ANNEX 6

OFCOM'S ANALYSIS OF MARKET DEFINITION AND MARKET POWER AT THE WHOLESALE LEVEL

1. Introduction

1.1 We do not propose to comment in detail on Ofcom's analysis of market definition and market power at the wholesale level. Instead, in the sections below, we provide brief comments on some of the more significant flaws in Ofcom's analysis of these matters.

1.2 There are several reasons for this.

1.3 First, Ofcom's singular focus on establishing the extent of Sky's upstream market power is misplaced, for two reasons:

(a) Ofcom's analysis proceeds as though Ofcom were engaged in an application of Chapter II of the Competition Act – i.e. as if it were necessary to establish that Sky holds a dominant position in a relevant market in order to apply the types of new regulation that Ofcom is seeking to impose on Sky. In fact, as discussed in **Section 7** of this Response, dominance is unlikely to be a necessary condition for the types of issues that appear to concern Ofcom in the Consultation Document;[1] and

(b) as discussed in **Section 4** of this Response, Ofcom has failed entirely to recognise that the issues concerning scope of the relevant downstream market(s), and the extent of competition within the relevant downstream market(s), are at least of equal importance in the context of Ofcom's 'concerns' as market power at the upstream level. Given that, in Sky's view, proper consideration of the relevant downstream market would remove the basis for Ofcom's 'concerns', it would not be a productive use of Sky's resources to undertake a detailed analysis of the numerous flaws in Ofcom's analysis of the issues of upstream market definition and market power.

1.4 Second, Sky considers that the issues of wholesale market definition and market power are foremost among those in which it is evident that (a) Ofcom's analysis is driven to a very significant degree by preconception about the 'right' conclusions on these matters, and (b) the process of collection and interpretation of evidence relating to these matters is strongly affected by Ofcom's preconceptions.[2] We discussed these observations in our Response to

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1 We agree, however, that market power at the level associated with dominance – i.e. a significant level of market power – is a necessary condition for concerns about excessive wholesale pricing.

2 For example, Ofcom continues to see the task before it as an exercise of confirming the findings reached by the OFT seven years ago. At Ofcom's City analyst briefing on 22 October 2008, in response to a question on Ofcom's conclusions on Sky's market power Ed Richards stated: "*The outstanding position on this was the OFT a few years ago which said that Sky has market*

the First Consultation Document and our views have been reinforced by the analysis of these issues in Ofcom's current Consultation Document.

2. Ofcom's approach to these issues continues to be fundamentally flawed

2.1 Ofcom has done little to remedy the significant analytical and evidential flaws discussed in detail in Sky's Response to the First Consultation Document.

2.2 The heart of Ofcom's argument is that Sky has extremely high market shares in two narrowly defined markets. In line with the normal precepts of competition law, market shares at the levels found by Ofcom create a presumption that Sky holds, in legal terms, a position of 'dominance', or, in economic terms, a high level of market power. This presumption is reinforced, in Ofcom's view, by findings of significant barriers to entry to, and expansion within,[3] Ofcom's narrowly defined markets, and the absence of countervailing buyer power.

2.3 Ofcom's approach to market definition, however, continues to be significantly flawed. The approach it adopts is mechanistic, and fails to have due regard to the complexity of defining the relevant market in the supply of pay TV channels. In particular, Ofcom places undue emphasis on the particular characteristics of Sky's channels and the preferences of infra-marginal customers in relation to programming content given that product differentiation is a central mode of competition in the television sector.[4] The result is that Ofcom reaches market definitions that are, essentially, descriptions of the products in which Sky has specialised. It is axiomatic in such circumstances that firms will be found to have high market shares – it is akin to saying that *The Guardian* has a high market share in a UK market for Left-leaning daily broadsheet newspapers. It is a classic situation of one in which, due to market circumstances, market shares calculated on the basis of a narrow view of relevant markets have little value in assessing market power – which is the true variable of interest.

2.4 Ofcom's analysis of barriers to entry and expansion is significantly flawed for the reasons set out in Part 6 below.

2.5 In Sky's view, Ofcom's expanded analysis of issues of market definition and market power at the wholesale level in the Consultation Document can be characterised as:

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power in these areas" (referring to the provision of premium sports and film channels). While he then added that Ofcom had undertaken its own analysis of these matters, on which it is consulting, it is in Sky's view highly instructive that Ofcom's first response to such a question is to refer to the OFT's conclusions. See paragraphs 1.23 to 1.27 of Annex 2, and Appendix 4 to that Annex, to Sky's Response to the First Consultation Document on this point, and **Section 8** of this Response.

3 We note that there is in fact no analysis at all in the Consultation Document of barriers to expansion within relevant markets on the part of firms already operating in Ofcom's proposed markets.

4 See, for example, Ofcom's analysis of "*Analysis of consumers' preferences for premium sports channels*", at Appendix 5 of Annex 6 to the Consultation Document.

(a) a search for additional pieces of evidence that support its earlier "*preliminary conclusions*" that Sky has a position of significant market power in narrowly defined wholesale markets; and

(b) a series of efforts to rationalise evidence which runs counter to Ofcom's preliminary conclusions, typically using extremely flimsy arguments, or convoluted theory.

2.6 Perhaps the best example of the latter is Ofcom's arguments as to why, in a sector in which there has been a massive proliferation of television channels over the past ten years, and where programming rights such as rights to broadcast sports events and Hollywood blockbusters are both contestable and periodically come up for re-licensing, Ofcom takes the view that there are significant barriers to entry.

