



Extracts from the Pay TV Statement

Annex 7 to Premium pay TV movies –
Market investigation reference to the
Competition Commission

This is the non-confidential
version. Confidential information
has been redacted. Redactions
are indicated by [X].

Publication date:

4 August 2010

Contents

A7.1 In this Annex we present key extracts from the Pay TV Statement¹. They are:

- Paragraph 4.89;
- Paragraphs 4.157 to 4.182;
- Paragraphs 5.42 to 5.45;
- Paragraphs 5.47 to 5.59;
- Paragraphs 5.519 to 5.573;
- Section 6, Annex 4 appendix 8, Annex 5;
- Paragraphs 7.59 to 7.171; 7.190 to 7.201; 7.210 and 7.219 to 7.233;
- Paragraphs 7.235 to 7.238; 7.246 to 7.259; 7.262 to 7.290;
- Paragraphs 7.291 to 7.312;
- Paragraphs 8.47 to 8.102, 8.106 to 8.109 and 8.113 to 8.114; and
- Paragraphs 8.187 to 8.218.

¹ Minor referencing errors have been corrected.

4.89 We said that each of these forms of vertical integration may enable firms to exploit synergies between different layers of the value chain and therefore deliver efficiency improvements. Examples include:

- Vertical integration between retail and wholesale platform operations may ensure a close fit between the requirements of consumers and the technical platform offering.
- Vertical integration between retail and wholesale content markets may allow content to be more closely tailored to consumer preferences.
- A wholesale channel provider which is vertically integrated with an incumbent retailer may have an informational advantage because its improved understanding of consumers' willingness to pay allows it better to assess the value of the content rights that it bids for.
- Vertical integration either between retail and wholesale platform operations, or between retail and wholesale content markets, may avoid the efficiency loss associated with 'double marginalisation'. This efficiency loss may arise when a retailer purchasing content from a third-party wholesale channel provider does not see the true marginal cost of supplying content to individual consumers, which is close to zero, but instead sees a per-subscriber wholesale subscription charge. Thus, the retailer's incentive to make the content widely available is weakened. As a result, the retailer is likely to set higher retail prices and may be discouraged from promoting / advertising the channel. In contrast, a vertically integrated retailer sees the true marginal cost of content.
- Vertical integration of content origination and wholesale channel provision may avoid the transaction costs associated with negotiating agreements to supply both content rights and the rights to market and assemble a channel using the content originator's brand.

The future of the UK pay TV sector

4.157 This Section sets out potential future developments for the UK pay TV sector, looking at a five-year timeframe and beyond. It considers the implications for content, distribution, devices and consumption habits and follows on from our views in the consumer effects Section of our Third Pay TV Consultation. In that document we identified:

- Steady growth in analogue pay TV services during the 1990s, on both satellite and cable, driven by access to premium content, and in particular the acquisition by Sky in 1992 of exclusive rights to live Premier League football.
- The migration from analogue to digital at the end of the 1990s, greatly increasing the range of content and value-added services that could be delivered to subscribers.
- Over the last five years, continued growth of Sky's satellite service and of Freeview, alongside very limited growth on cable. The key dynamic in recent years has been between Sky, driving growth in pay TV, and Freeview, driving growth in free-to-air multi-channel TV.

4.158 We then identified the need to take a forward-looking approach to understanding how the market is likely to develop, taking into account such issues as:

- The consolidation and restructuring of the historically fragmented UK cable industry under the Virgin Media brand.
- The emergence of new platforms for delivering pay TV services (BT Vision, Top Up TV, TalkTalk TV) based on new distribution technologies.
- The emergence of new platforms for the delivery of multi-channel free-to-air services; some of these also have the potential to deliver pay TV services (e.g. Freesat, the proposed Canvas service).
- The intervention by the European Commission to change the way in which Premier League football rights are sold. The 2007 / 08 football season was the first since 1992 for which Sky has not owned these rights exclusively.
- The increasing importance of convergence and the bundling of pay TV services with broadband and voice services.

4.159 To help frame various forward-looking scenarios we pointed to research by consultants Deloitte, which was carried out as part of Ofcom's ongoing strategic thinking. This research outlined seven different scenarios built around how the audiovisual markets could develop in the future. They ranged from scenarios in which there was little change to scenarios where there were more marked changes in technology, uptake of devices and changes in consumer behaviour.

4.160 This Section provides a more detailed overview of the UK pay TV sector and in doing so focuses on current trends and developments that could take place in the future based on a range of indications. The audiovisual industry is undergoing significant change in large part influenced by the widespread availability of broadband and related technologies coupled with changing consumer habits.

Current trends

4.161 While it may be difficult to accurately assess how a sector will develop over a longer time horizon, current trends can offer useful indicators to future behaviour and developments.

4.162 Current observations of the UK audiovisual sector suggest:

- There remains a strong appetite for watching TV and viewing levels on the whole are increasing⁹⁸.
- Consumers are demonstrating an appetite for enhanced viewing experiences. At the end of 2009, around 3.5 million homes had the reception equipment – set-top boxes and integrated digital televisions – capable of accessing HDTV channels and on-demand content⁹⁹.
- Content consumption habits are changing as on-demand services become more widespread. Such services enable consumers to take increasing control of their viewing through applications like DVRs or VoD (more than half of Virgin Media digital TV customers – 58% – regularly used VoD, including catch-up TV, at Q4 2009, up from 47% at Q4 2008¹⁰⁰).
- New technologies are becoming more robust. For example, increased broadband speeds and availability, coupled with more advanced delivery techniques, are enabling consumers to watch high-quality video over the internet: 23% of adults with home internet watch online catch-up TV, up from 17% a year earlier (Ofcom Communications Market Report 2009¹⁰¹).
- Portability and transferability are likely to become more important to consumers as they watch and listen to content on a greater range of devices. This is already being seen, in part helped by the take-up of devices such as Apple's iPod and iPhone.
- More consumers are buying pay TV services as part of bundles of communications services. In Q1 2009, 34% of UK adults that claimed to buy a bundle of services bought a three-product combination of TV, broadband and fixed-line telephone, up from 12% in 2005¹⁰².
- 'Hybrid' models are becoming more common, whereby different technologies are combined to create more advanced products and services. For example, combining broadcast and broadband distribution technologies in one device to offer both linear and non-linear programming. Figure 23 describes some of the hybrid devices currently available in the UK.

⁹⁸ <http://www.ipa.co.uk/content/IPA-publishes-Q4-2009-Trends-in-TV-Report>

⁹⁹ See Figure 13, UK homes with linear HDTV channels.

¹⁰⁰ <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MzMzMjI8Q2hpbGRJRD0tMXxUeXBIPtM=&t=1>

¹⁰¹ <http://www.ofcom.org.uk/research/cm/cmr09/>

¹⁰² <http://www.ofcom.org.uk/research/tce/ce09/research09.pdf>

Figure 23 Overview of selection of hybrid devices available in the UK

Service	Operator	Description	Hardware cost	Other costs
BT Vision	BT	TV service offering linear channel over DTT and on-demand content via IPTV	From £15	Minimum price £14.99 p/m (plus cost of broadband)
Connected TVs	Cello, Sony, LG and others	TV set with broadband connection for 'over-the-top' (i.e. unmanaged) online VoD content such as as YouTube and BBC iPlayer.	Cello TV set from £499	-
Fetch TV	IP Vision	DTT receiver with broadband connection for 'over the top' VoD. Has deal with Sky Player for premium channels and VoD.	£129.99 – £219	PPV and subscription required for Sky content.
Apple TV	Apple	Digital media receiver that plays content from iTunes store, selected websites and owner's PC	From £219 (for 160 GB)	Pay-per-view (from £1.19)
Xbox 360 Live	Microsoft	Games console offering on-demand capability through Xbox live network. PPV films and Sky Player premium channels available	From c. £150	PPV from c. £2.10. Subscription required for Sky content.
PlayStation 3	Sony	Games console with optional DTT tuner (Play TV) and DVR. VoD content from PlayStation network	From c. £249.99	Pay-per-view from c. £2
Slingbox	Sling Media	TV streaming and 'placeshifting' device that allows users to stream content remotely to a PC or mobile device	From c. £69.99	-

Source: Ofcom, operators

4.163 We have also assessed what consumer benefits these developments and innovations could bring. These include:

- Quality, as consumers are adopting enhanced viewing experiences in greater numbers, such as HDTV, and in the future, potentially 3DTV.
- Choice, where developments in technology or packaging can offer a greater range of products and services for consumers.
- Convenience, where products and services offer greater ease of use and control over viewing.

4.164 We have considered whether there is fair and effective competition by reference to the following ¹⁰³:

- Choice of platform and content:
 - Choice for consumers of platform and of content once platform selection is made.

¹⁰³ Third Pay TV Consultation, paragraph 7.8.

- 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.

4.165 Figure 24 looks in greater detail at the changes in the pay TV and related audiovisual sectors that are already happening and those that are likely to take place given announcements by industry. We have also categorised these developments around the three key consumer benefits of quality, choice and convenience.

Figure 24 **Developments in the UK pay TV sector**

Benefit	Topic	Development	Prospects
Quality	HDTV	Availability of HDTV across new platforms increases, driven by improvements in transmission and compression (for example, DVB-T2, S2, C2 and MPEG-4), analogue switch off (DTT/cable), fibre deployments and growing HDTV demand.	Happening already
	NGA	Next generation access (NGA) will facilitate the delivery of more bandwidth-dependent services such as TV, HDTV and VoD over broadband and IPTV connections.	Happening already
Convenience and choice	Advanced TVs / receivers	A shift towards hybrid devices drawing on different technologies to provide a range of linear and non-linear services. Increasing numbers of broadband-enabled TVs will become available.	Happening already
	Advanced TVs / receivers	The ability of content producers/aggregators to reach consumers will not be limited by access to traditional distribution and spectrum (some games consoles, Fetch TV and services like SeeSaw and the proposed Project Canvas).	Happening already
Convenience	VoD	Increasing availability of on-demand services available on the television as availability of two-way connectivity grows.	Happening already
	Content mobility	More sophisticated mobile devices with larger screens and greater storage capacity will become widespread, resulting in more content consumption.	Happening already
Choice	Content provision	More companies deliver audiovisual services to consumers as the barriers to entry to distribute content fall away.	Happening already
Quality	3DTV	A move towards 3DTV. BSkyB plans to launch 3DTV in 2010 and manufacturers have committed to produce 3DTV sets.	Very likely
Convenience	DVRs	Greater local storage in the home as hard drives on DVRs increase in size and as take-up of 'media centres' grows.	Very likely
	Content portability	Content will be increasingly moved around the home as content sharing technologies become mainstream (DLNA and DTCP).	Very likely
Convenience	Content mobility	Widespread availability and take-up of WiFi/WiMax/LTE drives greater use of wireless applications and services.	Very likely

Source: Ofcom

International examples

- 4.166 In previous consultation documents we have drawn on international examples to understand how different pay TV markets operate¹⁰⁴, as well as earlier in this Section when assessing the role of premium content in pay TV. Looking beyond the UK market can also help in a defining a forward-looking assessment of pay TV.
- 4.167 Despite significant differences in many cases, some international markets can offer indications of how particular technologies and sectors can develop. One of the more

¹⁰⁴ First Pay TV Consultation, Annexes 9 and 16, and Second Pay TV Consultation paragraph 3.62 to 3.86.

recent technologies to see notable take-up in some markets is IPTV, which enables the delivery of television channels and on-demand programming over a broadband network rather than traditional infrastructures such as terrestrial, satellite or cable.

- 4.168 In the UK, IPTV has seen limited take-up even though it was among the first countries in which such platforms were launched. There are currently around 50,000 subscribers to the TalkTalk TV¹⁰⁵ service, while 436,000 customers had BT Vision at Q3 2009, which offers VoD over the broadband network and live television channels through the DTT service Freeview. IPTV appears to have seen reasonable take-up in markets where it has had access to a wide range of content. At Q3 2009, the top ten operators in Western Europe, using a measure of subscriber numbers all offered some form of premium sports or movies channels.

Figure 25 Top 10 IPTV operators in Western Europe, by subscriber numbers

Service	Operator	Country	Subscribers	Premium channels
1. Freebox TV	Iliad	France	3,689,000	Canal Plus
2. Orange TV	France Telecom	France	2,006,000	Orange Sport and Film, Canal Plus
3. Neuf TV	SFR (Vivendi)	France	1,685,000	Canal +
4. T-Home Entertain	Deutsche Telekom	Germany	678,000	Domestic football
5. Imagenio	Telefonica	Spain	654,000	Gol TV
6. Belgacom TV	Belgacom	Belgium	575,000	Domestic football
7. BT Vision	BT	UK	436,000	ESPN, not Sky
8. Alice Home TV	Telecom Italia	Italy	405,000	Sky, football club channels
9. Telia Digital TV	Telia	Sweden	367,000	From MTG
10. Meo	Portugal Telecom	Portugal	289,000	From Zon

Source: Screen Digest, Ofcom. Subscriber numbers as of Q3 2009.

- 4.169 Telefonica's Imagenio IPTV service in Spain added 44,721 subscribers in Q3 2009, to reach 654,255. The company attributed the increase to a 'much-improved content offering after football channel Gol TV' – which broadcasts Spanish football matches – and was added to the platform's family package in the summer of 2009¹⁰⁶.
- 4.170 In Germany, Deutsche Telekom's Entertain IPTV service, which has acquired rights to domestic football, reported 885,000 subscribers at end of September 2009, up from a total of 257,000 a year earlier. The company offers live Bundesliga domestic

¹⁰⁵ <http://www.ft.com/cms/s/0/a76f1918-70ad-11de-9717-00144feabdc0,s01=1.html>

¹⁰⁶ http://www.telefonica.com/en/shareholders_investors/pdf/rdos09t3-ipp_dec_interm%20_eng.pdf

football after acquiring the rights to 612 first and second division games per season in November 2008¹⁰⁷.

- 4.171 While much of the growth of IPTV in France has been attributed to 'free' TV offered with a broadband subscription, Orange TV had attracted 596,000 subscribers to its premium sports and movies channels by Q3 2009¹⁰⁸. Other IPTV providers offer the premium sports and movies channels of Canal Plus.
- 4.172 IPTV and fibre-based broadband TV services have also seen reasonable take-up in other regions. In the US, there were 5.5 million subscribers at the end of Q1 2009¹⁰⁹. Some operators have adopted fibre technology to deliver a wide range of television services. Telecoms operators AT&T and Verizon began large-scale optical fibre network rollouts in 2006 (trials started in 2004).
- 4.173 Verizon's Fios TV, for example, offers up to 125 HDTV channels, Multiroom DVR functions and premium channels¹¹⁰. In June 2009, Verizon had 3.1 million FTTH subscribers, of which 80% had a TV subscription. At the same time, AT&T had 1.6 million subscribers on its fibre network, of which 99.5% were customers to its U-verse. AT&T had an initial target of 30 million homes passed by the end of 2010 (but this has now been pushed back a year)¹¹¹.
- 4.174 In the US, new entrants to the pay TV sector have benefitted from Program Access Rules, under which vertically integrated cable operators are required to provide channels in which they own 5% or more to competing platforms. The introduction of Program Access Rules in 1992 helped facilitate the entry of satellite broadcasters into the multi-channel TV market, and these have now gained sizeable subscriber bases. By 2008, IPTV/fibre platforms, which also benefit from Program Access Rules, were beginning to attract significant numbers of subscribers.

¹⁰⁷ <http://www.deutschetelekom.com/dtag/cms/content/dt/en/596270?archivArticleID=595952>

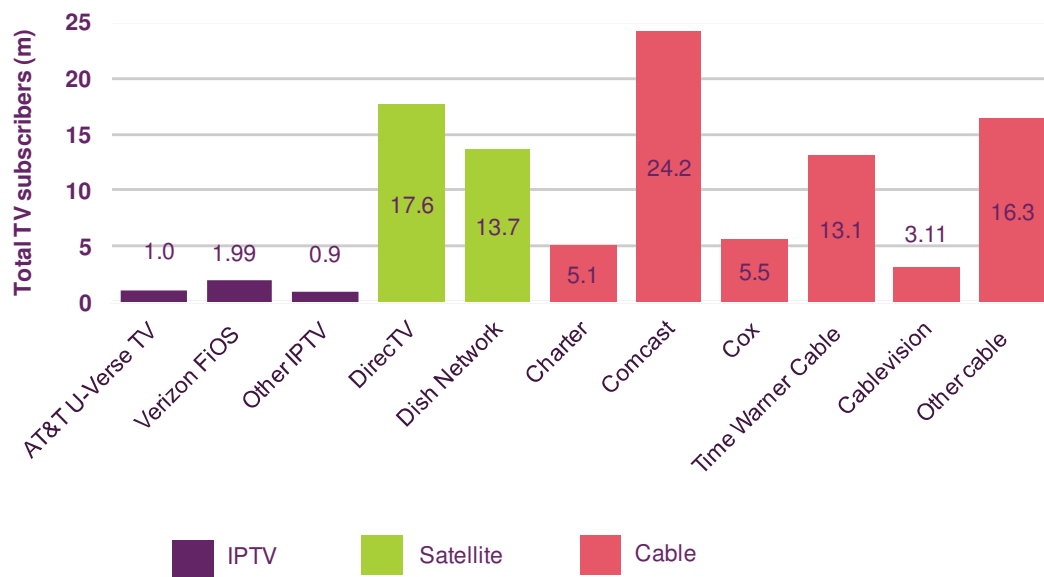
¹⁰⁸ <http://www.variety.com/article/VR1118010552.html?categoryid=14&cs=1>

¹⁰⁹ <http://www.screendigest.com/reports/10tvmarketmonitorq32009/pdf/RJAY-7ZPGPM/SD-2010-01-TVMarketMonitorIPTVQ32009.pdf>

¹¹⁰ <http://www22.verizon.com/Residential/FiOSTV/Details/Details.htm>

¹¹¹ IDATE FTTx Watch Service 2009.

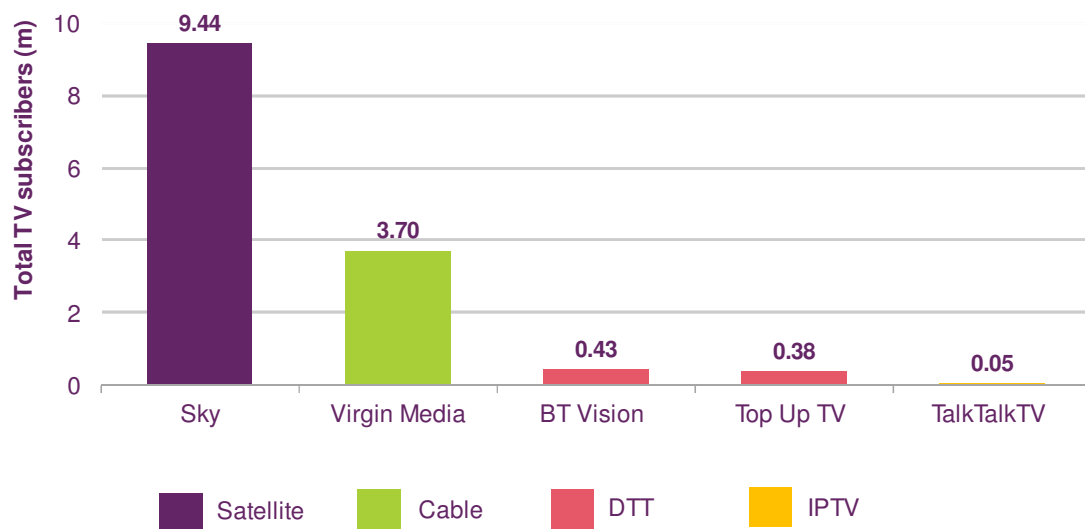
Figure 26 US multi-channel TV subscribers by platform, end 2008



Source: Informa Telecoms and Media

4.175 This compares to the UK, which is obviously a smaller country, but has far fewer operators, including only one broadcast IPTV operator.

Figure 27 UK multi-channel TV subscribers by platform, end 2009



Source: Ofcom

4.176 Some Asian markets have also experienced rapid growth in IPTV, especially in markets where 'super fast' broadband services are available. For example, South Korea reached one million IPTV subscribers less than a year after licensed platforms launched linear TV channels on their networks (some operators previously provided

only VoD on IPTV)¹¹². South Korea had the second-highest average advertised broadband download speeds globally in Q3 2008, at 81Mbit/s, behind Japan, with 93Mbit/s¹¹³.

Future developments

- 4.177 Within this context we have assessed the potential for future developments that could take place in the pay TV sector if there is fair and effective competition.
- 4.178 Figure 28 provides an overview of such developments, which draws on third-party analysis and commentary, future government policy and our own interpretation and understanding of sector trends¹¹⁴.

¹¹² <http://www.telecomskorea.com/market-7674.html>

¹¹³ http://www.oecd.org/document/54/0,3343,en_2649_34225_38690102_1_1_1_1,00.html

¹¹⁴ Credit Suisse research note, England vs Ukraine: the future of IPTV PPV?, December 2009; HSBC research note, DisContent, September 2009; Technology Trends in Converging Media Value Chains, Digital Public, 2009; Ofcom, Delivering Super-fast broadband in the UK, March 2009; Digital Economy Bill Final Report, June 2009.

Figure 28 Potential future developments in the pay TV sector

Benefit	Topic	Development
Choice	Market entry	Greater disintermediation of traditional broadcasters/platforms is seen. A recent note from Credit Suisse claimed that ‘the barriers to entry in the traditional broadcasting model of scarce bandwidth and platform have collapsed.’
Choice	Market entry	Access to attractive content, and on equitable terms, becomes important to a greater number and range of retailers of audiovisual services (for example, some new entrants such as Joost and Babelgum have encountered difficulties in securing access to high-end content).
Quality and convenience	Viewing	Decline in the number of linear channels (particularly time-shift ‘+1’s) as on-demand takes more prominence and as capacity is utilised for HD.
Choice	Standards	Standardisation of technology will bring economies of scale to new forms of distribution, such as the delivery of video over broadband to the TV.
Quality	NGA	High definition content sees widespread take-up via broadband as high-speed networks are launched.
Choice and convenience	NGA	Large scale investments in networks and infrastructure will be made to address a growing appetite for content on multiple devices.
Convenience	Mobile	Investments in infrastructure are made to allow broadcast content to be received on mobile devices.
Choice and quality	Spectrum	The allocation of ‘digital dividend’ spectrum could bring new opportunities, depending on the outcome of government review of what UHF spectrum is used for.

Source: Ofcom

- 4.179 In spite of these developments, we do not see that the appeal of premium sports and movie programming will diminish in the future. Indeed, such premium programming is expected to have enduring appeal across a range of platforms and devices. We believe that premium programming will form an important part of the service proposition of a new entrant. While technology and means of distributing content will evolve, some underlying characteristics of pay TV persist, particularly in terms of the types of content that are most attractive and therefore drive take-up.
- 4.180 Innovation can contribute towards greater consumer choice and, flowing from this, increased satisfaction among consumers and lower prices. These were explored in our First¹¹⁵ and subsequent Pay TV Consultations.
- 4.181 The UK pay TV sector has entered a phase where there is the potential for considerable innovation, facilitated by the emergence of new technology and

¹¹⁵ First Pay TV Consultation, paragraph 2.24.

changing consumer habits. There are several consumer benefits that these developments could bring: added quality of the viewing experience, wider choice of services, and added convenience.

- 4.182 However, innovation alone is unlikely to provide new entrants with a basis to prosper in the pay TV sector. As highlighted in this Section, sports and movies are the genres which stand out as being amongst the most valued by consumers, and also having a high degree of exclusivity to pay TV. Therefore, access to premium sports and movies channels, key drivers of take-up of pay TV, remains of vital importance to the competitive effectiveness of a pay TV business.

- 5.42 In assessing potential substitutes for market definition, it is appropriate to consider the preferences of **marginal** consumers, as Sky has argued. Marginal consumers are those who would be most likely to switch in response to a price increase.¹⁴⁵ Marginal consumers of a product are more likely than others to see other products as close substitutes, or to be willing to stop consuming the product without substituting.
- 5.43 However when analysing marginal consumers it should be borne in mind that:
- The identity of marginal consumers will depend on the price level: if prices are substantially above competitive levels, those consumers who would be marginal at competitive prices will not buy, while some consumers who would be infra-marginal (i.e. unlikely to respond to a price rise) at competitive prices may be marginal at higher prices. As a result, analysis of the preferences of marginal consumers is distorted if current prices are above competitive prices. At any given price level, some customers are likely to be marginal. A firm will only be constrained to the competitive price level if a sufficient number of customers are marginal at that price level.
 - Whether a subscriber is marginal or not will also depend on a range of other factors including whether other channels offer coverage of their favourite sports, their frequency of viewing, whether they also subscribe to premium movies channels, the preferences of others in the household, whether they are willing to watch sports in a pub or club, and their income.
 - As such, even if (for example) a proportion of Sky Sports subscribers are primarily fans of a sport which is extensively covered on other channels, it does not follow that all of this group of subscribers will be marginal. While they may be more likely (on average) to be marginal than fans of sports which are largely available only on Sky Sports, some or even most of them may be price-insensitive, whether because they can easily afford Sky Sports, or because they have a strong demand to see as much coverage of their favourite sport as possible, and so are not satisfied with FTA coverage.
- 5.44 We acknowledged the importance of focusing on marginal consumers in previous consultations¹⁴⁶. In assessing the extent to which other products are substitutes for packages including Sky Sports 1, we have had regard to the preferences of different groups of consumers (e.g. fans of different types of sport). However, crucially, marginal customers are defined by their propensity to switch in response to a price increase, and not simply by the availability on other channels of content which appears to match their preferences.
- 5.45 In particular, even if a particular group of customers is more likely than average to be marginal, it does not follow that **all** of the customers in this group should be seen as marginal. If customers in this group are relatively price sensitive, but account for a small part of the total customer base, it may be that the number of them who would switch in response to a price rise (above competitive levels) would be large as a proportion of that customer group, but too small a proportion of the whole customer base to make such a price rise unprofitable.

¹⁴⁵ See note 19 of OFT Market Definition Guidelines.

¹⁴⁶ For example, see Third Pay TV Consultation, paragraph 4.283 and Second Pay TV Consultation, paragraphs 4.189 and 4.192.

5.47 In fact, there are strong reasons to believe that the cellophane effect applies:

- Our analysis of product characteristics (discussed in paragraphs 5.195 to 5.289) indicates that Core Premium Sports channels are highly differentiated from their closest substitutes.
- The collective selling of rights on an exclusive basis, particularly in football, creates a barrier to market entry by any firm seeking to compete directly against Sky.
- Oxera's profitability analysis indicates that Sky in aggregate earns a return above its cost of capital and we conclude that Oxera's disaggregated analysis and our own analysis of cost-plus prices suggests that prices are above the competitive level for Sky Sports (see paragraphs 5.513 to 5.589 below). The collective selling of key sports rights, in addition to creating a barrier to entry, creates a further risk that the retail and wholesale prices of sports channels are above the competitive level, but that the benefits flow upstream to sports rights holders, rather than being retained by Sky.

5.48 Having a differentiated product (i.e. one with unique characteristics which are important to consumers) generally allows the provider to charge a higher price than would be possible if similar or identical products were available from other suppliers. The more differentiated a product is from its closest substitutes, the more scope its provider will have to set prices above competitive levels. With a limited degree of differentiation, prices may be close to their competitive levels. However, at the other end of the spectrum, the provider of a highly-differentiated product may be able to act as a monopolist¹⁵⁰."

5.49 Where products are differentiated, the focal product is generally supplied by a single firm. This is the case with the focal product we identify below (packages including Sky Sports 1), which is sold only by Sky at the wholesale level¹⁵¹. We would expect such a firm to set its prices at the profit-maximising level, such that further price rises would be unprofitable.

5.50 However, if we apply the HMT to this focal product, and take current prices to be competitive, then by asking whether a hypothetical monopolist could profitably raise prices above competitive levels, we are effectively asking whether the single firm that actually sells these products could profitably raise its prices above current levels. The answer to this question is likely to be "no", since if the firm could profitably raise its prices it would already have done so.

5.51 As such, we would expect any empirical study (or survey evidence) as to the likely effect of a price increase to indicate that a price rise would not be profitable. The result will be to indicate that the market is broader than the focal product, whether this is the case or not. In addition, even a qualitative assessment of consumers' willingness to substitute from a focal product, or Sky's views as to the strength of competition it faces, may be affected by Sky's Core Premium Sports channels being priced above competitive levels.

¹⁵⁰ This is distinct from cases where there are multiple providers of an undifferentiated product, and in which the current price can be taken to be competitive (e.g. in some merger cases).

¹⁵¹ At the retail level, the price is largely set by Sky, both directly as a retailer, and through its wholesale price to Virgin Media.

- 5.52 Even a moderate degree of differentiation can distort the outcome of the HMT¹⁵². However, the more highly differentiated a product is, the further prices are likely to be above competitive levels.
- 5.53 In view of these considerations, we remain of the view that the cellophane effect is likely to apply in this market, and that as a result we should not place weight on evidence of Sky customers being willing to switch in response to a price increase.
- 5.54 **Evidence that prices are above the competitive level.** For the reasons set out in paragraphs 5.513 to 5.589 below, which we summarise briefly here, we consider that it is likely that the wholesale and retail prices of bundles including Sky Sports, and those containing Sky Movies, are appreciably above the competitive level. This is supported by two pieces of evidence – Oxera’s analysis of Sky’s profitability and Ofcom’s pricing model – and, in the case of sports, reinforced by the collective selling of rights.
- 5.55 We consider Oxera’s work in further detail in paragraphs 5.519 to 5.573. In summary:
- Oxera’s work suggests that Sky has earned a return of 21% over the past five years (based on a truncated IRR, and also supported by ROCE)¹⁵³. This is around nine percentage points above its estimate of Sky’s cost of capital over the period¹⁵⁴. Previous findings by the CC and OFT suggest that this level of difference between Sky’s returns and its cost of capital is significant¹⁵⁵.
 - A disaggregation exercise by Oxera indicates that Sky earns a higher percentage return at the wholesale level than at the retail level.¹⁵⁶ Sky’s wholesale profitability appears higher than industry benchmarks, suggesting that Sky’s aggregate profitability is driven by its relatively high wholesale returns.¹⁵⁷
 - Oxera’s work also indicated that Sky earns higher margins on premium than basic channels.¹⁵⁸
 - Disaggregation of sports and movies channels is complicated as many subscribers buy both for a single package price. However, it appears that Sky

¹⁵² For example, suppose we wish to assess the effect of a 10% price increase. It may be that a price of 10% above competitive levels would be profitable (suggesting a narrow market), but that one of 12% would not. If current prices are already, say, 5% above competitive levels, and we apply the 10% HMT starting at this price level, we will find that a 10% price increase (to 15% above the competitive level) would be unprofitable (even though a price 10% above competitive levels would be profitable), and we may (incorrectly) infer from this that the market is narrow.

¹⁵³ See paragraph 5.545 below.

¹⁵⁴ See paragraph 5.548 below.

¹⁵⁵ See paragraph 5.549 below.

¹⁵⁶ Figure 67 below.

¹⁵⁷ See paragraph 5.559 below.

¹⁵⁸ Figure 68 below.

earns higher margins on movies services than sports services. Although margins for both are high.¹⁵⁹

- 5.56 In addition, the “cost plus” estimates derived from Ofcom’s pricing model provide an indication of the competitive price of Sky’s channels, although these are subject to assumptions about cost allocation and other assumptions. We find that Sky’s current wholesale prices are, on average, substantially higher than the prices generated by the cost plus approach.
- 5.57 Sky has argued¹⁶⁰ that we have not established that either the operating margin for its premium wholesale business, or wholesale charges for its premium channels, are high. It said this claim could not be based on Oxera’s analysis¹⁶¹ or our estimate of cost-plus prices. However, we consider that Oxera’s analysis shows that Sky’s wholesale prices are above the competitive level, and that this is corroborated by our pricing analysis.
- 5.58 The collective selling of sports rights gives rise to a further risk that the wholesale prices of packages including Core Premium Sports channels are above the competitive level.
- 5.59 We consider that high wholesale prices are reflected in retail prices (charged by Sky and Virgin Media) which are above the competitive level.

¹⁵⁹ Figure 69 below.

¹⁶⁰ September 2009 response, paragraph 7.4 and 7.12.

¹⁶¹ This referred to Oxera’s Report at Annex 9 to our Third Pay TV Consultation.

Oxera's analysis of Sky's profitability

- 5.519 In our Third Pay TV Consultation Document, we presented Oxera's assessment of Sky's profitability. This assessment informs both our understanding of current prices and, directly, our assessment of market power. Companies earning returns above their cost of capital for a sustained period may constitute evidence of barriers to entry and of the exploitation of market power through charging high prices to consumers⁵¹⁰.
- 5.520 Annex 3 sets out the conclusions of our assessment of Sky's profitability, informed by a second report we commissioned from Oxera, which is included in the Annex. The Annex sets out our position on profitability in the Third Pay TV Consultation; summarises the responses we received; describes the further analysis we and Oxera have carried out in order to address those responses and sets out our conclusions from this analysis. It also considers in more detail alternative measures of profitability such as total shareholder returns analysis, again in order to address consultation responses.
- 5.521 In its first report, Oxera also carried out an assessment of Sky's profitability at a disaggregate level. It considered specifically the profitability of Sky at the level of retail and wholesale, premium and basic channels and sports and movies channels.
- 5.522 Below we first summarise Oxera's results on Sky's aggregate profitability. We then summarise Oxera's work on disaggregating those results. Finally we set out the implications of this profitability analysis for our assessment of whether the retail prices of bundles including Sky Sports 1 and/or Sky Sports 2 are currently above the competitive level.

Sky's aggregate profitability

- 5.523 In assessing Sky's profitability at an aggregate level, Oxera used the truncated IRR methodology, in which the initial asset value is treated as a cash outflow and the residual value at the end of the period is treated as a cash inflow. We explained that in a competitive market with freedom of entry and exit, we would not expect the IRR to substantially exceed the cost of capital in the long run. An IRR substantially above the cost of capital could indicate the existence of barriers to entry and market power.
- 5.524 In our Third Pay TV Consultation we reported⁵¹¹ that Oxera's "aggregate profitability analysis suggests that... under the base case scenario the IRR ranges from 20% to 28%". Oxera also found that its estimates of ROCE supported the IRR results, particularly in the period 2004-2008.
- 5.525 We explained that the cost of capital was the relevant benchmark for Oxera's estimates of Sky's profitability under the IRR approach. Our forward looking cost of capital at the time was 10.3%⁵¹², which we also thought was a reasonable estimate of Sky's cost of capital in the last few years, including the 2004-2008 period. We observed that Sky's returns as measured using the IRR methodology were higher than its cost of capital, and we believed that this would continue if the pay TV sector was left unchanged.

⁵¹⁰ Annex 12 to Third Pay TV Consultation, paragraph 1.1

⁵¹¹ Third Pay TV Consultation, paragraph 6.186.

⁵¹² Third Pay TV Consultation, paragraph 6.193.

5.526 Annex 3 describes the responses we received on the issue of Sky's profitability and the conclusions from our analysis. Broadly:

- Several respondents agreed with the IRR approach used by Oxera and commented that it was conceptually appropriate in the context of a competition investigation. (See Annex 3, paragraphs 1.13-1.15)
- However, Sky, and its advisor Professor Grout, made a series of challenges to the profitability analysis and the conclusions that Ofcom drew. Sky's main challenges were that the IRR methodology was not appropriate; that its returns could be above its cost of capital as a result of its ongoing risk taking and innovation and that alternative measures of profitability (such as shareholder returns analysis) do not support a finding that Sky's returns have been abnormally high. (See Annex 3, paragraph 1.17)

5.527 We have commissioned Oxera to help us consider and respond to these comments. In particular, we asked Oxera to consider the relationship between Sky's returns and its cost of capital over a longer time period. To the extent that Sky's returns exceeded its cost of capital, we also asked Oxera to consider Sky's argument that this could be explained by its continuous successful risk-taking and innovation. This analysis is presented in Section 7.

5.528 We also asked Oxera to help us consider the challenges made by Sky and Professor Grout about the use of IRR in profitability analysis. Sky and Professor Grout suggested that the IRR is not well suited to assessing the question of whether returns are persistently and significantly above the cost of capital⁵¹³ and that there were issues with asset valuation which meant the IRR could be biased.⁵¹⁴ Sky also questioned the robustness of the IRR calculation.⁵¹⁵

5.529 As set out in Annex 3, informed by Oxera's second report, we consider the IRR an appropriate methodology for assessing profitability, and that the issues which Ofcom and Sky have previously identified with the use of IRR, such as the uncertainties associated with valuing intangible assets, have been reasonably addressed. We also note that the CC has previously used IRR analysis when assessing profitability.⁵¹⁶ We consider that Oxera's second report demonstrates that there is no evidence to suggest that the IRR estimates are biased due to issues with asset valuation or the choice of IRR as a measure of profitability.

5.530 We also consider in Annex 3 that the IRR calculation carried out by Oxera has undergone sufficient sensitivity testing and that the IRR estimate is reasonable, conservative, and towards the bottom of a potential range assessed over multiple time periods.

⁵¹³ Sky response to Third Pay TV Consultation, paragraph 4.45

⁵¹⁴ A report on profitability, September 2009 page 2.

⁵¹⁵ Sky response to Third Pay TV Consultation, Section 4 part C, page 53

⁵¹⁶ For example, in the classified directory advertising services market enquiry (2006). See Section A4.1 of Oxera's second report for more examples of the role of profitability analysis in competition investigations.

- 5.531 Sky / Professor Grout also carried out an assessment of Sky's profitability based on shareholder returns and concluded that "approaching Sky's profitability through this stock market evidence does not support a case that Sky is abnormally profitable."⁵¹⁷
- 5.532 In Annex 3 we explain that, informed by Oxera's second report, we do not think that an analysis of shareholder returns is an appropriate way to assess Sky's economic profitability. This is because shareholder returns can only measure returns based on shareholder expectations at two points in time, rather than the economic returns earned by Sky, which is the relevant measure for our competition assessment.
- 5.533 If high returns are already reflected in the share price at the first of these points in time, these will not be revealed by an analysis based on shareholder returns. As discussed in more detail below, there is evidence that Sky's subsequent high returns were largely already captured in its valuation at flotation.
- 5.534 An analysis based on shareholder returns also suffers from practical limitations related to the choice of appropriate time period and benchmark which means it is not a robust measure of returns.
- 5.535 In our Third Pay TV Consultation we included a chart which showed the value of Sky's asset base under different valuation approaches⁵¹⁸. This is shown in Figure 64 below, with values updated for 2009.

Figure 64 Value of Sky's asset base under different valuation approaches (£m)

[✕]

- 5.536 As noted in our Third Pay TV Consultation, Oxera said in its first report that "from flotation up to 2008, the estimated market value of Sky's assets was significantly higher than the estimated replacement cost value⁵¹⁹". It appears that the market perceived that the value of Sky's future cash flows would substantially exceed the underlying replacement cost of the assets. This illustrates the difference between IRR analysis and TSR analysis which is that IRR helps assess the relationship between prices and costs, while TSR captures the relationship between prices and expectations.
- 5.537 Professor Grout, on behalf of Sky, argued that because total shareholder returns since flotation had underperformed the market, this is evidence that Sky was not abnormally profitable. However, the reason why the IRR is greater than the TSR in Sky's case is because the value of the assets used in the TSR analysis is significantly greater than the value of the assets in the IRR analysis. This reflects the difference in what the two measures are capturing. TSR estimates returns to shareholders, so the asset value reflects the market value of assets, which is the NPV of present and future investments. The IRR on the other hand estimates returns relative to the costs incurred by Sky in building its asset base and uses the replacement cost value of assets.

⁵¹⁷ Sky response to Third Pay TV Consultation, paragraph 4.84

⁵¹⁸ Third Pay TV Consultation, Figure 58

⁵¹⁹ Oxera first report, page 26.

- 5.538 This observed difference between the market and replacement cost value of assets is consistent with the economic characteristics of Sky's investments. Oxera's report demonstrates that the costs to Sky of acquiring additional subscribers are significantly lower than the value of additional cash flows generated by these subscribers over their lifetime. Oxera says that its analysis shows that "it is reasonable to expect that the market valuation at flotation incorporated this significant expected difference between the lifetime cash flows of subscribers and their acquisition costs."⁵²⁰
- 5.539 Sky / Professor Grout also compared Oxera's estimate of Sky's ROCE to the ROCEs of firms previously investigated by the CC and concluded that Sky's book value ROCE appeared comparatively small⁵²¹. We explain in Annex 3 that we do not consider that this analysis is relevant to the assessment of Sky's profitability. Oxera points out that a "high ROCE based on historical cost asset values is not the only indicator that a company may be operating against the public interest. Therefore a strong relationship between the level of ROCE and the conclusions of the CC with respect to profitability would not be expected"⁵²².
- 5.540 Oxera also notes in its second report that the analysis does not attempt to control for factors that could reduce the comparability of ROCE as a measure of economic profitability between different competition cases. For example, Oxera's calculation of Sky's ROCE was based on a definition of capital employed equal to total assets rather than a common definition of capital employed which deducts current liabilities. Sky's calculated ROCE would have been considerably higher if current liabilities had been removed from the definition of capital employed – 45% over the period 2004-2008 rather than 29% excluding current liabilities⁵²³.
- 5.541 Finally, even if the ROCEs were all comparable and based on the same definition of capital employed, we do not agree with Professor Grout that the data implies that Sky's book value ROCE is comparatively small.
- 5.542 Sky, and its advisor PwC, also argued that Oxera's benchmarking analysis in its first report had no value because the comparators it used were not relevant⁵²⁴. In Annex 3 we note further benchmarking analysis from Oxera which suggests that the difference between Sky's ROCE and cost of capital is greater than 95% of the companies in the FTSE 350 Index over the period 2004-2008. Oxera's view is that this analysis addresses Sky's concerns around the choice of comparators.
- 5.543 We also note that Oxera's approach to selecting comparators in its first report is similar to the approach adopted by the CC in Classified Advertising Directory Services (see Annex 3, paragraph 6.5).
- 5.544 Overall we consider that the evidence on benchmarking supports the conclusions from our central analysis on Sky's IRR, which we set out below, although we recognise the difficulties with benchmarking of this kind.

