



**RESPONSE BY BRITISH SKY BROADCASTING GROUP PLC TO  
OFCOM'S CONSULTATION DOCUMENT 'PAY TV SECOND CONSULTATION: ACCESS TO  
PREMIUM CONTENT' OF 30 SEPTEMBER 2008**

**INTRODUCTION**

1. This document (the "**Response**") is the response of British Sky Broadcasting Group plc ("**Sky**") to Ofcom's Consultation Document 'Pay TV Second Consultation: Access to Premium Content' of 30 September 2008 (the "**Consultation Document**").<sup>1</sup>
2. This Response is structured as follows:
  - Section 1:** Overview
  - Section 2:** Pay TV delivers good outcomes for consumers in the UK
  - Section 3:** Ofcom's recourse to sectoral powers is not legally sound
  - Section 4:** Ofcom's market definition and market power analysis is defective
  - Section 5:** Ofcom's allegations regarding restriction of supply are unfounded
  - Section 6:** Ofcom's allegations regarding high wholesale prices are unfounded
  - Section 7:** Ofcom's proposed interventionist and unprecedented new regulation is not necessary, proportionate or consistent
  - Section 8:** Ofcom's case for intervention is not procedurally sound
3. This Response incorporates three Annexes prepared by external consultants: **Annex 1**, a supplementary report by PricewaterhouseCoopers on the outcomes for consumers in relation to pay TV in Europe;<sup>2</sup> **Annex 4**, a paper prepared by CRA International, containing their comments on the Consultation Document and specifically Ofcom's 'dynamic foreclosure' mechanisms; and **Annex 5**, a econometric study by Paul Seabright, Bruno Jullien and Thierry Magnac of the Toulouse School of Economics on the effect of DTT availability on households' willingness to subscribe to Sky.

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<sup>1</sup> All references to the "Consultation Document" in this Response are to Ofcom's Second Consultation Document unless otherwise stated.

<sup>2</sup> In accordance with the terms of PwC's engagement, Ofcom is referred to the disclaimer at Page i of **Annex 1** to this Response.

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4. This Response also incorporates five Annexes prepared by Sky:

**Annex 2:** A discussion of the development of innovative video on demand services in the UK.

**Annex 3:** A discussion of developments in the movie sector in the UK.

**Annex 6:** A critique of Ofcom's wholesale market power assessment.

**Annex 7:** A critique of Ofcom's analysis of Sky's incentives to supply its premium channels to other retailers.

**Annex 8:** A discussion of regulations relating to the compulsory license of premium pay TV channels in France, Italy, Spain and the United States.

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## SECTION 1: OVERVIEW

### Introduction

Ofcom has not, in its Consultation Document, established to the required standard, based on the evidence, that Sky's conduct is having a material impact on the competitive process, nor that its future conduct might be expected to have such an impact. Still less has Ofcom established that Sky's actual or future conduct would meet the requirements for compulsory supply of its sports and movie channels.

As Ofcom itself admits, the development of pay TV in the UK has been a success story. Outside the narrow perspective of its pay TV investigation, Ofcom has rightly recognised that UK consumers of audiovisual services as a whole are among the best served in the world. These factors alone indicate that there is no need for additional regulation in the pay TV sector.

Yet not only does Ofcom consider that such regulation is necessary, it is proposing the imposition of radical and highly interventionist regulation of a sort unseen in any developed market economy. Even more remarkably, Ofcom's limited assessment of the potential impact of its proposals is essentially confined to a consideration of whether they would be effective in delivering the particular outcomes in relation to premium channel availability which Ofcom wishes to see. Ofcom has failed to consider the potential for its proposals to have serious negative and unintended consequences.

Even leaving aside the damaging effects on investment incentives that would result from the confiscatory nature of Ofcom's proposals, those proposals have the potential to introduce long-term distortions in the sector, resulting in significant economic costs and, ultimately, a worse outcome for consumers.

### The market is working well for consumers

Today's consumer of audiovisual services is very well served. The UK audiovisual market is both extremely competitive and functioning well. It is delivering strong benefits to consumers who can choose from over 500 unique linear channels, thousands of hours of video-on demand ("**VoD**") content from a wide range of sources, the largest number of high definition ("**HD**") channels available in Europe, numerous suppliers of personal video recorders ("**PVRs**"), thousands of different packages of channels, and genuine value pay TV services from a number of providers over multiple platforms. The market is meeting consumer demands.

None of these positive outcomes happened by chance; they are the result of very significant levels of effort, innovation and risk taking on the part of many providers, including Sky. Sky has, through its own continuing effort, investment and innovation, made an important contribution to the health and vibrancy of the UK audiovisual sector, encompassing not only what Ofcom describes as the "*initial*" risks Sky took in establishing its business, but also investments and innovations such as the creation of the main UK digital satellite platform, the pioneering of PVRs and HD services, and the widening of its product range through its investment in a broadband network. As a result of wide-ranging investments and innovations such as these, underpinned by a brand that is trusted by consumers and major investments in delivering excellent

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customer service, Sky has become a successful multi-product company. Sky's success over a period of 20 years cannot be accounted for, and its significant and growing contribution to the vibrancy of the UK audiovisual sector cannot be measured, simply by reference to its "*initial*" investments in its sports and movie channels.

In its First Consultation Document, Ofcom concluded that the sector offered good consumer satisfaction levels, good choice of platforms and channels and continued delivery of innovative services. Nothing in Ofcom's current Consultation Document changes this conclusion.

Yet Ofcom now alleges that the record of the UK pay TV industry is "*less strong*" in three areas:

- Firstly, in relation to innovation in retail packaging of pay TV services compared to other countries. But if Ofcom had properly considered this matter, it would have found that the level of innovation in the UK is entirely consistent with the handful of international examples to which it refers. There is strong evidence of packaging innovation from both Sky and other market participants. A second report commissioned by Sky from PricewaterhouseCoopers ("**PwC**") confirms that the UK has experienced at least as many significant changes in packaging as other countries.
- Secondly, Ofcom states that other markets appear to be leading the UK in the development of VoD services. But its belief that VoD services are under-developed is not borne out by the facts. The UK market is developing VoD capability very quickly. As well as Sky's own VoD services, Virgin Media and BT in particular have both been able to develop substantial and successful VoD offerings on their platforms, which they use as a key form of differentiation and a reason for consumers to choose their platforms. PwC's first report had identified the UK as one of four leading countries in Europe in terms of innovation, but did not include VoD in its innovation assessment. In its second report, with the addition of VoD services, PwC finds that the UK remains one of the four leading European countries.
- Thirdly, Ofcom continues to express concern about Sky's retail prices, but still has no evidence that retail prices are high. Sky's evidence clearly shows that prices are consistent with prices for comparable packages in other countries. Moreover, despite a well functioning, strong free to air sector, both pay TV penetration and customer satisfaction with pay TV services in the UK are high, providing further strong evidence that prices are reasonable.

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None of these alleged concerns is borne out by evidence of the day-to-day experience of UK consumers. Nor are they consistent with Ofcom's own view as summarised in its recent International Communications Market Report:

*“UK consumers are blazing the way when it comes to embracing the digital TV age. ....New Ofcom research reveals that we've become one of the most digitally advanced nations in the world. ....Not only do 86 per cent of UK households now have digital TV on their main set, but services like High Definition TV and Digital Video Recorders are also soaring in popularity. ....And while UK consumers are making the most of the services on offer, we're also getting better value for money than ever before...competitive markets are driving down prices and consumers are also shopping around for good value 'bundled' deals.”*

### **Yet Ofcom is proposing highly onerous and confiscatory regulation**

Yet, despite these positive consumer outcomes, Ofcom is proposing to impose new and highly intrusive regulation into the audiovisual sector, at a time when it is more competitive than ever before, and characterised by rapid and pervasive change in both the technologies used to deliver services to consumers, and the services that are actually delivered to consumers.

The regulation that Ofcom is proposing - compulsory supply - would require Sky to license the intellectual property in its channels to third party retailers. This is one of the most Draconian remedies available to a competition authority. Moreover, this proposal is accompanied by proposals for detailed *ex ante* regulation, including price control, even though less prescriptive and confiscatory forms of 'must offer' regulation are clearly available.

Despite Ofcom's attempts to claim that such regulation is normal or 'not intrusive', it is in fact far more intrusive than anything in place in the small number of other territories referred to by Ofcom in its Consultation Document. Moreover, to the extent that regulation of channel supply continues to exist in those territories, in all cases it was imposed under very different conditions, such as in response to a merger resulting in a single pay TV operator.

Even more remarkably, Ofcom's proposed intervention seeks effectively to impose on Sky an obligation to subsidise other market players, by forcing Sky to reduce its wholesale prices to “*support entry into the market by new retailers*”. So Sky would need to set its wholesale prices below the levels currently charged to Virgin Media to levels which Ofcom considers new and less efficient entrants might be able to “*afford*” (whatever that may mean in practice). This is not an outcome that would be expected in a competitive market. A stand-alone broadcaster that did not have its own retail business could not be expected to reduce its wholesale price to accommodate such entrants in the way Ofcom proposes.

Ofcom is also proposing that if it considered that price control based on its novel 'affordability' approach did not reduce charges so as to eliminate any risk of excess profitability in Sky's premium sports and movies channel supply business, it would impose cost-plus based price controls.

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As if the scope of Ofcom's proposals were not remarkable enough, it is proposing to achieve this regulation of Sky's supply of sports and movie channels (regulation which goes far beyond anything Ofcom could achieve under its extensive general competition law powers) through the use of its sectoral competition powers. This is an unprecedented and highly questionable use of such powers, which are aimed at protecting fair and effective competition, rather than introducing far-reaching structural measures which it is hoped will inject additional competition into a market. Recourse to sectoral competition powers should not be seen as the easy option, enabling Ofcom to do as it wishes without regard to the principles underpinning competition law or the need for rigorous evidence-based analysis. Parliament put in place important safeguards to ensure that Ofcom did not misuse these powers, but Ofcom has not properly respected them.

If Ofcom is unable to achieve its preferred objective through use of its sectoral competition powers, it has reserved the possibility of doing so through a reference to the Competition Commission. This would be an equally extreme step for Ofcom to take, since a single issue of the narrowest type, such as this, should not be the subject of a reference under a regime designed to deal with market-wide features.

### **Ofcom's intervention would generate significant costs and risks of unintended adverse consequences**

Even leaving aside best regulatory practice, common sense dictates that any competition problems would need to be very serious indeed, and evidence of them strong and compelling, before any decision was taken to impose interventionist regulation. This is for the simple reason that any additional regulation gives rise to costs and the potential for unintended adverse consequences. The types of potential costs to which Ofcom's proposals would give rise are well-known, though disregarded in the Consultation Document. Ofcom's proposed intervention could, for example, reduce incentives to invest on the part of Sky and other operators, and diminish innovation levels, resulting in a possible reduction in new and improved services for consumers. It could also result in less competition for rights upstream, with potential adverse consequences for particular sports. And the effects on retail prices are unclear. It is noteworthy that the European Commission's intervention in the sale of rights to broadcast Premier League football resulted in consumers who wish to view all live matches broadcast having to pay more than they were prior to the intervention.

### **As a result, the hurdle for intervention is a high one**

Given the inherent contradiction between the favourable consumer outcomes in the UK audiovisual sector, on the one hand, and the highly onerous and confiscatory nature of Ofcom's proposed regulation together with the potential downsides for consumers of such regulation, on the other, Ofcom's proposed regulation would need to be justified by strong and compelling evidence of a material competition problem, identified within a proper legal framework after clear, sound and comprehensive analysis.

As a minimum requirement for the exercise of its sectoral competition powers, Ofcom must demonstrate that conduct having a "*material impact on the competitive process*" has occurred, or is more likely than not to occur.

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Where, as here, the proposed remedy is compulsory supply, additional conditions must be met, since it is well known that compulsory supply has a high potential to damage investment incentives, and it is accepted in EC law that use of such a remedy should be limited to the most exceptional cases. Accordingly, to impose a ‘must offer’ obligation, Ofcom must be satisfied that (i) there has been or is likely to be a refusal to supply; (ii) those requesting supply of Sky’s channels intend to offer new products or services (or technical developments of such products services) for which there is demand; (iii) there could be no objective justification for any refusal to supply; and (iv) any refusal to supply would result in the likelihood of elimination of effective competition on the downstream market.

### **Ofcom has failed to assess the relevant market**

In order to identify whether its concerns were sufficient to give rise to a material impact on the competitive process, Ofcom would have to determine the scope of the market affected by the conduct which Ofcom has identified as potentially problematic, which in this case is clearly a downstream, retail-level market (or markets). In this case, however, Ofcom has deemed it unnecessary to define the downstream market or markets in which it considers that competition problems meriting intervention exist. This fundamental error has meant that Ofcom has not, and could not, properly consider the extent of the competition problems that it believes exist, still less could it be in any position to assess whether the impact of those alleged problems on the downstream market would outweigh the potential downsides of any intervention. Sky’s Response to the First Consultation Document identified the relevant retail market as including both free to air and pay TV services, and the Competition Commission has also identified an “all TV market”. Sky now submits further evidence which confirms this, in the form of a significant experts’ report analysing the impact of the availability of DTT broadcasting on demand for Sky’s pay TV services. If Ofcom had properly defined the downstream market, even assuming its concerns about Sky’s incentives in relation to the distribution of its channels were valid, Ofcom would not have been able to establish a material impact on the competitive process in that market, let alone the likelihood of elimination of all effective competition.

### **Ofcom has rejected other established competition law principles and analysis**

In order to invoke its sectoral competition powers, Ofcom should have found a material impact on competition, based on strong evidence, and analysed within a proper legal framework. Ofcom’s actual approach falls well below this standard, and effectively consists of a theory made up of three elements: that ‘premium’ content is (as Ofcom puts it) “*important*”, that Sky has an incentive to withhold that content and that there is evidence that Sky is acting on that incentive.

### ***Sky’s channels are not indispensable to retailers***

Ofcom makes claims based on a series of vague and impressionistic pieces of evidence that Sky’s sports and movie channels are “*important*”. It is clear, however, that simply establishing that Sky’s channels are “*important*” is not enough. Ofcom would need to establish that a retailer that did not offer Sky’s premium channels could not compete in the market. This would be particularly hard to establish in circumstances where those channels were otherwise available on the same platform, or were available to most

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consumers over the Internet. In any event, the evidence on which Ofcom relies does not, in fact, support Ofcom's case. Instead it shows that there are many actual and potential pay TV subscribers who are not interested in Sky's sports and movie channels. A retailer that did not offer these channels could seek to attract this base of subscribers, which is borne out by the fact that BT and TUTV were both willing to launch pay TV platforms and invest heavily in marketing them, even though they did not include Sky's premium sports and movie channels as part of their offering. Both retailers have been able to build successful businesses.

Ofcom appears to suggest that, despite the very large number of potential customers not interested in 'premium' content, such content might nevertheless be important to ensure effective downstream competition, as there are economies of scale in retailing. In effect, Ofcom alleges that there are substantial fixed costs in retailing and that a retailer that is able to sell to all potential pay TV households will be at an advantage. However, Ofcom makes no attempt to quantify the size of these fixed costs. In fact, Sky's experience of retailing via DTH satellite indicates that true fixed costs are very modest in size in retailing pay TV services and there are, therefore, no significant economies of scale in this activity.

### ***Sky has no incentive to restrict supply***

Sky has no incentive to restrict supply of its sports and movie channels. The significant fixed costs involved in channel production and the fact there is a significant number of consumers who have a strong preference as to which platform they use means that wide distribution can increase total profits.

Ofcom's conclusion that Sky has incentives to restrict distribution of its premium channels appears to rely almost entirely on a hypothetical model which purports to show that a decision by Sky to withdraw supply of its premium channels from Virgin Media would pay back over seven or eight years. Ofcom's model, however, suffers from a number of serious errors which, once corrected, indicate that the pay-back period is substantially longer and in fact that it may never become profitable.

In any event, even if the permanent withdrawal of Sky's channels could be shown to be theoretically profitable over eight years, it is fanciful in the extreme to suggest that Sky would adopt such a policy. To draw such a conclusion ignores the fact that Sky has supplied its premium channels to cable operators since those channels' creation. If it now decided to withdraw them on a permanent basis without objective justification, it would do so at considerable legal and regulatory risk. Moreover, whilst Sky is willing to take a long term view when making investments, it is abundantly clear that it would not implement a policy that would result in an immediate and very significant commercial loss, whilst, in the context of a rapidly changing marketplace, the size of any potential gain to Sky from customers switching from Virgin Media is so speculative and uncertain that there would be considerable risk that it would never materialise even after eight years.

Rather than focus on Virgin Media, it would have been more appropriate for Ofcom to have considered Sky's incentives to supply retailers on new platforms that it does not currently supply. On this issue, Ofcom's modelling analysis supports Sky's own

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proposition that Sky does, in fact, have an incentive to supply its channels via these platforms.

### ***There is no evidence that Sky has restricted supply***

Ofcom's claim that Sky is acting on its incentive to restrict supply of its premium channels appears to be primarily based on its belief that new entrants have sought, but to date failed, to access Sky's premium channels. But in fact Sky's premium channels are available on the only IPTV network in the UK currently capable of delivering linear television channels. They are available on multiple mobile networks. The fact that Sky's sports and movie channels are still not being broadcast via DTT is primarily due to Ofcom's own regulation. Until Sky has a licence from Ofcom to broadcast those channels via DTT it will not be in a position to offer the channels to consumers via any DTT platform, either directly or through wholesale arrangements. In the circumstances it is, to say the least, ironic that Ofcom nevertheless appears to regard the absence of the channels from any DTT platform as evidence that Sky has, and is acting on, an incentive to limit their distribution.

Ofcom also ignores the likelihood that negotiations regarding supply of Sky's sports and movie channels have not made significant progress because new entrants are engaged in regulatory gaming, believing that failure to agree will secure more favourable terms via a regulatory route – something for which Ofcom itself should accept some responsibility. Indeed BT complained to Ofcom before it had had any substantive discussions with Sky and before it even had a technology capable of carrying Sky's channels.

### **Ofcom's own theory does not justify its proposals**

Even if Ofcom's theory were valid – which it is not, for the reasons we summarise above – it would not be sufficient to justify a number of Ofcom's proposals. The intrusiveness of Ofcom's remedy is compounded, for example, by Ofcom's proposal to require the compulsory supply of HD channels, when there is no suggestion in Ofcom's theory that HD channels are "*important*". In fact, Ofcom indicates that it is the content that is the most important, rather than other factors such as "*platform features*".

Similarly, even if Ofcom's theory were to be accepted, it would not justify a reduction of Sky's prices to levels that Ofcom deems new entrants can "*can afford*". Ofcom adduces absolutely no evidence that new entrants cannot afford Sky's wholesale prices, or even an explanation of what 'affordability' means in this context – a fundamental omission given that this conclusion is the cornerstone for Ofcom's belief that a remedy under its sectoral powers is necessary. Sky's own analysis undertaken for its proposed Picnic service demonstrated that Picnic would be profitable based on the wholesale rates which Sky charges to cable operators. Sky can see no reason why the same would not be true of, for example, BT.

Ofcom's threat directly to regulate Sky's wholesale margins using a 'cost-plus' approach to wholesale price levels is, again, not justified by Ofcom's own theory. Cost-plus regulation is meant by Ofcom to remedy its "*concern*" that Sky is setting high wholesale prices for its premium TV channels. But Ofcom has not established that Sky is setting high wholesale prices, and admits that its evidence on the subject is not clear

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cut. A comparison of Ofcom's estimate of the current profitability of Sky's notional premium channel business with the profitability of a number of other pay TV broadcasters shows that Sky's operating margin is normal and hence that Sky is not setting excessive wholesale prices for its channels.

### **Now is the time for Ofcom to step back**

It is time for Ofcom to take a step back from the detail of its Consultation Document and review its position with an open mind.

Any proposals by Ofcom to expand its regulation need to be the product of a process rooted in clear, objective analysis of the relevant facts and evidence, free from preconception. Due regard needs to be paid to the rights of those whose interests are likely to be adversely affected by those proposals; and due scepticism needs to be maintained in relation to the special pleading of competitors seeking to use the regulatory process to further their competitive positions.

These procedural requirements are all the more necessary in circumstances where the regulation proposed is aimed at a single firm and is as radical and confiscatory as that set out in the Consultation Document.

It is Sky's view that Ofcom has failed so far to conduct its investigation in accordance with these standards and that this failure has contributed significantly to the serious flaws in Ofcom's substantive analysis. Coupled with Ofcom's failure to conduct a proper assessment of the impact of its proposals, these factors have led Ofcom to perverse conclusions which risk consumer harm.

Now is the right time for Ofcom to review those conclusions with objectivity, and avoid being led into a misadventure which threatens to push Ofcom far outside the bounds of mainstream regulatory thinking. Ofcom should now decide that no regulatory action is required. Any other approach will ultimately be to the detriment of those whose interests Ofcom is supposed to protect – not Sky's competitors, but consumers.

## SECTION 2: PAY TV DELIVERS GOOD OUTCOMES FOR CONSUMERS IN THE UK

### 1. Introduction

- 1.1 The UK audiovisual market<sup>1</sup> is both extremely competitive and functioning well. It is delivering strong benefits to consumers who can choose from over 500 unique linear channels, thousands of different packages of channels, numerous suppliers of PVRs, thousands of hours of VoD content from a wide range of sources, the largest number of HD channels available in Europe, and genuine value pay TV services from a number of providers over multiple platforms. In sum, the market is meeting consumer demands.
- 1.2 This impressive outcome did not arise by chance, but as a result of very significant levels of effort, innovation and risk that, taken together, have made the UK *“one of the most digitally advanced nations in the world”*.<sup>2</sup> No single company is wholly responsible for the UK’s digital advancement. Rather, it is through the individual actions of an array of industry players (as a whole) that *“UK consumers are...embracing the digital TV age...[at] better value for money than ever before.”*<sup>3</sup>
- 1.3 It is within this vibrant and competitive marketplace that Sky finds itself. And it is because of the competitiveness of the market, and the growing expectations of consumers, that Sky has sought to offer better and more services to meet demand. Amongst other things, Sky provides consumers with access to a wide range of channels and content, including over 500 linear channels in total (including 30 HD channels), offered through a large variety of package choice, the control and flexibility of Sky+ (which over 4.65 million households use and enjoy), and the ability to consume audiovisual content via the Internet, DTH satellite, Internet Protocol Television (*“IPTV”*)<sup>4</sup>, Digital Terrestrial Television (*“DTT”*)<sup>5</sup>, cable and mobile TV.
- 1.4 Sky is not alone in understanding the increasing expectations of consumers and the need to fulfil them. Barely a week goes by without an announcement of a new audiovisual service that will meet some aspect of consumer demand. Whether that be the launch of the now ubiquitous iPlayer, the provision of new VoD services (such as those provided by Blinkbox), the addition of HD channels

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<sup>1</sup> As set out in **Section 4** below, Sky considers that the relevant market includes free to air, pay TV services, DVD sales and rental and pay-per-view/video on demand services.

<sup>2</sup> <http://www.ofcom.org.uk/media/features/icmrmain>

<sup>3</sup> <http://www.ofcom.org.uk/media/features/icmrmain>

<sup>4</sup> Sky’s channels are available on the only IPTV platform that delivers linear channels: namely, Tiscali’s.

<sup>5</sup> As Ofcom is aware, Sky has applied for Ofcom’s consent to vary its DTT licence such that Sky is able to remove its free to air channels on DTT and replace these with pay TV channels.

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to cable or the plan by the BBC, ITV and BT to “*promote a common industry approach...to deliver on demand TV over broadband.*”<sup>6</sup>

- 1.5 These developments help contribute to the competitive nature of a market in which there are high levels of penetration for pay TV and within that, for premium channels and PVRs. These high penetration levels show that households both want to consume these services and that they are satisfied with these services. In short, industry is giving consumers what they want: choice, great content and innovative services at a fair price.
- 1.6 In its Consultation Document, Ofcom proposes far-reaching and highly interventionist regulation of the pay TV sector, by requiring Sky to reduce its wholesale price to levels that Ofcom considers that new less efficient entrants can “afford”. It is Sky’s view that Ofcom has had insufficient regard to the current healthy and competitive state of the UK audiovisual market, and Ofcom therefore does not properly consider what is at risk through its proposed intervention.
- 1.7 In this Section 2, therefore, Sky provides a detailed look at the state of play in the UK audiovisual market, by reference to the criteria that Ofcom itself has used in assessing outcomes, namely (i) innovation; (ii) choice of platform and content; and (iii) pay TV services priced competitively and effectively.

## 2. Innovation

- 2.1 Changes in technology and changes in consumer demand are driving the market forward. Advances in technology, from new HD television standards, to new ways of delivering audiovisual content to people’s homes, to the ability for broadcasters to deliver and store programming on PVRs and also via VoD, have all brought significant consumer benefits.
- 2.2 The UK is a leader in terms of innovation in the pay TV industry, as Ofcom itself recognises “*I think everyone will recognise that in the UK...there’s a very strong track record of innovation.*”<sup>7</sup> More specifically, Sky is regularly identified as a “*very innovative company*”<sup>8</sup> which has a “*strong history of innovation on its satellite platform [which] is widely recognised*”.<sup>9</sup> Set out below are a number of innovations that have helped turn the UK into “*one of the most digitally advanced nations in the world*”.<sup>10</sup>

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<sup>6</sup> [http://www.bbc.co.uk/pressoffice/pressreleases/stories/2008/12\\_december/11/partnership2.shtml](http://www.bbc.co.uk/pressoffice/pressreleases/stories/2008/12_december/11/partnership2.shtml)

<sup>7</sup> Steve Unger at the Westminster Media Forum Seminar ‘Pay TV - market prospects, competition and services to viewers’, 27 November 2008 (the “**Westminster Media Forum**”). Sky notes that the transcript has not yet been corrected by contributing parties.

<sup>8</sup> *Ibid.*

<sup>9</sup> Paragraphs 1.12 and 2.5 of the Consultation Document.

<sup>10</sup> [http://www.ofcom.org.uk/media/news/2008/11/nr\\_20081120](http://www.ofcom.org.uk/media/news/2008/11/nr_20081120)

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### **PVRs**

- 2.3 UK consumers have embraced PVRs. Millions of homes now use and enjoy the control and flexibility that PVRs offer. PVRs allow people to fit their TV viewing around their lives. They allow multiple programmes to be recorded simultaneously and watched later at the consumer's convenience. Entire series can be recorded at the touch of a button. Sky customers can even set their Sky+ box to record from anywhere in the world either online, via a mobile phone application or via a text message.
- 2.4 PVRs are available from a wide range of manufacturers and service suppliers.
- 2.5 Sky introduced its own PVR, branded Sky+, in September 2001, which integrated a hard disk into a Sky DTH satellite set top box (some four years ahead of the introduction of PVRs into any of the other European countries surveyed in the first PwC report<sup>11</sup>). The convenience and ease of use of Sky+ and Sky's willingness to discount the price to customers means that Sky+ boxes have proved to be very popular. There are currently around 4.65 million households in the UK and ROI (around 50% of Sky subscribers) who use Sky+.<sup>12</sup>
- 2.6 Since the launch of Sky+, other providers have followed Sky and launched similar products and competing PVR services. As at November 2008, 13% of Virgin Media customers (some 468,700) have a V+ PVR,<sup>13</sup> and all 350,000 of BT Vision customers have a PVR<sup>14</sup>. Top Up TV's proposition is now entirely based around PVR functionality. The Top Up TV Anytime service downloads programmes from a range of channels onto subscribers' PVRs during the night. Subscribers can then choose to access content on an on demand basis. Freesat launched its PVR in November 2008:

*"it's an HD enabled, 320 gigabyte hard drive, it can record hundreds of hours of TV, HD and SD, and it's something that consumers just now expect from their TV equipment, to be able to record..."*<sup>15</sup> Freeview has stated that it is its intention that *"Freeview Plus [sic]...[will] do for the digital TV recording category what Freeview itself has done for digital as a whole, which is to make it free and for everyone"*.<sup>16</sup>

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<sup>11</sup> Paragraph 4.3 and Figure 7 of PwC's first report entitled 'The outcome for consumers in relation to pay TV in Europe', submitted as Annex 1 to Sky's Response to the First Consultation Document (the "**First PwC Report**").

<sup>12</sup> The above figures include Sky+ set top boxes as well as Sky+HD set top boxes.

<sup>13</sup> <http://pressoffice.virginmedia.com/phoenix.zhtml?c=205406&p=irol-newsArticle&ID=1222859&highlight=>

<sup>14</sup> Dan Marks, Chief Executive Officer, BT Vision at the Westminster Media Forum.

<sup>15</sup> Emma Scott, Managing Director, Freesat at the Westminster Media Forum.

<sup>16</sup> Ilse Howling, Managing Director, Freeview at the Westminster Media Forum. DTV Services Limited promotes PVRs for Freeview under the brand 'Freeview+'.

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- 2.7 Use of PVRs has become so commonplace that in a recent YouGov survey, 43% of people said that they viewed at least one hour of content each week that had been recorded on a PVR.<sup>17</sup> In addition, PVRs have changed the way in which consumers watch television, as Ofcom research shows “*Our consumer research suggests that consumer viewing behaviour changes among those with access to a DVR – 88% of DVR users ‘always’ or ‘almost always’ check live TV before watching a recorded programme...*”<sup>18</sup>
- 2.8 In summary, there can be no doubt that “*the UK is once again leading the way – with 30 per cent of people owning a DVR [PVR]*”.<sup>19</sup>

### **VoD**

- 2.9 As we note in **Section 5** below, Ofcom’s analysis of the state of VoD services in the UK is seriously flawed. There are multiple sources of VoD content, giving consumers choice about how and when to consume audiovisual content. Over 16,000 hours of VoD content including entertainment, movies and sports (delayed rather than live) are currently available.<sup>20</sup>
- 2.10 The PwC Report at **Annex 1** (which supplements the First PwC Report) incorporates VoD and near-VoD (“**NVoD**”) into its innovation indicator and found that this did not significantly alter the ranking in its first report, with the four leading countries in terms of innovation (the UK, France, Norway and Sweden) remaining unchanged. This is hardly a surprise as in the UK, the number of VoD services that are available to consumers has increased substantially in the past few years.<sup>21</sup> The following platforms provide VoD services:
- BT Vision provides a VoD movie and TV service via its IPTV network. The service is currently delivering over 5,000 hours of on demand content, including content from BBC, ITV, Channel 4 and Five as well as movies from the Hollywood major studios, via both the PictureBox<sup>22</sup> service and its own PPV movies service, before (and after) their availability on Sky’s linear movie channels.<sup>23</sup>

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<sup>17</sup> [http://www.olswang.com/convergence08/convergence08\\_survey\\_annex.pdf](http://www.olswang.com/convergence08/convergence08_survey_annex.pdf)

<sup>18</sup> Ofcom Communications Market Report 2008, page 67.

Available at: <http://www.ofcom.org.uk/research/cm/cmr08/>

<sup>19</sup> <http://www.ofcom.org.uk/media/features/icmrmain?lang=cy>

<sup>20</sup> Based on VoD content on Virgin Media, BT Vision, Tiscali TV, Top Up TV, Sky Anytime, BBC iPlayer, 4oD and ITV Player.

<sup>21</sup> This is reflected in the Competition Commission’s provisional findings on Kangaroo which state, at paragraph 2.7, that “*VoD services are new and developing quickly*”.

<sup>22</sup> PictureBox (which is provided by Universal Pictures) is a subscription movies service offering a weekly rolling selection of 28 titles with seven new titles added each week.

<sup>23</sup> <http://www.btplc.com/Thegroup/Industryanalysts/Industryanalystspresentations/BTVisionSport.ppt>

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- Virgin Media provides a VoD service, in which it has invested significantly. The service delivers over 4,600 hours of on demand content (in addition, it offers a range of BBC content under the iPlayer branding), which nearly half of Virgin Media homes are using on a monthly basis. The total number of on demand programmes viewed by Virgin Media customers “*exceeded 357 million by the end of the first nine months of 2008 and averaged 45 million views each month in the third quarter of last year.*”<sup>24</sup> Virgin Media’s VoD proposition also includes access to ITV content, and movies from Hollywood major studios, via the Filmflex<sup>25</sup> service, before (and after) their availability on Sky’s linear movie channels.<sup>26</sup>
- Tiscali provides its own VoD movie service, which includes movies from the Hollywood major studios, via Filmflex, Picturebox and Tiscali’s own movies service, before (and after) their availability on Sky’s linear movie channels.
- Apple TV provides a VoD service via its broadband TV service. Apple TV claims to offer the widest range of VoD movie content in the UK, including movies from the Hollywood major studios before (and after) their availability on Sky’s linear movie channels.

2.11 The internet is also a platform over which a number a broadcasters provide VoD services. One such example of distribution of VoD content on the internet is the BBC iPlayer, which is used by some 24% of consumers at least one hour a week.<sup>27</sup> iPlayer offers consumers the opportunity to stream or download a wealth of content from the BBC. iPlayer can also be accessed either via a web browser, through cable, via certain mobile phones or through a number of games consoles.

2.12 The iPlayer has been a huge success (albeit we note that Sky launched its ‘Sky by Broadband’ service, now called Sky Player, before the iPlayer was launched). Virgin Media’s 3.6 million TV subscribers (whose usage accounts for a third<sup>28</sup> of all iPlayer views) are able to “*watch full screen picture at full quality on their television set without the need for downloading*”.<sup>29</sup> One notable point about the usage of iPlayer on Virgin Media is that its use is not confined to a small hard-core set of users “[o]n a monthly basis, 1.6m of our TV customers are now using VoD, representing a reach of 48%. Average views per user per month in the quarter were 24 compared to 14 a year ago. Average monthly views were 38m in

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<sup>24</sup> <http://pressoffice.virginmedia.com/phoenix.zhtml?c=205406&p=irol-newsArticle&ID=1241606&highlight=>

<sup>25</sup> Filmflex (a joint venture between Disney and Sony) is a PPV movies service which offers access to more than 500 titles, including, where technically possible on the relevant platform, some in HD.

<sup>26</sup> [http://library.corporate-ir.net/library/13/135/135485/items/315577/london\\_nov132008.pdf](http://library.corporate-ir.net/library/13/135/135485/items/315577/london_nov132008.pdf)

<sup>27</sup> [http://www.olswang.com/convergence08/convergence08\\_survey\\_annex.pdf](http://www.olswang.com/convergence08/convergence08_survey_annex.pdf)

<sup>28</sup> [http://library.corporate-ir.net/library/13/135/135485/items/315577/london\\_nov132008.pdf](http://library.corporate-ir.net/library/13/135/135485/items/315577/london_nov132008.pdf)

<sup>29</sup> [http://www.bbc.co.uk/pressoffice/pressreleases/stories/2008/04\\_april/30/iplayer.shtml](http://www.bbc.co.uk/pressoffice/pressreleases/stories/2008/04_april/30/iplayer.shtml)

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*the quarter, up 5% on the previous quarter and up 92% on the same quarter last year”.*<sup>30</sup> These figures underline the success of the iPlayer on cable and the clear demand that has been met by the service.

- 2.13 The quality of the iPlayer and its associated functionality have no doubt helped drive usage and has brought considerable benefits to consumers. For example, it is possible for Virgin Media customers to use a ‘series stacking’ option in the iPlayer, which allows users to access multiple episodes of selected BBC series up to seven days after the final episode has been broadcast on a linear BBC television channel.
- 2.14 The iPlayer will also become available to more consumers later this year when it is integrated into the Freesat platform. At a recent conference in November 2008, Emma Scott, Managing Director of Freesat stated, “*we will be getting iPlayer launching on Freesat next year and it will be existing boxes as well as future ID TVs and HD Freesat boxes that can get it, so it [sic] been a success on Virgin Media...*”<sup>31</sup>
- 2.15 The growth in the use of VoD services provided by broadcasters is not confined to iPlayer. Earlier this year, ITV.com (now called ‘ITV Player’) saw a 21% month-on-month growth during a five month period:

*“Video views on ITV.com and ITV Local grew by 21% month-on-month for the last five months, with 12 million video views in May alone. On Sunday, 1st June, the day after ITV’s hit entertainment finale show for Britain’s Got Talent, a staggering 1.1 million video views were recorded across ITV.com, and over 8,000 hours of video watched on the Britain’s Got Talent site alone. There were 6 million video views in total during the series transmission period.”*<sup>32</sup>

*“We’ve seen massive traffic growth across our online sites during 2008 and the consumption of ITV content across our platforms has been staggering...”*<sup>33</sup>

- 2.16 With regard to the VoD services provided by the other PSB channels, Channel 4’s 4oD service is available on Virgin Media, on BT Vision, on Tiscali TV and on PC.<sup>34</sup> It enables customers to catch-up on Channel 4 programmes broadcast during the previous seven days. There have been over 100 million views of content on 4oD since launch. Five also offers a VoD service called Demand Five which is available on BT Vision and also on PC. Since relaunch, in July 2008, the PC service has reported a doubling in traffic.

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<sup>30</sup> <http://investors.virginmedia.com/phoenix.zhtml?c=135485&p=irol-newsArticle&ID=1184644&highlight=>

<sup>31</sup> Emma Scott, Managing Director, Freesat at the Westminster Media Forum.

<sup>32</sup> <http://www.itvplc.com/media/newsrelease/?id=3147>

<sup>33</sup> <http://www.itvplc.com/media/newsrelease/?id=13334>

<sup>34</sup> <http://www.channel4.com/4od/get4od/4odontv.html>

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2.17 In addition to those VoD services mentioned above, Sky also offers a number of VoD or PPV services:

- First, Sky Anytime which provides access to approximately 40 hours of content which is transmitted to and stored on the hard-drive of a Sky+ PVR. Sky Anytime is available via all Sky HD set top boxes and via newer models of Sky+ set top boxes (those acquired after November 2005). Viewers are able to access the content on Sky Anytime at no extra charge in accordance with their DTH satellite subscriptions (for example, customers who subscribe to the Sky Movies channels will have access to certain Sky Movies programming on Sky Anytime at no extra charge). Usage of Sky Anytime has been significant. [CONFIDENTIAL] were viewed on Sky Anytime. The rate at which Sky Anytime is being used is increasing. In January 2008, around [CONFIDENTIAL] programmes were viewed on Sky Anytime, this figure increased to [CONFIDENTIAL] in October 2008.
- Second, the Sky Box Office service offers DTH satellite subscribers further on demand content with over 50 screens of television premieres of movies and occasional live sports and other special events on a pay-per-view basis. Sky Box Office HD offers at least 10 movies each week in high definition on a pay-per-view basis.
- Third, the 'GO!VIEW' VoD service, which Sky has developed in conjunction with Sony for use on Playstation Portable ("PSP") devices. GO!VIEW users are able to download content on both a subscription and pay-per-view basis onto a PC, from where the content may be transferred onto a PSP for viewing.
- Fourth, Sky Player, which is a PC application that allows Sky subscribers and non-subscribers to download and watch a variety of programmes, including movies, sport and entertainment. [CONFIDENTIAL]

2.18 Usage of VoD services is growing and will continue to grow as consumers continue to embrace the convenience of VoD. It is clear that there is already a wealth of both VoD services and VoD content available to UK consumers and that consumers, in large numbers, are using VoD.<sup>35</sup> Indeed, Ofcom states that VoD services are now "*widely available to consumers.*"<sup>36</sup> The usage of such services will only increase in the future as internet speeds improve (the blended headline internet speed across the UK increased from 3.6 M/bits per second to 5.9 M/bits per second between December 2006 and the end of Q1 2008<sup>37</sup>) and more and better services are offered to consumers. Examples of possible future developments include:

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<sup>35</sup> **Annex 2** to this Response sets out further detail on the VoD services that are available to consumers.

<sup>36</sup> Paragraph 4.148 of the Consultation Document.

<sup>37</sup> Ofcom's Communications Market Report 2008, page 24. Available at: <http://www.ofcom.org.uk/research/cm/cmr08/>

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- The proposed joint-venture between BBC, ITV and Channel 4 under the working title 'Kangaroo', which "*will enable consumers to view and, in some cases, to own downloaded audiovisual material.*"<sup>38</sup> 'Kangaroo' demonstrates further recognition by the PSBs of the importance of VoD and the strength of competition in VoD services. This is recognised by the joint-venture parties in their submission to the Competition Commission, "*The joint venture has been designed with the fundamental aim of enhancing the consumer experience of VoD...*"<sup>39</sup>
- The BBC, ITV and BT proposal to "*promote a common industry approach and consumer offer to deliver on demand TV over broadband*".<sup>40</sup>
- **[CONFIDENTIAL]**

2.19 No doubt there will be further developments and further announcements in due course in order to meet future consumer demand. It is notable that, in this respect, Virgin Media agrees with Sky's assessment about VoD:

*"As a consequence of consumers' increasing demand for choice and flexibility as to what content they wish to view, and at what time, Virgin Media expects there to be a rapid growth in the demand for, and supply of, content delivered on a VoD basis".*<sup>41</sup>

### **High Definition**

- 2.20 Ofcom itself recognises the success of HD within the UK, such that it was able to boast recently that the "*UK leads take-up in Europe with 700,000 HD households, higher than the number of HD households in France, Germany and Italy combined*".<sup>42</sup>
- 2.21 HD television was introduced in the UK in 2006, and Sky has been at the forefront of developing and promoting HD television services in the UK from the beginning. Sky has invested in HD television, as pay TV retailer, platform, and as a broadcaster of pay TV channels.<sup>43</sup>

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<sup>38</sup> Parties Joint Background Paper on the Joint Venture, 25 July 2008, Paragraph 3.1. Available at: [http://www.competition-commission.org.uk/inquiries/ref2008/kangaroo/pdf/main\\_party\\_submission\\_ukvod\\_2.pdf](http://www.competition-commission.org.uk/inquiries/ref2008/kangaroo/pdf/main_party_submission_ukvod_2.pdf)

<sup>39</sup> *Ibid.*

<sup>40</sup> [http://www.bbc.co.uk/pressoffice/pressreleases/stories/2008/12\\_december/11/partnership2.shtml](http://www.bbc.co.uk/pressoffice/pressreleases/stories/2008/12_december/11/partnership2.shtml)

<sup>41</sup> [http://www.competition-commission.org.uk/inquiries/ref2008/kangaroo/pdf/third\\_party\\_submission\\_virgin\\_media.pdf](http://www.competition-commission.org.uk/inquiries/ref2008/kangaroo/pdf/third_party_submission_virgin_media.pdf)

<sup>42</sup> <http://www.ofcom.org.uk/media/features/icmrmain?lang=cy>

<sup>43</sup> By way of example: Sky developed a new HD PVR (known as Sky+HD), **[CONFIDENTIAL]**, Sky's HD platform is open to others (for example BBC HD, C4 HD and Luxe TV HD), Sky has launched numerous HD channels over the past year and Sky also broadcasts a large amount of HD content, including entertainment, movies and sport programming.