2.7 Central to Ofcom's argument on this matter are theoretical examples of the following kind:

> "*Example 2: Suppose A and B compete for the rights. If A wins, as the leading retailer it will retail the channel on platform α whereas on platform β it will wholesale that channel to the leading retailer B. The same occurs mutatis mutandis if B wins. A thus earns £118m if it wins the rights ((£12x8m) on platform α plus half of (£11x4m) on platform β). If, instead B wins the rights then A earns £44m (as the retailer, A receives half of the (£11x8m) generated on platform α). Similarly, B earns £92m if it wins the rights and £22m if A wins the rights. A is thus willing to pay up to £74m for the rights (£118m-£44m) whereas C is only willing to pay £66m. Conclusion: a vertically integrated firm on a larger platform has an advantage over a vertically integrated firm on a smaller platform when bidding for rights.*"[5]

2.8 In Sky's view, such convoluted hypothetical theorising is a poor basis for robust conclusions on this matter, particularly where there is more direct, real-world evidence available which can be used to inform conclusions.

2.9 In places, Ofcom's approach leads Ofcom also to adopt unreasonable tests or inconsistent standards of analysis.

<u>The use of unreasonable tests</u>

2.10 A key example of the adoption of an unreasonable test is the introduction in the Consultation Document of the test that focal products comprise separate relevant markets if Ofcom 'believes' that it is "*not clear*" that the constraint imposed by substitute products is "*sufficient to constrain prices to the competitive level*" (or various such formulations). For example:

[5] Annex 7 of the Consultation Document.

- *"We do not however believe that the volume of live high-quality football on free-to-air TV channels is sufficient to constrain the wholesale price of Core Premium Sports channels **to the competitive level**."*[6]

- "*While we acknowledge that other means of watching movies, such as the ability to purchase a DVD of a recent movie, or watch an older movie on free-to-air TV, will provide some constraint on the prices which can be charged for Core Premium Movies channels, we do not believe this constraint is likely to be sufficient to ensure prices are **at the competitive level**."*[7]

- *"Falling wholesale prices for Sky Movies Mix channels could be evidence that wholesalers face an increasing competitive constraint from other substitutes, although it is not clear that this would be sufficient to reduce prices **to competitive levels**.*"[8] (Emphasis added in each case.)

2.11 Ofcom's use of such a test, however, is unreasonable for two reasons. First, it clearly involves a reversal of the burden of proof: rather than Ofcom demonstrating that prices are not constrained to competitive levels, the burden is placed on Sky to overturn Ofcom's 'beliefs' that they are not constrained in this way.

2.12 Second, it does so in a situation in which it is unlikely that Sky would be able to overturn Ofcom's 'beliefs' because Ofcom sets out no views as to what it considers "*the competitive level*" (or "*competitive levels*") for prices to be, and it is not otherwise clear what the competitive level of prices should be.

2.13 In fact, in both Ofcom's pay TV consultation documents, Ofcom argued that it is not possible to determine the competitive level for charges. For example, in relation to retail prices, at paragraph 1.39 of the Consultation Document, Ofcom states:

> *"Our analysis of whether retail prices are high remains inconclusive, and this reflects the various practical difficulties associated with such an analysis, such as the lack of a marginal cost which could provide a benchmark for competitive prices."*

2.14 Similarly, at paragraph 4.47 of the Consultation Document, Ofcom states:

> *"In broadcasting markets it can often be difficult to identify the competitive price. In economic models, the competitive price is often equated with marginal cost. However, in broadcasting markets, a large proportion of*

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6 Paragraph 1.26 of the Consultation Document. Sky notes that this is, in any case, an irrational test, as it should not be expected that the "*volume of high-quality football on free-to-air TV channels*" would be the sole factor that constrains the wholesale price of Sky's premium sports channels. See Sky's submission on this matter at paragraphs 1.57 to 1.62 of Annex 2 to Sky's Response to the First Consultation Document, to which Ofcom has not had proper regard.

7 Paragraph 1.27 of the Consultation Document.

8 Paragraph 4.231 and 6.12 of Annex 6 to the Consultation Document.

> *production costs are fixed, and marginal costs are very low. We would therefore expect competitive prices to be well above marginal cost, but it is very difficult to assess just how much higher they will be."*[9]

2.15 This is not a new or unfamiliar issue. For example, in the only decision by a UK court dealing with the issue of market definition in relation to the production of pay TV channels, it was stated that:

> "*One consequence of the view that competition in Pay-TV depends on differentiation is that some aspects of economic theory dealing with competition cannot readily be applied to this case. If products or services in a market place are homogeneous it may be possible to identify a competitive level of price and so determine whether a competitor in that market place is extracting excess profits by its strength in the market or by a monopoly position. In a market place where products are differentiated and thus heterogeneous both in nature and price, such conclusions cannot reliably be drawn.*"[10]

2.16 Accordingly, if Ofcom is to adopt such a test, Ofcom must set out what it considers the "*the competitive level*" (or "*competitive levels*") for prices to be, and demonstrate that prices are above that level (or those levels).

