



## **TRENDS IN CHARGES FOR PAY TV SERVICES, THE QUALITY OF SERVICES PROVIDED TO CONSUMERS AND SUBSCRIBER NUMBERS**

### **Introduction and executive summary**

1. In its Third Consultation Document, Ofcom concluded that there are relevant markets at the retail level for (a) “*supply of Sky Sports 1, Sky Sports 2 or Setanta Sports 1 as well as HD versions of these channels or TV packages that contain these channels*” and (b) “*supply of television bundles containing Core Premium Movie channels*”<sup>1</sup>.
2. Part of Ofcom’s analysis in support of these conclusions has involved consideration of changes over time in:
  - (a) charges for Sky’s pay TV services;
  - (b) the quality of services provided by Sky to consumers; and
  - (c) the number of Sky subscribers.
3. In its inquiry Ofcom has put forward a view that Sky has continually raised charges for its pay TV services over time, reducing the value for money received by consumers, while at the same time increasing the number of its subscribers. Ofcom then infers from this assessment that Sky does not face effective competition at the retail level.
4. Sky considers that the facts of the matter wholly contradict this assessment by Ofcom, and the inference that is drawn from it. Sky has already provided Ofcom with significant evidence collected by PwC, which shows that in relation to pay TV services UK consumers are well served compared to their European peers. Similarly, in its Response to Ofcom’s Third Consultation Document, Sky demonstrated that Ofcom’s proposition that examination of Sky’s profitability shows that retail prices for pay TV services are excessive is without foundation.<sup>2</sup>

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<sup>1</sup> Paragraph 4.410 of Ofcom’s Third Consultation Document. Ofcom considers Sky Movies Action & Thriller, Sky Movies Comedy, Sky Movies Drama, Sky Movies Family, Sky Movies Premiere, Sky Movies Premiere+1, Sky Movies Sci Fi & Horror, Sky Movies Screen 1, Sky Movies Screen 2, Sky Movies Modern Classics, Sky Movies Indie and Disney Cinemagic and the HD versions of these channels to be “*Core Premium Movie Channels*”.

<sup>2</sup> See Section 4 of Sky’s Response to Ofcom’s Third Consultation Document.

5. Sky has, in responding to Ofcom's three Consultation Documents, also addressed Ofcom's somewhat disjointed consideration, in the course of its inquiry, of trends in relation to charges for Sky's pay TV services, the quality of services provided by Sky to consumers, and the number of Sky subscribers<sup>3</sup>.
6. However, comments recently made by Lord Mandelson in the House of Lords during the second reading of the Digital Economy Bill, referring to Ofcom's inquiry, indicate that Ofcom's consideration of these matters continues (notwithstanding the closure of Ofcom's third consultation) to contribute to the misconception that subscribers are "*paying more than they should*" for Sky's pay TV services.<sup>4</sup> These comments have recently been repeated in a MF Global analyst note entitled 'BSkyB; Another reason to sell'<sup>5</sup>, indicating that they continue to gain traction. Sky therefore considers it necessary to make a further submission to Ofcom in order to ensure that such misconceptions are corrected.
7. Accordingly, Sky has consolidated and updated both:
  - (a) evidence on changes over time in (i) charges for Sky's pay TV services, (ii) the quality of services provided by Sky to consumers, and (iii) the number of subscribers to pay TV services in the UK. This evidence is set out in **Part One**, below; and
  - (b) Sky's criticisms of Ofcom's analysis of these matters. This discussion is set out in **Part Two**, below.
8. Where appropriate, Sky has also set out additional background to these matters, to the extent that such background has not been adequately addressed in Ofcom's inquiry, and expanded on a number of points in its previous submissions.

### ***Summary of evidence and conclusions***

9. **Figure 5**, in **Part One**, which is reproduced below, shows high-level trends in the number of Sky UK DTH residential subscribers over the period January 2000 - December 2009.

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<sup>3</sup> A summary of Ofcom's analysis of these issues in its consultation documents, which shows clearly its disjointed nature, is set out at **Annex 1**.

<sup>4</sup> In a clear reference to Ofcom's pay TV review, Lord Mandelson asserted that Sky held an "*iron grip on pay-tv -a market in which many viewers feel they are paying more than they should for their movies and their sport.*" See: <http://www.publications.parliament.uk/pa/ld200910/ldhansrd/text/91202-0003.htm>.

<sup>5</sup> 'BSkyB; Another reason to sell', MF Global, 17 February 2010. Sky provided a copy of this note, and commented on it, in its submission to Ofcom on 23 February 2010.

**Figure 5**  
**Sky UK DTH residential subscribers**  
**Split by main package type**

[CONFIDENTIAL]

10. [CONFIDENTIAL]

11. [CONFIDENTIAL]

**Figure 10**  
**Sky UK DTH residential subscribers**  
**Dual Sports subscribers, split by basic Mix**

[CONFIDENTIAL]

12. Ofcom's analysis of trends over time in Sky's subscriber numbers has failed to have adequate regard to a wide range of factors that have had significant impacts on the number of Sky subscribers over this period – in effect, Ofcom has focused entirely on the 'value for money' (or quality-adjusted price) of Sky's pay TV packages. While this is a key determinant of demand for Sky's pay TV services, a number of other factors have also been of considerable significance in determining changes in Sky's subscriber numbers over time (and the mix of subscribers), including:

- consumer switching from analogue television to digital television services;
- repricing and repackaging of basic channels;
- Sky+;
- new services such as Sky Anytime and Sky Player;
- Sky's move into providing telecommunications services, so that it can now provide 'triple play' packages of TV, telephony and broadband;
- increased investment in customer service;
- high definition television services; and
- changes in the volume, type and effectiveness of Sky's marketing activity (including set-top box and installation subsidy).

13. These types of changes have affected demand for all types of Sky's pay TV packages. In order to assess the specific impact of changes in the value for money of Sky's pay TV packages on subscriber numbers it is necessary to focus on changes in charges for particular pay TV packages (measured in real terms) and changes in the quality of those pay TV packages.

14. In this submission, we have focused on four pay TV packages offered by Sky, which as at June 2009 accounted for [CONFIDENTIAL] of the total number of Sky UK DTH residential subscribers:

- Top Tier;
  - Dual Sports (including the Family Pack/Six Mix basic package);
  - Dual Movies (including the Family Pack/ Six Mix basic package); and
  - The Family Pack/ Six Mix basic package.
15. The extent of changes over time in charges for, and quality of, Sky's pay TV packages depends on both the time period adopted for analysis and the price index used to convert charges in nominal terms into charges measured in real terms.
16. Given that the focus of Ofcom's inquiry is on current and prospective competitive conditions, Sky has examined the period from 1 January 2004 to 1 September 2009. This period is most representative of current competitive conditions in that it covers a period in which, among other things, (a) Freeview achieved its current form, with a significant number of free to air television channels offered by the public service broadcasters ('PSBs'), and (b) ntl and Telewest merged into a single national cable company, and subsequently re-branded as Virgin Media.
17. In terms of price indices used to convert charges in nominal terms into charges expressed in real terms, Sky has used both the CPI and RPI (all items excluding indirect taxes and mortgage interest payments), which results in changes in charges over time being expressed as a range, as these two price indices have diverged over time.
18. The results of Sky's analysis of changes over time in subscription charges for the four packages set out above are shown in **Table 5 of Part One**.

**Table 5**  
**Total change<sup>6</sup> in charges in real terms**  
**January 2004 – September 2009**

Top Tier	1.7% - 5.5%
Dual Movies*	-3.8% - -0.2%
Dual Sports*	4.2 % - 8.1%
Family Pack/Six Mix	-1.1% - 2.6%

\* *in each case including Family Pack/Six Mix*

19. There were significant improvements in the quality of each of these packages over this period. The quality of all four packages increased as a result of a significant increase in the number of basic channels carried in these packages (over 20 new basic channels, not including time-shifted versions), and significant efforts by Sky to improve the quality of basic channels, for example via increased investment in its own basic channels (such as Sky One and Sky Arts).

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<sup>6</sup> This table provides the total change in charges of a period of 5 ¾ years. Sky has not converted such changes into 'annual percentage changes', as Ofcom has tended to, as such a presentation of changes is potentially misleading. In particular, it carries with it a suggestion of steady annual changes in charges in real terms when this has not been the case.

20. Over and above the quality improvements associated with improvements in the basic channels carried in these packages, the quality of the Top Tier and Dual Sports packages increased as a result of significant improvements in Sky's Sports channels during this period, most obviously as a result of a substantial increase in the breadth and depth of sports programming carried on these channels, including:
- an expansion in the number of live Premier League football matches – from 66 in 2003/04 to 88 between 2004/05 and 2006/07, increasing again to 92 matches from 2007/08 onwards;
  - the introduction of live coverage of UEFA Champions League football from the 2003/04 season;
  - a substantial increase in Sky Sports' cricket coverage, including, from 2006 onwards exclusive live coverage of England home Test Matches; and
  - the commencement of Sky Sports' coverage of Heineken Cup rugby from December 2003.
21. Sky also increased significantly the amount spent on producing Sky Sports channels during this period – spending on elements such as better sound and other equipment, and presentation (e.g. commentators, studio experts and graphics) – as well as continuing to remain at the forefront of the use of innovative new technology in sports broadcasting (e.g. the use of powerful infra-red cameras in cricket coverage to detect whether the ball has hit a batsman's pad or bat).
22. Over and above the quality improvements associated with improvements in the basic channels carried in these packages, the quality of the Top Tier and Dual Movies packages increased as a result of improvements in Sky's Movie channels during this period, including:
- an improvement in the mix of titles broadcast, **[CONFIDENTIAL]**;
  - moving forward of the pay TV window for movies so that they can be shown sooner after cinematic release;
  - the transformation in April 2007 of Sky's three movie channels (plus multiplexed versions of those channels) into nine new thematic channels; and
  - the introduction of PIN protection for movie channels in January 2006 which means that 12 certificate and 15 certificate movies can now be scheduled before 8pm.
23. **Table 5** shows that the real price of Sky's Dual Movies package (including Family Pack/ Six Mix) has fallen over the 2004 – 2009 period. It is more likely than not that over this period the charges for Sky's Top Tier, Dual Sports (including Family Pack/ Six Mix), and 'Big Basic' packages have also fallen in real, quality-adjusted terms.
24. These changes, together with changes in the number of subscribers to each of these packages are summarised in **Table 6** in **Part One**:

**Table 6**  
**Changes in prices, quality and subscriber numbers for the Sky pay TV packages**  
**examined above**  
**January 2004 - September 2009**

	<b>Top Tier</b>	<b>Dual Movies*</b>	<b>Dual Sports*</b>	<b>'Big Basic'</b>
Change in price in real terms	1.7% - 5.5%	-3.8% - -0.2%	4.2% - 8.1%	-1.1% - 2.6%
Improvements in basic channel packages	✓	✓	✓	✓
Improvements in Sky's sports channels	✓		✓	
Improvements in Sky's movie channels	✓	✓		
<b>[CONFIDENTIAL]</b>	<b>[CONFIDENTIAL]</b>	<b>[CONFIDENTIAL]</b>	<b>[CONFIDENTIAL]</b>	<b>[CONFIDENTIAL]</b>

\* including Family Pack/ Six Mix.

25. **Table 6** shows clearly that there is no merit at all in a proposition that, **[CONFIDENTIAL]** This view is strongly reinforced by **[CONFIDENTIAL]** - see **Figures 25 - 28** of **Part One**. **Figures 26 and 27** are reproduced below.

**Figure 26**

**[CONFIDENTIAL]**

**Figure 27**

**[CONFIDENTIAL]**

26. This analysis does not take into account the impact on subscriber numbers of the types of considerations set out at paragraph 12, above, such as the impact of Sky+, HD and Sky's provision of broadband and telephony services. **[CONFIDENTIAL]**
27. **[CONFIDENTIAL]**
28. As discussed in **Part One**, it also seems likely that **[CONFIDENTIAL]**
29. In view of these factors, **[CONFIDENTIAL]**
30. **Part Two** of this submission examines Ofcom's analysis of these matters. Ofcom has adopted two analytical approaches:

- (a) an attempt to examine “*subscribers’ responses to actual price rises*”; and
- (b) an ‘event analysis’ that purports to examine the reactions of pay TV subscribers and retailers of pay TV services to the emergence of Freeview.

*Subscribers’ responses to actual price rises*

- 31. A key problem with the first approach is that over the recent and more relevant past it is evident that there have not been “*actual price rises*” in real quality-adjusted terms for Sky’s pay TV services to which subscribers’ responses might be observed. This is certainly the case for Sky’s Dual Movies package, the price of which has fallen in real terms, even before improvements in its quality is taken into account. In relation to Sky’s Top Tier, Dual Sports and Big Basic packages, it is more likely than not that prices have not risen in real quality-adjusted terms, once changes in the quality of those packages are taken into account.
- 32. More generally, Ofcom’s analysis has been based on a proposition that, if it is observed that (a) charges have been rising in real terms, and (b) subscriber numbers have also been increasing, this is a good indication that Sky does not face effective competition at the retail level. This proposition, however, is not based on sound economic theory. Rising prices should be expected to reduce sales. If the opposite is observed (i.e. rising prices and increasing sales), the explanation cannot be weak competition; even firms with market power face reduced sales if they increase prices. Rising prices accompanied by increasing sales (if this is what is actually observed) indicates that something is acting to more than off-set the impact of price rises on sales.
- 33. As a result, Ofcom’s analysis of this matter provides no support for its conclusions about the scope of relevant markets at the retail level.

*Ofcom’s ‘event analysis’*

- 34. If Ofcom’s event analysis had been undertaken properly, it would comprise an extremely valuable part of Ofcom’s assessment of competition at the retail level. All available evidence suggests that major changes in the intensity of competition at the retail level have occurred in the recent past, and that the emergence and development of Freeview has been a major part of those changes, to which Sky has had to respond.
- 35. Proper examination of evidence from 2004 and 2005 would have shown that a key focus of external scrutiny of Sky’s business at that time was whether the increased competition it faced would mean that Sky would not meet its subscriber targets. Similarly, proper examination of Sky’s internal documents from this period would have shown that how to address the impact of increased competition from a variety of sources was a key consideration of Sky’s strategic planning at this time. It was only as a result of radical new initiatives – such as the repricing and repackaging of Sky basic channel packages, the move into telecommunications services, extensive marketing of Sky+, and investing in and

marketing high definition television services (as well as Sky's ongoing approach of continuing significantly to improve the value for money of its pay TV packages) – that Sky has been able to continue to grow its subscriber base and meet its subscriber targets.

36. While Ofcom's 'event analysis' has numerous significant flaws, which are discussed in **Part Two** of this submission, the principal problem is that Ofcom has not in practice undertaken an assessment of the impact of Freeview (and other market developments) on Sky's business, drawing on the full range of evidence that is (a) relevant to this issue, and (b) readily available to Ofcom. Ofcom's 'event analysis' in practice amounts to a statement of an ill-founded belief, rather than any serious attempt properly to evaluate this matter. As a result, it is wholly unreliable as a basis for Ofcom's conclusion about the scope of relevant markets at the retail level. Had Ofcom undertaken a proper analysis of these matters, there is little doubt that it would confirm Sky's view that retail markets are wider than those that Ofcom concludes are relevant for the purpose of its inquiry.



## Part One

### Trends in charges for pay TV services, the quality of services provided to consumers and subscriber numbers

38. **Part One** of this submission considers the following matters:

- background (**Section A**);
- numbers of UK residential pay TV subscribers (**Section B.1**);
- numbers of Sky UK DTH residential pay TV subscribers (**Section B.2**);
- introduction of new products and changes in the pricing and packaging of Sky's services (**Section C**);
- other relevant background (**Section D**)
- changes in Sky's subscription charges (**Section E**);
- changes in the quality of Sky's pay TV packages (**Section F**);
- summary of trends in prices, quality and subscribers relating to each main type of Sky package (**Section G**);
- comparison of changes in Sky's charges and subscriber numbers over time (**Section H**); and
- summary and conclusion (**Section I**).

#### A. Background

39. As discussed in greater detail in **Part Two**, below, Ofcom's general approach to these matters has been to seek to argue that (a) Sky has increased charges for its pay TV services in real terms over time and, despite this, (b) the number of subscribers to these services has continued to rise. Ofcom generally also acknowledges that the quality of services 'may have risen', but essentially plays down the role of quality improvements in contributing to subscriber retention and acquisition, and ignores entirely many other important contributory factors. These observations have often been expressed in vague terms – for example as to the specific services and time periods being considered.

40. Ofcom has then tended to argue that these observations provide supporting evidence (when placed alongside other observations and analysis) for its conclusions that relevant markets for pay TV services at the retail level are narrow.

41. Before turning to the evidence on these matters, two issues are discussed in the sections below:

- whether such analysis should focus on all pay TV services provided to consumers in the UK, or only those provided by Sky; and
- the aggregation of pay TV services into broader categories.

### ***Analysis of sectoral data or Sky's data?***

42. The key issue in Ofcom's retail-level market definition analysis is whether markets are broader than markets for the supply of particular types of pay TV services – for example, pay TV packages that include premium sports channels. Ofcom's focal products are not retailer-specific.<sup>7</sup> Accordingly, Ofcom's analysis should in principle include all pay TV retailers' services.
43. Throughout its inquiry, however, Ofcom's analysis of trends in charges for pay TV services, the quality of services provided to consumers and subscriber numbers has been based on Sky's services only.<sup>8</sup> This means that Ofcom's analysis offers only a partial view of overall trends in relation to such services and undermines significantly its ability to produce meaningful conclusions in a market definition analysis.
44. The principal purpose of this section, however, is properly to establish the relevant evidence in relation to the issues examined by Ofcom. Sky has, therefore, focused on data relating to Sky's services, rather than the pay TV sector as a whole. The exception to this is in relation to data on trends in subscriber numbers, where Sky has provided its estimates of sectoral trends (given that this is relatively straightforward) and Sky-only data.

### ***Aggregation of pay TV services into broader categories***

45. There is a large and increasing variety of pay TV packages available to consumers. In its analysis, Ofcom has sought to aggregate such packages into broader categories, notwithstanding that it has disaggregated data available to it.<sup>9</sup>
46. Immediately, this raises significant issues because:

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<sup>7</sup> Ofcom states:

*“our focal products for investigation of retail markets are:*

- *Retail packages containing Core Premium Sports channels.*
- *Retail packages containing Core Premium Movie channels.”*

(Paragraph 4.19 of Ofcom's Third Consultation Document.)

<sup>8</sup> It appears to be the case that the only reason given by Ofcom for this was in its First Consultation Document where it stated: *“The reason for selecting these data is unavailability of time-series data for other providers.”* (Footnote 15 Annex 13 of Ofcom's First Consultation Document.) This is an unusual justification. The Sky data used by Ofcom were obtained by Ofcom via information requests. It is unclear (a) why other providers would not have been able to provide corresponding data in response to Ofcom information requests, or (b) why Ofcom would be unable to form estimates at the sectoral level from readily available data sources.

<sup>9</sup> Ofcom's focal products comprise an extensive range of different types of pay TV services. See Table 1 and accompanying discussion in Sky's submission of October 2009 entitled 'A review of the evidence relied on by Ofcom as the basis for its conclusions about the scope of relevant retail markets in its third pay TV consultation document'.

- (a) trends in relation to charges, quality and subscriber numbers may differ significantly among different types of pay TV service, and aggregation therefore risks obscuring important information about particular services that is relevant to Ofcom’s market definition analysis; and
  - (b) it is unclear how variables such as ‘quality’ or ‘price’ might be established for categories that comprise a potentially diverse set of different services. (This issue is less significant in relation to subscriber numbers, where it is possible to aggregate, for example, all subscribers to ‘basic-only’ packages, or packages that include premium sports and movie channels.)
47. Ofcom’s approach to this issue has been wholly unsatisfactory due to its lack of precision. Ofcom’s analysis begins from three ‘focal products’: (a) pay TV services that include premium sports channels, (b) pay TV services that include premium movie channels, and (c) basic-only pay TV packages. The first two of these ‘products’ raise significant aggregation issues given that they include both (i) packages that include either premium sports channels or premium movie channels and (ii) packages that include premium sports and premium movie channels. These ‘products’ suffer from both the aggregation issues discussed above: (a) it is not clear how the notional charge for these ‘products’ should be established, or their quality evaluated, and (b) trends in charges, quality and subscriber numbers have differed considerably among the ‘product’s’ constituent packages.<sup>10</sup>
48. The aggregation problems associated with Ofcom’s approach are well illustrated by Ofcom’s discussion of “*evidence on pricing and subscriber growth*” in relation to “*packages containing premium sports channels*” in the First Consultation Document. Ofcom stated:
- “The price of Sky’s premium sports, and premium sports and movie packages has risen in real terms since January 2000; and*
- During the same period the number of subscribers has grown, although the growth has slowed in the last two years.”<sup>11</sup>*
49. As shown below, these statements mask important trends in the components of the ‘product’ examined by Ofcom. While it is correct that the price of each of (a) Sky’s premium sports packages (not including movie channels) and (b) Sky’s premium sports and movie packages, has risen in real terms since January 2000, the increase in the subscription charge for the latter has been significantly less than the former. And in relation to subscriber numbers, the number of subscribers to premium sports packages has risen strongly since 2004, while the

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<sup>10</sup> These issues would become even more problematic if the focus of analysis were at a sectoral level, rather than simply focusing on Sky’s services, as the nature of, and charges for, pay TV services offered by other operators differ significantly from Sky’s, and trends in subscriber numbers have differed from those of Sky.

