



Pay TV statement

Summary

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Redactions are indicated by [X].

Statement

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Section 1

Summary

Overview

- 1.1 After three rounds of consultation, we have made three decisions:
- To require that Sky Sports 1 and 2 are offered to retailers on platforms other than Sky's, at prices set by Ofcom.
 - To approve Sky and Arqiva's request for Sky to offer its own pay TV services on digital terrestrial TV ('Picnic'), but conditional on a wholesale must-offer obligation on Sky Sports 1 and 2 being in place, with evidence that it has been effectively implemented. This conclusion is also conditional on any movies channels included in Picnic being offered to other digital terrestrial TV retailers.
 - To consult on a proposed decision to refer two closely related movie markets – for the sale of premium movie rights and premium movie services – to the Competition Commission. This is with a view to asking the Competition Commission to remedy those competition concerns which we have identified, particularly in relation to the restricted exploitation of subscription video-on-demand movie rights, but which we cannot adequately address using our sectoral powers.
- 1.2 The pay TV sector has delivered substantial benefits to consumers since its emergence in the early 1990s. More than 12 million consumers now pay to access a greater choice of content, at higher quality, and with a greater degree of control than has historically been available from free-to-air broadcasters. Sky has been at the forefront of this development and has delivered substantial benefits to millions of consumers in the UK.
- 1.3 Pay TV services have to date been delivered primarily via satellite and cable networks. However, this investigation comes at a time of disruptive change in the way content is distributed. For example, digital terrestrial TV offers the scope for pay TV to be delivered via aerials, and new broadband networks could offer consumers an unprecedented choice of content, and the ability to access that content on demand.
- 1.4 The ability to provide such services depends not just on technology, but on access to content that consumers want to watch. Live high-quality sports and recent Hollywood movies retain an enduring appeal for many consumers. Access to this content has driven the historical development of pay TV, and we believe that it will remain crucially important for the development of new platforms and new services.
- 1.5 For many years Sky has held the exclusive rights to broadcast first-run Hollywood movies and many of the most sought-after premium sports. We have now concluded that Sky has market power in the wholesale of certain channels including this content. However, the position differs between sport and movies:
- Sky's position in sport arises from the unique ability of broadcast TV to reach a large live audience, and Sky's control of the live broadcast rights for many of the most important sports. This is unlikely to change in the next few years.

- The position in movies is more complex, since there are a variety of ways consumers can purchase movies content, and the importance of linear channels is starting to reduce. Looking forward, we expect video-on-demand to become increasingly important. However Sky controls not only all the major linear channel movie rights, but also all of the rights that would be required to develop a subscription video-on-demand service for first-run Hollywood movies.
- 1.6 Sky exploits its market power by limiting the wholesale distribution of its premium channels, with the effect of restricting competition from retailers on other platforms. This is prejudicial to fair and effective competition, reducing consumer choice and holding back innovation by companies other than Sky. In the case of movies the fact that Sky also owns but barely uses the subscription video-on-demand rights denies competitors the opportunity to develop innovative services.
- 1.7 We have decided that we should use our powers under section 316 of the Communications Act to ensure fair and effective competition by requiring Sky to offer the most important sports channels – Sky Sports 1 and Sky Sports 2 – to retailers on other platforms:
- Given that we cannot expect commercial agreement between Sky and other retailers, we have set a price for standard-definition versions of these channels at a level that should allow an efficient competitor to match Sky's retail prices. The calculations are based on Sky's own retail costs, adjusted for scale so as to allow for a market with several competitors rather than a single provider.
 - We have set a wholesale price for each of Sky Sports 1 and 2, when sold on a standalone basis, which is 23.4% below the current wholesale price to cable operators. Most consumers currently buy packages which include both channels, and the wholesale price for the service bundle which applies in those circumstances has been reduced by 10.5%.
 - In calculating these prices, we have taken into account the additional retail revenue generated by Sky from its Multiroom service enhancement, and have also taken into account any associated costs. Other retailers will be free to develop their own service enhancements, including offering Multiroom-type services, by using the same underlying wholesale product at no additional cost.
 - We have not set a price for high-definition versions of Sky Sports 1 and 2. We have accepted Sky's argument that high-definition services are a relatively recent innovation, and that pricing flexibility will help promote future innovation. We instead require Sky to offer contractual terms for supply of these channels on a fair, reasonable and non-discriminatory basis.
 - We have provided guidance on a number of non-price matters such as security, to ensure that the remedy is implemented as quickly as possible.
- 1.8 We have decided it would not be appropriate to impose a similar obligation on Sky's movies channels. We have concerns over restricted distribution of movies channels, but our main forward looking concern relates to the sale of video-on-demand rights. We cannot adequately address this concern under section 316 (which relates primarily to linear channels). Instead we believe we should make a reference to the Competition Commission under the Enterprise Act 2002, and as required by statute, we are consulting on that proposed decision.

