ANNEX 2

MARKET DEFINITION AND MARKET POWER

INTRODUCTION

This Annex examines three topics. In Part One, we set out the material flaws in Ofcom's analysis of market definition and market power in the Consultation Document. Part Two examines Ofcom's evidence in relation to the issue of switching by consumers in response to price changes for pay TV services. Finally, Part Three sets out Sky's views on the issues of relevant markets and market power in relation to pay TV services.

The topics discussed in this Annex are as follows:

PART ONE: MATERIAL FLAWS IN OFCOM'S ANALYSIS OF MARKET DEFINITION AND MARKET POWER

A. Background

1.1 In this Part One, Sky sets out the material flaws in Ofcom's analysis of market definition and market power in its Consultation Document. These flaws are the result of the following factors, which are inter-related:

- Ofcom's approach appears to be based on a set of preconceptions which adversely affect its analysis;
- much of Ofcom's analysis is cursory;
- the range of evidence considered by Ofcom is unduly narrow and Ofcom's approach to these issues is overly mechanistic;
- there are material analytical errors; and
- Ofcom's analysis is not forward-looking.

1.2 We discuss each of these elements of Ofcom's analysis in the sections below.

1.3 The cumulative effect of these flaws is that the preliminary conclusions that Ofcom has reached in relation to market definition and market power are unsafe and cannot be relied on.[1] In particular:

- the flaws in the evidence (and Ofcom's analysis of that evidence) in relation to market definition at the retail level mean that Ofcom effectively has no reliable evidence on which to base the preliminary conclusions that it has reached; and
- Ofcom fails entirely to recognise the disconnect between its preliminary conclusions in relation to market definition and market power, and the evidence cited in Section 4 of the Consultation Document.

B. Ofcom's approach appears to be based on a set of preconceptions which adversely affect its analysis

1.4 It is evident from the Consultation Document that Ofcom has approached the issues of market definition and market power in this case with a set of preconceptions which

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1 As set out in **Appendix 1** (Ofcom's inconsistent references to relevant markets) Ofcom uses a large variety of different descriptions of relevant markets in the Consultation Document such that, in practice, it is impossible for consultees to determine what markets Ofcom has actually defined. Moreover (and notwithstanding this), it is unclear in Ofcom's many formulations which relevant markets it considers pay TV packages of basic plus premium sports plus premium movie channels are supplied within.

adversely affect a number of aspects of its analysis. This set of preconceptions can be summarised as follows:

> Sky holds the rights to broadcast sports and film programming which falls into a category that is described as "*must have*" "*premium content*"; there is a limited amount of such content and the barriers to competing with Sky for it are insurmountable, so Sky has significant market power both upstream (in terms of its channel supply business, where its premium channels are also *"must have"*) and downstream (as a retailer of pay TV services.) The existence of such market power means that prices at either or both retail and wholesale levels are above competitive levels. This is what regulators in the past have found and there have been no (or insufficient) changes that should cause Ofcom to take a different view.[2]

1.5 There is a significant element of circularity in this story: the belief that there is market power at one or more levels of the market gives rise to a presumption that prices are above competitive levels, which in turn supports or reinforces the belief that there is market power at one or more levels of the market.

1.6 Aside from the procedural issues raised by an analysis that appears to be founded on preconceptions, the key problem with such an approach is that the preconceptions themselves are either ill-founded, or have no evidential support. In the following sections, we examine a number of the key elements of the story set out above, as follows:

(i) whether wholesale and/or retail prices are above competitive levels;

(ii) *"must have"* content;

(iii) *"premium content"*;

(iv) barriers to competing with Sky for programming rights; and

(v) treating past findings as "*precedents*".

(i) Whether wholesale and/or retail prices are above competitive levels

1.7 It is apparent that Ofcom takes the view that retail and/or wholesale prices are above competitive levels. Although this is only stated in one place in the Consultation Document – at Paragraph 5.45, where this is described as a "*likelihood*" – this belief emerges clearly from the facts that (among other things):

- Ofcom dismisses the relevance of the high levels to switching that it found in response to hypothetical price increases, based on a view that such responses are affected by the 'cellophane fallacy' – which is an issue that arises when current prices are above competitive levels. Although Ofcom refers to this as a

[2] Ofcom's preconceptions in relation to basic channels and basic-only packages appear to be that such services face increasing competition from multichannel free to air television services, which mean that providers do not have market power in their supply (either at the wholesale or retail level).

possibility rather than a probability, it is clear that it has placed little or no weight on the switching data it collected in large part as a result of a belief that it is subject to the 'cellophane fallacy' problem; and

- Ofcom downplays the finding of the Competition Commission in the ITV case[3] in relation to market definition, on the grounds that it conducted its market definition assessment on the basis of current pricing levels (with the inference – largely implicit – that the Commission's analysis is therefore irrelevant to the current case).[4] The fact that Ofcom reaches market definitions that, in Sky's view, are wholly inconsistent with that reached by the Competition Commission is clearly attributable to the fact that Ofcom believes that current prices are above competitive levels.[5]

1.8 Ofcom does not, however, cite any evidence that would support its belief that retail or wholesale prices are above competitive levels.[6]

1.9 In fact, the evidence on Sky's profitability considered by Ofcom suggests that prices are not above competitive levels at either the retail or wholesale levels. If prices were above such levels, it would be expected that Ofcom would find evidence that Sky (and other pay TV providers) would be earning excess profits. Instead, Ofcom concludes that:

> "*Sky has not made returns which could be judged to be excessive, particularly given the risk profile when the early investments were being made.*" [7]

1.10 The implication for Ofcom's analysis is that, in contrast to the approach that it has adopted, unless it provides strong and compelling evidence to the contrary, Ofcom must base its analysis of relevant evidence (such as the results of its application of the hypothetical monopolist test), and approach to recent findings (such as the market definition reached in the Competition Commission's BSkyB/ITV Report), on the presumption that Sky's charges for its pay TV services are not above competitive levels.

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3 The Competition Commission's report to the Secretary of State (BERR) on the Acquisition by British Sky Broadcasting Group plc of 17.9 per cent of the shares in ITV plc, 14 December 2007 (the "**Competition Commission's BSkyB/ITV Report**").

4 Paragraph 3.23 of Annex 13.

5 Sky considers that the other main reason is that the range and types of evidence considered by the Competition Commission was significantly broader than that which Ofcom has considered.

6 Nor does Ofcom give any consideration to the issue of what "*competitive levels*" for such services might be. Ofcom does, however, note that this is a difficult issue at paragraph 3.7 of Annex 13.

7 Paragraphs 1.21 and 4.76.

The implication of economic rents in the television sector for the assessment of market definition and market power

1.11 One explanation for Ofcom's evident belief that prices at the retail and/or wholesale levels are above competitive levels may be the potential confusion caused by the fact that there are economic rents in the television sector.[8] As Ofcom notes, correctly, such rents are likely to flow upstream:

> "t*o the extent that there are any monopoly rents associated with the aggregation of premium content, these will flow upstream. Although they may affect pricing, they are unlikely to result in excessive profits being generated by retail pay TV providers, and may not result in excessive profits at the wholesale channel level either.*"
>
> "*It is possible that significant profits may be being made upstream of Sky, for example by content providers.*"[9]

1.12 Rents in the television sector arise not only from the "*aggregation of premium content*", but also (and more importantly) from the creation of content in general. The media sector is based on the creation of unique assets from which the potential returns exceed the opportunity cost of the inputs used to produce them – for example, film scripts, films, television series, and sports competitions. Such returns are the rewards to those with the unique skills and talent that make the resulting products so appealing to consumers – for example, sports clubs, football and movie stars, writers and directors.

1.13 The existence of such returns upstream should have no bearing on the assessment of relevant markets and market power downstream. Analysis of relevant markets and market power downstream should be undertaken *taking input costs as given*. Accordingly, an observation that retail and/or wholesale prices are higher than they might otherwise be if input costs were lower should not be confused with a proposition that retail and/or wholesale prices are above competitive levels.

1.14 By way of an analogy, despite the international supply of diamonds being controlled by a small number of companies, the jewellery business is competitive and jewellers are unlikely to earn supernormal profits. The fact that the price of diamonds may exceed their extraction and distribution costs does not mean that jewellers are able to earn rents – the price they set to consumers simply reflects the costs of purchasing diamonds together with any value they add in on-selling products which include diamonds to consumers.

[8] A further, though somewhat less plausible (in view of its manifestly erroneous nature) explanation could be the fact that prices are above marginal cost in many areas of the provision of pay TV services. It is clear, however, that this fact simply reflects the nature of the cost structure of many aspects of the provision of television services.

[9] Paragraphs 1.21 and 4.55.

(ii) "*Must have*" content

1.15 It is evident that the concept of "*must have*" content plays a key role in Ofcom's thinking on these issues. The "*must have*" theory appears to apply in Ofcom's view at two levels: in terms of content that consumers "*must have*", and in terms of channels that pay TV retailers "*must have*". Ofcom states:

> "*We have therefore considered whether narrow economic markets exist for specific 'must have' content (premium sport and movies) at both the retail and wholesale level.*" [10]

1.16 Ofcom does not provide any explanation of what it means by this term and uses it throughout its Consultation Document and in its consumer research[11] as though its meaning is self evident. This is not the case.

1.17 At **Appendix 2** (Failure to explain the concept of *"must have"* content and channels) we consider the potential meanings that Ofcom may ascribe to this term. We conclude that the most plausible is that, at the retail level, Ofcom means that some consumers have a high willingness to pay to watch particular types of content on television. If this is the case, this proposition should have no bearing on market definition as this should focus on marginal consumers, rather than 'dedicated fans' of (or consumers with a high willingness to pay for) particular television programmes or types of television programme.

1.18 If this is not what Ofcom means when it uses this term, then it should provide appropriate explanation and indicate properly the relevance of the concept to the analysis of market definition in this case.

(iii) "*Premium content*"

1.19 As in the case of "*must have*" content, Ofcom uses the term "*premium content*" throughout its Consultation Document as though the meaning of the term is self evident. It is not.

1.20 This is not merely an issue of semantics; the concept appears to play a critical role in Ofcom's thinking - the term 'premium' occurs over 300 times in the Consultation Document and nearly 250 times in Annex 13 to the Consultation Document.

1.21 Sky considers Ofcom's use of this term at **Appendix 3** (Failure to explain what Ofcom means by *"premium content"*). We conclude that it is not possible to discern what Ofcom means when it uses the term. Accordingly, in view of the significant role that it appears to play in Ofcom's thinking, Ofcom should specify clearly what it means when it refers to "*premium content*".

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10 Paragraph 1.3 of Annex 13.

11 Somewhat bizarrely, Ofcom reports consumers as regarded things such as "*providers*" and "*content*" as "*must have*"– see Figure 12). We can only speculate as to what consumers mean if they respond that they consider that they "*must have*" something.

(iv) Barriers to competing with Sky for programming rights

1.22 A key element of Ofcom's conclusion that Sky has a dominant position in a number of putative markets is an evident belief that it is extremely difficult for other operators to compete with Sky for the acquisition of (a) rights to broadcast sports content and (b) the pay TV rights to Hollywood films. We consider this proposition in detail at **Annex 3** (Barriers to entry at the channel provider level) to Sky's Response. This analysis demonstrates that the proposition does not bear close scrutiny and is contradicted by actual evidence, and, accordingly, no weight should be placed on it in Ofcom's thinking.

(v) Treating past findings as "*precedents*"

1.23 In its analysis of market definition and market power, Ofcom places significant weight on past findings in relation to competition inquiries in cases involving pay TV both in the UK and other countries. These are described as "*precedents*" for the current case in the Consultation Document, and form the starting point for Ofcom's analysis.[12] Effectively, Ofcom's approach is to seek to examine whether such findings continue to hold. For example, Ofcom states:

> "*if competition has intensified sufficiently for the market definition to be widened* ***(as compared with previous precedent)*** *then we would expect to see some combination of falling prices, falling subscriber numbers and rising quality.*"[13] (emphasis added)

1.24 As we point out in Part Two of this Response, there is no such concept as "*precedent*" in relation to market definition, but only past cases which may provide some assistance in a new assessment (but may equally be of no relevance whatsoever).

1.25 Sky finds it surprising that Ofcom has chosen to adopt an approach to these issues that is simply to take work done by other regulators in the past as a given and seek to examine whether anything has changed sufficiently to depart from those previous

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12 Somewhat bizarrely, Ofcom appears to regard findings reached as long ago as 1996 and 1999 as "*recent*" (as indicated by the section heading preceding Paragraph 2.4 of Annex 13). Clearly, this is not the case. As set out in Sky's Response to the Complaint, and elaborated on at **Appendix 4** (Treating past findings by competition authorities as *"precedent"*) the significant changes in the competitive landscape that have occurred since 2002 – particularly the rise of Freeview - mean that it is unsafe to rely on the OFT's findings in the 2002 decision as "*precedent*" in the current case. By contrast, the Competition Commission's BSkyB/ITV report is so recent that the final report was published after Ofcom's Consultation Document.

13 Paragraph 4.30 of Annex 13. As set out in Part 2 of this Response, the fact that this is Ofcom's approach is also indicated by comments by Ed Richards at Ofcom's media analysts' briefing on 19 September 2007:

> "*If you look at* [the OFT's] *conclusions to a very substantial piece of work, they say, in their conclusions, that Sky is dominant in the provision of wholesale premium content, and that is the base from which I am working. It may be that, in the work that we do, we conclude that that is no longer the case, but that is the last serious competition authority assessment of that position and, at the moment, I do not see any reason to change that view. In the course of the work we do, we may do, but that is my current view. I am always happy to receive evidence to refute that from any party, but that is the basis of the current view*".

findings. This does not seem to square with Ofcom's general approach of taking a fresh look at issues for itself. Sky considers that this review should provide a real opportunity for an open-minded regulator to conduct a fresh – and, more importantly, forward-looking - examination of these issues.

1.26 Moreover, it is equally clear that in competition inquiries, previous findings are only of relevance to the extent that (a) findings were well-founded at the time that they were reached; and (b) if so, that the underlying facts are the same or generally similar to the case under consideration. Ofcom does not appear to have attempted to determine these matters. It is critical to note that an approach that relies significantly on past findings as the starting point creates an inherent risk of error. This is for the simple reason that if either (or both) of the conditions cited above are not met, then that approach is likely to lead to false conclusions in relation to the current case.

1.27 The extent to which past findings are likely to be relevant to the current case is discussed further at **Appendix 4** (Treating past findings by competition authorities as *"precedent"*). We conclude that, save for the Competition Commission's conclusions in the BSkyB/ ITV case (which we discuss in the following section), it is unsafe to use the findings cited by Ofcom as the starting point for analysis in the current case.

The Competition Commission's finding in the BSkyB/ITV case

1.28 Sky considers that the finding on market definition in the BSkyB/ITV case is of direct relevance to Ofcom's consultation. The Competition Commission's inquiry is: (a) a UK case; (b) recent (it is the only full inquiry in the UK in relation to these issues to have occurred since the emergence of Freeview, for example); (c) to a significant extent forward-looking (given that it was a merger case); and (d) based on a thorough analysis of a broad range of evidence collected from a wide range of industry participants.[14]

1.29 In this respect, it is important that Ofcom properly appreciates the Competition Commission's finding in relation to market definition; this is reported partially in the Consultation Document.[15] The Competition Commission's conclusion on market definition was straightforward. It stated:

> "*We concluded that the appropriate framework for analysing any loss of competition arising from the acquisition was a UK market for all-TV which included both pay-TV and FTA services.*"[16]

1.30 In its Consultation Document, however, Ofcom appears to believe that the Competition Commission concluded that basic pay TV and free to air television

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14 Sky notes that Ofcom's consultation is the first opportunity that industry participants have had to provide evidence to Ofcom on these matters.

15 Although Ofcom's consultation document was published after the Competition Commission's final report, the Competition Commission's analysis and conclusion in relation to the relevant market did not change from its earlier published Preliminary Findings report.

16 Paragraph 14 of the Competition Commission's BSkyB/ITV Report.

services are in the same relevant market, but not pay TV services that include premium channels. Ofcom's principal references to the Competition Commission's finding state:

> "*However, in its draft findings on the Sky/ITV merger, the CC suggests that this competitive constraint is now sufficiently strong for basic-tier pay TV and free-to-air TV to be included in the same relevant market*"[17] and
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> "*The CC concluded that… although there was a substantial amount of product differentiation, basic-tier pay TV and free-to-air were likely to be in the same economic market.*"[18]

1.31 Both of these statements are, clearly, partial representations of the Competition Commission's conclusion on the relevant market.