<sup>11</sup> Paragraph 4.26 of Annex 13 to Ofcom’s First Consultation Document.

number of subscribers to Sky's sports and movie packages has been declining since 2003.

50. The corresponding analysis of "*packages that include premium movie channels*" in the First Consultation Document does not mention at all packages that include both premium movie channels and premium sports channels.
51. The approach taken in this submission is to seek to avoid aggregating different types of services. Data on subscriber numbers, however, have been aggregated in a number of ways, in addition to providing data at the level of particular packages.

## **B. Subscriber numbers**

### **B.1 All UK pay TV retailers<sup>12</sup>**

52. As noted above, the area in which it is relatively straightforward to produce data at the sectoral level is in relation to subscriber numbers. **Figures 1- 3** below provide Sky's estimates of the total number of different types of pay TV subscribers in the UK over the period January 2000 – June 2009.<sup>13</sup> These estimates are based on Sky's own data, publicly available data and (in relation to Setanta) assumptions about the extent to which subscribers took Setanta's services in addition to other premium pay TV services.
53. An important issue in this regard is how Virgin Media XL Pack subscribers should be treated. Virgin Media has, for a number of years, included a premium sports channel – formerly Setanta Sports, latterly ESPN – in its XL Pack. The XL Pack, however, is normally regarded as being a 'basic' channel package. In the presentation of data below, Sky has treated such subscribers as 'basic' pay TV subscribers. It is clear, however, that alternative approaches – for example treating such subscribers as premium pay TV subscribers – might be equally valid. It seems somewhat anomalous to treat a household that subscribed to Setanta Sports via DTH satellite (where Setanta retailed its channels to

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<sup>12</sup> Over the period examined in this section, these were principally Sky, ONDigital/ ITV Digital, ntl, Telewest, Virgin Media, Setanta, Top Up TV, Video Networks Limited (later purchased by Tiscali, whose UK business was subsequently purchased by Carphone Warehouse), Kingston Interactive Technology (KIT) which ceased operating in 2006, BT, and a number of small cable network operators (e.g. Wightcable, which provides cable services on the Isle of Wight). Sky has been unable to include Top Up TV, KIT and BT Vision subscribers in its analysis as there is no reliable publicly available information on the number of subscribers to these services, and has not included the small cable operators. Adult pay TV services are not considered in this submission.

<sup>13</sup> In terms of total UK subscriber numbers, Sky has considered the period up to June 2009 in order to avoid complications arising from the exit of Setanta, and ESPN's development of a new premium sports channel. Data in relation to Sky's own subscriber numbers (and other variables) are presented for a longer period, below.

subscribers directly) as a premium pay TV subscriber, and a household that received Setanta Sports via Virgin Media as a basic pay TV subscriber.<sup>14</sup>

54. Sky's estimates of the number of Virgin Media 'M Pack' subscribers have also been excluded from these charts, as this pack does not constitute a genuine pay TV package, comprising channels that are delivered free to air on open television platforms.<sup>15</sup>

### **Figure 1**

#### **All UK residential pay TV subscribers Split by basic/ premium**

**[CONFIDENTIAL]**

55. **Figure 1** provides a high-level overview of the total number of UK residential pay TV subscribers, with a split between subscribers to (a) basic-only pay TV services and (b) packages that include at least one premium pay TV channel.<sup>16</sup>

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<sup>14</sup> If anything, this situation indicates the fact that, in relation to the provision of pay TV services, matters are rarely black and white, and require very careful consideration and analysis.

<sup>15</sup> Virgin Media has described this package in its marketing material as 'free TV'. In calculating the number of basic only cable subscribers Sky has adopted a simplifying assumption that there are no 'M pack' cable subscribers who also subscribe to premium channels. To the extent that this assumption is invalid, the effect will be to underestimate the number of basic-only Virgin Media subscribers - it has no bearing on Sky's estimates of the number of Virgin Media subscribers to premium channels. It would clearly be possible for Ofcom to clarify the actual situation by obtaining appropriate data from Virgin Media.

<sup>16</sup> The fall in subscriber numbers in 2002 resulted from the closure of the ITV Digital DTT-based pay TV service.

## Figure 2

**All UK residential subscribers to pay TV services that include premium sports channels, and to pay TV services that include premium movie channels**

[CONFIDENTIAL]

56. **Figure 2** shows the trend in UK subscriber numbers to premium pay TV services based on Ofcom's 'focal products' of (a) pay TV services that include premium sports channels, and (b) pay TV services that include premium movie channels. [CONFIDENTIAL]
57. The chart shows [CONFIDENTIAL] As shown in **Figure 3**, below, the factors underlying these high-level trends have been:
- (a) [CONFIDENTIAL] ; and
  - (b) [CONFIDENTIAL]

## Figure 3

**All UK residential subscribers to pay TV packages that include premium channels  
Split by main package type**

[CONFIDENTIAL]

58. **Figure 3** provides [CONFIDENTIAL]

## **B.2 Sky UK DTH residential subscribers**

### ***Nomenclature relating to Sky's pay TV packages***

59. It is helpful at this point to set out a brief overview of the way in which Sky has packaged the pay TV channels it offers to consumers, and the terms used to refer to different types of packages in this submission<sup>17</sup>.
60. As is common with pay TV retailers, Sky has offered (and continues to offer), pay TV services in channel 'packages'. A package is a group of television channels that a subscriber is entitled to view for a single monthly subscription fee. Broadly speaking, packages can comprise combinations of basic channels, premium sports channels and premium movie channels.
61. Prior to September 2009 Sky did not offer premium channels separately from basic channels so that all 'premium channel packages' comprised both premium channels and basic channels.
62. Sky's approach to the packaging of its premium sports channels has been to offer two separate packages, based around its Sky Sports 1 and Sky Sports 2 channels, so that consumers can, for example, subscribe to packages that include Sky Sports 1 but not Sky Sports 2 (in addition to basic channels). Packages that include both channels (and any bonus channels available to consumers who subscribe to packages that include both channels), as well as basic channels, are referred to as 'Dual Sports' packages.
63. The same approach is applied to packaging of Sky's premium movie channels, although the situation in relation to these packages has changed somewhat over time. In the past, Sky offered two main movie channels, with a series of 'multiplexes' (additional channels showing the same content at different times) of those channels. The names of the two primary movie channels changed on a number of occasions. In 2007, however, Sky restructured its movie channel offering into nine new movie channels, devoted to different movie genres. The approach of offering these channels in two packages has, however, been retained. Accordingly, packages that include all Sky's movie channels (and any bonus channels available to consumers who subscribe to packages that include both movie packs), as well as basic channels, are referred to as 'Dual Movies' packages.
64. The broadest package offered by Sky is referred to as the 'Top Tier' package. This contains all the channels retailed by Sky, both premium and basic, other than a small number of third party channels retailed by Sky as optional add-ons (e.g. Film Four when it was a pay TV service, or ESPN currently). It can be considered to comprise Dual Sports, Dual Movies and all basic channels retailed by Sky.

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<sup>17</sup> The nomenclature used in Sky's marketing of these packages to consumers differs from that used in this submission.

65. **Tables 1 and 2**, below, show the packaging associated with Sky's premium channels at 1 March 2002 and 1 February 2010 respectively.

**Table 1**

**Sky's retail packaging of its premium sports and movie channels  
As at 1 March 2002**

Package	Channels
<b>Single Sports</b>	<ul style="list-style-type: none"> <li>• Either Sky Sports 1 or Sky Sports 2</li> <li>• Sky Sports 3 (bonus channel)</li> </ul>
<b>Dual Sports</b>	<ul style="list-style-type: none"> <li>• Sky Sports 1</li> <li>• Sky Sports 2</li> <li>• Sky Sports 3 (bonus channel)</li> <li>• Sky Sports Extra</li> </ul>
<b>Single Movies</b>	Either Sky Premier or Sky MovieMax
<b>Dual Movies</b>	<ul style="list-style-type: none"> <li>• Sky Premier</li> <li>• Sky MovieMax</li> <li>• Sky Cinema (bonus channel)</li> <li>• The Disney Channel (bonus channel)</li> </ul>

At 1 March 2002 the Sky Premier multiplexes comprised Sky Premier 1, Sky Premier 2, Sky Premier 3, Sky Premier 4 and Sky Premier (Widescreen), and the Sky MovieMax multiplexes comprised Sky MovieMax 1, Sky MovieMax 2, Sky MovieMax 3, Sky MovieMax 4 and Sky MovieMax 5.

**Table 2**

**Sky's retail packaging of its premium sports and movie channels  
As at 1 February 2010**

Package	Channels
<b>Single Sports</b>	Either Sky Sports 1 or Sky Sports 2
<b>Dual Sports</b>	<ul style="list-style-type: none"> <li>• Sky Sports 1</li> <li>• Sky Sports 2</li> <li>• Sky Sports 3 (bonus channel)</li> <li>• Sky Sports 4 (bonus channel)</li> </ul>
<b>Sky Movies 1</b>	<ul style="list-style-type: none"> <li>• Sky Movies Comedy</li> <li>• Sky Movies Family</li> <li>• Sky Movies Classics</li> <li>• Sky Movies Modern Greats</li> <li>• Sky Movies Screen 1</li> </ul>
<b>Sky Movies 2</b>	<ul style="list-style-type: none"> <li>• Sky Movies Action &amp; Thriller</li> <li>• Sky Movies Drama</li> <li>• Sky Movies Sci Fi &amp; Horror</li> <li>• Sky Movies Indie</li> <li>• Sky Movies Screen 2</li> </ul>
<b>Dual Movies</b>	<ul style="list-style-type: none"> <li>• Sky Movies Comedy</li> <li>• Sky Movies Family</li> <li>• Sky Movies Classics</li> <li>• Sky Movies Modern Greats</li> <li>• Sky Movies Screen 1</li> </ul>



	<ul style="list-style-type: none"> <li>• Sky Movies Action &amp; Thriller</li> <li>• Sky Movies Drama</li> <li>• Sky Movies Sci Fi &amp; Horror</li> <li>• Sky Movies Indie</li> <li>• Sky Movies Screen 2</li> <li>• Sky Movies Premiere (bonus channel)</li> <li>• Disney Cinemagic (bonus channel)</li> </ul>
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66. Sky’s approach to the packaging of basic channels that it retails, and in particular the significant changes that occurred in relation to this packaging after September 2005, are described in greater detail below.
67. Prior to September 2005, while Sky offered a number of different basic channel combinations, **[CONFIDENTIAL]** of Sky subscribers subscribed to the package that included all basic channels retailed by Sky, called the ‘Family Pack’, and known informally as ‘Big Basic’.
68. In September 2005 the basic channels retailed by Sky were repackaged into six new packages, called ‘Mixes’, which were priced and packaged in such a way as to appeal to a greater degree to consumers who did not wish to subscribe to a package that included all basic channels retailed by Sky. Accordingly, a package that includes all six Mixes (known as ‘Six Mix’) corresponds directly to the former ‘Family Pack’.
69. **Figures 4 and 5** provide the corresponding charts to **Figures 1 and 3**, above, in this case for Sky alone.

**Figure 4**

**Sky UK DTH residential subscribers  
Split by basic/ premium**

**[CONFIDENTIAL]**

**Figure 5**

**Sky UK DTH residential subscribers  
Split by main package type**

**[CONFIDENTIAL]**

70. **Figure 6 and 7** show the numbers of UK subscribers to Sky’s Dual Sports and Dual Movies packages (in each case, including all basic package combinations).

**Figure 6**

**Sky UK DTH residential Dual Sports subscribers  
(All basic package combinations)**

[CONFIDENTIAL]

71. The number of UK households who subscribe to Sky's Dual Sports package (and no premium movie channels) [CONFIDENTIAL]

**Figure 7**

**Sky UK DTH residential Dual Movies subscribers  
(All basic package combinations)**

[CONFIDENTIAL]

72. The number of households who subscribe to Sky's Dual Movies package (and no premium sports channels) [CONFIDENTIAL]

[CONFIDENTIAL]

73. As discussed further in **Section C**, below, it is not possible properly to assess the pattern of changes in Sky's subscriber numbers over time without having regard to [CONFIDENTIAL]

**Figure 8**

[CONFIDENTIAL]

**Figure 9**

[CONFIDENTIAL]

**Figure 10**

[CONFIDENTIAL]

74. **Figures 8 - 10** indicate [CONFIDENTIAL]

75. [CONFIDENTIAL]

**Figure 11**

[CONFIDENTIAL]

76. **Figure 11** shows [CONFIDENTIAL]

***Relationships among subscriber series***

77. Significant caution must be exercised in drawing inferences about relationships among different subscriber data series. In particular, if the number of subscribers to a particular service has been increasing and another decreasing, it is not necessarily the case that subscribers have been switching between the two services. This is because changes in the number of subscribers to a particular service are determined by two inflows, and two outflows, namely:

- the number of new subscribers to that service (gross additions);
- the number of existing subscribers to that service who cancel their pay TV subscription altogether;
- the number of existing subscribers to other services who switch to the service in question; and
- the number of subscribers to the service in question who switch to an alternative pay TV package.<sup>18</sup>

78. Accordingly, it is possible for subscriber numbers for a particular package to increase, and those of a different package to decrease, even if there is no subscriber switching between the two packages.

79. [CONFIDENTIAL]

**Figure 12**

[CONFIDENTIAL]

**C. Introduction of new products and changes in the pricing and packaging of Sky's services**

80. Before turning to changes in subscription charges and quality of Sky's pay TV packages, this section discusses the introduction by Sky of new products and changes in pricing and packaging of its services. It is not possible properly to assess trends in the number of Sky subscribers over time without considering these matters.

81. In principle, these issues could be considered as quality or price changes. There are two reasons for considering them separately.

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<sup>18</sup> Subscribers who switch from a lower tier package to a higher tier package are said to 'upgrade', while subscribers who switch from a higher tier package to a lower tier package are said to 'downgrade' or 'spin down'.

82. First, in some cases they do not fit neatly into either category. For example, the changes to Sky's approach to packaging the basic channels it retails, beginning in September 2005, are difficult to categorise solely as price changes or quality changes.
83. Second, these products and services have been of such significance in terms of enabling Sky to continue to grow its subscriber base in an increasingly competitive market that they warrant separate discussion. The following sections discuss:
- repricing and repackaging of basic channels;
  - Sky+;
  - Sky Anytime;
  - Sky Player;
  - Sky's move into the provision of telecommunications services; and
  - high definition television services.
84. While these have been the most prominent of the new and/or revised products and services offered by Sky to consumers, there have been a large number of other such changes, each of which has made, and continues to make, a contribution to attracting new subscribers and retaining existing subscribers.<sup>19</sup>

#### ***Repricing and repackaging of basic channels***

85. Ofcom's focus on premium pay TV channels means that it fails properly to appreciate the significant role played by basic pay TV channels in attracting and retaining pay TV subscribers – including those who also subscribe to premium pay TV channels – and hence the importance of the repricing and repackaging of basic channels retailed by Sky beginning in September 2005. Basic pay TV channels are an important component of packages that include premium pay TV channels, and contribute significantly to attracting households to subscribe to such services. Consumers place significant value on the wide range of high quality programming available on basic channels, in a variety of genres.
86. In the analogue era satellite was able to offer greater channel choice than was available via analogue terrestrial television, but the move to digital television made the contrast much greater. Following the launch by Sky of digital television in 1998 and up until Freeview became well established the central marketing proposition for Sky was one of 'choice'. Sky was speaking to homes that primarily had 4 or 5 channels and it was offering a much greater degree of viewing choice. For many years selling 'choice' was a successful strategy for new subscribers.

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<sup>19</sup> By way of example, Sky has invested [CONFIDENTIAL] in developing a new EPG, with a new look and feel, and enhanced functionality – for example, including a 'mini TV' in the corner of the EPG which enables users to continue viewing television while browsing the EPG. The new EPG is available to users of Sky+ HD set-top boxes. It was delivered progressively to Sky+ HD set-top boxes from the beginning of 2009.

87. Prior to mid-2004 the principal focus of Sky's efforts to attract and retain subscribers was its Top Tier package. The main basic-only package marketed to consumers was the 'Family Pack', which, as set out above, included all basic pay TV channels retailed by Sky. **[CONFIDENTIAL]**
88. But by mid-2004 Sky began to find it increasingly difficult to attract new subscribers, and it was becoming evident that Sky's subscriber acquisition strategy would need to change. The success of Freeview, which by the end of 2004 had already attracted around 4.6 million households, was central to this. It was no longer as effective as it had been to seek to attract new subscribers with a simple message of choice. The reason was that Freeview customers tended to consider the additional viewing choice offered by channels available on Freeview was sufficient. Even those homes that did not yet have Freeview were increasingly aware of the increased choice that was available from Freeview and that the service did not cost anything after the initial purchase price of a Freeview box (prices for which were falling rapidly). **[CONFIDENTIAL]**
89. It is important to recognise that the significant expansion in free to air television services associated with the development of Freeview also affects demand for combined premium and basic channel packages. The most prominent and successful of the new free to air television channels that have emerged in the past five years have greatly expanded the amount of free programming available in the general entertainment genre which dominates day-to-day television viewing. This can erode the value consumers place on a combined premium and basic channel package - by eroding the value they derive from the basic element of such packages - even if the value they place on the premium component is unchanged.<sup>20</sup>
90. There were, however, other factors at play at this time, such as the diminishing number of potential subscribers interested in subscribing to large channel packages that included premium sports and movie channels. As a result of these factors, in order to continue to grow its subscriber base, Sky made three important changes to its strategy, one of which was repricing and repackaging of Sky's basic channel packages.<sup>21</sup>
91. Following a considerable programme of consumer research, Sky implemented changes to the pricing and packaging of its basic channel packages in September 2005. Sky recognised that, in order to continue to grow its subscriber base, it would have to offer smaller, cheaper channel packages alongside its more inclusive packages.

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<sup>20</sup> As discussed in a number of Sky's previous submissions, such channels have also carried large numbers of movies, which potentially directly reduces demand for pay TV services that include premium movie channels.

<sup>21</sup> The others were (a) Sky's move into the provision of telecommunications services and (b) devoting increased effort and investment to increasing the attractiveness of the pay TV proposition available to consumers. Each of these is discussed further below.

92. As a result, in September 2005, Sky introduced six new packages of basic channels, which it called 'Mixes'. Initially, subscribers could elect to subscribe to 2, 4, or 6 Mixes. Each Mix was based around a particular theme or genre as follows:
- Variety (such as general entertainment and basic movie channels);
  - Kids (children's channels);
  - Style and Culture (lifestyle channels such as channels dedicated to cooking and gardening as well as channels devoted to the arts);
  - Knowledge (such as wildlife documentary channels and history channels);
  - Music; and
  - News and Events (including basic sports channels).
93. Each Mix contained a significant number of true pay TV channels<sup>22</sup>, based around well-known channel brands. By way of example, there were 19 channels in the Knowledge Mix at launch in September 2005 (including channels from Discovery, National Geographic and the History Channel). Given that subscriptions started at £15 per month for 2 Mixes, the new packages were attractive products for potential customers who had been put off by higher prices for larger packages of channels.
94. At around the same time the focus of Sky's marketing of the pay TV packages available from Sky also shifted significantly towards promoting its basic-only packages. Sky had begun promoting its Family Pack more extensively than it had in the past in the period immediately prior to the repricing and repackaging of its basic channel packages.<sup>23</sup> The move to the new basic Mixes, however, resulted in a further shift of emphasis, with the introduction of significant marketing campaigns advertising the 2 Mix package available for £7.50 per month for the first six months of subscription.
95. **[CONFIDENTIAL]** in September 2007 Sky again changed the approach to selling its basic packages so that subscribers could subscribe to any number of the basic Mixes, with each additional Mix (after the subscriber had chosen an initial Mix) priced at an extra £1 per month. This approach was intended both to assist in acquiring new subscribers and to encourage existing subscribers to upgrade to a greater number of Mixes. The combination of the value provided by this proposition, the simplicity of the marketing message, and the use of key channel brands in each Mix has contributed to Sky's ability to sell more Mixes to customers.
96. Closely associated with the new approach of shifting the focus of Sky's marketing to packages other than its Top Tier package was the removal in July 2007 of the

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<sup>22</sup> *i.e.*, channels that are not available without subscription on any platforms.