2.17 Another test used by Ofcom in the Consultation Document is that evidence is only accepted as indicating significant substitutability between products if it can be shown to demonstrate a "*binding competitive constraint*". For example, having examined falls in wholesale charges for Sky's movie channels, in the face of falling subscriber numbers, Ofcom states:

> "*We therefore consider that the fall in wholesale prices of packages containing Movies Mix does not necessarily imply a binding competitive wholesale constraint.*"[11]

2.18 This is an unreasonable approach because Ofcom does not explain what it means by the concept of "*a binding competitive constraint*", and the meaning of this concept is not self-evident. To the extent that Ofcom's intention in relation to this test can be inferred, it appears to be simply an alternative formulation of the concept that Ofcom believes that competitive constraints are insufficient to constrain prices to competitive levels. If this is the case, then this test shares the same problems as those discussed above in relation to the more direct formulation of the 'competitive price levels' test. If this is not what Ofcom

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9 At paragraph 3.7 of Annex 13 to the First Consultation Document, Ofcom stated: "*TV markets in (common with many other information markets) are characterised by high fixed and low marginal costs of distribution. This means that the competitive price will inevitably be above marginal cost, and that the socially optimal pricing structure may require some form of price discrimination or non-linear pricing. **It may therefore be difficult to observe or estimate the 'competitive price' from which to make an assessment on market definition.***" (Emphasis added)

10 Paragraph 277 of the judgment of the Restrictive Practices Court in the *Premier League* case, 28 July 1999.

11 Paragraph 6.14 of Annex 6 to the Consultation Document. Similar formulations are used elsewhere by Ofcom in the Consultation Document – for example at paragraph 4.233.

means, then it must explain clearly what it means when it uses the term "*binding competitive constraint*".

Inconsistent standards of analysis

2.19 In Sky's view, Ofcom's approach of seeking to support its preliminary conclusions leads it in places to adopt inconsistent standards of analysis of evidence. For example, in relation to evidence on trends in prices over time, price rises are taken as strong evidence of the existence of market power, but price falls are dismissed as not providing relevant information on the issue of market power.

2.20 For example, at paragraph 6.5 of the Consultation Document (which appears to be written with a view to rationalising observed falls in prices – especially in real, value-adjusted terms), Ofcom states:

> "*We cautiously interpret evidence of changes in prices. This is because if an undertaking has market power to set wholesale prices above competitive levels, a subsequent decline in prices might still be consistent with the undertaking having market power.*" [12]

2.21 Whereas at paragraph 6.11 of Annex 6 to the Consultation Document, Ofcom states:

> "*We have considered whether evidence of changes to Sky's wholesale prices indicates that it is competitively constrained. We note that the wholesale price for Sky Sports Mix packages has increased considerably since 2002, indicating that these packages do not face a strong competitive constraint.*"

2.22 While the first statement is correct, a more standard interpretation of reductions in prices (if it is suspected that prices were initially above competitive levels) would be that, all else being equal, competitive constraints on the firm were increasing.[13] In the case of the second statement, Ofcom is wrong to draw such a strong conclusion from an observation that the price of a product has risen – even if that price rise is 'considerable'.

3. Ofcom's analysis of prices, quality and subscriber numbers

3.1 Ofcom's First Consultation Document included, as evidence in support of its conclusions on market definition, several separate analyses of changes in prices, quality and subscriber numbers over time that were wholly without merit. They were undertaken inconsistently, the hypotheses being tested were not adequately specified, Ofcom failed to recognise that subscriber numbers are affected by many factors other than quality-adjusted package prices, and

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12 Paragraph 6.5 of Annex 6 to the Consultation Document.

13 In a straightforward situation (which that under investigation by Ofcom is not), whether prices had declined sufficiently to be driven to competitive levels would clearly depend on the extent to which they were initially above such levels, and the extent of the decline in prices.

Ofcom's assessment of both changes in prices and changes in quality was impressionistic.[14]

3.2 Moreover, Ofcom reached very strong conclusions on the basis of these wholly inadequate analyses.

3.3 Ofcom has re-examined these analyses for the purpose of the Consultation Document.[15] It is now apparent that Ofcom accepts that it underestimated significantly the changes in quality of Sky's services over time, though perhaps fails to recognise that this was because it reached its original views on the basis of beliefs rather than gathering relevant evidence.[16] Similarly, it is apparent that Ofcom finds it difficult to refute Sky's proposition that real, quality-adjusted charges for the packages that it provides to consumers have fallen considerably in the past five years.

3.4 In the Consultation Document, Ofcom has attempted to bolster its original conclusions by reference to a single slide in a Powerpoint presentation obtained as part of a general Ofcom information request.[17] That slide referred to Sky's decision in 2006 to provide fewer discounted subscriptions to attract and retain subscribers, and included a chart showing a considerable fall in the number of subscribers in receipt of such discounts after 2006. Based solely on that slide - without seeking any information at all from Sky as to how this change in policy may have affected average charges paid by Sky subscribers, or otherwise discussing this matter with Sky - Ofcom concludes in the current Consultation Document that this resulted in increases in prices for Sky's services, with the strong (though entirely implicit) proposition that such effective price rises were sufficient to result in real, value-adjusted increases in charges over the period examined. In other words, Ofcom appears to consider that real, value-adjusted charges for Sky's services have increased over the period examined, as a result of the reduction in the number of discounted subscriptions offered to

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14 See Appendix 5 to Annex 2 to Sky's Response to the First Consultation Document.

15 This analysis is contained at paragraphs 3.22 to 3.66 of Annex 6 to the Consultation Document. It is notable that, in spite of the compelling evidence before it, Ofcom's conclusions on quality changes are nuanced. For example, in relation to Sky's sports channels, Ofcom concludes only that "*There have been a number of changes to Sky's sports channels that* ***could be*** *evidence of increasing quality*" (paragraph 3.37 of Annex 6 to the Consultation Document). Particularly when set against the strong conclusions reached by Ofcom on other matters on the basis of either theorising or very weak evidence, this does not appear to Sky to represent open-minded, evidence-based analysis.