1.32 As discussed above,[19] the observation that the Competition Commission's analysis in relation to market definition was conducted at current price levels does not provide a basis for claiming that the analysis is not relevant. If it were established that current prices were above competitive levels at the retail level, then such a claim of irrelevance might be appropriate (as it would mean that the Competition Commission's market definition could be subject to the 'cellophane fallacy'). In the absence of strong and compelling evidence that retail prices are above competitive levels, however, the Competition Commission's conclusion on market definition comprises a highly relevant finding for the current case.

C. Much of Ofcom's analysis is cursory

1.33 Significant parts of the analysis of market definition and market power in the Consultation Document are undertaken in a cursory manner. Given that this is a consultation, and Ofcom's thinking on these issues is at a preliminary stage, this is perhaps not unexpected. Nevertheless, it is important that Ofcom recognises that in order properly to take its analysis of these issues forward, considerably more detailed analysis and/or proper consideration of relevant evidence would be required.

1.34 We cite below examples of such analysis, which are representative rather than exhaustive.

1.35 On occasions, the analysis in the Consultation Document appears to be based on assertion. For example, in relation to the impact of changes in the quality of basic channels carried in basic-plus-premium channel packages, Ofcom asserts that subscribers who subscribe to a basic-plus-premium channel package do not value basic channels in those packages – i.e., they only subscribe to the package in order to receive the premium channels.[20] Clearly, this is unlikely to be the case in relation to

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17 Paragraph 2.5 of Annex 13.

18 Paragraph 2.9 of Annex 13.

19 Paragraph 1.7.

20 Paragraph 4.28 of Annex 13.

all subscribers.[21] Ofcom should ensure that its analysis is evidence-based and avoids making such assertions.

Consideration of the 'cellophane fallacy' and stated preference bias

1.36 Ofcom clearly places little or no weight on the consumer survey evidence that it has collected in relation to the application of the hypothetical monopolist test on the basis that the evidence may be subject to problems associated with the 'cellophane fallacy' and/or 'stated preference bias'. Ofcom's consideration of both these issues, however, is extremely cursory – in essence, Ofcom appears simply to presume that the data are subject to both these problems without further analysis.[22,23]

Assessment of changes in prices, quality and subscriber numbers

1.37 One of the two pieces of evidence in relation to market definition on which Ofcom does appear to place evidential weight is its examination of charges for, the number of subscribers to, and quality of Sky's pay TV packages.

1.38 As set out in detail at **Appendix 5** (Ofcom's analysis of past subscription charges, subscriber numbers and quality of services is fundamentally flawed), much of Ofcom's analysis in relation to this issue, however, is cursory. For example, the entirety of its assessment of changes in the quality of pay TV packages that include Sky's sports channels since the start of 2000 is the following:

> "*On a simple measure, although there has been some growth in the overall number of hours broadcast, the number of live FAPL games shown by Sky has actually declined following the 2006 auction.*

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21 [CONFIDENTIAL] percent of Sky's DTH subscribers who subscribe to packages that include premium channels subscribe to packages that include the 1 Mix basic pack, which is the cheapest way to gain access to premium channels. This provides strong evidence that most premium channel subscribers do in fact value the basic channels that they receive as part of their package.

22 This approach contrasts significantly with Ofcom's approach to these issues in a previous market definition exercise in relation to radio advertising. In that case Ofcom (a) used a 'high-level' profitability assessment to assure itself that the results of its consumer survey were not affected by the 'cellophane fallacy'; and (b) structured its survey in such a way as to ensure that issues associated with the potential for respondents to overstate their reactions to hypothetical price increases were minimised. See *Radio Advertising Market Research; Assessment of the constraints on the price of direct and indirect radio advertising*, Ofcom, October 2006.

23 Ofcom does not provide any explanation as to why, if it considered that the results from its research could not be relied on due to the cellophane fallacy and/or stated preference bias, it (a) undertook such extensive consumer research anyway; and (b) did not take any steps to mitigate against the potential for stated preference bias. In a sense, this analysis comprises a 'one way bet' for Ofcom: Ofcom appears to regard it as having the potential to confirm the existence of narrow markets, but not to determine if markets are wider than those hypothesised. If this is the case, it is not an appropriate approach to such questions. It is incumbent on Ofcom not to structure its analysis in such a way that hypotheses can only be rejected.

> *A more complex question is the impact of changes to the set of basic channels that are sold with Sky Sports, and of the introduction of Sky+. These represent improvements to the quality of the overall bundle."* [24]

1.39 The first part of this analysis appears to amount to no more than an impression of how Sky's sports channels have changed over time – certainly, Sky has not been requested to provide information that would assist in such an assessment. Sky notes that the statement that the number of live FAPL games shown by Sky on Sky's sports channels has declined following the 2006 rights auction is erroneous.

1.40 Ofcom concludes, however, in relation to pay TV services that include premium sports channels, that:

> "*On balance, we believe the evidence presented here suggests that historical precedent with respect to premium sports (sic) in the UK is likely to remain relevant.*"[25]

1.41 It is readily apparent that the analysis conducted by Ofcom is too cursory to support such a conclusion.

Assessment of product characteristics

1.42 The other main piece of evidence on which Ofcom appears to place considerable evidential weight in relation to market definition at the retail level is its assessment of product characteristics. Yet its description of both the characteristics of the focal products (different types of pay TV packages), and the alternatives available to consumers (for example free to air television, pay per view movie services, and DVD purchase and rental), is cursory.[26]

1.43 For example:

- it is entirely unclear whether or not Ofcom is aware that only a small minority of films carried on Sky's movie channels are Hollywood blockbusters in the pay TV window. Instead, all Ofcom's references to those channels suggest that it believes that this is all they broadcast. For example, Figure 3 in Annex 13 describes the programming on Sky's movie channels as being "*All movies from the six major Hollywood studios in the fist (sic) subscription (pay TV) window*" (a statement that is not only an inadequate description but also erroneous and highly confused); and

- in relation to sports programming, Ofcom refers to consumers of a pay TV package that includes Sky's sports channels as having access to around 14,000

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24 Paragraphs 4.27-4.28 of Annex 13.

25 Paragraph 4.30 of Annex 13.

26 Ofcom's descriptions of different products' characteristics are set out in Figure 1 of Annex 13, together with a number of additional passing references to products' characteristics elsewhere in Annex 13. For example, Paragraph 4.12 of Annex 13 provides data on the number of hours of sports programming available via different types of television services in Q3 2007.

hours of sports programming in Q3 2007, compared to 1,300 hours available free to air via DTH. There is, however, no attempt at all to examine what those hours of programming consisted of. It is self-evident that quantity of hours broadcast is only a small part of the attractiveness of a service.[27]

1.44 A proper appraisal of the extent to which consumers are likely to view different products as being substitutable, based on an assessment of product characteristics, is dependent critically on a full appreciation of the characteristics of each type of product (in addition to a proper appreciation of the trade-offs that consumers are prepared to make between different characteristics, including prices – see below). Accordingly, no evidential weight should be placed on the analysis that Ofcom has conducted.

D. The range of evidence considered by Ofcom is unduly narrow and Ofcom's approach is overly mechanistic

1.45 It is well-recognised that in cases focused on the assessment of market power it is necessary (a) to consider a broad range of evidence; and (b) not to adopt a mechanistic approach which entirely separates the analysis of relevant markets and market power. The former is recognised in both EC and UK jurisprudence on market definition in the context of cases involving the assessment of dominance.

1.46 EC jurisprudence states:

> *"According to settled case-law, for the purposes of applying Article 86 of the Treaty, the relevant product or service market includes products or services which are substitutable or sufficiently interchangeable with the product or service in question, not only in terms of their objective characteristics, by virtue of which they are particularly suitable for satisfying the constant needs of consumers, but* ***also in terms of the conditions of competition and/or the structure of supply and demand*** *on the market in question*"[28] (emphasis added).

1.47 While the CCAT, in its judgment in *Aberdeen Journals*, stated:

> "*The foregoing [European] cases indicate that the relevant product market is to be defined by reference to the facts in any given case****, taking into account the whole economic context****, which may include notably (i) the objective characteristics of the products; (ii) the degree of substitutability or interchangeability between the products, having regard to their relative prices and intended use; (iii) the*

[27] For example, 14,000 hours of a mix of pre-recorded coverage of ten pin bowling, table tennis and wakeboarding is unlikely to be as attractive to many people as a mix of 1,300 hours of programming that consists of live coverage of the FA Cup, Formula One motor racing, and the British Open golf championship.

[28] Judgment of the Court of First Instance in Case T-504/93 *Tiercé Ladbroke SA v Commission of the European Communities* of 12 June 1997, Paragraph 81. The CFI specifically referred to the following cases: Case 31/80 *L'Oréal* [1980] ECR 3775, Paragraph 25; Case 322/81 *Michelin v Commission* [1983] ECR 3461, Paragraph 37; Case C-62/86 *AKZO Chemie v Commission* [1991] ECR I-3359, Paragraph 51; Case T-30/89 *Hilti v Commission* [1991] ECR II-1439, Paragraph 64, and Case T-83/91 *Tetra Pak v Commission* [1994] ECR II-755, Paragraph 63.

> *competitive conditions; (iv) the structure of supply and demand; and (v) the attitudes of consumers and users.*
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> *However, this check list is neither fixed nor exhaustive, nor is every element mentioned in the case law mandatory in every case. Each case will depend on its own facts, and it is necessary to examine the particular circumstances* [of a case]*."*

1.48 In relation to the separation of market definition and market power, the CCAT stated:

> *"In general, the definition of the relevant market should not be an abstract exercise detached from the question of dominance."*[29]

1.49 Such a requirement was also noted in an OFT discussion paper in the context of industries in the "*new economy*"[30]:

> *"One of the points that Pleatsikas and Teece (2001) emphasise is that the enforcement agencies need to go beyond a mechanistic approach to market definition followed by a determination of market power based on market share in a market that is often too narrowly defined."*[31]

1.50 A further reason for undertaking a careful analysis of a broad range of evidence in the current case is that it involves analysis of a sector for which the framework normally used to define relevant markets is not particularly well-suited. That framework was developed in the context of the analysis of merger cases and works well in mergers involving particular types of products – commonly referred to generically (in notional terms) as 'widgets' – for example manufactured goods in relatively mature industries.

1.51 The marketplace in which TV broadcasters operate in the UK, however, is as far from the simple notional market for 'widgets' as can be imagined. Three key aspects of the industry make standard approaches to market definition potentially problematic:[32]

(a) one of its fundamental characteristics is the extent of **differentiation**, along two main dimensions. First, there is a plethora of business models. The undertakings that operate in the TV sector have significant differences in their

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29 Judgment of the Competition Commission Appeal Tribunal in *Aberdeen Journals Limited v. Director General of Fair Trading* (*Aberdeen Journals*), 19 March 2002. Case No. 1005/1/1/01, Paragraphs 96, 97 and 101.

30 It is notable for the purposes of this case that the Pleatsikas and Teece paper referred to here argued that avoiding "*a mechanistic approach to market definition followed by a determination of market power based on market share in a market that is often too narrowly defined*" is important in industries in "*the new economy*" for a number of reasons that are found in this case - for example because in those industries product differentiation plays a key role in competition between firms.

31 Paragraph 4.6, *Innovation and Competition Policy, Part I – conceptual issues*, Economic Discussion Paper 3, OFT, March 2002.

32 Ofcom recognises a number of these issues – in particular the problems that product differentiation introduce in the context of market definition. Having done so, however, Ofcom then simply ignores them.

means of funding, most notably the distinction between tax funding, funding from advertising revenues and funding from subscription revenues (and other direct charges to consumers, such as pay per view).[33] Most undertakings – even the BBC, which dominates the sector in the UK - derive funding from a mix of these sources.

Second, differentiation in terms of the programming offered to consumers is a central element of competition between firms in this sector. A principal method of competition between firms in television broadcasting is to broadcast programmes that are not available on other television channels – in other words, they compete on the basis of differences between their channels. A mechanistic approach to market definition which focuses mainly on the differences between the products that firms supply, risks defining the relevant market too narrowly when product differentiation is an important part of competition between them, as in this case.

There are also significant differences between firms in terms of factors such as the means by which they distribute, or arrange distribution of, those channels to viewers, although in light of continuing proliferation in distribution technologies, these are of increasingly diminishing importance. Differences between firms in terms of their rights and obligations under UK broadcasting legislation, however, (for example in terms of access to the "Crown Jewels" of sports broadcasting under Listed Events legislation, or access to gifted analogue and digital terrestrial spectrum) continue to have very important influences on competition in the sector;

(b) as described above, the sector is one in which there are persistent **economic rents**.[34] A key problem for market definition in this sector is that it is all too easy to confuse the existence of such rents with a proposition that the returns to firms which broadcast such content (and which must compensate the ultimate producers of these products for their skill and talent) are somehow above competitive levels, when in fact they earn returns commensurate with the value that they add to such products (e.g., by aggregating content into TV channels and broadcasting those channels); and

(c) the sector is subject to well-recognised changes in technology, product offerings and consumer tastes. Accordingly, it may be difficult to apply an analytical toolkit which is best suited to the analysis of industries in which supply and demand are broadly stable.

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33 This element of differentiation in the industry has been central to the European Commission's incantation as to why it considers pay TV and free to air television to comprise separate relevant markets. The Commission states: "*whereas in the case of advertising-financed television the audience share and the advertising rates are the key parameters in the case of pay-TV the key factors are the shaping of programmes to meet the interests of target groups and the level of subscriber prices.*" See, for example, MSG Media Service (1994), Case IV/M.469. Official Journal L-364, 31/12/94.

34 In manufacturing or retailing industries, for example, standard economic analysis indicates that economic rents will eventually be competed away, through a combination of entry, expansion and product and process innovation.

1.52 To be entirely clear, Sky does not maintain that standard market definition processes must be abandoned entirely as a result of these factors. These factors simply mean that it is important that standard approaches are used in a considered manner, alert to the implications of these issues, rather than in a narrow and mechanistic fashion. They argue for an intelligent and open-minded consideration of a broad range of relevant evidence which potentially goes beyond that which would be examined in relation to a more traditional sector in which supply and demand are broadly stable. Finally, as Ofcom recognises[35] (but does not adequately reflect in its analysis), it is likely to be important in such circumstances to avoid 'bright line' determinations of boundaries of relevant markets which purport that different types of products, and the firms that supply them are either 'in' or 'out' of a relevant market.

1.53 In its Consultation Document, however, Ofcom considers a very narrow range of evidence relating to market definition and market power,[36] and its approach to these two issues is clearly of the "*mechanistic*" type described above. In taking forward its work, Ofcom should also consider the following types of evidence in its assessment of market definition and market power in this case:

- evidence as to firms' behaviour and market outcomes for consumers;
- the extent to which suppliers of different types of products view each other as rivals (for example, as based on internal documents and public statements);
- firms' profitability;
- the competition between TV channels (both free to air and pay television) for audiences;
- the effect of the supply of pay TV services on the suppliers of free to air television services, and vice versa;
- the impact of the growth of multichannel free to air services on pay TV providers; and
- relevant features of the economic context in which pay TV services are provided – for example the fact that pay TV providers may incur customer acquisition costs.

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35 Paragraph 1.4 of Annex 13.

36 In relation to market definition, Ofcom considered three main types of evidence: (i) an examination of 'product characteristics' focused on identifying "*demand drivers*" (Ofcom's inappropriate emphasis on "demand drivers" is discussed further at **Appendix 6** (Inappropriate emphasis on "*key drivers*" of subscription); (ii) a survey-based examination of consumer responses to hypothetical price increases; and (iii) an examination of past changes in Sky's subscription charges, Sky's subscriber numbers and the quality of Sky's pay TV services. Ofcom also discusses 'supply side substitution' in each case. The discussion of this latter subject, however, amounts to a simple assertion that "*in practice we think that supply side substitution is unlikely to provide a constraint*" – see, for example, paragraph 4.32 of Annex 13.

1.54 In particular, Sky considers that detailed consideration should be given to the consistency between a proposition that Sky is alleged to hold a dominant position in a range of different putative markets (and, if that is the case, would have held such a position for many years) and the types of outcomes that are observed in the marketplace.

1.55 These types of evidence, among others, are examined in **Part Two** of this Annex, below.

E. There are material analytical errors

1.56 There are material errors in Ofcom's analysis of relevant markets and market power in the Consultation Document. We cite here three examples of such errors in Ofcom's analysis, which are representative rather than exhaustive.

(i) Ofcom's search for close substitutes

1.57 Ofcom states that its approach to market definition is to first identify "*the closest substitutes"* to its focal products by examining product characteristics and then to determine whether such "*closest substitutes*" provide *"a sufficient competitive constraint to be included in the* [same] *relevant market*".[37]

1.58 Applied in a thorough manner, such an approach will give appropriate conclusions in relation to the scope of the relevant market in those situations where the key competitive constraint on a product (or group of products) is a single product. Such a situation is not always the case, however. In particular, it will not adequately deal with a situation in which the reference product has no single close substitute, but the **combined competitive constraint** from a number of different products is sufficient to prevent a hypothetical monopolist of the focal product imposing a SSNIP.[38]

1.59 The failure to consider this possibility, as a result of the approach adopted, is most acute in relation to the supply of pay TV packages that include Sky's movie channels. In that case, it is clear that there is a wide range of alternatives available to consumers, including:

(a) cancelling their pay TV subscription altogether and:

- going to the cinema more frequently; and/or
- renting DVDs (potentially by taking up an online DVD rental subscription, or using it more frequently if they already have such a subscription); and/or
- buying more DVDs; and/or

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37 See, for example, Paragraph 4.3 of Annex 13.