- 1.9 We have decided to consent to Picnic, subject to a wholesale must-offer obligation on Sky Sports 1 and 2 being in place, and evidence that it has been effectively implemented. This conclusion is also subject to any movies channels included in Picnic being offered to other DTT retailers. These conditions will allow consumers to benefit from access to Picnic, whilst also ensuring fair and effective competition.
- 1.10 We expect these decisions to deliver substantial benefits to consumers.
- The most immediate benefit will be felt on digital terrestrial television. Ten million Freeview households will, if they so choose, be able to access the most attractive sports content via their existing aeriels, and competition between Sky and other retailers should ensure a wide range of packages, including lower-priced entry-level bundles.
 - Improved access to ‘must-have’ content will incentivise investment in new means of distributing content, such as faster broadband networks. In the longer term this will result in a range of innovative new services for consumers.
 - We also expect to see improved choice of wider bundles which include broadband, voice and TV services, with a variety of suppliers able to compete effectively across all three of these key communications markets.
- 1.11 In deciding what it is appropriate to do to ensure fair and effective competition, we are particularly mindful of the benefits that Sky has historically delivered to consumers, both through investment and innovation on its own platform, and its willingness to make long-term investments in UK sport. That is why we have deliberated carefully on these issues over the course of three consultations. We believe, however, that our remedy is appropriate:
- Although we acknowledge that Sky is opposed to the remedy, we see the reasons for this opposition as being related to its strategic incentives to protect its retail business. We do not expect the remedy to reduce Sky’s wholesale revenues. Sky already wholesales Sky Sports 1 and Sky Sports 2 to cable operators, and has expressed a willingness to extend wholesale supply to other platforms, including in prior discussions with Ofcom. The potential negative impact of the relatively modest price decrease we are implementing should be more than offset by market expansion effects.
 - We have designed the remedy to minimise the potential risk of any negative impact on the value of sports rights. The wholesale revenue available to Sky to pay for sports rights should not be reduced, and should in fact increase as the market expands. The other broadcasters whose bidding behaviour has driven rights values in the past should not be materially affected. And in the longer term the emergence of new retailers, with significant numbers of subscribers, should increase competition for rights, given the various benefits associated with direct control of those rights.
- 1.12 Similar interventions have succeeded in other countries. In the US in particular, the Program Access Rules have enabled market entry by new satellite and IPTV platforms.
- 1.13 Our sports channels remedy and our decision on Picnic both come into effect immediately, with a view to both Sky and its competitors being able to launch new services in time for the start of the next football season in August.

Introduction: A sector which offers increasing choice and innovation to consumers

- 1.14 We started this investigation in early 2007 after having received a major submission from BT, Setanta, Top Up TV and Virgin Media.
- 1.15 We have assessed whether competition in the sector is effective in delivering the following benefits to consumers:
- Choice of platform and content:
 - Choice for consumers of platform and of content once platform selection is made.
 - Switching between retailers and platforms should not be artificially difficult.
 - Generation and availability of a broad range of high-quality content: a variety of content should continue to be generated and made available to consumers on all platforms.
 - Innovation:
 - In platform services, for example in terms of interactivity, set-top box functionality such as DVR capabilities, or VoD options.
 - In retail service bundling, packaging and pricing.
 - Pay TV services priced competitively and efficiently:
 - Prices which give consumers good value and allow efficient producers to earn a reasonable return on their investment.
 - A sufficient variety of price points / bundles to allow consumers to tailor their purchases to meet their preferences.
- 1.16 An effectively competitive market should provide consumers with choice, innovation and competitive pricing. We have assessed the market against this benchmark, and have considered whether we need to act in order to ensure fair and effective competition, as provided for in section 316 of the Communications Act 2003.
- 1.17 The early parts of our investigation took a broad overview of the pay TV sector. We characterised the historic evolution of pay TV in terms of three major phases:
- The birth of pay TV and the development of analogue satellite and cable services in the late 1980s and 1990s.
 - The transition to digital services at the end of the 1990s.
 - The rapid take-up of digital multichannel TV during the 2000s, driven particularly by Sky's pay satellite service and the success of free-to-air digital terrestrial TV.
- 1.18 We are now moving into a new period of potentially disruptive technological change, as new means of distributing video content offer consumers greater control over what they watch and when they watch it. For example:

- The success of free-to-air digital terrestrial TV means that a large number of consumers are now familiar with multichannel TV, have an easy migration path to pay TV services provided via their existing TV aerial, and may be willing to take that path given a suitable choice of retail packages.
 - New broadband access networks allow consumers to access a variety of video-on-demand services, over closed IPTV platforms, and also over the open internet. Current generation broadband supports a limited range of such services, but sufficient to demonstrate their potential. A key driver of investment in superfast broadband is the ability to distribute video content in greater volumes and at higher quality than is currently possible.
- 1.19 Despite these technological changes, some underlying characteristics of the pay TV sector remain. Particular content holds enduring appeal for large numbers of viewers and is concentrated on pay TV – live top-flight sports and first-run Hollywood movies. Access to this content remains key for the development of any new platform, and is critical to ensuring effective competition.
- 1.20 Other characteristics of the sector also have the potential to affect competition:
- Some pay TV businesses are vertically integrated between wholesale and retail activities. This can be efficient but can also create incentives to act in a way which can limit competition.
 - Content aggregation – the assembly of programmes into channels, and channels into bundles – is important and generally beneficial as a means of delivering attractive retail packages in an efficient manner. However, it can also contribute to market power.

Market power: Sky has market power in the wholesale of Core Premium Sports and Movies channels

- 1.21 Our review of market power has focused on the two most important types of content – sports and films. We have reviewed a very wide range of evidence on both.
- 1.22 In sports, Sky has market power in the wholesale and retail markets for packages including ‘Core Premium Sports’ channels (Sky Sports 1 and 2 and ESPN).
- These channels contain a distinctively large amount of the most attractive live sports, shown regularly through the year. The most significant of these is live coverage of Premier League football, but a number of other important events are also shown on these channels.
 - We consider whether there are substitutes for these channels, mainly by comparing the channels’ characteristics with the characteristics of potential substitutes, but noting that the extent of substitutability is affected by the fact that prices for Sky Sports 1 and 2 appear to be above competitive levels.
 - The closest substitute is sports on free-to-air channels, but the most attractive events shown on these channels are either infrequent or offer lower volumes of content. Our conclusion on market power is in any case largely independent of where the market boundary is drawn. Even if we were to include sports broadcasting on free-to-air as well as pay TV, Sky’s market share would still be above 60%.

- In order to conclude that Sky did not have market power, it would be necessary to believe either that at competitive prices general entertainment programming would be a close substitute to sports, or that Sky was unlikely to retain a material proportion of the sports rights it currently controls. Both are highly improbable.