<sup>23</sup> For example, an above-the-line advertising campaign in which Sky invested over **[CONFIDENTIAL]** focused on the programmes carried on the basic channels in Sky's packages, such as Extreme Sports, National Geographic and TCM, and was designed to raise awareness of the broad range of high quality content carried on those channels. This advertising campaign, called '*What Do You Want to Watch?*' ran from October 2004 to December 2006.

monthly £10 subscription fee charged to basic-only subscribers for using Sky+ functionality, discussed above.

97. It is important to bear in mind that, given that premium channel packages comprise bundles of basic channel packs and premium channel packs, the shift to the new basic Mixes also resulted in the introduction of a series of new, cheaper price points for packages that include premium channels. For example, existing premium package subscribers who did not value all the basic channels that they received could reduce their monthly subscription by dropping basic Mixes. Again, this change improved Sky's ability to retain existing subscribers and attract new subscribers to its services.

### **Sky+**

98. Sky+ is a Personal Video Recorder ('PVR') product provided by Sky, which enables users to record programmes onto a hard disk for later viewing, and to pause and rewind live television. While there are now numerous PVRs available to consumers, the key advantage of Sky+ is that it enables customers easily to locate and record programmes via Sky's Electronic Programme Guide ('EPG'). Users are also able easily to set their Sky+ to record entire television series, using the 'series link' EPG function. Sky has devoted substantial effort into making Sky+ extremely user-friendly, and this has been one of its key attractions.
99. Sky+ set-top boxes include two television tuners, enabling users to record one programme while watching another. Alternatively, users can watch a programme stored on the hard disk while recording two programmes simultaneously.
100. Sky+ considerably enhances the value households are able to obtain from a pay TV subscription by enabling them easily to record programmes (a) when there is a viewing clash within the household, (b) when they are away from their homes, and (c) when programmes they want to watch are on at inconvenient times (e.g. late at night, or during the day for those who are not at home at that time). It also enables subscribers to record programmes, such as movies, in which they have an interest so that they have easy access to a store of programmes at times that they cannot find anything else on TV that they want to watch.
101. The first Sky+ set-top boxes were introduced in September 2001. Over time, however, there have been significant changes to the service, including the following:
  - Sky+ set-top box charge. As is common with consumer electronics products, prices for different generations of Sky+ set-top boxes have fallen significantly over time. For example, the first Sky+ set-top boxes were initially sold for £400. By November 2004, this had fallen to £100;
  - The monthly charge for using the Sky+ service. Originally, users of the Sky+ service were charged a £10 monthly fee. In October 2003 that fee was removed for any Sky+ subscribers who subscribed to more than two of

Sky's premium channels. The charge was removed for all Sky subscribers who use the Sky+ service in July 2007;

- Hard disk capacity. The capacity of the hard disk in Sky+ set-top boxes determines how much programming can be stored. The first Sky+ set-top boxes had 40 GB hard disks, which enabled around 20 hours of programming to be stored. Over time, the capacity in Sky+ set-top boxes has increased significantly. By January 2009 Sky+ set-top boxes included 160 GB hard disks of which 80 GB is available to the user, and 80 GB is used for Sky's Anytime VoD service (described further below), and in January 2010 Sky launched a Sky+ HD set-top box with 1.5 Terabytes of hard disk storage, of which 1 Terabyte (approximately 1,000 GB) is available to users; and
- Remote record. This service, which was launched in July 2006 on mobile phones and in January 2007 on the Sky.com web site, enables subscribers to set their Sky+ box to record programmes when they are away from their home.

102. The popularity of Sky+ among consumers is reflected in comments such as the following, in a review of a new Sky+ set-top box in the Home Cinema Choice magazine in 2005:

*"So why has Sky+ proved such a hit? Simply put, once you've lived with Sky+ it's difficult to imagine life without it."*<sup>24</sup>

103. Sky+ has played a critical role in Sky's ability to attract and retain subscribers to its pay TV services in the face of intensifying competition. For a considerable period of time it was a key factor differentiating Sky's services from those of rivals – both free to air and pay. Its significant appeal to consumers derives both from its simplicity of use and the additional value it enables subscribers to obtain from a pay TV subscription, and Sky has been able to flex both (a) charges for the Sky+ set-top box, and (b) charges for the Sky+ service to attract new pay TV subscribers, and to retain existing subscribers. Sky has also popularised Sky+ via a series of substantial marketing campaigns, which began as early as the end of 2003.

### **Sky Anytime**

104. Sky Anytime is a 'push' Video on Demand service in which a range of selected television programmes and movies is downloaded onto the hard disk of certain Sky+ and Sky+ HD set-top boxes of Sky subscribers. It was launched in March 2007. Subscribers receive programming from channels that are included in their subscription package (e.g. Sky Movies subscribers' programming includes movies from Sky's movie channels), at no additional charge to their monthly subscription.

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<sup>24</sup> Page 84, *Home Cinema Choice*, February 2005. Available at: [http://hcc.techradar.com/files/reviews/HCC/084\\_HCC\\_0205.pdf](http://hcc.techradar.com/files/reviews/HCC/084_HCC_0205.pdf)



105. Sky Anytime expands significantly the viewing options available to subscribers, by augmenting the programmes received via linear broadcast channels and those that subscribers have themselves recorded onto their Sky+ boxes.

### ***Sky Player***

106. Sky Player, which was formerly known as Sky by Broadband and Sky Anytime on PC, launched in January 2006. It relies on use of the internet to deliver programming and television channels to end-users. The nature and scope of the service has developed considerably over time. Until May 2008 it comprised a video on demand service, enabling consumers to access a range of content online appropriate to their pay TV subscription at no additional charge – for example, households who subscribe to a package from Sky that include the Sports Mix were (and continue to be) able to access Sky Sports programmes on an ‘on demand’ basis at no additional charge to their monthly subscription. This gives subscribers greater flexibility in watching content whenever they want, rather than being restricted to linear broadcasts.
107. In November 2006 Sky introduced the ability for consumers (including non-Sky subscribers) to purchase programming on a pay per view basis via the service, including movies and US television shows. Sky subscribers could then purchase programming carried on channels outside their subscription package.
108. In May 2008 Sky expanded the service to include live streams of Sky News and Sky Sports channels, and by 2010 27 TV channels were available via the service<sup>25</sup>. This means that these channels can be viewed via devices other than via a Sky set-top box. For example, they can be viewed via a PC or laptop, or on a TV via an Xbox 360 games console connected to the internet. Existing Sky subscribers are able to use Sky Player to view those channels to which they subscribe that are available via Sky Player at no additional charge to their monthly subscription.

### ***Sky’s move into telecommunications services***

109. During 2004 Sky also recognised that in order to continue to grow its subscriber base it would need to be able to offer broadband and telephony services. This would allow Sky to compete with bundles of TV, broadband and telephony provided by other service providers (principally ntl and Telewest at the time, but it was becoming clear that others like BT would move into this space), but would also provide FTA households with additional reasons to subscribe to Sky. In particular, because Sky was able to offer more attractive pricing than many FTA households were paying for broadband services, Sky judged that this would assist it in attracting households who had previously thought that Sky’s TV offering did not represent sufficiently good value.

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<sup>25</sup> These were G.O.L.D., Sky Real Lives, Sky Movies Screen 1, Sky Movies Screen 2, MTV, Sky Sports 1, Sky Sports 2, Sky Sports 3, Sky Sports 4, Sky Sports News, British Eurosport, British Eurosport 2, ESPN Classic, ESPN, National Geographic, Nat Geo Wild, Eden, Cartoon Network, Boomerang, Nickelodeon, Disney XD, The Disney Channel, Nick Jnr, Sky News, Sky Arts 1, and The History Channel.

110. After examining several options for delivering its own telephony and broadband services, at the end of 2005 Sky acquired Easynet, a telecommunications operator which, in the UK, had its own national telecommunications network, and offered residential broadband services to consumers via LLU. Following its purchase of Easynet, Sky expanded considerably the number of BT local exchanges in which Easynet equipment was located, requiring substantial investment on Sky's part.
111. Sky is now also able to offer packages of television, telephony and broadband internet access, and has promoted these packages extensively. For example, from January 2007 Sky undertook a large-scale advertising campaign advertising its triple-play packages entitled 'See, Speak, Surf'.
112. A key feature of Sky's broadband and telephony offers is that they have provided consumers with significant potential savings relative to packages offered by other providers. For example, Sky has offered all its subscribers who live in areas covered by its own broadband network a 2Mb/s broadband service at no additional charge to their pay TV subscription.
113. The value provided by these packages has made an important contribution to renewed growth in Sky's subscriber numbers, by attracting non-subscribers who might not otherwise have considered taking a pay TV subscription, as well as helping Sky better to compete with various suppliers of bundles of TV, broadband and telephony services (including Virgin Media, BT, and Tiscali TV) for those households interested in taking up a subscription to such services.

### ***High definition television***

114. Sky launched its high definition ('HD') television service in May 2006. Programming in HD is of a significantly higher picture quality than that in 'standard definition' ('SD'). In order to receive HD TV services subscribers require a new HD set-top box (which also contains a hard disk and Sky+ functionality), and a 'HD ready' television set. HD subscribers receive the HD channels to which they subscribe in addition to SD services, and pay an additional £10 per month.
115. At launch, the service comprised seven HD linear television channels, and two Sky Box Office HD services. Over the past four years, however, Sky has devoted substantial effort to both (a) developing new HD services of its own and (b) working with other broadcasters to develop HD versions of their services<sup>26</sup>. As at the beginning of 2010, there were 37 HD services available via Sky's digital satellite platform<sup>27</sup>, one of the broadest HD offerings in the world.

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<sup>26</sup> This has involved, among other things, **[CONFIDENTIAL]**

<sup>27</sup> Excluding ITV's HD channel broadcast via satellite which ITV has chosen not to make available to households on Sky's DTH satellite platform.

116. Sky's HD service has, again, provided Sky with an important means of differentiating its services from its rivals, and thereby continue to both retain existing subscribers, and add new subscribers to its services. Having initially been greeted with considerable media scepticism as to its value, HD has been extremely popular with consumers. By the end of 2009 over 2 million households in the UK and ROI subscribed to the service.
117. Sky's HD service does not fall into the category of being a quality improvement that subscribers receive as part of their standard subscription charge; as noted above, there is an additional fee of £10 per month, and subscribers potentially must pay for a new set-top box. Nevertheless, if the objective is to understand the factors that have contributed to Sky being able to continue to grow its subscriber base over time, Sky's HD service has clearly played an important role – the subscriber data set out above include subscribers who receive SD services only, and those who receive both SD and HD services.

***Take-up of a number of these services***

118. **Figure 13**, below, shows the extent of take-up of a number of the new products described above among Sky subscribers.

**Figure 13**

**Number of Sky UK subscribers using Sky+, Sky+ HD, and Sky's broadband services**

**[CONFIDENTIAL]**

119. **Figures 14 to 19**, below, provide an indication of the extent to which subscribers to particular types of Sky pay TV packages have taken up a number of the new products described above. **[CONFIDENTIAL]**

**Figure 14**

**Sky UK DTH Dual Sports subscribers (all basic package combinations)  
By set-top box type**

**[CONFIDENTIAL]**

**Figure 15**

**Sky UK DTH Dual Sports subscribers (all basic package combinations)  
Take-up of Sky's broadband service**

**[CONFIDENTIAL]**

**Figure 16**

**Sky UK DTH Dual Movies subscribers (all basic package combinations)  
By set-top box type**

**[CONFIDENTIAL]**

**Figure 17**

**Sky UK DTH Dual Movies subscribers (all basic package combinations)  
Take-up of Sky's broadband service**

**[CONFIDENTIAL]**

**Figure 18**

**Sky UK DTH Top Tier subscribers  
By set-top box type**

**[CONFIDENTIAL]**

**Figure 19**

**Sky UK DTH Top Tier subscribers  
Take-up of Sky's broadband service**

**[CONFIDENTIAL]**

120. These charts show the increasing penetration of these services within the Sky subscriber base over time.

***Improvements in customer service***

121. It is easy to overlook the fact that the provision of pay TV to consumers is a service and therefore the quality of subscribers' experiences as customers of a pay TV retailer also depends on the level of customer service they receive – for example in terms of accuracy of billing, ease of switching among services, and time taken to answer calls. The adverse effects on firms' reputations arising from delivery of poor customer service are well known<sup>28</sup>, and improvements in the

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<sup>28</sup> For example, one of the key motivating factors for the merged ntl/Telewest firm rebranding as Virgin Media was to attempt to disassociate the new company from the poor customer service record with which ntl in particular was associated. See, for example, the reported comments of Neil Berkett, now Chief Executive of Virgin Media, and Richard Branson on this matter at the rebranding of the ntl/Telewest business division in February 2010. <http://www.marketingmagazine.co.uk/news/983248/Virgin-Media-ditches-last-trace-NTL-Telewest-brands>.

quality of customer service can have a significant effect on pay TV operators' ability to attract and retain subscribers.

122. Significant initiatives by Sky in this respect during this period include:

- large scale investments in its call-centres and customer relationship management systems; and
- a two-year customer service plan, launched in August 2007 (known as 'Project Carlsberg') which was aimed at delivering world class customer service to Sky's subscribers.<sup>29</sup>

#### **D. Other relevant background**

123. Before turning to an examination of changes in charges for, and quality of, a number of key pay TV packages offered by Sky, we comment briefly on two issues that are also important to an effective analysis of trends in the number of Sky subscribers over time: growth in demand for pay TV services in the UK, and the effect of marketing on subscriber numbers. Each of these is discussed in the sections below.

#### ***Growth in demand for pay TV services in the UK***

124. Throughout its inquiry Ofcom's analysis of these matters has been based implicitly on a view of demand for pay TV services that takes no account of the key underlying trend in relation to demand for pay TV services in the UK, which is one of growing demand over time. In particular, Ofcom's analysis has implicitly been based on an assumption that demand for various types of pay TV services has reached a position of stability or equilibrium, so that developments such as the emergence of new competing services should be expected to reduce the number of pay TV subscribers (unless prices fall or the quality of pay TV services increase.)

125. Such a proposition is clearly wrong. The introduction of digital television broadcasting in the UK at the end of the 1990s enabled changes that are today largely taken for granted, such as:

- a very substantial increase in the breadth of television services that could be offered to consumers;
- a host of new complementary services, such as on-screen EPGs and interactive services; and
- enhanced picture and sound quality, including surround-sound, for broadcast television channels.

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<sup>29</sup> Key elements of the project included: **[CONFIDENTIAL]**

126. These changes generated the prospect of attracting a far greater number of subscribers to pay TV services than there had been in the past. Accordingly, one of Sky's key public objectives since the launch of its digital services, against which its performance is continually measured, has been the achievement of a succession of demanding targets for an increased number of subscribers.<sup>30</sup> In essence, Sky has aimed at expanding demand for pay TV services over time, by converting as many non-pay TV households – which in the early 2000s were predominantly 4 or 5 channel analogue terrestrial households – to subscribe to pay TV services as possible.
127. As the initial impetus of the introduction of digital television services diminished, the potential to grow subscriber numbers has been sustained by the introduction of new technologies (for example due to the introduction of PVRs, high definition television services and, in future, 3D television), the cumulative effect of large scale spending on promoting pay TV services, and, latterly, the impending switch-off of analogue television services which requires that all remaining analogue TV homes adopt digital television services.<sup>31</sup>
128. In such circumstances, it would be wrong to expect that the effect of increased competition should be to result in reductions in the overall number of Sky subscribers, unless prices are cut. Rather, it should be expected that competition would make it harder for Sky to realise its growth targets, and require greater effort, investment and innovation if it were to do so. In Sky's view, that is exactly what an objective, well-informed commentator would observe has happened over the past five years.

#### ***The effect of marketing on subscriber numbers***

129. Ofcom's analysis of trends in Sky subscriber numbers ascribes no role at all to marketing. That is a significant omission because marketing (including set-top box and installation subsidy) is a key component of Sky's customer acquisition and retention strategy. The simple fact is that the volume, type and effectiveness of marketing activity plays a central role in (a) attracting new subscribers to pay TV services, (b) retaining existing subscribers to pay TV services, and (c) affecting which services consumers choose to subscribe to.
130. One commonly recognised metric of the level of Sky's marketing is its subscriber acquisition cost ('SAC'). This measures how much Sky spends on marketing (on average) in order to acquire a new subscriber. It is generally recognised that Sky's SAC has been increasing over time – *i.e.*, that Sky must spend, on average, more now to acquire new customers than it did in the past. For example, in its report on Sky's profitability for Ofcom, Oxera recognised that Sky's SAC was

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<sup>30</sup> These targets were: 7 million subscribers by the end of 2003 (set in 2000); 8 million subscribers by the end of 2005 (set in August 2003); and 10 million subscribers by the end of 2010 (set in August 2004).

<sup>31</sup> In economic terms, the demand curve for services has been moving outwards, rather than being stable or 'in equilibrium'.

increasing over time<sup>32</sup>. **Figure 20** shows Sky's average annual SAC over the period 2002/03 – 2008/09.

## Figure 20

### Sky's average subscriber acquisition cost (SAC)

[CONFIDENTIAL]

131. [CONFIDENTIAL]

#### E. Changes in Sky's subscription charges

132. Ofcom's focus in its analysis of charges for pay TV services in the context of market definition throughout its inquiry has been on monthly subscription charges. In this respect, Ofcom has sought – appropriately – to evaluate changes in charges in 'real terms', i.e. adjusted for inflation. Accordingly, this section provides Sky's analysis of changes in charges for a number of its pay TV services measured on that basis.

133. For purposes of tractability<sup>33</sup> Sky has focused on changes in charges for four pay TV packages retailed by Sky:

- Sky's Top Tier package;
- Dual Movies (including Family Pack/ Six Mix);
- Dual Sports (including Family Pack/ Six Mix); and
- the 'Big Basic' (Family Pack/ Six Mix) package.

At the end of June 2009, subscribers to these four packages comprised around [CONFIDENTIAL]% of total Sky UK DTH residential subscribers.

134. Changes in nominal charges for these packages have not been smooth over time, so the extent to which prices are considered to have changed over time in real terms will depend on the period selected for analysis. It is, however, important to select comparable months as the beginning and end points for the time periods selected. A distorted picture of the extent of change over time is obtained if charges at different points in time (relative to the dates on which price changes have occurred) are compared – for example, comparing charges in

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<sup>32</sup> Oxera state: "*The reduction in the IRR over time seems to be driven by the fact that subscriber acquisition costs were increasing over time relative to cash flows generated by additional subscribers.*" Page 30 of Oxera's Report.

<sup>33</sup> A further reason is that focusing on these packages enables a longer period to be examined, as they have been available continuously throughout the period examined. By contrast, most other packages currently offered by Sky have been available only since September 2005, or a later date.

a month just after a price change, with those for an earlier period in a month just before a price change.<sup>34</sup>

135. To illustrate this, **Table 3**, below shows charges at different points in time for Sky's Dual Movies package (including Family Pack/ Six Mix).

