Competition Commission movies on pay TV market investigation

Ofcom comments on Working Paper 29

Introduction

1. This paper provides comments on the Competition Commission's (**CC's**) working paper 29 "*Developments since our provisional findings*" (**WP29**) and the research report prepared for the CC by Gfk, "*Pay TV Market – Netflix and LOVEFiLM*" (the **Gfk report**). It expands on points communicated at a working level meeting on 3 April 2012. The views presented in this paper are based principally on the information provided in non-confidential versions of WP29, the Gfk report, and other publically available information.[1]

2. In summary, we consider that recent market developments (i.e. those associated with Netflix and Lovefilm) should be viewed in context and that their potential market impact should not be overestimated. Equally, we consider that the significance of these developments for the CC's Provisional Findings should not be overstated. The underlying competition issue, of access to premium content, remains a fundamental concern. On the evidence presented by the CC, it is far from clear that the nascent offerings from LOVEFiLM and Netflix have changed the nature of the competition facing Sky's movie offering. It is also unclear whether they have the potential in future to address the adverse effect on competition and the resulting detriment to consumers identified by the CC in its Provisional Findings.

3. In the Provisional Findings, the CC found that Sky's market power in the pay TV retail market gives rise to barriers to the acquisition of first subscription pay TV window (**FSPTW**) movie rights, and Sky's control of the acquisition of FSPTW movie rights gives rise to it controlling almost all FSPTW movie content in the wholesale market. It found that Sky's control of the acquisition and distribution of FSPTW movie content on pay TV affects adversely competition between pay TV retailers.

4. In WP29, the CC sought views on certain developments since the announcement of its Provisional Findings on 19 August 2011:

   - New or enhanced standalone over the top (**OTT**) subscription video on demand (**SVoD**) streaming-only services have been launched by Netflix and LOVEFiLM.

   - These providers have also obtained access to rights for FSPTW movies from some of the non-major studios, as well as rights from major and non-major studios to stream movies in subsequent subscription pay TV windows.

   - Sky has announced that it intends to introduce a new stand-alone OTT service that will include movie content, and has made a number of other changes to its services.

[1] The views expressed in this paper are not binding on Ofcom in any future process requiring consideration of issues in these markets.

5. Having described these developments, the CC concluded that there appears to have been a material and non-transitory alteration in the supply of services with movie content for UK consumers and that it was examining the implications of this for its provisional competition assessment. We note however that WP29 does not seek to explain whether any alteration to the Provisional Findings is required as a result.

6. We explained in our reference decision of 4 August 2010 that the importance of linear channels had been declining, so that subscription pay TV services offering recent movies on demand were an important long-term proposition.[2] We were concerned not only that Sky would maintain and exploit its market power by restricting the distribution of its existing movies channels, but also that as Sky developed its SVoD services its current market power in relation to linear channels could be transferred across to these new services.

7. We understood the Provisional Findings to have recognised and taken account of the direction of change in relation to the provision of VoD services.

8. We view the new SVoD services offered by LOVEFiLM and Netflix as positive market developments, recognising that they have the potential to deliver better consumer outcomes in a market which is dominated by a very small number of players.

9. From a distribution of content perspective, an increasing number of homes are now receiving content via more than one distribution technology, such as satellite, cable, DTT or broadband IP infrastructure, which may serve to reduce concerns about bottlenecks traditionally associated with TV platforms.

10. However, we still consider that the key factor in the demand for any pay TV service is the ability to access compelling content. In our reference decision, we considered that first-run Hollywood movies on a subscription basis were particularly compelling to consumers because of three enduring characteristics: on average, they are high quality movies, at least in terms of box office success; they are available relatively close to their theatrical release date; and they are available via subscription (as opposed to pay-per-view). We considered that FSPTW movie content from the six major studios was particularly important to competition in the pay TV sector. We do not see that the evidence presented means this assessment is no longer correct.[3] [4]

11. Therefore we do not see that the new services from LOVEFiLM and Netflix have already addressed the issues identified in the CC's Provisional Findings, or that, in the absence of intervention, they can be relied on to do so in future.

12. In the following two sections we set out our views on the new services from LOVEFiLM and Netflix, first as to the likely impact of their current services on competition, and second as to the prospect of pro-competitive developments in the foreseeable future.