⁵²⁰ Oxera second report, page 18.

⁵²¹ Sky response to Third Pay TV Consultation, paragraph 4.85.

⁵²² Second Pay TV Consultation, Annex 9, paragraphs 1.58 to 1.62 and 1.64.

⁵²³ Oxera second report, Section 3.5.

⁵²⁴ Sky response to Third Pay TV Consultation, paragraphs 4.79 to 4.83.

Have Sky's returns exceeded its cost of capital?

- 5.545 As in its first report, Oxera estimated Sky's returns using a truncated IRR methodology, with the ROCE being used as a cross check. Figure 65 shows the updated estimates of the IRR under the depreciated replacement cost (DRC) approach to valuing assets which Oxera used in its first report⁵²⁵. The values in this table range from 21% to 28%. In that report, Oxera explained its view that this is the conceptually appropriate approach to valuing Sky's assets.

Figure 65 Updated estimates of the IRR

Measure	1995-2009	1998-2009	2005-2009
IRR (DRC, year of investment)	✂	✂	✂
IRR (DRC, annual revaluation)	✂	✂	✂

- 5.546 The updated estimates suggest that over the past five years (2005-2009) under the base case DRC scenarios, the IRR was around 21%. This is marginally higher than the returns presented in Oxera's first report, where returns over the period 2004-2008 were around 20%. Oxera's updated estimates of Sky's ROCE support these IRR estimates, especially in the period 2005-2009⁵²⁶.
- 5.547 We asked Oxera to consider the difference between Sky's returns and its cost of capital (the 'profitability gap') since it floated on the stock exchange in 1994. Oxera has estimated IRRs for Sky in three different time periods and compared this to its estimate of Sky's average cost of capital over the period⁵²⁷.
- 5.548 Figure 66 shows estimates of the profitability gap between Sky's IRR based on DRC asset values and its average cost of capital over the corresponding period. Estimates of the profitability gap range from 8% to 15%.

Figure 66 Estimates of the profitability gap above Sky's cost of capital

Profitability gap	1995-2009	1998-2009	2005-2009
Base case	✂	✂	✂
Range	✂	✂	✂

- 5.549 The analysis supports our conclusion from the Third Pay TV Consultation that Sky is earning returns above its cost of capital. It suggests that the profitability gap over the last five years has been approximately nine percentage points, and that this observed difference is persistent over time.

⁵²⁵ See Section 3.3 and 3.4 of Oxera's first report

⁵²⁶ See Section 2.1 of Oxera's second report.

⁵²⁷ See Section 2.2 of Oxera's second report for an explanation of how it estimated the ex ante cost of capital. Annex 3 also shows the estimates of the profitability gap by calculating the cost of capital at the beginning of the period rather than the average.

5.550 In line with Oxera, we consider that the size of the observed profitability gap is significant. This conclusion is consistent with a number of CC and OFT cases which linked high returns with the nature of the competitive process. For example:

- In the classified directory advertising services market enquiry, the CC estimated Yell's profitability gap in the range -2% to 12% based on a comparison of truncated IRRs and ROCEs to the cost of capital. The CC said "we conclude, based on the truncated IRR estimates, that Yell's profits were high over the five years to 31 March 2006 and in excess of its WACC⁵²⁸."
- In the CC's inquiry into the supply of banking services to SMEs, it identified a profitability gap of 9%, 10% and 12% in 1998, 1999 and 2000 respectively for the four largest clearing groups and considered that this indicated excessive profitability. The CC said "In our view, such a level of excess profits is unjustified and must be regarded as excessive."⁵²⁹
- When the OFT assessed BSkyB's profitability in its 1996 inquiry, an "excess return" of 10.3% was considered high and, according to the OFT, could not be sustained in a competitive market⁵³⁰. Oxera's analysis suggests that this gap has indeed been sustained.

5.551 Evidence that Sky has a persistent and significant profitability gap based on the difference between its ex post returns (measured by the IRR) and its ex ante cost of capital is a strong indicator of the existence of barriers to entry. In a well-functioning competitive market, we would expect the entry of new firms to drive prices down and reduce returns. We therefore conclude on the basis of this evidence that Sky's profitability suggests that it benefits from significant barriers to entry, and that the prices of some of its products are above the competitive level.

Sky's disaggregate profitability

5.552 The IRR analysis described above relates to the aggregate profitability of Sky's business as a whole, rather than the profitability of particular products sold by Sky. It provides evidence that the average price charged by Sky, looking across all the products it supplies, is above the average of the competitive prices for all those products. In principle, those high prices need not relate to wholesale or retail bundles including Sky Sports 1 and/or Sky Sports 2; rather high prices could be concentrated in some other part of Sky's business.

5.553 In its first report, Oxera attempted to disaggregate its findings on profitability in order to provide an indication of the sources of aggregate level profitability. As part of this exercise, Oxera considered a number of different methods for allocating revenues and costs. Oxera's key conclusions of relevance to our assessment of the level of retail prices were as follows:⁵³¹

⁵²⁸ Competition Commission (2006), 'Classified Directory Advertising Services market investigation', December 21st, paragraph 7.110.

⁵²⁹ Competition Commission (2002), 'The supply of banking services by clearing banks to small and medium-sized enterprises: A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK', Volume 1 summary and conclusions, paragraph 2.490.

⁵³⁰ See for example Section A4.1 of Oxera's Second Report.

⁵³¹ Third Pay TV Consultation, Annex 9, page iii.

- Returns for Sky wholesale activities appear higher than for Sky retail activities. These results seem to hold under a number of cost allocation approaches and sensitivity checks.
- At the wholesale level, returns for premium channels appear higher than for basic channels. However, this should be interpreted with care, given the adopted allocation approaches.
- The evidence was not sufficiently robust to conclude on the profitability of movies and sports channels, although the analysis seems to provide some weak evidence that movies channels may have higher margins than sports channels⁵³².

5.554 Oxera's analysis suggested that returns for Sky's wholesale activities were higher than for Sky's retail activities. Figure 67 shows the results of this analysis for the period 2004-2008. This shows that returns based on IRR, ROCE and ROS were all higher for wholesale than for retail⁵³³.

Figure 67 Disaggregate profitability analysis between retail and wholesale, 2004-2008

Profitability based on Oxera high level cost allocation	IRR (annual revaluation)	ROCE	ROS
Retail	✂	✂	✂
Wholesale	✂	✂	✂

Note: Oxera expressed IRR figures to 1 decimal place and ROCE/ROS figures to no decimal places.

- 5.555 This analysis indicates that the significant profitability gap we identified for Sky as a whole from our IRR analysis is likely to be driven by returns from Sky's wholesale business. Consequently we consider that Sky's wholesale returns are high.
- 5.556 This conclusion is consistent with our understanding of the operation of the market described above: Sky determines the optimal retail price based on the demand conditions it faces. For its own retail consumers, it charges this price directly; for the retail consumers of its wholesale customers, it is able to enforce a higher retail price by setting a high wholesale price.
- 5.557 We then need to assess whether the wholesale profitability (and hence price) of premium channels is higher than for basic channels, and to consider any differences between sports and movies profitability.

⁵³² Oxera also stated that "[t]he evidence was not sufficiently robust to conclude on the relative returns on basic and premium channels at the retail level." This is not surprising given our understanding of the operation of the market – if the profitability of premium channels is effectively reflected in high wholesale prices, then there is no reason to expect that retail returns for premium channels would be materially different to basic returns.

⁵³³ Figure 67 shows the results based on Oxera's high level cost allocation. Oxera also cross checked these results with the detailed cost allocation analysis carried out by Analysys Mason and the results were similar. See Table 5.1 of Oxera's first report.

5.558 We consider first the split between premium and basic. In this case revenue allocation between premium and basic channels is straightforward, since Sky's wholesale prices and hence wholesale revenues for its premium channels exclude basic channels. For the allocation of costs common to basic and premium channels, Oxera adopted two alternative approaches⁵³⁴:

- "Cost Allocation Approach 1": Sky subscribers who buy basic and premium packages are treated as premium subscribers, and those who buy basic packages only are treated as basic subscribers. Common costs are allocated on a pro rata basis.
- "Cost Allocation Approach 2": all Sky subscribers were treated as basic subscribers. Those who buy basic and premium packages are also treated as premium subscribers. Common costs are allocated on a pro rata basis.

5.559 Oxera's analysis of the profitability of basic and premium channels suggested that, at the wholesale level, the profitability of premium channels was higher than for basic channels, and this relationship was consistent under different approaches to cost allocation. Figure 68 shows the results of Oxera's ROS analysis in the period 2004-2008. Its analysis of margins over direct costs was also consistent with these results, with margins on premium channels estimated at [X]% compared to [X]% for basic channels⁵³⁵.

Figure 68 Estimates of ROS for basic and premium channels, 2004-2008⁵³⁶

	Common cost allocation	
Wholesale ROS	Approach 1	Approach 2
Basic	X	X
Premium	X	X

5.560 Oxera also compared Sky's wholesale ROS to the wholesale ROS of industry benchmarks. The industry benchmarks were based on firms that, in Oxera's view, were the most appropriate comparators for Sky, although this meant that at the wholesale level, the number of comparators was limited to just two TV companies and two non-TV companies. The median return on sales from 2003 to 2007 for these companies was -0.6% for the TV comparators and 8.4% for the non-TV comparators. Sky's wholesale return on sales for the same period was [X]%. Oxera concluded:

"On balance, it would seem appropriate not to draw firm conclusions about Sky retail's profitability compared with the retail comparators. However, the evidence that Sky's aggregate profitability may be

⁵³⁴ For more details of these approaches see Section 5.3 of Oxera's first report.

⁵³⁵ See Table 5.3 of Oxera's first report. Oxera's calculations of margins over direct costs were estimated as (revenues – direct costs)/revenues. We have amended this so that the denominator is direct costs rather than revenues.

⁵³⁶ Source: Oxera first report, Table 5.2.

driven by its relatively high wholesale returns is further reinforced in light of the above analysis.”⁵³⁷

- 5.561 We recognise the difficulty in identifying comparator companies for Sky, but we consider that these profitability results are supportive of the view that the retail and wholesale prices for Sky’s premium channels are above competitive levels.
- 5.562 We have further sought to identify whether there are marked differences in profitability – and hence the extent to which prices are above competitive levels – between premium sports channels and premium movies channels.
- 5.563 Such an analysis is complicated by the fact that a large proportion of Sky’s consumers purchase Sky Sports and Sky Movies together as part of a bundle. We therefore need to disaggregate revenues for these consumers. In principle, there are two extreme approaches to this disaggregation:
- The first assumes that all subscribers purchase the bundles primarily for access to the sports channels. Under this approach, Oxera assumes all subscribers effectively pay the standalone wholesale price for sports channels and the incremental wholesale price for movies. Hence if sports channels were available for £15 without movies and for £20 with movies, this approach would allocate 75% of revenues to the sports channels and 25% to the movies channels.
 - The second approach assumes that all subscribers purchase the bundles primarily for access to the movies channels. If movies channels were available for £15 without movies, and for £20 with sports, 75% of the revenues would be allocated to movies.
- 5.564 A middle ground is to look more closely at the preferences of subscribers. Oxera’s “preference based” approach draws on the Ofcom consumer survey carried out as part of the Second Pay TV Consultation which assessed the weights consumers attached to sports and movies channels, and repeated above in Figure 36⁵³⁸. In this survey, around 49% of subscribers purchasing both sports and movies stated that they purchased the bundle primarily for sports channels, so for these subscribers, revenues were allocated using the first of the two extreme approaches described above. Around 22% of subscribers stated that they purchased the bundle primarily for movies, so for these subscribers, revenues were allocated using the second of the extreme approaches. For the remaining 27% of subscribers, revenues were allocated equally between sports and movies.
- 5.565 Oxera’s results are presented in Figure 69. The table sets out both the return on sales and margins over direct costs⁵³⁹ for the wholesale sports and movies business under different cost and revenue allocations:

⁵³⁷ Oxera first report, page 53.

⁵³⁸ See Annex 10, Second Pay TV Consultation.

⁵³⁹ Oxera’s calculations of margins over direct costs were estimated as (revenues – direct costs)/revenues. We have amended this so that the denominator is direct costs rather than revenues. This more accurately reflects the relationship between margins and direct costs. In addition, the numbers presented in Oxera’s first report for sports and movies margins over direct costs excluded advertising revenues while (consistently with all of the other figures presented here and in Oxera’s report) these are now included in the figures in Figure 69.

- The first two columns show the results using the 'preference based' revenue allocation under two alternative cost allocation bases: first using Oxera's own high level cost allocation and second using the more detailed cost allocation carried out by Analysys Mason.
- While the results of the allocations are similar at an aggregate level, we consider that the detailed assessment carried out by Analysys Mason (built up line by line from Sky's management accounts) as set out in the second column is likely to be the more reliable measure.
- The final two columns show the results of an incremental prices approach to revenue allocation, under Oxera's high level cost allocation approach. We consider that this incremental approach provides the upper and lower ends of the range for the allocation of revenues between sports and movies channels.

5.566 The table below suggests that at the wholesale level, movies channels are more profitable than sports channels.

Figure 69 Estimates of wholesale ROS and margins over direct costs for sports and movies channels under alternative cost and revenue allocations, 2004-2008

	'Preference based' allocation – Oxera high level analysis	'Preference based' allocation – AM analysis	Allocation to movies based on incremental prices	Allocation to sports based on incremental prices
Return on Sales				
Sports	✂	✂	✂	✂
Movies	✂	✂	✂	✂
Margins over direct costs				
Sports	✂	✂	✂	✂
Movies	✂	✂	✂	✂

Source: Oxera first report.

- 5.567 We turn now to the question of whether the profitability gap that we observe in relation to Sky's aggregate business is evidence that the prices of retail and wholesale bundles including Sky Sports 1 and/or Sky Sports 2 that it supplies are above the competitive level.
- 5.568 Oxera interpreted its disaggregated profitability analysis cautiously, in the sense that it drew inferences about relative margins rather than absolute margins. We agree that this analysis does not allow us to identify robustly what the precise margin on different Sky products is. In relation to sports channels, the range of estimates produced by Oxera is, in and of itself, inconclusive. Under the incremental prices approach from Figure 69, the lower estimate of the wholesale margin over direct costs for sports channels could be [✂] (manifestly not above the competitive level) and the return on sales could be [✂].

- 5.569 That said, to sustain the proposition that Sky's sports margins are negative, we would need to believe a very extreme allocation of revenues to movies – and as a consequence, believe that movies margins over direct costs were [X].
- 5.570 We therefore attach considerably more weight to the preference based allocation of revenues than to the other two measures which are, by construction, very much extreme figures. We consider that the most reliable measure of Sky's wholesale sports margin over direct costs is likely to be the preference based figure using Analysys Mason's cost allocation of [X]. This corresponds to [X].
- 5.571 Figure 70 shows the evolution over time of wholesale ROS and margins over direct costs underlying the averages presented in Figure 69. The ROS and margins over direct costs for sports in particular have shown a general upward trend.

Figure 70 Evolution of wholesale ROS and margins over direct costs (preference-based allocation)

[X]

- 5.572 At first sight, [X] for wholesale sports channels may not appear especially high. However, there is evidence that Sky's return on wholesale packages is materially higher than would be expected in a competitive market.
- Sky's wholesale business is relatively "asset-light". A [X] is a material return on assets for such a business: Figure 67 above shows that Sky's wholesale business in aggregate earned a return on sales of [X] consistent with an IRR of [X].
 - This view is reinforced by the level of the margin over direct costs (an average of [X] for sports over the past five years) which appears substantial for a business with few assets and relatively few common costs.
 - In addition, over the period 2003 to 2007, Sky's preference based return on sales (using Analysys Mason's detailed cost allocation) is [X] for sports and [X] for movies, compared with wholesale ROS figures for the wholesale comparators identified by Oxera of -0.6% to 8.4%. Even though these comparators are imperfect, they support the view that Sky's return on the wholesale supply of Sky Sports is high⁵⁴⁰.
- 5.573 We accept that the profitability evidence in relation to the wholesale supply of Sky Sports is less clear-cut than in the case of Sky Movies. However, on balance, our overall conclusion from Oxera's analysis is that it indicates that prices are above the competitive level for Sky's sports channels.

⁵⁴⁰ We discuss the benchmarking analysis in Section 6 of Annex 3, noting that identifying comparators for Sky is difficult and that Sky has argued that the comparators chosen by Oxera in its first report were not relevant.

Section 6

Movies market definition and market power

Summary

- 6.1 Sky has market power in the wholesale of Core Premium Movies channels, due to its holding of exclusive rights to broadcast movies from the Major Hollywood Studios in the first pay TV subscription window. However, Sky's Core Premium Movies channels are not as highly differentiated as its Core Premium Sports channels, particularly because pay TV movies are available on other popular formats such as DVDs and FTA channels, before, during and after their appearance on Sky's Core Premium Movies channels.
- 6.2 Sky also purchases exclusive SVoD rights for movies in the first pay TV subscription window from all of the Major Hollywood Studios. An SVoD 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, SVoD 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 SVoD over linear channels.
- 6.3 Core Premium Movies services allow subscribers to see a wide range of relatively recent (and less recent) movies from the most popular studios on TV for a monthly fee. No other available service combines all of these features. We have assessed the competitive constraint these services face, both from other ways of watching movies and from non-movies content. In assessing potential substitutes we have focused on the characteristics of alternative offers (timing, quality, quantity, format and price) and the preferences of viewers with regard to these characteristics.
- 6.4 The potential substitutes we considered include cinema, pay-per-view video-on-demand, subscription video-on-demand, and DVD rental. However, of the potential substitutes we have identified, the most important – in terms of their scale and the likelihood that consumers would see them as substitutes – are retail movie DVDs, movies on free-to-air TV and general entertainment programming. While premium SVoD services are not yet fully developed, they are a potentially important constraint in future. Our view is that:
 - The format of Sky Movies gives subscribers ongoing and immediate access to a wide range of recent movies. The relative inconvenience of buying DVDs is likely to limit the degree of substitutability. In addition, for subscribers who watch more than two or three recent movies on Sky in a month, it is unlikely that buying these movies on DVD instead would be a cost-effective alternative. As such we do not consider that retail DVDs are a close substitute for Sky Movies. However, we recognise that Sky faces a moderate constraint from DVDs – particularly from those that are sold at a discounted price during the pay TV window.
 - A large number of movies are shown on free-to-air TV, and [X]. However, because of the importance of timing to viewers, the later date at which movies come onto FTA and basic channels puts these channels at a significant disadvantage to Sky Movies. The fact that Sky Movies subscribers already have free access to movies on FTA and (in the vast majority of cases) basic channels,

but are willing to pay a substantial premium for Sky Movies, indicates the extent to which Sky Movies is differentiated. As such, we do not see this content as a close substitute for Sky Movies, but recognise that it constrains Sky to some degree.

- Unlike movies on other channels and formats, general entertainment programming is not directly comparable to Sky Movies in terms of characteristics such as timing and quantity, because the underlying content is different. Furthermore, as with movies on FTA and basic channels, the free availability of this content does not stop subscribers from paying a substantial premium for Sky Movies. Sky's internal documents do not indicate that Sky sees this content as an important constraint to its movies service. We therefore see general entertainment programming as a distant substitute.

6.5 As noted, we have also considered a range of other products, most of which are at the current point in time insufficiently significant to dilute Sky's market power substantially, and offer different characteristics to pay TV channels. In particular:

- PPV VoD. The ability to pay monthly sets subscription movies channels apart from PPV – an otherwise apparently close substitute. The low total revenue from PPV movies compared to linear pay TV suggests that consumers have a strong preference for a subscription service.
- SVoD. Premium subscription VoD services could provide a very similar experience to subscribing to a linear channel, but with added convenience, and are likely to be a close substitute, particularly given that the rights are for the same window as linear channels. However, the content rights that would enable the delivery of such a service are currently controlled by Sky, so this does not affect our market power assessment.

6.6 We conclude that the relevant market is “pay TV packages including Core Premium Movies channels”; Core Premium Movies channels being defined as all Sky Movies channels⁵⁵⁸. Sky has a 100% share of this market – in other words it faces no close substitutes. However we have also considered what Sky's market share would be once the impact of moderate constraints is taken into account. If we were to include moderate substitutes (in particular, movies on FTA and basic channels, and retail DVDs sold during the first pay TV subscription window) Sky's market share would fall substantially.

6.7 Even on the strongest plausible assumptions (i.e. with all moderate substitutes included in the market), Sky would have a wholesale market share of around [X] [30 to 50]% (depending on how movies on FTA and basic channels are measured). At retail level, it would have a market share of around [X] [30 to 50]%. These figures overstate the strength of the constraint exerted by these other products, since they treat moderate substitutes as if they were close substitutes.

6.8 We thus consider that these figures are consistent with a finding that Sky has market power. If we added more distant constraints to the market, especially other retail DVDs (i.e. those sold before the first pay TV subscription window), Sky's market share would fall below a level consistent with its being likely to have market power. However, we consider that these distant constraints should not be included in the market. We conclude that Sky's market shares indicate that it has market power.

⁵⁵⁸ SVoD services showing movies in the first pay TV subscription window that are available via a television set will also be within the relevant market.

6.9 In addition, our conclusion that Sky has market power is supported by evidence that Sky's returns from the wholesale of movies are above the competitive level. This evidence is relevant in two ways:

- Much of the consumer survey switching data that we have reviewed seems to point to a broad market. However, our concern that prices are above the competitive level is even stronger for movies than sport. We mainly draw on Oxera's analysis that Sky as a whole consistently makes returns substantially above its cost of capital, as well as our own wholesale pricing analysis. Both of these pieces of analysis suggest that the profitability of Sky's premium wholesale activities is high, and that the profitability of its wholesale movies activities is higher than for sport. As a result we place very limited weight on switching data in attempting to draw a market boundary.
- Moreover, Sky's persistently high returns are directly indicative of market power⁵⁵⁹, and this is not dependent on the precise market definition or market shares. Under our central case (a preferences based allocation of revenues between sports and movies, and a detailed allocation of costs based on our pricing model) we find that Sky makes a return on sales for wholesale movies channels of [X]%, and a margin over direct costs of [X]%. These estimates are subject to some uncertainty, but are materially higher than would be expected in a competitive market.

6.10 Although the evidence on characteristics is complex, on balance Sky Movies channels appear to be sufficiently differentiated from other ways of watching movies that they have no close substitutes. In addition, Sky's returns provide direct evidence that its prices for Sky Movies are higher than would be expected in a competitive market. We therefore conclude that Sky has market power in the supply of bundles including Core Premium Movies channels.

6.11 Although we conclude that Sky has market power in the supply of Core Premium Movies channels, we do not in this statement take any decision to intervene which depends on this conclusion. We are instead consulting separately on referring this and related rights markets to the CC. Our position on market definition and market power is directly relevant to the conclusion in the Picnic Statement.

Structure of this Section

6.12 This Section is set out as follows:

- Introduction.
 - Purpose of this Section.
 - Third Pay TV Consultation.
 - Our approach to market definition.
- Overview of product characteristics and potential substitutes.
 - Distribution of movies content.

⁵⁵⁹ OFT Market Power Guidelines para.6.6.

- Provision of premium movies channels.
- Demand for premium movies channels.
- Scale of potential substitutes.
- Introduction to market definition.
 - Evidence base used to define markets.
- Retail market definition.
 - The focal product.
 - Substitution analysis.
 - Assessment of potential substitutes.
 - Supply side substitution.
 - Conclusion on retail market definition.
- Wholesale market definition.
 - Indirect constraints.
 - Direct constraints.
 - Wholesale supply side substitution.
 - Conclusion on wholesale market definition.
- Assessment of wholesale market power.
 - Existing wholesale competitors.
 - Barriers to entry and expansion.
 - Countervailing buyer power.
 - Whether current prices are above competitive levels.
 - Forward looking assessment of market shares.
 - Conclusion on wholesale market power.
- Retail market power.

Introduction

Purpose of this Section

6.13 The purpose of this Section is to assess whether any supplier of pay TV services has **market power** in relation to the supply of premium movies channels. As with the supply of sports channels, this is a step in establishing whether any current

arrangements or practices relating to the supply of pay TV movies channels are prejudicial to fair and effective competition.

6.14 As noted in the previous Section, market power can be thought of as the ability and incentive to sustain high prices, restrict output or harm competition in other ways; and the presence of market power may be inferred from a range of **evidence**, most notably:

- High market shares, in a market with barriers to entry, and in the absence of countervailing buyer power.
- Evidence that prices substantially exceed relevant costs or profits substantially exceed competitive levels.

6.15 In order to assess whether market shares are at a level which would be indicative of market power, it is necessary to **define the market** or markets within which these products are supplied⁵⁶⁰. However, the use of evidence that prices substantially exceed costs, or that profits are above competitive levels, as an indicator of market power, is not dependent on market definition.

6.16 As discussed in Section 4, we consider that the key drivers of demand for pay TV services are premium sports and movies channels. Our objective in the present Section is to establish whether market power exists in the supply of premium movies channels.

Third Pay TV Consultation⁵⁶¹

Our position

6.17 In our Third Pay TV Consultation we reached a preliminary view that there was a narrow economic market for the wholesale of “**Core Premium Movies channels**”⁵⁶², defined as channels including movies in the “first TV subscription window” produced or licensed by the six Major Hollywood Studios, and that Sky has market power in this market. We considered that Sky’s market power is enabled by the aggregation by Sky of rights to show the movies from all six Major Hollywood Studios⁵⁶³. Our market definition included all Sky Movies channels apart from Sky Movies Classics.

⁵⁶⁰ See Market Definition, OFT, 2004, paragraph 2.1:

http://www.offt.gov.uk/shared_offt/business_leaflets/ca98_guidelines/oft403.pdf

⁵⁶¹ For the source of this summary see Third Pay TV Consultation, paragraphs 1.16-1.22.

⁵⁶² See Section 4 of our Third Pay TV Consultation for the full description of what we meant by this term in that document. The channels in question were the SD and HD versions of all the Sky Movies except Classics as well as Disney Cinemagic (Third Pay TV Consultation, paragraph 4.13, paragraphs 4.377 to 4.378). In this statement, the term “Core Premium Movies channels” refers to the premium movies channels included in the market as defined. There is a slight difference between the market as defined in our Third Pay TV Consultation and this statement. “Core Premium Movies channels” in this statement refers to all Sky Movies channels. Disney Cinemagic is excluded, and Sky Movies Classics included.

⁵⁶³ In this document the term “Major Hollywood Studio” refers to NBC Universal, Viacom, Fox Filmed Entertainment, The Walt Disney Company, Sony or Time Warner or their wholly owned or controlled subsidiaries. Subsidiaries of these six companies include the six members of the MPAA (namely

- 6.18 We considered that Sky had market power in that market based on evidence of high market shares and little potential for entry or countervailing buyer power, and also on the high and increasing margin of wholesale prices over costs.
- 6.19 We also defined narrow markets for the retail of packages including Core Premium Movies channels to residential customers. In coming to this view, we relied on much of the same evidence as for our wholesale assessment, which suggests that demand-side substitution is unlikely. We considered that entry by new suppliers is unlikely in the short term, because of the lack of availability of the relevant wholesale channels.
- 6.20 We consulted on the view that Sky also holds a position of market power in the retail of packages including Core Premium Movies channels. We based this view on Sky's high market shares, and high barriers to entry in acquiring the relevant wholesale inputs. Although we believed Sky holds a position of retail market power, our competition concerns focused on the exercise of market power at the wholesale level.

Consultation responses

- 6.21 Sky made a number of comments which applied both to our analysis of sports and movies, and these are set out in paragraphs 5.25 to 5.34 of the previous Section. Sky also referred to a set of internal documents which it provided to us in response to an information request relating specifically to movies. Sky said that the Third Pay TV Consultation ignored internal Sky documents that (in Sky's view) demonstrated the range of competitive constraints on Sky's business⁵⁶⁴.
- 6.22 Virgin Media agreed with our analysis and conclusions in relation to Core Premium Movies channels and provided no substantive further representations on this issue⁵⁶⁵.
- 6.23 The BBC agreed that "Sky has market power in the wholesale markets for premium sports and movies channels"⁵⁶⁶.
- 6.24 [X]⁵⁶⁷.

Our view of consultation responses

- 6.25 Our view of Sky's response to our consultation is set out in the previous Section. We note that other respondents generally agreed with our approach to market definition

Paramount Pictures Corporation, Sony Pictures Entertainment Inc., Twentieth Century Fox Film Corporation, Universal City Studios LLP, Walt Disney Studios Motion Pictures and Warner Bros. Entertainment Inc) as well as a number of other movie studios (e.g. Fox Filmed Entertainment is also the parent of Fox Searchlight Pictures, Sony controls Screen Gems).

⁵⁶⁴ Sky response to Third Pay TV Consultation, paragraph 5.12 and footnote 9; also paragraph 5.63-5.64. Appendix 1 of the Sky response to Third Pay TV Consultation presented a series of extracts from internal documents.

⁵⁶⁵ Virgin Media response to Third Pay TV Consultation, paragraphs 3.2, 4.4, 4.6.

⁵⁶⁶ BBC response to Third Pay TV Consultation, p1.

⁵⁶⁷ [X].

and assessing market power. We consider more detailed comments and evidence relating to movies in the following discussion.

Our approach to market definition

- 6.26 We begin by identifying the products which are the subject of our investigation. As discussed in Section 4, premium movies channels are, along with premium sports channels, a key driver of demand for pay TV, and these channels were included in the complaints which gave rise to our investigation. We therefore consider Sky's premium movies channels as the starting point for our analysis. In market definition terms, these channels are the **"focal product"**.
- 6.27 We have generally adopted the same approach to defining markets for movies channels as for sports channels, as set out in paragraphs 5.39 to 5.85 of the previous Section, in particular in relation to:
- The hypothetical monopolist test (see paragraph 5.41).
 - Differentiated products (see paragraph 5.42).
 - Marginal customers (see paragraphs 5.43 to 5.46). Factors that determine whether a subscriber to movies channels is marginal will include how convenient they consider other means of watching movies to be, how many films they watch, what type of film they watch (e.g. the most recent films), whether they also subscribe to premium sports channels, the preferences of others in the household, and income.
 - The cellophane fallacy (see paragraphs 5.47 to 5.60): along with the arguments raised in Section 5, we note in particular that, as with Sky Sports, Oxera's profitability analysis indicates that Sky in aggregate earns a return above its cost of capital and we conclude that Oxera's disaggregated analysis suggests that prices are above the competitive level for Sky Movies. Indeed the profitability of Sky Movies appears greater than for Sky Sports.
 - Wholesale and retail markets (see paragraphs 5.61 to 5.67).
 - Market shares (see paragraphs 5.68 to 5.73).
 - Bundling (see paragraphs 5.74 to 5.78).
 - Two-sided markets (see paragraphs 5.79 to 5.80).
 - Monopolistic competition (see paragraphs 5.81 to 5.84).

Overview of product characteristics and potential substitutes

Distribution of movies content

- 6.28 From the time of their initial release, movies are sold in a series of different formats in distinct or overlapping time periods known as "windows". Typically a movie has a cinema release, then a DVD retail/rental window, then it will be shown on pay-per-view TV, then on premium subscription pay TV channels, before finally being shown on free-to-air services. In general terms, the commercial value of a movie declines over time following its release date. For example, newer DVDs and movies on pay-

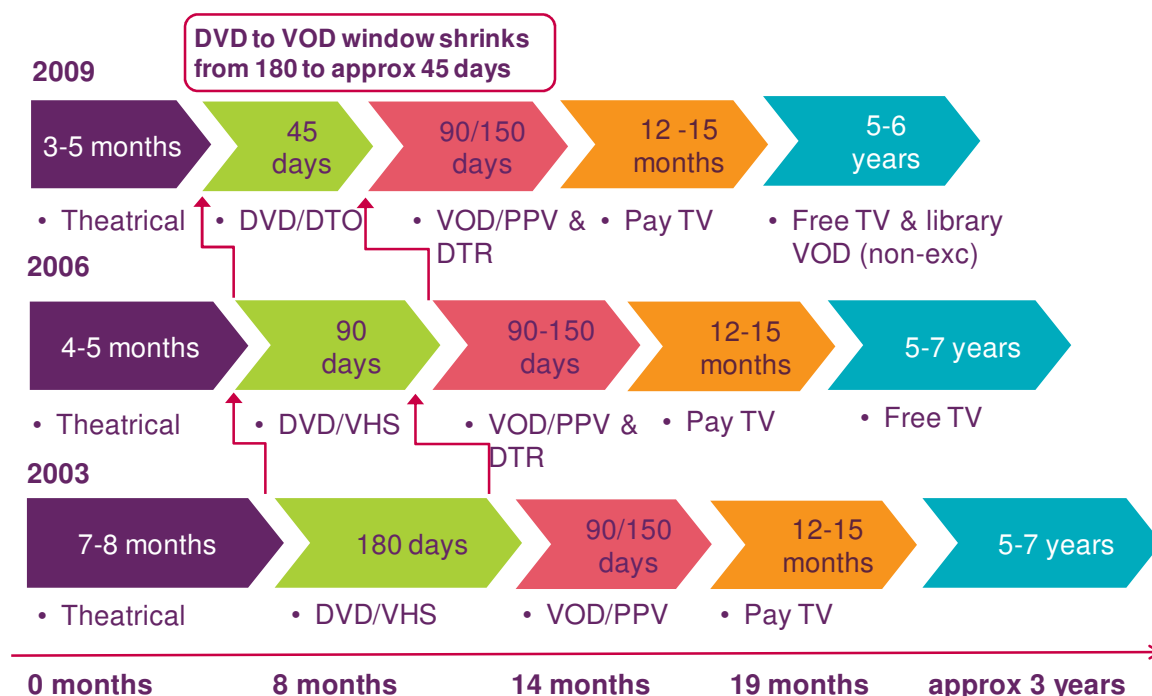
per-view services command higher prices than older releases, and movies typically appear on premium TV channels before they are shown on basic or FTA channels.

6.29 As such, the lifecycle of movies content differs from that of sports content, which has relatively limited value after the initial live broadcast of an event. This has a number of implications.

- While viewing of sports is largely limited to attendance at events, and live broadcast on linear channels and pay-per-view services, movies are available over a wider range of formats such as DVD retail and rental, and, increasingly, VoD.
- Linear movies channels regularly repeat movies, and in some cases multiple channels are used to show the same movie starting at different times.
- While premium sports channels primarily comprise bundles of different live sports content, premium movies channels bundle newer movies with older movies.

6.30 Movie studios manage the timing of film release across different formats, as we explained in further detail in Annex 11 of our First Pay TV Consultation. The timed availability of films across different formats (known as ‘film windows’) is a form of price discrimination. It enables studios to exploit consumers’ different willingness to pay for content in order to maximise the value of their movies and recover the fixed costs of production and marketing. The timing of the different windows and formats is set out in the Figure below. The Figure also shows the way in which the windows have changed over the past few years.

Figure 74 **Movie Windows**



Source: Ofcom, industry sources, Screen Digest (windows are indicative and change on a title-by-title basis)

Note: There are potential future changes in the movie windows. For example, Warner Bros is trialling the release of movies on PPV at the same time as DVDs.⁵⁶⁸

6.31 As the figure shows, in recent years, some of the movie windows have been getting shorter. For example, since 2003 the DVD window has shifted from 7-8 months to 3-5 months after the theatrical release⁵⁶⁹. The delay between cinematic release and the first pay TV window has also reduced⁵⁷⁰.

- Sky told us that “Over the last few years, Sky has renegotiated its movie contracts so that it can show titles at an earlier date post cinematic release. In 2001 the pay TV window ran from 18 to 33 months after cinematic release; by 2007 it had moved forward by six months, typically running from 12 to 27 months after cinematic release. Therefore any film can be shown six months earlier than would have been possible in 2001, meaning that it is closer to the cinematic release and the accompanying publicity”⁵⁷¹.
- In addition, [X]⁵⁷².

6.32 **Cinematic release:** films are first released at the cinema often accompanied by very substantial and costly marketing and promotional campaigns. Average ticket prices were £5.20 in 2008⁵⁷³. Screen Digest reported that the cinema release “is regarded as a marketing platform and most distributors will not make profit at this stage”⁵⁷⁴. However, cinema release is important to consumers: research conducted by Sky reported that “films were most special at the cinema, closely followed by owning films on DVD”⁵⁷⁵.

6.33 **DVD retail:** consumers purchase DVDs in order to obtain permanent access to a number of specific favourite films within a film library of their own. Sky’s consumer research⁵⁷⁶ showed that DVD retail was perceived as offering very good value as it provides the benefits of permanent ownership of an extremely popular delivery

⁵⁶⁸ See Matthew Garrahan (22 December 2009) “Warner launches video-on-demand in Europe” at FT.com.

⁵⁶⁹ The Odeon cinema group threatened not to show the film “Alice in Wonderland” in protest against Disney’s plan to shorten the theatrical run by bringing forward the DVD release date: see “Odeon ends Alice in Wonderland boycott”, guardian.co.uk, 25 February 2010.

⁵⁷⁰ Third Pay TV Consultation, paragraphs 4.295-4.296.

⁵⁷¹ Sky response of 9 July 2008 to Ofcom’s information request of 29 May 2008 question 6 “Changes in the quantity and quality of services delivered to subscribers to Sky’s packages that include Sky’s sports channels, 2001/02 – 2006/07” Section 4, paragraph 12.

⁵⁷² [X]

⁵⁷³ See for example: <http://www.cinema.uk.org.uk/ukcinemasector/ukcinema-industryeconomics/averageukticketprices/>.

⁵⁷⁴ First Pay TV Consultation, Annex 11, page 21.

⁵⁷⁵ Sky’s third response dated 1 July 2008 to Ofcom information request of 29 May 2008.

⁵⁷⁶ Ibid.

mechanism. The average price of a DVD movie was about £7.36 in 2008⁵⁷⁷, although the range of prices is wide – particularly as prices typically fall by more than half after the initial release period (see Figure 90). Just over a quarter of DVDs (27%) are bought as gifts rather than for personal or family use⁵⁷⁸.

- 6.34 **DVD rental:** consumers can rent DVDs to access recently released films on a temporary basis. Sky's research found that "renting films is still reasonably popular (even amongst Sky Subscribers) with renters welcoming variety, the mid week deals and improved window"⁵⁷⁹. Consumers can choose to rent from traditional over the counter stores or – increasingly – from online subscription services. The majority of rentals (by value) are still over-the-counter rentals but the quantity and value of online subscription rentals is growing rapidly. Typical prices to rent latest release films are around £3.75 over the counter (although there may be discounts to this headline price) and around £2.40 online⁵⁸⁰.
- 6.35 **Pay per view (PPV):** a number of TV retailers including Virgin Media, Sky, TalkTalk TV and BT Vision offer PPV movies, allowing consumers a convenient way to access new movies.
- 6.36 PPV services based on 'Pull VoD' or 'True' VoD⁵⁸¹ are possible on Virgin Media's cable network and TalkTalk TV's and BT's IP networks. Sky's satellite service provides both 'Push VoD'⁵⁸² and 'Near' VoD PPV services⁵⁸³. These services differ in terms of both pricing and the number of films available:
- In 2008 Sky offered a total of around 400 films (including HD) priced at £3.99 per film on its PPV NVoD service⁵⁸⁴. Only a small fraction of these films were available at any one time.
 - In 2008, Virgin Media offered a catalogue of around 500 films on its PPV VoD service. New releases were priced between £2.50 and £3.50 and library titles were priced between 50p and £2⁵⁸⁵. Virgin Media's PPV VoD service offers more films at any one time than Sky's PPV NVoD service.

⁵⁷⁷ See paragraph 6.152 for an explanation of how this figure was calculated. In the Third Pay TV Consultation we referred to an average DVD price of £8.97 (for example, in paragraph 4.265). That figure relates to the average price of all DVDs. It thus includes non-movie DVDs such as DVD box sets of television series. The £8.97 figure was taken from British Video Association Yearbook 2009, page 28.

⁵⁷⁸ Source: British Video Association Yearbook 2009 page 73.

⁵⁷⁹ Sky's third response, dated 1 July 2008, to Ofcom information request dated 29 May 2008.

⁵⁸⁰ Source: British Video Association Yearbook 2009 page 80.

⁵⁸¹ 'Pull' or 'True' VoD means consumers can get instant access to the film of their choice.

⁵⁸² 'Push' VoD refers to services where content is downloaded to the hard drive of the set-top box and made available to view on demand.

⁵⁸³ 'Near' VoD (nVoD) refers to a multiple linear channels that broadcast the same content at staggered start times.

⁵⁸⁴ UK Film Council Statistical Yearbook 2009, page 106.

⁵⁸⁵ Film Council Statistical Yearbook 2009, page 106.

- 6.37 We estimate that Sky's revenue from PPV NVoD services was [X] in 2008 and Virgin Media's revenue from PPV VOD services was [X] in 2008⁵⁸⁶. Taking into account the fact that there are markedly more subscribers to Sky's satellite platform than to Virgin Media's cable platform⁵⁸⁷, these revenue figures suggest that cable subscribers are more likely to purchase PPV VoD services than satellite subscribers are likely to purchase PPV NVoD services.
- 6.38 **Internet Download:** Downloading content to watch from the internet offers consumers a wide range of content that can be accessed relatively easily and viewed at their convenience. Content can be downloaded legally from the internet either to watch on a one-off basis (also known as download to rent or rental VOD) or to retain permanently (also known as download to own). Suppliers include Apple (via its iTunes store) and Blinkbox. Movies can also be downloaded illegally using file sharing applications such as Bit Torrent.
- 6.39 **Pay TV Subscription Services:** Sky Movies and Disney Cinemagic show films in the first pay TV subscription window from the six Major Hollywood Studios. Sky also has contracts with several independent distributors and other movie studios (see paragraph 4.276 in the Third Pay TV Consultation). Consequently, Sky's premium movies channels provide the first opportunity for viewers to watch the vast majority of the most popular films on a linear TV channel.
- 6.40 In addition, two types of Subscription VoD (SVoD) service are also available. First, Sky's SVoD service shows movies during the first pay TV subscription window. This is available via the Sky Player service and can be accessed via a subscriber's PC, or on TV via an Xbox [X]⁵⁸⁸. Second, there are various other SVoD services not owned by Sky that show films after the first pay TV subscription window, e.g. Picturebox.
- 6.41 **FTA Channels:** FTA channels and other basic tier subscription channels show a wide variety of older films. In 2007 there were 2,182 film transmissions on the main terrestrial channels, 20,271 film transmissions on FTA multi-channels and 34,782 transmissions on subscription movies channels⁵⁸⁹.