**Table 3**

**Monthly charge for Sky's Dual Movies package in the UK  
(including Family Pack/Six Mix)**

August 2006	£36.00
September 2006	£37.00
August 2007	£37.00
September 2007	£38.00

136. If charges in August 2006 and September 2007 were compared, it would be found that the charge for this package had risen by 5.6% (in nominal terms). If, however, charges in August 2006 were compared with those in August 2007, the increase would be found to be 2.8% (in nominal terms). The first comparison is inappropriate because it compares charges in a month just before a price increase, with charges in a month just after a price increase, thereby exaggerating the extent of the change in prices over time. The second comparison, which is based on two comparable months (i.e. months which both precede a price increase) is a more appropriate one.
137. The approach taken in this submission is to compare subscription charges for months in which price increases occurred.
138. One complication arises from the reduction of charges between 1 January 2009 and 1 January 2010 as a result of the Government's temporary reduction in the VAT rate. In order to address this, notional charges have been used for the period from 1 January 2009 – 1 September 2009 which exclude the reduction in charges arising from the VAT rate reduction.<sup>35</sup>
139. Any number of different price indices might in principle be used to convert charges in nominal terms into charges measured in real terms. Different price indices have, however, diverged over time and therefore choice of the price index

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<sup>34</sup> Despite recognising this issue, Ofcom continues to err in addressing it. Ofcom's evaluation in the Third Consultation Document compared charges in a month just after a price change with those in a month just before a price change. These are not comparable dates. See paragraph 4.157 of the Third Consultation Document.

<sup>35</sup> The same results could have been obtained by calculating changes in charges over time using retail charges excluding VAT. Given that the focus is on charges actually paid by consumers, which include VAT, the approach of using notional charges for the period 1 January 2009 – 1 September 2009 has been adopted. It is necessary to bear in mind, however, that the objective of the temporary VAT rate reduction was to stimulate spending and, accordingly, this price reduction may affect subscriber numbers during this period.



used to adjust nominal charges also produces different observations about the extent of change in charges over time when expressed in real terms.

140. In relation to choice of price index, it is important to bear in mind that purpose of conversion of charges expressed in nominal terms into charges in real terms is to compare how charges for pay TV packages have changed compared to prices for goods and services purchased by consumers more generally.<sup>36</sup> Ofcom argues that the most appropriate measure in this case is one that excludes changes in indirect taxes and mortgage interest payments<sup>37</sup>; Sky agrees with this proposition. Both the RPI measure used in **Table 4**, below, and the CPI exclude changes in indirect taxes and mortgage interest payments.
141. **Table 4**, below, provides observed changes in real charges for the Sky packages selected for analysis for a range of different time periods and two different price indices.<sup>38</sup> **Figure 21**, below, shows charges for these packages over time in real terms between January 2001 and September 2009.<sup>39</sup>

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<sup>36</sup> For this reason Ofcom's use of the GDP deflator is inappropriate, as it measures changes in the nominal price of the output of the economy as a whole, i.e. including goods and services purchased by businesses as well as consumers. A further reason for not using the GDP deflator is that it is only available on a quarterly basis. Other price indices are available on a monthly basis and are therefore better suited to adjusting charges for pay TV services, which are paid for on the basis of a monthly charge. It is not appropriate to use the GDP deflator simply because it produces results that lie somewhere between two measures of changes in consumer prices, as Ofcom proposes (see paragraph 4.158 of Ofcom's Third Consultation Document).

<sup>37</sup> See paragraph 4.158 of Ofcom's Third Consultation Document.

<sup>38</sup> Sky has not converted such changes into 'annual percentage changes', as Ofcom has tended to, as such a presentation of changes is potentially misleading. In particular, it carries with it a suggestion of steady annual changes in charges in real terms when, as shown in Figure 19, this has not been the case.

<sup>39</sup> Given the approach adopted of comparing charges in months in which price rises occurred, the periods covered in the table differ among packages. For example, there was no change in the charge for Dual Sports between January 2004 and September 2005, and the charge for the Six Mix package remained unchanged in nominal terms between September 2005 and September 2008.

**Table 4****Total change in subscription charge in real terms<sup>40</sup>**

	Using the RPI (excluding mortgage interest payments and indirect taxes)	Using the CPI	Period (years)
<b>Top Tier</b>			
Jan 2001 - Sep 2009	10.7%	18.9%	8 ¾
Jan 2002 - Sep 2009	4.7%	11.0%	7 ¾
Jan 2003 - Sep 2009	4.9%	9.5%	6 ¾
Jan 2004 - Sep 2009	1.7%	5.5%	5 ¾
Sep 2004 - Sep 2009	0.9%	4.2%	5
Sep 2005 - Sep 2009	-0.3%	3.0%	4
Sep 2006 - Sep 2009	0.6%	3.0%	3
Sep 2007 - Sep 2009	0.0%	1.3%	2
<b>Dual movies*</b>			
Jan 2001 - Sep 2009	0.9%	8.3%	8 ¾
Jan 2002 - Sep 2009	-2.6%	3.2%	7 ¾
Jan 2003 - Sep 2009	-2.8%	1.4%	6 ¾
Jan 2004 - Sep 2009	-3.8%	-0.2%	5 ¾
Sep 2004 - Sep 2009	-5.0%	-1.9%	5
Sep 2005 - Sep 2009	-5.3%	-2.3%	4
Sep 2006 - Sep 2009	-4.9%	-2.6%	3
Sep 2007 - Sep 2009	-4.8%	-3.5%	2
<b>Dual Sports*</b>			
Jan 2001 - Sep 2009	13.6%	22.0%	8 ¾
Jan 2002 - Sep 2009	9.2%	15.7%	7 ¾
Jan 2003 - Sep 2009	8.8%	13.5%	6 ¾
Jan 2004 - Sep 2009	4.2%	8.1%	5 ¾
Sep 2005 - Sep 2009	-0.5%	2.8%	4
Sep 2006 - Sep 2009	0.0%	2.4%	3
Sep 2007 - Sep 2009	0.1%	1.4%	2
<b>Family Pack/ Six Mix</b>			
Jan 2001 - Sep 2009	11.5%	19.8%	8 ¾
Jan 2003 - Sep 2009	2.2%	6.7%	6 ¾
Jan 2004 - Sep 2009	-1.1%	2.6%	5 ¾
Sep 2005 - Sep 2009	-4.3%	-1.2%	4

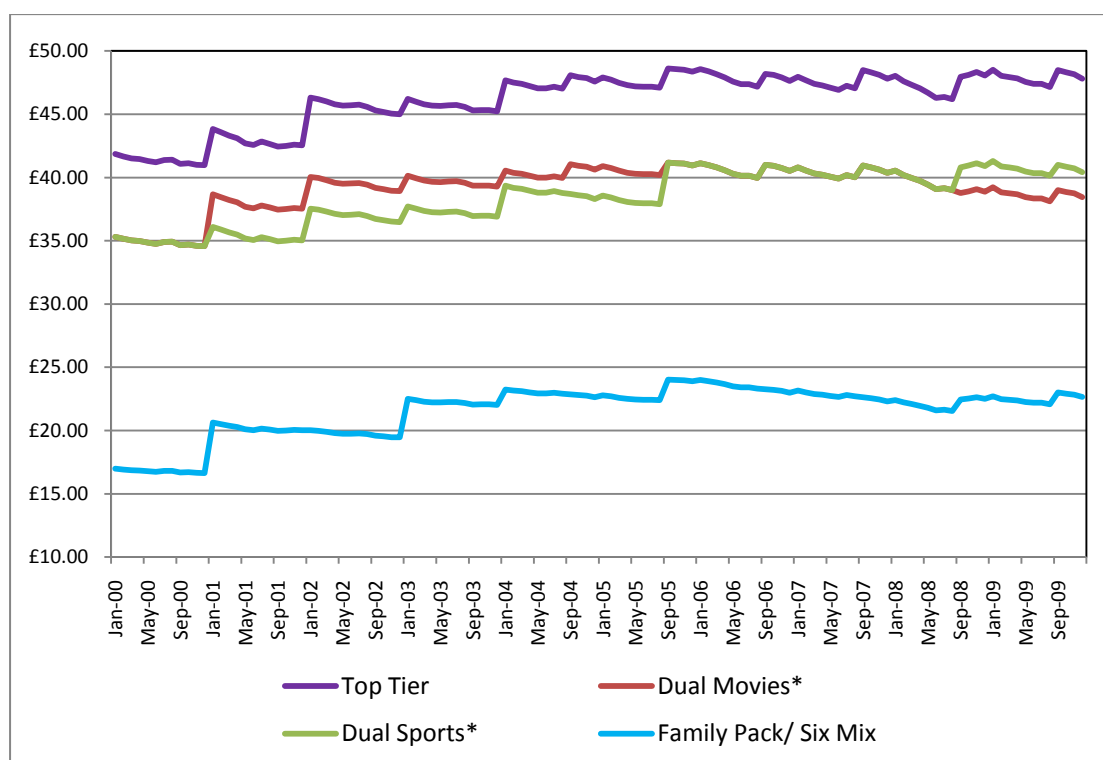
\* in each case including Family Pack/Six Mix

<sup>40</sup>

The data on which this table is based are set out at **Annex 2**.

**Figure 21**

**Charges for a number of Sky's UK DTH packages, in real terms**



\*in each case including Family Pack/ Six Mix

**Note:** the chart shows charges using the RPI (excluding indirect taxes and mortgage interest payments). The *pattern of changes* over time is the broadly the same if the CPI is used instead.

- 142. The dependence of the results on choice of time period and price index raises the issue of which is the most appropriate indication of changes in charges over time.
- 143. The time period for analysis should be determined by the focus of inquiry. In this case, as the focus of Ofcom's inquiry is on current and future competitive conditions<sup>41</sup> it is appropriate to focus on more recent time periods – in particular, periods that post-date the launch of Freeview in 2002, and the later expansion in the free to air channel portfolios of the major free to air broadcasters (including the conversion of previously pay TV channels (such as ITV2, E4 and Film4) to free to air television channels). (This is discussed in further detail in **Part Two**,

<sup>41</sup> Ofcom states: “it is particularly important that our competition analysis takes a forward-looking view, focusing on those characteristics of the market which are most likely to influence its development over the next few years.” Paragraph 3.7 of the Second Consultation Document. The focus in this submission is on the recent past; Sky has not attempted to examine potential future trends. It is clear, however, that ongoing technological change and change in the nature of consumer demand (for example, due to expanding consumption of programming delivered on demand via broadband) provide no reason to expect a diminution in the competitive pressure faced by Sky in the foreseeable future.

below.) Accordingly, in this submission, Sky has focused on the period from January 2004 – September 2009.<sup>42</sup>

144. In terms of choice of price index, the differences observed in the RPI and CPI indices used in Table 4 reflect differences in the way in which they are calculated. There is no objectively justifiable way of deciding among these two indices in this case, which means that it is appropriate to consider the observed changes in charges in real terms as falling within a range.
145. Taking these matters into account, Sky considers that the most relevant indication of changes in charges in real terms for the four Sky packages examined in this submission is as follows:

**Table 5**

**Total change in charges in real terms  
January 2004 – September 2009**

Top Tier	1.7% - 5.5%
Dual Movies*	-3.8% - -0.2%
Dual Sports*	4.2 % - 8.1%
Family Pack/Six Mix	-1.1% - 2.6%

\* in each case including Family Pack/Six Mix

146. The ranges in **Table 5** result from the use of the RPI and CPI in order to calculate charges in real terms. The lower bound in each case is determined by the use of the RPI, and the upper bound by the use of the CPI.

***The effect of discounts on effective subscription charges paid by consumers***

147. In its Second Consultation Document Ofcom argued that the amount that consumers actually paid for Sky's pay TV services increased during the period under consideration due to a reduction by Sky in the use of discounted subscriptions – for example, introductory offers of 'half price subscription for the first 3 months'.
148. **[CONFIDENTIAL]** It appears to be the case that Ofcom now accepts that changes in the use of discounting did not result in an overall increase in charges for Sky's

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<sup>42</sup> Sky notes that Oxera's analysis of Sky's profitability for Ofcom focused on the period between 2004 and 2008. (2008 was the last full year of data available at the time that Oxera undertook its analysis.)

pay TV services during the period considered in this submission<sup>43</sup>, although Ofcom does not always make this clear<sup>44</sup>.

### **Other costs to consumers**

149. Ofcom's singular focus on subscription charges in its analysis leads it to fail to ascribe any role in determining subscriber numbers to a range of charges paid by consumers that are commonly understood significantly to affect subscriber numbers.<sup>45</sup> While it is beyond the scope of this submission to provide historic series for all such variables it is Sky's view that a proper examination of the impact of changes over time in these variables would reinforce the conclusions of this submission.
150. Key among non-subscription costs to taking a pay TV subscription are (in Sky's case) charges for set-top boxes and installation of equipment in customers' homes. In relation to set-top boxes, standard Sky digiboxes have been provided for free to new subscribers since 1999. New types of set-top box with additional functionality (such as Sky+ and Sky+ HD set-top boxes) have tended to fall in price over time as (a) sales volumes increase, reducing manufacturing unit costs, and (b) Sky has moved to subsidise such set-top boxes in order to increase their take-up among existing subscribers and to attract new subscribers.
151. In relation to the cost of installing equipment in subscribers' homes, Sky has generally tended to pass on only a fraction of this cost (which has not altered significantly over time) to customers – or bear the cost fully itself.

## **F. Changes in the quality of Sky's services**

152. The four pay TV packages considered in this submission (Dual Sports (including Family Pack/ Six Mix), Dual Movies (including Family Pack/ Six Mix), Top Tier and

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<sup>43</sup> Ofcom states: **[CONFIDENTIAL]** (Paragraph 4.160 of Ofcom's Third Consultation Document.) Ofcom's statement at paragraph 4.152 of its Third Consultation Document that its analysis in Ofcom's Second Consultation Document showed that "*There was a temporary increase in the use of discounts around 2006 which was phased out in 2007*" is a clear misrepresentation of that earlier analysis. For further discussion of this issue see Annex 6 of Sky's Response to Ofcom's Second Consultation Document.

<sup>44</sup> For example, in its analysis relating to pay TV services that include premium movie channels in the Third Consultation Document, Ofcom states: "*We noted [in the Second Consultation Document] that Sky's reduction in the use of discounts in 2006/07 meant that while headline prices had been broadly constant, average prices after discounts were likely to have increased.*" (Paragraph 4.305.) Ofcom's only acknowledgment that that statement is incorrect comes eight pages later, and is opaque, as follows: "*For the reasons stated in paragraphs 4.157 to 4.160 we do not believe that our choice of price deflator, the start and end dates of the analysis, or our assessment of the use of discounts change our conclusion that the inflation adjusted price for Sky Movies had been broadly constant since 2002 and the price of Sky Sports and Movies Mix had been broadly constant since 2004.*" (Paragraph 4.343.)

<sup>45</sup> The rapid growth in subscriber numbers following Sky's decision to fully subsidise standard set-top boxes in May 1999 attests to the substantial effect that up-front costs have on consumers' decisions to take up a pay TV subscription, and both set-top box prices and installation charges play a central role in Sky's customer acquisition strategy.

'Big Basic' comprise bundles of services – principally access to basic and, other than in relation to the Big Basic package, premium pay TV channels, but also other services that consumers receive, or can elect to receive, in conjunction with television channels, such as Sky's Electronic Programme Guide (EPG), Sky+, Multi-room, HD services, Sky Anytime, and telephony and broadband services. As discussed in Section C, above, if the objective of analysis is to understand the factors that have influenced Sky's subscriber numbers over time, it is important to take into account the impact of trends relating both to Sky pay TV packages, other complementary and ancillary services, and factors such as the impact of changes in marketing and customer service.

153. The focus in this section, however, is confined to changes over time in the quality of the four pay TV packages for which changes in charges were evaluated in **Section E**, above.
154. Sky provided Ofcom with an extensive assessment of changes in quality of the channels provided in Sky's pay TV packages in a submission dated July 2008<sup>46</sup>. That analysis, however, focused on changes between 2001/02 and 2006/07. Given that Sky argues above that it is more appropriate in the context of Ofcom's inquiry to examine a more recent period, it would in principle be appropriate to revise that analysis for a more recent period.
155. Such a revision, however, would be a very considerable undertaking. Sky has taken the view that it is possible to provide a reliable indication of the material improvements in the quality of the services provided by Sky to consumers without a full revision of that analysis.
156. The following sections address improvements in:
  - (i) the range and quality of basic channels included in these packages;
  - (ii) Sky's sports channels; and
  - (iii) Sky's movie channels.

**(i) Improvements in the range and quality of basic channels included in these packages**

157. The quality of all four types of package increased over the period 2004-2009 as a result of improvements in the range and quality of basic channels included in these packages.
158. As set out in Section C, above, attempting to improve the attractiveness of Sky's basic pay TV packages has been a key focus of Sky's efforts to maintain subscriber growth in an increasingly competitive environment. As well as the repricing and repackaging of these channels, described above, there are two

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<sup>46</sup> 'Changes in the quantity and quality of services delivered to subscribers to Sky's packages that include Sky's sports channels, 2001/02 – 2006/07', July 2008. See also the subsequent submission entitled 'Analysis of the quality of films broadcast on Sky's movie channels: 2001/02 – 2006/07', August 2008. This submission also discussed the difficulties associated with measuring the quality of pay TV services.

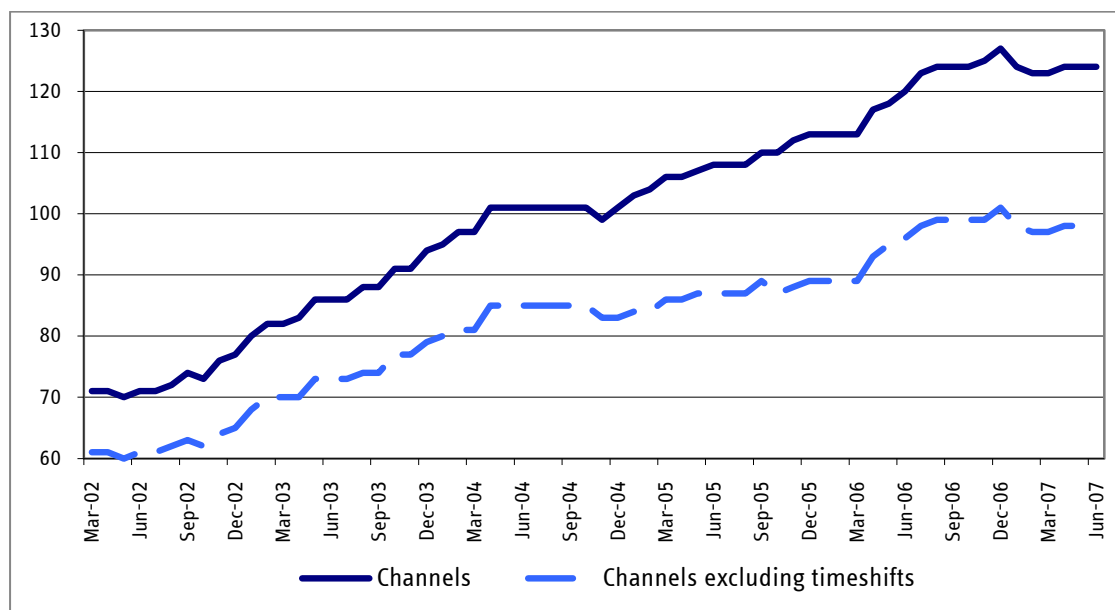
additional sources of improvements in basic channel packages: the addition of new channels, and improvements in the quality of existing channels.

159. There has been a significant increase in the number of basic pay TV channels retailed by Sky. The number of such channels increased from around 80 in January 2004 to over 100 standard definition basic channels (excluding timeshift channels, the number of which also increased significantly)<sup>47</sup>.

160. **Figure 22**, below, taken from an earlier submission by Sky, shows that there has been a large increase in the number of basic channels retailed by Sky over time.

**Figure 22**

**Number of basic channels retailed by Sky**



161. Among this increase, there have been a number of notable additions. In particular:

- TCM (January 2004)
- FX (January 2004)
- Artsworld (later renamed Sky Arts) (June 2005)
- ESPN Classic (March 2006)
- Playhouse Disney (March 2006)<sup>48</sup>
- Disney Channel (March 2006)

<sup>47</sup> By September 2009 there were also 18 high definition basic channels available to subscribers to Sky's HD service.

<sup>48</sup> Prior to 15 March 2006 The Disney Channel and Playhouse Disney were offered as bonus channels to Dual Movies and Top Tier subscribers. They were included in Sky's basic channel packages after that date.

