amount of Core Premium content. For example, Sky Sports 2 is caught based on the broadcast on this channel of typically five to ten live FAPL matches per season. If this content were no longer provided on this channel, then it may no longer be appropriate to impose a wholesale must-offer obligation.
- It is possible that Sky might at some point in the future create a new channel containing Core Premium content. It may be appropriate to impose a wholesale must-offer obligation in relation to this channel.

9.24 We therefore discuss below a potential framework for deciding which channels should be caught through licence conditions. We would expect these licence conditions to be varied in response to material changes in the level of Core Premium content shown on a specific channel.

9.25 Our starting point is that any supply obligation would apply to any channel broadcast by Sky which contained any Core Premium content as defined above. We note however that an over-strict interpretation of these rules may lead to some rescheduling. In particular, Sky currently broadcasts some live FAPL matches on Sky Sports 2 when there is a scheduling clash, either with other live FAPL matches, or with another important sporting event. We recognise that the imposition of a wholesale supply obligation in relation to live FAPL would create an incentive for Sky to move all live FAPL matches from Sky Sports 2 to Sky Sports 1, in order to avoid Sky Sports 2 being caught by the supply obligation. It would however be a perverse outcome if this resulted in a degradation of the quality of either channel. We would therefore be willing to consider specific exemptions from the approach set out above, in circumstances where such an exemption is the only practical means of avoiding such a perverse outcome.

¹⁹⁴ We refer here to “licence conditions” although it may be appropriate to use a licence direction as the form of any remedy.

9.26 As discussed above, we currently consider that any supply obligation should apply to any channel (or bundle of channels) which is currently broadcasting Core Premium content. However, we may also need to establish an agreed process and timeframe for withdrawal of a supply obligation. In doing so we would need to differentiate between the issues associated with the supply of channels to new consumers, and continued supply to existing consumers:

- Retailers will typically plan their sales and marketing activity over an extended period of time, and would need to have certainty as to what channels they are supplying over this period. A reasonable period of notice is required before a specific channel can be withdrawn from new supply. We would welcome comments as to what this period of notice might be.
- Consumers who are currently receiving a channel would expect to continue receiving it, even if the channel no longer contains Core Premium content. Retailers supplying such consumers ought to be able to develop alternatives to these channels, using alternative sources of content, and migrate their customers to this alternative. And, given the possibility of this alternative, such retailers may also be able to negotiate the continued supply of such channels by Sky, on commercial terms. However, we envisage that this process would take some time, and it may not be appropriate during this process for Sky to withdraw the supply of channels to existing retail consumers. At the same time, we recognise that Sky should not face an indefinite supply obligation in relation to a channel which no longer contains Core Premium content. We would welcome comments as to what length of transitional period we might require.

9.27 Finally, we note another type of transition issue. As described above, Sky currently supplies Virgin Media with sports channels that do not fall within the market for Core Premium Sports channels that we have identified in this process. This supply appears to be at least partially a consequence of the non-statutory undertakings that Sky gave the Director General of Fair Trading in the 1990s. While these commitments are no longer in force, it would still be a concern if Sky were to change its behaviour to act in a way that was inconsistent with those commitments.

Product definition

9.28 This section considers in more detail various issues of product definition. We consider the following questions:

- Whether there should be any conditions covering content contained within the channels, to cover issues such as cross-promotion.
- The technical means by which the channels are distributed to other retailers.
- The format in which they are distributed (SD / HD, compression levels).
- Support for interactivity.
- Support for Video on Demand.

Content of channels

9.29 The remedy we are considering would require Sky to make available specific channels on a wholesale basis to other retailers. However, these channels would still be branded as Sky channels, and would be under the editorial control of Sky. Given

that we expect these channels to underlie retail competition between a variety of different service bundles, from different retailers, we would need to consider whether any limits should be placed on this editorial control.

- 9.30 The most obvious concern that might arise is if Sky made extensive use of cross-promotion or advertising, and used this to promote channels which are included within Sky's own retail bundles, but which are not included within other retail bundles. This might include cross-promotion or advertising of other channels which are retailed by Sky as being premium channels, but which may not be caught by the proposed obligation (e.g. Sky Sports 3).
- 9.31 Another concern might be due to the "halo effect" of the Sky brand. Any marketing which promotes the Sky brand at the wholesale level is also likely to have a beneficial effect on Sky's retail offerings. To a certain extent this is inevitable: Sky's brand is an integral part of the service proposition, even at the wholesale channel level, so it is reasonable for Sky to use these channels to promote its brand. However, it should do so in a manner that is appropriate for a wholesale channel which is being distributed to a variety of other retailers.
- 9.32 We could therefore propose to require Sky to make available a 'clean feed' to other retailers, which complies with a set of rules governing advertising and cross-promotion. This clean feed may be the same channel which Sky provides to itself, if this is compliant, or it may be a different feed. We suggest the following, on which we invite comment:
- No cross-promotion of specific channels which are not included within the supply obligation proposed here.
 - 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.
- 9.33 This clean feed would have to be of comparable technical quality to the transmission which Sky uses for itself. For example, the process of generating the clean feed should not result in reduced video or audio quality or significant delay which is detrimental to the viewer experience.

Channel distribution

- 9.34 There are broadly three ways in which a channel can be distributed in real time to different platforms:
- Alternative retailers can pick the channel up 'at the factory gates', by purchasing private circuits / leased lines to an agreed point of handover.
 - Alternative retailers can pick up the broadcast signal from Sky's satellite transmission, either at a single location or more likely multiple locations (e.g. cable headends) and onward broadcast this to their subscribers (having removed Sky's chosen conditional access technology and applied its own CA technology).