1.23 In movies, Sky has market power in the wholesale and retail markets for packages including 'Core Premium Movies' channels (Sky Movies channels):

- These channels contain a wide range of recent popular movies, including all of the films from the six Major Hollywood Studios shown in the first pay TV window¹.
- We consider whether there are substitutes for these channels, mainly by comparing their characteristics with the characteristics of potential substitutes. We conclude that there are no close substitutes, implying that that Sky has a market share of 100%.
- However, this market share figure substantially overstates the degree of market power held by Sky. There are a variety of other ways of watching films, and the aggregate constraint from these may be significant. Retail DVDs and films on free-to-air channels are the two types of service that offer the strongest constraint, as they are the closest substitutes that are of significant scale.
- We have assessed the strength of this aggregate constraint by calculating market shares under a variety of assumptions for the market boundary. Considering the constraint to be as strong as it plausibly could be, Sky would have a market share of around [X] [30 to 50]%. However this figure understates the degree of market power held by Sky, since it treats moderate substitutes as if they were close substitutes.
- Our view that Sky has market power is directly supported by evidence that Sky's wholesale prices for movies channels are above the competitive level. This evidence is independent of the precise market definition or market shares.
- Sky also purchases exclusive subscription video-on-demand rights for movies in the pay TV window from all of the Major Hollywood Studios. A subscription video-on-demand service showing the same movies in the same window would appear to be the closest substitute for Sky's Core Premium Movies channels. If, as expected, subscription video-on-demand services increasingly replace linear channels, Sky's position is likely either to be maintained or to become more powerful, particularly due to the advantages of subscription video-on-demand over linear channels.

Competition issues and consumer harm: The restricted distribution of Core Premium channels limits choice and innovation

1.24 Sky restricts distribution of its Core Premium channels to potential new retailers in a way which is prejudicial to fair and effective competition. A number of companies have tried and failed, over an extended period of time, to negotiate terms with Sky which would allow them to retail premium channels to their customers.

¹ By 'Major Hollywood Studios', we mean NBC Universal, Viacom, Fox Filmed Entertainment, The Walt Disney Company, Sony or Time Warner and their wholly owned or controlled subsidiaries.

- 1.25 Our review of these negotiations reveals lengthy and ultimately fruitless discussions over a number of years between Sky and other pay TV operators over possible wholesale of Sky's premium channels. This impasse has remained despite, as Sky agrees, there being an immediate financial benefit to Sky from wholesale supply. We believe this is because Sky is acting on two strategic incentives – to protect its retail business on its own satellite platform, and to reduce the risk of stronger competition for content rights.
- 1.26 Sky's behaviour in negotiation has been to respond to requests for wholesale supply with counter-offers to retail its channels on behalf of other retailers. Sky's position has been that it would be unwilling to enter into a wholesale deal unless it could be shown that it would be better off than under a retail arrangement. We accept that other parties' preference for supply should not automatically take precedence over Sky's preferences. There are however legitimate reasons for the reluctance of third parties to enter into retail deals with Sky, and where it has been evident that no retail deal would be reached, Sky appears to have preferred to be absent from the relevant platform rather than to pursue wholesale supply.
- 1.27 An outcome where Sky was the dominant retailer of premium content across all platforms would not in any event ensure fair and effective competition, as Sky would still have the incentive and ability to manage competition in favour of its own platform(s). Practical examples such as Sky By Wire on Tiscali / TalkTalk's TV platform bear out this concern, where Sky's prices are high compared to those on satellite, and premium take-up is low as a result.
- 1.28 Sky already wholesales standard definition versions of premium channels to Virgin Media, as a result of a commercial agreement reached in the early 1990s when the negotiating positions were more evenly balanced, and following the competition case concluded by the Office of Fair Trading in 2002. However, more recent negotiations over the supply of new services to Virgin Media reveal a similar pattern to that set out above. The non-supply of these services to Virgin Media – especially high-definition versions of Sky's premium channels – prevents fair and effective competition.
- 1.29 Sky supplies standard-definition versions of its premium channels to Virgin Media at a price it believes is compliant with an ex post competition law margin squeeze test. Application of this test means that retailing based on this wholesale price should be profitable at Sky's scale, and at the level of the entire bundle of basic and premium channels. However, Virgin Media's scale – particularly in terms of premium subscribers – is much smaller than Sky's, so it is unsurprising if prices set on such a basis do not enable Virgin Media to compete effectively with Sky. This contributes to Virgin Media having little incentive to sell premium channels to existing basic subscribers, which in turn contributes to the low take-up of these channels on Virgin Media's platform.
- 1.30 More generally, to the limited extent that Sky enters into any discussions about wholesale pricing with any other retailer, these discussions centre on the prices which Sky currently sets to Virgin Media via the rate-card. We do not believe it to be a reasonable expectation for retailers other than Sky to be prepared to pay the rate-card price for Sky's Core Premium channels, as these prices would not allow them to compete effectively. The rate-card prices are set so as to allow a retailer with Sky's scale to compete effectively, and there is only room in the market for one such retailer.
- 1.31 We acknowledge that the pay TV sector has delivered substantial benefits to consumers, both through investment in high-quality content and through innovative

services, many of which have been driven by Sky. However, in a well-functioning market it is fair and effective competition that drives consumer benefits. The current restricted distribution of key content prejudices fair and effective competition, reducing choice of platforms and retail packages and dampening innovation.

- Consumers with a preference for platforms other than satellite or cable – such as the ten million households with digital terrestrial television – are currently unable to access Sky’s premium channels at all.
- Consumers on cable can access Sky’s premium channels, but in standard definition only, without the associated interactive services, and purchased from a retailer whose incentive is to use the channels solely as a retention tool, rather than as a source of added value.
- While there are a large number of package combinations in the market, consumers have less variety of price points available to them than we would expect to see in an effectively competitive market. In particular, consumers who want an entry-level pay TV package rather than a ‘big mix’ are under-served by current offerings.
- Bundles of TV and telecommunications services are becoming increasingly important. This is partially because regulation has been successful in ensuring that retail telecommunications markets are competitive. However, if pay TV markets are not effectively competitive, there is a risk that the forms of reduced choice we set out above will extend into these wider bundles.
- Although there has been considerable innovation in the sector, much of it has historically been of a type that suits Sky’s satellite platform. Sky is unlikely to innovate in ways which are suited to platforms other than its own. This is a particular concern looking forward, given the significant benefits we see for consumers in the effective exploitation of new distribution technologies.
- In particular, new broadband networks will have the ability to offer consumers an unprecedented choice of content, and access to that content on demand. This is a significant driver for investment in superfast broadband, but new content distribution platforms will not develop if they are denied access to key ‘must-have’ content.