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[2] http://stakeholders.ofcom.org.uk/binaries/consultations/movies_reference/statement/pay-tv-movies-decision.pdf

[3] There have been some recent developments in terms of an increase in high-budget TV drama, available for instance on Sky Atlantic. However, we have not seen any evidence that this has significantly altered the drivers of take-up of pay TV.

[4] The importance of movie content has been recognised in the recent undertakings provided by Foxtel in the context of its merger with AUSTAR in Australia that limit the proportion (50%) of exclusive movie content it is able to acquire: http://www.accc.gov.au/content/index.phtml/itemId/1044888/fromItemId/142.

Current impact of LOVEFiLM and Netflix on competition

13. We consider below some of the specific issues on which the CC has invited comments.

<u>Substitution with pay TV services</u>

14. It does not appear to us that the current SVoD services offered by LOVEFiLM or Netflix are substitutes for Sky Movies:

- While LOVEFiLM and Netflix have movie rights from some major and non-major studios in the second subscription pay TV window (**SSPTW**), their rights to FSPTW movie content are dwarfed by those of Sky, which retains control of all FSPTW movie rights from the six major studios.

- The services are not pure movies offerings and instead rely heavily on US and UK TV series content, a significant proportion of which is not recent.

- The essentially non-premium nature of the services from LOVEFiLM and Netflix are reflected in their prices (£4.99 per month and £5.99 per month, respectively), considerably cheaper than pay TV packages which include Sky Movies. Sky's "Movies Pack", for example, costs £16 per month on top of the minimum basic subscription (which is currently £20 per month).[5]

15. Rather than being substitutes for Sky Movies, these services appear to be designed to more closely resemble a general entertainment TV channel service.[6]

16. In our view the Gfk report does not provide a clear basis to conclude that LOVEFiLM and Netflix are effective substitutes for Sky Movies. While it is helpful to have information about subscribers to the new LOVEFiLM and Netflix streaming services, the report does not cover the attitudes and preferences of the large majority of Sky Movies customers who have not taken up these services. Understanding whether these consumers see the new services as substitutes for Sky Movies (and how many are even aware of them) is critical to any conclusion that these new services will deliver effective competition. Furthermore, the results should be interpreted in light of the fact that most of the respondents were early adopters of the new services (and likely to still be on a free trial at the time of the survey). 36% had signed up to the services in the two weeks prior to the survey and 41% had signed up three to four weeks before (new customers of Netflix and LOVEFiLM start on a 30-day free trial).

17. Notwithstanding the limitation of the Gfk report identified above, the report shows that over half of the respondents that also had Sky Movies at the time of being surveyed said that the services were worse than Sky Movies for showing recent movies. This also appears to be reflected in the fact that, among Sky Movies customers included in the survey, it seems that a substantial majority intend to retain their Sky Movies subscription.

[5] We recognise that, with bundled services, the perceived incremental cost of Sky Movies, from a consumer perspective, will depend in part on the consumer's valuation of other services in the bundle.

[6] One reason for this approach may be that LOVEFiLM faces a significant challenge in promoting the use of its streaming service to its DVD rental customers, given that it does not hold any FSPTW movie content from the major studios. These customers are used to being able to watch a broad range of recent movies on DVD, but subscribers to the streaming-only service face a more limited choice. LOVEFiLM therefore needs to persuade its customer base to accept a different proposition, one where consumers turn to LOVEFiLM to provide something entertaining to watch (as with a general entertainment TV channel service) rather than to offer a full-range movies service.

18. We also do not consider that a meaningful analysis of the competitive impact of these new services can be based on a simple count of the number of movies to which they provide access.

19. Sky's response to the launch of new services from Netflix and LOVEFiLM was to announce on 21 March 2012 the launch of its own OTT subscription service under a separate brand name, "Now TV". In that announcement, Sky's CEO, Jeremy Darroch, stated that Sky's rationale behind the launch of a second brand was to "*meet the needs and preferences of different customer segments more effectively*". To date, Sky has not made any changes to the price or packaging of its Sky Movies linear channels.

20. What impact Now TV will have on competition will depend on the content of this proposed service and its price point. We currently do not have details of its content line-up and, critically, are not aware of any pricing information that has been made available. In 2010, we considered a proposal from Sky to launch a limited Sky Movies product at a relatively low price point on DTT, within a service known as "Picnic". While Sky's reasons for launching Now TV are unclear, there may be some similarities with the Picnic proposal. It could be intended as a response to the LOVEFiLM and Netflix services. It may also be intended to encourage consumers to take up its full-service direct-to-home (DTH) offering. In any event, our assessment of the Picnic proposal would suggest that Sky will be keen to ensure that the Now TV service does not cannibalise its DTH business.