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- 2.22 Sky's DTH satellite platform currently carries 30 different HD channels (with more in the pipeline over the course of this calendar year) and is available to subscribers for an additional £10 per month.<sup>44</sup> Almost 7% of Sky subscribers take Sky's HD service. Such has been the consumer demand for HD that Sky+ HD is the fastest selling additional TV product ever offered by Sky. This figure is likely to grow further as Sky adds new HD channels to its service.
- 2.23 Earlier this year Sky took the decision to reduce the price of a Sky+ HD set top box in order to promote further the take-up of this service and to encourage existing subscribers to upgrade to HD. The effect of the price reduction has been to help accelerate take-up.
- 2.24 Absent Sky's investment and willingness to take risk, it seems likely that UK consumers would not now have access to the most linear HD channels available in Europe. Indeed, before Sky invested in HD, no other company in the UK was seriously interested in developing a HD service.
- 2.25 Following Sky's lead, and benefiting from Sky's risk-taking and investment, which helped to establish knowledge of and demand for HD services, other platforms have enabled the launch of HD services. BBC/ITV Freesat allows its customers to access two HD channels, namely BBC HD and ITV HD, free-of-charge. Virgin Media customers can watch the BBC HD channel as well as numerous HD programmes and HD movies on demand. BT Vision customers are able to download and watch HD movies and Apple TV customers have access to "*the largest selection of on demand HD movies in the UK*".<sup>45</sup>
- 2.26 It is as a result of the high levels of competitive pressure within the UK audiovisual market that the developments set out above have occurred. Moreover, it is as a result of competition within that market that benefits derived from these developments have been delivered to consumers.

### ***Packaging & pricing innovation***

- 2.27 Sky has made substantial innovations to its pricing and packaging over time. The introduction of genre packages, in September 2005, provides Sky's subscribers with greater choice and flexibility than any other pay TV retailer: just taking into account Sky's premium channels and the six basic mixes, the number of total bundles from which a customer is able to choose is 1,764 (Ofcom is referred to **Section 5** below for further detail on packaging and pricing).<sup>46</sup> There are therefore a large number and a broad range of bundles from which a consumer can choose (at varying prices according to the content of each bundle). There is support for Sky's innovation in the PwC Report (**Annex 1**), which found that Sky has been a leader in the introduction of genre-themed basic packages.

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<sup>44</sup> Free to air HD channels are available without charge and do not require a subscription to view.

<sup>45</sup> <http://www.apple.com/uk/appletv/>

<sup>46</sup> A very large proportion of Sky's subscribers (particularly new subscribers) have taken advantage of these new packages, despite the fact that these new packages have only been available for just 3 years.

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- 2.28 Sky has sought to drive take up of its premium channels by making single movies and single sports more attractive. One of the key factors in determining Sky's switch to genre-based movie channels was to create a more attractive single movies package. Single movies has also been reflected in Sky's lead marketing messages including the Christmas 2008 campaign which led with a £26 per month price for a package including single movies. Over the period of this campaign Sky added **[CONFIDENTIAL]**<sup>47</sup> single movie subscribers, representing a **[CONFIDENTIAL]**% growth in the number of subscribers on the £26 per month single movies package).
- 2.29 Sky has also experimented by offering subscribers the opportunity to subscribe to Sky Sports for a weekend in order to access a particular event. Sky marketed the 2008 Ryder Cup golf tournament in this way. Subscribers were offered the opportunity to access Sky Sports over the Ryder Cup weekend for a fixed fee. After the weekend they were automatically downgraded. **[CONFIDENTIAL]**
- 2.30 Consumers who do not take a DTH satellite package are now able to subscribe to Sky Sports and other pay TV channels via the Sky Player.<sup>48</sup> There are three different packages of linear channels available via the Sky Player with promotional launch prices currently ranging from £7.50 to £30 (prices for the service will increase to between £15 to £34 in February 2009). The first channel package includes eight different channels.<sup>49</sup> The second and third channel packages include the Sky Sports channels.
- 2.31 It is not only Sky that has innovated in terms of packaging and pricing. Ofcom considers that Setanta's pricing and packaging is innovative.<sup>50</sup>
- 2.32 It is clear from the above that there have been a number of developments in the pricing and packaging of main subscription packs on a number of different platforms. Packaging innovations are not however confined to main subscription packages. A number of broadcasters now offer multiroom subscriptions. Multiroom subscriptions provide the consumer with the ability to watch the same set of channels (that a consumer is entitled to view on a main subscription) on a second set top box in another room. Both Sky and Setanta offer consumers Multiroom subscriptions via the DTH satellite platform. Multiroom or (additional outlets) are also available to Virgin Media customers. 18% of Sky subscribers now take a Multiroom subscription and thus benefit

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<sup>47</sup> In the UK between 3 November 2008 and 2 January 2009.

<sup>48</sup> <https://skyplayer.sky.com/aboutskyplayer/online-live-tv.html>

<sup>49</sup> National Geographic, British Eurosport, Disney Channel, Sky Sports News, Sky News, MTV One, Nickelodeon and Nick Jr.

<sup>50</sup> Paragraphs 7.50 and 7.51 of the Consultation Document. Setanta Sports channels are bundled with other channels by both Virgin Media and BT Vision. In addition, over the course of this summer, "new" Top Up TV customers were entitled to view Setanta Sports 1 for free until the end of the 2008/09 Premier League football season (May 2009) (subject to a £20 connection fee). Currently, Top Up TV is offering its Top Up TV + set top box with a free nine month subscription to Setanta Sports 1. <http://www.topuptv.com/buynow/wizard/newcustomer.html>  
<http://www.btplc.com/News/ResultsPDF/q108release.pdf>

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from the added convenience of being able to watch different content in different rooms of the same house.

- 2.33 Collectively, these developments should be taken as yet further evidence that the market is working well and is competitive.

### **Conclusion on innovation**

- 2.34 It is clear that there has been and will continue to be, substantial innovation in the market due to significant competitive pressures at the retail level. The PwC Report (**Annex 1**) supports the fact that the UK is one of the “*leaders in terms of innovation services*”<sup>51</sup>
- 2.35 Sky led the way with PVRs and HD and has set new benchmarks which other broadcasters and also platforms, such as Freesat, have sought to meet: Freesat has stated that it is “*trying to emulate a lot of what Pay TV have done in terms of innovation and customer service*”.<sup>52</sup> This is clearly a good consumer outcome.
- 2.36 Sky has provided consumers with a number of VoD services either via the TV or the PC. The BBC brought consumers the now ubiquitous iPlayer (indeed, it is difficult to believe that the iPlayer launched only a little over a year ago) which, along with the other PSBs’ VoD content, is available through a number of different platforms and is being used by a large number and a wide variety of consumers.
- 2.37 These innovations have benefited consumers who are now, as Ofcom puts it, “*blazing the way when it comes to embracing the digital TV age*”.<sup>53</sup>

## **3. Choice of content and platform**

- 3.1 UK consumers have a greater choice of what to watch and how to watch than ever before. This is as a result of significant competitive pressure at the downstream level between, amongst others, pay TV providers and free to air TV providers.

### **Choice of content**

- 3.2 UK households have access to a wide range of free to air television channels. In addition to the five main free to air channels, which are available via analogue terrestrial television to almost all UK households, there are now over fifty free to air television channels available via DTT, over seventy channels available via Freesat and over 200 such channels available via DTH satellite.
- 3.3 There is a wealth of sports, entertainment and movies content available on free to air channels and whilst in the past, broadcasters were constrained by the limited number of broadcast hours available to them, this is no longer the case.

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<sup>51</sup> Paragraph 6.2.8 of the PwC Report (**Annex 1**).

<sup>52</sup> Emma Scott, Managing Director, Freesat at the Westminster Media Forum.

<sup>53</sup> <http://www.ofcom.org.uk/media/features/icmrmain>

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The large number of digital channels that are now available are being used to show programmes that previously were not shown. For example, broadcasters increasingly show movies on their main and sister 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%. Broadcasters are also showing more sports content, for example, a large number of the less prominent matches in the 2007 Rugby World Cup were broadcast live by ITV on ITV4. Previously, such matches would probably not have been screened live at all.

- 3.4 In addition to the content available on free to air channels, there is a huge variety of quality content available on pay TV channels. Consumers are also now able to view certain movies on television on the same day or shortly after the movie becomes available either in the cinema or on DVD release.<sup>54</sup> Further detail on ‘day and date’ release can be found above and at **Annex 3**.
- 3.5 Penetration levels for pay TV show that consumers clearly value the content that is made available to them by pay TV providers, as Ofcom itself agrees.<sup>55</sup> Ofcom need only look through the listings schedules for the over 200 pay TV channels to see that the pay TV sector provides consumers with a considerable degree of choice.
- 3.6 In summary, consumers have access to a wide range free to air and pay TV content.

### ***Choice of platform***

- 3.7 With regard to how viewers are able to consume audiovisual content, there are a number of different ways in which audiovisual channels may be accessed: DTH satellite, analogue, cable, IPTV, DTT, mobile TV and online.
- 3.8 Companies have invested significantly in these platforms. Sky’s investments in distributing content via satellite, mobile TV and online have been considerable. BT Vision has “*invested extremely heavily in our network to be able to deliver people television, quality content, including HD immediately at the touch of a button over our consumer retail network...that has been a very significant investment that we have made in order to do that. We have done it because it’s the right thing for our consumers and we believe that it builds the business in the right way*”.<sup>56</sup> That innovation has helped BT Vision to gain 350,000 customers in 18

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<sup>54</sup> “*The Edge of Heaven*” and “*Julia*” were both released theatrically on the same day they became available to Sky DTH subscribers on a pay-per-view basis via both Sky Box Office and the Sky Player. The films “*Beowulf*” and “*The Assassination of Jesse James by the Coward Robert Ford*” were made available to Sky DTH subscribers on a pay-per-view basis via both Sky Box Office and the Sky Player very shortly after their release on DVD.

<sup>55</sup> Paragraph 7.29 of the Consultation Document.

<sup>56</sup> Dan Marks, Chief Executive Officer, BT Vision at the Westminster Media Forum.

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months, which it considers is “*extremely respectable and we are comfortable about it*”.<sup>57</sup>

- 3.9 Consumers also now have additional platform choice that did not exist when Ofcom started its investigation. For example, in December 2008, Sky launched an online linear pay TV service via the Sky Player. This service enables customers in the UK and Ireland to subscribe to watch a package of channels<sup>58</sup> from Sky on either a PC or Mac without the need to install a TV-based service.
- 3.10 Consumers are also increasingly using games consoles such as the Xbox 360, PS3 and Wii and other digital media adaptors to view, on a television, audiovisual content downloaded and/or streamed from the internet. Nintendo recently announced that it would be launching its own TV channel, which will be viewable on its Wii games consoles (some 3.5 million Wii consoles have been sold in Britain). Ofcom notes that there is the “*possibility of disruptive change in the way the studios [sic] monetise their rights in the future, including in particular new means of distributing individual movies to consumers over the internet*”.<sup>59</sup> Moreover, Ofcom states that “*It is not difficult to imagine a world in which they [movies] are generally accessed more directly, for example via various forms of internet download.*”<sup>60</sup> Whilst Ofcom considers that “*disruptive change*” and access of movies via “*internet download*” may occur at some point in the future, it is clear from this section that this is already happening. As internet speeds increase, and technology develops, there is the increased probability of this disruptive change. In July 2008, Sony announced, at the E3 show in Los Angeles, the launch of a service that would allow PS3 users based in the US to download full-length television shows and movies in both standard definition and HD.<sup>61</sup> Sony is expected to announce the launch date for the PS3 movie and television service across Europe later this year. Press reports suggest that the service will be launched in the UK in 2009. This is the sort of disruptive change that Ofcom envisages. Further detail on the ways in which consumers are able to consume movies content and the state of flux that exists with regard to the distribution of, and consumption of, movies content can be found above and at **Annex 3**.
- 3.11 Finally, despite the non-availability of spectrum for the specific use of a mobile TV service, DTH satellite subscribers can access, at no additional cost, content from Sky Sports, Sky News and Sky One (provided they are entitled to view these channels on their DTH satellite subscription) on a 3G mobile phone. In addition, customers on either Vodafone, Orange or the T-mobile mobile phone networks in the UK or the Vodafone network in Ireland with a compatible mobile handset can subscribe to ‘Sky Mobile TV’. Sky Mobile TV offers over 25

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<sup>57</sup> *Ibid.*

<sup>58</sup> Sky Sports 1, Sky Sports 2, Sky Sports 3, Sky Sports Xtra, Sky Sports News, National Geographic Channel, Disney Channel, Eurosport, Sky News, MTV One, Nickelodeon, Nick Jr

<sup>59</sup> Paragraph 5.5 of the Consultation Document.

<sup>60</sup> Paragraphs 1.16 and 3.4 of the Consultation Document.

<sup>61</sup> <http://www.us.playstation.com/news/PressReleases/Print/480>

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channels streamed direct to the subscriber's mobile phone.<sup>62</sup> In addition, Setanta Sports 1 and 2, and Setanta Golf are all available to customers on the Orange network.

### Conclusion on choice

- 3.12 Developments in choice of content and platform provision have benefited consumers.
- 3.13 It is clear that the retail market<sup>63</sup> is competitive. This view is echoed by Virgin Media: "*The UK is a really competitive market with 150 pay-TV channels, Sky, Freeview, Tiscali and BT's TV service*".<sup>64</sup> This is further supported by the PwC Report (**Annex 1**), which finds that whilst the outcomes for consumers in different countries<sup>65</sup> in Europe in relation to pay TV services vary significantly, UK consumers are well-served and that the UK is one of the four leading comparator countries in terms of innovation.<sup>66</sup> Moreover, it is also clear that the retail market is driven by increasingly competitive pressures and that companies need to give consumers choice in order to gain their business. This view is echoed by BT Vision "*We are happy about the way that we are going and we think we are giving our customers exactly the sort of choice, convenience and control that they want...*"<sup>67</sup>
- 3.14 It is clear that consumers have good choice within a market that already is and will become even more competitive if left to develop unhindered.

## 4. Pay TV services priced competitively and effectively

- 4.1 Sky considers that the high levels of pay TV penetration in the UK indicate that UK price levels are reasonable. Penetration is a particularly useful measure as it provides a proxy for the overall quality-reflected price including subscription and upfront elements. Ofcom states that pay TV penetration in the UK is relatively high.<sup>68</sup> Sky agrees and notes that data on penetration supports this.

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<sup>62</sup> The following live channels are available on Sky Mobile TV: Sky Sports 1, Sky Sports 2, Sky Sports 3, Sky Sports News, At The Races, CNN, Sky News, MTV Trax, Kiss, Kerrang!, magic, thehits, BOX, Q and Smash Hits. The following made for mobile looped channels are made available on Sky Mobile TV: Sky One, Bravo, Sky Movies News, MTV Snax, [adult swim], Paramount Comedy, Nickelodeon, Cartoon Network, E!, Omni Sport TV, Extreme Sports Channel, WWE Mobile

<sup>63</sup> As set out in **Section 4** below, Sky considers that the relevant market includes free to air, pay TV services, DVD sales and rental and PPV/VoD services.

<sup>64</sup> <http://www.katebulkley.com/page6-7-1.pdf>

<sup>65</sup> Austrian, Belgium, Denmark, Finland, France, Germany, Greece, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

<sup>66</sup> Following Ofcom's criticism of the First PwC Report in the Consultation Document (see for example paragraph 7.47 of the Consultation Document), PwC added nVoD and VoD to its innovation assessment and found that this did not significantly alter the ranking in the First PwC Report, with the four leading countries in terms of innovation (the UK, France, Norway and Sweden) remaining unchanged, see paragraph 5.6 of the PwC Report.

<sup>67</sup> Dan Marks, Chief Executive Officer, BT Vision at the Westminster Media Forum.

<sup>68</sup> Paragraph 7.29 of the Consultation Document.

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Ofcom's most recent "Digital Progress Report" for Q3 2008 provides evidence on penetration. According to the Report, 12.5 million homes in the UK now take some form of pay TV service.<sup>69</sup> This represents 48.8% of all UK homes (growth of 1.7% compared to the previous quarter).<sup>70</sup> It is a considerable achievement on the part of pay TV providers that, despite a well funded and diverse free to air sector, penetration levels are as high as they are. This, together with the other evidence set out both immediately above and elsewhere in this section, provides very strong evidence that prices for pay TV services in the UK are reasonable.

- 4.2 Sky also considers that high levels of customer satisfaction provide evidence that pay TV services are priced competitively and effectively. According to Ofcom's own consumer research, 84% of pay TV consumers are either very satisfied or fairly satisfied with their service (48% of Sky's pay TV customers are very satisfied with their pay TV service and 37% are fairly satisfied; the satisfaction levels of Virgin Media's customers are lower: 32% very satisfied, 46% fairly satisfied).<sup>71</sup> As a comparison, the level of satisfaction in fixed line is 87%, for mobile it is 94%, for internet (both narrowband and broadband) it is 83% and for digital TV subscribers it is 87%.<sup>72</sup>
- 4.3 In terms of value for money, 70% of subscribers on satellite, 72% of cable subscribers and 82% of all digital TV consumers are either very or fairly satisfied in terms of value for money. These figures represent a high level of satisfaction with pay TV services. Given this, it is unsurprising that Ofcom recently stated that UK consumers are "*getting better value for money than ever before*".<sup>73</sup>
- 4.4 Sky has given consumers better value for money from pay TV services. Making improvements have been made to Sky's pay TV services, such as increased channel choice and additional services such as Sky Anytime and Sky Player, yet, in real terms, the cost of Sky's most popular packages have been broadly flat or falling. Ofcom is referred to Annex 2 of Sky's response to the First Consultation for further information on the price in real terms of Sky's subscription packages. In addition, the First PwC Report indicated that when compared to packages of similar quality, Sky's prices were lower than 10 of the 19 comparator packages.<sup>74</sup> Indeed if the analysis were amended to reflect the recent strengthening of the Euro the conclusions would be even more favourable to Sky. This report has been supplemented by the PwC Report

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<sup>69</sup> Figure 1 of the Digital Progress Report, Q3 2008. Available at: [http://www.ofcom.org.uk/research/tv/reports/dtv/dtu\\_2008\\_03/q3\\_2008.pdf](http://www.ofcom.org.uk/research/tv/reports/dtv/dtu_2008_03/q3_2008.pdf)

<sup>70</sup> *Ibid.*

<sup>71</sup> Figure 20 and Paragraph 1.15 of the First Consultation Document.

<sup>72</sup> Figure 19 of the First Consultation Document.

<sup>73</sup> <http://www.ofcom.org.uk/media/features/icmrmain>

<sup>74</sup> See Table 8 of the First PwC Report.

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**(Annex 1)** which finds that Sky has been a leader in terms of innovation on pricing and packaging.<sup>75</sup>

- 4.5 It is likely that both cost and quality of what is provided is the reason why consumers are satisfied with the service provided.

### **Conclusion on the competitive and effective pricing of pay TV services**

- 4.6 Ofcom's own research, both in respect of its investigation, and other consumer research, shows that consumers are satisfied with, and getting good value for money from pay TV services. There are a number of reasons why consumers are satisfied with the services they are receiving. There is more content to consume than ever before, which can be consumed in a way that is convenient to consumers, and at a lower real price than ever before. Given this, it is little wonder that levels of consumer satisfaction are so high.

- 4.7 Sky will further improve its proposition, whilst at the same time providing consumers with value for money services. No doubt Sky's free to air and pay TV competitors will also strive to improve the quality of their services in a bid to win subscribers/viewers. These improvements, together with the good value that pay TV offers will ensure that consumer satisfaction remains high and that "*Compared to many forms of entertainment, Pay TV subscriptions...[will continue to represent] phenomenal value for money...*"<sup>76</sup>

### **5. Ofcom risks disrupting a competitive market which already provides significant consumer benefits**

- 5.1 As has been shown above, within the UK audiovisual market there is considerable innovation, unrivalled choice of content, high levels of penetration and consumer satisfaction, and competitive and effective pricing that offers consumers "*better value for money than ever before*".<sup>77</sup> These factors are both current and observable and demonstrate that there is effective competition in the downstream market for audiovisual services.

- 5.2 Despite the fact that the UK audiovisual market is both highly competitive and functioning well, Ofcom nevertheless sets out a number of hypothetical concerns.<sup>78</sup> And, despite the fact that the Consultation Document seeks to justify these concerns with a voluminous amount of unsubstantiated documentation, Ofcom's concerns remain purely hypothetical. They are not supported by evidence and are entirely lacking in foundation. In fact, the very cornerstone of Ofcom's 'concern' lacks certainty:

*"Markets where competition is weak, and consumers are unable to exercise a real choice between suppliers, are unlikely to deliver the best outcomes"*

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<sup>75</sup> In comparison to the pay TV providers in the comparator European countries.

<sup>76</sup> David Cuff, Commercial Director, Virgin Media Television at the Westminster Media Forum.

<sup>77</sup> <http://www.ofcom.org.uk/media/features/icmrmain>

<sup>78</sup> Paragraphs 1.32 to 1.36 and 2.52 to 2.56 of the Consultation Document

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*for consumers. This **might** manifest itself in several ways.”<sup>79</sup> (Emphasis added)*

- 5.3 Everything from Ofcom that follows, every statement, every supposition, every speculation is subject to the uncertainty created by this “*might*”. The uncertainty is then further compounded by subsequent “*mights*”, “*maybes*” and “*coulds*”.<sup>80</sup> The liberal spattering of these caveats is such that uncertainty is heaped upon further uncertainty to the point where Ofcom simply has no basis to even propose the imposition of additional and unnecessary regulation (**Section 7** below provides further detail on the necessity – or lack thereof – of this regulation). It is clear that Ofcom’s “*concerns*” amount to nothing more than a ‘house of cards’ built on unstable footings.
- 5.4 Any intervention by Ofcom risks distorting competition and potentially undermining and/or reducing both existing benefits and future benefits to consumers. Ofcom is referred to **Section 7** below, which considers the costs of Ofcom’s proposed intervention as well as the intended or knowable consequences and the potential unintended consequences of the proposed intervention. For example, we consider that there are entirely plausible scenarios in which the result of this regulation would be higher prices for pay TV services for consumers.<sup>81</sup>
- 5.5 Given that the market is currently working well, Ofcom would need to have clear evidence of serious concerns to be confident that its intervention would remedy those concerns and would not have any detrimental effects. Ofcom has no such evidence. In contrast, there is significant evidence, as set out above, to demonstrate that the market is working well. Sky suggests that Ofcom considers carefully this evidence in order to inform its understanding of the market and to help it conclude that the proposed additional regulation is unnecessary.

## 6. Conclusion

- 6.1 *“The UK audiovisual market is today a very competitive one, with high levels of consumer choice thanks to the proliferation of new digital channels and services on a multitude of platforms. On demand services are now offered alongside scheduled broadcasting, while the rapid growth of broadband is encouraging the development of new platforms and innovative services. Today, UK consumers can receive television and on demand services (both free to air and pay-TV) over a variety of distribution technologies: cable, digital terrestrial television, satellite, TV over IP and mobile TV.*

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<sup>79</sup> Paragraph 1.32 of the Consultation Document.

<sup>80</sup> See for example, paragraphs 1.28, 1.36, 1.37, 2.53, 6.1, 6.5, 6.6, 7.1 and 7.5 of the Consultation Document.

<sup>81</sup> We understand that forthcoming economic papers prepared by Helen Weeds of the University of Essex indicate that this is a real possibility. See Annex B of CRA’s paper, attached at **Annex 4** to this Response.

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- 6.2 *The widespread deployment of new communications technologies has brought about a dramatic change in television consumption patterns and in consumer attitudes towards media more generally. This is fundamentally changing the audio-visual sector. As mobile and internet based technologies move from the world of technical jargon (such as DVB-H, IPTV and W-LANs) into people's homes viewers and listeners are becoming less and less content to be passive recipients of communications services. These developments are making the broadcasting market increasingly competitive and the audiovisual sector more complex."*
- 6.3 Whilst we agree with the above it is noteworthy that these are not Sky's words, but Ofcom's.<sup>82</sup>

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<sup>82</sup> Pages 2 and 5 of Ofcom's Response to the Commission's Consultation on the Application of State Aid Rules to PSBs. Available at: <http://www.ofcom.org.uk/tv/ifi/stateaidrules/ofcomresponse.pdf>

## SECTION 3: OFCOM'S RECOURSE TO SECTORAL POWERS IS NOT LEGALLY SOUND

### 1. Introduction

- 1.1 In **Section 2** above, we have summarised the evidence (well known to Ofcom) that demonstrates that the UK audiovisual sector is competitive and working well. Notwithstanding these positive outcomes for consumers, Ofcom has set out concerns in the Consultation Document that fall into two categories: (i) concerns about restricted distribution of Sky's premium channels in a way that favours Sky's own platform and retail business; and (ii) concerns about high wholesale prices that may have the effect of keeping retail prices high but without distorting competition. Ofcom believes that Sky does have the incentive to restrict distribution of its premium channels and considers that it has evidence that Sky is acting on that incentive; however in relation to the second of its concerns, namely possible high wholesale prices, Ofcom acknowledges that its evidence is not clear-cut.
- 1.2 Ofcom has made it clear in the Consultation Document that its preferred remedy for addressing the concerns that it has identified is by "*requiring [Sky] to provide wholesale access to particular content on regulated terms*" – an obligation known as a 'wholesale must offer' remedy.<sup>1</sup> A requirement to offer to wholesale channels to all comers is in itself a highly intrusive remedy, requiring compulsory licensing by Sky of the intellectual property in its channels.
- 1.3 What is even more remarkable is that Ofcom proposes that it would need to specify an *ex ante* pricing rule (even possibly a specific price) and that if a 'retail-minus' approach were followed to calculate the appropriate wholesale price, the retail margin "*may need to be set at a level which would support entry into the market by new retailers*".<sup>2</sup> This means that Sky would be required to set its wholesale price "*based on a forward-looking view of a new entrant's costs*"<sup>3</sup> (rather than based on the approach conventionally adopted under competition law in margin squeeze cases of considering an entrant that is as efficient as the wholesaler's own downstream retailing arm and using actual historic costs of that downstream arm). We refer to the approach of reducing Sky's margin to subsidise less efficient new entrants as Ofcom's 'extended retail-minus' approach.
- 1.4 Imposing an *ex ante* pricing rule, and in particular one that requires a forward-looking view of a new entrants' costs, goes beyond any remedy that could be imposed under general competition law, as Ofcom itself acknowledges.<sup>4</sup> Ofcom

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<sup>1</sup> Paragraph 1.41 of the Consultation Document.

<sup>2</sup> Paragraph 9.3 of the Consultation Document.

<sup>3</sup> Paragraph 9.56 of the Consultation Document.

<sup>4</sup> Paragraph 8.51 of the Consultation Document. Sky also notes the European Commission's statement of 3 December 2008 regarding their enforcement priorities in applying Article 82 to abusive exclusionary conduct by dominant undertakings that:

*"Since the focus of the Commission's enforcement policy is on conduct that harms the competitive process rather than individual competitors, for pricing conduct the Commission*

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is therefore “*consulting on the use of...sectoral competition powers under section 316 of the Communications Act to put such an obligation in place*”.<sup>5</sup>

- 1.5 Ofcom’s proposed use of its section 316 Communications Act 2003 (“**CA03**”) powers to impose a wholesale ‘must offer’ obligation on Sky is both novel and unprecedented. Whilst Ofcom has used its section 316 CA03 powers in the past, it has never done so to address the alleged conduct of a single broadcaster; and it has never imposed *ex ante* pricing regulation under its sectoral powers, still less *ex ante* pricing regulation that reduces a supplier’s margin in order to subsidise new entry.
- 1.6 Both Ofcom’s preferred remedy, and the preferred route of achieving it, are highly unusual, a fact that Ofcom does not acknowledge. Whether Ofcom is entitled to use section 316 in the manner proposed is a critical issue and we therefore address Ofcom’s chosen mechanism for dealing with its concerns in this section, before considering those concerns and Ofcom’s preferred remedy in detail in the remainder of this Response.
- 1.7 This Section considers:
  - (a) In Part 2, the purpose of section 316 and its relationship with Ofcom’s principal duty under CA03 to “*further the interests of consumers*”. It is clear that section 316 may not be used to ‘promote’ competition in the manner proposed.
  - (b) In Part 3, we consider the substantive test for the application of section 316, namely that the actual or potential conduct which is being addressed must have a material impact on the competitive process, and additional conditions must be met where compulsory supply is the proposed remedy.
  - (c) We summarise the reasons why Ofcom has not satisfied the substantive test, and why it could not be met in Part 4. We also explain why Ofcom’s approach fails to have regard to its duties and obligations under the CA03.
  - (d) In Part 5 we consider the important limitations on the use of section 316, which require Ofcom to consider conscientiously whether use of other available powers would be more appropriate, which it has failed properly to do.

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*establishes whether the conduct is likely to prevent competitors that are as efficient as the dominant undertaking from expanding on or entering the market and that can be expected to be most relevant to consumer welfare.”* Available at: <http://ec.europa.eu/competition/antitrust/art82/guidance.pdf>

<sup>5</sup> Paragraph 1.5 of the Consultation Document.

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### 2. The purpose of section 316: ensuring fair and effective competition

- 2.1 The powers set out in sections 316 to 318 of the CA03 are known as Ofcom’s sectoral competition powers. They empower Ofcom to impose conditions on providers of services licensed under the Broadcasting Acts that Ofcom “*consider appropriate for ensuring fair and effective competition*”. The powers are additional to and concurrent with Ofcom’s powers under the Competition Act 1998 (“**CA98**”).<sup>6</sup>
- 2.2 Section 316(1) provides that Ofcom “*may*” include conditions applicable to every licensed service that it considers appropriate “*for ensuring fair and effective competition in the provision of licensed services or of connected services*”. Section 316(2) provides that those conditions must include the conditions (if any) that Ofcom considers appropriate for securing that the provider of the service does not “*(a) enter into or maintain any arrangements, or (b) engage in any practice, which Ofcom consider, or would consider, to be prejudicial to fair and effective competition in the provision of licensed services or of connected services*”. Ofcom’s route to implementation of its preferred remedy would appear to be the imposition of a new licence condition, or a direction on Sky (presumably pursuant to the existing Condition 14 of Sky’s TLCS licences) in either case setting out the form of the wholesale ‘must offer’ obligation.<sup>7</sup>
- 2.3 Section 317 contains provisions relating to the exercise of Broadcasting Act powers (which include the power to impose or vary licence conditions, or give a direction to a licence holder) for a “*competition purpose*”. A power is exercised for a competition purpose if the only or main reason for exercising it is to secure that the holder of a licence does not enter into or maintain arrangements, or engage in a practice, that Ofcom considers, or would consider, to be prejudicial to fair and effective competition in the provision of licensed services or connected services (section 317(9)).
- 2.4 Particular safeguards apply where, as here, Ofcom proposes to exercise a Broadcasting Act power for a competition purpose. In particular, Ofcom is required to consider whether a more appropriate way of proceeding is under the CA98 (section 317(2)). Ofcom is also required to give notice to persons likely to be affected by its decision to exercise any powers for a competition purpose (section 317(4)), and such decision is subject to an appeal to the Competition Appeal Tribunal on the merits (section 317(7)).
- 2.5 Section 318 requires Ofcom to conduct a periodic review of any codes, directions and guidance that have effect for “*competition purposes*”.
- 2.6 The imposition and enforcement of a licence condition or direction has extremely serious potential consequences for broadcasters holding a UK broadcasting licence, since breach of such condition or direction could result in revocation of the licence in question, meaning that the licensee could no longer lawfully broadcast the channel in question from the United Kingdom. The

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<sup>6</sup> The latter powers were not conferred upon Ofcom’s broadcasting predecessor, the ITC.

<sup>7</sup> Paragraph 8.62 of the Consultation Document.

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important safeguards put in place particularly by section 317 were included in the legislation to seek to ensure that Ofcom exercises its Broadcasting Act powers for a “competition purpose” in an appropriate manner, and that it does not misuse such powers. We address the specific safeguard provided by section 317(2) in Part 5 below, but note at this stage that the very scheme of sections 316 to 318 emphasises the high hurdles that Ofcom must pass in order to invoke its sectoral competition powers. Recourse to sectoral powers is not to be seen as the easy option.

### ***Ofcom’s principal duty to further the interests of consumers***

- 2.7 A number of points arise in connection with Ofcom’s principal duty under section 3(1)(b) CA03 “*to further the interests of consumers in relevant markets, where appropriate by promoting competition*”. The first is that Ofcom places an inappropriate level of emphasis on the secondary part of the duty, namely “*where appropriate by promoting competition*”, with many references to this aspect of its duty throughout the Consultation Document. Although section 3(1)(b) is a target duty, which Ofcom is required to take into consideration when policy decisions are taken, Ofcom appears to overlook the fact that its principal duty is to further the interests of consumers, not to ‘promote competition’.
- 2.8 The inclusion in the statute of the words “***where appropriate by promoting competition***” is significant and cannot be ignored. Yet Ofcom has not considered whether in this case it **is** appropriate to promote competition, or whether an attempt to promote competition in the manner proposed would, in fact, further the interests of consumers, since it has not properly weighed up the downsides of interference in relevant markets. Sky submits that furthering the interests of consumers in this case does not require the promotion of competition but rather no action by Ofcom at all (see further **Section 7**).
- 2.9 Secondly, section 3(1)(b) is not the only duty of Ofcom, and it has to be balanced against other such duties as well as against the matters to which Ofcom is required to have regard. In particular, Ofcom has important duties under (i) section 6 CA03, to review regulatory burdens with a view to securing that regulation by Ofcom does not involve the imposition of burdens which are unnecessary; and (ii) section 7 CA03, to carry out impact assessments. The standard to which Ofcom must carry out such assessments has recently been established by the Competition Appeal Tribunal (“**CAT**”) in its judgment in the *Vodafone* case.<sup>8</sup> The CAT stated that Ofcom’s assessment of the costs and benefits of its regulatory proposals must be able to withstand “*profound and rigorous scrutiny*”.<sup>9</sup> Ofcom’s assessment of the costs and benefits of the proposals in the Consultation Document falls far short of this exacting standard, as we discuss further in Part 4 of this Section 3 below.

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<sup>8</sup> *Vodafone Ltd v Office of Communications* [2008] CAT 22, judgment of the CAT of 18 September 2009.

<sup>9</sup> *Ibid.*, at paragraph 47.

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- 2.10 Ofcom is also required to have regard to a number of matters when performing its duties, including the desirability of encouraging investment and innovation in relevant markets. Such a balancing exercise is one of the matters that Ofcom failed properly to do in deciding whether it is “*appropriate*” in this particular case to “*promote*” competition in the manner Ofcom proposes.
- 2.11 In performing its duties under section 3(1), Ofcom must have regard “*in all cases*” to the principles under which regulatory activities should be “*transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed*” (section 3(3)(a) CA03), as well as to any other principles appearing to Ofcom to represent the best regulatory practice (section 3(3)(b) CA03).
- 2.12 The obligation to have regard to such principles is not to be seen as a mere box-ticking procedural exercise, but rather an integral part of the performance by Ofcom of its duties. Section 3(3) was included by Parliament in order to provide very important controls on the performance by Ofcom of its principal duties. In this context, it is highly surprising that Ofcom has not had appropriate regard to such matters, or even attempted to address them in the Consultation Document, a point to which we return in Part 4 of this Section below.<sup>10</sup>

### ***Section 316 does not provide for the ‘promotion’ of competition***

- 2.13 Ofcom refers to Sky having a lack of incentive to supply its channels at prices other retailers can afford, and seeks to invoke section 316 to require Sky to lower its wholesale prices to such retailers to take account of their alleged higher costs, in order to stimulate entry. However, as we explain in more detail below in **Section 5**,<sup>11</sup> it would not be logical for a standalone broadcaster without its own retail business to reduce its wholesale prices to cater to a new retailer that was less efficient than established retailers (i.e., to subsidise inefficient entry), and such behaviour would not become logical where the firm allegedly had market power. Ofcom is, therefore, seeking to use section 316 to obtain outcomes that would not be expected to occur in a competitive market. This is an impermissible use of section 316.
- 2.14 Parliament did not provide for Ofcom to be able to impose licence conditions or directions under section 316 in order to ‘promote’ competition in the manner proposed, but to “*ensure fair and effective competition*” in the provision of the relevant services. Protecting the competitive process by preventing operators from engaging in anti-competitive agreements or practices (even on an *ex ante* basis) is not at all the same thing as introducing far-reaching structural measures which it is hoped will inject additional competition into a market.<sup>12</sup>

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<sup>10</sup> In the discussion of its duties at paragraph 2.19 *et. seq.*, Ofcom does not even mention section 3(3).

<sup>11</sup> See paragraph 2.35 of **Section 5**.

<sup>12</sup> There is a clear difference between the words ‘promote competition’ and the words “*ensure fair and effective competition*”. Promoting competition denotes taking positive steps to encourage competition. “*Ensuring fair and effective competition*” does not require the ‘promotion’ of

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Sky submits that the section 316 powers are only aimed at the former; and do not extend to the latter.

- 2.15 Ofcom's wish to interpret section 316 to allow it to take action to 'promote' competition is apparent from the Consultation Document. It is revealed by the inappropriate level of emphasis on the aspect of its principal duty relating to the promotion of competition, which we mention above. It is also exposed via Ofcom's attempt explicitly to link its power<sup>13</sup> under section 316 with its general duty under section 3(1)(b), in order to widen the ambit of section 316. Ofcom states:

*"Our principal duty is to further the interests of consumers, where appropriate by promoting competition. This is connected to our duty under section 316 CA03 to ensure 'fair and effective competition in the provision of licensed services'. This document identifies a lack of incentive for Sky to supply its wholesale Core Premium channels at prices that other retailers can afford. We consider that this has led, and will continue to lead, to reduced competition between retailers and platforms, which will damage the interests of consumers. Our sectoral powers are well suited to dealing with a concern that competition will not develop in a manner that best serves consumers".<sup>14</sup>*

- 2.16 The 'connection' that Ofcom claims to exist (which is implicitly presented as a special connection) between its section 3(1)(b) duty and its section 316 power to ensure fair and effective competition is not provided for in the statute. Whilst it is true that Ofcom must take its section 3(1)(b) duty into account when formulating policy, it is not the case that there is a special connection between Ofcom's duty under section 3(1)(b) and its power to ensure fair and effective competition under section 316. Certainly there is no greater connection than there is, for example, between Ofcom's duties to review regulatory burdens and to carry out impact assessments in sections 6 and 7 of the CA03, and its power under section 316.
- 2.17 In summary, therefore, whether Ofcom proposes to impose a new licence condition on Sky, or issue Sky with a direction pursuant to the existing TLCS licence Condition 14, Ofcom's aim must be to ensure fair and effective competition by requiring that Sky does not "*enter into or maintain any arrangements or engage in any practice*" which Ofcom considers is, or would be, "*prejudicial to fair and effective competition*". It is not the case that section 316 may be invoked by Ofcom to require Sky to supply its channels on a wholesale

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competition in the sense intended by section 3(1)(b), but rather the *protection* of competition, a different concept.

<sup>13</sup> It is not correct to elevate section 316 to the status of a duty. It is a power.

<sup>14</sup> Paragraph 1.44 of the Consultation Document. Whilst Ofcom may think that it has "*identified*" that there is a lack of incentive for Sky to supply its channels "*at prices that other retailers can afford*", there is no analysis of the prices that other retailers can afford – see **Section 5** below. Furthermore, as we note above and explain at paragraph 2.35 of **Section 5** below, it is not logical behaviour for a broadcaster to lower its price to a less efficient new entrant, since the new entrant would take sales away from existing retailers, and thus the broadcaster would not overall have maximised its wholesale revenues. This is irrespective of market power.

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basis to all retailers “*at prices they can afford*”, in order to facilitate entry. Section 316 is being invoked by Ofcom for a ‘competition purpose’, as that phrase is defined by section 316(9), to “*secure that [Sky] does not enter into or maintain arrangements, or engage in a practice, that Ofcom considers, or would consider, to be prejudicial to fair and effective competition*”. Section 316 does not confer on Ofcom the power to ‘promote’ competition in the manner proposed, any more than would Ofcom’s general competition powers under the CA98.<sup>15</sup>

### 3. The substantive test for the use of section 316

3.1 Even if Ofcom’s preferred remedy falls within the scope of section 316 (which for the reasons set out above Sky does not accept) it remains to be considered whether Ofcom has met the substantive tests for the exercise of that power. In particular it is incumbent on Ofcom to consider (i) the appropriate competition framework for analysis of the issues; (ii) the substantive test that needs to be satisfied before section 316 may be invoked; and (iii) the standard of proof that is required to be met in this case before a section 316 intervention is justified. Ofcom fails to consider these issues. These are material omissions, given that Ofcom proposes to use its section 316 powers in a highly novel and interventionist manner, to interfere with Sky’s property rights in its licensed channels.

3.2 We set out in Part 3 the substantive test or trigger for the use of section 316 powers, before turning in Part 4 to the reasons why Ofcom has not established to the appropriate standard that the threshold for use of its sectoral competition powers is met.