- Alternative retailers can use the same broadcast signal to serve their subscribers as is used by Sky, typically via the use of simulcrypt. This is only practical where the signal is broadcast using radio frequencies which can be received by all subscribers, as might be the case for both DSat and DTT.
- 9.35 Our 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. This method is also likely to provide the highest technical quality for the channels and give retailers the greatest flexibility to compress the signal using their preferred technology.
- 9.36 The only exception to this is DTT; due to the limited availability of spectrum we do not expect that multiple versions of the channels would be broadcast on DTT. As discussed in our second consultation on Sky's proposed Picnic service, we believe that it is appropriate for simulcrypt to be used in this case.
- 9.37 The broadcast feed which other broadcasters pick up at the factory gates would have to comply with an agreed set of technical standards:
- Video and Audio formats e.g. SD (576i), HD (1080i or 720p) for video and AC3 or MP2 for audio.
 - The type of compression applied and the bit rate of the feed. We would expect that a relatively light level of compression would be applied in order to maintain the highest video and audio quality while avoiding the need for a very high bandwidth leased line.
 - The type of the data circuits required to carry the signal e.g. PDH or SDH and mechanism by which resilience is achieved.
 - API for interactive applications.
- 9.38 We expect these technical standards would evolve with time, but this evolution should take place in a co-ordinated manner. Rather than trying to specify these standards ourselves, we propose that Sky would be required to publish an interface specification, and consult on any changes to this specification. We would normally expect six months notification to be provided for minor changes, more for major changes.

Channel format: SD and HD

- 9.39 Sky retails some of its premium channels in both SD and HD. The question therefore arises as to whether both might be made available to alternative retailers.
- 9.40 Any 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.
- 9.41 This does not however mean that the same price should be charged for an HD channel as for an SD channel. Indeed, we acknowledge the innovation and

investment required to put in place a new version of a service such as HD, and the risk at the time the service was developed should be reflected in the way the service is priced. We discuss this in more detail towards the end of this section.

Channel format: interactive services

- 9.42 There are a number of different types of content that can be described as “interactive”, primarily based on being accessible through the “red button”. These range from offering alternative football matches to the one being shown on the main channel, through alternative commentary, to facts about the content being shown. Interactive services tend to be more relevant to sports channels than to movies.
- 9.43 We 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.
- 9.44 Content 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.
- 9.45 We would however be concerned if consumers on one platform were to see messages or promotion relating to interactive content which was available only via other platforms, and not via their own platform.

Video on demand

- 9.46 Video on demand services are likely to become increasingly important, particularly in the context of IPTV. Premium content, in particular premium movies, could be an important factor driving take-up of such services. Live sports content, which loses (a significant proportion of) its appeal once it ceases to be live, is likely to be somewhat less important.
- 9.47 Several operators, namely Virgin Media and BT Vision, already offer PPV VoD services. However, as we indicated in our market definition section, the consumer demand for PPV services appears rather lower than the potential consumer demand for subscription services.
- 9.48 It is possible to distinguish a number of types of VoD service:
- PC-based 'Pull-VoD', in which the consumer downloads or streams content onto a computer using the internet, and views it via the computer screen. Sky offers such a service, in the form of its SkyPlayer service. A number of FTA services are available, including the BBC's iPlayer. Other pay services under development include Kangaroo.

- TV-based 'Pull-VoD', in which the consumer downloads or streams content onto a set-top-box, and views it via the television screen. Such services are difficult to implement on satellite or DTT platforms, but have been implemented on IPTV and cable platforms, albeit without premium subscription content.
 - TV-based 'Push-VoD', in which the retailer 'pushes' a selection of content over a broadcast channel (often overnight), and instructs the set-top box to record it to its internal the hard disk. The consumer is then able to view this via the television screen at a time that suits them. Sky Anytime TV is an example of such a service which incorporates premium content. Top Up TV Anytime is an example of such a service which does not have premium subscription content.
- 9.49 We would at the very least expect that, where Sky has the appropriate movie rights, and where it uses those as the basis of a subscription VoD service to its own retail customers, it should make a wholesale version of this SVoD service available to other platforms.
- 9.50 However, one risk associated with this approach is that Sky may have a limited incentive to develop a more extensive SVoD service containing all the movies to which it has relevant rights. Currently Sky is limited in the number of SVoD movies it can offer its subscriber via its TV set-top boxes due to the nature of its Push-VoD technology (and the number of subscribers which have the necessary set-top box). In the short term a wholesale service which contained all the movies for which it has exclusive SVoD rights would be of limited benefit to Sky satellite platform, but could be fully exploited by cable and IPTV platforms. It may therefore be appropriate to consider requiring Sky to launch a wholesale SVoD service which includes all the relevant premium movies by a specified date, subject to ownership of the rights.

Pricing

- 9.51 The price of any wholesale must-offer is clearly a central feature of the offer. Our preliminary view is that, if a wholesale must-offer obligation is appropriate, then in order for that obligation to be effective it would also be necessary to specify a framework which determines with a reasonable degree of certainty what the wholesale price should be. It may additionally be necessary to set the actual price.

The regulatory framework for setting wholesale prices

- 9.52 Any wholesale regime would typically include some or all of the following elements:
- An obligation to offer specific products and services on a fair, reasonable and non-discriminatory basis.
 - More specific conditions setting out pricing rules. These pricing rules can vary from a very high-level statement of how prices should be derived (e.g. retail-minus, cost-plus) to a much more detailed description of how this should be done (e.g. which costs are allowable, what constitutes efficiently incurred costs, how common costs should be recovered, over what product volumes fixed costs should be recovered, appropriate rates of return).
 - Other conditions which provide transparency that these conditions are being complied with. These conditions will typically include a requirement to publish prices, typically in the form of a rate-card, plus arrangements to ensure that internal transfers are also charged at rate-card prices, such as some form of accounting separation.

