Proposed BSkyB Digital Terrestrial Television Services

Second consultation on Sky's 'Picnic' proposal

Consultation

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Section 1

Executive summary

Introduction

1.1 National Grid Wireless Ltd (which has traded under the name "Arqiva" since 22 September) and British Sky Broadcasting Ltd (Sky) have applied to remove the three free to air (FTA) channels that Sky currently provides on digital terrestrial television (DTT). These would be replaced with five pay TV channels as part of Sky's "Picnic" service[1]. We published a consultation document on this proposal on 4 October 2007.

1.2 In parallel with our consideration of the proposal we have been carrying out a wider investigation into the pay TV sector, and we published a consultation document as part of that investigation on 18 December 2007. As noted in our news release of 13 May 2008[2], there are issues raised by the Sky/Arqiva proposal, such as access to premium content, that inform our wider pay TV market investigation and vice versa. In addition to this document, we are therefore also publishing today a further consultation in respect of our pay TV market investigation[3].

1.3 In the context of our pay TV investigation, we are consulting on a view that Sky has market power in separate wholesale markets for premium sports and movies channels, and that it is likely to exploit that market power by limiting the distribution of those channels to other retailers. We are further consulting on a proposal to address our concerns by requiring Sky to wholesale premium channels on regulated terms. In the light of these views we reach the view in this document that it is highly unlikely that any competitor would be able to compete effectively with Picnic in the absence of a wholesale arrangement.

1.4 Our conclusion in this document, on which we are consulting, is therefore that we are most likely to fulfil our regulatory duties by consenting to the proposal but only subject to effective fulfilment of certain conditions. This approach would seek to gain the benefits of greater choice in premium sports and movies on DTT, whilst ensuring fair and effective competition in pay TV. We are therefore also consulting on the potential use of the following conditions:

- A **wholesale must-offer arrangement**, under which Sky would be required to supply its premium sports and movies channels on a suitable wholesale basis which is commercially viable, in particular, subject to certain conditions in relation to wholesale pricing.

- The **use of simulcrypt**, under which other retailers of pay TV services on DTT, using different conditional access systems, could access Sky's premium sports

[1] Sky currently provides *Sky News, Sky Sports News* and *Sky Three* on a FTA basis. These would be replaced by *Sky Sports 1*, *Sky Movies Screen1* (in the evening) and *Sky One* (in the evening, including an hour of *Sky News* content). In addition, the remainder of Sky's capacity would be used by Sky to retail two further pay TV channels in the daytime: *Discovery Channel* and *Disney Channel*. The proposed Picnic service would not be compatible with any existing set-top boxes. Consumers would therefore need a new set-top box to receive these pay TV channels.
[2] The news release can be found at: http://www.londonstockexchange.com/LSECWS/IFSPages/MarketNewsPopup.aspx?id=1838680&source=RNS.
[3] The consultation can be found on our website at http://www.ofcom.org.uk/tv/paytv/.

and movies channels without needing to transmit the same channels more than once, subject to suitable security requirements.

- **Ancillary conditions**, which would focus on our intended outcome for competition and consumers by ensuring that a wholesale must-offer arrangement is not easily manipulated to be ineffective, but commercially and technically workable.

1.5 Some stakeholders have expressed concern to us regarding various advantages which Sky has as a retailer, which could not fully be addressed either by a wholesale must-offer arrangement, or by any other conditions of which we are aware. These stakeholders have therefore argued that Sky should not be permitted to retail pay TV services on DTT, even after the introduction of effective wholesale must-offer arrangements and related conditions. Our view is that a number of the advantages which have been cited (e.g. Sky's brand strength) are not unique to Sky and do not justify ex ante intervention. Some of the concerns, such as Sky's ability to influence manufacturers and retailers of set-top boxes, are more specific to Sky. However, the available evidence does not justify what would effectively be a blanket prohibition on Sky retailing on DTT.

Our October 2007 consultation

1.6 The proposal must be considered in the context of our regulatory duties and principles. In particular, we have a principal duty to further the interests of citizens and consumers, where appropriate by promoting competition. In light of this principal duty, and the significant competition issues raised by the proposal, we published a consultation document on 4 October 2007.

1.7 DTT, primarily driven by the popularity of Freeview, is widely regarded as a success story. By the end of March 2008, DTT had become the most common means of receiving television with almost 40 per cent of all TV sets being DTT-enabled, and more households receiving digital TV services via DTT than via satellite or cable. However, in comparison to satellite and cable, the provision of pay TV services on DTT is still emerging. The development of these services is still uncertain, especially at a time of significant technical evolution and service innovation with a number of issues to consider in the near future, including: digital switchover and the use of the released spectrum, a possible move to different technical transmission standards (e.g. MPEG4 and DVB-T2), and the introduction of high definition services. The evolution of DTT is therefore reaching a significant transition point.

1.8 Our preliminary view was that the launch of a Sky pay TV service on DTT, offering premium sports and movies, would have an immediate, positive effect on the choice and availability of retail pay TV services on DTT. However, we also expressed some concerns. The critical stage in the development of pay TV on DTT provides an opportunity for a pay TV provider on DTT to emerge to compete with existing providers on satellite and cable. If, as a result of Sky’s position in the wholesale provision of sports and movies channels, the proposal was to lead instead to Sky becoming the main provider of pay TV services on DTT as well as satellite, this in turn might lead to be the source of significant concern and potential consumer detriment in the long term.

1.9 Given the concerns raised, and the uncertainty about the development of DTT and the impact of the proposal, we identified the following options for consultation:

- Option 1: consent to the proposal unconditionally, relying on our ex post competition powers.
- Option 2: consent to the proposal subject to additional ex ante conditions, such as requiring Sky to make its channels available to other retailers on a wholesale basis.
- Option 3: not to consent to the proposal under any conditions.

Responses to the October consultation and our preliminary conclusions

1.10 In total, we received 450 responses to our October consultation: 426 responses from members of the public and 24 responses from organisations[4]. As a brief overview:

- About 87 per cent of the 426 individuals who responded said we should not consent to the proposal under any circumstances.
- Sky was the only organisation which said explicitly that we should consent to the proposal unconditionally.
- The majority of the other organisations (including all of Sky's retail competitors) said that we should not consent to the proposal, or consent to it only if appropriate ex ante conditions were imposed on Sky.
- Most organisations also said that we need to consider the proposal alongside our wider pay TV market investigation.

1.11 The issues raised in the responses can be considered in four specific areas: (i) access to content, (ii) Sky as a retailer of pay TV services, (iii) technical platform services, and (iv) other policy considerations.

Access to content

1.12 In October 2007 we expressed a concern that if Picnic was to launch on DTT it could become very difficult for competing pay TV retailers to gain or retain consumers, without similar access to Sky's sports and movies content. Stakeholder views were highly polarised on this issue. Sky said that there is a single "all TV" market which encompasses all sorts of audiovisual content, and hence the proposal would not significantly change the dynamics of competition. In contrast, most other respondents said that premium content was distinct from other TV content, and ownership of premium content such as sports and movies has provided Sky with enduring market power.

1.13 In our pay TV market investigation our current view for consultation is that some pay TV content is of particular importance: live Premier League football and first-run blockbuster movies have an especially wide appeal, and are not available via FTA TV. We consider that channels containing these types of content ("Core Premium channels") are in their own narrow wholesale markets and that Sky has market power in those markets. Given this view, we consider it is highly unlikely that any retailer of pay TV services on DTT would be able to compete effectively with Picnic in the absence of the wholesale supply of Sky's Core Premium channels.

[4] All of the non-confidential responses to our October consultation can be found on our website at: http://www.ofcom.org.uk/consult/condocs/dtv/responses/.

1.14 In the context of our pay TV investigation, we are consulting on a view that a wholesale must-offer arrangement, under which Sky would be obliged to supply its Core Premium channels on a suitable wholesale basis, would be the most appropriate solution to the competition concerns raised. This would seek to create an environment to promote fair and effective competition. We are consulting in this document on a view that such an arrangement would also address the competition concerns raised by this proposal.

1.15 In order for such a wholesale supply arrangement to work effectively in the context of this proposal, some particular conditions may be appropriate to ensure competitors' set-top boxes can receive the sports and movies channels, and to provide the right incentives to Sky and its competitors to achieve the intended outcomes.

1.16 In particular, we consider the use of simulcrypt would be appropriate to avoid using scarce capacity to transmit the same channels more than once. Simulcrypt enables the same channel to be broadcast with more than one conditional access system, which would allow both competitors' existing set-top boxes, as well as Picnic compatible boxes, to receive these wholesale channels.

1.17 In addition, it may be appropriate to impose ancillary conditions which provide incentives to implement a wholesale must-offer arrangement which is both commercially and technically viable, in a timely fashion. Our current view is that it is impossible in advance to identify comprehensively the types of behaviour which Sky might engage in to reduce the effectiveness of any wholesale must-offer arrangement. We recognise that third party retailers may also have an incentive to reduce the effectiveness of any wholesale must-offer arrangement. We therefore consider that it would be better to impose ancillary conditions which focus on delivering the intended outcome for competition and consumers rather than attempt to address a wide range of potential behaviours. Examples of such types of conditions may include a requirement that Picnic may not commence service until:

- A local simulcrypting trial involving Sky, Arqiva and one or more prospective third party retailers is carried out to the satisfaction of Ofcom and the relevant parties.

- At least one third party retailer is in a position to start retailing the wholesale channels.

- A short defined time period has elapsed following (i) the launch of a competing pay DTT service that includes at least one of the wholesale channels or (ii) the satisfactory completion of a local simulcrypting trial.

- Sky has achieved a specified number of wholesale DTT subscribers, defined to be subscribers of retail competitors on DTT who include at least one of the wholesale channels as part of their subscription.

1.18 Given our objective of finding the least intrusive means of achieving our intended outcomes, we encourage stakeholders to explain why any recommended ancillary condition would be necessary and why there would be no other practicable and less restrictive means of addressing the concern in question.

Sky as a retailer of pay TV services

1.19 A number of organisations told us that Sky (or possibly related News Corporation companies) would have the incentive and ability to restrict the take up of competitors' set-top boxes and services in order to become the sole retailer of pay TV services on

DTT. Sky told us that it intends to foster a contestable market for the supply of Picnic compatible set-top boxes by any manufacturer that could meet Sky's technical specifications, replicating the model for existing Freeview set-top boxes.

1.20 We do have concerns about the issues which could arise from Sky's position as a major purchaser of satellite set-top boxes and its relationship with retailers. However, at this stage, we have not been presented with convincing evidence to support the proposition that any anti-competitive activities would be likely to occur or would deny Sky's retail competitors access to potential subscribers. Of the activities highlighted by stakeholders, which could be used to gain competitive advantage, the majority do not appear to be unique to Sky. Other competitors could adopt similar practices, and it is not clear that these activities are in themselves undesirable. We also consider that putting in place arrangements to offer retail competitors access to Sky's premium content could, in principle, address some of the objections to Sky retailing on DTT.

1.21 Given the availability of our ex post competition powers, we consider there is insufficient evidence to justify ex ante intervention to prohibit Sky from retailing pay TV services on DTT.

Technical platform services

1.22 In our October consultation we recognised that the proposed use of set-top boxes incompatible with existing DTT pay TV services could ultimately result in Sky controlling access to technical platform services on DTT. Many respondents said this was a genuine concern and some said we should mandate the use of standards compatible with those already in use on DTT. Sky told us that it intends to promote an environment where, in principle, any manufacturer could build and supply Picnic compatible set-top boxes, subject to meeting Sky's technical specifications. It also said that it would provide technical platform services to broadcasters of other pay DTT channels, subject to a number of conditions.

1.23 We would be concerned if Sky leveraged its market power in the wholesale provision of premium content in order to gain control over technical platform services on DTT. However, we consider a suitable arrangement where competitors could gain access to Sky's premium channels would address this concern since it would then be possible to watch these sports and movies channels on a competitor's DTT platform, and not only on Sky's DTT platform.

Other policy considerations

1.24 In October 2007 we said we would be concerned if the proposal had a detrimental effect on the appeal of Freeview by significantly reducing the number of FTA channels, impeding the take up of digital television in the lead up to digital switchover, or causing consumer confusion over different types of DTT set-top boxes. Our preliminary view was that this was unlikely; a view shared by Sky. While most other organisations agreed that it was unlikely to have a detrimental effect on Freeview, they had greater concern about consumer confusion and Sky's continued presence on the board of Digital Television Services Limited (which manages Freeview) if it no longer had any FTA channels but replaced these with a competing pay TV offering. In contrast, 75 per cent of individuals who responded said that the removal of Sky's existing FTA channels would significantly harm Freeview, and over 60 per cent said they thought the proposal might lead to, or increase, consumer confusion.

1.25 While we recognise there may be issues about the plurality of news provision, our view at this stage is that the current proposal is unlikely to have a significant adverse impact on DSO or the popularity of Freeview with consumers. While the proposal will lead to greater choice, and potentially complexity, for consumers when they decide what set-top boxes and TVs to buy, a degree of greater complexity may be an inevitable and acceptable consequence of increased competition and innovation.

1.26 We do have a concern over Sky's position on the board of Digital Television Services Limited under the proposal, given its interests may be increasingly misaligned with those of Freeview as both services develop further. However, at this stage we would be cautious about pursuing a regulatory remedy without allowing the opportunity for a commercial resolution to be agreed.

Section 2

Introduction

Context

2.1 On 4 October 2007, we published a consultation (the "**October consultation**") entitled "*Proposed BSkyB digital terrestrial television services*" on a proposal (the "**Proposal**") by British Sky Broadcasting Ltd ("**Sky**") and National Grid Wireless Limited, which has since changed its name to Arqiva[5] ("**Arqiva**"), to replace Sky's existing free-to-air ("**FTA**") channels with pay television services over digital terrestrial television ("**DTT**")[6].

2.2 In the October consultation we set out our initial views on the impact of the Proposal on competition in the pay TV sector and in relation to the development of DTT. While recognising that the Proposal has some consumer benefits, we also considered that it raises competition concerns. We therefore sought comments on these views and on whether the Proposal should be approved unconditionally, approved with conditions or rejected.

2.3 The purpose of this consultation is to seek stakeholders' comments on our current views and recommendations in respect of the Proposal.

Our assessment of the Proposal to date

2.4 In order to provide maximum clarity to readers, we describe in chronological order below the key documents relating to our assessment of the Proposal.

- On 8 February 2007, Sky issued a press statement (the "**February 2007 announcement**") announcing its intention to replace its three FTA DTT channels with subscription channels[7].
- On 16 February 2007, we issued a press statement regarding the February 2007 announcement, noting that we would consult on the Proposal when we received a request for approval from Sky and Arqiva[8].
- On 17 April 2007, Sky submitted an application (the "**Sky Application**") to us to vary its Digital Television Programme Service ("**DTPS**") licences.
- On 30 April 2007, Arqiva submitted an application (the "**Arqiva Application**") to us to vary its multiplex C licence (the Sky Application and the Arqiva Application are together referred to as the "**Applications**").
- On 26 June 2007, following requests for further information, we announced that we had been provided with sufficient information from Sky and Arqiva to

[5] At the beginning of September Arqiva received approval from the Competition Commission for its merger with National Grid Wireless Limited. From 22 September 2008 National Grid Wireless Limited and its group companies traded under Arqiva brand names.
[6] http://www.ofcom.org.uk/consult/condocs/dtv/condoc_dtv.pdf
[7] http://phx.corporate-ir.net/phoenix.zhtml?c=104016&p=irol-newsArticle&ID=960773&highlight
[8] http://www.ofcom.org.uk/media/news/2007/02/nr_20070216

commence our assessment of the Proposal and that we intended to consult on the competition issues raised by the Applications[9].

- On 4 October 2007 we published our October consultation. The consultation period closed on 14 December 2007[10].

- Between October 2007 and February 2008 we received 450 responses to our October consultation[11].

- On 13 May 2008, we announced that as there are issues raised by the Proposal that inform our wider pay TV market investigation ("**MI**") and vice versa, we would publish a further consultation document on each subject simultaneously by the end of summer 2008[12].

- Today we are publishing this consultation and a further consultation on our MI (the "**second MI consultation**").

2.5 In paragraph 2.12 of our second MI consultation, we describe in chronological order the documents we have published in respect of our MI.

The Proposal

2.6 Sky currently broadcasts three channels on multiplex C on DTT: *Sky News; Sky Sports News* and *Sky Three*. Under the Proposal, part of Sky's "Picnic" entertainment and communications service (announced on 1 October 2007), these three channels would be replaced with five channels as follows:

- *Sky Sports 1*: the same channel broadcast as *Sky Sports 1* on digital satellite ("**DSat**") including live coverage of Football Association Premier League ("**FAPL**") football matches, broadcast 24 hours a day, seven days a week.

- *Sky Movies Screen1*: the same content as *Sky Movies Screen1* on DSat comprising a selection of recent movies covering different genres, broadcast between 6.00pm and 6.00am.

- *Sky One*: a simulcast of the general entertainment *Sky One* channel which is already available on DSat broadcast from 7.00pm to 6.00am, together with one hour of *Sky News* content scheduled between the hours of 6.00pm to 7.00pm daily, up to seven days a week.

- *Discovery Channel* [13], which will be broadcast between the hours of 6.00am and 6.00pm , seven days a week.

- *Disney Channel*, which will be broadcast between the hours of 6.00am and 6.00pm, seven days a week[14].

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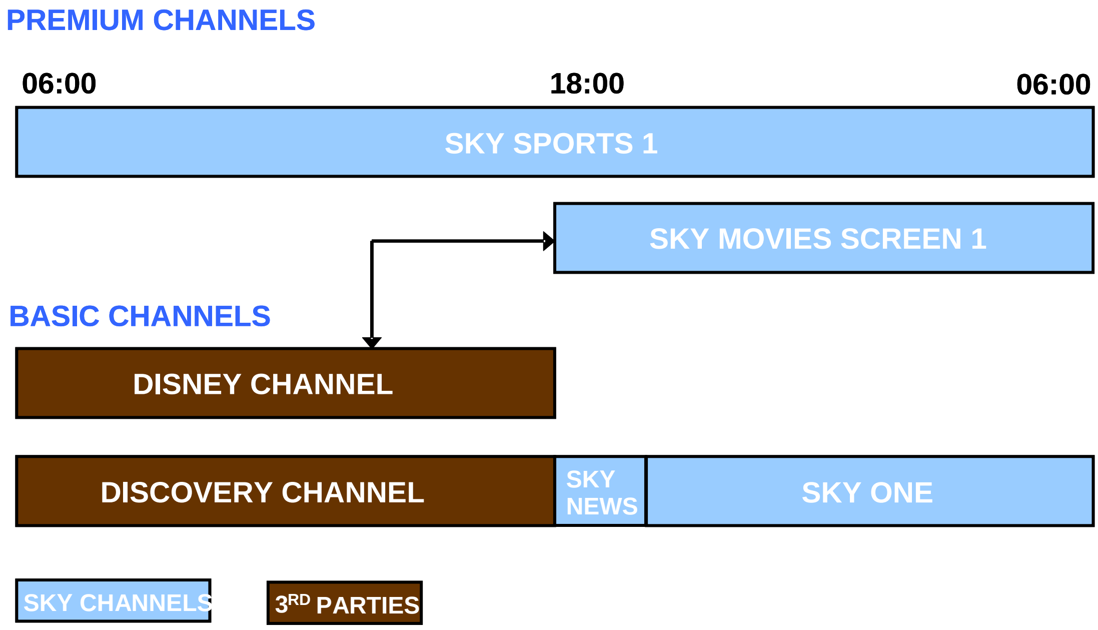
[9] Ofcom made an initial announcement on 16 February 2007 which, amongst other things, envisaged that competition issues raised by an application from Sky would be subject to consultation.
[10] http://www.ofcom.org.uk/consult/condocs/dtv/
[11] All non-confidential responses to our October consultation can be found on our website at http://www.ofcom.org.uk/consult/condocs/dtv/responses/.
[12] http://www.londonstockexchange.com/LSECWS/IFSPages/MarketNewsPopup.aspx?id=1838680&source=RNS
[13] Sky did not announce the inclusion of *Discovery Channel* and *Disney Channel* until after the publication of our October consultation.

2.7 The Proposal is illustrated in the diagram below (which is based on a similar diagram provided to us by Sky).



2.8 Under the Proposal, only those viewers that had been appropriately authorised would be able to access the Picnic channels. To prevent unauthorised viewing, the channels would be protected using conditional access ("**CA**") technology. This comprises scrambling and encryption technologies that allow a broadcaster to restrict reception of its digital channels to consumers who have been authorised to view them. Typically it is used by pay TV operators to protect subscription and pay per view revenues. Consumers would need a set-top box ("**STB**") that supported the relevant CA technology in order to gain access to the channels. Choice of CA technology is therefore an important component of the Proposal.

2.9 Sky is proposing to use CA technology supplied by NDS Group plc ("**NDS**")[15], which is used by broadcasters around the world to encrypt pay TV services. NDS is different from the CA technology used by existing pay TV services on DTT in the UK, who all use CA technology supplied by Nagra France ("**Nagra**"), a company which is part of the Kudelski Group[16].

2.10 Sky and Arqiva require consent from us before they are able to implement the Proposal.

[14] Sky announced in its press release of 1 October 2007 that it initially expects the children's channel to commence broadcasts daily at 6.00am, but will have the flexibility to commence its DTT broadcasts as early as 3.00am, when the *Sky Movies Screen1* service usually ends its daily schedule.

[15] A company headquartered in the UK which develops and supplies digital rights management and CA products. Its shareholders are Permira with a 51 per cent stake and News Corporation with a 49 per cent stake.

[16] A Swiss corporation which operates in the business areas of digital TV, public access and audio products.

The October consultation

2.11 We consulted on the Proposal because it raised a number of potentially significant competition issues. We also consulted on the impact of the Proposal on digital switchover ("**DSO**"), Freeview and consumer confusion.

2.12 Our October consultation outlined three approaches in response to the Proposal:

- Consent to the Proposal unconditionally, relying on our ex post competition powers ("**Option 1**").
- Consent to the Proposal subject to additional ex ante conditions, such as requiring Sky to make its channels available to other retailers on a wholesale basis ("**Option 2**").
- Not to consent to the Proposal under any conditions ("**Option 3**").

2.13 In total, we received 450 responses to our October consultation: 426 responses from members of the public (of which 142 are confidential) and 24 responses from organisations (of which 5 are confidential). We are grateful for all responses, which we have considered carefully in reaching our current views. We summarise the responses received in Sections 3 and 4 and Annexes 5, 6 and 7. By way of brief overview:

- About 87 per cent of the 426 individuals that responded to the October consultation said that we should not consent to the Proposal.
- Sky was the only organisation which said explicitly that we should consent to the Proposal unconditionally.
- The majority of the other organisations that responded (including all of Sky's retail competitors) said that we should not consent to the Proposal or consent to it only if appropriate ex ante conditions are imposed on Sky.
- Most organisations said that we need to consider the Proposal alongside our MI.

2.14 We recognise that the publication of this consultation comes almost a year after the publication of our October consultation. As noted in our news release of 13 May 2008, there are issues raised by the Proposal, such as access to premium content, that inform our MI and vice versa. We therefore decided to publish a further consultation document on each subject simultaneously.

The legal framework

2.15 Paragraphs 2.9 to 2.15 of our October consultation explained our process and the legal framework for assessing the Proposal. The Proposal raises significant competition issues relating both to competition on DTT and across a broader set of digital television platforms[17]. Those issues were therefore consulted on in the light of our statutory duties, and in particular our principal duty under section 3(1)(b) CA03 2003 ("**CA03**") to "further the interests of consumers, where appropriate by promoting competition".

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

2.16 The issues raised by the Proposal give rise to concerns as to whether, in the relevant markets identified, the interests of consumers are being, or will be, well served by the operation of competition. In Section 3 we explain the markets which we consider to be relevant to our analysis of the Proposal. The duty at section 3(1)(b) establishes that we are required, where appropriate, to take a dynamic and forward-looking view of the effectiveness with which competition is expected to deliver benefits to consumers. In this consultation we carry out that assessment by reference to the statutory framework. Our principal duty also establishes that if we identify that the interests of consumers are not being, or will not be, furthered by the operation of competition in the relevant markets, we should, where appropriate, act in order to promote competition.

2.17 In its response Sky commented in detail on the application of our duties to the assessment of the Proposal. We therefore set out at Annex 5 a detailed description of the relevant duties in the context of Sky's comments.

2.18 As explained at paragraphs 3.2 to 3.12 of the October consultation, there is a particular sectoral competition regime which applies to the consideration of competition issues in the broadcasting sector. This is set out at sections 316 to 318 CA03. In particular section 316(1) provides that:

"*The regulatory regime for every licensed service includes the conditions (if any) that Ofcom consider appropriate for ensuring fair and effective competition in the provision of licensed services or of connected services*".

2.19 Under section 316(4) "licensed services" means any service licensed by a Broadcasting Act 1990 or Broadcasting Act 1996 ("**Broadcasting Act**") licence. The term "connected services" is defined broadly: "in relation to licensed services, it means the provision of programmes for inclusion in licensed services and any other services provided for purposes connected with, or with the provision of, licensed services".

2.20 In relation to the broadcasting sector there is therefore a relationship between the principal duty at section 3(1)(b) (to further the interests of consumers, where appropriate by promoting competition) and the particular concept of "ensuring fair and effective competition" pursuant to section 316(1). Section 316 provides the ability for Ofcom to intervene on an ex ante basis where this is appropriate.

2.21 Pursuant to this sectoral regime all Broadcasting Act licences include standard conditions concerning fair and effective competition. The relevant conditions in the licences held by Arqiva and Sky are as follows:

- Condition 11(1) of the multiplex C licence contains a general "fair and effective" competition clause based on section 316 CA03. It requires that Arqiva shall:

  "(a) not enter into or maintain any arrangement, or engage in any practice, which is prejudicial to fair and effective competition in the provision of licensed services or of connected services; and

  (b) comply with any code or guidance for the time being approved by Ofcom for the purpose of ensuring fair and effective competition in the provision of licensed services or of connected services; and

  (c) comply with any direction given by Ofcom to the Licensee for that purpose.".

- Sky's DTPS licences also contain a general fair and effective competition clause which mirrors the clause in Condition 11(1) of the multiplex C licence. The provision can be found at Condition 14(1) of the Sky DTPS licences and provides that Sky shall:

  "(a) not enter into or maintain any arrangement, or engage in any practice, which is prejudicial to fair and effective competition in the provision of licensed services or of connected services; and

  (b) comply with any code or guidance for the time being approved by Ofcom for the purpose of ensuring fair and effective competition in the provision of licensed services or of connected services; and

  (c) comply with any direction given by Ofcom to the Licensee for that purpose.".

2.22 These provisions are based on the wording of section 316 CA03, and in particular provide us with the power to issue codes, guidance and directions "for the purpose of ensuring fair and effective competition".

2.23 We also have powers to apply and enforce competition law in relation to the prohibitions under the Competition Act 1998 ("**CA98**") and Articles 81 and 82 of the EC Treaty (together our "**competition powers**"). Under section 317 CA03, where we are considering competition issues we must, before acting pursuant to section 316, consider whether a more appropriate way of proceeding in relation to some or all of the matters in question would be under CA98.

2.24 In following this process, Section 3 sets out our forward-looking views on (i) the markets relevant to the competition assessment and (ii) the competition issues we have identified within those markets relating to the Proposal. Section 4 then addresses the issue of what action we might take in light of the issues identified. With regard to section 317, the question to be addressed is whether it is more appropriate to proceed in relation to the issues identified by reliance on CA98 or if it would be more appropriate to use our sectoral powers under section 316 CA03.

Impact assessment

2.25 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 CA03, which means that generally we have to carry out impact assessments where our proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in our activities. However, as a matter of policy we are committed to carrying out and publishing impact assessments in relation to the great majority of our policy decisions.

2.26 The analysis presented at Sections 3 and 4 and Annex 6, when read in conjunction with the rest of this consultation, represents an impact assessment of the Proposal, as defined in section 7 CA03.

2.27 The analysis represents our preliminary conclusions. We hope that this consultation will elicit comments and information to enable us to refine our assessment of the impact of different options.

2.28 For further information about our approach to impact assessments, see the guidelines, "*Better Policy Making: Ofcom's approach to Impact Assessment*"[18].

How this consultation relates to our pay TV market investigation

2.29 Our assessment of the Proposal is closely linked to our MI. For example, both the assessment of the Proposal and the MI have considered the issue of access to premium content. However, it is important to understand that, while related, they remain separate matters and while progressing these issues in parallel, they will not necessarily follow the same timetable moving forward.

2.30 In this context, the majority of organisations which responded to the October consultation said that we need to consider the Proposal in conjunction with the MI. For example, Setanta Sport Holdings Limited ("**Setanta**") and Top Up TV Europe Limited ("**Top Up TV**") said in their joint response that if we were to consent to the Proposal (with or without conditions) ahead of the completion of the MI, it would have pre-judged the outcome of that investigation. The BBC told us that it would not be prudent to consent to the Proposal until the outcome of the MI is known.

2.31 On 18 December 2007 we published our initial assessment of the operation of the pay TV sector in the UK (the "**December consultation**"). Without reaching any final conclusions, the December consultation raised some competition concerns relating, in particular, to whether vertically-integrated firms have the incentive to make their premium content (such as sports and movies) available to other retailers, and whether the risk of foreclosure could adversely affect the prospects for competition.

2.32 Today we published our second MI consultation. This consultation refers to the relevant parts of our second MI consultation where appropriate and vice versa.

Other related matters

2.33 The issues which we discuss here have links to our other ongoing policy projects and activities – either in relation to DTT, spectrum or broadcasting policy. We mention them and their respective status below.