#### ***Competition framework***

3.3 Ofcom is conducting an assessment of competition in pay TV, and accordingly that assessment should be conducted within a proper framework and in accordance with general competition law principles. It is therefore necessary to establish the relevant behaviour or conduct, (or the likelihood of future conduct), define the relevant market and assess the degree of market power (if any) that is held, and finally assess the impact of the identified conduct on the affected market(s). These are well-established steps in the process. As the OFT explains in its Guidelines on Market Definition:<sup>16</sup>

*“Market definition is not an end in itself but a key step in identifying the competitive constraints acting on a supplier of a given product or service. Market definition provides a framework for competition analysis. For example, market shares can be calculated only after the market has been defined and, when considering the potential for new entry, it is necessary to identify the market that might be entered. Market definition is usually the first step in the assessment of market power. Therefore, market definition is important in the process of establishing whether or not particular agreements or conduct fall within the scope of the competition rules...”*

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<sup>15</sup> See also paragraph 1.4 of this Section 3 above.

<sup>16</sup> Paragraphs 2.1-2.2 of OFT 403 ‘Market Definition’, December 2004.

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- 3.4 Given that Ofcom is investigating competition issues, there can be no good reason for departure from the generally applicable framework for competition analysis. The analysis should follow the same approach, irrespective of the exact legal powers that are used, or the remedy that is proposed.
- 3.5 In this case, for no discernible good reason, Ofcom has not conducted a proper competition analysis within a proper framework. Ofcom’s concerns “*relate to the manner in which market power in upstream content markets can be exploited in downstream markets*”.<sup>17</sup> Yet, Ofcom has not defined the relevant downstream market, nor has it assessed the impact of the conduct that gives rise to its concerns on the downstream market. Thus, there is no proper basis for Ofcom’s concerns about competition in the downstream market. We address this serious issue in more depth in **Section 4** below.

### **Substantive test**

- 3.6 Ofcom has not set out an explanation of what it understands by the concept of ‘fair and effective competition’ or of conduct that would be ‘prejudicial’ to such competition. One might have expected that it would do so, given that use of section 316 powers is relatively rare, and in this case, particularly contentious. Ofcom has, however, used its section 316 powers in the past, most recently in the context of the rules on cross-promotions, and in that case it did set out the test that it was applying.<sup>18</sup> We set out below an extract from Ofcom’s Statement on the review of the cross-promotion rules which explains how Ofcom applied the ‘fair and effective’ competition test in that context:

“5.32 *In order to assess the impact of cross-promotion on competition in the relevant product markets, it is necessary for Ofcom to set out the way in which it is proposing to apply the ‘fair and effective’ competition test in this context.*

5.33 ***The assessment of whether a course of conduct is likely to be prejudicial to fair and effective competition needs to be tempered by the notion of materiality. Competition involves rivalry between firms and actions taken by one firm will have an impact on other firms in the same market. A key issue in considering whether conduct might be prejudicial to fair and effective competition is whether the conduct is having, or might be expected to have, a material impact on the competitive process.***

5.34 *The fact that there are current rules on cross-promotion in operation means that it is difficult to point to specific evidence to support or reject an assessment about the potential anti-competitive effect of any particular course of behaviour. If the existing code has been successful, then it will have restricted certain types of behaviour. In order to deal with this problem, Ofcom considers that it would be appropriate to examine other*

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<sup>17</sup> Paragraph 1.31 of the Consultation Document.

<sup>18</sup> <http://www.ofcom.org.uk/consult/condocs/promotion/statement/statement.pdf>

*indicators in order to assess the extent to which firms might act in a way which could have a material impact on competition. The main indicators that Ofcom is proposing to consider are the incentives on broadcasters and the specific time window in relation to digital switchover, i.e. to abstract from the current situation and to consider what might happen in the absence of the current rules and how the behaviour of market participants might change.*

5.35 *If there is the potential for behaviour to have a material impact on competition, Ofcom considers that it should adopt a precautionary principle and put in place ex ante rules to prevent such behaviour from emerging. However, any such rules should be a proportionate response to the potential competition issue that has been identified.” (Emphasis added)*

- 3.7 The key paragraph, highlighted above, states that the assessment of whether a course of conduct is likely to be prejudicial to fair and effective competition needs to be “*tempered by the notion of materiality*”, with a key issue being whether the conduct is having or might be expected to have “*a material impact on the competitive process*”. Sky agrees that the ‘fair and effective competition’ test needs to be tempered by the notion of materiality.<sup>19</sup> This is, of course, consistent with case law under general competition law (which requires an “*appreciable*” restriction of competition). There is, moreover, no reason why Ofcom should apply a materiality threshold in relation to one type of conduct or in one market but not another.
- 3.8 We also note that Ofcom has defined the ‘fair and effective competition’ test as requiring a material impact on the “*competitive process*”. The use of the words “*the competitive process*” makes it clear beyond doubt that what Ofcom must consider is the impact of the conduct in question upon the process of competition, rather than the impact on particular competitors. Again, this is consistent with the requirements of general competition law.<sup>20</sup>
- 3.9 It would seem that establishing dominance or market power is not a legal prerequisite to the use of section 316. However, where dominance or market power is properly established (which Sky submits is not the case here) it is not enough simply to **assume** that this is giving rise or will give rise to a material impact on the competitive process that is sufficient to trigger intervention under section 316. It is necessary to demonstrate that the dominance or market power is giving rise (or is likely to give rise) to conduct which is having (or would be likely to have) such a material impact on the competitive process.

<sup>19</sup> There can be no suggestion that Ofcom considered that there is a requirement for a material impact only for ‘administrative priority’ reasons.

<sup>20</sup> See paragraph 1.4 of this Section 3 above.

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### Compulsory supply

- 3.10 The case in which Ofcom used the “*material impact on the competitive process*” test as set out above, involved the regulation by Ofcom of cross-promotions by the commercial PSBs. The case did not involve any form of compulsory supply or licensing of products or services; rather it involved *ex ante* rules around the content of such cross-promotions in the narrow area of references to digital television platforms and services.
- 3.11 Ofcom’s key concern in this case is that Sky is currently refusing to supply, or will in the future refuse to supply, its ‘Core’ Premium channels at prices that other retailers can afford. Contrary to Ofcom’s somewhat facile comment in the Consultation Document about a wholesale ‘must offer’ remedy being “*not very intrusive*”, because “*Sky has argued that it has no incentive not to supply its content more widely*”,<sup>21</sup> Ofcom is in fact proposing one of the most Draconian remedies available to a competition authority, namely compulsory supply (and this is the case even leaving to one side the ‘extended retail-minus’ approach). In order to justify compulsory supply, further conditions must be satisfied in addition to the test of “*conduct having a material impact on the competitive process*”.
- 3.12 It is well-known that compulsory supply obligations have a high potential to damage investment incentives, and it is accepted in EC law that use of such a remedy must be limited to the most exceptional cases. The requirements which must be satisfied under Article 82 EC Treaty, before a refusal to supply will constitute an abuse, are correspondingly onerous. In the leading case on refusals to supply, *IMS Health*, the European Court of Justice held:<sup>22</sup>

*“The refusal by an undertaking which holds a dominant position and owns an intellectual property right in a brick structure indispensable to the presentation of regional sales data on pharmaceutical products in a Member State to grant a licence to use that structure to another undertaking which also wishes to provide such data in the same Member State, constitutes an abuse of a dominant position within the meaning of Article 82 EC where the following conditions are fulfilled:*

- *the undertaking which requested the licence intends to offer, on the market for the supply of the data in question, new products or services not offered by the owner of the intellectual property right and for which there is a potential consumer demand;*
- *the refusal is not justified by objective considerations;*
- *the refusal is such as to reserve to the owner of the intellectual property right the market for the supply of data on sales of pharmaceutical*

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<sup>21</sup> Paragraph 1.4 of the Consultation Document.

<sup>22</sup> Paragraph 52 of *Case C-418/01 IMS Health GmbH & Co. OHG v NDC Health GmbH & Co. KG*, judgment of the ECJ, 29 April 2004.

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*products in the Member State concerned by eliminating all competition on that market.”*<sup>23</sup>

- 3.13 Given that there can be no good reasons for departing from well-established competition principles, the conditions that must be satisfied in order for compulsory supply to be justified by Ofcom in this case, are (i) there has been or is likely to be a refusal to supply; (ii) those requesting supply of Sky's channels intend to offer new products or services (or technical developments of such products services) not otherwise offered for which there is demand, (iii) there could be no objective justification for any refusal to supply, and (iv) any refusal to supply would result in the likelihood of elimination of effective competition on the downstream market.

### Standard of proof

- 3.14 The standard of proof is the civil standard of the balance of probabilities. In relation to existing conduct, Ofcom must be satisfied, based on clear evidence, that it is more likely than not to have a material effect on the competitive process. Where both the conduct in question and its impact on the market are speculative, Ofcom must establish, based on clear evidence, that the conduct in question is more likely than not to occur and if it does occur, it is more likely than not to have a material effect on the competitive process.
- 3.15 If the conduct in question relates to a potential refusal to supply, then Ofcom must be satisfied in particular that if such refusal does occur, it could not have an objective justification and it would be more likely than not to result in the elimination of competition in the downstream market.
- 3.16 Where conduct and its effects are hypothetical, it is all the more important that Ofcom has sufficient evidence that both the conduct and the effects are likely to occur.

## **4. Ofcom has not met the standard required for use of section 316**

### ***Material impact on the competitive process is not established***

- 4.1 We set out below in **Section 5** why Ofcom has not established to the required standard, based on the evidence, that Sky's actual or future conduct is having or might be expected to have a material impact on the competitive process, still less that Sky's actual or future conduct would meet the requirements for compulsory supply.
- 4.2 In relation to the first of Ofcom's concerns, namely the restricted supply of its premium channels, Sky has critically analysed the data and arguments put forward by Ofcom and shows in **Section 5** below that (i) Sky has no incentive to restrict the supply of its premium channels; and (ii) there is no evidence to suggest that Sky is acting on these alleged incentives.

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<sup>23</sup> The Court's judgment in *IMS Health* was considered and adopted in the Case T201/04 *Microsoft Corp. v Commission of the European Communities*, judgment of the Court of First Instance, 17 September 2007.

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- 4.3 In relation to evidence that Sky is acting on the alleged incentives, **Section 5** below shows that (i) there is no evidence that Sky is supplying channels to Virgin in a way that favours its own retail/platform business; (ii) Sky has not refused to supply its premium channels to retailers on new platforms; and (iii) Sky's preference for retailing is not evidence that Sky is restricting distribution of its premium channels.
- 4.4 Moreover, Ofcom has not demonstrated that Sky's alleged conduct would be more likely than not to result in a material impact on the competitive process. In order to assess whether or not Sky's premium sports and movies channels are necessary in order to compete in the market, it is first necessary to determine the scope of the downstream market in which retail competition is said to be weakened or materially impaired, which as we note above, Ofcom has not done. On the retail market that Sky considers relevant, namely one that is at least as wide as 'all TV',<sup>24</sup> competition is likely to be sufficiently robust that restricted availability of Sky's channels would be unlikely to have a material adverse impact on the competitive process. Even on a narrow market, it is not clear that restricted availability of Sky's premium channels would inhibit the competitive process.
- 4.5 Ofcom states that competition in pay TV is likely to be weakened by Sky's alleged restricted distribution of premium channels, and suggests that this lack of competition at the retail level is likely to give rise to, and has in fact given rise to, several adverse effects for consumers. Yet the importance of premium content to retail competition going forward has been exaggerated and Ofcom has not demonstrated any adverse effect on either the competitive process or consumers. In particular, Ofcom does not assess, as it should have done, whether Sky's premium sports and movies channels are necessary for a retailer to compete in the relevant market. It therefore fails to acknowledge that for the majority of consumers Sky's premium content is not important.
- 4.6 Finally, Ofcom has not met, and could not meet the requirements necessary for the imposition of compulsory supply obligations. Ofcom could not show that (i) there is an actual or likely refusal to supply; (ii) those requesting Sky's channels intend to offer new products or services, or enhancements, not offered by Sky for which there is demand; (iii) there could be no objective justification for any refusal to supply; and (iv) any refusal to supply would result in the elimination of effective competition on the downstream market. In relation to (iv), even if the relevant market were limited to retailing of pay TV, it is clear that if Sky failed to agree wholesale terms with any new retailer, competition would not be eliminated. For example, within this more narrowly defined market there would nevertheless be competition between Sky, Virgin Media, BT Vision, Tiscali TV, TUTV and Setanta.
- 4.7 In relation to Ofcom's second concern, namely the risk of Sky setting high wholesale prices for its premium channels, Ofcom falls even further short of the standard required to establish a valid competition concern meriting intervention. In fact, even Ofcom acknowledges - despite proposing to use a

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<sup>24</sup> See Sky's Response to the First Consultation Document, and **Sections 4** and **5** below.

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cost-plus approach to regulation of Sky's wholesale prices - that the evidence it has in relation to high wholesale prices is not clear-cut. Ofcom does not provide any framework against which the reasonableness of its profitability estimates can be judged, nor does it even attempt to show that setting high wholesale prices for premium channels might damage the competitive process. We discuss Ofcom's approach in **Section 6**.

### ***Major flaws in Ofcom's approach to assessment of its proposals***

- 4.8 As well as failing to establish to the required standard that Sky is actually engaging, or is more likely than not to engage in the alleged conduct, and that such conduct was having or might be expected to have a material impact on the competitive process, or that Sky's actual or future conduct would meet the requirements for compulsory supply, Ofcom's Consultation Document raises significant issues concerning Ofcom's approach to the assessment of proposals for new regulation.

### *Failure to conduct a proper impact assessment*

- 4.9 We noted above, in paragraph 2.9 of this Section 3, that Ofcom has a duty to carry out impact assessments under Section 7 CA03. As we also mentioned above, Ofcom's assessment of the costs and benefits of its regulatory proposals must be able to withstand "*profound and rigorous scrutiny*".<sup>25</sup> Ofcom's analysis of the need for, and potential costs and benefits of, such regulation in the Consultation Document is profoundly unsatisfactory, and falls short of this very high standard. We address this point in more detail in **Section 7** where we note that Ofcom's analysis of the benefits of the proposed regulation is meagre and it does not analyse at all the costs of such regulation. We therefore submit that Ofcom has failed in its duty to conduct a proper impact assessment as required by section 7 CA03 and the applicable case law.

### *Failure to have regard to relevant principles*

- 4.10 As outlined above, in paragraph 2.11 of this Section 3, Ofcom is also required to have regard to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed. Ofcom's failure to do so means that it has not properly performed its duty to further the interests of consumers, where appropriate by promoting competition.

### *Transparent*

- 4.11 The obligation to regulate *transparently* is not fulfilled by the issuing of unmethodical and deeply flawed consultation documents in a particular inquiry accompanied by the assertion that "*the analysis presented in the whole of this document represents an impact assessment*".<sup>26</sup> Instead, arguments for each

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<sup>25</sup> *Vodafone Ltd v Ofcom*, supra., note 8.

<sup>26</sup> Paragraph 2.9 of the Consultation Document.

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element of proposals for new regulation must be properly reasoned, with clear explanations and evaluation of:

- (a) how each element of the regulation proposed by Ofcom will reduce the detriment to consumers that Ofcom considers that it has identified; and
- (b) the costs associated with each of those elements.

4.12 The Competition Appeal Tribunal judgment in *Vodafone* also highlights a key element of transparency in the assessment by Ofcom of proposals for new regulation – a requirement that proposals for new regulation are sufficiently well-specified that consultees are able to comment on them properly, in order to inform Ofcom’s assessment as to their necessity and proportionality. This is not the case in relation to the Consultation Document.

### Consistent

4.13 Any regulation that Ofcom puts in place must satisfy the requirement of *consistency*, and must be capable of application in a non-discriminatory manner. We explain in **Section 7** below that if Ofcom proposes to regulate the supply of Sky’s sports and movie channels, it must also regulate the supply of the only other channel in the relevant wholesale markets that Ofcom has identified, i.e. Setanta Sports 1, as well as any other channels that Ofcom considers are sufficiently important to affect consumers’ choices of platform.<sup>27</sup> However, Ofcom’s chosen method of regulation is not capable of applying to Setanta, whether now, or in the future, for example, if Setanta won additional packages of Premier League rights, since Setanta does not hold an Ofcom broadcasting licence for the premium channel on which it shows Premier League football (Setanta Sports 1), and so Ofcom could not impose licence conditions or directions upon Setanta under section 316.

### Proportionate

4.14 The requirement that regulatory proposals are *proportionate* means that, even if the necessity threshold has been passed (which clearly it has not in this case), Ofcom should seek the most proportionate, least intrusive means of remedying the significant and persistent consumer detriments that Ofcom has identified – the option that results in the greatest benefit at the least cost. Such a proposition accords with common sense, the promotion of economic efficiency, and regulatory best-practice.<sup>28</sup>

4.15 The requirement to regulate in a proportionate manner leads to two further requirements in developing proposals for new regulation. First, it is necessary

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<sup>27</sup> Sky notes that on Ofcom’s own analysis certain of the public service channels would meet this criterion.

<sup>28</sup> To some extent, it is also reflected in Ofcom’s own guidance (‘Better Policy Making: Ofcom’s approach to impact assessment’, 21 July 2005) on how it intends to regulate, which states:

*“If intervention is justified, we aim to choose the least intrusive means of achieving our objectives, recognising the potential for regulation to reduce competition.”*

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to examine a range of realistic potential solutions to the consumer detriment that has been identified. Clearly, it would be impossible to identify the least intrusive means of remedying any detriments that have been identified if only a single regulatory option is examined. Equally clearly, it is necessary for the options that are examined to be realistic ones. Again, it is not possible to identify the least intrusive means of remedying any detriments that have been identified if one realistic option is compared only against obviously disproportionate options. Such a proposition accords with both common sense and regulatory best-practice. As stated in European Commission guidance on regulatory impact assessment:

*“You should certainly avoid the trap of considering only the three following options: the ‘Do Nothing’ Option, the Preferred Option, and the Ridiculous Option that nobody wants!”<sup>29</sup>*

- 4.16 Even assuming that Ofcom had established a case for intervention, which it has not, Ofcom has failed to examine a range of realistic scenarios and in particular has not looked at less prescriptive, less intrusive forms of ‘must offer’ obligation, as we explain in **Section 7** below.
- 4.17 Second, it is necessary to undertake a proper evaluation of the costs and benefits of each of the options, including the benchmark ‘do nothing’ option. Again, this is largely a matter of common sense: if the objective is to select the most effective option – that for which the ratio of benefits to costs is greatest – it is impossible to do so without evaluating the costs and benefits of each option under consideration. Again, as set out in **Section 7** below, Ofcom has not given proper consideration to the ‘do nothing’ option.
- 4.18 Where costs and benefits are prospective rather than existing, proper evaluation of the likelihood of them arising is necessary. The approach of claiming that regulatory intervention is necessary in order to avoid problems that have a very remote prospect of occurring has a long and undistinguished record in policy appraisal and Ofcom should not adopt this approach.

### Targeted/necessary

- 4.19 The requirement that proposals for regulation are *targeted only at cases in which action is necessary* means that Ofcom must establish that its regulatory proposals are:
- (a) aimed at remedying **significant and persistent consumer detriment**.<sup>30</sup>  
The requirement of transparency means that Ofcom must identify clearly and evaluate the extent of such detriment; and

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<sup>29</sup> Page 24 of ‘Impact Assessment Guidelines’, SEC(2005) 791, European Commission, June 2005. Available at: [http://ec.europa.eu/governance/impact/docs/SEC2005\\_791\\_IA%20guidelines\\_annexes.pdf](http://ec.europa.eu/governance/impact/docs/SEC2005_791_IA%20guidelines_annexes.pdf)

<sup>30</sup> CA03 refers to Ofcom’s duties in relation to the interests of citizens and consumers. It is clear that the focus of this inquiry is in relation to issues relating to consumers. Accordingly, we do not refer to citizens hereafter.

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- (b) be capable of remedying the identified consumer detriments cost-effectively. Clearly, it would be irrational to argue that it is *necessary* to engage in actions which, while remedying one problem, create other problems which result in consumers being made worse off overall.

4.20 In identifying significant and persistent consumer detriment, Ofcom must ensure that its analysis is based on realistic benchmarks. For example, in assessing existing detriment, it is commonplace in regulatory analysis that regulators should avoid measuring outcomes for consumers against those that would be delivered by a perfectly competitive market – one in which there are no fixed costs, no transaction costs and in which everyone has perfect information. For example, such a view was also put forward in a 2002 paper by the current Chairman of Ofcom, Lord Currie, and the then Professor Cubbin of City University:

*“Clever people in the DTI or in regulatory offices can readily identify any number of areas where it can plausibly be argued that the market is **not working ideally, especially if the benchmark ideal is the textbook version of perfect competition**. This can lead to any number of regulatory interventions. Each in themselves is well-intentioned and may work well in isolation. But overlaying too many interventions stifles the operation of the market and generates unforeseen interaction effects between the various interventions. The result can well be incoherence and stagnation. **What is needed instead is an appreciation that effective and robust competition is not perfect, but is better than any regulation-managed alternative.**”<sup>31</sup>*  
(Emphasis added)

4.21 Ofcom itself cites in the Consultation Document the advice of the (then) Better Regulation Task Force – which is included in Ofcom’s own guidance on impact assessments – that:

*“Sometimes the fact that a market is working imperfectly is used to justify taking action. But no market ever works perfectly, while the effects of...regulation and its unintended consequences, may be worse than the effects of the imperfect market”<sup>32</sup>*

4.22 The analysis of proposals for new regulation in the Consultation Document fails to meet Ofcom’s obligations and duties under the CA03. For the reasons set out in this Response, far from being able to withstand profound and rigorous scrutiny, Ofcom’s analysis fails to withstand even modest scrutiny.

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<sup>31</sup> David Currie and John Cubbin, ‘Regulatory Creep and Regulatory Withdrawal: Why Regulatory Withdrawal is Feasible and Necessary’, City University, March 2002. Available at: <http://www.staff.city.ac.uk/~sm340/Consulting&Policy/Regulatory%20Withdrawal%20Report%20020317.pdf>

<sup>32</sup> Paragraph 8.16 of the Consultation Document. This point was also made in Sky’s Response to the First Consultation Document.

**5. Limitations on section 316**

5.1 We have set out above why we believe that Ofcom cannot use section 316 to ‘promote’ competition, in particular through the use of extended retail-minus ‘must offer’ regulation in the manner proposed by Ofcom. Even if Ofcom were proposing to use its section 316 powers to ensure fair and effective competition in the provision of licensed services, it has not demonstrated that there is a material impact on the competitive process sufficient to engage section 316, let alone an elimination of effective competition downstream sufficient to justify the compulsory licensing of Sky’s channels.

**Section 317 CA03**

5.2 We now turn to consider the important limitations on section 316 which are contained in section 317. As we outline above, section 317(2) provides that before exercising any of its Broadcasting Act powers for a competition purpose, Ofcom “*must consider whether a more appropriate way of proceeding in relation to some or all of the matters in question would be under the Competition Act 1998 (c. 41)*”. If Ofcom decides that a more appropriate way of proceeding in relation to a competition matter would be under the CA98, “*they are not, to the extent of that decision, to exercise their Broadcasting Act powers in relation to that matter*”.<sup>33</sup>

5.3 A power is exercised by Ofcom for a competition purpose “*if the only or main reason for exercising it is to secure that the holder of a Broadcasting Act licence does not (a) enter into or maintain arrangements, or (b) engage in a practice, which Ofcom consider, or would consider, to be prejudicial to fair and effective competition in the provision of licensed services or of connected services*”.<sup>34</sup>

5.4 It is clear that the main reason for Ofcom exercising its section 316 power should be to secure that Sky does not enter into or maintain arrangements or engage in any practice which Ofcom considers prejudicial to fair and effective competition.<sup>35</sup>

5.5 The statutory duty under section 317 to consider whether a more appropriate way of proceeding would be under the CA98 is important in itself and sheds considerable light on the way that Ofcom may employ section 316. It is clear from the case law, both of the Administrative Court and the Court of Appeal (in relation to other statutory schemes),<sup>36</sup> and of the CAT (in relation to Ofcom’s powers),<sup>37</sup> that the section 317 duty is an absolute requirement to which Ofcom must do more than pay lip service. It must take it into account as an integral part of deciding what action is needed and how it can best be achieved. In

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<sup>33</sup> Section 317(3) CA03.

<sup>34</sup> Section 317(9) CA03.

<sup>35</sup> Paragraphs 8.54 to 8.63 of the Consultation Document.

<sup>36</sup> *R(E) v JFS* [2008] 1535/1536 (Admin), *R (BAPIO Action Limited) v Home Secretary* [2007] EWCA 1119, *Secretary of State for Defence v Elias* [2006] EWCA Civ 1293.

<sup>37</sup> *BT v Ofcom* (TRD) [2008] CAT12.

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particular, compliance with such a duty cannot be by way of “*a rearguard action following a concluded decision*” but must be treated as “*an essential preliminary to any such decision*”.<sup>38</sup>

- 5.6 In light of this case law it ought to be apparent from the Consultation Document that Ofcom has had full regard to the possibilities afforded by its CA98 powers and has found good reasons for rejecting those before deciding to use the section 316 powers: there has to be a good reason, arrived at after conscientious analysis, why the CA98 powers cannot be used before resort to the section 316 powers may be made. Similarly, the statutory objectives must be taken into account at the stage of formulating policy, and not merely by way of a limit on policy decisions already taken. Thus, it is not sufficient for Ofcom to reach a view as to what it wants to do with the sectoral powers and then find reasons as to why the CA98 powers are less suitable.
- 5.7 Accordingly we have considered whether Ofcom has carried out a sufficiently detailed analysis to determine whether or not there was (or was likely to be) an infringement of either of the CA98 prohibitions. This would require Ofcom first to undertake a proper market definition exercise and second, having done so, to identify any agreements or behaviour on the market that in its view prevents, restricts or distorts competition and to consider whether they could be addressed by taking action under CA98. That would require consideration of whether competition was being affected to an appreciable extent on the relevant market, either by agreements between firms, or by the conduct of a firm found to have a dominant position on that market or an upstream market.
- 5.8 As we outline above in the context of section 316, Ofcom has not conducted its analysis within a proper competition framework, notably because it has not defined the downstream markets in which the effects of the alleged actual or potential conduct are said to be felt. Accordingly, Ofcom’s analysis of the competition issues is inadequate for the purposes of section 316, and does not meet the required standard for the purposes of section 317.
- 5.9 It is illustrative to consider Ofcom’s actual analysis. In paragraphs 8.46 to 8.52 of the Consultation Document Ofcom assesses whether it should rely on the use of its *ex post* powers under the CA98. Ofcom commences with a summary of its concerns and then identifies three types of conduct that have previously been found to be an abuse of a dominant position. Ofcom notes that its concerns “*might therefore in principle be addressed to some extent by opening CA98 cases to investigate abuses if and when they are alleged to have occurred*”. It then goes on to state that it has:
- (a) **not** carried out a CA98 investigation to establish whether Sky has refused to supply its premium channels in the sense set out in CA98;
  - (b) **not** investigated whether the issues raised by Sky in negotiations for the supply of its premium channels are objectively justified; and

<sup>38</sup>

*R (BAPIO Action Limited) v Home Secretary*, supra, at 1139, per Sedley LJ.

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- (c) **not** investigated whether the issues raised by Sky in the context of these negotiations might be regarded as a constructive refusal to supply.

- 5.10 This can hardly be described as the type of conscientious analysis that is required by section 317. In effect, Ofcom has admitted that it has carried out no analysis.<sup>39</sup>
- 5.11 Ofcom next states its belief that it would be more appropriate to use its sectoral powers under section 316 to address its concerns, referring to its section 3(1)(b) duty and the alleged connection to its section 316 powers, stating that its sectoral powers “*are better suited to dealing with a concern that competition will not develop in a manner that best serves consumers*”. As we have stated above, it is not open to Ofcom to invoke section 316 to promote future competition in the manner proposed, and this is not therefore an appropriate reason why it is not more appropriate to use CA98 powers. In addition, the order in which Ofcom addresses these issues gives the strong impression that Ofcom has first reached a view as to what it wants to do with the sectoral powers, and then found a few cursory reasons as to why the CA98 powers should be discarded as a less suitable alternative.
- 5.12 In paragraph 8.51 of the Consultation Document, Ofcom goes on to set out the reasons why it does not believe that relying on its CA98 powers would be an appropriate response to its competition concern. First, Ofcom states that it “*would still see a competition problem even absent a finding of anti-competitive behaviour*”. The stated reason for this is that Sky’s alleged lack of incentives to supply its channels may be caused by differences in efficiency between Sky and other retailers, and if that were the case, “*an abuse might well not have taken place, but the negative impact on competition and consumers that we have identified would still exist*”. This shows just how confused Ofcom has become. Section 316 targets conduct that is or would be prejudicial to fair and effective competition. In a situation where there is no expected abuse under general competition law, it is extremely difficult to see how there could be conduct that is or would be prejudicial to fair and effective competition. Ofcom comes nowhere near overcoming the very high hurdle necessary to show that this is such a case.<sup>40</sup> Moreover, as we note above, the outcome that Ofcom seeks via section 316 is not one that would exist in a competitive market.
- 5.13 In a situation where even an outright refusal to supply the channels in question would not be problematic under general competition law (by reference to *Microsoft*, *IMS Health* and previous cases), the existence of an (unproven) lack of

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<sup>39</sup> If Ofcom did carry out this analysis, Sky submits that it would not be able to establish any refusal to supply, actual or constructive, as Sky has not in fact refused to supply its channels.

<sup>40</sup> See paragraph 4.20 of the Joint DTI/Treasury report entitled ‘Concurrent Competition Powers in Sectoral Regulation’:

*“The argument that competition law sets a high hurdle for intervention is not a convincing argument for using sector-specific regulation as an alternative. If regulators believe that they cannot use their competition powers to remedy perceived problems within a competitive market, then it is questionable whether it is appropriate to use sector-specific regulatory instruments in that market instead.”* (Emphasis added)

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incentive to supply, and (unsubstantiated) differential efficiency levels cannot be described as a “*competition problem*” meriting intervention under section 316. Further, Ofcom’s reference to the negative impact on consumers reveals Ofcom’s desire that all consumers should receive the same channels. There is simply no basis for the assumption that unless all consumers receive the same channels, there is a “*competition problem*”.

5.14 Ofcom also states as a reason for not relying on its CA98 powers that “*there is ....a material risk that it may not be possible to remedy a refusal to supply under CA98 through an obligation on Sky to enter into a wholesale arrangement*”. This again reveals that Ofcom has first reached a view as to what it wishes to do with the sectoral powers (i.e. require Sky to wholesale) and then subsequently looked for reasons why action under the CA98 powers is not appropriate. Clearly it would be possible to remedy an actual refusal to supply under general competition law powers. The fact that Ofcom considers that it may not be able to achieve its desired remedy of a positive obligation to wholesale on particular terms is not a permissible reason why use of its CA98 powers would be less appropriate.

5.15 Ofcom goes on to state:

*“if we saw fit to determine a wholesale price designed to facilitate entry, that price would be based on different cost data from a test of whether Sky was applying a CA98 margin squeeze. **Specifically a remedy intended to promote competition** might seek to reflect the lack of scale economies of a new entrant.”*<sup>41</sup> (Emphasis added)

As we have stated numerous times above, section 316 may not be invoked to promote competition in this way. Ofcom cannot rely on an improper use of section 316, namely a remedy intended to ‘promote’ competition by imposing an extended retail-minus wholesale ‘must offer’ obligation, as a good reason why it is not more appropriate to proceed under CA98 powers. This is particularly the case given that Ofcom has not in fact established that new entrants cannot afford Sky’s wholesale prices and hence has not established that such an approach would even be necessary to ensure the entry of new retailers.

5.16 It is implicit in Ofcom’s Consultation Document that Ofcom does not believe that Sky is applying a margin squeeze. There is no discussion of a margin squeeze and no suggestion that there is any evidence that Sky is supplying its channels at a price that would not allow its downstream retail arm to make a reasonable return based on its own historic costs. We have already noted above that Ofcom’s assessment should be conducted in accordance with competition law principles.<sup>42</sup> The same competition principles should underlie the exercise of power under section 316 as under the CA98. The fact that Sky is not infringing an established CA98 margin squeeze test cannot be a good reason for determining that CA98 powers are less appropriate than sectoral powers

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<sup>41</sup> Paragraph 8.51 of the Consultation Document.

<sup>42</sup> Paragraph 3.2 of the Consultation Document.

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because the latter would allegedly allow for a different approach to calculating the margin. Departure from established competition law procedures cannot be a good basis for preferring to use section 316.

- 5.17 Ofcom’s approach to the use of its sectoral powers versus its CA98 powers reveals a fundamental misunderstanding on the part of Ofcom about its sectoral powers. Unlike the CA98, section 316 clearly can be used prospectively to prevent particular conduct occurring. Ofcom does not have to wait for the conduct which it believes would damage competition to arise. But this is not to say that section 316 can be invoked *ex ante* to resolve a likely harm to competition that would not be an infringement if considered *ex post* under the CA98. If something would not be a “*competition problem*” when considered *ex post* under CA98, then section 316 cannot ride to the rescue to allow Ofcom to deal with it on an *ex ante* basis.<sup>43</sup>
- 5.18 In the third of its specific reasons for explaining Ofcom’s belief that relying on CA98 powers would not be an appropriate response to its competition concerns, Ofcom states that:

*“Even if anti-competitive behaviour were taking place, under a CA98 process it might take a considerable amount of time for this to become apparent”.*<sup>44</sup>

Ofcom goes on to say that if it were to:

*“carry out an external analysis of Sky’s conduct, it would be exceptionally difficult to determine whether a failure to reach an agreement on supply was attributable to (a) the difficulty of reaching agreement on these complex commercial issues (b) an inability to agree a price satisfactory to both parties or (c) an incentive to restrict supply in order to distort competition”.*

Ofcom claims in terms that it is likely that “*a substantial period of time may have to be passed before Ofcom could be satisfied that any failure to reach agreement is attributable to the difficulty of reaching agreement rather than an incentive not to supply*”. This would appear to undermine entirely the basis for Ofcom’s *current* belief in the Consultation Document that Sky has an incentive not to supply.

- 5.19 Section 317(2) requires that Ofcom must consider whether a more appropriate way of proceeding in relation to “**some or all of the matters in question**” would be under the CA98. Ofcom’s consideration of the use of its *ex post* powers relates entirely to the first of Ofcom’s identified concerns, namely concerns about restricted distribution of Sky’s premium channels in a way that favours Sky’s own platform and retail business. There is no consideration of whether it would be more appropriate to use CA98 powers to address the second of Ofcom’s concerns, about high wholesale prices that may have the effect of

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<sup>43</sup> Ofcom must perform its duties using the available powers, not seek to extend those powers by reference to its duties.

<sup>44</sup> Paragraph 8.51 of the Consultation Document.

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keeping retail prices high.<sup>45</sup> In Section 9 of the Consultation Document Ofcom appears to be unclear about whether its remedy is designed to deal with only its first concern, or also its second. Ofcom states that if its only concern is that Sky may price in a discriminatory manner then a retail-minus approach may be appropriate, but if it is also concerned about high wholesale prices now or in the future, it may be appropriate to consider drawing on a cost-based approach.<sup>46</sup>

5.20 As we note in **Section 6** below, Ofcom has not even reached a conclusion that Sky earns excess profits in its notional premium channel business, and therefore there is no justification for Ofcom to seek to impose a remedy to a problem that it has not established exists.

5.21 In any event, it is clear that Ofcom is not permitted to invoke a remedy under section 316 in relation to the second of its concerns, since it has not considered at all whether it would be more appropriate to proceed under its CA98 powers in relation to this particular matter. If Ofcom had reached a valid conclusion, based on conscientious analysis, that Sky is earning excess profits (which it could not), and then conducted an appropriate consideration of which powers it should use to resolve its concern, as required under section 317, then it would find no valid reason why its CA98 powers were a less appropriate way of proceeding.

### ***Use of Enterprise Act powers***

5.22 In application of normal public law principles, it is also incumbent on Ofcom to consider, before recourse to the general section 316 powers, whether an Enterprise Act 2002 (“**EA02**”) reference to the Competition Commission is a more appropriate way of proceeding. A public body should consider all the powers at its disposal when deciding what action to take, and make the most appropriate choice. To this extent, section 317 can be seen as a specific statutory reminder, albeit placing especial emphasis on the CA98 powers.

5.23 Ofcom expressly states that its current view is that a structural remedy meriting a reference to the Competition Commission “*would not be a proportionate means of addressing our competition concerns, and it would not therefore be appropriate to make a reference for this purpose*”.<sup>47</sup> Although Ofcom is ostensibly consulting on this current view, it is very difficult to see what evidence could be provided in response to the Consultation Document that would indicate that a structural remedy would be proportionate. It is clear that, even if Ofcom’s concerns were properly founded, structural separation of Sky would be wholly disproportionate, and, as Ofcom notes, would fail to take into consideration the fact that Sky’s success is based on a historic willingness to invest and the need to ensure that investment is not deterred in future.

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<sup>45</sup> We respond to Ofcom’s concerns about excessive wholesale prices in **Section 6**.

<sup>46</sup> Paragraph 9.3 of the Consultation Document. It is extraordinary that Ofcom feels able to propose a remedy without having finally determined what problem(s) that remedy is supposed to resolve, and that it admits this in the Consultation Document.

<sup>47</sup> Paragraph 8.67 of the Consultation Document.

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5.24 Ofcom also concludes that an intervention into the way rights are sold, via an EA02 reference, would not be appropriate, as such an intervention would involve “*draconian restrictions on the aggregation of content, which are likely to have adverse consequences for consumers*”. Again, it is very difficult to see what evidence could be provided in response to the Consultation Document that could result in this remedy being viewed as proportionate to the concerns identified, even if they were valid.

5.25 Ofcom states:

*“Given we believe that the most appropriate way forward is to consult on imposing a wholesale must-offer obligation on Sky, and given that we believe we can achieve this using our sectoral powers, it is not currently appropriate for us to make a Competition Commission reference for this purpose”.*

If Ofcom decides to proceed with the wholesale ‘must offer’ obligation but is then unable to achieve a workable remedy under section 316 (and we refer to the considerable practical difficulties below in **Section 7**), then there is no reason to believe that the Competition Commission would be able to achieve a workable remedy under the EA02. Given that Ofcom may not make a reference unless it is satisfied that there is a “*reasonable chance that appropriate remedies will be available*”,<sup>48</sup> it is difficult to see how Ofcom could consider it appropriate to make an EA02 reference in the case where it had itself been unable to achieve a workable ‘must offer’ obligation.

5.26 In addition, given that Ofcom will, generally speaking, deal with single firm conduct under either CA98 or sectoral powers, and that “[i]t is not the present intention of [Ofcom] to make market references based on the conduct of a single firm, whether dominant or not, where there are no other features of a market that adversely affect competition”,<sup>49</sup> it is difficult to see how Ofcom could make a market investigation reference purely on the basis that Sky has alleged incentives not to supply its channels and is acting on such incentives. This is alleged single firm conduct of the narrowest type that should not be the subject of a reference under a regime designed to deal with market-wide features.

## 6. Conclusion

6.1 Ofcom’s sectoral powers in section 316 are not designed for the introduction of far-reaching structural measures which it is hoped will inject additional competition into a market, but for the protection of the competitive process by preventing operators from engaging in anti-competitive agreements or practices. Ofcom’s proposed use of section 316 to introduce price regulation of the supply of Sky’s channels in order to subsidise new entry, is not permissible.

6.2 Ofcom’s analysis has seemingly been driven by its desired policy outcome, to regulate the provision of Sky’s sports and movie channels and reduce Sky’s

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<sup>48</sup> OFT 511, paragraph 2.1.

<sup>49</sup> OFT 511, paragraph 2.7.

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wholesale prices, rather than being conducted according to well-established competition principles.

- 6.3 Ofcom should have properly considered the most appropriate way of proceeding, as required by the legislation. Rather than ‘preferring’ its sectoral powers to address the alleged “competition problems”, Ofcom should have taken a step back and asked itself whether the fact that the CA98 is not engaged as a result of any anticipated behaviour on the part of Sky indicates that there is, in fact, no competition problem requiring a remedy.

## SECTION 4: OFCOM'S MARKET DEFINITION AND MARKET POWER ANALYSIS IS DEFECTIVE

### 1. Introduction

- 1.1 In **Section 3**, we argue that, in order to use section 316 CA03 to impose new regulation on Sky, Ofcom must first demonstrate, in a manner consistent with standard analysis under competition law, that the behaviour which is of concern to Ofcom is having, or is likely to have, a material adverse effect on the competitive process. Where the regulation in question involves compulsory supply additional conditions must be met, including that, in the absence of supply, effective competition in the downstream market would be likely to be eliminated.
- 1.2 Market definition, and to a lesser extent, the assessment of market power, is central to demonstrating such effects. It is central because, in order properly to assess the extent to which the alleged behaviour affects 'the competitive process' it is necessary to understand the boundaries of the relevant market in which the relevant 'competitive process' might be considered to be affected. Firms operating in a broad market (or providing inputs used by firms which operate in a broad market) which contains other firms of significant size and economic strength are unlikely to be able unilaterally to adversely affect 'the competitive process' in that market.

### 2. Ofcom has failed to define the relevant downstream market

- 2.1 In this case, the most relevant of Ofcom's "*concerns*" – those at which its proposed compulsory licensing regulation appear to be targeted – relate to the potential effects of Sky's conduct on competition among retailers of pay TV services. In other words, Ofcom's concern is about the effect of the alleged behaviour (or potential future behaviour) on competition **at the retail level**.
- 2.2 The following statements in the Consultation Document make this clear:

*"The effect of [Sky's behaviour or potential behaviour] would be to distort **retail competition** for the provision of pay TV services"*<sup>1</sup>

*"The limited **retail competition** that we see in pay TV as a result of limited distribution of premium content is likely to manifest itself in terms of reduced choice, reduced retail innovation, reduced platform innovation or higher prices"*<sup>2</sup>

*"We believe that this remedy would allow for the strengthening of **competition between retailers** and between platforms."*<sup>3</sup>

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<sup>1</sup> Paragraph 1.28 of the Consultation Document.