Provision of premium movies channels

- 6.42 The main suppliers of wholesale premium movies channels (i.e. those for which a subscription fee is charged) are Sky and Disney. Sky's premium movies channels and Disney's premium movie channel (Disney Cinemagic) are retailed by Sky (both on its satellite platform and on TalkTalk's IPTV platform) and the cable companies, primarily Virgin Media.

⁵⁸⁶ Virgin Media response dated 8 April 2009 to question 12 of Ofcom information request dated 24 March 2009, and Annex 5 to Sky's response dated 27 March 2009 to question 20 of Ofcom information request dated 20 March 2009.

⁵⁸⁷ In 2008, Virgin Media had approximately 3.6m subscribers and Sky had 8.8m satellite subscribers. Statistical Yearbook 2009, UK Film council, page 106.

⁵⁸⁸ On 25 March 2010, Sky announced that it would launch a range of internet connected TVs and STBs.

⁵⁸⁹ UK Film Council Statistical Yearbook 2008 figure 11.6 p92, figure 11.7 page 95. PSB channels refer to BBC1, BBC2, ITV1, Channel 4 and Five.

- 6.43 Sky offers twelve premium movies channels. Until recently, eight were, broadly speaking, genre-specific, while two (Sky Movies Screen 1 and Sky Movies Screen 2) put “the best of Sky Movies in one place”, and two (Sky Movies Premiere and Sky Movies Premiere +1) show a small number of major new releases (five per week)⁵⁹⁰.
- 6.44 All these channels are available in both SD and HD except for Sky Movies Classics and Sky Premiere +1, which are only available in SD. They are aggregated into 3 packages:
- **Sky Movies 1:** Sky Movies Comedy, Sky Movies Family, Sky Movies Classics, Sky Movies Modern Greats, Sky Movies Showcase.
 - **Sky Movies 2:** Sky Movies Action and Thriller, Sky Movies Sci-Fi and Horror, Sky Movies Indie, Sky Movies Drama, Sky Movies Crime and Thriller.
 - **Sky Movies Pack (Sky Dual Movies / Sky Movies Mix):** Sky Movies 1 and Sky Movies 2, Sky Premiere and Sky Premiere +1.⁵⁹¹
- 6.45 These channels, taken together, show all of the films from the six Major Hollywood Studios, among others, in the “first pay TV subscription window”.
- 6.46 As shown in Figure 31 below, Sky retails Sky Movies 1, Sky Movies 2 and Sky Dual Movies in bundles with other basic packages (mixes) and Sky Sports packages.
[X]⁵⁹².
- 6.47 [X]⁵⁹³ As shown in that Figure, Virgin Media retails Sky Movies 1, Sky Movies 2, Sky Dual Movies, on its cable platform with other basic TV packages (“M”, “M+”, “L”, and “XL”) and Sky Sports channels⁵⁹⁴. Virgin Media retails Sky Movies 1 or standalone Sky Movies 2 at between £16.50 per month (if they are taken with the ‘XL’ package) and £28 a month (if taken with the ‘M’ package).⁵⁹⁵
- 6.48 Alternatively, Virgin Media customers can subscribe to the ‘Sky Movies Collection’⁵⁹⁶ (comprising Sky Movies 1, Sky Movies 2, Sky Movies Premiere and Sky Movies Premiere +1) for between £19.50 and £30 per month, or to Sky Sports and Movies (including all channels in the Sky Movies Collection) for between £27.50 and £37 per

⁵⁹⁰ Sky Movies Screen 1 was replaced with Sky Movies Showcase (“the one-stop shop for Sky Movies seasons and specials”) from 26 March 2010. Sky Movies Screen 2 became Sky Movies Crime and Thriller.

⁵⁹¹ Sky retails its 12 Sky Movies channels in this pack with Disney Cinemagic, but Disney Cinemagic is not included within its wholesale products.

⁵⁹² Sky response dated 28 November 2008 to Ofcom information request dated 12 November 2008. Sky notes that [X]

⁵⁹³ Number of subscribers in September 2008. Source: Virgin Media response to question 1 of Ofcom’s information request on 12.11.2008

⁵⁹⁴ Virgin Media has also recently added an “M+” basic package. This is not included in Figure 33 as it was not available in September 2008.

⁵⁹⁵ See <http://allours.virginmedia.com/html/tv/sky-movies-channels.html> (as viewed on 22 March 2010). Note these prices are from a different time period to those used in Figure 33.

⁵⁹⁶ This is equivalent to Sky Dual Movies as set out in paragraph 6.44.

month. Again, the price depends on the basic package to which the consumer has subscribed.

- 6.49 As described in paragraph 5.107, Sky Movies are also retailed by Sky on TalkTalk TV's platform.

Demand for premium movies channels

- 6.50 Here we set out our view of the nature of demand for premium movies channels. In particular we consider:

- The extent to which movies are distinct from non-movies content;
- The characteristics of the channels – quantity, quality, format, timing and price, and subscribers' preferences for these characteristics;
- Bundling of premium movies channels with premium sports channels.

- 6.51 Demand for premium movies channels also depends on the availability of substitutes. We have identified a range of potential substitutes, which we consider in the following Section.

Extent to which movies are distinct from other TV content

- 6.52 As set out in Section 4, movies are the genre other than sports which stands out as being amongst the most valued by consumers and which also has a high degree of exclusivity to pay TV⁵⁹⁷.
- 6.53 Around 15% of Sky's premium subscribers take Sky Movies as a standalone product (i.e. without Sky Sports). Of those who subscribe to Sky Sports and Sky Movies, (55% of all premium subscribers), half (i.e. over 25% of premium subscribers) do so either primarily because of Movies, or see both Sports and Movies as important. In total then, around 40% of Sky premium subscribers (15% plus 25%) see Movies as an important part of their subscription.
- 6.54 The willingness of millions of UK households to pay a substantial premium for access to this content, when they already have access to a wide range of other content from FTA and basic channels, is evidence of the distinctiveness of Sky's movies coverage. We consider this point further in our assessment, below, of non-movies content as a substitute for movies content.

Characteristics of premium movies services

- 6.55 As we set out in our Third Pay TV Consultation,⁵⁹⁸ Sky Movies services combine a number of important characteristics relating to the quantity and quality of the films shown and the timing and format of release⁵⁹⁹. We also considered price carefully in relation to potential substitutes for Sky Movies and we remain of the view that this is also important. We therefore consider again the importance to Sky Movies

⁵⁹⁷ We also made this point in paragraph 3.22 of the Third Pay TV Consultation.

⁵⁹⁸ See paragraph 4.256 in our Third Pay TV Consultation.

⁵⁹⁹ An internal document from Sky, to which Sky drew our special attention in Appendix 1 of its September 2009 Response, emphasises the importance of quantity. [X]

subscribers (and particularly to marginal subscribers) of each of these characteristics:

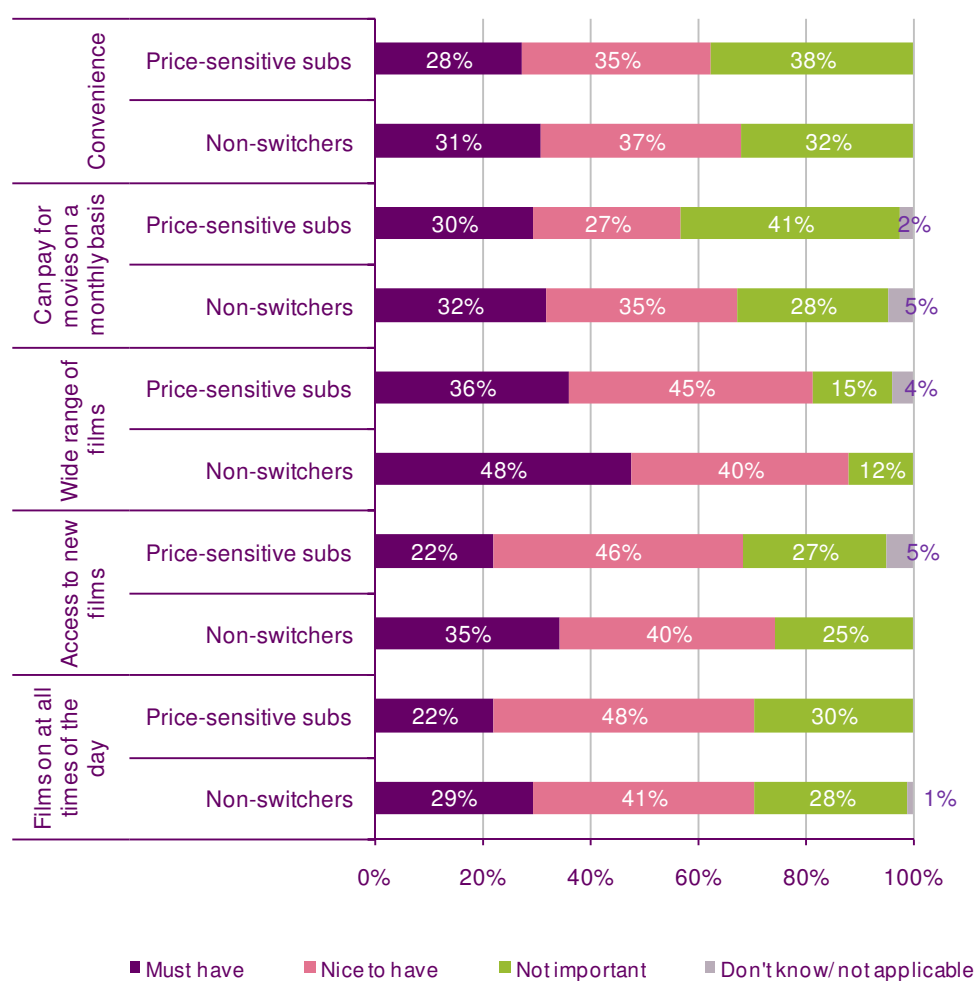
- Quantity: the number of hours (or film slots) of films shown and the number of film titles shown.
- Quality: by quality, we mean the attractiveness of a film to subscribers, of which previous box office success is likely to be the strongest indicator. The perceived quality of a film to a viewer also tends to depend on how old the film is. However, we consider this specific characteristic separately under “timing” below.
- Timing: the age of films shown (from their first UK release date).
- Format: e.g. linear channel, DVD etc.
- Price: per film view. For subscription services, this clearly depends on viewing frequency. When viewers subscribe to a bundle of services, the perceived price of the movies channels/services included in that bundle is subject to a degree of interpretation. Nonetheless Sky Movies is more expensive than other types of channel packages, for example Sky’s basic mixes.

Quantity of films

- 6.56 The quantity of films is important to subscribers, because having more movies available (particularly at the same time) increases the likelihood that there is a film that the consumer wants to watch. The Figure below sets out the preferences of subscribers to Sky Movies, specifically splitting out the views of price sensitive subscribers. It shows that 36% of price sensitive consumers said that a wide range of movies is “must have” and another 45% said it is “nice to have” For those subscribers that are not price-sensitive, the corresponding figures are 48% and 40% respectively⁶⁰⁰. From our survey evidence this appears to be the most important characteristic to Sky Movies subscribers.
- 6.57 In addition, having movies available at all times of the day is “must have” to a minority (22%) of price sensitive consumers and “nice to have” for 48% of price sensitive consumers. Digital video recorders arguably reduce the importance of having movies available at all times of day, but do not reduce the importance of overall choice.

⁶⁰⁰ See paragraph 4.283 in our Third Pay TV Consultation and Figure 24 in Annex 6 of the Second Pay TV Consultation.

Figure 75 Preferences of subscribers to Sky Movies



Base: All Sky Movies subscribers (203)

Source: Ofcom pay TV research phase 2. A similar chart was previously presented at Figure 24 of Annex 6, Appendix 7 to Second Pay TV Consultation.

Quality of films

6.58 In our Third Pay TV Consultation we said that Sky's premium movies channels also show a large quantity of films that are of particularly high quality (at least in terms of box office success). We also noted that Sky has exclusive agreements with the six Major Hollywood Studios to exploit their films in the first pay TV subscription window and that these films accounted for 80% of UK box office revenues⁶⁰¹.

6.59 Sky argued in response to our Third Pay TV Consultation that we gave insufficient weight to the quality of films as distinct from timing⁶⁰². As we said, we agree that quality is important. Many of the films viewed on Sky Movies are those that had large box office revenues (Figure 76). Sky describes Sky Premiere as "home of the biggest

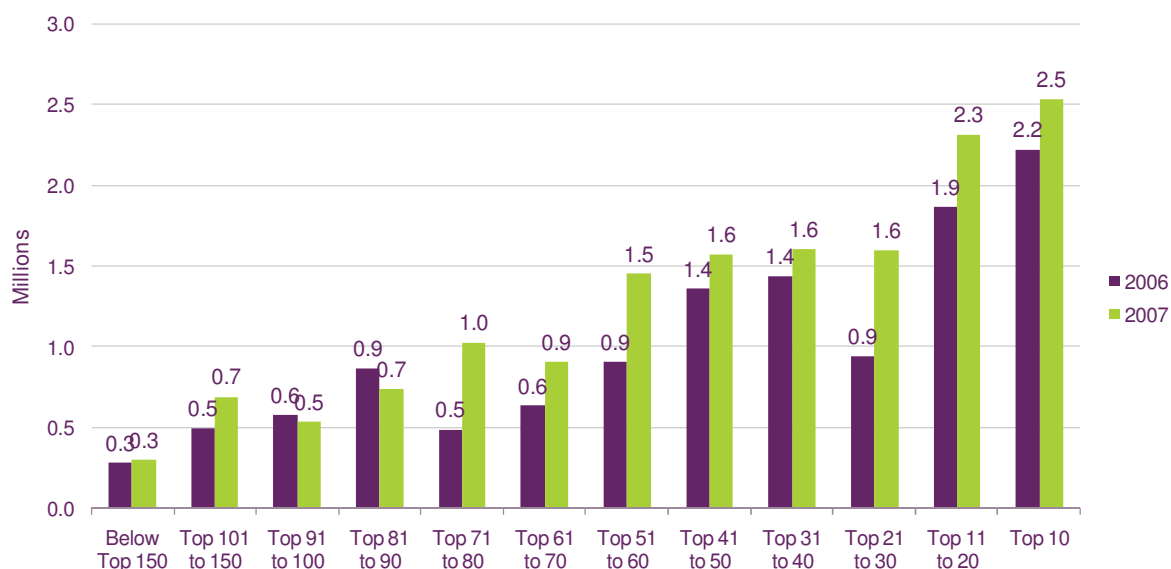
⁶⁰¹ Paragraph 4.274 to 4.275.

⁶⁰² October 2009 Sky Submission, paragraph 95.

new movies"⁶⁰³. This channel has by far the most views per film (Figure 77) than any other Sky Movies channel, which suggests the importance of big box office films.

- 6.60 In contrast, Sky Indie has the fewest views per film. The differences in the viewing figures for the different Sky Movies channels emphasise the importance of films distributed by the Major Hollywood Studios. This is evidence that consumers regard the films distributed by these studios as relatively attractive (i.e. in some sense higher 'quality' from the perspective of the majority of consumers).

Figure 76 Average views per film by UK box office revenue rank*

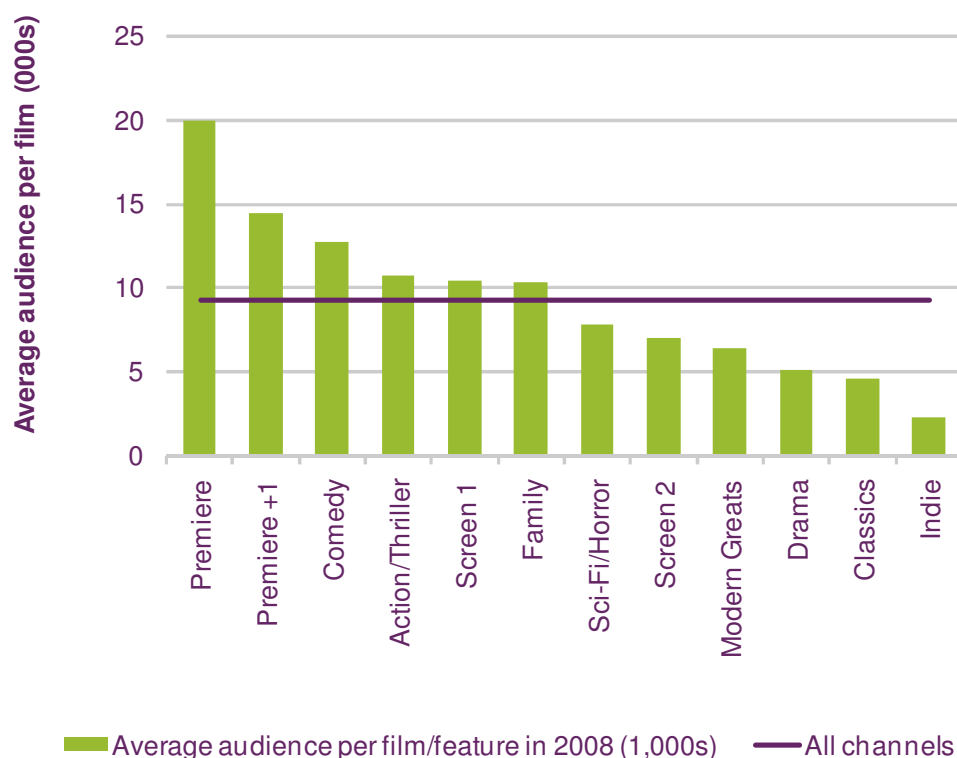


Sources: BARB viewing data for 2008, <http://boxofficemojo.com/intl/uk/yearly>.

Note: *E.g. "Top 10" refers to the top 10 films in the UK by box office revenue. Sky Movies may not have shown all of these films. Box office revenues also include those from Ireland and (perhaps surprisingly) Malta.

⁶⁰³ <http://movies.sky.com/sky-movies-home> (as viewed on 15 February 2010)

Figure 77 **Average audience per film on Sky premium movies channels in 2008**



Source: BARB data for 2008, as presented at Figure 2 of Annex 6 to the Third Pay TV Consultation

Timing

- 6.61 Consumers typically value a given film more the closer it is to its release date. Sky accepted this⁶⁰⁴, but also stated that an older movie may be valued more highly than another (different) film that is more recent for example because viewers consider the older film to be higher quality. Sky gave a number of examples in support of this proposition, including viewer data showing that a repeat on Channel 4 attracted a greater number of viewers (among households with Sky Movies) than the first showing of a more recent film on Sky Movies⁶⁰⁵.
- 6.62 While some older films may be more attractive than some newer films, most films are more attractive when they are closer to their release date. As we noted at paragraphs 4.282 to 4.285 of our Third Pay TV Consultation, all other things being equal, more recent movies are more attractive. As stated in paragraph 4.270 of the Third Pay TV Consultation, this is in part because significant marketing occurs around the time of the initial cinema release which increases the awareness of a film⁶⁰⁶. The value of

⁶⁰⁴ October 2009 Sky Submission, footnote 67 to paragraph 95.

⁶⁰⁵ Sky's data related to the evening of 26 September 2009. The Lord of the Rings: The Two Towers was released in the cinema in 2002 and attracted an average audience amongst households that subscribe to Sky Movies of 162,000. Tropic Thunder was released in the cinema in 2008 and was broadcast on Sky Movies for the first time. It attracted an average audience of 100,000. October 2009 Sky Submission, Table 3 and paragraph 95.

⁶⁰⁶ As noted in paragraph 4.295 of the Third Pay TV Consultation, Sky referred to the pay TV window moving closer to the cinematic window "and the accompanying publicity". Sky response of 9 July 2008 to Ofcom's information request of 29 May 2008 question 6 "Changes in the quantity and quality of

this marketing will diminish over time. Furthermore, once a consumer views a film in an earlier window its value to that consumer in later windows is likely to be diminished.

6.63 The attractiveness of recent movies is supported by a number of pieces of evidence:

- Internal research supplied to us by Sky⁶⁰⁷, [X].
- A survey carried out for Virgin Media asked consumers for which genre of content they would consider paying more than their current subscription. This Virgin Media survey found that “new” movies was the most popular movie genre for both Virgin Media and Sky subscribers (cited by [X]% and [X]% of subscribers on each platform). This was significantly above “classic movies”, cited by only [X]% of subscribers on both cable and Sky⁶⁰⁸.
- [X]. This provides further evidence on the importance of newer films.
- In addition, in our survey 22% of price sensitive consumers responded that access to new films is a “must have” and 46% say it is “nice to have” (Figure 75).

6.64 We have also examined viewing data. Our view of the value of newer films is corroborated by the higher audience numbers for Sky Movies Premiere compared with the other channels (Figure 77). Sky Movies Premiere – which tends to show new releases before they are shown on the genre specific movies channels – is the most popular channel measured by audiences in 2008, suggesting that Sky Dual Movies viewers place a relatively high value on seeing the latest films. In this context, we note that Sky in its results for the half year ended 31 December 2009, said that “Sky Movies had a particularly strong quarter in terms of customers and audience share with seven premieres each achieving audiences of more than a million”⁶⁰⁹.

6.65 As we noted at paragraphs 4.291 and 4.292 of our Third Pay TV Consultation, the value of newer films is also reflected in the higher audience received for newer films (see the Figure below). According to our analysis, movies from the pay TV window⁶¹⁰ accounted for about 60% of all viewing on Sky Movies in 2008. In other words, viewing was disproportionately focused on recent films.

services delivered to subscribers to Sky’s packages that include Sky’s sports channels, 2001/02 – 2006/07” Section 4 paragraph 12.

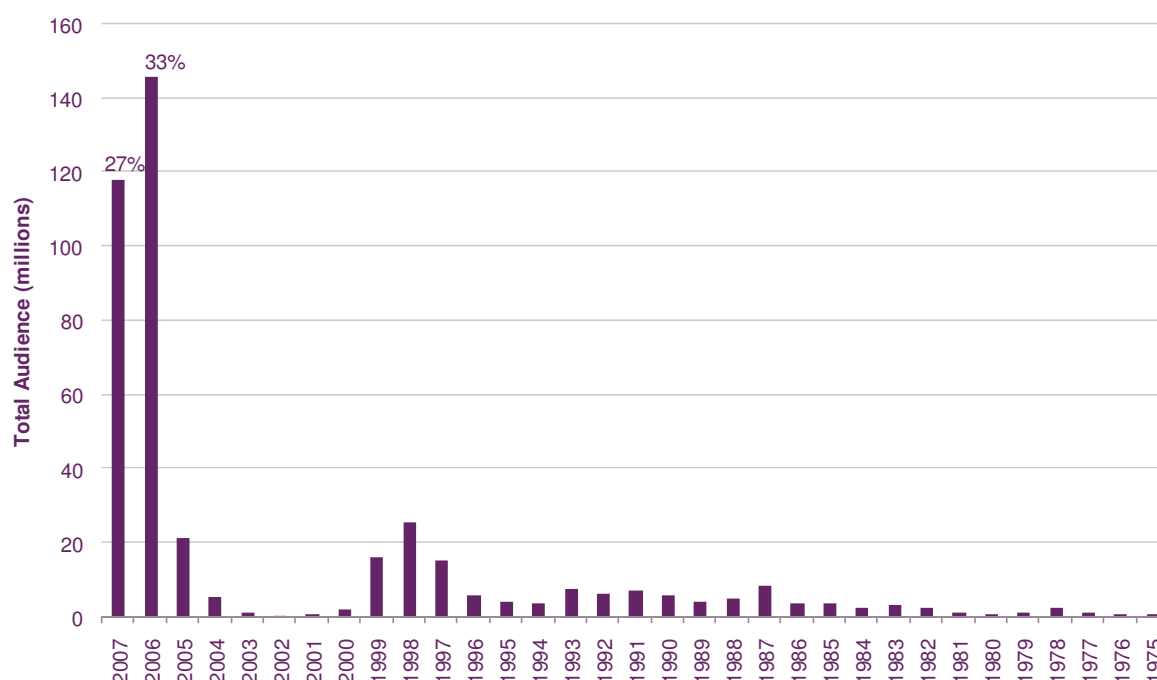
⁶⁰⁷ Sky’s third response to Ofcom’s questions of 29 May 2008, [X].

⁶⁰⁸ Virgin Media response to information request of 15 May 2007, [X].

⁶⁰⁹ http://corporate.sky.com/documents/pdf/press_releases/4ad9b907f137492d998022a042ac035b/280110_Interim_Results_Press_Release.

⁶¹⁰ Defined as films with a cinematic release of 2006 or 2007.

Figure 78 **Total satellite viewing of films on Sky Movies in 2008 by year of film release**



Source: BARB data for 2008, as presented at Figure 29 of Third Pay TV Consultation.

Format

6.66 By format we refer both to where and how films are viewed (e.g. in the cinema, via DVD purchase or DVD rental, via linear channel) and the way in which they are paid for (subscription, pay per view, advertising funded). In terms of format, linear premium movies channels are differentiated from alternatives in two main ways:

- They offer a high degree of convenience: 28% of price sensitive consumers say that the “convenience of not going to the DVD shop” is “must have” and another 35% say it is “nice to have” (Figure 75).
- The subscription price structure of Sky Movies is also important to price sensitive consumers. Figure 75 shows that paying monthly was “must have” for 30% of price sensitive consumers and “nice to have” for another 27%.

6.67 Sky disputed the importance of a subscription price structure and “the inconvenience associated with movie rental” for “marginal subscribers” such as subscribers that watch only one or two movies in the first pay TV subscription window per month⁶¹¹.

6.68 Sky’s revenues from the sale of Sky Movies are an order of magnitude higher than its revenue from the supply of PPV movies⁶¹². While there is clearly a wide range of factors that influence the revenue earned by these two services, we consider that the

⁶¹¹ Sky response to Third Pay TV Consultation, footnote 38 to paragraph 5.29.

⁶¹² In 2008, Sky earned in the region of [£] from the retail supply of Sky Movies compared to [£] from PPV. These figures were derived as part of our analysis of retail market shares (described in further detail below and set out in a separate confidential Ofcom spreadsheet).

stark difference in revenue supports our view that consumers find a subscription price structure particularly attractive.

- 6.69 Moreover, it cannot be assumed that subscribers who do regularly watch one or two movies per month in the third pay TV subscription window are automatically marginal customers (or vice versa), although they may, on average, be more likely to be marginal customers than more frequent viewers. Even consumers that watch few movies may value a subscription price structure because it gives them the *option* of watching additional films for no extra charge.

Price

- 6.70 Sky said that a product with relatively less attractive characteristics ('lower quality') but at a cheaper price can be an effective substitute⁶¹³.
- 6.71 We recognise that close substitutes can have different prices (and similarly products which are not substitutes for each other may happen to have the same price). To take a simple example, a battery with 10 hours' life and priced at £1 may be a very close substitute for one with 50 hours' life priced at £5. On the other hand, if we observed a battery with 5 hours' life priced at £10 we would need an explanation for the high price. We might infer that that battery served a different purpose from the cheaper batteries. However, for many products, including pay TV movies channels, product quality is far more complex and subjective than battery life.
- 6.72 The 'quality'⁶¹⁴ of pay TV movies channels and their potential substitutes is a combination of their different characteristics including the quality, quantity and timing of the movies they offer, and the format of the service. As such, when comparing product quality of different offers, the price that they command can be an important indicator of the extent to which they are differentiated from one another,⁶¹⁵ and therefore of the scope for substitution.
- 6.73 In this respect, consumers who subscribe to Sky Movies have already demonstrated their willingness to pay a substantial premium for those channels, suggesting that the presence of content on FTA and basic channels is not a strong substitute.

Bundling with sports

- 6.74 Sky Movies can be purchased as part of a bundle with Sky Sports. As described in the previous Section (paragraphs 5.125 to 5.130) customers who purchase a bundle of sports and movies will have different preferences, and face a different incremental price, than customers who buy standalone sports (or, in the present case, standalone movies).

⁶¹³ October 2009 Sky Submission, paragraph 94.

⁶¹⁴ Here we are using 'quality' in a more general sense than that set out in paragraph 6.55, to describe all those product characteristics that together determine the attractiveness of a product to consumers.

⁶¹⁵ Differentiation can be 'vertical' where one product is widely seen as a better than another, or 'horizontal', where different products appeal to different tastes, or a combination of the two. In particular, price differences may be indicative of vertical differentiation.

6.75 Figure 36 in Section 5 shows that 49% of Top Tier subscribers subscribe to Sky Movies because they wanted Sky Sports, and Sky Movies did not cost much extra. For these customers Sky Movies is a comparatively cheap add-on⁶¹⁶.

Potential substitutes for premium movies channels

6.76 In the light of our assessment of the key drivers of demand for premium movie services, we now identify the potential substitutes for these services. Most of the potential substitutes which have been identified in our consultations are alternative ways of watching movies – whether different movies from those on premium movies channels, the same movies in different time periods, or the same movies in the same time periods. However, we also consider the potential for substitution from non-movies content.

6.77 The particular potential substitutes that we have assessed are as follows:

- Movies in cinemas;
- Movies on DVD (retail);
- Movies on DVD (over-the-counter and online rental);
- Pay-per-view movies on other platforms;
- Disney Cinemagic;
- Dedicated free-to-air and basic movies channels;
- Movies on other free-to-air and basic channels;
- General entertainment content on free-to-air and basic channels.

6.78 In order to focus our analysis, we have considered which of these potential substitutes is likely to pose the greatest constraint on Sky Movies in terms of substitutability and scale (measured by volume of sales).

6.79 As in our Third Pay TV Consultation, our view is informed by our comparison of the product characteristics of Sky Movies and potential substitutes. While Sky has argued that a focus on product characteristics is inappropriate, we believe it to be an important part of our assessment. The extent of competitive constraint from potential substitutes cannot be reliably inferred from the behaviour of market participants or from switching surveys, because prices are likely to be above the competitive level. Because of this, we consider that comparison of product characteristics is important in understanding the extent of substitutability.

6.80 However, in assessing the relative closeness of substitutability of these different services, we have, in light of Sky's comments, taken account of further evidence from Sky's internal documents, and from a recent Ofcom survey, as described below.

⁶¹⁶ For these customers the typical price for adding Sky Movies in September 2008 was £[X] (average incremental price weighted by the number of subscribers taking Virgin Media's basic channels packages) compared to £[Y] (average incremental price weighted by the number of subscribers taking Virgin Media's basic channels packages) for those that do not take Sky Dual Sports.

Internal Sky documents

6.81 Sky provided us with a number of internal documents in response to a May 2008 information request. We have examined these documents to shed light on how Sky views the constraint from potential substitutes to Sky Movies and on which potential substitutes are the most important.

6.82 [X]

- [X]⁶¹⁷.
- [X]⁶¹⁸.
- [X]⁶¹⁹
- [X]⁶²⁰.

6.83 [X] With regard to DVDs:

- An internal document from 2005 identified “DVD Retail” [X]⁶²¹. It said that “Films are ‘most special’ at the cinema, closely followed by owning films on DVD” and “DVD retail perceived as offering very good value as it provides the benefits of permanent ownership of an extremely popular delivery mechanism”⁶²².
- Similar points are also made in presentations [X]⁶²³.
- [X]⁶²⁴.

6.84 With regard to free-to-air movies:

- An internal document from 2005 identified the “proliferation of digital multichannels offering movies in a later window” [X]⁶²⁵. Similarly a presentation to [X] referred to the “proliferation of movies on free to air services ...”⁶²⁶

⁶¹⁷ [X]

⁶¹⁸ [X]

⁶¹⁹ [X]

⁶²⁰ [X]

⁶²¹ [X] “the increasing proliferation of digital multichannels offering movies in a later window”. [X], 1 July 2005, Sky, slide 6. Provided at tab 5 of Sky’s response dated 1 July 2008 to question 10 of Ofcom’s information request dated 29 May 2008.

⁶²² [X], 1 July 2005, Sky, slide 7. Provided at tab 5 of Sky’s response dated 1 July 2008 to question 10 of Ofcom’s information request dated 29 May 2008.

⁶²³ This document gave the example of a popular film [X] whose DVD’s recommended retail price was £24.99, but was being sold by internet retailers for £5.47 plus postage by the time the film was available to view on Sky Movies channels. [X], August 2007, Sky, slide 18. Provided at tab 15 of Sky’s response dated 1 July 2008 to question 10 of Ofcom’s information request dated 29 May 2008.

⁶²⁴ [X]

- [X]. This stated that on average there are 20 titles on a Saturday on Freeview and 228 titles over a two week period⁶²⁷.
- In addition, numerous internal documents identify free to air content, particularly Freeview, as a rival to Sky (e.g. “As the FTA proposition gets stronger it becomes increasingly hard to attract and retain customers to pay TV”⁶²⁸). [X]⁶²⁹.

6.85 In interpreting these documents it is important to recognise that if retail prices are currently above the competitive level (see paragraphs 5.47 to 5.60 and 6.27 above), alternatives to Sky Movies will appear relatively more attractive than they would do at the competitive price. Accordingly, Sky will tend to regard other products as strong competitors even where they would not be close substitutes if packages including Sky Movies were priced at the competitive level. In other words, internal documents will tend to overstate the extent of the constraints that Sky would face if prices were in fact at the competitive level (this is a manifestation of the cellophane fallacy).

6.86 [X]. However, internal documents are helpful in providing an indication of the relative **ranking** of those potential constraints.

6.87 In this regard, we consider it striking that Sky [X]⁶³⁰ [X].

6.88 [X].

Survey evidence

6.89 Sky argued that, given that product differentiation plays a “central role” in this case, it is “inappropriate to focus on differences in products’ characteristics as delineating market boundaries”⁶³¹.

6.90 In order to supplement our analysis of product characteristics, we have therefore also considered the results of a survey that we conducted in November/December 2009⁶³². We asked non-subscribers to Sky Movies why they did not subscribe. We would expect some of these respondents to be marginal customers of Sky Movies at

⁶²⁵ [X] was the “proliferation of digital multichannels offering movies in a later window”. Source: [X], 1 July 2005, Sky, slide 6. Provided at tab 5 of Sky’s response dated 1 July 2008 to question 10 of Ofcom’s information request dated 29 May 2008.

⁶²⁶ [X] September 2006, Sky slide 26. Provided at tab 10 of Sky’s response dated 1 July 2008 to question 10 of Ofcom’s information request dated 29 May 2008.

⁶²⁷ [X], August 2007, Sky, slide 19. Provided at tab 15 of Sky’s response dated 1 July 2008 to question 10 of Ofcom’s information request dated 29 May 2008.

⁶²⁸ [X], July 2005, Sky, slide 4. Provided at tab 3 of Sky’s response dated 1 July 2008 to question 10 of Ofcom’s information request dated 29 May 2008. See also Section 2 of [X] 1 July 2005 provided at tab 4 of this response.

⁶²⁹ [X]

⁶³⁰ [X]

⁶³¹ Sky response to Third Pay TV Consultation, paragraph 5.17.

⁶³² See paragraphs 5.156 to 5.158 for more details.

the competitive price level. Sky provided its comments on this survey in March 2010. Our assessment of Sky's comments is set out in Appendix 5 of Annex 6.

6.91 The responses are summarised in the Figure below.

Figure 79 Reasons for not subscribing to Sky Movies

Packages	Unprompted	Prompted
Too expensive	35%	49%
Not very interested in movies	29%	36%
Wouldn't watch it enough	14%	37%
I watch DVDs instead	6%	19%
Enough films available on TV	4%	11%
I watch films at the cinema instead	3%	5%
Too many repeats	2%	3%

Source: Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009.

6.92 The survey results provide support for the view that DVDs and free-to-air movies are likely to be the closest substitutes for Sky Movies (although again this does not imply that they are close in an absolute sense). None of the survey respondents mentioned non-movies content as an unprompted response⁶³³.

Scale of potential substitutes

6.93 In assessing the scale of potential substitutes we primarily consider retail revenues. However, many FTA movies are broadcast on BBC channels without advertising, and therefore without generating revenue that is directly attributable to the broadcasting of those movies. Therefore, we assess the scale of FTA movie broadcasting with reference to expenditure on movie rights (relative to Sky).

6.94 **Retail revenues** from different ways of seeing movies are shown in the Figure below. Retail DVDs account for almost half of these revenues. However, most of the revenues from a new DVD movie release will be earned before the movie is shown on pay TV (by which time both the price and sales levels of that particular DVD will be much lower). Cinema and Sky Movies are the second and third largest sources of retail revenue. Revenues from DVD rental and PPV services are substantial but somewhat smaller.

⁶³³ We did not prompt respondents in relation to non-movies content.

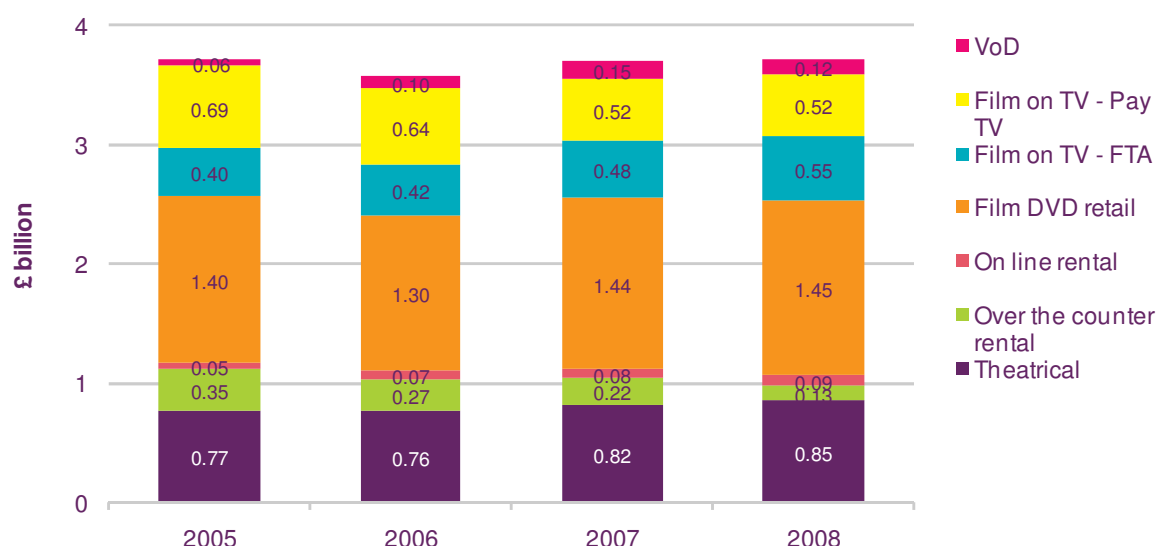
Figure 80 Revenues from pay movie services (2008)

[✕]

6.95 The Figure below summarises trends in revenues associated with different film formats and windows. It shows that revenues have declined overall, though trends vary between the different formats. We observe:

- There has been a small decline in revenues associated with films on TV. According to Screen Digest the value of the FTA window is forecast to be broadly flat over the period 2006-2011⁶³⁴.
- VoD and SVoD services have been relatively unimportant to date. However, as we discuss in Section 7, our view is that there is considerable scope for these services to grow in popularity if they are able to provide sufficiently attractive content. In particular, premium SVoD services accessible via the television have the potential to be highly attractive.
- Revenues from over the counter DVD rentals are falling sharply, but this is partly offset by increases in PPV and online DVD rentals.

Figure 81 Value of films from different formats, nominal figures



Sources: Theatrical, retail film, film on TV and VoD: UK Film Council Statistical Yearbook 2009; over the counter and online rentals: British Video Association Yearbook 2009.

Notes: 'Film on TV' covers terrestrial, subscription and free multi-channel. Pay-per-view is included within the VoD total. 'VoD' includes Near Video on Demand (NVoD) and true Video on Demand.

6.96 The Figure below shows **rights and programming costs** for movies shown on TV. Sky's movie rights spending of [✕] (which includes library films but excludes spend on PPV) is much higher than that of other movies channels (which spend about [✕

⁶³⁴ See figure 10 of Annex 11 to the First Pay TV Consultation.

], but broadly similar to spending on movies by PSB channels [635,636]. Most FTA movies will be less recent than those shown on Sky Movies.

Figure 82 Rights expenditure and programming costs on movies, 2008

[635]

Source: Broadcasters' licence returns to Ofcom.

Note: PSB channels include BBC1, BBC2, ITV1, Channel 4, Five and BBC digital channels.

Conclusion

6.97 The extent to which a potential substitute is likely to constrain Sky's movies channels depends both on the closeness of substitutability and the likely future scale of that substitute. On this basis, the strongest potential constraints on Sky's linear movies channels are (a) movies on retail DVDs, (b) FTA movies channels and movies on other FTA and basic channels, (c) non-movies content on television and (d) SVoD TV services in the first pay TV subscription window. As noted at paragraph 6.77, we have considered other closer potential substitutes. However, they do not materially affect our market power assessment. Accordingly, we address those substitutes, together with cinema, in Appendix 2 of Annex 5.

6.98 Our overall view of the extent of substitution is illustrated in the following Figure. The following discussion of market definition sets out the basis for this view.

Figure 83 Substitutes for Sky Movies

	Close substitute	Moderate substitute	Distant substitute
Large scale		<ul style="list-style-type: none"> Movies on other FTA and basic channels 	<ul style="list-style-type: none"> Non-movie TV content Other retail DVDs Cinema
Medium scale		<ul style="list-style-type: none"> Retail DVDs in pay TV window Online DVD rental PPV VoD 	<ul style="list-style-type: none"> OTC DVD rental
Small scale	<ul style="list-style-type: none"> SVoD on TV in pay TV window (currently only via Xbox/PC) 	<ul style="list-style-type: none"> Disney Cinemagic SVoD on PC in pay TV window 	<ul style="list-style-type: none"> SVoD on TV, after pay TV window

Note: We have assessed scale qualitatively, based on movies expenditure (on rights and/or programming costs) and retail revenues.