Remedies: A wholesale must-offer on sports, and a consultation on a proposed decision to refer to the Competition Commission on films

A wholesale must-offer remedy on sports

- 1.32 We have decided that an appropriate way to ensure fair and effective competition is to put in place a wholesale must-offer obligation on Sky Sports 1 and 2 under section 316 of the Communications Act, by including a condition to this effect in the relevant channel licences. This, we believe, will bring about greater choice and innovation, to the benefit of consumers.
- 1.33 We have rejected BT / Setanta / Top Up TV / Virgin Media’s (the ‘Four Parties’²) suggestion for operational separation of Sky. Only structural separation – i.e. full

² The Four Parties have since become the ‘Three Parties’, with the demise of Setanta’s UK operations in June 2009.

divestment – could address the underlying issue of incentives. Structural separation is however a costly and highly interventionist form of remedy, which we believe to be disproportionate in current circumstances, given the availability of other remedies.

- 1.34 We have also, at this point, set aside the possibility of a substantial intervention in the way sports rights are sold, which would have the intention of significantly reducing market power. We acknowledge that this is in principle an attractive means of eliminating any potential competition concern at source. It would not be as immediately disruptive as structural separation of Sky, but has the same advantage as structural separation, in that it potentially permanently changes Sky's incentives and its ability to act on those incentives.
- 1.35 However, a remedy which places severe limits on content aggregation may also risk a number of less desirable consequences. For example, it might result in reduced convenience for some consumers, who might have to take multiple subscriptions or purchase multiple set-top boxes to get the content they want, and it could result in artificial depression of rights values, if splitting up content rights created packages for which there was limited bidding competition. Careful design of rights packages would be essential to minimise these risks.
- 1.36 Our current view is therefore that a remedy which addressed our competition concerns by placing severe limits on content aggregation, in order to eliminate market power at source, would be disproportionate. We might need to revisit this question if a regulated wholesale must-offer obligation proved ineffective.
- 1.37 It might still be appropriate to take specific targeted action in the case of the Premier League. We noted in our previous consultation that the commitments made by the Premier League to the European Commission will not apply to the sale of its rights from the 2013 / 2014 season onwards. We may therefore need to revisit the compliance of the Premier League's arrangements with competition law. We can certainly see benefit in establishing certainty prior to the next auction given the changes that have taken place since the last commitments were given to the European Commission. We will continue to keep under review the need for action on this issue.
- 1.38 We conclude that imposing an obligation on Sky to offer to wholesale its Core Premium Sports channels, Sky Sports 1 and 2 – a wholesale must-offer remedy – is the most appropriate way to ensure fair and effective competition in light of our findings on the effects of the restricted distribution of Core Premium Sports channels:
- A wholesale must-offer obligation will directly target restricted distribution.
 - The obligation is proportionate: costs are likely to be low, and we expect them to be offset by market expansion effects.
 - Sky already wholesales to Virgin Media, and has told us it is willing to wholesale if it cannot retail. It was also prepared to commit to wholesaling to other retailers in discussions with us in late 2007 and early 2008. Wholesaling is therefore not a radical departure from Sky's existing business practice, and is certainly not as "extreme" as Sky has suggested in its submissions to us.
 - The obligation will seek to replicate the outcome we would expect in an effectively competitive market, where channel providers assemble a wide range of content and have an incentive to distribute it widely. The restricted distribution of Sky's channels, arising from Sky's vertical integration and its market power,

contrasts for example with the wide distribution of ESPN's premium channel, and with the fact that that the original cable distribution deals were made at a time when Sky had less market power.

- This type of remedy has been implemented and been effective elsewhere in the world. We are cautious about making comparisons between countries, given the inevitable differences between different national markets, but we note in particular the role played in the United States by the Program Access Rules. These have played a significant role in the development of first satellite and now IPTV challengers to cable's dominant position.

1.39 Section 316 of the Communications Act 2003 empowers and requires us to impose licence conditions to ensure fair and effective competition in the provision of licensed services. We consider that it is appropriate in this case to impose conditions in the form of a wholesale must-offer obligation so as to ensure fair and effective competition. Under section 317 we must consider whether it would be more appropriate to proceed under the Competition Act 1998 before proceeding under section 316. We have decided that it would not be more appropriate to proceed under the Competition Act 1998 because of the need for a comprehensive solution to a general problem affecting the relevant markets.

A consultation on a proposed decision to make a reference to the Competition Commission on films

1.40 We previously proposed to include both sports and movies channels in a wholesale must-offer remedy. In light of consultation responses we now do not believe it appropriate to include Sky Movies channels. Our findings on market power and restricted distribution extend to Sky Movies channels, but the importance of linear movies channels appears to be declining over time, as illustrated by the apparent lack of demand for them from pay TV retailers in responses to our consultation.

1.41 Subscription services offering recent movies on demand seem to present a significantly more compelling long-term proposition and stronger prospects for securing effective competition, particularly as IPTV and video-on-demand services provided over the open internet come of age.

- IPTV and video-on-demand offer new means of accessing content, with significant potential consumer benefits in terms of greater choice of content and control over when and how to watch it.
- IPTV and video-on-demand will be enhanced by large-scale investments in superfast broadband. However, such investment only makes sense if it is possible to develop the sorts of services that can exploit their capabilities.
- Such services focus on content; movies content is important for video-on-demand services generally, and subscription video-on-demand movie rights are among the most important sets of video-on-demand rights.