<sup>2</sup> Paragraph 1.4 of the Consultation Document.

<sup>3</sup> Paragraph 1.43 of the Consultation Document.

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*“Section 6 above reaches views on concerns over the incentive and ability for Sky’s actions to restrict **competition in pay TV retail markets** through its approach to the wholesale of Core Premium Sports and Movies channels.”<sup>4</sup> (Emphasis added in each case)*

- 2.3 Yet, rather than seek to define the market(s) relevant to the retailing of pay TV services, and consider the extent of competition within that market (or those markets), Ofcom’s assessment of market definition and market power in the Consultation Document is entirely focused on the wholesale (channel supply) level. Ofcom even goes so far as to state in relation to market definition and market power:

*“Our focus [in relation to market definition and market power] is on wholesale markets. **It is not necessary formally to define the downstream markets.**”<sup>5</sup> (Emphasis added)*

This is an extremely important error.

- 2.4 The appraisal of the relevant market must relate to the market which is considered to be affected by the behaviour about which Ofcom has expressed concern. Given that, as demonstrated above, Ofcom’s concerns relate to the retail level, Ofcom’s erroneous assertion that it is not necessary for it to define “*the downstream markets*” is a fundamental flaw in the Consultation Document.

### **3. The consequences of Ofcom’s failure to define the relevant downstream market**

- 3.1 The consequences of Ofcom’s erroneous belief that it is not necessary for it to define the relevant downstream markets are profound, and a significant number of the analytical errors in Ofcom’s Consultation Document stem from this error.
- 3.2 Ofcom’s failure properly to consider the relevant downstream market has led it, implicitly, to consider downstream issues as though the relevant market were the retail supply of pay TV services, where the only competition faced by pay TV retailers comes from other pay TV retailers. It is the fundamentally flawed framework of a “*hermetically sealed bubble*”<sup>6</sup> of intra-pay TV competition proposed by the Complainants in their Complaint to Ofcom<sup>7</sup>.
- 3.3 When the issues of ‘concern’ to Ofcom are instead assessed within the appropriate context of a relevant market that includes, at least, free to air television services, there can be no basis for Ofcom’s “*concerns*”. This is for the straightforward reason that competition among existing pay TV retailers **and** providers of free to air television services is a key factor that drives observed

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<sup>4</sup> Paragraph 8.61 of the Consultation Document.

<sup>5</sup> Paragraph 4.36 of the Consultation Document.

<sup>6</sup> See paragraph 2.1 of Sky’s Response to the Complaint.

<sup>7</sup> ‘Submission to Ofcom on the need for a market investigation into the pay TV industry’, by British Telecommunications plc, Setanta Sport Holdings Limited, Top Up TV Europe Limited and Virgin Media Limited (the “**Complainants**”), 3 July 2007 (the “**Complaint**”).

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market outcomes – including pay TV retailers’ and platform operators’ continued striving to improve services to customers and to price keenly. As a result, Ofcom’s arguments as to the need for intrusive new regulation in order to address its concerns are fatally undermined.

- 3.4 Ofcom’s error in failing to examine competition in the relevant downstream market has also led it to have no regard at all to significant elements of Sky’s Response to the First Consultation Document,<sup>8</sup> and significant amounts of documentary evidence provided by Sky in response to requests from Ofcom which indicate the profound importance of competition from free to air television services for Sky’s business **at the retail level**.
- 3.5 Similarly, it is in this context that the findings of the Competition Commission in its inquiry into Sky’s purchase of a stake in ITV are relevant to Ofcom’s current inquiry. As Ofcom is aware, the Competition Commission concluded that Sky holding a 17.9% stake in ITV was sufficient to result in a significant lessening of competition in the relevant downstream market, and that the reduction of competition warranted forcing Sky to divest a substantial portion of its stake.<sup>9</sup> This is not, as Ofcom appears to believe, an arcane matter of approaches to market definition in merger inquiries as compared to other types of competition inquiries; the Competition Commission’s decision was based on the examination of substantial amounts of relevant evidence – including substantial submissions from ITV about the strength of dynamic competition between free to air and pay TV services – and has a direct read-across to the issue of the relevant retail market in Ofcom’s current inquiry.
- 3.6 The importance of properly considering the relevant downstream market is demonstrated by the fact that many of the issues considered by Ofcom are issues related to competition at the downstream level. For example, at paragraph 7.105 of the Consultation Document, Ofcom notes that consumers increasingly subscribe to packages that include television and other services such as broadband and telephony, and Ofcom states that it sees “*risks to the strength of competition between triple play operators if distribution of premium content remains limited*”<sup>10</sup> – both of which clearly raise issues related to the scope of relevant downstream markets, and the extent of competition (both current and prospective) within such markets.
- 3.7 If Ofcom chooses to pursue its proposals to impose new regulation on Sky, Ofcom’s failure to define the relevant retail market can only be rectified by a further consultation in which the retail market is properly defined, and the effects of the alleged conduct on that market properly established. It is not open to Ofcom to issue a consultation on the “*detail*” of proposed new

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<sup>8</sup> For example, Ofcom has taken little account of the arguments and evidence set out by Sky in Annex 2 to Sky’s Response to the First Consultation Document in relation to market definition at the retail level.

<sup>9</sup> [http://www.competition-commission.org.uk/rep\\_pub/reports/2007/fulltext/535.pdf](http://www.competition-commission.org.uk/rep_pub/reports/2007/fulltext/535.pdf)

<sup>10</sup> Paragraph 7.106 of the Consultation Document. Sky notes that there is no evidence or analysis underpinning this statement.

compulsory licensing regulation without a proper analysis of the retail market on which Sky and other interested third parties may comment.

#### **4. Sky's view on the relevant downstream market**

4.1 Sky set out its views on the relevant downstream market in its response to Ofcom's First Consultation Document. Sky argued that:

*“the relevant evidence points to a view that the relevant downstream market is broad – encompassing both free to air 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).”<sup>11</sup>*

4.2 We defined this market as a retail market for the supply of audiovisual services to consumers.<sup>12</sup> We remain of the view that this is the market relevant to the issues which Ofcom is considering in its current inquiry – particularly the necessity and proportionality of introducing highly interventionist new regulation in order to support the development of new pay TV retailers.

#### **5. The results of an independent econometric study on the impact of DTT availability on subscriptions to Sky's pay TV services**

5.1 In addition to the evidence provided by Sky as part of its response to the First Consultation Document, Sky submits at **Annex 5** to this Response a new independent report and technical description of an econometric study undertaken by Professors Paul Seabright, Thierry Magnac, and Bruno Jullien of the Toulouse School of Economics. This study examines the impact of the availability of DTT broadcasting, which in the UK is used predominantly for free to air television channels, on demand for Sky's pay TV services. The fact that the availability of DTT broadcasts varies across the UK for technical reasons, while availability of Sky's pay TV services (to all intents and purposes) does not, enables the extent of the impact of the availability of one type of free to air television service on demand for Sky's pay TV services to be measured.

5.2 The study addresses a similar question to Sky's unpublished paper *“Regression analysis of effect of DTT on Sky subscriptions”* (previously provided to both the Competition Commission and Ofcom) but goes considerably beyond Sky's earlier work, including: analysing more recent data from 2008, adopting significantly more sophisticated econometric techniques, and undertaking a rigorous series of checks of the robustness of the analysis and results. The study corroborates the strong negative relationship between the availability of DTT services and Sky subscriptions estimated in Sky's study and verifies its robustness to a number of statistical concerns.

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<sup>11</sup> Paragraph 3.26 of Annex 2 to Sky's Response to the First Consultation Document.

<sup>12</sup> Paragraph 3.94, *ibid.*

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- 5.3 Professor Seabright *et al.*'s study confirms that the retail-level constraint from the availability of DTT services on the provision of basic and premium pay TV packages is significant in both a statistical and economic sense. In particular, Professor Seabright *et al.* show that the extent of constraint on the take-up of Sky's services from the availability of DTT services is as great as the constraint from the availability of cable services in respect of premium subscriptions<sup>13</sup> and in fact substantially greater in the case of basic subscriptions. Since Ofcom "*observed*", in its "*initial analysis of market definitions and market power*" in the First Consultation Document,<sup>14</sup> that cable pay TV services and Sky's DTH satellite pay TV services should be regarded as being provided in the same relevant market,<sup>15</sup> the results of Professor Seabright *et al.*'s study have profound implications for Ofcom's consideration of market definition at the retail level. This is all the more so given that Professor Seabright *et al.*'s estimates of the strength of constraints on Sky's pay TV services from free to air DTT services are likely to underestimate the strength of constraints imposed by all free to air TV services (including those delivered via analogue terrestrial and DTH satellite).
- 5.4 In order to ensure that this study was prepared with the same degree of independence and integrity as an expert would prepare a report in connection with litigation proceedings, Sky's external legal advisers have engaged Professor Seabright *et al.* under the terms of the Civil Procedure Rules ("**CPR**") and the protocol for instruction of experts, which provide for a duty of independence and an overriding duty to the court, above any obligation to those who have instructed them.<sup>16</sup> Considerable weight should be attached, therefore, to this significant and independent evidence.
- 6. Ofcom's assessment of market definition and market power at the wholesale level**
- 6.1 We discuss Ofcom's approach to market definition and market power at the wholesale level at **Annex 6**. We do not comment in detail on Ofcom's analysis as it is, in Sky's view, evident that Ofcom has not approached these issues with an open mind. Ofcom's analysis and use of evidence, instead, appears to comprise an effort to support a pre-determined conclusion. As a result, Ofcom asserts market definitions that are predictably narrow – focused on the

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<sup>13</sup> Subdividing premium subscriptions into subscriptions to different package types shows DTT availability to have a slightly weaker impact than cable availability on 'Top Tier' (namely premium sports plus premium movies) pay subscriptions, though still of a broadly comparable magnitude. Moreover, since the study measures only the direct impact of DTT availability on the demand for each of premium sports-only, premium movies-only and Top Tier subscriptions separately, it does not consider any indirect substitution that may exist due to the fact that premium sports-only and premium movies-only packages may be substitutes for Top Tier packages.

<sup>14</sup> Section 5 and Annex 13 to the First Consultation Document.

<sup>15</sup> See paragraph 6.21 of Annex 13 to the First Consultation Document.

<sup>16</sup> See, in particular, Rule 35.3 of the CPR and paragraphs 4.1 and 4.3 of the Civil Justice Council's Protocol for the Instruction of Experts to give evidence in civil claims. Professor Seabright was previously separately engaged by Sky as an independent expert under the same rules and protocol in the High Court proceedings brought by Virgin Media, which recently settled prior to finalisation and exchange of expert reports.

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products that Sky supplies at the wholesale level – and finds that Sky has market power in those narrow markets. Sky considers that Ofcom’s analysis of these matters is fundamentally flawed and does not support the conclusions reached by Ofcom.

## SECTION 5: OFCOM'S ALLEGATIONS REGARDING RESTRICTION OF SUPPLY OF SKY PREMIUM CHANNELS ARE UNFOUNDED

### 1. Introduction

- 1.1 In Section 6 of the Consultation Document Ofcom identifies two types of conduct (which Ofcom describes as “*competition concerns*”) that it considers might potentially arise from alleged market power held by Sky:
  - (a) the restriction by Sky of the distribution of its premium channels; and
  - (b) setting “*high*” wholesale charges for those channels.
- 1.2 As set out in **Section 3** above, in order to use its section 316 powers, Ofcom must show that Sky is: (i) actively engaging in this alleged conduct (or the alleged conduct is more likely than not to occur); and, (ii) that the alleged conduct is more likely than not to result in a material impact to the competitive process. Where compulsory supply obligations are proposed, additional conditions must be met.
- 1.3 Ofcom has not, however, structured its analysis around this, or any other, set of criteria. Hence, there is no simple mapping between the key criteria which Ofcom would need to satisfy and the sections in the Consultation Document. Sky has, nevertheless, sought to identify the parts of the Consultation Document that are most relevant and then examine whether the evidence contained within them is sufficient for Ofcom to meet the conditions necessary to apply section 316 in the manner proposed in the Consultation Document.
- 1.4 This Section 5 focuses on the first of these alleged competition concerns. Ofcom’s second concern relating to high wholesale prices is addressed in **Section 6** below.
- 1.5 In Part 2 of this Section 5 Sky critically analyses the data and arguments put forward by Ofcom and shows that Ofcom has not satisfied the first criterion. Sky is not, in fact, restricting the supply of its premium channels and there is no evidence to suggest that it has an incentive to do so. There are therefore no grounds upon which Ofcom could properly find that Sky is more likely than not to restrict the supply of its premium channels in the future.
- 1.6 With respect to the second criterion (i.e. whether conduct is more likely than not to result in a material impact on the competitive process) both Section 3 and Section 7 of the Consultation Document seem relevant. In Section 3 Ofcom purports to demonstrate that Sky’s premium channels are “*important*”. Then in Section 7 Ofcom claims that Sky’s alleged conduct has given rise to a number of “*effects on consumers*” thus allegedly further demonstrating that competition is weak. In Part 3 of this Section 5 we analyse the data and arguments presented by Ofcom in Sections 3 and 7 and show that Ofcom has not demonstrated that the alleged conduct would be more likely than not to result in a material impact on the competitive process.

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1.7 In Part 4 of this Section 5 we consider whether the arguments presented by Ofcom are sufficient to meet the additional conditions that must be satisfied in order for compulsory licensing to be justified.

### 2. **Alleged conduct**

2.1 Ofcom alleges that Sky has an incentive to distort downstream competition by favouring its own platform and retail businesses. It further alleges that there is evidence that Sky is acting on this incentive. Each of these allegations is considered in detail in the sections below.

#### 2(a) ***Sky has no incentive to restrict supply of its premium channels***

2.2 Sky's preferred strategy is to maximise revenue from its premium channels by distributing them across all secure platforms. The economics of channel production mean that a significant proportion of costs (especially in the case of Sky Sports) are fixed. Wide distribution can substantially increase both subscription revenues and advertising revenues. Sky believes that making its content available across a variety of platforms increases demand because there is a significant number of consumers who have strong preferences as to which platform they use, or are restricted as to which platforms are available to them. Therefore there are clear incentives to reach as many consumers as possible, subject to receiving a reasonable commercial rate.

2.3 Despite this, Ofcom states that it believes that Sky has "*the incentive to restrict the supply*" of its premium channels<sup>1</sup> and says that its "*primary competition concern is a lack of incentive for Sky to wholesale [premium channels]*".<sup>2</sup>

2.4 Ofcom's conclusion appears to rely almost entirely on its analysis of Sky's incentives to (continue to) supply its premium channels to Virgin Media. Ofcom's principal approach to this issue is via the construction of a hypothetical model of how withdrawal of supply of those channels from Virgin Media would affect Sky's profitability. Based on this hypothetical model Ofcom concludes that a decision by Sky to withdraw supply of its premium channels from Virgin Media would be substantially loss-making at first but would pay back over seven or eight years,<sup>3</sup> and that this means that Sky has an incentive to withdraw its premium channels from Virgin Media.

2.5 Sky is astonished at Ofcom's analysis of this issue. Both the extent of the focus on supply of channels to Virgin Media and the complete failure to have regard to real-world facts are perverse, and the conclusions that Ofcom draws are misguided.

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<sup>1</sup> Paragraph 1.29 of the Consultation Document.

<sup>2</sup> Paragraph 8.68 of the Consultation Document.

<sup>3</sup> Paragraph 3.57 of Annex 8 to the Consultation Document.

Ofcom's conclusion on Sky's incentives to supply Virgin Media is incorrect

## 2.6 Ofcom's analysis fails to have regard to five real-world facts:

- (a) Sky has supplied its premium channels to cable operators since those channels' creation, prior to any regulatory obligation to do so. If Sky really had the incentive and ability to withdraw its premium channels from cable operators, it might reasonably be expected that it would have done so at some point in the past twenty years;
- (b) the existing regulatory framework is a relevant factor in considering Sky's incentives. The effect of past competition inquiries into Sky's business is that Sky already operates under a *de facto* 'must supply' requirement in relation to cable. These inquiries have found Sky to be dominant in the supply of premium sports and film channels - a conclusion that Ofcom also draws - and competition case law establishes that it may be an abuse of a dominant position to withdraw supply of an input to a downstream rival's business without objective justification. Accordingly, were Sky to withdraw its premium channels from Virgin Media without objective justification, there is little doubt that it would face a significant risk of a CA98 investigation with the consequent risk of statutory fines - up to 10% of Sky's relevant turnover - and claims for damages. Indeed, Sky was forced to defend a competition law-based claim from Virgin Media when it could not agree terms for carriage of Sky's *basic* channels. Regardless of Sky's views of the merits of arguments about its dominance in narrowly defined pay TV markets, it is simply not able to ignore the significant real-world risk of incurring substantial costs, for no gain were it to attempt to withdraw its premium channels from Virgin Media. Indeed the ECJ has confirmed that, in considering the likelihood of conduct (particularly in the context of non-horizontal merger analysis), it is essential to assess comprehensively the likelihood of its adoption, the incentives to adopt such conduct and the factors liable to reduce, or even eliminate, those incentives, including the possibility that the conduct is unlawful.<sup>4</sup> Failure by Ofcom to have any regard at all to this consideration is a very material flaw in its analysis of Sky's incentives;
- (c) in the real world, it is abundantly clear that a policy of withdrawing supply of Sky's premium channels from Virgin Media would result in an immediate and very significant commercial loss and could also result in significant adverse publicity. Overnight, Sky would lose **[CONFIDENTIAL]**

<sup>4</sup> See paragraph 74 of Case C-12/03 P *Commission v Tetra Laval*, judgment of 15 February. See also paragraph 46 of the European Commission's Guidelines on the assessment of non-horizontal mergers under Council Regulation on the control of concentrations between undertakings (OJ 08/C 265/6). The ECJ concluded that an evaluation of any disincentive due to unlawfulness of the relevant conduct should not require "*an exhaustive and detailed examination of the rules of various legal orders which might be applicable and of the enforcement policy practiced in them*", as this would be too speculative (*Tetra Laval*, paragraphs 76 and 77). This is not the case here, however, as an analysis of the competition constraint posed by EC and UK competition law, including the OFT's CA98 decision CA98/20/2002, 17 December 2002 (the "**2002 OFT Decision**"), is neither speculative nor burdensome for Ofcom. On the contrary, it is an important factor in its assessment.

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per year in wholesale revenue, and potentially [CONFIDENTIAL] per year in advertising revenues, both of which are ‘bottom line’ revenues – i.e. direct reductions of Sky’s profitability, in the order of [CONFIDENTIAL]% of Sky’s 2007/08 EBITDA.<sup>5</sup> Sky could be expected to forego these sums every year following withdrawal of the channels];

- (d) in the context of a rapidly changing TV sector the size of any potential gain to Sky from customers switching to Sky from Virgin Media is speculative and highly uncertain. As just three examples of the risk involved, were Sky to pursue the strategy hypothesized by Ofcom: Sky may lose rights to some of its content (potentially to Virgin Media who would as the result of Sky withholding its channels have an added incentive to bid for rights); the attractiveness of Sky’s propositions may diminish (particularly in relation to movies); and there is the constant spectre of regulatory intervention; and
- (e) given the size of the immediate revenue loss involved, it is totally unrealistic to expect that Sky would be willing to sanction a strategy, which, even ignoring the regulatory risk and potential adverse publicity, would involve a certain reduction in profits of [CONFIDENTIAL] per year in return for a potential gain to Sky from customers switching from Virgin Media that is so speculative and uncertain that there would be considerable risk that it would never materialise even after eight years.<sup>6</sup> It is fanciful of Ofcom to presume that Sky would.<sup>7</sup>

2.7 Accordingly, Ofcom’s focus on Sky’s incentives to supply its premium channels to Virgin Media, via the construction of hypothetical spreadsheet models, is perverse, and the conclusion it draws from those models is incorrect. Proper consideration of real-world facts shows that the prospect of Sky withdrawing its premium channels from Virgin Media is remote.

*Ofcom should have focused on Sky’s incentives to supply retailers on new platforms*

2.8 The issue that should have formed the focus of Ofcom’s inquiry is Sky’s incentives to supply retailers on new platforms which it does not currently supply. On this issue, however, Ofcom’s modelling analysis supports Sky’s own proposition that Sky has an incentive to supply its channels via these platforms. In fact, based on Ofcom’s own analysis (in particular the assumption about the proportion of a new retailer’s sales which represent growth in the market), Sky

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<sup>5</sup> Removing Sky’s saving in variable movie costs implies a potential impact on profit of [CONFIDENTIAL].

<sup>6</sup> This would undoubtedly be a Board-level decision.

<sup>7</sup> Note that such a policy would be highly likely to depress Sky’s share price. If Sky’s PE ratio remained the same then the loss in wholesale revenue would result in a decline in Sky’s share price. To the extent that Sky’s share price might also reflect the expectation of a future increase in DTH satellite subscription revenue, it would nevertheless still be expected to decline as, even accepting Ofcom’s arithmetic, the long term gain is speculative and uncertain whereas the loss in wholesale revenue would be immediate and certain.

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would have an incentive to supply new retailers even at prices well below those currently paid by Virgin Media.<sup>8,9</sup>

- 2.9 Ofcom attempts to overturn the finding of its model by claiming that refusing to supply new retailers “*is likely to be profitable within a significantly shorter time period*” than withholding from Virgin Media.<sup>10</sup> This claim is not based on any formal modelling but is simply asserted. It would not have been difficult to adapt the ‘longer-term’ model of Virgin Media: this is symptomatic of Ofcom’s approach to economic models, where Ofcom only uses models where it progresses one side of a matter of debate.
- 2.10 Instead it would appear that this proposition rests entirely on Ofcom’s claim that consumers have lower ‘switching costs’ when joining retailers on DTT-based and IPTV-based platforms than when joining Sky or Virgin Media, meaning that Sky’s existing subscribers would be more likely to switch to a new retailer than to Virgin Media. But Ofcom does not examine any evidence in relation to switching costs, and even a cursory investigation shows that its claim is contradicted by reality: financial switching costs are no lower for new platforms, and non-financial costs do not appear to be systematically lower.<sup>11</sup> There is, therefore, no reason to presume that Sky has a greater incentive to refuse to supply new or smaller pay TV retailers than it does to withdraw its premium channels from Virgin Media.<sup>12</sup>

### *Ofcom’s vertical arithmetic is flawed*

- 2.11 Not only does Ofcom focus on the wrong issues using an approach that has no regard to real-world facts, but its hypothetical modelling of the effect of withdrawal of supply from Virgin Media is also fundamentally flawed. The flaws are discussed in detail in **Annex 7** but the three main issues are as follows:

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<sup>8</sup> Although the Sky Movies 1 proposition for DTT would include fewer channels than Single Movies, Ofcom’s model finds that it would be profitable for Sky to supply Sky Sports 1 and Sky Movies 1 at any price higher than [CONFIDENTIAL] per month. The current wholesale price for Sky Sports 1 and Sky Movies 1 is [CONFIDENTIAL] per month.

<sup>9</sup> Ofcom appears to have concerns about the price at which Sky would be willing to supply its premium channels. Sky notes that whether a stand-alone broadcaster would be willing to supply a new entrant will also depend on the price. In particular a stand-alone broadcaster would not be prepared to reduce the price relative to that paid by existing distributors because a new entrant was less efficient than other existing retailers. A stand-alone broadcaster would want to ensure that a new retailer would expand the total number of subscribers by a sufficient amount so as to offset any lost wholesale revenue caused by people switching from existing retailers to the new retailer. A stand-alone broadcaster might be expected to ask a new retailer to offer volume commitments or minimum guarantees.

<sup>10</sup> Paragraph 6.97 of the Consultation Document.

<sup>11</sup> See **Annex 7** for further details.

<sup>12</sup> We address the question of dynamic incentives below.

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- (a) Ofcom bases its key input - the proportion of Virgin Media subscribers that would immediately switch<sup>13</sup> - on survey data that is not fit for purpose: they are significantly out of date (even though more recent data is available) and based on a very small and likely unrepresentative sample. Had Ofcom used the more recent survey data its estimate of the pay-back period would have increased by four years;<sup>14</sup>
- (b) the profitability of withholding depends on ongoing gains in subscribers over time. In addition to the immediate switchers (referred to above) Ofcom assumes, without any support or evidence, that consumers would continue to switch from Virgin Media to Sky, and join Sky rather than Virgin Media, as a result of Sky's premium channels no longer being available via Virgin Media over a considerable period of time. In fact the assumed number of subscribers that switch over the long-term is very significant and accounts for 60% of the total number of subscribers that Sky is assumed to gain as a result of withdrawing its channels from Virgin Media. Sky considers that such significant switching over the long-term is unlikely [CONFIDENTIAL].<sup>15</sup> Ofcom's result is highly dependent on this long-term effect - if there were no further switching beyond the assumed immediate impact, withdrawal of Sky's channels would never pay back; and
- (c) the implications of the model are implausible: the model predicts that by withdrawing its premium channels from Virgin Media, the total number of subscribers to Sky's premium channels increases. Even a moment's thought suggests that withholding supply will reduce the total number of subscribers to these channels - for example because some cable subscribers would be unable to switch to DTH satellite reception.<sup>16</sup> This shows that Ofcom has significantly overstated Sky's incentive to withhold supply - if the total number of subscribers did not increase compared to the scenario in which the channels are available via both platforms, as it is highly unlikely to, Ofcom's estimate of the pay-back period would increase by at least three years, and potentially more depending on which assumptions are changed.

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<sup>13</sup> The outcomes of the model are highly susceptible to Ofcom's assumptions on this point. For example, Annex 8 Figure 12 shows that simply varying the survey inputs within confidence intervals can cause the predicted payback period to vary between 4 years and 13 years.

<sup>14</sup> The survey was conducted in December 2006, prior to (i) the creation of Virgin Media and (ii) Setanta's acquisition of two packs of FAPL rights and Setanta Sports' subsequent inclusion within Virgin Media's 'XL' pack. Samples are far too small to be relied upon: for example, only 21 cable subscribers were asked what they would do if Sky's movie channels were no longer available from Virgin Media.

<sup>15</sup> See **Annex 7** for further details.

<sup>16</sup> By the end of the twelve year period modelled, withholding has somehow persuaded nearly 100,000 extra households to take out a premium subscription, even though consumers would have fewer options and the model does not assume any extra marketing activity or price changes by Sky. This is entirely implausible: some consumers are unable or unwilling to receive Sky's channels via DTH satellite, and subscribers do not make their decisions as to which platform to subscribe to based solely on premium channel availability.

*Sky has no significant dynamic incentives to withhold supply from any retailer*

- 2.12 Ofcom alleges that Sky has a ‘dynamic incentive’ to restrict the supply of its premium channels (i.e. withdrawal of channels from Virgin Media and/or refusal to supply its channels to new pay TV retailers) because doing so benefits Sky in the **future** in relation to bidding for content rights and in the retailing of basic channels. Ofcom’s discussion of potential dynamic incentives is both brief and vague. It is, however, clear that based on a corrected analysis of static effects the only way that Sky could be found to have an overall incentive not to supply its channels to new retailers would be if these alleged dynamic incentives were substantial – i.e. they outweighed strong ‘static’ incentives to supply. Ofcom has presented no proper arguments or evidence that this is the case.
- 2.13 As Sky and its economic advisers, CRA, have repeatedly argued, in order to establish such dynamic incentives it is essential to identify mechanisms which link short-run conduct with a long-term ability to compete. Ofcom now appears to agree with this proposition. Ofcom states:
- “We also agree with CRA that it is important to explain carefully the relevant dynamic effects and consider whether those effects are plausible, in light of the available evidence”.*<sup>17</sup>
- 2.14 Yet Ofcom does not do this. Ofcom’s arguments about dynamic incentives do not involve appropriate dynamic mechanisms, in an economic sense,<sup>18</sup> and they do not fit with observed facts.
- 2.15 For example, Ofcom claims that Sky has an incentive to withhold in order to strengthen its position in the acquisition of content rights. But this theory is inconsistent with the implication of Ofcom’s arguments about barriers to entry, which is the proposition that Sky is able easily to win all available content rights in which Sky is interested.<sup>19</sup> By Ofcom’s own argument, Sky would be incurring a significant loss in wholesale revenue in the hope that, at best, it can secure a small saving in the amount it pays for rights. Furthermore, under Ofcom’s argument Sky only gains an advantage against retailers who are integrated with platforms, so withholding would lead to no benefit when bidding against the likes of Setanta, ESPN/Disney or the terrestrial broadcasters, amongst others. Lastly, and perhaps most importantly, any platform operator wanting to retail premium channels would be more likely to bid for content rights itself if it does not have wholesale access to Sky’s channels. So contrary to Ofcom’s suggestion, withdrawing supply could in fact lead to more competition for rights thus raising the cost to Sky of acquiring any rights that it manages to retain and increasing the risk of rights being lost. Ofcom also claims that Sky has an incentive to withhold its premium channels in order to gain an advantage against rival retailers of basic channels. Ofcom’s arguments are not sufficiently developed for Sky to be able to respond properly, but appear to rely on the

<sup>17</sup> Paragraph 2.30 of Annex 8 to the Consultation Document.

<sup>18</sup> See CRA’s paper ‘Some comments on Ofcom’s second consultation document’ at **Annex 4**.

<sup>19</sup> See, for example, paragraphs 2.63 and 3.38 of Annex 7 to the Consultation Document.

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existence of features such as significant economies of scale at the retail level. Sky considers that such economies of scale are not significant and Ofcom makes no attempt to demonstrate otherwise.<sup>20</sup> In both cases, not only is the theory unconvincing, any putative future gain is unlikely to compensate for the large, ongoing 'static' loss.

### **2(b) *There is no evidence Sky is acting on an alleged incentive to restrict the distribution of its premium channels***

2.16 Ofcom states that there is “*evidence which suggests that Sky is acting on that incentive*”.<sup>21</sup> Ofcom cites three pieces of evidence to support this claim that Sky is acting on this incentive to restrict supply of its premium channels.

2.17 First, Ofcom notes that whilst Sky’s channels are offered to Virgin Media on a wholesale basis the “*current combination of wholesale charges and incremental retail price makes it unprofitable for Virgin Media to sell premium channels to existing basic subscribers, and Virgin Media therefore has no incentive to do so unless this is absolutely necessary in order to retain a subscriber*”.<sup>22</sup>

2.18 The second piece of evidence mentioned by Ofcom is that new entrants have sought access to Sky’s premium channels but have so far been unsuccessful.

2.19 The third piece of evidence relates to Sky’s preference to retail its premium channels directly on other operators’ platforms. Each of these is considered in more detail below.

#### *There is no evidence that Sky is supplying Virgin Media with its premium channels in a way which favours Sky’s own retail/platform business.*

2.20 It is a non-sequitur for Ofcom to claim that its observation regarding the profitability of Virgin Media selling Sky’s premium channels to existing basic subscribers provides evidence that Sky is acting on the alleged incentive to restrict the supply of its premium channels. Ofcom states that it broadly agrees with the OFT that the reasonableness or otherwise of Sky’s wholesale prices should not be based on the notional incremental retail price of premium content (which is in fact determined by Virgin Media).<sup>23</sup> Having rejected comparisons of wholesale prices and notional incremental retail prices as a basis for assessing the profitability of retailing Sky’s channels, Ofcom cannot then use such comparisons as evidence that Sky’s wholesale prices are unprofitable for Virgin Media or that Sky is restricting supply of its premium channels. It is also clearly profitable for Virgin Media to retail Sky’s premium channels; if it were not then Virgin Media would cease to carry them.

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<sup>20</sup> For a more detailed discussion of fixed costs see paragraph 3.30 of this **Section 5** below.

<sup>21</sup> Paragraph 6.2 of the Consultation Document.

<sup>22</sup> Paragraph 1.29 of the Consultation Document.

<sup>23</sup> Paragraph 6.36 of the Consultation Document.

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- 2.21 Moreover, even if these observations were accepted, they clearly relate to the second of Ofcom's concerns, i.e. whether or not Sky is setting high wholesale prices. Sky has not denied Virgin Media supply of its premium channels. Nor has Sky supplied its channels in a manner which favours its own retail business or platform – the 2002 OFT Decision demonstrated that Sky's own retail business could pay ratecard wholesale prices and remain profitable, as can Virgin Media.
- 2.22 The suggestion that Virgin Media's incentive to sell Sky's channels might be modest and that this might explain, at least in part,<sup>24</sup> the decline in Virgin Media's wholesale subscribers is something of which Sky is acutely aware and which Sky has repeatedly tried to resolve. The various attempts Sky has made to try and increase Virgin Media's incentive to sell Sky's premium channels are outlined in Section 5 of Annex 5.1 of Sky's Response to the Complaint.
- 2.23 The fact that this situation continues to persist, despite Sky's efforts, cannot be taken as evidence that Sky is satisfied with this situation. The decline in premium subscribers on the Virgin Media network in the last four years has resulted in a decline in wholesale revenue of some [CONFIDENTIAL], at current prices.
- 2.24 Any attempts Sky has made to resolve these issues have been repeatedly hampered by regulators. Discount structures which reward better performance with lower wholesale prices have been alleged to create barriers to entry for new premium channel providers. Discount structures which are tailored to a particular retailer's business model or stage of development and might therefore need to vary between retailers have been alleged to be discriminatory.<sup>25</sup> Sky's attempts to seek confidential guidance to try to find a way through these issues have met with very limited assistance.
- 2.25 These attempts have been further hampered by regulators repeatedly signalling to Virgin Media that wholesale rates might be reduced across the board through regulatory action. It is very difficult to negotiate an incentive discount structure based on current ratecard prices against a backdrop where Virgin Media is being encouraged to believe that some blanket regulatory dispensation may be forthcoming.<sup>26</sup>
- 2.26 These are the principal reasons why Sky has reached a view that retailing directly is likely to generate better premium channel penetration than a wholesale model.

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<sup>24</sup> Other explanations include Virgin Media's failure to address the incidence of piracy on its network.

<sup>25</sup> See, for example, the OFT's CA98 investigation of Sky.

<sup>26</sup> See for example Virgin Media's presentation "Investor & Analyst Day: London, 13 November 2008, which refers in slide 80 to the "*regulatory opportunity*". Available at: [http://library.corporate-ir.net/library/13/135/135485/items/315577/london\\_nov132008.pdf](http://library.corporate-ir.net/library/13/135/135485/items/315577/london_nov132008.pdf)

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2.27 It might be argued that Sky should simply reduce its wholesale prices and that, if it were to do so, Virgin Media would be more successful in selling Sky's channels and Sky would be better off as wholesale revenue would increase to reflect higher sales. Whilst this is one potential outcome another equally plausible outcome, particularly given the much higher margins that Virgin Media earn on other products, is that it would simply use the reduced wholesale price to bolster its profits and make no additional effort to sell Sky's channels, so Sky would be made worse off through lower wholesale revenue.  
**[CONFIDENTIAL]**

2.28 Moreover, it is not clear how the declining penetration of Sky's premium channels on Virgin Media's network could work to Sky's advantage. The suggestion being made is that, as a result of Sky's pricing, significant numbers of customers take a basic only service because Virgin Media does not encourage them to also take Sky's premium channels. This would appear to be an unambiguous loss for Sky. There is no suggestion (and there is no plausible reason why this might be the case) that this loss might be mitigated because these basic only subscribers, who could have elected to take premium channels from Virgin Media, would somehow be more likely to switch to Sky.

*Sky has not refused to supply its premium channels to retailers on new platforms*

2.29 The second piece of evidence mentioned by Ofcom relates to new entrants that have sought, but to date failed, to access Sky's premium channels. Ofcom refers to TUTV, BT, Orange and Tiscali.<sup>27</sup>

2.30 Whilst Ofcom concedes that it has not been able to reach a view as to the specific reasons why individual negotiations have so far failed, it nevertheless uses the fact that no commercial agreements have been agreed as evidence that Sky is in fact distributing content in a way that favours its own platform.

2.31 Ofcom puts forward two possible explanations as to why no agreements have been reached:<sup>28</sup>

- (a) a deal has not been reached because Sky has intentionally withheld its premium content; or,
- (b) a deal has not been reached because Sky is not willing to reduce the price to a level that a new entrant would be "*prepared to pay*",<sup>29</sup> or "*can afford*".<sup>30</sup>

2.32 Ofcom could only rely on the failure to reach an agreement as evidence that Sky is acting on the alleged incentives to restrict supply of its premium channels if it had been able to conclude that the reason why such negotiations had failed was because Sky was intentionally withholding its premium channels (i.e. the first of

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<sup>27</sup> See paragraph 3.35 of this **Section 5** below.

<sup>28</sup> Paragraph 6.18 of the Consultation Document.

<sup>29</sup> Paragraph 6.2 of the Consultation Document.

<sup>30</sup> Paragraph 1.44 of the Consultation Document.

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Ofcom's possible explanations). Ofcom did not, however, reach this view. In fact Ofcom appears to favour the second explanation (option (b) above). In considering possible 'remedies' Ofcom indicates that its competition concern is that *"Sky lacks the incentive to supply its wholesale Core Premium channels at prices that competitors can afford"*.<sup>31</sup>

- 2.33 Ofcom cannot argue that failing to agree to lower rates provides evidence that Sky is *"acting"* on an incentive to *"distribute its premium content in a manner that favours its own platform and its own retail business"*.<sup>32</sup>
- 2.34 The 2002 OFT Decision established that Sky's own retail business could afford to pay the wholesale rates charged to cable operators and remain profitable. The fact that other retailers might not be prepared to pay them cannot be used as evidence that Sky is favouring its own platform. If Sky were to offer new retailers terms which were below the price at which it wholesales to Virgin Media (or notionally to itself on its own platform) then it would disadvantage Virgin Media (or its own downstream retail operation) and would discriminate in favour of other retailers.
- 2.35 Indeed a reluctance to reduce wholesale prices for an inefficient entrant is entirely consistent with the behaviour that would be expected of a stand-alone broadcaster that did not have its own retail business. Such a broadcaster (assuming costs are largely fixed) would distribute its channels to third party platforms so as to maximise aggregate wholesale revenues. As such it would have no incentive to reduce its wholesale prices to cater to a new retailer that was less efficient than established retailers. The stand-alone broadcaster would be concerned that the new entrant would simply take sales away from its more established customers leading to lower wholesale revenues overall. In order to off-set this risk a stand-alone broadcaster would be expected to try to secure a minimum guarantee or other form of commitment so as to ensure that overall it would be better off. **[CONFIDENTIAL]**.<sup>33</sup> Ofcom cannot claim that by failing to agree to lower these prices Sky would be acting on the alleged incentive to favour its own retail business or platform.
- 2.36 Ofcom's analysis of the possible explanations for a failure to reach agreement is also far too narrow and ignores other much more plausible explanations.
- 2.37 Ofcom ignores the possibility that new entrants are engaged in regulatory gaming. Notwithstanding the fact that Sky has a strong preference to retail its content over other networks, **[CONFIDENTIAL]**.<sup>34</sup> **[CONFIDENTIAL]**
- 2.38 The fact that BT is trying to game the regulator is evidenced by **[CONFIDENTIAL]**.<sup>35</sup>

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<sup>31</sup> Paragraph 8.9 *et seq* of the Consultation Document.

<sup>32</sup> Paragraphs 1.28 & 6.1 of the Consultation Document.

<sup>33</sup> **[CONFIDENTIAL]**

<sup>34</sup> **[CONFIDENTIAL]**

<sup>35</sup> **[CONFIDENTIAL]**

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- 2.39 Ofcom also ignores the fact that there has been no commercial urgency to reach agreement as none of the new entrants currently have any means by which to distribute Sky's channels (securely or otherwise).
- 2.40 The only IPTV platform that actually exists today and is capable of delivering linear channels is Tiscali's. Sky's channels are available on this network. There are currently no other IPTV networks in the UK that stream linear channels. Although Ofcom places great emphasis on BT and Orange neither of these parties has actually launched an IPTV network for the delivery of linear channels. Indeed Orange has now publicly withdrawn its IPTV proposals, apparently having concluded that (unlike in France) the underlying UK network is not up to the job. Tom Alexander, CEO of Orange UK stated that the company was "*reviewing plans to launch internet protocol television because it was not happy with the service*" and that it will consider investing in its own backend network rather than leasing it from BT.<sup>36</sup> BT has also repeatedly explained that its existing IPTV network will only be used to deliver VoD services and that the delivery of linear channels via IPTV is contingent on completing its 21CN roll-out.
- 2.41 The same applies in the case of DTT. Sky could not broadcast its premium content via DTT without first securing DTT capacity. Sky is not permitted to obtain any DTT channel slots on Multiplex B or D or any further DTT channel slots on Multiplex C.<sup>37</sup> Whilst it has three slots on Multiplex C it has not been able to broadcast its premium channels using this capacity. When the licences to Multiplex B, C and D were awarded to the BBC and NGW (formerly Crown Castle) they included a requirement that any services carried "*shall be provided on a free to air basis save with the prior consent of Ofcom*". This requirement remained in force until April 2006. Once this requirement was removed Sky initiated plans to switch its DTT capacity from broadcasting free to air channels to three pay channels, including Sky Sports 1 and Sky Movies 1, which would have introduced the potential to wholesale to other DTT retailers perhaps by means of simulcrypt. Sky has not been able to broadcast its premium channels on its existing DTT capacity as its application to Ofcom to change its channels line-up is still pending, after 18 months. Accordingly, Sky has had no means by which it could offer its channels to any of the DTT retailers for distribution.
- 2.42 **[CONFIDENTIAL]**. As Ofcom correctly identifies in paragraphs 9.79 and 9.80 of the Consultation Document, ensuring that Sky's content is distributed in a secure manner is fundamental to Sky's business model. It would be irresponsible for Sky to distribute its channels on any platforms that were not secure.<sup>38</sup>

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<sup>36</sup> <http://uk.reuters.com/article/technology-media-telco-SP/idUKL58581520081105?feedType=RSS&feedName=technology-media-telco-SP>

<sup>37</sup> See Conditions 11(8) and (11) of the Multiplex B, Multiplex C and Multiplex D licences, as at 19 February 2007.

