

**Joint response to Sky's submission
to Ofcom of April 2008**

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Joint response to Sky's submission to Ofcom of April 2008

Executive summary

1. Despite its length, Sky's Response to Ofcom's Consultation Document fails meaningfully to address the substance of the very real concerns raised by Ofcom and the Parties. Notwithstanding Sky's claims that the market is working well, Sky has, over time, been able to strengthen its market position and substantial market power at all levels of the pay TV supply chain whilst its competitors either lost ground or failed to generate any scale. Had the market been working well, one would have expected to have seen much more entry over recent years, a sustained challenge to Sky and greater innovation and development from Sky's competitors and entrants. Due to the features of the market identified by Ofcom and the Parties, this has not happened. In short, consumers are being denied the benefits that effective competition would deliver. (See section 1 below.)
2. Sky seeks to place disproportionate weight on the consumer research carried out by Ofcom and ignores the limitations of that research. For example, the research takes no account of the views of the 54% of households who do not subscribe to pay TV services. In addition, Ofcom's survey results as regards those consumers who do subscribe to pay TV are not consistent with the extensive research carried out by YouGov this year which confirmed that, of the major digital TV service providers, Sky was ranked worst for value for money. It is clear, therefore, that very many consumers are not being well served in respect of pay TV. In a more competitive market, consumers would benefit from retail and wholesale price competition, greater choice and increased innovation by Sky's competitors. (See section 2 below.)
3. Sky seeks to argue that it has no incentive to refuse to wholesale its premium channels to its retail competitors. This argument is based on a "*simple*" model which is described in a working paper by Harbord and Ottaviani that dates from 2001. This working paper (and Sky's argument) not only ignores the dynamic features of pay TV but is also underpinned by the assumption that a vertically integrated firm would set its wholesale charges at a level that prevents effective downstream competition and would lead to very high prices being set for premium channels, thereby exploiting consumers' high valuations of such channels. When the dynamic aspects of competition in pay TV are taken into account, it is clear that the vertically integrated firm has an incentive to foreclose competitors. Furthermore, the reduction in, or elimination of, downstream competition through excessive wholesale prices (which Sky effectively advocates) is not an outcome that benefits consumers. In any event, Sky's theoretical discussion as to its incentives is rendered otiose given its actual conduct and refusal to wholesale at all to certain competitors and the onerous terms imposed on Virgin Media which prevent it from competing effectively on either price or

- quality. Thus, it is clear that Sky enjoys substantial downstream advantages as a result of its position as a broadcaster. (See section 3 below.)
4. Sky argues that it does not enjoy a bidding advantage due to its substantial base of existing subscribers as a new entrant would be able to wholesale its channel to Sky and that Sky would retail that channel on a competitive basis to Sky's subscribers. This impractical proposal ignores, among other things, (i) the fact that Sky would be highly unlikely to assist a rival by agreeing to competitive wholesale terms that would signal that it could be outbid for content rights, (ii) Sky would not have an incentive to promote the rival channel effectively in competition with its own channels and (iii) even if an entrant were to wholesale its new channel to Sky, the new channel would still have no DTH subscribers at the outset and thus such a wholesale arrangement would not overcome the barrier to entry presented by the time needed to build a subscriber base for the new channel. It is clear, therefore, that Sky does enjoy substantial bidding advantages as a result of its downstream position. (See section 4 below.)
 5. Sky seeks to argue that there can be no dynamic foreclosure in pay TV in the UK as there is no credible mechanism which links a particular commercial practice in one period to rivals' loss of share in another and further links this to rivals' marginalisation in the market. This statement is simply not correct. Through Sky's exploitation of the vicious circle in pay TV in the UK, its competitors face the handicap of having to compete for subscribers with inferior content and to compete for content with fewer subscribers. As a consequence, Sky's access to superior content enables it to build a customer base advantage which consolidates its ability to monopolise the acquisition of content and, in turn, to maintain its leading position downstream. Hence, due to this dynamic foreclosure, Sky has been able to entrench its market position across the pay TV supply chain. (See section 5 below.)
 6. In its econometric analysis which has already been submitted to Ofcom, LECG has been able to demonstrate that average pay TV prices in the UK are significantly above average pay TV prices in fourteen other European countries even when differences in content quality and income per capita are taken into account. LECG has also demonstrated that these price differentials can be substantially explained by differences in market structure. In its Response, Sky has included a study by PwC which seeks to demonstrate that the UK is a leader among European countries in terms of choice and value from pay TV and innovation in pay TV. Yet, PwC's study actually demonstrates that Sky's retail prices are significantly above the sample average price for three of the four pay TV packages which it investigates. PwC's study also confirms that, despite the high prices paid by UK consumers, they do not have greater retailer choice and do not benefit from more innovation than the average European consumer. Thus, when considered objectively and interpreted vigorously, it can be seen that PwC's study confirms the conclusion of LECG's international pay TV price comparison. (See section 6 below.)

7. Sky asserts that the concerns set out by Ofcom in its Consultation Document are “*purely hypothetical*”. Yet, among other aspects of the current market failure, there are significant barriers to competitors, such as Setanta, bidding for rights to attractive content, Sky supplies its premium channels to Virgin Media at excessive wholesale rates and without the associated interactive and HD services, Sky refuses to wholesale its premium channels to relatively new pay TV retailers such as BT Vision and TUTV and by refusing to wholesale its premium channels to pay TV retailers over new platforms, such as DSL, Sky is significantly impeding the development of those new platforms. It is clear, therefore, that Ofcom’s competition concerns are certainly not “*hypothetical*”. (See section 7 below.)

8. In order to make a reference to the Competition Commission under the Enterprise Act, Ofcom need only have reasonable grounds to suspect that features of the market prevent, restrict or distort competition. This threshold is recognised as being a very low one, reflecting Ofcom’s role as a first phase investigator. To date, there have been nine market investigation references to the Competition Commission. The Parties estimate that the average duration of the initial investigations to determine whether to make a reference in these nine cases was approximately seven months. In contrast, Ofcom’s first phase investigation into pay TV has now been underway for more than sixteen months. In the Association of Convenience Stores case the CAT stated that the OFT’s proposed timescale of approximately sixteen months for determining whether to make a reference to the Competition Commission was not reasonable. In light of the substantial information which has been made available to Ofcom and the market realities and outcomes outlined above, it is clear that Ofcom already has reasonable grounds for suspecting that features of the market prevent, restrict or distort competition. In the circumstances, Ofcom should not unduly prolong its investigation into pay TV, as delay will result in consumers continuing to suffer detriment while being denied the benefits of a more competitive market. Instead, Ofcom should exercise its discretion under the Enterprise Act and make a reference to the Competition Commission for a full market investigation. (See section 8 below.)

Joint response to Sky's submission to Ofcom of April 2008

1. Introduction

- 1.1 This document addresses issues raised in Sky's Response of April 2008 ("Sky's Response") to Ofcom's Consultation Document of December 2007 (the "Consultation Document").¹ This document does not, however, seek to restate the case put by BT, Setanta, TUTV and Virgin Media (together "the Parties") to Ofcom on the need for a market investigation by the Competition Commission to address the structural market features which prevent, restrict or distort competition in pay TV in the UK. Before addressing specific issues raised in Sky's Response, the Parties set out the following general observations on Sky's Response having regard to the context of Ofcom's investigation.
- 1.2 Ofcom initiated its investigation following the Parties' Joint Submission of 16 January 2007 on the need for a market investigation into the pay TV industry. This Submission, together with the Joint Submission of 3 July 2007, was prompted by the fact that each of the Parties is being significantly constrained in its ability to compete in pay TV by features of the market (and by Sky's behaviour which is facilitated by the relevant features of the market). Each of the Parties provided details of the way in which their competitive behaviour is being constrained by the relevant features of the market (and by the behaviour of Sky facilitated by those features of the market). These Submissions have been further supported by the responses of the Parties to questions from Ofcom.
- 1.3 Notwithstanding Sky's claims that the market is working well, the Parties' Submissions were made against the background of Sky having, steadily over time, been able to strengthen its market position and market power at all levels of the pay TV supply chain whilst its competitors either lost ground or failed to generate any scale. Had the market been working well, one would have expected to have seen much more new entry over recent years, a sustained challenge to Sky and greater innovation and development from Sky's competitors and entrants. Due to the features of the market identified by the Parties, this has not happened. In short, consumers are being denied the benefits that effective competition would deliver.

¹ It should be noted that this document is not intended to address comprehensively the issues raised in Sky's Response. To the extent that it does not address a particular issue, it should not be treated as agreeing with that issue.

- 1.4 Against this background, and based on evidence and material obtained from third parties and its own detailed investigation, Ofcom proposed in its Consultation Document that:
- (a) Sky is dominant in the wholesale supply of premium sports channels and premium movie channels;
 - (b) Sky is dominant in the retailing of packages containing premium sports channels and packages containing premium movie channels;
 - (c) barriers to entry in each of the above markets are high;
 - (d) Sky, as a vertically integrated operator, may have the incentive to engage in behaviour that forecloses, or marginalises, competition both upstream and downstream; and
 - (e) there exist a range of factors which point to Sky's behaviour having had the effect of foreclosing, or marginalising, other market participants at all levels of the pay TV supply chain.

1.5 These findings strongly suggest that there are features of the pay TV market that are not serving the interests of consumers. Remedying these features would promote competition leading to lower prices, greater choice and increased innovation.

1.6 Notwithstanding the volume of factual and documentary evidence considered by Ofcom, the length of its investigation and the detail contained in the Consultation Document, Sky asserts in its Response that:

*"Any intervention based on the "possible concerns" set out by Ofcom would amount to 'regulation by hypothesis'...."*²

1.7 This assertion is entirely without foundation. Indeed, far from Ofcom relying on hypothesis, it is Sky that relies on theory and hypothesis in seeking to rebut the concerns identified by the Parties and Ofcom. In particular, in addressing the key concerns raised by the Parties in their Joint Submission of 3 July 2007, and by Ofcom in the Consultation Document of 18 December 2007, in relation to Sky's incentives as a vertically integrated operator to engage in upstream and downstream foreclosure, Sky relies almost entirely on a theoretical economic paper prepared by CRA (see section 10 and Annex 4 of Sky's Response). Among other things, CRA's paper considers Sky's incentives in a vacuum and, as is explained in sections 3, 4 and 5 below, entirely omits to consider how Sky's actual behaviour can be reconciled with the way in which CRA argues Sky should behave. In other words, CRA conveniently ignores the fact that, as demonstrated in the Parties' Submissions, Sky has been engaging in conduct that leads to foreclosure.

² Paragraph 14 of Part 1 of Sky's Response.

1.8 In practice, despite its length, Sky’s Response fails meaningfully to address the substance of the very real concerns raised by the Parties and by Ofcom in its Consultation Document.

1.9 In the circumstances, and as is explained in more detail in section 8 below, Ofcom has sufficient evidence for it to have reasonable grounds for suspecting that there are features which prevent, restrict or distort competition in pay TV in the UK. Accordingly, instead of unduly prolonging its investigation into pay TV, Ofcom should now make a market investigation reference to the Competition Commission.

2. Consumer experience

2.1 In its response, Sky places significant weight on Ofcom’s statement that:

*“Our initial assessment of the various criteria ... reveals a market that currently appears to be serving its existing consumers reasonably well”.*³

2.2 Sky then states that:

“There are a number of reasons why this is the most important conclusion that Ofcom reaches in the Consultation Document:

- *It is based on a detailed consideration of consumer outcomes ...;*
- *It is based on the **current, observed** position and therefore is not prone to general theorising or reliance on hypothetical scenarios;*
- *It is based on evidence in relation to **current** purchasers of pay TV services rather than speculative, so called, “evidence”, based on a vague theory of “customer exclusion” ...”.*⁴ (Emphasis in the original.)

2.3 Ofcom’s assessment in the Consultation Document of the consumer experience of pay TV is based on a survey of consumer satisfaction levels which is necessarily of limited utility for the following two reasons, among others:

- the results of the survey are biased as they only relate to consumers who have chosen to subscribe to pay TV services at current prices. As Ofcom itself notes: *“there may be certain types of consumers who are not well served by pay TV in the sense that the pricing structure may serve to exclude them from the market”*. In light of this, Ofcom

³ Paragraph 4.76 of Ofcom’s Consultation Document and paragraph 2.2 of Part 2 of Sky’s Response.

⁴ Paragraph 2.4 of Part 2 of Sky’s Response.

concludes that evidence on consumer satisfaction levels “*obviously reflects the fact that those consumers who are able to express a view are those that have voluntarily chosen to pay for the service. For [this] reason, it is hard to infer conclusions on the effectiveness of competition within the market from satisfaction measures alone*”;⁵ and

- current consumers of pay TV services may express relative satisfaction with their service because they cannot conceive of the alternatives that would be available in a more competitive market. As Ofcom observes: “*Evidence on consumer satisfaction levels is often hard to interpret ... as it is difficult to establish benchmark levels of satisfaction*”.⁶

2.4 The magnitude of the first issue highlighted above is very significant. Ofcom’s Digital Progress Report for Q4 2007 confirms that only 46% of UK households subscribe to a pay TV service.⁷ Thus, 54% of (i.e. 13.8 million) households do not subscribe to a pay TV service.