Digital Television: Enabling New Services

2.34 In our October consultation we referred to expected developments on the DTT platform and to our 3 April 2008 Statement entitled "*Digital Television: Enabling New Services*". Since our October consultation was published the Secretary of State made an Order[19] which provides for the upgrade of multiplex B[20] to use the more efficient technologies MPEG-4 and DVB-T2 and for us to reserve some of the capacity on Multiplex B[21] for new services. The Order also authorises us to reorganise services on DTT which are necessary to accommodate the existing Multiplex B services.

2.35 In July 2008 we invited applications from eligible broadcasters; two applications were received[22]. We will publish our decision once that assessment is completed; we

[18] http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf
[19] 2008 No. 1420, Broadcasting. The Television Multiplex Services (Reservations of Digital Capacity) Order 2008 see: http://www.opsi.gov.uk/si/si2008/uksi_20081420_en_1.
[20] Operated by BBC Free to View Ltd.
[21] The BBC HD service will be carried on one of three initial HD sized slots, the remaining two slots will be allocated by Ofcom – as will a further (fourth) slot once predicted MPEG-4 coding gains are confirmed, possibly in late 2009 or early 2010.
[22] See: http://www.ofcom.org.uk/radiocomms/digital/hd_on_dtt/ita/applications/.

expect that to be this autumn. If we decide to reserve capacity for the proposed services, we will proceed to licence the services as soon as possible. If that is not the case, for example if capacity is only reserved for one service, we will outline both our reasoning and how we intend to proceed.

2.36 In parallel with this capacity allocation process a major programme of work led by the BBC is underway to implement the practical changes required and with the objective of launching the new services on multiplex B in late 2009. Ofcom is supporting the BBC in preparing for a successful launch as soon as practically possible - as are a wide range of stakeholders including the broadcasters, transmission companies, receiver manufacturers, Digital UK and the DTG[23].

TV platform market review

2.37 In October 2006, we announced that we were in the process of conducting a review of wholesale digital television platform markets (the "**platform review**"). This will, among other things, include a determination of which firms, if any, have market power in relation to access to digital television platforms, and what remedies might be appropriate to address any concerns arising from this market power.

2.38 In our December consultation we explained that the more strategic issues which might be considered in the platform review overlap with issues raised in our pay TV MI and therefore we had decided to give priority to the MI with a view to restarting the platform review once there is greater clarity as to the likely range of outcomes of the MI.

2.39 The platform review is relevant to the current Proposal because it will consider whether operators of pay TV platforms on DTT will be required to provide access to their platform on regulated terms.

Digital Dividend Review

2.40 The process of DSO began in Cumbria in 2007 and will continue on a region by region basis through to 2012. The radio spectrum freed up by the cessation of analogue television broadcasts for new uses is known as the "digital dividend". After conducting a review of policy options, we decided in December 2007 that the bulk of the digital dividend spectrum should be released on a technology and service neutral basis by way of an auction.

2.41 The released spectrum is suitable for a number of applications including mobile TV and wireless broadband. It could also be used to provide additional digital terrestrial television services and hence it is relevant to our consideration of the Proposal.

2.42 We are conducting a number of consultations in 2008 as part of our digital dividend review ("**DDR**") including the proposed timing of spectrum awards and the structure of the auction process[24].

Structure of this document

2.43 The remainder of this document is structured as follows:

[23] For further information see: http://www.ofcom.org.uk/radiocomms/digital/hd_on_dtt/.
[24] Details can be found on our website at http://www.ofcom.org.uk/radiocomms/ddr/documents/.

- Section 3 summarises the responses which we received to our October consultation and our current thinking on the concerns which we raised in respect of the Proposal.

- Section 4 sets out for consultation our recommended solutions to our ongoing concerns in respect of the Proposal.

- Annexes 1 to 8 set out further material relevant to the consultation including a key part of our impact assessment, a consideration of our legal duties and a summary of responses to our October consultation.

2.44 This is the non-confidential version of this document. Confidential information and data have been redacted. Redactions are indicated by "**[✂]**".

Section 3

Assessment of responses to our October consultation

Overview

3.1 This Section provides our current views on the responses to our October consultation. All responses received, views expressed and questions raised during our consultation have been assessed against our statutory duties as discussed in Section 2 and Annex 5.

3.2 Our October consultation set out a number of proposals on which we invited comments. We received 450 responses to our consultation (of which 147 are confidential) and would like to thank all those who contributed their views. We published the non-confidential responses on our website[25] and have taken comments received into account in our subsequent analysis. We have also held discussions with stakeholders[26] (including some organisations that wish to remain anonymous) which has helped inform our consideration of the issues raised.

Background

Market structure

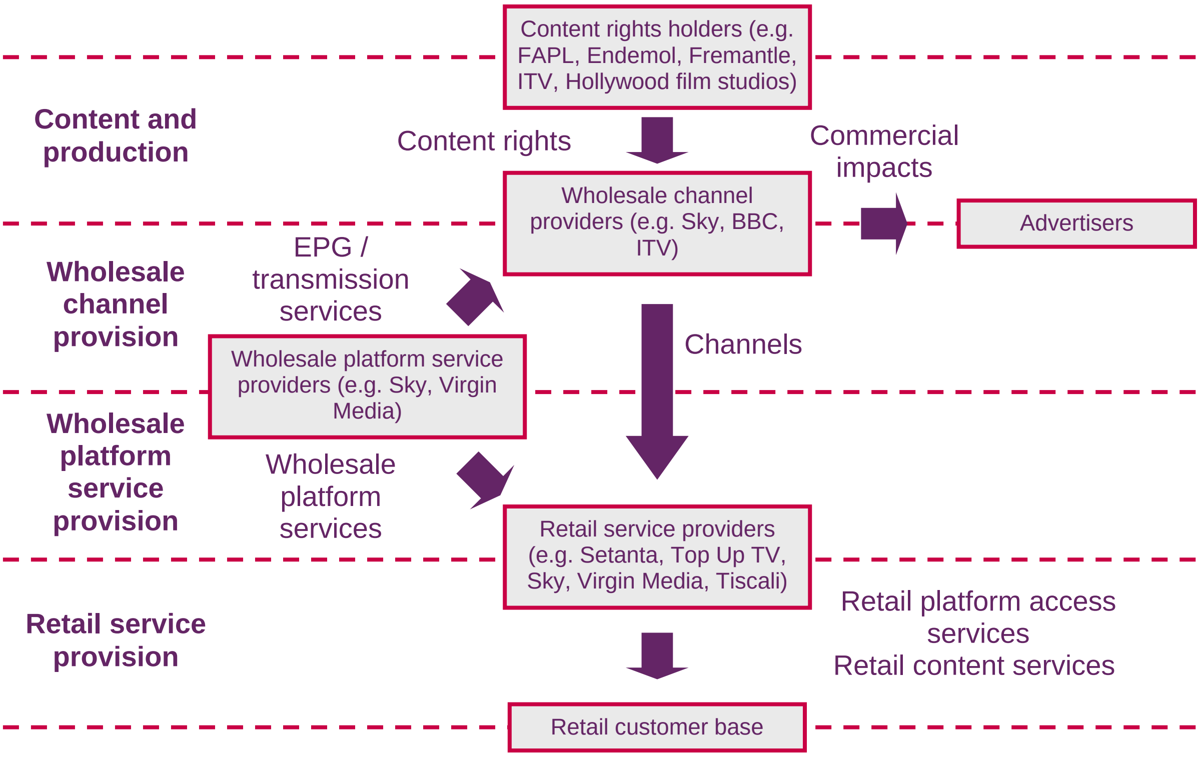
3.3 In our October consultation and our December consultation, we laid out our view of the structure of the pay TV value chain.

3.4 In our December consultation, we suggested a model, illustrated in the diagram below, in which the supply chain for the UK broadcasting industry consists of four layers:

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

3.5 This model is substantively the same as the model in our October consultation, the only difference of note being that we included EPG/transmission services at the wholesale channel provision level.

[25] http://www.ofcom.org.uk/consult/condocs/dtv/responses/
[26] BBC, BT, Setanta, Sky, Top Up TV, Virgin Media, **[✂]**.



3.6 We recognise that the TV sector is complex, and that there are therefore challenges in characterising all the activities involved in a single diagram. We also accept that it is somewhat simplistic to characterise a linear value chain in an environment as complex as TV broadcasting. However, in our view the market structure as set out in the December consultation continues to be a useful overall analytical framework.

3.7 The responses to our December consultation concerning the pay TV market structure and our views on those responses can be found at paragraphs 4.10 to 4.15 of our second MI consultation.

Key developments

3.8 At paragraphs 2.16 to 2.57 of our October consultation we set out our understanding of some of the key background points regarding the supply of pay TV in the UK. We summarise here some of the key developments since the publication of that document which are relevant to our assessment of the Proposal. These developments relate to the product offerings of service providers and the development of new technologies.

3.9 Since our October consultation there has been continued development in existing digital TV services provided on DTT and new digital TV service offerings:

- BT has continued to market its BT Vision hybrid DTT/internet protocol television ("**IPTV**") service. By the end of its financial year ending March 2008 it had 214,000 customers, with 94,000 of these added in the last quarter[27]. In July 2008, BT Vision announced that it would offer *Setanta Sports 1* for free to encourage take up of its new viewing packages.

[27] See page 18 of BT's Annual Report and Form 20-F 2008 which can be found at: http://www.btplc.com/Report/Report08/pdf/AnnualReport2008.pdf.

- Setanta continues to secure additional sports rights to increase the appeal of its suite of sports channels. In June 2008 it agreed a £125 million, four year contract with the Scottish Premier league to broadcast live matches starting from the 2010/11 season. It has also secured a three year deal to show over 30 UEFA cup matches a year from the 2009/10 campaign. In addition to football, Setanta has recently secured rights for a variety of darts and cricket tournaments and boxing matches. As well as expanding its range of sports content rights, since October Setanta has also secured carriage on the Tiscali TV ("**Tiscali**") IPTV platform and launched a Sports News channel in partnership with Virgin Media.

- Top Up TV continues to promote its Digital Video Recorder ("**DVR**") based 'Anytime' service and PictureBox movies service which use proprietary DVR technology and DTT transmission capacity to 'push' pay TV content on to the hard disks of its consumers' STBs. In July 2008, Top Up TV entered into an agreement with Setanta, which allowed Top Up TV to retail *Setanta Sports 1* via its 'Anytime' STBs. In August 2008 it offered new customers a free *Setanta Sports 1* "season ticket" for the 2008/09 FAPL season. Also in 2008, Top Up TV entered into an agreement with Warner Bros. to add new programmes to the Anytime service.

- This year Tiscali has also introduced a hybrid DTT/IPTV set-top box which provides its customers access to DTT channels and DVR functionality in addition to its existing IPTV service.

- In May, the BBC and ITV launched its joint venture "Freesat" service. Freesat-compatible STBs and integrated digital TVs provide consumers access to a range of the FTA channels available on DSat along with an 8-day Electronic Programme Guide and interactive services. HD content from the BBC and ITV is also available on HD compatible Freesat receivers. Freesat is contract and subscription free and increases the choice of digital platforms available to consumers as analogue services are switched-off on a region by region basis through to 2012. It is currently unclear what effect, if any, this digital TV platform will have on Freeview and other DTT based services.

- In July 2008 Orange announced that it intended to launch an IPTV service in the UK later in the year.

3.10 In addition to the new digital TV services that have launched since our October consultation there have been a number of new technology developments.

3.11 In paragraph 2.42 of our October consultation we explained that there was a new transmission technology, DVB-T2, in development which could be used to increase the capacity of a DTT Multiplex. The technical specification has now been agreed by the DVB industry standards body and manufacturers are in the process of developing compliant equipment.

3.12 In April Ofcom published a statement following a consultation on how MPEG-4 H264/AVC ("**MPEG-4**") and the new DVB-T2 technology could be introduced to the DTT platform. The statement set out a number of recommendations to Government, including a recommendation that these technologies should be introduced on DTT Multiplex B which would allow three HD (or up to 15 SD) services to be introduced from 2009 and a fourth HD service available from 2012. The introduction of DVB-T2 technology in 2009 is a significant development for the DTT platform and affects both broadcasters and consumers.

3.13 In paragraph 2.47 of our October consultation we also noted that the DVB industry standards body was developing an updated version of the common interface specification to better address security concerns. This interface is commonly found in integrated digital TVs and some STBs and allows pay TV providers to deploy their CA technology as a plug-in module rather than it being embedded in a STB or TV, thereby allowing consumers to switch between different pay TV operators without having to change their STB or have multiple STBs. Since October 2007, the development of this specification has progressed outside of the DVB process and has been driven by a group of TV and common interface module manufacturers including Sony, Philips, Samsung and Panasonic. The new specification, called CI+, is now complete but there is still uncertainty on where and when the first CI+ compliant equipment will be deployed.

3.14 These developments in technology and project offerings, over a relatively short period of time, are an indication of the dynamic nature of this sector and the potential for innovation in digital TV services, and DTT services in particular (during a period in which Sky has not been retailing pay TV services on DTT).

Context and structure of the remainder of this Section

3.15 Our October consultation invited views on a number of issues relating to the Proposal and included ten questions covering our competition assessment, other policy considerations and the options available to us. Rather than addressing each of those questions in turn, we consider that it is more appropriate to structure this Section to reflect the comments that we received. Accordingly, we have grouped the responses into four specific areas encompassing the three relevant layers of the value chain (set out in the diagram above) and our broader policy considerations. To facilitate the discussion of these issues we will consider them in the following order: (i) access to content, (ii) Sky as a retailer of pay TV services, (iii) technical platform services and (iv) other policy considerations.

A. ACCESS TO CONTENT

The October consultation

3.16 In our October consultation we expressed a concern that if we consented to the Proposal on an unconditional basis, then Sky might emerge as the sole provider of pay TV services on DTT as well as on DSat. This could weaken inter-platform competition which may not be in the long term interest of consumers. Our concern was founded mainly on the basis that Sky currently has exclusive access to the majority of premium sports and premium movies content. Given the capacity constraints of DTT, we noted that it is possible that features of the pay TV market make it likely that a single retail provider of pay TV services will emerge on DTT. We recognised that Sky might emerge as the main retailer of pay services on DTT as a result of its position in the wholesale provision of premium content.

3.17 In order to assess the impact on competition of Sky's strong position in premium content, it is necessary to consider (a) the relevant markets in which Sky would be operating and (b) whether Sky has market power in any of those markets. When we published our October consultation we had not reached any preliminary conclusion on how the relevant markets should be defined or whether Sky might have market power. Instead, we sought stakeholders' views on a number of candidate markets at the wholesale and retail levels of the value chain. We also asked stakeholders whether they considered that retailers on DTT, DSat, digital cable ("**cable**") and IPTV are in competition with one another for subscribers of pay TV services – either at present or in the future.

Consultation responses

Sky

3.18 At the retail level of the value chain, Sky said that there is a single "all TV" market for the supply of audiovisual content to end users, which includes the supply of individual programmes, films and television channels (whether FTA or pay, whether broadcast in linear format or downloaded/viewed on demand) and programmes in pre-recorded formats (e.g. DVDs).

3.19 At the wholesale level, Sky said that there is a relevant market which is at least as wide as the production and supply of television channels. It said that the demand for such channels is derived from demand downstream – ultimately, from the demands of end users of audiovisual content.

3.20 Sky said that in looking at the retail and wholesale market, it would be inappropriate to make any distinction between DTT, DSat, cable and IPTV – given that retailers on platforms using all these distribution technologies compete with one another for viewers/subscribers.

3.21 Sky said that as the relevant retail and wholesale markets are wide, the Proposal could not significantly change the dynamics of competition.

3.22 Sky argued that it had strong incentives to make its channels available on a wide basis "across multiple platforms". It stated that:

> "*Forgoing revenues from potential subscribers on other platforms (whether served directly by Sky as retailer or via wholesale arrangements with a third party retailer) implies significant costs to Sky which, in practice, provide a strong disincentive on Sky from engaging in downstream foreclosure*".

3.23 Sky did not however comment on any current or future plans to wholesale its channels to existing or potential competitors on DTT.

3.24 Sky said that it would wish to retail its channels via any compatible and secure platform using the DTT distribution technology to which it was granted access on fair, reasonable and non-discriminatory ("**FRND**") terms.

Other organisations

3.25 Most organisations which provided views on market definition said that premium content is distinct from basic-tier pay TV and FTA TV content. The majority also considered that premium content is a key driver in the take up of pay TV services. However, while there was agreement that Sky's sports and movies channels should be regarded as "premium" content, there was some disagreement as to whether the concept might extend further. The BBC, for example, suggested that premium content might also include a few key US TV acquisitions such as "Lost" and "24", while BT Vision said that such content should definitely be included.

3.26 Some organisations (e.g. Tiscali, Virgin and the UK Film Council) said that retailers on platforms using DTT, DSat, cable and IPTV are in competition with one another for subscribers of pay TV services, although many did not believe that the distribution technologies compete on an equal basis. The BBC, for example, told us that:

> "*As far as IPTV is concerned, we fully agree with the analysis set out by the Competition Commission[28]: Although services provided over the IPTV platform offer a certain level of competitive constraint with an all-TV market, it is not clear that these players will be able to acquire significant market share within the next few years.*"

3.27 Most organisations (e.g. the BBC and Virgin Media) said that ownership of premium content has provided Sky with market power, which has endured over a significant period of time. Virgin Media, for example, considered that Sky has a near monopoly share of approximately 96 per cent in relation to the wholesale supply of sports channels and a dominant position in the distribution and retailing of pay TV content with a 67.6 per cent share of pay TV subscribers.

3.28 While some organisations recognised the benefits of having Sky's more attractive content on DTT, the majority considered that the Proposal would be likely to lead to adverse effects on competition and consumers. The main reasons given are as follows:

- Sky's market power would be extended in what is already a concentrated sector.
- Within a relatively short timeframe, Sky's competitors on DTT would be forced to exit the retailing of pay TV services.
- In becoming the sole provider of pay TV services on DTT, Sky would foreclose the opportunity for competitor market entry and significantly reduce future competition for the retailing of premium content on platforms across all distribution technologies.
- This would lead to consumer harm in the form of higher prices, restricted choice or reduced innovation.

Individual respondents

3.29 Of the 426 individuals who responded to our October consultation, over 70 per cent considered that the Proposal would be likely to lead to an adverse effect on competition and/or consumers.

Our current views

3.30 As explained in our October consultation, and pursuant to our duties under section 3(2)(c) and section 3(5) CA03, we recognise that the Proposal would benefit consumers by making some of Sky's more attractive content available on DTT.

3.31 Notwithstanding the consumer benefits, our view is that the Proposal would be likely to result in Sky becoming the main retailer of pay TV services on DTT. The reasons for this are three-fold. Firstly, we consider that certain premium content is a critical factor in the take up of pay TV services; without access to such content it is highly unlikely that any existing or potential competitor would be able to compete on equal terms with Picnic. Secondly, we consider that Sky has market power in the separate

[28] Competition Commission Provisional Findings in Sky/ITV investigation (http://www.competition-commission.org.uk/inquiries/ref2007/itv/pdf/prov_find_report.pdf) at paragraph 4.70.

wholesale markets for the supply of premium content. Thirdly, we consider that Sky has an incentive to withhold wholesale supply of premium content from actual and potential competitors on DTT. We therefore consider there is a potential conflict with our principal duty under section 3(1)(b) CA03 (to further the interests of consumers, where appropriate by promoting competition) as well as our duties under section 3(4)(b) and 3(4)(d) to have regard to the desirability of "promoting competition in relevant markets" and "encouraging investment and innovation in relevant markets".

The importance of premium content[29]

3.32 Section 3 of our second MI consultation explains that choice of content is the key driver of pay TV take-up (see in particular paragraphs 3.1 to 3.4 and 3.29 to 3.37 of that document).

3.33 Section 3 of our second MI consultation also explains that some types of content are more attractive to consumers than others (see paragraphs 3.38 to 3.91 of that document). Several types of content have a broad appeal, including for example, much of the UK-originated content available via the public service broadcasters ("**PSBs**"). However, there are two types of content which have a significant appeal and a high degree of exclusivity to pay TV: live top-flight[30] sports and first-run Hollywood movies. It is these types of content which are the primary drivers of pay TV take-up.

3.34 The importance of these types of content is revealed by a variety of evidence which we have considered, including:

- Consumer surveys, which show that live top-flight sports and first-run Hollywood movies are amongst the content genres most valued by consumers. This is consistent with a common-sense observation of the level of interest shown by consumers in live sports and blockbuster movies.

- Observed consumer behaviour, in particular the high proportion of pay TV subscribers who are willing to pay a substantial premium for bundles which include this content.

- The observed behaviour of firms, and in particular the high prices which pay TV channel providers are willing to pay for key content rights.

- The effects on firms and on consumers following changes in the ownership of key content rights. These effects cannot be observed in the UK, where the majority of key rights have not changed hands since the early 1990s, but they can be observed in other international markets.

Sky's position in the wholesale supply of premium channels

The relevant markets

3.35 In our October consultation, we explained that we had not been able to carry out a detailed market definition exercise at that stage. Instead, we set out a range of potential candidate markets and the way in which those candidate markets affect our conclusions on potential competition concerns. In our December consultation we

[29] See further paragraphs 3.10 to 3.13 of our second MI consultation on use of the term "premium".
[30] By "top-flight" sports we mean for example international matches or matches from the top national sports leagues. By "first-run" movies we mean movies that are being shown for the first time on TV.

carried out a preliminary assessment of the relevant markets for pay TV to residential subscribers and our views on the likely markets were as follows.

3.36 We considered that separate retail and wholesale markets exist for the supply of premium sport and movies channels. We found that consumers were unlikely to find sport on FTA channels an adequate substitute for sport on premium channels, and that they did not regard other ways of watching films (e.g. DVDs, pay per view) as a close substitute for premium movies channels. The price which can be charged for these premium channels is therefore unlikely to be constrained to the competitive level by the availability of other content.

3.37 The differentiated nature of content markets means that there is some ambiguity over the precise boundary of these premium content markets, and this complicates the process of market definition. We proposed the following market definitions:

- Premium sports channels were defined as channels that provided access, often on an exclusive basis, to a set of highly valued sports events, for example live FAPL matches.

- Premium movies channels were defined as channels that provide access on a subscription basis to first run movies in the first subscription pay TV window[31] from the six ‘Major' Hollywood studios: Disney, Paramount, Sony, 20th Century Fox, Universal and Warner Bros.

3.38 We considered that separate retail markets also exist for basic-tier pay TV and FTA TV channels. However, this conclusion was less firm than our conclusion on premium sports and movies channels, since we recognised that the availability of FTA services is likely to represent a significant constraint on the price that can be charged for basic-tier pay TV. We also recognised that the strength of this constraint has grown in recent years, due to the growth of FTA multi-channel services such as Freeview. However, we did not believe that this constraint was sufficient to constrain prices of basic-tier pay TV services to the competitive level.

3.39 Consumers are able to gain access to pay TV and FTA TV content across a number of different platforms. We therefore analysed whether these retail markets operated across platforms or were specific to particular platforms. On balance, the lack of strong evidence of platform-specific preferences led us to conclude that retail services provided on alternative platforms compete in the same relevant market.

3.40 We did not assess the wholesale market for basic-tier pay TV as the evidence indicated it would be a relatively unconcentrated market, and we would therefore be highly unlikely to find that any firm was dominant within that market.

3.41 Since the October and December consultations we have carried out further work gathering and assessing evidence as set out in Section 4 of our second MI consultation.

3.42 In our second MI consultation, we are consulting on our view that there is a narrow economic market for the wholesale of certain premium sports channels, specifically those premium channels or packages of premium channels which contain live FAPL

[31] Films generally first become available in the ‘pay TV window' about 12 months after they are first shown in the cinema and about 12 months before they become available in the FTA TV window.

matches ("**Core Premium Sports channels**"). We believe such channels are significantly differentiated from other channels in their appeal to consumers and therefore their value to wholesalers. We consider that *Sky Sports 1* in its current format, which Sky proposes to retail on DTT under the Proposal, falls within the market for the wholesale supply of Core Premium Sports channels.

3.43 We acknowledge that there are arguments both for a slightly narrower market definition (e.g. one which excludes channels such as *Sky Sports 2*, which only contain a small number of live FAPL matches) and for a slightly broader market definition (e.g. one which includes channels which contain a significant volume of other high-quality live sports). These changes would not affect our market power assessment, but they would result in a less precise market definition. There is an element of judgement in establishing which channels fall within the market. It is not helpful to have a loose or vague market definition. We would therefore describe Core Premium Sports channels as being those channels or packages of channels which include any live FAPL matches.

3.44 In our second MI consultation, we are also consulting on our view that there is a narrow economic market for the wholesale supply of channels which include movies from the six Major Hollywood Studios, shown in the first pay TV window ("**Core Premium Movies channels**"). We acknowledge that there is a growing constraint on such channels from other means of watching movies, but do not consider that the strength of this constraint currently justifies the adoption of a broader market definition. We consider that *Sky Movies Screen1* in its current format, which Sky proposes to retail on DTT under the Proposal, falls within the market for the wholesale supply of Core Premium Movies channels.

3.45 We remain of the view that retail pay TV markets operate across different platforms.

3.46 In line with OFT guidelines[32] on assessing market definition and the views of respondents to our December consultation, we have considered a range of evidence in arriving at our current view of the relevant markets. Our evidence base includes[33]:

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

[32] OFT Guidelines on Market Definition, 2004, http://www.oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft403.pdf.
[33] In section 5 we also consider further evidence relating to our assessment of market power including evidence on profitability, market outcomes, and barriers to entry.

Market power

3.47 In our October consultation, we did not form a view on whether Sky has market power in any relevant market. However, in our December consultation we concluded that Sky is likely to be dominant in the wholesale supply of “premium sports” and “premium movies” channels. This conclusion reflected Sky’s very high market shares, the existence of high barriers to entry and limited countervailing buyer power (“**CBP**”).

3.48 As part of our MI, we carried out further analysis of market power. In our second MI consultation we are consulting on the conclusion that Sky has market power in the wholesale of Core Premium Sports channels. We base this conclusion on the following:

- Sky has consistently won the rights to televise live FAPL matches in the UK (“**Live FAPL Rights**”) since 1992, until the European Commission’s intervention ensured that one company could no longer win all Live FAPL Rights in 2006. We estimate that Sky’s market share now stands at **[✂]** per cent.

- Sky’s market share remains high even if we expand our market definition. Including additional sports rights of similar quality to Live FAPL Rights within our market definition makes little difference to our assessment of market power, due to the more limited volume of content associated with these other rights, and the fact that many of these other sports rights are also owned by Sky.

- Sky has argued for a much broader market definition than we adopt, encompassing FTA and pay TV within a single economic market, and has said that if markets were defined in this way Sky would be unlikely to be dominant. We do not however believe that the volume of live high-quality football on FTA TV channels is sufficient to constrain the wholesale price of Core Premium Sports channels to the competitive level.

- There are significant barriers to entry in acquiring Live FAPL Rights. Sky’s established subscriber base, coupled with other factors such as its vertical integration and brand strength, means that it can afford to bid a larger amount than any other bidder, and we therefore expect Sky to maintain its market power following the next auction. However, if Sky were to win a significantly smaller set of Live FAPL Rights in the next auction, this would constitute a material change in circumstances and we would need to revisit our assessment of market power.

- We have said that market boundaries are not clear-cut. To the extent that some other football competitions just outside our stated market represent partial substitutes for FAPL content, it might in theory be possible to assemble some of those into an offer to compete with Core Premium Sports channels. However, no other single competition offers the same volume of highly attractive sport as FAPL, while many of the content rights which would need to be aggregated to create such an offer are already controlled by Sky. The staggered availability of rights is therefore an additional barrier to entry in creating such an offer.

- The fact that some platforms, notably Virgin’s, are closed to other retailers, means that they are more likely to have some CBP in dealing with Sky. However, we currently see the commercial balance of the relationships between Sky as a wholesaler and other retailers as being strongly in favour of Sky.

3.49 In our second MI consultation, we are also consulting on our conclusion that Sky has market power in the wholesale of Core Premium Movies channels. We base this conclusion on the following:

- No company other than Sky has ever won any of the rights to films in the first TV subscription window from the Major Hollywood Studios ("**Movie Rights**"), giving Sky 100 per cent market share.

- Sky's market share remains high even if we expand our market definition slightly, to include for example pay-per-view movies or subscription DVD rental services. Sky has argued for a much broader market definition than we adopt, which includes FTA channels as well as a variety of other means of watching movies (e.g. DVD sales), and has stated that if markets were defined in this way Sky would be unlikely to be dominant. While we acknowledge that other means of watching films, such as the ability to purchase a DVD of a recent movie, or watch an older film on FTA TV, will provide some constraint on the prices which can be charged for Core Premium Movies channels, we do not believe this constraint is likely to be sufficient to ensure prices are at the competitive level.

- Sky's strong position in the market is unlikely to be undermined by potential entrants in the near future. The bidding advantages that we set out above in the context of sport also apply to movie content, and mean that Sky can afford to bid a larger amount than any other bidder for the rights to each individual studio's output. This, in conjunction with the staggered availability of Movie Rights, creates a significant barrier to entry.

- There is however the possibility of disruptive change in the way the studios monetise their rights in the future, including in particular new means of distributing individual movies to consumers over the internet. We acknowledge that any major change in the pattern of rights ownership, or in the means by which the studios monetise their rights, would constitute a material change in circumstances and we would need then to revisit our assessment of market power.

- The position with respect to CBP is similar to that in sports. We see the balance of power in the relationship between Sky as a wholesaler and other retailers as being in favour of Sky.