- 9.53 Where a reasonable degree of certainty could be provided by the elements described above, it might be beneficial to leave the final process of setting prices to commercial negotiation. Ofcom would need to provide a mechanism for resolving disputes, since we have already identified one of the possible reasons for content not being distributed as being the inability to agree commercial terms. However, this approach would reduce the time taken to establish an initial framework, and should allow for greater commercial input to pricing than if the entire process of setting prices is a regulatory one.
- 9.54 Alternatively, it may be desirable for us to set a specific set of price controls as part of any initial framework. This may be an appropriate approach to take if we believed that commercial negotiations were likely to be slow, and that ultimately Ofcom was going to have to set prices anyway. In such circumstances, setting a price control as part of the initial framework might increase the time required to establish such a framework, but might reduce the total time taken to provide sufficient certainty for alternative retailers to launch. We would welcome views on this choice.

Approaches to setting prices

'Retail-minus' and 'cost-plus' approaches to setting wholesale prices

- 9.55 At a high level, there are in principle two broad approaches to setting a wholesale price.
- The first is to follow a 'retail-minus' approach. Under this method, the wholesale price for a particular piece of content is set equal to the retail price for that content minus an assessment of the costs incurred at the retail level, including an appropriate retail profit margin.
 - The second is to follow a 'cost-plus' approach. Under this method, the wholesale price for a particular piece of content is set equal to an assessment of the wholesale costs that should be attributed to that content, including an appropriate wholesale profit margin.
- 9.56 At a greater level of detail, there are different approaches to each of these options – retail-minus in particular.
- One approach would be to adopt the type of test used in *ex post* competition law cases. In such cases the competition concern normally focuses on the historic conduct of an incumbent, and it is normal to assess this conduct by applying a margin squeeze test based on the incumbent's own historic costs. This is the approach used in cases such as the OFT's case involving Sky¹⁹⁵, the Court of Appeal in *Albion Water*¹⁹⁶ or the Competition Appeals Tribunal in *Genzyme*¹⁹⁷.
 - However, an alternative approach could be used under Ofcom's sectoral competition powers (under section 316 CA03) in the event that ensuring "fair and effective" competition on a forward-looking basis required the promotion of entry. In that situation, it might be appropriate to set a price based on a forward-looking view of a new entrant's costs. There would be some similarities between this and

¹⁹⁵ See section 6.

¹⁹⁶ *Dwr Cymru Cyfyngedig and Albion Water Limited and Water Services Regulation Authority* [2008] EWCA Civ 536.

¹⁹⁷ Case No 1016/1/1/03 [2004] CAT 4.

the approach taken under the margin squeeze test which Ofcom applied to the DataStream remedy¹⁹⁸.

- 9.57 In the absence of supernormal profits in either wholesaling or retailing, we would expect wholesale prices derived on a cost-plus basis to be at the same level as prices established on a retail-minus basis. If there is a gap between the two, that may be an indication of high prices at some point in the value chain. It is however particularly important to adopt a consistent approach to the allocation of common costs and intangible assets when comparing prices determined using different methodologies
- 9.58 The process of setting prices therefore requires much the same analysis as the process of determining wholesale margins. As we discuss below, the approach to setting prices is closely related to the level of wholesale margins. What this means in practice is that these two pieces of analysis would have to be carried out in parallel.
- 9.59 Any approach which we adopt would involve a number of practical challenges, which we discuss further below.
- Treatment of costs, including the allocation of common costs and intangible assets.
 - In the case of a retail-minus approach, determining the appropriate measure of retail price. This may be complex in circumstances where the product for which we wish to determine a wholesale charge is normally retailed in bundles including a range of other products.
 - The mechanism by which the regulated price varies over time, and the set of incentives which this creates.
- 9.60 We welcome comment on the different approaches to setting prices, and the practical challenges which they create.

The link between the competition concerns and the approach to setting wholesale prices

- 9.61 Which of the two approaches discussed above (retail-minus or cost-plus) is most appropriate could relate to the competition concern that we are seeking to address.
- 9.62 If the competition concern were primarily with a high wholesale margin, a retail-minus approach would not directly address those excessive wholesale profits. Rather, drawing on a cost-plus approach might be more appropriate.
- 9.63 In contrast, if the competition concern were primarily that retail competitors were being foreclosed, then a retail-minus approach would seem to be more directly focused on tackling the competition concern. This is because a retail-minus approach assesses whether the wholesale price is sufficiently low to enable efficient competitors to compete against the retail arm of their wholesale supplier.
- 9.64 However, in these circumstances a cost-plus approach might also provide relevant evidence on the appropriate wholesale price. This is because, as stated above, if the firm that is subject to the wholesale supply obligation is not earning high profits, the two approaches should give a similar answer. A wide disparity between a price

¹⁹⁸ http://www.ofcom.org.uk/consult/condocs/adsl_price/statement/statement.pdf

derived from a cost-based analysis and a price derived from retail-minus might represent evidence of high wholesale margins, although it would be important to ensure consistent treatment of common costs and intangible assets¹⁹⁹.

Practical challenges in assessing appropriate wholesale prices

9.65 Regardless of which approach we might adopt, there are a number of theoretical and practical complexities that we would need to consider in the event that we seek to establish a wholesale price. We do not comprehensively discuss these here. Rather we briefly outline, at a high level, three issues that arise. We welcome comments on these issues and more generally on the appropriate approach to pricing.