2.5 In addition to the deficiencies with Ofcom’s consumer survey that are outlined above, it should be noted that Ofcom’s survey results are not consistent with the research carried out by YouGov in January 2008 and published by youSwitch.com in May 2008. This research covered nearly 10,000 digital TV customers and confirmed that one in four digital TV customers are not satisfied with their service and that, as between Freeview, Sky and Virgin Media, Sky was ranked worst for value for money. It is clear, therefore, that very many consumers are not being well served in respect of pay TV.⁸

2.6 In this context, a key question is whether retail prices would be lower and consumers’ choices of platforms and content could be greater in a more competitive market. Ofcom has observed that Sky’s premium channels, which represent very attractive content for pay TV services and subscribers, are only fully available on the satellite platform and partially available on cable. Accordingly, in circumstances in which Sky’s premium channels were made available at competitive rates on all platforms, consumer choice of the available combinations of platform/content would increase (not just in respect of premium channels but also basic channels and other services).

2.7 If Sky were to wholesale its premium channels to competing pay TV retailers on these other platforms, consumers would also gain substantial benefits as a result of the ensuing retail price competition. In circumstances in which competing pay TV retailers on other platforms had access to this key pay TV content at

⁵ Paragraph 4.7 of Ofcom’s Consultation Document.

⁶ Paragraph 4.7 of Ofcom’s Consultation Document.

⁷ The Communications Market: Digital Progress Report, dated 27 March 2008. It should be noted that pay TV penetration of 46% in the UK is substantially below the pay TV penetration of 80% in the US, which is a much more competitive market.

⁸ www.netimperative.com/news/2008/may/12/digital-TV-disappointing-customers

economically viable prices, they would also be incentivised to develop their platforms and pay TV offerings further.

- 2.8 Consumers would also benefit in terms of platform/content choice if there were greater competition upstream. Setanta is the only broadcaster of premium pay TV services other than Sky. Yet, the competitive pressure which Setanta is able to exert on Sky is limited, and Sky has expressly acknowledged this fact.⁹ In addition, for the reasons explained in sections 4 and 5 below, there are significant barriers to entry upstream.¹⁰ Hence, there are limited opportunities for Setanta to obtain additional content and thereby increase the competitive pressure which it exerts on Sky. If these upstream barriers were to be reduced (or indeed eliminated), consumers would benefit from increased choice and competition.
- 2.9 Furthermore, for the reasons explained in the Joint Submission of 3 July 2007, Sky has been able to inhibit the launch of HD services by competing pay TV platforms and competing broadcasters. Similarly, Sky has been able to inhibit the supply of content which competing pay TV retailers could offer on a video on demand (“VOD”) basis through “warehousing” VOD rights (i.e. acquiring such rights and not utilising them) and by discouraging rights owners from licensing these rights separately to competing platforms. In this context, it should be noted that there are several platforms/technologies in the UK that would be able to offer consumers extremely feature-rich on-demand services if they were able to access attractive content. Given that such platforms/technologies have much greater capability in this regard than the satellite platform, Sky clearly has an incentive to inhibit their access to attractive content. Consumers would, however, undoubtedly benefit if HD and VOD services were more widely available.
- 2.10 The ability for Sky’s competitors to innovate is limited due to Sky’s control of mutually reinforcing upstream and downstream bottlenecks. Sky’s control of these bottlenecks not only limits its competitors’ access to key content which could form the basis of further innovative services but also limits its competitors’ ability to offer such content in cheaper and more flexible packages.
- 2.11 In a more competitive market, it is clear that further innovations would result – for example, greater availability of HD services on platforms other than satellite and the development of an increased range of on-demand services by Sky’s competitors. In the circumstances, it is clear that consumers are suffering as a result of the lack of effective competition in pay TV in the UK.
- 2.12 For the reasons outlined above, Ofcom must take a dynamic view of the consumer experience of pay TV. If there were to be greater competition in pay TV in the UK, consumers would enjoy increased choice of platforms and

⁹ See paragraph 5.11 below.

¹⁰ See also sections 6, 7 and 8 of the Joint Submission by Setanta and TUTV dated March 2008.

content, third party pay TV operators would be able to undertake more innovation and pay TV prices would come down as a result of retail price competition.

3. Refusal to supply downstream competitors

- 3.1 Paragraphs 10.25 to 10.47 of Sky's Response and the paper by CRA which is attached at Annex 4 to Sky's Response effectively reiterate Sky's previous arguments from its Submission of October of 2007 which seek to deny the existence of downstream advantages due to its leading position in broadcasting. These arguments have already been addressed by the Parties.¹¹ Nevertheless, the following paragraphs outline a number of additional deficiencies.

One monopoly profit theory

- 3.2 In seeking to deny that Sky has the incentive to engage in downstream foreclosure, CRA relies on the Chicago school's "*one monopoly profit*" theory as to why foreclosure is unprofitable. Specifically, CRA claims in Annex 4 to Sky's Response that:

"In order to be able to argue that a vertically integrated retailer/broadcaster would do better by adopting a downstream foreclosure strategy, Ofcom would need to examine carefully the traditional "one monopoly profit" critique, and explain why it does not apply".¹²

- 3.3 The Parties note that, in a recent article, Professor Van Reenen, who was one of the authors of Annex 4 to Sky's Response, stated that:

"There are many reasons why the Chicago critique of the leveraging theory breaks down The lack of any long-run incentives to foreclose in the "one monopoly profit theory" arises primarily from the assumption of the Chicago school that the monopolist has a permanent unchallenged position with no threat of future entry in his primary market".¹³
(Emphasis added.)

- 3.4 In practice, Sky's incentives to withhold its premium channels from its downstream competitors derive from its desire not only to soften downstream competition but also to weaken the ability of these competitors to bid for the rights to attractive content and develop their own premium channels as

¹¹ See, for example, section 6 of the Parties' Joint Submission on 29 February 2008.

¹² Paragraph 47 of Annex 4 to Sky's Response.

¹³ Centre of Economic Performance/Special Paper No. 20, dated February 2008, entitled "*Interoperability and Market Foreclosure in the European Microsoft Case*" by Kai-Uwe Kühn and John Van Reenen

competitors to Sky's premium channels. Hence the primary assumption underpinning the Chicago school theory, which is mentioned by Professor Van Reenen, would not apply in pay TV, notwithstanding the substantial barriers to entry.

Harbord and Ottaviani's model

- 3.5 In this context, Sky's Response also seeks to place great weight on the claim that:

*"In relation to downstream foreclosure... CRA concludes that a vertically integrated firm that can use sufficiently non-linear tariffs would never refuse to sell to an efficient downstream rival".*¹⁴

- 3.6 In practice, Sky's claim is not correct. CRA's alleged conclusion merely amounts to the observation that in a working paper from 2001:¹⁵

*"Harbord and Ottaviani consider a model... [and] find that a vertically integrated firm would never refuse to sell the premium content to its downstream rival".*¹⁶

- 3.7 This "*finding*" by Harbord and Ottaviani is treated by Sky and CRA as if it were an universal truth. Yet Harbord and Ottaviani concede in their working paper that their model is "*simple*". Indeed, in their conclusion they refer to the possibility of having a "*more realistic version of the model*". Nevertheless, through their "*simple*" model, Harbord and Ottaviani demonstrate that a vertically integrated firm is able to set a:

"per-subscriber resale price [which] acts as an effective mechanism for relaxing downstream price competition and extracting consumer surplus from the premium product". (Emphasis added.)

Thus, in Harbord and Ottaviani's model, the vertically integrated firm is able to set such a high wholesale price that it restricts, or eliminates, retail competition and consumers face very high retail prices exploiting their willingness to pay for pay TV (hence the reference to extracting "*consumer surplus*" with consumer

¹⁴ Paragraph 10.15 of Part 2 of Sky's Response. In this context it should also be noted that, since 2003 (i.e. after the date of the working paper by Harbord and Ottaviani on which Sky and CRA rely), Sky has set linear wholesale tariffs (i.e. tariffs which are calculated purely on a pence per subscriber basis, rather than on a "non-linear" basis so that, for example, they decline the more subscribers are served).

¹⁵ The relevant working paper by Harbord and Ottaviani is entitled "*Contracts and Competition in the Pay-TV Market*" and is dated July 2001. It is notable that, since being written 7 years ago, this paper has not been published. The Parties understand that is as a result of Harbord and Ottaviani's results not being regarded as robust.

¹⁶ Paragraph 56 of Annex 4 to Sky's Response. Clearly, the model's output is contingent upon the assumptions that are built into it and different assumptions would lead to a different outcome. See Patrick Rey and Jean Tirole. "*A Primer on Foreclosure, Handbook of Industrial Organisation*" Volume III, North Holland 2007.

surplus being the gap between the maximum prices which consumers are willing to pay and the actual price they pay).

3.8 On the basis of this article by Harbord and Ottaviani, CRA argues that, by imposing a high per-subscriber fee, “*pricing by competing downstream retailers will be less aggressive*” and “*the upstream firm would not ... decline to license content to other firms*”.¹⁷ CRA expressly acknowledges that, in Harbord and Ottaviani’s model, “*the vertically integrated channel provider uses the per-subscriber fee to reduce the harshness of downstream competition*”.¹⁸ CRA’s position is therefore clear - it effectively argues that it is acceptable for Sky to charge as high a wholesale per-scriber fee as it sees fit so as to reduce, if not eliminate, effective retail competition when licensing its content to a competing retailer.¹⁹ In order to imply that this is a desirable outcome, CRA rather theatrically describes downstream competition in pejorative terms such as “*harsh*” and “*fierce*”.²⁰ Clearly, however, the reduction in, or elimination of, downstream competition is not an outcome which benefits consumers and CRA ignores the fact that effective retail competition would deliver lower retail prices, an increase in output, innovation and consumer choice and lead to greater competition for premium content.

3.9 In support of its position, CRA also seeks to rely on a paper by Weeds. Yet Weeds observes that the “*softening of downstream competition*” certainly does not justify one retailer (i.e. Sky) having exclusive access to key content but instead it may be appropriate to impose regulation to reduce high per-subscriber (i.e. wholesale) fees:

*“Although non-exclusivity is socially optimal, consumers are worse off than under exclusive distribution: the softening of downstream competition results in higher prices that outweigh the benefit to them to viewing the content. However, this should not be seen as an argument in favour of exclusivity: rather, regulation to reduce per-subscriber fees might be considered ...”.*²¹

¹⁷ Paragraph 56 of Annex 4 to Sky’s Response

¹⁸ Paragraph 58 of annex 4 of Sky’s Response.

¹⁹ It is notable that this is the course of conduct which Sky has employed consistently with the pay TV retailers (i.e. the cable operators and ITV Digital) to which it has wholesaled its channels.

²⁰ CRA also argues that “*fierce*” retail competition “*would potentially reduce the overall rents that can be obtained from holding the rights to premium content*”. (Paragraph 87 of Annex 4 to Sky’s Response.) CRA also argues that in Harbord and Ottaviani’s model: “*... the per-subscriber fee is useful to avoid harsh competition downstream (because with per-subscriber fee, pricing by competing downstream retailers will be less aggressive). Having ensured that downstream competition is not too destructive, the upstream firm has the incentive to extract surplus from the largest number of customers...*”. (Paragraph 56 of Annex 4 to Sky’s Response.)

²¹ “*TV Wars: Exclusive Content and Platform Competition in Pay TV*”, Helen Weeds, University of Essex, 19 May 2008.

- 3.10 Weeds also emphasises that a static model, and Harbord & Ottaviani’s model is static, does not capture dynamic competition between pay TV retailers and distribution platforms:

*“...the static model omits an important dimension of competition in the television industry: competition between and within distribution platforms. The economic characteristics of distribution systems generate a dynamic aspect to competition: future profits typically increase with current market share. When this feature is incorporated, a new motive for exclusivity emerges: exclusive content gives its owner an initial advantage that is amplified by dynamic competition. Under certain conditions this benefit outweighs the opportunity cost of foregone distribution revenues and the content holder chooses exclusivity. Such a dynamic mechanism arises when platform investment is important, or when consumers incur switching costs of changing operator. These mechanisms may be found to dominate at times of rapid platform development and uptake which may currently be occurring in a number of countries, with the expansion of digital terrestrial and IPTV platforms, and the approach of digital switchover”.*²² (Emphasis added.)

- 3.11 Weeds also cautions that a vertically integrated wholesale channel provider may have an incentive to exclude rival retailers as:

*“The analysis in this paper assumes market structure to be fixed If this assumption were relaxed the following implications might be drawn. A content holder [i.e. a wholesale channel provider] might benefit from excluding a rival [retailer]: the increase in concentration would raise industry profit, giving rise to a similar dynamic mechanism”.*²³

- 3.12 Hence, whilst Harbord & Ottaviani’s “simple” model may suggest that the upstream firm would not decline to license content to other firms, that model does not reflect the dynamic aspect to competition in pay TV. When that aspect is taken into account, as Weeds observes, “a new motive for exclusivity emerges: exclusive content gives its owner an initial advantage that is amplified by dynamic competition”.