16 Sky notes that Ofcom was extremely reluctant to allow Sky to make a full representation to it on this matter. Ofcom's preference was for Sky simply to provide it with information that Ofcom considered sufficient to form a judgment on this issue – information which, had Sky not persevered with its efforts to be permitted to make a proper submission, would have been wholly insufficient for such a purpose. Ofcom has also, both publicly and to Sky, been critical of Sky submitting evidence to it prior to the publication of the Second Consultation Document, even though it is of clear relevance to the issues being considered by Ofcom. See **Section 8** of this Response in relation to the procedural weaknesses in Ofcom's dealings with Sky during its inquiry.

17 Annex 15 to Sky's response to Ofcom's information request of 29 May 2008, 1 July 2008.

subscribers after 2006, rather than accepting the clear evidence that such charges have in fact fallen.

3.5 For example, Ofcom states:

> "[the reduction in the availability of discounted subscriptions] *has had the effect of increasing the effective retail price over the period.*" [18]

And:

> "*Numbers of subscribers to Sky Movies have declined somewhat despite falling real prices. Offsetting this apparent fall in prices is a reduced availability of discounts, **which is likely to have increased the effective price to consumers**.*"[19] (Emphasis added)

3.6 Ofcom has no basis for these statements,[20] and, since the publication of the Consultation Document, Sky has received a request from Ofcom for data which was clearly intended to seek to establish whether or not they are correct.[21]

3.7 It is clear from brief consideration, however, that the slide on which Ofcom based its views on the effect of the withdrawal of discounts provides no basis for the views expressed by Ofcom for two reasons:

(i) the slide showed only the number of subscribers on offers over time. There was no information at all about the value of offers. If discounts had been very small, the overall effect on average effective charges – which is what Ofcom was examining – would also have been small; and

(ii) the slide showed that the number of subscribers on offers had grown significantly **during the period on which Ofcom was focused**. Ofcom appears to fail to recognise that this growth clearly implies effective **reductions** in charges during that period, which may then have been reversed with a subsequent decline in the number of subscribers on offer. This is another example of Ofcom's inconsistent approach to the use of evidence in this matter.

3.8 In fact, a proper evaluation of relevant evidence on this matter shows that, as expected, the growth of such discounts at first reduced prices below 'headline prices' and then, with the withdrawal of such discounts returned effective prices to be more in line with headline prices.

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18 Paragraph 4.94 of the Consultation Document.

19 Paragraph 4.234 of the Consultation Document.

20 For example, in relation to the second statement quoted, whether the removal of discounts would have increased average charges for subscribers to pay TV packages including movie channels clearly depends on whether subscribers to such packages received discounts. Ofcom had no way of knowing this when it formed the view stated above.

21 Ofcom's information request of 29 May 2008.

3.9 The following **Figures 1 to 3** show the estimated effect[22] of the expansion, and subsequent contraction, in the value of special offers made available to Sky subscribers on average effective retail prices, compared to headline prices.

Figure 1

[CONFIDENTIAL]

Figure 2

[CONFIDENTIAL]

Figure 3

[CONFIDENTIAL]

3.10 **Figures 1 to 3** clearly show that as would be anticipated, the expansion in the total value of such discounts first reduces effective average retail charges below headline prices, with the effect of the reduction in the number of these discounts then moving the effective average retail charge back towards the actual headline charge.[23]

3.11 Clearly, then, the proposition that real, value-adjusted charges for Sky's pay TV services are likely to have fallen considerably over the period with which Ofcom is concerned remains correct. In Sky's view, this is a key indicator that the competitive constraints that it faces are increasing over time.

4. Trends in charges over time

4.1 Despite Ofcom's continued failure to explain properly the hypotheses it considers are relevant to the examination of changes in prices over time, Ofcom continues to place significant weight on trends in charges for Sky's services, both at the wholesale and retail levels, as in some way indicative of the existence of market power.

4.2 Ofcom's analysis of trends in real charges for Sky's services, however, is subject to significant flaws.

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22 It is an estimated rather than actual measure of this effect as Sky does not hold offer data at the level of detail required to calculate the effect directly.

23 Sky finds it highly surprising that Ofcom has chosen to conduct its analysis of this matter in the way that it has. Had Ofcom put this point to Sky prior to issuing its formal Consultation Document, Sky would have been able to provide an analysis such as that set out above which would have enabled Ofcom to reach better-informed conclusions than those reached in the Consultation Document.

Retail charges for Sky's pay TV packages in real terms

4.3 Ofcom's discussion of changes in retail charges for Sky's main pay TV packages which contain premium pay TV channels is set out at paragraphs 3.16 to 3.18 of Annex 6 to the Consultation Document. Three things are notable about this analysis:

(a) Ofcom has adopted an unusual approach to calculating charges in real terms. In particular, Ofcom adopts the unusual approach of using the GDP deflator to adjust charges for a service offered to consumers. The more normal approach would be to adjust charges using a measure of changes in prices of goods and services purchased by consumers. Use of the GDP deflator also introduces additional problems because it is only available on a quarterly basis. Given that charges for Sky's services are monthly charges, it is clearly more sensible to use a price index that is available on a monthly basis – as the main consumer price indices are;