Treatment of costs

9.66 The first issue involves the treatment of costs. Under a cost-plus approach it is necessary to assess the wholesale costs of supplying the regulated content; under a retail-minus approach it is necessary to assess the retail costs of supplying that content. The level of those costs would depend on the extent to which fixed and common costs are allocated to the supply of the content in question.

9.67 The treatment of costs may depend on the competition concern that is being addressed. For example, if the competition concern is the foreclosure of efficient new entrants then the appropriate cost measure may be different than when assessing the foreclosure of well-established firms that already supply a range of related products. For example, it may be appropriate to take explicit account of new entrants' lack of economies of scale and scope and the rate at which a new entrant's costs might be expected to converge to those of an efficient established firm. This would potentially lead to a larger retail margin than that which would arise using an 'equally efficient operator' approach.

9.68 There is also an amount of uncertainty involved in rights costs, as illustrated by Figure 9, which shows Sky's expenditure on rights over time, and Figure 8. Movie rights prices have been somewhat more stable over time than sports rights prices, perhaps due to the effect of there being a portfolio of six Major Hollywood Studios' rights. Football rights prices have followed a generally upward trend, but have not increased at a constant rate.

Determining the appropriate measure of retail price

9.69 The second issue is determining the appropriate measure of retail price under a retail-minus approach. One 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.

9.70 A further potential complexity is that the product for which we may wish to determine a wholesale charge, and the retail bundles within which that is sold, may vary between different platforms. For example, the multi-channel movies packages which Sky retails on its satellite platform would not be an appropriate package to retail on a DTT-based platform, given likely capacity constraints, and the stand-alone retail price

¹⁹⁹ Differences in the treatment of fixed and common costs and intangible assets can mean that the two approaches give different results. In such circumstances, using both approaches may provide a useful cross-check on the reliability of any results. However, further differences might also arise if retail costs under a retail-minus approach were assessed on the basis of new entrant costs.

of a single movie channel may be difficult to determine from the price of a multi-channel package.

Changes in price over time

- 9.71 The third issue relates to the way in which the appropriate wholesale price should change over time once an appropriate level had been established in year zero.
- 9.72 For example, under a retail-minus approach there would be a number of possible adjustment mechanisms, each of which would create different incentives and would have different advantages and disadvantages.
- The regulator forecasts retail prices and retail costs and sets the appropriate wholesale price for each year within the forecast period based on these forecasts. This might be achieved, for example, by setting an ‘RPI-x’ price control. Only under exceptional circumstances would the question of pricing be re-opened during the period of the price control. The wholesale price would not therefore normally change if retail prices or costs changed from the forecast levels.
 - The regulator forecasts retail costs and specifies that the wholesale price must equal the current retail price minus those forecasts. As a result, if the retail price increases then the wholesale price also increases by a commensurate amount. It would in principle be possible for the margin to be held constant either in percentage or absolute terms.
 - The regulator reassesses retail costs each year and reassesses the appropriate wholesale price each year using that updated cost information.
- 9.73 A particular potential difficulty with a retail-minus approach is that the outcome could be gamed by the wholesale channel provider – Sky in this case. This could happen in several ways.
- First, Sky could flex its own retail prices to affect the wholesale input prices of its competitors, although depending on the adjustment mechanism, this would not necessarily change retail margins.
 - Second, Sky could change its retail bundles or increase their complexity in a way which makes it difficult to calculate an appropriate price for other retailers, particularly those on other platforms.
- 9.74 There are also challenges in adjusting wholesale prices over time under a cost-plus approach, particularly related to the fact that programming costs are largely determined by periodic auctions. Setting forward-looking wholesale prices on the basis of the outcome of rights auctions risks creating circularity. Channel providers’ decisions on how to bid would be informed by the knowledge that their bidding strategies would be likely to affect one of the biggest input costs to their retail businesses, and would be likely to adjust their strategies accordingly. Not only could this affect the amount that Sky would pay for the rights; it could also create a situation in which other bidders were deterred from bidding against Sky for fear of forcing up their own input costs (i.e. Sky’s wholesale prices) in the event that Sky continued to win the rights.

Summary of challenges in assessing appropriate wholesale prices

- 9.75 In assessing appropriate wholesale prices, we would need to be very conscious of any negative effects that a particular pricing mechanism could have. In particular, any mechanism that caused an artificial depression of rights values would be extremely undesirable. On the other hand, if we were to propose a retail-minus approach, we would need to ensure that we took steps to ensure that the mechanism was robust to changes in retail price levels and structures over time.
- 9.76 In an attempt to mitigate the likely effects of the various practical difficulties, one method would be to adopt a retail-minus approach, but use a cost-based analysis as a cross-check, noting the need to consider how the value of intangible assets should be considered in that calculation. If this cross-check were to result in a significant discrepancy, providing evidence of excessive wholesale margins, we might consider whether there was a way of bringing prices into line with costs without opening up the difficulties relating to rights auctions.

Commercial terms

- 9.77 In addition to pricing, there are a number of other commercial terms which would need to be agreed. Rather than attempting to specify all of these, Ofcom's preference would be for these to be negotiated commercially between Sky and those other retailers wishing to retail the content included within this offer. Ofcom would only intervene if those negotiations were unsuccessful. However, we recognise that it might be necessary to provide a greater level of guidance on the likely commercial terms of wholesale deals.
- 9.78 We suggest that any wholesale obligation could contain a requirement on Sky to publish a reference agreement, which would be available to all qualifying retailers. This agreement could cover:
- Security requirements and liability for security breaches.
 - Interactive content.
 - Subscriber audit.
 - New service development.