⁶³⁵ Confidential 2008 broadcaster returns to Ofcom.

⁶³⁶ BBC's recent strategy review proposed reducing spending on imported programmes and films by 20%, and capping this spending at no more than 2.5p in every licence fee pound.
http://www.bbc.co.uk/bbctrust/assets/files/pdf/review_report_research/strategic_review/strategy_review.pdf.

6.99 If Sky has market power, our view is that it can best be assessed as operating at the wholesale level, both in Sky's current wholesale supply to cable firms, and its response to requests for such supply by other retailers. However, any such market power depends on the willingness or unwillingness of retail customers to switch to alternative services. We have considered the constraints facing a hypothetical wholesale monopolist, rather than an integrated wholesale/retail monopolist, in order to focus on effects at this level. However, where relevant, we have had regard to the fact that Sky is vertically integrated.

6.100 With this in mind, our market definition is set out as follows:

- We begin with an assessment of potential retail substitutes, and conclude on the definition of the **relevant retail market**.
- We consider the presence of retail substitutes as 'indirect constraints' in assessing the **relevant wholesale market**.

6.101 In order to set out our views as clearly as possible, we have modified our presentation from that in our Third Pay TV Consultation, which began with an assessment of wholesale markets. However, this is a presentational change and not a substantive one. In particular, in assessing wholesale market power we are relying on the evidence we have set out on retail demand substitution, just as we did in our Third Pay TV Consultation.

Evidence base used to define markets

6.102 To define the relevant wholesale and retail markets in respect of premium movies channels, we have considered a wide range of evidence on substitution from a variety of sources. We have reviewed evidence which was considered in previous consultations,⁶³⁷ and also gathered some new evidence in order to address responses to our Third Pay TV Consultation. In summary, we have considered the following:

- Product characteristics evidence: One method of assessing substitutability is to examine the characteristics of a particular product. We have considered a range of characteristics evidence including data submitted by Sky on types of films broadcast on Sky's movies channels, BARB data on the characteristics and viewing figures of different channels, consumer survey evidence on viewing habits and consumer survey evidence on the preferences of subscribers to Sky Movies. We have also extensively assessed the characteristics of potential substitutes to Sky's movies channels.
- Survey evidence on stated responses to price rises: We have considered three pieces of evidence: (i) a survey which we carried out in 2007 on consumers' stated response to a rise in the price of Sky Movies Mix, (ii) a consumer survey carried out by Sky in 2007 on the willingness of consumers to switch in response to a rise in the price of Sky Movies and Top Tier packages and (iii) a further survey carried out by Sky in 2009 on consumer switching.
- Changes in demand for movie formats: We have examined a range of evidence on changes in demand for different movie formats (Sky Movies, FTA movies,

⁶³⁷ In Figure 6 of our Third Pay TV Consultation, we referred to the broad categories of evidence which we had considered. See also Third Pay TV Consultation, paragraph 4.23.

PPV, retail DVD sales and DVD rental) with a view to assessing what inferences can be drawn from those changes. The evidence we have considered has included an econometric study carried out for Sky, the Seabright Study, which estimated the impact of Freeview availability on demand for Sky's movies channels.

- Movie viewing data: We have considered viewing data, provided to us by Sky, on a sample of consumers that ceased subscribing to Sky Movies in 2007/8.
- Internal documents: Company documents such as internal communications, studies on consumer preferences or business plans can provide useful evidence of substitution. We have considered internal papers from Sky and [X] on the extent to which their respective movie products face competition from other movie formats.
- Consultation responses: We have taken account of all respondents' views in reaching our conclusions on wholesale and retail market definition.
- Movie rights: Our market definition analysis has considered revenues from the supply movies in different "windows".

6.103 We have also considered the following evidence, which is not directly related to assessing substitutability of products, but which is nonetheless relevant to defining markets.

- Pricing and profitability evidence: In order to determine whether Sky's prices are above the competitive level, and whether this might have an impact on our market definition assessment, we have considered (i) an analysis of Sky's profitability carried out by Oxera, (ii) the extent to which Sky's current wholesale rate-card prices are significantly and consistently above our estimates of cost-plus wholesale prices. As noted in Section 5, profitability analysis also provides direct evidence as to the presence of market power.
- Price and quality changes: We have also examined what can be inferred from observed responses to changes in price and quality over time.

Retail market definition

The focal product

6.104 Sky Movies content is offered in a range of bundles to subscribers, as illustrated in the Figure below. The possible Sky Movies configurations are:

- Standalone Sky Movies 1 (known as "Single Movies");
- Standalone Sky Movies 2 (also known as "Single Movies" and sold for the same retail price as Sky Movies 1);
- Sky Movies 1, 2, Sky Premiere and Sky Premiere +1 (known as "Dual Movies").

6.105 Each of these three configurations is bundled with various Sky Sports packages. All of the Sky Movies channels are available in HD with the exception of Sky Movies Classics and Sky Premiere +1.

6.106 [38]⁶³⁸.

Figure 84 Sky's Movies packages

[38]

6.107 Our starting point for product market definition is to determine the focal product (see paragraph 5.39). In the Third Pay TV Consultation we assessed retail markets for the provision of packages containing any of the following channels: Sky Movies channels (apart from Classics) and Disney Cinemagic⁶³⁹. Sky Movies Classics had too few new movies to be included within the relevant wholesale market (Third Pay TV Consultation, paragraph 4.261).

6.108 Virgin Media made no new submissions in relation to movies in response to the Third Pay TV Consultation⁶⁴⁰. However, in the context of sports channels, it argued that the focal product should refer to packages of premium channels as opposed to individual channels⁶⁴¹. Sky stated that the approach in the Third Pay TV Consultation gave rise to analytical difficulties because the wholesale and retail focal products were different⁶⁴².

6.109 We agree with Virgin Media that we should consider packages of channels that are offered in the market, and this is the approach that we adopted at the retail level in both the Third Pay TV Consultation and in this document⁶⁴³. However when assessing constraints we consider the competitive constraints on the premium movies element of the bundle (rather than the package as a whole)⁶⁴⁴. Appendix 3 of Annex 4 explains why, having considered consultation responses, we remain of the view that this approach is appropriate.

6.110 We recognise the importance of adopting a consistent approach at both the wholesale and retail levels. As explained in paragraph 6.258 below, the wholesale focal product is the provision of wholesale packages containing the Sky Movies channels (i.e. containing Sky Movies 1, Sky Movies 2 or Sky Dual Movies). Consistency with the wholesale focal product means that Disney Cinemagic should not be part of the retail focal product. Since Sky Movies Classics is not available on a standalone basis, analysing the products (bundles) that are actually supplied to

⁶³⁸ Sky notes that its subscriber numbers changed since this information was provided – specifically, Top Tier subscribers now represent just under half of Sky premium subscribers [38] and [38] of premium movies subscribers. (Sky response dated 19 March 2010 to Ofcom letter dated 11 March 2010, row 30).

⁶³⁹ Third Pay TV Consultation, paragraph 4.379 (this referred to “Core Premium Movie channels”; this term was defined in paragraphs 4.377-4.378).

⁶⁴⁰ Virgin Media response to Third Pay TV Consultation, paragraph 3.2.

⁶⁴¹ Virgin Media response dated 15 April 2009 to question 2 of Ofcom's information request dated 29 October 2009. Also Virgin Media response to Third Pay TV Consultation, paragraphs 3.9, 3.16 and 3.18.

⁶⁴² 6 October 2009 Sky Submission, paragraph 22.

⁶⁴³ Third Pay TV Consultation, paragraph 4.379.

⁶⁴⁴ We adopted the same approach in the Third Pay TV Consultation (see paragraph 4.379 of that document).

consumers means we do not exclude Sky Movies Classics. However, these channels were and remain of negligible importance to our overall analysis.

6.111 We thus conclude that the most appropriate retail focal product is the provision in the UK of residential packages containing HD and/or SD versions of any of the following groups of channels: Sky Movies 1 or Sky Movies 2 or Sky Dual Movies.

6.112 As explained above, Sky Movies 1 and 2 consist of five channels each and Sky Dual Movies consists of twelve channels. We recognise that the characteristics of Sky Movies 1 and 2 are somewhat different from the characteristics of Sky Dual Movies: they have seven fewer channels and lack Sky Movies Premiere (which broadcasts major new releases). Packages containing Single Movies are thus likely to be less attractive to movie fans⁶⁴⁵. However in 2008 [X] of subscribers to Sky Movies on Sky's satellite platform took a package containing Dual Movies rather than a package containing Single Movies⁶⁴⁶. In the analysis that follows we focus on the characteristics of Sky Dual Movies (i.e. all twelve Sky Movies channels).

Substitution analysis

Our approach in the Third Pay TV Consultation

6.113 In the Third Pay TV Consultation we considered a range of evidence, including product characteristics⁶⁴⁷. We stated that "access to new films is an important feature of premium movies" and inferred that "channels containing older films or other film content are likely to be a weak substitute"⁶⁴⁸. Further, "consideration of the different characteristics of DVDs and premium movies" was part of our evidence that retail DVD sales are a "relatively weak substitute" for premium movies channels⁶⁴⁹.

6.114 We also relied on a range of other evidence including wholesale margins⁶⁵⁰, estimates of demand elasticities based on survey responses⁶⁵¹ and analysis of sales volumes⁶⁵².

Consultation responses

6.115 In its response to our Third Pay TV Consultation Sky questioned the relevance and reliability of product characteristics as a means of defining markets where products are differentiated. Sky's views are set out in paragraphs 5.147 to 5.148.

⁶⁴⁵ Accordingly wholesale packages including Single Movies are unlikely to be commercially attractive to retailers.

⁶⁴⁶ Ofcom calculations using figures set out in our confidential market share spreadsheet.

⁶⁴⁷ We considered the "Characteristics of premium movies channels and potential substitutes" in paragraphs 4.259-4.297. See also paragraphs 4.393-4.396.

⁶⁴⁸ Third Pay TV Consultation, paragraph 4.376, third bullet.

⁶⁴⁹ Third Pay TV Consultation, paragraph 4.376, fourth bullet.

⁶⁵⁰ Third Pay TV Consultation, paragraph 4.376, final bullet.

⁶⁵¹ Third Pay TV Consultation, paragraph 4.376, penultimate bullet and paragraphs 4.390 to 4.392.

⁶⁵² Third Pay TV Consultation, paragraphs 4.376 and 4.400.

6.116 Sky argued that it is important to focus on the preferences of marginal consumers⁶⁵³ and that marginal consumers may have different preferences to other consumers⁶⁵⁴.

6.117 Sky said that only a small proportion of the movies shown on Sky Movies are 'Hollywood blockbusters' (e.g. 10% of the films shown in 2006/07). It said that approximately 60% of the films shown on Sky Movies were library movies⁶⁵⁵.

6.118 [X]⁶⁵⁶

6.119 In the Third Pay TV Consultation we considered constraints on the premium element of the retail bundle purchased by consumers (paragraph 4.379). This was consistent with the approach adopted when defining sports retail markets and Sky advanced the same criticisms with regards to both sports and movies (see paragraph 5.76).

Our current view

6.120 Our view on product characteristics is set out in paragraphs 5.150 to 5.153. As we note there, where a product does not meet the same consumer demand as the focal product then it will not be a close substitute. Even where a potential substitute is intended to meet the same demand, whether it is in fact a competitive constraint depends on its attractiveness relative to the focal product, taking into account both its price and its quality. In order to assess quality, it is necessary to identify which characteristics are important to consumers and then evaluate each potential substitute in the light of those important characteristics. Accordingly we have identified the most important characteristics of premium movies services in paragraph 6.55, and systematically assessed each potential substitute identified in paragraphs 6.77 in terms of these substitutes.

6.121 We have sought where possible to consider whether there is any indication that the preferences of marginal customers may differ from those of non-marginal customers.

Sky Dual Movies

6.122 To understand what motivates consumers to subscribe to Sky Movies, it is helpful to look at the extent to which viewing is concentrated on a small number of films.

6.123 Figure 76, Figure 77 and Figure 78 above demonstrate that viewing is concentrated on popular, premiere and recent films. Figure 85 shows the importance of a comparatively small number of recent movies to Sky Movies subscribers:

- In 2008 100 films accounted for 38% of all viewing on Sky Movies and 200 films accounted for 56% of all viewing.
- Out of the top 100 films (as measured by total film views), 83% were first released in 2006 or 2007. Out of the top 200 films (again as measured by total film views), 69% were first released in 2006 or 2007.

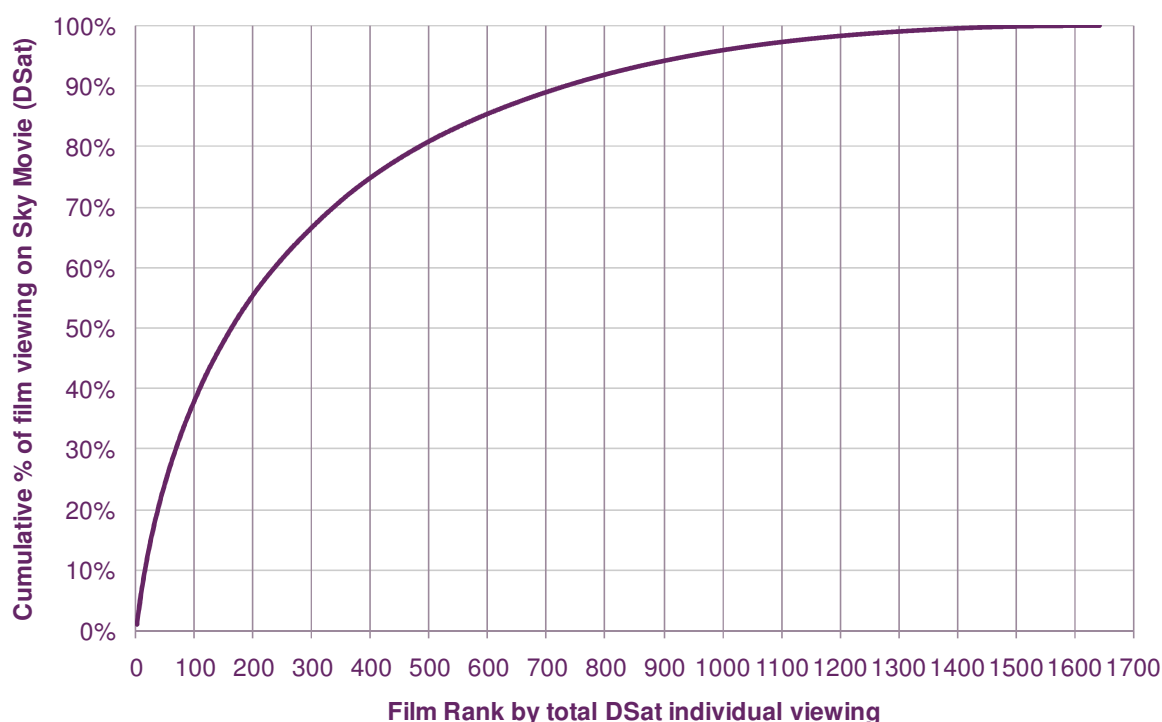
⁶⁵³ Sky September 2009 Response, paragraph 5.16; also 5.32.

⁶⁵⁴ This point underlies the argument in Sky September 2009 Response, footnote 38 to paragraph 5.29.

⁶⁵⁵ Sky response to Third Pay TV Consultation, paragraph 5.30.

⁶⁵⁶ [X].

Figure 85 Distribution of film viewing on Sky Movies in 2008



Source: BARB viewing data (2008)

6.124 Unsurprisingly, viewing also tends to be concentrated on movies that were box-office successes. Movies that were in the top 60 films (measured by box office receipts) in either 2007 or 2006 accounted for 54% of viewing of recent movies and 32% of overall viewing despite representing only 5% of the titles broadcast on Sky Movies⁶⁵⁷.

6.125 However, Sky Movies subscribers also watch large volumes of other movies which are either less attractive (as measured by their box office success) or older (outside the pay TV window)⁶⁵⁸:

- In 2008, 40% of total viewing was from films released in 2005 or earlier.
- A further 10% of total viewing was of films released in 2006 or 2007 that were not within the top 150 movies at the box office (either because they were not released theatrically, had a limited theatrical release, or performed very poorly in cinemas).

⁶⁵⁷ We have assessed the viewing of the top 60 films to illustrate the importance of big box office movies. We recognise that it is quite arbitrary how many of the top films we assess, as Figure 76 shows that viewing of films generally decreases steadily between the top and bottom movies (by box office revenue). Looking at the 2007 data in the Figure, there is a sharp drop in average viewing between movies ranked 51 to 60 and movies ranked 61 to 70.

⁶⁵⁸ Using number of film views is not a perfect indicator of the value of a film. It shows that new films are more important than older films, but it does not say by how much. The fact that film viewing of pay TV window films is 50% more than library content does not suggest that pay TV films are 50% more valuable to subscribers. If a consumer is willing to pay more for newer films (as illustrated by the fall in DVD prices in Figure 89 below), then pay TV window films could be over 50% more valuable than library content.

- Thus films that are either relatively old or did not have a material presence in cinemas accounted for half of all viewing on Sky Movies. Such films are relatively unattractive individually (they account for well over half the films shown on Sky Movies but only half of all viewing), but do have some value in aggregate.
- This suggests that Sky Movies subscribers attach particular value to recent box-office successes, but also value access to a wide range of movies content.

6.126 The top four reasons given by respondents for subscribing to Sky Movies were:

- “To access a wider range of movies than you receive on other TV” (37%),
- “I got a good deal/it came with my package” (23%),
- “To watch recently released movies” (19%) and
- “To have a wider range of TV than available with my basic package” (17%).⁶⁵⁹

6.127 Of these reasons, the first and fourth relate to the importance of a range of movies.

6.128 While the availability of a wide range of library films enhances the value of Sky Dual Movies to subscribers, this does not imply that a premium service which relied exclusively on library content would have mass appeal. We consider that the key determinant of consumer demand for Sky Dual Movies is access to new movies. This is what allows Sky Dual Movies to command a substantial premium.

6.129 We now set out our view of Sky Dual Movies in terms of the characteristics we identified in paragraph 6.55.

6.130 **Quantity:** Sky Dual Movies show a large quantity of films that are of particularly high quality (at least in terms of box office success). The UK Film Council reported that:

- Sky Movies channels showed 1,446 different films in 33,978 slots in 2007⁶⁶⁰.
- Sky Movies channels showed 1,500 different films in 39,238 slots in 2008.⁶⁶¹

6.131 **Quality:** Sky has had exclusive rights to show films in the first pay TV subscription window from the six Major Hollywood Studios since [X]⁶⁶², and also contracts with Icon, Momentum and Lionsgate,⁶⁶³ [X], and Pathé.

⁶⁵⁹ This survey evidence was presented in Figure 16 from Annex 10 of the Second Pay TV Consultation.

⁶⁶⁰ Response of UK Film Council 18 May 2009 to Ofcom information request of 11 May 2009.

⁶⁶¹ Statistical Yearbook 2009, UK Film Council, page 98 and 99.

⁶⁶² The year depends on the studio. Source: Sky response to information request of 20 December 2007. Note however that Disney premieres its animated films on its Disney Cinemagic channel, before they are shown on Sky Movies (see for example http://media247.co.uk/skydigital/newsarchive/2006/02/sky_launch_conf.php).

⁶⁶³ First Pay TV Consultation, Figure 131 of Annex 11.

- 6.132 Screen Digest estimates that US films typically account for around 35% of films released at UK cinemas but for up to 80% of UK box office revenues⁶⁶⁴.
- 6.133 The particular importance of the Major Hollywood Studios is also illustrated by the lower viewing figures for Sky Indie compared to the other Sky Movies channels (see Figure 77above).
- 6.134 Sky Dual Movies shows a significant number of films that previously appeared in the cinema and were box office successes.

Figure 86 Number of unique titles broadcast on Sky's movies channels by category

[✕]

Source: Sky response to email of 17 July 2008 , 'Analysis of the quality of films broadcast on Sky's Movies channels: 2001/02 – 2006/07' page 6, as presented in Figure 9, Annex 6, Appendix 3 to Second Pay TV Consultation.

- 6.135 **Timing:** The majority of movie viewings on Sky Dual Movies are of new releases – around twelve months after their cinema release, and before they are available on other TV channels or services⁶⁶⁵. As noted above, this content is supplemented with older films.
- 6.136 **Format:** Sky Dual Movies is a television service, delivered to people in their homes. It is available on a pay monthly subscription basis. Films on Sky Movies are not interrupted by advertisement breaks – instead these are concentrated before and after films. This is likely to increase the attractiveness of films on Sky Movies relative to other channels (with the exception of the BBC).
- 6.137 **Price:** The retail price of Sky Dual Movies is set out in the following Figure (this is based on the data presented in Figure 22).

⁶⁶⁴ First Pay TV Consultation, Annex 11, paragraph 79.

⁶⁶⁵ As shown in Figure 78 above.

Figure 87 Pay TV packages and pricing

Retailer	Packages	Implied premium over basic	Subscribers as a % of total (as of June 2009)
Sky Digital	Basic + sports	£18	[X]
	Basic + movies	£16	[X]
	Basic + both	£25.50	[X]
Virgin Media TV	Basic ³ + sports	£26	[X]
	Basic ³ + movies	£30	[X]
	Basic ³ + both	£37	[X]

Source: Ofcom, operators.

Notes: Prices correct as of February 2010. Sports and Movies refer to Sky Core Premium Channels. 1 Based on total satellite subscriber numbers for Sky of [X]. 2 Based on total (digital and analogue) subscriber numbers for Virgin Media of [X] as of June 2009. 3 Based on a Virgin Media entry level basic pay TV package (M), which is available free only when taken with a phone line of £11 per month. Note that the incremental price is smaller for Virgin Media subscribers that take a larger basic pay TV package.

6.138 Comparison of these prices with the prices of available substitutes is complicated by a number of factors:

- The majority of Sky Dual Movies subscribers also subscribe to Sky Sports. Some of these subscribers are primarily interested in movies, others in sports. For a subscriber who is willing to pay the standalone price for Sky Sports, the “true” price of Sky Dual Movies is arguably the *incremental* price of the Top Tier package, above the Sky Sports standalone price.
- Comparing Sky Dual Movies with potential substitutes such as movies on DVD entails comparing access to a single movie with the option to access a large number of movies. One way of addressing this is to consider the price per movie viewed on Sky Dual Movies.
- We have two estimates of the number of movies viewed per month:
 - BARB viewing data shows that there were 471m film views on Sky Movies through the satellite platform in 2008. In September 2008, [X] households subscribed to Sky Movies on Sky’s satellite platform⁶⁶⁶. These households thus account for an average of [X] film viewings per month (e.g. one person watching [X] films per month, two people watching an average of [X] films each).
 - Sky provided viewing data for former Sky Movies subscribers. This data suggested that, prior to ending their Sky Movies subscription, those

⁶⁶⁶ Sky response dated 9 November 2008 to Ofcom information request 08/01/09.

households watched 2-3 movies per month^{667 668}. This is not necessarily inconsistent with BARB data. For example, a household of three people⁶⁶⁹ watching three movies per month would account for nine viewings per month, similar to that recorded by BARB.

- Subscribers differ widely in the frequency with which they watch movies (see Figure 88 below), so an average figure is not very typical.
- Subscribers do not necessarily place an equal value on all movies that they view. For example, a subscriber may particularly want to see one new release in an average month, and watch one or two other movies but not have a strong preference for them over movies or content available elsewhere. This is particularly the case given that movie viewing is split between new releases and library content.
- Any comparison based on current prices is potentially subject to the cellophane fallacy, as described in paragraphs 5.47 to 5.60.

6.139 With these caveats in mind, our approach to assessing the price of Sky's movies channels is as follows. Most Sky Dual Movies subscribers also buy Sky Dual Sports. To those buying Sky Dual Movies as a cheap add-on the typical incremental price of the Sky Dual Movies element (on top of Sky Dual Sports and basic content) is £7.50. For those buying Dual Movies without Sports, or taking Sports as a cheap add-on, the incremental price for Movies (on top of basic content) is £16. As such, the relevant price for movies is to some extent subjective, and depends on the subscriber's perspective as to the relative value of movies and sports. However, overall the price of Sky Dual Movies ranges from £7.50 to £16. On this basis:

- For households that purchase Dual Movies as a cheap add-on to Dual Sports (our survey evidence suggests that half of Top Tier subscribers fall into this category) the price per movie is between £3.75 and £7.50 per movie (based on 1-2 movies), or between £2.50 and £3.75 (based on 2-3 movies). More frequent viewers will pay a lower price per movie.
- For households that purchase Dual Sports as a cheap add-on to Dual Movies (our survey evidence suggests that 22% of Top Tier subscribers fall into this category), the standalone price of Sky Dual Movies without Sky Dual Sports is more relevant. The implied price that these subscribers are paying for Sky Dual Movies is around £16. These consumers could be paying around £8 to £16

⁶⁶⁷ Figure 1 on page 64 of Sky's June 2009 response to our Second Pay TV Consultation presents viewing data for households that ceased subscribing to Sky Movies. This shows that these households on average watched as much as 800 minutes of movies on Sky Movies per quarter. If we assume that the average film is 100 minutes long, this suggests that these households could be watching up to 8 films per quarter on Sky Movies. A conservative estimate is that these households watch 2 to 3 films per month.

⁶⁶⁸ Note that Sky's data was based on viewing by the household (as a whole) whereas the BARB data relates to the number of people watching a programme. Thus if two people view a one hour programme it will be counted as one hour of viewing using Sky's data set and two person hours of viewing using BARB's approach. Sky's data does not necessarily differ significantly from BARB data as several household members may watch the same movie at the same time.

⁶⁶⁹ Ofcom's Phase 3 Survey (Sept 2007) indicated that Sky Movies households had an average of three members.

based on 1-2 views or £5.50 to £8 per film view based on 2-3 views. Again, more frequent viewers will pay a lower price per movie.

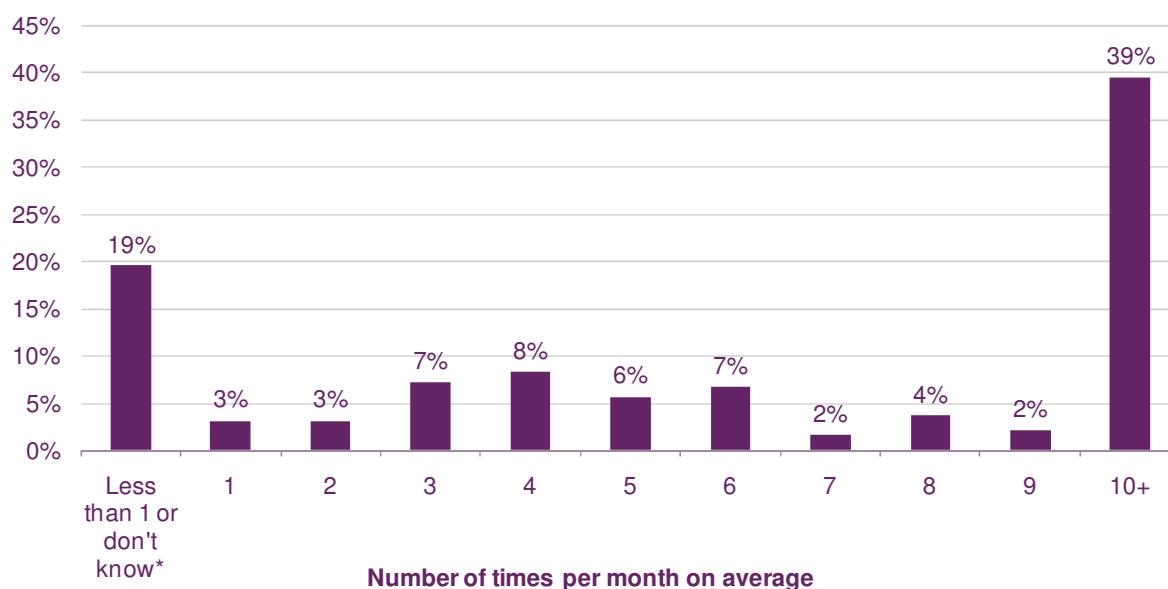
- For households who see both movies and sports as important in their purchasing decision, the effective price per movie will be between that for households which are primarily interested in sports and those which are primarily interested in movies. Again, this will also depend on the number of movies viewed.

6.140 The figures in the preceding paragraph should be interpreted carefully for three reasons:

- First, one of the attractive features of the subscription price structure of Sky Movies is that the incremental cost of watching a film is zero. Subscribers (and their families) can thus control their expenditure and watch as many movies as they like without incurring any extra cost. Sky Movies thus gives subscribers the option to watch additional films costlessly if they wish to do so. This option value is not reflected in the above calculations but we consider it is likely to be important to a significant proportion of Sky Movies subscribers. The greater popularity of subscription movies over PPV illustrates the extent of this preference.
- Second, they relate to relatively infrequent viewers of movies and are not representative of the average price paid per film by a typical Sky Movies subscriber. Rather they are 'upper bounds' for prices per film.
 - Figure 88 below sets out the number of times per month that households that subscribe to Sky Movies watch films on the channels that are now part of the Sky Movies suite of channels. Our survey first asked respondents whether their household watches films on these channels on a regular basis. Respondents that answered "yes" to this initial question were then asked a follow up question asking how frequently they did so. 19% of respondents did not answer "yes" to the initial question. It is unclear whether this is because they watch these channels irregularly or whether they did not know (for example because they do not know the viewing habits of other household members).
 - A further 13% of households that subscribe to Sky Movies reported that they watch Sky Movies one to three times per month on average.
 - The median number of films watched (by one or more members of the household) is six per month, assuming that the 19% of respondents described in the first bullet above watch six or fewer films per month. This implies that the average price per film is £1.25 for Top Tier households that buy Dual Movies as a cheap add-on to Dual Sports (i.e. using an incremental price of £7.50) and just over £2.50 for Top Tier households that buy Dual Sports as a cheap-add-on (i.e. using an incremental price for movies of £16). This indicates that, compared to the typical price of a DVD, Sky Movies is a relatively cheap way of watching a large number of films for a typical subscribing household.
 - An alternative approach would be to base our comparison on BARB data. In this case, if a movie is watched by several member of the household, each person counts as a separate viewing. BARB suggests that the average price-per-person-viewing for Sky Movies is between 75p (based on an incremental price of £7.50) and £1.60 (based on an incremental price of £16). By way of

comparison, if a DVD costing around £7.50 were watched by three members of a household, this would mean an average price-per-person viewing of £2.50. Again, this suggests that Sky Movies is a relatively cheap way of watching a large number of films for a typical subscribing household.

Figure 88 **Number of times Sky Movies households watch films on Sky Movies or Sky Cinema per month**



*Note: * A breakdown of less than 1 or don't know is not possible.*

Survey was carried out in November/December 2006. At that time Sky's movies channels were known as "Sky Movies" and "Sky Cinema" (Sky has subsequently rebranded and reorganised these channels).

Source: Ofcom Phase II Research, fieldwork 14 November 2006 to 17 December 2006, MOV1 D

Assessment of potential substitutes

6.141 As discussed above, we have focused on the following substitutes which we see as of the greatest importance, in terms of their scale, their prominence in Sky's internal documents and survey results, and, in the case of SVoD, their future potential growth.

- Movies on retail DVDs.
- FTA movies channels and movies on other FTA and basic channels.
- Non-movies content on television.
- Subscription VoD (SVoD) services on TV and showing movies that are in the pay TV window.

6.142 Although this analysis is presented sequentially for clarity, we agree with Sky that it is the aggregate constraint exerted by all potential substitutes that is important. We recognise that a movie fan is likely to watch movies in a range of different ways – e.g.

- Going to the cinema to see the most appealing new releases and/or as a social event.
- Buying recent DVDs for a range of possible reasons (e.g. because they particularly enjoyed the film in the cinema, or missed seeing it in the cinema), or receiving them as gifts.
- Watching movies when they first appear on pay TV (if a subscriber) or on FTA TV.
- Watching a range of older movies on pay TV, FTA TV, or on (usually discounted) DVDs.

6.143 With this in mind, the way we have presented our analysis is as follows. First we set out a pairwise comparison between bundles including Sky Movies and the various potential substitutes. Second, drawing on the totality of the pairwise comparisons, we assess the overall (aggregate) constraint on bundles including Sky Movies channels.

6.144 We also recognise that assessing the attractiveness of potential substitutes may involve trading off different characteristics (e.g. trading off older or low quality films for a cheaper price⁶⁷⁰, or an older, high quality film for a more recent, lower quality film⁶⁷¹). We therefore assess potential substitutes with respect to all five key characteristics in addition to other relevant evidence.

Movies on retail DVDs

6.145 In our Third Pay TV Consultation we argued that DVD sales were a relatively remote substitute for Core Premium Movies channels, as evidenced by their very different characteristics and the pattern of retail price changes⁶⁷² (i.e. we noted that the growth in volume, and reduction in prices, of movie DVDs did not appear to have had an impact on Sky Movies subscriptions).⁶⁷³

6.146 Sky said it faced strong constraints from other means of watching movies, including retail DVD sales.⁶⁷⁴ Sky argued that movies are available on DVD for almost a year before appearing on Sky, by which time the DVD price is frequently £5 or less.⁶⁷⁵ Sky also referred to the “novelty and appeal” of owning DVDs.⁶⁷⁶

⁶⁷⁰ This proposition underlies Sky’s argument that ‘lower quality’ products at a cheaper price may be effective substitutes (October 2009 Sky Submission, paragraph 94).

⁶⁷¹ October 2009 Sky Submission, Table 3.

⁶⁷² Third Pay TV Consultation, paragraph 5.90.

⁶⁷³ Third Pay TV Consultation, paragraph 4.335.

⁶⁷⁴ Sky response to Third Pay TV Consultation, paragraphs 5.28 and October 2009 Sky Submission, paragraph A2.50.

⁶⁷⁵ Sky response to Third Pay TV Consultation, paragraph 5.29.

⁶⁷⁶ Sky’s response dated 1 July 2009 to Ofcom information request dated 29 May 2008.

- 6.147 Sky commented on our observation that the price difference between Sky Movies and retail DVDs had widened since 2000,⁶⁷⁷ arguing that a decline in Sky Movies subscribers may be a consequence of this,⁶⁷⁸ and also suggesting that this analysis failed to control for changes in the quality of Sky Movies⁶⁷⁹.
- 6.148 Most, if not all, of the movies shown on Sky Movies at any given time are also available on DVD along with many other movies, so DVDs match Sky Movies for **quality**, and exceed it in quantity. However, a subscriber to Sky Movies can watch an almost unlimited number of movies for no extra price, while each additional DVD watched represents an additional purchase. As a result, for customers who wish to watch a large number of movies, and particularly recent releases, DVDs may be a poor substitute. We return to this issue in our discussion of price.
- 6.149 The main advantage of the DVD **format** over Sky Movies is *permanence*, which allows repeated viewing or giving to others.⁶⁸⁰ In contrast, the main advantage of Sky Movies over DVDs is their relative *immediacy*, as subscribers can have access to a range of movies without planning to watch them in advance. As noted in Figure 75, 28% of price sensitive subscribers regard the convenience of not having to go to a shop for DVDs as “must have” and a further 35% regard it as “nice to have”. The fact that a Sky Movies subscription allows access to a large *volume* of movies, whereas the purchase of a DVD typically allows access to only one, can also be seen as an aspect of the format. Like Sky Movies, DVD movies are also available in HD for a higher price (i.e. on Blu-Ray).
- 6.150 Taking these aspects of permanence, immediacy and volume together, we consider that Sky Movies is significantly differentiated from DVDs.
- 6.151 As regards **timing**, films are released on DVD approximately four months after they are released theatrically and approximately eight months before they are available on Sky Movies. As the Figure below shows, the majority of DVD sales take place in the first month of release.

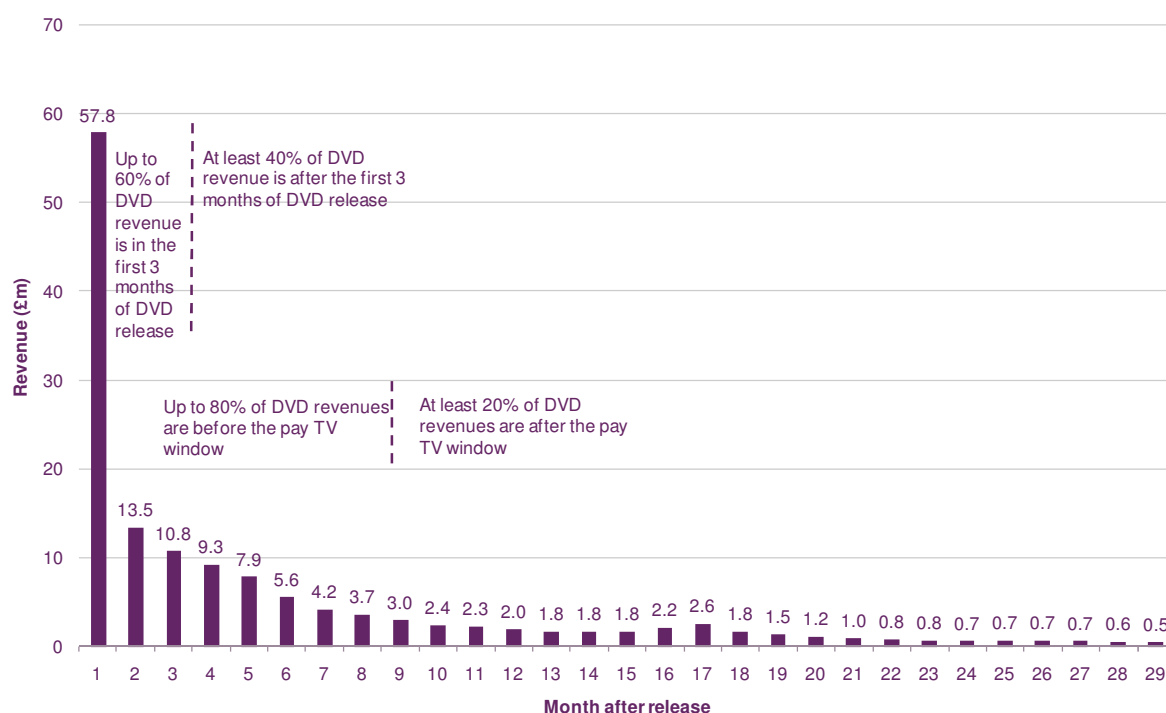
⁶⁷⁷ Paragraph 4.335 of the Third Pay TV Consultation.

⁶⁷⁸ October 2009 Sky Submission, paragraphs A2.48 and A2.49.

⁶⁷⁹ October 2009 Sky Submission, footnote 123 to paragraph A2.48.

⁶⁸⁰ Around 25% of DVD purchases are gifts. BVA Yearbook 2009, page 73.

Figure 89 Revenue from retail DVD sales over time



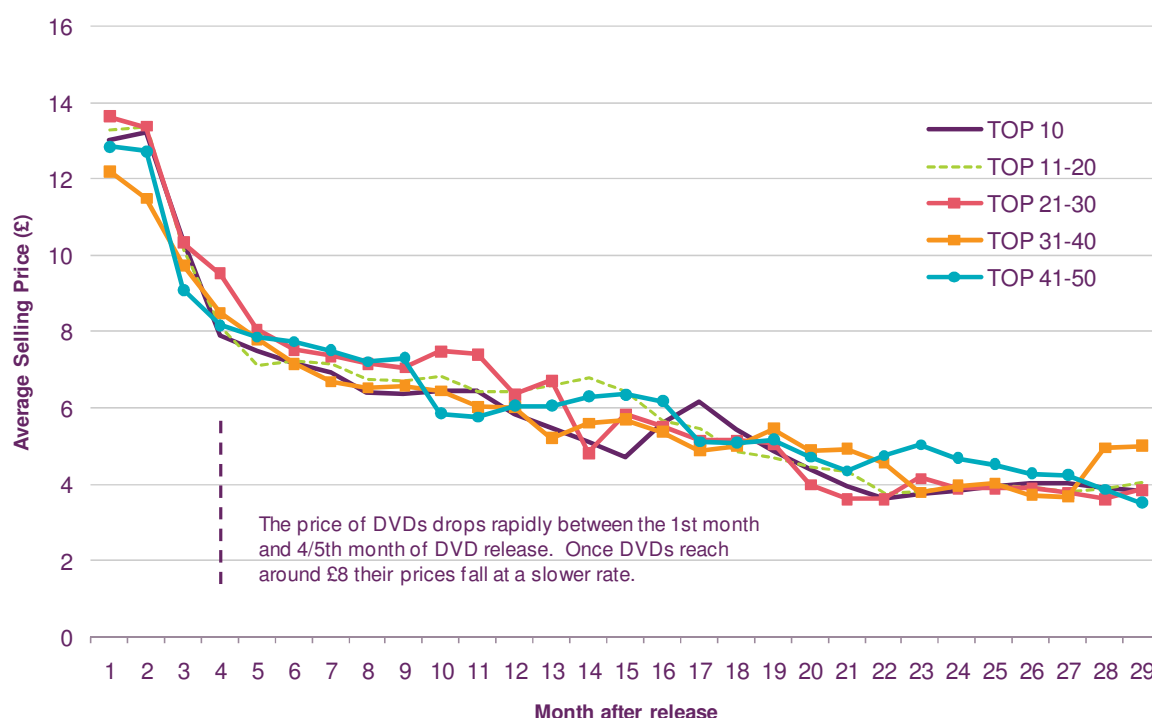
Source: The Official UK Charts Company

6.152 As shown by the Figure below, the retail **price** of DVDs declines sharply from around £12 to £14 in the first month to £8 in the fifth month after release⁶⁸¹. By the time a film first appears on Sky Movies the average retail DVD price is £6.50-£7.50. The price continues to decline during the first pay TV subscription window. In 2008, almost 180m movie DVDs were sold and the value of these sales was £1,321m⁶⁸², suggesting that the average price of a movie DVD in 2008 was £7.36.