The impact on competition

3.50 Our current view is that the Proposal, unchanged, would be likely to result in Sky becoming the sole or main retailer of pay TV services on DTT as a result of its market power in the wholesale markets for Core Premium channels. If so, we consider that this would diminish significantly the number of addressable consumers on the platform for other retailers, thereby restricting or preventing the growth or entry of efficient competitors at the retail level.

3.51 In such a situation it is likely that inter-platform competition would be weaker than in a scenario in which there was a strong competitor to Sky on DTT. This is because Sky would be in control of two out of the three main distribution technologies (DTT as well as DSat) at the retail level.

3.52 In turn, we consider that this would be likely to lead to consumer detriment in the form of reduced choice of pay TV provider, higher prices or poorer quality of service.

We address the impact of the Proposal on consumer welfare in paragraphs 4.7 to 4.12 and Annex 6.

3.53 Another adverse effect of Sky becoming the sole or main provider of pay TV services on DTT through this route is that the incentive for a competitor to submit a competitive bid for Live FAPL and Movie Rights may be (further) diminished. This is because competing retailers of pay TV services on DTT would be faced with a significantly reduced number of subscribers from which to recover the cost of acquiring such rights.

Why Sky would be likely to emerge as the sole or main retailer of pay TV services on DTT

3.54 We consider that Sky would be likely to emerge as the sole or main retailer of pay TV services on DTT for three main reasons.

3.55 Firstly, owing to its market power in the wholesale markets for Core Premium channels, Sky would, under current market conditions, be the exclusive retailer of the majority of Core Premium channels on DTT, which we consider to be the main driver for the take-up of pay TV services. It is therefore unlikely that a third party retailer of pay TV services on DTT would be able to compete on equal terms with Sky's Picnic service unless it could obtain the same Core Premium channels on a suitable wholesale basis.

3.56 Secondly, our current view is that Sky has various incentives to withhold its Core Premium channels from other retailers of pay TV services in a way which may weaken the longer term competitive landscape. On this point, we carried out some analysis as part of our MI to determine the incentives which Sky faces in withholding or making available its Core Premium channels to third party retailers. The results of our analysis, which we set out in Section 6 of our second MI consultation, indicate that, for a variety of reasons, Sky may not have an incentive to supply other retailers at affordable prices. This is particularly the case when the competing retailers' offerings are not strongly differentiated from Sky's.

3.57 With regard to DTT, Sky's incentive to wholesale *Sky Sports 1* and *Sky Movies Screen1* to other DTT retailers is likely to be highly contingent on its wholesale price (see paragraphs 6.107 to 6.113 of our second MI consultation). Our highly indicative analysis has shown that wholesaling to other DTT retailers might be profitable to Sky at wholesale rates higher than just over **[✂]**. However, it is not clear whether this price would be affordable for Sky's retail competitors. This analysis also excludes the effects of the longer term strategic factors described in paragraphs 6.69 to 6.87 of our second MI consultation. These are likely to be particularly relevant at the present time, when various companies are making decisions about their entry strategy on DTT.

3.58 Sky's Core Premium channels are currently only wholesaled to Virgin Media. Although we have not attempted to judge the course of specific negotiations, we know that several companies have sought wholesale supply (see, for example, Figure 29 in our second MI consultation), and that despite this, Virgin Media remains Sky's only major wholesale customer.

3.59 Our current view therefore is that it seems unlikely that Sky's retail competitors on DTT would be able to obtain access to Sky's Core Premium channels on a suitable wholesale basis in the absence of regulatory intervention.

3.60 Thirdly, as explained at Section 5 of our second MI consultation, our current view is that at least for the next few years, it is likely that Sky will continue to win the majority of Live FAPL Rights and Movie Rights, when they next become available. Therefore, if Sky emerged as the sole or main retailer or pay TV services on DTT, this position is unlikely to be undermined by competitors seeking to acquire Live FAPL Rights or Movie Rights directly from rights holders.

Adverse effects on competition likely to materialise quickly

3.61 We consider that the emergence of Sky as the sole or main retailer of pay TV services on DTT and the consequent adverse effects on competition described above would be likely to occur in a relatively short timeframe.

3.62 The main reason for this view is that we consider Picnic's content offering is likely to be much more popular than the content available on other pay TV services on DTT. This is because under the Proposal, Picnic would be offering Core Premium channels (*Sky Sports 1* and *Sky Movies Screen1* respectively), neither of which would be available from any other pay TV retailer on DTT[34]. We recognise that a Core Premium channel in the form of *Setanta Sports 1* would be available on DTT from BT Vision, Setanta and Top Up TV. However, this would only account for a minority of Core Premium sports content available on DTT.

3.63 Given the likely popularity of Picnic, our current view is that a significant number of subscribers to BT Vision, Setanta and Top Up TV would switch away from those services to Picnic. This view is strengthened by our current view in the context of our MI that the costs of switching from one pay TV retailer to another are unlikely to deter switching[35].

3.64 The likely popularity of Picnic also suggests that Sky's retail competitors on DTT would be less likely to attract new subscribers to their services than in a scenario where Picnic was not available to consumers.

3.65 Potentially high rates of subscribers switching away to Picnic combined with lower levels of new subscribers are likely to threaten the economic viability of Sky's competitors on DTT. **[✂]** In this context, we are aware of recent reports and newspaper articles expressing the view that Setanta's viability, even in the coming year, may depend on its ability to grow its subscriber base, which in turn may be influenced by competition from Sky on DTT[36].

B. SKY AS A RETAILER OF PAY TV SERVICES ON DTT

3.66 In paragraphs 3.67 to 3.114 we consider the potential impact of Sky as a retailer of pay DTT services on competing retailers of pay TV services and on the manufacture and retail supply of DTT reception equipment.

The October consultation

3.67 In our October consultation, we recognised concerns that:

[34] Furthermore, consumers would have access to *Sky One*, which also would not be available from any other pay TV retailer on DTT, as well as *Discovery Channel* and *Disney Channel*.
[35] See paragraphs 6.57 to 6.66 of our second MI consultation.
[36] See for example the article entitled "*Zero hour nears for Setanta in fight to steal Sky's viewers*" published in *The Guardian* on 13 August 2008 and the research note entitled "*Setanta faces the credit crunch*" published by Enders Analysis on 18 July 2008.

- Sky may be able to influence the marketing of STBs in such a way as to distort competition, for example by incentivising leading retailers with discounts and commissions.

- Sky would have a particular advantage as a result of its existing relationships with manufacturers for DSat STBs: for instance, it might benefit from economies of scope in terms of STB design or economies of scale in terms of volume of orders.

- Sky's announcement of its proposal to replace its FTA channels on DTT with pay TV channels may have had an impact on competition. For example, retailers of STBs may have been less inclined to stock STBs of competing pay TV providers. However, we also said that we would wish to see evidence from both pay TV retailers and STB manufacturers that the pre-entry announcement had a significant and sustained impact on their businesses.

- Capacity constraints will limit the number of viable providers of pay TV services on DTT. Given the risk that one single monopoly provider could emerge on DTT, there could then be scope for abusive behaviour in relation to pricing, customer service and provision of access to other channels.

Consultation responses

Sky

3.68 Sky made clear in its response that it intends to foster conditions for the supply of reception equipment to DTT subscribers that will essentially replicate the "horizontal market" already in place for DTT Freeview STBs. According to Sky, this would mean that there would be a contestable market for the supply of Sky STBs by any manufacturer that could meet Sky's technical requirements. At paragraph 2.10 of its response to our October consultation it added that:

> "*Picnic will be happy for manufacturers to include functionality in reception equipment which will enable customers to access further pay TV services, in addition to those provided by Picnic, encrypted with different Conditional Access (CA) technologies. For example, manufacturers will be free to manufacture Picnic compatible set top boxes that contain a common interface (including the ability to connect to a separate conditional access module), or a second CA technology in addition to the NDS CA system selected by Picnic*."

3.69 With regard to the issue of whether Sky may be able to stifle the take up of competing pay TV services and DTT reception equipment, Sky said at paragraphs 6.7 to 6.10 of its response to our October consultation:

> "*For example, Top Up TV "inherited" a population of over 1.2 million set top boxes from the former ITV Digital platform (many of which would have subsequently been rendered obsolete when it moved to a "push" broadcast model). Sky understands that it has recently commenced subsidising the retail price of its PVRs, in order to achieve greater penetration of compatible set top boxes, and is currently estimated to have attracted a subscriber base of around 200,000 homes.*
>
> *BT Vision, in common with Top Up TV (and Setanta) enjoys the benefits of access to significant funding resources. BT Vision has*

commenced offering its set top box for free to its new and existing customers that sign up to BT Total Broadband. It is expected to have attracted around 100,000 subscribers by the end of 2007, and has publicly stated that, in the medium term (to around 2011) it is seeking to gain around 2-3 million subscribers.

Upon launch, Picnic will start from a base of zero subscribers/set top boxes, which it will have to grow in the face of significant competition both from existing DTT operators and from other digital television platforms. Ofcom is aware of Picnic's (confidential) subscriber projections, which amount to around [REDACTED – CONFIDENTIAL] TV subscribers 3 years after launch (i.e. potentially at a similar time as BT's target of 2-3 million subscribers is reached).

Ofcom acknowledges that the opportunity for pay TV on DTT is likely to be small in the short term, and that its "starting presumption is that pay TV subscribers will form only a small proportion of DTT households in the short term". This starting presumption, combined with the diversified nature of the DTT platform, and the existence of well funded existing retailers on DTT, all undermine the likelihood that Ofcom will need to use its ex post powers, let alone that Ofcom could justify ex ante regulation."

Other organisations

3.70 A significant number of organisations (**[✂]** and Virgin Media) told us that Sky has considerable and unique incentives and advantages which would enable it to become the main or sole provider of pay TV services on DTT.

3.71 Sky's purported incentives can be summarised as follows:

i) It would remove the growing threat of pay TV services on DTT to Sky's DSat business.

ii) It would increase Sky's pay TV subscriber base and strengthen its position as the largest retailer of pay TV services in the UK.

iii) In turn this would further increase Sky's purchasing power in relation to attractive content (as it would be able to spread the cost of that content over an even larger installed retail subscriber base).

iv) This would make it even less likely that Sky's market power could be successfully challenged at any level of the value chain by an existing market participant or new entrant.

v) Sky would be able to "manage" competition between platforms using the DSat and DTT distribution technologies so as to ensure that DTT does not cannibalise its DSat subscribers. It might do this by delaying innovation on DTT or ensuring that prices for Picnic are maintained above a certain level.

3.72 These organisations told us that Sky has many competitive advantages in addition to its exclusive access to premium content, and that this would give it the ability as well as an incentive to become the sole retailer of pay TV services on DTT. Virgin Media, for example, told us that:

"*BSkyB would enjoy overwhelming advantages as compared to other retailers of pay TV arising from its existing scale, enormous resources, vertical integration (particularly access to superior content on an exclusive basis), influence over third parties, brand recognition and, crucially, access to scarce DTT capacity*.

……*These factors make it almost inevitable that if Ofcom were to consent to the Proposal, BSkyB would, within a short period, become the sole retailer of pay-TV services on the DTT platform*."

3.73 We summarise below Sky's purported advantages.

Financial resources

3.74 **[✂]** and Virgin Media told us that Sky's very significant financial resources would enable it to market Picnic extensively, influence and subsidise the prices charged by retailers for Picnic STBs and undertake significant investment (including additional spectrum for DTT services as part of the DDR award). Virgin Media, for example, said that:

"*Neither Setanta nor Top Up TV (nor indeed any other pay-TV retailer in the UK) has access to anything like the marketing resources of BSkyB. BSkyB recorded in its 2007 annual report an annual marketing spend of £734 million for the year ended June 2007. This marketing spend is also increasing; in its quarterly results for the three months ended September 2007, BSkyB reported that its marketing costs increased by £35 million to £196 million*".

Brand strength

3.75 A number of organisations such as **[✂]** told us that Sky's considerable brand strength in pay TV confers on it a significant competitive advantage. They also argue that to compete with Sky, other retailers would need to spend considerable sums on marketing.

3.76 Some organisations, such as Virgin Media, said that the mere presence of Sky as a retailer of pay TV channels on DTT would act as a very material entry barrier for any potential third party considering making the significant investments necessary to commence offering pay TV services on DTT.

Access to DTT capacity

3.77 Virgin Media told us that Sky benefits from the fact that it has access to scarce DTT capacity at well below the current market price. In its response to our October consultation it said:

"*In summary, there is currently almost no capacity available on the DTT platform for the launch of pay-TV services and that capacity which has been made available attracts a very significant price. Whilst it may be expected that further capacity on the DTT platform will become available either as a consequence of technical developments within existing capacity, or as a consequence of the DDR, this capacity will either not be available to pay-TV operators on a DTT platform or, if available, will again require very significant capital expenditure*".

Influence over manufacturers of STBs

3.78 A number of organisations (e.g. **[✂]**) told us that Sky's financial resources and its status as a large purchaser of DSat STBs would enable it to influence in many ways the types of DTT STBs that are manufactured, thereby impeding the take up of competing pay TV services on DTT. In particular they said that this could be achieved by Sky and/or its largest shareholder, News Corporation:

- Underwriting research and development and other capital investment costs incurred by manufacturers thereby reducing the manufacturing cost and the ex-factory price of STBs.
- Managing after-sales and "sale or return" support on behalf of manufacturers.
- Offering large orders for DSat STBs to those manufacturers producing its preferred DTT boxes at low prices.
- Linking Picnic compatible STB prices to DSat STB orders.
- Inhibiting the inclusion of competitors' CA technology in Picnic compatible STBs.

Influence over retailers of STBs

3.79 These organisations also told us that Sky and/or related companies (e.g. News International), can influence high street retailers so as to restrict the take up of competing pay TV services on DTT in a number of ways, in particular by:

- Granting direct subsidies to retailers of Picnic STBs[37].
- Providing advertising or co-marketing support to retailers that promote Picnic.
- Paying commissions and bonuses to retailers to encourage retailers to discount Picnic STBs.
- Making one-off payments for the initial stocking of Sky's preferred STBs and/or other contributions to retailers such as store refits.
- Providing "below the line" support in the form of e.g. point of sale materials, merchandising and staff training.
- Providing "sale or return" support to retailers.
- Bundling TV, telephony and broadband services.
- Offering increased support for Sky Digital if Picnic is stocked (e.g. a bonus on Sky Digital sales if Picnic is stocked by the retailer) or delisting as Sky Digital retailers if (a) Picnic is not stocked or (b) Top Up TV and Setanta products are stocked.

[37] Some organisations consider that Picnic's stated intention not to subsidise STBs (see paragraph 8.13 of Sky's response to our October consultation) can easily be reversed.

Sky's announcement in February 2007

3.80 We were told that the February 2007 announcement had an actual impact on retailer demand and the consequent manufacture of competitors' STBs. We were also told that if Sky were to launch Picnic as proposed, STBs for competing retailers would not be ordered by retailers or manufactured. **[✂]**

Individual respondents

3.81 Over 60 per cent of individual respondents said that we should not consent to the Proposal given the capacity constraints on DTT. More generally, over 70 per cent of individuals said that the Proposal would have a negative impact on competition and/or consumers.

Our views

3.82 In assessing whether intervention is required we need to determine whether the issues raised above would be likely to lead to an adverse effect on competition and/or consumers. If so, after consideration of all our duties and following our regulatory principles, we need to determine whether it is more appropriate to use ex ante conditions to deal with each relevant issue or whether it is more appropriate to rely on our ex post powers to address any concerns. In this context we are conscious of our duty under section 3(3) CA03 to have regard to the need to act in a manner which is proportionate and targeted only at cases in which action is needed.

3.83 We recognise that a number of organisations are genuinely concerned that the Proposal would significantly constrain the ability of existing and potential competitors to compete with Sky at the retail level. We also recognise that some organisations said this would hold true even if Sky's premium content became available on a suitable wholesale basis.

3.84 However, we are wary of prohibiting Sky from retailing pay TV services on DTT, a highly interventionist measure, without being convinced that such action is necessary and proportionate. In order to assess the various concerns raised regarding Sky's advantages and alleged types of possible future conduct, we consider the issues that have been raised within the context of the following categories, each of which are addressed further below:

- Issues which are not unique to Sky.
- Issues which are unique to Sky but addressable, in principle, under an appropriately structured set of arrangements to make Sky's premium content available on a wholesale basis.
- Issues which are unique to Sky and, in principle, may raise competition concerns.

Issues which are not unique to Sky

3.85 We recognise that Sky has a strong, widely recognised brand and significant financial resources. In the 12 month period which ended on 30 June 2008, the company's revenue was £4,952 million, its adjusted operating profit was £752 million and its marketing spend was £743 million (representing 15 per cent of sales)[38]. We also

[38] http://media.corporate-ir.net/media_files/irol/10/104016/press/FY_2008_pr.pdf

recognise that these factors mean that Sky is in a strong position with regard to its retail competitors.

3.86 However, we are wary of prohibiting Sky retailing pay TV services on DTT on the basis that it has significant financial resources and brand strength, given that these advantages, to varying degrees, are shared by at least some of its existing retail competitors (BT Vision and Virgin Media) and by some of its potential competitors (e.g. Orange and O2).

3.87 We recognise that these companies may not enjoy the same brand strength as Sky in the pay TV sector. However, Sky has stated that the Proposal would be marketed under the "Picnic" brand, and kept distinct from the Sky brand. This may mean that Sky will not benefit fully from its brand strength in respect of its DTT platform (although regardless of Sky's intention to promote distinct brands, we consider there will be a degree of consumer awareness of the relationship between Sky and Picnic).

3.88 We would expect an initial period during which Sky would seek to establish the Picnic brand, based on the proposition of offering Sky Core Premium channels, amongst others, on DTT. To some degree, existing competitors on DTT have already benefited from having had the opportunity to establish their brand as a result of offering pay DTT services earlier. Furthermore, if Sky's Core Premium channels were to be made available on a wholesale basis, these existing competitors (as well as potential new competitors) would also have the opportunity to establish their brand on the basis of offering Sky premium content in addition to their other content and services.

3.89 Of the activities which stakeholders considered Sky would be likely to engage in if it was allowed to retail on DTT, we consider the following would derive mainly or entirely from Sky's financial resources and therefore should not, in and of themselves, raise competition concerns requiring ex ante intervention:

- Underwriting research and development and other capital investment costs incurred by manufacturers thereby reducing the manufacturing cost and the ex-factory price of STBs.

- Managing after-sales and "sale or return" support on behalf of manufacturers.

- Granting direct subsidies to retailers of Picnic STBs.

- Providing advertising or co-marketing support to retailers that promote Picnic.

- Paying commissions and bonuses to retailers to encourage retailers to discount Picnic STBs.

- Making one-off payments for the initial stocking of Sky's preferred STBs and store refits.

- Providing "below the line" support in the form of e.g. point of sale materials, merchandising and staff training.

- Providing "sale or return" support to retailers.

3.90 We consider that Sky's existing and potential competitors, some of which have significant financial resources, also have the ability, in principle, to engage in these types of activities. Furthermore, **[✂]**. The incentive to engage in these activities may, depending on the relevant wholesale prices, also be enhanced if they are able to secure wholesale access to Sky's Core Premium channels; for example, if offering a service including premium content enables a retailer to charge a higher monthly subscription, it may have a greater incentive and ability to provide an upfront STB subsidy and make bonus payments to retailers. It is not clear that any of these activities are in themselves necessarily undesirable, and in some cases they may be efficient in promoting and enabling the take-up of services to the benefit of consumers. Given that the ability to engage in the list of activities above are not unique to Sky, we therefore question whether it would be appropriate to prohibit Sky from retailing pay TV services on DTT simply on the basis that it would be likely to engage in these activities.

3.91 With regard to the views expressed by some organisations that Sky could influence STB retailers by bundling TV, telephony and broadband services, we note that its existing and potential competitors (e.g. BT Vision, Virgin Media and Orange) already offer bundled services. Such bundling can also be efficient and to the benefit of consumers. Accordingly, this does not seem to us to justify a prohibition on Sky retailing pay TV services on DTT.

3.92 As noted above, some organisations told us that Sky's access to scarce DTT capacity at well below the current market price was a factor that would lead it to become the sole provider of pay TV services on DTT if we consented to the Proposal unchanged. Currently, we are not convinced that this should lead us to prohibiting Sky from retailing pay TV services on DTT. Firstly, Sky has access to less than 10 per cent of the total DTT capacity that is currently available across all DTT multiplexes. Secondly, some other competitors may also benefit from a similar advantage to Sky. In some respects this advantage can be considered a reward for the risk taken in committing to DTT at the time of the launch of Freeview and when the success of DTT was highly uncertain.

3.93 Although not an issue forming part of our assessment of the Proposal, it should be noted in this context that we might have concerns if Sky was able to use its DTT capacity rights on multiplex C to limit the efficient use of DTT capacity, for example by restricting the introduction of additional channels.

Issues which are addressable, in principle, under an appropriately structured set of arrangements to make Sky's premium content available on a wholesale basis

3.94 Our current view is that if Sky's Core Premium channels were to become available to its retail competitors on a suitable wholesale basis this could, in principle, address our competition concerns regarding Sky's exclusive access to that content (see Section 4). As noted in paragraphs 3.32 to 3.34, access to Core Premium channels is likely to enhance the attractiveness of the retail offerings of Sky's competitors, providing them with greater opportunity to develop their brands and encourage the take-up of STBs compatible with their retail services.

3.95 In terms of promoting competition, the effectiveness of any intervention to make Sky's Core Premium channels available to retail competitors is likely to depend on the technical and commercial terms on which Sky's premium content is made available, in particular, the wholesale pricing arrangements for this premium content.

3.96 In particular, the workability of such intervention would depend very much on the appropriate price points. One method for deriving wholesale prices, as raised in our October consultation, is a "retail-minus" approach where Sky would be required to maintain a specified gap between its own retail prices and the corresponding wholesale price offered to retail competitors. Under this approach competitors would have the discretion to set retail prices at a similar level to Sky, or reduce their retailing expenditures (such as marketing expenditure) and compete by offering lower retail prices. In principle, depending on the wholesale pricing arrangements, there may therefore be potential for effective competition notwithstanding:

- Sky's significant financial resources.
- Sky's brand strength.
- Sky's ability to engage in some or all of the activities referred to in paragraph 3.89 which derive mainly or entirely from its significant financial resources.

3.97 In paragraphs 4.22 to 4.64 of this consultation and in Sections 8 and 9 of our second MI consultation, we raise for consultation the potential content of a wholesale remedy in more detail. If we do not choose to pursue a wholesale remedy then this assessment would have to be revisited.

Issues which are unique to Sky and, in principle, may raise competition concerns

3.98 Having considered the various concerns discussed above, we recognise that there are still issues raised by stakeholders which are unique to Sky and which, in principle, could raise competition concerns in the retailing of pay TV services on DTT. These issues may derive either from the position of Sky or related News Corporation companies, which together are responsible for very substantial orders of STBs worldwide, and relate to various ways in which Sky could influence the STBs which are manufactured and retailed in order to impede the take up of competing pay TV services on DTT.

STB manufacturers

3.99 We understand that some organisations which responded to our October consultation have serious concerns that Sky would have a unique incentive and ability to prevent the manufacture of STBs for competing retailers of pay TV services on DTT.

3.100 In March and April 2007, as part of our MI, we sent information requests to 16 STB manufacturers regarding the supply of DTT STBs. While we recognise that it may be difficult in practice to obtain evidence of the types of activity listed in paragraph 3.78, none of the 13 responses which we received[39] gave us clear grounds to suspect that Sky had been attempting to prevent the manufacture of STBs for its retail competitors, such that it would be appropriate to open a CA98 investigation at this point.

3.101 It was clear from the responses to our formal information requests that the manufacture of STBs is a global industry in which a significant number of businesses compete. Furthermore, the responses suggested that a significant number of manufacturers are likely to be willing, in principle, to produce STBs (i) for any creditworthy purchaser that is able commit to a minimum purchase order or (ii) in respect of which they consider there will be significant demand. It therefore seems

[39] We received responses from the following manufacturers: **[✂]**, Alba plc, Amstrad plc, Eurosat Distribution Ltd, Humax Electronics Co. Ltd, Pace Micro Technology plc, Panasonic UK Ltd, Philips Electronics UK Ltd, Sony United Kingdom Ltd, Step One Technology Ltd, Thomson Multimedia S.A. and Vestel UK Ltd.

unlikely that no manufacturer would be prepared to supply STBs to a competitor to Sky if there is sufficient demand from retailers of STBs and/or the competitor is prepared to place an order for a reasonable quantity of STBs.

3.102 We also asked STB manufacturers specifically whether their business decisions had been impacted by Sky's February 2007 announcement. The responses we received indicated that it did not have a material impact. In this context, Freesat[40], which may exert a degree of competitive constraint on Sky's DSat business, has been able to engage major manufacturers such as Humax and Panasonic to produce its reception equipment.

3.103 On the specific concern that Sky would inhibit the inclusion of competitors' CA technology in Picnic compatible STBs, we have considered the points put to us by relevant stakeholders and, in particular, manufacturers themselves. We agree that STB manufacturers would be unlikely to incorporate CA technology (e.g. from Nagra) in addition to NDS CA technology in Picnic compatible STBs. However, it is questionable whether this decision would be the consequence of any action taken by Sky. Rather, regardless of any influence exerted by Sky, we consider that manufacturers would be unlikely to produce Picnic compatible STBs incorporating more than one CA technology unless there was clear consumer demand for such a product. This is because we understand that the incorporation of multiple CA systems:

- Increases manufacturing costs significantly and hence would need to be reflected in retail pricing.
- Adds significant complexity to the STB development process since it requires extensive co-operation between competing CA vendors, all of whom are keen to guard their business secrets closely.
- Consequentially results in a much longer lead time before the product can be brought to market, making it more challenging to be competitive with single CA STBs which have a shorter development cycle and can therefore take advantage of more recent chipsets.

3.104 Considering all of these points put to us, given Sky's position in the provision of DSat STBs, we see merit in the arguments that Sky could have the ability and incentive to influence STB manufacturers. We would clearly be concerned if Sky or a related News Corporation company used its position as a leading buyer of DSat STBs to influence the manufacture of DTT STBs with the intention of impeding the take up of competing pay TV services on DTT. However, we have not been presented with evidence to support this being a likely proposition, and indeed some of the information available to us suggests the contrary (e.g. the recent launch of Freesat). Therefore, at this stage, an ex ante prohibition on Sky retailing pay TV services on DTT seems to us to be an inappropriate response. We do accept, however, that this is a genuinely held concern for Sky's retail competitors. Accordingly, if we were to consent to the Proposal we would monitor carefully the supply chain for DTT reception equipment. If we had reasonable grounds to suspect that Sky or a related company had engaged in behaviour aimed to prevent the take-up of competing pay TV services on DTT we would be likely to consider investigating such behaviour under CA98.

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[40] Freesat is a FTA DTT service developed by the BBC and ITV. The service began broadcasting on 6 May 2008 and offers a satellite alternative to the Freeview service on DTT, with a selection of channels available without subscription for users purchasing a receiver.

STB retailers

3.105 We were told by some organisations that if we consented to the Proposal, Sky and/or News Corporation would be likely to promote Picnic STBs by influencing high street retailers in many different ways to restrict the take up of competing pay TV services on DTT, as summarised in paragraph 3.79. **[✂]** expressed further concerns about Sky's unique advantages, noting that Sky's main shareholder News Corporation could offer subsidised or free advertising space in its newspapers to retailers of STBs on condition that the retailer stocked Picnic STBs and/or did not stock STBs compatible with competing pay TV services.

3.106 We acknowledge that Sky's retailing of DSat services affords it a unique ability to influence retailers and agree that the type of behaviour indicated to us in the last bullet point of paragraph 3.79 would be a serious concern if it resulted in retailers not supplying STBs for competing pay TV services on DTT. However, at present, it is difficult to establish whether such an outcome is likely or not.

3.107 Alongside the information requests which we sent to STB manufacturers, we sent information requests to nine major high street and online retailers of consumer electronics. This was with a view to better understanding the retail supply of DTT STBs. We received responses from eight retailers[41].

3.108 It appears from those responses that the objective of STB retailers is to promote pay TV services for which there is reasonable consumer demand. We consider that the main driver for the take up of pay TV services, and therefore compatible reception equipment, will be the content offered, in particular premium content. It follows that if Sky's retail competitors on DTT are able to secure wholesale supply of Sky's Core Premium channels on terms which allow them to compete on price, there should be consumer demand, and therefore retailer demand, for their STBs.

3.109 We asked retailers specifically whether their business decisions had been impacted by Sky's February 2007 announcement. The responses we received indicated that it did not have any material impact. Moreover, none of the responses gave us grounds to suspect that Sky had been attempting to prevent or restrict the retail supply of STBs for its retail competitors, such that it would be appropriate for us to open a CA98 investigation at this point. Moreover, none of the respondents to our October consultation provided us with evidence regarding such conduct.

3.110 We are also aware that in practice, the launch of Freesat has not been prevented by the lack of compatible reception equipment available in retail outlets. Freesat-compatible STBs, DVRs and IDTVs are available from a number of retailers such as Argos, Comet, Currys and John Lewis.

3.111 While we recognise that high street retailers are the primary distribution channel for STBs at present, even if Sky were able to influence these retailers as to impede the take up of competing pay TV services, there would remain alternative supply channels for Sky's retail competitors. The most obvious examples are direct sales by pay TV retailers themselves and online sales (e.g. through retailers such as Amazon.co.uk).