Security requirements and liability for security breaches

- 9.79 Minimising the number of consumers who have unauthorised access to pay TV content is fundamental to the sustainability of the subscription TV business model. Any service theft that results from weaknesses in the CA system operated by one retailer may not only reduce the revenues of that retailer, but may also impact on the revenues of other retailers and the wholesale provider. It is therefore vital that all retailers use effective CA technologies and are incentivised to minimise service theft.
- 9.80 Tight security arrangements would be particularly important under a wholesale must-offer. It is vital that content owners continue to have confidence in the secure distribution of their content in a situation where that content is distributed more widely at the wholesale level.
- 9.81 One 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. In conjunction with a subscriber and security audit of each retailer the MSRs could form the basis of an agreement between Sky and each retailer for supply of wholesale must-offer channels.

- 9.82 There are a number of options as to how any such MSRs could be defined. These include:
- i) Sky, as the wholesale channel provider, defines the MSR by specifying which CA technology must be used by each retailer. In this scenario Sky would be fully responsible for the integrity of the CA system and as such would also be liable for any breaches of that security system.
 - ii) Sky negotiates with each prospective retailer to agree the CA technology used and how liability for any breaches of security would be shared.
 - iii) Sky defines a set of technology and platform agnostic MSRs and retailers select a CA technology which they consider best fulfils these requirements.
- 9.83 While option (i) gives Sky full control over which CA technology is used and hence responsibility for ensuring its ongoing integrity this approach has a number of limitations. First, established pay TV platforms such as those operated by Virgin Media and Top Up TV have already invested heavily in CA technology and swapping out systems in order to meet Sky's requirements may not be commercially viable. Second, specifying a single CA technology to be used across a number of digital TV platforms may not be efficient as the optimum solution for one platform may not be the optimum solution for another. For example, the always-on return path on IPTV and cable networks may allow a different solution to be used from that used on a broadcast-only platform such as DTT. Finally, there is ongoing innovation in CA technologies and any requirement to use a particular technology may need to be reviewed on a regular basis.
- 9.84 Allowing Sky to negotiate with each prospective retailer of the wholesale must-offer channels would appear to be the least interventionist option to establishing the necessary security regime (option ii). Allowing the parties to agree on the extent to which liability for security breaches would be shared should incentivise both parties to minimise piracy. However, due to the potentially wide range of technical solutions that a retailer may wish to employ to protect the wholesale must-offer channels, the complexities associated with agreeing the criteria for the technical assessment and the clear incentive for each party to try and avoid the liability associated with any security breach there is a possibility that negotiations would be prolonged and could often result in the need for dispute resolution if the parties cannot reach agreement.
- 9.85 Option (iii) addresses some of the issues associated with options (i) and (ii). By providing a set of generic, platform and technology agnostic security requirements, Sky would be able to establish the minimum requirements it considered were necessary to protect its wholesale must-offer channels and prospective retailers could base their evaluation of candidate CA technologies on those requirements. This option provides transparency to prospective retailers on the level of security they are expected to meet and places the onus on them to achieve it. The options for identifying and quantifying security breaches are discussed further below.
- 9.86 We welcome stakeholders' views on whether we should consider other approaches for setting security requirements or whether requiring Sky to define a technology- and

platform-agnostic set of MSRs and requiring retailers to 'self-certify' their chosen technology (option (iii) above) is a viable approach.

Interactive content

- 9.87 Wholesale distribution of interactive content associated with the wholesale must-offer channels poses more complex technology challenges than standard audio and video due to the wide range of solutions used for interactive services in the UK. The situation is further complicated by the need for 'broadcast' initiated applications running on set top boxes and iDTVs to connect via a return path and interact with server based applications in real time.
- 9.88 Sky currently uses a technology from a company called OpenTV to author and execute interactive TV applications on its DSat platform and does not supply interactive content to Cable or on Tiscali TV who use different technologies. Conversion from OpenTV to other formats is technically complex, but wholesale distribution might be possible if Sky developed its applications using a more platform agnostic format and then converted this into the formats used by each platform. Alternatively, Sky could develop its interactive applications in both OpenTV (for use on its DSat platform) and another format that is widely used by other retailers.
- 9.89 MHEG5 is the technology used for authoring applications for the DTT platform (and the recently launched Freesat platform). With an increasing number of pay TV retailers (e.g. BT Vision) supporting MHEG5 in their set top boxes, applications developed in this technology have the potential to form the basis of a wholesale must-offer offering. However, Virgin Media does not currently support MHEG5 in its cable STBs and so an additional or alternative remedy may be necessary.
- 9.90 As an alternative to 'dual authoring' of interactive services we are aware that there are a number of standards based technologies which could be used to distribute Sky's interactive service to retailers. DVB-PCF (Portable Content Format) is a technical specification that is specifically designed to provide an abstraction layer between the on screen presentation and functionality of an interactive application and the underlying operating system and hardware. To our knowledge DVB-PCF is not currently used by Sky for developing its interactive applications, but we would welcome stakeholder views on whether it could form the basis of a common standard for distributing the interactive services associated with Sky's wholesale must-offer channels to retailers.
- 9.91 Many interactive services provide consumers with the option to connect on-line (using a dial up or broadband connection built into the set top box) to provide greater level of interaction (e.g. voting on a talent competition or requesting information about a TV advertisement). In a scenario where interactive services developed by Sky, as part of its wholesale must-offer content offering, are distributed on digital TV platforms of a number of retail providers it is not clear whether the applications would connect to the retailers' on-line servers or whether they would connect directly to Sky. This is further complicated in situations which require access to the subscriber data held by the retailer, for example where the application pre-fills an on screen registration form with name and address information extracted from the subscriber database.
- 9.92 The authoring, distribution and operation of interactive services by multiple retailers across multiple digital TV platforms is a technically complex subject and we welcome stakeholders' views on how it might be addressed.