⁶⁸¹ This additional information was gathered to address the arguments raised in Sky's response to the Third Pay TV Consultation.

⁶⁸² The BVA reported that 258m units were sold in 2008 and that the value of these sales was £2,343m (BVA Yearbook 2009, page 26). These figures include other genres of DVD such as TV programmes and programming for children. In 2008, films accounted for 56.4% of total value and 69.6% of total volume (BVA Yearbook 2009, page 40). Multiplying £2,343m by 56.4% gives £1,321m and multiplying 258m units by 69.6% gives 180m units. Note that the UK Film Council reported that films accounted for £1,454m of sales volumes and 76% of volume (196m units) (Statistical Yearbook 2009, UK Film Council, page 89). These alternative figures imply an average price of £7.42.

Figure 90 **Retail price of DVDs over time**



Note: Top DVDs released in August to October 2007 (ranked by retail DVD revenue in 1st year of DVD release).

Source: The Official UK Charts Company.

Analysis of prices

6.153 Because DVD prices decline after release, the relative price of films viewed on DVD compared to films viewed on Sky Movies depends on the time of purchase. If, for example, a consumer bought 2-3 DVDs per month of a similar age to the films on Sky Movies, they would pay £12-£21 per month⁶⁸³. In contrast, if bought close to the time of release, the DVDs would cost twice as much. Older DVDs would be slightly cheaper. These effects are illustrated in the table below.

⁶⁸³ Sky Movies subscribers watch a large number of films in the first few months of the pay TV window as shown by the higher viewing figures of Sky Premiere and Sky Premiere+1 in Figure 77. This timing corresponds to DVDs bought 9 to 12 months after release. These cost £6-£7. If 2-3 DVDs were bought per month, they would cost £12-£21.

Figure 91 Illustrative example of cost of buying films on DVD

	Consumer watching two movies per month	Consumer watching three movies per month	Median consumer watching six movies per month ¹
Cost of buying DVDs close to release	£24-£28	£36-£42	£72-£84
Cost of buying DVDs of a similar age to films on Sky Movies	£12-£14	£18-£21	£36-£42

Notes: Assumes a price of £6-7 per DVD for films of a comparable age to Sky Movies and £12-14 per DVD for films in the month that they are released.

1. Based on Ofcom Phase II Research, Field work 14 November 2006 to 17 December 2006. Irregular viewers and “don’t knows” are assumed to watch six movies per month or fewer for this calculation.

6.154 As such, we consider that DVDs bought close to the time of release are not comparable to Sky Movies in terms of price. As shown in Figure 89, even if a consumer only purchased two new DVD releases per month the price would be in the region of £24-28 and if they purchased six new DVDs per month the price would be in excess of £70.

6.155 DVDs within the first pay TV subscription window (i.e. with the same age as movies on Sky Movies) (“Pay TV DVDs”) account for around 17% of total DVD sales⁶⁸⁴. In arguing that DVDs were substitutes, Sky focused on these Pay TV DVDs. Whether these movies are substitutes to Sky Movies depends on a subscriber’s reason for purchasing Sky Movies and frequency of viewing:

- For subscribers buying Sky Movies as a cheap **add-on**, Pay TV DVDs are likely to be a more expensive option (unless viewing of movies is very infrequent).
- For subscribers willing to pay the **standalone** price for Sky movies, substitutability is likely to depend on the **frequency** of viewing. On the basis of the prices we have considered:
 - Those watching fewer than 2 movies per month may see Pay TV DVDs as a cheaper alternative to Sky Movies.
 - Those watching around 2-3 moves per month may see Pay TV DVDs as comparable in price to Sky Movies.

⁶⁸⁴ We obtained data on DVDs released between August 2007 and October 2007. We do not have data on the window associated with each particular film. Rather we assumed that the pay TV window began in month 9 and ended in month 20 for all DVDs (in this data set the month in which a DVD is first released is labelled “month 1”). Ofcom calculations based on data from The Official Chart Company.

- Those watching more than 3 movies per month are less likely to see Pay TV DVDs as substitutes in that they would find it more expensive to watch the same movies on DVD.

- 6.156 Figure 88 above indicates that at most 22% of Sky Movies subscribers are **irregular viewers** of movies (i.e. watch fewer than two movies per month on Sky Movies). For these irregular viewers, Pay TV DVDs will be cheaper than a standalone Sky Movies subscription but may not be cheaper than Sky Movies if it is purchased as an add-on to a Sky Sports subscription. However, in practice, consumers may not explicitly take account of the cost per view of movies (based on their expected viewing patterns) when deciding whether to join or continue with a subscription service. As noted above, direct price comparisons do not reflect the value to subscribers of being able to watch as many movies as they like without incurring any extra cost, and as such these comparisons will tend to overstate the closeness of substitutability.
- 6.157 19% of **non-subscribers** to Sky Movies mentioned DVDs as a reason for not subscribing to Sky Movies⁶⁸⁵. The number of marginal consumers in this group (non-subscribers) is unclear. It is likely that some non-subscribers would be marginal consumers if prices were at competitive levels.
- 6.158 We accept that the evidence here is not clear-cut. However if we consider that marginal Sky Movies subscribers are no more likely than non-subscribers to see DVDs as a substitute, this suggests that at most around one in five marginal consumers may see retail DVDs for movies shown within the first pay TV subscription window as a substitute for Sky Movies. In our view, this is not sufficient to conclude that Pay TV DVDs are a close substitute for Sky Movies, although it may suggest that they are a moderate substitute.

Trend data

- 6.159 In the Third Pay TV Consultation we analysed changes in the number of Sky Movies subscriptions between 2000 and 2008 in the light of the growth in total retail sales of DVDs over that period. The number of Sky Movies subscriptions [X] in the period 2000-2004, [X] in the period 2004-2008. We noted the widening price differential between DVDs and Sky Movies, and said that Sky's ability to sustain this price difference without customers switching to DVDs was evidence that retail DVDs and premium movies packages were in separate markets (Third Pay TV Consultation, paragraph 4.335)⁶⁸⁶.
- 6.160 Sky argued that a similar analysis that we carried out in relation to sports channels was unreliable since it failed to control for changes in other relevant variables (such as price, quality, marketing expenditure) and that we had failed to specify the counterfactual⁶⁸⁷.
- 6.161 We recognise that the range of factors which may affect Sky's subscriber numbers means that strong inferences should not be made from a simple comparison. We

⁶⁸⁵ With prompting; 6% mentioned DVDs without prompting. See Figure 79.

⁶⁸⁶ In paragraphs 89 to 92 of Sky's October 2009 response to our Third Pay TV Consultation, Sky claims we cited erroneous analysis. Given that we no longer rely on this evidence, we do not need to address Sky's concern.

⁶⁸⁷ October 2009 Sky Submission, paragraph 76; also October 2009 Sky Submission, paragraph A2.20.

also recognise that the extent to which Sky Movies subscribers would have stopped subscribing if DVDs had never been introduced is uncertain. As such, we do not base our view of whether DVD retail is a close substitute on this analysis. However, we note that Sky's ability to [X] over a period of falling prices and growing sales for retail DVDs is at least consistent with a view that the two are not close substitutes.

6.162 We can also draw inferences from how DVD prices change in the period following release (see Figure 90). If DVDs and pay TV were close substitutes, we might expect the price of DVDs to fall as the relevant movies enter the first pay TV subscription window. There is no evidence that this happens, again suggesting that retail DVDs and Sky Movies are in separate markets.

6.163 However, this is not a strong conclusion: there are a number of possible explanations as to why DVD prices do not fall as they enter the first pay TV subscription window. One possibility is that DVD rights holders drop DVD prices a few months before the first pay TV subscription window instead because this maximises each rights holder's revenue. Furthermore, the constraint of pay TV on DVDs may not be the same as the constraint of DVDs on pay TV: that is, the constraints could be asymmetric.

Sky's internal documents

6.164 As discussed in paragraph 6.85, we do not consider that Sky's internal documents provide evidence that prices are constrained to the competitive level by any of the substitutes they discuss, or by those substitutes in aggregate.

6.165 However, the documents provide useful evidence about the relative importance of different potential substitutes. [X]. In a presentation that Sky made to [X] in August 2007:

- One slide was titled "The value of Sky Movies has been undermined by the availability of DVDs at discount prices **during its licence period**" (emphasis added).
- That slide stated that "Approximately 20% of UK VHS and DVD sales of [X] **have occurred** during **Sky's 'exclusive' licence period**" (emphasis added) and "The price of the title is currently well below its initial retail price"⁶⁸⁸.

Conclusion on DVD retail

6.166 In some respects – for example range – retail DVD purchases are more attractive than Sky Movies. In other respects, such as format, retail DVD purchases are simply different, and potentially fulfil different consumer needs (e.g. being able to watch a favourite film repeatedly, whereas subscription services offer convenient access to a range of recent films). In terms of timing and price, DVD consumers face a trade off (buying a film closer to the point at which it is released on DVD is more expensive).

6.167 We have exercised our judgement in weighing up these conflicting features.

6.168 We recognise that the availability of a movie on DVD prior to the first pay TV subscription window is likely to place a degree of constraint over demand for that movie on pay TV. However, we conclude from [X] that the strongest constraint

⁶⁸⁸ [X] August 2007, Sky, slide 18. Provided at tab 15 of Sky's response dated 1 July 2008 to question 10 of Ofcom's information request dated 29 May 2008.

from DVD movies is from their availability during the first pay TV subscription window, when they are typically available at a discounted price i.e. Pay TV DVDs.

6.169 In conclusion we continue to think it reasonable to characterise DVDs as generally being more expensive than subscribing to Sky Movies but generally more attractive in terms of timing. We consider that it is helpful to distinguish between two categories of DVD sales:

- Pay TV DVDs: Sales of Pay TV DVDs and packages including Sky Movies have significant differences in format; Sky Movies also allows immediate access. In terms of price, Sky Movies is likely to be cheaper – its subscription price structure allows subscribers to watch as many movies as they like without incurring any extra charge. We thus consider DVD sales within the first pay TV subscription window to be a moderate substitute for Sky Movies i.e. outside the relevant market but still capable of exerting a reasonable constraint.
- Other DVDs: We consider DVD purchases in the first few months to be very different in nature from a subscription to Sky Movies and thus a distant substitute i.e. outside the relevant market. Similarly DVDs after the first pay TV subscription window are likely to be distant substitutes. This is supported by [X].

FTA/basic movies channels and movies on other FTA and basic channels

6.170 Movies are available on general entertainment television channels, including the PSB channels and on basic pay TV channels, such as Sky1, Bravo and the Sci Fi Channel for example.

6.171 Sky told us in response to our Third Pay TV Consultation that it faces strong competition from the combined strength of FTA broadcasters⁶⁸⁹. It considered that a vast range of high quality programming is available free of charge⁶⁹⁰, pointing out that the top ten films shown free to air in 2007 had an average audience of 6.9 million viewers and an average audience share of 33%⁶⁹¹. Sky presented various pieces of evidence in support of its position which we set out and consider below.

6.172 Our assessment of the evidence relating to the substitutability of movies on FTA and basic channels is structured as follows⁶⁹²:

- First, we set out our analysis of the characteristics of movies on FTA and basic channels.
- Second, we set out various other pieces of evidence we considered for the purposes of market definition (internal Sky documents, trend data, viewing data on former Sky Movies subscribers, the Seabright Study).

⁶⁸⁹ Sky response to Third Pay TV Consultation, paragraph 5.27.

⁶⁹⁰ Sky response to Third Pay TV Consultation, paragraphs 5.25, 5.32. See also October 2009 Sky Submission, paragraph 94. In addition, Sky claimed that its view accords with Ofcom's position in the Third Pay TV Consultation, paragraphs 3.9-3.10 (Sky response to Third Pay TV Consultation, paragraph 5.26).

⁶⁹¹ Sky April 2008 Response, annex 2, paragraph 3.23.

⁶⁹² Our full assessment of the evidence relating to dedicated movies channels, including Film 4, is set out in Appendix 2 of Annex 5.

- 6.173 Finally we set out our conclusions on the extent to which FTA/basic movies channels and movies on other FTA and basic channels pose a constraint on Sky Movies.
- 6.174 We address Sky's arguments about the relevance of the CC's findings in Appendix 6 of Annex 4. As explained in that annex, the CC was assessing the likely impact of a merger between Sky and ITV. As such, its analysis was not focused around premium pay TV channels. Furthermore, while assessing the likely effect of a merger, it is generally appropriate to take current prices as competitive prices. However, when assessing competition outside the context of a merger, this approach raises the cellophane fallacy issue. In conclusion, we do not consider that the CC's findings are relevant in the context of this investigation.

Ofcom's assessment of the characteristics of movies on FTA and basic channels

- 6.175 We have evaluated movies on FTA and basic channels in terms of each of the important characteristics set out above.
- 6.176 In terms of **timing**, Sky Movies is more attractive than films on FTA and basic channels. New to TV films account for around 40% of the films shown on Sky Movies and 60% of viewing^{693, 694}. We recognise that the remaining 40% of the film viewing on Sky Movies is of older films and so is more comparable with the older films shown on other channels. However, our view is that demand for Sky Movies is primarily driven by the availability of new-to-TV movies.
- 6.177 Overall FTA and basic channels show a similar selection of films to Sky Movies, albeit at a later date after release. Accordingly we would expect the average **quality** to be similar to Sky Dual Movies. Individually FTA and basic channels have fewer movies than Sky Movies^{695, 696, 697}. However, looking at these channels in aggregate, the position on the **quantity** of movies is somewhat more nuanced. Overall there is a greater number of unique film titles on general entertainment channels than on Sky

⁶⁹³ Sky response to Third Pay TV Consultation, paragraph 5.30.

⁶⁹⁴ In 2008, movies released in 2007 and 2006 accounted for 60% of the viewing on Sky Movies. This will include movies that were not released at the cinema (i.e. direct to DVD films). Of the films released in 2006 and 2007, 84% of the viewing on Sky Movies in 2008 was of movies in the top 150 films at the UK theatrical box office. Accordingly approximately 50% of the viewing of Sky Movies in 2008 was accounted for by recent movies (2006 or 2007) that had at least some presence at the cinema (i.e. in the top 150 films), rather than library films.

⁶⁹⁵ The terrestrial channels and digital sister channels (BBC3, BBC4, ITV2, ITV3, ITV4, E4, More 4, Film 4, Five US, Five Life) broadcast 4,524 different films in 2007 and a total of 9,947 films (i.e. 27 per day) if repeats are included. Sky response to Second Pay TV Consultation, annex 2, paragraph 3.23.

⁶⁹⁶ For example, in 2008 Bravo had 133 film transmissions (film slots) and the Sci Fi Channel had 913 films. *Statistical yearbook 2009*, UK Film Council, table 12.3 on page 98.

⁶⁹⁷ In 2008, a total of 2,221 films were broadcast on the main five PSB channels (including 381 on BBC1 and 367 on ITV1). UK Film Council *Statistical Yearbook 2009*, table 12.6 on page 100.

Movies⁶⁹⁸. However, taking repeats into account, there are markedly more films on Sky Movies⁶⁹⁹.

- 6.178 FTA/basic movies channels and movies on other FTA and basic movies channels clearly have the same **format** as Sky Dual Movies, in that they are shown on linear TV channels and an additional film can be viewed with no additional cost (unlike, say, PPV).
- 6.179 FTA movies are free. Consumers have to pay for basic TV channels, but they are less expensive than Sky Movies, and movies channels may be seen as a free add-on to subscribers who have a basic TV package for other reasons. While the **price** of movies on FTA/basic is clearly more attractive than that of Sky Movies, the fact that Sky Dual Movies commands a premium of around £7.50 per month as an add-on to Sport, and around £16 per month as a standalone service, indicates that consumers place considerable value on the different characteristics of Sky Movies – i.e. that it is highly differentiated.
- 6.180 Overall, films on FTA and basic channels are materially inferior to Sky Movies. In particular, these channels do not show new films that are from the first pay TV subscription window. They mainly show library movies. Sky highlighted the importance of price, as a cheaper but low quality product can in principle be an effective substitute for a more expensive but higher quality product⁷⁰⁰. However, the extent of the price difference suggests that there is no significant constraint – Sky Movies subscribers appear prepared to pay a substantial premium for the superior timing and quantity of movies that they receive as compared with what is available on FTA and other basic channels. This is supported by viewing data which shows that Sky Movies subscribers prefer new films⁷⁰¹. Survey evidence⁷⁰² and [X]⁷⁰³ also suggest that new films are a strong driver of demand for Sky Movies. Library movies on other channels do not satisfy this demand.
- 6.181 In its response to our Third Pay TV Consultation, Sky provided viewing data that showed that a repeat of an older film on Channel 4 attracted a higher audience amongst households with Sky Movies than the premiere of a new film on Sky Movies⁷⁰⁴. Given that Sky only provided a single, and therefore unrepresentative, sample, we do not consider that this affects our view that, when looked at as a whole,

⁶⁹⁸ Sky Movies broadcast 1,500 titles in 2008. This is markedly less than the number of films broadcast on the main five PSB channels (2,221, although some of these may be repeats) even before other channels showing movies are taken into account. UK Film Council *Statistical Yearbook 2009*, page 99 and table 12.1 on page 95.

⁶⁹⁹ Sky Movies broadcast films in 39,238 slots in 2008. This is more than the PSB channels (2,221 in total) and the various digital channels for which the UK Film Council provided figures (22,071 in total; moreover this includes some dedicated movies channels). UK Film Council *Statistical Yearbook 2009*, table 12.1 on page 95 and table 12.6 on page 100.

⁷⁰⁰ October 2009 Sky Submission, paragraph 94.

⁷⁰¹ See paragraph 6.65.

⁷⁰² See paragraphs 6.61 and 6.63.

⁷⁰³ [X].

⁷⁰⁴ October 2009 Sky Submission, Table 3 and paragraph 95.

movies content on FTA channels is not a substitute for Sky Movies. Moreover, the two films appear to be of radically different quality, as shown by their very different performance at the box office.

Internal Sky documents

- 6.182 [X]. However internal documents show that a key driver for demand for Sky Movies is access to new films and we have taken this into account.

Trend data

- 6.183 In our Third Pay TV Consultation we considered changes in the total audience for films on FTA and basic tier channels and in the audience of subscription movies channels, both of which declined between 2003 and 2007⁷⁰⁵. We considered that the evidence did not point towards substitution from subscription channels to basic and FTA channels – rather it pointed to an overall decline in movie viewing on linear channels⁷⁰⁶.
- 6.184 In response, Sky argued that the relevant figures for 2008 showed that total viewing of movies on television rose⁷⁰⁷ i.e. that the decline identified in the Third Pay TV Consultation reversed in 2008. Sky added that, even if demand for watching movies on all television channels had declined, it would not support the view in the Third Pay TV Consultation that movies on FTA and basic channels fail to effectively constrain packages including premium movies channels⁷⁰⁸.
- 6.185 We have updated the trend data that was previously set out in Figure 33 of the Third Pay TV Consultation to reflect the 2008 data highlighted by Sky. See Figure 98 below (which forms part of our forward looking analysis of shares of supply). Sky is correct that overall viewing rose sharply in 2008, driven by higher viewing of movies on basic channels and on channels such as ITV2, BBC3 and Film4. Viewing on subscription movies channels was almost unchanged from 2007.
- 6.186 In paragraphs 5.355, in relation to sports, we discuss our reasoning in the Third Pay TV Consultation on changes in demand for various means of viewing live sports content. In response, Sky argued that such analysis is unreliable as it fails to control for changes in other relevant variables (such as price, quality, marketing expenditure) and that we had failed to specify the counterfactual⁷⁰⁹. This comment is also relevant to the interpretation of changes in the audience for movies on different categories of channel. Indeed we made a similar point in the Third Pay TV Consultation in the context of PPV⁷¹⁰. In particular, we agree that many other variables affect the

⁷⁰⁵ Third Pay TV Consultation, paragraph 4.317 and Figure 33; also paragraph 4.345.

⁷⁰⁶ Third Pay TV Consultation, paragraph 4.318.

⁷⁰⁷ October 2009 Sky Submission, footnote 116 to paragraph A2.41.

⁷⁰⁸ October 2009 Sky Submission, paragraph A2.42. Sky also considered that the analysis of the effects of cable retailers replacing a NVoD service (Front Row) with a true VoD service (Film Flex) does not directly relate to the impact of introducing a PPV movie service (October 2009 Sky Submission, paragraph A2.44).

⁷⁰⁹ October 2009 Sky Submission, paragraph 76; also October 2009 Sky Submission, paragraph A2.20.

⁷¹⁰ Third Pay TV Consultation, paragraph 4.329, first bullet.

audiences for different categories of channel and that it is therefore difficult to draw sound conclusions on market definition from changes in the number of subscribers to Sky Movies. We therefore remain of the view that this evidence is inconclusive.

Viewing behaviour of former Sky Movies subscribers

6.187 In its June 2009 submission, Sky said that it gathers data on the amount of viewing on the main television set in 33,000 households. Sky identified 434 households that (i) subscribed to a package including Sky Movies in a twelve month period ("Year 1"); (ii) downgraded to a package that did not contain Sky Movies at some point in the next twelve month period ("Year 2"); and (iii) did not subsequently restore Sky Movies to their subscription in the following twelve months ("Year 3"). Sky compared quarterly viewing by these households in Year 1 and Year 3⁷¹¹. It stated that this data showed that:

- For the households that downgraded, overall viewing of movies fell from Year 1 to Year 3 but viewing of movies on channels other than Sky Movies increased. Sky interpreted this as indicating that these downgrading households replaced some of their viewing of Sky Movies with viewing of movies on other channels (6 June 2009 Sky submission, annex 4, paragraph 1.6 and figure 1).
- Total TV viewing increased for all Sky households between Year 1 and Year 3. However, it increased slightly more amongst the households that downgraded in two of the quarters. Sky interpreted this as indicating that the downgraders also replaced viewing of movies with viewing of non-movies programming (6 June 2009 Sky submission, annex 4, paragraph 1.7 and figure 2).

6.188 In the Third Pay TV Consultation, we said there was no evidence that this downgrading was a response to pricing or the availability of FTA movies and other content⁷¹². We also stated that Sky's results appear counter-intuitive, because lapsed Sky Movies subscribers appeared to increase their overall television viewing despite having a smaller range of TV programming available to them. This led us to doubt the reliability of Sky's analysis⁷¹³.

6.189 Following publication of the Third Pay TV Consultation, Sky continued to regard its viewing data as strong evidence of the substitutability of Sky Movies with movies on other channels and with non-movies content⁷¹⁴. We remain of the view that this evidence is inconclusive⁷¹⁵. As we explained in our Third Pay TV Consultation, there is no evidence that this downgrading was a response to the pricing of Sky Movies or the availability of other content. Indeed, we would expect a Sky Movies subscriber who cancelled their subscription to watch more movies on other channels⁷¹⁶.

⁷¹¹ 6 June 2009 Sky Submission, annex 4, paragraphs 1.1-1.5.

⁷¹² Third Pay TV Consultation, paragraphs 4.319-4.320.

⁷¹³ Third Pay TV Consultation, paragraph 4.319.

⁷¹⁴ Sky response to Third Pay TV Consultation, paragraphs 5.65-5.67; October 2009 Sky Submission, paragraph A2.60.

⁷¹⁵ This is not to suggest that the underlying data is unreliable. Rather it is the market definition inferences that can be drawn from that data that are unreliable.

⁷¹⁶ We would expect a person who ceased to own a car to travel more often by bus, but it does not necessarily follow that bus services constrain the price of cars or vice versa.

However, the viewing data does not provide evidence that, in response to an increase in the price of Sky Movies above the competitive level, subscribers would cancel their subscription in favour of FTA movies (particularly given the evidence that current retail prices are likely to be above the competitive level).

The Seabright Study

- 6.190 As set out in Section 5, paragraphs 5.257 and 5.311 to 5.315, Sky considered that the Seabright Study provides compelling evidence of the constraint imposed by the availability of FTA television.
- 6.191 The model presented in the Seabright Study predicts that in a given area if DTT availability increased by 20%, take up of packages including Sky Movies (but not Sky Sports) would decline by 0.21 percentage points and take up of packages including Sky Sports and Sky Movies would decline by 0.37 percentage points. The latter figure is not statistically significant from zero. If the area had average take up of packages including Sky Movies (only) and packages including Sky Movies with Sky Sports ([X] and [X] respectively), this would represent approximately [X] and [X] proportionate declines respectively⁷¹⁷.
- 6.192 For the reasons set out in paragraphs 5.317 to 5.323, we do not consider that the Seabright study can be relied upon to demonstrate that pay TV services are constrained by FTA TV.

Our conclusions on other films on FTA and basic channels

- 6.193 A large number of movies are shown on free-to-air TV, and FTA and basic channels spend almost as much on movie rights as Sky. However, because access to recent movies is important to Sky Movies subscribers, the later date at which movies come onto FTA channels puts these channels at a significant disadvantage to Sky Movies. The fact that Sky Movies subscribers already have free access to movies on FTA and basic channels, but are willing to pay a substantial premium for Sky Movies, indicates the extent to which Sky Movies is differentiated. As such, we do not see this content as a close substitute for Sky Movies, but recognise that it constrains Sky to some degree.
- 6.194 We therefore consider that these channels lie outside the relevant market, although we recognise that there is likely to be a moderate degree of substitutability with Sky Movies.

Non-movies content on television

- 6.195 Sky criticised our Third Pay TV Consultation for failing to consider adequately the extent to which non-movies programming is a substitute for services that include Sky Movies⁷¹⁸. Sky stated that the supply of premium pay TV packages is likely to be constrained by basic-only TV packages⁷¹⁹. In support of this proposition Sky stated that [X] of its current basic-only subscribers have previously subscribed to premium content. Similarly [X] of current Dual Sports, [X] of current Dual Movies

⁷¹⁷ Third Pay TV Consultation, Figure 21.

⁷¹⁸ October 2009 Sky Submission, paragraph A2.58-A2.59.

⁷¹⁹ Sky response to Third Pay TV Consultation, paragraph 5.34; October 2009 Sky Submission, paragraph A3.1.

and [X] of current Top Tier subscribers have previously been basic-only subscribers⁷²⁰.

Characteristics evidence on non-movies content

- 6.196 Viewers have access to a wide variety of programming other than movies, including soap operas, comedies, drama (both one off and as part of an ongoing series), nature etc. Such programming is broadcast on both free to air channels, including the main PSBs' channels, as well as on pay TV channels (e.g. the Discovery Channel, Living, G.O.L.D., Sky1).
- 6.197 Non-movies content is first released on television, unlike movies (where the first opportunity to view a film is generally in the cinema). A substantial share of non-movies content is part of TV series. Non-movies content is typically interspersed with advertising breaks (with the exception of programmes broadcast by the BBC), whereas there are no adverts during a film on Sky Movies.
- 6.198 In terms of the product characteristics which we have set out above, non-movies content comprises a large quantity of content, with a combination of new broadcasts and repeats. Some of this content is of high quality. However, as the underlying content is fundamentally different from that on Sky Movies (unlike the other potential substitutes we have considered), there is no clear basis of comparison of Sky Movies and non-movies content in terms of these characteristics. We recognise that there is some high quality general entertainment content on TV which has production values comparable to some movies – and, unlike movies, it generally has the advantage, at its first TV broadcast – of not having previously appeared in the cinema or on DVD.
- 6.199 As such it is necessary to consider other evidence as to likely substitutability. Clearly, in some circumstances, a TV viewer will choose between watching a movie or other content, depending on the relative attractiveness of what is on TV, and some genres (e.g. high quality dramas) may be seen as a closer substitute for movies than others. However, the key question is the extent to which access to the wide range of recent and library films offered by Sky Movies is seen as distinctive by viewers who also have access to a wide range of other content.
- 6.200 The price of Sky Movies, relative to other services, gives a strong indication of the answer to this question. Televised non-movies content is significantly cheaper to subscribers than Sky Movies. In particular, a substantial amount of non-movies content is available from FTA broadcasters. Some attractive content, particularly certain US drama series such as *Lost* and *24*, for example, is only available on pay TV channels such as Sky1. However the price of subscribing to a pay TV bundle that includes Sky1 is very substantially less than the price of subscribing to a pay TV bundle that includes Sky Movies. In particular, as set out in paragraph 5.101 above, the incremental cost of adding a “mix” of channels including Sky1 is only £1.
- 6.201 Sky Movies subscribers have access to vast amounts of non-movies content, both on FTA television and as part of the basic component of their pay TV bundle⁷²¹. However these subscribers choose to pay a significant extra amount each month in order to have access to Sky Movies, for example an extra £16 per month on top of Sky's basic channels for standalone Sky Dual Movies on satellite (or £7.50 for

⁷²⁰ October 2009 Sky Submission, paragraph A3.1.

⁷²¹ Sky offers six “mixes” of basic channels to its subscribers. As shown out in Figure 31 above, [X].

existing Sky Sports subscribers). This suggests that Sky Movies is highly differentiated from other basic content⁷²².

Internal Sky documents

6.202 Of the internal documents provided by Sky in response to Ofcom's information request of 29 May 2008, there was only a single specific reference to substitutability between Sky Movies and non-movies content⁷²³. In contrast there were multiple references to DVDs and movies on other channels⁷²⁴. This suggests that Sky is more concerned about alternative ways of watching movies, than television programming in general⁷²⁵.

Survey evidence provided by Sky

6.203 [X]⁷²⁶. [X]⁷²⁷. [X].

Figure 92 Preferences of price sensitive subscribers

[X]

6.204 [X].

- [X]⁷²⁸. [X].
- [X].

6.205 [X].

- [X]⁷²⁹. [X].
- [X].

⁷²² This point relates to the total demand for Sky Movies at current prices, rather than the question of whether subscribers would switch in response to a price rise above competitive levels – as a result the cellophane fallacy effect does not apply to this point.

⁷²³ As noted above, a 2005 internal Sky document states that for “Films on TV ... their competition is not just other windows, but all other TV programmes that happen to be on (including first run drama etc)”. [X], 1 July 2005, Sky, slide 7. Provided at tab 5 of Sky's response dated 1 July 2008 to question 10 of Ofcom's information request dated 29 May 2008. We note that Sky's response dated 19 March 2010 to Ofcom's letter of 11 March 2010 suggests that Sky may hold further documents which suggest substitutability between Sky Movies and non-movies content. Sky did not provide these in response to our information request.

⁷²⁴ See paragraph 6.83 and 6.84 above.

⁷²⁵ [X]

⁷²⁶ [X]

⁷²⁷ [X]

⁷²⁸ [X]

⁷²⁹ For example, the top five channels spontaneously mentioned by pay TV subscribers that they considered content to be “must have” were: BBC1, E4, ITV1, BBC2, and Channel 4. First Pay TV Consultation, annex 14, Figure 26.

Viewing behaviour of former Sky Movies subscribers

- 6.206 In support of the proposition that non-movies programming is a substitute, Sky referred to viewer data for former Sky Movies subscribers that it provided in its June 2009 submission⁷³⁰. It considered that the data shows that these households replaced some of their viewing of Sky Movies with viewing of non-movies on other channels⁷³¹.
- 6.207 These data are described and analysed in paragraphs 6.187 to 6.189 above. We continue to regard this evidence as inconclusive and unreliable for the purposes of market definition⁷³².

Expenditure by the PSBs

- 6.208 Sky stated that, in total, the PSBs spend over £3bn on creating and acquiring programmes for their channels, including £2bn expenditure by the BBC, and that it is “implausible” that they exert only a moderate constraint on pay TV retailers⁷³³.
- 6.209 In particular, as explained at paragraphs 6.196 to 6.201, non-movies content on television satisfies a different demand from Sky Movies. Accordingly the amounts spent on these two types of programming do not provide reliable evidence for the purposes of market definition.

Ofcom’s conclusion on non-movies content

- 6.210 In summary, we consider that non-movies content satisfies a different demand from Sky Movies. This is shown by the lower price / free availability of such content and is consistent with the differences between the two types of programming. This inference is reinforced by the internal documents provided to us by Sky, which suggest that Sky does not regard non-movies programming as a particularly important competitor to Sky Movies. It is also supported by the absence of responses identifying this product as a substitute in our November / December 2009 survey of individuals that do not subscribe to Sky Movies. Accordingly our conclusion is that non-movies content is likely to be at most a distant substitute for Sky Movies.

Subscription VoD (SVoD) in the pay TV window

Description of SVoD movies

- 6.211 There are two types of SVoD service. First, Sky’s SVoD service that shows movies in the first pay TV subscription window. Clearly this service will not constrain Sky’s prices as it is owned by Sky. Second, there are other SVoD services, which show films after the first pay TV subscription window. These are not owned by Sky and so could constrain the price of Sky Movies. In this Section we consider Sky’s SVoD service. In Annex 5 we assess the other SVoD services.

⁷³⁰ Sky response to Third Pay TV Consultation, paragraphs 5.65-5.67; October 2009 Sky Submission, paragraph A2.59(ii).

⁷³¹ 6 June 2009 Sky submission, annex 4, paragraph 1.7 and figure 2.

⁷³² This is not to suggest that the underlying data is somehow unreliable. Rather it is the market definition inferences that can be drawn from that data that are unreliable.

⁷³³ Sky response to Third Pay TV Consultation, paragraph 5.27.

- 6.212 Sky currently owns most of the SVoD rights for movies in the first pay TV subscription window. It buys these rights together with the linear rights for the same films.⁷³⁴ [X]⁷³⁵.
- 6.213 There are usually a number of conditions attached to the SVoD rights acquired by Sky. First [X]⁷³⁶. [X]⁷³⁷. [X]⁷³⁸. [X]⁷³⁹.
- 6.214 Currently, Sky only exploits its SVoD film rights through Sky Player. This internet based VoD service shows films through a PC, Mac or Xbox 360. Sky offers SVoD films for free as part of a Sky Dual Movies subscription on Sky's satellite platform. For other consumers, Sky offers it as part of bundle with Sky Movies Screen 1, Sky Movies Screen 2 and basic content on Sky Player for £32 per month (£17 per month extra on top of the £15 it charges for Sky Player basic content)⁷⁴⁰. In 2008, Sky's SVoD service had 400 films in its catalogue from all the Major Hollywood Studios⁷⁴¹.
- 6.215 In 2009, Sky announced the launch of a "comprehensive 'pull' video-on-demand ... service next year, to provide Sky+HD customers with additional choice ..." Sky indicated that this service will use the broadband capability of existing Sky+HD boxes. Sky has not yet announced further details on how the service will be priced or packaged or which consumers will be eligible for the service⁷⁴². [X]⁷⁴³.

Representations on SVoD

- 6.216 [X]⁷⁴⁴ [X]⁷⁴⁵. [X]⁷⁴⁶.

⁷³⁴ Source: Sky's contracts with various movie studios, received 17 August 2007 and 15 May 2009, in response to Ofcom's information requests dated 18 July 2007 and 8 May 2009.

⁷³⁵ [X]. Sky response dated 13 June 2008 to Ofcom information request dated 13 May 2008.

⁷³⁶ [X].

⁷³⁷ [X].

⁷³⁸ [X].

⁷³⁹ [X].

⁷⁴⁰ Source: <http://skyplayer.sky.com/> (as viewed on 22.01.2010).

⁷⁴¹ Source: Film Council 2009 Statistical Yearbook (p106).

⁷⁴² *Sky to launch 3D TV in 2010 following record Sky+HD growth*, Sky press release dated 30 July 2009 available at: http://corporate.sky.com/media/press_releases/2009/3d_tv.htm.

⁷⁴³ Sky response to Third Pay TV Consultation, paragraph A6.20. [X]. Sky response to Third Pay TV Consultation, paragraph A6.12.

⁷⁴⁴ [X]

⁷⁴⁵ [X]

⁷⁴⁶ [X]

Ofcom's assessment of SVoD movies

- 6.217 Sky's SVoD service on its Sky Player platform shows a smaller **quantity** of films to Sky Dual Movies. In terms of **timing**, Sky's SVoD service features movies from the first pay TV subscription window. Sky's SVoD service features the same type of movies that it shows on Sky Dual Movies. The **quality** of the films shown on the two services is thus likely to be comparable.
- 6.218 In some respects, SVoD is a more attractive **format** than a linear subscription TV channel, since it gives consumers the freedom to decide when to watch a particular film. It is equivalent in that the movie is delivered to the home without the need for advance planning and in that it is available on a subscription basis. However where an SVoD service is only available through a PC or other non-TV device, as is currently the case with Sky Player, it is likely to be less attractive than watching Sky Movies via a television set.
- 6.219 For households that do not subscribe to Sky's satellite service, the incremental monthly **price** of Sky's SVoD films service is £17 on top of its Sky Player basic content. This is currently more expensive than the £16 incremental cost of buying Sky Dual Movies through satellite on top of Sky's basic TV packs. The lowest total monthly price of Sky's SVoD service (bundled with other content) is £32. This is slightly cheaper. But this bundle contains less basic content, for example, it does not include Sky1⁷⁴⁷.

Conclusion on SVoD movies in the pay TV window

- 6.220 Sky's current SVoD service, available via Sky Player, will not act as a constraint on Sky Dual Movies, as Sky provides it. Its inclusion within the market will therefore not affect our conclusions on market power. In any event, as a service delivered via PCs (rather than the main television set) we consider that it is a moderate substitute for Sky Movies.
- 6.221 However, an SVoD service that was available on TV via a standard set-top box, and that featured films in the first pay TV subscription window is highly likely to be a close substitute for Sky Movies, although we recognise that this would depend on the price at which that service was sold.
- [✕]
 - It would have similar characteristics to Sky Movies (in terms of quantity, quality and timing of films) and a format that is likely to be more attractive than Sky Movies (namely VoD rather than a linear channel). This view is consistent with submissions made by Virgin Media⁷⁴⁸.
 - Such an SVoD service does not exist at present (although see footnote 588 to paragraph 6.40). [✕].

⁷⁴⁷ As explained above, households that subscribe to Sky Movies on Sky's satellite platform can watch VoD movies on the Sky Player service without additional charge. However this is not the relevant price to consider when assessing whether a household would replace its Sky Movies subscription with watching movies on their PC via Sky Player.

⁷⁴⁸ Virgin Media's response to the Second Pay TV Consultation stated that it had been unable to secure non-exclusive SVoD rights with any of the Major Hollywood Studios (paragraphs 4.19-4.22). [✕]. As noted in paragraph 4.324 of the Third Pay TV Consultation, [✕].

- Sky Movies available on TV via an Xbox is also potentially a close substitute – although this is not at present a constraint on Sky as it is not sold by an independent retailer.

Other potential substitutes

Cinema

6.222 Sky argued in its October 2009 Response that cinema is a substitute⁷⁴⁹. In Appendix 2 to Annex 5 we set out our full assessment of the evidence relating to the substitutability of cinema.

6.223 We recognise that, in revenue terms, watching films at the cinema is of significance. However this does not imply that it is substitute for Sky Movies.

6.224 As we have said, cinema is different from pay TV in that it does not involve the provision of a wide range of films at home and free at the point of consumption.⁷⁵⁰ We consider that these differences between cinema and pay TV are in some respects much more marked than those between cinema and, for example, DVD retail.

- The nature (or format) of films at the cinema is very different: they are watched communally, outside the subscriber's own home. In our view, the cinema is more of an 'event' or a 'night out' for consumers and is very different in nature from watching films at home.
- Cinema is not usually paid for by subscription; moreover, while films are available earlier in the cinema, the price is markedly higher (particularly where multiple people wish to watch the same film).
- These differences in characteristics limit the extent to which consumers would switch to viewing movies at the cinema, which suggests that this is a distant substitute and outside the relevant market. [X].

Online DVD rental

6.225 In Appendix 2 to Annex 5 we set out our full assessment of the evidence relating to the substitutability of online DVD rental.

6.226 In our judgement, the difference in format (having to pre-order movies) outweighs the attractive characteristics of a potentially lower price, greater quantity and more recent movies. This limits the extent to which consumers would substitute to online DVD rentals and suggests that they are a moderate substitute (i.e. outside the relevant market but still capable of exerting a constraint).

Over-the-counter DVD rental

6.227 In Appendix 2 to Annex 5 we set out our full assessment of the evidence relating to the substitutability of OTC DVD rental.

⁷⁴⁹ Paragraph 50 of Sky's October 2009 response.

⁷⁵⁰ Third Pay TV Consultation, paragraph 4.394.

6.228 While we recognise that there is a degree of substitutability between OTC DVD rental and Sky Movies, we consider that, as with retail DVDs, the relative inconvenience of renting DVDs is likely to limit the degree of substitutability, particularly for frequent viewers of recent movies on Sky Movies. Also, the format for payment lacks the certainty of a fixed monthly subscription⁷⁵¹. As such, we do not consider OTC DVD rental to be a close substitute to Sky Movies. However, we have considered it as a moderate substitute.

Movie downloads

6.229 In Appendix 2 to Annex 5 we set out our full assessment of the evidence relating to the substitutability of movie downloads. In that annex we distinguish between legal downloads and illegal downloads:

- Legal downloads can either be on a download to own basis or a download to rent basis (the former having some similarities with DVD sales and the latter having similarities with PPV and DVD rental). As in the Third Pay TV Consultation, we consider that the current constraint from legally downloading content from the internet is weak, but may grow over time. We consider legal downloads as moderate substitutes.
- In our Second and Third Pay TV Consultations we noted a study which indicated that 4% of people had illegally downloaded content over a one-month period.⁷⁵² This group was strongly biased towards students, who are relatively unlikely to subscribe to pay TV services (48% were in school or further education). As in the Third Pay TV Consultation, we do not consider that this constraint is strong.

PPV through a TV service

6.230 Sky strongly criticised the reasoning in our Third Pay TV Consultation on PPV movies. In Appendix 2 to Annex 5 we set out our full assessment of the evidence relating to the substitutability of PPV movies.