3.112 In summary, we recognise there is a possibility that Sky may seek to influence the retail supply of STBs in the ways outlined in paragraph 3.79 to the detriment of

[41] We received responses from the following retailers: **[✂]**, Woolworths plc, Argos Ltd, ASDA Stores Ltd, DSG Retail Ltd, John Lewis plc, Sainsbury's Supermarkets Ltd.

competing pay TV retailers on DTT, and ultimately to the detriment of consumers. We share the concern that stakeholders have raised where Sky's ability and incentive to engage in these activities is derived from its position as a leading buyer of DSat STBs. While taken in isolation each of the issues raised may not necessarily appear to be that significant, we acknowledge that the cumulative effect of Sky's advantages may well be material. We would, of course, consider any CA98 complaint supported by evidence in the usual manner.

3.113 However, at this stage, the proposition that these activities would deny Sky's retail competitors access to potential subscribers is speculative given the lack of supporting evidence. Instead, we consider that such activities, to the extent that they amounted to anti-competitive conduct, would be more appropriately addressed though reliance on our ex post powers under CA98. This is because our ex post powers would enable us to address the harm to competition and consumers by requiring the infringing conduct to be terminated[42].

3.114 It has been put to us that the use of ex post powers would be insufficient to address these concerns and the only effective approach would be for Sky to be prohibited from retailing pay TV services on DTT. Following the discussion above, our current view is that there is insufficient evidence to justify ex ante measures (beyond ensuring access to Sky's premium content), and prohibiting Sky from retailing pay TV services on DTT would be an inappropriate response to the concerns raised. While we recognise that there is a risk Sky may seek to influence the take-up of competing pay TV services, we consider that this risk is outweighed by the benefit to consumers of having Picnic on DTT.

C. TECHNICAL PLATFORM SERVICES

The October consultation

3.115 Under the Proposal, Sky intends to protect its pay TV content on DTT from piracy by using CA technology supplied by NDS. While NDS is used by Sky in respect of its pay TV services on DSat, all other major retailers of pay TV services in the UK use CA technology supplied by Nagra.

3.116 In our October consultation we expressed a concern that the Proposal might lead to an outcome where NDS is ultimately the prevailing single CA technology on DTT, with Sky controlling access to technical platform services ("**TPS**") on DTT, in particular the wholesale provision of CA services.

3.117 We stated that we are aware that concerns of this nature might be addressed through existing TPS regulation, which is harmonised at EU level by the Access Directive[43] and implemented in the UK under sections 73 to 75 CA03. In this context Sky is already subject to conditions relating to the provision of TPS, and these conditions are not platform specific. However, the guidelines which set out how these TPS conditions apply to Sky's DSat platform do not apply to any prospective Sky DTT platform[44].

3.118 We also stated that we recognise that alternatively there may be a desire to foster an environment for fair and effective competition at the wholesale platform service layer

[42] Our ex post powers would also enable us to impose fines if we considered this appropriate.
[43] Directive 2002/19/EC.
[44] See "Provision of Technical Platform Services, Guidelines and Explanatory Statement 21 September 2006" at: http://www.ofcom.org.uk/consult/condocs/tpsguidelines/statement/statement.pdf.

of the value chain, on the merits of competing TPS. We said that it may also be appropriate to stipulate technical conditions which address concerns of incompatibility in pay TV services offered by different retailers, while nonetheless allowing for competition between different technologies. In our October consultation we considered "simulcrypt", a technical solution which allows a single broadcast channel to be used with two or more CA systems, in the context of TPS.

Consultation responses

Sky

3.119 Sky told us that it is putting in place arrangements for the supply of reception equipment that will essentially replicate the "horizontal market" already in place for DTT Freeview STBs. This would mean that, in principle, any manufacturer would be permitted to build and supply Picnic STBs so long as it could meet Sky's basic requirements. Furthermore, Sky told us that it would not prevent such manufacturers from incorporating additional functionality, such as a second CA system for example.

3.120 Sky also said that in relation to Picnic STBs, it will provide CA services to retailers of other pay DTT channels on FRND terms, subject to the following:

- To provide (pay) broadcasters with similar rights of access to all DTT platforms that support pay services, we should ensure that access to CA provided by other DTT platform operators is available on the same FRND basis. Such an access obligation should therefore also apply, inter alia, to Top Up TV and BT Vision.

- Any guidelines published by Ofcom concerning the interpretation of the FRND principles relating to the provision of such CA services should be similar for all three providers of pay services on DTT[45].

Other organisations

3.121 Some organisations (e.g. the BBC) said that allowing Sky to retail on DTT using "proprietary" CA (NDS) could enable it to control platform access. Some of them suggested that if we are minded to consent to the Proposal, then to address the problem we need to mandate the use of standards compatible with those already in use on existing DTT platforms.

Individual respondents

3.122 Few individual respondents provided views on the wholesale provision of TPS. However, we are aware that that more than 50 per cent of individual respondents are of the view that all pay TV services should be capable of being received through a single STB, rather than requiring consumers to purchase multiple STBs to view all available channels.

Our views

3.123 As we explained in our October consultation, this is a critical stage in the development of DTT, given the lead up to DSO and technical developments in the

[45] In particular, Sky referred to our consultation on *The Setting of Access-Related Conditions on Top Up TV* (February 2007) (http://www.ofcom.org.uk/consult/condocs/tutv/topup.pdf) to argue that any guidelines applicable to Picnic should take account of the early stage in its business lifecycle and its associated bargaining position with broadcasters.

provision of DTT services. We might therefore be concerned if Sky had the opportunity to gain control over DTT in respect of the wholesale provision of TPS simply as a result of its unique market position in other parts of the supply chain, rather than on the merits of its TPS in comparison to competing TPS.

3.124 Our current view is that Sky's market power in the wholesale provision of Core Premium channels (see paragraphs 3.47 to 3.49) is likely to provide it with such an opportunity. However, our current view is that if Sky's Core Premium channels were to become available to third party retailers on DTT on terms which enabled them to compete with Picnic effectively, it is far from clear that Sky would inevitably become the sole provider of TPS on DTT.

3.125 We are also aware of concerns raised by other organisations resulting from Sky's ability and incentive to influence the manufacturing and retailing of STBs (see paragraphs 3.78 and 3.79). The concern is that Sky would be able to promote STBs compatible with its own service ahead of STBs compatible with competing services, thus gaining control over the provision of TPS on DTT, not necessarily on the merits of its TPS, but as a result of its position in the supply chain for STBs. We recognise the potential for Sky to influence the supply chain for DTT STBs and address this issue in paragraphs 3.98 to 3.114.

3.126 While an issue such as Sky's influence in the provision of DSat STBs may afford Sky a unique advantage in the provision of DTT STBs, Sky would start from a position of zero STBs which are compatible with its proposed DTT service, in contrast to the significant installed base of DTT STBs which are compatible with existing pay TV services and not capable of receiving Sky's proposed service[46]. Furthermore, if Sky's Core Premium channels were to be made available to third party retailers using an existing DTT platform and TPS, the corresponding STBs would be capable of receiving both the existing pay TV services as well as Sky's Core Premium channels, and might therefore be perceived as more attractive than new DTT STBs which might only be compatible with Sky's proposed service. Therefore our current view is that it is not clear that Sky would necessarily become the sole provider of TPS on DTT as a result of its influence over the supply chain for DTT STBs. If we do not choose to pursue a wholesale remedy then this assessment would have to be revisited.

3.127 In any event, even if Sky's market position developed in such a way that it gained market power in relation to the provision of TPS on DTT, it would be subject to existing regulations regarding the provision of TPS[47]. We consider that the appropriate vehicle for deciding whether any competitor might have market power in the wholesale provision of TPS is our market review of wholesale digital television broadcasting platforms, which (as we explained in our December consultation) is currently on hold. As we explained in our December consultation, we consider that our MI will serve to highlight the issues which need to be addressed as part of that review.

[46] We understand that there are more one million STBs in use in the UK which are compatible with existing pay TV services on DTT. We recognise, however, that a significant number of these STBs may not meet the security requirements of some providers of pay TV content.
[47] Although we recognise that the guidelines which set out how the TPS regulations apply to Sky's DSat platform do not apply to the DTT platform.

D. OTHER POLICY CONSIDERATIONS

The October consultation

3.128 In our October consultation we explained that we would be concerned if the Proposal had a detrimental effect on the appeal of Freeview, and DTT more generally, by significantly reducing the number of FTA channels available to consumers on DTT or impeded the take up of digital television in the lead up to DSO. For example by reducing the appeal of Freeview or if it led to consumer confusion as to which services are available from different types of DTT reception equipment.

3.129 Our preliminary view was that the Proposal would be unlikely to reduce significantly the appeal of Freeview, given the strong presence of the PSB channels on DTT.

3.130 With regard to DSO, our preliminary conclusion echoed the view expressed in our April 2006 statement entitled "*Pay TV channels on multiplexes B, C and D*" (the "**April 2006 statement**")[48], which is that we did not consider the Proposal would be likely to affect materially the take up of digital television.

3.131 With regard to the marketing of Freeview, we said that we would be concerned if the Proposal resulted in any conflict of interest between Sky's role as a shareholder of Digital Television Services Limited ("**DTVSL**"), the company which promotes Freeview, and its role as a provider of pay TV services.

Consultation responses

Sky

3.132 Sky agreed with our preliminary view that given the strong presence of PSB channels on DTT the removal of Sky's FTA channels on DTT should not be of concern in terms of the appeal of Freeview. With regard to DSO, Sky said that the Proposal will only have a positive effect on the take up of digital television by encouraging households to view services over DTT.

3.133 Sky disputed the premise that customers will be (any more) confused about STB functionality as retailers will inherently seek to minimise any scope for confusion through clear marketing.

3.134 With regard to the removal of *Sky News* from DTT, Sky told us that if it were permitted to use its allocated DTT capacity to broadcast more than the present three channels, *Sky News* would be one of the additional channels that Sky broadcasts using this capacity. We are also aware that under the Proposal, Sky intends to schedule an hour of *Sky News* content per day up to seven days per week.

Other organisations

3.135 It appears from the responses to our October consultation that few organisations believe the Proposal is likely to have a significant impact on the appeal of Freeview. The notable exception to this is Freeview itself, which commissioned some consumer research[49] and found that one third of Freeview viewers said they would be less

[48] http://www.ofcom.org.uk/consult/condocs/paytv/statement/statement.pdf
[49] 462 face-to-face interviews were conducted in November 2007 by Taylor Nelson Sofres – 70 per cent were Freeview viewers and 30 per cent were non-digital respondents. Freeview's response to

satisfied with the service if Sky's channels were removed. Freeview also told us that 60 per cent of respondents to its consumer survey are concerned that the Proposal might signal the loss of further free channels in the future.

3.136 Some organisations considered that the Proposal would lead to consumer confusion. This is because Picnic would not be compatible with any existing STBs, given Sky's choice of CA and technical standards. Consumers would therefore need a new STB to receive the new pay TV channels.

3.137 The BBC, Rapture TV and **[✂]** told us that under the Proposal, the removal of *Sky News* would result in a further reduction in the plurality of the provision of news on FTA DTT, with the BBC remaining the only 24-hour news provider.

3.138 A number of organisations, such as the BBC, for example, raised serious concerns about Sky's continued membership of DTVSL if Picnic is allowed to launch. They told us that as certain Freeview decisions require the unanimous agreement of its members, Sky is well positioned to delay or prevent certain developments. They said that in such circumstances a conflict of interest will arise for Sky in connection with its ownership interest in DTVSL since it will no longer have any FTA channels on Freeview, but would instead be promoting a pay DTT proposition. Accordingly, they said that if we were to consent to the Proposal, such consent would need to be subject to a condition that Sky should terminate its involvement in DTVSL as a shareholder.

Individual respondents

3.139 Over 75 per cent of the 426 individuals that responded to our October consultation stated a belief that the removal of Sky's existing FTA channels under the Proposal will result in significant harm to Freeview. A significant number said that it will encourage other providers of FTA channels on Freeview to remove their channels from DTT or to start supplying them on a paid-for basis. Some individuals even believe that the Proposal could lead to the eventual collapse of Freeview.

3.140 As to whether the Proposal might lead to or increase consumer confusion, over 60 per cent of individuals that responded said that this is likely to be the case. It should be noted, however, that many responses are unclear as to whether it is them as the respondent and/or other individuals that would suffer from confusion.

3.141 About 12 per cent of individuals told us that the Proposal would have a negative impact on the availability of news on digital television.

Consumer survey

3.142 In November 2007 we carried out a consumer survey to help us assess whether the Proposal would be likely to impede the take up of digital television as DSO approaches[50]. This was in response to the large number of individual responses to our October consultation which we received shortly after publication, the majority of which said that the Proposal would be likely to have a negative impact on Freeview and consumer confusion. We conducted telephone interviews with 2072 individuals. Only 207 of those respondents were aware of the existence of digital TV but had yet

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our October consultation, which is based on its consumer research, can be found on our website at http://www1.bsc.org.uk/consult/condocs/dtv/responses/organisations/.

[50] The full results of the survey, which was carried out on our behalf by ICM Research, can be found on our website at: http://www.ofcom.org.uk/tv/paytv/.

to switch from an analogue service. This is consistent with our Digital Television Update – 2007 Q4[51], which showed that about 13 per cent of UK households had yet to switch to digital TV.

3.143 One of the questions we asked these individuals was whether they would be more or less likely to switch to Freeview from analogue TV if Sky removed its three existing FTA channels. Of these respondents, 50 per cent said that they would be less likely to switch in such circumstances. A simple reading of these responses might suggest that the Proposal is likely to impede the DSO process. However, some care is necessary in interpreting these results in the context of the responses given to other questions. For the most part, it appears that our analogue-only survey sample was not particularly interested in switching to digital TV, regardless of Sky's current FTA channels. For example, 37 per cent of the 207 analogue-only respondents told us that they did not have digital television because they do not watch much television or would probably not use it, and 67 per cent said that they were fairly unlikely or very unlikely to switch to digital in the next six months. It would therefore seem that for many of these remaining analogue-only viewers, switching to digital TV is not a high priority and while half said that the removal of Sky's FTA channels would mean they would be less likely to switch, it is unclear that this would have a material impact on when they switch and hence to the overall DSO process.

3.144 We also wanted to assess whether the launch of Picnic-compatible STBs might adversely affect consumers by increasing confusion over the types of DTT reception equipment which are available. We took the view that it would be appropriate to ask the relevant questions only of viewers who were interested in pay TV services on DTT: either viewers who had already taken up a subscription, or viewers who had stated they were interested in doing so. We considered that consumers who were not interested in pay TV on DTT would be unlikely to experience significant additional complexity in choosing DTT reception equipment, as we had understood from Sky that all Picnic-compatible STBs would be Freeview-compatible and marketed as such (as is the case with STBs compatible with existing DTT pay services).

3.145 Of the 2072 individuals that we interviewed, only a very small number fell within these categories. It was therefore not possible to obtain a reliable indication of whether the Proposal would adversely effect consumer confusion from this consumer survey.

Our views

Freeview

3.146 We recognise that the views of individual respondents to our October consultation, and potentially the findings of our consumer survey, provide some support for the proposition that the Proposal will have a negative effect on Freeview, including the provision of news content[52]. In contrast, the majority of organisations who responded to our October consultation do not appear to believe that the Proposal would have a significant impact on the appeal of Freeview. We have considered this issue from two perspectives: the impact on the appeal of Freeview to viewers and the impact on the effective functioning of DTVSL, the company which promotes Freeview.

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[51] http://www.ofcom.org.uk/research/tv/reports/dtv/dtv_2007_q4/dtvq407.pdf

[52] **[✂]** told us that we should examine the implications of the loss of plurality in news channel supply on the platform since one of only two dedicated news channels is potentially to be removed.

3.147 While we recognise there may be issues about the plurality of news provision, our current view is that the Proposal would not have a material impact on the overall popularity of Freeview with viewers. This is because Sky's existing channels on DTT, taken together, have a small audience share of not more than two per cent and the PSB channels will remain on DTT on a FTA basis. While the PSB channels have continued to lose audience share on DTT over the past few years, the combined audience share of the PSB channels taken together with their spin-off channels has significantly increased. In mid-2008 they accounted for over 90 per cent of overall viewing on DTT[53]. Furthermore, the responses to information requests that we sent to channel providers in the context of our MI indicate that there are no proposals by any current FTA channel provider other than Sky to start providing FTA channels on a paid-for basis.

3.148 To the extent that the removal of Sky's FTA channels has an impact on the appeal of content available on Freeview, this will be considered under the applicable statutory test relating to the variety of tastes and interest served by the programmes broadcast. As stated in paragraph 2.11 of our October consultation, we will first consider the competition implications of the Proposal before carrying out this test.

3.149 We also do not consider that Sky would be able to restrict the manufacture of Freeview-compatible STBs and integrated digital televisions ("**IDTVs**") given the support for Freeview provided by its other shareholders including the BBC, ITV and Channel 4, and for the reasons given in paragraphs 3.98 to 3.104. Furthermore, Sky said in its response to our October consultation that all Picnic STBs will be compatible with all Freeview channels and services.

3.150 With regard to DTVSL (which promotes Freeview), we recognise that if we consented to the Proposal and Sky remained as a shareholder of the company, Sky may pursue a strategy which conflicts with the interests of Freeview. For example, Sky may have the incentive to use its position to slow down technical innovations on Freeview or veto budget increases for Freeview so that its DSat and Picnic offerings are comparatively more attractive or better promoted. This is a concern which was raised by a number of organisations in their responses to the October consultation. The BBC, for example, told us that:

> "*There is also a concern that if Sky were to remain on the board of Freeview, they would be able to take decisions on its strategy when their interests (pay-TV) and those of Freeview (primarily free-TV) are no longer aligned. Whilst this is a matter for the board of Freeview, it remains the case that Sky could use its position to, for instance, slow down innovations on Freeview*."

3.151 Following meetings with stakeholders, we understand that there have already been some difficulties regarding the governance of DTVSL. For example, we were told that earlier this year it was not possible to agree a collective increase in the budget for Freeview. Furthermore, we are aware that any existing divergence of Sky's incentives may widen over time, particularly if we were to consent to the Proposal. While we recognise that Sky may have some incentive to promote DTT generally, Sky may perceive Freeview's attractiveness as an increasing threat, particularly:

- If more FTA channels are launched on DTT.
- If HD services become available on Freeview.

[53] BARB data.

- To the extent that DTVSL develops its focus towards setting common specifications and technical standards to promote the development of Freeview compatible STBs.

3.152 However, we would be cautious about pursuing a regulatory remedy to this concern without sufficient evidence that commercial solutions have been explored and found to be unworkable. Accordingly, our current view is that, in the first instance, we would look to the relevant parties to seek to resolve the issue through commercial negotiation.

3.153 In summary, for the reasons set out above, our current view is that the Proposal is unlikely to have a material adverse effect on Freeview. We have a greater concern over Sky's position on the board of DTVSL given the potential for conflicting interests with Freeview. However, at this stage we would be cautious about pursuing a regulatory remedy without allowing the opportunity for a commercial resolution to be agreed.

Consumer confusion

3.154 We recognise that the Proposal might increase the complexity of the decision-making process for consumers looking to buy DTT reception equipment. However, we are also aware that an incremental degree of greater complexity may be an inevitable consequence of increased competition and innovation[54]. This is arguably true in the context of other sectors, such as mobile telephones and personal computers. We also observe that reducing levels of complexity at the cost of restricting innovation may not be consistent with our duty in section 3 CA03, which requires us to have regard, where appropriate, to "*the desirability of encouraging investment and innovation in relevant markets*".

3.155 Furthermore, to the extent that there is potential for increased complexity in the purchasing decision, this may already exist. Consumers already have a choice of digital television platforms and distribution technologies and, in relation to DTT, they have a choice of obtaining television services from Freeview, Top Up TV, Setanta and BT Vision, which necessitates different reception equipment. For example, the Top Up TV Anytime service can only be received through a dedicated STB with DVR functionality and older Top Up TV upgradeable STBs are no longer compatible with all of Top Up TV's services. BT Vision services cannot be received through Top Up TV STBs and the Setanta basic STB is compatible with neither the Top Up TV Anytime service nor BT Vision services.

3.156 In addition, we do not consider that it will be in the interests of retailers of Sky's services, STB manufacturers or STB retailers for there to be widespread consumer confusion. On the contrary, it is our view that these market participants will inherently seek to ensure that their marketing materials are clear and compelling so that they encourage the uptake of their products and services.

3.157 Lastly, it is important to remember that all existing Freeview channels, other than *Sky News*, *Sky Sports News* and *Sky Three*, which Sky proposes to remove under the Proposal, will be available on all Picnic STBs as well as all current DTT reception equipment.

[54] For example, Top Up TV's 'Anytime' service can only be received through a dedicated STB with DVR functionality. Arguably this has made the purchasing decision for consumers more complex. However, it has also enabled scarce DTT capacity to be used more efficiently.

3.158 It should be noted that in our statement entitled "*Digital Television: Enabling New Services*"[55], we considered the potential impact that our proposals could have on the DSO process. We observed that there is a risk that any changes to the options faced by consumers at DSO will increase the risk of consumer confusion. Accordingly, we said that if our recommendations set out in the statement are adopted by Government, we will work closely with the DSO campaign, specifically with Digital UK and the Digital Switchover Help Scheme to ensure that clear and consistent information about any changes is made available to viewers as soon as is practicable. Similarly, in this context, if we were to consent to the Proposal (with or without conditions) we would expect Picnic and Sky to adopt a similar approach to address any concerns regarding increased complexity of the decision-making process for consumers wishing to purchase DTT reception equipment.

Impact on DSO

3.159 We do not consider that the Proposal will adversely affect confidence in DSO given our current view that:

- The Proposal will not have a material impact on the appeal of Freeview to viewers.
- Sky would not have the ability to restrict the manufacture of Freeview-compatible DTT reception equipment.
- A degree of greater complexity may be an inevitable and acceptable consequence of increased competition and innovation.

Consultation questions

1. *Do you agree with our current view that under the Proposal, Sky would be likely to emerge as the sole or main retailer of pay TV services on DTT, given its market power in the wholesale markets for Core Premium channels and its incentives to withhold its Core Premium channels from other retailers of pay TV services?*

2. *Do you agree with our current view that the emergence of Sky as the sole or main retailer of pay TV services on DTT and the consequent adverse effects on competition would be likely to occur in a relatively short timeframe?*

3. *Do you agree with our current view that Sky should not be prohibited from retailing pay TV services on DTT provided that its Core Premium channels on DTT are made available to its retail competitors on a suitable wholesale basis?*

4. *If we were to consent to the Proposal, subject to a condition that Sky must make its Core Premium channels available to competing retailers on a suitable wholesale basis, do you agree that it would not be necessary to impose additional conditions addressing the provision of TPS by Sky?*

5. *Do you agree with our current view that the Proposal is unlikely to have a significant adverse effect on the DSO process or the appeal of Freeview to consumers?*

6. *Do you agree with our current view that the extent to which the Proposal may increase complexity in the decision-making process for consumers wishing to buy*

[55] http://www.ofcom.org.uk/consult/condocs/dttfuture/statement/statement.pdf

DTT reception equipment, this issue can be managed effectively without the need for imposing relevant conditions on Sky?

7. *Do you consider that to the extent the Proposal may lead to a (greater) conflict of interests between Sky and the other members of DTVSL (the company which operates Freeview), this is a matter which in the first instance should be resolved by the relevant parties through commercial negotiation?*

Section 4

Provisional conclusions and recommendations

Background

4.1 In our October consultation, given the consumer benefits of the Proposal, but the concerns about the longer term consequences for competition and the development of pay TV, we identified three options for consultation:

- **Option 1: consent to the Proposal on an unconditional basis**. In light of the increased choice of programming, including premium sports and movies, and associated consumer benefits identified in our October consultation, one option would be for us to consent to the proposal as it stands without requiring any additional specific conditions to be met. This option would reflect a conclusion that any competition concerns could be effectively addressed under ex post competition powers.

- **Option 2: consent to the Proposal subject to imposing additional conditions**. This option would seek (i) to gain the benefits of bringing new programming content to DTT, providing consumers with a greater choice of premium sports and movies, as well as factual, children's and general entertainment programming, but also (ii) to ensure the conditions for competition in pay TV, both on DTT and more widely, to the benefit of consumers in the longer term. In balancing these objectives, and consistent with our regulatory principles, we would seek to impose additional conditions which are the least intrusive necessary to achieve the policy objectives effectively.

- **Option 3: not consent to the Proposal**. Given the competition issues and the critical stage in the development of pay TV on DTT, a third option would be not to consent to the proposal at this point in time. Despite the consumer benefits associated with increased choice of programming, including premium sports and movies, this option would reflect a decision that it is not possible to identify appropriate conditions to address concerns about longer term competition problems in the development of pay TV services.

4.2 In this Section we consider each of the four areas of concern assessed in Section 3. In each case we summarise the concerns identified and then set out our provisional conclusions and recommendations, in particular with regard to the potential use of ex ante conditions.

A. ACCESS TO CONTENT

Potential wholesale conditions

4.3 As explained in paragraphs 3.30 to 3.65, our view is that, notwithstanding the consumer benefits, the Proposal would be likely to result in Sky becoming the main retailer of pay TV services on DTT. The reasons for this are three-fold. Firstly, we consider that certain premium content is a critical factor in the take up of pay TV services; without access to such content it is highly unlikely that any existing or potential competitor would be able to compete on equal terms with Picnic. Secondly, we consider that Sky has market power in the separate wholesale markets for the supply of premium content. Thirdly, we consider that Sky has an incentive to withhold wholesale supply of premium content from actual and potential competitors on DTT. We therefore consider there is a potential conflict with our principal duty under section 3(1)(b) CA03 (to further the interests of consumers, where appropriate by promoting competition) as well as our duties under section 3(4)(b) and 3(4)(d) to have regard to the desirability of "promoting competition in relevant markets" and "encouraging investment and innovation in relevant markets". We identify at paragraphs 3.50 to 3.65 the adverse effects on competition we consider are likely to result if the Proposal were to proceed without any conditions.

4.4 In our October consultation, one potential set of conditions on which we sought stakeholder views was a requirement on Sky to make some or all of its channels available to other retailers on a wholesale basis. These conditions would seek to address our concerns relating to the wholesale provision of content.

4.5 Sky said in its response to our October consultation that it does not consider that we have discharged our obligations for the imposition of ex ante regulation, so that Option 1 is the only appropriate option. Sky also said that to the extent that our concerns were to materialise in practice (i.e. with sufficient likelihood or materiality), they would appear to be capable of remedy on an ex post basis. It is concerned that in our October consultation we had dismissed the potential for ex post enforcement and that our dismissal was unreasoned.

4.6 Many organisations and some individual respondents said that it would be acceptable for us to consent to the Proposal so long as a technically and commercially viable wholesale must-offer arrangement was put in place. Stakeholders told us that a wholesale must-offer arrangement would need to be structured in such a way that:

- Competing retailers of pay TV services could obtain Sky's Core Premium channels on a wholesale basis.
- It was not restricted to DTT but would apply in respect of pay TV platforms over all distribution technologies (i.e. cable, DSat, DTT and IPTV).
- It would offer a sufficient margin and certainty of supply so that competing retailers could compete effectively with Sky.
- The relevant Sky channels could be received by STBs using Nagra CA (in excess of one million existing STBs[56]) as well as by Picnic STBs, which may include only NDS CA.

Indicative analysis

4.7 In order to inform our analysis, we have carried out an indicative analysis to compare the likely impact of the different approaches, Options 1, 2 and 3, set out in the October consultation and summarised in paragraph 4.1. Given the uncertainty about the future development of pay TV services on DTT, the analysis is inevitability stylised and is aimed at facilitating comparisons between the different approaches rather than representing projections or forecasts of what we think will actually happen.

[56] See paragraph 2.39 of our October consultation.

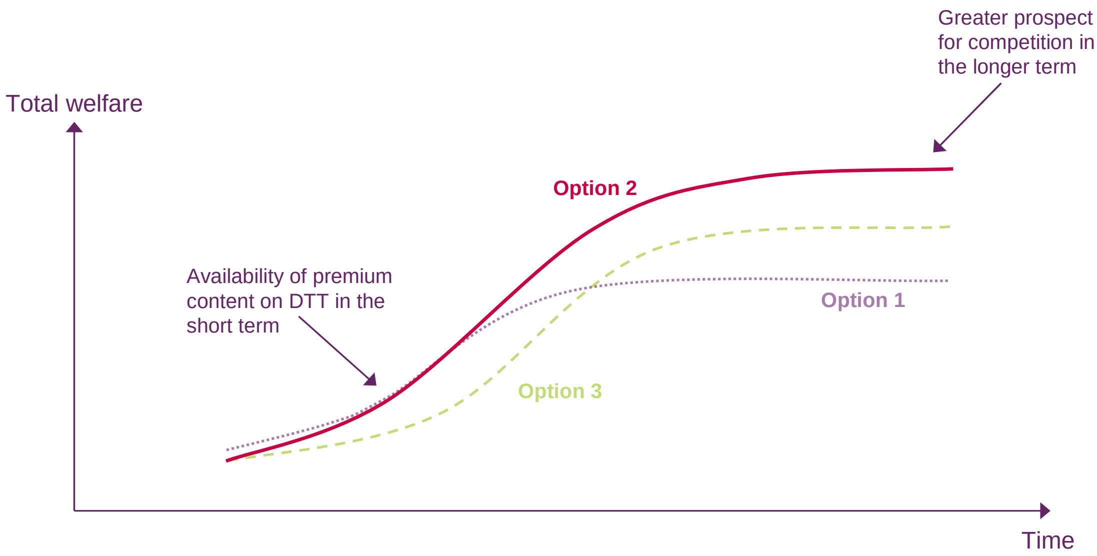
4.8 Firstly, we considered a comparison between an Option 1 approach (i.e. giving consent to the Proposal unconditionally) and an Option 3 approach (not giving consent to the Proposal). Unsurprisingly, our analysis suggests that in terms of availability of content an Option 1 approach would be likely to deliver a higher level of benefit, largely as a result of the belief that the Proposal is likely to expand the addressable market for pay TV services on DTT. However, we have also noted the risk to competition and of longer term consumer detriment if an Option 1 approach resulted in Sky becoming the largest single provider on DTT and reduced the competitive pressure at the retail level in pay TV more generally.