38 In terms of the normal process of applying the hypothetical monopolist test, adding any product which forms part of the competitive constraint imposed by a set of products to the candidate market would be found not to alter the conclusion that a SSNIP is profitable for a hypothetical monopolist of the candidate market. It is only when the full set of potential substitutes is added to the candidate market that the SSNIP is found to be unprofitable and the analysis can be concluded.

- watching more non-film programmes on free to air channels; and/or
- watching more films on free to air channels; and/or
- taking up a service such as PictureBox, BT Vision, Xbox Live or Apple TV that offers on-demand films;

or:

(b) spinning down to a basic pay TV package (or, if they were previously subscribers to a package that includes sports and movies, spinning down to a package that includes basic and sports channels only) and:

- any of the options in (a), above; and/or
- watching more films on Sky Box Office or, in the case of Virgin Media subscribers, Virgin Media's VoD movie service; and/or
- watching more films on basic pay TV channels; and/or
- watching more non-film programming on basic pay TV channels.

1.60 As consumer preferences are likely to be diverse, and there is a broad range of options, it should be expected that in such circumstances there would be no *"close substitute"* for a pay TV package that includes premium movie channels. In particular, an examination of product characteristics alone would indicate that each of the options above was different to that of the focal product. However the competitive threat that a provider of such a package faces is the prospect of a large number of subscribers, in aggregate, switching to the large range of different options available to them – with potentially relatively small numbers of subscribers going to any single option or combination of options - in response to a SSNIP.

1.61 Ofcom's analysis, particularly in relation to pay TV services that include premium movie channels, comes extremely close to an erroneous position that products must be identical to be in the same relevant market,[39] as reflected in its belief that products do not comprise adequate substitutes because they are unable to provide access to unique content, the same number of hours of programming, or the same quality of programming.

1.62 In particular, there is no consideration whatsoever in the Consultation Document of the potential for non-sports and non-film programming which is free to view to be a substitute for paid-for content on Sky's premium sports and movie channels. This is particularly relevant in the case of films. Ofcom fails entirely to ask itself a key question: is watching non-film content an adequate substitute for viewing films?

[39] It is commonly accepted that products do not have to have the same characteristics to be included in the same relevant market. See, for example, the OFT's guidance on market definition which states: "*Substitute products do not have to be identical to be included in the same market... Similarly, the products' prices do not have to be identical. For example, if two products perform the same purpose, but one is of a higher price and quality, they might be included in the same market.*" Paragraph 3.5 of *Market Definition*, OFT 403.

A priori, we would expect that it would potentially be the case that a television programme – for example a quality drama, or comedy – could be regarded by many consumers as an adequate substitute for watching a film on any particular viewing occasion. Instead, Ofcom's analysis proceeds as though the only potential substitute to viewing a film is considered to be viewing another film.[40]

(ii) Inappropriate focus on consumers least likely to switch in relation to a price rise

1.63 A key problem with focusing on product characteristics in any market definition exercise is that it creates an inherent tendency to focus on the preferences of *infra-marginal customers* - those who are most attached to the product, or who (for some reason) would be unable to switch to an alternative in the event of a price rise. In any market definition exercise the key question is the profitability of a hypothetical price rise above 'the competitive level'. This depends on the number of *marginal consumers* of a product – i.e., the number of consumers who are sufficiently unattached to a product that they would switch to another in the event of a permanent small but significant price rise. Accordingly, focusing on the preferences of those least likely to switch is erroneous. This error is known as 'the toothless fallacy'.[41]

1.64 Ofcom's analysis of consumers' interest in different aspects of Sky's products clearly falls into this trap. Its focus, in relation to both sports and movies, is on the number of consumers who regard access to the range and types of sport and films shown on Sky's pay TV channels as "*must have*", or for whom the ability to watch a particular type of programming is the main reason that they subscribe to a pay TV service (the "*key driver*"). These are the consumers who would be **least likely** to switch to another product in the event of a price rise.

1.65 For example, one of the small number of pieces of evidence cited by Ofcom in relation to its conclusion that "*premium sports pay TV channels do not have any particularly close substitutes*"[42] is the observation that "*35% of Sky Sports consumers*

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[40] Closely related to this is an erroneous assumption that is often made that a film is of a higher 'quality' than another if the first film is more recent than the second. Common sense indicates that this proposition is flawed, regardless of how 'quality' is evaluated. A key reason for this fact is that the intrinsic attractiveness of many films does not decay significantly over time. This means that there are large numbers of films that are five, ten, or twenty years old which have the capacity to attract far larger audiences when broadcast on television than a film that is six or twelve months old (even among Hollywood films).

[41] This term derives from a European Court of Justice decision in 1978 in the United Brands case, which argued that bananas formed a separated product market because "*the banana has certain characteristics, appearance, taste, softness, seedlessness, easy handling, a constant level of production, which enable it to satisfy the constant needs of an important section of the population consisting of the very young, the old and the sick.*" (Case 27/7614, United Brands Company and United Brands Continental BV v Commission of the European Communities, Chiquita Bananas, 14 February 1978, Paragraph 31.) The existence of such a subset of existing customers says nothing about whether there is a sufficient number of other customers who are able and willing to switch to an alternative product in the event of a price increase. See P. Hofer, M. Williams and L. Wu, "The Economics of Market Definition in Theory and Practice", *The Asia-Pacific Antitrust Review, a Global Competition Review Special Report*, May 2007. Available at: http://www.nera.com/image/PUB_Asia-Pacific_AT_Review2007.pdf.

[42] Paragraph 4.19 of Annex 13.

questioned in a 2005 survey stated (unprompted) that access to live FAPL matches was the main reason for subscribing to Sky Sports."[43] On the assumption that those whose "*main reason*" for subscribing to Sky Sports was to watch live FAPL football are those least likely to switch to other services in the event of a price rise, this leaves 65% of Sky Sports subscribers who are potential switchers.

(iii) Failure to consider trade-offs that consumers make between characteristics (including prices)

1.66 Ofcom fails to consider the price and quality trade-offs made by consumers. Ofcom's basic position is that subscription to pay TV services offers consumers an increased choice of television programming (including some programming which is "high *quality*"). Yet, Ofcom fails entirely to ask itself whether lower priced services with a smaller choice of programming (but which also include a significant amount of "*high quality*" programming) might be an adequate substitute for a higher priced service with a greater choice of programming. This is a material flaw in Ofcom's analysis.

F. Ofcom's analysis is not forward-looking

1.67 At Paragraph 1.13 of the Consultation Document, Ofcom states:

> "*it is particularly important that our competition analysis take a forward-looking view.*"

1.68 It is evident, however, that Ofcom's analysis of relevant markets and market power fails in this aspiration. The analysis is founded on "*historical precedent*" and whether this is "*likely to remain relevant*".[44] It is entirely backward-looking.

1.69 Moreover, even if the preliminary conclusions that Ofcom has reached in relation to the scope of relevant markets and market power were well-founded (which they clearly are not), Ofcom fails to consider whether the narrowly defined markets that Ofcom considers currently exist are likely to remain as narrow as this in the future. Similarly, given that Ofcom concludes that Sky has a position of dominance in a number of putative markets, Ofcom fails to consider whether any of the well-known changes in the sector that are occurring currently are likely to impact that alleged dominance.

1.70 The contrast between Ofcom's analysis of market definition and market power in this Consultation Document, and its approaches to other areas of its activities could not be starker. For example, in his recent speech on the future of public service broadcasting, Ed Richards said:

> "*The future will never be about linear television alone, but a rich mix of linear TV and new and diverse forms of content and delivery.*"[45]

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[43] Paragraph 4.15 of Annex 13. Sky notes further that the fact that a consumer says that something is the "*main reason*" that they subscribed to a particular service in fact says nothing at all about their degree of attachment to that service.

[44] Paragraph 4.30 of Annex 13.

1.71 The Ofcom Consultation Document on pay TV services, however, is entirely focused on linear television services and references to the future arise predominantly in the context of Ofcom's concerns.

G. Conclusion on Ofcom's analysis of market definition and market power

1.72 Sky recognises that Ofcom's document is intended to form the basis for consultation and, therefore, evidence and analysis is unlikely to be fully formed at this stage. Nevertheless, it is evident from the foregoing that the analysis of the issues of market definition and market power, both at the wholesale and retail levels, that is set out in the Consultation Document is subject to numerous significant flaws, the cumulative effect of which is that the preliminary conclusions that Ofcom has reached cannot be relied on. Three aspects of Ofcom's analysis are particularly noteworthy:

- Ofcom's analysis of market definition at the retail level (which is strongly determinative of the conclusions reached at the upstream (channel provider) level) is based on three pieces of analysis. Ofcom places no weight on one of those analyses – the application of the hypothetical monopolist test (for reasons that are not well-founded). Yet the other two analyses (of consumers' preferences in relation to product characteristics and the relationship between charges, quality and subscriber numbers) are themselves so cursory and/or flawed that no evidential weight can be placed on them either. Ofcom therefore has no evidence at all on which to base its preliminary conclusions in relation to market definition at the retail level;

- one of the key issues in relation to the narrowness of the range of evidence considered by Ofcom is the failure to have regard to the evidence on market outcomes presented in Section 4 of the Consultation Document. It is improbable that markets in which consumers are satisfied, there is a high level of innovation, consumer take-up of products is very high and firms do not earn excess profits, are markets that have been dominated by particular firms for long periods of time; and

- Ofcom fails entirely in its aspiration that its analysis is "*forward-looking*". It is readily apparent that Ofcom's analysis of market definition is firmly rooted in the past.

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45 Speech by Ed Richards to the Royal Television Society, 11 March 2008.

PART TWO: EVIDENCE ON SWITCHING IN RESPONSE TO A SSNIP

A. Background

2.1 Application of the hypothetical monopolist test ("**HMT**") plays a key role in the assessment of relevant markets. This test seeks to identify whether a product or group of products is 'worth monopolising'. It seeks to do so by attempting to determine, if a product or group of products were hypothetically supplied by a single firm, whether that firm would be able profitably to impose a 'small significant non-transitory increase in price' ("**SSNIP**") above competitive levels.

2.2 The evidence obtained by Ofcom from consumer surveys in relation to the application of the HMT in this case, together with evidence available to Sky, provides good evidence that markets are broader than the reference products considered by Ofcom.

B. Ofcom's findings

2.3 Ofcom's consumer evidence on reactions to increases in subscription charges for their pay TV services clearly indicates that such increases would be unlikely to be profitable for pay TV retailers (all else being equal) due to significant numbers of consumers switching away from the relevant product.[46] The switching levels found by Ofcom were as follows:

Table 1: Switching levels in response to a SSNIP

	Percentage of respondents who would switch away from Sky's package in response to a SSNIP
Basic-only packages	31%[47]
Basic-plus-sports packages	25%[48]
Basic-plus movie packages	37%[49]

46 As set out in **Appendix 7** (Errors in Ofcom's application of the hypothetical monopolist test), Ofcom in fact erroneously applies price increases of about half the level that would normally be used in applying the HMT. It is therefore evident that the conclusions reached above would be even stronger, had Ofcom applied price increases of the usual 5%-10% level.

47 Pay TV Research, Phase 3, Table 214. Asked of Sky basic subscribers only. A further 11% answered "*Other*" or "*Don't know*".

48 Percentage of respondents who would switch away from a Sky package that included its sports channels. Pay TV Research, Phase 3, Table 165, reported for consumers who take a package including both Sky Sports and Sky Movies (consistent with the approach at Annex 13 paragraph 4.22). A further 6% answered "*Other*" or "*Don't know*".

49 Percentage of respondents who would switch away from a Sky package that included its movie channels. Pay TV Research, Phase 3, Table 68, reported for consumers who take a package including both Sky Sports and Sky Movies (consistent with the approach at Annex 13 paragraph 4.62). A further 6% answered "*Other*" or "*Don't know*".

2.4 In relation to pay TV packages that include premium sports channels, Ofcom found:

> "*this reported level of switching would be sufficient to make a price rise unprofitable, implying that the relevant market is wider than the retailing of packages containing Sky Sports. Indeed these results suggest that the market is likely to include Setanta's sports programming. They could further imply a market which is wider than all premium sports packages (Sky Sports and Setanta).*"[50]

2.5 In relation to pay TV packages that include premium movie channels, Ofcom found:

> *"Taken at face value, these results would suggest that it would not be profitable for a hypothetical monopoly retailer of Sky Movies packages to raise prices."*[51]

2.6 While in relation to basic-only pay TV packages, Ofcom found:

> "*At face value, this evidence also implies that it would not be profitable for a hypothetical monopoly supplier of basic-tier pay TV services to raise prices, and that the relevant market should therefore include free-to-air as well as basic-tier TV services.*"[52]

2.7 We discuss Ofcom's application of the hypothetical monopolist test further at **Appendix 7** (Errors in Ofcom's application of the hypothetical monopolist test). While this indicates that the way in which Ofcom has applied the test is not ideal, Sky considers that the results are strongly indicative of the fact that large numbers of subscribers would be likely to switch in response to increases in subscription charges.

2.8 Clearly, therefore, this comprises good evidence against the narrow markets that Ofcom reaches in its preliminary conclusions, and Ofcom should adduce strong reasons for disregarding it.

C. Ofcom's reasons for disregarding this evidence are ill-founded

2.9 In each case, Ofcom disregards the evidence set out above on the basis that prices **may** already be above competitive levels (in which case the observed reactions to further price increases would be subject to the 'cellophane fallacy'), and/or that respondents in Ofcom's survey **may** have overstated the extent to which they would switch away from the reference products in the event of a hypothetical increase in their subscription charges (described by Ofcom as "*stated preference bias*").

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50 Paragraph 4.23 of Annex 13.

51 Paragraph 4.63 of Annex 13.

52 Paragraph 4.106 of Annex 13.

(i) There is no evidence that prices are above competitive levels

2.10 In relation to the risk that the observed reactions are tainted by the 'cellophane fallacy' it is critical to note that Ofcom adduces no evidence which would suggest that charges for pay TV services are currently significantly above competitive levels. In the absence of strong and compelling evidence that this is the case, the findings from Ofcom's consumer research must be presumed to be informative on the issue of market definition.

2.11 Furthermore, as noted above, the evidence obtained by Ofcom on Sky's profitability strongly suggests that prices are not above competitive levels at either the wholesale or the retail levels. This provides further confidence that the findings from Ofcom's consumer research can be relied upon.

2.12 Finally, it is important to note that the levels of likely switching found by Ofcom in its research are far in excess of those that would be likely to be found if Ofcom's conclusion as to market power were correct and prices were already above competitive levels.

2.13 Basic economic theory indicates that, if a firm had significant market power and were thereby able to set prices that were above the competitive level, the amount of switching that would be observed in relation to a given price increase would be roughly proportionate to the increase in price. A monopolist would choose a price at which demand just becomes elastic, at which point a 1% increase in price would result in roughly a 1% loss in sales.

2.14 Given this, the levels of likely switching found by Ofcom's consumer surveys are significantly above the levels that would be expected to be found in circumstances in which Sky held a significant degree of market power in relevant markets – even if it were accepted that the findings were subject to a degree of 'stated preference bias'. The levels of likely reduction in sales found by Ofcom in response to what is (as Ofcom acknowledges) effectively a 2-6% increase in charges are between 25-37%.[53] Even if these figures were subject to considerable "*stated preference bias*", these levels are far in excess of what would be anticipated if subscription charges were already significantly above competitive levels.

(ii) Stated preference bias would need to be very significant to overturn these findings

2.15 Clearly, it is **possible** that the findings from Ofcom's consumer research suffer from a degree of stated preference bias. Equally, it is possible that they **do not**. Given this, it is incumbent on Ofcom to seek to examine this issue in more detail in order to determine whether there is in fact any 'stated preference bias' and, if so, the extent to which it affects the results.

2.16 What is clear, however, is that the extent of "*stated preference bias*" would need to be very significant in order to overturn the findings that SSNIPs in relation to each of the reference products would not be profitable. Accordingly, the key question is whether the bias could be so significant as to reverse these findings. Sky considers that, given

53 Even if the charge increase is regarded as being between 5-10%, this does not affect the argument.

the limited incentive for consumers to exaggerate their behaviour in the context of the particular survey undertaken by Ofcom, this is implausible.