6.231 In our Third Pay TV Consultation, we noted that there is some evidence that premium movies on PPV may be substitutable for linear channels carrying premium movies⁷⁵³, but that the data should be interpreted cautiously⁷⁵⁴. We considered VoD likely to be a less close substitute for Sky Movies than a subscription service (we discuss SVoD movies separately)⁷⁵⁵.

6.232 Sky argued that having acknowledged some potential for substitution we ought to have included PPV in the market and it said that the data we considered related not to the launch of a PPV service but the replacement of an NVoD service with a true VoD service.

⁷⁵¹ In paragraph 4.339 of the Third Pay TV Consultation we stated that OTC DVD rental lacks some product characteristics of Sky Movies packages such as the convenience with which films can be chosen, and the certainty of a fixed monthly subscription.

⁷⁵² Source: British Video Association Yearbook 2008, page 112.

⁷⁵³ Third Pay TV Consultation, paragraph 4.330.

⁷⁵⁴ Third Pay TV Consultation, paragraph 4.329.

⁷⁵⁵ Third Pay TV Consultation, paragraph 4.330.

- 6.233 The characteristics of PPV movies are similar to those of Sky Movies: PPV's less attractive format is counteracted by the attractive characteristic of having more recent movies.
- 6.234 However, as set out in the Second Pay TV Consultation, Virgin Media research into preferences of subscribers who were interested in a subscription Virgin Media Movies channel⁷⁵⁶ asked which features of the proposed service were 'key drivers of interest'. [X]⁷⁵⁷. We take the view that this important difference in format between PPV and linear channels implies that they are moderate substitutes.
- 6.235 This evidence is reinforced by the amounts paid for the rights to PPV movies. In 2008, movie studios earned around [X]⁷⁵⁸ from the rights to Sky and Virgin Media's PPV on-demand services compared to [X] for the linear pay TV rights⁷⁵⁹. This is notwithstanding the strong growth in PPV services in recent years⁷⁶⁰. The value of linear TV services to movie studios is [X] higher than the value of PPV services. The scale of the difference in the value of the rights suggests that pay TV retailers do regard PPV services as markedly less attractive than linear movies channels. We thus consider that PPV movies are a moderate constraint on Sky Movies (i.e. outside the relevant market but still capable of exerting a reasonable constraint).

SVoD movie services after the first pay TV subscription window

- 6.236 In Appendix 2 to Annex 5 we set out our full assessment of the evidence relating to the substitutability of SVoD movie services after the first pay TV subscription window (e.g. Lovefilm and Picturebox).
- 6.237 SVoD services after the first pay TV subscription window are distant substitutes to Sky Dual Movies. In our judgement, their less attractive characteristics, specifically the older films that they show and the smaller range on offer, outweigh the attractive characteristics of a lower price and SVoD format. This is reflected in the number of subscribers to these services.

Disney Cinemagic

- 6.238 In Appendix 2 to Annex 5 we set out our full assessment of the evidence relating to the substitutability of Disney Cinemagic.
- 6.239 In the Third Pay TV Consultation we concluded that Disney Cinemagic lay within the relevant market⁷⁶¹. Since that consultation we have carried out further analysis of the

⁷⁵⁶ Second Pay TV Consultation, paragraph 4.194.

⁷⁵⁷ Virgin Media response to Ofcom information request of 15 May 2007 [X].

⁷⁵⁸ Source: Virgin Media response dated 8 April 2009 to question 12 of Ofcom's information request dated 24 March 2009; Sky response on 22 December 2008 to question 15 of Ofcom's information request dated 12 November 2008.

⁷⁵⁹ Source: Transmission and revenue return for BSkyB 1 January – 31 December 2008.

⁷⁶⁰ In 2008, the estimated value of PPV movies via TV VoD was £120m (Source: UK Film Council Statistical Yearbook 2009, figure 14.1 on page 112). In 2005, this was £63.8m. We take this growth into account in our market power analysis by considering future shares of supply.

⁷⁶¹ Third Pay TV Consultation, paragraph 4.378.

types of movies broadcast on Disney Cinemagic. That further analysis indicates that Disney Cinemagic has different characteristics from Sky Dual Movies, namely far fewer first run movies. In our judgement, these less attractive characteristics outweigh the cheaper price of Cinemagic. This limits the extent to which consumers would substitute to this channel and suggests that it is at most a moderate substitute (i.e. outside the relevant market but is still capable of exerting a reasonable constraint).

Assessment of the aggregate impact of the potential substitutes considered above

6.240 We now consider the aggregate constraint exerted on packages including Sky Movies. This reflects the sum of the switching to the various substitutes that would be expected in response to an increase in prices from the competitive level. Moreover, even if two potential substitutes are comparatively unattractive on an individual basis, in combination they may form a close substitute. For example if one substitute is unattractive in respect to characteristic X but another substitute is highly attractive with respect to that characteristic then, in combination, those two substitutes may offset each others' weaknesses.

6.241 Below we first set out our analysis of the characteristics of combinations of potential substitutes. We then set out a range of other evidence. Finally we set out our conclusions on the aggregate constraint facing packages including Sky Movies.

Characteristics of combinations of products

6.242 Sky has stressed the importance of the aggregate constraint exerted by potential substitutes. For example, Sky stated that, rather than subscribe to Sky Movies, consumers could rely on alternatives such as a combination of FTA television, DVDs and VoD services⁷⁶².

6.243 We have considered the aggregate constraint imposed on Sky Movies by all the potential substitutes listed above. In particular, the characteristics of movies on other FTA channels are inferior in terms of the number of hours of movie programming and the lack of recent movies. It might appear that these weaknesses could be addressed by supplementing movies on FTA channels with PPV, retail DVD purchases or DVD rentals (either OTC or online), which allow access to recent movies and give consumers a degree of extra freedom to watch films at the time that is most convenient to them. We recognise that consumers 'self assemble' movies content in this way and that it strengthens the case for treating products such as PPV, online DVD rental and Pay TV DVDs as moderate substitutes.

6.244 It thus adds support for our approach to the assessment of market power, in which we have considered the impact of including a fairly wide range of moderate substitutes within the relevant market to assess their impact on our market share estimates⁷⁶³.

6.245 However there are two drawbacks to self assembly. As described above under the pairwise assessment of each of these substitutes, all these supplementary means of watching movies differ from Sky Movies in terms of format: none of them offers a

⁷⁶² October 2009 Sky Submission, paragraph 31.

⁷⁶³ As explained below, even on the strongest plausible assumptions, Sky would still have a market share of around [X]% (depending on how movies on FTA and basic channels are measured).

wide range of recent popular movies for a fixed monthly subscription. As a result, ceasing to subscribe to Sky Movies in the event of a SSNIP and instead self assembling a range of products entails a loss of convenience. A typical subscriber watches six movies per month, the majority of which are from the previous two years. We have no evidence that marginal consumers are atypical in this regard. Buying these movies on DVD or finding them on FTA channels (with advertising) is likely to lead to considerably greater expense or inconvenience. We would not expect many consumers to consider this an attractive alternative in the event of a small price increase.

- 6.246 In our judgement, the various differences in terms of format (as set out above) imply that the characteristics of an aggregate product differ materially from Sky Movies. This reduces the likelihood that consumers would substitute from Sky Movies to a combination of the various potential substitutes listed above. Accordingly, our consideration of the aggregate effect of the substitutes listed above does not alter our conclusions on the extent of substitutability.

Survey evidence on sensitivity to price increases

- 6.247 Surveys conducted by Ofcom and Sky on consumers' sensitivity to price increases are set out in paragraphs 5.291 to 5.306 above. As noted in paragraphs 5.43 to 5.46 and 6.27 above and 6.329 to 6.337 below, we consider that Sky Movies prices are currently above competitive levels. For this reason, as we explained in the context of survey evidence on sports, consumers' propensity to switch in the surveys that we have considered is unlikely to be informative as to the market boundaries. We thus consider that these surveys are all inconclusive and we do not rely upon them.

Observed response to retail price changes and Sky Movies subscriber numbers

- 6.248 In previous consultations, we analysed changes in the number of subscribers to Sky Movies channels since 2000⁷⁶⁴. As part of this analysis we considered changes in the retail price of packages including Sky Movies since 2002⁷⁶⁵. We concluded that the decline in subscriber numbers did not point clearly to an effective competitive constraint from other products⁷⁶⁶.
- 6.249 Sky stated that the Third Pay TV Consultation referred to evidence on changes in the retail price of Sky Movies (taken from the First Pay TV Consultation) that was contradicted by pricing evidence in the Second Pay TV Consultation⁷⁶⁷. Moreover Sky asserted that the discussion of this evidence was unduly brief and unsound⁷⁶⁸.
- 6.250 Simply considering changes in retail prices or Sky's subscriber numbers is inconclusive, particularly as it is not possible to control robustly for other key factors such as costs and quality. Moreover, the current retail price of bundles including Sky Movies is likely to be above the competitive level. As a result, consumers' response

⁷⁶⁴ Third Pay TV Consultation, paragraphs 4.303-4.304.

⁷⁶⁵ Third Pay TV Consultation, paragraph 4.305.

⁷⁶⁶ Third Pay TV Consultation, paragraph 4.308 in conjunction with paragraph 4.314.

⁷⁶⁷ October 2009 Sky Submission, paragraphs 90-91.

⁷⁶⁸ October 2009 Sky Submission, paragraph 92.

to changes from current prices is likely to be a poor guide to their response to changes from competitive prices.

Overall conclusion

6.251 Our view is that the relevant market only includes retail bundles including Sky Movies. Moderate substitutes that lie outside the relevant market are PPV, Disney Cinemagic, FTA/basic movies channels, movies on other FTA channels, online DVD rental and retail Pay TV DVDs. We consider that OTC DVD rental, DVD retail purchases outside the first pay TV subscription window, non-movies programming on television and cinema are distant substitutes that lie well outside the relevant market.

Supply side substitution

6.252 At the retail level, supply side substitution refers to the possibility that a retailer rapidly enters the relevant market with a closely substitutable product. On the basis of the analysis above, such entry would require a rival retailer to gain access either to Sky's movies channels, or to a channel or set of channels that was closely substitutable for Sky's movies channels. As we explain below in Section 7, non-cable retailers have been unable to acquire Sky Movies (see Section 7). Furthermore, if a retailer supplies bundles including Sky Movies then this would not act as a constraint on Sky's wholesale pricing of those channels.

6.253 As a result, entry is not feasible even over longer timescales than typically considered for the purposes of supply side substitution.

Conclusion on retail market definition

6.254 Given that we do not consider that supply side substitution is feasible, it is the evidence on demand side substitution that determines the boundaries of the relevant market. We have assessed the constraint imposed by all substitutes on the supply of the focal product and conclude that they do not constrain Sky Movies to the competitive price, even when taken in aggregate. The pricing / profitability evidence implies the relevant market is sufficiently narrow for Sky to enjoy market power. The evidence we have considered overall leads us to conclude that:

- The relevant market at the retail level comprises retail bundles including Sky Movies.
- Moderate substitutes that lie outside the relevant market are PPV, Disney Cinemagic, FTA/basic movies channels, movies on other FTA channels, online DVD rental and retail Pay TV DVDs.
- OTC DVD rental, DVD retail purchases outside the first pay TV subscription window, non-movies programming on television and cinema are distant substitutes that lie well outside the relevant market.

Wholesale market definition

Wholesale products and the focal product

- 6.255 Sky supplies Sky Movies 1, Sky Movies 2, and Sky Dual Movies on a wholesale basis to Virgin Media on the basis of the existing rate-card, as set out in the Figure below.⁷⁶⁹ Sky does not supply Virgin Media with any HD versions of these channels.
- 6.256 While some of these Sky Movies packages are available on a standalone basis, there is extensive bundling at the wholesale level, reflecting the bundles available at the retail level (see paragraphs 6.104 to 6.106).

Figure 93 Sky wholesale rate-card to cable operators

Package supplied	Monthly wholesale charge (per subscriber)	% of Sky TV premium subscribers
Single Movies (Sky Movies 1 or Sky Movies 2)	£12.48	[X]
Single Movies + Single Sport	£17.99	[X]
Dual Movies (Sky Movies 1, Sky Movies 2, Sky Premiere and time shifted versions of Sky Premiere)	£16.59	[X]
Dual Movies + Single Sport	£20.20	[X]
Single Movies + Dual Sports	£21.36	[X]
Top Tier (Dual Movies + Dual Sports)	£24.16	[X]

Source: Sky, Virgin Media

- 6.257 In the Third Pay TV Consultation the focal product for our assessment of the wholesale market was the suite of Sky Movies channels⁷⁷⁰. Although Virgin Media made no further submission in relation to movies market definition,⁷⁷¹ its submissions in relation to sport appear relevant to this issue. In the case of sports, Virgin Media considered that the focal product should refer to packages of premium sports channels (Virgin Media's emphasis) as this reflects the way in which these channels are actually sold and thus the options actually available to consumers⁷⁷².
- 6.258 As we explained in relation to sports, we consider that Virgin Media's arguments have merit. We also consider that we should adopt a consistent approach when analysing both sports and movies channels. Accordingly, we consider that the focal product should reflect the products actually purchased by Sky's wholesale

⁷⁶⁹ Sky also wholesales Sky Movies to some smaller operators (e.g. Martin Dawes Ltd, SCC International and Star Systems)

⁷⁷⁰ Third Pay TV Consultation, paragraph 4.255.

⁷⁷¹ Virgin Media response to Third Pay TV Consultation, paragraph 3.2.

⁷⁷² Virgin Media response dated 1 December 2009 to question 2 of Ofcom's information request dated 29 October 2009. Also Virgin Media response to Third Pay TV Consultation, paragraph 3.9, 3.16, 3.18.

customers, namely the provision in the UK of wholesale packages containing the Sky Movies channels. This changes slightly the focal product that we identified in the Third Pay TV Consultation, in that we now refer to packages including Sky Movies, rather than just Sky Movies. However, when assessing constraints we consider the competitive constraints on the premium movies element of the bundle rather than the package as a whole (Appendix 3 to Annex 5 explains why this approach is appropriate). The substance of our analysis is thus the same as in the Third Pay TV Consultation.

Direct and indirect constraints

6.259 We set out below our assessment of both the indirect and direct constraints on a hypothetical monopolist of wholesale premium movies channels, as described in paragraph 5.66.

Indirect constraints

6.260 If there are no direct constraints then the boundaries of the wholesale market will be no wider than the retail market.

6.261 We concluded above that the relevant retail market comprised only retail bundles including Sky Movies. Moderate substitutes that lie outside the relevant market are PPV, Disney Cinemagic, FTA/basic movies channels, movies on other FTA channels, online DVD rental and retail Pay TV DVDs. These products will therefore act as a moderate constraint on wholesale bundles including Sky Movies.

Direct constraints

6.262 Direct constraints refer to retailers simply ceasing to acquire Sky Movies in response to a price rise. If a retailer were to do this, it has two options:

- Replace Sky Movies with other movies channels; and/or
- Replace Sky Movies with non-movies content.

Direct substitution to another movies channel

6.263 Our analysis of the indirect retail constraint indicated that there are no close substitutes for content found on Sky Movies channels. We do not consider therefore that there are likely to be any wholesale products that a retailer could substitute to in the event of a small but significant increase in the carriage fee.

6.264 Furthermore, we observe that retailers (i.e. cable companies) have not previously dropped Sky Movies channels even when the wholesale price has increased. Our conclusion is therefore that wholesale demand side substitution is unlikely to be a significant constraint.

Direct substitution to non-movies content

6.265 In response to our Third Pay TV Consultation, the Premier League made submissions in relation to sport which are equally relevant to our consideration of movies. The Premier League considered that retailers and broadcasters can choose from a wide variety of content and that their preferences are not necessarily the

same as the preferences of individual (final) consumers' preferences⁷⁷³. The Premier League stated that broadcasters will seek to acquire a wide range of content. Accordingly, the analysis of what content is substitutable at the wholesale level should consider content generally⁷⁷⁴.

- 6.266 We accept that retailers' preferences are not necessarily the same as final consumers' preferences as noted in paragraph 5.347.
- 6.267 We have therefore considered what channel a retailer would replace Sky Movies with (i.e. how attractive is the alternative to Sky Movies?).
- 6.268 Sky Movies are highly attractive to large numbers of inframarginal consumers. We estimate that Sky's retail revenue from the supply of Sky Movies was over [X]⁷⁷⁵. This shows how important these channels are and how difficult they would be for a retailer to replace with something of comparable attractiveness.
- 6.269 In contrast the alternatives are likely to be unattractive:
- A retailer could replace Sky Movies with whatever is the most profitable of the channels that it currently does not supply (the marginal channel). For satellite/cable retailers (which have large capacity), the marginal channel is likely to generate low returns (it will be less profitable than the least profitable channel currently retailed).
 - Alternatively, a retailer could attempt to launch its own movies channel. This is unlikely to be feasible – see the analysis of wholesale barriers to entry below.
- 6.270 Furthermore, the main retailer of Sky Movies is Sky itself, which accounts for around [X] of retail supply. Sky (as a retailer) is unlikely to seek to constrain itself (as a wholesaler) by responding to an increase in its nominal wholesale price by dropping its own channels. As such, the scope for any such direct constraint is limited to switching by Virgin Media.

Wholesale supply side substitution

- 6.271 Supply side substitution is unlikely. As we explain below in our assessment of market power, there are significant barriers to entry into the wholesale market.

Conclusion on wholesale market definition

- 6.272 Given that direct constraints are weak, the scope of the relevant market is no wider than the relevant retail market, which we have defined as comprising retail bundles including Sky Movies. We conclude that the relevant wholesale market comprises wholesale bundles including Sky Movies.

⁷⁷³ Premier League response to Third Pay TV Consultation, paragraph 5.8.2.

⁷⁷⁴ Premier League response to Third Pay TV Consultation, paragraph 5.6.

⁷⁷⁵ Ofcom's confidential market share spreadsheet.

Assessment of wholesale market power

6.273 We now set out our assessment of wholesale market power. The framework for this assessment is set out in paragraphs 5.361 to 5.390. The broader evidence on market power presented in paragraphs 5.396 to 5.404 is also relevant here.

6.274 As noted in paragraph 5.16, market power can be inferred from a range of evidence, most notably:

- High market shares, in a market with barriers to entry, and in the absence of countervailing buyer power. As we discussed in paragraph 6.97, in a market with differentiated products the strength of competition depends on both the scale of competitors and the closeness of competition. A simple market share calculation does not reflect the fact that some competitors are closer substitutes than others. As we explain below, the evidence on Sky's market shares suggests that Sky has market power in the wholesale market for wholesale bundles including Sky Movies.
- Evidence that prices substantially exceed relevant costs or that profits substantially exceed competitive levels. As explained in paragraph 6.9 above, we consider that the retail prices of bundles including Sky Movies are appreciably above the competitive level. Thus, contrary to Sky's claim that evidence on consumer outcomes suggests that the relevant markets are competitive, the evidence on pricing supports the conclusion that Sky enjoys wholesale market power⁷⁷⁶. The pricing evidence thus provides direct evidence that the constraint exerted by competitors to Sky is insufficient to constrain Sky's wholesale prices to the competitive level i.e. that Sky does in fact possess wholesale market power.

6.275 We consider each of these in turn.

Existing wholesale competitors

6.276 This Section assesses the strength of competition between existing competitors. As explained above, only wholesale bundles including Sky Movies lie within the relevant market. However, there are a number of moderate substitutes that lie outside the relevant market.

6.277 This Section is structured as follows:

- First, we consider the strength of competition within the relevant market.
- Second, we consider the constraint imposed by moderate substitutes outside the relevant market.
- Third, we set out evidence of how third parties view Sky's position.
- Fourth, given that our market power assessment is forward looking, we test whether our analysis is robust to possible future changes in the next few years.
- Fifth we consider representations that we have received on this issue.

⁷⁷⁶ Third Pay TV Consultation, annex 8, paragraph 2.41.

- Sixth we set out our conclusions on the extent of existing competition at the wholesale level.

Close existing competitors

6.278 For the reasons set out in our market definition assessment, we do not consider any of the potential substitutes we have identified to be close substitutes for Core Premium Movies channels. While other ways of watching movies, and other sources of audio-visual entertainment, are widely available, each of the alternatives differs crucially from Sky Movies in terms of timing of movie availability, price structure and levels, quality and quantity of movies content, format, or a combination of these characteristics. Sky Movies is the only service that gives subscribers immediate access to a wide range of recent major Hollywood movies. As such, we consider that the relevant market is the supply of bundles including Core Premium Movies channels, and that Sky has a 100% share of this market.

Moderate existing substitutes

6.279 Certain other ways of viewing movies may constrain Sky to a degree. As set out in our market definition analysis above, we recognise that there is a moderate degree of substitutability between wholesale bundles including Sky Movies and the following products: (i) Pay TV DVDs; (ii) library films (on FTA and basic channels, including dedicated FTA movies channels); (iii) PPV movies; (iv) online DVD rental subscription packages; (v) Disney Cinemagic; and (vi) legal movie downloads. On balance, we took the view that these services lay outside the relevant market but they nonetheless are moderately close substitutes for Sky Movies.

6.280 We have thus considered the extent of the constraint imposed by these products. In particular, we have calculated market shares as if all moderately substitutable content were within the relevant market (this updates similar calculations set out in the Third Pay TV Consultation). These market shares can be seen as providing an upper estimate for the strength of the aggregate constraint that may be exercised by products that lie somewhat outside the relevant market but that may nonetheless act as (imperfect) substitutes.

6.281 Our market share calculations (illustrated in the Figure below) are based on (a) Sky Movies revenue, (b) Pay TV DVD revenue, (c) the value of movies on FTA and basic channels and (d) revenues from online rental, OTC rental, online movie downloads and PPV. Because FTA and basic channels are funded in a range of different ways (licence fees, advertising, and a share of basic subscriptions), and we do not have data on the associated advertising revenues from broadcasting movies on these channels, we cannot directly compare the value of movies on these channels to those on Sky Movies. We have therefore calculated market shares on the basis of two different approaches.⁷⁷⁷

6.282 The first approach is to compare movies on FTA and basic channels with those on Sky Movies, on the basis of rights values. Sky paid [X]⁷⁷⁸ for movie rights in 2008 and earned revenues on these rights of [X]. FTA and basic channels paid [X]⁷⁷⁹

⁷⁷⁷ Because all of the close and moderate substitutes we considered for Sky Sports were TV channels, the approach we used there was to measure market shares on the basis of rights values.

⁷⁷⁸ Sky's 2008 transmission and revenue return to Ofcom.

⁷⁷⁹ 2008 transmission and revenue returns to Ofcom.

for movie rights in 2008. If we assumed that the value (to consumers) of the movies they showed had a similar uplift on rights values to movies on Sky Movies, this would suggest a valuation of [X] for movies on FTA and basic channels. The first numerical column sets out market shares based on this approach. If we include all moderate substitutes using this approach, Sky has a market share of [X].

- 6.283 However, this approach assumes that the relative costs of Sky Movies content compared to FTA and basic movies content reflects their relative value to final consumers. This may not be the case.
- 6.284 Sky is able to command a large premium for its content as shown by its movie margins over direct costs (paragraph 6.336). In contrast, Channel 4's margin over all its programming costs (not just movies content) is 30%⁷⁸⁰ and ITV1's margin is 15%⁷⁸¹. Sky's premium is partly because it can charge for its content. It may also be able to negotiate costs down with the movie studios through its stronger buyer power. This means the relative value of Sky Movies and other movies content on TV may not be reflected in their relative costs.
- 6.285 We use the "revenue-based" approach as another way to estimate the relative value of FTA and basic movies content. Comparing market shares by revenue is preferable to comparing input costs. To reflect the revenue that the FTA and basic movies content is likely to generate, we uplift their costs by 30%. This is consistent with the margin that Channel 4 earns across all its programming content and is double ITV's margin. Under this approach, Sky has a market share of [X] if we include all moderate substitutes⁷⁸².
- 6.286 Both the "revenue-based" and "cost-based" approaches may not reflect the relative value to consumers of commercial FTA movies content and Sky Movies. This is because commercial FTA revenue (and therefore FTA movie expenditure) only directly reflects the value that advertisers place on this content in drawing in an audience. While the two are related, alternative funding models (such as advertising rather than direct charges to viewers) can differ in their ability to extract value from content.

⁷⁸⁰ The broadcasting revenue and programming costs of Channel 4 are £669m and £516m respectively (p95 and p97 of Channel Four Television Corporation Report and Financial Statements 2008).

⁷⁸¹ The broadcasting revenue and programming costs of ITV1 are £1,127m and £979m respectively (ITV plc Report and Accounts 2008 p31 and 32). This gives a margin of 15%.

⁷⁸² The purpose of using this uplift was to reflect the retail value of this content – and hence to calculate market shares on a comparable basis with Sky (subscription and advertising revenues) and other moderate substitutes for Sky (e.g. DVD sales revenues). We take a different approach to *sports* market power – which is that we calculate market shares for Sky and moderate substitutes from their spending on relevant sporting events (see Figure 20 in the previous Section). In that case it is not necessary to uplift the figures as for movies, because the same valuation approach is used for Sky and each potential substitute. However, we do consider the effect of uplifting the value of lifted events.

Figure 94 Wholesale movie market shares if moderate substitutes were included in the relevant market

	Cost-based approach	Revenue-based approach			
	All out of market constraints	All out of market constraints	TV out of market constraints ¹	Commercial TV out of market constraints ²	Non-PSB commercial TV out of market constraints ³
Sky (inc PPV)	[30-40]%	[40-50]%	[60-70]%	[70-80]%	[90-100]%
Online DVD rental	[0-10]%	[0-10]%			
OTC DVD rental	[0-10]%	[0-10]%			
Legal movie downloads	[0-10]%	[0-10]%			
DVD retail (pay TV window)	[10-20]%	[10-20]%			
BBC	[0-10]%	[0-10]%	[0-10]%		
ITV	[0-10]%	[0-10]%	[0-10]%	[0-10]%	
Channel 4	[0-10]%	[0-10]%	[0-10]%	[0-10]%	
Five	[0-10]%	[0-10]%	[0-10]%	[0-10]%	
Virgin (inc PPV)	[0-10]%	[0-10]%	[0-10]%	[0-10]%	[0-10]%
Other: Basic, Film 4, BT Vision & Disney Cinemagic	[0-10]%	[0-10]%	[0-10]%	[0-10]%	[0-10]%

Notes: 1. excludes Pay TV DVD retail, online rental, OTC rental and online movies; 2. excludes the BBC, Pay TV DVD retail, online rental and online movies; 3. excludes the PSBs (but not Film 4), Pay TV DVD retail, online rental and online movies.

Source: Ofcom calculations. Shares of supply do not sum to 100% due to rounding.

- 6.287 Under the “revenue based” approach, if we only include TV-based moderate constraints, Sky has a market share of [X][60-70]%. Taking out all the PSB channels (but not Film 4) gives Sky a market share of [X][90-100]%.
6.288 There are difficulties in attributing wholesale revenues to Sky Movies when it is wholesaled in a bundle with Sky Sports. In the description of our profitability analysis we allocate revenue either using a “preference based approach”, or using the incremental price of Sky Movies, or using the incremental price of Sky Sports. The Figure above presents market shares using the “preference based approach”. The Figure below shows Sky’s market shares under all the approaches.

Figure 95 Revenue allocation sensitivity – Sky’s wholesale movie market shares if moderately close substitutes were included in the relevant market

	Cost-based approach	Revenue-based approach
Preference-based	[30-40]%	[40-50]%
Incremental price of movies	[30-40]%	[30-40]%
Incremental price of sports	[40-50]%	[50-60]%

Source: Ofcom calculations.

- 6.289 As discussed in paragraph 5.564, the two incremental price approaches give extreme allocations of revenues to Sky Movies. These two incremental price approaches give Sky a “revenue-based” market share of [X][30-60]% and “cost-based” market shares of [X][30-50]%. These give an indication of the lower and upper bounds of Sky’s market share when we include all moderate substitutes.
- 6.290 As explained in our market definition analysis above, we consider it reasonable to include DVD sales from within the first subscription pay TV window as a moderate constraint (Pay TV DVD sales). But we recognise that the line we draw around the first subscription pay TV window is not precise. It could be that only DVDs within the first few months of the pay TV window are a moderate constraint. Or it could be that DVDs sold either side of the pay TV window are also moderate constraints. Given this uncertainty, the large value of retail DVD sales and their potential impact on the shares of supply presented above, we have considered sensitivities around the treatment of retail DVD sales.
- 6.291 At one extreme, we only include DVDs sold in the first four months of the first subscription pay TV window. We estimate that this accounts for around 7%⁷⁸³ of DVD revenues. At the other extreme, we include DVDs sold five or more months after release. We estimate that this accounts for around 36%⁷⁸³ of DVD revenue. The Figure below presents Sky’s market shares under these two extremes.

⁷⁸³ Ofcom calculations based on data from The Official Chart Company.

Figure 96 DVD revenue sensitivity – Sky’s wholesale movie market shares if (more) DVD sales were included in the relevant market

	DVDs sold in the first 4 months of the pay TV window (7% of DVD revenues)		DVDs sold 5 or more months after release (36% of DVD revenues)	
	Cost-based approach	Revenue-based approach	Cost-based approach	Revenue-based approach
Preference-based	[40-50]%	[50-60]%	[30-40]%	[30-40]%
Incremental price of movies	[30-40]%	[40-50]%	[20-30]%	[30-40]%
Incremental price of sports	[40-50]%	[50-60]%	[30-40]%	[40-50]%

Source: Ofcom calculations.

6.292 At one extreme, Sky’s market share is as low as [X][20-30]%. We consider this unlikely as it involves both attributing the lowest amount of revenue to Sky Movies and attributing the highest amount of revenue to DVD sales. Furthermore, the DVD revenues are retail rather than wholesale revenues, so will tend to be overstated.⁷⁸⁴ At the other extreme, Sky’s market share is [X][50-60]%.

6.293 When considering the shares of supply presented above it is also important to recognise that moderate substitutes lie outside the relevant market (for the reasons given above in the market definition assessment). Accordingly, they will overstate the strength of the competitive constraint exerted by these products. We therefore place greater weight on the upper range of Sky’s market shares.

Evidence from third party documents

6.294 As noted in paragraph 2.233 of Annex 8 of the Third Pay TV Consultation, demand for PPV and online DVD rentals is increasing (albeit from small bases). We thus presented further evidence [X].

6.295 [X]:

- [X].
- [X].
- [X]⁷⁸⁵.

⁷⁸⁴ We have used an estimate of Sky’s *wholesale* revenues. This is the correct measure given that we are attempting to calculate wholesale market shares. However, for retail DVDs in the pay TV window, PPV movies, legal downloads and DVD rental subscription packages we do not have data on wholesale revenues and have instead used retail revenues. As noted in paragraph 2.228 of annex 8 of the Third Pay TV Consultation, combining retail and wholesale revenues in this way is likely to overstate the market shares of these substitutes and understate Sky’s market share.

⁷⁸⁵ [X].

6.296 We consider that this evidence is consistent with our analysis above of market shares including moderate constraints: while wholesale bundles including Sky Movies may face competition from new means of accessing movies, Sky remains in a strong position. The constraint may be asymmetric – i.e. Sky may constrain DVD rental providers, without those DVD rentals necessarily constraining Sky (given their respective market shares in a broad market definition).

Representations

6.297 In response to the Third Pay TV Consultation, Sky submitted extensive representations in relation to market definition. These are addressed above. Sky did not specifically respond to the part of the market power section of the Third Pay TV Consultation dealing with existing competitors. However in previous consultations Sky made the following points:

- Previously, when calculating market shares including moderate substitutes, we included online DVD rentals but not DVD retail sales. In its 1 June 2009 submission Sky asserted that this is inconsistent as there is no difference in the strength of our reasoning on the extent to which these products are substitutes (paragraph 4.16). As explained in paragraph 6.251 above, we consider that online DVD rentals and some retail DVDs (Pay TV DVDs) are moderate substitutes for packages including Sky Movies. We remain of the view that other retail DVDs are distant substitutes that lie outside the market.
- In its response to the Second Pay TV Consultation, Sky argued that focusing on putative market shares understates the extent of the competitive constraints on its channels. We accept that looking at market shares alone might not be a reliable guide to market power⁷⁸⁶. However, we nonetheless consider that the high market shares set out above, in conjunction with the evidence on the extent of substitutability presented as part of our market definition analysis, indicates that existing competitors only impose a weak constraint on Sky's movies channels. Moreover the shares of supply including moderate substitutes that are presented above include products that lie outside the relevant market⁷⁸⁷. Accordingly these market shares will tend to *overstate* the extent of the competitive constraint exerted by these products, rather than understating it.

6.298 Virgin Media considered that, even if Sky's market share were declining, Sky's market power is unlikely to materially change in the foreseeable future. This is because there are obstacles to acquiring the rights to the first TV subscription window of movies produced or licensed by the Major Hollywood Studios (the "Movie Rights")^{788,789}.

⁷⁸⁶ OFT Market Power Guidelines, paragraph 4.3.

⁷⁸⁷ For the reasons set out in the market definition analysis above, we do not consider that Sky's evidence justifies the inclusion of these products within the relevant market.

⁷⁸⁸ A channel which includes the first TV subscription window of movies produced or licensed by any of the Major Hollywood Studios would lie within the relevant market regardless of whether it is a linear channel or a subscription VoD service. Accordingly, both the linear rights and the subscription VoD rights fall within the definition of the Movie Rights. The pay per view rights do not allow entry into this relevant market and are thus excluded from the definition of the Movie Rights.

⁷⁸⁹ Virgin Media response to Third Pay TV Consultation, paragraph 4.5.

Ofcom's conclusion on existing competitors

6.299 Our conclusion on existing competitors is as follows:

- Sky's share of the relevant market is 100%, which indicates that it has market power (and potentially a dominant position⁷⁹⁰). If this share is retained over the next three to four years, we would expect that market power to be retained over that period.
- We recognise that products outside the relevant market can exercise some degree of competitive constraint. Taking moderate substitutes into account reduces Sky's share of supply. Including moderate substitutes reduces Sky's share of supply to [X], as shown in Figure 92. However these alternative market share figures will overstate the strength of the competitive constraint exercised by moderate substitutes and thus understate the extent of Sky's market power.
- We recognise that these market share figures do not reflect the competitive constraint exerted by more distant substitutes. However we do not consider that this is a sufficiently borderline case for the effect of more remote substitutes to alter our conclusion.
- Moreover, for the reasons set out in paragraphs 5.47 to 5.60 and 6.27 above and 6.329 to 6.337 below, we consider that retail prices are currently above the competitive level. This, in itself, is strong evidence that Sky is not significantly constrained by existing competitors and possesses market power.
- Looked at in the round, we consider that these measures are supportive of our view that Sky possesses a high market share that is consistent with it possessing market power in the wholesale supply of bundles including Sky Movies and that it in may have a dominant position in that market.

Barriers to entry and expansion

6.300 Where entry barriers are low, it may not be profitable to sustain prices above competitive levels because this would attract new entry which would then drive the price down, at least in the long term⁷⁹¹. We believe that there are important entry barriers and in the absence of further regulatory intervention these will remain.

6.301 In order to enter this market it is necessary to acquire Movie Rights.

6.302 As in the case of sports rights, we consider that material changes in a wholesale channel provider's portfolio of Movie Rights can lead to a very significant expansion (or contraction) in that broadcaster's market share (see paragraph 5.450 above). Thus barriers to acquiring Movie Rights also act as barriers to expansion. Our analysis focuses on whether there are obstacles to acquiring the Movie Rights.

6.303 Below we explain:

⁷⁹⁰ As noted above, the ECJ has stated that dominance can be presumed in the absence of evidence to the contrary if an undertaking has a market share persistently above 50%. Case C62/86 *AKZO Chemie BV v Commission* [1991] ECR I-3359.

⁷⁹¹ OFT Market Power Guidelines, paragraph 3.3, second bullet.

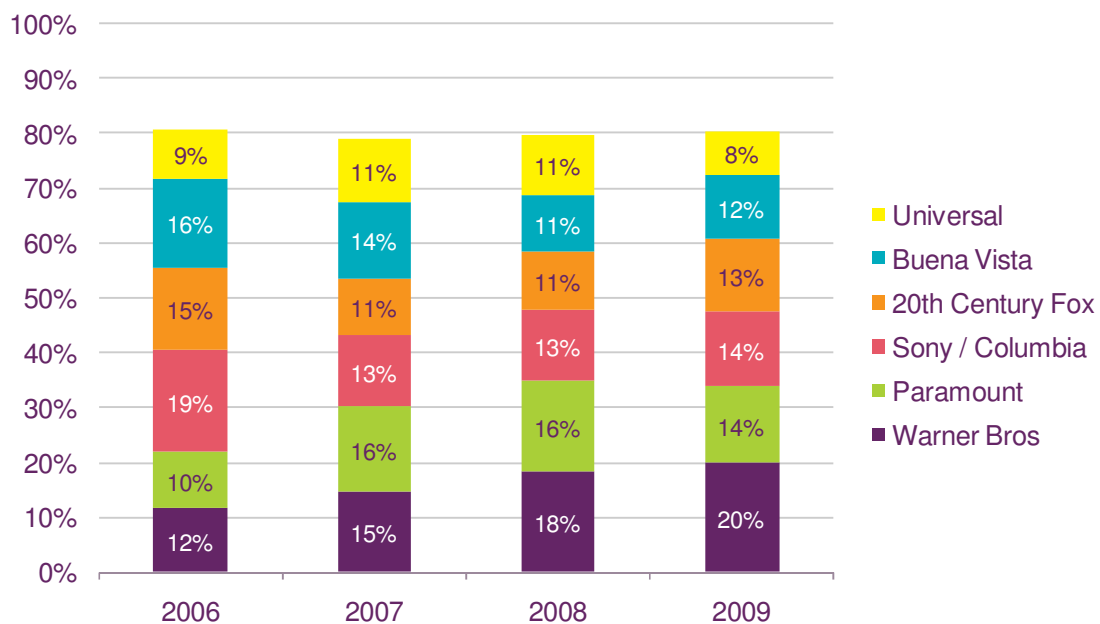
- The sale process for the Movie Rights.
- Why, in order to materially undermine Sky's wholesale position, Sky would need to lose the majority of the Movie Rights.
- Why Sky is likely to retain the majority of the Movie Rights.

Sale process for the Movie Rights

6.304 The Movie Rights are sold following negotiations between interested parties and each individual Major Hollywood Studio. Such negotiations may take place before the current agreement to license the Movie Rights expires. This contrasts with the more formalised and collective way in which the Premier League sells its rights. Currently the Movie Rights are sold on an exclusive basis i.e. only one wholesale channel provider holds the rights to the first TV subscription window of any particular film.

6.305 To illustrate the relative sizes of the Major Hollywood Studios, the Figure below sets out the six largest US distributors' share of US box office receipts. Each of these distributors is controlled by a Major Hollywood Studio. As in the Third Pay TV Consultation, we treat this as an indicator of the Major Hollywood Studios' shares of supply although we accept that they are not definitive⁷⁹².

Figure 97 The largest distributors' shares of US box office receipts



Source: <http://www.boxofficemojo.com>, retrieved 17 February 2010. This updates Figure 18 in annex 8 of the Third Pay TV Consultation.

⁷⁹² These figures relate to the films distributed by the Major Hollywood Studios and thus include films produced by some small third parties. Note that these figures relate to US (rather than UK) box office revenues and in any event shares of supply shares are volatile, depending on the success of each Major Hollywood Studio's particular slate of films in a given year.

In order materially to undermine Sky's wholesale position, Sky would need to lose the majority of the Movie Rights

- 6.306 It is important to distinguish between the minimum viable scale for entry (e.g. could a wholesaler with only a small amount of content enter this market) and the scale of entry necessary materially to undermine Sky's wholesale position. As noted in paragraph 5.13 above (in the context of the Live Premier League Rights), the central issue is whether potential entry by competitors and the potential expansion of existing competitors prevent Sky from profitably sustaining wholesale prices above the competitive level and/or harming the process of competition (e.g. by weakening existing competition, raising entry barriers or slowing innovation).
- 6.307 Given the strength of Sky's current position, small-scale entry and expansion is unlikely materially to undermine its wholesale position, since Sky would still enjoy a high market share. This is the case even if (small) entrants have a viable business. For example, even if a new entrant acquired the rights from one or perhaps two Major Hollywood Studios, then this might only reduce Sky's market share by some 10-25% (based on Figure 97 above)⁷⁹³. Thus, even if entry on this scale were viable it is unlikely to be sufficient materially to undermine Sky's wholesale position. Rather, it would require a large shift from the status quo to undermine Sky's position materially.
- 6.308 Accordingly we consider that the wholesale position held by Sky would not be materially undermined unless Sky lost the majority of the Movie Rights. It is difficult to be precise about what is meant by "majority" in this context, particularly as the importance of a Major Hollywood Studio's Movie Rights will vary from year to year depending on its slate of films. We would certainly regard Sky as having lost the majority of the Movie Rights if it lost 50% of the rights, measured by the Major Hollywood Studio's box office receipts in a particular year⁷⁹⁴. This would probably require the loss of two to four Major Hollywood Studios' Movie Rights, depending on the identity of the Major Hollywood Studios in question and what other Movie Rights are acquired⁷⁹⁵.

Sky is likely to win the majority of the Movie Rights

- 6.309 In principle, as Sky's current contracts with the Major Hollywood Studios expire, a new entrant might be able to win the newly available Movie Rights. However in practice we consider that Sky is likely to win the majority of those rights.

⁷⁹³ For example, based on the 2006 market shares set out in Figure 18 above, a broadcaster that secured the Movie Rights of Universal might gain a market share of approximately 10%. A broadcaster that secured the Movie Rights of Universal and Paramount might have a market share in the region of 20-25%.

⁷⁹⁴ The loss of 51% of the Movie Rights would leave Sky with a market share of 49%. While this would still be a high market share, given the evidence on moderate constraints presented in paragraphs 6.279 to 6.293 above it seems plausible that the aggregate effect of the constraints (both in and out of market) on Sky Movies would be sufficient to prevent Sky holding a dominant position.