4.9 We have adopted a simple approach to representing this longer term effect on consumers by modelling it as if prices were higher in the long term than would otherwise have been the case. This is not intended to imply that any detrimental impact on competition would automatically take the form of higher prices – for instance, this approach could equally represent a reduction in quality (e.g. lower customer service or innovation). Our indicative analysis suggests that a relatively modest one-off future increase in monthly package prices of around 3.2 per cent could be sufficient to negate the benefits of an Option 1 approach over an Option 3 approach. It is therefore possible to envisage situations where there is greater net benefit from not giving consent to the Proposal, and other situations where there is greater net benefit from giving consent to the Proposal unconditionally. The question of which situations are more likely depends on the likelihood and magnitude of higher prices for consumers in the future due to reduced competitive pressure. It is therefore difficult, on this basis alone, to determine definitively whether an Option 1 approach or Option 3 approach ultimately leads to greater benefits for consumers.

4.10 Secondly, we have considered a comparison between Options 1 and 3 and Option 2 (i.e. giving consent to the Proposal subject to certain conditions). Our analysis suggests that an Option 2 approach could give rise to a higher level of benefit than either of the other options since it would both promote wider availability of content and provide more scope for competitors to Picnic to develop alternative packages of services, providing greater choice for consumers, and to continue to compete with Picnic. Coupled with ameliorating the risk of reduced competitive pressure at the retail level in the longer term, our analysis indicates that an Option 2 approach is most likely to generate the greatest level of benefits to consumers.

4.11 The diagram below presents a highly simplified and stylised representation of the consumer benefit that we consider Options 1, 2 and 3 are likely to deliver over time.

Stylised comparison of Options 1, 2 and 3



4.12 The qualitative and quantitative analysis set out in Annex 6 helps to inform our decision making process although it is not determinative on its own. Taking into account the impact assessment analysis and comments in response to the consultation process, we consider that consenting to the Proposal subject to appropriate conditions including a wholesale must-offer arrangement for premium content (Option 2) would appear to be more likely to deliver benefits to consumers than either an Option 1 or Option 3 approach. We therefore consider that of the three options available to us, Option 2 is most likely to satisfy our regulatory duties, in particular our duties to have regard to the desirability of promoting competition and encouraging investment and innovation to the benefit of consumers.

Our views

4.13 In Section 3 we identified our competition concerns in relation to Sky's market power in the markets for the wholesale supply of Core Premium channels. We consider below the most appropriate means of addressing that concern.

Regulatory options

4.14 Before considering the use of ex ante conditions through our sectoral competition powers under section 316 CA03, it is necessary for us to determine whether it would be more appropriate to rely on our ex post powers under CA98 to address the competition concerns identified[57]. In this context we are conscious of our duty under section 3(3) CA03 to have regard to the need to act in a manner which is proportionate and targeted only at cases in which action is needed. In the context of our duty under section 3(4)(d) we are also conscious of the impact our process may have on investment decisions being made current and potential operators on DTT.

4.15 In our view it would be more appropriate to use our sectoral competition powers. Our principal duty is to further the interests of consumers, where appropriate by promoting competition. This is connected to our duty under section 316 to ensure "fair and effective competition in the provision of licensed services". This consultation identifies how a lack of incentive for Sky to supply its wholesale Core Premium

[57] Section 317 CA03.

channels at prices that competitors can afford is likely to impact on competition on DTT in the event the Proposal was to proceed. Our sectoral powers are therefore more suited to dealing with a concern about the way we see competition developing in a manner that will not best serve consumers.

4.16 Conversely, there are a number of reasons why we do not consider it would be more appropriate to rely on our ex post powers.

- **We would still see a competition problem even absent a finding of anti-competitive behaviour.** One of the potential reasons we identified for Sky's lack of incentive to supply was possible differences in efficiency between Sky and other retailers. If that were the case, an abuse might well not have taken place, but the negative impact on competition and consumers that we have identified would still exist. If we were to rely on our powers under CA98, we would not be able to address this competition problem absent an actual finding of anti-competitive behaviour.

- **Ex post CA98 powers are used to address infringements of competition law**. They are not primarily used to further the interests of consumers by promoting competition through creating the incentives for expansion and entry that would have existed prior to the incumbent achieving market power. We consider that the next few years are likely to provide a unique opportunity for new entrants to focus on DTT viewers who do not currently subscribe to pay TV services. If we consented to the Proposal without imposing conditions, potential competitors are likely to be dissuaded from launching pay TV services on DTT given Sky's market power. We do not consider that this could be addressed effectively using our ex post competition powers.

- **Some types of remedy would not be available under CA98.** Even if it were demonstrated that Sky had committed a breach of the Chapter II prohibition, the remedies available under CA98 might not be able properly to address the concerns we have identified. The imposition of a fine would not in itself secure supply of the wholesale product. It would be necessary for us to issue directions under section 33 CA98. In advance of any particular breach occurring it is not possible to determine what scope of directions might be justified in the particular circumstances. There is therefore a material risk that it may not be possible to remedy a refusal to supply under CA98 through an obligation on Sky to enter into a wholesale arrangement. In particular, one possible component of a remedy to address the problem we have identified is to impose an ex ante pricing rule on wholesale channels. It is probably not possible to introduce this under CA98. Further, if we saw fit to determine a wholesale price designed to facilitate entry, that price would be based on different cost data from a test of whether Sky was applying a CA98 margin squeeze. Specifically, a remedy intended to promote competition might seek to reflect the lack of scale economies of a new entrant. The CA98 margin squeeze test is more focused on an equally efficient operator. It might therefore generate a different result and in this case be less effective at promoting the dynamic benefits of competition.

- **Even if anti-competitive behaviour were taking place, under a CA98 process it might take a considerable amount of time for this to become apparent.** If we were to carry out an external analysis of Sky's conduct, it would be exceptionally difficult to determine whether a failure to reach an agreement on supply was attributable to (a) the difficulty of reaching agreement on these complex commercial issues (b) an inability to agree a price satisfactory to both parties or (c) an incentive to restrict supply in order to distort competition. It is at least very likely, given the evidence available to date on the duration of wholesale discussions, that a substantial period of time may have to have passed before we could be satisfied that any failure to reach agreement is attributable to the difficulty of reaching agreement rather than an incentive not to supply. In the meantime the negative impact on consumers of a failure to agree terms for wholesale supply, as described above at section 7, will persist. In our view there may be a risk that damage to the market would occur during that period because potential new retailers will not be able to take advantage of technological changes to enter the market. We do not consider that this situation would be consistent either with our principal duty to further the interests of consumers, where appropriate by promoting competition, or with the concept of ensuring "fair and effective competition" under section 316 CA03. Specifically with regard to the Proposal, it may be too late to address the impact on competition once existing competitors had exited. We are conscious that this might occur within a very short period (possibly within a matter of months), and we are concerned that we would not be able to take action sufficiently quickly to prevent this under CA98 (even recognising the possibility of seeking interim measures). **[✂]**

4.17 We therefore consider it is more appropriate to consider the use of our sectoral powers under section 316 CA03, as described above at Section 2.

4.18 Sky holds television licensable content service licences under the Broadcasting Act for its Core Premium channels. These channels are therefore "licensed services" for the purpose of section 316. We can therefore consider appropriate action under section 316 to ensure fair and effective competition in the provision of those channels, and any services provided for purposes connected with those channels. In addition to the possibility of new licence conditions, there are the existing licence conditions described in Section 2 above which are relevant in this context.

4.19 In Section 3 above we reach a view that at the wholesale level there are separate markets for the supply of the Core Premium channels which are the subject of these licences. This Section therefore identifies markets which are relevant to a consideration by us of fair and effective competition in the provision of the licensed services.

4.20 In Section 3 we also reach views on concerns over the ability of existing or potential competitors to compete effectively with Sky in the absence of wholesale must-offer arrangements for the Core Premium channels. We therefore have a concern that fair and effective competition in the provision of the licensed services will be restricted. It may therefore be necessary to intervene in the wholesale of Core Premium channels to ensure fair and effective competition in:

- The retail provision of the Core Premium channels which are "licensed services" and services connected to the provision of those services.

- The retail provision of licensed services in the relevant markets which are affected by the terms on which the Core Premium channels are supplied, and services connected to the provision of those services.

4.21 Following the analysis of consultation responses we therefore propose to consider further the imposition of a remedy under section 316 through a licence condition or direction on Sky in the form of a wholesale must-offer obligation.

Further investigation of a wholesale must-offer solution

4.22 In practice, there appear to be three broad approaches to ensuring that Picnic's competitors on DTT have access to Sky's Core Premium channels: (i) a commercially and technically workable wholesale must-offer arrangement, (ii) operational separation of Sky's channel and distribution businesses and (iii) changing the way in which rights are sold at the content layer[58]. In the context of this Proposal, approaches (ii) and (iii) appear disproportionate. They might achieve increased retail competition, but at significant cost, either to rights holders or Sky. Furthermore, operational separation of Sky's channel and distribution business is not a remedy which we have the power to impose. Accordingly, our current view is that a wholesale must-offer obligation is the most appropriate solution to the competition concerns identified.

4.23 In our second MI consultation a wholesale must-offer arrangement is also proposed as a solution to the wider competition concerns addressed in that document. As explained above, there are various parts of the analysis of the Proposal which are connected to the analysis set out in our second MI consultation, for example in relation to market definition and market power. Those are issues upon which our second MI consultation seeks further comment before conclusions can be reached. It would therefore not be appropriate for our assessment of the Proposal to reach a final conclusion on the implementation of a wholesale must-offer arrangement at this stage. We also agree with Virgin Media that putting in place a wholesale must-offer arrangement in respect of DTT without considering other platforms and distribution technologies would be less desirable given the potential to distort competition in the pay TV sector.

4.24 Our second MI consultation sets out for consultation discussion of a number of issues which might need to be addressed in a WMO. However, it does not propose specific conditions, for example conditions which we might impose to ensure that any wholesale must-offer arrangement is commercially viable; that is to say conditions addressing certain commercial terms, in particular those relating to the wholesale price for the relevant channels.

4.25 Nevertheless, within this consultation we have sought to assess the impact of the Proposal, different stakeholders, in particular consumers, to determine the appropriateness of a form of wholesale must-offer arrangement. Our views are set out in more detail at Annex 6.

4.26 The remainder of this Section discusses conditions which we consider may be required to ensure that any wholesale must-offer arrangement is workable specifically in relation to the Proposal and DTT.

Potential conditions of a wholesale must-offer arrangement specific to the Proposal

4.27 The Proposal requests the relevant licences of Arqiva and Sky to be altered such that *Sky Sports 1* and *Sky Movies Screen1* can be broadcast utilising DTT capacity on multiplex C which is currently used to broadcast its FTA channels. As discussed above, we currently consider that Sky should be required to offer these licensed channels on a wholesale basis as a requirement of proceeding with these changes.

4.28 A wholesale must-offer arrangement specific to the Proposal should be considered within the context of DTT's unique characteristics, compared to other digital TV

[58] See further paragraphs 8.25 to 8.36 of our second MI consultation.

distribution technologies, in order for it to work efficiently and effectively. For example, as noted in our October consultation: (i) DTT is relatively capacity constrained compared to cable and DSat; (ii) the market for reception equipment is characterised by a range of different STBs, all capable of receiving Freeview and some capable of receiving pay TV services; and (iii) there is existing regulation of DTT, in particular technical performance standards for DTT broadcast transmission signals through the Ofcom Television Technical Performance Code[59]. Imposing a wholesale must-offer arrangement at a time of significant change needs careful consideration, given the DSO process and relocation of existing services on DTT to enable the introduction of HD services.

4.29 In particular, in paragraph 5.26 of our October consultation, we considered a broad range of mechanisms to ensure that wholesale access to content could be provided in a way which was technically workable for competing DTT retailers given different CA systems and Sky's security concerns.

Conditions relating to CA technology

4.30 The Proposal envisages that three of the existing videostreams on multiplex C, which are currently used for Sky's three FTA channels, would instead be used for Sky's proposed Picnic service, including Core Premium channels. Under a wholesale must-offer arrangement to address the competition concerns identified with the Proposal, we would seek an appropriate mechanism to provide competing pay TV retailers with access to the videostreams for Sky's Core Premium channels. However, for this to work in practice, those retailers would need to support the same transmission and compression technologies. They may also need to arrange for multiple CA technologies to be supported if they do not make use of the same CA technology.

4.31 As noted in paragraph 5.23 of our October consultation, we recognise that a technically feasible option would be for multiple videostreams of the same TV channel to be broadcast in order to make it available on STBs supporting different transmission and compressions technologies or different CA systems. However, given the significant capacity constraints on DTT we do not at present consider that we should recommended this approach, especially in light of our duty under section 3(2) CA03 to ensure optimal use of spectrum. For example, if *Sky Sports 1* and *Sky Movies Screen1* were made available to two of Sky's competitors on DTT and each competitor used its own DTT capacity, this would require six videostreams instead of just two. This would be equivalent to roughly one third of the total commercial DTT capacity available at present and it is unlikely that that this would be consistent with our duty referred to above.

4.32 Sky and Arqiva have proposed to use NDS CA for the broadcast of the proposed channels – the same CA technology that is already used by Sky on its DSat platform. Top Up TV provides CA services for its own retail service, Setanta and BT Vision on DTT using Nagra CA technology.

4.33 In order for the wholesaling of the licensed channels to be effective, it appears that there are four broad options available with regard to CA:

- **Use of Nagra CA technology**. All retailers use the same Nagra CA technology as provided by Top Up TV. This would ensure interoperability of CA for all DTT pay TV reception equipment and may increase economies of scale for both manufacturing and the resources employed to maintain security.

[59] http://www.ofcom.org.uk/tv/ifi/tech/codes_guidance/tv_tech_platform_code.pdf

- **Use of NDS CA system**. All retailers use the same NDS CA as chosen by Sky and Arqiva in the specification of their Proposal.

- **Use of simulcrypt**. Each retailer chooses their own preferred CA system and CA provider and simulcrypt is implemented to allow different types of CA encryption to be carried alongside a single transmission of the wholesale must-offer channels. The principles behind simulcrypt were set out in paragraphs 2.48 to 2.50 of our October consultation.

- **Use of STB compatible with multiple CA systems**. All STBs compatible with the proposed Picnic service would be required to also be compatible with existing Nagra-encrypted pay TV services.

4.34 In this context, we note Sky's response to our October consultation, in which it said:

> "*In relation to the availability of Sky's channels on DTT, other than via the Picnic service:*
>
> *Sky plans to retail some or all of the Sky channels (namely Sky Sports 1, Sky Movies Screen1 and Sky One and any other Sky channel that Picnic makes available in the future, for example Sky News) over third party compatible DTT platforms. In this case, "compatible" would mean, inter alia, that the other DTT platform could support the Sky channel in the format in which it is broadcast, e.g. in MPEG-4.*
>
> *Again, simulcrypting arrangements for Sky's channels would be feasible, so long as (i) Sky's reasonable security concerns by any third party CA system are satisfied, (ii) the third party DTT platform operator offers CA services on FRND terms to enable Sky or Picnic to access their platform and provide the Sky channels as retailer, and (iii) Sky has sufficient capacity available to support the transmission of multiple CA streams without adverse effects.*"

4.35 Whilst adopting a common CA technology on DTT may provide some benefits in terms of interoperability and economies of scale it would reduce competition in the provision of CA services and, as a consequence, could reduce innovation in the development of CA services. This would therefore conflict with our duties under sections 3(2)(b), 3(4)(b) and 3(4)(d) CA03.

4.36 For the reasons set out in paragraphs 3.103, we consider the option of requiring STBs compatible with multiple embedded CA systems to have significant implications for the complexity, development timescales and resulting retail price of such STBs. Rather than requiring a second embedded CA system, Picnic-compatible STBs could be enabled to access existing Nagra-encrypted CA services through the inclusion of a suitable CA slot into which a Nagra-based conditional access Module ("**CAM**") could be inserted (such a solution is already supported by Setanta which supplies CAMs to consumers who have DTT reception equipment with CAM slots). However, Sky and Arqiva have raised concerns relating to the ease with which decrypted pay TV services can be copied from CAMs by intercepting the digital stream between the CAM and the receiver. It is possible that the new specification of common interface noted in paragraph 3.13 would address these concerns, but there is still uncertainty on where and when compliant DTT reception equipment will be deployed.

4.37 Our current view is that simulcrypt is the most appropriate solution to allow multiple retailers of the DTT wholesale must-offer channels, without needing to transmit the same channels more than once, and ensuring that competition in the provision of CA services is not distorted by effectively pre-selecting a "winner". This approach may have the effect of lowering barriers to entry by reducing the need to secure separate DTT capacity. In this context, Sky said in its response to our October consultation that simulcrypting arrangements are technically workable in principle. Simulcrypt was also recommended as a solution by other respondents such as the BBC and BT.

4.38 In this context, we are aware that Sky has genuine concerns regarding the security of CA systems other than NDS. In its response to our October consultation it said that:

> "*Sky has security concerns about the implementation of the MediaGuard CA system employed by Top Up TV which would currently preclude any simulcrypting arrangement with Top Up TV. These concerns relate to (i) the security that Top Up TV's MediaGuard system would provide for Sky's content and (ii) the steps that Top Up TV has indicated that it would be willing to take, were such a security breach to occur*."

4.39 We recognise that a need to minimise the number of consumers who have unauthorised access to pay TV content is fundamental to the sustainability of a subscription TV business model. Any service theft that results from weaknesses in the CA system operated by one retailer may not only reduce the revenues of that retailer, but may also impact on the revenues of other retailers and the wholesale provider. It is therefore vital that all retailers use effective CA technologies and are incentivised to minimise service theft. We also recognise that this is an issue which would need to be addressed with regard to all pay TV platforms to which we consider any wholesale must-offer should apply. Accordingly, we have decided to consult on the issue of security requirements and liability for security breaches as part of our second MI consultation.

4.40 In Section 9 of our second MI consultation we consult on a possible approach to ensuring consistency of security measures across the industry. This would involve each retailer of Sky's Core Premium channels ensuring that its chosen CA system complied with a defined set of Minimum Security Requirements ("**MSRs**") and was incentivised to maintain the integrity of its chosen CA system. In conjunction with a subscriber and security audit of each retailer the MSRs could form the basis of an agreement between Sky and each retailer for supply of the wholesale must-offer channels.

4.41 We envisage that simulcrypting arrangements may require additional changes to the carriage agreement between Sky and Arqiva. Pursuant to Condition 11(8) of Arqiva's Multiplex C, licence changes to that agreement require consent from Ofcom. As at the end of August 2008, Sky and Arqiva were still in commercial discussion regarding changes to the carriage agreement required in order to implement the Proposal.

Ancillary conditions

4.42 As explained above, any wholesale must-offer arrangement would need to be workable both from a commercial and technical perspective. We consider that this objective would be met if the arrangement created the necessary conditions for sustained retail competition. In meeting this objective our prime concern would be to ensure that third party retailers had effective access to the wholesale must-offer channels.

4.43 It follows that if we were to consent to the Proposal subject to a commercially and technically workable wholesale must-offer arrangement being put in place, we would be concerned if a third party retailer's ability to obtain the wholesale must-offer channels was compromised.

4.44 Our current view is that the Proposal may provide Sky with an incentive to act in such a way as to reduce the effectiveness of any wholesale must-offer arrangement. This is because a less effective wholesale must-offer arrangement would limit increased competition from other retailers of pay TV services on DTT to the benefit of Picnic and Sky. In particular, we would be concerned if Sky was able to launch Picnic before third party retailers were able to start retailing the wholesale must-offer channels effectively, as this "first mover advantage" might lead to Sky inevitably becoming the sole retailer of pay TV services on DTT, thereby defeating the purpose of the wholesale must-offer arrangement.

4.45 There are potentially numerous ways in which the effectiveness of a wholesale must-offer arrangement might be compromised in practice. Such concerns have been raised by a number of respondents to our October consultation (e.g. **[✂]** Virgin Media). For example, we were told by Virgin Media that Sky would have an incentive to stall negotiations with third parties. We agree that Sky would be likely to have such an incentive if it was allowed to launch Picnic before all the relevant terms of any wholesale must-offer arrangement had been reached.

4.46 We are mindful of other ways in which the effectiveness of a wholesale must-offer arrangement may be reduced. For example, Sky may have an incentive to enter only into wholesale supply agreements of short duration or require exclusivity provisions which prohibit third party retailers from retailing other subscription channels.

4.47 Our current view is that it is impossible in advance to identify comprehensively the types of behaviour which Sky might engage in to reduce the effectiveness of any wholesale must-offer arrangement. We therefore consider that it would be better to impose ancillary conditions which focus on delivering our intended outcome for competition and consumers rather than attempt to address a wide range of potential behaviours.

4.48 We recognise that if we imposed ancillary conditions on Sky which must be met prior to Picnic being allowed to launch this might provide third party retailers with an incentive to delay the launch of Picnic. For example, if a condition was imposed on Sky whereby it could not launch Picnic until simulcrypting tests had been completed satisfactorily, there may be an incentive for third parties to extend the testing period for as long as possible.

4.49 It is unclear how significant a risk is posed by the potential for such conduct by third party retailers. This would seem to depend on whether third party retailers considered the competitive threat posed by Picnic to outweigh the benefit of having access to the wholesale must-offer channels. If we concluded that the risk was material then we might need to take this into account in drafting ancillary conditions. For example, to prevent either Sky or a prospective third party retailer from stalling contractual negotiations and thus delaying the availability of Sky's premium content to DTT consumers it might be appropriate to stipulate that wholesale terms will be determined by an independent third party if agreement cannot be reached within a defined period of time.

4.50 In summary, given the potential incentives which Sky and third parties may have to reduce the effectiveness of any wholesale must-offer arrangement, our consent to the Proposal may need to be subject to additional conditions. Such conditions may include a requirement that Picnic may not commence service until:

i) A local simulcrypting trial involving Sky, Arqiva and one or more prospective third party retailers is carried out to the satisfaction of Ofcom, Sky and Arqiva.

ii) At least one third party retailer is in a position to start retailing the wholesale must-offer channels.

iii) A defined time period has elapsed following (i) the launch of a competing pay DTT service that includes at least one of the wholesale must-offer channels or (ii) the satisfactory completion of a local simulcrypting trial (referred to in the first bullet point above).

iv) Sky has achieved a specified number of wholesale DTT subscribers, defined to be subscribers of retail competitors on DTT who include at least one wholesale must-offer channel as part of their subscription.

4.51 We are not suggesting that all of these would be appropriate or that they comprise an exhaustive list of potential conditions. Rather, our intention is to stimulate debate by listing a number of possible examples, in order to inform our thinking and determine the least intrusive conditions required to achieve our intended outcomes.

4.52 We are aware that potential ancillary conditions will vary in terms of their impact on Sky and third party retailers. This can be seen from the example conditions in paragraph 4.50, which are listed in ascending order of intrusiveness. For instance, conditions iii) and iv) are far more intrusive that condition i), as they would give the relevant third party retailer(s) an element of competitive advantage over Sky.

4.53 Given our aim of finding the least intrusive means of achieving our intended outcomes, we encourage stakeholders to explain in their responses to this consultation:

- Whether any consent to the Proposal would need to be subject to ancillary conditions being put in place.

- If so, what ancillary conditions would be required and the specific concern(s) they would seek to address.

- Why there would be no other practicable and less restrictive means of addressing the concern(s) in question.

Interactive and advanced services

4.54 Sky told us that Picnic has actively engaged with the DTG and is requesting that manufacturers use the DTG D-Book as the “base line” specification for its reception equipment, to ensure that set top boxes comply with industry-accepted standards.

4.55 We would therefore expect Sky to work closely with industry to ensure any technology developments required to support service enhancements associated with the wholesale must-offer channels and content are standardised across the industry. The timing of this standardisation should be such that all manufacturers have equal opportunity to bring new products and software upgrades to the market on the same timescale and that all retailers have the opportunity to make the service enhancements available to their end customers on the same timescale. In developing this new functionality based on the wholesale must-offer content and channels, Picnic should not be given preferential treatment over other retailers.

Transmission and compression technologies

4.56 While the Proposal does not include a request to use MPEG-4 for the transmission of the proposed pay TV channels, Sky and Arqiva have separately proposed that they should be able to adopt MPEG-4 and DVB-T immediately. In our statement entitled "*Digital Television: Enabling New Services*" we said that we are not yet in a position to be able to take a final view on this matter, particularly as we need to understand and then evaluate any risks associated with such implementation.

4.57 In our statement, "*Digital Television: Enabling New Services*" we explained that we have two general concerns regarding the launch of MPEG-4 services without DVB-T2 (as proposed by Sky and Arqiva). The first is in respect of the potential for confusion among consumers who are faced with three types of digital receiver equipment: (i) the current MPEG-2 / DVB-T receivers used to view existing Freeview services, (ii) MPEG-4 / DVB-T2 receivers which would be required to view any HD channels to be broadcast on DTT, and (iii) MPEG-4 / DVB-T equipment which may be required to receive new services offered by Sky and Arqiva. It is possible to envisage that consumers may, in the early stages, consider buying MPEG-4 / DVB-T equipment in order to receive new services offered by Sky and Arqiva, without being aware that such equipment will not be compatible with HD broadcasts potentially available in the near future, and for which a further new MPEG-4 / DVB-T2 STB would be necessary. The second relates to whether manufacturers will have less incentive to develop and support the DVB-T2 format if the existence of multiple receiver equipment types fragments the market.

4.58 Our current view is that these could represent material risks – particularly in the lead up to DSO. However, we also note the strong arguments that a more flexible route to the adoption of MPEG-4 may encourage efficiency and result in commercial multiplexes adopting the new standards (MPEG-4 and DVB-T2) earlier than would otherwise be the case.

4.59 We propose, therefore, to consider any applications for new services using MPEG-4 with DVB-T on a case-by-case basis for the time being, taking into account the benefits and impacts that may arise. This should specifically include any possible impact on the development and take up of MPEG-4 and DVB-T2 equipment and communications to consumers around DSO.

4.60 Turning to the specific implications for the Proposal, even though the Proposal does not include a request to use MPEG-4, Sky told us that it intends to require all manufacturers of Picnic STBs to ensure that they are MPEG-4 / DVB-T and MPEG-2 / DVB-T compatible. If we were to consent to Sky and Arqiva adopting MPEG-4 without DVB-T2, this would allow them to introduce broadcasts using MPEG-4 compression at some time in the future (subject to regulatory approval) without Picnic having to swap-out STBs.

4.61 If the Sky channels were to be broadcast using MPEG-4 compression in the future this would lead to greater efficiencies by allowing a further MPEG-4 TV channel to be broadcast on multiplex C. However, it would also mean that most existing STBs, whether used for obtaining FTA or pay TV services, would not be compatible with the Sky services because, with the exception of BT Vision's "V-box", these STBs only support MPEG2 decoding[60]. It follows that if the wholesale must-offer channels are to be transmitted just once on DTT and accessible on existing pay TV enabled STBs then they would have to be transmitted using MPEG-2.

4.62 We acknowledge that, should Picnic be launched, Sky and Arqiva may then apply to us to transmit the Picnic channels using MPEG-4 compression and DVB-T or DVB-T2. Our current view is that it would be appropriate to make any consent subject to an ancillary condition to ensure that competing retailers making use of the wholesale must-offer arrangements are given sufficient notice of any changes in transmission standards (in particular from MPEG-2 to MPEG-4). The intention would be to provide them with the opportunity to make appropriate arrangements, such as swapping out their non-compatible STBs with compatible STBs or finding alternative DTT capacity, and hence able to continue to compete effectively with Sky. The duration of any notice period might depend on such factors as the length of time required by Sky's competitors to manufacture compatible STBs, the extent to which such STBs are already in development and the availability of alternative DTT capacity.

4.63 If we were to consent to the Proposal (with or without conditions) we would expect to see over time the development of Picnic STBs which are also MPEG-4 and DVB-T2 compatible, given that we would expect the majority of Picnic subscribers to also want access to free HD channels.

4.64 In light of the complexities highlighted above, we will continue to discuss these proposals with Sky and Arqiva with a view to gaining a better understanding of how the variation to use MPEG-4 and DVB-T could be adopted without causing any detrimental impact to DTT viewers.

B. SKY AS A RETAILER OF PAY TV SERVICES ON DTT

4.65 As we explained in paragraphs 3.66 to 3.114, other organisations argued that Sky should not be allowed to retail pay TV services on DTT given its overwhelming competitive advantages and its incentive and ability to influence manufacturers and retailers of STBs so as to impede the take up of competing pay TV services.

4.66 In paragraphs 3.85 to 3.93, we explained our view that the majority of the activities which Sky might engage in to gain competitive advantage are not unique to Sky. Furthermore, it is not clear that any of these activities are in themselves necessarily undesirable, and in some cases they may be efficient in promoting and enabling the take-up of services to the benefit of consumers (for example, investment in marketing and developing a brand is likely to promote consumer choice). We therefore do not believe it would be appropriate to prohibit Sky from retailing pay TV services on DTT simply on the basis that it would be likely to engage in these types of activities.

4.67 In paragraphs 3.94 to 3.97, we also expressed our view that a suitable wholesale must-offer arrangement could, in principle, address some of the objections to Sky retailing on DTT. Access to premium content is likely to enhance the attractiveness of the retail offerings of Sky's competitors, providing them with greater opportunity to develop their brands and encourage the take-up of STBs compatible with their retail services. In particular, in constructing an appropriate pricing structure as part of a wholesale must-offer arrangement, our underlying approach would be to develop it in a way that promoted effective retail competition with Sky, mindful of Sky's strength in the retailing of pay TV services.