<sup>38</sup> **[CONFIDENTIAL]**

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- 2.43 The fact that Sky is not in a position to offer its premium channels to any DTT retailer also invalidates any inferences being drawn from comparison with Setanta. The only technology via which one of Setanta's channels is made available, but Sky's are not, is DTT. It is a glaring omission that in drawing this comparison Ofcom makes no reference to the difference in the regulatory scrutiny applied to Sky and Setanta. SDN/Setanta's application for a channel variation and Setanta's application for a Digital Programme Services licence was granted without any investigation. Sky's Picnic application is, however, still pending and Sky has no other means by which to facilitate the provision of its channels either to itself or to any other retailer over the DTT platform.
- 2.44 Ofcom's comparison of Sky versus Setanta is also incomplete. Ofcom fails to take account of the fact that Sky's channels are distributed over several platforms on which Setanta's channels are not available. Sky's premium sports channels are available on Orange, Vodafone, T-Mobile and 3's 3G mobile networks whereas Setanta's main sports channel is only available on that of Orange. It also fails to take account of the fact that none of Setanta's channels are available in HD on any platform.<sup>39</sup>

*Sky's preference for retailing is not evidence that Sky is restricting distribution of its premium channels*

- 2.45 Ofcom has also sought to demonstrate that Sky is acting on its alleged incentives to favour its own distribution platform by reference to Sky's proposals to retail its premium channels directly via other operators' platforms, in particular by alleging that Sky's Sky by Wire service on Tiscali's platform is an inferior proposition than its DTH satellite service. Ofcom's consideration of Sky by Wire is, however, flawed. A proper review of Sky by Wire shows that it is not appropriate to characterise Sky's preference for retailing as evidence of Sky acting on an incentive to restrict distribution of its premium channels.
- 2.46 Ofcom asserts that "*where Sky retails via other operators' platforms, it has an incentive to weaken its retail offering*".<sup>40</sup> Ofcom states that the existence of this incentive is supported by price comparisons which show that prices of packages including premium channels are more expensive on Tiscali's platform than on DTH satellite.
- 2.47 Ofcom's price analysis is, however, wrong as it does not make like-for-like comparisons. The DTH satellite price used by Ofcom includes Sky's base broadband package which is a 2Mb/s product, whereas the Tiscali pricing cited by Ofcom includes an 8Mb/s broadband product. Ofcom's analysis also compares Sky's six mix TV package to Tiscali's £19.99 TV package. Tiscali states that this £19.99 pack includes over 70 channels, many of which are free to air, whereas Sky's six mix pack offers over 100 pay channels.

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<sup>39</sup> See paragraphs 3.33 to 3.36 of this **Section 5** below.

<sup>40</sup> Paragraph 6.120 of the Consultation Document.

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- 2.48 In the table below the Sky prices have been adjusted to reflect Sky's 8Mb/s "Mid" package and TV packages containing one basic Mix.<sup>41</sup> The Tiscali access price reflected in the table is made up of two separate components, the broadband, telephone and basic TV elements are priced by Tiscali (£19.99 pack) whereas the premium channel component is priced by Sky.
- 2.49 Once these adjustments are made the access price to Sky Movies would be slightly more expensive via Tiscali TV than via DTH satellite but the price for all other premium tiers would be more expensive via DTH satellite than via Tiscali TV. In particular, Sports Mix and Sports Mix plus Sky Movies 1 would be approximately £5 more expensive via DTH satellite than via Tiscali TV.
- 2.50 Moreover, given that Ofcom is suggesting that it would be preferable if Tiscali were supplied on wholesale terms it is more relevant to compare Tiscali TV prices to Virgin Media prices. The Virgin Media prices reflect Virgin Media's 'L' pack. These show that Tiscali is substantially cheaper than Virgin Media particularly on the more inclusive premium channel packages.

**Table 1**

**Prices via Sky, Tiscali and Virgin Media for comparable TV, broadband and talk packages including line rental.**

BUNDLE	Sky	Virgin Media	Tiscali	Sky/Tiscali Differential	Virgin/Tiscali Differential
Basic	£32.00	£39.45	£19.99	£12.01	£8.46
Basic + Single Movies	£41.00	£58.45	£41.99	-£0.99	£5.46
Basic + Single Sports	£43.00	£58.45	£41.99	£1.01	£5.46
Basic + Dual Sports	£51.00	£63.45	£46.49	£4.51	£5.96
Basic + Dual Movies	£49.00	£63.45	NA	NA	NA
Basic + Single Movies + Single Sports	£50.00	£77.45	£46.49	£3.51	£19.96
Basic + Dual Sports + Single Movies	£55.00	£82.45	£49.99	£5.01	£21.46
Basic + Dual Movies + Single Sports	£55.00	£82.45	NA	NA	NA
Basic + Dual Sports + Dual Movies	£58.00	£70.45	NA	NA	NA

Sky: Broadband Mid (8Mb/s), Sky Talk Freetime, 1 Mix TV, £10 line rental.

Virgin Media: broadband L Pack: 10Mb/s broadband, TV L pack, phone L pack, £11 line rental.

Tiscali: 8MB broadband, free weekend UK calls and line rental, Tiscali TV.

Note: Where bundled prices were not advertised for Virgin Media, prices are calculated based on advertised prices for individual package elements.

<sup>41</sup> This is conservative, in that it implies a low price for Sky relative to Tiscali. Using a larger Sky basic package would reinforce Sky's findings.

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- 2.51 Ofcom also claims that the unattractiveness of Sky by Wire is borne out by the fact that the number of subscribers to Sky's premium channels on Tiscali TV is much lower than on DTH satellite or on cable.<sup>42</sup> Sky notes that although Sky by Wire penetration on Tiscali TV is now relatively low this has not always been the case. In 2004 nearly [CONFIDENTIAL]% of Tiscali TV subscribers took a Sky by Wire package. The take up of Sky's premium channels on Kingston Interactive Television (KIT) (an IPTV service, operated by Kingston Communications in Hull, via which Sky also retailed its premium channels) was also high and significantly higher than on cable. In 2002, [CONFIDENTIAL]% of KIT subscribers took Sky's premium channels; [CONFIDENTIAL]% subscribed to Sky premium channels at the end of 2005 when Kingston Communications announced that it was to close KIT.
- 2.52 In any event, Tiscali is a relatively new platform which has only recently expanded its coverage area and hence it is no surprise that amongst subscribers to its IPTV platform, the take-up of Sky's premium channels, which have been available on other platforms for 15-20 years, is more limited.
- 2.53 Sky notes that Ofcom has also alleged that an outcome in which Sky is the only retailer of its content is undesirable because there would be minimal pressure on retailing costs for that content. This ignores the pressure that Sky faces to reduce its costs from its shareholders and from competitors including from free to air services. It is also difficult to reconcile this apparent concern about lack of pressure to reduce retail costs with statements made elsewhere in the Consultation Document where Ofcom suggests that Sky benefits from certain scale advantages which are likely to make it more efficient than rivals and mean that its retail costs are likely to be much lower than a new entrant's costs.

### **3. Effects on the competitive process**

- 3.1 Ofcom has raised the concern that Sky might engage in conduct to restrict the distribution of its premium channels. As set out above, in order to apply section 316 of the CA03, Ofcom must demonstrate that this alleged conduct is more likely than not to result in a material impact on the competitive process.
- 3.2 Ofcom states that competition in pay TV is likely to be weakened by Sky's alleged restricted distribution of premium channels.<sup>43</sup> It then goes on to suggest that this lack of competition at the retail level is likely to give rise to, and has in fact given rise to, several adverse effects for consumers.
- 3.3 The support for these assertions is not set out neatly in one place. Rather, attempts at such support are scattered haphazardly through the document, which makes it difficult for Sky to respond effectively to the arguments that Ofcom is making.
- 3.4 In Section 3 of the Consultation Document Ofcom purports to show that access to premium channels is "important" to a retailer's competitive position and

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<sup>42</sup> Paragraph 6.127 of the Consultation Document.

<sup>43</sup> Paragraph 7.1 of the Consultation Document.

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therefore that restricted access to Sky's content is likely to result in weak competition. In Section 7 of the Consultation Document Ofcom builds on this conclusion and suggests that this weakness of competition might give rise to, and has in fact given rise to, several adverse effects for consumers.

3.5 The following paragraphs critically review Sections 3 and 7 of the Consultation Document. This review shows that the importance of premium content to retail competition going forward has been exaggerated and that Ofcom has not demonstrated any adverse effect on either the competitive process or consumers. The data included in Sections 3 and 7 provide no basis on which to conclude that competition is likely to be weak or, more importantly, that the competitive process is more likely than not to be materially impaired.

### **3(a) Competition is weak**

3.6 Ofcom asserts that "*competition in pay TV is likely to be weakened by restricted distribution of Core Premium channels*".<sup>44</sup> Ofcom does not, however, set out in any detail why it considers that this would be the case. Ofcom states that it has set out its reasons for this view "*above*" the paragraph in which it makes this statement, which Sky has taken to refer to Ofcom's findings on the "importance" of premium content as set out in paragraphs 1.13 to 1.16 of the Summary. We assume that Ofcom is also referring to arguments raised in Section 3 of the Consultation Document.

3.7 The data in Section 3, however, are qualitative and impressionistic. They simply show, not surprisingly, that watching sports and/or movies on TV is important to some consumers. Ofcom does not frame its review of the data against a well defined question. It does not assess, as it should have done, whether Sky's premium channels are sufficiently important so as to be necessary for a retailer to compete in the relevant market. In so doing it fails to acknowledge that for the majority of consumers Sky's premium content is not important.

3.8 As with its First Consultation Document, Ofcom seems to think that competition will only be effective if Sky faces competition from a number of identical players. Ofcom fails to place any value on competition between differentiated players. This is surprising given that elsewhere Ofcom indicates that "*effective retail competition might result in different retailers providing services which are optimised for different market segments*".<sup>45</sup> Sky considers that one substantial "*market segment*" will be subscribers not interested in premium linear sports or movies content.

3.9 That this segment is substantial is borne out by the fact that BT and TUTV were both willing to launch pay TV platforms and invest heavily in marketing them even though their offering did not include Sky's premium channels. Both platforms have been able to acquire a significant number of subscribers. TUTV is reported to have approximately 300,000 subscribers and BT recently

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<sup>44</sup> Paragraph 1.32 of the Consultation Document.

<sup>45</sup> Paragraph 1.12 of the Consultation Document.

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announced that it had 350,000 subscribers to BT Vision and that it was on track to hit 2-3 million by 2010, its medium term target.<sup>46</sup>

- 3.10 Ofcom's assertion that Sky's premium channels are so important that without them a retailer cannot compete effectively is also in stark contrast to statements previously made by Ofcom when considering the removal of the free to air only restriction from multiplexes B, C and D. In its consultation document on this issue Ofcom stated:

*"A further disincentive for Sky to change its three channels into pay TV channels comes from the fact Ofcom understands that the majority of the existing DTT set top boxes in the UK do not have the capability to support pay TV services. This means that Sky's pay TV offer on DTT **would have to be sufficiently attractive** to either drive consumers to replace their set top box or generate sufficient revenues for Sky to subsidise its replacement. Given that Sky is restricted to the usage of three video streams, it therefore seems unlikely that this incentive would be sufficiently strong."<sup>47</sup> (Emphasis added)*

- 3.11 Accordingly, as recently as October 2005 Ofcom did not think that Sky's premium channels were sufficiently attractive to persuade significant numbers of DTT homes to replace their set top boxes.

### Relevant market

- 3.12 In order to assess whether or not Sky's premium channels are necessary in order to compete effectively it is first necessary to determine the scope of the downstream market in which retail competition is said to be weakened or materially impaired. Ofcom did not, however, do this. The Consultation Document only considers market definition at the upstream level.

- 3.13 As set out in **Section 4** above, Sky considers that the relevant market includes free to air, pay TV services, DVD sales and rental and PPV/VoD services<sup>48</sup>, and indeed Ofcom has itself acknowledged the "*growing number of potential substitutes which consumers find attractive: [including] PPV [and] VoD*".<sup>49</sup> Sky has also provided further evidence to suggest that the relevant retail market includes pay and free to air television services in **Section 4** above. Within this market competition is likely to be sufficiently robust that restricted availability of Sky's channels would be unlikely to have a material adverse impact on the competitive process.

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<sup>46</sup> Moreover, at the Westminster Media Forum seminar, Dan Marks, CEO of BT Vision, stated that "*I think that in comparison to the growth of other digital platforms and digital devices, I think that we can hold our heads up and say that it is extremely respectable*".

<sup>47</sup> Ofcom's consultation "*Pay TV channels on multiplexes B, C and D: proposal to remove the 'free to air only' requirement*", 27 October 2005 at paragraph 2.28.

<sup>48</sup> See paragraph 4.1 of **Section 4** of this Response.

<sup>49</sup> Paragraph 4.234. See further **Annex 6** of this Response.

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- 3.14 Even if the relevant market were limited to retailing of pay TV, Ofcom would need to establish (which it has not) that a retailer that did not offer Sky's premium channels could not compete. It would be even harder to establish that a retailer needed Sky's channels in circumstances where Sky's channels were widely available on the same platform or were available to most consumers over the Internet.<sup>50</sup> In any event, the evidence on which Ofcom relies does not, in fact, support Ofcom's case. Instead it shows that there are many actual and potential pay TV subscribers who are not interested in Sky's premium sports and movie channels.<sup>51</sup>

### Ofcom's data

- 3.15 Below we examine the various categories of evidence considered by Ofcom. Several of these are irrelevant and those that are pertinent do not support Ofcom's case. Instead they show that there are many actual and potential pay TV subscribers who are not interested in Sky's premium channels. A retailer that did not offer these channels could compete for this base of pay TV subscribers.

#### *(a) Consumer surveys*

- 3.16 The consumer survey data set out in Section 3 of the Consultation Document replicates the data provided in Annex 14 of Ofcom's First Consultation Document. In Appendix 4 of Annex 6 to Sky's Response to the First Consultation Document, Sky set out a detailed line by line account of the problems with this consumer survey and in particular Ofcom's interpretation of those results. Ofcom has, however, ignored Sky's comments. Ofcom is referred to **Section 8** of this Response, which considers the implications of Ofcom's failure to take into account Sky's comments. Sky has not replicated below all the problems set out in Appendix 4 but a couple of key examples are as follows.
- 3.17 Ofcom concludes that content is the major driver behind consumers' selection of their pay TV service on the basis of the data provided at Figure 4 of Section 3 of the Consultation Document. In the text Ofcom implies that the data in Figure 4 reflects the "*stated reasons for choosing their current service*". Figure 4 is, however, labelled as the proportion of consumers who cite elements of their TV service as "*must have*". In fact the survey actually asked consumers whether particular elements of their TV service were "*important to their household*." Sky is surprised that Ofcom uses the term "*must have*" when in fact the research asked whether something was "*important*".
- 3.18 Ofcom claims that sports and movies are key drivers of pay TV based on the data in Figure 5. Figure 5 shows that amongst Pay TV homes for whom content is an "*important*" element of their TV service, sports and films were spontaneously mentioned by 33% and 18% respectively. As Ofcom notes,

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<sup>50</sup> Sky's premium sports channels are available via the internet to consumers that do not subscribe to any DTH satellite service. See paragraph 3.36 of this **Section 5** below.

<sup>51</sup> Sky notes that the Chief Executive of BT Vision was recently reported as being "adamant that pay TV does not begin and end with football..." Daily Telegraph, 6 January 2009.

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however, other types of content were also mentioned with similar frequency. Moreover, sports and movie content is not only available on Sky's premium channels. Such content is also available on free to air channels,<sup>52</sup> from other pay or PPV/VoD broadcasters or from other sources such as DVDs. Accordingly, Figure 5 does not provide any indication of the number of consumers for whom **Sky's premium channels** were potentially important and hence cannot provide any indication of how important it might be for a retailer to be able to include them as part of its offering.

- 3.19 The very same consumer survey did, however, ask a series of questions that are more relevant to determining the importance of Sky's premium channels. In particular as well as asking consumers for spontaneous mentions of programme genres (as reported in Figure 5) it also sought spontaneous mentions of channel genres and of particular channels. The data for these two questions suggest that Sky's premium channels are much less important than even Figure 5 would suggest. For example, whereas in Figure 5 33% of those who say content is "*important to their household*" spontaneously mentioned sports programmes, only 25% mentioned sports channels and only 9% mentioned Sky Sports (compared to 9% for Discovery and 12% for Sky One). Similarly, in the case of movies, whereas in Figure 5 21% of those who say content is "*important to their household*" spontaneously mentioned films, only 12% mentioned film channels and only 2% mentioned Sky Movies.
- 3.20 Ofcom's FAPL Omnibus Survey directly asked consumers the main reasons for subscribing to pay TV. This indicated that only 2% of Sky subscribers spontaneously mentioned live Premier League. Indeed on the basis of this survey Ofcom states:

*"for both Sky TV and cable subscribers, 'more channels' and 'more sports' were the top two reasons for subscribing to a pay TV service. Among cable subscribers there was a broadly even split of mentions of 'more content' and 'more sports', but Sky subscribers were significantly more likely to mention 'more channels.'"*<sup>53</sup>

<sup>52</sup> As outlined in Sky's Response to the First Consultation Document, 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, UEFA European Football Championship, 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.

Similarly, and as is set out in **Section 2** of this Response above, 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.

<sup>53</sup> Paragraph 4.2 of Annex 14 to Ofcom's First Consultation Document.

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3.21 It is untenable for Ofcom to conclude, on the basis of this evidence, that Sky's premium channels are key drivers of pay TV. When looked at properly Ofcom's own consumer survey supports Sky's view that there are very many actual and potential subscribers that a retailer could compete for without access to Sky's premium sports and movie channels.

*(b) Consumers' take-up of premium channels in the UK*

3.22 Ofcom claims that the importance of sports and movie content is supported by subscriber data.<sup>54</sup> Although take-up of Sky's premium channels via DTH satellite is over [CONFIDENTIAL]%, the number of cable homes taking Sky's channels is [CONFIDENTIAL]% and in total [CONFIDENTIAL] [more than half] of pay TV subscribers across all platforms do not take any of Sky's premium channels. Even more relevant is the take-up of Sky's premium channels amongst new additions to pay TV. Over the last year Sky has acquired [CONFIDENTIAL] new subscribers, but only [CONFIDENTIAL]% of them took premium channels. This clearly demonstrates that there are many potential subscribers that a retailer can compete for without access to Sky's premium channels. In total there are [CONFIDENTIAL] pay TV subscribers that do not take any Sky premium channels.

*(c) Prices paid for content by pay TV operators*

3.23 Ofcom claims that the large amount consistently paid for premium content rights "*is the clearest indicator*"<sup>55</sup> of the importance of such content. The fact that sports and movie rights are expensive does not in any way demonstrate that a retailer or platform needs to offer Sky's premium channels to compete effectively in the downstream market. The amount that Sky and others are willing to pay for these rights reflects the revenue that can be earned by supplying those channels to subscribers. It provides no information as to the number of subscribers that a retailer that did not offer Sky's premium channels would be able to attract.

*(d) Statements made by market players*

3.24 Ofcom cites several "*revealing statements about the importance of particular content*".<sup>56</sup> These statements do not, however, provide a sound basis for concluding that the availability of Sky's channels is important for effective downstream competition. Ofcom has been highly selective in the statements to which it refers. The countless statements made by industry players which refer to other factors, such as discounted PVRs, as important drivers of pay TV are simply ignored. This is symptomatic of Ofcom's failure to approach the issue with an open mind. Many of the statements are so old that they are of limited relevance. [CONFIDENTIAL]. They have no bearing on the question of whether a retailer that did not carry Sky's premium channels could compete effectively.

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<sup>54</sup> Paragraph 3.47 of the Consultation Document.

<sup>55</sup> Paragraph 3.49 of the Consultation Document.

<sup>56</sup> Paragraph 3.53 of the Consultation Document.

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### (e) *International examples*

- 3.25 Finally, Ofcom refers to a number of international examples where there have been major changes in the ownership of live rights to broadcast domestic top league football. All these examples show is that, where a retailer that has built their business around coverage of their domestic football league then lost access to these rights they suffered the loss of some subscribers. The example does not show that a retailer could not have built a base of subscribers around different content. Moreover, it is not sufficient for Ofcom simply to show that the loss of domestic football league content will reduce a retailer's actual subscriber base. It has to demonstrate further that the loss is large enough that the retailer can no longer compete in the relevant market. It also has to demonstrate that there are no other business strategies that a retailer could adopt to mitigate this loss.
- 3.26 Looked at from this perspective, the experiences following the change in ownership of rights, in France, where TPS lost only 10% of its subscribers, and in Germany, where Premiere lost only 4.4% of its subscribers, do not, in fact, support the view that restricted access to premium content is likely materially to weaken the competitive process. Despite the loss of premium content TPS and Premiere were able to retain over 90% of their subscribers.

### *Economies of scale are small*

- 3.27 The fact that there are a large number of actual and potential subscribers that a retailer could compete for even without access to Sky's premium channels is not a new point. Sky raised this in its Response to the Complaint<sup>57</sup> and in its Response to the First Consultation Document<sup>58</sup> and indeed Ofcom refers to this part of Sky's Response to the Complaint in paragraph 3.25 of the Consultation Document. The only explanation Ofcom provides as to why, despite the very large number of potential customers not interested in premium content, such content might nevertheless be important to ensure effective downstream competition is at paragraphs 3.89 to 3.91 of the Consultation Document.
- 3.28 Ofcom identifies two reasons why offering premium content might be important to retailers who want to sell basic-only pay TV content:
- there are bundling efficiencies that arise from combining premium and basic content, and;
  - there are economies of scale in retailing.
- 3.29 The claimed bundling efficiency is irrelevant. It does not explain why a retailer that offered basic content could not compete for customers that were not interested in premium content. It only explains why a retailer that only offered

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<sup>57</sup> See paragraphs 5.4 to 5.9 of Part C of Sky's Response to the Complaint.

<sup>58</sup> See paragraph 10.50 of Part 2 of Sky's Response to the First Consultation Document which refers to CRA's paper "*Vertical integration and short run/long run issues*", at Annex 4 of Sky's Response to the First Consultation Document.

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basic content might be able to compete less effectively to supply such basic content to subscribers who also wished to subscribe to Sky's premium content.<sup>59</sup>

- 3.30 The second point relates to shared fixed costs and argues that a retailer that is able to sell to all potential pay TV households will be at an advantage. However, Ofcom makes no attempt to quantify the size of these fixed costs. Sky considers that the truly fixed costs associated with its DTH satellite retail business are very modest in size. This is because the large majority of a Sky's retail costs are accounted for by per-subscriber costs such as third party channels, 'lumpy' costs such as subscriber handling which increase in steps as the number of subscribers grows, and discretionary costs such as marketing which are also relatively scalable.<sup>60</sup>
- 3.31 Indeed the most significant fixed cost is the cost of establishing and maintaining a consumer brand. This cost can, however, be shared by selling basic TV as part of a triple play bundle including broadband and telephony.

### **3(b) Consumer harm**

- 3.32 Ofcom asserts that weakness in competition at the retail level might manifest itself in a number of ways. Ofcom uses this discussion of the hypothetical impacts of weak competition on consumers to seek to bolster its conclusion that competition has in fact been weakened. In the following paragraphs we examine the data included in Section 7 of the Consultation Document and show that the conclusions Ofcom draws from that data are flawed and that, in any event, the data does not demonstrate that competition has been materially impaired.

#### Choice of platform

- 3.33 Ofcom asserts that the most obvious manifestation of Sky's alleged conduct is restricted availability of Sky's premium channels on other platforms. Whilst it accepts that the reasons for this may be complex from a competition perspective it concludes that:

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<sup>59</sup> Ofcom also ignores the potential for a retailer to extract the alleged bundling efficiencies by combining basic content with Setanta's premium content, for example.

<sup>60</sup> Paragraphs 3.87 to 3.91 of the Consultation Document focus on economies of scale and scope in the retailing of pay TV. Where a retailer is vertically integrated into platform operations then economies of scale and scope at the platform level may also be relevant. However, in the case of platform operations economies of scale are likely to be quite limited as per-platform-user costs (i.e. costs which are variable with the number of households who use the platform, such as the cost of set top boxes) tend to dominate any fixed costs of developing and operating television platforms (such as the costs of setting up a conditional access system, or an electronic programme guide). That said it is clear that there is a very strong economy of scope as between offering platform services for pay TV and free TV services. Sky considers that a platform that did not enable access to free to air services, particularly the main UK free to air television channels, would have a very restricted addressable base. This is because the major terrestrial channels must have channels for almost all UK households and their digital sister channels are very important to large numbers of UK households.

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*“We discuss this issue from a competition perspective in section 6 above, and acknowledge that in this context interpretation of evidence is complex. From a consumer perspective however the issue is simple: **consumers on a number of platforms are currently unable to access the most valuable sport and movie content [on that platform], and this must be a source of concern.**”<sup>61</sup> (Emphasis added)*

- 3.34 It is not open to Ofcom to divorce the failure to reach agreements from the reasons for such failure. Ofcom cannot simply focus on the outcome and argue that the outcome itself is sufficient to justify the imposition of new and draconian regulation on Sky, without any consideration as to why these particular circumstances have arisen. It would be disproportionate for Ofcom to seek to remedy the lack of availability of Sky’s channels by imposing new regulation on Sky in circumstances where the reasons behind such lack of availability lay elsewhere.
- 3.35 As set out in paragraphs 2.29 to 2.44 of this Section above, Sky’s premium channels are available on the only IPTV network in the UK currently capable of delivering linear television channels. They are available on multiple mobile networks. The fact that Sky’s sports and movie channels are still not being broadcast via DTT is primarily due to Ofcom’s own regulation. Until Sky has a licence from Ofcom to broadcast those channels via DTT it will not be in a position to offer the channels to consumers via any DTT platform, either directly or through wholesale arrangements.
- 3.36 Also relevant is the fact that Sky’s premium sports channels are now available via the internet. Sky Sports 1, 2, 3, Xtra and Sky Sports News are streamed online and are available for free to dual Sky Sports subscribers that also take Multiroom or Broadband Max. Dual Sky Sports subscribers that do not take Multiroom or Broadband Max can access the channels for £10 a month. Alternatively, consumers that do not subscribe to any DTH satellite service can subscribe to an internet TV package including Sky Sports 1, 2, 3, Xtra and Sky Sports News for £34 per month. Accordingly, a sports fan with a strong preference for the services that are currently provided by BT Vision, for example, can subscribe to BT Vision and can access Sky Sports via the open internet, over their BT broadband connection.

### Retail packaging innovation

- 3.37 Ofcom asserts that a second source of evidence that competition in retailing of pay TV is weak is a lack of innovation in retailing. In support of this statement Ofcom notes that whilst Sky offers a wide range of content bundles “*the pricing of these encourages consumers to trade up to a small number of ‘big mixes’*”.<sup>62</sup> Ofcom claims that this is reflected in the fact that [CONFIDENTIAL]% of Sky’s basic-only subscribers take all six basic mixes and that [CONFIDENTIAL]% of

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<sup>61</sup> Paragraph 7.32 of the Consultation Document.

<sup>62</sup> Paragraph 7.33 of the Consultation Document.

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subscribers take Sky's most inclusive package (top tier), [CONFIDENTIAL] as the next most popular package combination.<sup>63</sup>

- 3.38 It is hard to see what kind of distribution of subscribers across Sky's different packages Ofcom would need to observe for it to conclude that Sky provides effective package choice. Sky only launched its genre mixes in 2005. At that time over [CONFIDENTIAL]% of its subscribers took its most inclusive basic package. In just over three years the take-up of less inclusive basic packages has grown sharply so that at the end of September 2008 [CONFIDENTIAL] of Sky's basic-only subscribers in the UK take its most inclusive basic tier. Indeed this means that in the UK, [CONFIDENTIAL] homes do not take all of Sky's six mixes (made up of [CONFIDENTIAL] basic only homes and [CONFIDENTIAL] premium homes).<sup>64</sup> Similarly, although [CONFIDENTIAL]% of subscribers take dual sports and dual movies<sup>65</sup> this means that [CONFIDENTIAL] homes subscribe to a tier that is smaller than top tier.
- 3.39 Moreover, if more recent sales data is considered then Sky's record in packaging innovation is even more impressive. Looking at sales for 2007/08 in the UK, [CONFIDENTIAL] subscribers took fewer than six basic mixes and only [CONFIDENTIAL] subscribers took top tier (i.e. dual sports and dual movies with six mixes).
- 3.40 Ofcom also draws comparisons between the way in which Sky's premium content is offered and the way in which Setanta provides its content, with the wholly unwarranted inference that Setanta is more "innovative" in retail packaging than Sky. This is where Ofcom's analysis becomes confused. The purpose of Ofcom's analysis of retail innovation should be to gauge the strength of retail competition in the **market as a whole**. Accordingly, the fact that Ofcom considers that Setanta's pricing and packaging is innovative should be taken as evidence that the market is working well and is competitive, not as evidence that competition is weak.
- 3.41 In a competitive market Ofcom should not expect all channels to adopt the same packaging strategy. Different channels will have different business models and will choose a packaging strategy that reflects that business model. Business models and hence packaging strategies may also differ across platforms. For example, the way in which Setanta is packaged on DTT is consistent with experience in other territories where, because of capacity constraints associated with that technology, pay TV services tend to be offered à la carte or in small packages. On the DTH satellite platform where there are no such capacity constraints, Setanta's approach is to offer its channels only as part of a bundle of one 'core premium channel' (using Ofcom's definition - Setanta Sports 1) and seven other channels (notwithstanding the MCR Direction, which requires

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<sup>63</sup> Paragraph 7.49 of the Consultation Document.

<sup>64</sup> Numbers do not sum due to rounding.

<sup>65</sup> At the end of October 2008.

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premium channels to be offered à la carte).<sup>66</sup> Whereas on closed cable networks such as Virgin Media packaging has to be agreed with the platform operator hence the packaging strategy will reflect the channel's strategy but also that of the platform operator, with the precise outcome depending on their relative bargaining strengths.

- 3.42 Ofcom's comparison is in any case misdirected because it ignores the fact that when Sky owned the Premier League rights currently held by Setanta it offered those matches on a pay per view basis. Sky offered these Premier League matches on a season ticket basis and on a per game basis to Sky Sports and non-Sky Sports subscribers. With the loss of the underlying FAPL rights Sky had no choice but to cease offering its PPV service. As compared to Sky's PPV offering, Setanta's service provides less flexibility as it requires customers to subscribe to a channel that includes a range of sports content. The matches are no longer available on a PPV basis.
- 3.43 Ofcom also ignores the substantial innovations which Sky has made to its pricing and packaging over time. The introduction of genre mixes provides Sky's subscribers with greater choice and flexibility than any other pay TV retailer (Virgin offers subscribers the choice of only two genuine basic pay TV packages, compared to the 63 basic package combinations offered by Sky). Sky has also innovated within its premium tiers and in particular has created more attractive smaller packages of premium content to encourage its basic only subscribers to upgrade. Indeed, this is exactly what Ofcom should expect because Sky has every incentive to package content in more innovative ways. There are **[CONFIDENTIAL]** Sky subscribers on the DTH satellite platform in the UK that do not take any premium content. This represents a very substantial opportunity if Sky can upgrade these subscribers to add some premium content to their subscription.
- 3.44 For example, Sky has sought to drive take up of premium channels by making single movies and single sports more attractive. One of the key factors in determining Sky's switch to movie genre channels was to create a more attractive single movies package. Single movies has also been reflected in Sky's lead marketing messages including the Christmas 2008 campaign which led with a £26 per month price for a package including single movies. Over the period of this campaign Sky added **[CONFIDENTIAL]** single movies subscribers.
- 3.45 More recently, Sky has also experimented by offering subscribers the opportunity to subscribe to Sky Sports for a weekend in order to access a particular event. Sky marketed the 2008 Ryder Cup golf tournament in this way. Subscribers were offered the opportunity to access Sky Sports over the Ryder Cup weekend for a fixed fee. After the weekend they were automatically downgraded. **[CONFIDENTIAL]**.

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<sup>66</sup> Ofcom also draws attention to the fact that TUTV is offering Setanta free of charge to new subscribers for a whole season. Discounting subscriptions for new subscribers is a subscriber acquisition policy that has a long history in the pay TV industry.

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- 3.46 Finally, Ofcom draws particular attention to buy-through and states that, although the First PwC Report<sup>67</sup> indicated that buy-through exists to some extent in all 15 counties examined in its study, European operators “*are increasingly launching services which differ from the traditional buy-through model*”.<sup>68</sup> Ofcom’s reference to such examples, however, is, as usual, impressionistic and does not appear to be supported by any serious attempt to investigate the nature of its examples or their suitability to the point it is seeking to make.
- 3.47 In light of these criticisms Sky has commissioned a second report from PwC (submitted as **Annex 1** to this Response) which considers, amongst other things, the provision of à la carte and standalone channels, pay per view content and content provided on a pay TV “*light*” basis in the 15 European countries included in its first report. PwC found that there have not been strong trends in significant changes in the pricing and packaging of audiovisual content in the past five years, and Sky has been a leader in the introduction of genre-themed basic packages. Buy-through to premium channels is prevalent in the 15 countries with few exceptions. The retail of channels on a standalone or à la carte basis is not common, and nor are premium pay TV “*light*” services.
- 3.48 In any case, Ofcom’s interpretation of these examples is difficult to fathom. Ofcom is not suggesting that in Italy and Germany no retailer operates a buy-through model, simply that there are some new entrants that don’t – particularly on DTT platforms, which tend to be limited in the number of television channels carried. But this is exactly the same as in the UK. Rather than demonstrating that the UK is somehow unusual, the international examples cited at paragraph 7.53 of the Consultation Document are entirely consistent with the experience in the UK where a new entrant with a different business model is choosing a business strategy that differs from the established incumbents.
- 3.49 Moreover, the buy-through requirement which is reflected in Sky’s wholesale contracts cannot be said materially to reduce consumer choice or impose a material extra cost. It only requires Sky’s premium channels to be purchased through a basic package that contains two pay channels. **[CONFIDENTIAL]**

### Platform enhancements

- 3.50 Ofcom asserts that a third source of evidence that competition in retailing of pay TV is weak is a lack of certain types of platform innovation. Ofcom’s concerns appear to focus on a perceived lack of development of VoD services. Ofcom states that “*some other markets appear to be leading the UK in the development of VoD services*”.<sup>69</sup> Moreover, Ofcom alleges that this is unsurprising because “*Sky has had little incentive to develop such services, and other platforms have lacked*

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<sup>67</sup> Submitted as Annex 1 to Sky’s Response to the First Consultation Document.

<sup>68</sup> Paragraph 7.53 of the First PwC Report.

<sup>69</sup> Paragraph 7.47 of the Consultation Document.

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*effective access to the content necessary to exploit such services*".<sup>70</sup> Ofcom's analysis of the development of VoD in the UK is seriously flawed.

- 3.51 Sky faces considerable challenges in providing VoD services as it is not possible to deliver true VoD via satellite. Given the competition which Sky faces from other retailers that are able to offer VoD, Sky has a very considerable incentive to overcome these technical limitations and has been determined to innovate in the provision of on demand services. This is clearly evidenced by Sky's launch of a push VoD service – Sky Anytime – in March 2007. This offers subscribers an average of 40 hours of content at any one time. The service has been very successful. In October of this year it was accessed by [CONFIDENTIAL]% of subscribers with access to the service and is the [CONFIDENTIAL] most watched 'channel' in those homes. In addition, despite the huge attention being paid to the BBC iPlayer (which is itself a function of the BBC's huge cross-promotional power and large pool of content assets), Sky launched its 'Sky by broadband' service a year before the BBC and was in fact the first UK broadcaster to launch a VoD service to the PC. Sky Player offers over 4,500 pieces of content and has had over [CONFIDENTIAL] free and paid downloads since launch. [CONFIDENTIAL].
- 3.52 The implicit assertion that rivals are unable to develop VoD services because of a lack of access to the content on Sky's premium channels also demonstrates Ofcom's poor understanding and awareness of the UK media sector. Sports and movies in the pay window are not the backbone of VoD services. To date VoD services have mainly been driven around catch-up TV and therefore centre on those channels which are mostly highly viewed.<sup>71</sup> In any event sports content is not particularly well suited for VoD due to the difficulty of delivering content in real time. In respect of delayed Premier League content, BT holds the rights to exploit this content via a VoD service.
- 3.53 In the case of movies, Virgin Media and BT have both acquired rights for their VoD services directly from the studios, to show films before (and after) they are available on Sky's so-called "*must have*" movie channels. Virgin Media has deals with Sony and Disney through its Filmflex service and with Warner Brothers offering over 500 titles. BT Vision has deals with Universal, Disney, Paramount and Warner Brothers that provide around 60 titles at any one time, 28 of which are from Universal.<sup>72</sup>

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<sup>70</sup> Paragraph 7.47 of the Consultation Document.

<sup>71</sup> This is reflected in the Competition Commission's provisional findings in relation to Kangaroo which state that "*an important characteristic of successful VoD content is that it has previously been broadcast on linear TV... and that certain genres (e.g. comedy and drama,) tend to make more successful VoD than others (e.g. news and sport)*", Competition Commission provisional findings report, 5 December 2008 at paragraph 4.15. Available at: [http://www.competition-commission.org.uk/inquiries/ref2008/kangaroo/pdf/prov\\_find\\_report.pdf](http://www.competition-commission.org.uk/inquiries/ref2008/kangaroo/pdf/prov_find_report.pdf)

<sup>72</sup> Sky notes that Ofcom may downplay the importance of these movie contracts because it believes that consumer demand for PPV services is lower than the potential consumer demand for subscription services (paragraph 9.47). To support this view Ofcom refers to Section 4 of its Consultation Document. We have carefully reviewed Section 4 and it is unclear to what, specifically, Ofcom is referring. At paragraph 4.195 and Appendix 7 of Annex 6 of the Consultation Document Ofcom references a survey of Sky Movie subscribers which shows that

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- 3.54 To support its claim that the UK is somehow lagging behind other countries in the development of VoD services Ofcom also cites the example of Comcast and data from Screen Digest. Comcast, however, is a large US cable company operating in a market which is fundamentally different in nature to the UK. Ofcom cannot rely on comparisons with the US to support a claim that competition in the UK is weak. The US started offering pay TV services more than ten years before the UK. The US is several years ahead of the UK and the rest of Europe in the development and take-up of many entertainment services. For example it introduced PVR and HD services before they were available in Europe. In any event, Virgin Media's VoD service offers very similar capability to that which is available via Comcast. The fact that Comcast has secured more content than Virgin Media currently has rights to cannot be attributed to any conduct by Sky. The gap between Comcast and Virgin Media's content does not just relate to content which Sky owns. Virgin Media does not offer catch-up services for channels other than the BBC, ITV, Channel 4 and Virgin Media's wholly owned channels.
- 3.55 The Screen Digest data cited by Ofcom in support of its proposition also cannot be used for this purpose. The Screen Digest data in Figure 37 of the Consultation Document includes revenue from a range of services other than VoD services. In particular, as indicated in the notes below the table, they include subscription revenues from the provision of PVRs. Accordingly, countries in which operators have dropped such subscriptions – such as in Sky's case – will be shown to perform 'worse' on the Screen Digest metric, even though having no PVR subscription charge means that consumers are better off.
- 3.56 Even if this data were limited to revenue from VoD services, it would be difficult to draw sensible conclusions from such data since they are based on revenue rather than usage or availability. The data will therefore under-represent situations where VoD services appear to be supplied free-of-charge but are in fact offered as part of a bundle (for example, Virgin Media provides its VoD service "free-of-charge" to its 'XL' customers) and over-represent services where consumers must pay high prices for content that is in high demand.

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around 30% indicated that "*can pay for movies on a monthly basis*" was a 'must have' feature of their movie package. Figure 16 of Annex 10 of the Consultation Document tells a somewhat different story. It shows that when asked why they subscribed to Sky Movies only 7% mentioned "*not having to pay every time I watch a movie*". All the other reasons cited for subscribing to Sky Movies would also be satisfied by a VoD service which provided a wide range of movies at any one time. In addition both of these surveys considered preferences amongst Sky Movies subscribers. These are subscribers who have, amongst all the different ways in which movies can be consumed, opted to pay to consume movies on a monthly basis. Accordingly, the fact that for some of them paying for movies on a monthly basis might be important is not surprising. To reach a view on the potential consumer demand for a VoD service versus a subscription service Ofcom would need to research consumers more generally, which it has not done. We also note that data on the revenue generated from PPV/VoD services versus subscription services will also show a misleading picture as it fails to take account of the fact that VoD services have also been launched relatively recently. Sky Movies has been available for almost 20 years. Although PPV movie services such as Sky Box Office have also been available for some time, true VoD services (which provide for a much broader range of films viewed at a time of the consumer's choosing) are relatively recent.

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3.57 In fact it is clear that the UK market is developing VoD capability very quickly.<sup>73</sup> The PwC Report (**Annex 1**) referred to above also incorporates IPTV, VoD and NVoD into its innovation indicator but found that this did not significantly alter the ranking in its first report, with the four leading countries in terms of innovation (the UK, France, Norway and Sweden) remaining unchanged. The UK introduced both NVoD and VoD earlier than the sample average.<sup>74</sup> Virgin Media and BT both offer VoD on their platforms and use this as a key form of differentiation and a reason for choosing their platforms:

- BT offers over 5,000 hours of content<sup>75</sup> and Virgin Media offers 4,600 hours;
- Virgin Media announced that it had 45 million views in August of this year and that 50% of its digital TV base now actively uses VoD services at an average of 24 views per month.

3.58 Ofcom also suggests that there is a risk that the development of new platforms such as mobile TV could be held back by limited access to premium content.<sup>76</sup> A review of the facts shows that Ofcom's concerns are not well founded. Sky was the first to launch a mobile TV service in the UK. Sky's Mobile TV service includes live and made for mobile channels from a number of broadcasters and is available on most of the mobile network operator's networks including Vodafone, T-Mobile, 3UK and Orange to customers with a 3G mobile phone handset. It appears that Ofcom is wholly unaware of these services. **[CONFIDENTIAL]**.