D. Ofcom's findings are in accordance with Sky's own evidence

2.17 [**CONFIDENTIAL**]

E. Conclusion – evidence on switching in response to a SSNIP

2.18 The evidence available strongly supports a conclusion that it would not be profitable for a hypothetical monopolist of a range of different pay TV services to impose a SSNIP, and Ofcom must adduce good reasons for rejecting this evidence if it is to confirm its preliminary conclusions on the scope of relevant markets. The reasons adduced in the Consultation Document are not good reasons for disregarding these findings.

PART THREE: SKY'S VIEWS ON THE RELEVANT MARKETS AND MARKET POWER

A. Introduction

3.1 In this Part Three, we set out Sky's views on the issues of relevant market definitions and market power. It is divided into three sections. The first section (B) sets out key considerations to which it is necessary to have regard in seeking to assess market definition and market power in relation to pay TV. The second section (C) considers market definition and market power at the retail level, while the third section (D) examines these issues at the wholesale (channel provider) level.

B. Key considerations

3.2 The assessment of the issues of market definition and market power in relation to pay TV services in the UK, both at the wholesale and retail levels, must have regard to the following considerations:

- it is critical not to lose sight of the fact that the ultimate purpose of defining relevant markets is to examine the issue of market power. It should not be an exercise that is divorced from that objective, or be regarded as an end in itself. This is particularly important in the current case due to the complexity of the issues raised (which stem from a number of key features of the sector being examined). Accordingly, evidence on firms' behaviour and market outcomes is likely to be highly informative on the relevant issues;[54]

- similarly, it is necessary to keep a sense of perspective in relation to the relevant issues, and approach them with a degree of common sense;

- in cases involving the assessment of market power, it is critical to go beyond examination of product characteristics, and demand-side substitutability and also examine the 'whole economic context' in which firms operate;[55] and

- given the complexity of the issues raised in this case it is necessary to take into account a range of evidence which is potentially broader than that which would be assessed in a more straightforward case. In particular, a focus on particular pieces of evidence, or a small range of evidence, is inappropriate. The full range of available evidence must be assessed carefully 'in the round'.

C. Particular issues in relation to the assessment of relevant markets and market power in the context of audiovisual services

3.3 In the context of the current case, it is also necessary to bear in mind the following issues:

- the focus should be on the preferences of marginal consumers, not dedicated fans;[56]

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[54] Paragraphs 1.5-1.30 of Part 1 of Annex 2.

[55] Paragraph 1.44 of Part 1 of Annex 2.

- consumers make trade-offs between the cost of a pay TV subscription and the additional viewing opportunities it affords them; and

- in the context of the consumption of audiovisual services, 'switching' by consumers involves the reallocation of viewing across different portfolios of viewing options.

(i) The trade-offs made by consumers

3.4 In relation to the second of these points, it must be borne in mind when examining the choices that consumers make that the relevant question is whether they derive sufficient value from the programming delivered by a pay TV subscription to justify paying the monthly charge for that service. The alternative facing consumers is to forgo those programmes that they would otherwise have watched on a pay TV service and not to incur the monthly charge (or to incur a smaller monthly charge if they choose to 'spin-down' to a less-inclusive pay TV package).

3.5 Viewing data suggests that consumers tend to watch a relatively constant amount of television regardless of the range of services they have available to them,[57] which suggests that dropping a pay TV subscription, for example, involves replacing viewing of programmes carried on basic pay TV channels with viewing of programmes carried on free to air television channels. While the consumer is likely to place a lower value on at least some of the 'replacement' programmes, relative to those that they would have watched if they had maintained their pay TV subscription, this disadvantage is traded-off against the savings in payments of subscription charges (which, in the case of Sky's pay TV services, are currently between £16-£45 per month).

(ii) The nature of switching in relation to consumption of audiovisual services

3.6 While it would seem an obvious point, it is important to recognise that subscribers to pay TV services continue to consume audiovisual services from a range of different sources other than the pay TV package to which they subscribe. For example, subscribers to basic-only pay TV packages also view audiovisual programming (including films) from a set of options that includes:

- watching free to air television channels;[58]

- pay per view movies delivered via services such as Sky Box Office (to the set top box) or Sky Anytime (to the PC);

- buying or renting programming (including films) on DVD;

- seeing films at the cinema; and

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56 Paragraph 1.16 of Part 1 of Annex 2.

57 See further, Paragraph 2.5 of Part B of Sky's Response to the Complaint.

58 In fact, as discussed below, the majority of the television viewing of households with pay TV subscriptions is to free to air television channels.

- (increasingly) free to air and paid for content delivered via the internet (e.g., via the BBC's iPlayer service, or by downloading a programme from iTunes).

3.7 Too often, subscribers to, for example, pay TV packages that include premium sports channels are treated as though they watch nothing but live sports on those channels.

3.8 The importance of this factor lies in the fact that 'substitution' on the part of pay TV subscribers involves a reallocation of viewing across an alternative set of viewing opportunities. In particular, such a reallocation may involve switching viewing to programmes (or means of watching programming) which are not 'close substitutes' in the sense of having **the same, or nearly the same,** product characteristics as programming carried on pay TV channels. For example:

- someone who cancels a pay TV subscription that includes premium movie channels may watch more non-film programming on free to air channels as a result;

- someone who cancels a pay TV subscription that includes premium movie channels may rent more DVDs, or go to the cinema more often as a result;

- someone who cancels a pay TV subscription that includes premium sports channels may watch different sports events on free to air channels than they would otherwise have done if they had maintained their pay TV subscription.

3.9 It is critical to recognise that, as a result of its implications for the revenues of suppliers of different types of audiovisual services, such changes in consumers' allocations of their desired viewing of audiovisual services must be regarded as comprising demand side substitution.[59] In particular, it is an overly narrow conception of substitution to only regard viewing of the same type of programming – let alone the same programmes - as counting as such substitution.

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59 Sky considers that Ofcom's reasons for dismissing such switching as effective demand side substitution are entirely erroneous. For example, Ofcom's view set out in paragraphs 3.18-3.19 of Annex 13 that switching to rely on a smaller subset of services does not comprise switching because there is no switching of expenditure involved is without merit.

D. Analysis of market definition and market power at the retail level

(i) Description of products and services available to UK consumers

3.10 As set out in Part One of this Annex, above, a proper appreciation of products' characteristics is a key prerequisite for an examination of relevant economic markets. In this section we provide an overview of Sky's pay TV services and free to air television services available in the UK.[60]

Sky's DTH retail products

3.11 Sky currently retails to DTH customers a wide range of pay TV channels, including 141 basic channels and 24 premium channels, including 12 HD channels. Sky retails these channels in packages. Subscribers create their own channel packages by choosing from among six basic channel packages (denoted 'Mixes'), and six premium channel packs (subject to a requirement that the subscriber's package must contain at least one basic Mix). (As indicated below, Sky also uses the term 'Mixes' to refer to packages that include all Sky's movie channels, for example.) Customers may switch between packages at any time.

Table 2: Sky's basic Mixes and number of channels (March 2008)

Mix	Number of basic channels
Variety	39
Kids	20
Knowledge	23
Music	18
News and Events	12
Style and Culture	29

60 Clearly, free to air television services comprise only part of the set of products and services that compete with Sky's pay TV services. However, we have included a description of free to air television services here because Sky considers that the strength and attractiveness of these services, in aggregate, is not recognised sufficiently in Ofcom's consultation document. The absence of a description in this section of products and services such as DVD sales and rental, other subscription pay TV services, VoD etc., should not be taken to mean that Sky considers them to be unimportant. In fact, as set out in the sections below, these types of services compete directly with Sky's pay TV services.

Table 3: Sky's sports packs (March 2008)

Pack	Channels
Sports 1	Sky Sports 1
Sports 2	Sky Sports 2
Sports Mix	Sky Sports 1, Sky Sports 2, Sky Sports 3* & Sky Sports Xtra*, Sky Sports HD1**, Sky Sports HD2**

* available as bonus channels to Sports Mix subscribers. Sky Sports Xtra is also available on a stand-alone basis.
** available to subscribers with an HD subscription.

Table 4: Sky's movie packs (March 2008)

Pack	Channels
Sky Movies 1	Sky Movies Comedy, Sky Movies Family, Sky Movies Classics, Sky Movies Modern Greats, SD1, Sky Movies HD1**
Sky Movies 2	Sky Movies Action & Thriller, Sky Movies Sci-Fi & Horror, Sky Movies Indie, Sky Movies Drama, SD2, Sky Sky Movies HD2**
Movies Mix	Sky Movies 1 and Sky Movies 2 packs, plus bonus channels Sky Movies Premiere, Sky Movies Premiere+1, Disney Cinemagic, Disney Cinemagic+1

** available to subscribers with an HD subscription.

3.12 **Table 5** shows Sky's current pricing grid for UK residential DTH customers.

Table 5: Monthly charges for Sky's UK residential DTH packages

	Basic only	Basic plus 1 Sport/Movies pack	Basic plus 2 Sport/Movies packs	Basic plus 3 Sport/Movies packs	Basic plus 4 Sport/Movies packs
1 Mix	£16	£26	£34	£38	£41
2 Mix	£17	£27	£35	£39	£42
3 Mix	£18	£28	£36	£40	£43
4 Mix	£19	£28	£36	£40	£43
5 Mix	£20	£29	£37	£41	£44
6 Mix	£21	£30	£38	£42	£45

3.13 Sky operates a High Definition TV ("HD") service which currently includes 12 channels and is available for an additional £10 per month. Sky also retails five channels on an à la carte basis: Disney Cinemagic, Sky Sports Xtra,[61] Chelsea TV, MUTV and Music Choice Extra.

3.14 The Sky Box Office service offers DTH subscribers over 50 screens of television premieres of movies and occasional live sports and other special events on a pay-per-view basis.

3.15 In March 2007, Sky launched Sky Anytime on TV, an on-demand service that provides access to approximately 30 hours of content available at any one time, based on selected programmes that are sent to the subscriber's Sky+ or HD box overnight. Sky Anytime on PC is a PC application that provides subscribers with on demand access to a range of programming provided by both Sky and third parties.

3.16 Sky Broadband was launched in July 2006. The service is available to all Sky's DTH subscribers in the UK, offering three different packages to those covered by Sky's own LLU network and a single package to other subscribers. Sky Talk is a telephony service available to all of Sky's DTH subscribers in the UK. Customers with a compatible 3G handset on the Vodafone, T-Mobile or Orange networks can subscribe to Sky Mobile TV. Sky Mobile TV offers over 20 channels in four packages streamed direct to the subscriber's 3G mobile phone.

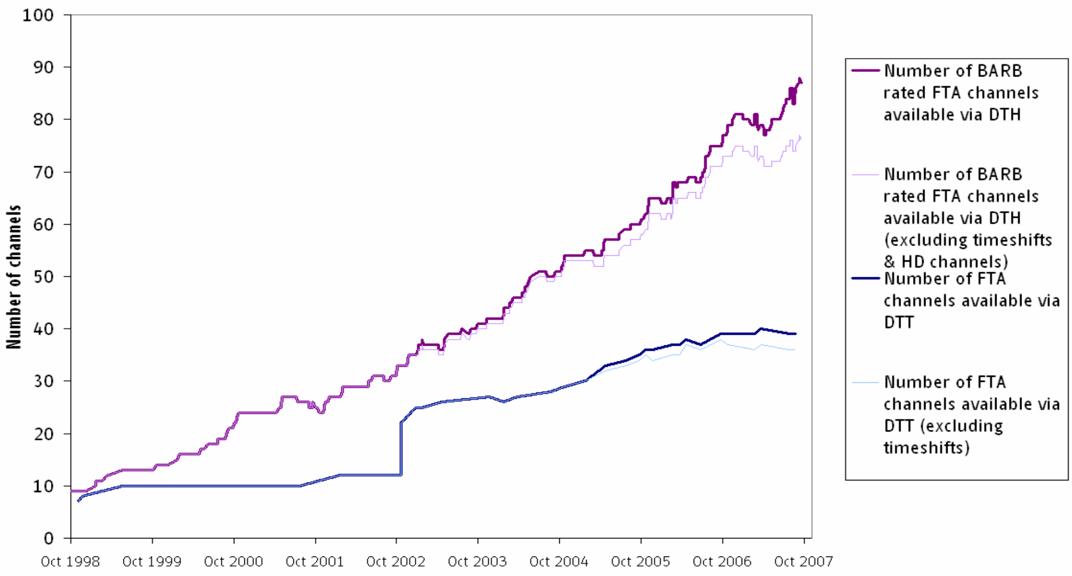
Free to air services

3.17 UK households have access to a wide range of free to air television channels. In addition to the five main free to air channels (BBC1, BBC2, ITV1, Channel 4 and five), which are available via analogue terrestrial television to almost all UK households, there are now forty free to air television channels available via DTT, and over 200 such channels available via DTH.

3.18 These channels offer viewers an extremely wide range of programming at no additional cost to the licence fee, which is compulsory. The combined programming budget of the terrestrial broadcasters alone is over £3 billion per annum. This enables them to acquire and produce a very wide range and large amount of programming of a very high quality in those genres which continue to dominate consumers' demand for television viewing, such as drama, comedy, soap operas, news, reality shows and documentaries.

[61] Sky Sports Xtra is provided as a free 'bonus' channel to certain Sky Sports subscribers.

Figure 1: Number of BARB rated FTA channels available to DTH households and number of FTA channels available to DTT households



3.19 In addition to the genres dominated by free to air television broadcasters, they also provide a wealth of sports and movie programming.

3.20 Free to air broadcasters hold a powerful portfolio of sports rights, including rights to most of the UK's most popular live sporting events. Listed events legislation ensures that live coverage of events such as the Olympic Games, the World Cup Finals, European Cup Finals, Wimbledon, the Grand National, the Derby, and the finals of various competitions are broadcast on free to air channels. Free to air broadcasters also have a wide range of other rights including the Rugby World Cup, the Six Nations, Commonwealth Games, Winter Olympics, World Athletics Championship, the Open Golf Championship, Champions League, UEFA Cup, US Masters Golf, Formula 1 racing, numerous key horseracing events and various boxing events. The result is that, across all free to air channels, there is a rich variety of sports programming available to television viewers at no cost (other than the cost of the licence fee which is compulsory).

3.21 Moreover, free to air broadcasters are in constant competition with pay TV providers for sports rights. There is no bright line distinction between pay sports rights and free sports rights. Many rights, including several of the most popular sports rights, have been, in recent times, and still are, exploited (both concurrently and consecutively) on both pay television and free to air television.[62]

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62 Within each bidding process, the division between the pay rights and the free rights is often not set in stone and both broadcasters would like a greater share of the coverage of a particular sports events or series of events than they currently have. In particular, both pay and free broadcasters would like to be known as the 'home of' the right in question (be it the FA Cup, the UEFA Champions' League etc). This means that there is bidding competition at the margin between pay and free broadcasters every time these rights are renewed.

3.22 Simple evidence for this phenomenon is provided by the range of sports events that are currently split between being exploited on a premium sports channel and on free to air television. For example:

- the FA (FA Cup and England International) rights are currently[63] shared between pay television (Sky) and free television (the BBC) with the balance having shifted in the direction of the BBC when the current contract was awarded;[64]

- the Champions League rights are currently[65] shared between free television (ITV – two live games exclusively on Tuesday nights, the Final on a non-exclusive basis) and pay television (Sky – all non-ITV games exclusively plus the Final on a non-exclusive basis);

- various UEFA Cup matches (which are currently sold individually by the clubs) appear on free and pay television;

- the rights to the four golf majors (each of which is sold individually) are split between pay TV (Sky – the US Open and the USPGA) and free to air television (the BBC – the Open and the Masters);

- up to two NFL games per week are shown on a non-exclusive basis on both free television (Five) and pay television (Sky), with the remaining broadcast games shown exclusively live on pay television (Sky). The Superbowl is shown on a non-exclusive basis on both free television (BBC) and pay television (Sky); and

- the Football League has recently concluded an auction for rights covering the three years from 2009/2010. Free television (BBC) will show 10 games from the Championship per annum and two semi-finals from the Carling Cup per annum on an exclusive basis plus the Carling Cup Final on a non-exclusive basis. Pay television (Sky) will show all the non-BBC games on an exclusive basis and will also show the Carling Cup Final on a non-exclusive basis.

3.23 Similarly, there is a wealth of movie content available on free to air channels. The terrestrial channels and digital sister channels (BBC3, BBC4, ITV2, ITV3, ITV4, E4, More 4, Film 4, Five US, Five Life – excluding timeshift channels), combined, broadcast 4,524 different films in 2007, and a total of 9,947 films (including films which were shown more than once) – an average of 27 films screened per day. The top ten films shown free to air in 2007 had an average audience of 6.9 million viewers and an average audience share of 33%.