[60] The inability for MPEG-2 STBs to decode MPEG-4 broadcasts is independent of interoperability issues associated with CA systems.

4.68 We do have concerns about the issues which could arise from Sky's position as a major purchaser of STBs and its relationship with retailers. However, at this stage, we have not been presented with convincing evidence to support the proposition that any anti-competitive activities would be likely to occur or would deny Sky's retail competitors access to potential subscribers. Of the activities highlighted by stakeholders which could be used to gain competitive advantage, the majority do not appear to be unique to Sky. Other competitors could adopt similar practices, and it is not clear that these activities are in themselves undesirable. We also consider that putting in place arrangements to offer retail competitors access to Sky's premium content could, in principle, address some of the objections to Sky retailing on DTT.

4.69 Given the availability of our ex post competition powers, we consider there is insufficient evidence to justify ex ante intervention to prohibit Sky from retailing pay TV services on DTT.

C. TECHNICAL PLATFORM SERVICES

4.70 For the reasons given in paragraphs 3.123 to 3.127, we do not intend to recommend any conditions to address the provision of TPS by Sky in the context of this assessment.

4.71 We would be concerned if Sky leveraged its market power in the wholesale provision of premium content in order to gain control over technical platform services on DTT. However, we consider a suitable arrangement where competitors could gain access to Sky's premium channels would address this concern since it would then be possible to watch these sports and movies channels on a competitor's DTT platform, and not only on Sky's DTT platform.

D. OTHER POLICY CONSIDERATIONS

4.72 For the reasons given in paragraphs 3.146 to 3.159, we consider that the Proposal is unlikely to have a significant adverse impact on DSO or the appeal of Freeview to consumers. Therefore, we are currently of the view that if we were to consent to the Proposal, we should not impose conditions addressing these issues.

4.73 We recognise that the Proposal could lead to increased complexity in the decision-making process for consumers wishing to purchase DTT reception equipment. We are also aware that an incremental degree of greater complexity may be a necessary consequence of increased competition and innovation. Therefore our current view is that we should not seek to impose conditions in this respect.

4.74 However, if we were to consent to the Proposal we would expect Sky to work closely with the DSO campaign to ensure that clear and consistent information about any changes is made available to viewers as soon as is practicable. This is consistent with our April 2008 statement entitled "*Digital Television: Enabling New Services*" (see paragraphs 2.34 to 2.36) in which we said that if our recommendations are adopted by Government we will do the same.

4.75 With regard to Sky's continued involvement with Freeview, a number of organisations (who wish to remain anonymous) said that Sky should terminate its involvement in DTVSL (the company which operates Freeview) as a shareholder prior to any launch of Picnic. This would be to ensure that Sky could not act in manner which conflicted with the interests of Freeview.

4.76 We have a greater concern over Sky's position on the board of DTVSL, should Sky's Picnic proposal proceed, given its interests may no longer be aligned with those of Freeview as both services develop further. However, at this stage we would be cautious about pursuing a regulatory remedy to these concerns without sufficient evidence to justify regulatory intervention or sufficient evidence that commercial solutions have been explored and found to be unworkable. In the first instance, we would look to the relevant parties to seek to resolve these issues through commercial negotiation, and are keen to monitor this issue closely.

Provisional conclusions

4.77 As noted in paragraph 4.1 we identified three options in our October consultation:

- Option 1: consent to the Proposal on an unconditional basis.
- Option 2: consent to the Proposal subject to imposing additional conditions.
- Option 3: not consent to the Proposal.

4.78 For the reasons discussed in this Section in relation to access to content, our view is that it is highly unlikely that any existing or potential competitor would be able to compete effectively with Picnic as the Proposal stands since Sky has exclusive access to a majority of premium sports and movies content, which we consider are critical inputs for the take up of pay TV services. In the light of our duties and regulatory principles, we therefore consider it is necessary to investigate the option of making consent to the Proposal subject to conditions regarding wholesale supply.

4.79 Conversely, as recognised in our October consultation, there are consumer benefits associated with increased choice of programming, including premium sports and movies which the Proposal would bring. Consistent with our regulatory principles, we would seek to impose conditions to address the competition concerns which are the least intrusive necessary to achieve our policy objectives effectively. At this stage, having considered the competition concerns and other issues raised, our view is that it would be possible to address these without prohibiting all aspects of the Proposal. Hence our view is that it would be inappropriate not to consent to the proposal under any conditions (Option 3).

4.80 Therefore our current view is that we are most likely to fulfil our regulatory duties by consenting to the Proposal subject to imposing additional conditions (Option 2) in order to (i) gain the benefits of bringing new programming content to DTT, providing consumers with greater choice in premium sports and movies, but also (ii) ensure the conditions for fair and effective competition in pay TV, both on DTT and more widely, to the benefit of consumers in the longer term. We are therefore also consulting on the potential use of the following conditions:

- A **wholesale must-offer arrangement**, under which Sky would be obliged to supply its Core Premium channels on a suitable wholesale basis which is commercially viable, in particular, subject to certain conditions in relation to wholesale pricing.
- The use of **simulcrypt**, under which other retailers of pay TV services on DTT, using different CA systems, could make use of the Core Premium channels without needing to transmit the same channels more than once, subject to suitable security requirements.

- **Ancillary conditions**, which focus on our intended outcome for competition and consumers by ensuring that the wholesale must-offer arrangement is not easily manipulated to be ineffective, but commercially and technically workable. For example, it might be appropriate to require that Picnic may not launch until at least one third party retailer is able to start retailing the wholesale must-offer channels effectively.

Consultation questions

8. *Do you agree with our current view that a wholesale must-offer arrangement, under which Sky must provide wholesale access to its Core Premium channels on DTT, is the most appropriate solution for us to pursue to address the competition concerns we have identified?*

9. *Do you agree that simulcrypt is the most appropriate means of allowing multiple retailers to have access to Sky's Core Premium channels on DTT?*

10. *Do you consider that Sky or relevant third party retailers on DTT would be provided with an incentive to reduce the effectiveness of a wholesale must-offer arrangement? If so, in what ways might they seek to achieve this?*

11. *If we were to consent to the Proposal subject to a suitable wholesale must-offer arrangement being put in place, do you consider that any ancillary conditions would be required to ensure that it was workable from a commercial and technical perspective? If so, please explain: (i) the ancillary conditions that would be required and the specific concern(s) they would seek to address and (ii) why there would be no other practicable and less restrictive means of addressing the concern(s) in question.*

12. *Do you consider that our indicative analysis, summarised at paragraphs 4.7 to 4.12 and set out more fully in Annex 6, supports our current view of whether we should opt for Option 1, Option 2 or Option 3?*

Annex 1

Responding to this consultation

How to respond

A1.1 We invite written views and comments on the issues raised in this consultation document, to be made by 5pm on 9 December 2008.

A1.2 We strongly prefer to receive responses using the online web form at http://www.ofcom.org.uk/consult/condocs/picnic/howtorespond/form, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.

A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email steven.ball@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.

A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.

Steven Ball
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA

Fax: 020 7981 3333

A1.5 We do not need a hard copy in addition to an electronic version. We will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.

A1.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views and how our proposals would impact on you.

Further information

A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Steven Ball on 020 7981 3379.

Confidentiality

A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.

A1.10 Copyright and all other intellectual property in responses will be assumed to be licensed to us to use. Our approach on intellectual property rights is explained further at http://www.ofcom.org.uk/about/accoun/disclaimer/

Next steps

A1.11 Following our consideration of the responses to this consultation and our second MI consultation, we intend to publish a statement in the coming year.

A1.12 You can register to receive free mail updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm

Our consultation processes

A1.13 We seek to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.

A1.14 If you have any comments or suggestions on how we conduct our consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk . We would particularly welcome thoughts on how we could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.

A1.15 If you would like to discuss these issues or our consultation processes more generally you can alternatively contact Vicki Nash, Director Scotland, who is our consultation champion:

A1.16 Vicki Nash
Ofcom
Sutherland House
149 St. Vincent Street
Glasgow G2 5NW

Tel: 0141 229 7401
Fax: 0141 229 7433

Email vicki.nash@ofcom.org.uk

Annex 2

Our consultation principles

A2.1 We have published the following seven principles that we will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened version for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will normally allow ten weeks for responses to consultations on issues of general interest.

A2.6 There will be a person within Ofcom who will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organizations interested in the outcome of our decisions. This individual (who we call the consultation champion) will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why. This may be because a particular issue is urgent. If we need to reduce the amount of time we have set aside for a consultation, we will let those concerned know beforehand that this is a ‘red flag consultation’ which needs their urgent attention.

After the consultation

A2.8 We will look at each response carefully and with an open mind. We will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.

A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.

A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore we would encourage respondents to complete their coversheet in a way that allows us to publish their responses upon receipt, rather than waiting until the consultation period has ended.

A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at www.ofcom.org.uk/consult/.

A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we do not have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing	☐	Name/contact details/job title	☐
Whole response	☐	Organisation	☐
Part of the response	☐	If there is no separate annex, which parts?	

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here. ☐

Name Signed (if hard copy)

Annex 4

Questions for consultation

Section 3: Assessment of responses to our October consultation

1. *Do you agree with our current view that under the Proposal, Sky would be likely to emerge as the sole or main retailer of pay TV services on DTT, given its market power in the wholesale markets for Core Premium channels and its incentives to withhold its Core Premium channels from other retailers of pay TV services?*

2. *Do you agree with our current view that the emergence of Sky as the sole or main retailer of pay TV services on DTT and the consequent adverse effects on competition would be likely to occur in a relatively short timeframe?*

3. *Do you agree with our current view that Sky should not be prohibited from retailing pay TV services on DTT provided that its Core Premium channels on DTT are made available to its retail competitors on a suitable wholesale basis?*

4. *If we were to consent to the Proposal, subject to a condition that Sky must make its Core Premium channels available to competing retailers on a suitable wholesale basis, do you agree that it would not be necessary to impose additional conditions addressing the provision of TPS by Sky?*

5. *Do you agree with our current view that the Proposal is unlikely to have a significant adverse effect on the DSO process or the appeal of Freeview to consumers?*

6. *Do you agree with our current view that the extent to which the Proposal may increase complexity in the decision-making process for consumers wishing to buy DTT reception equipment, this issue can be managed effectively without the need for imposing relevant conditions on Sky?*

7. *Do you consider that to the extent the Proposal may lead to a (greater) conflict of interests between Sky and the other members of DTVSL (the company which operates Freeview), this is a matter which in the first instance should be resolved by the relevant parties through commercial negotiation?*

Section 4: Provisional conclusions and recommendations

8. *Do you agree with our current view that a wholesale must-offer arrangement, under which Sky must provide wholesale access to its Core Premium channels on DTT, is the most appropriate solution for us to pursue to address the competition concerns we have identified?*

9. *Do you agree that simulcrypt is the most appropriate means of allowing multiple retailers to have access to Sky's Core Premium channels on DTT?*

10. *Do you consider that Sky or relevant third party retailers on DTT would be provided with an incentive to reduce the effectiveness of a wholesale must-offer arrangement? If so, in what ways might they seek to achieve this?*

11. If we were to consent to the Proposal subject to a suitable wholesale must-offer arrangement being put in place, do you consider that any ancillary conditions would be required to ensure that it was workable from a commercial and technical perspective? If so, please explain: (i) the ancillary conditions that would be required and the specific concern(s) they would seek to address and (ii) why there would be no other practicable and less restrictive means of addressing the concern(s) in question.

12. Do you consider that our indicative analysis, summarised at paragraphs 4.7 to 4.12 and set out more fully in Annex 6, supports our current view of whether we should opt for Option 1, Option 2 or Option 3?`

Annex 5

Legal framework

A5.1 This Annex describes the legal duties relevant to the assessment of the Proposal, and discusses points made by Setanta, Sky and Top Up TV in their responses to our October consultation in relation to those duties.

A5.2 Under section 3(1) CA03 it is our principal duty in carrying out our functions to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition.

A5.3 Sky commented in its response that competition concerns should not be “elevated” above other issues and that it is necessary pursuant to section 3(1)(b) CA03 for us to identify the markets relevant to its assessment.

A5.4 Conversely, Setanta and Top Up TV told us in their joint response that we are under a principal statutory duty to promote competition and that we should not subjugate that duty to (or seek to offset it against) any other purpose, such as the desire to bring new programming content to DTT. They also told us that a duty to promote competition clearly extends further than a duty to preserve the existing state of competition and a duty to prevent anti-competitive behaviour. They said that there can be no doubt that it is appropriate for us to further the interests of consumers by promoting competition in respect of the licensing of DTT services.

A5.5 The issues raised by the Proposal give rise to concerns as to whether, in the relevant markets identified, the interests of consumers are being, or will be, well served by the operation of competition. In Section 3 we explain the markets which we consider to be relevant to our analysis of the Proposal. The duty in section 3(1)(b) CA03 establishes that if we identify that the interests of consumers are not being furthered by the operation of competition in those markets, we should, where appropriate, act in order to promote competition. The powers that we have available to promote competition are discussed further at paragraphs 2.15 to 2.24. Section 3(1) CA03 must however be read in the context of our other duties and objectives.

A5.6 Under section 3(2) CA03 the objectives which, by virtue of our principal duty under section 3(1), we are required to secure include:

a) the optimal use for wireless telegraphy of the electro-magnetic spectrum;

b) the availability throughout the United Kingdom of a wide range of electronic communications services;

c) the availability throughout the United Kingdom of a wide range of television and radio services which (taken as a whole) are both of high quality and calculated to appeal to a variety of tastes and interests; and

d) the maintenance of a sufficient plurality of providers of different TV and radio services.

A5.7 Sky commented that our consideration of the objective under section 3(2)(a) should include an assessment of whether it is better to use DTT capacity to provide pay content under the Proposal rather than the existing free-to air channels. In our view this is a rewording of the more general competition issue, which is the focus of our analysis, rather than an issue concerning optimal use of spectrum. We do however identify, in the context of the discussion around simulcrypt in Section 4, a specific area where the optimal use of spectrum may be relevant.

A5.8 In relation to section 3(2)(b) it should be noted that there is a specific regime under the Access Directive and sections 73 to 75 CA03 which we can use to address competition concerns relating to technical platform services.

A5.9 Pursuant to section 3(2)(c) CA03 we must consider the impact of the Proposal on the range, quality and appeal of content being offered to consumers in the relevant markets. The benefits of the Proposal are discussed in the main document and are taken into account in our impact assessment. Assuming the Proposal proceeds, these issues would also be addressed under the assessment of the test in Condition 17(2) of Arqiva's Multiplex C licence.

A5.10 Sky commented that section 3(2)(d) is relevant in that the greater appeal of the proposed channels would help to improve plurality on the DTT platform, which is dominated by PSB broadcasters. As the provision of channels by Sky is a requirement of Arqiva's Multiplex C licence the number of providers will not however be affected by the assessment of the Proposal.

A5.11 Section 3(3) CA03 requires that in performing our section 3(1) duties we must have regard to:

a) the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed; and

b) any other principles appearing to us to represent the best regulatory practice.

A5.12 In this context we have published the following "regulatory principles":

- we will regulate with a clearly articulated and publicly reviewed annual plan, with stated policy objectives.
- we will intervene where there is a specific statutory duty to work towards a public policy goal which markets alone cannot achieve.
- we will operate with a bias against intervention, but with a willingness to intervene firmly, promptly and effectively where required.
- we will strive to ensure our interventions will be evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome.
- we will always seek the least intrusive regulatory mechanisms to achieve our policy objectives.
- we will research markets constantly and will aim to remain at the forefront of technological understanding.
- we will consult widely with all relevant stakeholders and assess the impact of regulatory action before imposing regulation upon a market.

A5.13 Sky commented in this context that the basis for the imposition of any regulatory burden must be clearly identified with a sufficient degree of certainty and to the requisite standard of proof. It considered that our October 2007 consultation had not discharged those obligations insofar as justifying the use of ex ante intervention. Sky commented that there was no clear assessment of the different costs and benefits of the options identified in the October consultation.

A5.14 Ofcom does have a bias against intervention, but this does not mean we will not intervene where necessary, and in particular it may in some circumstances be necessary to intervene in areas where regulation does not currently exist. Interventions proposed must be proportionate to the problem identified. We have therefore prepared an impact assessment at Annex 6 to assist in the consideration of the relevant competition concerns and the possible impact of intervention. We must also act proportionately in considering whether it is appropriate to deal with competition issues on an ex ante rather than an ex post basis. In considering conditions which might apply in permitting the Proposal to proceed, we must identify the least intrusive means of addressing the concern identified. In the context of reliance on ex post regulation this is discussed further at paragraphs 4.14 to 4.21.

A5.15 Sky has also argued that the approach taken by us in this case is not consistent with either our April 2006 statement or our process for the approval of other pay TV services on DTT. It is therefore argued that the approach conflicts with the duty in section 3(3)(a). Sky argues that the conclusions in our April 2006 statement provided general guidance on our approach to pay TV services on DTT. It points out that the April 2006 statement was conducted under the same principles as those which apply to the current process. Sky argues that these “duties are of universal and absolute application, and are not susceptible to consideration in isolation, or variation in relation to any particular proposal”. Sky also argues that we did not apply the same approach to the assessment of the launch of other pay services on DTT. In addition to the competition assessment, Sky argues that we did not in those other cases question the impact on Freeview or on the market for reception equipment.

A5.16 We do not accept Sky’s arguments. Our duties are constant but we must always consider how those duties relate to the particular issues and facts that arise in each instance. This application clearly gives rise to issues which differ in nature and in magnitude to those arising under previous applications. The impact of the Proposal is discussed in detail at Annex 6.

A5.17 We consider that we should have regard to the following sub-sections of section 3(4) in performing our section 3(1) duties in the context of the Proposal:

(a) the desirability of promoting the fulfilment of the purposes of public service television broadcasting in the United Kingdom;

(b) the desirability of promoting competition in relevant markets;

(d) the desirability of encouraging investment and innovation in relevant markets;

(f) the different needs and interests, so far as the use of the electro-magnetic spectrum for wireless telegraphy is concerned, of all persons who may wish to make use of it; and

(k) the opinions of consumers in relevant markets and of members of the public generally.

A5.18 Sky commented that section 3(4)(a) is not relevant as Freeview channels will be available on all Sky boxes. We do consider this provision is relevant given the potential broader impact on Freeview and DTT. Those issues in particular are discussed at Section 3, where Sky's comments are addressed.

A5.19 Sky commented in relation to section 3(4)(b) that Ofcom was wrongly conflating this with section 3(1)(b) to assume that there is an overriding duty to promote competition by bringing about alternative market outcomes. Sky also points out that section 3(4)(b) refers only to the "desirability" of promoting competition, rather than a stricter requirement, and that taking into account that Ofcom's competition concerns are forward-looking this does not provide a strong basis for ex ante intervention. In our view the elements of section 3(4) highlighted above are all relevant to our assessment of whether it is appropriate to intervene in order to promote competition pursuant to section 3(1)(b). In the context of a set of concerns based around the operation of competition the "desirability of promoting competition" is clearly a consideration to which we must have particular regard.

A5.20 Sky commented that we had not made reference to section 3(4)(d) in our October consultation. We agree that this is a relevant consideration for this process. As explained at Section 3 we are taking into account the impact on investment decisions by Sky and by other competitors resulting from our decision on the Proposal

A5.21 Sky commented that we had not made reference to the relevance of section 3(5) in the October consultation, which requires that in performing our duty of furthering the interests of consumers, we must have regard to "*the interests of those consumers in respect of choice, price, quality of service and value for money*". We agree that this section is relevant to our assessment. These factors are taken into account in our impact assessment discussed further at Annex 6.

A5.22 Sky commented that we had not made reference to the relevance of section 6 in the October consultation. This section imposes duties on us to review regulatory burdens. This process involves a first instance consideration of whether a regulatory intervention is appropriate rather than a review of an existing burden. We therefore do not agree that this section is relevant to our assessment.

A5.23 In summary, Sky comments that:

> "*Ofcom's bias against intervention means that, unless there is a "clear case for regulation", it should allow markets, and therefore competition, to develop without interference, in full knowledge that its ex post enforcement powers remain at its disposal*".

A5.24 We agree with that assessment and consider the case for ex ante regulation in Section 4.

Annex 6

Impact assessment: option evaluation

Introduction

A6.1 The analysis in this Annex, taken together with Sections 3 and 4, represents an impact assessment as defined in section 7 CA03.

A6.2 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 CA03, which means that generally we have to carry out impact assessments where our proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in our activities. However, as a matter of policy we are committed to carrying out and publishing impact assessments in relation to the great majority of our policy decisions. For further information about our approach to impact assessments, please refer to our guidelines[61].

A6.3 As part of this consultation process, we have considered the impact on different stakeholders of the Proposal and of the different options which we are examining.

A6.4 We have sought to compare the outcomes of different options in terms of the impact on total welfare (that is to say consumer and producer surplus taken together). Given the inherent uncertainties regarding the development of services in this area the focus of our indicative calculations is on the relative ranking of the different options rather than the absolute scale of consumer and/or producer benefits. In addition, it is important to understand that this evaluation is just one aspect of our assessment of the impact on stakeholders.

A6.5 The analysis presented in this Annex represents our preliminary conclusions. We hope that this consultation will elicit comments and information to enable us to refine our assessment of the impact of different options.

Overview

A6.6 In our October consultation, we commented that the Proposal would be likely to lead to an immediate benefit to consumers associated with the greater availability of content on DTT, in particular premium sports and movies. However, we also expressed a concern that there could be a longer term detrimental impact on competition.

A6.7 Responses to our October consultation have challenged this proposition. For example, Sky told us that we are seeking to set off more speculative, longer term competition concerns against clear, short term consumer benefits from the launch of Picnic. In contrast, **[✂]**

A6.8 In making an assessment of the different options, we consider the impact on the following four groups of stakeholder:

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[61] http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf

- Viewers of FTA channels on DTT.
- Subscribers to pay TV services on DTT, cable and DSat.
- Picnic's competitors.
- Sky/Picnic.

A6.9 In each case, we consider the impact under Options 1, 2 and 3 (unconditional consent to the Picnic Proposal, acceptance with a wholesale must-offer obligation, and rejection of the Proposal respectively). Since Option 3 effectively represents the status quo, we regard this to be the appropriate counterfactual against which to assess Options 1 and 2.

A6.10 In paragraphs A6.11 to A6.40 we describe in qualitative terms the different types of costs and benefits to consumers and producers that might be associated with the launch of Picnic. Although it is not possible to quantify the absolute magnitude of the different effects with any certainty, we have carried out some high level, quantitative analysis, set out in the appendices to this Annex, to assess the relative impact of different options, both in the short and longer term. Our qualitative and quantitative analysis is intended to inform our decision-making process, but is only part of that process.

Short term impact on viewers of FTA channels on DTT

A6.11 Under the Proposal, all DTT-only households would in theory be adversely affected by the loss of *Sky News*, *Sky Sports News* and *Sky Three*, which are currently offered on a FTA basis on DTT. The launch of Picnic could therefore be regarded as imposing a cost of some sort on these consumers – although clearly some would subscribe to the new Picnic channels, offsetting any detriment for that subset of consumers.

A6.12 To estimate the magnitude of this effect, we need to ascertain how highly viewers value these channels. For this purpose, we have used audience share data, although we recognise that it may have limitations in reflecting the importance of news channels to viewers. Audience share data for Sky's FTA channels shows that taken together they account for not more than two per cent[62] of viewing on DTT. This suggests that the value placed on these channels by DTT-only households is relatively low (although we recognise that there may be some households which place a high value on these channels). In turn, this suggests that the scale of any consumer detriment from the loss of the FTA channels is likely to be relatively modest.

A6.13 In summary, because Options 1 and 2 both entail the withdrawal of Sky's FTA channels, they have an identical negative impact on viewers of those channels compared with the counterfactual (Option 3). However, we do not consider this impact to be substantial because of the relatively low viewing figures for Sky's FTA channels.

[62] For instance, BARB data for July 2008 indicates that the combined audience share for the three channels in DTT-only homes was 1.7 per cent (on an all individuals basis).

Short term impact on subscribers of pay TV services on DTT

A6.14 Most Picnic subscribers will either be consumers who had not previously subscribed to any pay TV services or consumers switching away from other providers of pay TV services (whether or DTT, cable, DSat or IPTV). Although we recognise that some subscribers may subscribe to Picnic as well as one or more other pay TV services.

A6.15 Most of the responses to our October consultation that addressed the issue considered that the take-up of pay TV services on DTT was likely to be relatively modest in absolute terms, at least compared with the take-up of DSat and cable services[63].

A6.16 Subscribers to Picnic would derive a benefit in that they would have access to new subscription channels at a price which was less than their willingness to pay for such channels. The magnitude of the benefit would depend on the degree of subscribers' willingness to pay. However, without a detailed knowledge of the nature of demand for Picnic and other pay TV services, it is not possible for us to accurately gauge the magnitude of any benefit. For example, we cannot determine whether the benefit enjoyed by new pay TV subscribers is likely to be greater than the benefit enjoyed by subscribers that had switched from other pay TV providers.

A6.17 Consumers who remain with competing pay TV services on DTT should not be any worse off as a result of the launch of Picnic services. If the value they place on such services is not at least equal to the price being charged for those services, then we assume that they would not subscribe in the first place. Indeed subscribers to competing pay TV services could be better off as a result of enhanced competition. It is only if existing pay TV providers on DTT exit the market that there could be a detriment to those subscribers, since they would no longer have access to services where their willingness to pay was at least as high as the price of those services.

A6.18 The actual magnitude of any benefit to consumers from the launch of Picnic would be determined by the take-up of the service, subscribers' willingness to pay and the price of the service.

A6.19 Sky has provided us with an estimate of the number of Picnic subscribers it is expecting to gain in the first three years of the service, together with an indication of how these subscribers might be distributed between the basic and premium pay TV offerings. It does not include any information about where these subscribers might come from.

A6.20 The estimate suggests that the number of Picnic subscribers is likely to be relatively modest in absolute terms compared with the subscriber base for cable or DSat. This may suggest that Picnic would be priced in such a way as to minimise the risk of DSat or cable subscribers switching to the service. However, the content that is made available via Picnic – i.e. premium sports and movies – would be considered to be attractive pay TV content that is not otherwise available to DTT households.

A6.21 We would expect the consumer benefit from the launch of Picnic to be enhanced with a WMO arrangement (Option 2). Consumers choosing to view Sky's Core Premium channels via other retailers will do so because those retailers' services offer them additional benefits, and the potential to avoid switching costs.

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[63] We note in particular responses from the BBC, Freeview, Setanta, Sky, Tiscali, Top Up TV, Virgin Media and **[✂]**.

Furthermore, to the extent that those retailers are able to access additional customers that would not subscribe to Picnic, there will be a market growth effect.

A6.22 In summary, rather obviously, there are likely to be benefits to potential pay TV subscribers on DTT from both Options 1 and 2 versus Option 3 because of the expanded availability of pay content. The potentially wider distribution of that content under Option 2 suggests that these benefits are greater than under the unconditional consent option (Option 1).

Short term impact on Picnic's competitors

A6.23 Another set of stakeholders that would be affected by the launch of Picnic are Picnic's competitors on DTT. To the extent that their existing subscriber base switches to Picnic then they would obviously suffer a reduction in revenue. To the extent that the cost base of these providers mainly comprises fixed costs (e.g. transmission and distribution costs and some marketing costs) then their ability to reduce costs with a reduction in subscriber numbers would be limited. This would suggest that any loss of revenue could have a significant detrimental financial impact. In the extreme it could result in them ceasing to be viable financially and being forced to exit.

A6.24 Even if a high proportion of competitors' costs were variable, increased competition from Picnic could still have significant financial implications. For example, it is possible that a failure by a competitor on DTT to meet or maintain specific subscriber targets could have implications in terms of its ability to secure necessary additional financing. In turn, this could restrict its ability to expand its service offerings or (again in the extreme) force it to exit the market.

A6.25 That is not to say that competitors need to be shielded from competition: as explained above, enhanced competition and choice is likely to benefit subscribers of existing pay TV providers. Rather, we simply recognise that the launch of Picnic could have negative implications for particular stakeholders and that this needs to be taken into account as part of our impact assessment.

A6.26 The absence of actual information on consumer switching behaviour in response to the launch of Picnic means that it is difficult to attempt any quantification of the scale of any detriment to competitors. At this stage we assume that there will be some switching away from existing pay TV providers to Picnic services on the grounds that the Picnic service makes some of the most attractive premium pay TV content available to DTT households. Obviously, the more significant the extent of this switching by existing subscribers the greater the impact on Picnic's competitors.

A6.27 Under Option 2, however, we would expect the risk of exit to be lower because Picnic's competitors would have access to the same attractive content and would therefore be better able to compete on even terms with Picnic.

Short term impact on Picnic/Sky

A6.28 In simple terms there would be a producer benefit to Picnic/Sky that could be expressed in terms of the difference between the revenue it derived from subscribers to its services less the costs of providing those services. We would expect the nature of Sky's businesses to be such that many of the key costs would be broadly fixed in nature so that the incremental costs of the Picnic business were low.

A6.29 At this stage we conclude that Picnic is likely to generate significant producer surplus and thus be an important aspect of the consideration of the impact on total welfare.