- Nick Jnr 2 (April 2006)
  - TCM2 (May 2006)
  - Extreme Sports (June 2006)
  - Movies24 (June 2006)
  - Crime Investigation Network (July 2006)
  - Sky Arts 2 (October 2008)
  - Shorts TV (November 2008)
  - Investigation Discovery (January 2009)
162. On the debit side, important channels that have left Sky's basic packages since January 2004 include ITV2 (November 2004), E4 and More 4 (both June 2008).
163. Sky has also devoted considerable effort and investment to improving the quality of existing basic pay TV channels over this period. Sky has two main ways of achieving this: (a) via improvements in its own basic channels, and those in which it is a joint-venture partner, and (b) by seeking to encourage third party broadcasters of channels retailed by Sky to improve their channels.
164. In relation to Sky's own basic channels, Sky has devoted substantial effort to seeking to improve its Sky One and Sky Arts channels.
165. Sky's approach to Sky One has been based on a recognition that, in order for pay TV services to compete effectively with free to air television services, it is imperative for pay TV services (a) to improve the attractiveness of general entertainment programming carried on pay TV channels, and (b) increasingly to exploit such programming on an exclusive basis. Sky has sought, therefore, to make Sky One a driver of consumers' decisions to subscribe to pay TV. An indication of the changes to Sky's strategy in relation to Sky One around the end of 2004 is provided in an article from the web site of Campaign magazine at that time, attached at **Annex 3**.
166. In terms of acquired content, Sky has paid large amounts for US series that are likely to appeal significantly to non-pay TV households, such as 'Lost' and '24'. Sky has also shown itself willing to pay substantial sums for programming which does not have mass appeal but which is highly valued by a small audience (and the availability of which on Sky alone therefore engenders loyalty from that smaller audience). 'Deadwood' (a gritty, brutal Western series, made by the US operator HBO) is a good example of such programming: it attracted a dedicated audience of 250,000 to 300,000 viewers. The price that Sky paid for the rights **[CONFIDENTIAL]**, however, could never be justified by reference to the advertising revenues which such an audience would bring in, but rather by (a) the value which these viewers attribute to the programme, which is manifested in the willingness to pay to have access to the channels which exhibit them, and (b) the extent to which the programme is critically acclaimed in, for example, newspaper reviews (which will be read by FTA homes).



167. Sky has also increased significantly its investment in expensive originated programming for Sky One as demonstrated, for example, by its investment in the production of Terry Pratchett's 'Hogfather' in which Sky invested £[CONFIDENTIAL]. Other examples of commissioned content more recently have been Terry Pratchett's 'The Colour of Magic' (in which Sky invested £[CONFIDENTIAL]), Martina Cole's 'The Take' (£[CONFIDENTIAL]), Skellig (£[CONFIDENTIAL]), 'Grease: The School Musical' (£[CONFIDENTIAL]), a number of documentary series starring Ross Kemp (e.g. 'Ross Kemp in Afghanistan'), 'Gladiators' and game show 'Don't Forget the Lyrics'.
168. Since 2005 Sky has committed, as far as possible, to making this high quality programming on its channels exclusive to pay TV. This contrasts with the practice of other pay TV channel providers of acquiring only pay TV rights to programming, which means that such programming normally appears on free to air television channels after the pay TV window. This diminishes consumers' propensity to subscribe to pay TV services in order to watch popular TV series, as they recognise that such TV series will appear on free to air channels later. Purchasing only the pay TV rights to acquired TV series is a cheaper option for pay TV channel broadcasters, but it adversely impacts overall demand for pay TV services.
169. Accordingly, wherever possible, Sky has sought to secure programming on terms that mean that it will not appear on free to air channels after it has been on Sky's pay TV channels. This improves the effectiveness of Sky's basic pay TV channels in terms of attracting and retaining pay TV subscribers.
170. In relation to Sky Arts, Sky increased its investment in programming, from £[CONFIDENTIAL], million in 2005/06 to £[CONFIDENTIAL], in 2008/09 and doubled its output with the launch of Sky Arts 2 in October 2008. This resulted in the creation of two bespoke Sky Arts channels, offering a wide variety of classical and contemporary arts content.<sup>49</sup>

**(ii) Improvements in Sky's sports channels**

171. Over and above these quality improvements, the quality of Sky's Dual Sports and Top Tier packages increased significantly as a result of improvements in Sky's sports channels. Above all, these channels increased in quality over this period by virtue of carrying a significantly expanded amount of high quality programming. Among the most significant improvements were:
- a substantial increase in the number of live Premier League football matches broadcast on Sky's sports channels, from 66 during the 2003/04

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<sup>49</sup> Despite its relatively small budget, Sky Arts has significant value as a pay TV channel, by providing programming that is highly valued by a relatively small number of viewers, but, perhaps equally importantly, by raising the profile and changing the perception of Sky's pay TV services generally by providing programming that often receives considerable positive media coverage.

season, to 88 for the 2004/05 – 2006/07 seasons, increasing again to 92 matches from the 2007/08 season onwards;

- the introduction of the ‘Football First’ service in August 2004. Football First offers full delayed coverage of one of the day’s FAPL matches, together with extended highlights of all other FAPL football matches from the day of broadcast. Highlights of all matches run for around 50 minutes each, and are accessed via a “red button” interactive application;
- the introduction of live broadcasting of Champions League football matches from the 2003/04 football season onwards, with further live match coverage added in August 2009.<sup>50</sup> Other than the 2005/06 season, the 2003/04 – 2008/09 period has been one of considerable success for English football clubs in the Champions League, including Liverpool’s victory in 2004/05, three major English clubs progressing to the semi-final stage in each year between 2006/07 and 2008/09<sup>51</sup>, and an all-English final in 2007/08.<sup>52</sup> **Figure 23** below highlights the increased attractiveness of the Champions League tournament to English audiences from 2003/04;
- a substantial increase in the coverage of live cricket matches, the centrepiece of which was the commencement of exclusive live broadcasts of England domestic cricket Test matches from 2006 – 2010. This expanded the number of live domestic Test matches on Sky’s sports channels from 1 in 2004 and 2005 to 7 from 2006 onwards, and included a victorious Ashes Test series in the Summer of 2009. Other elements of Sky’s increased coverage of domestic cricket have included greatly expanded coverage of: (a) the County Championship; (b) international limited overs matches; (c) both domestic limited overs competitions; and (d) domestic and international Twenty20 cricket; and
- the commencement of coverage of live Heineken Cup rugby from December 2003 onwards, which had previously been broadcast by the BBC. The switch of Heineken Cup rugby from the BBC to Sky came at a time of heightened interest in Rugby Union, following England winning the Rugby World Cup in Australia in November 2003.

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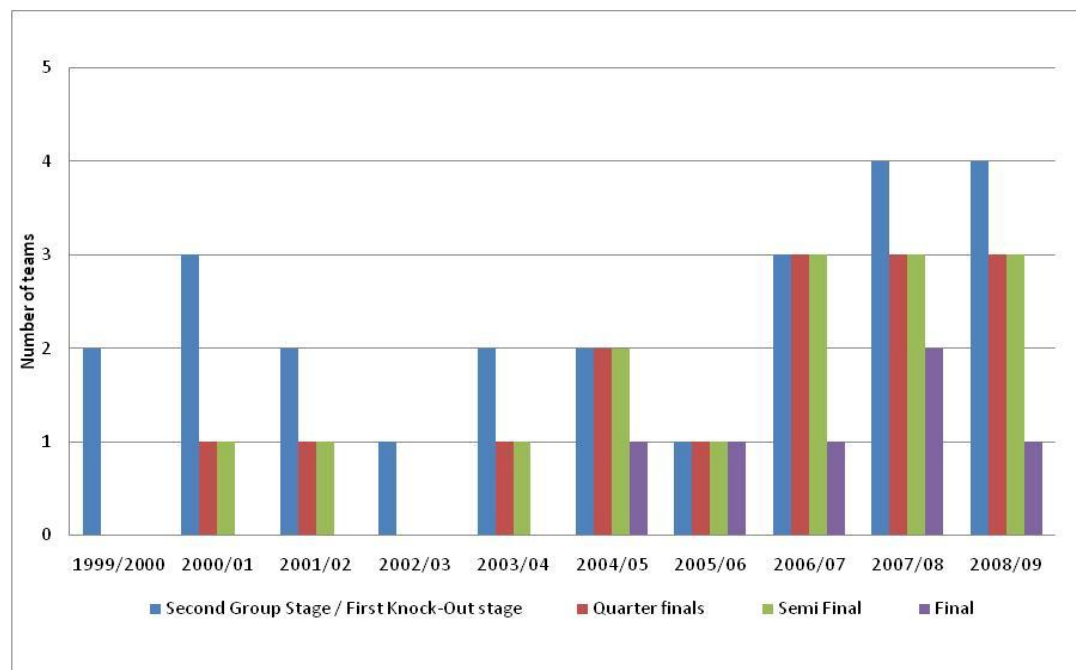
<sup>50</sup> Live rights to Champions League matches are shared with ITV.

<sup>51</sup> These were Manchester United, Chelsea and Liverpool in 2006/07 and 2007/08, and Manchester United, Chelsea and Arsenal in 2008/09.

<sup>52</sup> This is a good example of the fact that in sports broadcasting the attractiveness of a given set of rights can change over time (either positively or negatively), depending on the fortunes of the particular underlying events or competitions.

**Figure 23**

**Performance of British teams in the UEFA Champions League competition**



172. On the debit side, the most significant losses of sports rights during this period were the loss of rights to the US PGA Tour (lost to Setanta for its Setanta Golf channel) in 2006, and FA Cup rights (also lost to Setanta) from the start of the 2008/09 football season.

173. Sky has also increased its expenditure on producing its sports channels, and continued to provide viewers with innovative new ways of covering sport.

174. **Figure 24**, below, shows Sky Sports' production expenditure in each year from 2001/02 to 2008/09. This expenditure includes both the costs of capturing a sporting event (cameras, sound and other equipment, together with operators and other technical staff) and the presentation of the broadcast (commentators, studio experts and graphics). Increased investment in production is reflected in an improvement in the quality of the broadcast product in at least three ways:

- coverage of more events;
- use of more and better equipment (e.g. by using more cameras to capture more angles and, especially in cricket coverage, special cameras to capture slow motion and infra-red imaging); and
- employing a high standard of experts (such as notable former players and coaches) to introduce, discuss and commentate on the action.

## Figure 24

### Sky Sports production expenditure

[CONFIDENTIAL]

175. Sky Sports has also continued to remain at the forefront of the use of innovative new technology in sports coverage – over the past five years, in particular through its introduction of coverage of numerous sports in high definition, but also through the use of new technology notably in its coverage of cricket. For example, Sky’s cricket coverage has introduced technologies such as ‘hi-motion’ (a technology that captures images, typically sports content, in super-slow-motion, typically at 300 frames per second to give a very smooth replay at slow speeds) and infra-red camera technology, also known as ‘hot-spot’, which uses powerful infra-red cameras to detect the distinct thermal signature left when a cricket ball hits either a batsman’s pad or bat.

#### (iii) *Improvements in Sky’s movie channels*

176. Over and above the quality improvements associated with improvements in the basic channels carried in these packages, the quality of Sky’s Dual Movies and Top Tier packages increased as a result of improvements in Sky’s movie channels. These included:

- an improvement in the mix of titles broadcast, [CONFIDENTIAL]<sup>53</sup>;
- moving forward of the pay TV window for movies so that they can be shown sooner after cinematic release<sup>54</sup>;
- the transformation in April 2007 of Sky’s three movie channels (plus multiplexed versions of those channels) into nine new thematic channels; and
- the introduction of PIN protection for movie channels in January 2006 which means that 12 certificate and 15 certificate movies can now be scheduled before 8pm.

#### G. **Summary of trends in prices, quality and subscriber numbers relating to each main type of package considered in this section**

177. In this section, Sky briefly draws together the evidence related to each of the four Sky pay TV packages examined above, and provides changes in subscriber numbers to each of those packages over the 2004 – 2009 period.

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<sup>53</sup> [CONFIDENTIAL]

<sup>54</sup> Over a number of years prior to 2008 Sky renegotiated its movie contracts so that it can show titles at an earlier date post cinematic release. In 2001, for example, the pay TV window ran from 18 to 33 months after cinematic release; by 2007 it had moved forward by six months, typically running from 12 to 27 months after cinematic release. Therefore any film can be shown six months earlier than would have been possible in 2001, meaning that it is closer to the cinematic release and the accompanying publicity.

### **Top Tier**

178. Between January 2004 and September 2009:

- the monthly charge for Sky's Top Tier package increased by between 1.7% - 5.5% in real terms (over a period of 5 ¾ years);
- the quality of this package increased as a result of:
  - (i) an increased number of basic channels carried in the package, and improvements to existing basic channels (arising for example, from Sky's increased investment in Sky One and Sky Arts);
  - (ii) significant improvements in Sky's sports channels, for example due to: a significant expansion in the number of Premier League football matches broadcast; the addition of Champions League football during a period in which English teams have been very successful in that tournament; the introduction of the Football First service; a substantial expansion in live coverage of cricket, including exclusive coverage of England's domestic Test matches, and coverage of new highly popular Twenty20 cricket tournaments; and the introduction of coverage of Heineken Cup rugby; and
  - (iii) improvements in the quality of Sky's movie channels (arising, for example, from broadcasting fewer low quality movies, the introduction of PIN protection for the movie channels, the transformation of Sky's movie channels into nine new thematic channels, and Sky's movie channels becoming able to broadcast movies closer to their cinematic release date).

179. Over the same period [**CONFIDENTIAL**]

### **Dual Movies (including Family Pack/Six Mix)**

180. Between January 2004 and September 2009:

- the monthly subscription charge for this package fell by between 0.2% - 3.8% in real terms; and
- the quality of the package increased as a result of: (i) an increased number of basic channels carried in the package, and improvements to existing basic channels (arising for example, from Sky's increased investment in Sky One and Sky Arts), and (ii) improvements in the quality of Sky's movie channels (arising, for example, from broadcasting fewer low quality movies, the introduction of PIN protection for the movie channels, the transformation of Sky's movie channels into nine new

thematic channels, and Sky's movie channels becoming able to broadcast movies closer to their cinematic release date).

181. Over the same period [**CONFIDENTIAL**]

***Dual Sports (including Family Pack/Six Mix)***

182. Between January 2004 and September 2009:

- the monthly subscription charge for this package increased by between 4.2% - 8.1% in real terms (over a period of 5 ¾ years); and
- the quality of the package increased as a result of (i) an increased number of basic channels carried in the package, and improvements to existing basic channels (arising for example, from Sky's increased investment in Sky One and Sky Arts), and (ii) significant improvements in Sky's sports channels, for example due to: a significant expansion in the number of Premier League football matches broadcast; the addition of Champions League football during a period in which English teams have been very successful in that tournament; the introduction of the Football First service; a substantial expansion in live coverage of cricket, including exclusive coverage of England's domestic Test matches, and coverage of new highly popular Twenty20 cricket tournaments; and the introduction of coverage of Heineken Cup rugby.

183. Over the same period [**CONFIDENTIAL**]

***'Big Basic' (Family Pack/ Six Mix)***

184. Between January 2004 and September 2009:

- the monthly subscription charge for Sky's Family Pack/Six Mix package changed by between -1.1% - 2.6% in real terms. (The £10 per month charge for using Sky+ was also removed for subscribers to this package in July 2007); and
- the quality of the package increased as a result of: (i) an increased number basic channels carried in the package, and improvements to existing basic channels (arising for example, from Sky's increased investment in Sky One and Sky Arts).

185. Over the same period [**CONFIDENTIAL**]

186. **Table 6**, below, draws together the evidence related to each of the four Sky pay TV packages examined above.

**Table 6**

**Changes in prices, quality and subscriber numbers for Sky pay TV packages examined above  
January 2004 - September 2009**

	<b>Top Tier</b>	<b>Dual Movies*</b>	<b>Dual Sports*</b>	<b>'Big Basic'</b>
Change in price in real terms	1.7% - 5.5%	-3.8% - -0.2%	4.2% - 8.1%	-1.1% - 2.6%
Improvements in basic channel packages	✓	✓	✓	✓
Improvements in Sky's sports channels	✓		✓	
Improvements in Sky's movie channels	✓	✓		
<b>[CONFIDENTIAL]</b>	<b>[CONFIDENTIAL]</b>	<b>[CONFIDENTIAL]</b>	<b>[CONFIDENTIAL]</b>	<b>[CONFIDENTIAL]</b>

\* including Family Pack/ Six Mix.

**H. Comparison of changes in charges and subscriber numbers over time**

187. As discussed in greater detail in **Part Two**, below, a central part of Ofcom's analysis of these issues has been a contention that Sky has raised charges for its pay TV services in real terms yet, despite this, the number of subscribers to these services has increased over time.
188. **Figures 25 – 28**, below, show the pattern over time in (a) UK subscriber numbers and (b) charges in real terms<sup>55</sup> for the four Sky packages considered above (Top Tier, Dual Sports (including all basic packages), Dual Movies (including all basic packages) and 'Big Basic' (Family Pack/ Six Mix)).

**Figure 25**

**[CONFIDENTIAL]**

189. **Figure 25** shows that **[CONFIDENTIAL]**

<sup>55</sup> The charges in these charts are converted to real terms using the RPI (all items excluding indirect taxes and mortgage interest payments). The observed pattern would be broadly the same if the charges in the charts were calculated using the CPI instead. In relation to the change in charges arising from the reduction in the VAT rate in January 2009, these charts show **actual** charges – i.e. including the reductions that occurred in January 2009.

## Figure 26

[CONFIDENTIAL]

190. **Table 6**, above, shows that over the period from January 2004 – September 2009 [CONFIDENTIAL] This can be seen in **Figure 26**. **Figure 26** also shows, [CONFIDENTIAL]

## Figure 27

[CONFIDENTIAL]

191. **Figure 27** shows that [CONFIDENTIAL]

## Figure 28

[CONFIDENTIAL]

192. **Figure 28** shows that [CONFIDENTIAL]
193. These charts show that the experience of the recent past – the period that is the most relevant to Ofcom’s inquiry, given that the focus of Ofcom’s market definition analysis is on current and future competitive conditions – [CONFIDENTIAL]

## I. Summary and conclusion

194. This **Part One** of Sky’s submission provides data and analysis relating to changes over time in (a) the number of pay TV subscribers in the UK, (b) charges for Sky’s pay TV services, and (c) the quality of services provided by Sky. It also provides a description of a range of the actions taken by Sky, and new services that Sky has introduced, aimed at continuing to grow its subscriber base in order to meet Sky’s demanding subscriber targets, in response to increasing competition from other pay TV providers, free to air television services, and other ways of watching movies.
195. The underlying argument in Ofcom’s consultation documents in relation to these matters has been that Sky has been able to continue to increase the number of subscribers to its pay TV packages while, at the same time, increasing charges for those packages in real terms. The inference that Ofcom seeks to draw is that Sky does not face effective competition at the retail level, and that the markets in which it provides pay TV services are narrow.



196. The data and accompanying background provided in this **Part One** shows that this proposition is not well-founded, particularly for more recent periods that are of greatest relevance to Ofcom's inquiry. Instead, the evidence presented in this **Part One** indicates that over the period January 2004 - September 2009:

- [CONFIDENTIAL]
- [CONFIDENTIAL]
- [CONFIDENTIAL] and
- [CONFIDENTIAL]

197. Sky's subscriber numbers, and the mix of Sky subscribers, have also been affected by range of factors to which Ofcom's analysis pays little or no regard, including:

- consumer switching from analogue television to digital television services;
- repricing and repackaging of basic channels;
- Sky+;
- new services such as Sky Anytime and Sky Player;
- Sky's move into providing telecommunications services, so that it can now provide 'triple play' packages of TV, telephony and broadband;
- high definition television services; and
- changes in the volume, type and effectiveness of Sky's marketing activity (including set-top box and installation subsidy).

## Part Two

### Ofcom's approaches to analysis of trends in prices, quality and subscriber numbers

199. Ofcom's analysis of trends in these variables in the context of market definition has been based on two principal approaches:

- (a) an attempt to examine "*subscribers' responses to actual price rises*"<sup>56</sup>; and
- (b) an attempt to conduct an 'event analysis' of the impact of the development of Freeview<sup>57</sup>.

200. Each of these is discussed below.

#### A. "*Subscribers' responses to actual price rises*"<sup>58</sup>

201. Part of Ofcom's market definition analysis has comprised an attempt to examine existing subscribers' responses to price increases. In its Third Consultation Document Ofcom stated:

*"In both our first and our second consultation documents, we examined subscribers' responses to actual price rises."*<sup>59</sup>

202. Ofcom purports to have done this by examining the number of Sky subscribers to various types of services, given Ofcom's view that there have been increases in prices of such services.