Subscriber audit

- 9.93 In a wholesale charging structure which is based on the number of retail subscribers it is clearly important that each retailer maintains an accurate record of the number of retail subscribers it has and that these figures can be verified and validated by a third party auditor.
- 9.94 If a charging structure were to be adopted in which retailers are required to pay additional charges as a result of service theft (due to security breaches in its chosen CA system) it is important to be able to quantify the magnitude of theft accurately and have a robust process for assigning liability to a particular CA system.
- 9.95 There are a number of options for establishing reporting and audit procedures associated with subscriber numbers and service theft. These include:
- i) Sky negotiates reporting and audit procedures with each prospective retailer.
 - ii) Sky defines generic reporting and audit procedures to be used by all retailers.
 - iii) Ofcom defines the reporting and audit procedures and appoints an independent audit firm to implement them.
- 9.96 While option (i) provides the greatest commercial freedom to define a process it may lead to prolonged negotiations and, where agreement cannot be achieved, frequent complaints and disputes being brought to Ofcom. Defining the process for assigning responsibility for service theft is likely to be particularly problematic and the subject of disputes.
- 9.97 While Ofcom could minimise the possibility of disputes between Sky and potential retailers by defining the necessary processes and procedures (option (iii)) this level of intervention may not be necessary if Sky is able to develop a standard set of processes and procedures which the industry is prepared to adopt (option (ii)). To attain buy in from retailers it may be useful for Sky to consult with industry on its proposed processes and appoint an independent audit firm to implement them.
- 9.98 While the use of standard audit procedures conducted by an independent party may be acceptable to both Sky and the retailers, any claim that a particular platform has been subject to a CA security breach that has resulted in significant service theft is likely to be strongly contested by the retailer. The source of the any service theft may be very hard to identify and, due to the potentially large financial liabilities involved, disputes are highly probable. Consequently a robust and rapid resolution process is likely to be required.

New service development

- 9.99 It is possible that Sky would make enhancements to wholesale must-offer channels and associated services in the future e.g. introduction of 1080p HD or additional interactive services.
- 9.100 Where such enhancements fall within the scope of any wholesale must-offer obligation Ofcom would expect these enhancements to be made available to third party retailers at the same time as they are made available to Sky's own retail business to avoid distorting competition at the retail level.

Review provisions

- 9.101 Such an intervention should not have an indefinite life. We would consider reviewing the regulation after it had been in force for a period of time – three years might be appropriate, but we would welcome views on this. This reflects the possibility that market conditions may change over time, or market power may shift.
- 9.102 It is also possible that specific events might trigger a review of the obligation. For example, if the rights ownership situation were to change sufficiently significantly to make it likely that the balance of market power in the provision of wholesale channels shifted, that might necessitate a review of the provisions. Where a review necessitated a lifting of supply obligations, we would recognise the need for some form of transitional arrangements.

Consultation questions

35. If we were to pursue a wholesale must-offer, which retailers should be able to purchase what content on what terms?

36. What is your view on which retailers should be eligible for any wholesale offer?

37. What is your view on our decision to focus in this document on residential subscribers?

38. Have we identified the right content and channels to be captured by any wholesale offer?

39. Have we picked up all the relevant issues to do with defining the wholesale product – i.e. conditions on channels, technical distribution, format, interactivity, VoD? How would you suggest proceeding on any or all of these?

40. Do you agree with our discussion of the need to set prices?

41. Do you agree with our characterisation of the two main approaches to setting prices – retail-minus and cost-plus – and the practical issues with each?

42. If we were to use a retail-minus approach, what would be the set of costs that we should take into account? Should we base the assessment on new entrant costs or on the costs of an efficient large-scale operator?

43. Have we identified the important issues related to commercial terms? How would you suggest proceeding on any or all of these?

44. In particular, how should we tackle the issue of security?

45. Is three years the right length of time before the first review of this provision? What factors should cause us to review it earlier than this?

Annex 1

Responding to this consultation

How to respond

- A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on 9 December 2008**.
- A1.2 Ofcom strongly prefers to receive responses using the online web form at http://www.ofcom.org.uk/consult/condocs/second_paytv/, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.
- A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email william.hayter@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.
- A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.
- Will Hayter
Competition Group
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA
- Fax: 020 7783 4143
- A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.
- A1.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

- A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Will Hayter on 020 7783 4197.

Confidentiality

- A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether

all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

- A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.
- A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at <http://www.ofcom.org.uk/about/accoun/disclaimer/>

Ofcom's consultation processes

- A1.11 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.
- A1.12 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk. We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.
- A1.13 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Vicki Nash, Director Scotland, who is Ofcom's consultation champion:

Vicki Nash
Ofcom
Sutherland House
149 St. Vincent Street
Glasgow G2 5NW

Tel: 0141 229 7401
Fax: 0141 229 7433

Email vicki.nash@ofcom.org.uk

Annex 2

Ofcom's consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

- A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.
- A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.
- A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.
- A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at www.ofcom.org.uk/consult/.
- A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing Name/contact details/job title

Whole response Organisation

Part of the response If there is no separate annex, which parts?