- 3.13 Sky and CRA’s claim that “a vertically integrated firm that can use sufficiently non-linear tariffs would never refuse to sell to an efficient downstream rival” not only ignores dynamic features of pay TV but is also underpinned by the assumption that such a vertically integrated firm would set its wholesale charges

²² “TV Wars: Exclusive Content and Platform Competition in Pay TV”, Helen Weeds, University of Essex, 19 May 2008.

²³ “TV Wars: Exclusive Content and Platform Competition in Pay TV”, Helen Weeds, University of Essex, 19 May 2008.

at a level which prevents effective downstream competition and extracts the consumer surplus from the premium product.²⁴

3.14 Furthermore, Sky and CRA's claim that "*a vertically integrated retailer would never refuse to sell premium content to its downstream rival*" is clearly contradicted by Sky's actual behaviour and the conduct of other vertically integrated pay TV companies abroad.²⁵

3.15 Ultimately, Harbord and Ottaviani conclude that:

"Exclusive vertical contracts ... permit upstream rights owners to transfer their monopoly power downstream, resulting in higher prices and lower consumer welfare. Effective remedies should therefore focus on regulating the way in which rights are sold and resold"; and

"A ban on exclusive vertical contracts would intensify downstream competition and transfer the benefits of premium programming to consumers".²⁶

3.16 Thus, Harbord and Ottaviani's conclusion is that the distortion of competition and consumer harm which results from Sky's control of premium content should be addressed by banning the exclusive licensing of premium content to Sky (and others). Hence third parties could also acquire the rights to broadcast on their own channels the content that is currently broadcast on Sky's premium channels. It is notable that, despite attaching so much weight to Harbord and Ottaviani's "*simple*" model, Sky does not apparently endorse their ultimate conclusion.

3.17 In light of all these issues, it is clear that the academic papers, on which Sky and CRA seek to rely, do not support their claim that Sky's incentives lie in wholesaling its premium channels on fair and non-discriminatory terms to all competing pay TV retailers. Moreover, it is important to appreciate that these papers focus narrowly on downstream retail foreclosure and not the broader anti-competitive effects of upstream and downstream foreclosure across the entire pay TV supply chain.

3.18 In any event, as noted above, such a theoretical discussion as to Sky's incentives is rendered otiose given Sky's actual conduct and refusal to wholesale to competitors. Notwithstanding all Sky's protestations to the contrary,²⁷ it is clear that Sky does not wholesale the whole of its portfolio of premium channels and services to any of its competitors. By withholding this content, Sky gains a

²⁴ In addition, Sky and CRA have not sought to establish that Sky's wholesale charges are "*sufficiently*" non-linear. Hence their reliance on Harbord and Ottaviani's paper is speculative.

²⁵ See, for example, paragraphs 8.9 to 8.11 of the Joint Submission by the Parties of 29 February 2008 which briefly summarises the views of the FCC about vertically integrated cable programmers in the US withholding their programming from competitors.

²⁶ Harbord and Ottaviani "*Contracts and Competition in the Pay-TV Market*", July 2001.

²⁷ See, for example, Paragraphs 10.29 and 10.46 of Sky's Response

competitive advantage not only downstream when retailing pay TV services but also upstream when bidding for rights.

4. Bidding advantages

4.1 Paragraphs 10.3 to 10.24 of Sky’s Response effectively reiterate Sky’s previous arguments from its Submission of October 2007 which seek to deny the existence of barriers for Sky’s competitors when attempting to develop premium channels. These arguments have already been addressed by the Parties.²⁸ Nevertheless, the following paragraphs outline a number of additional deficiencies.

Incremental entry

4.2 In its Response, Sky claims that:

*“... it is notable that Ofcom has adopted an unreasonable benchmark of what constitutes ‘entry’ in this context. ... Ofcom ignores the approach of building up channels gradually over time”.*²⁹

*“Ofcom also entirely overlooks the fact that “staggering” of rights can make entry easier, by allowing broadcasters to enter the market incrementally ...”.*³⁰ (Emphasis in original.)

4.3 In this regard, it is important to appreciate that:

- (a) a premium channel needs to offer a range of premium content, and a materially lower quality channel will not compete effectively with Sky’s premium channels. This is not just about consumers being able to watch more sports (although different sports have different seasons and are shown at different times), but also reflects the fact that consumers value variety and the appeal of any particular sport will vary (for example, depending on whether consumers’ supported teams compete in key events); and
- (b) Sky also has an incentive to acquire a range of substitutable content (and thus to pay more for this range of content), so as to give it market power as the monopoly (or leading) supplier of this content.³¹

²⁸ See, for example, section 7 of the Parties’ Joint Submission of 29 February 2008.

²⁹ Paragraph 10.7 of Part 2 of Sky’s Response.

³⁰ Paragraph 10.9 of Part 2 of Sky’s Response

³¹ Ofcom makes this point in relation to movies, although it applies equally to sports rights in the following way:

“For example, a wholesale channel provider that is seeking to accumulate exclusive rights to packages of subscription movie rights from all studios is likely to outbid a rival

- 4.4 In practice, if an entrant were to build up a channel gradually over time, it would not be able to persuade viewers to switch their subscriptions from Sky's premium channels to the new channel during that period of evolution. Sky's proposed strategy for third party entrants of "*building up channels gradually over time*"³² would, at best, involve those channels being complements to, rather than substitutes for, Sky's premium channels.
- 4.5 This is the situation currently in respect of Setanta Sports. As a consequence, it is Setanta's experience that, on the satellite platform (which is, of course, the largest pay TV platform), premium sports subscribers tend to subscribe either to Sky's premium sports channels or to Sky's premium sports channels and Setanta's premium sports channels. In Setanta's experience, very few, if any, of its subscribers on satellite do not also subscribe to Sky's premium sports channels.
- 4.6 In such circumstances, Sky is able to inhibit the take up of the competing channel by raising its own retail prices – thereby deterring consumers from purchasing the competing channel in addition to Sky's own premium channels. This is precisely what Sky did when Setanta started to broadcast live FAPL matches in the UK in August 2007.³³

Wholesaling a new channel to the incumbent

- 4.7 Sky claims that:

*"In relation to upstream foreclosure ... CRA show that even where a vertically integrated firm is assumed to benefit from some retail advantage, an independent upstream broadcaster would have exactly the same incentives to bid for content".*³⁴

- 4.8 In fact, CRA does not "*show*" this. As Sky acknowledges in its response to question 16 of Ofcom's Consultation Document, CRA merely cites the rather idiosyncratic views put forward by Harbord and Ottaviani in 2001.³⁵ In this context, it is argued that:

"The upstream broadcaster's ability to monetise any rights acquired would not be adversely affected by the fact that it was not itself a retailer. The broadcaster would be able to extract the value of the rights that it

wholesale channel provider that only wishes to acquire rights from one or two studios. This is because a firm which has aggregated substitutable rights in this way is likely to possess a degree of market power and can thus pay more for the underlying rights. (See the second bullet point of paragraph 6.11 of Ofcom's Consultation Document of 18 December 2007.)

³² Paragraph 10.7 of Part 2 of Sky's Response.

³³ See paragraph 3.4 of the Joint Response to Ofcom's Consultation Document by Setanta and TUTV dated March 2008.

³⁴ Paragraph 10.16 of Part 2 of Sky's Response.

³⁵ See paragraph 16.4 of Part 3 of Sky's Response.

*had acquired by wholesaling the content to the vertically integrated operator's downstream arm".*³⁶ (Emphasis added.)

4.9 In practice, Sky and CRA are arguing that a third party, such as Setanta, could neutralise Sky's bidding advantage (due to its substantial installed subscriber base) by entering into a wholesale arrangement with Sky under which Sky would retail Setanta's channels. Yet, this proposal ignores the following:

- Sky would be highly unlikely to assist a rival by agreeing to wholesale terms that would signal to it and other rivals that Sky could be outbid for content rights;³⁷
- even if wholesale terms were agreed, Sky would not have an incentive to promote the rival channel in competition with its own channels;
- in order to be able to agree wholesale terms with Sky, the third party would have to cede to Sky a portion of the revenues that would be generated from the content in question. This would disadvantage the third party when bidding against Sky for the rights;
- in its Submission of October 2007, Sky explains why it has a preference for retailing, rather than wholesaling, its content over third party platforms.³⁸ For example, Sky states that:

*“Third party retailers do not have the same incentives as Sky to market Sky's channel. Whereas Sky has very low marginal costs (since many of its rights costs are largely fixed), third party retailers must bear a marginal cost (namely the wholesale price). This is inherent in wholesale distribution, as there is a marginal cost whatever the supply price (unless it is zero).”*³⁹ (Emphasis added.)

To the extent that these arguments by Sky have any validity, they also explain certain disadvantages that would be faced by any new entrant wholesaling to Sky; and

- most importantly, even if an entrant were to wholesale its new rival channel to Sky for Sky to retail on DTH, the rival channel would still have no DTH subscribers at the outset. Such wholesale arrangements almost always involve variable charges – i.e. wholesale charges calculated on a per subscriber basis. Thus, such wholesale arrangements

³⁶ Paragraph 16.4 of Part 3 of Sky's Response.

³⁷ In this context, it is notable that ITV Sport, the premium sports pay TV channel launched by ITV Digital, was not at any stage during its brief existence wholesaled to Sky.

³⁸ Paragraph 4.16 et seq of Part D of Sky's Submission of October 2007.

³⁹ Paragraph 4.17(b) of Part D of Sky's Submission of October 2007.

would not overcome the barrier to entry presented by the time needed to build a subscriber base for the new channel.⁴⁰

4.10 Other attempts by Sky to argue that it enjoys no bidding advantages are addressed in section 5 below on dynamic foreclosure. Ultimately, it is self-evident that Sky enjoys very significant bidding advantages and that there are substantial barriers to entry for Sky's competitors when seeking to develop premium channels.

5. Dynamic foreclosure

5.1 In its Response, Sky states that:

"We address the so-called dynamic foreclosure theory ... at paragraphs 10.48 to 10.51 and explain why the necessary conditions for the theory to apply are simply not present".⁴¹

Sky's arguments in this context are considered below.

Microsoft

5.2 In the section of its Response on dynamic foreclosure, Sky claims that:

"... if Ofcom has in mind a dynamic foreclosure theory similar to that advanced in the Microsoft case, it should be aware that a number of conditions were central to that case. It would be critical for Ofcom to show that a credible mechanism existed which linked a particular commercial practice in one period to rivals' loss of share in another, and further linking this loss of share to rivals' lack of ability to invest, and therefore ... exit from, or [marginalisation] in, the market".⁴²

Whilst it is clear that the approach adopted in the Microsoft case is not the sole way in which to assess dynamic foreclosure, it should, nevertheless, be noted that this "*credible mechanism*" to which Sky refers does exist: it is the vicious

⁴⁰ Even if Sky (or any other existing pay TV retailer) were to bundle a new channel with one of its existing packages (as Virgin Media has done by including Setanta's channels in its XL package) that would not generate as much revenue per subscriber for the new entrant as selling the new channel as a stand-alone premium channel. This is because the latter would retail for say £10 per subscriber per month whereas the existing pay TV retailer would most likely not be able to introduce pure bundling of the new channel and impose a £10 retail price rise on the existing price of its package.

⁴¹ Paragraph 10.24 of Part 2 of Sky's Response.

⁴² Paragraph 10.49 of Part 2 of Sky's Response.

circle described by the Parties in their Joint Submission of 3 July 2007, the components of which are acknowledged in Ofcom's Consultation Document.⁴³

5.3 In Annex 4 to Sky's Response, CRA expands upon Sky's claim when it states:

"We see nothing in pay TV like the well-established features of the software market that could drive these effects. In particular:

- *There is nothing like a super-dominant player with a near-monopoly grip on a critical market, supplying a product for which there are in effect no alternatives ...;*
- *There is nothing in pay TV that resembles the threat to the super-dominant firm's main market, in the form of rivals potentially developing alternative future "platforms" that could replace it – retailers and delivery systems can co-exist, as shown by the experience of other markets;*
- *There is nothing in pay TV like the OS-specific application network effects, whereby application developers have reduced incentives to use rival server OS as an alternative platform and therefore the attraction of such rival OS is greatly reduced ...;*
- *There is indeed no network effect that we can see that is likely to cause the pay TV market to "tip" towards one particular retailer ...".⁴⁴*

5.4 These comments by CRA disclose an apparent wilful blindness to the following factors:

- Sky has a monopoly position in respect of the broadcasting of premium movie channels and a near-monopoly position in respect of the broadcasting of premium sports channels, products for which there are in effect no substitutes;
- a potential threat to Sky's market position would be the development of competing premium channels to which viewers could subscribe in substitution for Sky's premium channels;
- viewers are less likely to subscribe to the pay TV services of Sky's retail competitors if they are unable to offer premium channels at competitive rates; and

⁴³ In their Joint Response of 29 February 2008 to Sky's Submission to Ofcom of October 2007, the Parties demonstrated that Sky's arguments against the vicious circle are not sustainable.