203. At the outset, it is evident that in order to conduct such an analysis it is necessary to be reasonably confident that there have in fact been "*actual price rises*" – this simple point has become lost in Ofcom's analysis. Yet it is also clear that over the more recent (and relevant) past:

- (a) this is certainly not the case in relation to Sky's Dual Movies package; as shown in Part One, above, its charge has fallen in real terms, even before improvements in quality are taken into account; and

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<sup>56</sup> Paragraph 4.147 of the Third Consultation Document. The discussion of this subject in the Second Consultation Document is under the title of "*Observed consumer response to price rises*". Appendix 3 of Annex 6 of Ofcom's Second Consultation Document.

<sup>57</sup> In fact, Ofcom has sought only to consider the impact on Sky.

<sup>58</sup> What Ofcom appears to mean by "*actual price rises*" is not particular price rises, but increases in charges for Sky's pay TV packages generally, over a period of time (e.g. over a number of years). Similarly, in terms of "*subscribers' responses*" Ofcom appears to mean 'changes in the overall number of (Sky DTH) subscribers to particular types of pay TV services over time'.

<sup>59</sup> Paragraph 4.147. Ofcom's analysis has failed to have any regard at all to the fact that, in a growing market, an increase in prices is likely to deter potential future subscribers as well as causing existing subscribers to cancel their subscriptions.

(b) in relation to Sky's other main packages it is more likely than not that prices have not risen in real terms, once changes in the quality of those packages are taken into account. As set out in Part One, above, the monthly charge for these packages increased over the period 2004 - 2009 by 1.7% - 5.5% in the case of Sky's Top Tier package, 4.2% - 8.1% in the case of Sky's Dual Sports package, and between -1.1% - 2.6% in the case of Sky's Big Basic package. At the same time, however, there have been significant improvements in the quality of these packages (and other services available to subscribers to them) which are likely to have, at the least, off-set the impact of these price increases.

204. Accordingly, it is evident that over the more recent and relevant past there have not in fact been increases in prices in real quality-adjusted terms to which subscribers' reactions might be examined, and therefore Ofcom's analysis of this issue does not lend any support to its conclusions about the scope of relevant markets at the retail level.

***Ofcom's argument is not based on sound economic analysis***

205. Moreover, Ofcom has never set out a clear, well-founded explanation of how it considers its analysis contributes to defining relevant retail markets for the services that it has been examining.

206. Ofcom has on numerous occasions observed that (a) prices have risen, and (b) the number of subscribers to a service has risen and concluded that this is evidence in support of a proposition that Sky does not face strong competition in retailing pay TV services. For example, in the Third Consultation Document, Ofcom states:

*"we observe that... the price of Sky Sports Mix packages, [CONFIDENTIAL], while the total number of subscribers to Sky Sports Mix packages has increased over this period."*<sup>60</sup>

*"Taken together these factors suggest that the growth of FTA channels has not sufficiently constrained Sky's pricing of Sky Sports for FTA channels to be included in the same market."*<sup>61</sup>

207. Basic economics, however, indicates that, all else being equal, a rise in prices will be associated with a reduction in sales.<sup>62</sup> An observation of a simultaneous rise in prices and an increase in sales means that the 'all else being equal' assumption does not hold - something else is acting to more than offset the effect of a price increase on sales.

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<sup>60</sup> Paragraph 4.183 of Ofcom's Third Consultation Document. It is not clear what period Ofcom is referring to in these statements. Other such observations arise at paragraphs 5.33 and 5.44 of the First Consultation Document, paragraph 3.70 of Appendix 3 to Annex 6 of the Second Consultation Document and paragraph 4.95 of the Second Consultation Document.

<sup>61</sup> Paragraph 4.184, *ibid*.

<sup>62</sup> There is a category of goods called 'Giffen goods' for which demand rises as the prices of those goods increase. It is, however, wholly implausible that pay TV services fall into this category.

208. Weak competition is not able to explain an observation of a rise in prices accompanied by an increase in sales; even firms with market power face reduced sales if they raise prices. Ofcom's proposition that an observation of increasing prices and increasing sales indicates that a seller does not face effective competition has no foundation in standard economic analysis.
209. Accordingly, Ofcom's analysis provides no support at all for the conclusions it reaches about the scope of relevant retail markets.

## **B. Event analysis**

210. Ofcom's second main approach has been to seek to use data on prices, service quality and subscriber numbers (and other variables) as part of an 'event analysis'.
211. In the context of market definition, event analysis is based on the proposition that examining the impact on market outcomes and firms' behaviour of particular 'events', such as an improvement in quality of potential substitute products, or the emergence of a new supplier, can provide evidence on the competitive constraints faced by firms already operating in a sector. Ofcom describes its analysis as follows:

*"One way to consider whether two products are close substitutes for each other is an 'event analysis' which examines, for example, the impact of the entry or exit of a firm within the markets being assessed. If we observed a strong response from incumbents or from existing consumers when a new product joined the market, this might be evidence that the incumbent's product and the new entrant's product were close substitutes."*<sup>63</sup>

212. The particular 'event' on which Ofcom has focused in its inquiry has been the "entry of Freeview in 2002"<sup>64</sup>. Ofcom states that:

*"The entry of Freeview in 2002 enables us to examine the response of other TV providers and of consumers."*<sup>65</sup>

213. Ofcom, however, has not applied this approach in a consistent or rigorous manner.
214. In particular, Ofcom has sought only to apply it to defining the relevant market for pay TV packages that include premium sports channels. This is unusual

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<sup>63</sup> Paragraph 4.164 of Ofcom's Third Consultation Document. In practice, the first of Ofcom's approaches, discussed above, also comprises a form of event analysis, although Ofcom does not recognise it as such. In this case the 'event' in question is a rise in prices.

<sup>64</sup> Paragraph 4.165 of Ofcom's Third Consultation Document.

<sup>65</sup> Paragraph 4.164 of Ofcom's Third Consultation Document.

because the approach is arguably of greater applicability to premium movie packages than premium sports packages<sup>66</sup> in view of the facts that:

- the expansion of free to air television services in the UK, of which the development of Freeview has been a part, has resulted in a massive expansion in the availability of movies on a free to air basis – on both new general entertainment television channels such as ITV2 and ITV3, and on dedicated free to air movie channels, such as Film 4 and True Movies. There has been comparatively less use made of new digital channels for sports broadcasting<sup>67</sup> – the main example being ITV’s use of ITV4 for this purpose, given its male demographic focus<sup>68</sup>; and
  - there is a strong argument that movies compete directly with non-movies programming,<sup>69</sup> in which case the significant expansion in the range of free to air TV channels available might be anticipated directly to reduce demand for pay TV services that include premium movie channels by offering consumers a greater choice of substitutable programming for free.
215. Ofcom has provided no explanation for choosing not to apply this approach when defining the relevant market for pay TV packages that include premium movie channels, even though it appears to be of direct relevance to those services.
216. Moreover, the expansion of the availability of free to air television services in the recent past, of which the introduction and expansion of Freeview has been a part, does not comprise a discrete ‘event’ that, as Ofcom would have it, occurred in 2002. Instead, it has been part of an ongoing process, a significant feature of which has been an expansion in the number of free to air television channels available via DTT and DTH broadcasting, and available as part of cable TV and IPTV services, including as a result of conversion of formerly pay TV channels to free to air television channels. This process has not been constant over time. A

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<sup>66</sup> For the avoidance of doubt, this point does not mean that Sky argues that Freeview has not had an impact on demand for pay TV services that include premium sports channels. The point is simply that the impact would be expected to be greater in the case of pay TV services that include premium movie channels, so it is unusual that Ofcom has chosen not to apply its ‘event analysis’ approach to those services.

<sup>67</sup> This principally reflects the facts that the UK PSBs dominate the supply of free to air television services in the UK, and the large majority of sports rights they hold are rights to premium sports events. The PSBs naturally prefer to broadcast such events on their television channels that are available to all households (i.e., BBC1, BBC2, ITV1, and C4), or widely available in the case of five, in order to maximise viewing of those events.

<sup>68</sup> Events and competitions that ITV currently broadcasts, or has broadcast in the past, on ITV4 include: UEFA Champions League football matches, UEFA Europa League football matches, cycling’s Tour de France and Tour of Ireland, the Isle of Man TT motorcycle racing, British Touring Car championships, matches from the Rugby World Cup, highlights of rugby union’s Guinness Premiership, and the Grand Slam of Darts.

<sup>69</sup> See paragraph 6.18 and Annex 4 of Sky’s submission ‘Additional comments on Ofcom’s analysis of market definition and market power in the pay TV review’, June 2009, and paragraphs A2.58 – A2.61 of Sky’s supplemental submission of October 2009 in relation to Ofcom’s Third Consultation Document.

submission by ITV to the Competition Commission in its 2007 inquiry into Sky's purchase of a stake in ITV described this process in relation to Freeview:

*"A key driver of the growth of Freeview has been the improvement in its channel line-up. At the time of its launch in 2002, Freeview offered a limited number of free-to-air channels. In the past four years there has been a significant increase in the number of Freeview channels – and, more particularly, in the number of well funded general entertainment channels.*

*The new channels include 'spin-offs' of the traditional terrestrial channels. The BBC has re-vamped BBC3 and BBC4 and has heavily promoted them on and off air. ITV3 was launched in November 2004 and ITV4 in November 2005. In May 2005, Channel 4 converted its existing pay-TV channel, E4, into a free-to-air channel on Freeview (together with the E4+1 timeshift channel), following this with More 4 in October 2005, and Film 4 in July 2006. Beyond the terrestrial broadcasters, new Freeview channels include Sky Three, a sister channel to Sky One, and abc1."*<sup>70</sup>

217. Ofcom itself has also commented on this process in its annual Communications Market reports. For example, its Communications Market report for 2006 stated:

*"The growing popularity and reach of Freeview came alongside both a broadening of the range of channels available on the platform and an increase in the levels of investment made by operators in channel content meant [sic] that multichannel share on Freeview exceeded that of any one of the five main networks for the first time"*<sup>71</sup>

*"The five main channels (BBC One, BBC Two, ITV1, Channel 4 and Five) have launched a range of spin-offs over the last eight years, starting with BBC News24 in 1997. In 2005 the commercial mainstream channels were especially active – ITV launched ITV4, CITV and ITVPlay; Channel 4 took E4 and Film Four free-to-air on Freeview and launched More4 and Quiz Call; Five announced the 2006 launches of Five Life and Five US.*

*These new channels have come to air with a number of advantages over their competitors:*

- *established brand identities;*
- *promotional airtime on channels with a wide reach; and*
- *access to rich programme archives and well-known programme brands.*

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<sup>70</sup> Paragraph 7.36, Statement of Case on Competition Issues, June 2007. Available at: [http://www.competition-commission.org.uk/inquiries/ref2007/itv/main\\_party\\_submissions.htm](http://www.competition-commission.org.uk/inquiries/ref2007/itv/main_party_submissions.htm).

ITV's position in the inquiry was one of considerable hostility to Sky. While Sky disagreed with many of ITV's views and with the Competition Commission's conclusions in relation to the ability of Sky to affect competition through its stake in ITV, ITV's observations cited above are factual in nature.

<sup>71</sup> Page 188 of 'The Communications Market 2006', Ofcom, 10 August 2006.

*An analysis of the channels available only in multichannel homes that gained the most share in 2005 shows that mainstream spin-offs featured prominently in the top twenty strongest performers.”<sup>72</sup>*

218. Ofcom’s Communications Market report for the following year (2007) emphasised the growth in use of free to air time-shifted ‘+1’ channels by the PSBs, as well as the ongoing launch of new free to air channels:

*“The 2006 Communications Market highlighted the success that four of the five terrestrial channels were having in offsetting parent channel share losses with new channel launches. The BBC launched the first PSB spin-off in 1997, while ITV followed a year later with ITV2. In 2006 launches included CITV and ITV Play from ITV in March 2006, Film4 from Channel 4 in June and Five Life and Five US in October.*

**Figure 2.4 PSB spin-off channel launches in 2006/07**

Operator	Channel	Launch
ITV	CITV ITV Play ITV2+1 ITV3+1	March 2006 March 2006 (pulled March 2007) October 2006 October 2006
Channel 4	Film4* Film4+1	Relaunched July 2006 July 2006
Five	Five Life Five US	October 2006 October 2006
Intended launches	Channel 4+1 Five life+1 Five UK+1	August 2007 Autumn 2007 Autumn 2007

*\*Originally subscription-only services*

*As prominent in 2006 as these new spin-off launches was the introduction by public service broadcasters of time-shifted versions of established channels. Channel 4 led the PSBs’ way in 2002 and 2005 with E4+1 and More4+1. But in 2006, ITV2 and ITV3 time-shifts were introduced, while Five announced the autumn launch of time-shifted versions of its spin-offs. Channel 4 has become the first PSB to decide to timeshift its parent channel, from August 2007.”<sup>73</sup>*

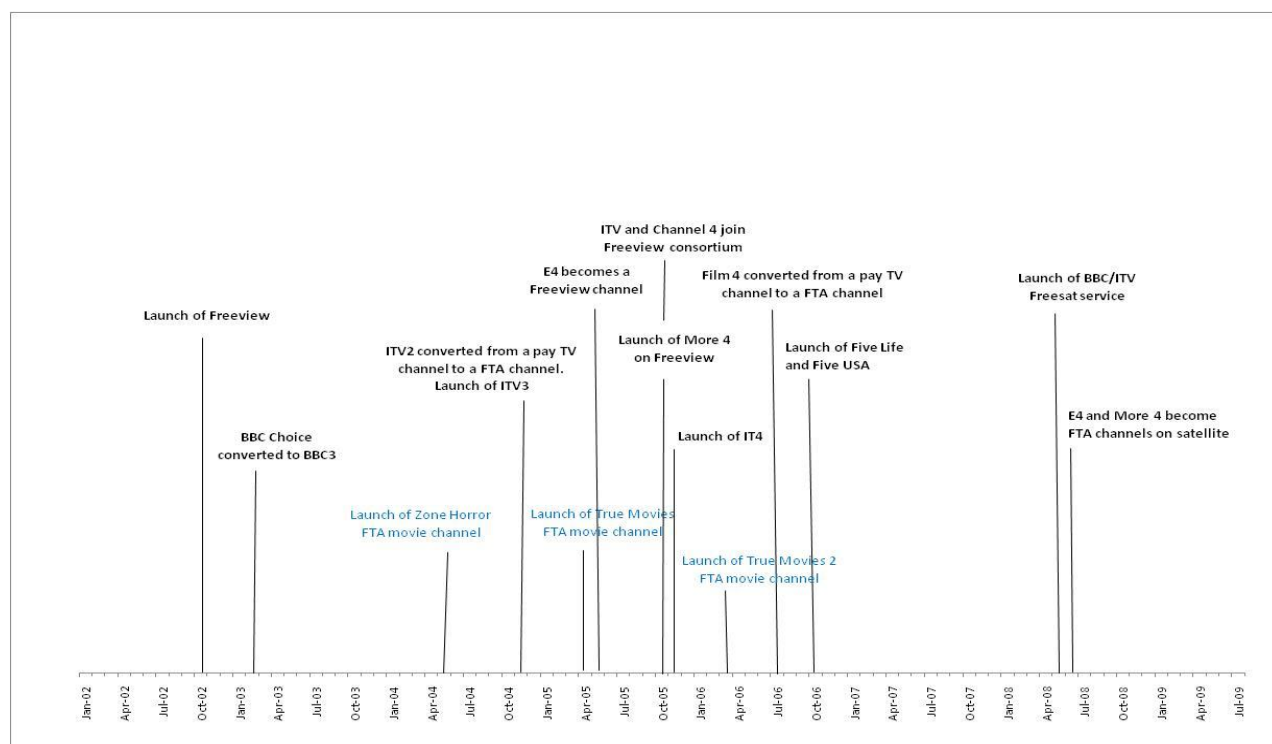
219. **Figure 29**, below, lists the dates of introduction of a number of the more important new free to air channels, and the conversion of pay TV channels operated by the PSBs to free to air channels;

<sup>72</sup> Page 184, *ibid.*

<sup>73</sup> Pages 104 - 105, ‘Communications Market Report 2006’, Ofcom, 23 August 2007.

**Figure 29**

**Date of launch of important new free to air television channels and platforms**



**Note:** channels in blue are not available via Freeview

220. Additional important changes to the competitive position of Freeview over time include:

- increased investment by broadcasters in their digital channels<sup>74</sup>;
- both (a) declines over time in the price of Freeview set-top boxes and (b) increasing ubiquity of DTT tuners built into consumer electronic devices (such as televisions and DVD players), so that households that purchase such equipment (for example due to purchasing a new flat screen television) automatically have access to Freeview (provided that it is available where they live); and
- the introduction of a Freeview branded PVR – originally branded Freeview Playback, later rebranded as Freeview+ – at the end of 2007.

221. These considerations have two implications. First, it should not be expected that either consumers or other operators would have reacted suddenly to the emergence of Freeview, or that such a reaction would have comprised a single, easily observable response confined to a short period of time. Second, while Freeview was a very popular service from the outset, and the number of homes

<sup>74</sup> See, for example, the reference to additional investment in such channels in the quote from Ofcom's Communications Market 2006 report, at paragraph 217 above.



adopting it grew rapidly, the quality and scope of the free to air multichannel offering began to increase substantially from late-2004 onwards, when the main commercial free to air broadcasters adopted and implemented their strategies of developing portfolios (or ‘families’) of digital television channels, rather than emerging fully-formed at the end of 2002. Accordingly, if evidence is to be sought on competitors’ and consumers’ reactions as a result of Freeview’s emergence and development it is most likely to be found from late-2004 onwards.

### ***The importance of the counterfactual***

222. Event analysis seeks to compare evidence on potentially affected variables (such as prices, quality, subscriber numbers, firms’ strategies, SAC etc.) in two states of the world: (a) what has been observed to happen, and (b) what would have been expected to happen, absent a particular perturbation or ‘event’ (the ‘counterfactual’). The extent of the impact of the event in question depends on the difference between outcomes in these two states of the world. Accordingly, it is evident that in order to draw well-founded conclusions from an event analysis it is, at least, necessary to develop a clear view of the counterfactual.

223. Yet, despite recognising that this is an issue with its analysis on a number of occasions, Ofcom has never set out a counterfactual on which its analysis is based, arguing that to do so is “*difficult*”. For example, Ofcom has stated:

*“It is of course difficult to identify the counterfactual of how numbers of Sky Sports subscribers would have grown were Freeview not available.”<sup>75</sup>*

*“We accepted that the very real difficulties in estimating the counterfactual meant that we cannot rule out the possibility that the price of Sky Sports has been moderated by increased competition.”<sup>76</sup>*

224. Ofcom’s argument that it cannot evaluate the counterfactual in this case because it is “*difficult*” is inconsistent with Ed Richards’ argument in relation to the analysis undertaken by Ofcom in order to determine the wholesale charges it considers it should set for Sky’s premium channels that:

*““because it is difficult” is not a good enough reason to ignore it.”<sup>77</sup>*

225. Without any attempt at all by Ofcom to set out a counterfactual no weight can be placed on its analysis of the impact of Freeview as supporting Ofcom’s conclusions about the scope of relevant markets at the retail level.

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<sup>75</sup> Paragraph 4.99 of Ofcom’s Second Consultation Document.

<sup>76</sup> Paragraph 4.239 of Ofcom’s Third Consultation Document.

<sup>77</sup> Page 30 of the transcript of ‘Ofcom briefing for analysts: broadcasting & media’, Tuesday 22 September 2009.