Assessing the short term benefit

A6.30 Based on the above characterisation of the impact of the launch of Picnic, we consider that the net benefit of consenting to Picnic (Option 1) is likely to be largest if:

- The value viewers place on Sky's existing FTA channels is relatively low.
- Picnic services offer highly attractive content that is not otherwise available on DTT and a sufficient number of consumers place a high value on this content i.e. Picnic increases consumer choice and enhances competition between pay TV providers.
- The take-up of Picnic services is primarily by consumers that have not previously subscribed to pay TV i.e. Picnic expands the addressable market for pay TV services on DTT.
- It does not result in a material reduction in the competitive pressure in the relevant market or related markets. The entry of Picnic should increase the competitive pressure in the relevant market but if the widespread response of competitors is to exit the market, then that could negate the pro-competitive effect of the launch of Picnic.

A6.31 Option 2, qualitatively, appears likely to offer additional short term benefits over Option 1 in three ways:

- First, consumers are able to purchase premium content from a number of different retailers, potentially on different DTT platforms. This expands consumer choice.
- Second, competing retailers may be able to attract a different set of consumers to those that would subscribe to Picnic, thereby expanding the overall market.
- Third, by allowing other retailers access to highly attractive content that we believe is important to building a compelling pay TV proposition, those alternative retailers are able to compete with Picnic on more equal terms and we believe this gives a greater opportunity for sustainable competition.

Longer term impact

A6.32 Unconditional consent to the Proposal may have a potentially detrimental impact on competition, which is a central concern as highlighted above and in our October consultation. For instance, if Picnic were to become the main provider of pay TV services on DTT, this would mean that Sky controlled two of the three main existing distribution technologies for pay TV services. In such a situation we expressed the concern that this could lead to a reduction in competitive pressure at the retail level.

A6.33 The reduction in competitive pressure could manifest itself in a number of ways. Most directly it could take the form of an increase in retail prices or at least a reduction in the rate at which retail prices were decreasing. This could result purely from weaker competitive pressure on prices, regardless of any impact on costs, but it could also result from weaker pressures on productive efficiency feeding through to higher costs. Similarly, less competition can lead to poorer customer service, reduced choice of content or platform or a reduction or slowing down in the rate of innovation.

A6.34 These effects would affect not just subscribers to pay TV services on DTT but also subscribers to pay TV services on cable and DSat. Given that there are over 12 million subscribers on these platforms even a relatively small reduction in competitive pressure would have the potential to translate into significant consumer detriment.

A6.35 We recognise the argument put forward by Sky that such concerns can only be speculative at this stage. However, that does not mean that we should ignore the potential for consumer harm. Instead, we need to consider the potential impact of such an event occurring.

A6.36 Given the uncertainty about the development of pay TV services on DTT it is virtually impossible to make any proper probabilistic assessment of the likelihood of there being a widespread consumer detriment in the longer term which we could use to calculate an expected value to this outcome. Instead we have looked at other ways of trying to evaluate the potential detriment.

A6.37 In particular, we have sought to evaluate the potential detriment in terms of price increases. This involves looking at how large a price rise would be needed in the longer term to cancel out the short term benefits from the launch of Picnic. This approach is developed more fully as part of the option analysis set out below.

Preliminary conclusions

A6.38 Our analysis (set out in more detail in the appendices to this Annex) suggests that if we were to consent to the Proposal unconditionally (Option 1) it would be more likely in the short term to lead to an increase in consumer and producer welfare than if we did not consent to the Proposal (Option 3). However, it also takes account of the concern that consent to the Proposal without conditions could lead to reduced competition in the longer term if Sky became the main retailer of pay TV services on DTT as well as on DSat.

A6.39 We can potentially address these competition concerns by consenting to the Proposal subject to conditions under which Sky has to make its premium content available to its retail competitors (Option 2). Our analysis indicates that:

- The short term benefits of Option 2 consistently exceed the short term benefits of Option 3 and a wide range of alternative assumptions.

- The short term benefits of Option 2 are similar to, but in all cases exceed, the short term benefits of Option 1.

- The additional long term competition benefits of Option 2 suggest that it is likely to be strongly preferable to Option 1.

A6.40 Taking into account our qualitative analysis and our indicative quantitative analysis, we consider that an Option 2 approach would be most likely to enable us to fulfil our statutory duties.

Appendix I: Indicative calculations

Outline of conceptual approach

A6.41 As explained above, consumers and producers will be affected by the launch of Picnic in different ways. The basic conceptual approach we have adopted in our analysis is to make an assessment of the costs and benefits to these stakeholders (together with the timing of such costs and benefits) over a number of years. For example, we have assumed that the benefit to consumers can be measured in terms of the difference between their willingness to pay and what they actually pay for a pay TV service[64].

A6.42 The (discounted) costs and benefits across the different groups of consumers and producers can be aggregated to derive a value for the total net benefit under the different options. This approach allows us to rank the options in terms of their overall impact on total welfare. It also enables us to consider the effect on each particular group of stakeholders.

A6.43 We have applied the analysis to the following options that are discussed in this consultation:

- Option 1: consenting to the Proposal without conditions.
- Option 2: consenting to the Proposal subject to appropriate conditions.
- Option 3: not consenting to the Proposal.

A6.44 As explained above, we have used Option 3 as our starting point as this is the closest representation of the status quo. We then consider the difference between that option and Options 1 and 2. Accordingly we begin by describing our assumptions under Option 3 and then turn to Options 1 and 2.

A6.45 In these comparisons we have taken the “short term” to be the first five years from the launch of Picnic. As part of our sensitivity analysis, we have considered the impact on total welfare of reducing this period to three and four years (see paragraphs A6.60 and A6.61).

Option 3 – rejection of the Proposal (no Picnic and no wholesale must-offer)

A6.46 Our base comparison for these indicative calculations – or counterfactual – is the scenario in which we do not consent to the Proposal (Option 3). In this case we have assumed that existing pay TV providers on DTT continue to grow steadily over time so that total subscribers to pay TV services on DTT grows from 400,000 at present to about one million after five years. This forecast is informed by responses to our October consultation from Freeview and Sky and a report by investment bank,

[64] Such an approach requires us to make some assumptions about the underlying demand function. For the sake of simplicity we have assumed a linear demand curve for Sky and for its competitors and have approximated the shape of the demand curve using estimates of prices/subscriber numbers in each year together with a “choke” price i.e. the price at which demand falls to zero. We have assumed that the choke price might be capped by existing DSat prices – for instance, the choke price is set just below the DSat price which best approximates to the mix of premium channels available via Picnic: otherwise subscribers would be expected to take the DSat package. In practical terms we have used £41 per month as the choke price for premium channels and £15 per month as the choke price for the basic channels.

UBS[65]. We consider that in the absence of Sky's premium content on DTT this is a reasonable assumption. In addition we have assumed a degree of churn each year in the subscriber numbers: we have assumed that existing pay TV providers are able to manage churn to a level that can be approximated by the weighted average of the churn levels currently being achieved by Sky and Virgin Media[66] and have therefore used a figure of just under 12 per cent.

A6.47 With regard to other distribution technologies, we assume that the subscriber base for cable is stable overall i.e. any new digital additions coming from conversion of their remaining analogue subscribers. We assume that Sky steadily increases its DSat subscriber base to ten million after five years and then focuses on maintaining that base going forward. We have not made any assumptions about the development of IPTV services over this period or the number of competitors. That is not to downplay the role of IPTV as a technology: for instance, competitors providing hybrid DTT/IPTV options such as BT Vision are treated as existing DTT competitors for the purposes of the indicative calculations. Rather it is a reflection of the fact that our immediate focus is on the role of DTT whereas the development of services over IPTV is not likely to be so immediate.

A6.48 In terms of pricing, we assume that there are no real price increases over this period i.e. prices increase in line with inflation.

Option 1 – unconditional consent (Picnic only)

A6.49 Under Option 1, Sky is permitted to launch Picnic unconditionally. We assume that Picnic steadily builds up its subscriber base for the first three years in line with Sky's projections of the take-up of the service, and that the split between basic and premium subscribers mirrors the existing split on Sky's DSat service[67]. We also assume that the price of the basic and premium packages is in line with the prices that Sky has indicated it has considered for the launch of the Picnic service and that these prices remain constant in real terms in the short term.

A6.50 As different types of STB will be compatible only with specific pay TV services, most consumers will be in the position of making "either/or" decisions to subscribe to one service or other. As a result, although the launch of the Picnic service does grow the market overall, some of the growth in Picnic's subscriber base is at the expense of its competitors. As our starting point, we have assumed that around 50 per cent of subscribers to Picnic's competitors on DTT switch across to the Picnic service relative to the situation without Picnic. However, we do not assume that Picnic's competitors exit in the short term.

A6.51 In this option (as with the Option 2) we also take account of the disbenefit to DTT viewers due to the removal of the existing FTA services. However, our analysis suggests that the consumer detriment is unlikely to be significant.

Option 2 – conditional consent (Picnic and wholesale must-offer)

A6.52 Under Option 2, we consent to the Proposal, subject to a technically and commercially workable wholesale must-offer arrangement being put in place. The consequence of the wholesale must-offer condition is that Picnic's retail competitors

[65] UBS research report entitled "*Blue Sky*", dated 29 May 2007.
[66] The figures we have used of 9.8 per cent for BSkyB and 16.8 per cent for Virgin Media are taken from their latest annual results.
[67] Based on information provided by Sky.

on DTT are able to offer packages of services which include Sky's Core Premium channels. There is more opportunity for Picnic's competitors to develop compelling alternative bundles of services. We have assumed Picnic's competitors are able to maintain the same level of subscriber numbers as in the counterfactual which means that the total number of pay TV subscribers on DTT increases.

A6.53 We assume that the prices of the services offered by Sky's competitors increase as a result of offering larger bundles which now include Sky content. At the same time their cost base also increases from having to pay a wholesale charge to Sky. We assume that the price of the basic and premium Picnic packages is the same in the "Picnic-only" and "Picnic and wholesale must-offer" options.

Assessing the longer term impact of the Proposal

A6.54 As discussed above, we consider that there could be longer term concerns regarding the impact of the Proposal on competition. At present Sky faces a degree of competition from providers of pay TV services on other platforms – specifically cable and more recently DTT. If Picnic were to become the largest provider of pay TV services on DTT as well then that would tend to imply a lessening of the competitive pressure on Sky and this in turn could lead to a detrimental impact on consumers. However, as indicated above, it is difficult to be specific about the precise form that any longer term detriment to consumers might take (e.g. whether it is a lack of innovation in the future, poorer customer service or higher prices).

A6.55 In order to examine this issue we have used a price increase as a proxy for the impact of the consumer detriment, focusing on DSat and cable customers. We have thus considered the stylised case in which the detriment is represented as if consumer prices were higher than would otherwise have been the case if competition had been more effective. Specifically, we have looked at the impact on cable and DSat subscribers of small increases in the weighted average package price[68] faced by these subscribers at the end of the five year reference period. However, we would emphasise here that we are not attempting to model the specific form that any consumer detriment might take from a reduction in competition if Sky were to become the largest pay TV retailer on DTT. What we are looking to determine is the scale of price increase that would be needed in order to cancel out the value of the benefits derived in the initial short-term phase.

A6.56 Representing the consumer detriment in terms of a price increase impacts on welfare in two different ways: one is a transfer of consumer surplus to producer surplus and the other is a negative impact on welfare from the deadweight loss. The main issue for this analysis is the reduction in welfare through the deadweight loss. This approach may therefore under-estimate the total welfare reduction to the extent that there is a loss of productive efficiency as a result of weaker competitive pressure on retailers.

A6.57 There would then be the need to make some sort of assessment as to the likelihood of such an outcome. For instance, if the price increase needed to eliminate any short term benefit was significant then we might assume that the probability of that outcome was likely to be small e.g. even with a reduction in competition in the market overall, Sky would be unable to force through such a significant consumer

[68] We use a weighted average package price based on what consumers are currently paying to Sky or Virgin. The package price is weighted according to the numbers of subscribers to different types of packages. The weighted average package price we have used is just under £39 per month (including VAT).

detriment. However, if the modelled increase in price was not particularly large, then we might be more concerned that the probability of a long term consumer detriment would be higher and that any benefits derived in the short term would be vulnerable to a longer term reduction in competition.

A6.58 Appendix II to this Annex provides a more detailed review of the way in which the different aspects of our analysis have been constructed.

Sensitivity analysis

A6.59 As noted, many of the assumptions used in our analysis are subject to considerable uncertainty. In order to test the robustness of the ranking of the different options we have therefore considered a range of sensitivities to some of the key parameters which might reflect changes in competitive conditions.

A6.60 In particular we have looked at four main areas. The first is in relation to the level of new entrants' costs – specifically in relation to marketing and customer acquisition costs. The second is in relation to the form of the demand function. In particular we have considered changes to the level of the "choke" prices we have assumed (i.e. the maximum amount that customers might be prepared to pay for packages of pay TV services on DTT). This has a direct impact on our consumer surplus calculations. We have also looked at the impact of changing the discount rate we use to assess producer surplus. Finally, we looked at the impact of reducing, from five years to three or four years, the duration of the period which we have treated as the "short term" for the purposes of our analysis. This examines whether our results depend critically on the duration over which we examine the producer and consumer surplus i.e. is it only the case that there are positive results because we are looking at returns over a certain number of years? The sensitivity analysis is then used to generate ranges around our base case estimates.

A6.61 The results of the sensitivity analysis are in line with what might be expected. For instance, increasing the scale of costs incurred by new entrants has the effect of reducing the scale of producer surplus. In contrast reducing the level of the "choke" price - i.e. the amount that people are prepared to pay for the services - has an impact on the scale of the consumer surplus. Changing the duration of the period that is regarded as the short term e.g. shortening it to three or four years, reduces the scale of both consumer and producer surplus.

Results

A6.62 The table below sets out the preliminary results of our analysis for the short term period. We have presented the outcomes as broad ranges. This is a reflection of both the inherent uncertainty involved in the exercise and also the sensitivity analysis. As mentioned above, we have not focused on the absolute level of the benefits per se – rather we have focused on the relative ranking of the different options.

Preliminary results of scenario analysis of short term impact – NPV over 5 years

Scenario	Consumer surplus (£ million)	Producer surplus (£ million)	Total welfare (£ million)
Option 3 (Base case / "No Picnic")	70-130	0-150	80-280
Option 1 ("Picnic only")	10-170	100-400	170-570
Option 2 (Picnic and wholesale must-offer)	100-190	80-390	190-580

A6.63 If we start with a comparison of the outcomes from Options 1 and 3, then our analysis indicates that in the short term Option 1 might be expected to generate a higher level of total welfare – in terms of both consumer and producer surplus - than an Option 3 approach. In overall welfare terms the benefits of Option 1 consistently exceed those of Option 3.

A6.64 However, the potential reduction in competition in the longer term may undermine this short term benefit. Our analysis suggests that a one-off (real) increase in monthly package prices of just over three per cent after a period of five years from the launch of Picnic would be sufficient to eliminate the consumer and producer surplus generated in the short term in the "Picnic-only" scenario i.e. to negate the benefits of Option 1 over Option 3.

A6.65 However, our analysis also suggests that the outcome of an approach which combines Sky launching its Picnic service together with an effective wholesale must-offer that enables competitors to develop alternative packages of services – an Option 2 approach - might be expected to deliver an even greater benefit than Option 1. Our analysis suggests that the short term benefits of Option 2 are close to, but in all cases exceed, the short term benefits of Option 1.

A6.66 A key factor in this outcome is the assumption that the Option 2 approach has a positive impact on the size of the market in the short term compared to Options 1 and 3. The wholesale must-offer component might be expected to give Picnic's competitors on DTT more scope to develop alternative packages of services and enable them to compete with Picnic and in turn provide greater choice for consumers. An Option 2 approach might thus be expected to increase the overall addressable market for pay TV services on DTT. In terms of the ranking of the different options, our short term analysis would suggest that Option 2 could be expected to deliver the greatest overall benefit. Furthermore, by helping to create the conditions for effective competition, the wholesale must-offer component of this option is more likely to reduce concerns about the potential for there to be a detrimental impact on competition in the longer term.

A6.67 The relative ranking of the different options is not affected in the short term by changes to the choke price, the duration of the period over which the "short term" is defined or increased new entrant costs. We note though, as we would expect, that higher new entrant costs do reduce the differential between Options 1 and 2. However, our analysis of the longer term benefits of Option 2 suggests that Option 2 is strongly preferable to Option 1. We estimate total welfare over a ten year time horizon for Option 2 to be just under £1.2 billion. In line with the discussion above about the comparison of Options 1 and 3, if reduced competitive pressure under Option 1 led to a sustained price rise of around 3 per cent from year six onwards, the total welfare gain (also over ten years) under that option would be just over £400 million – i.e. markedly less than the £1.2 billion under Option 2. If the reduction in competitive pressure were to take effect more quickly, the gain under Option 1 would be further reduced: if prices rose from year four onwards, the gain in welfare would fall to less than £100 million.

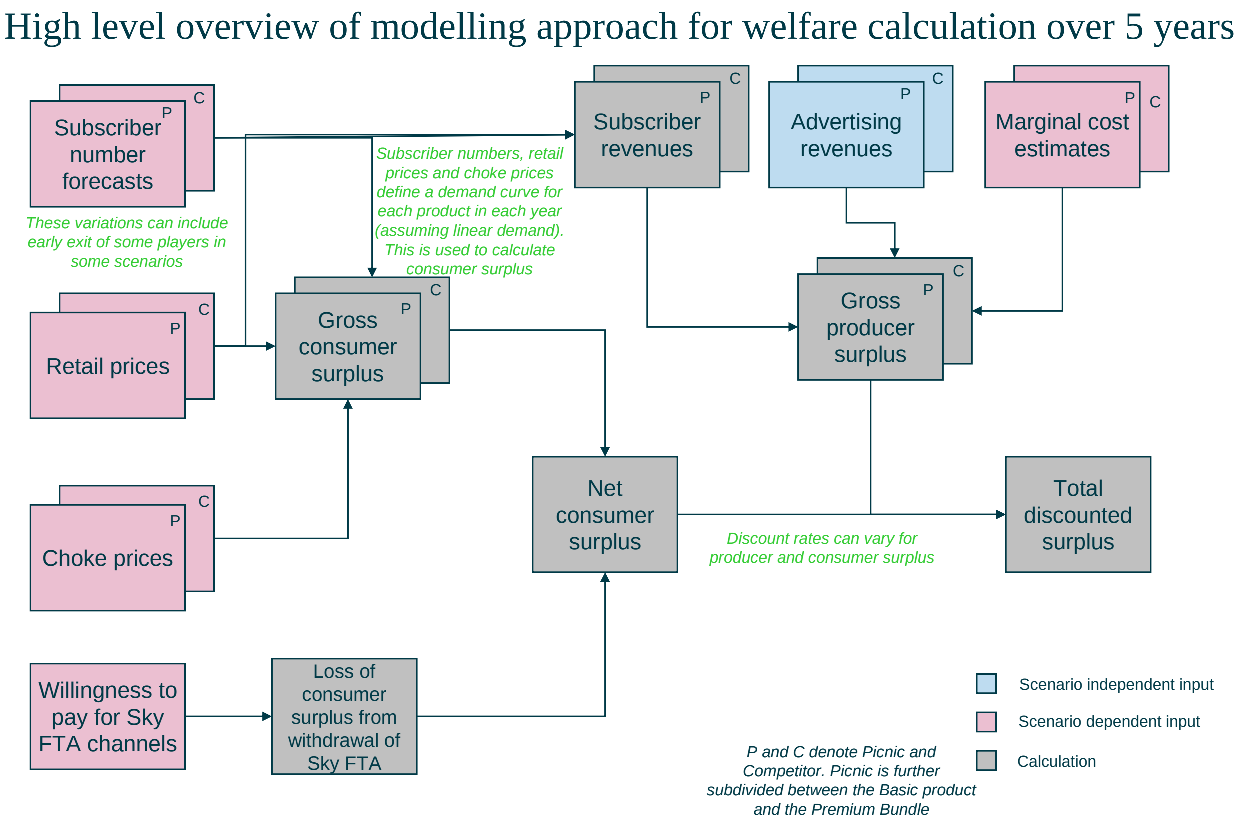
Appendix II: Description of indicative calculations

A6.68 This appendix provides an overview of the structure of the calculations that underpin our indicative calculations. The overall aim of the analysis is to examine the short term impact on the DTT platform of consenting to the Proposal under various scenarios, and in parallel to consider the potential longer term impact on the DSat and cable platforms. To assess the impact on total welfare, we first calculate consumer and producer surplus.

Assessment of the short term impact

A6.69 The short term analysis compares the three different options over a five year period. We have structured the base case (Option 3) as an extrapolation of the current state of play with no launch of Picnic.

A6.70 In each option we have calculated the gross consumer surplus and gross producer surplus in each year. We have then discounted total producer and consumer surplus separately to provide net present values ("**NPVs**") which are used to rank the scenarios in terms of overall attractiveness. We have used the Treasury's social discount rate of 3.5 per cent to discount both consumer surplus and producer surplus[69]. This discount rate is the same discount rate as that used in the assessment of public sector projects. We have also considered the impact of using a higher discount rate to discount producer surplus in our sensitivity testing.



[69] This is in line with the approach that we adopted in our DDR (see paragraph A8.18 of our DDR statement: http://www.ofcom.org.uk/consult/condocs/ddr/statement/ddrannex.pdf). See paragraphs 5.48 to 5.53 of the Treasury Green Book for information on the Treasury's social discount rate: http://greenbook.treasury.gov.uk/chapter05.htm.

A6.71 Calculations for consumer surplus and producer surplus begin with projections of subscriber numbers and retail prices over the five year period. We have made these projections separately for Sky's basic Picnic service, Sky's premium bundle Picnic service, three potential competitors and the DTT platform as a whole (all FTA "subscribers"). We have treated the three potential competitors as an aggregate competitor throughout the model, but separate forecasts of subscribers and retail prices are used to generate a weighted average competitor average revenue per user ("**ARPU**") figure. This average ARPU is weighted by year average subscriber numbers.

A6.72 We have split the projections for the three potential competitors between subscribers to existing packages and subscribers to packages including Sky Core Premium channels under wholesale must-offer scenarios. We have projected the total number of subscribers to Sky Core Premium channels on DTT, with the majority defined as "contestable" customers who are then divided between all retailers and a small proportion defined as "uncontestable" who will always pick a particular retailer. The pool of contestable customers remains constant regardless of the number of retailers, with a small number of customers added to the market as uncontestable for each new retailer entering the market.

A6.73 We have also calculated gross customer additions in each year using the year end subscriber forecasts to generate net additions and a forecast of churned subscribers based on a fixed churn rate over the whole period. We have used the same churn rate – just under 12 per cent – for Sky's Picnic service and for pay TV services provided by Sky's competitors.

A6.74 The consumer surplus calculation has two parts. In the first we calculate the gross consumer surplus of subscribers to the two Picnic packages and to the competitor package. This is combined with the second part in which we calculate a loss of consumer surplus from the withdrawal of Sky's FTA channels from the DTT platform, to generate a net consumer surplus (see below).

A6.75 We calculate the gross consumer surplus separately for each Picnic service and the competitor service using an assumed "choke price" in each case. This is the price at (or above) which it is assumed that no subscribers would subscribe to the relevant service. We have assumed that the choke price for each service remains constant in real terms in each year. We define a linear demand curve for each service in each year based on the choke price (where there is no demand) and the other price/demand point defined by the subscriber numbers and retail price to the service in each year.

A6.76 From this we calculate the gross consumer surplus for each service as the area of the triangle bounded by the demand curve, the price axis and the current retail price: i.e. (the choke price less the current retail price) multiplied by the current subscriber numbers and then divided by 2. Again, year average subscriber numbers are used.

A6.77 In the options where Picnic is launched we assume that there is a disbenefit to consumers from the withdrawal of Sky's three FTA channels on DTT (*Sky News*, *Sky Three* and *Sky Sports News*). In order to derive an estimate for the scale of this effect we use an estimated willingness to pay for each of the channels combined with an estimate of the percentage of content on each channel which is easily substitutable in order to derive the loss of consumer surplus due to the withdrawal of each channel, on a per subscriber per annum basis. We have made an allowance in the case of *Sky News* which is still planned to be broadcast for 1 hour per day following the launch of Picnic.

A6.78 We then calculate the total loss in surplus by multiplying the total loss per subscriber (from all 3 channels) by the year average total DTT "subscriber" numbers. As set out above, we then subtract this result from the gross consumer surplus figure calculated for the pay TV services to generate a net consumer surplus figure in each scenario. The modelling suggests that the scale of this disbenefit is not significant.

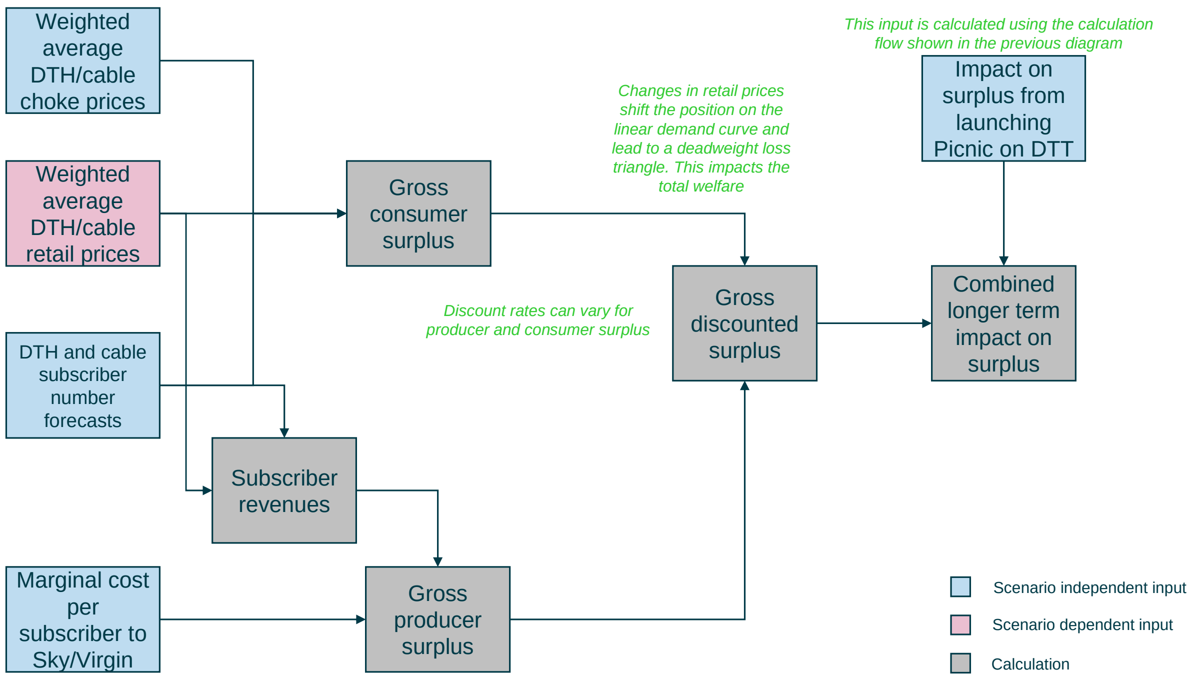
A6.79 We calculate the producer surplus separately for Sky and its competitors. Our overall approach is to subtract marginal costs from total revenues in each case. We calculate subscriber revenues from the above projections of ARPU and subscriber numbers and combine these with projected advertising revenues in each scenario.

A6.80 We build up estimates of incremental costs in each scenario by adding together transmission costs, platform access costs, smartcard costs, marketing costs, retailing costs and customer acquisition costs. The levels of these costs vary between Sky and its competitors. For Sky, we have assumed that marketing costs and transmission costs are fixed per annum, whereas platform access costs and retailing costs vary per year average subscriber and customer acquisition costs and smartcard costs vary per gross addition. For Sky's existing competitors on DTT (BT Vision, Setanta and Top Up TV), we have assumed that the cost categories which they incur are the same as those incurred by Sky, with assumptions based on our current understanding of their cost structures[70].

The longer term impact calculation

A6.81 In the longer term analysis we compare Option 1 with Option 3 in terms of total surplus over a ten year period across cable, DSat and DTT.

Approach for calculation of the wider impact over 10 years



[70] We have assumed that transmission costs vary slightly with year average subscriber numbers and platform access costs have a small fixed element.

A6.82 We calculate an NPV of the total net change in surplus on DTT over a ten year period based on the shorter term impact calculation, with the surplus in each year after year five remaining equal to that in the fifth year in real terms. We have used the same real discount rates as in the short term calculation. This provides a total gain in welfare over ten years on DTT in the scenario where we consent to the Proposal on an unconditional basis.

A6.83 In parallel we have calculated the impact on consumer and producer surplus of a price rise on the DSat and cable platforms. We also make projections for the year average total subscriber numbers for DSat and cable platforms over ten years. We calculate the current weighted average retail price on these platforms across all subscribers and packages and we have assumed that this then stays constant in real terms. We use an estimated choke price for the single DSat/cable product being considered together with the subscriber number and retail price projections described above to calculate the consumer surplus in each year. We again make this calculation assuming a linear demand curve and applying the same techniques as in the shorter term impact calculation.

A6.84 We have calculated subscriber revenues for Sky and Virgin Media using the subscriber number and retail price projections. We then multiple an estimated marginal cost per subscriber by the year average subscriber numbers to calculate the total marginal costs in each year. We can then calculate the producer surplus in each year by subtracting the total marginal costs from the total subscriber revenues.

A6.85 This provides an “as is” extrapolation of total surplus on these platforms. However, changes in retail prices will shift the position on the assumed linear demand curve and lead to a deadweight loss, which impacts the total welfare.

A6.86 We test different retail price rises, assumed to change from the “as is” case over only the latter five years of the ten year period. This is modelled as a step change in retail price after five years which remains in effect for the latter five years of the modelling period.