1.42 We therefore consider that a linear channel wholesale must-offer remedy on all platforms would not by itself be an effective forward-looking solution to our competition concerns, which focus on the limited exploitation of subscription video-on-demand rights. At the same time, our powers under section 316 of the Communications Act 2003 are limited in relation to subscription video-on-demand services, while action under Competition Act 1998 is unlikely to be effective as a means of addressing our concerns. We are therefore consulting on a proposed

decision to refer two closely related movie markets – for the sale of premium movie rights and premium movie services – to the Competition Commission. This is with a view to asking the Competition Commission to remedy those concerns which we have identified. This is set out in a separate document³.

- 1.43 We have also considered whether to put in place a wholesale must-offer remedy immediately until any reference to the Competition Commission reaches a conclusion. We have concluded that it would not be appropriate to put in place an interim wholesale must-offer remedy for all Sky’s movies channels on all platforms, because of the likely lack of demand for linear movies channels on existing platforms over the relevant time horizon.
- 1.44 However, we would have a specific concern if Sky were to launch a service on digital terrestrial TV during this interim period which contained Core Premium Movies channels as well as Core Premium Sports channels. We address this in our separate statement on Picnic⁴, where we conclude that a launch by Sky on digital terrestrial TV should be subject to any such channels being made available to other digital terrestrial TV retailers first.

Concerns regarding high prices

- 1.45 As noted above, our analysis of whether Sky has market power has included a review of its pricing and profitability. This review has shown that Sky has earned high returns for a sustained period. The riskiness of Sky’s early investments will have demanded such returns for a period. However, despite the fact that Sky’s more recent investments have entailed lower levels of risk, Sky’s returns remain at a high level and appear unlikely to be competed away in the future.
- 1.46 We have considered whether we should take action specifically to address this finding, and we have concluded in the case of sports that we should not. To do so would require us either to set wholesale prices on a cost-plus basis, or intervene to place severe restrictions on the way rights are sold. Both such approaches carry risks, including a risk that we might artificially reduce the value of sports rights. It might be possible to address these risks by appropriate design of any remedy, but we do not believe that the level of harm to consumers that we have currently identified in this process justifies the risks of intervening in these ways at this point in time.
- 1.47 In any case, while the remedy which we have put in place is not intended to reduce the overall prices of those sports packages which are currently in the market, it is intended that more effective distribution of sports channels should result in new packages being made available. These should offer consumers a wider variety of price points and bundles to choose from, including new entry-level packages. Much of the market expansion which we expect to occur as an immediate result of our remedy results from increased consumer take-up of these packages.
- 1.48 In the case of movies we note that a further reason for considering a subscription video-on-demand-related remedy is that it could potentially tackle concerns over high wholesale profitability. The margins that we see Sky making appear to be highest in

³ http://www.ofcom.org.uk/consult/condocs/movies_reference/.

⁴ <http://www.ofcom.org.uk/consult/condocs/picnic/statement/>.

the movies part of its business, and this is something we would expect the Competition Commission to consider, in a market reference.

Impact of the wholesale must-offer remedy: positive balance of consumer benefit against the risks of regulation, without significant harm to Sky or rights-holders

- 1.49 Taking into account both quantifiable and non-quantifiable benefits and costs to consumers and industry participants, the remedy we are putting in place has a positive effect.
- 1.50 There is always risk associated with new regulation, which is why we have taken care to design our remedy to minimise negative effects on the market.
- One of our primary reasons for putting a remedy in place is to ensure fair and effective competition between different retailers, in order to deliver both retailing and platform-related innovation for consumers. We acknowledge the risk that regulation in a fast-moving market can reduce innovation, and in this particular case that it could restrict innovation by Sky. We believe the design of our remedy addresses this concern, not only because it is likely to enable Sky to maintain and most likely increase its wholesale revenues, but also because we have modified our remedy to address specific concerns, for example by allowing pricing flexibility in the case of Sky's most important recent innovation – high definition.
 - There could be a risk to the value of the content rights held by sports bodies. Again, we have designed our remedy specifically to minimise any negative impact, through for example the approach we have adopted to pricing.
 - After several years of prolonged but ultimately fruitless commercial negotiations between Sky and others, we believe regulation to be necessary and that the licence conditions imposed are in the best interests of consumers.
- 1.51 **Consumers** will benefit substantially from the remedy we are putting in place, in terms of choice and innovation.
- Consumers will be able to make a freer choice of platform without being restricted by the unavailability of Sky's Core Premium channels on particular platforms or distribution technologies. Ten million digital terrestrial TV homes will potentially have access to premium content, the majority for the first time.
 - Moreover, they will potentially have the choice of a wider range of types of package, as different retailers innovate by packaging premium channels in different ways. We expect this to include a wider range of lower-cost entry-level bundles, including for example those proposed by Sky for its Picnic service, as well as through competing services from other retailers.
 - The benefit that we expect will accrue to consumers as a result of this increased choice is considerable. We expect to see around 1.6 million additional consumers of premium channels after five years. This is based on there being 1.8 million new consumers on digital terrestrial TV or IPTV, including Picnic, plus 0.3 million additional customers on cable platforms, partially offset by a reduction of 0.6 million on satellite as customers switch to digital terrestrial TV or IPTV platforms. Expressed in terms of the overall effect on consumer surplus, this translates into

a £280m gain for consumers, discounted to present value, over five years. Furthermore, this static analysis excludes dynamic gains from innovation.

- New platforms will be able to compete effectively and will be able to develop innovative new services, as they will be able to compete effectively for all types of pay TV customers. We would expect to see new platforms making full use of digital terrestrial TV and / or various forms of broadband distribution, and providing a variety of video-on-demand offers. We have not attempted to quantify the benefits arising from this type of innovation, but we believe they are likely to be substantial.

1.52 **Operators taking the wholesale must-offer remedy** will benefit due to their ability to compete effectively, through sustainable access to the most important pay TV content:

- We have set prices for Sky's channels at a level that will not allow other retailers to earn short-term profits at Sky's expense by simply reselling its channels. Our objective is to ensure effective competition from efficient operators that are prepared to make a substantial long-term investment in innovative pay TV services, not to support entry by firms that are either inefficient or unable to achieve sustainable scale.
- The benefits to these retailers will arise from the other services and propositions we would expect these providers to be able to offer as a result of access to premium content. These benefits are difficult to quantify with certainty, but are likely to be significant.
- In addition, our remedy should allow these retailers to compete effectively in the retail of wider bundles including non-TV services.