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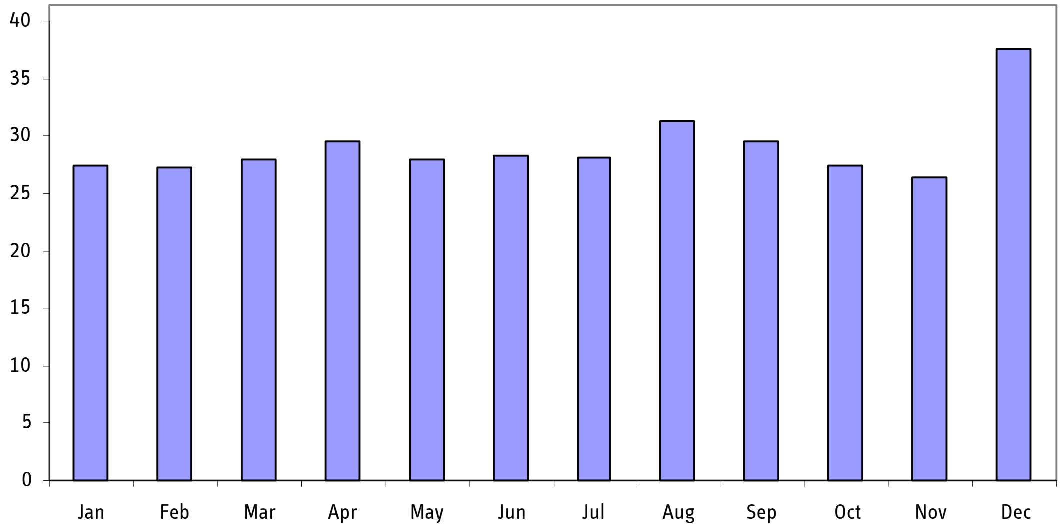
63 The next set of FA rights (from 2008/2009) have been acquired by Setanta (pay) and ITV (FTA) and so will continue to be split between pay and free television.

64 Note that only the FA Cup final is a Group A listed event. For all other matches in the FA Cup, there is bidding competition between pay and free broadcasters.

65 In March 2008, UEFA awarded the next set of rights (from 2009/2010) to ITV and Sky, again maintaining a split between free and pay television.

Figure 2: Average number of movies per day – FTA & digital sister channels 2007



3.24 In addition to films shown on terrestrial channels and their digital sister channels, there is a number of new free to air movie channels – for example, Zone Horror, True Movies, and Movies 24. In 2006 BARB data indicates that such channels broadcast 15,645 movies, compared to 5,751 movies broadcast on the terrestrial channels and their sister channels. [66]

(ii) Assessment of relevant evidence and arguments

3.25 Sky considers that a key issue at the retail level is whether pay TV and free to air television can be considered to be differentiated products provided in a single relevant market. If the relevant market is defined broadly – or if the relevant market is considered at least to be broader than pay TV alone – it is improbable that Sky is dominant in such a market.

3.26 In Sky's view, the weight of available evidence, assessed in the round, points strongly to the conclusion that Sky does not hold a dominant position at the retail level. Sky considers that the relevant evidence points to a view that the relevant downstream market is broad – encompassing both free to air television and pay TV services (including PPV services), but 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).

3.27 The relevant evidence and arguments on which Sky relies in support of these views comprises the following:

(a) the finding of the Competition Commission in the BSkyB/ITV inquiry;

(b) the absence of excess profits;

66 Both figures exclude timeshifted channels and movies repeated on the same day. Movies on Film4 are included only after it became a FTA channel on 23rd July 2006.

(c) positive outcomes for consumers: high levels of innovation and high penetration of pay TV services;

(d) pay TV and free to air television are substitutes;

(e) the strength of the UK's free to air services;

(f) switching costs are low;

(g) Sky incurs subscriber acquisition costs, which makes it highly sensitive to losing subscribers;

(h) [**CONFIDENTIAL**];

(i) econometric evidence on the impact of free to air television on demand for pay TV services;

(j) Sky's response to the growth of free to air multichannel television;

(k) flat or falling charges in real terms;

(l) introduction of free or low-cost broadband services;

(m) evidence on price sensitivity of pay TV subscribers;

(n) likelihood that there are significant numbers of marginal subscribers;

(o) there is an expanding range of ways of watching films;

(p) [**CONFIDENTIAL**];

(q) increasing availability of content broadcast on pay TV channels via means other than those channels;

(r) Sky's internal documents; and

(s) statements by other operators.

Each of the above are discussed further in the sections below.

(a) The finding of the Competition Commission in the BSkyB/ITV inquiry

3.28 In its report on the purchase by Sky of a 17.9% stake in ITV, the Competition Commission concluded that there is sufficient evidence to regard all television services – including free to air television, basic-only pay TV packages and basic-plus-premium channel packages - as being supplied in a single relevant market at the retail level. This conclusion appears to be in conformity with previous findings by the Competition Commission.[67]

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67 See the Competition Commission's report on the Carlton Communications plc/Granada plc merger, October 2003; and the Competition Commission's report on three proposed mergers: Carlton Communications Plc/Granada Group PLC/United News and Media plc, July 2000.

3.29 The Commission's finding was reached after an intensive inquiry, which received a significant amount of evidence from a wide range of firms operating in the sector. It comprises the last serious competition authority assessment of this issue, and is the only such inquiry to post-date the development of Freeview. Accordingly, this finding must be afforded significant weight by Ofcom in the current inquiry.

(b) The absence of excess profits

3.30 Ofcom has examined Sky's profitability and concludes that "*Sky has not made returns which could be judged to be excessive, particularly given the risk profile when the early investments were being made.*"[68] This finding is strongly corroborative of an absence of significant market power at both the wholesale and retail levels. Such a finding would normally be regarded as contradicting a proposition that a firm holds a position of dominance in a range of markets.

(c) Positive outcomes for consumers: high levels of innovation and high penetration of pay TV services

3.31 Ofcom has examined the outcomes for consumers in relation to the provision of pay TV services in the UK (discussed above), and Sky has provided further evidence in the PwC report. The clear conclusions from this evidence are that: (a) consumer choice of pay TV services is strong, and prices for such services are not out of line with those found in the rest of Europe; (b) consumers are satisfied with the pay TV services available to them; (c) penetration of pay TV services is among the highest in Europe and Sky strongly suspects that the UK would be a leader in terms of the penetration of pay TV services that include premium channels; and (d) perhaps most importantly, along with France, the UK is significantly ahead of all other countries in Europe in terms of the introduction and take up of innovative new products and services, such as personal video recorders ("**PVRs**") and high definition ("**HD**") television services.

3.32 The last of these observations is particularly important in two respects. First, it is evident that Sky has been a key driving force with respect to the UK's position as one of the leaders in terms of innovation in Europe. For example, Sky has been a key driving force behind the UK's leading position in Europe in relation to digital television, PVRs and HD television. Second, the gains to consumers from the introduction of new products and services are commonly regarded to be very important sources of welfare gain for consumers. Accordingly, it is appropriate to place significant weight on the benefits to UK consumers from the innovations that Sky has introduced and driven.

3.33 The key point, however, for the assessment of market definition and market power at the retail level is that the set of observed market outcomes is wholly incompatible with a hypothesis that Sky holds a dominant position at this level. A lack of innovation, indifference to consumers' demands (including poor customer service and infrequent changes to products) resulting in significant consumer dissatisfaction, and pricing levels which suppress demand, are among the key indicators of firms holding positions of significant market power. Yet all the evidence referred to above runs strongly counter to such indicators.

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68 Paragraph 1.21.

3.34 Sky considers that it is a largely academic issue whether the absence of market power is attributed to the relevant market being wide, or constraints on market power within a more narrowly defined market (or markets) being strong. The fact is that evidence on outcomes contradicts the proposition that such market power exists at all.

(d) Pay TV and free to air television are substitutes

3.35 The starting point for any analysis of competition between pay TV and free to air television services is the fact that they are economic substitutes: an increase in the price for, or reduction in the quality of, pay TV reduces demand for that service and leads to increased consumption of free to air television services, as both services can be used to satisfy the same consumer demand - the demand for audiovisual entertainment, information and education.[69]

3.36 As was emphasised in Sky's earlier submission it is critical to take into account the fact that the constraint that pay TV providers face from free to air television (and other free audiovisual services) arises from the **aggregate** of the audiovisual programming supplied in this way. As set out above, there is a vast amount of programming available to consumers for free, including a vast range of high quality programming in the genres which continue to dominate consumers' viewing preferences such as drama, soap operas, news, reality shows and documentaries.

3.37 In addition, as was also emphasised in Sky's earlier submission, given this substitutability, the massive growth in the range of free to air television services available in the UK in the recent past would strongly suggest that the constraint on the providers of pay TV services from free to air television has increased very significantly. We discuss a number of important aspects of this increase in competition in the section below.

3.38 In a forward-looking evaluation it is critical to appreciate the ongoing proliferation of the means of delivering free to air content to consumers, particularly on an 'on-demand' basis. This includes both devices such as PVRs and online services such as iPlayer (and the forthcoming Kangaroo).[70] In essence, such developments act as a step-change improvement in the quality of free to air audiovisual services, by making it more likely that when consumers want to watch a programme they will be able to find something they want to watch that is offered free.

3.39 Although some of these services rely on broadband delivery (many do not), it would be inappropriate to play down their competitive threat as a result of concerns about picture quality, for three reasons. First, a very significant number of consumers can already receive audiovisual services via a broadband connection that are as good (in

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69 See Paragraphs 2.4 to 2.9 and Annex 1 of Sky's Response to the Complaint.

70 It is of course highly surprising how little attention Ofcom has paid to such services given (a) its intention to make its analysis forward-looking; and (b) the importance it clearly ascribes to such services in other areas of its activities. For example, as noted above, in his speech on the future of public service broadcasting, Ed Richards said: "*The future will never be about linear television alone, but a rich mix of linear TV and new and diverse forms of content and delivery.*" (Speech by Ed Richards to the Royal Television Society, 11 March 2008.)

terms of picture quality) as those that they receive over the air (and probably at least as good as they received via analogue terrestrial delivery). Second, it is abundantly clear that picture quality via such services will only increase in the future, via both improvements in compression technology, and higher speed broadband connections. Finally, it ignores entirely the trade-offs that consumers are likely to be willing to make between relatively small degradations in picture quality and factors such as (a) cost-savings, (b) portability of content around the home, and (c) the ability to watch programmes of their own choosing at a time of their own choosing.

3.40 It is also important to appreciate that whereas previously the main free to air channels were, due to limited broadcast hours and scheduling clashes, constrained in their ability to show sports or films, the expansion in the number of free to air channels that has been facilitated by digital broadcasting has largely removed this constraint. The last few years have seen a large expansion in the use by these broadcasters of their 'sister channels' for broadcasting such programming. For example, a large number of the less prominent matches in last year's rugby World Cup were broadcast live by ITV on ITV4. Previously, such matches would probably not have been screened live.

The importance of basic channels carried in basic-plus-premium channel packages

3.41 It is important to recognise that the existence of buy-through requirements does not mean that subscribers to pay TV packages that include premium channels attribute little or no value to the basic channels included in their packages. That is a non-sequitur. On the contrary, evidence suggests that subscribers to such packages do value such channels. In particular, among Sky's DTH subscribers less than one percent of subscribers who subscribe to packages that include premium channels 'buy through' to premium channels in the cheapest way possible.

3.42 This means that an increase in the value that subscribers derive from free to air television services may cause them to cancel their subscription even if the value they place on the premium channels included in the package to which they subscribe remains unchanged.

3.43 This can be illustrated by way of a simple example, set out in the table below. In period 1 a household subscribes to a hypothetical pay TV package that includes three basic channels and one premium channel. The household's total monthly willingness to pay for the package exceeds the subscription charge, as set out in Table 6 below.[71] Subsequently, new free to air television channels are introduced, or the quality of programming on existing free to air television channels improves, and the household finds that it watches them more, and basic channels 2 and 3 less.[72] This causes their willingness to pay for those channels to fall in period 2.[73] Accordingly, given that household utility derived from the subscription declines to less than the monthly

71 The household in this example is a 'marginal consumer' in the sense that its net utility from its pay TV subscription is sufficient to justify subscribing, but is low.

72 It is also possible that a consumer simply 'discovers' programmes on free to air channels which they have received for some time that they find they like.

73 We note that this is clearly a stylised example. In practice, such a decline in willingness to pay is unlikely to be instantaneous, though of course no less significant for this reason.

subscription charge, this household would cancel its pay TV subscription even though there has been no diminution in its willingness to pay for the premium channel in the package.

Table 6: Willingness to pay for different packages

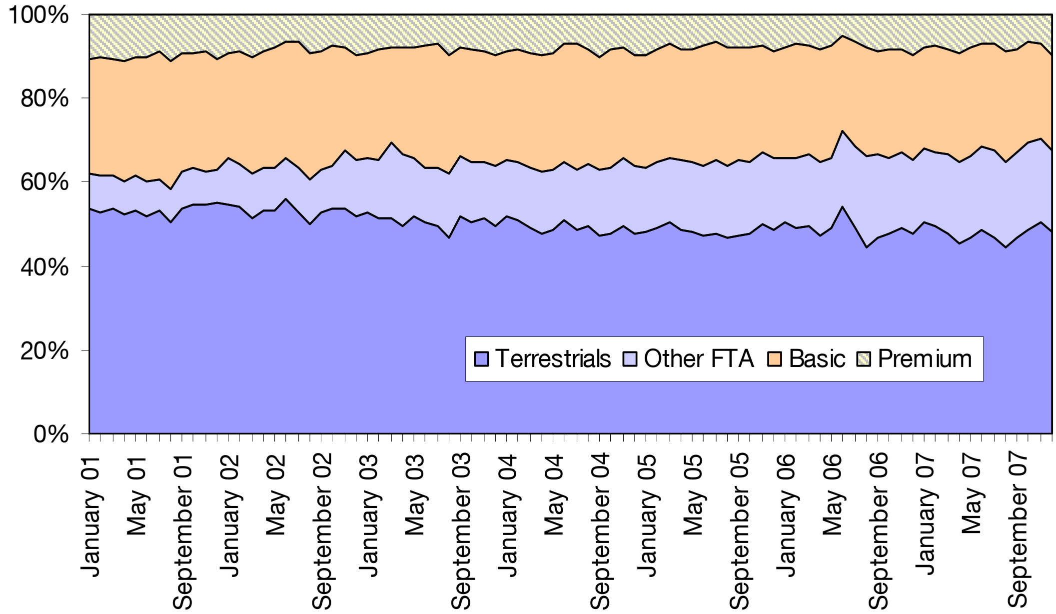
	Period 1	Period 2
Willingness to pay:		
Basic channel 1	£8	£8
Basic channel 2	£5	£4
Basic channel 3	£5	£4
Premium channel	£13	£13
Total willingness to pay	£31	£29
Subscription charge	£30	£30
Net Utility	£1	-£1

3.44 Accordingly, this example indicates the importance of the increased competitive pressure that improvements in the quality of free to air television services exert on the provision of basic-plus-premium pay TV packages via their basic component (in addition to more direct constraints arising from their provision of a wide range of sports and film content). It indicates that many of the considerations relating to basic-only pay TV packages apply also to basic-plus-premium channel packages. For example, the concerns that led Sky to significantly enhance the appeal of its basic packages, and the resulting improvements, described below, apply equally in relation to basic-plus-premium subscribers and basic-only subscribers.

(e) The strength of the UK's free to air services

3.45 More than fifteen years after the first introduction of pay television services in the UK a key characteristic of television broadcasting is that television viewing is still dominated by the free to air channels in general and the five major free to air channels in particular, even within homes equipped to receive pay television services. In DTH households, nearly two-thirds of television viewing is of free to air channels, with the large majority of that viewing (about half of total viewing) being to the five main terrestrial channels (BBC1, BBC2, ITV1, Channel 4, and five) – see **Figure 3** below.

Figure 3: Audience share in DTH homes



3.46 The reasons for the continuing pre-eminence of free to air broadcasters after many years of competition from pay TV operators are straightforward. They include:

- both collectively and, in some cases, individually, access to a significant revenue stream, which is used to fund the creation and acquisition of an extremely broad range of programming, including a vast amount of high quality programmes particularly in those programme genres which most appeal to consumers on a day-to-day basis: soaps, drama, comedy, documentaries and general entertainment. As noted above, collectively, UK free to air broadcasters spend over £3 billion a year on content;

- privileged access to gifted analogue spectrum (which enables the main free to air channels to be available in almost every UK home), and DTT spectrum;

- privileged access to rights to broadcast a set of the most popular sports events on television, commonly known as the 'Crown Jewels' of sports broadcasting; and

- many years in which the main free to air channels were (a) universally availability, and (b) the only television channels available, which results in a very high degree of consumer awareness of those channels. Universal availability of their main channels continues to afford the terrestrial broadcasters unique opportunities for cross-promotion of their other services.