(b) some of Ofcom's conclusions about the magnitude of price increases over time appear to be driven by increases in its measures of the real monthly charge for Sky's Dual Sports and Top Tier packages at the end of Ofcom's series.[24] This reflects the fact that price changes for Sky's packages occur in September, which appears to be the final month in Ofcom's price series. Examination of the time series for charges shows clearly that the pattern over time is that nominal increases in charges first increase Sky's charges in real terms and then, given that Sky's charges are normally only adjusted annually, that real increase is eroded over the course of the following year. Typically, the nominal increases that occur have been sufficient only to return charges to their previous level in real terms a year earlier. Accordingly, it is straightforward to recognise that basing conclusions on the level of price increases over time using September 2008 as the end-point of the series, as Ofcom has, would produce erroneous conclusions about the pattern of price changes over time; and

(c) Ofcom appears to have had no regard to the data on this matter put to it by Sky in its response to the First Consultation Document. Ofcom draws different conclusions about changes in charges over time to those set out by Sky without apparently considering at all what might lie behind such differences. For example, Ofcom states that:

> "*Average annual growth of real top tier prices was about 1.1% per year since 2002*"[25]

This is misleading. As stated in Sky's Response to Ofcom's First Consultation Document[26], and shown in **Figure 1** below, charges in real

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24 To the extent that we have been able to replicate Ofcom's charts, they appear to contain errors.

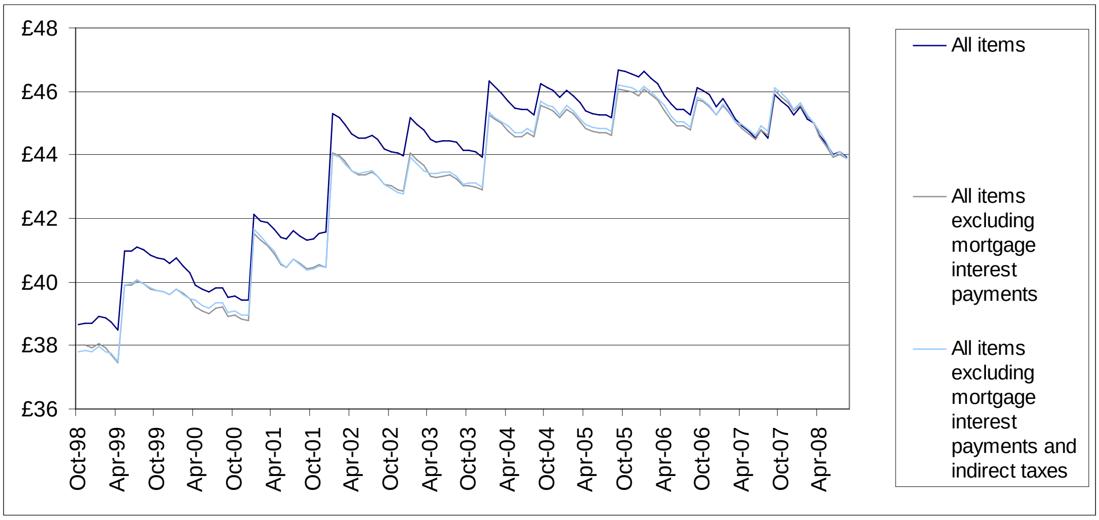
25 Paragraph 3.16 of Annex 6 to Ofcom's Consultation Document.

26 Paragraph 3.64 of Annex 2 of Sky's Response to the First Consultation Document.

terms for Sky's Top Tier package were broadly constant in real terms from 2004 to 2006/07. To the extent that prices have changes significantly since 2002, this is the result of an increase in January 2004, which has largely been reversed by a falling real charge for Sky's Top Tier package over the 2007/08 period.

Figure 4

Real charge for Sky's 'Top Tier' package, March 2008 prices, using various RPI measures

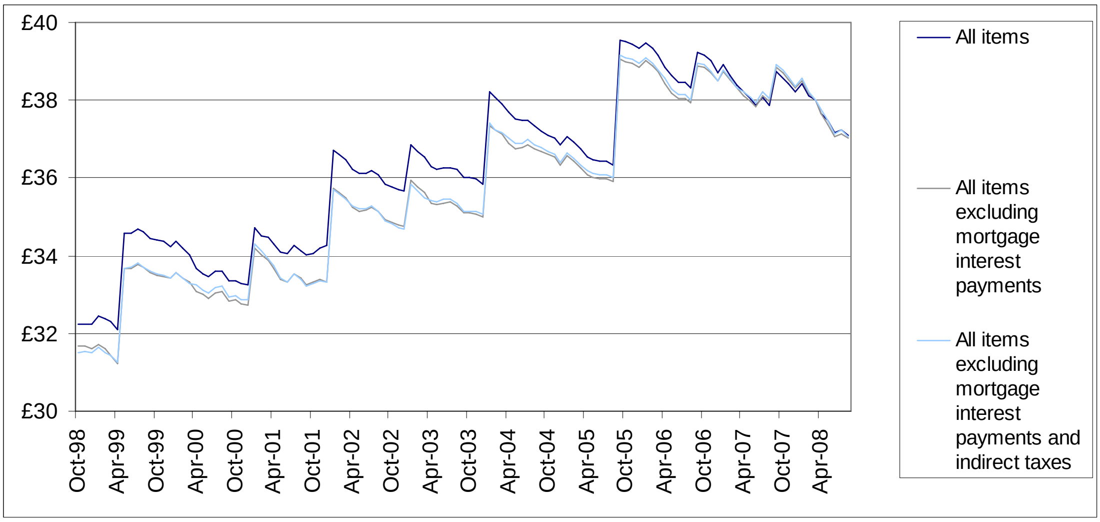


Similarly, proper evaluation of relevant evidence shows that Ofcom's conclusion that "*real Sports Mix prices have grown by about 1.8% per year since 2002*" is ill-founded. It is clear that such a statement implies a belief that real charges for Sky's Sports Mix package have increased by "*about 1.8%*" in real terms each year since 2002. Instead, proper regard to relevant evidence shows that there has been one main increase in the charge for this package in real terms since 2002, which occurred in September 2005 (see **Figure 5**, below). The effect of inflation, however, is that, despite this increase, the charge for this package in real terms was around the same level in both August 2008 and January 2002. If two directly comparable dates are chosen – for example the month directly preceding any nominal price increases – the charge in August 2008 was only in the order of 60p higher in real terms than that the charge at the same point three years earlier. Ofcom's attempt, therefore, to argue that the charge for Sky's sports package has been increasing continually over time is ill-founded.