⁴⁴ Paragraph 119 of CRA's paper entitled "*Ofcom's Consultation on the UK Pay TV Industry: Vertical integration and short-run/long-run issues*" dated 4 April 2008.

- through Sky’s exploitation of the vicious circle in pay TV in the UK, its competitors face the handicap of having to compete for subscribers with inferior content and to compete for content with fewer subscribers. As a consequence, Sky’s access to superior content enables it to build a customer base advantage which consolidates its ability to monopolise the acquisition of content and, in turn, to maintain its leading position downstream. Hence, Sky’s market position has become entrenched.

5.5 Sky and CRA also claim that dynamic foreclosure cannot arise in the pay TV industry as:

*“... there is no equivalent in the pay TV sector to the ‘applications networks effect’ mechanism which was at the core of the Microsoft dynamic leveraging theory: ‘[p]orting’ software applications to different systems is costly and therefore application developers tend to write for the dominant platform, marginalising others, but in the pay TV sector, content can be transported across many platforms without difficulty”.*⁴⁵

5.6 Ofcom will appreciate that this is a fallacious distinction. Competition concerns in pay TV do not arise from any alleged technical inability to “transport” content across many platforms. Instead, competition concerns arise from, among other things, Sky’s refusal to supply its premium channels to competing pay TV retailers.

Sky’s installed subscriber base

5.7 As Ofcom notes in its Consultation Document, other competition concerns arise as a result of the “significant barriers to entry into the market for premium channels”.⁴⁶ In this context, a key issue is “the first-mover advantage conferred on the incumbent by its existing retail customer base”.⁴⁷ In its Response, Sky argues that:

*“Installed bases can only confer a competitive advantage if they cannot be accessed by rivals ...”.*⁴⁸

This statement is misleading as it overlooks the temporal aspect of building a subscriber base.

5.8 A critical issue for entrants is the hurdle presented by the time needed to build a subscriber base. As is explained by the Parties in their Joint Submission of 3 July 2007, contracts for key content are often limited in duration. For example, some of the most valuable rights (such as live rights to the FAPL) expire after

⁴⁵ Paragraph 10.49 of Part 2 of Sky’s Response.

⁴⁶ See paragraphs 1.57, 1.58 and 1.64 of Ofcom’s Consultation Document.

⁴⁷ Paragraph 6.18 of Ofcom’s Consultation Document.

⁴⁸ Paragraph 10.50 of Part 2 of Sky’s Response.

just three years. This means that acquiring firms have a strictly limited time period in which to make a return on their content investments and hence firms with an established subscriber base downstream enjoy a competitive advantage when bidding for content.⁴⁹

5.9 Sky then states that:

*“CRA ... explores whether ... installed bases of customers at the retail level might nonetheless be important, but concludes that this is not the case for two reasons. First, the importance of existing bases of retail customers is lessened by being able to sign channel supply agreements with third party retailers, and since this would be anticipated at the time of bidding for content, this would tend to reduce differences in the value of content to channel providers with small and large retail bases”.*⁵⁰

For the reasons outlined in paragraph 4.8 above, such a wholesale arrangement would not neutralise Sky’s bidding advantages.

5.10 Sky then argues that its substantial base of installed subscribers does not confer a bidding advantage because:

*“... customers are able to **switch retailers** relatively easily, especially to another retailer operating on the same platform, **in order to ‘follow’ attractive content**”.*⁵¹ (Emphasis added.)

5.11 Whilst the parties acknowledge that the level of switching costs does not impede consumers subscribing to alternative pay TV services, the available evidence demonstrates that such switching by Sky’s subscribers is not taking place. Indeed, Sky itself acknowledges this fact. On 7 February 2008, the Financial Times reported that:

“The fourth-quarter figures include the first season of Sky’s new contract to air Premier League games since it was forced to share the rights with Setanta Sports. Mr Darroch [Sky’s CEO] said the group had seen no fall off in its football audience as a result of the regulatory intervention, saying that subscriber numbers for its sports packages had grown”.

5.12 Furthermore, Sky’s observation that customers are able to switch retailers relatively easily in order to follow attractive content is not consistent with its own claims about market entry. For example, in its Response, Sky argues that:

“... it is notable that Ofcom has adopted an unreasonable benchmark of what constitutes ‘entry’ in this context. Ofcom’s benchmark is a very strong form of entry, namely the rapid and direct replication of Sky’s

⁴⁹ See paragraphs 2.4 and 2.5 of Part 3 of the Joint Submission of 3 July 2007.

⁵⁰ Paragraph 10.50 of Part 2 of Sky’s Response.

⁵¹ Paragraph 10.50 of Part 2 of Sky’s Response

*sports or movie channels. Ofcom ignores **the approach of building up channels gradually over time***".⁵² (Emphasis added.)

5.13 As noted in section 4 above, if a competitor were to attempt to build up a premium sports channel over time, the response of consumers would not be "*to switch retailers ... in order to 'follow' attractive content*" because the new channel would not be a substitute for the existing channel as it would only have a relatively small portfolio of rights.

5.14 Sky's Response includes further overt contradictions. For example, Sky states that:

*"In addition, high levels of switching also **increase the incentives of a channel provider to license content to all**, which makes it hard to believe that retail switching costs would be a factor when bidding for content"*.⁵³ (Emphasis added.)

Yet, Sky also argues that:

*"low switching costs make it **less likely that there is licensing to multiple retailers ...**"*.⁵⁴ (Emphasis added.)

Thus, Sky simultaneously argues that low switching costs (leading to high levels of switching) will result in increased and decreased licensing to multiple retailers.

5.15 The Parties consider that switching costs should not be overstated, particularly in relation to new subscribers. It is clear, however, that a new channel will not be able readily and rapidly to match Sky's subscriber base, even if it has direct access to the satellite platform (as noted above).

Sky's existing portfolio of rights

5.16 Sky then asserts that:

"... in relation to the assumption that an incumbent can extract more value from the same rights than a new entrant, CRA argues that there are diminishing marginal returns to similar content, and so conversely, at the margin, a right adds more value to a channel provider with fewer rights than to one who already has a large number of rights".⁵⁵

5.17 In light of such diminishing marginal returns, one would expect to see ample instances of Sky being outbid for attractive content by entrants with small (or

⁵² Paragraph 10.7 of Part 2 of Sky's Response.

⁵³ Paragraph 10.50 (and also paragraph 10.10) of Part 2 of Sky's Response.

⁵⁴ Paragraph 10.26 (ii) of Part 2 of Sky's Response.

⁵⁵ Paragraph 10.50 of Part 2 of Sky's Response.

no) rights portfolios. Yet, there are very few, if any, examples of such an outcome.⁵⁶ Indeed, in practice Sky frequently outbids competitors in respect of content which does not add much to Sky's very substantial existing portfolio of content (such as the most recent auctions for rights to broadcast the NFL and La Liga).⁵⁷

- 5.18 It is very clear, therefore, that Sky's arguments against the vicious circle, and against the existence of dynamic foreclosure in pay TV in the UK, are without merit.

6. Pay TV prices in the UK

- 6.1 With regard to the pricing of pay TV services, Ofcom has noted that the average revenue per pay TV subscriber in the UK is higher than in other European countries. Nevertheless, Ofcom proposes a cautious approach to this issue due to perceived difficulties with cross-country comparisons.⁵⁸
- 6.2 The Parties' Joint Submission of 3 July 2007 included econometric analysis by LECG which sought to address these difficulties. Ofcom put certain concerns to LECG in respect of this analysis. Ofcom also put this analysis to Sky which argued, in its Submission of October 2007, that the analysis could not be relied upon to draw any conclusions about consumer detriment.⁵⁹
- 6.3 In their Joint Submission of 29 February 2008, the Parties included a further paper by LECG which responded to Sky's criticisms of its econometric analysis. This further paper shows that Sky's criticisms have no material impact on the conclusions of the econometric analysis. LECG has, therefore, been able to demonstrate that average pay TV prices in the UK are significantly above average pay TV prices in 14 other European countries even when differences in content quality and income per capita are taken into account. LECG has also demonstrated that these price differentials can be substantially explained by differences in market structure.
- 6.4 In its Response, Sky refers to a study which Sky commissioned from PwC and which is attached at Annex 1 to the Response. Sky argues that PwC's study confirms, among other things, that:

⁵⁶ On 11 August 2006, Broadcast included an article on Richard Freudenstein, the then Chief Operating Officer of Sky, who was described as "*a man who can't remember a single deal that got away*". In that article, Richard Freudenstein was quoted as saying "*Honestly! I can't think of a time I've had to go into the Chief Executive's office and say 'Sorry I've missed out on that'. Anything we've really wanted, we've got*".

⁵⁷ See Confidential Annex 4 to the Parties' Joint Submission of 3 July 2007.

⁵⁸ Paragraph 4.41 of the Consultation Document.

⁵⁹ Paragraph 4.47 of the Consultation Document.

*“... when evaluated properly, charges for pay TV services in the UK cannot be said to be high compared to other countries”.*⁶⁰

Sky goes on to claim that:

*“As Ofcom will see, PwC’s report has been very thoroughly researched and the evidence very carefully analysed. Accordingly, weight may be placed on its conclusion, which demonstrate that the UK is a leader among the comparator countries in terms of ... choice and value from pay TV and innovation in pay TV”.*⁶¹

- 6.5 The Parties attach at Annex 1 a brief assessment of PwC’s study by LECG. LECG’s assessment highlights a number of aspects of PwC’s methodology which are likely (i) to have caused material biases in its analysis and (ii) to have the effect of making the UK appear to be relatively more competitive than it really is.
- 6.6 LECG also show that, of the four pay TV packages investigated by PwC, Sky’s retail prices are significantly above the sample average price for three packages and significantly above the prices charged by 50% of the sample of retailers considered by PwC. In other words, notwithstanding PwC’s methodological flaws, the evidence presented by PwC shows that UK pay TV consumers face relatively high prices compared with the prices paid by consumers in other European countries. In addition, LECG show that PwC’s study actually confirms that, despite the high prices paid by UK consumers, they do not have greater retailer choice and do not benefit from more innovation than the average European consumer.
- 6.7 Thus, when considered objectively and interpreted vigorously, it can be seen that PwC’s study confirms the conclusion of LECG’s international pay TV price comparison. PwC and LECG compare pay TV prices across countries controlling for both quality differentials and differences in the ability to pay. They use different methods to control for these variables. Yet, both studies find that UK consumers pay more than a significant proportion of their European counterparts.
- 6.8 Notwithstanding Ofcom’s cautious approach to cross-country comparisons, it is clear that UK consumers are paying relatively high prices for pay TV services. If there were to be greater competition in pay TV in the UK, consumers would benefit from lower retail prices.
- 6.9 Such a benefit from increased competition is demonstrated by Setanta’s entry as a mainstream premium pay TV sports broadcaster following the European Commission’s intervention in respect of the FAPL. That intervention has enabled Setanta to offer a premium sports pay TV service (including live

⁶⁰ Paragraph 4.4 of Part 2 of Sky’s Response.

⁶¹ Paragraph 4.5 of Part 2 of Sky’s Response.

coverage of FAPL matches) in the UK at the price of £10 per subscriber per month, which is far lower than the access price to Sky Sports

- 6.10 In a market in which Sky’s retail competitors could obtain wholesale supply of Sky’s premium channels at economically viable rates and in a market in which the barriers to entry upstream for broadcasters such as Setanta were to be reduced (or indeed eliminated), consumers would undoubtedly benefit not only from increased retail price competition but also from greater choice and increased innovation.

7. Actual and current competition concerns

- 7.1 Sky’s summarises certain competition concerns raised by Ofcom as follows:

- “1) *Significant barriers to entry in the “market for premium wholesale channels”, exacerbated by the presence of a vertically integrated incumbent “with an incentive to control access to downstream markets” ...;*
- 2) *Ability and incentive of vertically integrated incumbent to reduce the quality of what it supplies in order to strengthen its retail offering ...;*
- 3) *Ability and incentive of vertically integrated incumbent to foreclose potential new retailers by denying them content ...;*
- 4) *Prevalence of vertical integration may cause foreclosure of new retailers to foreclose the possible development of new platforms;*
- 5) *Dynamic foreclosure”.*⁶²

- 7.2 In its Response, Sky asserts that:

*“... even if Ofcom’s market definition and market power analyses were correct, the “concerns” that Ofcom sets out in the Consultation Document are purely **hypothetical** and cannot form the basis for regulatory intervention under any of Ofcom’s available powers”.*⁶³ (Emphasis added.)

- 7.3 Yet the facts clearly contradict Sky’s assertion in respect of each of Ofcom’s competition concerns summarised above. For example:

⁶² Paragraph 7.4 of Part 2 of Sky’s Response.

⁶³ Paragraph 7.2 of Part 2 of Sky’s Response.