### ***The importance of proper consideration of the reactions of competitors***

226. As is clear from the statements by Ofcom quoted at paragraphs 210 and 211, above, in order to conduct an adequate event analysis of the impact of Freeview, it is necessary properly to examine the reactions of both consumers and competitors to its emergence and development.
227. One of the main focuses of Ofcom's 'event analysis' has been on the impact of the development of Freeview on the number of subscribers to premium sports packages. In this context, examining the reactions of pay TV operators is particularly important because, if free to air television services are an important part of the competition faced by suppliers of pay TV services, the expansion in the supply of free to air services (of which the development of Freeview is a part), would be expected to provoke competitive responses aimed at retaining existing subscribers and continuing to attract new subscribers to pay TV services. If they were successful, the observed impact of the expansion in free to air television services on subscriber numbers would be expected to be small.
228. There are two problems with Ofcom's analysis in this respect.
229. First, Ofcom has taken a narrow view of the ways in which suppliers of pay TV services might respond to increased competition from free to air television services. Ofcom seeks competitive reactions only in terms of reduced prices or reduced returns to broadcasters (i.e. suppliers of pay TV channels to retailers). Ofcom states:
- “Given the growth in the number of FTA channels and the increasing popularity of Freeview, we might expect that if FTA TV and premium sports channels were strong substitutes, **we would observe a competitive response from Sky in the form of lower prices or margins for its Sky Sports channels, or for Sky Sports to have lost subscribers.**”<sup>78</sup> (Emphasis added.)*
230. Ofcom's narrow approach to this matter is particularly inappropriate because there is copious, readily available evidence – including much that Sky has already supplied to Ofcom – that indicates that pay TV suppliers have responded to increasing competitive pressure, including the emergence and development of Freeview, in a wide variety of ways. In Sky's case, these have included:
- repricing and repackaging of its basic channel packages;
  - moving into the provision of telecommunications services;
  - changing the nature of Sky's marketing activities;
  - spending more on customer acquisition and retention;
  - investing significantly in customer service;
  - introduction of Sky's new 'FreesatfromSky' proposition in June 2004<sup>79</sup>;

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<sup>78</sup> Paragraph 4.182 of Ofcom's Third Consultation Document.

<sup>79</sup> 'FreesatfromSky' comprises a DTH satellite set-top box, satellite dish, viewing card and installation for a one-off charge of £150. It enables consumers to receive over 200 free to air television channels (including all the free to channels offered by the PSBs available via Freeview).

- investing in innovative new services and driving demand for them, such as Sky+, high definition television, online TV services, enhanced EPG functionality (including a new EPG), VoD services and mobile TV;
  - seeking to develop a new DTT-based pay TV service; and
  - seeking to increase the attractiveness of the pay TV proposition, for example through substantial additional investment in Sky's own channels (both basic and premium), changes in Sky's strategy in relation to rights acquisition and exploitation for Sky One, and seeking to focus the amounts Sky pays for carriage of third party basic pay TV channels on those which make the greatest contribution to differentiating pay TV services from free to air television services in a positive way.
231. Second, Ofcom's approach fails to have regard to the fact that firms' actions may be responses to increased competition from a variety of different sources.
232. This is certainly the case in relation to the types of actions set out above. At the same time that Sky has faced increasing competition from Freeview, it has also faced intensifying competition resulting from (among other things):
- a strengthened ITV as a result of the merger of Carlton and Granada to form a single ITV company in 2003, and the subsequent significant relaxation of its PSB obligations;
  - increased competition from Channel 4 as a result of its adoption of a strategy of spending aggressively on US television series;
  - the launch by cable operators (beginning with Telewest in 2005) of 'true video on demand' services, offering movies in windows earlier than the pay TV window exploited by Sky's movie channels;
  - significantly stronger competition from the cable sector as a result of the merger of ntl and Telewest in early 2006 to form a single UK cable operator, its subsequent rebranding as Virgin Media, and investment in high speed broadband services;
  - increasing availability, and use by consumers, of online services such as the BBC's iPlayer;
  - increasing purchasing of programming including movies on DVDs; and
  - the entry of BT into the audiovisual sector with the launch of BT Vision in December 2006.
233. Sky's efforts to improve its competitive position cannot be neatly compartmentalised into responses to each one of these developments. The simple fact is that the environment in which Sky operates has become, and continues to become, increasingly competitive – as a result of all such developments – and Sky has been required to continue to improve the value of its services, and to invest and innovate in relation to the product set offered to consumers, in order to continue to attract and retain subscribers to its services. For example, Sky's pioneering investment in HD services (ahead of free to air and pay TV competitors who at the time took the view that HD services would not be attractive to consumers) is a good example of these competitive dynamics operating in practice.

234. It is clear that in order properly to conduct an assessment of the extent to which Freeview (and other changes in the market) have caused Sky to change its behaviour would require a broader and more in-depth analysis than that which Ofcom has undertaken to date, drawing on a wide range of contemporaneous sources, such as commentary by financial and media analysts, and Sky's public statements about relevant issues. Above all, however, it requires proper examination of internal documents, and perhaps the most unsatisfactory feature of Ofcom's 'event analysis' is its failure to consider that such documents are of relevance to addressing the issue at the centre of this analysis. Ofcom is in the privileged position of having access to Sky's internal documents, which, both individually and taken as a whole, provide strong and compelling evidence that consideration of how to meet the challenges to its business posed by developments such as Freeview (among numerous other competitive challenges) is a central preoccupation within Sky. Yet Ofcom has chosen to make no use at all of the insights delivered by such documents into the issue of the response by Sky to Freeview and other market developments in its event analysis.
235. Had Ofcom undertaken this analysis, evidence from 2004 and 2005 would show that a key focus of external scrutiny of Sky's business (e.g. in the media, and by investment analysts) was whether the increased competition it faced would mean that Sky would not meet its subscriber targets.<sup>80</sup> Similarly, proper analysis of Sky's internal documents from this period would have shown that how to overcome the impact of increased competition from a variety of sources was a key consideration of Sky's strategic planning at this time. It was only as a result of radical new initiatives – such as the repricing and repackaging of Sky basic channel packages, the move into telecommunications services, extensive marketing of Sky+, and investing in and marketing high definition television services (as well as Sky's ongoing approach of continuing significantly to improve the value for money of its pay TV packages) – that Sky has been able to continue to grow its subscriber base and meet its subscriber targets.

### **Lower prices**

236. Sky also notes that even based on Ofcom's own benchmark for assessment – the observation of lower prices or margins – it is likely that, in the period in which competition has intensified, prices for Sky's services have fallen in real, value-adjusted terms, thereby meeting Ofcom's own test for determining whether "*the incumbent's product and the new entrant's product were close substitutes*". As shown in **Part One**, above, this is clearly the case for Sky's Dual Movies package, the price of which has fallen in real terms prior to taking any quality changes into account. For Sky's Dual Sports, Top Tier and 'Big Basic' packages it is more likely

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<sup>80</sup> See, for example, the public comments by James Murdoch, then CEO of Sky, quoted in DTG News in relation to Sky's Q2 results for 2004/05, attached at **Annex 4**, and the Sunday Herald article attached as **Annex 5**. These show clearly that a central issue at that time was how Sky was addressing the issue of continuing to grow its subscriber base in the face of the increased competition posed by Freeview. This is a good reflection of the general perception at the time that the growth of Freeview (in particular) meant that Sky might not hit its subscriber targets.

than not that the improvements in quality of these packages that have occurred since 2004 have more than offset the modest increases in charges in real terms that have occurred over this period.

***Ofcom's 'event analysis' is imprecise, cursory and flawed***

237. Finally, Sky notes that Ofcom's 'event analysis', in practice amounts to no more than an assertion of an ill-founded belief on Ofcom's part that Freeview does not act as a significant competitive constraint on the supply of pay TV services that includes Sky's premium sports channels. In Ofcom's Third Consultation, Ofcom presents virtually no analysis of this matter – almost all of Ofcom's attention is devoted to rebuttal of econometric analysis conducted by Professor Seabright and his colleagues (**the 'Seabright Report'**). Ofcom's 'event analysis' essentially comprises the following statements:

*“As we set out in paragraphs 4.200 – 4.208 below, the relationship between prices, quality and programming costs is complex. Nonetheless we observe that both the price of Sky Sports Mix packages, and [CONFIDENTIAL], while the total number of subscribers to Sky Sports Mix packages has increased over this period. Oxera's analysis also shows that the growth of FTA has not prevented Sky from making high profits from its pay TV channels.*

*Taken together we consider that these factors suggest that the growth of FTA channels has not sufficiently constrained Sky's pricing of Sky Sports for FTA channels to be included in the same market.”<sup>81</sup>*

238. The following features of this extremely brief 'event analysis' are notable:

- it is imprecise. For example: (a) Ofcom does not specify clearly what it means by “Sky Sports Mix packages” (for example, whether this is intended to refer to Dual Sports packages, or whether Ofcom also considers it to include Dual Sports packages that also include premium movie channels); (b) the meaning of “the price of Sky Sports Mix packages” is unclear; and the phrase “since 2002” is vague;
- neither the cross-reference cited by Ofcom, nor the paragraphs quoted above, include any consideration of the fact that changes in quality of Sky's services - and potentially a myriad of other factors (as discussed in this submission) - are able to account for the observation of increasing numbers of subscribers to packages that include Sky Sports Mix (and no movie channels) since the end of 2002;
- Ofcom's analysis of “the mark up on programming cost per subscriber” is cursory and wholly unreliable. In particular it **[CONFIDENTIAL]**;

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<sup>81</sup> Paragraph 4.183 of the Third Consultation Document.

- Ofcom’s argument that Oxera’s analysis “shows that the growth of FTA has not prevented Sky from making high profits from its pay TV channels” is wrong.

Ofcom’s wholesale misrepresentation of Oxera’s analysis - of which the above quotation is a prime example - is discussed in detail in Section 4 of Sky’s Response to Ofcom’s Third Consultation Document. In the current context, three observations are relevant:

- (a) Oxera’s analysis does not show that Sky has made “high profits”, whether “from its pay TV channels” or otherwise;
- (b) Ofcom’s reference to “high profits from [Sky’s] pay TV channels” appears to be a reference to Oxera’s disaggregated profitability analysis. In relation to that analysis, Oxera state:

*“The objective of the disaggregate profitability analysis has been, where possible, to provide an indication of the sources of profitability at the aggregate level. In light of this objective, the results of disaggregate profitability analysis were used to inform relative returns between activities, **as opposed to absolute levels of returns.**”<sup>82</sup> (Emphasis added.)*

*“Unlike analysis at the aggregate level, which uses directly observed data, disaggregate profitability analysis relies on assumptions about the allocation of costs, revenues and assets, and hence is inherently more uncertain.”<sup>83</sup>*

- (c) Oxera’s analysis finds that Sky’s profitability has been falling over time. Oxera’s report states:

*“**Evolution of returns over time:** the estimates of the IRR under the replacement costs approach seem to have been decreasing over time.... The reduction in the IRR over time seems to be driven by the fact that subscriber acquisition costs were increasing over time relative to cash flows generated by additional subscribers.”<sup>84</sup>*

This observation, to which Ofcom has had no regard, either in its ‘event analysis’ or more generally, supports the view that the competition faced by Sky is increasing over time.

239. The reality is that Ofcom has not attempted a proper assessment of the impact of Freeview on Sky’s business, drawing on the full range of evidence that is (a) relevant to this issue and (b) readily available to Ofcom.

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<sup>82</sup> Page iii of Oxera’s Report.

<sup>83</sup> Page 33, *ibid.*

<sup>84</sup> Page 30, *ibid.*

240. Finally, it is notable that Ofcom's conclusion is expressed as a 'suggestion' that it considers may be drawn from its 'event analysis'. Even setting to one side the numerous significant flaws in Ofcom's analysis discussed above, it is evident that a 'suggestion' cannot be regarded as comprising soundly based support for Ofcom's conclusion about the scope of the relevant retail markets.

***The relevance of the Seabright Report to Ofcom's 'event analysis'***

241. The Seabright Report is of direct relevance to the issue addressed by Ofcom in its 'event analysis' – the impact of Freeview on the number of UK pay TV subscribers. It is thorough and sophisticated, and produces clear evidence that Freeview has reduced demand for pay TV subscriptions by a significant amount. Yet Ofcom's response has been to seek to undermine that research on the basis of spurious and incorrect arguments, and the misrepresentation of the views of its own expert.<sup>85</sup>
242. Sky considers that the Seabright Report confirms that which a wide range of other observations about Sky's behaviour suggest – that Freeview has had a significant impact on demand for pay TV subscriptions, which Sky has had to work extremely hard to mitigate.

**C. Summary and conclusion**

243. Ofcom's examination of data on changes over time in Sky's subscriber numbers, charges and the quality of pay TV services in relation to market definition in its consultation documents has been (a) in order to examine subscribers' responses to price increases, and (b) in order to determine whether there have been reactions on the part of consumers or competitors to the emergence of Freeview.
244. The discussion of Ofcom's analysis of these matters in this **Part Two** shows that Ofcom's analysis suffers from numerous significant flaws. As a result, neither exercise offers any support at all for Ofcom's conclusions about the scope of relevant markets at the retail level. On the contrary, the evidence presented in this submission is consistent with Sky's views that the sector in which it operates at the retail level has become increasingly competitive over the recent past, and that Sky has been required continually to invest and innovate, and to offer consumers increasing value for money, in order to continue to attract new subscribers and retain existing subscribers to its pay TV services. This would have emerged clearly had Ofcom undertaken a proper analysis of Sky's response to the increased competition that it has faced in the recent past.

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<sup>85</sup> See further Sky's comments at paragraphs 5.54 – 5.55 and Annex 3 of Sky's Response to Ofcom's Third Consultation Document, which includes a submission by Professors Magnac and Seabright commenting on Ofcom's criticisms of the Seabright Study.

## Annex 1.

### The analysis of prices, subscriber numbers and quality in Ofcom’s consultation documents

This Annex 1 indicates the parts of Ofcom’s three consultation documents that address trends in prices, subscriber numbers and the quality of pay TV services. All references are to the main body of each consultation document unless otherwise stated.

#### 1. Ofcom’s First Consultation Document

Context	Relevant heading	Relevant parts of Consultation Document	Ofcom conclusion
Market definition in relation to <b>“retail of packages containing premium sports channels”</b>  Page 13, Annex 13.	<i>“Packages containing premium sports channels: evidence on pricing and subscriber growth”</i>  Page 19, Annex 13.	Paragraphs 4.26 - 4.30, Annex 13.	<i>“It is of course difficult to draw firm conclusions from these data. In particular, we cannot assess what would have happened in the absence of changes to the market. However, if competition has intensified sufficiently for the market definition to be widened (as compared with previous precedent) then we would expect to see some combination of falling prices, falling subscriber numbers and rising quality. On balance, we believe the evidence presented here suggests that historical precedent with respect to premium sports in the UK is likely to remain relevant.”</i> (Paragraph 4.30, Annex 13.)
	<i>“Preliminary conclusions on content / channel market definitions”</i>  <i>“Premium sport channels”</i>  Page 73.	Paragraph 5.33.	<i>“We have also considered how prices and consumption levels have changed over time. While there are always challenges in interpreting historic data of this sort – especially where there may have been changes to the underlying quality of the products – evidence provided by stakeholders suggests that subscriber numbers have grown even as the prices of premium sports packages have risen steadily in real terms since 2000.”</i>
Market definition in relation to <b>“retail of packages containing premium movie channels”</b>  Page 22, Annex 13.	<i>“Packages containing premium movie channels: evidence on pricing and subscriber growth and churn”</i>  Page 27, Annex 13.	Paragraphs 4.71 - 4.75, Annex 13.	<i>“As stated above, it is difficult to draw firm conclusions from such data. However, it is notable that the price of Sky Movies has grown at approximately the same rate as that of Sky Sports, despite what appear to be a greater array of potential substitutes. In particular, the growth in popularity of renting and purchasing DVDs does not appear to have had a constraining impact on the price of Sky Movies.”</i> (Paragraph 4.75, Annex 13.)



	<p>“Preliminary conclusions on content / channel market definitions”</p> <p>Page 73.</p> <p>“Premium movie channels”</p> <p>Page 76.</p>	<p>Paragraph 5.44.</p>	<p>“We have also considered historic price data and consumer responses to changes in prices. As with sports, we find from evidence provided by stakeholders that prices for premium movies have risen steadily in real terms while subscriber numbers have also continued to rise. While this finding needs to be treated with caution, this evidence of actual consumer behaviour is suggestive of a narrow market.”</p>
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## 2. Ofcom’s Second Consultation Document

### A. Consumers’ responses to price increases

Context	Relevant heading	Relevant parts of Consultation Document	Ofcom conclusions
<p>“Assessment of relevant markets for the <b>wholesale of premium sports channels</b>”</p> <p>Page 62.</p>	<p>“Observed consumer response to price rises”</p> <p>Page 8, Appendix 3 to Annex 6.</p>	<p>Appendix 3 to Annex 6.</p>	<p>“It is difficult to isolate the impact of retail price changes for Sky’s sports channels on DSat. We observe increasing prices and growing subscriber numbers, but also some indicators that quality may have increased. The rises in prices and subscriber numbers may purely reflect the quality changes, but equally may suggest a lack of a strong competitive constraint. We do not regard the evidence as absolutely conclusive in either direction, but consider that the extent of the quality changes may not explain fully Sky’s ability to simultaneously increase prices and grow its subscriber base.” (Paragraph 3.70, Appendix 3 to Annex 6.)</p>
<p>“Indirect constraints on wholesalers of premium sports channels”</p> <p>Page 64.</p>	<p>“Observed response to price changes”</p> <p>(Page 67.)</p>	<p>Paragraphs 4.87 – 4.95.</p>	<p>“We have reassessed the change in quality of packages containing Sky Sports channels over time. It is difficult to quantify quality changes, but we accept that the greater number of FAPL games and additional content introduced to the channels has probably more than offset any reduction in quality resulting from the loss of content.</p> <p>Since 2006, Sky has reduced the availability of retail discounts, which has had the effect of increasing the effective retail price over the period. Indeed, we understand that in 2006 about [ _ ]% of Sky subscribers had a discount deal, whereas by August 2007, this figure had come</p>

			<p>down to [ _ ]%. Sky stated that one outcome of [ _ ]. We were unable to quantify the value of the discounts available to subscribers to premium sports channels or premium movie channels. However, the reduced availability of offers is likely to have increased the average price that premium subscribers pay for their service.</p> <p>While it is difficult to identify directly the consumer response to price changes as the quality of the product changes over time, the numbers of retail subscribers to packages containing Sky Sports channels on DSat have increased despite the price increases and reduction in discounts. On its own, this evidence is somewhat ambiguous, and we agree with Sky that there are substantial difficulties in drawing firm conclusions. However, we believe the evidence is consistent with the findings from our consumer research that consumers are unwilling to switch to substitute products despite increases in the price of Sky Sports and the increased availability of sport on FTA channels. At the same time, we recognise that the consumer responses may at least partly reflect an increased willingness to pay for a better quality product.” (Paragraphs 4.93 - 4.95.)</p>
<p>“Assessment of markets for the <b>wholesale of premium movie channels</b>”</p> <p>Page 77.</p> <p>“Indirect constraints on wholesalers of premium movie channels”</p> <p>Page 80.</p>	<p>“Consumer response to increase in the price of Sky Movies channels”</p> <p>Page 25, Appendix 3 to Annex 6.</p>	<p>Appendix 3 to Annex 6.</p>	<p>“By comparison with our analysis of Sky Sports, we believe that the improvements in the quality of Sky Movies are less significant, but so too are the increases in prices and subscriber numbers – indeed the latter have declined over the past few years. On balance, we therefore consider that the evidence of changes to prices, subscriber numbers and quality for Sky Movies suggests a somewhat greater constraint from other products than is the case for Sky Sports, but it is not clear from this evidence alone whether that constraint is sufficient to broaden the market.” (Paragraph 3.73, Appendix 3 to Annex 6.)</p>
	<p>“Consumers’ observed response to price changes”</p> <p>Page 82.</p>	<p>Paragraphs 4.175 - 4.184</p>	<p>As far as Sky can discern, this section does not include a summary of Ofcom’s analysis or its conclusions.</p>

## B. The impact of Freeview

Context	Relevant heading	Relevant parts of Consultation Document	Ofcom conclusions
<p>“Assessment of relevant markets for the <b>wholesale of premium sports channels</b>”</p>	<p>“The popularity of FTA TV”</p>	<p>Paragraphs 4.96 - 4.106.</p>	<p>“if Sky were correct to assert that the FTA offering competes closely with premium sports channels, we would expect some of that substantial growth [this appears to refer to growth in the number of Freeview households] to be attributable to switching away from Sky</p>

<p>Page 62.</p> <p><i>“Indirect constraints on wholesalers of premium sports channels”</i></p> <p>Page 64.</p>	<p>Page 69.</p>	<p><i>Sports. In fact Sky Sports numbers have grown since 2000. Although some of this growth may be attributable to changes in the quality of Sky Sports channels, this suggests to us that the very strong growth in popularity of Freeview has not had an observable impact on subscriber numbers to packages containing Sky Sports.</i></p> <p><i>This is not conclusive evidence that FTA services and premium sports channels are in distinct economic markets. However we believe that the overall evidence on consumer switching behaviour in response to changes in quality, price and availability of products indicates that premium sports channels are indeed likely to be in a separate economic market.”</i> (Paragraphs 4.105 - 4.106.)</p>
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### 3. Ofcom’s Third Consultation Document