### Retail pricing

3.59 Ofcom states that it "[does] *not feel confident that competition is sufficiently vigorous that there is downward pressure on Sky's retail prices*".<sup>77</sup> It is clear from a review of paragraphs 7.56 to 7.79 that Ofcom has no actual evidence that retail prices are high. Ofcom's concerns are nothing more than a hypothesis. They certainly do not provide sufficient evidence that the competitive process is, or is more likely than not to be, harmed.

3.60 Sky has, however, already demonstrated that its prices are consistent with prices for comparable packages in other countries. The First PwC Report indicated that when compared to packages of similar quality Sky's prices were

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<sup>73</sup> This is reflected in the Competition Commission's provisional findings on Kangaroo which state, at paragraph 2.7, that "*VoD services are new and developing quickly*".

<sup>74</sup> See **Annex 1** and **Annex 2**. Consistent and reliable data on VoD usage were not available.

<sup>75</sup> BT claims to have the largest on demand library in the UK with over 5,000 hours of content in all genres. It also claims to have built up a comprehensive catch-up service, "*the only and best catch-up service in the UK in which you can have access to Channel 4, ITV, Five and BBC catch-up programming*." Dan Marks, Westminster Media Forum seminar.

<sup>76</sup> Paragraph 7.6 of the Consultation Document.

<sup>77</sup> Paragraph 7.79 of the Consultation Document.

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lower than 10 of the 19 comparator packages.<sup>78</sup> Indeed if the analysis were amended to reflect the recent strengthening of euro the conclusions would be even more favourable to Sky. Ofcom does not question PwC's conclusion. Instead Ofcom suggests that "*the PwC report provides only a partial comparison of prices with other countries as it does not cover lower priced entry packages from DTT providers, for example*".<sup>79</sup> It is not clear, however, what the value of including data on lower priced 'entry level' packages would have been. Comparing the price of Premiere Flex, for example, with Sky's service would be meaningless as they are not similar services. Sky's prices can only be compared to services of similar quality – this is exactly what PwC has already done and shows that Sky's prices are consistent with those prevailing in other European markets. Ofcom's concern appears to be more about whether the UK is offering smaller pay TV packages that are competitively priced rather than a concern about the prices Sky charges for the packages that it actually offers. As such, this is really another way of expressing its earlier concern about the extent of package innovation.

3.61 Nor does the evidence on profitability provide any support for the claim that Sky's retail prices are excessive. Sky notes that the analysis in **Section 6** below shows that Sky's wholesale prices are not excessive. In light of the evidence on wholesale prices any concern about the level of Sky's retail prices essentially amounts to a concern that Sky's retail margin might be too high. It is clear, however, that Ofcom thinks this is unlikely. In its discussion of "*remedies*" Ofcom argues that other retailers may not be able to afford to pay Sky's cable wholesale rates and that accordingly it may be appropriate to establish a price rule<sup>80</sup> which includes a minus that exceeds Sky's retail costs and is instead based on the new entrant's costs. Given that Ofcom is arguing that new entrant retailers are not as efficient as Sky and cannot compete based on Sky's retail margin it is difficult to see how Ofcom can at the same time have concerns that Sky's retail margin is excessive and results in high retail prices.

3.62 Sky considers that the high levels of pay TV penetration in the UK provide further support that UK price levels are reasonable. Ofcom broadly agrees that pay TV penetration in the UK is relatively high.<sup>81</sup> Penetration of pay TV provides an indication of output. Other things being equal, as prices decline, penetration or take-up of pay TV will increase. Penetration is a particularly useful measure as it provides a proxy for the overall quality-reflected price including subscription and upfront elements. Sky considers that the agreed high level of pay TV penetration in the UK, despite a well funded and diverse free to air sector, provides very strong evidence that prices are reasonable, given the quality of the services being offered.

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<sup>78</sup> See Table 8 of the First PwC Report, submitted as Annex 1 to Sky's Response to the First Consultation Document.

<sup>79</sup> Paragraph 7.71 of the Consultation Document. In discussing the omission of lower priced 'entry level' packages from DTT providers Ofcom makes reference to Italy (Mediaset), Germany (Premiere Flex) and Sweden (Boxer). Ofcom seems to fail to recognise that any such comparison would also have to include Setanta's, TUTV's and BT's various DTT services.

<sup>80</sup> Paragraph 1.45 of the Consultation Document.

<sup>81</sup> Paragraph 7.29 of the Consultation Document.

Satisfaction

3.63 Ofcom rejects its own evidence on high levels of consumer satisfaction on the basis that such data only picks up on those people who actually take pay TV services already. Ofcom states that it is concerned that high levels of satisfaction amongst existing customers could fail to take account of the views of those people who are excluded because of high prices or lack of package choice. This is again where data on pay TV penetration can be insightful. If the number of people taking pay TV services were very low then Ofcom's argument might have some validity. However, as Ofcom accepts, pay TV penetration in the UK is relatively high. A greater proportion of TV homes subscribe to pay TV than in many other European markets and hence there is no evidence that large numbers of people are being excluded based on package inflexibility, lack of platform choice or high prices.

**4. Threshold for compulsory supply**

4.1 As set out above in **Section 3**, additional conditions would need to be satisfied to justify use of section 316 CA03 powers to impose compulsory licensing of Sky's channels. In addition to showing an actual or likely refusal to supply, Ofcom would need to show that (a) those requesting Sky's channels intend to offer new products or services or enhancements not offered by Sky for which there is demand; (b) there could be no objective justification for any refusal to supply; and (c) any refusal to supply would result in the likely elimination of effective competition on the downstream market. Each element of the test is discussed in the paragraphs below.

**4(a) New products or services**

4.2 Ofcom is proposing that Sky should be required to make its content available to all retailers on platforms other than DTH satellite. By including Sky's channels as part of their offering such retailers would not be providing any new products or services or enhancements of existing products or services. Sky's channels are widely available on a number of different platforms including DTH satellite, cable, Tiscali's IPTV network and four mobile phone networks. Sky has also just launched an internet TV service whereby consumers can subscribe to Sky's channels, including Sky Sports, for viewing via the internet.<sup>82</sup>

4.3 Even if the availability of Sky's channels via DTT or IPTV could be considered to result in the creation of new products or services it is clear that Sky's channels are likely to be available via such technologies even absent compulsory licensing.

4.4 In relation to DTT, Sky has submitted an application to vary the channels broadcast in its capacity on Multiplex C. If Sky were permitted to retail its premium channels on DTT then it is not clear what new services would be made available by also requiring Sky to wholesale its channels to other retailers for distribution via DTT.

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4.5 Similarly in the case of IPTV Sky's channels are already available by means of an arrangement with Tiscali TV under which Sky retails its premium channels. Requiring Sky to offer its channels to Tiscali TV on a wholesale basis would not result in the creation of any new products or services. The products available via Tiscali's network would remain essentially unchanged, the only difference being the company from whom a subscriber would purchase any Sky premium channels. There are currently no other IPTV networks operating in the UK but Sky has sought to negotiate retail relationships with each of the third parties contemplating the creation of such a network. In each case it is not clear what additional products and services would be made available by requiring Sky to wholesale its channels versus circumstances in which Sky were to secure direct access to such new IPTV platforms so as to enable Sky to retail its channels itself.

### **4(b) Objective justification**

4.6 There has not been a refusal to supply by Sky, either actual or constructive. Even if there were such a refusal or Ofcom believed that one was more likely than not to occur, in order to mandate licensing of Sky's premium channels, Ofcom would have to establish that there could be no objective justification for such a refusal. In this context it should be noted that there is no closed list of objective justifications and each case would need to be considered on its facts. What is clear is that an objective justification would include, as Ofcom effectively recognises, inadequate security of the requesting platform or a failure to agree an appropriate price.

### **4(c) Likely elimination of competition**

4.7 A crucial first step in assessing whether, absent Sky offering to wholesale its channels to new retailers, competition would be likely to be eliminated is determining the scope of the downstream market. Ofcom did not, however, do this. The Consultation Document only considers market definition at the upstream level.

4.8 Sky considers that the relevant retail market (as set out in paragraph 4.1 of **Section 4** above) includes pay (including VoD) and free to air television services. It is clear that within this market, competition would not be eliminated if Sky did not offer to wholesale its channels to new retailers.

4.9 Even if the relevant market were limited to retailing of pay TV, it is clear that if Sky failed to agree wholesale terms with any new retailer competition would not be eliminated. For example, within this more narrowly defined market there would nevertheless be competition between Sky, Virgin Media, BT Vision, Tiscali TV, TUTV and Setanta.

## SECTION 6: OFCOM'S ALLEGATIONS REGARDING HIGH WHOLESALE PRICES ARE UNFOUNDED

### 1. Introduction

- 1.1 The second form of conduct described by Ofcom as a “*competition concern*” identified in **Section 5** is the risk of Sky setting high wholesale prices for its premium pay TV channels.
- 1.2 As set out in **Section 3** above, in order to use its section 316 powers, Ofcom must show that Sky is: (i) actively engaging in this alleged conduct (or the alleged conduct is more likely than not to occur); and, (ii) that the alleged conduct is more likely than not to result in a material impact to the competitive process. Where compulsory supply obligations are proposed, additional conditions must be met.
- 1.3 In relation to the first criterion, that Sky is engaging or likely to engage in the conduct, Ofcom attempts to examine this issue by evaluating the current profitability of Sky’s notional premium channel business.<sup>1</sup> In Part 2, below, we review Ofcom’s profitability analysis and show that it suffers from a number of significant flaws.
- 1.4 In Part 3 of this Section we consider Ofcom’s interpretation of its profitability estimates and show that Ofcom does not provide any framework against which the reasonableness of any estimate can be judged. Sky considers that the normal framework for such an evaluation is to consider the profitability of comparator companies. A comparison of Ofcom’s estimate of the profitability of Sky’s notional premium channel business with the profitability of a number of other pay TV broadcasters shows that Sky’s operating margin is normal, (i.e. within an acceptable range) and hence that Sky is not setting excessive wholesale prices for its channels.
- 1.5 In relation to the second criterion, that the conduct has a material impact on the competitive process, Ofcom does not even attempt to show that setting high wholesale prices for premium channels might damage the competitive process. There is no discussion anywhere in the Consultation Document relevant to this issue. A proposition that high charges, in themselves, might damage the competitive process would be unusual – the more usual concern lies with the potential effects of undue discrimination on competition in relevant downstream markets – i.e. as a result in differences among charges paid by different competing downstream operators. In fact, Ofcom appears to accept that pricing levels are unlikely to affect the competitive process. Ofcom states that “[high wholesale prices] *would have the effect of keeping retail prices high without necessarily distorting competition between retail operators*”.<sup>2</sup>

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<sup>1</sup> Section 2 of Annex 9 to the Consultation Document.

<sup>2</sup> Paragraph 1.28 of the Consultation Document. This is further supported by the Office of Fair Trading who commented, in a June 2007 workshop entitled Towards an Appropriate Policy for Excessive Pricing:

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1.6 We do not comment further on the second criterion in this Response, but simply note that, even if Ofcom were to establish that Sky were setting high wholesale prices, which it has not and could not, Ofcom would still not have met the threshold necessary to exercise its section 316 powers.

### **2. Errors in Ofcom's estimates of Sky's profitability in supplying its premium pay TV channels**

2.1 In order to examine whether Sky is setting excessive charges for its premium sports and movie channels, Ofcom has undertaken an evaluation of the profitability of Sky's notional premium channel supply business for a single financial year (2007/08). Ofcom does so in three steps:

- (a) an evaluation of the "*gross margin*" of a notional standalone Sky Sports channel business;
- (b) an evaluation of the "*gross margin*" of a notional standalone Sky Movies channel business; and
- (c) an evaluation of the "*operating margin*" of a notional Sky Sports and Sky Movies channel business.

2.2 In Ofcom's analysis the term "*gross margin*" refers to a profit figure that excludes an allocation of corporate overhead costs, while the term "*operating margin*" includes such an allocation.

2.3 Critically, however, steps (a) and (b) require the allocation of, in particular, shared revenues among the two notional businesses that Ofcom has defined.

2.4 In undertaking these analyses, Ofcom commits a number of errors which mean that the conclusions that Ofcom draws are unreliable. These are discussed in the following paragraphs.

#### **2(a) *It is not possible separately to evaluate the profitability of Sky's supply of premium sports and premium movie channels***

2.5 Ofcom has attempted to evaluate separately the profitability of a notional Sky premium sports channel business, and a notional Sky premium movie channel business. This methodology is not meaningful for the straightforward reason that these two notional lines of business have substantial common revenues, and, to a lesser extent, common costs, which cannot meaningfully be divided among those notional lines of business.

2.6 If common costs and/or revenues are significant, and they are allocated among different lines of business, the estimates of the profitability of each line of business will then simply reflect whatever approach to allocation is selected.

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*"It should be noted that this paper focuses on exploitative excessive pricing, which is not in itself harmful to the structure of competition in the relevant market."* (Emphasis added)  
Available at: [http://www.iue.it/RSCAS/Research/Competition/2007\(pdf\)/200709-COMPed-Fletcher-Jardine.pdf](http://www.iue.it/RSCAS/Research/Competition/2007(pdf)/200709-COMPed-Fletcher-Jardine.pdf)

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There is no “right” way of allocating common costs and revenues.

- 2.7 In relation to revenues, as well as being available individually, Sky’s premium sports and movie channels are available at the wholesale level in packages, for which retailers pay a single wholesale charge. For example, the current wholesale charge for all Sky’s premium sports and movie channels excluding Sky Sports Xtra is [CONFIDENTIAL]. There is no meaningful way of dividing that charge between the sports channels and the movie channels supplied to retailers: it is a single charge for a package of channels.
- 2.8 Moreover, a significant proportion of subscribers to Sky’s premium channels (whether Sky subscribers or Virgin Media subscribers) subscribe to a package that includes both sports and movie channels. During 2007/08 on average around [CONFIDENTIAL]% of the total number of Sky’s premium subscribers fell into this category. At the end of September 2008, [CONFIDENTIAL]% of Virgin Media customers who subscribed to Sky’s premium channels took a combination of both sports and movie channels. As a result, the majority of Sky’s wholesale revenue (both notional and actual), comprises revenue that is common to its premium sports and movie channels.
- 2.9 In relation to costs, there are a number of costs which are common across a range of Sky’s channels. These include the running costs of broadcasting facilities and associated personnel, such as edit suites, studios or tape usage, which are utilised for a variety of different channels on a daily basis.
- 2.10 The problems with separating Sky Sports from Sky Movies can be seen clearly in Ofcom’s own estimates. Using different approaches to common revenue allocation results in Ofcom’s estimates of Sky’s gross margin on supplying its premium sports channels varying between [CONFIDENTIAL]% and [CONFIDENTIAL]%. Similarly, Ofcom’s estimates in relation to Sky’s movie channels are between [CONFIDENTIAL]% and [CONFIDENTIAL]%.<sup>3</sup> In financial terms, this represents a potential swing in revenues by up to around [CONFIDENTIAL] for each of premium sports or movie channels. These variations are caused wholly by adopting different rules as to how to divide up common revenues among the two lines of business.
- 2.11 The only meaningful way of approaching the evaluation of the profitability of Sky’s notional premium channel supply business is to examine its profitability *as a whole*.
- 2(b) *Ofcom’s approach is likely to overstate the profitability of Sky’s notional premium channel business over the medium term***
- 2.12 Ofcom considers that in carrying out its duty to promote competition it is required to take a dynamic and forward-looking view.<sup>4</sup> Accordingly, in considering whether Sky might set high wholesale prices, it is important to consider not just

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<sup>3</sup> Paragraph 2.44 of Annex 9 to the Consultation Document.

<sup>4</sup> See Part 2 of **Section 3** above, where Sky argues that Ofcom misinterprets its duty to promote competition.

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Sky's profitability today but also how this can be expected to evolve in the future. The profitability analysis carried out by Ofcom in its Consultation Document is, however, historic in nature.

- 2.13 Moreover, it is important to bear in mind that the profitability of most businesses fluctuates year-on-year, so examining profitability in only a single year may provide an unreliable view of profitability. Ofcom's historic analysis only looks at a single year - 2007/08. In the case of the profitability of Sky's notional premium channel business, elements such as advertising and sponsorship revenue, sports rights costs and the sterling equivalent of dollar denominated movie rights costs can vary significantly year-on-year. As a result, in order to avoid false conclusions about both the historic and future profitability of Sky's notional premium channel supply business, it is necessary to examine a number of years' data.

### **[CONFIDENTIAL]**

#### Variability of advertising and sponsorship revenues

- 2.14 Advertising and sponsorship revenues can fluctuate significantly from year to year. For example, advertising and sponsorship revenues for Sky's premium channels declined by around **[CONFIDENTIAL]**% between 2004/05 and 2007/08, with around a **[CONFIDENTIAL]**% decline between 2006/07 and 2007/08. Such revenues are affected both by changes in market conditions, and by the performance of the relevant channels.
- 2.15 Advertising and sponsorship revenue will vary depending on the viewing performance of Sky's channels, which can vary significantly year-on-year. Viewing may be impacted, for example, by different sports content being broadcast each year, or the volume of popular movies available and by what is available on other channels. For example, the Olympic Games or FIFA World Cup would tend to depress viewing of Sky's channels.
- 2.16 The change in the value of the television advertising sector also has a very significant impact on advertising revenues received by Sky. In particular, the advertising sector for the 2008 calendar year is expected to have declined by **[CONFIDENTIAL]**% year-on-year, with a further decline expected of up to around **[CONFIDENTIAL]**% during the 2009 calendar year.<sup>5</sup> This will have a direct impact on Sky's advertising and sponsorship revenues, and **[CONFIDENTIAL]**.

#### Variability of the cost of programming rights

- 2.17 The total cost of programming rights is also subject to large fluctuations year-on-year, in addition to a general upward trend caused by increasing intensity in competition for rights.
- 2.18 In relation to sports rights, there are two key sources of such variation: changes at the end of rights contracts, and broadcasting events that do not occur each year.

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<sup>5</sup>

**[CONFIDENTIAL]**

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2.19 [CONFIDENTIAL]

2.20 [CONFIDENTIAL]

**Figure 1**

[CONFIDENTIAL]

2.21 The timing of sporting events also significantly generates movements in sports rights costs, and therefore profitability, year-on-year. Sky currently holds the rights to a number of sporting events which do not occur on an annual basis. These are set out in **Table 2** below. Given that the majority of non-annual rights that Sky holds did not occur in the financial year examined by Ofcom, taking this year in isolation underestimates Sky’s ongoing rights costs.<sup>6</sup>

**Table 2**

**Non-annual sports rights**

Sport	Event	Frequency	Last event
<i>Non-annual events</i>			
Rugby League	World Cup	Ad-hoc	2008/09 <sup>7</sup>
Golf	Ryder Cup	Biennial	2008/09
Golf	Solheim Cup	Biennial	2007/08
Cricket	World Twenty20	Biennial	2007/08
Cricket	ICC Champions Trophy	Biennial	2006/07
Sailing	America’s Cup	Ad-Hoc	2006/07
Rugby Union	Lions Tour	Every 4 years	2004/05
<i>Variable annual events<sup>8</sup></i>			
Cricket	England Overseas Tours	n/a	n/a
Football	International Qualifiers	n/a	n/a

<sup>6</sup> Taking 2008/09 as an example, the incremental cost of non-annual rights, and the associated production costs, when compared to 2007/08, is around [CONFIDENTIAL]. As the majority of these events occur every two years, there is a similar pattern for 2006/07 (high cost) and 2005/6 (low cost). Adjusting 2007/08 to be an average year, sports rights costs would need to increase by [CONFIDENTIAL] to reflect these events.

<sup>7</sup> The previous event was held in 2000 and the next event is scheduled for 2013.

<sup>8</sup> Cost of rights depends on number of games played and teams participating.

Foreign exchange rate fluctuations

- 2.22 Movie output deals from all of the major US studios are negotiated in US dollars, exposing Sky to a degree of risk and uncertainty relating to exchange rate fluctuations. For example, the US dollar spot rate declined by over 28% in the last six months of 2008.
- 2.23 Sky hedges its exposure to fluctuations in foreign exchange rates thus sheltering Sky's P&L from short-term exchange rate volatility. [CONFIDENTIAL]. However, hedging in advance only delays the impact of exchange rate movements into future years – it does not remove it. Once short term hedging protection falls away, Sky is ultimately exposed to movements in spot rates. Whilst Sky's movies costs will benefit in 2007/08 from hedges placed in prior years (when for example, Sky hedged its US dollar exposure at around [CONFIDENTIAL]), future years costs will be impacted by hedging placed at this year's rates of around [CONFIDENTIAL].
- 2.24 [CONFIDENTIAL] thus sheltering Sky's P&L from short-term exchange rate volatility.

**2(c) Errors in Ofcom's analysis of wholesale profitability**

- 2.25 Given that Ofcom's profitability analysis is historic in nature and is, due to the variability in key costs and revenues, likely to provide a poor indicator of future profitability, we have not considered the calculations in any detail. However, based on our cursory examination we consider that Ofcom's analysis contains a number of analytical errors.<sup>9</sup>

**3. Evaluation of Sky's operating margin in its notional premium pay TV channel business**

- 3.1 Ofcom concludes that Sky is making a gross margin on the wholesaling of premium sports channels of between [CONFIDENTIAL]% and [CONFIDENTIAL]%, and between [CONFIDENTIAL]% and [CONFIDENTIAL]% for premium movie channels, depending on how revenue for combined sports and movie bundles is allocated. On the basis of these estimates of gross margin, Ofcom concludes that gross margins on movies are significantly higher than those observed on sports. This observation does not provide any indication as to whether either of these gross margins is "high" and is simply a function of the allocation method used in relation to common revenues.

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<sup>9</sup> Ofcom's estimate of advertising and sponsorship revenues materially over-states (by over [CONFIDENTIAL]) the amounts of advertising and sponsorship revenue earned by Sky in financial year 2007/08 in relation to its premium channels. Ofcom also appears to have substantially overstated the revenue in relation to the supply of Sky's premium channels to commercial premises (by around [CONFIDENTIAL]) by using retail revenues earned by Sky rather than actual and (notional) wholesale revenues. In addition it would appear that Ofcom has overestimated Sky's residential notional wholesale revenue (by over [CONFIDENTIAL]) by using the wholesale ratecard applicable from September 2008 which included £1 price increases for several packages.

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- 3.2 Ofcom then proceeds to assess the operating margin earned by a notional combined Sky Sports and Sky Movies business in 2007/08 by deducting an allocation of corporate overheads from the combined gross margin of these two activities. Ofcom estimates that the operating margin for Sky's notional premium channel supply business in 2007/08 was approximately [CONFIDENTIAL]%. As set out above, in Sky's view this is the relevant metric against which the profitability of Sky's notional premium channel supply business should be judged.
- 3.3 The obvious question such an estimate raises is how to judge its reasonableness. It is unclear, however, how Ofcom intends to draw a conclusion as to the reasonableness or otherwise of the estimated operating margin. In order to draw any conclusions from its estimates, Ofcom would need to set out a framework which would enable it to establish what a reasonable operating margin might be and then consult on this framework.<sup>10</sup>
- 3.4 The only comparisons Ofcom makes are between this margin and (a) the operating margin of Sky as a whole, and (b) Ofcom's estimate of the margin earned by Sky's pay TV business. The comparison with the margin earned by Sky as a whole or on Sky's pay TV business is inappropriate. There is no reason why either of these should be considered to be a relevant benchmark. Sky's business is complex and spans a range of different activities at different parts of the value chain, at different stages of maturity, with different levels of risk, and in different sectors. For example, the margin earned on Sky's whole business will reflect returns on investments in lines of business which include: high definition television services, betting, online portals, broadband and telephony. The different parts of Sky's businesses will be exposed to different levels of risk, sunk costs and reflect different levels of capital investment. They would therefore be expected to earn different operating margins. Hence the suggestion that the margin earned on Sky's notional premium channels business is higher than for Sky's whole business, or its pay TV business, provides no good evidence on the reasonableness of [CONFIDENTIAL]% as an operating margin for Sky's notional premium channel supply business. Specifically, it should be noted that it is Sky's notional broadcasting business which faces the risk associated with large fixed term contracts for rights. In contrast, Sky's retailing activities (and those of third party retailers), operating largely on a variable cost basis, are able to take advantage of content investments on a low-risk per subscriber basis.
- 3.5 Sky considers that in reaching a view as to the reasonableness or otherwise of Sky's operating margin, it is more appropriate to compare Sky's margin with that earned by companies in similar businesses. Such an approach is a standard one in competition enquiries, and it is somewhat surprising that Ofcom has not undertaken any analysis of this type itself.

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<sup>10</sup> We note that in assessing whether Sky's wholesale prices were "high" Ofcom would need to have regard to the economic value of the product supplied and would also need to bear in mind the clear guidance from the Court of Appeal in *Attheraces v BHB 2007* [EWCA] Civ.38, in which the Court of Appeal reversed the High Court's finding of excessive pricing.

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3.6 Sky has identified (as far as possible) comparable broadcasting businesses in the UK and internationally (some of which operate worldwide<sup>11</sup>) and assessed their profitability. Our analysis is limited to those companies whose accounts were readily available to Sky, either publicly or through Sky’s existing relationships, i.e. joint venture agreements.<sup>12</sup> The results of this analysis are summarised in **Table 3** below.

**Table 3**

**Operating margin benchmarking <sup>13</sup>**

	2005/6	2006/7	2007/8
<b>UK</b>			
[CONFIDENTIAL] <sup>14</sup>	[CONFIDENTIAL]%	[CONFIDENTIAL]%	[CONFIDENTIAL]%
Viacom: Nickelodeon UK <sup>15</sup>	26%	32%	35%
UK Gold Holdings	38%	35%	35%
<b>Other countries</b>			
Time Warner Networks	29%	27%	29%
Viacom Media Networks	39%	40%	38%
Discovery	21%	20%	20%
Disney Media Networks	24%	25%	28%
CBS Television	18%	18%	19%
Mediaset	32%	28%	28%
Media Capital Television (TVI / NBP Portugal)	26%	26%	26%
[CONFIDENTIAL] <sup>16</sup>			[CONFIDENTIAL]%

<sup>11</sup> Channel providers operating out of their domestic market are: National Geographic Europe; Viacom: Nickelodeon UK; Time Warner Networks; Viacom Media Networks; Discovery; Disney Media Networks.

<sup>12</sup> Some operations include a mixture of pay and free to air services.

<sup>13</sup> Unless otherwise noted, all benchmarked companies report for the 12 months to 31 December. Note that several companies (Time Warner, Viacom, Disney and CBS) have not allocated all shared / corporate costs across their business segments. Sky consider that this will not materially impact the operating margins of these companies and has not attempted to allocate out these corporate costs.

<sup>14</sup> [CONFIDENTIAL]

<sup>15</sup> Due to a change in accounting period, “2006/7” refers to an 18 month period for Nickelodeon UK and “2007” reflects the 12 months to 30 June 2008.

<sup>16</sup> [CONFIDENTIAL]

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- 3.7 Comparing the Ofcom estimate of the operating margin earned by Sky's notional premium channels business with operating margins of similar companies, demonstrates that Sky's operating margin is at the lower end of the range provided by comparator companies. In Sky's view, this is a strong reflection of the intensely competitive environment in which Sky operates.
- 3.8 In addition, Sky employs a number of highly experienced people with in-depth knowledge of the broadcasting and media sector from across both the UK and the rest of the world. It is with this knowledge, and as a shareholder in a number of joint ventures, that Sky is confident that these levels of operating margin are typical of other comparable entities.

### ***Ofcom's proposition that returns to rights owners should be taken into account***

- 3.9 Ofcom, however, appears to consider that even if the returns earned by Sky's own premium channel business are found to be reasonable, it might still be the case that Sky could be considered to be earning excess returns, as Ofcom's estimates do not include payments to rights owners. For example, Ofcom states:

*“even if we could obtain an accurate estimate of Sky's profitability, it may under-estimate the total profitability associated with the wholesale of this premium content, since it excludes any rents which are retained by rights owners.”<sup>17</sup>*

- 3.10 We can only assume that we have misunderstood what Ofcom has stated here – although on the face of it, the statement appears fairly clear.
- 3.11 If this is, in fact, what Ofcom believes, then such a proposition is simply nonsensical. It suggests that Ofcom considers that the returns to a provider of premium pay TV channels should be taken also to include the rents earned by the suppliers of inputs to the pay TV channel provider's business – i.e. income that is earned by someone else entirely.
- 3.12 There is a risk that the evidence Sky has set out above to demonstrate that its wholesale prices are reasonable may be ignored and that Ofcom may seek to find that Sky has exploited its alleged market power by setting high wholesale prices on the basis of the profits that rights holders might earn from selling rights to Sky. This would be entirely incorrect. The returns earned by Sky in relation to its premium channels comprise the income earned by Sky from those channels, less the costs incurred by Sky (in which payments to the owners of programme rights predominate). It is clear that, in assessing whether Sky has in fact engaged in the second form of conduct of setting high wholesale prices, only Sky's profits are relevant. The level of profits earned upstream of Sky has no bearing on whether **Sky** is setting high wholesale prices.

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<sup>17</sup> Paragraphs 1.30 and 6.2 of the Consultation Document.

## SECTION 7: OFCOM'S PROPOSED INTERVENTIONIST AND UNPRECEDENTED NEW REGULATION IS NOT NECESSARY, PROPORTIONATE OR CONSISTENT

### 1. Introduction

- 1.1 Ofcom has a legal obligation to ensure that its regulation is, among other things, targeted only at cases in which action is needed. Even leaving aside the other shortcomings from a legal perspective flowing from Ofcom's proposals to impose new regulation on Sky (which we address in detail in **Section 3** above), they fail this elementary test. Although Sky has chosen in this Section 7 to address many of the other significant flaws in Ofcom's proposals to introduce significant new regulation, this should not detract in any way from the fundamental point that Ofcom has not established to the required standard that it is necessary to introduce regulation in any form.
- 1.2 Foremost among the other flaws in Ofcom's approach to its regulatory proposals is the fact that Ofcom has not undertaken any substantive assessment of their costs and benefits. Ofcom has a legal duty to undertake such analysis, to a rigorous standard, and the analysis in the current Consultation Document does not come close to fulfilling that duty. In particular, there is essentially no consideration of the numerous and significant costs that are likely to be associated with the introduction of new regulation of the type that Ofcom proposes.
- 1.3 This is particularly important in light of the fact that the approach to regulation being contemplated by Ofcom is both radical and unprecedented. In such circumstances there is a considerable risk of unintended consequences, which argues for a careful and rigorous assessment of what might happen if the new regulation were to be introduced. Ofcom has argued that its proposals are a relatively standard form of regulation. This is erroneous. Ofcom's proposals (a) are far more prescriptive and wide-ranging than such regulation in Ofcom's comparator countries, and (b) are significantly different in form to the regulation that exists in those countries, particularly with regard to issues of price control. Ofcom has further argued that its proposals simply replicate what would be expected to occur in a competitive market. This is also erroneous: suppliers of premium channels would never willingly license their channels to retailers on the terms that Ofcom proposes to impose on Sky, regardless of the structure or competitiveness of the markets in which they operate.
- 1.4 A further major flaw in Ofcom's proposals is that consideration of significant issues such as the range of services to which regulation would apply, and the commercial matters which Ofcom proposes to regulate (including control of Sky's charges for its premium channels), is regarded as simply a matter of "*getting the detail right*"<sup>1</sup>. That is a fundamental misconception. Ofcom must, instead, properly consider the necessity and proportionality of (a) extending the scope of compulsory licensing beyond linear standard definition versions of Sky's premium channels, and (b) micro-regulating a wide range of wholly

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<sup>1</sup> Paragraph 9.8 of the Consultation Document.

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standard commercial issues. A brief analysis of some of the issues raised as matters of “*detail*” by Ofcom indicates that they involve significant matters such as the expropriation of Sky’s property, or appear to be founded on an inadequate level of knowledge of the matters considered – for example the fact that Sky’s interactive services are almost never used to provide live Premier League football matches to consumers.

- 1.5 Finally, Ofcom’s proposals do not meet its legal obligation to ensure that its regulation is applied consistently. Ofcom proposes to impose regulation only on Sky. Yet the rationale on which Ofcom’s proposals are based has far wider application, and it would appear evidently inconsistent to require Sky to license HD versions of its premium channels and to provide its interactive services to other platforms, while there is no ‘must offer’ obligation on PSBs in relation to HD versions of their main channels or any of their interactive services. This inconsistency is further underlined by Ofcom’s rejection of the imposition of a ‘must offer’ obligation on Setanta in relation to its services which carry 46 live Premier League football matches a year.
- 1.6 The most appropriate next step in Ofcom’s inquiry is to draw it to a close. If, however, Ofcom is to continue to propose the imposition of new regulation on Sky, it must first remedy the very significant flaws discussed above, and consult properly on suitably revised and expanded analysis. Such consultation must occur before any consultation on the specific regulation that Ofcom proposes to impose on Sky.

## 2. Ofcom’s proposals

- 2.1 In Sky’s view, it is evident that, notwithstanding statements to the contrary, Ofcom has already reached a firm view that it is necessary to impose new regulation on Sky. For example, at paragraph 8.23 of the Consultation Document, Ofcom states (without any analysis that would enable Ofcom to form such a judgment) that:

*“the likely detriment [from not introducing new regulation] outweighs the risks of intervention.”*

- 2.2 Similarly, the level of detail in some areas discussed in Section 9 of the Consultation Document, and Ofcom’s comments at its most recent City media analysts briefing,<sup>2</sup> suggests strongly that Ofcom is currently fully engaged in, as Ofcom puts it, “*getting the detail right*”<sup>3</sup> of the proposed intervention.
- 2.3 It is also evident that Ofcom’s preferred option is to adopt a highly interventionist approach, involving the confiscation of Sky’s legitimate property rights and the imposition of detailed, prescriptive *ex ante* regulation. We see Ofcom’s central proposal as comprising the following:

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<sup>2</sup> For example, Steve Unger stated: “*One of the challenges we have in setting a price is working out what is the right way of setting that price.*” Steve Unger also stated: “*There is also a question about the return on capital. This is an issue we **will have to address** in the next phase of our work.*” (Emphasis added)

<sup>3</sup> Paragraph 9.8 of the Consultation Document.

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- (a) a licence condition or direction that would require Sky to supply to third parties (other than in respect of platforms on which Sky itself supplies its channels) on request:
  - (i) standard definition versions of its premium sports and film channels;
  - (ii) high definition versions of its premium sports and film channels; and
  - (iii) interactive services which carry “*Core Content*”;
- (b) *ex ante* control of the wholesale charges for Sky’s channels according to a pricing formula which is based on a ‘retail-minus’ approach where the ‘minus’ is determined by the costs of potential new third party retailers – as set out in **Section 3** above, we refer to this as ‘extended retail-minus’ price control to distinguish it from the more usual ‘retail-minus’ approach in which the relevant costs are a firm’s own retail costs. Ofcom also raises the possibility of setting charges based on a “*cost-plus*” approach (i.e. the cost to Sky of producing and supplying its channels) if this results in charges which are lower than those which result from a retail-minus approach;
- (c) regulation of the “*content of [Sky’s] channels*”, and technicalities of distribution, including, for example:
  - (i) expropriation of Sky’s right to benefit from both cross-promotional airtime, and advertising airtime on its channels, as Sky sees fit;
  - (ii) the type of compression technology used by Sky and the bit rate at which channel feeds are supplied; and
- (d) regulation of the terms and conditions of carriage agreements in relation to Sky’s television channels and other services that Sky would be compelled to supply to third parties.

### **3. There is no need for new regulation in any form**

3.1 As discussed in **Section 3** above, Ofcom’s legal obligations require, among other things, that it should regulate only where necessary. Ofcom has not, however, established, to any reasonable standard, that any new regulation is needed in relation to pay TV services in the UK.

#### **3(a) Compulsory licensing of Sky’s premium pay TV channels**

3.2 The core of Ofcom’s proposals for new regulation is the proposal to require Sky to license its premium sports and film channels to third parties, a proposal that is inherently confiscatory. Ofcom concludes that this is necessary in order to achieve the outcomes it wishes to see.

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- 3.3 As we set out in detail in **Section 5** above, Ofcom's conclusions about Sky's incentives to supply its channels to consumers on other platforms are flawed and cannot be relied on. Ofcom draws the wrong conclusions from both the theoretical modelling analysis it has undertaken (which itself is fundamentally flawed), and its observation of the current pattern of distribution of Sky's channels. In relation to Ofcom's analysis of Sky's incentives to continue to supply its channels to Virgin Media, the major existing third party retailer of Sky's channels, Ofcom fails to have regard to numerous real-world facts which mean that the reality is that the prospect of Sky withdrawing its premium channels from Virgin Media is remote. Moreover, given the focus of Ofcom's Consultation Document on Sky's incentives to supply its premium channels to new pay TV retailers and/or platforms, Ofcom's focus on Sky's incentives to supply Virgin Media is irrelevant. In relation to new pay TV retailers and/or platforms, Ofcom's modelling analysis supports Sky's own proposition that Sky does, in fact, have an incentive to supply its channels via these retailers and/or platforms.
- 3.4 Furthermore, even if Ofcom's conclusions in this respect were correct (which they are not), as discussed in **Section 4** above, Ofcom has failed properly to assess competition in the relevant downstream market. As a result, Ofcom fails to recognise:
- (a) the powerful competitive discipline that the free to air television sector in the UK places on the providers of pay TV services generally; and
  - (b) the additional constraint that a wide and increasing variety of ways in which consumers can watch movies imposes on the providers of pay TV services that include premium movie channels.<sup>4</sup>
- 3.5 When these matters are taken into account it is evident that Sky would not be in a position to distort the competitive process in the UK audiovisual sector via selective distribution of its premium sports and movie channels among different pay TV retailers and/or platforms.
- 3.6 Once these errors are corrected, there is simply no case for compulsory licensing of Sky's premium pay TV channels. Ofcom's proposal to compel Sky to license its premium pay TV channels to other operators fails the basic test of being targeted only at cases in which action is needed.

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<sup>4</sup> In a number of places in the Consultation Document Ofcom recognises the significant changes that are taking place in the ways in which consumers can access Hollywood blockbuster movies. (See, for example, paragraph 1.16 of the Consultation Document.) These types of changes are discussed further at **Annex 3**. Such changes, however, lead Ofcom only to conclude that it would be necessary to review its proposed regulation in the future, rather than the more natural conclusion that, in light of the changes that are occurring, it would be an unusual time to introduce a 'must offer' obligation on the supplier of one means of accessing such movies. The latter conclusion would only be reinforced by consideration of the potential for a 'must offer' obligation on the supply of Sky's premium movie channels to reduce incentives to develop alternative types of movie services.

**3(b) Proposals to set price controls to directly control excess profitability**

- 3.7 The failure to target proposals for regulation only at cases in which action is needed is even starker in relation to Ofcom's proposals to introduce a "cost-plus" price control which has the objective of controlling the level of Sky's profitability in the production and distribution of its premium pay TV channels. This is for two reasons.
- 3.8 First, such price control is not necessary for the purpose to which Ofcom's 'must offer' proposals are directed – ensuring the availability of Sky's premium pay TV channels to consumers on other platforms.
- 3.9 Second, and most importantly, as Ofcom acknowledges, the purpose of such regulation is to control excess profits (or, in Ofcom's formulation, "*setting high wholesale prices*"<sup>5</sup>). Ofcom has not, however, even reached a conclusion that Sky earns excess profits in its notional premium channel business. It is therefore wholly improper for Ofcom to be seeking to develop a remedy to a problem that it has not established exists.<sup>6</sup> As we show in **Section 6** above, no such problem exists, so no remedy is necessary.

**3(c) The benefits of relaxing existing regulation instead of introducing new regulation**

- 3.10 Ofcom has failed to have regard to the potential beneficial effects of a combination of ending its inquiry, and taking a deregulatory stance towards carriage agreements for premium pay TV channels. This is particularly surprising because Ofcom's own guidance on the assessment of proposals for new regulation indicates that Ofcom "*will start by considering the option of not changing the regulatory framework*" and that "[t]his option – no new intervention – will generally be the benchmark against which other options are judged".<sup>7</sup>
- 3.11 As we discuss in **Section 5** above, Ofcom's pay TV inquiry, and Ofcom's prevention to date of Sky developing its own DTT pay TV service, have themselves been the key impediments to making Sky's channels available to consumers on new pay TV platforms over the past two years. Drawing Ofcom's inquiry to a close would return the sector to a more normal commercial footing, and strengthen considerably the likelihood of either channel supply agreements or access arrangements being commercially negotiated.

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<sup>5</sup> Second bullet point, paragraph 1.50 of the Consultation Document.

<sup>6</sup> We note, in this respect, the mindset that is betrayed by Ofcom's approach to this issue. Subsequent to the publication of the Consultation Document, Ofcom has sought from Sky financial information intended to inform an analysis of this matter. Ofcom's approach is essentially that it should carry out work on the remedy while it seeks the evidence which might establish that there is a problem, in spite of all evidence available at this point in time suggesting that there is no problem to be addressed. In other words, Ofcom is operating according to a preconception that a problem exists, and that the alleged problem requires a regulatory remedy.

<sup>7</sup> Paragraph 3.3 of 'Better Policy Making, Ofcom's approach to impact assessment', July 2005. Available at: [http://www.ofcom.org.uk/consult/policy\\_making/guidelines.pdf](http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf)

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- 3.12 Although Sky already has significant incentives to supply its channel to new retailers and platforms, Ofcom could also *improve* those incentives by taking a more rational, deregulatory approach to examination of carriage agreements for Sky's premium pay TV channels.
- 3.13 Wholesaling pay TV channels to third party retailers raises standard principal-agent issues. A channel provider is dependent to a significant extent on the efforts of the pay TV retailer, whose interests may not be aligned with those of the channel provider. It is, however, possible to mitigate such issues via the negotiation of contracts that better align incentives – for example by providing discounts in wholesale charges in return for the retailer achieving targets in terms of subscriber numbers.
- 3.14 Since 2002, however, Sky has effectively been prohibited from negotiating such agreements, and has had, instead, to wholesale its channels on the basis of a ratecard without discount structures.<sup>8</sup> An Ofcom policy which took a more rational approach to the negotiation of economically efficient carriage contracts for Sky's premium channels would be likely to have significant beneficial effects. Instead, Ofcom's proposals would perpetuate existing principal-agent problems by eliminating entirely any possibility of negotiating economically efficient carriage agreements.