- there are significant barriers to Sky’s competitors bidding for rights to attractive content and Sky is able to exacerbate these barriers through its control of access to the largest pay TV platform.⁶⁴ Hence Sky is, as it claims, able to win any content it wishes;⁶⁵
- Sky supplies its premium channels to Virgin Media without the associated interactive and HD services. It then actively markets the better quality of its own retail offering;
- Sky refuses to wholesale its premium channels to relatively new pay TV retailers such as BT Vision and TUTV;
- by refusing to wholesale its premium channels to pay TV retailers over new platforms, such as DSL, Sky is significantly impeding the development of those new platforms; and
- for the reasons outlined in sections 3, 4 and 5 above and in the Joint Submissions of 3 July 2007 and 29 February 2008, it is clear that there is a vicious circle in pay TV in the UK which entails “*dynamic foreclosure*”.

7.4 In the circumstances, Sky’s claim that Ofcom’s competition concerns are “*hypothetical*” is not sustainable.

8. Threshold for a reference

8.1 The Parties have previously explained why there are reasonable grounds to suspect that features of the market prevent, restrict or distort competition and hence the threshold for Ofcom making a reference to the Competition Commission under the Enterprise Act has been passed.⁶⁶ In this context, it is worth emphasising that this threshold is recognised as being a very low one,⁶⁷ reflecting Ofcom’s role as a first phase investigator.

8.2 At Annex 2, the Parties reiterate why, by reference to the criteria set out in the OFT’s Guidance of March 2006 on “*Market investigation references*” (the “*OFT’s Guidance*”), the statutory threshold has been met. In the circumstances and for the reasons set out in the Parties’ previous Submissions, the Parties believe that a reference of the pay TV industry to the Competition Commission for a market investigation is now fully justified.

⁶⁴ See Part 3 of and the Confidential Annexes to the Parties’ Joint Submission of 3 July 2007.

⁶⁵ See footnote [] above.

⁶⁶ Part 6 of the Parties’ Joint Submission of 3 July 2007.

⁶⁷ See Peter Freeman, “*Regulation and Competition – Chalk and Cheese? The role of the Competition Commission*”, CRI Frontiers of Regulation Conference Keynote Speech, 7 September 2006.

8.3 In this context, it should be noted that the OFT’s Guidance states that, when undertaking a first phase investigation, it will carry out an appropriate competition assessment, but it:

*“... is not required to reach firm conclusions before making references and it would be inappropriate for it to engage in extensive research. Provided it has reasonable grounds for suspecting that there are market features that adversely affect competition, the reference test has been met and further investigation can be left to the CC”.*⁶⁸ (Emphasis added.

8.4 This approach was put into practice by the OFT last year in respect of BAA. In the report which detailed its reasons for referring BAA to the Competition Commission, the OFT stated that:

*“We recognise that our preliminary analysis has not reached firm views on these matters, but consider the analysis appropriate for the first phase and look forward to the outcome of the CC’s investigation of these significant issues”.*⁶⁹

8.5 To date, there have been nine market investigation references to the Competition Commission under the Enterprise Act. The Parties estimate that the average duration of the initial investigations to determine whether to make a reference in these nine cases was approximately seven months. In contrast, Ofcom’s first phase investigation into pay TV has already been underway for more than sixteen months.

8.6 In this context, the CAT’s Judgment in the Association of Convenience Stores case is particularly pertinent.⁷⁰ In that Judgement, the CAT confirmed that:

- the discretion of the OFT (and hence Ofcom) under section 131 of the Enterprise Act to make a market investigation reference to the Competition Commission must, like all discretions, “*be exercised according to law*”;⁷¹
- a failure by the regulator to take a decision within a reasonable timescale on whether or not to refer is reviewable by the CAT;⁷² and

⁶⁸ Paragraph 4.7 of the OFT’s Guidance.

⁶⁹ Paragraph 1.15 of the OFT’s Report entitled “*BAA: The OFT’s reference to the Competition Commission*”, dated April 2007.

⁷⁰ Judgment of the CAT dated 1 November 2005 in case number 1052/6/1/05: The Association of Convenience Stores and Friends of the Earth -v- Office of Fair Trading.

⁷¹ Paragraph 4 of the Judgment of the CAT dated 1 November 2005 in case number 1052/6/1/05: The Association of Convenience Stores and Friends of the Earth -v- Office of Fair Trading.

⁷² Paragraph 12 of the Judgment of the CAT dated 1 November 2005 in case number 1052/6/1/05: The Association of Convenience Stores and Friends of the Earth -v- Office of Fair Trading.

- the OFT’s proposed timescale in that case of approximately sixteen months for determining whether to make a reference to the Competition Commission was not reasonable.⁷³

8.7 Specifically, the CAT stated that:

*“... There is, if we may say so, some risk that one may mistake the height of the hurdle which s.131(1) presents. It is a “reasonable ground to suspect” test. The scheme of the Act is that a full investigation is carried out at the stage of the Competition Commission not at the stage of the OFT, although admittedly the OFT has to address the matter sufficiently to decide whether there are reasonable grounds “to suspect”, and sufficiently in order to consider the question of undertakings under s.154 of the Act in lieu of making a reference. Subject to that, it seems to us that on the presently envisaged timetable it would have taken some 16 months to decide even whether to make a reference in this case and, if a reference was then made, that would be followed by an investigation by the Competition Commission lasting up to two years making a total period of three or four years altogether. That seems to us to be unsatisfactory to all parties on which ever side of this particular argument they happen to be ...”.*⁷⁴

8.8 Ofcom might consider that it has a somewhat different role to the OFT in this process as it is a sectoral regulator. In this regard, it is instructive to note that there has already been a reference in April 2007 by a sectoral regulator, the ORR, in respect of rolling stock leasing. The ORR’s first phase investigation in that case took approximately nine months. Certain affected parties argued that the ORR was the specialist sectoral regulator and, therefore, would be better placed than the Competition Commission to address the relevant issues. The ORR responded as follows:

*“A more detailed examination of the relevant issues would, in our view, be necessary in order to give robust recommendations on changes to the franchise system to introduce more competition into the leasing of rolling stock. The CC is a specialist second stage investigatory body and so is best placed to carry out a detailed investigation of this sort. Moreover, our sectoral experience will be available to the CC during the course of its investigation”.*⁷⁵

⁷³ Paragraph 8 of the Judgment of the CAT dated 1 November 2005 in case number 1052/6/1/05: The Association of Convenience Stores and Friends of the Earth -v- Office of Fair Trading.

⁷⁴ Paragraph 7 of the Judgment of the CAT dated 1 November 2005 in case number 1052/6/1/05: The Association of Convenience Stores and Friends of the Earth -v- Office of Fair Trading.

⁷⁵ Paragraph 37 of the ORR’s Report of 26 April 2007 entitled “*The Leasing of Rolling Stock for Franchised Passenger Services*”.

*“Further, whilst the CC has powers to impose behavioural remedies we can only take undertakings that have been offered voluntarily”.*⁷⁶

8.9 In practice, there is no reason why the particular position of a sectoral regulator should justify that regulator in taking longer to determine whether to make a market investigation reference. A factor that affected the CAT’s conclusions on timescales in the Association of Convenience Stores case was that the OFT already had a familiarity with the market in question before commencing its investigation.⁷⁷ Sectoral regulators are, of course, even better placed to understand the markets in question, given their sectoral expertise and statutory functions.

8.10 This issue was specifically addressed as follows by the ORR, in the context of its reference decision:

*“We have taken into account the concerns of the CAT that a first stage investigation should not be unduly long. Accordingly, we have taken care not to carry out analysis to a level of detail that would be disproportionate given that this is a first stage investigation”.*⁷⁸

8.11 The ORR carried out its first phase investigation within a period of approximately nine months. This compares very favourably to the sixteen months to date that Ofcom has already spent on the pay TV investigation, with apparently no conclusions likely to emerge in the near future. It would be somewhat incongruous, and reviewable by the CAT as being “unreasonable”, if an initial investigation to determine whether to make a reference were to take around two years, given that the statutory function of the Competition Commission is to carry out in-depth investigations within a two year period.⁷⁹

8.12 Finally, the parties note that the House of Lords Select Committee on Regulators has recommended that:

*“Where possible, utility regulators should look to bring more cases to the competition authorities ... and the regulators should work to ensure that the cases most likely to establish useful precedents are brought to the CC”.*⁸⁰

8.13 The Government response to this Report stated that:

⁷⁶ Paragraph 38 of the ORR’s Report of 26 April 2007 entitled “*The Leasing of Rolling Stock for Franchised Passenger Services*”.

⁷⁷ Paragraph 7 of the Judgment of the CAT dated 1 November 2005 in case number 1052/6/1/05: *The Association of Convenience Stores and Friends of the Earth -v- Office of Fair Trading*.

⁷⁸ Paragraph 59 of the ORR’s Report of 26 April 2007 entitled “*The Leasing of Rolling Stock for Franchised Passenger Services*”.

⁷⁹ See section 137 of the Enterprise Act.

⁸⁰ Paragraph 6.26 of the First Report of the House of Lords Select Committee on Regulators dated 23 October 2007.

*“The Government agrees with the Committee that regulators should be encouraged to think about whether they can be more pro-active in using competition law, including market investigation references to the Competition Commission”.*⁸¹

- 8.14 In light of all the above, it is clear that Ofcom should not unduly prolong its investigation into pay TV. Instead, it should exercise its discretion to refer the pay TV industry for a full market investigation by the Competition Commission.

⁸¹ Paragraph 1.22 of the Government’s Response to the House of Lords Select Committee on Regulators entitled *“UK Economic Regulators”* dated 13 November 2007.

Annex 1

Critique of PwC's study entitled "*The outcomes for consumers in relation to pay TV in Europe*"

A Report for British Telecommunications plc, Setanta Sport Holdings Ltd, Top Up TV Europe Ltd and Virgin Media Ltd.

Jorge Padilla, Ciara McSorley and Wim Koevoets¹

1 August 2008

1. Introduction and Conclusions

This paper provides an assessment of PwC's study *The outcomes for consumers in relation to pay TV services in Europe*, submitted by British Sky Broadcasting Ltd ("Sky") to Ofcom in April 2008 in the context of Ofcom's investigation of the UK pay TV industry.

PwC's study identifies as its main objective "to establish a resource that can be used to assess and compare the outcomes for consumers" of pay-TV services in fifteen different European countries.² The study seeks to compare consumer outcomes across countries in terms of prices, consumer choice and innovation using publicly and non-publicly available data and PwC "local expertise, industry experience and [...] expert judgement".³

PwC's conclusions can be summarised as follows:

- The outcomes for consumers in relation to pay TV in Europe vary significantly across countries.⁴
- **Prices.** Of the four pay TV packages investigated by PwC – the fully inclusive package,⁵ the inclusive of important sports package,⁶ the inclusive of important

¹ The authors are economists at LECG. Jorge Padilla and Wim Koevoets co-authored the report, *Pay TV Prices in Europe (1997 – 2005): An Econometric Analysis*, 18 June 2007 (the "LECG study"), which was appended to the Parties' *Submission to Ofcom on the need for a market investigation into the pay TV industry*, dated 3rd July 2007 (the "Joint Submission").

² PwC report, page 1. We note, however, that Sky has declined to swap PwC's data with LECG's ScreenDigest sample in order to enable the robustness of PwC's and LECG's analyses to be tested.

³ PwC report, page 28.

⁴ PwC report, pages 57-58.

⁵ The fully inclusive package is defined as the most comprehensive package containing all the important/key content available from the pay TV retailer but excludes adult channels, foreign

movies package,⁷ and the inclusive of important sports and movies package⁸ – Sky's retail prices, measured in purchasing power parity euros ("PPP€"), are (1) significantly above the sample average price for three of the four premium packages considered and (2) significantly above the prices charged by 10 or 11 of the sample of 15 retailers considered by PwC (depending on the package considered).⁹ In other words, the evidence presented by PwC shows that the UK pay TV consumer faces high prices for various premium packages compared with the prices paid by consumers in other European countries.

- **Consumer choice.** PwC relies on two indicators of retailer choice across countries: (1) the indicative estimate of minimum retailer choice for a large majority of consumers (which ranges from 1 to 4 in PwC's sample) and (2) the indicative estimate of minimum retailer choice for consumers living in major cities (which ranges from 3 to 5 in PwC's sample). The UK estimate for the first indicator, 2, is significantly below the sample average, 2.6. The UK estimate for this indicator is below the estimates for 8 countries and only above 1 country, Greece, for a total of 15 countries in the sample. The UK estimate for the second indicator, 4, is above the sample average, 3.75.¹⁰ Nevertheless, the majority of UK consumers enjoy less retailer choice than their European counterparts. We would also query PwC's reported indicator of consumers having a choice of 4 pay TV retailers in major cities in the UK given that the only other retailer offering Sky's premium sports and movies channels is Virgin Media, and Sky has chosen to deny wholesale supplies of its premium channels to all other pay TV retailers and hence the premium packages considered by PwC in its price comparisons are only offered by Sky and Virgin Media.
- **Innovation.** PwC compares innovation across national pay TV markets using three indicators: (1) the number of years since the introduction of digital pay TV, (2) the number of years since the introduction of PVRs (personal video recorders) and (3) the number of years since the introduction of HDTV.¹¹ The UK figure is below the sample average in terms of the first indicator, above average for the second, and is identical to the sample average for the third indicator.¹² That is, the evidence shows that the UK pay TV market cannot be regarded as particularly innovative. Such comparisons certainly do not suggest that there is no scope for greater innovation in the UK – this is particularly the case as Sky's conduct is limiting the scope for greater competition and innovation.

language channels and some more specialised channels as these would distort comparability across countries (PwC report, page 23).