#### A. Consumers’ responses to price increases

<b>Context</b>	<b>Relevant heading</b>	<b>Parts of Consultation Document</b>	<b>Ofcom conclusions</b>
<p><i>“Assessment of markets for the wholesale of <b>premium sports channels</b>”</i></p> <p>Page 66.</p> <p><i>“Evidence on indirect constraints”</i></p> <p>Page 70.</p>	<p><i>“Observed responses to price changes”</i></p> <p>Page 86.</p>	<p>Paragraphs 4.147 - 4.162.</p>	<p><i>“Taken together, we consider the evidence on Sky’s premium sports subscriber numbers and prices continues to point towards a degree of constraint on premium sports channels, although we accept that the evidence on quality changes makes a definitive judgement difficult.”</i> (Paragraph 4.162.)</p>
<p><i>“Assessment of markets for the wholesale of <b>premium movies channels</b>”</i></p>	<p><i>“Consumers’ observed responses to price changes”.</i></p>	<p>Paragraphs 4.303 - 4.315.</p> <p>Paragraphs 4.343 - 4.345. (This section occurs under</p>	<p><i>“For the reasons stated in paragraphs 4.157 to 4.160 we do not believe that our choice of price deflator, the start and end dates of the analysis, or our assessment of the use of discounts change our conclusion that the inflation adjusted price for Sky Movies had been broadly constant since 2002 and the price of Sky Sports and Movies Mix had been broadly</i></p>

<p>Page 106.</p> <p><i>“Evidence on the indirect constraint on <b>wholesale premium movies</b>”</i></p> <p>Page 107.</p>	<p>Page 119.</p>	<p>a different heading but appears intended to relate to “Consumers’ observed responses to price changes”.)</p>	<p><i>constant since 2004.</i></p> <p><i>Our view on the margin of prices over input costs remains as before. There has been [ ] in programming costs for Sky Movies channels without any significant reduction in retail prices. This does not suggest to us a strong competitive constraint on Sky’s pricing of its movie channels.</i></p> <p><i>Overall, while we recognise that there has been a reduction in the number of subscribers to Sky Movies over the past few years, we do not believe this provides evidence that Sky’s premium movies channels are constrained to competitive levels.</i></p> <p><i>In particular:</i></p> <ul style="list-style-type: none"> <li>• <i>Demand for the most likely close substitutes to premium movie channels – namely movies shown on other channels and DVD rentals – has also declined.</i></li> <li>• <i>Real prices have remained broadly constant despite sharp falls in input costs.”</i></li> </ul> <p>(Paragraphs 4.343 – 4.345.)</p>
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## B. The impact of Freeview

Context	Relevant heading	Parts of Consultation Document	Ofcom conclusions
<p><i>“Assessment of markets for the <b>wholesale of premium sports channels</b>”</i></p> <p>Page 66.</p> <p><i>“Evidence on indirect constraints”</i></p> <p>Page 70.</p>	<p><i>“Assessment of the constraint from FTA TV”</i></p> <p>Page 89.</p>	<p>Paragraphs 4.163 – 4.184.</p>	<p><i>“Given the growth in the number of FTA channels and the increasing popularity of Freeview, we might expect that if FTA TV and premium sports channels were strong substitutes, we would observe a competitive response from Sky in the form of lower prices or margins for its Sky Sports channels, or for Sky Sports to have lost subscribers.</i></p> <p><i>As we set out in paragraphs 4.200 to 4.208 below, the relationship between prices, quality and programming costs is complex. Nonetheless we observe that both the price of Sky Sports Mix packages, and [ ], while the total number of subscribers to Sky Sports Mix packages has increased over this period. Oxera’s analysis also shows that the growth of FTA has not prevented Sky from making high profits from its pay TV channels.</i></p>

			<p><i>Taken together we consider these factors suggest that the growth of FTA channels has not sufficiently constrained Sky's pricing of Sky Sports for FTA channels to be included in the same market."</i></p> <p>(Paragraphs 4.182 - 4.184.)</p>
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## Annex 2 Calculation of changes in charges in real terms<sup>86</sup>

### Charges in nominal terms

	Top Tier	Dual Movies	Dual Sports	Big Basic
Jan-01	£34.00	£30.00	£28.00	£16.00
Jan-02	£37.00	£32.00	£30.00	£16.00
Jan-03	£38.00	£33.00	£31.00	£18.50
Jan-04	£40.00	£34.00	£33.00	£19.50
Sep-04	£41.00	£35.00	£33.00	£19.50
Sep-05	£42.50	£36.00	£36.00	£21.00
Sep-06	£43.50	£37.00	£37.00	£21.00
Sep-07	£45.00	£38.00	£38.00	£21.00
Sep-08	£47.00	£38.00	£40.00	£22.00
Sep-09	£48.50	£39.00	£41.00	£23.00

### Price indices

	RPI, All items excluding mortgage interest payments and indirect taxes	CPI
Jan-01	160.2	92.9
Jan-02	165.0	94.4
Jan-03	169.8	95.7
Jan-04	173.2	97.0
Sep-04	176.1	98.2
Sep-05	180.5	100.6
Sep-06	186.4	103.0
Sep-07	191.6	104.8
Sep-08	202.4	110.3
Sep-09	206.5	111.5

### Charges in September 2009 prices, using RPI (all items excluding mortgage interest payments and indirect taxes)

	Top Tier	Dual Movies	Dual Sports	Big Basic
Jan-01	£43.83	£38.67	£36.09	£20.62
Jan-02	£46.31	£40.05	£37.55	£20.02
Jan-03	£46.21	£40.13	£37.70	£22.50
Jan-04	£47.69	£40.54	£39.34	£23.25
Sep-04	£48.08	£41.04	£38.70	£22.87
Sep-05	£48.62	£41.19	£41.19	£24.02
Sep-06	£48.19	£40.99	£40.99	£23.26
Sep-07	£48.50	£40.96	£40.96	£22.63
Sep-08	£47.95	£38.77	£40.81	£22.45
Sep-09	£48.50	£39.00	£41.00	£23.00

<sup>86</sup> All references to 'Dual Movies' and 'Dual Sports' in this Annex are to packages that include the Family Pack/ Six Mix basic package.

### Charges in September 2009 prices, using CPI

	Top Tier	Dual Movies	Dual Sports	Big Basic
Jan-01	£40.81	£36.01	£33.61	£19.20
Jan-02	£43.70	£37.80	£35.43	£18.90
Jan-03	£44.27	£38.45	£36.12	£21.55
Jan-04	£45.98	£39.08	£37.93	£22.41
Sep-04	£46.55	£39.74	£37.47	£22.14
Sep-05	£47.10	£39.90	£39.90	£23.28
Sep-06	£47.09	£40.05	£40.05	£22.73
Sep-07	£47.88	£40.43	£40.43	£22.34
Sep-08	£47.51	£38.41	£40.44	£22.24
Sep-09	£48.50	£39.00	£41.00	£23.00

### Changes in charges to September 2009, based on RPI (all items excluding mortgage interest payments and indirect taxes)

	Top Tier	Dual Movies	Dual Sports	Big Basic
Jan-01	10.7%	0.9%	13.6%	11.5%
Jan-02	4.7%	-2.6%	9.2%	n.a.
Jan-03	4.9%	-2.8%	8.8%	2.2%
Jan-04	1.7%	-3.8%	4.2%	-1.1%
Sep-04	0.9%	-5.0%	n.a.	n.a.
Sep-05	-0.3%	-5.3%	-0.5%	-4.3%
Sep-06	0.6%	-4.9%	0.0%	n.a.
Sep-07	0.0%	-4.8%	0.1%	n.a.
Sep-08	1.1%	n.a.	0.5%	2.5%

### Changes in charges to September 2009, based on CPI

	Top Tier	Dual Movies	Dual Sports	Big Basic
Jan-01	18.9%	8.3%	22.0%	19.8%
Jan-02	11.0%	3.2%	15.7%	n.a.
Jan-03	9.5%	1.4%	13.5%	6.7%
Jan-04	5.5%	-0.2%	8.1%	2.6%
Sep-04	4.2%	-1.9%	n.a.	n.a.
Sep-05	3.0%	-2.3%	2.8%	-1.2%
Sep-06	3.0%	-2.6%	2.4%	n.a.
Sep-07	1.3%	-3.5%	1.4%	n.a.
Sep-08	2.1%	n.a.	1.4%	3.4%

## **Annex 3**

### **Will Sky One's revamp draw in viewers?**

#### **Campaign, 03 September 2004**

<http://www.campaignlive.co.uk/news/221181/Media-Forum-Will-Sky-Ones-revamp-draw-viewers/?DCMP=ILC-SEARCH>

Sky One is not attracting enough viewers, so its revamp and high-profile new shows need to work hard. The first round of Sky's major investment programme is kicking in. As competition in the multichannel marketplace increases, its flagship entertainment channel Sky One is hoping to impress audiences and advertisers with a revamped identity and high-profile new shows.

It has pensioned off its trademark orange in favour of a glossier, more upmarket look for its idents. And its autumn schedule includes several US imports and some home-grown commissions.

The critically acclaimed Western, Deadwood, from HBO, tops the list.

The series, set in South Dakota, combines fictional and historical characters.

It stars an almost unrecognisable Ian "Lovejoy" McShane and airs on 21 September.

And Sky One is billing 4400 -where 4,400 abductees are returned by their alien captors - as "the must-see sci-fi series of the year". Meanwhile, the nerd-pleaser Battlestar Galactica has been refreshed to appeal "beyond the sci-fi genre". In other words, girlfriends might not switch off.

The autumn schedule also includes the UK-produced supernatural drama Hex and Long Way Round, a motorbike journey around the world with Ewan McGregor, alongside familiar Sky One fare such as Dream Team.

A football reality show, called The Match, launches in October. Presented by Ulrika Jonsson and Mark Durden-Smith, it features celebrities living and training at Newcastle United's Football Academy.

The big question is whether Sky One's shiny new shows can improve the channel's fortunes. Barb figures show that in July its share of viewing in multichannel homes was 2 per cent, down from 2.8 per cent the previous year. There are concerns that this difficulty in attracting audiences will cost Sky in its dealings with advertisers.

But James Baker, Sky One's controller, is confident. "We've put together a stack of shows I'm really proud of," he says.

And this is just the beginning, according to Baker. "We have opted to focus on quality. After two weeks of Nip/Tuck, we brought in an audience of nearly a million people who used to watch Friends and ER on Sky One and had forgotten about the channel.



Now we're looking at shows that can bring in more women. We need to explore the notion of being a premium entertainment channel by building a combination of shows. With Deadwood and 4400, we have a good start."

Yet there's no point in having great shows if poor scheduling prevents them from reaching the audiences for which they're intended. Mark Jarvis, the head of media at Carat, thinks that Sky One tends to shoot itself in the foot: "HBO has a track record of producing high quality programming such as The Sopranos, but whether HBO shows will translate into an immediate audience uplift for Sky One depends on scheduling. Sky spent an awful lot of money on marketing 24, but then moved it from Sunday night. Thursday night at 10pm is never going to attract the same kind of audience."

There might be another problem. Channels such as E4 have, to some degree, stolen Sky One's lunch by bidding for the hot US imports. "There's no doubt that Sky One's programme acquisition strategy has struggled in the face of much stronger competition from other channels," Jarvis says.

Freeview has been a particular thorn in Sky One's side. Viewers are now accessing multichannel through a one-off payment but Sky One isn't on the platform. Bernard Balderston, the associate media director at Procter & Gamble, says: "Freeview has made significant platform gains and is progressing much faster than Sky One.

Sky has elected not to put Sky One on to the platform and I don't think it will. James Murdoch has set a target of ten million Sky households by 2010 and Sky needs to consider that as a major objective. So they don't want to put a subscription-led channel on to a platform which is effectively free. But if people are going to pay for TV, you have to provide an attractive product."

And Sky is clearly hoping that the new programming will make it a more enticing channel. Nick Theakstone, the managing director of Group M, says: "At the moment, Sky One is not a good enough reason to buy Sky.

Sky needs to increase the channel's profile in terms of producing talked-about television.

"Sky One has tremendous potential, but it's not living up to its full capacity because it's not delivering quality programmes or ratings. They've been given long enough to deliver on Sky One. Now it's time to come up trumps."

- "I'd love to think that in two years' time, people will say 'did you see that show on Sky One? It's great. Check it out.' We need to explore the notion of being a premium entertainment channel and we want to trickle in an older, more aspirational audience."

- James Baker controller, Sky One

- "The new look is about focusing a marketing effort toward a different set of people. Penetration levels have been flattening off and a significant proportion of the population don't have Sky. The new look and schedule have to go with an increased subscriptions drive."

- Mark Jarvis head of media, Carat

- "A healthy Sky One is important for advertisers because more people are in multichannel homes and Sky One is the main channel for targeting female viewers. If Sky One doesn't get it right, it'll keep trying. There's a major commitment to making it work."

- Bernard Balderston associate media director, P&G

- "Everyone wants Sky One to deliver and we're hoping that some of these programmes will do that. The multichannel world is becoming increasingly competitive. Autumn 2004 is a key period and we'll be looking closely to see how successful it is."

- Nick Theakstone managing director, Group M.

## **Annex 4**

### **Sky wins 192,000 new subscribers**

**DTG News, 2 February 2005**

<http://www.dtg.org.uk/news/news.php?id=615>

BSkyB has unveiled its eagerly awaited second-quarter results showing a much larger-than-expected rise in subscribers and 25% increase in half-year operating profits.

The UK's dominant pay-TV provider added 192,000 new subscribers in the three months to December 31, boosted by its 'what do you want to watch?' marketing campaign. Analysts had forecast a consensus increase of 150,000. The rise takes BSkyB's total direct-to-home (DTH) UK and Ireland subscriber base to 7,609,000.

Half-year operating profits before goodwill came in at £354m while revenues rose 10% to £1.95bn. Profit after tax rose 18% to £154m.

The number of households taking Sky Plus, the personal video recorder service, rose by 168,000 in the second-quarter to 642,000, 8.4% of the total DTH subscriber base. Of those 168,000 new Sky Plus takers, 28% were first-time subscribers to Sky.

Annualised churn - the proportion of subscribers failing to renew when subscriptions fall due - fell 0.3% on the previous quarter to 9.5%. Annualised average revenue per DTH subscriber was £386, up £17 on the year-ago period.

Interviewed by financial web site Cantos, BSkyB chief executive James Murdoch said the results - representing the strongest Christmas quarter in two years - showed Sky had been "able to stimulate demand in the marketplace", in spite of the challenge of Freeview.

He went on: "There has been a huge amount of work going on in terms of really executing our strategy both from a product perspective and from a marketing perspective, as well as the long term strategic initiatives that are going to ensure the durability of this business and really create value for everyone."

Murdoch said he was confident of reaching Sky's target of 8m customers before the end of 2005. The long-standing annualised average revenue per household target of £400 was now "less important to us", but "nonetheless, we expect to make good progress towards that number and we'll be there or thereabouts at the end of the year."

Murdoch said BSkyB was talking to advertising agencies about Sky Plus, and the ability for viewers to fast-forward through advertising breaks. "We talk to a lot of our larger agencies, as well as a number of our larger clients, about it quite a lot. The advertising community, I think, has to really engage with this issue.

"It is starting to engage now as the (Sky Plus) numbers grow. It's important to note that advertising revenue for us is about 8% of our total revenue. But it's a very, very

important part of our revenue as well. So we work with advertisers and we work with agencies to try and figure out ways through this.

"It's really incumbent on us and the marketing community to think about different ways and innovative ways to continue to bring those brands to our customers in a way that resonates with them. I think you'll see more experimentation, you'll see more things like interactive advertising, direct. You'll see us working with advertisers in innovative ways to reach our customers and really enhance what they're already buying from us, in terms of just the pure television advertising stream."

On Freeview, Murdoch said the free-to-view digital terrestrial platform was "having an impact and will continue to have an impact". Murdoch added he was closely watching the roll-out of video-on-demand services by cable operators ntl and Telewest. "I think that the marketplace has always been competitive and it will continue to be competitive. The onus is really on us to be able to continue to innovate, to put great products in our customers hands at great prices. And I think we'll be able to do that."

## **Annex 5**

### **BSkyB to offer Freeview alternative in bid to stop falling shares**

The Sunday Herald, 8 August 2004

[http://findarticles.com/p/articles/mi\\_qn4156/is\\_20040808/ai\\_n12589990/](http://findarticles.com/p/articles/mi_qn4156/is_20040808/ai_n12589990/)

BSKYB's profits and share price were like two Red Arrows hurtling in opposite directions last week as the satellite operator announced a change of strategy to turn around another disappointing set of subscriber growth figures.

Despite a profits hike of 65% to (pounds) 600 million the company's shares plunged by more than a pound to 488p on the news that Sky attracted just 81,000 new customers in the second quarter of the year. This means that the combined total growth for the first half was lower than any individual quarter last year. Investors who have questioned the appointment of James Murdoch as chief executive since he arrived last November seem to be gathering support.

So what is going on? Is Sky, conqueror of BSB, ITV Digital and digital cable running out of steam? In terms of current strategy, the cautious answer seems to be yes. Sky has attracted 147,000 new subscribers in the first half of the year, compared with more than 500,000 in the same period last year. If Sky believed this was a blip, it's unlikely it would undergo a shift in strategy.

The main reason for the slowdown is probably Freeview. The digital terrestrial platform, which is backed by the BBC and supported by Sky and the transmitter company Crown Castle, has taken the UK by storm since it emerged in autumn 2002.

Customers can get access to 26 digital channels and numerous radio stations by buying a (pounds) 50 decoder on the high street. In under two years, they have found their way into around four million homes, and if the rate of growth continues Freeview will be in more homes than Sky (currently 7.4 million) by 2007.

As Ben McOwen Wilson, partner at Spectrum Strategy, said, Freeview is becoming a major fly in Sky's ointment. "The growth of Freeview has surprised everybody, including Sky, and their concern is that a house that goes Freeview will see no need to turn to Sky in the medium or long term." The recent subscriber figures suggest this is happening already.

From October, Sky will be responding by marketing a free satellite service, with the working title of Freesat. For (pounds) 150, customers will get a dish, encryption card and installation of the service, consisting of more than 100 TV channels, including most of the Freeview offering. There is also a raft of radio channels and interactive services, and, like Freeview, once people make the initial purchase there will be nothing else to pay.

What you won't read in the marketing bumf is that this is mostly old rope. If you buy a dish, which Sky currently sells and installs for (pounds) 120, you can already get most

of the TV and radio channels that will comprise Freesat, with no obligation to pay a monthly subscription to any additional Sky packages.

The main differences with the new deal will be the interactive services and access to the digital versions of ITV, Channel 4 and Five, which are only available on digital satellite if you take a Sky package. Otherwise, this is just a sales push.

McOwen Wilson says that Sky's logic is twofold. "First, it will slow the growth of Freeview. Second, it gives [Sky] a new potential entry level product for a new group of customers."

Sky has said that at first, it will only market Freesat to areas where Freeview is either not available (25% of homes) or requires a new aerial (another 25%). In other words, Sky's very un-Sky-like strategy is to avoid going head to head with the competition.

Sky spokesman Robert Fraser said: "We think that a focused roll- out will enable us to assess the attractiveness of the product to consumers and manage our supply chain effectivity."

At first sight, this seems an odd decision. Most of the 25% of the country in which Freeview is not available will stay out of range until analogue switch-off, planned for 2012. Surely Sky would be better to sell Freesat to potential Freeview customers and then Hoover up the rest at a later date?

Maybe so, but the City is in no mood for a war of attrition. "I think what they want is a strong success story early on," said McOwen Wilson. "Going head to head with Freeview is an expensive and difficult way to get those subscribers. Going elsewhere means you are going to get that growth very quickly."

But remember this is only half the battle. Assuming the marketing strategy is right, it will only be a success if Sky can persuade enough customers to migrate to its pay-TV packages.

Sky predicts that 80% of homes will have moved to pay-TV of one sort or another by the time the market matures in 15 years. It points out that this has happened in the US, and that a far higher proportion of younger consumers subscribe to packages than the over- 55s. The hope is that the 20 and 30-somethings will stay with pay-TV as they get older and the market will expand.

Sky sees Freesat as a Trojan horse that can help bring this about. If it is wrong, there will be more bad days at the stock exchange to come, and James Murdoch might end up wishing his father had assigned him to a different part of the NewsCorp empire.