(f) Switching costs are low

3.47 The costs to consumers of switching between pay TV and free to air television services, between different pay TV products provided by the same retailer and between different retailers operating on the same platform are negligible. While the costs of switching between pay TV retailers operating on different platforms are higher, they are still modest:

- *Between pay TV and free to air television*: clearly, it is in pay TV operators' interests to make it as easy as possible to take up (or to restore) a pay TV subscription and they do all that they can to investigate and minimise any impediments to doing so.[74] In Sky's case, for example, this has involved spending hundreds of millions of pounds on subsidising set top boxes.[75]

  The costs of reverting to viewing free to air television services are negligible. They are the costs of cancelling a pay TV subscription, which normally simply involves a telephone call. In the case of Sky's DTH subscribers, churners can continue to use their set top box to receive over 200 digital free to air television channels – including the most popular digital free to air channels, such as ITV2 etc.

- *Between different pay TV services provided by particular pay TV retailers*: the costs of switching between pay TV packages are negligible. Typically, this can be done by phoning a pay TV retailer. The lack of impediments to switching are indicated by the considerable level of such movements on the part of Sky's subscribers. During October 2007, for example, [**CONFIDENTIAL**] Sky subscribers upgraded the number of premium channels taken and [**CONFIDENTIAL**] downgraded the number of premium channels taken. [**CONFIDENTIAL**]% of the upgrades were from subscribers previously on basic-only channel packages, with [**CONFIDENTIAL**]% of the downgrades to basic-only channel packages. In addition [**CONFIDENTIAL**] subscribers changed their package without changing the number of premium channels taken (i.e. just changing the number of genre mixes taken or moving from Dual Sports to Dual Movies). By comparison, during the same period gross churn comprised [**CONFIDENTIAL**] subscribers.

  Ofcom's evidence on consumer switching in response to a SSNIP also appears to suggest that significant proportions of subscribers would switch to a different pay TV package in response to a SSNIP, which, again, is suggestive of low barriers to switching.

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74 One impediment to switching is that retailers tend to adopt initial subscription periods in order to seek to ensure that they recover at least part of their initial investment in customer acquisition. Over time, however, a relatively small part of a subscriber base will come to be covered by such initial subscription periods, which is certainly the case with Sky's subscriber base. Moreover, it may be difficult for any pay TV retailer cost-effectively to enforce initial subscription terms. [**CONFIDENTIAL**]. The fact that they continue to be used by Sky and other pay TV retailers is, therefore, indicative of the importance of customer acquisition costs as a feature of operation at the retail level.

75 Take-up of Sky's digital television services was slow following their introduction. [**CONFIDENTIAL**]. Sky took the view that subsidising set-top boxes was likely to be a more cost-effective way of promoting take-up of DTH subscriptions than other forms of marketing expenditure.

- *Between different retailers operating on the same platform*: as Ofcom appears to recognise,[76] the costs of switching between different retailers operating on the same platform are negligible. Currently, the only platforms in the UK which support multiple pay TV retailers are the DTH platform and Tiscali's IPTV network. In relation to the DTH platform, switching between different pay TV services is entirely straightforward.

- *Costs of switching between pay TV services provided by different pay TV retailers*: Sky considers that Ofcom's assertion that the costs of switching between pay TV services provided by different pay TV retailers are "*high*" cannot be supported.

(g) Sky incurs subscriber acquisition costs, which makes it highly sensitive to losing subscribers

3.48 Sky spends considerable sums on persuading consumers to take up a pay TV subscription and incurs significant per-subscriber costs in initially providing services to a household (for example in installation subsidies). Sky therefore makes an initial investment in acquiring a customer, and earns a return on that investment over the course of that customer's subscription. Given the scale of the investment required Sky must, on average, retain customers for a number of years in order to earn an adequate return on its investment. For example, if the cost of acquiring a customer is £250 and they subscribe to a service which delivers a net monthly contribution of £10, the customer must stay with the service for at least 27 months before Sky even begins to earn a return on that customer.[77]

3.49 This makes the commercial economics of Sky's retail businesses highly sensitive to 'churn' – the industry term for switching away from pay TV services, usually to free to air television.[78] Relatively small variations in churn rates may have very significant consequences for profitability because it means that Sky retains customers, on average, for a shorter period, reducing the level of recovery of its initial investment.

3.50 In this context, a singular focus on pay TV retailers' pay TV packages omits consideration of many other ways in which those operators compete – both with each other and with the alternative of free to air television. Key among these is customer service: pay TV retailers are as liable to lose customers through dissatisfaction with the way they are treated – for example due to incorrect billing, or failing to answer their telephone calls – as they are through dissatisfaction with the programming in their pay TV packages.

3.51 Sky's massive efforts in relation to delivering first-class customer service testify to the competitiveness of the market in which it operates. Such initiatives include:

- large scale investments in its call-centres and customer relationship management systems;

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76 For example, at paragraph 1.29.

77 Assuming, for the sake of example, an annual discount rate of 10%.

78 [CONFIDENTIAL].

- [**CONFIDENTIAL**]

(h) [**CONFIDENTIAL**]

3.52 [**CONFIDENTIAL**]

3.53 [**CONFIDENTIAL**]

Figure 4: [**CONFIDENTIAL**]

[**CONFIDENTIAL**]

(i) Econometric evidence on the impact of free to air television on demand for pay TV services

3.54 Sky has provided Ofcom with the results of its econometric research which shows that the availability of Freeview results in a very significant reduction in demand for its pay TV services.[79] The results of this research are both (a) robust in econometric terms, and (b) highly significant in the context of market definition in this case.[80]

(j) Sky's response to the growth of free to air multichannel television

3.55 Sky has had to give significant consideration to the impact of the growth of free to air multichannel television (and in particular, the rapid take up of Freeview) on its business strategy. This has resulted in a range of competitive initiatives designed to boost the appeal of its pay TV services in order to maintain and enhance consumers' perceptions of those services.

3.56 These types of initiatives in the context of growing competition from multichannel free to air television are widely recognised. For example, they were cited by ITV in its main submission to the Competition in the BSkyB/ITV inquiry.

3.57 Particular initiatives include:

- the introduction of a range of new basic packages in September 2005 containing significant numbers of basic channels at attractive price points, described further below;
- an above-the-line advertising campaign in which Sky invested over [**CONFIDENTIAL**] focused on the programmes carried on the basic channels in

79 In order to undertake this research Sky used a multinomial logit model, which includes a range of factors that affect the take-up of Sky's pay TV services in a particular geographic area (for example demographic factors and availability of cable services, together with Freeview availability in that area), in order to isolate the effect on this variable of Freeview availability. It uses regression analysis to estimate the parameters of the model, using a large postcode-based data set.

80 On the one hand, Ofcom appears to recognise the very significant reduction in demand for Sky's pay TV services caused by Freeview. (See paragraph 4.118 of Annex 13) Ofcom then, however, follows this with a statement that "*we think that it is plausible that the entry of Freeview may have had a market expansion effect.*" It is entirely unclear what "*market*" Ofcom thinks may have been expanded by Freeview's "*entry*". Clearly, Sky's research shows that it is not Ofcom's putative "*market*" for basic-only pay TV services.

Sky's packages, such as Extreme Sports, National Geographic and TCM, and designed to raise awareness of the broad range of high quality content carried on those channels. This advertising campaign, called '*What Do You Want to Watch*?' ran from October 2004 to December 2006;

- a decision to invest significant amounts in programming for Sky One (including a significant increase in spending on original programming[81]);
- dropping the £10 Sky+ charge for basic-only subscribers; and
- development of free or cheap broadband services for Sky subscribers (discussed further below).

3.58 Such initiatives provide strong and compelling evidence as to the significant competition that multichannel free to air television poses to retailers of pay TV services.

The introduction of new basic packages in September 2005

3.59 By 2005 it had become evident to Sky that the range of the basic packages that it provided were ill-suited to an environment in which there was very rapid take-up by consumers of the means to receive multichannel free to air television services and a massive proliferation of such services – including an increasing number of channels provided by the UK's main free to air broadcasters (the BBC, ITV, Channel 4 and five) in which they were making significant investments.[82]

3.60 At that time, Sky offered a 'Big Basic'/Family pack, which contained all the basic channels retailed by Sky and a number of significantly smaller and less attractive packages which were not widely marketed. In essence, Sky's pricing and packaging structure for its basic packages significantly incentivised consumers to subscribe to the Family Pack – and nearly all Sky subscribers did so.

3.61 Given the rapid increase in competition from multichannel free to air services, such a position was not sustainable. Accordingly, after a significant programme of

81 Sky One broadcast its first high-budget UK drama commission with its adaptation of Terry Pratchett's *Hogfather* (with a production budget of [CONFIDENTIAL]) in December 2006. This was followed by a second Terry Pratchett adaptation (*Colour of Magic*), with an increased production budget of around [CONFIDENTIAL], which was broadcast in 2008. In the next financial year, Sky will be making its biggest investment yet in UK drama to deliver three new drama commissions, including its third adaptation of a Terry Pratchett novel (*Going Postal*) and adaptations of two other British authors' books (Chris Ryan's *Strike Back* and David Almond's *Skellig*). During 2008/09, Sky expects to contribute a total [CONFIDENTIAL]of production costs to these commissions. In addition, Sky One has ringfenced around [CONFIDENTIAL]for researching and developing further original drama projects. Sky's increased focus on original programming extends beyond drama, with both factual and family entertainment commissions such as *Ross Kemp on Gangs*, *Ross Kemp on Afghanistan* and *Are You Smarter than a 10 year-old* representing key elements of the Sky One schedule. Overall, in 2008/09, Sky One's amortised spend on UK commissions across all genres is budgeted to increase to around [CONFIDENTIAL] (compared with around [CONFIDENTIAL]in 2007/08) and will represent a higher proportion of Sky One's total programming budget ([CONFIDENTIAL] in 2008/09 compared to [CONFIDENTIAL] in 2007/08).

82 An additional impetus for these changes was an increasing recognition that there was a rapidly diminishing number of non-pay TV subscribers with an interest in premium sports and movie channels.

consumer research, negotiations with the providers of basic channels in Sky's pay TV packages, and a very considerable amount of development in its customer management systems, Sky developed and introduced a set of six new genre-based packages (denoted 'Mixes') among which consumers could select 2, 4 or 6 Mixes. (Following further consideration of the best way of marketing these packages, Sky subsequently altered this approach so that consumers can subscribe to any number of basic Mixes.)

3.62 The result of this change and the marketing of these new packages (including using one and two Mix packages in Sky's headline messages) has been to introduce an attractive range of subscription products between the 'Big Basic'/ Six Mix pack, and free to air television services in order to both (a) attract new subscribers; and (b) ensure the retention of existing subscribers in the face of a very considerable increase in competition from free to air television services.

3.63 An indication of the very significant improvements in the value for money of Sky's sub-Big Basic basic-only packages is set out in **Appendix 8** (Examples of changes to Sky's basic packages in September 2005).

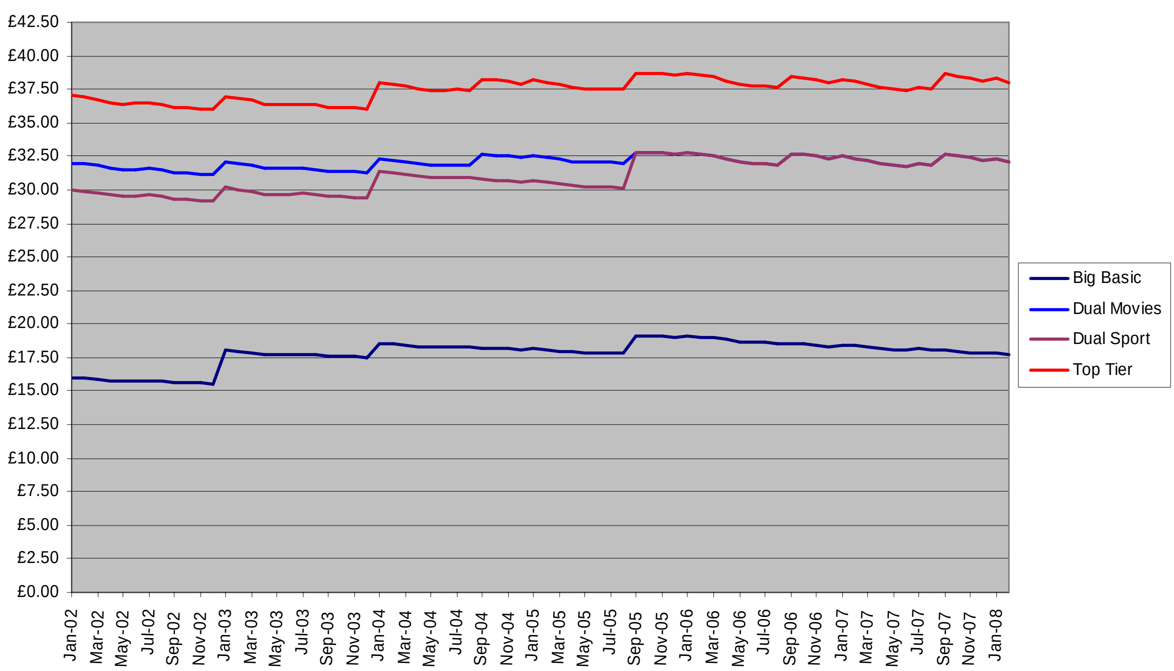
(k) Flat or falling charges in real terms

3.64 Charges for Sky's pay TV packages have either been not increasing or declining in real terms in the past few years. **Figure 5** below shows charges for Sky's most popular packages, in real terms, since January 2002. Sky notes the following facts indicated by this chart:

- the charge for Sky's most inclusive 'Top Tier' package has barely changed in real terms over the past four years, and is only marginally higher now than the charge for this package in January 2002 ;
- the charge for Sky's Dual Movies package has effectively not increased in real terms over the past six years;
- the charge for Sky's Dual Sports package is around the same level now (in fact marginally lower) in real terms that in September 2005; and
- the charge for Sky's Big Basic package has been declining in real terms since September 2005.[83] The current price for that package, in real terms, is marginally lower now than in January 2003.

Figure 5: Changes in Sky's subscription charges in real terms

83 Ofcom appears to consider that these reductions are simply the result of Sky offering new cheaper basic-only packages which some 'Big Basic' subscribers have switched to and new subscribers have joined (i.e., an average revenue effect deriving from the change in the package mix of customers). Such an effect (which has certainly occurred) is, clearly, entirely separate to the falling charge for Six Mix in real terms.



3.65 In all cases there have been significant improvements in the quality of these packages – whether through: improvements in quality of the premium channels in those packages (discussed further in **Appendix 9** (Changes in the quality of Sky's sports and movie channels over time)); an increasing number of, and improvements in, the basic channels carried in these packages; reducing charges for Sky+; introduction of free, or cheap, broadband services, and so on. Accordingly, it is evident that the value for money of Sky's pay TV packages has been improving significantly over time, particularly in the past 3-5 years.

(l) Introduction of free or low-cost broadband services

3.66 Sky's major investments in delivery of broadband services – first through the purchase of Easynet, and subsequently through investment in a significant roll-out of LLU-based services – have been a major component of its initiative in relation to the rapidly changing environment in which Sky operates, and intensification of competition. This aspect of Sky's current and future activities should not be downplayed or overlooked as a result of a preconception that they are a relatively new line of business for Sky and, for that reason, somehow less important.

3.67 These investments have enabled Sky to deliver real increases in value to its subscriber base. Sky customers that live in areas where Sky has its own network (around 70% of the UK) can obtain three different services - Sky Broadband Base; Sky Broadband Mid; and Sky Broadband Max. Sky Broadband Base is free with download speeds of up to 2Mb/s and 2GB monthly usage. Sky Broadband Mid costs £5 per month and offers download speeds of up to 8Mb/s and 40GB monthly usage. Sky Broadband Max costs £10 per month and offers download speeds of up to 16Mb/s and unlimited monthly usage.

3.68 Charges for these services are well below those of most ISPs, enabling Sky subscribers to make very significant savings on their broadband services if they switch to Sky. For example, a BT customer using an 8 Mb/s broadband service switching to Sky would save over £10 per month. Accordingly, the value for money of Sky's packages has increased very significantly.

3.69 Despite being only available to Sky subscribers, Sky has been the fastest growing ISP (in absolute terms) for the last four quarters. In December 2007, less than 18 months after launch, Sky became the UK's 4th largest ISP with 1.2m Sky subscribers having taken up Sky's broadband service.

(m) Evidence on the price-sensitivity of pay TV subscribers

3.70 As set out in Part Two of this Annex, the available evidence on subscribers' reactions to increases in subscription charges, while not ideal, is strongly suggestive of sufficient price sensitivity that small but significant increases in charges in real terms (all else being equal), would not be profitable for the providers of pay TV services.