Once changes to the range of basic and premium pay TV channels provided to subscribers to these packages, and the provision of other services to subscribers (such as use of PVRs and free or cheap broadband services), are taken into account, it is (as Sky has argued previously to Ofcom[27]) entirely likely that charges in real, value-adjusted terms have fallen over time.

Figure 5

Real charge for Sky's Dual Sports package, March 2008 prices, using various RPI measures



For completeness, we include the equivalent chart to those above for Sky's Dual Movies package at **Figure 6** below. This clearly shows, as we have argued previously, that Sky's charges for this package have been relatively constant in real terms for many years, and have recently fallen.

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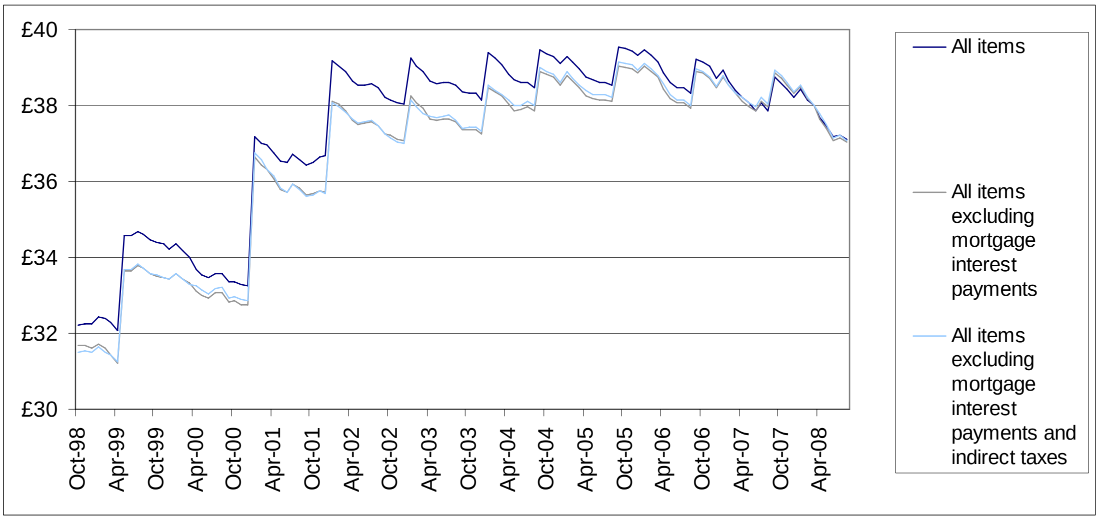
27 See Sky's submission entitled 'Changes in the quantity and quality of services delivered to subscribers to Sky's packages that include Sky's sports channels, 2001/02 – 2006/07', July 2008.

Figure 6

Real charge for Sky's Dual Movies package, March 2008 prices, using various RPI measures



<u>Trends in wholesale charges</u>

4.4 Similar issues of inadequate analysis of evidence of trends in charges by Ofcom arise in relation to wholesale charges for Sky's premium channels. For example, Ofcom's conclusions on the magnitude of increases in wholesale charges appear to exaggerate such increases, by using an end-point for its data series on charges which is just after a nominal price rise in September 2008.[28]

4.5 Perhaps the most unusual aspect of Ofcom's analysis of trends in charges at the wholesale level is the fact that Ofcom considers evidence of increases in wholesale charges on their own to be determinative of the absence of competitive constraints on Sky's wholesale charges. Ofcom states:

> "*We note that the wholesale price for Sky Sports Mix packages has increased considerably since 2002, **indicating that these packages do not face a strong competitive constraint**. The wholesale price of the Sky Sports and Movies Mix is* **[CONFIDENTIAL]**% *higher than it was in 2002.*"[29] (Emphasis added)

4.6 The key reasons that this is unusual are that (a) Ofcom recognises that changes in the quality of services provide a potential explanation for increases in prices at the retail level,[30] yet fails entirely to recognise this point at the wholesale level, and (b) Sky indicated to Ofcom that any analysis of this type would need to take into account changes in the quality of its channels in an earlier

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28 It is perhaps not coincidental that, in relation to wholesale charges, as discussed further above, Ofcom considers evidence of increases in wholesale charges on their own to be determinative of the absence of competitive constraints on Sky's wholesale charges.

29 Paragraph 6.11 of Annex 6 to the Consultation Document.

30 See paragraphs 3.22 to 3.39 of Annex 6 to the Consultation Document.

submission.[31] We are therefore puzzled as to the reason for this oversight on Ofcom's part. Ofcom's failure to consider changes in wholesale charges for Sky's channels in real terms, taking into account changes in their quality over time, is a fundamental flaw in Ofcom's consideration of this issue.