1.53 **Sky** should benefit in a static sense from the expansion of its wholesale revenues. Likely increases in wholesale customer numbers across all platforms should more than offset any loss in retail customers on its own platform and the reduced wholesale price we are setting:

- We acknowledge that Sky will not regard the remedy as positive, or it would not have been necessary for us to impose it. We believe however that Sky's opposition is driven by two strategic incentives – to protect its retail business on its own platform(s), and to reduce the risk of stronger competition for content rights. To the extent that our remedy enhances competition between retailers on different platforms, and enhances competition for content rights, we believe these would be positive outcomes.
- We do not however believe that the remedy will be disruptive to Sky's existing business. The expected static effects on Sky include increased wholesale profits, a slight upfront reduction in wholesale revenues from Virgin Media, a reduction in satellite retail profits from customers switching to other platforms, plus the impact of Picnic (should Sky want to pursue this proposal). In terms of Sky's overall producer surplus (its total five-year profits in both retail and wholesale, discounted to present value), this is likely to translate into a net increase for Sky of more than £600m over five years.
- We acknowledge that Sky will have to bear some administrative cost of implementation, but given that this remedy largely extends the existing cable wholesale arrangement to other platforms, this cost should not be substantial.

1.54 **Rights-holders.** Our remedy has been deliberately designed to minimise the effect on the content rights held by sports bodies. For example, one of our key decisions – to use retail-minus pricing rather than cost-plus – has been influenced precisely by the desire to minimise the impact on the underlying rights, despite the other merits of cost-plus relative to retail-minus:

- The most important competing bidders for sports rights in the past have been companies that will not take up the wholesale must-offer – free-to-air broadcasters such as the BBC, ITV, C4 and Five, and broadcasters such as ESPN and Setanta whose primary focus is on building their own wholesale business. These companies' incentives to bid are largely unaffected by our remedy.
- The incentives of platform operators / retailers such as BT and Virgin Media may be somewhat altered by the availability of our remedy. We do not however expect this to have a negative impact on rights values. Key rights holders have acknowledged in their responses to us that these companies have not historically been prepared to make significant investments in sports content, a position which is consistent with our own review of all the significant sports rights auctions in recent years.
- Our review of recent auctions indicates that there are likely to be additional determinants of Sky's bidding strategy, over and above the presence of competing bidders: first, its stated intention to invest in the quality of the sports content it buys, which in turn increases the attractiveness of the channels; second, the option for rights holders to go direct to consumers themselves, which provides a competitive constraint on Sky's bidding strategy.
- Sky already pays substantial sums for premium sports content at the same time as supplying its premium channels on a wholesale basis to cable operators. An important difference between the terms of current supply to cable operators and the terms of our remedy are the prices we have set. These prices are precisely intended not to damage Sky's ability to bid the sums it currently pays – hence the use of retail-minus pricing (i.e. where wholesale prices are worked out from the retail price rather than from wholesale costs), with a cross-check to ensure that we are not pushing prices below a cost-based price which includes a fair return on investment. As noted above, we believe that Sky's overall wholesale revenues, taking account of market expansion effects, are more likely to increase than decrease.
- The prices we have set for wholesale sports channels are unlikely to allow other retailers anything above a normal return in retailing those channels. As a result, although operators can avoid risk by taking Sky's channels, the real economic returns are at wholesale level. This, in addition to the importance of control over editorial decisions and branding, underlines why not only will Sky have an incentive to continue to bid in order to retain control over the rights, but also other operators such as BT or Virgin Media should have an incentive to gain control over the rights upstream rather than being content in the long term with wholesale access.

Scope of the wholesale must-offer remedy: Sky Sports 1 and 2 in both standard and high definition

1.55 Having decided that a wholesale must-offer obligation is appropriate to ensure fair and effective competition, there are a number of important questions of scope that

we have considered. In each case we have assessed the proportionality of the options, as part of our impact assessment:

- The channels covered by the remedy will be Sky Sports 1 and 2. We believe that neither Sky Sports 3 nor 4 make a material contribution to Sky's market power, given the range of content currently shown on these channels, and that access to these channels is not therefore necessary to ensure fair and effective competition.
- We recognise the risk that a potential response to the remedy from Sky could be to attempt to undermine it by shifting content onto channels not covered by the remedy. If Sky were to do this to any material extent, we would need to review the remedy and consider extending it to all of Sky's sports channels. This would not require a protracted consultation process, since the substantive issues would be the same as those on which we have concluded in this statement.
- The wholesale must-offer obligation should not extend to retailers on Sky platform(s). We are concerned about ensuring fair and effective competition between retailers on different platforms, leading to choice and innovation on non-Sky platforms, and the development of new platforms. Extending the remedy to Sky's own platform(s) would not address this concern, and could be disruptive to Sky's existing business and customers.
- We want to avoid interfering with Sky's existing platform(s), but this does not mean we expect Sky to be the sole retailer of premium content across entire distribution technologies. The remedy therefore extends to non-Sky satellite platforms such as Freesat. Similarly, if Sky develops its own IPTV or internet-based platform, we would still expect other such platforms to be included within the scope of the remedy, subject to appropriate security provisions. In particular, Sky should not expect to be the sole retailer of premium channels on any future platforms based on Project Canvas⁵.
- Virgin Media is in a different position to prospective entrants, in that it already has a number of premium subscribers. We have therefore considered whether it should be included within the scope of the remedy, and receive the same wholesale price. We conclude that it should, taking account of the need to avoid distorting the market, and the fact that Virgin Media's current scale is closer to that of entrant retailers than that of Sky. Indeed, Virgin Media has not yet reached anything like the scale of premium subscriber base that we assume in our pricing model to be necessary for a hypothetical new entrant to break even.
- The wholesale must-offer obligation will not include supply for onward retail to commercial premises. The nature of competition in pubs and clubs is very different from that for residential consumers, focussing on the price of standalone sports rather than pricing and innovation across wider bundles. This is reflected in the concerns brought to us by bodies such as the Association of Licensed Multiple Retailers, which focus on price, and is illustrated also by the low level of interest in supply to commercial premises shown by other retailers. A retail-minus wholesale must-offer is the wrong remedy to deal with any concern about the absolute level of retail prices. We do however consider that this is an issue that may be relevant to a future analysis of the sale of Premier League rights.