21. We therefore do not see that there is a clear need to alter the CC's Provisional Findings on the assessment of competition in the retail market identified.

<u>Significance of Sky Movies and FSPTW</u>

22. The CC's assessment of the significance of Sky Movies and FSPTW content in its Provisional Findings relied principally on the following elements:

- that FSPTW movies are highly significant to the appeal of Sky Movies;
- that Sky Movies does not have close substitutes; and
- that Sky Movies is significant to consumers when choosing a pay TV retailer.

23. It is not clear to us that the new services from LOVEFiLM and Netflix have had any demonstrable impact which requires the Provisional Findings to be altered.

24. We note in this context that the CC has referred to the Now TV proposal from Sky as suggesting that Sky Movies is of less significance than before. We would caution against drawing strong conclusions from this development, for the reasons set out above.

<u>Sky's bidding advantages</u>

25. When it comes to bidding for exclusive FSPTW movie rights, Sky's advantages over its competitors have been identified and set out in the CC's Provisional Findings. We have not seen any evidence presented which would suggest that these advantages, relating principally to Sky's large subscriber base, have diminished. In addition, the continued bundling of linear and SVoD rights by the six major studios is likely to be a barrier to LOVEFiLM and Netflix successfully acquiring any FSPTW rights from them.

26. We note that the CC is also considering, in relation to the barriers to acquiring movie content in the FSPTW, whether the content required to create a product which is a substitute to Sky Movies has changed. For the reasons set out above, we do not believe this to be the case.

<u>Conclusions on current impact on competition</u>

27. In summary, we have not seen any clear evidence presented to demonstrate that the SVoD services offered currently by LOVEFiLM and Netflix exert a sufficient competitive constraint on Sky Movies for the CC to need to alter its conclusions in the Provisional Findings given that:

    - Sky continues to have market power in the pay TV retail market and there appears to be no impact on the findings relating to persistent earning of excess profits and high consumer prices.
    - Sky continues to control rights to FSPTW movies from the six major studios.
    - This content motivates the purchasing decisions of a significant number of consumers.
    - Without access to this content, there will continue to be ineffective competition in the pay TV retail market, particularly in relation to movie products.

Uncertainty of future developments

<u>Introduction</u>

28. We recognise that Amazon (the parent of LOVEFiLM) and Netflix are well financed companies and that developing pay TV movie services in the UK is a part of their long-term global strategies. However, it does not follow that they will remain committed to the UK market in all scenarios. A forward looking analysis of the likely impact of the new services must therefore be conducted against the particular characteristics of the UK market.

29. The future development of the new services remains speculative, not least because they have only just launched – LOVEFiLM launched its streaming-only SVOD service in December 2011 and Netflix entered the UK in January 2012.

30. It is clear that there are significant challenges to launching new TV services in the UK on a sustainable basis. There are a limited number of pay TV retailers, with Talk Talk and Top Up TV both struggling to make a mass market impact. There are other examples of entry into pay TV in the UK, such as by Setanta and Ondigital / ITV Digital, having failed. Outside the pay TV sphere other providers have found it difficult to enter and maintain a presence, as illustrated by the exit of SeeSaw and Fetch TV, and the delays to the launch of YouView.

31. We note that LOVEFiLM and Netflix have made public statements which suggest they may in future challenge Sky for FSPTW movie rights. We consider that the CC should be cautious in considering the evidential weight to be attached to statements of this type as to the likely future acquisition of these rights, and in particular with reference to any timescales in which this might occur. This is because the statements are necessarily speculative and LOVEFiLM and/or Netflix may have certain target audiences in mind, e.g. investors, leading them to adopt a positive stance.

International comparisons

32. WP29 recognises the difficulties of drawing comparisons from international experiences, but suggests that the success of Netflix in the USA and Canada might be replicated in the UK[7].