### **Conclusion**

- 3.15 Ofcom's proposals to impose new regulation on Sky fail the basic test of being targeted only at cases in which action is needed. New regulation is not required. As we indicated in our Response to the First Consultation Document, Ofcom was in a position a long time ago to reach that conclusion, and it should certainly do so now. Drawing Ofcom's long-running inquiry to a close would go a long way towards achieving the distribution of Sky's channels to consumers on new platforms that Ofcom would like to see, particularly if combined with a more rational stance towards efficient carriage agreements.
- 3.16 The discussion of Ofcom's regulatory proposals contained in the rest of this Section 7 of Sky's Response is without prejudice to the fundamental point that there is no justification for new regulation. Although we have chosen not to make this point repeatedly below, its importance should not be diminished in any way as a result.

## **4. Ofcom fails to consider the costs of regulation**

- 4.1 In order properly to determine whether proposals for new regulation are necessary and proportionate it is necessary to evaluate and compare the benefits that are anticipated to be delivered by the new regulation with its expected costs.
- 4.2 While Ofcom's evaluation of the potential benefits of its proposals for new regulation in the Consultation Document is meagre, among the most surprising

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<sup>8</sup> See Sky's response to Ofcom's questions of 2 July 2008.

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aspects of that document is the fact that consideration of the potential costs associated with its proposals is virtually non-existent. Ofcom's apparent premise in the Consultation Document is that regulation is essentially costless. The analytical approach that Ofcom has adopted towards proposals for new regulation in the Consultation Document is, first, to decide whether new regulation is, in Ofcom's view, required, and, second, to seek to determine the detail of that regulation – described as “*getting the detail right*”<sup>9</sup>. Save for cursory references to “*risks*”<sup>10</sup>, and an intention on Ofcom's part to develop an “*awareness*” of the impact of its proposals on rights owners<sup>11</sup>, there is no consideration of the potential detriments arising from Ofcom's regulatory proposals.

4.3 We find this omission astonishing. Not only is a proper evaluation of the likely costs of proposals for regulation normally an issue that is central to the bringing forward of such proposals, but it is also central to Ofcom's own guidance on how it will approach such proposals. Ofcom's impact assessment guidelines state:

“A **key part** of our assessment of which is the best option will be an analysis of the benefits **and costs** that would flow from each option.”<sup>12</sup>  
(Emphasis added)

4.4 In fact, there is a significant risk that new regulation will worsen outcomes for consumers relative to a no-new-regulation scenario in this case. As we discuss further below, Ofcom's proposals create real and significant risks of causing the following types of detriments:

- introducing significant long-term economic inefficiency into the UK pay TV sector;
- reducing investment and slowing the pace of innovation in the UK pay TV sector;
- reducing competition for programming rights, or reducing the returns to the producers of pay TV channels, with consequential reductions in revenue received by rights owners;
- increases in prices to consumers; and

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<sup>9</sup> Paragraph 9.8 of the Consultation Document.

<sup>10</sup> See for example, paragraph 8.1 of the Consultation Document, where Ofcom states: “*Despite the existence of the concern, we could deem the risks of intervention too great, and take no further action*”. The use of the word “*risks*” in this sentence is erroneous. Ofcom should compare the costs of intervention against its benefits. Where Ofcom considers that there is uncertainty about whether a potential cost that has been identified will arise, Ofcom should *further* evaluate the probability (i.e. the *risk*) of that cost arising. Paragraphs 8.17 and 8.19 of the Consultation Document also erroneously discuss the “*risks*” arising from Ofcom's regulatory proposals.

<sup>11</sup> Paragraph 8.88 of the Consultation Document.

<sup>12</sup> Paragraph 5.30 of ‘Better Policy Making’. *Op cit*.

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- new administrative and compliance costs which are likely only to increase over time.

4.5 In addition, as we also discuss below, Ofcom's proposals create a risk of giving rise to unintended adverse consequences – i.e. consequences which it is difficult if not impossible to anticipate occurring, even after thorough analysis.

### 4(a) The economic costs of access regulation

4.6 The general form of regulation contemplated by Ofcom is known as 'access regulation' – the compulsory supply by one party of inputs to another party's business. Such a policy abrogates a fundamental freedom available to firms in a market economy: the right freely to choose their trading partners and the terms upon which they trade with such partners. One of the most obvious and well-known problems with such regulation – and one of the reasons that its use is seen as something not to be engaged in lightly – is that this abrogation of firms' property rights has the potential to damage incentives which lie at the heart of the competitive process: incentives for investment and innovation.<sup>13</sup> It has the potential not only to damage the incentives to invest and innovate of the party required to offer up its products to other firms, but it may also reduce similar incentives:

- (a) on the part of firms who may operate at the same level as the regulated firm, by posing a risk that, if they too are successful, regulated access to their products will then be imposed upon them; and
- (b) on the part of downstream firms in relation to incentives to compete on the upstream market, by developing their own competing products.<sup>14</sup>

4.7 Among the most well-known articulations of such issues is the Opinion of the Advocate General in the Oscar Bronner case, which states:

*“In the long term it is **generally pro-competitive and in the interest of consumers** to allow a company to retain for its own use facilities which it has developed for the purpose of its business. For example, if access to a production, purchasing or distribution facility were allowed too easily there would be no incentive for a competitor to develop competing facilities. Thus while competition was increased in the short term it would be reduced in the long term. Moreover, the incentive for a dominant undertaking to*

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<sup>13</sup> A good example of this is that, if Ofcom imposed the type of obligations on Sky in relation to interactive services contemplated in the Consultation Document, the best course of action from Sky's point of view would be to cease developing and investing in interactive services covered by the regulation, to the detriment of consumers.

<sup>14</sup> In this case, this might reduce upstream competition for rights, as pay TV retailers who have guaranteed access to Sky's premium channels have a reduced incentive to develop their own sports and film channels.

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*invest in efficient facilities would be reduced if its competitors were, upon request, able to share the benefits.”<sup>15</sup> (Emphasis added)*

- 4.8 Such issues have been recognised in the economic literature for many years, both in relation to compulsory access to inputs generally and in relation to intellectual property rights in particular. For example, Gilbert and Shapiro state:

*“An obligation to deal does not necessarily increase economic welfare even in the short run. In the long run, obligations to deal **can have profound adverse incentives for investment and for the creation of intellectual property**. Although there is no obvious economic reason why intellectual property should be immune from an obligation to deal, the crucial role of incentives for the creation of intellectual property is reason enough to justify skepticism toward policies that call for compulsory licensing. Equal access (compulsory licensing in the case of intellectual property) is an efficient remedy only if the benefits of equal access outweigh the regulatory costs and the long run disincentives for investment and innovation. This is a high threshold, particularly in the case of intellectual property.”<sup>16</sup> (Emphasis added)*

- 4.9 Similarly, Overd and Bishop state:

*“From an economist's point of view (a view we think is shared by most lawyers), the key issue is that we do not normally think that it is a good idea to require third-party access to a private asset. The argument against such a requirement is that it might undermine the incentive to develop the asset in the first place. Moreover, the effect could extend beyond the asset in question and might affect the incentives of all firms that came to know that requests for such access were often granted. The argument for such a requirement is that it might increase competition in a downstream market to the benefit of consumers. In the majority of situations we believe that the argument against dominates and only in exceptional circumstances do we consider it appropriate to require such access to be made available.”<sup>17</sup>*

- 4.10 Such issues are of central importance in the context of Ofcom's proposals, and it is therefore of considerable surprise that Ofcom makes no mention of them in its Consultation Document.
- 4.11 While these issues are of central relevance to proposals to provide compulsory supply of standard definition versions of Sky's channels, they are even more

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<sup>15</sup> Opinion of Advocate General Jacobs in Case C-7/97 *Oscar Bronner GmbH & Co. KG Mediaprint Zeitungs- und Zeitschriftenverlag Y Co. KG et. Al – Reference for a preliminary ruling: Oberlandsgericht Wien - Austria* (1998) ECR I-7791 at paragraph 57.

<sup>16</sup> R.J. Gilbert and C. Shapiro, 'An economic analysis of unilateral refusals to license intellectual property', *Proceedings of the National Academy of Sciences of the United States of America* 93(23), November 1996, at pages 12749–12755.  
Available at: <http://www.pnas.org/content/93/23/12749.full.pdf?ck=nck>

<sup>17</sup> A. Overd and B. Bishop, 'Essential Facilities: The Rising Tide', *European Competition Law Review* (1998), page 183.

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significant in relation to high definition versions of Sky's channels. It is a little over two and a half years since Sky incurred considerable cost and risk to launch the first high definition television platform in the UK. The launch of this platform has been accompanied by significant investment as both a pay TV retailer and a broadcaster of pay TV channels, and it is clear that, absent Sky's efforts, the UK would not be in the position that it is in today with respect to high definition television broadcasting, one where consumers have access to more HD channels than in any other European country.<sup>18</sup>

4.12 Ofcom's proposal to mandate access to high definition version of Sky's channels sends all the wrong signals to the communications industry in relation to Ofcom's attitude to rewards for risk taking and innovation, and runs directly counter to Ofcom's statutory responsibility to have regard to the desirability of promoting investment and innovation.

4.13 We discuss further issues in relation to Ofcom's proposals to require Sky to supply high definition versions of its channels in Part 8(a)(i), below.

### **4(b) Other costs of regulation**

#### **4(b)(i) Costs associated with the imposition of prescriptive regulation on Sky, and reduction in revenues**

4.14 Ofcom's clear inclination with respect to regulation in this case is towards the imposition of a panoply of prescriptive *ex ante* rules on Sky, together with a price control that would result in significant reductions in Sky's revenue. Aside from brief and passing references to "risks" (as discussed above<sup>19</sup>) Ofcom has failed to have any regard at all to the very serious potential consequences of such an approach.

4.15 It is critical that Ofcom takes into account in its further consideration of these matters the risks that such regulation would generate in relation to Sky's position as a key driver of the positive outcomes that have been delivered to UK consumers to date – not only in terms of the platform innovations recognised by Ofcom, but also in terms of a demonstrated propensity to undertake significant, risky investments across a wide range of products and services.<sup>20</sup> Ofcom must

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<sup>18</sup> For example, *New Media Markets's* recent survey of the availability of HD channels in Europe found that: "The UK boasts the biggest HD service, with BSkyB's 28-channel package offering 10,000 hours of HD content a month. The closest any other operator gets to that is the 16 channels offered by French cable operator Numericable", *New Media Markets*, 21 November 2008. Sky has since added more HD channels and plans further expansion.

<sup>19</sup> See paragraph 4.2. The entirety of Ofcom's purported consideration of the impact of its proposals on Sky consists of three paragraphs (paragraphs 8.78 to 8.80 of the Consultation Document), two of which do not in fact discuss the impact of Ofcom's proposals on Sky.

<sup>20</sup> In Sky's view, Ofcom's apparent perception of the factors that lie behind Sky's success is ill-founded. Ofcom's suggestion that Sky is successful because it was, at a point in the past, willing "to invest in what was initially a risky business" (for example, at paragraph 1.41 of the Consultation Document) betrays a very fundamental misperception of both the reasons for Sky's continuing success and the environment in which Sky operates. For example, it would appear to overlook the following major, risky investments undertaken by Sky (among others): (a) the launch in 1998 and subsequent development of a digital television platform; (b) the supply of

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have due regard to the potential for detailed intrusive regulation to stifle such behaviour.

- 4.16 Similar considerations apply in relation to the *ex ante* determination by a regulator of required terms and conditions to be included in carriage agreements. The fundamental problem introduced by prescriptive *ex ante* regulation in a complex and dynamic sector is that it is impossible to anticipate all the relevant issues that need to be addressed in contracts, and how those issues might change over time. This creates an inevitable need for constant applications to the regulator to alter terms and conditions (or the perseverance with unsuitable terms and conditions in order to avoid the need for such applications). The consequence would be a significant regulatory drag on efficient contracts between Sky and third party retailers of its channels.
- 4.17 Ofcom must also consider more carefully and in greater detail the risk that its proposals will reduce the level of revenue earned from producing premium pay TV channels.<sup>21</sup> In Sky's view, the most likely result of such a reduction would, over time, be a reduction in the level of income flowing to rights owners.

### **4(b)(ii) *The promotion of inefficiency and encouragement of wasteful expenditure***

- 4.18 Ofcom has stated explicitly that the aim of its proposals is to promote the emergence of inefficient new retailers of Sky's channels.<sup>22</sup> Ofcom appears to believe that such inefficiency will diminish over time. Ofcom does not, however, disclose any evidence to support such a belief, and there are good reasons to believe that this may not be the case. Furthermore, there are good reasons to believe that firms that are dependent on regulatory assistance will tend to devote significant resources to wasteful lobbying activities. We discuss these issues further in Part 6, below. In taking forward its proposals, Ofcom must also have proper regard to the significant likelihood of the long term economic costs arising from these types of considerations.

### **4(b)(iii) *Regulatory creep***

- 4.19 The type of detailed micro-management of the pay TV sector proposed by Ofcom gives rise to a significant potential for 'regulatory creep' – the tendency for regulation to become ever more detailed and intrusive, with accompanying

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PVRs; (c) the development of a broadband network; (d) major re-pricing and repackaging of Sky's basic pay TV services from 2005 onwards; (e) major investments in Sky's customer service capabilities; and (f) the launch in 2006 and subsequent development of a high definition television platform, and high definition television services. Sky has also been at the forefront of the development of mobile TV services in the UK. Alongside these major investments has been a continual flow of new products and services of considerable value to consumers – from Sky's electronic programme guide, to the provision of Sky's television channels via the internet.

<sup>21</sup> As set out in Part 6, below, Ofcom's proposition that revenue may increase as a result of regulation of the terms of supply of Sky's channels to third parties is perverse.

<sup>22</sup> At the Westminster Media Forum, Steve Unger stated: "*you're not in the long term wanting to allow inefficient retailers to survive but what you do want is to find a method for allowing them to enter the market*". As we note below, experience suggests that once inefficient firms have been encouraged to begin operating, it becomes extremely difficult later to withdraw support.

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increases in regulatory costs, over time – often even in circumstances where the original rationale for the regulation is diminishing in significance.

- 4.20 It is somewhat surprising that there is no acknowledgment of the risk of regulatory creep in the Consultation Document in light of the fact that Ofcom’s current Chairman, Lord Currie, together with (then) Professor Cubbin of City University, warned of such risks in a 2002 paper. Currie and Cubbin describe regulatory creep as “*regulators [being]...unwilling to let go and indeed...inclined to increase over time the range and scope of what they control*” and warn of the dangers posed by creeping regulation, particularly in “*fast-moving, innovative sectors*”:

*“Regulatory creep can tie down an otherwise dynamic and flexible industry and inhibit investment and innovation to the detriment of consumers. Interventions intended to help the consumer can end up having the opposite effect.”<sup>23</sup>*

- 4.21 Little if any of this wisdom appears to permeate Ofcom’s thinking in the current Consultation Document.
- 4.22 In Sky’s view, the risk of regulatory creep is significantly enhanced, as in this case, where there are likely to be gains to competitors from a regulator imposing new regulation on their rivals, thereby providing further impetus for extension of regulation over time.

### **4(b)(iv) Administrative and compliance costs**

- 4.23 Ofcom should also consider carefully the direct costs of administering and complying with new regulation. The greater the level of detail and prescription involved in regulation, the more significant such costs are likely to be. Both in its Consultation Document, and in its approach to regulation more generally, Ofcom has demonstrated a strong tendency towards a preference for detailed prescriptive regulation which increases the likelihood of administrative costs and compliance costs of its proposals being significant, and growing over time.

## **5. Ofcom fails to consider non-prescriptive approaches to ‘must offer’ regulation**

- 5.1 Having concluded (erroneously) that ‘must offer’ regulation is required, Ofcom then turns to the “*detail*” of the regulation that it proposes to specify. In doing so, Ofcom reaches immediately for detailed, prescriptive *ex ante* measures to accompany the ‘must offer’ obligation, with little or no justification. This is surprising in view of Ofcom’s commitment to act with a bias against intervention. Here, it would seem, the bias in fact operates in precisely the opposite direction.

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<sup>23</sup> David Currie and John Cubbin, *Regulatory Creep and Regulatory Withdrawal: Why Regulatory Withdrawal is Feasible and Necessary*, City University, March 2002. Available at <http://www.staff.city.ac.uk/~sm340/Consulting&Policy/Regulatory%20Withdrawal%20Report%20020317.pdf>

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- 5.2 Ofcom appears to believe that, once it has decided to impose ‘must offer’ regulation on Sky, it follows axiomatically that it is necessary to accompany such an obligation with a panoply of detailed, prescriptive *ex ante* regulation. Ofcom states that:

*“Any wholesale must-offer remedy **would need to** include a number of detailed conditions governing the terms and conditions of wholesale supply. The most obvious of these conditions is some form of ex ante pricing rule.”*<sup>24</sup> (Emphasis added)

- 5.3 This proposition is fundamentally flawed, and reveals a great deal about Ofcom’s failure to have regard to its regulatory principles, and regulatory best practice in this case. There is simply no reason why ‘must offer’ regulation must be accompanied by “*detailed conditions governing the terms and conditions of wholesale supply*” and it is not “*obvious*” why an *ex ante* pricing rule would be required.
- 5.4 This is demonstrated by the fact that there are numerous examples of firms operating under ‘must offer’ obligations where there is little or no prescriptive, *ex ante* specification of how that obligation must be fulfilled, let alone price control. Instead, reliance is placed on *ex post* examination of complaints within a framework of broadly framed principles that must be adhered to. Indeed, Ofcom itself is responsible for administering other ‘must offer’ obligations which are not accompanied by detailed, prescriptive *ex ante* regulation – such as the requirements imposed on Sky in relation to the provision of digital conditional access services and listings in electronic programme guides to third parties.<sup>25</sup> None of the international examples in pay TV referred to by Ofcom involve the level of intrusive *ex ante* regulation that is proposed by Ofcom.<sup>26</sup>
- 5.5 Ofcom has essentially treated ‘must offer’ regulation as a single regulatory option in which the “*details*” are to be filled in. That proposition is flawed. There is a large range of different possible types of ‘must offer’ regulation, with Ofcom’s proposals for detailed prescriptive *ex ante* regulation at the extreme end of that range.
- 5.6 The costs and benefits of different approaches to ‘must offer’ regulation differ significantly from each other and, accordingly, even if it is considered necessary to impose ‘must offer’ regulation, it is then necessary to properly consider different approaches – including ‘light touch’ approaches – to such regulation. In order that stakeholders are able to comment effectively on their costs and benefits such alternatives must be properly specified proposals, as opposed to broad brush discussions of the type set out in Section 9 of the Consultation Document.

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<sup>24</sup> Second bullet point, paragraph 8.5 of the Consultation Document.

<sup>25</sup> We note that Ofcom has sought to impose prescriptive regulation via the back door of “*guidance*” on the approach it would take in resolving disputes in relation to the pricing of such services. Such guidance, however, does not have the formal status of regulation; it binds neither Ofcom nor those regulated by Ofcom.

<sup>26</sup> See **Annex 8**.

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### **6. Ofcom's proposal for 'must offer' regulation with extended retail-minus price control**

6.1 In this Part 6 of Section 7, we discuss Ofcom's central proposal as we see it – to impose on Sky a 'must offer' obligation, accompanied by an extended retail-minus price control. Ofcom has proposed an approach in which it is seeking to encourage new retailers that are considered to be less efficient than Sky to begin retailing Sky's premium pay TV channels, with their high costs financed by compulsory reductions in wholesale charges for those channels. Ofcom describes this as setting charges that are 'affordable' to new retailers.

6.2 The voluminous and somewhat unsystematic nature of the Consultation Document, and Ofcom's own efforts to play down the significance of this proposal (which are discussed further below), serve to obscure the radical and unprecedented nature of Ofcom's extended retail-minus price control proposal.

#### **6(a) Ofcom provides no proper justification for its proposal to impose extended retail-minus price control on Sky**

6.3 One of the more surprising elements of Ofcom's proposals for new regulation is the complete absence of a proper justification for its proposal to impose an unorthodox form of price control on Sky. Ofcom's proposition, which must be inferred from its Consultation Document, is that Ofcom's objectives – in terms of promoting entry of new pay TV retailers and/or platforms – would not be achieved (or achieved to a lesser extent), if Sky were permitted to set wholesale charges on a normal retail-minus basis. Indeed, there is a strong implication in Ofcom's repeated statements that Sky would not set charges that other pay TV retailers can 'afford',<sup>27</sup> that no new entry at all would occur if charges were set on a normal retail-minus basis, so that the only way of encouraging the entry desired by Ofcom is to set charges below that level.

6.4 There is, however, no consideration at all of these matters in the Consultation Document and therefore Ofcom has no way of forming a judgement on the necessity and proportionality of mandating charges set on an extended retail-minus basis, as opposed to allowing Sky to set charges subject to the constraints imposed by competition law.

6.5 On the face of it, a proposition that either (a) entry will not occur at all if wholesale charges for Sky's premium pay TV channels are set on a retail-minus basis, or (b) there would be a substantially greater level of entry if such charges were set on an extended retail-minus basis, is not plausible – and it is certainly not established by Ofcom.

6.6 In this context, it is necessary to bear in mind that operators such as BT, Tiscali and TUTV are not potential new entrants – they are existing pay TV retailers, who have already invested in their pay TV platforms. Accordingly, Ofcom's

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<sup>27</sup> This statement is made at paragraphs 1.44, 8.44, 8.9, 8.11, and 8.50 of the Consultation Document. Ofcom does not at any point in its voluminous Consultation Document set out what it means by the concept of 'affordability' of Sky's channels, and the meaning of that concept is not self-evident.

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implicit theory that firms need to be provided with lower charges for Sky's premium channels in order to encourage them to incur the initial set-up costs associated with entering the industry cannot apply to these operators.

- 6.7 Ofcom has no evidence that potential new entrants 'cannot afford' Sky's wholesale prices.<sup>28</sup> There is no analysis anywhere in the Consultation Document setting out the wholesale rates a genuine new entrant might be able to afford to pay. This is a fundamental omission given that this conclusion is the cornerstone for Ofcom's belief that an extended retail-minus price control is necessary.
- 6.8 Sky notes, however, that the business planning undertaken for Picnic demonstrated that Picnic was profitable based on the wholesale rates which Sky charges to cable operators. Sky can see no reason why the same would not be true of BT, for example. In particular any scale advantage that Ofcom might allege accrues to Sky in retailing over DTH satellite would not have applied to Picnic. Picnic would have been a new brand, on a new platform and would have started with zero customers. Any such scale advantages would be more likely to accrue to BT who, compared to Picnic, already has a well established brand and a customer base exceeding 21.5 million homes. Indeed this is consistent with Ofcom's own views as set out in the consultation document concerning Picnic, where it concluded that Sky's financial resources and brand strength are not unique and were likely to apply to BT as well.<sup>29</sup>
- 6.9 It is also important to bear in mind that the most likely new entrants are large, well-funded companies operating at significant scale, and not in need of Ofcom's assistance in entering new markets. For example, in 2007 France Telecom, which is the world leader in operating IPTV services and which (via its Orange subsidiary) has considered developing an IPTV network in the UK, had a turnover of almost €60 billion – around six times the **total revenue of the whole of the UK television sector** in that year. The idea that the only thing that holds such an operator back from developing an IPTV service in the UK is the ability to access Sky's pay TV channels at discounted rates is fanciful. In France, where France Telecom had over 1.5 million IPTV subscribers at the end of Q3 2008, France Telecom does not retail any of Canal+'s premium sports and movie channels (though these are available from Canal+ via France Telecom's network).

### *The significance of scale and/or scope diseconomies*

- 6.10 Ofcom's proposal to impose extended retail-minus price control on Sky appears to be based on a notion that there are significant economies of scale and/or scope associated in retailing pay TV services and/or new platform development. Ofcom's idea seems to be that providing new entrants with cheap access to

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<sup>28</sup> Ofcom has confirmed in correspondence with Sky that it did not rely on any modelling in concluding that new entrants cannot afford Sky's wholesale rates.

<sup>29</sup> See paragraphs 3.85-3.87 of Ofcom's consultation document "*Proposed BSkyB Digital Terrestrial Television Service: second consultation on Sky's 'Picnic' proposal*", 30 September 2008 (the **Second Picnic Consultation Document**).

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Sky's channels will enable them to grow their subscriber bases and thereby overcome initial scale and/or scope disadvantages, at which point the compulsory entry assistance that Sky would be required to provide could be withdrawn.

- 6.11 At the outset it is important to recognise that Ofcom offers no evidence at all as to the existence or significance of economies of scale and/or scope, and, as set out in **Section 5** above, Sky's experience in retailing via DTH satellite is that such economies are not significant.
- 6.12 It is also important to recognise that, even if such economies existed, they could not form an adequate basis for a regulatory policy of compelling successful incumbents to support new entry into the sector in which they operate. Economies of scale and scope exist in a wide range of industries and do not form an insurmountable barrier to new entry. The normal presumption is that, if there is a long term profitable entry opportunity, entrants will finance their initial high costs from future returns – especially in the case of firms the size of France Telecom. Ofcom would need to have significant reasons why such a presumption should be abandoned in the case of entry into the UK pay TV sector.
- 6.13 Finally, to the extent that new entrants suffer from an alleged comparative cost-inefficiency, Ofcom simply assumes that this would be temporary in nature and arise due to a lack of scale which could in theory be overcome once such operators have established a large subscriber base. However, if in fact the types of technologies that Ofcom is seeking to promote – namely DTT and IPTV technologies – are less cost-efficient methods of delivering television services than DTH satellite and existing cable networks then any such comparative cost inefficiency may be permanent. In fact in these circumstances in order to achieve the same level of average per-subscriber costs as Sky and Virgin Media such operators would need to establish a subscriber base which exceeded those of Sky and Virgin Media, which, given the fact that pay TV is already well established in the UK, seems unlikely. Ofcom has not, however, undertaken any analysis of the extent of any comparative cost-inefficiency or of its cause and hence has no idea as to the likelihood of any new retailers being able to overcome such inefficiency in the medium term, even if they were to retail Sky's premium sports and film channels.

### **6(b) Extended retail-minus price control is not compatible with best practice approaches to sectoral regulation**

- 6.14 Ofcom has an obligation to ensure that its policy reflects regulatory best practice. For some time the approach to addressing competition issues in the electronic communications sector via direct regulation in Europe has been to seek to align that regulation with competition law on abuse of a dominant position, and to ensure that policy is technology neutral. For example, convergence between sectoral regulation and competition law and technology neutrality are two of the key underlying principles of the European Directives on electronic communications services, which comprise the foundation for regulation in the electronic communications sectors in Member States.

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- 6.15 Ofcom’s proposed approach to regulation of charges for Sky’s channels, however, goes far beyond any remedy that could be justified under competition law. This is indicated both by Ofcom’s own statements in the Consultation Document,<sup>30</sup> the judgment of the Court of Appeal in the Albion Water case,<sup>31</sup> and the European Commission’s recently published guidance on enforcement priorities in relation to exclusionary abuses of a dominant position.<sup>32</sup> For example, in announcing the publication of its Article 82 guidance, the Commission stated:

*“Since the focus of the Commission’s enforcement policy is on conduct that harms the competitive process rather than individual competitors, for pricing conduct the Commission examines whether the conduct is likely to prevent competitors that are **as efficient as the dominant undertaking** from expanding on or entering the market and that can be expected to be most relevant to consumer welfare.”<sup>33</sup> (Emphasis added)*

- 6.16 Ofcom’s proposals are also distinctly non-technology neutral (an approach that is also inconsistent with other Ofcom policies) in that they place a great deal of emphasis on seeking to support new operators who use DTT or IPTV technology.

### **6(c) Ofcom has sought to obscure the radical, unprecedented and interventionist nature of its proposals**

- 6.17 Ofcom has sought to portray its proposals as relatively minor, ‘normal’ interventions, on three grounds, each of which is flawed:

- (a) both in the Consultation Document, and in analyst briefings, Ofcom has attempted to portray its proposals as a ‘normal’ form of regulation, by pointing to examples of ‘must offer’ regulation that exist in other countries. For example, at Ofcom’s City media analysts briefing on 22 October 2008, Ed Richards stated:

*“This is not a revolutionary approach...this kind of wholesale must offer... has existed in the States for years.”*

Such a proposition is erroneous. While it is correct that ‘must offer’ regulation exists in a relatively small number of other countries (and as we note above exists in the UK in relation to other services), the notion that such regulation is ‘normally’ accompanied by pricing rules, in

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<sup>30</sup> See for example, paragraph 9.56 of the Consultation Document, which makes it clear that Ofcom’s proposed approach using its sectoral powers is going beyond that which would be acceptable under competition law.

<sup>31</sup> <http://www.catribunal.org.uk/files/Judg1046Albion22.05.08.pdf>

<sup>32</sup> <http://ec.europa.eu/competition/antitrust/art82/guidance.pdf>

<sup>33</sup> See: “Antitrust: consumer welfare at heart of Commission fight against abuses by dominant undertakings”, European Commission press release, 3 December 2008. Available at: <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1877&format=HTML&aged=0&language=EN&guiLanguage=en>

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particular ones that are intended to support inefficient retailers, or wide-ranging, detailed, prescriptive *ex ante* regulation, is not.<sup>34</sup>

In the specific case of the US regulation cited by Ed Richards, the only thing that the US approach and that proposed by Ofcom have in common is that they both involve a ‘must offer’ obligation in relation to the supply of pay TV channels. The US approach is based on *ex post* assessment of complaints of refusal to supply. There is a strong burden of proof imposed on complainants, which reduces clear incentives for vexatious complaints. There are no *ex ante* pricing rules, and no extensive panoply of detailed, intrusive regulation. Finally, the obligation applies to all operators who meet the criteria set out in legislation – it is not imposed in a discriminatory fashion on specific firms, nor is it based on an approach of applying regulation to firms considered by a regulator to have a dominant position in a relevant market.

(b) Ofcom has sought to argue that the proposals would have little if any impact on Sky, and could potentially act to Sky’s benefit.<sup>35</sup> For example:

- one of the assumptions adopted by Ofcom in its modelling of Sky’s incentives to supply new pay TV retailers is that:

*“Additional retailers are likely to expand the overall size of the market, delivering incremental (wholesale) revenues to Sky”<sup>36</sup>*

- at the Westminster Media Forum session, Steve Unger stated:

*“We don’t believe it would have a particularly disruptive impact on Sky’s own business.”*

- Steve Unger also stated at the Westminster Media Forum session that:

*“It’s about making sure that content is more widely distributed via different retailers and different platforms. And actually if that has a market expanding effect, that might even be beneficial for those content owners.”*

Although the last statement referred to content owners, we consider that it is implicit in this statement that Ofcom considers that its proposals might also be beneficial for Sky.

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<sup>34</sup> We discuss the details of the ‘must offer’ regulation that exists in the countries cited by Ofcom at **Annex 8**.

<sup>35</sup> Ofcom’s failure to undertake any form of proper impact assessment means that its view of the effects of its proposals on Sky are not evidence-based. This is demonstrated by the fact that Ofcom’s proposition that its proposals would not have “*a particularly disruptive impact on Sky’s own business*” is based on its ‘belief’.

<sup>36</sup> Figure 32 on page 141 of the Consultation Document.

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In Sky's view, it is perverse for Ofcom to assert that it can increase Sky's revenue via regulation. Sky is in a significantly better position than Ofcom to determine whether the types of measures being contemplated by Ofcom would deliver incremental wholesale revenues to Sky. Sky's view is that it is highly improbable that the extended retail-minus price control approach being contemplated by Ofcom would increase Sky's revenue and profitability.

- (c) Ofcom has argued that its proposals simply replicate what would be observed in a competitive market. Ofcom states:

*“Indeed, [the new regulation’s] objective is to replicate the natural outcome of a competitive market.”<sup>37</sup>*

Again, such a proposition is incorrect. Suppliers of premium channels would never willingly license their channels to retailers on the terms that Ofcom proposes to impose on Sky, regardless of the structure or competitiveness of the markets in which they operate.<sup>38</sup>

- 6.18 The reality is that Ofcom's proposals are both radical and, in the context of pay TV services, without precedent. This is reflected in Section 9 of the Consultation Document, in which Ofcom considers how such a price control could practically be implemented, making it clear that there is no existing approach that might be emulated.

### *The implications of the radical and unprecedented nature of Ofcom's proposals*

- 6.19 Other than issues of working out how new approaches to regulation might be implemented, the key problem with adopting an unorthodox approach to regulation is that its consequences are difficult to predict. In other words, there is a real and significant risk of unintended adverse consequences from adopting a novel and radical regulatory approach. For example, we consider that there are entirely plausible scenarios in which the result of this regulation would be higher prices for pay TV services for consumers.<sup>39</sup>
- 6.20 Such risks may be mitigated, though not avoided, by a rigorous assessment of the potential effects of the proposed regulation. Proceeding to implement radical and unprecedented regulation without proper examination of its consequences would – to use a phrase used in a US paper on the implications of a different type of pay TV regulation – “*not be unlike a bather jumping off a cliff at night hoping there is water below.*”<sup>40</sup>

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<sup>37</sup> Fourth bullet, paragraph 1.41 of the Consultation Document.

<sup>38</sup> See footnote 9 of **Section 5** above.

<sup>39</sup> We understand that forthcoming economic papers prepared by Helen Weeds of the University of Essex indicate that this is a real possibility. See Annex B of CRA's paper, attached at **Annex 4** to this Response.

<sup>40</sup> See page 28 of Steven S. Wildman 'A Case for A La Carte and "Increased Choice"? An Economic Assessment of the FCC's Further Report', Michigan State University, March 2006.

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6.21 The risk of adopting a policy that reduces welfare as a result of unintended consequences may also be mitigated by adopting a threshold for adoption of the new policies that is higher even than Ofcom's own claimed "*high hurdle*" for intervention – i.e., to take a precautionary approach. In particular, we would expect that such radical policies could only be justified on the basis of both the clear identification of very significant long-term problems in a relevant downstream market and the lack of any suitable alternative.

### **6(d) Ofcom fails to recognise that there are formidable practical problems with this proposal**

6.22 In Section 9 of the Consultation Document, Ofcom seeks views on a number of practical issues associated with designing a forward-looking price control rule that is intended to take into account the efficiency of the operators to whom services are supplied. Ofcom's discussion, however, fails to address a number of very significant further issues, which we discuss below. These issues differ somewhat in nature depending on whether Ofcom would require uniform wholesale charges for Sky's channels among retailers, or whether charges would be tailored to the inefficiency or otherwise of particular operators.

#### **6(d)(i) *Extended retail-minus price control with uniform pricing***

6.23 If Sky is required to set a single wholesale charge for each premium channel (or package of channels) payable by every retailer of its channels, two obvious issues arise.

6.24 First, under the approach proposed by Ofcom of enabling inefficient entry, that charge would have to be the charge that is able to be paid by the least efficient potential retailer. If this were the case, it would (a) lead to wholly unwarranted windfall gains on the part of more efficient retailers who were able to pay normal wholesale charges, and (b) be confiscatory.

6.25 Second, we assume that the only practicable way of administering such an approach would be for Ofcom to base regulated wholesale charges on detailed rules about: (a) what the minimum level of efficiency of a potential third party retailer needs to be in order to qualify for compulsory wholesale supply of Sky's premium channels; (b) the relevant costs that it would take into account in determining whether a potential third party retailer achieved that minimum level of efficiency; and (c) levels of those costs that Ofcom considered to be acceptable – for example, in relation to discretionary activities such as marketing expenditure, or investments in customer service. Such rules would be essentially arbitrary. In Sky's view, the fact that the outcome of this type of approach would be Ofcom having to set arbitrary rules which specified the maximum permitted level of inefficiency of third party retailers, and acceptable budgets for retailers' marketing expenditure, demonstrates its disproportionate nature. The irrationality of this type of approach is a significant reason why it does not exist anywhere else in the world.<sup>41</sup>

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<sup>41</sup> The alternative, in which the uniform wholesale charges would be required by Ofcom to be 'affordable' to *any* pay TV retailer who requested supply of Sky's channels would be so

**6(d)(ii) *Extended retail-minus price control with differentiation of charges***

6.26 Alternatively, in order to avoid charges being set at the level that the least efficient downstream operator could afford, it would in theory be possible to differentiate charges according to each operator's efficiency.<sup>42</sup>

6.27 This type of approach raises a different set of issues, including:

- how such an approach would fit with competition law requirements in relation to discriminatory pricing – there would appear to be a significant risk of 'double jeopardy' under this type of approach, with Sky being sued for discrimination by the most efficient operator who is required to pay the highest price;
- how assessments of what each individual operator could "afford" to pay would be undertaken; and
- what would happen if new retailers turned out to be less efficient than predicted by Ofcom, or developed plans for substantial new tranches of investment in their businesses. This raises the prospect of Sky being required to cut its wholesale charges further over time to accommodate greater than originally anticipated inefficiency, or further investment deemed desirable by Ofcom.

6.28 Again, the only feasible way of overcoming these types of problems (if, indeed, issues such as the potential for double jeopardy could in fact be overcome) would be via a complex and highly intrusive set of regulatory rules being designed and implemented by Ofcom. Sky considers that such an outcome would also be a wholly disproportionate response to any issues that Ofcom may consider that it has identified. It would also be likely to result in large amounts of expenditure on Ofcom inquiries into what the appropriate charge for each operator should be, as each operator would seek to persuade Ofcom to lower the wholesale charge it was required to pay for Sky's channels.

6.29 Above all, however, a central practical issue which Ofcom has failed entirely to address is how this approach might provide appropriate incentives for new entrants to improve their efficiency over time. Ofcom's proposed approach is one in which new entrants face the prospect, if they become efficient, of Ofcom determining that it is then permissible for Sky to increase wholesale charges for its channels. Such a prospect creates extremely poor incentives for the beneficiaries of Ofcom's support to improve their efficiency over time.

6.30 In theory, such an incentive might be provided by a commitment to limit the duration of regulated discounts on charges for Sky's channels – either for all

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irrational that we discount it as an approach that would be considered by Ofcom. Such an approach would be open to obvious opportunities for gaming by existing third party retailers of Sky's channels.

<sup>42</sup> We note that a degree of differentiation in charges among different types of retailers might be anticipated in a competitive market.

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potential entrants (i.e. creating a time-limited window for new entry), or for any given new entrant.<sup>43</sup> It would be beyond credibility to believe that Ofcom would be able to commit to time-limit the availability of regulated discounts on charges for Sky's channels. At the end of such a period there is little doubt that Ofcom would be faced by vociferous lobbying for the extension of such a regime, no doubt on an indefinite basis, which Ofcom may find difficult to resist.

### **6(e) Ofcom's proposed policy is a type of industrial policy which generally does not work well**

6.31 Ofcom's proposal to support entry into pay TV retailing via mandated reductions in charges for Sky's premium pay TV channels is a form of 'vertical' industrial policy – policy that is applied to specific firms or industries – rather than horizontal industrial policies which are applied in a consistent manner across all industries (such as competition law, or subsidies for research and development).

6.32 Vertical industrial policies were once commonplace in the UK. They were largely abandoned in the 1980s in favour of horizontal industrial policy due to their dire consequences for economic performance.<sup>44</sup> Nor have they generally been successful in other countries. As one World Bank report states:

*“Well motivated or not, vertical industrial policies have often either prevented the emergence of dynamic, competitive enterprises or entailed significant unintended consequences, not only when the policies were in place, but for long period [sic] afterwards.”<sup>45</sup>*

6.33 The core of Ofcom's proposal is that Sky should be compelled to support new entrants to pay TV retailing. According to Ofcom, forcing Sky to provide its premium pay TV channels to new entrants at reduced charges will enable them to grow their businesses and thereby realise scale and/or scope economies. Ofcom's argument is that while this leads to economic inefficiency in the near term, this will be more than offset by dynamic efficiency gains (for example via more innovation than would otherwise have emerged<sup>46</sup>) in future.

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<sup>43</sup> Such a consideration appears to lie behind Steve Unger's comment at the Westminster Media Forum that it is necessary for Ofcom to have an “*exit strategy*” from such regulation. The Consultation Document, however, makes no mention of such an exit strategy.

<sup>44</sup> See N.F.R. Crafts. *Can De-Industrialisation Seriously Damage Your Wealth? A Review of Why Growth Rates Differ and How to Improve Economic Performance*, Hobart Paper 120, Institute of Economic Affairs, 1993.

<sup>45</sup> M. K. Nabli, J. Keller, C. Nassif, C. Silva- Jáuregui, ‘The political economy of industrial policy in the Middle East and North Africa’, World Bank, March 2006.

<sup>46</sup> Ofcom also implies that lower prices in the future may offset the clear costs of its proposed policy. (Ofcom does not at any point clearly set out the benefits that it expects to arise from its proposed new regulation.) It is, however, wholly unclear where Ofcom expects such price reductions to come from, given that firms in the sector (a) are currently likely to be highly efficient, and (b) do not earn excess profits.