⁵ Project Canvas is a proposed joint venture between the BBC and various other operators, intended to combine broadcast content with broadband content, delivering both through the television.

- The wholesale must-offer remedy will apply to high-definition versions of the included channels. High-definition is increasingly important to effective competition, and a remedy which excluded it would become ineffective over time. Sky has suggested that including high-definition in a wholesale must-offer remedy would damage innovation. We do not believe that including high-definition would be damaging to innovation in the way Sky suggests. However, because high-definition is a relatively recent innovation and there is a degree of uncertainty as to the appropriate approach to setting a price, we have decided not to set a price for supply of these channels. Setting prices might bring about supply faster, but doing so particularly in relation to a relatively new service such as high-definition might risk harming incentives for future innovation. Instead we have included an obligation for supply to be on a fair, reasonable and non-discriminatory basis. This should allow scope for commercial negotiation, with the possibility of bringing a complaint to Ofcom as a backstop.
- The wholesale must-offer remedy covers further primary content, i.e. matches or sports events, shown via the red button, which is associated with the included channels. We would expect viewers of the included channels to have access to the same range of primary content regardless of which platform they use. However, in recognition of the additional technical requirements of delivering interactive content, we would expect the retailer to bear any incremental costs to Sky of delivering interactive content.

1.56 We expect to start a review of the obligation no later than three years from when the wholesale must-offer remedy comes into force. We would expect a review primarily to focus on establishing whether there had been any areas of material change, such as a major change in the ownership of key rights. If we saw major change in the market, we would carry out a full review of the remedy. Otherwise, our analysis indicates that Sky's market power appears to be enduring, and the remedy is not designed to remove that market power.

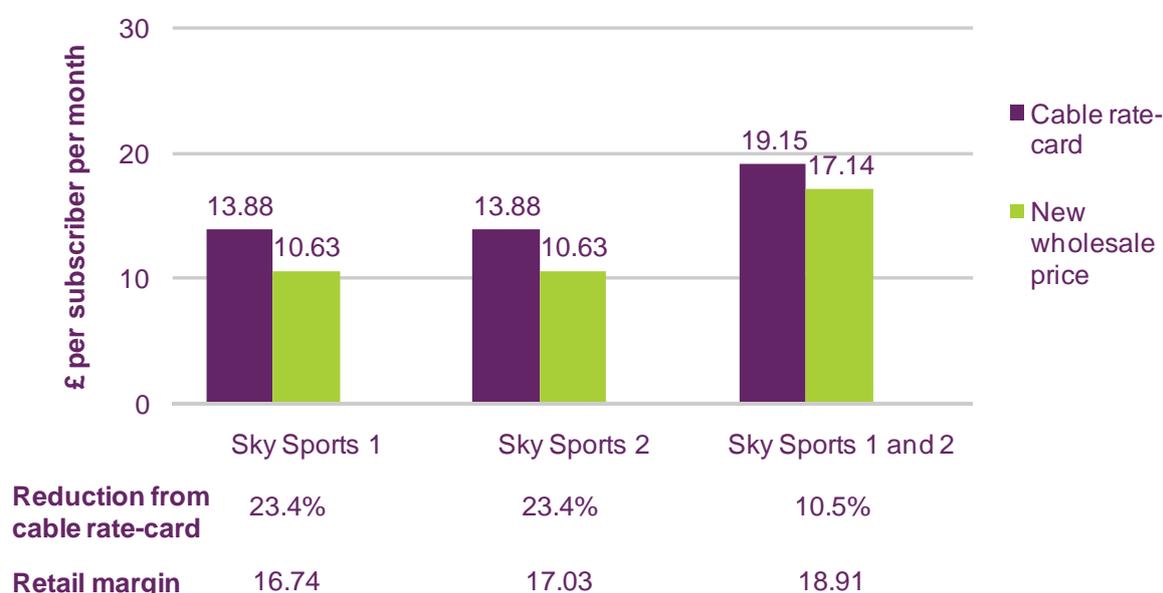
Terms of the wholesale must-offer remedy: wholesale price for Sky Sports 1 and 2 10.5% below the current cable rate-card when sold as a bundle, and 23.4% when sold standalone; non-price terms to ensure rapid implementation

- 1.57 We need to ensure that the wholesale must-offer remedy is implemented in a way that ensures effective competition in as short a time as possible.
- 1.58 Given the history of fruitless discussions between Sky and other retailers, we think the regulated offer should deal with all contractual terms. In particular, we believe it is necessary to set prices for standard definition versions of the channels included in the remedy. As both our review of wholesale negotiations between Sky and potential customers and our own discussions with Sky indicate, even if Sky were to negotiate in earnest, it would be unlikely to diverge from the cable rate-card.
- 1.59 The rate-card appears to be set by considerations relating to the Office of Fair Trading's 2002 margin squeeze test, rather than by commercial considerations. Despite the fact that Sky could increase wholesale revenue by selling to more retailers at a reduced wholesale price, it does not do so. As our pricing analysis and our analysis of Sky's own business plan for Picnic show, relying on the current cable prices would not ensure fair and effective competition, as retailers with smaller scale than Sky's would not be able to compete effectively.