5. Ofcom's "critical loss analysis"

5.1 A further approach to analysis of market definition used by Ofcom in the Consultation Document is 'critical loss analysis'.[32] This is a means of applying the hypothetical monopolist test. It involves comparing the estimated level of sales that would be lost in the event of a price rise (ideally using data on actual responses to price rises) with the level of sales loss estimated to be required to make that price rise unprofitable.

5.2 Ofcom states that this analysis is "*somewhat theoretical*".[33] Ofcom, however, has no regard at all to two further obvious problems with applying this approach in this case.

5.3 First, critical loss analysis is open to numerous criticisms, which have been the subject of many articles in the past – the most well-known being "*A Critical Analysis of Critical Loss Analysis*", by economists at the US Federal Trade Commission.[34] Ofcom fails entirely to have any regard to the types of issues raised in this and other similar papers.

5.4 Second, Ofcom fails to recognise the role that retail bundling plays in driving its results. Essentially, retail bundling of pay TV channels means that there will generally be a large gap between the monthly licence fee for a pay TV channel – i.e. its wholesale price – and the monthly subscription charge for packages in which the channel is included. As a result, it is likely that every pay TV channel supplied as part of a package would fail the test used by Ofcom. Ofcom cannot draw any conclusion in support of its case from a test that would almost certainly imply that Fox News, the National Geographic Channel, and Living are supplied in separate relevant markets.

6. Ofcom's discussion of barriers to entry and expansion

6.1 The facts that (a) both entry and expansion in television broadcasting is relatively straightforward – as is clearly evidenced by the massive proliferation of television channels in the UK over the past ten years, and (b) programming

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31 See paragraph 2 of Sky's submission entitled 'Changes in the quantity and quality of services delivered to subscribers to Sky's packages that include Sky's sports channels, 2001/02 – 2006/07', July 2008.

32 Appendix 10 of Annex 6 to the Consultation Document. This approach was not used in Ofcom's First Consultation Document.

33 Paragraph 4.87 to the Consultation Document.

34 Daniel P. O'Brien and Abraham L. Wickelgren, 'A Critical Analysis of Critical Loss Analysis', May 2003. Available at: http://www.ftc.gov/be/workpapers/wp254.pdf. Another article that discusses some of the problems associated with critical loss analysis is 'Improving Critical Loss Analysis', by Joseph Farrell and Carl Shapiro, February 2008. Available at: http://www.abanet.org/antitrust/at-source/08/02/Feb08-Farrell-Shapiro.pdf

rights such as rights to broadcast sports events and Hollywood blockbusters are both contestable and periodically come up for re-licensing represent significant problems for a proposition that there are major barriers to entry into relevant markets for the supply of premium sports and film channels.

6.2 Ofcom places a substantial amount of weight on the issue of barriers to entry as giving rise to market power for Sky. Its analysis of this issue, however, is significantly flawed.

6.3 In relation to sports channels, Ofcom's analysis of barriers to entry is highly unusual, largely (though not entirely) as a result of Ofcom's very narrow market definition.[35] Ofcom argues that, in order to enter a putative market for pay TV sports channels that broadcast live FAPL matches:

(a) it is necessary to hold rights to broadcast live FAPL matches; and

(b) other firms are not able to compete with Sky for 'sufficient' rights to broadcast live FAPL matches in future rights auctions.

6.4 Ofcom's view is that potential entry into its putative market will only be sufficient to ensure that Sky does not have market power if potential entrants are able to prevent Sky from winning "*the majority*" of "*Live FAPL rights*" (whatever that means) in any rights auction – a proposition for which Ofcom provides no analytical or evidential support – due to Sky's alleged "*advantages*" in bidding for such rights. Ofcom considers such "*advantages*" to comprise barriers to entry to its putative market.

6.5 Ofcom states:

> "*Our current conclusion…is that Sky is likely to obtain* ***the majority of the Live FAPL Rights*** *when they next become available.* ***This reflects a number of advantages that Sky is likely to enjoy when bidding for these rights – these advantages constitute barriers to entry*** *and expansion from the perspective of competitors seeking to acquire the Live FAPL Rights and enter the relevant market.*"[36] (Emphasis added)

6.6 Somewhat unusually, Ofcom is seeking to confirm its views by asking consultees about Sky's prospects in the next few FAPL rights auctions – a matter that in Sky's view other consultees would be in a position only to speculate about.

6.7 Ofcom's analysis of barriers to entry is, at the same time, both overly simplistic, and overly complicated. We discuss these criticisms in the sections below.

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35 Ofcom's argument in relation to barriers to entry to its narrow market for the supply of pay TV channels that broadcast Hollywood blockbusters in the pay TV window is essentially the same as its argument in relation to sports channels. Accordingly, the criticisms that we set out above apply equally to Ofcom's argument in relation to such putative barriers to entry.

36 Paragraph 2.150 of Annex 7 to the Consultation Document. Ofcom states further that such "*advantages*" so insulate Sky from competition in FAPL rights auctions that "*Sky is unlikely to be constrained by the threat of entry*". (Paragraph 2.40 of Annex 7 to the Consultation Document.)

Overly simplistic

6.8 Ofcom's approach is overly simplistic because it devotes inadequate attention to the concept of what comprises an entry barrier in the particular circumstances of pay TV broadcasting. In Sky's view, it is simplistic – and moreover in all likelihood erroneous – to regard as a barrier to entry anything that gives a firm already in the market an advantage in bidding for content rights over a firm not in the relevant market. We consider that it is even less relevant to regard an entry barrier as something that prevents a firm already in the market from winning "*the majority*" of particular content rights – whatever that means in this context - when they are re-auctioned.