33. It is not clear that the experience of Netflix in the USA or Canada serves as a guide to the future performance of Netflix or LOVEFiLM in the UK, as there may be significantly less scope for growth in the UK compared with North America, given the popularity in the UK of public service broadcasting (**PSB**) and other free catch-up content.[8] As this content is free, there may be less of an incentive for UK consumers to pay a subscription fee for similar offerings, especially given that the services offered by LOVEFiLM and Netflix may bear more of a resemblance to a general entertainment TV channel service, as discussed above.

Distribution challenges

34. Given that consumers prefer to watch VOD content, in particular movies, on a TV set rather than a computer (see paragraph 3.42 of the Provisional Findings), the ability of LOVEFiLM and/or Netflix to build a sufficient subscriber base will depend principally on whether there is significant consumer take-up and usage of internet-enabled TVs (IETVs). It is clear that increasing numbers of TVs are capable of being connected to the internet. It is less clear what proportion of consumers actually connect their TV to the internet and then watch content via that connection on a regular basis.[9] [✂] [10].

35. There are also technical challenges in facilitating the widespread adoption of streaming TV services, the timing of which may add further uncertainty, such as the development of multicast technology to improve the efficient use of network resources, and the more extensive geographic roll-out and take up of high-speed broadband.[11]

36. In the pay TV statement, Ofcom found that that there was potential for considerable innovation in the market, facilitated by the emergence of new technology and changing consumer habits, but that access to premium content was vitally important to the effectiveness of any pay TV business wishing to exploit that potential.

37. In the context of potential developments in the market, we note that Sky's position in the pay TV appeal was that Ofcom had overplayed the potential for change. In February 2011, Sky's COO, Mike Darcey, gave evidence on the development of the

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[7] In our pay TV review, Ofcom was cautious about the ability to draw direct comparisons with other countries when considering the existence of competition issues. In the context of considering pricing comparisons we pointed particularly to differences such as: the historical development of markets; the form of public service broadcasting; varying preferences for content; and different socio-demographic conditions, which made it very difficult to draw conclusions from the positions in other countries.

[8] In Q1 2011, 35% of adults claimed to use the internet for viewing catch-up television. Ofcom Communications Market Report, 2011.

[9] We note that in WP29, paragraph 21 the CC refers to the increasing penetration of internet connected televisions, but does not set out any evidence as to the connection and usage of such devices.

[10] [✂]

[11] While it is arguable that high broadband speeds are not needed for IPTV services, super-fast broadband is necessary for some consumers, including those in households where there are multiple broadband users. In this context, we estimated in July 2011 that 57% of UK homes were able to receive super-fast services, but that take-up of such services remained low at just 2%: http://stakeholders.ofcom.org.uk/binaries/research/cmr/cmr11/UK_CMR_2011_FINAL.pdf.

pay TV sector in his third witness statement in support of Sky's appeal. Mr Darcey's evidence was that he did not consider that the TV industry was on the verge of experiencing a wave of new development and innovation.[12] In the view of Mr Darcey it was better to view developments over the 12 years since the launch of digital television as a period of "*steady evolution in the way content is distributed and consumed, and of continuous innovation*". He said that "*I expect this to continue over the next several years but do not think we are on the verge of a period of particularly revolutionary change in consumer behaviour, in the rate of innovation or in the way content is distributed and consumed*".[13] Mr Darcey went on to make a strongly pessimistic assessment of the prospects for the growth in consumption of VoD content.[14]

38. It may be the case that Sky's assessment of the market has shifted over the course of the past year. We note in this context that in its September 2011 response to the Provisional Findings Sky considered that "*it is evident that there is the potential for significant disruptive change in the market*".[15] It remains our view that there is significant potential for innovation in the interests of consumers, but that access to compelling content is required for a pay TV business to be successful.

<u>Conclusion on future developments</u>

39. For the reasons set out above, while we recognise that in the long-term there is the potential for the OTT SVoD services from LOVEFiLM and Netflix to have a positive impact on competition, the future development of these new services remains uncertain. LOVEFiLM and Netflix clearly have ambitions in the pay TV retail market, but their ability to compete directly with Sky on a sustainable basis is not certain and critically dependent on access to compelling content which is currently controlled by Sky and likely to remain so. Therefore, it is unclear that they can be relied upon in the future to address the adverse effect on competition and the resulting detriment to consumers identified by the CC in its Provisional Findings.

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[12] Paragraph 14.
[13] Paragraph 16.
[14] Paragraphs 17, 20, 22, 26 and 27.
[15] See paragraph 85.