- 1.60 We have revisited our pricing analysis since our Third Pay TV Consultation, in light of consultation responses and made some updates to reflect the latest available data. We have decided to adopt the same underlying approach towards pricing:
- We have derived retail-minus prices by considering a discounted cashflow analysis. We have determined the wholesale price that an efficient retailer could afford to pay given efficient retail costs and the need to earn a return, while at the same time matching Sky's current retail prices. We have stayed as close as possible to Sky's own costs, as the best available proxy of an efficient competitor.
 - The analysis we have carried out is to consider the characteristics of a hypothetical entrant, not in order to pre-determine what will happen in the market, but in order to establish a price which will ensure that an efficient generic company is able to compete fairly and effectively.
 - The prices we have set discourage entry by companies simply reselling Sky's channels; rather they require entrants to innovate around the channels in order to build a successful business.
 - We cross-check these retail-minus prices against cost-plus figures, also based on a discounted cashflow analysis, by determining the price that Sky's wholesale business would need to charge to earn a reasonable return given its input costs.
- 1.61 We have derived prices for competitors that would be as efficient as Sky at equivalent scale, but do not have the same scale as Sky. Given the number of subscribers Sky has built up, there is not room in the market for more than one firm to have the same scale as Sky currently has. Therefore any remedy which sets out to ensure fair and effective competition has to allow for smaller scale. However, our approach is also designed to avoid the costs of market entry by firms that are either inefficient or unable to achieve sustainable scale.
- 1.62 Within this overall approach, we have made some changes to ensure that the remedy is appropriate. Our Third Pay TV Consultation set out a range of principles concerning price, and the central case of our illustrative scenarios assumed three million subscribers on digital terrestrial TV. We have updated our modelling to include more up-to-date data. Our decision on price reflects satellite transmission costs rather than digital terrestrial TV, and a subscriber base of 1.5 million rather than three million. The reasons for this change are as follows:
- All parties (including Sky in the context of our impact assessment) argued that our original scale assumption of three million subscribers for the competitor was unrealistically high. The effect of reducing this scale to 1.5 million subscribers is, in the presence of fixed costs, to increase retail costs per subscriber and hence reduce wholesale prices.
 - Our overall aim is to stay as close as possible to Sky's own costs, as the best available proxy for an efficient retailer, while still allowing for market entry on non-Sky platforms, notably via digital terrestrial TV. In our Third Pay TV Consultation we therefore took account of the higher transmission costs of digital terrestrial TV. We have now decided that this is not necessary in order to ensure fair and effective competition, given the lower customer acquisition costs associated with digital terrestrial TV platforms in the absence of satellite dish and installation costs. We therefore derive prices based on Sky's own costs for satellite transmission.

- 1.63 It is clearly beneficial to consumers for competing retailers to be able to use the same wholesale input to offer differentiated retail services, thereby allowing for innovation in retail packaging, rather than for all retailers to be constrained to adopt Sky’s pricing structure. We have therefore concluded that competing retailers should be able to develop their own retail service enhancements, without paying an additional wholesale charge, subject to them using the same underlying wholesale input. Consistent with this, we have included in our derivation of wholesale prices the retail revenues and costs generated by Sky from such services, specifically Multiroom services. The effect of this is that competing retailers will be able to add Multiroom services at zero incremental cost, and offer and price those services in a manner that best complements their overall proposition to retail customers.
- 1.64 The figure below shows our final wholesale prices, based on our updated calculations. We have set prices for three products: Sky Sports 1, Sky Sports 2, and the bundle of Sky Sports 1 and 2. These are the prices that we consider are necessary to ensure that other retailers are able to compete fairly and effectively.

Figure 1 New wholesale price for Sky Sports 1 and 2



Source: Ofcom

- 1.65 The reduction relative to the rate-card is greater for single channels than for the bundle of Sky Sports 1 and 2. This reflects the fact that the Office of Fair Trading’s margin squeeze test, by reference to which Sky appears to set its prices, is carried out at an aggregate level, giving Sky the freedom to set prices for some bundles high and some lower. Relatively speaking, the current wholesale prices seem to be higher for single channels than the bundle, leading to a greater reduction. Setting specific wholesale prices for each bundle allows competing retailers to be able to choose what types of retail package they wish to offer, and potentially differentiate these from Sky’s, in order to ensure fair and effective competition.
- 1.66 Wholesale prices will track changes in retail prices over time based on a constant absolute (pounds) margin between retail and wholesale prices. We have decided not to adopt the ‘ratchet’ approach, of automatic downward changes but upward changes having to be approved by Ofcom. We suggested this in our Third Pay TV

Consultation, but have now decided that this would involve both excessive asymmetry and uncertainty.

- 1.67 We have put in place wholesale pricing rules to ensure competitors can replicate Sky's broader bundles which contain Core Premium Sports channels, recognising that many consumers now buy TV broadband and telephony as part of a wider bundle.
- 1.68 We require Sky to make available a 'reference offer', including Minimum Security Requirements for wholesale supply within six weeks of the new licence condition coming into force, which is on the day of publication of this statement. Six weeks is reasonable given the existing contract with Virgin Media and progress made on contracts with other operators.
- 1.69 The purpose of requiring a reference offer and Minimum Security Requirements is to minimise the amount of time it takes from the licence condition coming into force until other retailers are able to start taking wholesale supply from Sky and competing in the retail market:
- **Reference offer.** The purpose of the reference offer is to maximise the transparency of wholesale supply arrangements for prospective customers. Given the length of time over which Sky has engaged in negotiations with other retailers in the past, it is likely that allowing Sky to negotiate bespoke terms with each wholesale customer from scratch would introduce an unacceptable amount of delay into the process.
 - **Minimum Security Requirements.** Apart from price, the main issue that has prolonged the process of negotiations between Sky and other retailers is platform security. It is absolutely legitimate for Sky to want to ensure that its channels are broadcast securely, but again this should not be used as a reason unduly to prolong wholesale discussions.
- 1.70 Our intention is not to attempt to set non-price terms ourselves, but to leave as much as possible to be decided by Sky in negotiation with its customers. We acknowledge however that this may prove impossible. As a backstop, Ofcom is prepared to resolve any complaints in a timely manner, in order that consumers can benefit as quickly as possible from our remedy.