6.9 The concept of barriers to entry is not a straightforward one, particularly in a situation in which there is periodic auctioning (whether formal or otherwise) of key inputs for operation in the relevant downstream market. For example the New Palgrave Dictionary of Economics Online states:

> "*The precise definition of barriers to entry is controversial; different versions have been proposed over the years. The issue is not one of pure semantics, since evidence of barriers to entry plays an important role in merger review and other areas of antitrust policy.*"[37]

6.10 In a similar vein, McAfee et. al. state

> "*Unfortunately, economists have not yet been able to reach broad consensus over the definition of an entry barrier, and this has probably hindered the development of efficient antitrust policy.*"[38]

6.11 Similarly, some economists argue that approaching the concept of a barrier to entry mechanistically, as we believe Ofcom has, can give rise to serious analytical errors in competition analysis.[39]

6.12 The OFT Market Power Guidelines (which are cited by Ofcom[40]) define entry barriers as follows:

> "*Entry barriers are factors that allow an undertaking profitably to sustain supra-competitive prices in the long term, without being more efficient than its potential rivals.*"[41]

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37 See http://www.dictionaryofeconomics.com/article?id=pde2008_B000077

38 R.P. McAfee, H. Mialon, and M. Williams, 'When are sunk costs barriers to entry? Entry barriers in economic and antitrust analysis'. American Economic Review Papers and Proceedings 94 (2), 2004, 461–465.

39 See, for example, D.W. Carlton, 'Why Barriers to Entry are a Barrier to Understanding', American Economic Review, 2004, 94(2).

40 See, for example, paragraphs 5.39 of the Consultation Document, and paragraph 1.31 of Annex 7 to the Consultation Document.

41 Paragraph 5.3 of the Consultation Document. The definition contains redundancy in the sense of referring to an ability "*profitably to sustain supra-competitive prices*". This does not, however, affect the reasonableness of this as a definition. This definition has much in common with that

6.13 This seems to Sky to be a reasonable approach to defining barriers to entry.

6.14 Three elements of the OFT's definition are notable: (a) it defines an entry barrier as something that allows an undertaking to sustain prices above competitive levels, (b) it must do so "*in the long term*", and (c) it states that being more efficient than rivals should not be regarded as being a barrier to entry.

6.15 It is immediately clear that Ofcom's approach performs poorly on all three of these criteria: (a) there is no evidence that the types of factors in the theories that Ofcom has constructed enable Sky to earn excess profits, and all the available evidence points to the returns to Sky in the production of premium pay TV channels not being excessive (see **Section 6** of this Response), (b) the periodic re-auctioning of rights on a relatively short-term basis (every three years in the case of FAPL rights) provides an obvious reason why Sky would not be in a position to earn excess profits "*in the long term*", and (c) it is abundantly clear that most of the factors in Ofcom's theories in fact describe ways in which Sky is more efficient than rivals.

Overly complicated

6.16 Ofcom's reasons for concluding that there are significant barriers to entry into its narrowly defined markets are theory-based rather than evidence-based. We have already noted above that (a) these theories have all the hallmarks of constructions intended to support predetermined conclusions, and (b) they are highly convoluted. In Sky's view, this is an unsound basis for reaching well-supported conclusions on the existence and impact of barriers to entry.

7. Ofcom has failed to have regard to key pieces of relevant evidence which Sky has put to it

7.1 Sky's response to Ofcom's First Consultation Document provided a number of pieces of relevant evidence and analysis to which Ofcom appears to have had no regard at all in preparing its Second Consultation Document. The types of points which Ofcom has failed to consider include:

- the inappropriateness of focusing on 'close substitutes' (particularly judged on the basis of product characteristics) rather than considering the aggregate constraint imposed by a range of substitutes. For example, in relation to premium film channels, despite Sky's explanation in its Response to the First Consultation Document that the pricing constraint on these channels arises from the totality of both alternative ways of watching films, and non-film programming, Ofcom's consideration of substitutes continues to be limited to pair-wise comparisons of the products such as (a) Ofcom's comparison of "*the volume of high-quality football on free-to-air TV channels*" as a constraint

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advanced by the New Palgrave Dictionary of Economics Online, which states: "*One definition that seems to reflect current thought and practice is as follows: barriers to entry are structural, institutional and behavioural conditions that **allow established firms to earn economic profits for a significant length of time**.*" (Emphasis added) *Op. cit.*

on the suppliers of premium sports channels, and (b) Ofcom's pair-wise evaluations of the constraint on suppliers of premium movie channels arising from the availability of movies on DVDs (paragraphs 4.196 to 4.204 of the Consultation Document), and movies downloaded over the internet (paragraphs 4.213 to 4.219 of the Consultation Document); and

- the lack of correspondence between observed outcomes and the proposition that Sky has a position of dominance (and has had such a position for many years). For example, in spite of many pages of theorising, Ofcom does not have a persuasive explanation of why Sky continues to invest and innovate in both its premium sports and premium film channels when – on Ofcom's view – it is wholly insulated from competitive pressure, and why Sky fails to earn excess profits on its premium pay TV channel business in such a situation.

7.2 Ofcom has also failed to have proper regard to the wealth of relevant material which runs counter to its conclusions in internal documents that it has obtained pursuant to its information requests. In fact, the only use to which it appears that such documents have been put is a source of quotations that Ofcom believes accords with its conclusions throughout the Consultation Document, in spite of the significant amount of evidence they contain which contradicts those conclusions.