⁶ The important sports package is defined as the lowest-priced package that includes a significant amount of the important sports content (typically live broadcasts of the domestic football league) in the country to the extent available through the pay TV retailer (PwC report, page 24).

⁷ The important movies package is defined as the lowest-priced package that includes a significant amount of the important movies content in the country to the extent available through the pay TV retailer (PwC report, page 24).

⁸ The important sports and movies package is defined as the generally lowest-priced package combining the important sports and movies content from the important sports package (see note 6) and the important movies package (see note 7) that is available through the pay TV retailer.

⁹ PwC report, Table 8, page 34. For the fully inclusive package, Sky's price is reported as being below the sample average, but 8 other countries/retailers have lower prices,

¹⁰ PwC report, Table 1, page 13.

¹¹ PwC could have used other indicators, such as the number of years since the introduction of IPTV or mobile TV services or the penetration of these two technologies.

¹² PwC report, Table 12, page 48.

In short, even taking the actual reported results at face value, PwC's study, when considered objectively and interpreted rigorously, confirms the main finding of LECG's international pay TV price comparison.¹³ PwC and LECG compare pay TV prices across countries controlling for both quality differentials and differences in the ability to pay. They use different methods to control for those differences. Yet, both studies find that UK customers pay more than a significant proportion of their European fellows even after controlling for quality and other legitimate factors. In addition, PwC's study shows that, despite the high prices he/she pays, the UK customer does not have greater retailer choice and does not benefit from more innovation than the average European consumer.

We have reviewed the methodology employed by PwC. The conclusions of this exercise cast serious doubt on the robustness of PwC's results and suggest that pay TV consumers in the UK fare less well than those in other Member States. These conclusions can be summarised as follows:

- As noted above, the main objective of PwC's study was "to establish a resource that can be used to assess and compare the outcomes for consumers" of pay-TV services across European countries. However, the non-confidential version of the report raises serious doubts about the (forensic) value of the data collected by PwC. PwC fails to report and document much of the data used. In addition, the data is subject to a number of important adjustments, which are subjective and are unjustified or, as explained below, incorrect.
- PwC's methodological choices are likely to have caused material biases in the analysis, which have the effect of making the UK appear to be relatively more competitive than it really is. In particular:
 - PwC's cross-country analysis of *pay TV penetration* is flawed. PwC has artificially reduced the penetration of pay TV services in several countries by incorrectly excluding pay TV cable packages. These packages, which PwC arbitrarily denotes as "mini-pay TV",¹⁴ are however directly comparable to the pay TV packages offered by Sky in the UK, which are considered "genuine" pay TV services by PwC. PwC has even excluded what under its own stated definition would be "genuine" pay TV packages in Germany. (See section 2 below.)
 - PwC's cross-country *pay TV price comparison* is also flawed. There are three reasons for this. First, as explained above, PwC has excluded from the sample pay TV subscribers enjoying low prices. Second, the packages used for the cross-country price comparison are not representative of the packages actually purchased by consumers in those countries. (See section 3 below.) Third, adjusting nominal pay TV prices using PPP (purchasing power parity) exchange rates is bound to bias the price comparison in favour of wealthy countries like the UK. (See section 4 below.)

In the light of the above, it is clear that PwC's international comparisons do not provide any basis for concluding that UK consumers are better off than consumers elsewhere in Europe.

¹³ See note 1 *supra*.

¹⁴ PwC report, page 5.

2. Exclusion of cable TV offerings

PwC has significantly reduced the number of pay-TV subscribers in several countries – Belgium, the Netherlands, Germany, Norway and Sweden.¹⁵ In certain of these countries poor analogue terrestrial reception has meant that much of the population traditionally received their TV service via cable. Consequently, these countries have had a large cable penetration for many decades.

In three of the countries, Belgium, Germany and Norway, the impact of PwC's adjustment to the number of subscribers was dramatic. Each of these three countries went from having a high pay-TV penetration at relatively low prices to having some of the lowest pay-TV penetration and highest pay-TV prices. In both Germany and Belgium, PwC reduced the pay-TV penetration by 80%. The reduction in the German subscriber figure was particularly dramatic, especially when it is considered that, unlike Belgium, Germany is not a legacy cable country. German cable penetration in 1996 was less than 50% compared with 90% for Belgium. Nevertheless, PwC adjusted the German pay TV subscriber numbers from over 60% of households, to less than 10%.

These adjustments significantly bias PwC's cross-country comparison in favour of the UK, since they artificially reduce pay TV penetration in cable countries such as Belgium, the Netherlands and Sweden. They also bias PwC's cross-country price comparison to create the false impression that the cost of pay TV services in the UK is relatively low, since in cable countries average prices for pay-TV prices have been lower even after controlling for quality differentials.

PwC claims that this adjustment is required in order to distinguish between what it terms as "cable access services" or "mini-pay TV" services from so-called "genuine" pay-TV services.¹⁶ According to PwC, "genuine" pay-TV services are said to give access to a wide range of choice and value added content beyond what is available in a standard cable access TV package, and cable access services generally have a significantly higher proportion of FTA (free to air) channels than a "genuine" pay-TV package.

However, PwC's adjustment is methodologically flawed and economically unjustified.

Methodological flaws

PwC provides no explanation of how to distinguish in practice between cable access services and "genuine" pay TV services. Furthermore, its own classification of pay TV packages as either "genuine" pay-TV packages or standard cable access TV packages is inconsistent and biased:

- **Over-inclusion.** Sky's entry level TV package in the UK is a '3 for 1' offer for TV, phone and broadband for £16 per month. The TV element of this package is a combination of over 200 FTA channels with between 11 and 39 "pay TV" channels, some of which are also available FTA on other platforms. This package is classified as a "genuine pay TV" package even though it appears to meet the criteria stated by PwC for standard cable access TV packages. Indeed, given the large number of FTA channels available on satellite in the UK, virtually all of Sky's subscribers are likely to

¹⁵ Strictly speaking, PwC has excluded several pay TV packages from its comparisons and, as a result, it has reduced the number of pay TV subscribers in some countries.

¹⁶ Id.

have TV packages with more FTA channels than “pay TV” channels and yet, as far as we can infer from the PwC report, all Sky’s packages are treated as “genuine”.

- **Under-inclusion.** Our analysis of ScreenDigest’s data for Germany suggests that PwC considers the pay-TV operator, Premiere, to be the only source of “genuine” pay-TV in Germany.¹⁷ However, German cable operators provide a range of different products, including both premium TV channels and FTA channels, which are comparable to Sky’s own packages. The subscribers to “premium” or “genuine” cable packages in Germany are not insignificant. In 2007, Kabel Deutschland alone claimed that it had over 700,000 subscribers to one of its extended tiers.¹⁸ This number does not include subscribers to the Premiere channels and Kabel Deutschland is just one of several German cable operators.

Furthermore, PwC assumes that as the channels provided in what it terms standard cable access packages are mostly available FTA, only a small fraction of the charge paid to the provider is for “content”. This assumption is incorrect. If customers are not paying for the opportunity to view the TV content, then what are they paying for?

Lack of economic justification

PwC fails to explain why “genuine pay TV services” with “relatively little” pay TV content and “cable access services” services with no less pay TV content are not demand-side substitutes. But if they are substitutes, as logic would dictate given the similarity in the content they offer,¹⁹ then there is no economic justification for the segmentation made in the PwC report.

3. Choice of packages for price comparison

When comparing prices across countries, PwC does not use a measure of the average price *actually* paid by customers in each country.²⁰ Instead, PwC purports to compare the prices of a few selected packages offered by the largest pay TV retailer in the country.²¹

¹⁷ See Annex A for our analysis of ScreenDigest’s German data.

¹⁸ See <http://www.broadbandtvnews.com/?p=924> and Annex B.

¹⁹ Note that we are not claiming that premium and basic channels belong to the same relevant product market. Our claim is that a package including a number of so-called “genuine” basic pay TV channels and some FTA channels may well be a close substitute for a package also including some additional so-called “genuine” basic pay TV channels particularly if these additional channels are of relatively minor significance. This issue does, of course, depend on the nature of the additional channel(s) - i.e. a package of basic pay-TV channels will not be a substitute for a package containing the same basic channels and one premium sports pay-TV channel.

²⁰ The prices reported by PwC “do not include any discounts that may be received by communities collectively negotiating with pay TV retailers”. (PwC report, page 28.) In some cases, PwC “combined retailer offerings to build comparable packages across countries”. (PwC report, page 24.) Not surprisingly, given the prevalence of bundle discounts, a significant proportion of the most expensive packages identified by PwC are these combined packages. (See PwC report, Table 8, page 34.) Had PwC excluded these artificially created packages from the sample, it would be clear that Sky’s prices are even less competitive than Table 8 shows.

²¹ PwC report, page 22.

This approach presents a number of serious drawbacks, which are bound to have a material impact on the conclusions of the cross-country price comparison performed by PwC:

First, given PwC's biased definition of a "genuine" pay-TV retailer excludes many cable retailers in some countries, the retailer selected by PwC may not even be the largest pay-TV retailer in those countries. This is, for example, the case in Belgium and Germany.

Second, PwC defines four kinds of pay TV packages for comparison: an all inclusive package, a sports oriented package, a movies oriented package and a sports and movies oriented package. This division follows the structure of Sky's offers,²² but does not reflect the way in which pay-TV is sold in other countries. For example, the offers of the leading cable operator in France, Numéricable, all include a mixture of sports, movies and entertainment channels that do not fit neatly into any of the categories that PwC has used in its comparison.²³

Third, subscriber numbers are not taken into account. There is no guarantee that the packages chosen for the analysis are representative of the packages *actually* purchased by customers. This makes PwC's international price comparison meaningless: it provides no valid information as regards consumer welfare or choice. To see why, consider the following hypothetical two country example. The selected retailer in country A offers no "basic" packages. It offers only a single "premium" package which includes all sports and movie rights. Although this "premium" package may look good value when compared with similar "all-inclusive packages" offered in country B, a consumer in country A who wishes to purchase only basic entertainment channels, or only sports or only movie channels, is forced to purchase a very expensive package or none at all. As customers are denied the opportunity to select cheaper packages, average prices paid by customers in country A would be relatively expensive and consumer welfare would be relatively low. However, under PwC's methodology, which restricts the set of comparable packages to the very expensive ones, country A would falsely appear to be relatively cheap and its citizens relatively happy.

Fourth, PwC's price comparison also makes no adjustment for the quality of the channels available in the packages. This is surprising given PwC's recognition that "[quality] factors should be taken into account for a fully comprehensive assessment of the outcomes for consumers".²⁴ The only check for quality is the number of channels available in a package.²⁵ PwC implicitly assumes that more TV channels are synonymous with greater quality, so for example shopping channels are given the same weighting as premium sports channels. As Sky's subscribers can view over 200 FTA channels, Sky scores rather well on this measure. This is obviously a highly imperfect measure of quality, particularly as it has no regard to the viewing of the channels in question. Furthermore, it is at odds with PwC's exclusion of "cable access services",

²² Sky's offerings are structured in entertainment mix options and premium mix options which comprise sports mix options, movies mix options and options in a combined sports & movies mix (see Annex B).

²³ Numéricable offers the following packages: Prima, Premium, Premium Plus and Infinity. Prima contains only channels included in Sky entertainment mixes. The upgrade to Premium adds some more entertainment channels and some sport channels, Premium Plus adds more entertainment and movie channels, and finally Infinity includes the remaining important sport channels.

²⁴ PwC report, page 8.

²⁵ PwC report, page 37.

based on the assumption that the FTA channels they offered were of little value to the customer.

4. Use of Purchasing Power Parity Exchange Rates

PwC compares prices using purchasing power parity (PPP) exchange rates rather than market exchange rates in order to “control for the price level prevalent in a country”.²⁶ PPP exchange rates compare the cost of a basket of goods in several countries and calculate the exchange rate required so that that basket of goods would cost the same across countries.²⁷ For example, if a specific basket of goods and services cost £100 in the UK and €300 in the Germany, then the PPP exchange rate between Germany and the UK is £1 = €3 (regardless of the actual market exchange rate).

The use of PPP exchange rates in international price comparisons raises a number of conceptual and practical issues which can have a material impact on the results of that comparison and that must be taken into account when interpreting those results. This is particularly the case when the ultimate goal of the international price comparison is to identify market power problems in one or several countries.

Unjustified biases

Note first that adjusting nominal pay TV prices using PPP exchange rates is bound to bias the price comparison in favour of wealthy countries like the UK. This is because the cost of living in wealthy countries, where consumers have a greater ability to pay for goods and services, tends to be higher than in less rich countries (particularly as regards goods and services which are not internationally traded, and as regards more labour intensive service activities in countries where wage rates are higher). In other words, the pay TV prices in a country like the UK may be regarded as relatively cheap on a PPP basis even when they could be much lower if competition was as strong as in the benchmark countries simply because the cost of other goods/services, like a pint of beer in a pub or a haircut, is relatively more expensive in the UK than in the benchmark countries.