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- 6.34 This is a similar approach to a type of vertical industrial policy known as ‘infant industry’ policy. Infant industry policy is a policy of supporting nascent industries, for example via state subsidies or trade protection, in their early stages of growth, on the basis that such support is necessary to help them grow and achieve economies of scale, or benefit from ‘learning by doing’ efficiencies, such that in the future state support can be withdrawn and the industries can stand on their own feet. The policy relies on the economic costs of the supported growth phase being outweighed by those industries’ later contributions to economic welfare.
- 6.35 There are, however, two key differences between infant industry policy and Ofcom’s proposals.
- 6.36 First, in principle, infant industry policy has a sound economic rationale, which is based on targeting assistance or protection at *emergent* industries which have significant externalities – i.e. where social returns to investment exceed private returns. Ofcom’s proposals, however, aim to support entry into a sector that is already well-established and thriving – a highly innovative sector that provides high quality pay TV services to over 12 million UK households.<sup>47</sup> It seems wholly implausible that the social returns to government support in this sector would be significant.
- 6.37 Second, normally support for new firms or industries would be provided by the Government, rather than an incumbent operator in the sector. This is an important distinction because Government support for particular firms and industries is subject to strong constraints in the European Union intended to restrict governments’ freedom to undertake this type of activity. Ofcom’s proposals to force Sky to support new entrants would effectively enable Ofcom to bypass such constraints and any assessment of the important policy considerations which underpin them.
- 6.38 The policy of subsidising firms in order to encourage them to expand, or enter new lines of business, including infant industry policy, is now generally not well-regarded as it has been found that it is difficult to implement in practice without creating incentives for inefficiency of three types.
- 6.39 First, government support for particular firms or industries tends to result in them becoming inefficient (in a productive sense) and unresponsive to consumers’ demand, rather than achieving the goals at which government support was initially targeted. One reason for this is that such schemes often have built-in disincentives to improve efficiency because the result of firms improving their efficiency is simply to remove the case for the provision of support.

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<sup>47</sup> This is broadly recognised by Ofcom. See paragraph 8.13, where Ofcom states: “*the [UK] pay TV industry...now provides services to over 12 million consumers, and is characterised by technical innovation as well as delivering reasonable levels of consumer satisfaction.*” Ofcom, however, confuses households and consumers in this statement. Given that there are roughly 2.1 people over the age of 4 in each UK pay TV household, the UK pay TV sector in fact provides services to over 25 million consumers. It is also characterised by significant service innovation as well as technical innovation.

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- 6.40 Second, government subsidies may create allocative inefficiency by encouraging excess entry to a sector.
- 6.41 Finally, the dependence of assisted firms on political and/or regulatory support for their success encourages them to devote resources to maintaining or extending such support, rather than focusing on running their businesses well. From an economic point of view, such ‘rent seeking’ activity is a wasteful use of resources: it produces nothing of any value.
- 6.42 In Sky’s view, it is readily apparent that Ofcom’s proposals would be highly likely to give rise to economic costs of these types.
- 6.43 Ofcom’s proposals share a further element of discredited approaches to industrial policy in that theories like those underpinning infant industry policies were often used to justify government support for particular industries without adequate inquiry as to whether they met the conditions required for such a policy to be successful. For example, Ofcom has undertaken no analysis of the importance of economies of scale and scope in pay TV retailing, which is a key element of its case for compelling Sky to support entry by new retailers. As we note above, Sky’s experience of retailing via DTH satellite suggests that they are not significant – and certainly not sufficiently significant to warrant government intervention aimed at overcoming them. Furthermore, Ofcom’s propositions that (a) any inefficiencies to which its policies give rise will be short-lived, and (b) that gains from factors such as increased future innovation will more than offset any inefficiencies introduced, are both based purely on conjecture. As indicated in the World Bank quotation above, experience suggests that such policies tend to be difficult to reverse, and therefore can cause long-lived economic detriments.
- 6.44 The fact that Ofcom is putting forward largely discredited industrial policies demonstrates that it has not had due regard to its legal obligation to take into account regulatory best practice in its approach to regulation.

### **6(f) It is unfair to require Sky to finance other operators’ investments**

- 6.45 Ofcom’s proposal to require Sky to cut its charges so as to be ‘affordable’ to new entrants amounts to a proposal that Sky should be required to finance those operators’ investments. As well as being unnecessary (as discussed above) as other operators are able to finance their own investments, such a proposal is manifestly unfair.

### **Conclusion**

- 6.46 As set out in Part 3, above, the introduction of compulsory licensing of Sky’s channels is unnecessary; Ofcom’s justification for proposing such regulation is flawed. If, however, Ofcom were able to continue to believe that a ‘must offer’ obligation is a necessary solution to a clearly identified problem (which Sky submits it could not), it should reject the option of accompanying that regulation with an *ex ante* extended retail-minus price control. Such a price control rule would be a manifestly disproportionate response to any potentially identified issues.

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6.47 Ofcom has stated that it is minded to rule out, at this stage, one of the options that it has considered – structural break-up of Sky – on the basis that it would be a disproportionate response to Ofcom’s concerns.<sup>48</sup> In Sky’s view, imposing extended retail-minus price control falls into the same category as structural break-up because it is similarly disproportionate and it should therefore also be ruled out at this stage.

### **7. Ofcom has failed to consider the necessity, proportionality or consistency of the regulatory proposals set out in Section 9 of the Consultation Document**

7.1 In Parts 8, 9 and 10, below, we comment on a number of the specific issues raised in Section 9 of Ofcom’s Consultation Document. We have restricted our comments on the range of issues discussed as we have taken the view that it would not be a productive use of Sky’s resources to comment in detail on all the matters raised in Section 9 of the Consultation Document at this stage for the following reason.<sup>49</sup>

7.2 Having concluded that it is, in Ofcom’s view, necessary to impose a ‘must offer’ obligation on Sky in order to ensure that the premium content to which Sky holds the rights is made available to other pay TV retailers and/or platforms, Ofcom then turns to a range of issues such as the specific services to which the ‘must offer’ obligation would be applied, and the regulation that would be applied to various other matters – most importantly the terms and conditions of supply (including charges). Ofcom regards these matters as one of sorting out the “*details of a wholesale must-offer remedy*” – as indicated in the title of Section 9 of the Consultation Document. As a result, Ofcom treats the matters covered as simply an issue of *specifying* what it proposes to regulate and how it proposes to regulate those things.

7.3 This approach is misconceived. Ofcom must first establish that it is necessary, proportionate and consistent to regulate both (a) the range of services, and (b) the terms and conditions of supply that it is proposing to regulate, in the manner that Ofcom is proposing to regulate them.

7.4 For example, given that Ofcom’s apparent concern is the availability of premium content provided by Sky to other pay TV retailers and/or platforms it is entirely insufficient for Ofcom simply to deem that Sky must license high definition versions of its premium channels to other operators, or make available its interactive applications on other platforms. Ofcom must set out a compelling case as to why it is necessary, proportionate and consistent to require such licensing over and above the licensing of linear standard definition versions of Sky premium pay TV channels. In doing so, Ofcom must identify what material impact on the competitive process in a relevant market would eventuate in the absence of Ofcom’s licensing requirement being extended to cover HD channels.

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<sup>48</sup> Third bullet point, paragraph 1.41 of the Consultation Document.

<sup>49</sup> For this reason, failure by Sky to comment on any particular issue raised in Section 9 of the Consultation Document cannot be taken to mean that Sky has no view on that issue, or that it is in agreement with Ofcom.

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7.5 This failure runs throughout Section 9 of the Consultation Document.

### **8. Issues concerning the scope of new ‘must offer’ regulation**

8.1 There are two key issues that must be addressed in relation to the scope of any new ‘must offer’ regulation: (a) the services to which it would apply, and (b) the retailers to which Sky would be compelled to supply those services. We discuss each of these in the following sections having regard to the requirements of necessity, proportionality and consistency to which we refer in Part 7, above.

#### **8(a) The type of services to which the ‘must offer’ obligation would apply**

8.2 The combination of the requirement to target new regulation only at cases where action is needed, and Ofcom’s commitment to impose new regulation in the least intrusive manner possible, taken together, argues for a tightly focused scope of any ‘must offer’ regulation. Instead, Ofcom takes a ‘scattergun’ approach to the scope of its proposed regulation, proposing that any ‘must offer’ regulation would apply to a range of existing and prospective Sky services, with little or no regard to the necessity or proportionality of such proposals.

8.3 In this Part 8 of Section 7 we discuss Ofcom’s proposals to include within the scope of new ‘must offer’ regulation:

- (i) high definition versions of Sky’s premium sports and film channels;
- (ii) interactive services/ “*Interactive content*”; and
- (iii) subscription video on demand (“**SVoD**”) services.

#### **8(a)(i) High definition versions of Sky’s premium channels**

8.4 We discussed in Part 4, above, the adverse signal that Ofcom’s proposal to require Sky to license high definition versions of its premium sports and film channels sends to Ofcom’s stakeholders in terms of its attitude to encouraging investment and innovation, and we do not discuss that issue further here.

8.5 The proposal to compel licensing by Sky of high definition versions of its premium pay TV channels is, as discussed above, a primary example of Ofcom’s failure to consider at all the necessity, proportionality or consistency of such a requirement **in addition to** compulsory licensing of standard definition versions of those channels.

8.6 In this respect, it is notable that other statements by Ofcom – both in the Consultation Document and elsewhere – indicate that, had it examined these matters properly, it is unlikely to have concluded that it is necessary and proportionate to compel licensing of high definition versions of Sky’s channels to third parties. Ofcom’s argument in the remainder of the Consultation Document is that it is content that matters to consumers – Ofcom gives a section of the Consultation Document the title of the old adage that “*content is king*” (paragraphs 3.34 to 3.86) – and argues that how that content is delivered to

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consumers, and platform features that may accompany such content, are of relatively minor importance. Ofcom states:

*“This observed primacy of content over and above platform features is intuitively reasonable. Most platform features are designed to enhance the way in which viewers watch content, by allowing them to select content more efficiently (EPGs), view it at a time of their choice (DVRs, VoD), or **enhance its technical quality (HD)**. However, **none of these capabilities can turn undesirable content into desirable content**: if a viewer doesn’t want to watch a programme, then this will not be altered by the ability to time-shift the programme, **or view it in HD.**”<sup>50</sup> (Emphasis added)*

- 8.7 Ofcom repeated this argument in its October City media analysts briefing. Ofcom stated:

*“Consumers’ choice of pay TV service is primarily influenced by the content that is available rather than by platform features”<sup>51</sup>*

- 8.8 Accordingly, Ofcom’s own arguments suggest that, in a situation in which standard definition versions of Sky’s premium channels were available on regulated terms to all pay TV retailers and/or platforms, the potential non-availability of high definition versions of Sky’s premium pay TV channels is unlikely to have a significant adverse effect on the competitive process in any relevant market. In particular, it is unlikely that, if Ofcom’s proposed new regulation was extended to high definition versions of Sky’s premium channels, significant *additional* new entry to pay TV retailing and/or platform operation would occur. Such a conclusion would be reinforced by recognition of the fact that neither DTT-based services, nor IPTV-based services would be in a position to retail high definition versions of Sky’s channels in the UK for the foreseeable future. As a result, it would be neither necessary nor proportionate to extend the ‘must offer’ requirement to high definition versions of Sky’s premium sports and film channels.

- 8.9 Ofcom’s proposals in relation to high definition versions of Sky’s premium channels also raise significant issues of consistency of regulation.<sup>52</sup> The CA03 places ‘must offer’ obligations on PSBs in relation to their main television channels, in clear recognition of their importance in terms of the potential to influence platform choice. No such obligation exists, however, in respect of high definition versions of those channels, and ITV appears to be free to withhold (and to promote the withholding of) its high definition service which carries content broadcast on ITV1 (including live premium sports events) from particular platforms if it so chooses – as it does currently in relation to Sky’s high definition DTH satellite platform. It is, therefore, clearly not axiomatic that ‘must offer’ obligations should apply to a high definition version of a particular

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<sup>50</sup> Paragraph 3.36 of the Consultation Document.

<sup>51</sup> Ofcom presentation, media analysts briefing, 22 October 2008.

<sup>52</sup> As discussed below, the same issue arises in relation to interactive services and video on demand services.

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television channel if such an obligation is imposed on a standard definition version of that channel.

### **8(a)(ii) *Interactive services/ “interactive content”***

- 8.10 Ofcom’s central concern in the Consultation Document is associated with access to premium content - indeed, this is the title of Ofcom’s Consultation Document. Ofcom proposes to extend the ‘must offer’ obligation to include Sky’s interactive services, even though, as discussed below, Ofcom (partially) recognises the formidable technical difficulties to which this would give rise. It would appear that this proposal is based on a belief on Ofcom’s part that such services are often used by Sky to provide access to live Premier League football matches.<sup>53</sup>
- 8.11 In fact, of the 1,364 live Premier League football matches broadcast by Sky between the 1994/95 football season and the end of the 2007/08 football season, only one has been shown live via the red button - a match between Birmingham and Blackburn Rovers on the final day of the 2007/08 season, which was shown at the same time as two other matches on Sky Sports 1 and Sky Sports 2.<sup>54</sup>
- 8.12 Accordingly, Ofcom’s highly interventionist approach to this issue appears to be based on a misconception that there is a problem that needs to be remedied, when in fact there is no such problem. It would be wholly disproportionate to proceed with Ofcom’s proposals to mandate supply of Sky’s interactive services on other platforms in circumstances where provision of live Premier League football via such applications is extremely rare.
- 8.13 As a result, we do not propose to comment further on Ofcom’s discussion of mandating the supply of Sky’s interactive services via other platforms, other than to note that Ofcom’s statement that “*the authoring, distribution and operation of interactive services by multiple retailers across multiple digital TV platforms is a technically complex subject*”<sup>55</sup> is perhaps one of the most accurate statements in Ofcom’s Consultation Document, if somewhat understated.

### **8(a)(iii) *Subscription video on demand***

- 8.14 The radical nature of Ofcom’s regulatory proposals is well-illustrated by its proposition that it would consider compelling Sky to develop a SVoD service and supply that service to third parties as set out at paragraph 9.50 of the Consultation Document. Such a proposal goes beyond compulsory access to existing property or facilities - which is in itself controversial - and is an extreme form of intervention in normal market processes.

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<sup>53</sup> Ofcom states at paragraph 9.44 of the Consultation Document that the ‘must offer’ obligation should cover situations: “*where two different live FAPL matches are shown at the same time, one on a premium channel, and one behind the red button on the same premium channel...*”.

<sup>54</sup> There are in fact good commercial reasons for this situation. It would not make sense for a broadcaster with a limited number of choices of which Premier League matches to broadcast during the season frequently to select matches being played simultaneously and to provide access to one or more of those matches via an interactive application.

<sup>55</sup> Paragraph 9.92 of the Consultation Document.

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- 8.15 Both this proposition and the less extreme proposal to include any SVoD services offered by Sky within the scope of a compulsory licensing obligation are, once again, not founded on any analysis of the necessity, proportionality or consistency of imposing such regulation *in addition to* compulsory licensing of Sky's premium sports and movie channels. Instead, Ofcom simply states that:

*“We would at the very least expect that, where Sky has the appropriate movie rights and where it uses those as the basis of a subscription VoD service to its own retail customers, it should make a wholesale version of this SVoD service available to other platforms.”<sup>56</sup>*

- 8.16 In re-examining this matter, Ofcom must have regard to, among other things: (a) the potential negative impact on Sky's incentives to invest in and develop SVoD services resulting from Ofcom's proposed new regulation, and (b) the likelihood that, if Ofcom's proposed new regulation was extended to SVoD services developed by Sky, it would not result in any significant *additional* new entry to pay TV retailing and/or platform operation.

### **9. Eligibility**

- 9.1 In relation to the issue of the retailers to whom Sky would be compelled to supply its services, Ofcom fails to have due regard to the necessity of allowing Sky to refuse to supply its channels in circumstances where there is a clear objective justification for doing so. Such an approach is, for example, a clear part of the US program access rules. It is necessary to take into account the possibility that there will be situations where requiring supply of Sky's channels would be wholly disproportionate for any number of reasons – including, for example, the lack of security of the operator's system, or its anticipated scale of operation – and, in such circumstances, Sky should legitimately be allowed to decline to supply a particular operator.
- 9.2 Ofcom should also resist the temptation to seek to codify the circumstances in which Sky would be allowed to decline to supply, as it would be impossible to anticipate *ex ante* all possible reasons why such a refusal might be reasonable. Instead, Ofcom should – as in the US system – adopt an *ex post*, case-by-case approach to such situations, particularly in view of the fact that they are unlikely to be frequent.

### **10. Other elements of the new regulation proposed by Ofcom**

- 10.1 In various places in Section 9 of the Consultation Document, Ofcom sets out a range of proposals for detailed, prescriptive regulation concerning numerous issues related to services provided by Sky, and the terms and conditions of carriage agreements. Such proposals have two common features:
- (a) in light of the complete absence of discussion by Ofcom of critical issues such as the costs of, and rationale for, many aspects of its regulatory proposals, they are discussed in an incongruous level of detail. For

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<sup>56</sup> Paragraph 9.49 of the Consultation Document.

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example, a whole page is devoted to how Ofcom would propose to regulate the technology used for interactive services, and nearly another page devoted to the regulation of auditing of subscriber numbers; and

- (b) as explained above, there is no discussion in each case of the necessity or proportionality of seeking to regulate such matters in circumstances where, on the face of it, the types of regulation envisaged (a) do not appear necessary and (b) appear vastly disproportionate to any reasonable objective. At no stage does Ofcom even attempt to identify what material impact on the competitive process would eventuate in the absence of Ofcom's proposed regulation.

10.2 In the following parts of this Section 7 we discuss a number of such proposals.

### **10(a) Regulation of the content of Sky's channels**

10.3 In paragraphs 9.29 to 9.33 of the Consultation Document, under the heading of "*content of channels*", Ofcom discusses proposals to (a) regulate the use by Sky of both promotional airtime and advertising airtime on its channels, and (b) to require Sky to allow retailers of its channels to insert their own advertisements into broadcasts of Sky's channels.

10.4 Sky finds such proposals extraordinary. Promotional airtime and advertising airtime are the property of television broadcasters, and, therefore, Ofcom's proposals amount to proposals to further expropriate Sky's property. Such proposals go far beyond anything that might be regarded as being necessary or proportionate responses to the concerns that Ofcom considers that it has identified, and we are highly surprised that Ofcom has seen fit to put them forward as serious proposals. Regulation which expropriates firms' legitimate property rights should be treated with extreme caution, and subject to careful justification. Instead, in this instance, Ofcom provides no transparent justification for its intrusive and unreasonable proposals.

10.5 To the extent that such a justification can be discerned, it appears to be based on a proposition that to enable new entrants to "*thrive*" it is insufficient to require Sky to supply them with its premium channels at reduced wholesale charges. It would appear that Ofcom considers that such entrants also need to be protected from the legitimate use by Sky of its channels to promote Sky's services, and that Sky should be compelled to provide them with airtime on Sky's channels. In Sky's view, such propositions are unsupportable.

### **10(b) Regulation of "*commercial terms*"**

10.6 At paragraphs 9.77 to 9.100 of the Consultation Document, Ofcom discusses proposals for regulation in relation to commercial terms in a range of areas, including:

- security requirements and liability for security breaches;
- subscriber auditing; and

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- the technology used to provide interactive services.
- 10.7 The first two of these issues are matters which are standard issues in the negotiation of carriage agreements, and there is simply no need at all for intervention by Ofcom in relation to those issues – let alone highly intrusive proposals to micro-manage these elements of carriage agreements.
- 10.8 Moreover, in spite of Ofcom’s incongruously detailed discussion of these issues, that discussion appears to be based on only a passing familiarity with the issues involved, which means that Ofcom fails to recognise key problems raised by its proposals for regulation.
- 10.9 For example, in relation to proposals to regulate terms and conditions that would be acceptable to Ofcom in relation to security requirements and liability for security breaches, Ofcom fails to have any regard to the central issue of how Sky is to be protected from or compensated for losses resulting from piracy. This is not simply an academic matter; it is a real, significant and ongoing issue in the pay TV sector where it is extremely difficult to ensure that *existing* third party licensees, let alone new licensees, of Sky’s premium channels take the necessary steps (which are likely to require significant ongoing investment on their part) to prevent the theft of Sky’s intellectual property. It is wholly unclear, for example, who Ofcom considers would compensate Sky for its losses, in the event that Sky was compelled by Ofcom to supply its channels to an operator which failed to deal with piracy. Such matters are best left to normal commercial law.

### **11. Consistency of regulation**

- 11.1 As set out in **Section 3** above, Ofcom is under an obligation to ensure that regulation is consistent. Currently, Ofcom’s proposals are focused entirely on Sky, with little regard to the consistency of those proposals in relation to services provided by other UK television broadcasters.
- 11.2 We have set out in Part 8, above, a number of areas in which Ofcom’s proposals appear manifestly inconsistent – for example, proposals to apply ‘must offer’ regulation to high definition versions of Sky’s premium channels, and interactive services, when no such regulation would apply to HD channels, or interactive services, provided by UK PSBs.
- 11.3 The issue of consistency, however, is more general in that the types of issues of “*concern*” to Ofcom – the ability of the holder of rights to ‘important content’ to affect the growth of new platforms and retailers – have broader applicability than Ofcom recognises. For example, the main terrestrial free to air broadcasters have significant portfolios of important programming which is could, should they so choose, be offered on their digital sister channels (or future services) on an exclusive or selective basis via particular platforms. It is highly surprising that Ofcom proposes to extend the scope of its compulsory licensing obligations to cover Sky channels and services on the basis that they very occasionally carry a live Premier League football match (for example, Sky

Sports Two, or Sky Active), without considering the consistency of this approach in relation to the channels and services provided by other broadcasters.

- 11.4 In particular, it is important to recognise that the types of downstream effects about which Ofcom is concerned do not depend on broadcasters being dominant in a relevant upstream market.<sup>57</sup> Instead, it is likely to be necessary only that they have a degree of market power associated with the exclusive control of rights to content that is widely valued by consumers. In this context, Ofcom's proposition that 'must offer' regulation should not be applied to Setanta appears manifestly inconsistent. If Ofcom's approach to upstream market definition and market power analysis were applied to Setanta in a consistent manner, it would be clear that Setanta has a significant degree of market power. Furthermore, Ofcom's reasons for not applying 'must offer' regulation to Setanta, even if it were to be found to have market power, are insufficiently reasoned to form the basis for such a decision.<sup>58</sup> We note in this context, however, the difficulty that Ofcom would face in applying regulation to Setanta, were it to decide that it was appropriate to do so, given that Setanta operates from Luxembourg and does not hold an Ofcom licence for its channels.

## **12. Next steps in relation to proposals for new regulation**

- 12.1 As indicated in Part 3, above, there is no case for introducing new regulation in the UK pay TV sector, let alone confiscatory, wide-ranging and highly prescriptive regulation of the type proposed by Ofcom in its Consultation Document. The most appropriate next step, therefore, is for Ofcom to conclude its inquiry by issuing a statement to that effect. The only possible reason for proceeding would be to consider further the proposals made by Sky that Ofcom should examine ways in which it might encourage more efficient contracting for the supply of Sky's pay TV channels set out in Part 3(c) above.
- 12.2 Currently, Ofcom envisages that, if it decides to proceed further with proposals for new regulation, its next consultation (if indeed Ofcom chooses to have such

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<sup>57</sup> In fact, Ofcom's views as to the appropriate market power threshold for the application of 'must offer' regulation on a firm are entirely unclear. For example, in Annex 7 to the Consultation Document – which underpins Ofcom's conclusions as to the necessity of imposing new regulation – Ofcom states: "*We thus consider whether any firm is currently dominant in the relevant markets and whether any firm is likely to be dominant in the relevant markets in the next three to four years.*" (Paragraph 1.24) In Section 8 of the Consultation Document, which discusses Ofcom's proposal to impose 'must offer' regulation on Sky, however, Ofcom appears to use both dominance and market power as thresholds. The discussion of the rationale for imposing must offer regulation on Sky in the paragraph 8.1 is in terms of Sky's "*market power*". Later in Section 8, however, at paragraph 8.8, Ofcom states that: "*Section 5 reached a view that Sky has a dominant position in those markets and that this dominant position is expected to persist over the next three to four years*", thereby appearing to tie Ofcom's proposals to an alleged finding of dominance. Yet paragraph 8.39 of the Consultation Document argues that save for other factors, Setanta's market power might be sufficient for Ofcom also to impose 'must offer' regulation on Setanta.

<sup>58</sup> These comprise two brief bullet points in paragraph 8.39 of the Consultation Document.

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a consultation)<sup>59</sup> would “*propose specific conditions of supply*”<sup>60</sup> to be imposed on Sky. That view is erroneous.

- 12.3 In the event that Ofcom remains of the view that new regulation of the type that it contemplates in the Consultation Document is appropriate, it will be necessary for Ofcom first to remedy the very significant analytical and procedural failures of the current Consultation Document **before** any consultation that proposes “*specific conditions of supply*” to be imposed on Sky. In particular, Ofcom would have to remedy: (a) the complete absence of a proper impact assessment, to the requisite standard, of its proposals – including proper assessment of (i) the option of not introducing new regulation, (ii) properly formed, less intrusive approaches to a ‘must offer’ obligation than Ofcom’s favoured option, and (iii) other less interventionist ways of achieving any specified objectives; and (b) the failure properly to establish that all the main elements of its proposals are proportionate, consistent, targeted only at cases in which action is necessary and represent best regulatory practice. Ofcom must then provide stakeholders with a proper opportunity to comment on its analysis.

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<sup>59</sup> At paragraph 1.41 of the Consultation Document, Ofcom states only that it “*would expect to*” issue a further consultation if it decided that new regulation was necessary.

<sup>60</sup> Paragraph 1.41 of the Consultation Document.

## SECTION 8: OFCOM'S CASE FOR INTERVENTION IS NOT PROCEDURALLY SOUND

### 1. Introduction

- 1.1 So far in this Response, Sky has focussed on the substantive failings of Ofcom's Consultation Document – the analytical and legal problems with Ofcom's approach to the investigation, competition concerns identified and solutions proposed. However, some of the analytical deficiencies in the Consultation Document may also be explained by procedural failings which, in Sky's view, result from Ofcom's inability to conduct its investigation with an open mind. Sky submits that Ofcom's thinking to date has been fettered by three key preconceptions.
- 1.2 First, Ofcom started its analysis with a preconception that Sky enjoys market power in narrowly defined markets.<sup>1</sup> Notwithstanding Sky's robust criticism of using past decisions as 'precedent'<sup>2</sup>, and the submission of evidence to the contrary, Ofcom continues to be unwilling to approach this issue afresh and with an open mind. Indeed, as recently as October 2008, Ofcom referred to the 2002 OFT Decision as the "*outstanding position*" on this issue.<sup>3</sup>
- 1.3 Second, Ofcom assumes that the very existence of market power in an upstream market gives rise to competition problems downstream. This assumption of competition problems where none is predicted by economic theory or in fact exists is illustrated by Ofcom's failure to define the relevant downstream market or markets in which such problems are alleged to occur. In order to back up its assumptions, Ofcom is, therefore, forced to take an entirely hypothetical view; building its case for intervention on far-fetched theories of harm. For example, the vertical arithmetic exercise applied to the supply of Sky's premium channels to Virgin Media (which is a crucial part of Ofcom's theory on Sky's alleged incentives to restrict distribution) flouts common sense. However, when the application of the *same* test to new entrants did not produce the same result (as explained in Part 2(a) of **Section 5** above), Ofcom chose to ignore the outcome. Moreover, Ofcom's case for dynamic foreclosure (itself a relatively exceptional theory of harm) and its allegations concerning high wholesale prices are entirely unsupported by evidence.

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<sup>1</sup> This was made clear by the comment about market definition and Sky's alleged dominance made by Ed Richards of Ofcom at the 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.**"*  
(Emphasis added)

<sup>2</sup> See paragraphs 6.7 to 6.10 of Part 2 of Sky's Response to the First Consultation Document.

<sup>3</sup> Ed Richards of Ofcom speaking at Ofcom's media analysts' briefing on 22 October 2008.

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1.4 Third, Ofcom starts from the position that the alleged problems must be addressed swiftly by ensuring that Sky is obliged, or pressured into acceding to, the supply of its premium channels to other retailers at reduced wholesale prices. Despite purporting to be consulting on several possible remedies (one of which is to ‘do nothing’, although this appears to be no more than a notional option) it is clear that all Ofcom’s efforts are targeted on a single objective:

- Ofcom’s overriding objective is to complete its investigation by the start of the 2009/10 football season,<sup>4</sup> therefore, at this stage Ofcom seems to be focussed solely on “*getting the detail right*”,<sup>5</sup> rather than on the fundamental question of whether such a remedy is necessary and justified.
- Ofcom is already seeking data to inform its preferred remedy. Sky has provided Ofcom with substantial amounts of highly sensitive data relating to its costs and revenues for the apparent purpose of assessing the margins earned by Sky’s notional television channel wholesaling business “*to inform whether or how... a wholesale must-offer remedy as proposed in the Consultation Document... could resolve the competition concerns identified*”<sup>6</sup>.
- In relation to Ofcom’s review of Sky’s ‘Picnic’ proposals, Ofcom seems to have bypassed any assessment of necessity or justification for a wholesale ‘must offer’ remedy and proceeded straight to the conclusion that if Sky wants to implement its proposals it would be “*entirely subject*

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<sup>4</sup> Most recently at the Westminster Media Forum seminar Steve Unger stated that

*“If we decide to proceed with [sic] issue of further consultations detailing specific conditions of supply, in terms of timing we would expect any further consultation to come out in the spring 2009, I am not going to be more specific than that about what I mean by spring. We’re aware that it would clearly be beneficial if we could reach closure on this process ahead of the next football season because that’s a key point in time for many people trying to build businesses around this content.”*

See also Stuart McIntosh’s comments at Ofcom’s media analysts’ briefing on 22 October 2008:

*“The consultation closes on 9 December. Following that, if we decide that we are going to proceed with a wholesale must offer in respect of the market investigation, we would expect to issue a further consultation setting out as I have described above, the conditions of supply, the regulatory conditions of supply, that would come into effect and we would expect to issue a further consultation on that in Spring 2009. We are very very mindful of the industry timetable and we would bring the process to a close in time to allow this to come into effect before the next football season 2009/2010.”*

<sup>5</sup> Paragraph 9.8 of the Consultation Document. See also statements of Stephen Unger of Ofcom, speaking at the Westminster Media Forum seminar:

*“There’s a lot of devil in the detail with these types of obligations, as always, if we proceed then we expect it will be necessary to determine various issues around pricing, we would also have to address a number of non-price issues, particularly, I think, in relation to, if you like, security and content piracy. So essentially if we proceed with this type of proposal we would expect to issue a further consultation setting out those sorts of details.”*

<sup>6</sup> Ofcom’s ‘Notice requiring information under section 174 of the Enterprise Act 2002’, 12 November 2008.

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*to those conditions*<sup>7</sup> (notwithstanding that the “conditions” concerned are themselves subject to consultation).

- 1.5 That Ofcom starts with these preconceptions is itself a serious breach of natural justice (and Ofcom’s statutory duties under the CA03):

*“It is common ground that, whether or not consultation of interested parties and the public is a legal requirement, if it is embarked upon it must be carried out properly. To be proper, a consultation must be undertaken at a time when proposals are still at a formative stage”*; <sup>8</sup>

and contravenes Ofcom’s own “Regulatory Principle” which obliges Ofcom to:

*“consult widely with all relevant stakeholders and assess the impact of regulatory action before imposing regulation upon a market”*.<sup>9</sup>

Indeed, the indication that Ofcom has reached a decision prior to conducting its consultation risks undermining the legitimacy of its conclusions:

*“If a consultation takes place at a point when all the work has been done and there is a timescale set for the making of the final decision, this will inevitably colour the approach of the authority to any representations. There will almost inevitably be a reluctance to go back to the drawing board and disrupt the time scale. **If the consultation is to be genuine, there must be a real willingness to alter or even reject the proposals in light of the consultation.**”*<sup>10</sup> (Emphasis added)

- 1.6 It is no surprise to Sky that Ofcom is pursuing this blinkered approach to its investigation. As far back as September 2006, Ofcom was pondering an internal policy paper entitled “Premium sports content – way forward”.<sup>11</sup> It is, therefore, clear that when Ofcom launched its investigation in 2007 it had already reached a view that a “way forward” (i.e., intervention or regulation) was required in relation to “premium sports content”, and it may be inferred that Ofcom’s

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<sup>7</sup> Ed Richards of Ofcom, speaking at Ofcom’s media analyst’s briefing on 22 October 2008.

<sup>8</sup> *R v. North and East Devon Health Authority, ex part Coughlan* [2000] QB 213, Lord Reid’s judgment at paragraph 108.

<sup>9</sup> <http://www.ofcom.org.uk/about/sdrp/>

<sup>10</sup> See page 249 of Michael Supperstone QC, James Goudie QC and Sir Paul Walker Eds., *Judicial Review*, Butterworths, Third Edition, which contains this summary of the judgment of O’Connor LJ in *Nichol v. Gateshead MBC* [1988] LGR 435 at 455.

See also the Cabinet Office “Five Principles of Good Regulation... regulators should bear in mind when devising, implementing, enforcing and reviewing regulations”, which states that an “effective consultation must take place before proposals are developed to ensure that stakeholders’ views and expertise are taken into account”. Available at :

<http://archive.cabinetoffice.gov.uk/brc/upload/assets/www.brc.gov.uk/principles.pdf>

<sup>11</sup> Ofcom internal paper ‘Premium sports content – way forward’, 21 September 2006, (obtained by Sky pursuant to a Freedom of Information Act 2000 request, 25 April 2008).

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current proposals, and stated policy objectives, are consistent with or represent that “*way forward*”.<sup>12</sup>

1.7 Ofcom’s pursuit of its preferred objective has led it to cut corners in a number of ways (as set out below). Each of these separately represents a serious procedural defect. Collectively, they have contributed to the substantive and analytical failings that we have identified in **Sections 3 to 7** of this Response. Unless they are rectified, Ofcom’s continuing pursuit of its investigation will be undermined.

### **2. Ofcom has failed to have due regard to Sky’s submissions to date**

2.1 Ofcom is under a duty to have due regard for submissions made to it:

*“To be proper... the product of consultation must be conscientiously taken into account when the ultimate decision is taken.”*<sup>13</sup>

2.2 Sky has already raised a serious concern that the amount of time Ofcom had allowed itself to consider Sky’s Response to the Complaint before publishing its First Consultation Document, was manifestly inadequate, indicating that Ofcom’s thinking was well developed before Sky’s submission was even considered.<sup>14</sup> Notwithstanding this criticism, it is evident that the second Consultation Document exhibits that same deficiency.

2.3 By way of example, Ofcom has had scant regard to the First PwC Report in the Consultation Document, giving almost equal weight to the poor counterpart submitted by the Complainants. Indeed, PwC’s work represents exactly the “*clarification and extend[ed] coverage*” that Ofcom’s own expert, Professor Andrew Chesher, suggested was missing from LECG’s analysis.<sup>15</sup> We have also discussed in detail, in Part 7 of **Annex 6**, Ofcom’s selective use of Sky’s evidence relating to market definition and market power and the fact that Ofcom has failed to have due regard to key pieces of relevant evidence which Sky has put to it.

### **3. Ofcom has not properly balanced its dealings with stakeholders**

3.1 The *audi alteram partem* rule, enshrined in Article 6(1) of the European Convention on Human Rights (ECHR), dictates that any body having the power to make decisions affecting a person’s rights or interests, must comply with the requirements of natural justice which, *inter alia*, require that prior notice of the allegations a party be given along with a fair opportunity to be heard.<sup>16</sup>

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<sup>12</sup> We note that Ofcom has withheld the bulk of the paper concerned.

<sup>13</sup> *R v. North and East Devon Health Authority, ex part Coughlan* [2000] QB 213 at para. 108.

<sup>14</sup> See paragraph 12.6 of Sky’s Response to the First Consultation Document.

<sup>15</sup> Andrew Chesher, ‘Comments on the slides: ‘Pay TV Prices in Europe (1997-12005) An Econometric Analysis’, 18 June 2007’, 13 August 2007 (obtained by Sky pursuant to a Freedom of Information Act Request).

<sup>16</sup> See Lord Reid’s dictum in *Ridge v. Baldwin* [1964] AC 40 at para. 114

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- 3.2 Given the targeted and confiscatory nature of Ofcom's proposals, there can be no doubt that Sky stands to be uniquely affected by any course of action taken by Ofcom as a consequence of its investigation. Therefore, Ofcom is obliged to provide a process that is compliant with Article 6(1) of the ECHR and, in particular, should have engaged closely with Sky in the period prior to its publication of the Consultation Document.
- 3.3 However, Ofcom has consistently chosen to keep Sky in the dark about matters, such as Ofcom's profitability analysis, on which Sky would have been uniquely able to provide insight. Sky made repeated offers to engage informally with Ofcom in the period leading up to the publication of the Consultation Document.<sup>17</sup> However, it became clear that Ofcom's thinking was so far progressed that any contribution that Sky could have made would be unlikely to have any meaningful impact on the Consultation Document. By contrast, over the course of its investigation (since August 2007 at the latest), Ofcom has had far greater interaction with not only the Complainants but also their advisors,<sup>18</sup> enabling the Complainants to respond directly to Ofcom's concerns and tailor their submissions accordingly.
- 3.4 The failure properly to balance dealings with stakeholders especially in the period leading to publication of the Consultation Document, is not only unfair but validates Sky characterisation of Ofcom's investigation as a "*quasi-adversarial process*"<sup>19</sup>, and reinforces Sky's role as 'Defendant' to proceedings.
- 4. Ofcom has failed to comply with *Vodafone Limited v. Ofcom* standards in its consultation to date**
- 4.1 Sky raised concerns about the opacity of Ofcom's First Consultation Document and the resulting difficulty Sky had in responding to it.<sup>20</sup> The same allegations could be made against Ofcom in relation to the Consultation Document which appears to overlook the obligation that:

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<sup>17</sup> [CONFIDENTIAL]

<sup>18</sup> See footnote 14 of Annex 9 which refers to a "*conference call between Top Up TV/Setanta representatives and Ofcom on 3 September 2008*" and an email from Mark Caines to Andrew Chesher, 17 September 2007 (obtained by Sky pursuant to a Freedom of Information Act request) which states:

*"we [Ofcom] met LECG in the second half of August, using your [Andrew Chesher's] notes as a guide. We have answers to some, but not all, of the questions, and are awaiting responses to the majority of the others. We are [sic] also awaiting the model that underpins the results."*

See also paragraph 4.1 of Virgin Media's 'Supplementary Submission', 15 August 2008.

<sup>19</sup> Paragraph 12.6 of Sky's Response to the First Consultation Document.

<sup>20</sup> *Ibid.*

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*“To be proper, a consultation... must include sufficient reasons for particular proposals to allow those consulted to give intelligent consideration and an intelligent response [and] adequate time must be given for this purpose”.*<sup>21</sup>

4.2 In **Section 3** and Part 4 of **Section 7**, Sky notes that in order properly to determine whether proposals for new regulation are necessary and proportionate it is necessary to evaluate and compare the benefits that are anticipated to be delivered by the new regulation with its expected costs. Moreover, to provide a basis for regulatory intervention such an assessment must be able to withstand “*profound and rigorous scrutiny*”. Ofcom simply fails to undertake this assessment to the requisite standard.

### **5. Ofcom has unfairly hampered Sky’s ability to put its case in the investigation**

5.1 As stated at paragraph 4.1 above, allowing stakeholders the opportunity to respond intelligently to a decision maker’s proposals includes the obligation to allow adequate time for this purpose. Ofcom’s investigation has had a substantial and disproportionate impact on Sky’s limited resources.<sup>22</sup> Despite the onerous nature of its information requests, Ofcom has been singularly unsympathetic to Sky’s position. This is especially true in relation to Ofcom’s third, ninth and tenth information requests, which were issued during periods in which Sky was preparing its responses to Ofcom’s consultation documents.

### 5.2 **[CONFIDENTIAL]**

5.3 Furthermore, Sky was not provided with a full ‘Sky only’ version of the Consultation Document, containing confidential information vital to Ofcom’s case and therefore Sky’s response, until 30 October 2008.<sup>23</sup> This means that prior to the requested extension being granted, Sky had, in effect, a period of

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<sup>21</sup> *R v. North and East Devon Health Authority, ex part Coughlan* [2000] QB 213 at para. 108.

<sup>22</sup> To date, Sky has submitted over 6,000 pages of evidence to Ofcom, including:

- comprehensive responses to the Complaint and Ofcom’s two consultations;
- responses to ten information requests, many of which required the provision of large quantities of highly sensitive data;
- a thoroughly researched and extensive report prepared and (following Ofcom’s comments in its Second Consultation document) updated by PwC on ‘outcomes for consumers in relation to pay TV in Europe’;
- a series of informative expositions, prepared by CRA, evaluating Sky’s vertical integration, Sky’s incentives for withholding content and economic evidence submitted by LECG and NERA on behalf of the Complainants;
- individual ‘issue papers’ responding to specific questions raised by Ofcom; and
- Sky’s responses to ongoing submissions of the Complainants in the period between closure of the first pay TV consultation and publication of the second Consultation Document.

<sup>23</sup> Relevant research material and supporting documentation, including material essential for Sky to understand Ofcom’s analysis of Sky profitability, continued to emanate from Ofcom until as late as 20 November 2008.

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only five weeks in which to prepare its response. Common sense should dictate that having adopted a consultation period shorter than the one recommended by Government best practice,<sup>24</sup> Ofcom would have had a version of the Consultation Document containing all confidential information pertaining to Sky, to give Sky the benefit of the full period allowed for preparation of its response.

### 6. Conclusion

6.1 [CONFIDENTIAL].<sup>25</sup>

6.2 [CONFIDENTIAL].<sup>26</sup> If Ofcom wishes to pursue its objectives, it must first ensure that its consideration of the matters pertinent to its investigation is carried out both in accordance with the principles of natural justice and with its duties under Sections 3 and 7 of the CA03.

Sky

January 2009

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<sup>24</sup> The House of Lords Select Committee on Regulators has recommended that “*wherever possible regulators allow for **at least** a 12 week consultation period in their forward planning to give industry a reasonable amount of time to respond to their papers*” and the Cabinet Office’s “*Five Principles of Good Regulation*” state that “[s]takeholders should be given **at least** 12 weeks, and sufficient information, to respond to consultations”. (Emphasis added)

<sup>25</sup> [CONFIDENTIAL]

<sup>26</sup> [CONFIDENTIAL]