A6.87 As part of this analysis we have noted that an increase in the retail price would be likely to lead to some reduction in subscriber numbers and that will then affect the size of the consumer and producer surplus. We calculate the change in subscriber numbers following a change in retail price using the ratio of the (choke price less new retail price) divided by (choke price less old retail price) multiplied by the old number of subscribers (at the old retail price).

A6.88 We then calculate the new consumer surplus as the area of the triangle under the demand curve in the same way as previously i.e. (choke price less new retail price) multiplied by the new subscriber numbers divided by 2. We calculate the annual loss in consumer surplus in each year by subtracting this value from the “as is” total consumer surplus.

A6.89 We also calculate the new producer surplus (at the new retail price) by multiplying the new subscriber numbers by the total revenues minus the marginal costs per subscriber. Whilst the marginal costs per subscriber are the same as in the “as is” case, the total revenues per subscriber increase by the change in annual retail price (excluding VAT).

A6.90 Using the same discount rates as previously, we then discounted the annual changes in consumer and producer surplus on DSat and cable to obtain the NPV of net loss in surplus on DSat and cable as a result of retail price rises.

A6.91 Finally, we offset the loss in welfare on these platforms against the gain on DTT from the launch of Picnic by comparing NPVs. As such we are able to test what level of retail price rise on DSat and cable in later years would be required to eliminate total welfare across all cable, DSat and DTT in the longer term.

Annex 7

Summary of responses to the October consultation

A7.1 This Annex draws out the key points from the responses which we received to our October consultation. In total, we received 450 responses: 426 responses from members of the public (of which 142 are confidential) and 24 responses from organisations (of which 5 are confidential). All of the non-confidential responses can be found on our website at http://www.ofcom.org.uk/consult/condocs/dtv/responses/.

A7.2 Where applicable, references to paragraph numbers in stakeholder responses are included below in parentheses.

Access to content, market definition and market power

Sky

- There are strong incentives on any channel provider, including Sky, having invested in attractive content to make its channels available on all efficient platforms in order to reach as many interested consumers as possible (paragraph 6.13).

- The relevant retail market is the supply of all audiovisual programming to end users (7.5).

- The relevant retail and wholesale markets are all-platforms markets: platforms compete with each other as agreed by competition authorities (7.6).

- At the wholesale level, the relevant market is at least the production and supply of TV channels (it could be wider to include wholesale supply of individual programmes and films) (7.8). This market is diverse and intensely competitive (7.10).

- Given the existence of such cross-platform competition, together with the established constraints that FTA services pose on pay TV services, the introduction of Sky's pay TV channels to DTT would not significantly change the dynamics of competition (7.16).

Sky's retail competitors (BT Vision, Setanta, Tiscali, Top Up TV, Virgin Media)

- There is currently significant unmet demand for unbundled pay TV content (BT Vision – 15).

- Premium content is a key driver for the take up of pay TV services (BT Vision – 27).

- "Key" content may no longer simply be "premium" content as defined in the previous decisional practice of the UK competition authorities and the European Commission, but also other content (e.g. Lost on Sky One) (BBC, BT Vision – 34 and 35).

- Sky has both the incentive and the ability to distort emerging competition in light of its control of "key" content (BT Vision – 50).

- Sky has leading market positions at each of the three tiers of the value chain in respect of sports and movies content and channels which are widely acknowledged to be the drivers of pay TV (Setanta / Top Up TV – 3.4).

- Sky would be able to leverage power and control over premium content and its pricing into pay DTT (as is done in other parts of the pay TV market), while the situation for sport would be lessened only slightly due to the existence of Setanta Sports' pay service on DTT (Tiscali).

- The relevant retail market should be no wider than all pay TV given that: (i) FTA TV does not provide a competitive constraint; (ii) it is consistent with settled precedent (the exception to this – Sky/ITV – was specific to the facts of the case i.e. the CC needed to consider the full extent of the reduction in strategic rivalry) (Virgin Media – Annex 1 paragraphs 4 – 15).

- There may well be narrower retail markets for premium content or each of premium sports and premium movies given that premium content has been shown to be a key driver in take up of pay TV services (Virgin Media – Annex 1 paragraphs 11 – 15).

- Sky has a leading position in the acquisition of content, a dominant position in the wholesale supply of sports and movies channels and a dominant position in the distribution and retailing of pay TV content (Virgin Media – 3.5).

Other organisations

- The pay offer on DTT is too limited for it to create a real competitive challenge to DSat (BBC 3.2.6).

- Ownership of rights to premium content provides a source of market power (BBC, B4.6).

- Neither FTA nor basic pay DTT services seem to offer significant competition for premium services (**[✂]**).

- Sky has exclusive access to a dominant share of premium sports and premium movie rights on an ongoing basis, at no incremental cost (**[✂]**).

- Access to premium sports (in particular football rights) is the key driver for platform take up. Premium movie content and hit US shows are secondary (**[✂]**).

- Sky has a likely dominant market position in respect of the wholesale supply of premium pay TV content (**[✂]**).

Impact of the Proposal

Sky

- Ofcom has not demonstrated with sufficient certainty that the "significant competition issues" it contemplates happening, or the assumed certain outcomes, are anything other than hypotheses. There is no proper assessment of the “balance of probabilities” as per various CAT decisions (4.13).

- Ofcom has also not fully articulated which aspects of the Proposal underpin its concerns (5.10).
- Ofcom has made various assumptions about Sky’s likely incentives, following the launch of Picnic, which amount to assertion not supported by evidence (5.11).
- To adequately assess the nature and substance of any hypothesised barriers to entry, an appropriate frame of reference should be set, with an analysis undertaken against an appropriate counterfactual (6.4).
- Ofcom has not articulated why it considers the emergence of a single or main retailer on a particular platform is necessarily something that should be prevented (and how such prevention would be consistent with Ofcom’s duties) (6.5).
- Picnic will start from a base of zero subscribers/set top boxes, which it will have to grow in the face of significant competition both from existing DTT operators and from other digital television platforms (6.9).
- The concerns about Sky’s incentives are not substantiated in the consultation document, but are presented on a hypothetical basis (6.12).
- The removal of Sky’s current FTA channels cannot be expected to have a negative impact on competition or the range of content available (via DTT on a FTA basis), given the modest viewing these channels experience in comparison to other FTA channels on DTT, the existence of a wide range of other FTA services that will remain available to DTT viewers, and the lack of consumer concern about the loss of the Sky FTA channels from Freeview (as reflected by research undertaken on behalf of Picnic) (7.20).

Sky’s retail competitors (BT Vision, Setanta, Tiscali, Top Up TV, Virgin Media)

- There is a risk that Sky could dominate pay TV on DTT if Ofcom consented to the Proposal unchanged (BT Vision – 4).
- If Sky were to become the sole pay TV retailer on DTT, Sky would also have extended the vicious circle and its downstream bottlenecks, which are being considered as part of Ofcom’s market investigation into pay TV, from the DSat platform into DTT (Setanta / Top Up TV – 2.5).
- It is almost inevitable that if Ofcom were to consent to the Proposal, Sky would, within a short period, become the sole retailer of pay TV services on the DTT platform, which would reinforce its dominant position in pay TV (Virgin Media – 1.7).
- Ofcom should be wary of taking any action which may undermine the willingness of operators making investments in DTT capacity, e.g. following release of DDR spectrum (Virgin Media – 2.10).

Other organisations

- Given Sky’s advantages in relation to premium content it is likely that Sky would, in a short time, become the sole pay DTT retailer (BBC – A3.3).

- Sky could hope to bid for DDR spectrum capacity at a lower price – given the absence of competition from other channel operators – and control spectrum supply to create its own DTT MPEG4 channel package (**[✂]**).

- Sky's advantages in the broader market and the competitive structure of television platforms in the UK mean that it is highly likely that the Proposal would lead to Sky securing a dominant position in pay DTT. In turn, this would allow it to choke off competition from other fledgling providers (**[✂]**).

- In the event that Sky was able to secure a leading position in pay DTT, it would be in a very strong position to bid aggressively to secure DDR spectrum to secure a further multiplex at DSO (**[✂]**).

- There is a concerned that the Proposal may reduce the attractiveness of FTA outlets for films on DTT (UK Film Council).

Individual respondents

- About 6 per cent of individual respondents said that Proposal would benefit consumers.

- About 72 per cent of individual respondents said that the Proposal would harm competition and/or consumers.

- About 30 per cent of individual respondents said that the loss of Sky's existing FTA channels would outweigh the benefits of Picnic.

Platform access

Sky

- Picnic welcomes manufacturers seeking to develop a variety of reception equipment containing a range of functionality, for example set top boxes which contain multiple CA and an integrated DVR, which could be *Freeview Playback* compatible (2.9).

- Picnic is also asking manufacturers actively to support the requirements of the "*Digital Tick*" and to work to an industry best practice standard on all accessibility issues, such as ensuring the availability of audio description services (2.11).

- Picnic proposes in this submission to provide CA services on Picnic STBs on FRND terms, subject to similar conditions imposed on other DTT platform operators (9.4).

Sky's retail competitors

- It is unlikely that manufacturers would build boxes with multiple CA (BT Vision – 72).

- **[✂]**

- **[✂]** Other organisations

- If Sky were to become the dominant pay TV retailer on DTT and control the STB developments then this could have an impact on FTA service development on DTT. There may be less innovation in the horizontal market for FTA STBs if the market size shrinks due to the dominance of Sky's STBs (**[✂]**).

- The introduction of proprietary CA onto the platform will lead to the end of the open standard environment which has been a key factor in the success of Freeview (BBC - A2.4).

- Sky's STB advantages are: (a) the connection to NDS (b) DSat purchasing leverage (c) its unique incentives as a vertically integrated operator (B4.9). Sky is likely to subsidise its STBs (BBC - A2.4.4).

- Sky's STBs will become prevalent – leading to potential compatibility issues affecting the platform as a whole (BBC - A3.3.9).

- It is unlikely that manufacturers would build boxes with multiple CA given the cost implications (BBC - B10.2.1).

- Sky could inhibit the development of Freeview through new technologies by becoming the STB gatekeeper. This could damage the competitiveness of Freeview (**[✂]**).

- Sky may undermine the horizontal market for higher value equipment such as DVRs if it subsidises Sky STBs or provides incentives to retailers to promote Sky STBs ahead of other equipment (even for customers who do not want to take Sky's pay TV service at point of sale) (**[✂]**).

- If successful in the mass deployment of its STBs Sky may be able to achieve gatekeeper status on DTT (**[✂]**).

Sky as a retailer of pay TV services

Sky

- A proposal to limit Sky's ability to retail channels directly to DTT customers would be entirely disproportionate (9.11).

- BT Vision, Setanta and Top Up TV benefit from access to significant funding resources and existing STB populations, while Sky would be starting off with a STB population of none (6.5 – 6.9).

Sky's retail competitors

- Sky is in a much better position to obtain the rights given its financial resources (BT Vision – 22).

- Sky's advantages are also enhanced by its equity interests in a range of pay TV channels (BT Vision – 53).

- The benefits that are attributed to Picnic by Ofcom either do not arise at all or are not dependent on the implementation of the whole of Picnic (Setanta / Top Up TV – 2.2).

- **[✂]**
- **[✂]**
- Sky has unique incentives to become the sole provider of pay TV services on DTT (most notably, to protect Sky's DSat customer base) (Virgin Media 3.27 to 3.35).
- Sky has a unique ability to become the sole provider on DTT given its financial resources, relationships with STB manufacturers, exclusive relationships with content providers and access to scarce DTT capacity (Virgin Media – 3.20 to 3.26).
- In practice, Sky could influence in many different ways the types of DTT boxes that are manufactured and thereby impede the take up of competing pay TV services on DTT. For example, by:
  - underwriting manufacturing R&D costs;
  - providing "sale or return" support for manufacturers;
  - providing "after sales" support for manufacturers;
  - inhibiting the inclusion of competitors' components in set top boxes; and
  - linking Picnic box prices to DSat box orders (Virgin Media – 3.12 to 3.17).
- In addition, there are many different ways in which Sky could influence high street retailers so as to restrict the take up of competing pay TV services on DTT. These include (but are not limited to) the following:
  - subsidising DTT boxes;
  - providing marketing support for retailers;
  - paying significant retail commissions;
  - linking the price of Picnic boxes to subscriptions;
  - providing "above the line" advertising support for retailers;
  - providing "sale or return" support for retailers;
  - making payments for listing and store refits etc.;
  - providing "below the line" support (such as point of sale materials, staff training etc.); and
  - providing increased financial support for Sky Digital to retailers who promote Picnic (Virgin Media – 3.12 to 3.17).
- Sky can leverage existing relationships with third party channels to secure exclusivity of supply (Virgin Media – 3.18 and 3.19).

Other organisations

- The entry of Sky on pay DTT at this stage of development risks stifling the nascent competitive challenge to DSat that pay DTT represents (BBC – 3.3.1).

- Sky has overwhelming market advantages such as: funding (e.g. to subsidise sales) from profitable DSat business ([✂]), low marginal advertising costs ([✂]) and the ability to bundle pay TV with telephony and broadband services ([✂]).

- Sky's statement that it does not intend to subsidise boxes is neither definitive nor irreversible ([✂]).

- Sky overwhelming market advantages. For example it:

    - o has a unique incentive and ability to undermine and diminish the overall Freeview proposition in order to protect its core DSAT proposition ([✂]);

    - o can leverage existing relationships with STB manufacturers ([✂]);

    - o can leverage relationship with high street retailers (established through volume sales of DSAT STBs) to promote Sky DTT sales ([✂]);

    - o has exclusive access to NDS technology ([✂]);

    - o can leverage existing relationships with third party channels to secure exclusivity of supply ([✂]).

Impact on DSO and Freeview

Sky

- Research undertaken on behalf of Sky shows that the availability of pay DTT can be a strong driver of the take up of DTT (footnote 9).

- The removal of Sky's FTA channels is not significant for Freeview. Two thirds of respondents to Sky's research said that Picnic will not significantly impact Freeview viewers' satisfaction with their overall channel line up, or confidence in their television service (2.7).

- Picnic boxes will be compatible with all Freeview channels and services (2.11).

- Consumers will not be required to take out a Picnic subscription as a condition of acquiring a Picnic set top box, which could be acquired solely for the purposes of watching other services, notably Freeview services (footnote 16).

Sky's retail competitors

- The proposal could result in a conflict of interest between Sky's pay TV and Freeview roles. Sky would be the only shareholder in DTVSL that provides pay TV services (BT Vision - 96 and 99).

- The Proposal would be unlikely to have any significant detrimental effects on the availability of FTA channels on DTT or lead to major changes in terms of charges for previously free channels or the take-up of DTT (Tiscali).

Other organisations

- The extension of pay services on DTT is unlikely to undermine the DSO process (BBC - A2.2; **[✂]**).
- Sky could use its position in the Freeview organisation to its competitive advantage (BBC - A2.9).
- If Ofcom consents to the Proposal, then this will lead to a conflict of interests for Sky in connection with its ownership interest in DTVSL since it will no longer have any FTA channels on the Freeview platform, and will instead be driving a pay DTT proposition (**[✂]**).
- Through its growing control over the pay TV DTT gateway, Sky will be able to reduce the competitive impact it faces from Freeview (**[✂]**).
- The removal of *Sky News* will result in a very significant reduction in the plurality of news provision on free DTT (BBC, Rapture TV and **[✂]**).
- Until digital switchover is achieved the interests of viewers are best served by ensuring a clear and well understood Freeview proposition (**[✂]**)
- Freeview should not be unduly affected by the Proposal (BBC – A2.3; **[✂]**).
- The Proposal would risk seriously undermining the Freeview proposition at a critical point in the DSO process due to the consumer confusion that could follow if it were approved (**[✂]**).
- If the three Sky channels are to be withdrawn, satisfaction with Freeview, which has been consistently high the past five years, has the potential to be affected (Freeview – 2).

Individual respondents

- About 75 per cent of individual respondents said that the Proposal would have a negative impact on Freeview.
- About 12 per cent of individual respondents said that the Proposal would have a negative impact on the availability of news.

Consumer confusion

Sky

- To the extent that there is consumer confusion, it will not be caused or exacerbated by Picnic – consumers already face incompatibility issues as between Top Up TV and BT Vision (8.8 and 8.9).
- Picnic has actively engaged with the DTG and is requesting that manufacturers use the DTG D-Book as the “base line” specification for its reception equipment, to ensure that set top boxes comply with industry-accepted standards (footnote 17).

- Retailers will inherently seek to minimise any scope for confusion through clear marketing (9.8).

Sky's retail competitors

- Issue of consumer confusion could be adequately addressed through appropriate conditions on Sky (BT Vision – 97).
- It is very difficult to predict levels of confusion that may arise in the minds of UK consumers, but easy to imagine some confusion arising. (Tiscali).

Other organisations

- Picnic could increase levels of hardware incompatibility in the market, in turn creating consumer confusion (**[✂]**).
- The future for reception equipment must be managed to take into account the DTT reorganisation consultation – and a simultaneous upgrade to DVB-T2 and MPEG-4 (BBC – A2.8).
- Picnic has the potential to have a negative impact on the successful introduction of DVB-T2 and HD reception equipment (STBs would be MPEG-4 but DVB-T) (**[✂]**).
- Consumer confusion may be increased, e.g. as a consequence of using NDS CA (**[✂]**).
- Sky's service not compatible with other DTT boxes. Consumers would need to buy multiple boxes to get all pay TV services. This could lead to consumer confusion and would be inefficient (**[✂]**).
- Sky proposed STB not compatible with technologies proposed for use on DTT in the near future (i.e. DVB-T2) and there will undoubtedly be consumer anger at the need to purchase a replacement STB (**[✂]**).
- Increased customer confusion on DTT could benefit DSAT if DSAT maintains a simple marketing message (**[✂]**).
- There is no other western TV market in which rival DTT services require consumers to purchase separate STBs (**[✂]**).

Individual respondents

- About 60 per cent of individual respondents said that the Proposal would increase consumer confusion regarding what pay TV services are available from which STBs.

How we should respond to the Applications

Sky

- The only appropriate outcome for this consultation is for Ofcom to opt for Option 1 and approve the launch of Picnic (9.1).

- Ofcom does not have an adequate basis for the imposition of *ex ante* regulation as condition of approval of the Proposal (9.6).

- In order for Ofcom to regulate on an ex ante basis, it must discharge a burden of proof to the requisite standard. In Ofcom's own words, given its "*bias against intervention*", this means that "*a high standard of proof must be satisfied*". This standard of proof has not been met by Ofcom (10.2).

- Any concerns raised by the Proposal could be addressed by Ofcom using its ex post competition powers (5.12).

- Sky plans to retail on third party "compatible" platforms. Simulcrypting arrangements would facilitate this, though again they would be subject to certain requirements e.g. security (9.5).

- Other remedies have no basis (banning retailing, preventing from deploying proprietary CA, mandating Nagra CA, other ex ante regulation) (9.6 – 9.10).

- The concerns that Ofcom has raised relate, however, to "wider" issues, which are not directly related to the applications that have been submitted to Ofcom. They are also issues that Ofcom is already considering as part of its pay TV investigation.

Sky's retail competitors

- Commitments from Sky are unlikely to provide the level of security that can be provided by ex ante conditions (BT Vision – 57).

- Sky should be required to wholesale on a standalone basis to third parties any channel containing premium content which it proposed to retail on DTT (BT Vision – 58).

- It is important that Sky One is included as (a) it includes premium content and (b) to avoid Sky migrating sports and movies content to that or other basic channels (BT Vision - 58).

- The appropriate framework for establishing the appropriate level of wholesale prices is highly complex and should be the subject of a separate consultation (BT Vision - 59 to 63).

- Simulcrypt may be an appropriate solution to facilitate wholesale must-offer (BT Vision – 75).

- Although Sky has raised security concerns in respect of Nagra CA, Fox uses this CA system in the US (BT Vision – 76).

- Mandating a CA system and prohibiting Sky from operating a CA system (which amounts to the same thing) might chill innovation and undermine Ofcom's duty of technological neutrality (BT Vision – 78).

- Ofcom should not consent to the proposal at least until the pay TV MI has been concluded. (Setanta / Top Up TV – 3.2; Virgin Media – 1.4 and 4.2).

- An extended remedy of obliging Sky to sell premium content on a wholesale basis to all market players (DSat, DTT, IPTV and cable) is a potential outcome of the ongoing pay TV market investigation and, if applicable, should therefore apply in the conclusion of this consultation (Tiscali).

- There are no practical remedies that would address the very significant competition concerns that would arise in the event that Sky was permitted to retail the Picnic proposal on the DTT platform (Setanta / Top Up TV – 1.2 and 1.3; Virgin Media – 4.19).

- Ofcom should confirm that Sky can broadcast its premium channels on DTT subject to a condition that they are made available on commercially viable wholesale terms to competing pay TV retailers and that Sky itself is prohibited from retailing the channels on DTT (Setanta/Top Up TV – 14).

- If Sky channels are provided on DTT on wholesale basis only, this will promote retail price competition (Setanta / Top Up TV – 1.2 and 5.1 to 5.11).

- The pricing structure of any wholesale must-offer arrangement must satisfy the OFT's retail margin squeeze test and the OFT's wholesale mixed bundling test (Setanta / Top Up TV – 10.5 to 10.7).

- If Ofcom did opt for a wholesale remedy, it would need to: (i) apply in respect of all pay TV platforms, (ii) offer third parties sufficient margin and certainty to compete substantially with Picnic's retail prices, (ii) offer the channels on an equivalent basis across platforms and (iv) offer the third party a sufficient certainty of supply (Virgin Media – 4.17 and 4.21 – 4.28).

- Ex post competition powers would be insufficient as:(i) they have so far proved ineffective in curbing Sky's growing dominant position in pay TV; (ii) investigations take a long time to reach a conclusion; (iii) investigations would result in increased use of management time and expense for all parties involved; (iv) ex post regulation can create uncertainty for all operators in the market; (v) ex post regulation is unable to reverse the creation or strengthening of market power (Virgin Media – 4.29 to 4.36).

Other organisations

- It would not be prudent for Ofcom to allow this Application before the outcome of this MI is known (BBC – 3.2).

- Sky should commit to "open standards" for STBs through simulcrypt or licensing of CA technology to STB manufacturers (BBC – B10.3).

- Ofcom must make its decision on the timing of the move to DVB-T2 prior to the proposal proceeding. If DVB-T2 is coming in from 2009/2010 then the launch of Sky should await the availability of DVB-T2 equipment (BBC - B10.4).

- If Ofcom consent to the Proposal it is essential that Sky is required to terminate its involvement with DTVSL, the company which operates Freeview (BBC – 3.5.4; **[✂]**).

- Ofcom should require Sky to provide its channels on a wholesale basis to competitors and ensure that effective price and non-price terms are put in place (BBC – B10.5).

- Mandating the use of simulcrypt might not be effective and requiring Sky to use or ensure compatibility with Mediaguard might have negative consequences (BBC – 10.6).

- We should not consent to the proposal (with or without conditions) at least until such time as the pay TV MI is complete (Information TV; **[✂]**).

- Ex-post remedies would not be effective; rivals to Sky would have withdrawn from the market before they could be applied (**[✂]**).

- Developing ex ante conditions which would ensure competition was maintained would be too complex to put in place and monitor (**[✂]**).

- Consumers receive Disney Channels via DSat, cable, IPTV and programming from *Disney Channel* (and Playhouse Disney) via DTT through Top Up TV's service. Disney hopes that the potential expansion of pay DTT in the UK is likely to assist in achieving this goal and in the process, widen consumer choice even further (Disney).

- If Ofcom does propose to consent to Picnic, it is critical that a workable wholesale must-offer remedy is put in place (**[✂]**).

- The introduction of any proposed additional pay TV service should embrace and adopt open technology standards to protect the interests of the consumer, and to preserve clarity and simplicity of the overall DTT proposition as the nation proceeds through digital switchover (Freeview – 2).

- Ofcom should consent to the Proposal subject to a requirement Sky makes its premium channels available to competitors on a suitable wholesale basis (**[✂]**).

- Ofcom should mandate the use of simulcrypt, which with Option 2 would facilitate the development of effective inter-platform and intra-platform competition (**[✂]**).

- Ofcom should consent to the Proposal subject to imposing additional conditions (S4C).

- The UK Film Council is likely to look to Ofcom's overall review of the pay TV market for remedies which address broader aspects of market dominance in pay TV.

Individual respondents

- About 4 per cent of individual respondents said that Ofcom should consent to the Proposal unconditionally.

- About 7 per cent of individual respondents said that if Ofcom was to consent to the Proposal such consent should be subject to appropriate conditions.

- About 5 per cent of individual respondents said that if Ofcom consents to the Proposal, Sky should be required to provide open access services to other retailers.

- About 5 per cent of individual respondents said that if Ofcom consents to the Proposal, Sky should be required to make its channels available to other providers such as Top Up TV and Setanta.

- About 87 per cent of individual respondents said that we should not consent to the Proposal.

Annex 8

Glossary

Arqiva[71]	A company that operates the terrestrial TV transmission network in the UK and is licensed to operate two of the digital terrestrial multiplexes.
British Sky Broadcasting Group plc ("**Sky**")	Operator of the primary digital satellite platform in the UK and retailer of the 'Sky' pay television service.
BT Vision	A video-on-demand service offered by BT to BT broadband customers. Services are delivered using both the digital terrestrial TV platform and BT telephone lines.
conditional access ("**CA**")	Scrambling and encryption technologies that allow a broadcaster to restrict reception of its digital channels to consumers who have been authorised to view them. Typically used by pay TV operators to protect subscription and pay per view revenues.
digital cable ("**cable**")	A television distribution network based on optical fibre and coaxial cable technology. The main provider in the UK is Virgin Media.
Communications Act 2003 ("**Communications Act**")	The parliamentary act that set out, amongst other things, Ofcom's duties and powers.
Competition Act 1998 ("**CA98**")	The parliamentary act that provides an updated framework for identifying and dealing with restrictive business practices and abuse of a dominant market position.
conditional access module ("**CAM**")	A device inserted into a set-top box or integrated digital TV which allows digital services protected with different conditional access technologies to be displayed.
digital satellite ("**DSat**")	The digital television distribution network based on DSat transmission.
digital switchover ("**DSO**")	The process in the UK by which analogue terrestrial television services will cease on a region by region basis between 2008 and 2012.
Digital Television Programme Service ("**DTPS**") Licence	A licence issued by Ofcom to all broadcasters of digital television channels on the UK digital terrestrial TV platform.
digital video recorder ("**DVR**")	A device for recording digital television broadcasts, typically using a computer hard disk with a set-top box. Also known as a personal video recorder (PVR) and digital television recorder (DTR).

[71] Defined terms used in this consultation are shown in bold type.

Digital Television Services Limited (“**DTVSL**”)	The consortium that owns and markets the Freeview brand on the digital terrestrial TV platform. Jointly owned by Arqiva, Sky, BBC, ITV and Channel 4.
digital terrestrial television (“**DTT**”)	The digital television distribution network based on terrestrial transmitter towers
Digital Video Broadcasting (“**DVB**”)	The standards development body that has produced many of the specifications used on DSat, cable and terrestrial platforms, including transmission and conditional access technologies.
DVB-T	The DVB transmission technology standard that forms the basis of the digital terrestrial television platform. The DVB-T standard has been in use in the UK since 1997, work is underway to develop and improved standard (DVB-T2).
electronic programme guide (“**EPG**”)	An on-screen guide to scheduled broadcast television programmes, allowing a viewer to navigate and select content by time, title, channel and genre.
Football Association Premier League (“**FAPL**”)	The body which is responsible for licensing the television rights for the English Premier Football league.
free to air (“**FTA**”)	The transmission of digital television (and radio) services without conditional access.
Freeview	The brand used to promote the free to air services available on the digital terrestrial television platform.
high definition (“**HD**”)	A television picture format that has higher picture resolution than standard definition (SD) services.
integrated digital television (“**IDTV**”)	A television set which has a built in digital tuner and receiver (typically for reception of digital terrestrial TV). IDTVs remove the need for an external set-top box.
internet protocol television (“**IPTV**”)	Delivery of television content using the internet protocol used for transferring data over the internet and private IT networks. IPTV is often used to refer to services delivered across the public internet as well as “walled garden” services provided over broadband connections, such as BT Vision.
MPEG-2	The digital technology used to compress the video component of the majority of digital television services in the UK. MPEG2 has been in use for over 10 years.
MPEG-4 H264/AVC (“**MPEG-4**”)	A relatively new digital compression technology which is more efficient than MPEG2.
multiplex	The combination of a number of digital television and radio services into a single datastream in order that they can be

	transmitted on a network. The DTT platform currently consists of 6 multiplexes.
Nagra France ("**Nagra**")	A company which is part of the Kudelski group and operates in the business areas of digital TV, public access and audio products.
Nagra CA	The conditional access (CA) technology provided by Nagra and currently used in the UK by Top Up TV and Setanta on the digital terrestrial television (DTT) platform.
NDS Group plc ("**NDS**")	A technology company that provides the conditional access (CA) technology used by Sky on its DSat service.
public service broadcaster ("**PSB**")	The four PSBs in the UK include: BBC, ITV, Channel 4 and Five.
Setanta Sport Holdings Limited ("**Setanta**")	A provider of pay TV sports channels on all the major digital TV platforms in the UK.
set-top box ("**STB**")	A digital television receiver that is connected to a television display. A STB may also include DVR capabilities.
simulcrypt	A technology that allows a single broadcast channel to be used with two or more conditional access systems.
technical platform services ("**TPS**")	The provision by digital television platform operators of various technical services (including CA and EPG listing services) on a wholesale basis to broadcasters. Provision of some TPS may be regulated.
Tiscali TV ("**Tiscali**")	An IPTV provider which provides linear and on-demand TV services via BT telephone lines.
Top Up TV ("**Top Up TV**")	A provider of pay TV services on the digital terrestrial TV platform.