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

Name

Signed (if hard copy)

Annex 4

Consultation questions

A4.1 Questions in bold are the summary questions for each section, with subsidiary questions below each one.

Introduction

1. What characteristics should the pay TV sector display in order to serve consumers best?

2. Do you agree with the amendment to our criteria for assessing the pay TV market?

The importance of premium content

3. Why do consumers pay for TV services?

4. Do you agree with our assessment of the relative importance of platform features and content?

5. Do you agree with our views on the importance of premium sports and premium movies content for competition in pay TV?

6. Are there any other international examples to which you would draw our attention?

Market structure and market definition

7. Do you agree with our overall approach to market definition analysis?

8. Do you agree with our definition of the market for Core Premium Sports channels or do you believe it to be narrower or wider than we have suggested? If so, what specific evidence do you have to support your view?

9. Do you agree with our definition of the market for Core Premium Movies channels or do you believe it to be narrower or wider than we have suggested? If so, what specific evidence do you have to support your view?

10. How would you see the future development of consumers' viewing habits for sports and movies, and of the ways movies will be delivered to them? How would this affect market definition?

Content aggregation and market power

11. Does Sky have market power in the wholesale of Core Premium pay TV channels?

12. Do you agree with our conclusion that Sky has market power in the wholesale of Core Premium Sports channels? What specific evidence would you provide to support your view?

13. Do you agree with our conclusion that Sky has market power in the wholesale of Core Premium Movies channels? What specific evidence would you provide to support your view?

Competition issues related to Core Premium content

14. Can retailers and / or platform operators get sufficient access to Sky's Core Premium channels?

15. Have we presented a factually correct picture of current distribution of premium sports and premium movie channels?

16. Do you agree with the list of factors we present as being relevant when Sky considers whether to supply?

17. Do you agree with our presentation of the longer-term factors in Sky's decisions to supply?

18. Do you agree with our discussion of the role of vertical integration?

19. Do you agree with the figures we have presented to illustrate the playing-out of incentives to supply?

20. Do you agree with our proposal that it is important for multiple operators to have wholesale access to Core Premium content, rather than Sky retailing on others' platforms?

21. Do you agree with our analysis of the profitability of Sky's wholesale premium business?

Effects on consumers

22. What is the effect on consumers of the current situation with regard to access to premium content, now and in the future?

23. Do you agree with our analysis of the current situation with regard to choice, innovation, pricing and consumer satisfaction?

24. How would you see differently the future of pay TV as outlined in our "forward look"?

25. Would you agree with our analysis of the likely effects of restricted distribution of Core Premium content on consumers?

Remedies

26. What should we do, if anything, to tackle the problem we have identified relating to Core Premium content?

27. What would you see as the key objectives of any remedy in pay TV?

28. Do you believe we have identified the right list of regulatory options?

29. Have we made a suitable assessment of the option of taking no further action?

30. *Have we made a suitable assessment that it would be more appropriate to use our sectoral competition powers than to rely on ex post action under CA98?*

31. *Have we made a suitable assessment of the option of pursuing a process under our sectoral competition powers?*

32. *Have we made a suitable assessment of the option of pursuing a reference to the Competition Commission?*

33. *Do you agree with our discussion of the legal framework for a wholesale must-offer remedy?*

34. *Have we captured the potential impact on consumers and stakeholders in our preliminary impact assessment?*

Details of a wholesale must-offer remedy

35. *If we were to pursue a wholesale must-offer, which retailers should be able to purchase what content on what terms?*

36. *What is your view on which retailers should be eligible for any wholesale offer?*

37. *What is your view on our decision to focus in this document on residential subscribers?*

38. *Have we identified the right content and channels to be captured by any wholesale offer?*

39. *Have we picked up all the relevant issues to do with defining the wholesale product – i.e. conditions on channels, technical distribution, format, interactivity, VoD? How would you suggest proceeding on any or all of these?*

40. *Do you agree with our discussion of the need to set prices?*

41. *Do you agree with our characterisation of the two main approaches to setting prices – retail-minus and cost-plus – and the practical issues with each?*

42. *If we were to use a retail-minus approach, what would be the set of costs that we should take into account? Should we base the assessment on new entrant costs or on the costs of an efficient large-scale operator?*

43. *Have we identified the important issues related to commercial terms? How would you suggest proceeding on any or all of these?*

44. *In particular, how should we tackle the issue of security?*

45. *Is three years the right length of time before the first review of this provision? What factors should cause us to review it earlier than this?*

Annex 5

Glossary

API: Application Program Interface. A technology that facilitates exchanging of messages or data between two or more different software applications.

BARB: Broadcasters Audience Research Board. The pan-industry body which measures television viewing.

Broadband. A service or connection generally defined as being 'always on' and providing a bandwidth greater than narrowband.

CA: Conditional Access. A technology enabling a broadcaster to restrict access to content that it has made available on a digital platform only to those customers that have been authorised to access it.

CA03: Communications Act 2003.

CA98: Competition Act 1998.

CC: Competition Commission.

CAGR: Compound Annual Growth Rate. The average annual growth rate over a specified period of time. It is used to indicate the investment yield at the end of a specified period of time. The mathematical formula used to calculate CAGR = $(\text{present value}/\text{base value})^{(1/\#\text{of years})} - 1$.

Churn. The loss of customers subscribing to a particular pay TV package or retailer.

Core premium channels. Includes both Core Premium Sports channels and Core Premium movie channels (see individual definitions below).

Core premium movie channels. Specifically those premium channels or packages of premium channels which include movies from the major six Hollywood studios, shown in the first pay TV window.