(n) Likelihood that there are significant numbers of marginal customers

3.71 Digital pay TV services have now been offered in the UK for nearly ten years. While there have been significant changes in the pay TV offering over that period, it is reasonable to assume that households with the highest willingness to pay for pay TV services were the first to sign up to them. Common sense suggests that, as time goes on, the types of consumers who take up pay TV subscriptions will have increasingly lower willingness to pay for pay TV services. This proposition simply reflects the well-known 'diffusion curve' for new products and services.

3.72 Accordingly, the high rate of penetration of pay TV services in the UK, and in particular the high rate of penetration of pay TV services that include premium channels,[84] creates an *a priori* proposition that there is a considerable number of marginal subscribers to such packages - subscribers whose valuation of the services they receive is relatively close to what they pay for them each month.

(o) ***There is an expanding range of ways of watching films***

3.73 The principal competitive constraint on the providers of pay TV services in the UK is the strength of the UK's free to air television proposition. For the providers of pay TV services that include movie channels, however, means of delivering films to consumers other than via linear television services impose a significant and increasing competitive constraint over and above that imposed by free to air television services. Services such as cinema, VOD, pay per view and sale and rental of films on pre-recorded media have always been a significant part of the competitive constraint faced by the providers of such pay TV packages. As set out in Sky's Response to the Complaint, in recent years, (a) falling prices of DVDs; (b) massive expansion in existing means for consumers to watch films via ways other than pay TV movie channels (such as via free to air television, and DVD rental); and (c) the introduction of wholly new ways for consumers to watch films, mean the extent of this competition has increased enormously.[85]

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[84] As noted in Section 2, it is Sky's view that the penetration of these packages in the UK is likely to be the highest of any country in Europe.

[85] It is evident that Ofcom has not had regard to this part of Sky's previous submission.

3.74 Ten years ago, the DVD did not exist as a consumer product in the UK: the predominant form of viewing of pre-recorded programming in the home was on VHS. Since the launch of the product in 1998, over 1 billion DVDs have been sold, and penetration of DVD hardware now stands at 80% of homes.[86] A large number of new entrants have begun **retailing** DVDs – including both 'bricks and mortar' stores, such as Tesco, and online retailers, such as Amazon. Part of the slowing of the rate of growth in the value of sales of DVDs that has been observed in recent years has been attributed to fierce price competition among sellers of DVDs.

3.75 Similarly, the growth in DVD **rental** over this period, including via the entry of a wide range of new players, has been phenomenal.[87] The most recent set of entrants has been the online DVD rental providers – operators such as Tesco, Amazon, LoveFilm, EasyCinema and MyMovieStream. There are now more than 20 UK online DVD rental sites, each offering up to 50,000 titles. The largest of these services had 340,000 subscribers in Q1 2007.[88]

3.76 The development of 'true' video on demand services in the past few years has provided yet another way of delivering films to consumers. In the UK, these now include: the Filmflex service (a joint-venture between Columbia Pictures and Disney), which is available on Virgin Media's network; BT Vision's own VoD movie service, available via BT's IPTV network; Picturebox (provided by Universal) which is available via Tiscali's IPTV network; Tiscali's own VoD movie service which it provides to its customers; and Sky Anytime, which enables Sky Movies subscribers to view films on both a subscription and pay per view basis.

3.77 Finally, there is an increasing number of download-to-own and download-to-rent film services provided via the internet.

3.78 At the same time, the number and variety of films shown on free to air and basic TV channels has expanded enormously. In 2001, the five main free to air channels broadcast 2,954 different films, and a total of 3,126 films (including films which were shown more than once) – an average of more than 8 films screened per day. By 2007, the number of films broadcast on the terrestrial channels and digital sister channels (BBC3, BBC4, ITV2, ITV3, ITV4, E4, More 4, Film 4, Five US, Five Life) had increased to 4,524 different films in 2007, and a total of 9,947 films (including films which were shown more than once) – an average of 27 films screened per day.

3.79 Given the plethora of alternatives available to consumers, and likely heterogeneity in consumer preferences, the **aggregate constraint** from all such services on the providers of pay TV packages that include pay TV movie channels has clearly increased very significantly in recent years.

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86 British Video Association Yearbook, 2006. It took VHS 17 years to reach this level. DVD sales figures have grown in value every year, almost entirely replacing VHS in the last couple of years, and the growth in DVD sales has been faster in the UK than in the US.

87 See Paragraph 3.7 of Sky's Response to the Complaint.

88 Some evidence that consumers switch away from subscribing to movie channels when they take up an online rental subscription is provided by [**CONFIDENTIAL**].

3.80 As ever in relation to market definition, it is critical to bear in mind that the key constraint on providers of such services derives from the preferences of marginal subscribers – which is likely to be subscribers to pay TV services that include movie channels who watch a relatively small number of films each month. It is readily apparent that the types of market developments outlined above are likely to be of greatest appeal to exactly this type of subscriber.

3.81 Sky considers that a degree of common sense is required in relation to the assessment of the competition faced by a supplier of such services, which is lost in a mechanistic approach to market definition and market power. From a common sense point of view, it is obvious that such services are coming under significant competitive pressure from two directions: (a) the enormous expansion in multichannel free to air television services eroding the value of the basic component of such packages; and (b) the range of services described above.[89] To allege that 'nothing significant has changed' since 2002 (in practice, to a period considerably before 2002) in relation to such services defies common sense entirely.

(p) [**CONFIDENTIAL**]

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3.83 [**CONFIDENTIAL**]

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3.85 [**CONFIDENTIAL**]

3.86 [**CONFIDENTIAL**]

(q) Increasing availability of content broadcast on pay TV channels via means other than those channels

3.87 There is an increasing availability of television content carried on basic pay TV channels (particularly of a general entertainment nature) which is available on DVD and VoD services, including internet based services – a trend which is likely to increase significantly in the future. For example, consumers now increasingly purchase and rent DVDs of television series such as *Lost*, *24* and *The Wire*, and there is increasing availability of such programmes on internet-based download services (e.g., iTunes[90]). Such developments act to undermine the attractiveness of pay TV services, particularly from the point of view of subscribers who tend to watch only a relatively small range of programming carried on the services to which they subscribe.

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89 Paragraphs 3.65-3.70.

90 See, for example, *iTunes TV comes to the UK*, http://uk.gizmodo.com/2007/09/01/itunes tv comes to the uk.html, 1 September 2007. Further discussion of this subject is contained in the Appendix to Annex 6 (Errors in the Consultation Document); (Audiovisual programming delivered via the internet).

(r) Sky's internal documents

3.88 Sky is able to supply Ofcom with a large range of internal documents which address the challenge to its business from (among others) multichannel free to air television, other pay TV providers and other means by which consumers are able to watch films.

(s) Statements by other operators

3.89 There is a wealth of evidence available that indicates that the providers of free to air television channels (particularly commercial providers) regard themselves as being in competition with the providers of pay TV services. Most notable in this respect are statements by ITV in its main submission to the Competition Commission in the ITV/BSkyB inquiry. ITV stated:

> *"the core business models of the free-to-air advertiser funded ITV and the pay TV subscription funded BSkyB are fundamentally opposed and competing."*[91]
>
> "*The existence of an attractive and strong free-to-air alternative in the form of DTT therefore imposes a* ***very significant competitive constraint*** *on BSkyB's pay TV offering. As the OFT Report noted, the stronger the free-to-air viewing proposition (via analogue and now digital free-to-air platforms), the less likely consumers will be willing to convert to (or maintain their subscription with) a pay TV platform.*" [92] (emphasis added).

3.90 In relation to the views of other pay TV operators, Virgin Media's Form 10-K for 2007 states:

> "*Risks Relating to Our Business and Industry*
>
> *We are subject to significant competition and we expect that competition will intensify.*
>
> ***The level of competition is intense in each of the markets in which we compete, and we expect competition to increase****...*
>
> ***In the digital television market****, we compete primarily with BSkyB in providing digital pay television services. Competition increased as a result of the launch of Freeview in October 2002, which provides approximately 43 digital terrestrial TV channels on a free-to-air basis to consumers who have purchased a Freeview digital set-top box, digital or digital TV recorder television. In March 2004, Top Up TV launched a pay-television service offering approximately 120 programs from 19 channels for a fixed fee to subscribers who otherwise receive Freeview and have purchased a Top Up TV set-top box. This year, BT Vision launched a PC download service of video on demand home entertainment content over a broadband connection. BSkyB and others offer a similar service.*" [93] (emphasis added).

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[91] Paragraph 2.5.

[92] Paragraph 2.12.

[93] See Pages 27-28. Virgin Media's From 10-K, which is available at: http://investors.virginmedia.com/phoenix.zhtml?c=135485&p=irol-

3.91 It is evident, therefore, that in filings that are required to be accompanied by statements as to their truthfulness (as in the case of the Form 10-K), Virgin Media takes the view that it is subject to "*intense*" competition in a "*digital television market*" that includes Sky, Freeview, Top Up TV and BT Vision.

(iii) Conclusions on market definition and market power at the retail level

3.92 Sky considers that the arguments and evidence set out above are strongly supportive of a view that Sky does not hold a dominant position at the retail level. It does not matter particularly for the purpose of Ofcom's consultation whether that conclusion is couched in terms of (a) markets being sufficiently wide that Sky is not dominant in them; or (b) the constraints on Sky being sufficient that it does not have the ability to operate independently of its competitors and consumers at this level.

3.93 Nevertheless, it is Sky's view that it is the case that the relevant market should be defined broadly at the retail level. Sky considers that the relevant market is at least as wide as that defined by the Competition Commission in its recent report on Sky's purchase of a 17.9% stake in ITV: a retail market for 'all-TV'. Sky considers, however, it is appropriate also to include in the relevant market services such as PPV movie services, DVD sale and rental, and VoD services, particularly in view of the key role such services play in the competition faced by the retailers of pay TV packages that include movie channels.

3.94 Sky considers that the relevant market in which these services are provided is a market for the supply of audiovisual programming to consumers. Within that market, operators such as the BBC, ITV, Channel 4, five, Sky, Virgin Media, Setanta and Tiscali (among others) adopt different strategies, and have different strengths and weaknesses. However, there is intense and effective competition between them which delivers extremely positive outcomes for UK consumers.

E. Analysis of market definition and market power at the channel provider level

(i) Background

3.95 The assessment of market definition and market power at the upstream level raises difficult issues. It is Sky's view that it is at this level that it makes least sense to adopt a framework of analysis that comprises a mechanistic process of seeking to define relevant markets and then subsequently, and entirely separately, to determine the extent of market power.

3.96 The key reason for this is that television channels are highly differentiated products. In such circumstances, a mechanistic approach (particularly one that is heavily focused on product characteristics and the preferences of infra-marginal customers) will tend to define individual TV channels (or types of TV channels) as being supplied in separate relevant markets. Any firm that specialises in supplying that particular type of television channel will then be found to have a very high 'market share' which, in standard competition policy terms, creates a presumption of dominance.

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Such presumptions are then confirmed by referring to theories of barriers to entry and/or absence of buyer power. Clearly, this is the approach adopted in the Consultation Document.

3.97 Sky considers that, in view of the difficulty associated with defining the relevant market at the wholesale level, principally as a result of the centrality of product differentiation as a mode of competition at this level, the issue of relevant markets should be left relatively open.[94] Instead, the focus should be on whether there are sufficient constraints on a provider of particular TV channels (or types of TV channels) as to ensure that they cannot behave independently of competitors, customers, suppliers and, ultimately, the final consumer.

3.98 As a result, in the sections below, we consider the following factors that constrain Sky's behaviour as a provider of pay TV sports and movie channels:

- switching by consumers;
- switching by retailers; and
- absence of significant barriers to entry and expansion.

3.99 In addition, in the final section we examine evidence in relation to market outcomes as indicators of whether Sky is likely to have a dominant position in the relevant markets that Ofcom has defined.

(ii) Description of Sky's sports and movie channels[95]

3.100 In this section we set out a factual description of Sky's sports and movie channels.

Sky Sports

3.101 Sky's sports channels comprise:

- Sky Sports 1
- Sky Sports 2
- Sky Sports 3
- Sky Sports Xtra
- Sky Sports HD1

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94 Sky notes that, unlike an inquiry under competition legislation, for example, there is no requirement for Ofcom to define relevant markets in the current exercise. For the avoidance of doubt, Sky considers that the relevant market at the wholesale level is a broad one, principally by virtue of the breadth of the relevant downstream market. Sky considers that the relevant market in which these services are provided is a market for the supply of audiovisual programming to distributors (both in the form of television channels, and in the form of individual programmes) which includes the suppliers of free to air, basic and premium pay TV channels.

95 Currently, Sky broadcasts 26 Sky channels via its DTH service (or 28 including multiplex versions), and 8 further HD simulcast versions of those channels. Given the focus of Ofcom's analysis, however, in the following we focus on Sky's sports and movie channels.

- Sky Sports HD2
- Sky Sports HD3

3.102 Sky Sports 1 and Sky Sports 2 each provides on average 22 hours of sports programming per day, including live coverage of sports events. Sky Sports 3 currently provides, on average, 18 hours of sports programming each day. Sky Sports Xtra provides, on average, 16 hours of sports programming per day.[96]

3.103 Sky Sports HD1, Sky Sports HD2 and Sky Sports HD3 are simulcasts of Sky Sports 1, Sky Sports 2 and Sky Sports 3 respectively. Sports events covered in HD include England's domestic Test matches, one day internationals and county matches in cricket, Engage Super League rugby, Guinness Premiership Rugby and a range of live football including matches from the Football Association Premier League, Coca-Cola Football leagues, Carling Cup, UEFA Champions League, FA Cup and some international games.

3.104 As at 31 December 2007, there were [**CONFIDENTIAL**] UK DTH subscribers to Sky Sports 1 or Sky Sports 2 and a further [**CONFIDENTIAL**] subscribers on Virgin Media, and [**CONFIDENTIAL**][a large majority] of these sports subscribers subscribed to both Sky Sports 1 and Sky Sports 2.

3.105 Sky's programming rights for the Sky Sports channels include exclusive live rights to broadcast, in the UK and Ireland, a range of sport including a number of football, rugby union, rugby league, cricket, motor sport, golf, boxing and tennis events. In addition, Sky purchases rights to broadcast a wide range of additional sports programming on both an ad-hoc and longer term basis.

3.106 In the period July-September 2007, Sky Sports broadcast 6,740 hours of programming (excluding Sky Sports News and teleshopping), of which approximately 1,830 hours of programming (27%) included live sports content.[97] This included approximately 39 hours of coverage of live FAPL football, or less than half of one percent of all content and 2% of live content.

Sky Movies

3.107 Sky's movie channels comprise:

- Sky Premiere
- Sky Premiere+1
- Sky Comedy
- Sky Action
- Sky Family
- Sky Drama

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96 All four channels broadcast an amount of teleshopping each day. This is not counted as sports content.

97 Source: BARB data. The 1,830 hours includes all programmes which feature live sport, and so also includes analysis and advertisements.

- Sky SciFi/Horror
- Sky Classics
- Sky Modern Greats
- Sky Indie
- Sky Movies Screen 1
- Sky Movies Screen 2
- Sky Premiere HD
- Sky Movies Screen 1 HD
- Sky Movies Screen 2 HD

3.108 The channels principally broadcast a combination of movies in the pay TV window (which are divided into categories A, B and C depending on their performance in previous windows), made-for-television movies and library movies, as well as a small amount of 'magazine' programming. Categories A, B and C are defined as follows:

- Category A: US box office $100m-$150m and/or UK box office >£10m and/or UK DVD and video rentals >1.5m transactions.
- Category B: US box office $50m-100m and/or UK box office £2.5m-£10m and/or UK DVD and video rentals 0.5m-1.5m transactions.
- Category C: US box office <$50m and/or UK box office <£2.5m and/or UK DVD and video rentals <0.5m transactions.

3.109 The pay TV window for films commences around 12 months after the release of a title at cinemas and runs for around 15 months. The films in these categories are still available to rent or buy on DVD and video during the pay TV window. Many will have been available via VOD and internet download.

3.110 **Figure 6** shows the breakdown of movies shown on the Sky movie channels over the last three years. Approximately 60% of the films shown on Sky's movie channels each year are library titles[98] (i.e., they have previously been shown on television) and around 15% are TV movies or straight-to-video titles (i.e. have not had a cinema release). Only around 6% can be described as "blockbusters".