A few practical difficulties

PwC states: “Our PPP€ measure is formed by constructing a price level index from World Bank data of national GDP at market exchange rates and in PPP terms. We then rebased this index to form an index corresponding to nominal €PPP€ exchange rate in each of the sample countries. Note that while countries in the Euro area share a common currency, price levels may still differ on average across national borders and hence they can have differing rates of conversion to PPP€”²⁸

²⁶ PwC report, page 28.

²⁷ This is not an easy task as the goods consumed vary from country to country (e.g. more pasta is consumed in Italy than in Spain), which makes it difficult to define a suitable benchmark basket of goods. See for example, Heston A., and R. Summers, “International Price and Quantity Comparisons: Potentials and Pitfalls”, *American Economic Review*, vol. 86:2, 1996.

²⁸ PwC report, page 28.

The quantitative and qualitative results of a PPP adjustment like that used by PwC depend on a number of assumptions:

- *First*, they are a function of the basket of goods that is selected and the expenditures on the reference basket that are taken into account in the calculations. PwC has chosen to include in its calculations not only individual expenditure on domestic consumption goods but also collective expenditure by governments, expenditure on capital, and expenditure on foreign goods. Given the ultimate objective of the PwC report, namely comparing prices of domestic pay TV packages purchased by individual households, we consider that PwC's choice is unjustified.
- *Second*, they also depend on the country which is selected to be the reference for the PPP calculation, with this influencing the absolute magnitude of the estimated price difference in PPP€. This results arises as €1 of actual currency (converted into local currency as appropriate) will buy you more in Greece than in Denmark, so that if the PPP€ conversions use Denmark prices as the base more Euros will be needed in every country whereas if Greece is used as the base fewer Euros will be needed in every country. To illustrate this point, we have constructed the following example. Suppose an identical pay TV package was offered in all countries at the price of 10€ in the euro countries and at the corresponding price in the national currencies in the non-euro countries.²⁹ In order to compute the PPP€ prices for this common pay TV package in the euro and non-euro countries, we obtained data from the World Bank on national gross domestic product ("GDP") at market exchange rates and on national GDP at PPP exchange rates and calculated the ratio between these two GDP measures. This ratio provides a measure of the relative price levels across countries for each given reference country. We calculated this ratio using three reference countries: the US, Denmark and Greece. To obtain PPP exchange rates for the euro, we multiplied as standard the market exchange with this ratio on a country-by-country basis. Table 1 shows that absolute price differences across countries depend on the reference country used. Depending on whether the US, Denmark or Greece is used as the reference country, we find price differences for our identical pay TV packages between the UK and Germany equal to 54 euro cents, 77 euro cents and 47 euro cents, respectively. Given the importance of the choice of reference country, we are surprised that PwC did not state its choice in the report.

Table 1 PPP price of an identical pay TV package of 10 euros by base country (€)

	Price (€)	Price (national currency)	PPP Price (€) US rebased	PPP Price (€) Denmark rebased	PPP Price (€) Greece rebased
Austria	10	10	9.20	13.08	8.04
Belgium	10	10	8.95	12.72	7.81
Denmark	10	74.56	7.04	10	6.14
Finland	10	10	8.18	11.62	7.14
France	10	10	8.72	12.39	7.61
Germany	10	10	9.01	12.81	7.87

²⁹ Where the prices in non-euro countries are calculated using 2007:Q4 market exchange rates.

Greece	10	10	11.45	16.28	10
Italy	10	10	9.19	13.06	8.03
Netherlands	10	10	8.95	12.72	7.82
Norway	10	78.78	7.29	10.36	6.36
Portugal	10	10	11.37	16.16	9.93
Spain	10	10	10.48	14.89	9.15
Sweden	10	92.90	8.08	11.48	7.05
Switzerland	10	16.60	7.15	10.16	6.24
United Kingdom	10	7.08	8.47	12.04	7.40

Notes: The price of the 10€ pay TV package is converted to national currencies using the Q4:2007 rate to exchange 1€ for the national currency of the non-euro country under consideration. These rates are equal to 7.4557, 9.2899, 0.7078, 7.8778 and 1.6596 for Denmark (DKK), Sweden (SEK), United Kingdom (GBP), Norway (NOK) and Switzerland (CHF), respectively.

Source: LECG calculations using data from Eurostat and The World Bank

A conceptual objection

We conclude with a general comment regarding the use of PPP exchange rates in the assessment of the strength of competition across countries. The use of PPP exchange rates rather than market based exchange rates causes pay-TV packages in countries with less competitive markets to look relatively cheaper. Since the cost of living in countries with less competitive markets is greater, the PPP adjustment will tend to deflate the price of the pay TV packages offered in those countries. In other words, expensive pay TV packages offered in countries where competition is generally less intense will appear to be relatively cheaper than cheap pay TV packages available in countries where overall competition is intense. This circularity problem raises significant doubts about the use of PPP exchange rates to compare price levels in competition investigations.

5. Conclusions

We have reviewed PwC's study *The outcomes for consumers in relation to pay TV services in Europe*, submitted by Sky to Ofcom in April 2008 in the context of its investigation of the UK pay TV industry.

When considered objectively and interpreted rigorously, the results of PwC's study, confirm the main finding of the LECG's international pay TV price comparison: UK customers pay more than a significant proportion of their European fellows even after controlling for quality and other legitimate factors. In addition, even taking the reported results at face value, PwC's study shows that, despite the high prices he/she pays, the UK customer does not have greater retailer choice and does not benefit from more innovation than the average European consumer.

In addition, we have reviewed the methodology employed by PwC. We find that PwC's methodological choices – such as the use of a few selected premium packages and the unjustified exclusion of cheaper pay TV packages or the use of PPP exchange rates – are likely to have caused material biases in the analysis, which have the effect of making the UK appear to be relatively more competitive than it really is.

Annex A: Screen Digest data for German subscribers

In Figure 3 of its report, PwC illustrates the adjustments it made to distinguish between 'cable access services' and 'genuine pay TV'. For Germany, the difference is huge: where Screen Digest finds a penetration of about 62%, PwC consider that the penetration of 'genuine pay TV' is just 7.5%. That is, PwC consider that almost 90% of that which Screen Digest classify as pay TV is in fact 'cable access'.³⁰ Those percentages are the respective share of TV households receiving "genuine pay TV" and those of the rejected offers of the total TV households of pay TV in Germany.

We have used the Screen Digest data to find out which products PwC has rejected in order to arrive at its figures for 'genuine pay TV'. Table 2 shows the number of pay TV subscribers in Germany by platform. It follows from Table 2 that excluding the almost 90% of subscribers to total cable pay TV leaves us with the subscribers to Premiere packages.³¹

Table 2: Number of subscribers of pay TV in Germany in 2006

		2006
analogue cable	000s	20,757
digital cable	000s	1,404
Premiere analogue cable	000s	0
Premiere digital cable	000s	1,785
analogue DTH	000s	0
digital DTH	000s	1,521
analogue terrestrial	000s	0
digital terrestrial	000s	0
total cable pay TV	000s	20,757+1404=22,160
total DTH pay TV	000s	1,521
Total Premiere Cable	000s	1,785
Total Premiere (Cable&DTH)	000s	1,521+1,785=3,306

Note: The 1521 digital DTH subscribers are subscribers to Premiere packages.

Source: Screen Digest

We find that PwC has included only the subscribers to the specialist company 'Premiere' as being 'genuine pay-TV' subscribers. We can therefore conclude that in Germany, PwC only considers Premiere offers as "genuine Pay TV", as the one proposed by Sky.

³⁰ The ratio of the total penetration of pay TV in Germany is consequently due to "genuine pay TV" for 12.1%, and to rejected offers for 87.9%.

³¹ The ratio of 22160 and the sum of 22160 and 3306 equals 87%.

Annex B: Kabel Deutschland and Sky Products

Figure 1: Kabel Deutschland Subscribers

- Broadband TV News - <http://www.broadbandtvnews.com> -

One million digital homes for KDG

Posted By [Robert Briel](#) On May 6, 2007 @ 7:48 pm In [Cable](#), [Newsline](#) | [Comments Disabled](#)

German cable operator Kabel Deutschland KDG is claiming one million digital homes connected out of the total of 9.5 million customers the company serves. The basic digital bouquet, which is offered free of charge, includes all the German public and commercial broadcasters as well as a choice of international channels, both public and private, up to a total of 102 channels.

About 700,000 homes subscribe to one of the extended tiers including Kabel Digital Home, which offers 30 low-pay channels such as TCM, AXN, Kinowelt, 13th Street, Sci-Fi, Disney Channel, History Channel, the MTV mux of music channels, Boomerang and Cartoon Network. The basic tier starts at €10.90 a month for viewers that bought a KDG approved receiver (€12.90 including cable tuner rental). The total does not include Premiere subscribers on the the KDG networks.

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Figure 2 Sky's prices and packages

The screenshot shows the Sky website's 'Prices and Packages' section. On the left is a navigation menu with links like 'Sky Products Home', 'Explore TV', 'Sky TV Channel Mixes', 'Sky TV Boxes', 'Sky+', 'Sky HD', 'Sky Multiroom', 'Prices and Packages', 'Sky TV Packages', 'Upgrading Your Sky TV', 'Other Ways To Join Sky', 'Help and Questions', and 'Terms and Conditions'. The main content area is titled 'Prices and Packages' and includes a paragraph explaining that the monthly cost is determined by TV channels and equipment. Below this is a table titled 'Monthly TV viewing cost'.

Prices and Packages

Your monthly Sky TV cost is determined by which TV channels and Sky equipment you choose. We group our channels into Mixes so that you only pay for the types of channels you want to watch. If you need some help deciding, with [Help Me Choose](#) just answer a few simple questions and we'll show you the ideal TV package to suit you. Or, have a look at some of our [Popular Combinations](#).

Monthly TV viewing cost

ENTERTAINMENT MIX OPTIONS		PREMIUM MIX OPTIONS		
Entertainment Mixes		Sports Mix	Movies Mix	Sports & Movies Mix
Any 1 Mix	£16	£34	£34	£41
Any 2 Mixes	£17	£35	£35	£42
Any 3 Mixes	£18	£36	£36	£43
Any 4 Mixes	£19	£36	£36	£43
Any 5 Mixes	£20	£37	£37	£44
All 6 Mixes	£21	£38	£38	£45

Source: Downloaded from Sky's homepage on 25 June 2008
 (<http://www.sky.com/portal/site/skycom/skyproducts/skytv/pricesandpackages>)

Annex 2

The market reference test

1. Introduction

1.1 In its announcement of 20 March 2007, Ofcom stated that, following its initial investigation and having obtained information from market participants, it will determine whether a market reference to the Competition Commission is required.¹

1.2 As Ofcom is aware, it has a discretion under section 131 of the Enterprise Act to make a market investigation reference to the Competition Commission where:

*“... it has **reasonable grounds to suspect that any feature, or combination of features, of a market in the United Kingdom for goods and services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom.**”* (Emphasis added.)

1.3 Thus, in order to make a reference, Ofcom only needs to establish “*reasonable grounds to suspect*” that a feature, or combination of features, prevents, restricts or distorts competition in a market in the UK for goods and services.² This threshold is recognised as being a very low one, reflecting Ofcom’s role as first phase investigator.³

1.4 Accordingly, Ofcom need not reach a definitive view on the concerns that have been identified. A full Competition Commission investigation would establish whether there are in fact adverse effects on competition and how competition can be improved (in other words, the determination of appropriate remedies to address the harm identified). A full investigation by the Competition Commission would also reveal the extent to which Sky is taking advantage of existing market features to its benefit and to the detriment of competition and consumers.

1.5 As Ofcom is aware, for the purposes of section 131 of the Enterprise Act, the feature (or features) of the market that gives rise to the adverse effect on competition may relate to:⁴

- (a) the structure of the market concerned or any aspect of that structure; and/or

¹ Ofcom’s announcement dated 20 March 2007 entitled “*Market investigation into the pay TV industry*”.

² Where this threshold is met, Ofcom has a discretion whether to make a reference.

³ See Peter Freeman’s speech “Regulation and Competition - Chalk and Cheese? The Role of the Competition Commission”, CRI Frontiers of Regulation Conference Keynote Speech, 7 September 2006.

⁴ Section 131(2) of the Enterprise Act 2002.

- (b) any conduct of one or more than one person who supplies or acquires goods or services in the market concerned.

These criteria are considered below.