⁷⁹⁵ For example, based on the 2006 market shares set out in Figure 18 above, Fox and Sony accounted for approximately 40% of box office receipts. If Sky did not secure Fox and Sony's Movie Rights and failed to secure the Movie Rights from a number of smaller suppliers this may be sufficient to give competitors the majority of the Movie Rights. Similarly, the if Sky did not secure the Movie Rights of Universal, Warner, Paramount and Disney it would have failed to acquire the majority of the Movie Rights.

- 6.310 Our view is strongly supported by the historical evidence. Over a period of almost 20 years Sky has never lost any of the Movie Rights. We regard this as clear evidence, contrary to Sky's claims that these rights are "contestable", that in practice there are significant barriers to other parties winning sufficient rights away from Sky.
- 6.311 Further evidence that new entrants are not in a position to outbid Sky is provided in internal documents. In particular, on a number of occasions Virgin Media has considered purchasing the Movie Rights, including entering into discussions with a Major Hollywood Studio. However on each occasion Virgin Media ultimately decided that it was [REDACTED].
- 6.312 For example, [REDACTED]⁷⁹⁶. [REDACTED]⁷⁹⁷.
- 6.313 A further possibility that we have considered is that Sky might not lose the movie rights to another bidder, but that a Major Hollywood Studio might decide to exploit its rights directly, by for example developing its own movie channel. Indeed this is what Disney has done (to a very limited degree) with Disney Cinemagic. Similarly in its response to the First Pay TV Consultation, Sky argued that most of the Movie Rights owners are already active in the television sector internationally. For example, Time Warner is involved in broadcasting in the US. Sky thus regarded the owners of the Movie Rights as potential entrants and stated that they could form joint ventures to combine their rights.
- 6.314 We consider that a Movie Rights holder that wished to directly exploit its rights in the UK faces material barriers to entry:
- As explained in paragraphs 6.307 to 6.308 above, direct distribution by a single Major Hollywood Studio would be insufficient to materially undermine Sky's wholesale position.
 - In paragraph 6.315 below we set out a number of factors that suggest that Sky has an advantage over other firms seeking to acquire the Movie Rights. These factors also apply to Major Hollywood Studios. For example, a single Major Hollywood Studio is likely to lose the synergies from aggregating Movie Rights if it directly exploited its own rights alone (see paragraphs A3.5 to A3.10 of Appendix 4 of Annex 5). Whilst that Major Hollywood Studio might be able to develop a more compelling proposition if it combined its content with that of other Movie Rights holders, this is made difficult by the staggering of their contracts with Sky (see Appendix 4 of Annex 5). Any agreement which they did reach to sell their content jointly might also be subject to review under competition law.
 - Evidence of these entry barriers is the failure of any rights holder to directly exploit their rights in this way, apart from Disney Cinemagic (which only shows a limited category of its own first-run movies).

Factors that explain why Sky is likely to win the majority of the Movie Rights

- 6.315 Consultation respondents have not argued to us that there is likely to be a material strengthening in the position of rival bidders for movie rights in the future. We

⁷⁹⁶ [REDACTED].

⁷⁹⁷ [REDACTED].

consider that Sky has considerable advantages in winning key movie rights in future, particularly due to:

- The impact of the staggered expiry of Sky's contracts with the Major Hollywood Studios. (See Appendix 4 of Annex 5).
- The efficiency advantages (such as greater certainty about wholesale income) that flow from bidders such as Sky being vertically integrated with pay TV retailers with a significant premium movie subscriber base⁷⁹⁸. Any competitor for the bids would face a delay in establishing such a subscriber base – or would have to negotiate access to Sky's subscriber base. (See Appendix 8 of Annex 4).

6.316 These factors also suggest that there are significant barriers to a rights holder such as a Major Hollywood Studio exploiting its rights directly, for example by developing its own movie channel.

Consultation responses

6.317 In general, the points made by respondents to our previous consultations in relation to movies channels overlapped with the points made in relation to sports channels. Accordingly, consultation responses have largely already been addressed above as part of our analysis of Core Premium Sports channels. Other consultation responses that are specific to Core Premium Movies channels have been addressed in the course of our analysis above.

Conclusion on barriers to entry and expansion

6.318 As explained above, we are assessing whether Sky possesses market power in the wholesale supply of bundles including Sky Movies. We do so by reference to the dominance threshold. Our view on whether potential competition is sufficiently strong to undermine the market power suggested by Sky's market shares is as follows:

- We consider that Sky is likely to maintain its wholesale position unless it loses the majority of the Movie Rights.
- We consider that Sky is likely to win the majority of the Movie Rights that become available. This reflects a number of advantages that Sky enjoys when bidding for these rights. These advantages constitute barriers to entry and expansion from the perspective of competitors seeking to enter the relevant market.
- Accordingly we consider that potential competition is not strong enough to prevent Sky exercising the market power suggested by its market shares. The weakness of potential competition is consistent with Sky possessing market power, and potentially a dominant position.

6.319 As noted in the Second and Third Pay TV Consultations, if the ownership of the Movie Rights were to change significantly in the future we would revisit our assessment of market power.

⁷⁹⁸ See Appendix 7 of Annex 4 for a discussion of the concept of entry barriers.

Countervailing buyer power

- 6.320 The only major independent purchaser of Sky Movies channels is Virgin Media, although a number of other parties have sought to acquire these channels. We have considered whether these buyers (actual and potential) are likely to exert sufficient CBP to offset Sky's seller power over the next three to four years.
- 6.321 As with our assessment of direct wholesale demand side substitution for premium sports channels, Sky argued that we failed to have regard to the argument that a retailer reallocating sales effort away from particular channels, rather than dropping those channels, could act as a constraint on the wholesale price⁷⁹⁹. In particular it cited the example of Virgin Media reallocating marketing effort to its PPV VoD service.
- 6.322 In our previous consultations we concluded that Sky is in a very powerful bargaining position as regards retailers. We indicated that, while Virgin Media is likely to have some CBP, this is likely to be limited. Responses to our previous consultations on CBP did not draw a distinction between sport and movies channels. We consider that the points set out above in Section 5 on this issue apply equally here. We recognise that cable operators offer on demand PPV films that are, to an extent, an alternative to Sky Movies^{800,801}.
- 6.323 Our overall position on CBP with respect to movies is the same as that for the wholesale supply of bundles including Core Premium Sports channels. Virgin Media is the most likely retailer to exercise CBP over Sky. While Virgin Media is a significant outlet for Sky, the commercial balance of the relationship is strongly in favour of Sky (this is for the reasons summarised in relation to Core Premium Sports channels above). Furthermore, around [X]% of Sky's supply is direct to subscribers, where there is no scope for buyer power to arise. We therefore believe that no party exercises sufficient buyer power to counter Sky's seller power in the wholesale supply of bundles including Core Premium Movies channels.

Summary

- 6.324 As described in paragraph 6.278, Sky has a 100% market share in the market for bundles including Core Premium Movies channels, which is consistent with very high market power, and indeed a position of dominance. **Even** if moderately close substitutes are included in the market (thereby overstating their importance), Sky still has a share of between 30-40% and 40-50%, which is consistent with market power and potentially dominance.
- 6.325 Lack of access to premium movies content is a barrier to market entry and expansion. Sky will retain its market power as long as it retains the rights to the majority of these rights.
- 6.326 Most of Sky's subscribers are supplied directly by Sky, limiting the scope for countervailing buyer power. In addition, the importance of Sky Movies to Virgin

⁷⁹⁹ Sky Response of 1 June 2009 to Ofcom's Second Pay TV Consultation "Additional comments on Ofcom's analysis of market definition and market power in the pay TV review" Annex 1 paragraphs 3.34 to 3.37.

⁸⁰⁰ Sky also referred to these services in its 1 June 2009 submission at Annex 1, paragraph 3.39.

⁸⁰¹ [X]

Media, and Sky's approach to supplying Virgin Media, indicate that Virgin Media has little if any buyer power over Sky.

- 6.327 As a result, our analysis based on market definition and market shares provides strong evidence in support of our view that Sky has market power and indeed a dominant position in the wholesale supply of bundles including Core Premium Movies channels, which is likely to persist in the absence of regulatory intervention.
- 6.328 Next we consider whether the current prices of packages including Sky Movies channels are above the competitive level, with reference to evidence as to Sky's profitability and costs.

Whether current prices are above competitive levels

- 6.329 Our Third Pay TV Consultation presented evidence that prices were above competitive levels⁸⁰².
- 6.330 We said that, even absent evidence that Sky were earning high profits, we would be concerned that retail prices were above the competitive levels because rights holders may be extracting monopoly rents via high rights prices. While we considered this to be less likely in the case of the Movie Rights than in the case of sports rights, we nonetheless stated that it is likely that a proportion of the rents created by aggregating rights at the wholesale level are shared with the studios⁸⁰³.
- 6.331 As noted in paragraph 5.58, Sky has argued⁸⁰⁴ that we have not established that either the operating margin for its premium wholesale business, or wholesale charges for its premium channels, are high. It said this claim could not be based on Oxera's analysis⁸⁰⁵ or our estimate of cost-plus prices.
- 6.332 We remain of the view that the retail prices of bundles including Sky Movies are appreciably above the competitive level. This is supported by two pieces of evidence⁸⁰⁶:
- Oxera's analysis of Sky's profitability.
 - Ofcom's pricing model, which corroborates Oxera's analysis.
- 6.333 As explained above, the likelihood that retail prices for bundles including Sky Movies are above competitive levels has two implications. First, it provides direct evidence that Sky has market power. Second, it implies that consumers' propensity to switch at current prices will be overstated.

⁸⁰² Third Pay TV Consultation, paragraph 4.52.

⁸⁰³ Third Pay TV Consultation, paragraph 4.53.

⁸⁰⁴ Sky response to Third Pay TV Consultation, paragraph 7.4 and 7.12.

⁸⁰⁵ This referred to Oxera's Report at Annex 9 to our Third Pay TV Consultation.

⁸⁰⁶ At paragraph 4.53 of the Third Pay TV Consultation we raised the possibility that movie studios may be sharing in any rents. We remain of the view that this is possible. However we do not consider that there is clear evidence that the price of the Movie Rights is above the competitive level.

Oxera's analysis of Sky's profitability

- 6.334 We have highlighted above the difficulties of disaggregating the profitability of Sky's wholesale sports and movies business, but in line with our conclusions in Section 5, we believe that Sky earns high margins in both businesses, and that those margins are likely to be higher in movies than in sports. We consider that the most reliable measure of Sky's wholesale movies margin over direct costs is the preference based figure using Analysis Mason's cost allocation. As Figure 61 shows, this implies a margin of [X] and [X].
- 6.335 This finding is backed up by comparing Sky's current rate-card prices for its most popular wholesale channels to the estimates of the costs of providing those channels (including an allowance for a reasonable return on investment) that come from our pricing model. While we no longer intend to use our pricing model to set actual prices for Sky's wholesale movies channels, the model provides useful information on the costs Sky incurs in supplying those channels. Differences between those costs (which include a reasonable return) and Sky's current rate-card prices are therefore evidence that prices are likely to be above the competitive level.
- 6.336 As Figure 67 shows, rate-card prices for the most popular package (Sky Sports Mix and Sky Movies Mix) are 42% above the cost plus estimate. The figure for the Sky Movies Mix is 230%. These figures are substantially above the 5-10% increase in prices above the competitive level normally considered for the purposes of the SSNIP test. Moreover they are particularly striking given [X].
- 6.337 This is evidence that the retail price of bundles including Sky Movies is likely to be above the competitive level. It also suggests directly that Sky has market power in relation to its wholesale movies products.

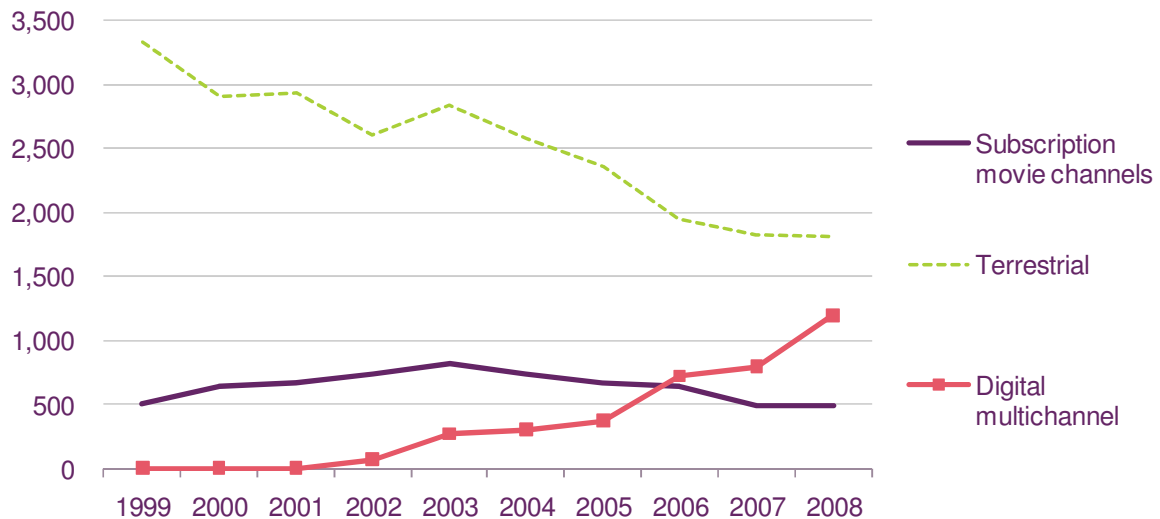
Forward looking assessment of market shares

- 6.338 The OFT Market Power Guidelines state that "The history of the market shares of all undertakings within the relevant market is often more informative than considering market shares at a single point in time ..." (paragraph 4.3). Moreover our market power assessment looks into the future to consider whether Sky is likely to be dominant for the next three to four years. In the Third Pay TV Consultation we noted that Sky's wholesale supply of Sky Movies may well be subject to a strengthening competitive constraint over the next three years⁸⁰⁷.
- 6.339 We have considered how Sky's market power might have changed in the past and how it might change in the future. As in the Third Pay TV Consultation, we have not calculated market shares (including moderate substitutes) prior to 2007. Instead we discuss past changes in market power qualitatively.
- 6.340 There is some evidence that suggests that Sky's market power may have declined in recent years:
- As shown in Figure 98 and Figure 99 below, there has been a decline in viewing of subscription movies channels equivalent to about 330 million views (or 40%) since a peak in 2003. While audiences on terrestrial channels have also fallen, viewing of films on other digital channels has risen. As a consequence, Sky's share of viewing of films has fallen from a peak of 22% in 2002 to 14% in 2008.

⁸⁰⁷ Third Pay TV Consultation, paragraph 2.238.

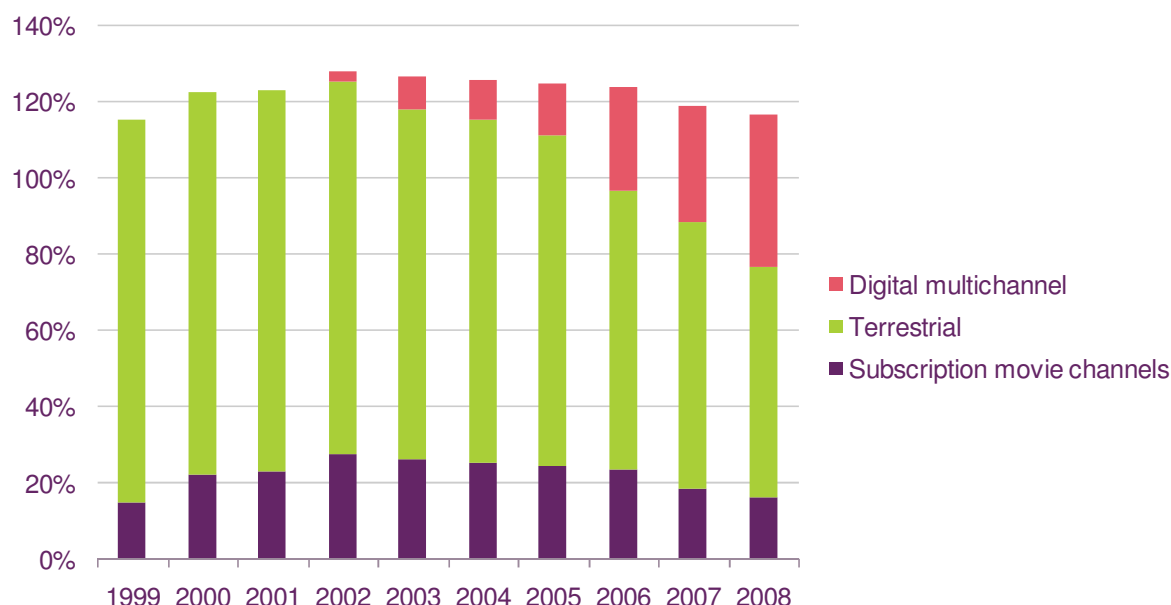
- As shown in Figure 100 below, [X] since 2005 while Sky's expenditure has fallen. While [X], this suggests that this constraint has strengthened in recent years. However, the BBC is planning to reduce its spending on movies in future⁸⁰⁸.
- Although less important, in recent years other means of watching movies such as subscription online DVD rental services and movie downloads have also emerged.

Figure 98 Total audience for films on TV (not PPV) (1999-2008)



Source: Statistical Yearbook 2009, UK Film Council, Figure 12.4. This updates Figure 33 in the Third Pay TV Consultation and adds digital multichannel audiences.

Figure 99 Shares of the audience for films on TV (not PPV) (1999-2008)



Source: Ofcom calculations based on Statistical Yearbook 2009, UK Film Council, Figure 12.4.

Figure 100 Expenditure on movies by Sky, the PSBs and basic / FTA dedicated movies channels

[X]

Figure 101 Estimates of wholesale margins over direct costs for sports and movies channels — preference-based allocation

[X]

6.341 Our market power assessment is forward looking. It is thus important to consider the impact of recent trends and prospective future changes, in particular [X]. We have thus estimated what Sky's share of supply might be in the future⁸⁰⁹. These figures include moderate substitutes for packages including Sky Movies. Specifically:

- In 2008, Sky's revenue from the wholesale supply of Core Premium Movies channels was [X] (under a "preference based" revenue allocation; see paragraph 5.564). We have modelled three scenarios ('low', 'medium' and 'high') for how this revenue might change.
 - Under the 'low' scenario, we have assumed that Sky Movies revenue declines by 5% annually until 2013. This implies that Sky Movies revenue in 2013 would be [X]. This scenario corresponds to a continuation of trends in the number of Sky Movies subscribers seen over the last few years.
 - Under the 'medium' scenario we have assumed that Sky's revenue increases by 0% annually until 2013. This implies that Sky Movies revenue in 2013 would be [X]. This scenario reflects the possible impact of [X].

⁸⁰⁹ We carried out a similar exercise in the Third Pay TV Consultation, Annex 8, paragraphs 2.236-2.238.

- Under the 'high' scenario we have assumed that Sky's revenue increases by 5% annually until 2013. This implies that Sky Movies revenue in 2013 would be [X]. This scenario takes a more aggressive view of the possible impact of [X].
- We have also made the following assumptions about other products:⁸¹⁰
 - In 2008, Disney's revenue from the wholesale supply of Core Premium Movies channels was [X] (see confidential market share spreadsheet). We have assumed that this remains unchanged in 2013.
 - In 2008, the estimated value of online DVD rental services was £92m⁸¹¹; in 2005 it was £46m. Over 3 years it has therefore grown at an average annual rate of 26%⁸¹². We assume that this growth rate slows to an average of 13% per year from 2008 to 2013⁸¹³. This assumption implies retail revenues from online DVD rental services in 2013 would be £169m.
 - In 2008, the estimated value of legal downloads movies was £7m⁸¹⁴. If this figure grows at 50% per year then revenues from legal downloads would be £53m in 2013⁸¹⁵.
 - In 2008, the estimated value of PPV movies via TV VoD was £120m⁸¹⁶; in 2005 this was £64m⁸¹⁷. Over 3 years it has therefore grown at an average annual rate of 23%. We assume that this growth rate slows down to an average of 12% per year from 2008 to 2013.

⁸¹⁰ [X]. As a result, under the 'medium' and 'high' scenarios, the growth in other means of watching movies may be slower. However, given the uncertainties created by the lack of data on this issue, we have not modelled this potential impact. Rather the qualitative point is that Sky's share of supply under the 'medium' and 'high' scenarios may be understated, given that the growth in moderate substitutes may be lower under these scenarios.

⁸¹¹ BVA Yearbook 2009, British Video Association, page 80.

⁸¹² In the Third Pay TV Consultation we considered the rate of growth between 2007 (when the value of online DVD rental services was £77m) and 2008 (when it was £92m). This produced an almost identical estimated annual rate of growth, namely 27%. Figures taken from *BVA Yearbook 2009*, page 80.

⁸¹³ As explained in paragraph 2.236 of the Third Pay TV Consultation, we previously assumed that online DVD rental services would sustain a 27% annual growth rate for the period 2009 to 2012. We consider this to be implausibly high (it implies the industry would grow by 160% over 4 years and 231% over 5 years).

⁸¹⁴ This a 1300% increase on the 2007 figure of £0.5m. *BVA Yearbook 2009*, British Video Association, page 97.

⁸¹⁵ As explained in paragraph 2.236 of the Third Pay TV Consultation, we previously assumed that legal download services would sustain a 100% annual growth rate for the period 2009 to 2012. We consider this to be implausibly high (it implies the industry would grow by 1500% over 4 years and 3100% over 5 years).

⁸¹⁶ UK Film Council Statistical Yearbook 2009, table 14.1 on page 109.

⁸¹⁷ UK Film Council Statistical Yearbook 2009, Figure 14.1, p. 112.

- In 2008, the estimated value of DVD retail was £1,454m⁸¹⁸; in 2005 this was £1399m. Over 3 years it has therefore grown at an average annual rate of approximately 1%. We assume the same growth rate for Pay TV DVD retail.
- In 2008, the estimated value of film on free multichannel and terrestrial TV was £546m⁸¹⁹; in 2005 this was £410m⁸²⁰. Over 3 years it has therefore grown at an average annual rate of 10%. We therefore assume a 10% annual growth rate until 2013.

6.342 The Figure below sets out Sky's "revenue-based" market share of supply in 2013 under the 'low', 'medium' and 'high' scenarios described above. These figures take into account the impact of moderate substitutes, namely PPV, online DVD rental services, legal downloads, movies on FTA channels and retail Pay TV DVD sales. We consider that the 'medium' and 'high' scenarios are more plausible, given [X], and the current funding challenges faced by FTA broadcasters.

Figure 102 Indicative estimates of Sky's share of supply in 2013

Assumed growth rate of Sky Movies revenue	Sky's market share
Low: -5%	[30-40]%
Medium: 0%	[40-50]%
High: 5%	[40-50]%

Source: Ofcom calculations

6.343 Projecting future market shares, particularly for relatively new services like legal movie downloads [X], is an inherently speculative exercise. Thus, as in the Third Pay TV Consultation, we only put limited weight on the shares of supply calculated above. The key implication that we draw is that Sky's market power is unlikely to decline materially in the next few years. In particular, [X].

Conclusion on wholesale market power

6.344 In the light of Sky's very high and sustained market shares, the existence of barriers to entry and limited prospects for countervailing buyer power, and evidence that current prices are above the competitive level, we consider that Sky holds market power in the wholesale supply of Core Premium Movies channels, and is likely to do so for the next three to four years.

⁸¹⁸ UK Film Council Statistical Yearbook 2009, Figure 14.1, p. 112.

⁸¹⁹ Summing £257m for "Terrestrial TV" and £289m for "'Free' multi-channel TV". UK Film Council Statistical Yearbook 2009, Table 14.1 on page 109.

⁸²⁰ Summing £325m for "Terrestrial TV" and £85m for "'Free' multi-channel TV". UK Film Council Statistical Yearbook 2006/07, Table 13.1 on page 132.

Retail market power

Our views in the Third Pay TV Consultation

- 6.345 We calculated market shares based on the proportion of revenues earned by Sky and Virgin Media from the supply of retail television bundles containing Core Premium Movies channels. While the available data had some limitations, Sky clearly accounted for a very high proportion (around [X]) of the market, so we considered the overall conclusion that Sky had a high market share to be reliable. On a measure which included some moderate substitutes (namely PPV, online DVD rental services and legal movie downloads), Sky still possessed a high market share (around [X]). On an alternative measure that looked at broadcasters' expenditure on rights to movies Sky has a share of [X].
- 6.346 Lack of access to Sky's Core Premium Movies channels was a significant barrier to entry and expansion in the market, and there was no offsetting buyer power. As such, Sky's high market share and the presence of entry barriers led to the conclusion that Sky had a dominant position in the retail market. However we stated that the finding of retail 'dominance' (applying this test) is not a necessary precondition for the competition concerns set out in the Third Pay TV Consultation. Rather those competition concerns centred on Sky's conduct at the wholesale level⁸²¹.
- 6.347 However, this did not imply that Sky had any *additional* market power, over and above its position at the wholesale level, by virtue of its retail position. In particular, it did not imply any additional scope to raise retail prices above the level that would prevail if Sky had only wholesale market power.
- 6.348 To assess whether Sky had such additional market power, we distinguished between retail prices being above the competitive level due to (a) high wholesale prices and (b) high retail margins. In Sky's case the retail margin would be the total margin it earns on retail sales, minus the wholesale margin it earns on sales to Virgin Media. On this point, we argued that:
- Sky set its wholesale prices to avoid a margin squeeze test, so it was unlikely to allow an excessive retail margin,
 - Similarly, Sky would not have an incentive to increase its retail prices without also increasing its wholesale prices to Virgin Media, keeping retail margins broadly constant.
- 6.349 Accordingly we did not consider that there was sufficient evidence to conclude that Sky could sustain retail margins appreciably above the competitive level.

Responses to the Third Pay TV Consultation

- 6.350 Virgin Media characterised Ofcom's position in the Third Pay TV Consultation as being that Sky was not constrained by existing competitors or "out-of-market" constraints, and that there would be insufficient retail competition to constrain Sky

⁸²¹ Third Pay TV Consultation, paragraph 5.154.

even if it did not have market power at the wholesale level of the supply chain. Virgin Media agreed with this purported position⁸²².

Our conclusion

6.351 As set out in our Third Pay TV Consultation, Sky has a very high share of a retail market for the supply of retail television bundles including Core Premium Movies channels. We have calculated current market shares based on incremental prices (i.e. the price of a package which includes Core Premium Movies channels, over the basic package price), and also based on subscriber numbers, as shown in the Figure below. Sky's market share ranges from [X][80-100]%.

Figure 103 Market shares in the supply of retail television bundles containing Core Premium Acj Yg channels

	Sky	Virgin Media	Other
Revenues			
All Core Premium Movies channel packages	[80-90]%	[10-20]%	[0-10]%
Subscriber numbers			
All Core Premium Movies channel packages	[90-100]%	[0-10]%	[0-10]%

Source: Ofcom calculations

Notes (1) Market shares are based on incremental revenues. (2) September 2009 subscriber numbers are used for all packages containing any Sky Movies channels (except for those from "Sky by Wire" and small cable operators where June 2009 figures were the latest figures available). (3) Sky Sports satellite price based on the incremental price of Sky Dual Movies on top of the variety pack. (4) Sky Sports "Sky by Wire" price based on the price charged by Sky for Sky Dual Movies. (5) Virgin Media's price of Sky Movies based on its incremental price on top of Virgin Media's M+ pack (See Figure 86).

6.352 Our Third Pay TV Consultation also estimated market shares if "out of market" constraints were included. As was the case with our analysis of wholesale market shares, these market shares depend on the treatment of movies broadcast on FTA and basic channels. As explained as part of our wholesale analysis above, we have used two approaches: a cost based approach and a revenue based approach. If all moderate substitutes are taken into account, Sky has a retail market share of [X] [80-100]%. This is markedly higher than any of the other moderate competitors listed in Figure 101.

⁸²² Virgin Media response to Third Pay TV Consultation, paragraph 4.6.

Figure 104 Market shares in the supply of retail television bundles containing Core Premium Movies channels (includes moderate substitutes)

	Cost-based approach	Revenue-based approach			
	All out of market constraints	All out of market constraints	TV out of market constraints ¹	Commercial TV out of market constraints ²	Non-PSB commercial TV out of market constraints ³
Sky (inc PPV)	[30-40]%	[40-50]%	[60-70]%	[60-70]%	[80-90]%
Online DVD rental	[0-10]%	[0-10]%			
OTC DVD rental	[0-10]%	[0-10]%			
Legal movie downloads	[0-10]%	[0-10]%			
DVD retail (pay TV window)	[10-20]%	[10-20]%			
BBC	[10-20]%	[0-10]%	[0-10]%		
ITV	[0-10]%	[0-10]%	[0-10]%	[0-10]%	
Channel 4	[0-10]%	[0-10]%	[0-10]%	[0-10]%	
Five	[0-10]%	[0-10]%	[0-10]%	[0-10]%	
Virgin (inc PPV)	[0-10]%	[0-10]%	[10-20]%	[10-20]%	[10-20]%
Other: Small cable operators, BT Vision, Film 4 & basic ⁴	[0-10]%	[0-10]%	[0-10]%	[0-10]%	[0-10]%

Notes: 1. excludes DVD retail, online rental and online movies; 2. excludes the BBC, DVD retail, online rental and online movies; 3. excludes the PSBs (but not Film 4), DVD retail, online rental and online movies. 4. Our data does not separate out the expenditure on basic content from Film 4.

Source: Ofcom calculations, share of supply may not sum to 100% due to rounding.

6.353 Turning to barriers to entry, as described in Section 7, no independent retailers have obtained wholesale access to Sky's Core Premium channels in recent years, despite a number of attempts to negotiate such access with Sky.

6.354 As regards countervailing buyer power, individual households have no such power and must take or leave the prices that Sky offers.

6.355 In light of Sky's high market share, the presence of significant barriers to entry, and the lack of buyer power, we remain of the view expressed in our Third Pay TV Consultation⁸²³ that Sky holds a position of retail market power.

6.356 However, as in our Third Pay TV Consultation, we consider that this does not imply any additional scope for Sky to raise retail prices above the level that would prevail if

⁸²³ Paragraphs 1.22 and 5.3.

it only had wholesale market power. Put differently, even if retail competition were to increase, there might be a limited impact on retail prices because Sky could continue to restrict competition through charging high wholesale prices to other retailers.

6.357 To illustrate, consider the example of a monopoly wholesaler that supplies a perfectly competitive retail market.

- That wholesale monopolist is capable of significantly increasing wholesale prices and thereby increasing retail prices appreciably above the competitive level. Moreover if that wholesaler were vertically integrated with one of the retailers, the vertically integrated firm would also have the ability to increase its retail price (along with that of all other retailers) above the competitive level. Applying the standard approach to assessing market power, one might conclude that the vertically integrated firm is dominant at both the wholesale and retail level.
- However clearly in this example the source of the market power is the firm's wholesale position. Because the retail market is assumed to be perfectly competitive, no retailer (including the vertically integrated firm's retail arm) has the ability to earn an excessive retail margin.

6.358 The OFT Market Power Guidelines state that "Market power can be thought of as the ability profitably to sustain prices above competitive levels or restrict output or quality below competitive levels" (paragraph 1.4).

6.359 Footnote 13 of the OFT's guidelines on market definition also states that⁸²⁴:

"When carrying out the test, we assume ... that the prices of products outside of the hypothetical monopolist's control are held constant at their competitive levels."

6.360 This standard approach to assessing market power would apply if the wholesale level of the supply chain were competitive i.e. if wholesale prices and supply arrangements reflected the outcome of a competitive wholesale market. In such circumstances, it is only the actions of retailers that can potentially increase retail prices above the competitive level⁸²⁵. Clearly this is a somewhat artificial test since Sky is dominant in the wholesale supply of Core Premium channels.

6.361 Sky raised these issues in its response to the First Pay TV Consultation.⁸²⁶ CRA, on behalf of Sky, noted that Ofcom had concluded that Sky had significant market power in the retail of sports channels because it had "better sports content" but this same source of market power was also used to justify Ofcom's view that Sky had market power at the wholesale level. CRA argued that this was a "double counting" of market power.

⁸²⁴ In annex 3 of its 1 June 2009 submission Sky disagreed with our interpretation of these guidelines. We do not accept Sky's criticisms. *Market definition*, OFT, December 2004 available at http://oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft403.pdf

⁸²⁵ In this context the "competitive retail price" means the level of retail prices that would prevail if the supply chain were competitive at each and every level.

⁸²⁶ Paragraphs 47-49 of Annex 4 to Sky's response, noted in paragraph 3.13 of annex 8 of the Third Pay TV Consultation.

6.362 We agree that there is a risk of giving a misleading impression, for the reasons described above. As set out in our previous consultation⁸²⁷, we do not consider that Sky has an incentive to set retail margins above competitive levels:

- First, Sky said that its wholesale prices are cross-checked so as to satisfy the conditions of the margin squeeze test [X]⁸²⁸. This suggests that Sky's wholesale prices are unlikely to allow a high retail margin to be earned. Accordingly, even if retail prices were appreciably above the competitive level, this would reflect high wholesale prices rather than the exercise of retail market power.
- Second, it may be more attractive for Sky to earn a high margin on Sky Movies at the wholesale level rather than at the retail level. A £1 increase in Sky's retail margin only increases its revenue from consumers that it directly supplies. Also, by increasing Sky's retail price relative to that charged by Virgin Media, consumers are more likely to switch away from Sky's retail business. In contrast, a £1 increase in Sky's wholesale margin (including the implicit wholesale price that it charges its own retail business) increases its revenue both from consumers it supplies indirectly via Virgin Media as well as from consumers it directly supplies.

6.363 On this basis, we consider that Sky has a stronger incentive to exercise its market power at the wholesale level than at the retail level.

Conclusion on retail market power

6.364 We remain of the view that Sky has retail market power, based on its high market share and the presence of entry barriers. However, we conclude that Sky does not have an incentive to allow high retail margins to Virgin Media, and so it can best be characterised as exercising its market power at the wholesale level, rather than the retail level

⁸²⁷ Third Pay TV Consultation, paragraph 3.40.

⁸²⁸ [X]

Appendix 8

Factors explaining Sky's success when bidding for rights

Introduction

- 8.1 In the main document we explain why we consider that Sky is likely to win the majority of the Live Premier League Rights and the Movie Rights in the future. Given Sky's history of success in bidding for these rights, we do not consider that it is necessary for us to conclude on which factors explain Sky's strong bidding position. Consultation respondents have not suggested that there is likely to be a material strengthening in the position of rival bidders in the future. However we have identified a number of factors that contribute to Sky's advantage over rival bidders.
- 8.2 In the case of the Live Premier League Rights we consider that the following factors are relevant:
- The delay that a new entrant would face in building a subscriber base.
 - The efficiency advantages that may flow from bidders such as Sky being vertically integrated with pay TV retailers with a significant subscriber base.
 - A range of bidder-specific factors, including branding advantages in relation to sports coverage.
- 8.3 We discuss these factors in turn below. We consider that in aggregate these factors are likely to contribute to Sky being likely to win the majority of the Live Premier League Rights. These factors are also likely to contribute to Sky's success in bidding for the Movie Rights, with the exception of some of the bidder specific factors that we identify (see below).

Delays for new entrants in building a subscriber base

Evidence of the delays experienced by new entrants

- 8.4 There is evidence that, were a firm to acquire Live Premier League Rights for the first time, there would be a delay while it built up a subscriber base to comparable levels to those that could be attained by the current rights holder(s). This delay would reduce the value of the Live Premier League Rights to a potential new entrant. As a result, the incumbent rights holder(s) are likely to be able to outbid potential new entrants.
- 8.5 This reasoning is consistent with Sky's successful record in bidding for Live Premier League Rights, [X] and the failure of any new entrants to win Live Premier League Rights in the Initial 2009 Sale¹²⁶. Nonetheless, we recognise that other factors are at play in determining the outcome of specific Premier League package rights bids.¹²⁷

¹²⁶ [X]

¹²⁷ Prior to the Second Pay TV Consultation, both Virgin Media and Setanta/Top Up TV asserted that, if a new entrant tried to distribute its channel on DSat via a wholesale relationship with Sky then this would not resolve the delay problem, since that new channel would still have no subscribers at the outset. Setanta/Top Up TV did not

- 8.6 Figure 8 shows the number of paying Setanta Sports subscribers on Sky's DSat platform at the end of each month. The number of Setanta Sports subscribers increased substantially with the addition of Premier League matches, from under 200,000 prior to 31 May 2007 to over 700,000 by 30 November 2007. Setanta began broadcasting live Premier League matches in August 2007. [X]¹²⁸.
- 8.7 Ofcom considers that this data clearly shows that, where a firm acquires the Live Premier League Rights for the first time, there is a delay whilst it builds up its subscriber base. [X].

Figure 8: Paying Setanta Sports subscribers on Sky's DSat platform

[X]

Source: Annex 1 of Setanta response of 15 April 2009 to Ofcom information request dated 20 March 2009. Figures for "DTH paying" subscribers in Great Britain at the end of each month.

- 8.8 As in our Third Pay TV Consultation, we do not attribute this delay to the costs of taking up an additional channel on the platform that a household currently uses, since we consider these are likely to be negligible. However, the O&O NTL Report identified "consumer inertia/loyalty to Sky Sports" as a factor that depresses the "non Sky rival[s] value" from a package (slide 9). This report attempted to assess the extent of this inertia. [X] This report identified "the inertia of Sky Sports subscribers" as one reason why "the maximum value to Sky ... for every package is always greater than a rival pay TV bidder" (slide 49). This provides further evidence that a firm that wins the Live Premier League Rights for the first time may attract markedly fewer subscribers than the incumbent channel provider. See also the discussion of retail switching costs in paragraphs paragraph 3.45 to 3.51 of Annex 8 of the Third Pay TV Consultation.
- 8.9 The evidence above relates to delays in building up a subscriber base for a sports channel. We consider that it is likely that a firm that acquires the Movie Rights for the first time would experience a similar delay in building up its subscriber base.

Representations relevant to building a subscriber base

- 8.10 The Premier League stated that our arguments "about the need for a subscriber base" are inconsistent with paragraph 6.64 of the Third Pay TV Consultation. In that paragraph we stated that "while a large existing subscriber base may provide some advantage in bidding for rights, it is one of a number of factors ... and perhaps not the most important of these factors". However the qualification set out in paragraph 6.64 actually related to the efficiency advantages that may flow from bidders being vertically integrated with pay TV retailers with a significant subscriber base (discussed in paragraphs 8.13 to 8.46 below). This is a separate line of reasoning and we address the Premier League's arguments as part of this analysis below.
- 8.11 Sky argued that it has faced considerable competition for sports rights in the last several years from, for example, Setanta and ESPN, both of which, when they

attempt to reconcile this argument with their view that bundling allows rights to be monetised rapidly. We do not need to form a view on this point as it does not matter for the purposes of establishing whether entry barriers exist. Even if these respondents were incorrect (i.e. even if this delay can be avoided by distributing that channel via the leading retailer) then third parties still face a disadvantage. This is because they lack the benefits of vertical integration that Sky enjoys (see below).

¹²⁸ In the Second Pay TV Consultation, we considered comparing subscriber numbers to Premiership Plus (a PPV sports channel that featured 50 live Premier League matches) in the 2007/08 season with Setanta Sports subscriptions in the 2008/09 season. We considered that the evidence and data available did not allow meaningful conclusions to be drawn.

entered, had no established subscriber base¹²⁹. We consider that a number of factors affect bidding behaviour, of which this is one. We consider that the outcome of Premier League auctions tends to confirm our view that Sky is likely, for the most part, to prevail over a new entrant and that while BT and Virgin have large numbers of customers, they do not have a comparable premium subscriber base. We remain of the view that, as the evidence set out above demonstrates, a new entrant is disadvantaged by delay in building up a subscriber base.

8.12 We also received a number of responses to the First Pay TV Consultation that are relevant to this issue. We considered and addressed these arguments in paragraphs 2.139 to 2.142 of Annex 8 of the Third Pay TV Consultation. We continue to rely upon those paragraphs.

The efficiency advantages that flow from bidders such as Sky being vertically integrated with pay TV retailers with a significant subscriber base

8.13 This section is structured as follows:

- First, we provide a summary of the analysis originally set out in the Second Pay TV Consultation¹³⁰.
- Second, we discuss the implications of the evidence and representations that we have subsequently gathered.

Summary of the position in the Second Pay TV Consultation

8.14 In the Second Pay TV Consultation, we set out our view about the role of retail subscriber bases and asymmetries between bidders for particular rights. Specifically we considered that Sky was the most effective retail outlet on the largest platform and that third parties were unable to access that platform as efficiently. As a result, we considered that Sky enjoyed an advantage over potential rival bidders for the Live Premier League Rights and the Movie Rights¹³¹.

8.15 This argument involved a number of logical steps. First, we set out an overview of those steps. Second, we consider in turn the detailed logical steps, including the consultation responses that are relevant to each of those steps. Third, we set out the implications of those steps, including an illustrative example.

Overview of the ability to access final consumers most effectively

8.16 In overview, this argument involves two steps.

- **Step 1:** the importance of dealing with the leading retailer on each platform. On most platforms, we observe a leading retailer (e.g. Virgin Media on cable, Sky on its DSat platform) that retails the vast majority or all of the channels available on that platform. In principle, a firm that successfully bid for the Live Premier League Rights or the Movie Rights could either directly retail the resulting channel on a particular platform or wholesale that channel to a third party retailer on that

¹²⁹ Sky September 2009 Response, paragraph 6.30.

¹³⁰ This analysis was repeated in the Third Pay TV Consultation, annex 8, paragraphs 4.3-4.35.

¹³¹ The idea that Sky gains an advantage when bidding for rights from having the largest number of subscribers is not dissimilar to the “vicious circle” set out by the Four Parties in their July 2007 submission. The Four Parties stated in Figure 2 in that document that “Sky’s control of the biggest base of pay TV subscribers and the largest pay TV platform inhibits competitive bids from third parties for content”.

platform. Greater total industry profits are likely to be generated when that channel is distributed by the leading retailer on each platform.