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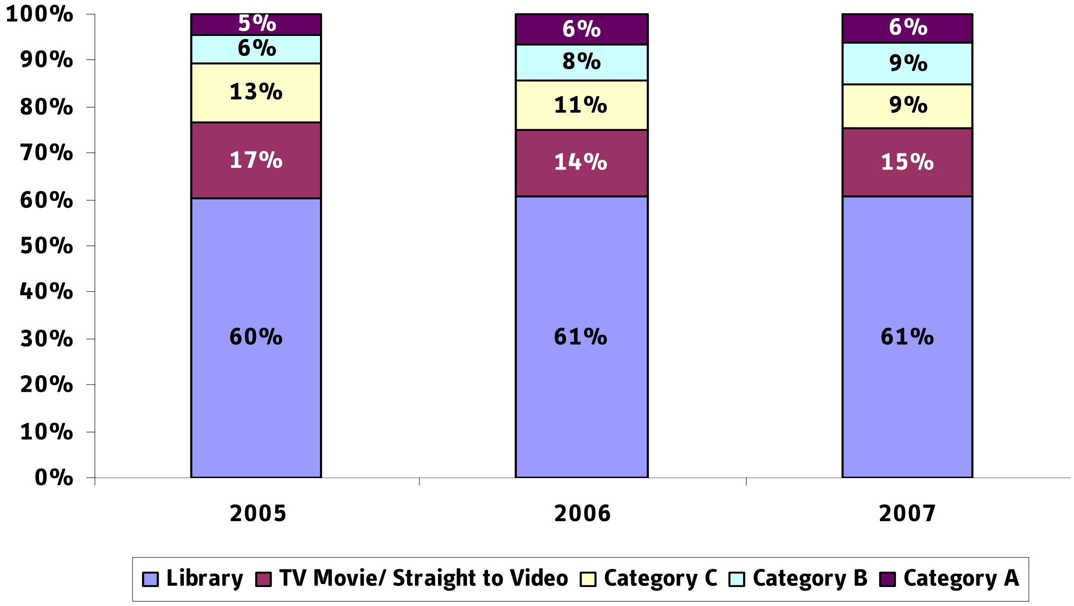
98 Sky notes that free to air broadcasters have considerable competitive advantages in relation to library films. After the pay TV window, free to air broadcasters benefit from a long licence period - we understand the free to air licence period to be between 4 to 7 years in duration, dependent on studio and broadcaster, compared to 15 months for the pay TV window. At that point, films become available to all broadcasters as library content. However, we understand that free to air broadcasters' licences in relation to library content tend to be for longer periods than library films are licensed to Sky - between 3 to 7 years compared to Sky Movies' range of [**CONFIDENTIAL**].

Figure 6: Films shown on Sky Movies by category, 2005-2007



3.111 Sky Movies Comedy, Family, Classics, Modern Greats, Action/Thriller and Drama broadcast 24-hours per day, seven days a week. Sky Movies Sci-Fi/Horror and Indie both broadcast from 10am to 4am, seven days a week. Each channel is based on a genre of films and broadcasts movies from each of the five categories described above.

3.112 Sky Movies Screen 1 broadcasts from 11am to 3am and Sky Movies Screen 2 broadcasts from 12pm to 4am, both seven days a week, and they show similar content to the genre movie channels.

3.113 Sky Movies Premiere broadcasts from noon to 2am, seven days a week. Unlike the other movie channels, Sky Movies Premiere focuses predominantly on broadcasting titles in the pay TV window. It typically broadcasts five new films per week, and two films from the previous week, every day for seven days. It also broadcasts a small amount of 'magazine' programming. Sky Movies Premiere +1 is a one hour delayed multiplex of the Premiere channel, broadcast from 1pm to 3am.

3.114 There are three Sky Movies HD channels dedicated to movies broadcast in high definition: Sky Movies Screen 1 HD, Sky Movies Screen 2 HD and Sky Movies Premiere HD. These channels are HD simulcasts of Sky Movies Screen 1, Sky Movies Screen 2 and Sky Movies Premiere respectively.

3.115 As of 31 December 2007 there were [**CONFIDENTIAL**] UK DTH subscribers to Sky Movies and a further [**CONFIDENTIAL**] subscribers on Virgin Media, and [**CONFIDENTIAL**][a large majority]of movie subscribers subscribed to both Sky Movies 1 and Sky Movies 2.

(iii) Constraints on Sky's behaviour as a supplier of pay TV channels

(a) Constraints arising from the retail level

3.116 Demand for pay TV channels is a derived demand and, therefore, the conditions of competition at the downstream level play a key role in determining the constraints faced by upstream suppliers. Accordingly, the entirety of Section 2, above, is relevant to the assessment of the constraints faced by Sky in the provision of pay TV sports and movie channels. This assessment strongly suggests that the downstream market is broad – at least the market for all-TV defined by the Competition Commission – which means that it is improbable that a supplier of inputs to the products supplied to consumers at the retail level holds a position of significant market power, or dominance.

3.117 Sky considers that this proposition is not affected by the argument that, as pay TV services are provided to consumers as part of broader packages, a given increase in wholesale charges will – even if passed on to consumers in full – result in smaller increases in charges at the retail level.[99] If such an argument were accepted uncritically, it would imply that virtually any product supplied at the wholesale level comprised a separate relevant market, which is clearly nonsensical. For example, it would directly contradict Ofcom's conclusion that there is no market power upstream in relation to basic pay TV channels.

3.118 Despite its significant flaws (discussed in Part Two above), Ofcom's consumer research on the application of the SSNIP test provides some indication of the constraints that consumer behaviour downstream imposes on Sky's wholesale charges for its sports and movie channels. In effect, Ofcom applies retail price increases to pay TV packages that include premium sports and/or premium movie channels of 2%-6%. Given the ratio of wholesale charges to retail charges (which, in Sky's case averaged around [**CONFIDENTIAL**]% over the past three years), this level of increase is, clearly, compatible with wholesale charge increases of 5%-10%. Accordingly, Ofcom's findings that there would be considerable amounts of switching away from the relevant retail packages provides some evidence that such wholesale charge increases would be unprofitable.[100]

Additional constraints on providers of movie channels

3.119 Clearly, the types of developments outlined in section (o), above, have direct implications for Sky's position as a provider of movie channels. It is evident that developments such as, for example, increased availability of films on free to air channels, cheaper DVDs, the development of online DVD rental services, and the emergence of a range of 'true' video on demand movie services, mean that it is essential that Sky sets competitive wholesale charges for its movie channels.

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99 Sky notes that this erroneous argument played a key role in the OFT's arguments on wholesale market definition in its 2002 Decision.

100 This is more clearly the case for Sky's sports channels, which have virtually no marginal cost of supply. It is less clear-cut for movie channels, which have per-subscriber input costs associated with them.

(b) Constraints arising from switching by retailers[101]

3.120 Ofcom argues that third parties have no bargaining power in relation to the distribution of Sky's premium sports and premium movie channels.[102] This is not the case. In particular, Ofcom's analysis ignores the fact that Sky, like any other pay TV channel provider, is dependent on the operators of closed networks (a) to carry its channels on their closed networks, and (b) to retail its channels to their subscribers effectively. This combination of factors provides such pay TV retailers with considerable leverage over channel providers, including Sky. Their 'bargaining power' derives from their ability simply to withhold marketing effort (in its broad sense)[103] if they are dissatisfied with the terms of supply offered.

3.121 Pay TV retailers are intermediaries; their business is in aggregating inputs from a variety of different providers and on-selling them to consumers.[104] Most pay TV retailers are multi-product businesses and therefore potentially earn revenues from a range of products. These products include basic pay television channels, premium pay television channels, pay per view services, telephony and broadband. The objective of retailers is to maximise the profit they earn, which is a function of the margin (or contribution) earned per customer, multiplied by the number of customers they have. Retailers typically offer a variety of packages assembled from these products.

3.122 This is clearly the case, for example, with both cable and IPTV operators, both of which operate closed networks in the UK, whose businesses are based on supplying bundles of TV, telephony and broadband services to subscribers. Such operators have tended to focus their efforts in selling to consumers on products other than Sky's channels for three reasons:

(i) the margins available to them from broadband and telephony (and potentially basic pay TV packages) are far greater than those available from selling Sky's channels – cable operators in the past have claimed margins of 70% on telephony services;

(ii) lack of clarity in regulatory pronouncements and unwillingness of regulators to provide reasonable legal comfort has prevented Sky and cable companies

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101 Ofcom takes a simplistic approach to its analysis of possible responses by a distributor to a rise in the licence fee requested for a pay TV channel: it appears to consider that the only options to a retailer are to pass on the price increase to consumers, or to cease carrying the channel. (See Paragraphs 4.41 and 4.45 of Annex 13.)

102 Paragraphs 5.50 and 5.68 of Annex 13.

103 In this context, 'marketing effort' refers to the full range of ways in which a pay TV retailer encourages take-up of particular pay TV services, including, for example, pricing and packaging decisions, and advice to consumers when they phone to subscribe, or cancel subscriptions, as well as more traditional forms of marketing such as mailings and 'above the line' promotions.

104 This is not to diminish the important role they play. Pay TV retailers specialise in creating services that meet consumer demands and pricing them appropriately, and the challenging activities of attracting and retaining subscribers and providing high quality customer service.

implementing agreements which would incentivise cable companies to sell Sky's channels more effectively;[105] and

(iii) non-pay TV services represent a point of differentiation against the services provided by other operators, such as Sky. Although Sky has been able to erode some of that differentiation by extending its business into the provision of broadband and telephony, the different technical characteristics of cable networks mean that they continue to claim superiority – particularly in relation to broadband services – over other types of networks.

3.123 Virgin Media has acknowledged the relative importance of its non-TV products in driving profitability, and the extent to which they can be emphasised ahead of pay TV. For example:

> "*In broadband we have the strongest position. It is a fast growing market, and we have the best product and the best economics due to the ownership of our state of the art network, which has fibre much closer to the home than all of our competition. This means we can offer great value and quality at both the top and bottom of the market. Therefore broadband offers us the greatest opportunity and differentiation, and should be our hero product, backed up in the bundles by differentiation and basic and free TV, mobile contract, and the great economics from a fixed line phone.*"[106]

3.124 Of course, this is not to say that telephony, or broadband internet access, are substitutes for television programming in the eyes of consumers. They are, however, substitutes from the point of view of a multi-product firm choosing how best to maximise the contribution to its fixed costs from the portfolio of products which it sells.

3.125 The impact of the lack of marketing effort devoted to Sky's pay TV channels by cable operators can be seen in the take-up of those channels among their pay TV subscribers. For example, **Figure 6** below shows the number of cable pay TV subscribers who subscribe to one or more of Sky's sports and movie channels. The number of cable subscribers to Sky's sports channels declined by around [**CONFIDENTIAL**]% between July 1998 and July 2007, while the number of cable subscribers to Sky's movie channels declined by around [**CONFIDENTIAL**]% over this period.

Figure 7: Numbers of cable subscribers to Sky's premium channels

[**CONFIDENTIAL**]

3.126 This potential diversion of sales effort is, clearly, likely to be all the more important where retailers have their own services which are at least partial substitutes for Sky's channels. For example, part of the steep decline in the number of cable subscribers to Sky's movie channels may be attributable to the fact that cable operators provide their own pay per view, and now 'true VOD', movie services.

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105 See paragraph 4.34 of Part D and Section 5 of Annex 5.1 of Sky's Response to the Complaint.

106 Neil Berkett, Virgin Media: "*Third Quarter Results 2007*" conference call presentation.

(c) Absence of significant barriers to entry and expansion

3.127 The threat of entry by new operators, or existing providers of pay TV services expanding their services to include films, or live sports events, both provide very important competitive disciplines on Sky's behaviour as a provider of premium sports and premium movie channels. This issue is discussed in detail in **Annex 3** (Barriers to entry at the channel provider level).

(iv) Evidence from market outcomes

3.128 There are three clear types of evidence that are strongly suggestive that Sky lacks significant market power in relation to the provision of premium sports and movie channels: an absence of excess profits, flat or declining wholesale charges even though channel costs are increasing, and Sky's innovativeness as a channel provider.

- ***Absence of excess profits***

3.129 Again, Ofcom fails entirely to consider the inconsistency between its conclusion that "*Sky has not made returns which could be judged to be excessive, particularly given the risk profile when the early investments were being made* [107] and its conclusion that Sky is likely to hold a dominant position in relation to narrowly defined markets for the provision of premium pay TV sports and movie channels. Sky considers that the absence of excess profitability is a good indicator that Sky does not hold a dominant position.

3.130 As explained in Part One, above, the most likely cause of Ofcom's confusion on this matter is the fact that there are likely to be significant rents associated with owning valuable content rights. As Ofcom appears to acknowledge, such rents, however, naturally go to the owners of such content, not its licensees.

- ***Flat or falling wholesale charges in real terms***

3.131 Unlike the retail level, Ofcom has not examined trends in wholesale charges for Sky's premium pay TV channels. Trends in wholesale charges for Sky's premium pay TV channels are set out in **Figure 8**, below. Two features of this chart are notable:

- charges for a package of all Sky's premium channels have been broadly flat in real terms for the past four years; and
- there have been declines in charges for (a) Dual Movies, and (b) a single Sky sports channel over the past four years, with the declines for Dual Movies being particularly pronounced.

3.132 Given 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 this period.

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[107] Paragraph 1.21.

Figure 8: Cable wholesale charges in real terms

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- ***Innovation***

3.133 As noted above, the level of innovation by participants in a sector is often a good indicator of its competitiveness. Sky considers that both its sports and movie channel businesses demonstrate high levels of innovation.

Sky's sports channels

3.134 The high quality and innovativeness of Sky's sports channels are commonly acknowledged. The list of Sky's innovations in relation to its sports channels include:

- bringing new sports competitions to viewers (for example, Tri Nations and Twenty/20 cricket), and broadcasting events which have been deemed not worthy of coverage by other broadcasters (for example overseas English cricket tours, women's football, America's Cup yachting, and dressage);

- the introduction of services by which subscribers can choose between multiple events being played simultaneously, such as Sky Sports' Champions League coverage – which has offered viewers the ability to choose from eight different matches, and Ryder Cup coverage which offers viewers the ability to follow different players;

- investing very significant amounts in high definition versions of its channels. Sky's investments in high definition television channels (in addition to its other investments in delivering high definition television services to consumers) have helped make the UK the leader in high definition services in Europe; and

- introducing new technologies into sports coverage, many of which are now taken for granted – for example Sky introduced innovations such as Sky Scope,[108] Hi Motion,[109] 'zoom box',[110] the use of infrared camera technology[111] in cricket coverage and interactive services such as Player Cam for football matches.

Sky's movie channels

3.135 In relation to its movie channels, there are clearly limits to the scope for innovation, given that these are based primarily on 'bought-in' programming. Nevertheless, taking this into account, Sky continually strives to make its movie channels as

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108 Sky Scope is used at certain cricket matches to predict whether the cricket ball would hit the stumps for the purposes of determining whether a batsman should have been given out 'leg-before-wicket'.

109 Hi-motion is a technology that captures images, typically sports content, in super-slow-motion, typically at 300 frames per second to give a very smooth replay at slow speeds.

110 Zoom-box is a technology used to provide both umpires and viewers with a closer insight into play by magnifying replay footage.

111 Also known as 'hot-spot', this technology uses powerful infra-red cameras to detect the distinct thermal signature left when a cricket ball hits either a batsman's pad or bat.

appealing to existing and potential subscribers as possible.[112] The key recent innovations have been:

- a significant repackaging of Sky's movie channels into genre-based channels that enable consumers more easily to identify the type of programming carried on those channels. While to the outside world this might seem a relatively straightforward change, in practice it comprised a very significant project;
- the bringing forward of the pay TV window in relation to a significant amount of films in that window carried on Sky's movie channels;
- the development of the Sky Anytime on PC service which enables subscribers to Sky's movie channels to download films available on the movie channels at no extra cost. Sky has obtained rights to provide such a service from a large range of film distributors and the service comprises the largest legal movie download service in the UK; and
- within the Sky Anytime service, Sky has developed the Sky Box Office World service, a download-based PPV service devoted to World Cinema films which has enabled hundreds of titles which have never had a cinema release or been shown on TV to be made available to consumers;

3.136 Sky considers that this type of evidence strongly contradicts a view that markets are as narrow as premium sports channels or premium movie channels.

(v) Conclusions on market definition and market power at the channel provider level

3.137 Sky considers that there are strong and compelling evidence and arguments that support a view that Sky does not hold a position of significant market power in relation to the supply of television channels in the UK. In producing and licensing its television channels for distribution, Sky faces very significant constraints on its behaviour, which mean that it is unable to act independently of (a) distributors of its channels; and (b) consumers.

3.138 Sky considers that the factors set out above mean that all broadcasters, whether free or pay, are in competition with each other and, therefore, that the relevant market is at least all television channels. In principle, it should also be defined to include the provision to retailers of programming on a stand-alone basis – such as a film, television series, or episode of a television series for offering, for example, on DVD or on a VoD service - given the significant and increasing role that such services play at the downstream level.

112 Sky engages in constant consumer research aimed at understanding consumers' perceptions of its television services in order to better meet consumer demands.