Core premium sports channels. Specifically those premium channels or packages of premium channels which contain live FAPL matches.

December Consultation. The first Ofcom pay TV consultation published on 18 December 2007.

Digital switchover. The process of switching over the current analogue television broadcasting system to digital, as well as ensuring that people have adapted or upgraded their televisions and recording equipment to receive digital TV.

DSat: Digital satellite. A term used in the UK to refer to the digital satellite platform.

DTH: Direct to home. Another term for satellite distribution technology.

DTT: Digital Terrestrial Television. Currently most commonly delivered through Freeview.

DVB: Digital Video Broadcasting. A set of internationally accepted open standards for digital broadcasting, including standards for distribution by satellite, cable, radio and handheld devices (the latter known as DVB-H).

DVB-PCF: Digital Video Broadcasting-Portable Content Format. A technical specification that is specifically designed to provide an abstraction layer between the on screen presentation and functionality of an interactive application and the underlying operating system and hardware.

DVD: Digital Versatile Disc. A high capacity CD-size disc for carrying audio-visual content. Initially available read-only, but recordable formats are now available.

DVR: Digital Video Recorder (also known as Personal Video Recorder and Digital Television Recorder). A digital TV set-top box including a hard disc drive which allows the user to record, pause and rewind live TV.

EA02: Enterprise Act 2002.

EPG: Electronic Programme Guide. A programme schedule, typically broadcast alongside digital television or radio services, to provide information on the content and scheduling of current and future programmes.

FAPL: Football Association Premier League.

FTA: Free-to-air. Broadcast content that people can watch or listen to without having to pay a subscription.

HD: High Definition. A technology that provides viewers with better quality, high-resolution pictures.

HMT: Hypothetical Monopolist Test. An economic test used to assess whether demand- and supply-side substitutes provide a sufficiently strong competitive constraint to be included in a relevant market.

iDTV: Integrated Digital Television. A television set which has a built in digital tuner and receiver (typically for reception of digital terrestrial TV). iDTVs remove the need for an external set-top box.

Internet. A global network of networks, using a common set of standards (e.g. the Internet Protocol), accessed by users with a computer via a service provider.

IP: Internet Protocol. The packet data protocol used for routing and carriage of messages across the Internet and similar networks.

IPTV: Internet Protocol Television. The term used for television and/or video signals that are delivered to subscribers or viewers using Internet Protocol (IP), the technology that is also used to access the Internet. Typically used in the context of streamed linear and on demand content, but also sometimes for downloaded video clips.

ITC: Independent Television Commission. One of the regulators replaced by Ofcom in 2003.

Major Hollywood Studios. The six biggest Hollywood studios, namely Disney, Fox, Paramount, Sony, Universal and Warner.

MHEG5: Multimedia and Hypermedia Experts Group 5. Technology used for authoring applications for the digital terrestrial television platform.

Multi-channel. In the UK, this refers to the provision or receipt of television services other than the main five channels (BBC ONE & TWO, ITV1, Channel 4/S4C, Five) plus local analogue services. 'Multi-channel homes' comprise all those with digital terrestrial TV, satellite TV, digital cable or analogue cable, or TV over broadband. Also used as a noun to refer to a channel only available on digital platforms (or analogue cable).

Multiplex. A device that sends multiple signals or streams of information on a carrier at the same time in the form of a single, complex signal. The separate signals are then recovered at the receiving end.

MSR: Minimum Security Requirements.

OFT: Office of Fair Trading.

PPV: Pay-per-view. A service offering single viewings of a specific film, programme or event, provided to consumers for a one-off fee.

Platform. A pay TV platform can be defined as the specific combination of distribution and reception technology and conditional access that enables consumers to receive broadcasts. For example, Sky on DSat, Virgin Media on its cable network, Top Up TV on DTT or BT Vision and Tiscali TV on IPTV.

PSB Public Service Broadcasting, or Public Service Broadcaster. The Communications Act in the UK defines the PSBs to include the BBC, ITV1, Channel 4, Five and S4C.

PVR. See DVR.

SD: Standard Definition. As opposed to high definition.

Simulcrypt. A technology that allows a single broadcast channel to be used with two or more conditional access systems.

STB: Set-top Box.

Service bundling. A marketing term describing the packaging together of different communications services by organisations that traditionally only offered one or two of those services.

SSNIP: Small, but significant, non-transitory increase in price. Used in the hypothetical monopolist test.

SVoD: Subscription Video on Demand. A type of VoD service that enables subscribers unlimited access to watch programmes or films whenever they choose to, not restricted by a linear schedule, for a regularly charged fee.

Time-shift. The broadcasting of a television service on more than one channel with a specified delay (typically an hour), to provide more than one opportunity for viewers to watch the service. Alternatively, the recording of programmes by viewers (using PVRs, recordable DVDs or VCRs) to watch at another time.

Top-flight sport. Sports matches from the higher competitive levels of the most popular sports in the UK. For example FAPL matches, FA Cup matches, English Test cricket matches, the Ryder Cup, Six Nations rugby union.

TPS: Technical Platform Services. A group of services comprising Conditional Access, Geographic Masking, Regionalisation, Electronic Programming Guides and Access Control.

UEFA: Union of European Football Associations. The governing body of football in Europe.

VoD: Video on Demand. A service or technology that enables TV viewers to watch programmes or films whenever they choose to, not restricted by a linear schedule. Also Near Video on Demand (NVoD), a service based on a linear schedule that is regularly repeated on multiple channels, usually at 15-minute intervals, so that viewers are never more than 15 minutes away from the start of the next transmission.

WCP: Wholesale channel provider.