2. Market structure

2.1 The OFT recognises in its Guidance that it may not always be clear whether a feature of a market that affects competition is best described as structural or as an aspect of conduct but that, provided the relevant feature is clearly identified, categorising it will be a semantic exercise.⁵

2.2 **Market concentration:** The first structural feature considered in the OFT's Guidance is market concentration. Part 2 of the Parties' Joint Submission of 3 July 2007 demonstrated the substantial degree of concentration at all levels of the pay TV supply chain, particularly in respect of premium channels. Section 5 of Ofcom's Consultation Document has confirmed this substantial degree of concentration. For example, Ofcom found that Sky has:

*“Sky has revenue market shares of ... (well over 70%) in the premium sports retail market and ... (well over 80%) in the premium movies retail market, and its market share has increased every year in each of the last five years in both markets”.*⁶

*“Sky has a share of ... (well over 80%) in the premium sports content [i.e. wholesale] market ... and 100% of the premium movies [wholesale] market”.*⁷

2.3 **Vertical integration:** The next structural feature considered in the OFT's Guidance is vertical integration. It notes that a vertically-integrated firm may give rise to adverse effects on competition “if it can foreclose ... competitors from a significant part of their market either by refusing to supply or to deal with them or by discriminating against them in its pricing”.⁸ Sky is, of course, vertically integrated and the Parties various Submissions establish its ability and incentives to foreclose competition.

2.4 In this regard, weight should be attached to the fact that Sky's own arguments disclose Sky's incentives to foreclose. Thus, for example :

- Sky accepts that it has no incentive to supply its channels to third parties on the same platform;
- the logic of Sky's reasoning applies equally in respect of supply to a third party on any other platform where barriers to switching from Sky's platform to that platform are low;

⁵ Paragraph 1.9.

⁶ Paragraph 5.54 of Ofcom's Consultation Document.

⁷ Paragraph 5.56 of Ofcom's Consultation Document.

⁸ Paragraph 5.8 of the OFT's Guidance.

- Sky argues that the costs of switching between platforms are low;

This constitutes direct evidence from Sky of its lack of incentives to supply third parties. Sky will, after all, act on the basis of its own assessment of switching costs, not on the basis of any evidence of switching costs. gathered by any other party, including Ofcom.

- 2.5 **Barriers to market entry and expansion:** The OFT’s Guidance then considers barriers to market entry and expansion. It notes that “*entry conditions are always a crucial part of any competition assessment*”.⁹ The Parties various Submissions have described the significant barriers to entry at each level of the supply chain and the resulting persistent first mover advantage. For example, the Parties’ various Submissions have, among other things, explained Sky’s substantial advantages in the acquisition of content. Accordingly, and given Sky’s lack of incentive to supply content to competing retailers, it is clear that there are significant barriers to market entry at both the wholesale and retail levels.¹⁰

3. Sky’s conduct

- 3.1 The OFT’s Guidance states that:

*“A significant part of the evidence on which the OFT will base its case for a market investigation reference will normally concern the conduct of firms (as sellers or buyers) who, because of structural or other features of the market, are in a position to exercise a degree of market power”.*¹¹

- 3.2 The Parties’ various Submissions disclose a plethora of examples of conduct which, particularly when considered in aggregate, would justify a reference to the Competition Commission, including the following:

- (a) inhibiting competitive bids for key content (such as sports rights);
- (b) the restricted or selective distribution of Sky’s channels and enhanced, interactive and HD services;
- (c) the level of Sky’s wholesale rates for cable distribution of its channels;
- (d) the nature of Sky’s agreements with content providers, including the effect of its bundled rights acquisition;
- (e) the nature of Sky’s agreements with third party channel providers, including the effect of its most favoured nation clauses;

⁹ Paragraphs 5.10 of the OFT’s Guidance.

¹⁰ It is worth noting that the OFT’s Guidance specifically envisages that market investigation references may embrace several levels of a supply chain (paragraph 4.3).

¹¹ Paragraph 6.1 of the OFT’s Guidance.

- (f) inhibiting access to the satellite platform; and
- (g) the proliferation of Sky's activities into additional and new platforms and technologies.

3.3 Whilst an argument could be constructed that it is not the purpose of the market investigation provisions of the Enterprise Act to deal **solely** with single firm conduct, these provisions **can** clearly be used in circumstances where, as is the case here, the combination of single firm conduct and other structural features of a market results in adverse effects on competition¹². This is supported by paragraphs 2.7 and 2.8 of the OFT's Guidance and by the OFT's decision of April 2007 to refer the supply of airport services in the UK by BAA to the Competition Commission. The OFT recognised in its decision that, whilst the reference focused on a single firm, it was nonetheless appropriate (and equally the use of Chapter II prohibition was inappropriate) because the underlying issues were structural in that case.

3.4 It is the particular features of the pay TV industry which ensure that Sky is not subject to normal competitive constraints from rivals and which therefore allow it to behave in a way which forecloses, or at least marginalises, its competitors. Its stranglehold on the industry gives particular cause for concern at a time when advances in technology offer the potential for new entry, for example, PVR based services on DTT and DSL delivered on-demand services.

3.5 The many examples of market failure identified in the Parties' Submissions are thus a direct consequence of and are inextricably linked to the structural features at each level of the pay TV industry. If changes are not made to these underlying structural defects, then new entry and competition will be stifled or foreclosed. It is only if the pay TV supply chain becomes contestable both upstream and downstream that the vicious circle will collapse and with it Sky's ability to exclude or marginalise its competitors. In other words, it is clear that co-ordinated intervention is needed at all levels of the supply chain. In such circumstances, the market investigation provisions under the Enterprise Act provide a clear route for redress.

4. Reference criteria

4.1 In determining whether the relevant thresholds for a reference are satisfied, the OFT's Guidance indicates that the following criteria must be met:

- (a) it would not be more appropriate to deal with the competition issues identified by applying the provisions of the Competition Act 1998 or using other available sectoral powers;

¹² It is worth noting in this regard that the relevant provisions of the Enterprise Act have effectively replaced the Fair Trading Act's monopoly reference provisions, including not only complex monopoly references, but also references of "scale" monopolies where distortions of competition were identified as a result of the conduct of a firm or firms with over 25 percent of the market.

- (b) it would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference;
- (c) the scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it; and
- (d) there is a reasonable chance that appropriate remedies will be available.¹³

4.2 Each of these criteria is considered below.

5. Availability of other powers

5.1 The prohibitions contained in Chapter I and Chapter II of the Competition Act 1998 (and Articles 81 and 82 of the EC Treaty) do not provide appropriate tools to deal with a situation where, as here, the process of competition is not working effectively at the different levels of the supply chain and the entire structure of a given industry needs to be reviewed to identify remedies which will secure the future contestability at each such level.

5.2 The behavioural remedies available under the Competition Act are inadequate to deal with the industry-wide market failure and structural features identified in the Parties' various Submissions and Ofcom's Consultation Document, as Competition Act remedies by their very nature are intended to address individual instances of anti-competitive behaviour and redress past or current infringements rather than introduce prospective contestability at every level of the supply chain. They are also ineffective to deal with the breadth and extent of the adverse effects on competition identified at every level of the industry.¹⁴ The OFT's Guidance notes that, in such circumstances where the effectiveness of competition at various levels of the supply chain is questioned, the market investigation route allows sufficient flexibility to investigate.¹⁵

5.3 In this regard, it is useful to note that, when referring liquid petroleum gas supply to the Competition Commission under the market investigation procedure, the OFT stated that:

“Given the breadth of issues arising in relation to domestic bulk LPG, the OFT does not currently consider that action taken under the Competition Act, or under Articles 81 or 82 of the EC Treaty, as appropriate, if a breach of one or more of the relevant provisions were

¹³ Paragraph 2.1 of the OFT's Guidance.

¹⁴ The OFT specifically referred to the number and diversity of issues in its decision to make a reference of the supply of liquefied petroleum gas in July 2004 (see, for example, paragraphs 20 and 27 of the OFT's report). See also the OFT's report on its market reference of store cards, dated March 2004, paragraphs 6.16 and 6.23.

¹⁵ See paragraph 2.2 of the OFT's Guidance.

established, would be effective in resolving all the adverse effects on competition which it has identified".¹⁶

A similar view should be taken in respect of pay TV in the UK.

- 5.4 As is explained above, the features of the UK pay TV industry that prevent, restrict or distort competition arise inherently and persistently as a result of the existing industry structure. Even if a breach of one or more of the relevant Competition Act prohibitions were established, the Parties consider that this would not be effective either in resolving *all* of the adverse effects on competition arising from Sky's behaviour or in addressing the failures in the market which enable Sky to engage in that conduct.
- 5.5 Accordingly, piecemeal intervention under the Competition Act attempting to address individual symptoms of the underlying structural failure would not be sufficient to redress the vicious circle of mutually reinforcing upstream and downstream bottlenecks in the UK pay TV industry. The wide range of distortive conduct is such that even if one aspect is remedied, the existing market structures will enable Sky to undertake alternative behaviour, which will have a similar foreclosing effect. Therefore, to resolve the adverse effects on competition identified and to enable the pay TV industry to work better for consumers, it is not enough to endeavour to analyse each aspect of conduct in terms of separate instances of abuse by a dominant operator. In this regard, the OFT notes at paragraph 2.8 of its Guidance that it may make a market investigation reference even where there has been an infringement of Article 82 EC or Chapter II, but it is clear that nothing short of a structural remedy going beyond what is appropriate under the Competition Act would be effective in dealing with the consequential adverse effect on competition.
- 5.6 For the sake of completeness, the Parties have also considered whether Ofcom could consider using its powers to issue directions under section 316 of the Communications Act. However, as Ofcom is aware, these powers are expressly directed at addressing fair and effective competition in the provision of licensed services or connected services and appear to be inadequate to deal with the structural concerns identified in this case.

6. Undertakings in lieu

- 6.1 In the absence of appropriate undertakings being offered and accepted, the Parties would urge Ofcom to exercise its discretion to make a market investigation reference to the Competition Commission.

¹⁶ Paragraph 20 of the OFT's Report on its reasons for making a reference to the Competition Commission of the supply of Liquefied Petroleum Gas, dated July 2004.

7. Proportionality

- 7.1 The OFT's Guidance states that it will only make a market investigation reference when it has reasonable grounds to suspect that the adverse effects on competition of features of a market are "*significant*".¹⁷ As part of its assessment, the OFT states that it will consider whether such suspected adverse effects are likely to have a significant detrimental effect on customers through higher prices, lower quality, less choice or less innovation.¹⁸ As noted in the Parties' Joint Submission of 3 July 2007, UK consumers pay substantially more on average for pay TV than their counterparts in other territories, (even having adjusted prices to take into account differences in content quality, i.e. programming expenditure, and income).¹⁹ Further, the Parties' various Submissions have highlighted the adverse impact of the current market failure on choice and innovation.
- 7.2 The OFT guidance further states that the following relevant factors will be taken into account when assessing whether adverse effects on competition are "*significant*":²⁰
- (a) the size of the market to be investigated;
 - (b) whether a significant proportion of that market is affected by the issues identified;
 - (c) whether it is likely that the issues identified are expected to be present in that market in the foreseeable future; and
 - (d) whether the adverse effects identified are likely to be offset by consumer benefits.
- 7.3 The pay TV industry in the UK is important both socially and in economic terms and the adverse effects on competition identified by the Parties have a detrimental effect on a significant proportion of that industry. The vicious circle operates to ensure that neither incumbent operators, (such as Virgin Media) nor relatively new entrants (such as Setanta, TUTV and BT Vision) are able to penetrate any level of the supply chain to an extent that threatens Sky's position. Given that Sky's behaviour is fostered by a market structure which will not change without regulatory intervention, it is likely that its conduct, as well as the structural features which promote it, will remain in the market for the foreseeable future. Finally, as described above, UK consumers pay more for pay TV services than their European counterparts, there is less choice available for subscribers and Sky's competitors have limited ability to innovate because the opportunity is foreclosed to them. Accordingly, the Parties do not consider that the adverse effects identified are offset by consumer benefits.

¹⁷ Paragraph 2.27.

¹⁸ Paragraph 2.27.

¹⁹ The Parties have also shown that there is a strong indication that a significant proportion of the price differential arises from the market structure in the UK.

²⁰ Paragraph 2.28 of the OFT's Guidance.

8. Remedies

- 8.1 There is certainly a more than reasonable chance that appropriate remedies would be available in this case to the Competition Commission to address both horizontal and vertical features of the pay TV industry (albeit on a non-exhaustive basis), including: extending the existing access regulation and introducing constraints on the sale of content to ensure that competitors can compete effectively at all levels of the supply chain; and operational separation of Sky's upstream and downstream businesses.²¹ In the Parties' view, this wide range of potential remedies would be unlikely to result from isolated investigations of Sky's conduct under the general competition prohibitions. Indeed, in view of the interrelationship between the structural features of the pay TV industry, dealing with each individual feature in isolation would be insufficient to remedy the concerns identified.
- 8.2 Finally, a market investigation reference of the pay TV industry to the Competition Commission would be entirely consistent with Ofcom's principal duty afforded to it under the Communications Act 2003, which is to further the interests of consumers in relevant markets where appropriate by promoting competition. Ofcom has frequently referred to this overriding duty as being "*at the core of its raison d'être*" and paramount to its approach to regulation.
- 8.3 In light of this duty, the Parties consider that Ofcom should exercise its powers under section 131 of the Enterprise Act and refer the pay TV industry to the Competition Commission as a step towards remedying the market failures identified and to generate an environment in which there can be effective competition leading to enhanced consumer benefits from a market that is properly contested.

²¹ See Part 5 of the Parties' Joint Submission of 3 July 2007