- **Step 2:** vertical integration allows certain bidders to access the leading retailer on certain platforms more efficiently. A third party channel provider cannot obtain access to the leading retailer on a platform as efficiently as a wholesale channel provider that is vertically integrated with that retailer. This is for a number of reasons (explained below) that we refer to as 'Access Disadvantage'.

8.17 The following consequences flow from Step 1 and Step 2:

- An entirely independent bidder faces the Access Disadvantages on all platforms. A bidder that is vertically integrated with the leading retailer on one platform avoids the Access Disadvantages on that platform but faces the Access Disadvantages on all other platforms. An entirely independent bidder will thus be at a disadvantage compared to vertically integrated bidders.
- When assessing whether one vertically integrated wholesaler-retailer is in a relatively stronger position than another, the relative size of those firms' subscriber bases is crucial. The effect of the Access Disadvantages is larger on platforms with more subscribers. Since a vertically integrated wholesaler-retailer avoids the access disadvantages on 'its' platform, this implies that the leading retailer on the largest platform is least affected. It is thus likely to be able to outbid vertically integrated retailers on other (smaller) platforms for the Live Premier League Rights.
- Sky is the most effective retail outlet on the largest platform (Step 1) and third parties are unable to access that outlet as efficiently (Step 2).

8.18 The following sub-sections discuss Step 1 and Step 2 in detail.

Step 1: the importance of dealing with the leading retailer on each platform

8.19 Step 1 relates to the importance of dealing with the leading retailer on each platform. We observe that, for the majority of pay TV platforms, there is a leading retailer on that platform i.e. a single retailer that sells all/the majority of the content retailed on that platform. Specifically, Sky is the leading retailer on its DSat platform, Virgin Media is the leading retailer on its cable platform and BT Vision is the leading retailer on its platform. The exception is Tiscali / TalkTalk TV (where both Sky and Tiscali / TalkTalk TV retail)^{132 133}.

8.20 In principle, wholesale channel providers could directly retail their channels but in practice the majority of them instead distribute their channels via the leading retailer on each platform. There are three reasons why greater total industry profits are likely to be generated when a Core Premium Channel is distributed by the leading retailer on each platform:

- On closed platforms there is obviously no alternative other than dealing with the leading retailer.

¹³² Previously Setanta retailed its channels on Top Up TV's platform.

¹³³ Tiscali / TalkTalk TV currently has few subscribers (compared to cable and Sky's DSat platform). It is not central to our assessment of entry barriers.

- On open platforms the leading retailer is likely to be able to generate greater revenue by aggregating that channel with other content and services.
- On open platforms and where the leading retailer was the previous incumbent supplier of the channel, a new entrant is likely to suffer a delay in building up its subscriber base to match that of the former incumbent.

8.21 We discuss each of these three factors in turn.

Closed platforms

8.22 To date, neither Virgin Media nor BT Vision has allowed third parties to retail on their platforms. On such closed platforms there is no alternative other than dealing with the leading (sole) retailer.

Aggregation by the leading retailer

8.23 On open platforms, the leading retailer is likely to be able to generate greater revenue by aggregating that channel with other content and services¹³⁴.

- One possible synergy stems from the increased profits from dampening competition if one retailer supplies two substitutable channels. In other words, if substitutable channels are all retailed by the leading retailer on a particular platform then this creates a degree of market power that allows suppliers to earn greater revenue than if those channels were supplied in competition with each other on that platform.
- Another possible synergy arises because aggregation of such content in the hands of one retailer facilitates bundling at the retail level. Bundling of content that is not closely-substitutable can allow retailers to sell more content, at different price points, to a wider range of consumers. This enables more effective price discrimination and thus increases the revenue generated from that content¹³⁵. We refer to this as the “preference smoothing effect”.

8.24 In terms of the first of these synergies, there is likely to be an incentive for a third party to wholesale a Core Premium Sports or Movie channel to the leading retailer, rather than directly retailing that channel in direct competition with any other substitutable Core Premium Sports or Movie channels supplied by the leading retailer. Dampening competition in this way generates higher profits for suppliers (albeit at the expense of subscribers), enabling a greater amount to be paid for the underlying rights.

8.25 In terms of the second of these synergies, we consider that there are a number of pieces of evidence supporting our view about the benefits of bundling:

¹³⁴ Paragraphs 2.90-2.97 of Annex 7 of the Second Pay TV Consultation discussed the responses to the First Pay TV Consultation that were relevant to the aggregation of content. We have received no further submissions on these issues. We do not repeat these points here but do continue to rely upon these paragraphs of the Second Pay TV Consultation.

¹³⁵ To illustrate, one consumer may value football at £10 and rugby at £2, and another vice versa. Both consumers would buy a channel featuring both sports priced at £12, generating total revenue of £24. In contrast, separate channels featuring rugby and football priced at £10 each would only attract those consumers who valued the individual elements at £10, generating total revenue of £20. Also see, for example, section 4.3.2.1 of B Nalebuff “Bundling, Tying, and Portfolio Effects: Part 1 – Conceptual Issues”, DTI Economics Paper No.1, February 2003, pp 33-37, available from: <http://www.berr.gov.uk/files/file14774.pdf>

- The preference smoothing effect is more likely to be material when consumer preferences are heterogeneous (in contrast, if all consumers had identical preferences then this motivation for bundling disappears). This is the case in the pay TV industry – consumers have widely varying preferences for content (see First Pay TV Consultation, Annex 14, paragraphs 4.10-4.17).
- It is consistent with the fact that retail bundling is widely practised.
- It is supported by documents produced for industry participants. The O&O NTL Report stated that “by bundling matches in a channel and then bundling a sports channel in a pay TV package more value can be extracted” (slide 31) and “it is likely, therefore, that a channel can extract more value than PPV, and a pay TV package can extract more value than a single price sports channel” (slide 33). This report identified “the ability of Sky to bundle its sports package” as one reason why “the maximum value to Sky ... for every package [of Live Premier League Rights] is always greater than a rival pay TV bidder” (slide 49).

Delays in building a subscriber base

- 8.26 As noted in paragraphs [8.4 to 8.11] above, were a firm to acquire Live Premier League Rights for the first time, there would be a delay while it built up a subscriber base to comparable levels to those that could be attained by the current rights holder(s).

Step 2: vertical integration allows certain bidders to access the leading retailer on certain platforms more efficiently

- 8.27 We now turn to Step 2. A third party channel provider cannot obtain access to the leading retailer on a platform on equivalent terms to a wholesale channel provider that is vertically integrated with that retailer. This is for two reasons that we refer to as the “Access Disadvantages” namely¹³⁶:
- Double marginalisation and aligning retailer and wholesaler incentives.
 - Uncertainty about wholesale prices.
- 8.28 Sky and the April 2008 CRA Report argued that Sky’s vertical integration does not increase barriers to entry because its DSat platform is open. We discuss the CRA Report in Annex 6, Appendix 4. Specifically, Sky claimed that it cannot restrict access to its platform. Accordingly, Sky considered that a new entrant is certain that it will be able to reach a large number of subscribers. Moreover, Sky argued that the openness of its platform also strengthens a wholesaler’s bargaining position when negotiating distribution agreements with a DSat retailer.
- 8.29 In our view, Sky’s arguments appear to go to the question of whether Sky is able to refuse access to its platform altogether. We did not and do not identify this as a barrier to entry. We thus do not regard Sky’s arguments as relevant to evaluating Step 2 of our analysis.

¹³⁶ Paragraph 5.124 of the First Pay TV Consultation set out a number of examples illustrating the potential benefits of vertical integration including information advantages when bidding. The April 2008 CRA Report argued that such information advantages are unlikely to be significant and that, in any event, they are better characterised as incumbency advantages rather than a benefit of vertical integration. We do not rely on such advantages in this document, recognising for example, that less well informed bidders may inadvertently overbid for rights. [X]

Double marginalisation and aligning retailer and wholesaler incentives

- 8.30 The first Access Disadvantage is the difficulty of aligning the retailer's and wholesaler's incentives. Wholesale prices are structured as a price per subscriber¹³⁷. This has the effect of slightly diminishing the incentive for the retailer to attract additional subscribers by engaging in marketing/advertising or by dropping retail prices (as compared to the situation where the wholesale price is a fixed, lump sum payment). In contrast, a vertically integrated firm does not face this effect because the per subscriber wholesale price is simply an internal transfer within the firm. This is identical to the efficiency effect that can result from a vertical merger, namely avoiding so-called "double marginalisation"¹³⁸.
- 8.31 The benefits enjoyed by a vertically integrated firm are likely to be larger in relation to platforms with a large number of consumers that are likely to subscribe to the channel in question. In other words, the benefits of vertical integration with a retailer with 100,000 subscribers will be markedly less than in relation to a retailer with 1 million subscribers.
- 8.32 The submissions that we have received support the existence of such incentives¹³⁹. In its October 2007 submission, Sky (part D, paragraphs 4.17(b)-(d)) identified these differences in incentives as one reason why other retailers have been less successful than Sky at marketing Sky's channels¹⁴⁰. BT Vision, Virgin Media, the Four Parties and the March 2008 LECG report all argued that, even if a new entrant agreed wholesale terms with Sky, Sky would not have the incentive to promote the rival channel in competition with its own channels.
- 8.33 The experience of [X] is evidence of the difficulties in aligning wholesale channel provider and retailer's incentives. [X]. [X]. This is evidence that wholesale channel providers consider that retailers have impeded their ability to successfully promote their channels. Clearly such difficulties are unlikely to arise in a vertically integrated firm.

Uncertainty about wholesale prices

- 8.34 The second Access Disadvantage is uncertainty both about the level of the wholesale price at the time the rights are bid for and whether a wholesale distribution agreement will be agreed. That uncertainty, and the associated risk that a successful bidder incurs losses because it overestimated the wholesale price that it is able to charge to retailers or because negotiations (temporarily) break down, imposes an additional cost on bidders that diminishes the expected value generated from the rights. In contrast, a vertically integrated wholesaler does not face this uncertainty related cost when dealing with its retail arm – the implicit wholesale price paid by that retailer is simply an internal transfer within the firm that does not affect its overall profitability.

¹³⁷ Per subscriber fees directly address the risk for the channel provider of retail prices collapsing to near zero, given that channels are not sold exclusively.

¹³⁸ Merger guidelines: Competition Commission Guidelines, Competition Commission, June 2003, paragraph 4.44 and footnote 40.

¹³⁹ Paragraphs 2.114-2.115 of the Second Pay TV Consultation considered and rejected an argument by LECG for the Four Parties that double marginalisation does not occur since retailers on other platforms do not have appreciable market power. We maintain our view that LECG's argument is incorrect for the reasons set out in the Second Pay TV Consultation.

¹⁴⁰ Sky also stated that it has tried to improve the incentives for retailers to sell its premium channels, for instance by working with cable retailers on non-linear discount structures from the wholesale rate-card prices. These efforts were abandoned, [X]

8.35 [X]^{141 142}.

8.36 These uncertainty costs are likely to be larger in relation to platforms with a large number of consumers that are likely to subscribe to the channel in question. Put simply, if a particular platform has 100,000 potential subscribers then the consequences of the uncertainty about the wholesale price paid in relation to those 100,000 subscribers will be markedly less than in relation to a platform with 1 million subscribers.

Implications of Step 1 and Step 2

8.37 Having discussed Steps 1 and 2, the Second Pay TV Consultation set out the consequences. When bidding for the Live Premier League Rights or the Movie Rights, the bidder that is likely to generate the greatest overall profits from the onward sale of the rights (both wholesale and retail) is likely to win those rights. Such a bidder can afford to pay more to the Premier League or to the Major Film Production Groups.

8.38 A third party bidder that is not vertically integrated with the leading retailer on any platform is likely to generate less value from the Live Premier League Rights and the Movie Rights. If it attempts to retail directly on a particular platform then it is likely to generate less revenue (e.g. because it cannot bundle its channel with the leading retailer's content) (see Step 1 above)¹⁴³. If that third party bidder instead wholesales its channel to the leading retailer, it is still likely to generate less value than the leading retailer would if the leading retailer had won the rights. This is because it faces the Access Disadvantages (see Step 2 above), namely an additional uncertainty cost and more difficulties in aligning retailer and wholesaler incentives.

8.39 A bidder that is vertically integrated with the leading retailer on a particular platform avoids the Access Disadvantages on that platform. However, in relation to other platforms it is in the same position as a third party bidder i.e. both direct retailing and wholesaling to that other platform's leading retailer generate less value from rights (compared to the amounts that that platform's leading retailer would generate). Thus each vertically integrated firm only enjoys an advantage in relation to the platform where it is the leading retailer. The issue is thus the relative size of those advantages. The Access Disadvantages are likely to be larger in relation to platforms with more likely subscribers to Core Premium channels (Step 2). In other words, a bidder that is vertically integrated with the leading retailer on the platform with the greatest number of likely subscribers to Core Premium channels is in a stronger position than vertically integrated bidders on other platforms.

8.40 To assist understanding of this argument, Figure 9 below sets out an illustrative example.

¹⁴¹ [X]

¹⁴² As discussed in (Competition Annex, Appendix 4) and above, access to Sky's DSat platform is regulated, but launching an independent retail operation on DSat may be less commercially attractive than reaching a wholesale agreement with Sky.

¹⁴³ Setanta directly retailed its channels on DSat, rather than distributing them via Sky (the leading retailer on that platform).. However, we consider that this is explained by the magnitude of the benefits of distributing via the leading retailer (Step 1) relative to the magnitude of the Access Disadvantages (Step 2). For example, if the Access Disadvantages are large then a wholesaler may choose to directly retail its channel even though it fails to reap the benefits that come from distributing that channel via the leading retailer.

Figure 9: Illustrative example

Assumptions:

There are two pay TV platforms (X and Y) with 8m and 4m subscribers respectively.

There are three firms (A, B and C) considering bidding for key rights that enable them to assemble a pay TV channel. Firm A is vertically integrated with the leading retailer on platform X. Firm B is vertically integrated with the leading retailer on platform Y.

If the channel is directly retailed on a platform by someone other than the leading retailer, it generates industry profits of £10/subscriber. If the channel is instead retailed by the leading retailer then it generates industry profits of £12/subscriber (Step 1). If the channel is wholesaled to that leading retailer by a third party there is an additional cost (loss of efficiency) of £1/subscriber, which reduces the industry profits to £11/subscriber (Step 2); this cost is avoided if the wholesaler is vertically integrated with the retailer.

If a firm wholesales the channel to the leading retailer, the resulting industry profits (£11/subscriber) are split 50-50 between the retailer and the wholesaler (NB. the consequences below still hold if a different percentage split is chosen).

Consequences:

Example 1: Suppose A and C compete for the rights. If A wins, as the leading retailer it will retail the channel on platform X whereas on platform Y it will wholesale that channel to the leading retailer B. If C wins, it will wholesale the channel to the leading retailer on each platform. A thus earns £118m if it wins the rights ((£12x8m) on platform X plus half of (£11x4m) on platform Y). If C wins the rights then C earns £66m (half of (£11x8m) on platform X plus half of (£11x4m) on platform Y) and A earns £44m (as the retailer, A receives half of the (£11x8m) generated on platform X). A is thus willing to pay up to £74m for the rights (£118m-£44m) whereas C is only willing to pay £66m. **Conclusion: an entirely independent bidder is at a disadvantage compared to vertically integrated bidders when bidding for rights.**

Note that this same outcome arises if C instead retails the channel directly on platform X. If C wins, it earns £80m on that platform (£10x8m) whereas A receives nothing. If A wins, it earns £96m on platform X (£12x8m). A is thus willing to outbid C (note that whatever course of action C adopts on platform Y does not matter; A can also adopt that course of action and earn just as much).

Example 2: Suppose A and B compete for the rights. If A wins, as the leading retailer it will retail the channel on platform X whereas on platform Y it will wholesale that channel to the leading retailer B. The same occurs *mutatis mutandis* if B wins.

A thus earns £118m if it wins the rights ((£12x8m) on platform X plus half of (£11x4m) on platform Y). If, instead B wins the rights then A earns £44m (as the retailer, A receives half of the (£11x8m) generated on platform X). Similarly, B earns £92m if it wins the rights and £22m if A wins the rights. A is thus willing to pay up to £74m for the rights (£118m-£44m) whereas B is only willing to pay £66m. **Conclusion: a vertically integrated firm on a larger platform has an advantage over a vertically integrated firm on a smaller platform when bidding for rights.**

- 8.41 Sky is the leading retailer on the largest platform: in June 2007 Sky retailed its Core Premium Sports channels to [X] subscribers on DSat as compared to Virgin Media's [X] subscribers to those channels on its cable platform. Similarly, in June 2007 Sky retailed its Core Premium Movie channels to [X] subscribers on its DSat platform as compared to Virgin Media's [X] subscribers to those channels on cable. Accordingly, in the Second Pay TV Consultation we considered that Sky was the most effective retail outlet on the platform with the largest number of likely subscribers to Core Premium channels (namely Sky's DSat platform). Sky's vertical integration allows it to access that outlet more efficiently than third party wholesalers. As a result of this advantage, in the Second Pay TV Consultation we considered that Sky is likely to generate greater value from the Live Premier League Rights and the Movie Rights than other potential bidders. As a result, Sky is likely to be able to outbid rival bidders for those rights.

Ofcom's current position

- 8.42 Following the publication of the Second Pay TV Consultation, we gathered further information on the 2006 and 2009 sales of the Live Premier League Rights. As we explained in the Third Pay TV Consultation, this new later evidence suggests that the ability to access final consumers more effectively (for the reasons set out above) may play less of a role in determining whether a bidder is likely to win key rights than we thought in the Second Pay TV Consultation, perhaps because other factors are relatively more important than Sky's more efficient access to the most effective retail

outlet on the largest platform. However, this does not imply that this effect does not exist at all, merely that other factors are likely to outweigh it.

8.43 In particular, if the ability to access final consumers more effectively were very important (relative to all the other factors affecting a bidder's position) then we would expect Virgin Media (and its predecessor companies) to be the second strongest bidder for key rights, since it is vertically integrated with the leading retailer on the platform with the second largest number of likely subscribers. However:

- In 2006, [X]¹⁴⁴. This is inconsistent with the predictions of the analysis in paragraphs 8.14 to 8.41 above and suggests that other factors were more important in influencing the amounts bid by [X]¹⁴⁵.
- Indeed in 2009, [X].

8.44 Our position thus remains unchanged from the Third Pay TV Consultation¹⁴⁶. We consider that this is evidence that other factors are of greater importance than certain bidders' ability to access subscribers on the larger platforms more efficiently.

8.45 The Premier League stated that our position means that this factor is therefore not a 'credible consideration' when assessing entry barriers¹⁴⁷. We disagree. The further evidence we identified in the Third Pay TV Consultation suggests that there are other factors that also determine the strength of a bidder. However, we remain of the view set out above that Sky enjoys a significant efficiency advantage when bidding for rights, as a result of being a vertically integrated pay TV retailer with a significant subscriber base. We recognise that this advantage will not determine, in every instance, which firms bid for rights and how much they bid relative to each other. However, we consider that this advantage has been important in allowing Sky to sustain its position as the leading provider of Core Premium channels over many years.

8.46 The Premier League also said that Sky did not have access to a significantly larger customer base than Virgin Media or BT¹⁴⁸. As explained above, Sky is the most effective retail outlet on the platform with the largest number of likely subscribers to Core Premium channels¹⁴⁹. Thus, insofar as the Premier League is referring to the large number of households that purchase fixed line telephony services from BT then this is simply not relevant. The argument above concerns effective access to potential subscribers to Core Premium channels, rather than access to consumers of other services such as telephony. In relation to Virgin Media, the Premier League's position is factually incorrect: see paragraph 8.41 above.

Bidder specific factors

8.47 There is some evidence to suggest that other factors affect the specific circumstances of particular bidders. Below we discuss free to air broadcasters and branding factors that may disadvantage some bidders. In addition, other factors that

¹⁴⁴ 2006 Monitoring Trustees' Reports.

¹⁴⁵ In paragraph 2.126 of the Second Pay TV Consultation, we set out a possible explanation for why Virgin Media did not win the packages of Live Premier League Rights packages that Sky failed to secure (notwithstanding the fact that Virgin Media is vertically integrated with the leading retailer on the platform with the second largest number of likely subscribers). We stated that [X]. However this does not explain why [X].

¹⁴⁶ See in particular Third Pay TV Consultation, annex 8, paragraph 4.37.

¹⁴⁷ Premier League response to Third Pay TV Consultation, paragraph 6.48.

¹⁴⁸ Premier League response to Third Pay TV Consultation, paragraph 6.47.

¹⁴⁹ A point that we also made in the Third Pay TV Consultation at annex 8, paragraph 4.34.

may limit the ability or willingness of particular bidders to outbid Sky for the Live Premier League Rights and the Movie Rights are:

- Their ability to obtain funding. [X]¹⁵⁰.
- How they wish to position their business. [X]¹⁵¹.

Free to air broadcasters

8.48 Free to air broadcasters have a very different funding model, being much more dependent on advertising or public funding (such as the TV licence fee). As a result their willingness to pay for the Live Premier League Rights may differ very substantially from pay TV broadcasters¹⁵². For example, [X]¹⁵³ Bids of this order of magnitude (i.e. [X]) are lower than Sky's bids for even the cheapest package of Live Premier League Rights (i.e. [X]).

Branding

8.49 We consider that Sky enjoys a branding advantage over at least some other potential bidders for the Live Premier League Rights. As in the Third Pay TV Consultation, we do not rely on branding advantages when assessing barriers to acquiring the Movie Rights.

¹⁵⁰ [X]

¹⁵¹ [X]

¹⁵² Indeed in 2002 the Director General of Fair Trading considered that "... certain content will only appear on premium sports channels, due to their inherent funding characteristics". BSKyB investigation: alleged infringement of the Chapter II prohibition, Decision of the Director General of Fair Trading, 17 December 2002, paragraph 80. Available at: http://www.offt.gov.uk/advice_and_resources/resource_base/ca98/decisions/bskyb2

¹⁵³ [X]



Movies market definition and market power appendices

Annex 5 to Pay TV Statement

This is the non-confidential
version. Confidential information
has been redacted. Redactions
are indicated by [X].

Publication date:

30 March 2010

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Appendix 1

Overview of this annex

Introduction

- 1.1 In this annex we set out the following discrete appendices that provide further detail on our assessment of market definition and market power in relation to premium movies.
- Appendix 2: Extent of substitutability with other means of watching movies.
 - Appendix 3: Further details on our calculation of movies market shares.
 - Appendix 4: The staggered expiry of Sky's contracts with the major Hollywood studios.
- 1.2 These appendices deal with topics that only relate to our assessment of movies. In addition, some of the material presented in the appendices to Annex 4, which primarily relates to sports, also applies here, namely:
- Appendix 3: Approach towards carrying out market definition for bundles.
 - Appendix 6: Relevance of previous market definition findings.
 - Appendix 7: The concept of entry barriers.
 - Appendix 8: Factors explaining Sky's success when bidding for rights.
 - Appendix 9: Other entry barriers mentioned by consultation respondents.
 - Appendix 12: Position at the retail level if wholesale market power was not exercised.

Appendix 2

Extent of substitutability with other means of watching movies

Introduction

2.1 In Section 6, our focus is on assessing the constraint of four potential substitutes to Sky Movies: movies on retail DVDs; FTA movie channels and movies on other FTA and basic channels; non-movies content on television; and SVoD in the pay TV window. In this Appendix, we set out our assessment of other potential substitutes:

- Cinema.
- Online DVD rental.
- OTC (over-the-counter) DVD rental.
- Movie Downloads.
- PPV.
- SVoD after the first pay TV window.
- Disney Cinemagic.

Cinema

2.2 In our Third Pay TV Consultation, we said that cinema is different from pay TV in that it does not involve the provision of a wide range of films at home and is not free at the point of consumption¹. We consider that these differences between cinema and pay TV are much more marked than those between cinema and, for example, DVD retail.

2.3 Cinema viewing is a qualitatively different **format** from subscription to a pay TV service. It is a communal event which takes place outside the viewer's home. In our view, the cinema is more of an 'event' or a 'night out' for consumers and is very different in nature from watching films at home. Cinema has a **timing** advantage over pay TV, in that movies appear in cinemas around 12 months before they appear on pay TV. However, the **price** of going to the cinema is markedly higher (particularly as each individual has to buy a ticket, unlike pay TV which is available to the whole household for a single subscription). The average UK cinema ticket price was £5.20 in 2008², so a household of three would pay over £30 to watch two movies a month. This is considerably more expensive than the £16 per month implied premium for Sky Dual Movies over basic on Sky's DSat platform (see Figure 22 in Section 4). Cinema is not usually paid for by subscription.

2.4 At any one time, a smaller **quantity** of films is available at the cinema than on Sky Movies. During the course of a week, Sky Movies shows a much wider range of

¹ Third Pay TV Consultation, paragraph 4.394.

² Source: Screen Digest from CAA/Nielsen EDI. See

<http://www.cinemauk.org.uk/ukcinemasector/ukcinema-industryeconomics/averageukticketprices/>

films than are available at the cinema³. Also, Sky Movies includes ‘made for TV’ and “straight to DVD” releases. However, cinema can match the **quality** of the most important content on Sky Movies.

2.5 [X][X]

- 2.6 We recognise that the cinema is an attractive way of watching films for movie fans – both subscribers and non-subscribers to Sky Movies and that the higher price per film is reflected in the superior timing (and a bigger screen). However, we consider that the availability of movies in the cinema is unlikely to be seen by many current or potential Sky Movies subscribers as a close substitute. Respondents to our 2009 survey (Figure 79 in Section 6 of the main document) did not mention cinema as reason for not subscribing to Sky Movies.

Online DVD movie rental

- 2.7 Online DVD rental typically involves paying a monthly subscription in return for DVDs delivered by post. Typically, subscribers get to keep DVDs for as long as they like, but must return them to receive new ones. An example of such a service is Lovefilm. These services offer a number of packages that usually vary in terms of the number of DVDs posted per month (including unlimited packages) and the number of DVDs that consumers can keep at any one time.
- 2.8 In our Third Pay TV Consultation, we noted that online DVD rental services seemed to be growing at the expense of over-the-counter rentals and that the evidence did not suggest a strong degree of substitution between Sky Movies and DVD rentals⁵. We said that online DVD rental offers the same certainty of a fixed monthly subscription as pay TV, as well as a convenient means of choosing films⁶. However it does not provide the same degree of convenience as a pay TV service, since no matter how straightforward the ordering process, a consumer cannot view a movie until it has been delivered in the post. Consumers therefore need to be willing to plan their viewing several days in advance to be able to make effective use of such a service.

Representations on online DVD movie rental

- 2.9 Sky stated that it faces strong constraints from other means of watching movies including DVD rental services⁷. Sky noted that Figure 27 of the Third Pay TV consultation aggregates all movies on television and thus does not provide adequate information about the extent to which Sky Movies is substitutable with online DVD rental⁸.

³ The quantity of films available in a cinema is limited by the number of screens that it has (although cinemas can use the same screen to show different films at different times of the day). In 2006, there were 783 cinemas with an average of 4.6 screens each. Of these, 252 were multiplexes (defined as a site with 5 or more screens). Multiplexes had an average of 10 screens each. First Pay TV Consultation, annex 11, paragraphs 58-59.

⁴ [X]

⁵ Third pay TV consultation, paragraph 4.338.

⁶ Third pay TV consultation, paragraph 4.341.

⁷ Sky response to Third Pay TV Consultation, paragraphs 5.28-5.29.

⁸ October 2009 Sky Submission, paragraphs A2.54-A2.55.

Ofcom's view of online DVD movie rental

Our assessment of the characteristics of online DVD movie rental

- 2.10 Most, if not all, of the movies shown on Sky Movies at any given time are available on DVD along with many other movies. Online DVD rental services offer access to this very large range of films. So online DVD rental matches Sky Movies for **quality**, and exceeds it in **quantity**.
- 2.11 Online DVD rental is more attractive than Sky Movies in terms of **timing**. Online DVD rental subscribers can rent movies in the DVD window, so they can watch them before the movies are on Sky Movies.
- 2.12 Online DVD rental operates on a subscription basis and so has a similar price structure to Sky Dual Movies. However, it requires movies to be pre-ordered, delivered and returned. For many movie fans, the inconvenience of this is likely to outweigh the advantage of seeing more recent films. On balance, we consider online DVD rental a less attractive **format** than Sky Movies.
- 2.13 The BVA estimated that the average **price** per transaction was £2.40 in 2008⁹. Lovefilm offers 2 DVD rentals per month for £3.99 per month and an “unlimited” number of DVDs for £12.99 per month, which are both less than the incremental price of standalone Sky Dual Movies¹⁰. As such, the price of online DVD rental is relatively attractive for most standalone Sky Dual Movies subscribers¹¹. However, subscribers who buy Sky Dual Movies as a cheap-add on to Sky Dual Sports will find the price of online DVD rental less attractive than Sky Dual Movies.

Our assessment of other evidence on online DVD movie rental

- 2.14 We considered changes in the total audience for DVD rentals, which we found to have declined over time¹². We observed that the rise in the value of DVD rental subscription packages was at the expense of over-the-counter rentals and, when read in conjunction with Figure 81¹³, does not appear to suggest a strong degree of substitution between Sky Movies and DVD rentals¹⁴.
- 2.15 [X]¹⁵[X]

Our conclusions on online DVD movie rental

- 2.16 In our judgement, the difference in format (i.e. having to pre-order movies) outweighs the attractive characteristics of a potentially lower price, greater quantity and more recent movies. We have placed little weight on the lower price of online DVD rental services given the risk of the cellophane fallacy. We conclude that online DVD rentals are a moderate substitute to Sky's linear movies channels (i.e. outside the relevant market but still capable of exerting a constraint).

⁹ BVA Yearbook 2009, page 80.

¹⁰ Source: <http://www.lovefilm.com/dvd-rental/> (viewed on 16 March 2010)

¹¹ Only those subscribers who watch more movies than online DVD rental services could deliver in a month may find the price of online DVD rental services less attractive.

¹² Third Pay TV Consultation, paragraph 4.345 and Figure 35.

¹³ An modified version of Figure 27 in our Third Pay TV Consultation.

¹⁴ Third Pay TV Consultation, paragraph 4.338 and Figure 35; also paragraph 4.398, 4.400.

¹⁵ [X]

OTC DVD rental

- 2.17 OTC DVD rental typically involves obtaining a film from a rental shop and returning it within a few days.
- 2.18 In our Third Pay TV Consultation, we said that OTC DVD rental by comparison with pay TV provides a similarly wide choice of films, to be viewed on a one-off basis. However, these rental services do not share other product characteristics with Sky Movies packages, such as the convenience with which films can be chosen, and the certainty of a fixed monthly subscription¹⁶. We noted that online DVD rental services seemed to be growing at the expense of over-the-counter rentals and that the evidence did not suggest a strong degree of substitution between Sky Movies and DVD rentals¹⁷.

Representations on OTC DVD rental

- 2.19 Sky stated that it faces strong constraints from other means of watching movies including rental services¹⁸. Sky noted that Figure 27 of the Third Pay TV consultation aggregates all movies on television and thus does not provide adequate information about the extent to which Sky Movies is substitutable with OTC DVD rental¹⁹.

Ofcom's view of OTC DVD movie rental

Our assessment of the characteristics of OTC DVD movie rental

- 2.20 Most, if not all, of the movies shown on Sky Movies at any given time are available on DVD along with many other movies. OTC DVD rental services offer access to a relatively large number of DVDs. So OTC DVD rental matches Sky Movies for **quality**, and exceeds it in **quantity**.
- 2.21 OTC DVD rental is also more attractive than Sky Movies in terms of **timing**. This is because movies are available in the DVD window before they are on Sky Movies.
- 2.22 OTC DVD rental requires consumers to visit the rental store to both collect and return the film. In the Second Pay TV Consultation we noted that the "convenience of not going to the DVD shop" was "must have" for 28% of marginal consumers²⁰. OTC DVD rental is also not widely available on a subscription basis (paying for movies on a monthly basis was "must have" for 30% of marginal consumers²¹). The **format** of OTC DVD rental is therefore less attractive than Sky Movies.
- 2.23 Headline prices for renting a new release DVD are around £3.75²², although this does not reflect special offers such as reduced prices for renting multiple titles or renting for multiple nights. The BVA estimated that the average OTC rental price in 2008 was £3.10²³. Sky Dual Movies subscribers who watch many movies per month and/or buy it as a cheap add-on to Sky Dual Sports may find the **price** of

¹⁶ Third Pay TV Consultation, paragraph 4.339.

¹⁷ Third Pay TV Consultation, paragraph 4.338.

¹⁸ Sky response dated September 2009 to Third Pay TV Consultation, paragraphs 5.28-5.29.

¹⁹ October 2009 Sky Submission, paragraphs A2.54-A2.55.

²⁰ See Figure 24 in Annex 6 of the Second Pay TV Consultation.

²¹ See Figure 24 in Annex 6 of the Second Pay TV Consultation.

²² Source: British Video Association Yearbook 2009 page 80.

²³ BVA Yearbook 2009, page 80.

OTC DVD rental less attractive compared to Sky Dual Movies. Other Sky Dual Movies subscribers may find the price of OTC DVD rental more attractive than Sky Dual Movies.

Our assessment of the other evidence on OTC DVD rental

2.24 [X]²⁴[X]

Our conclusions on OTC DVD rental

2.25 While we recognise that there is a degree of substitutability between OTC DVD rental and Sky Movies, we consider that, as with retail DVDs, the relative inconvenience of renting DVDs is likely to limit the degree of substitutability, particularly for frequent viewers of recent movies on Sky Movies. As such, we do not consider OTC DVD rental to be a close substitute, although it is likely to be a moderate substitute (i.e. outside the relevant market but still capable of exerting a constraint).

Movie downloads

2.26 The internet offers consumers a wide range of content that can be accessed relatively easily and viewed at their convenience. Movies are available for downloads either legally or illegally. Legal movie downloads can be downloaded for free (e.g. FTA broadcasters' websites) or at a price. This category thus encompasses a heterogeneous range of services.

2.27 We have not assessed it by reference to the five characteristics set out in Section 6 of the main document, partly because of its heterogeneity and partly because the volumes of movies downloaded by Sky subscribers are relatively low. In April/May 2008, we commissioned a survey to understand the current level of consumption of content delivered via the internet. Our survey indicated that relatively few consumers currently download content, and that the constraint is therefore relatively weak. For example, only 13% of respondents with access to the internet and that subscribed to Sky Sports and/or Sky Movies had downloaded content from the internet in the last month²⁵. Moreover, of these respondents, only a minority had downloaded or streamed movies over the internet²⁶.

Legal movie downloads

2.28 [X]²⁷[X]

2.29 On the other hand, we noted that Sky's decision to invest in offering content over broadband (and to renegotiate rights contracts where necessary²⁸) could be a competitive response to the potential for increasing demand for downloading movie content, which would support the view that downloading content could become a more important competitive constraint.

²⁴ [X]

²⁵ Source: Ofcom online content omnibus survey April/May 2008. Presented in Figure 48 of Annex 10 of the Second Pay TV Consultation.

²⁶ Second Pay TV Consultation, annex 10, figure 52.

²⁷ Annex 21 Sky response to Ofcom request for information of 29th May.

²⁸ See for example Sky response to First Pay TV Consultation, Annex 2, paragraph 3.135.

2.30 [X]²⁹[X]³⁰[X]³¹

2.31 In Sky's response to our Third Pay TV Consultation³², it stated in relation to downloading films that given Ofcom's analysis is intended to be forward looking, services that "may become a more important factor" in the future should be considered carefully by Ofcom, rather than being dismissed in a sentence.

2.32 While our analysis shows that the current indirect constraint is relatively weak, we consider that downloading content could be a significant constraint in the future as the popularity of downloads increases and capacity to download grows. The scale of the constraint is likely to grow as more homes have broadband internet connections and the average connection speed increases. It may also grow if it becomes easier for viewers to watch content on their TV screens rather than on a computer.

Illegal Downloads

2.33 We also considered the impact of illegal file downloading using file sharing applications such as BitTorrent as a constraint on providers of premium movie channels. [X]³³[X]³⁴

2.34 In our Third Pay TV Consultation, we quoted a study³⁵ which found that 4% of the UK population had illegally downloaded content from the internet in the last month. However, around half (48%) of these were students (either at school or in further education), who are relatively unlikely to subscribe to premium pay TV channels. From these figures, it appears likely that only a small proportion of actual or potential premium channel subscribers engage in illegal downloading.

2.35 Given the relatively small numbers of subscribers who are likely to have illegally downloaded content, we did not consider that constraint it posed was likely to be strong. Furthermore, as rights holders take action to protect their copyright³⁶, we consider the constraint is likely to weaken over time.

Our conclusions on legal and illegal downloads

2.36 As in the Third Pay TV Consultation, we consider that the current constraint from legally downloading content from the internet is weak, but may grow over time. However, as our market share analysis is forward-looking, potential growth in legal movie downloads is relevant. Legal downloads also have similarities with DVD sales, VoD and DVD rental. They can either be on a download to own basis or a download to rent basis (the former having some similarities with DVD sales and the

²⁹ [X]

³⁰ [X]

³¹ [X]

³² Sky's October 2009 response, footnote 63.

³³ [X]

³⁴ [X]

³⁵ British Video Association Yearbook 2008, page 112. The study found that 8.1 million people or 17% of the population had downloaded content in the last month, of which a quarter (or just over 4% of the population) had downloaded content illegally.

³⁶ For example the BPI, the British Film Industry, major internet service providers (ISPs) and government have signed a memorandum of understanding which aims to significantly reduce the amount of illegal file sharing in the next three years (see Third Pay TV Consultation, footnote 252)

latter having similarities with VoD and DVD rental). We consider legal movie downloads to be a moderate substitute (i.e. outside the relevant market but still capable of exerting some degree of constraint). The strength of this constraint may grow over time as downloads can more easily be viewed on a TV rather than a computer – although this would effectively make downloads equivalent to VoD services. As explained below, we consider that PPV VoD services are also a moderate substitute for Sky Movies, but SVoD services for films in the first pay TV window are likely to be a close substitute.

- 2.37 Users of illegal downloads are typically students, who are unlikely to subscribe to Sky Movies anyway. As in our Third Pay TV Consultation, we do not consider that this constraint is strong.

Pay Per View (PPV) through a television service

- 2.38 A number of TV retailers including Virgin Media, Sky, Tiscali / TalkTalk and BT Vision offer PPV³⁷ movies via VoD, allowing consumers a convenient way to access new movies. 'True' VoD³⁸ is possible on Virgin's cable network and Tiscali / TalkTalk's and BT's IP networks. Sky's DSat service provides 'Near' VoD³⁹. The two largest TV VoD services by revenue are Sky Box Office and FilmFlex via Virgin Media as shown in Figure 1 below.

Figure 1 2008 TV VoD revenue split

[X]

- 2.39 In 2008, Sky offered around 400 PPV movies (including HD) priced at £3.99 per movie. Sky's service has films from all major Hollywood studios and is available to 8.8 million satellite subscribers. Its films can be stored on PVRs.⁴⁰ However, only a few films are available at any one time.⁴¹
- 2.40 In 2008, FilmFlex via Virgin Media had around 500 films. New releases were priced between £2.50 and £3.50 and library titles were priced between 50p and £2. It offered films from all major Hollywood studios except Fox, and was available to 3.6 million cable subscribers⁴⁰. FilmFlex offers more films at any one time than Sky Box Office via DSat.
- 2.41 Though these services are available to many households, take-up is relatively limited. In 2008, movie studios earned around [X] from the rights to Sky and Virgin's PPV on-demand services compared to [X] for the linear pay TV rights^{42,43}.

³⁷ Most services (e.g. Filmflex via Virgin Media) allow the viewer to watch a film as many times as they want during a short rental period (e.g. a day). It is therefore not strictly Pay-per view.

³⁸ 'True' VoD means consumers can get instant access to the film of their choice.

³⁹ 'Near' VoD (nVoD) refers to a multiple linear channels that broadcast the same content at staggered start times.

⁴⁰ Page 106 of Film Council 2009 Statistical Year Book

⁴¹ On page 8 of Sky's 2008 Annual Report, it states that the "Sky Box Office service currently offers our DTH subscribers over 50 screens of television premieres of movies and occasional live sports and other special events on a pay-per-view basis."

⁴² Source: Virgin Media response dated 8 April 2009 to question 12 of Ofcom's information request dated 24 March 2009; Sky response on 22 December 2008 to question 15 of Ofcom's information

- 2.42 In our Third Pay TV Consultation, we noted that there is some evidence that premium movies on PPV may be substitutable for linear channels carrying premium movies⁴⁴, but that the data should be interpreted cautiously⁴⁵. We considered VoD likely to be a less close substitute for Sky Movies than a subscription service (we discuss SVoD movies separately)⁴⁶.

Representations on PPV movies

- 2.43 Sky stated that it faces strong constraints from other means of watching movies including PPV services⁴⁷. Sky said that the retail market definition section of the Third Pay TV Consultation failed to consider the constraint exerted by VoD services⁴⁸. It also argued that having acknowledged some potential for substitution we ought to have included PPV in the market and said that the data we considered related not to the launch of a PPV service but the replacement of an nVoD service with a true VoD service.⁴⁹

Ofcom's assessment of PPV movies

Our assessment of the characteristics of PPV movies

- 2.44 Consumers can access PPV via their TV remote control as is the case with Sky Movies, although consumers can watch a PPV film at any time. In this respect its **format** is better than Sky Movies. However, it is not available on a subscription basis. As discussed below, many Sky Movies customers are likely to see this as a drawback.
- 2.45 In terms of **timing**, PPV is more attractive than Sky Movies. Some of the movies on PPV are more recent than those on Sky Movies due to the PPV window being earlier than the Pay TV window. The **price** of PPV movies varies depending on the service the consumer accesses (e.g. Sky Box Office or Virgin's Film Flex) and which films the consumer watches. As set out in paragraphs 2.39 to 2.40 above, prices are as low as 50p for some library movies, but can rise to £3.99 for recent films on Sky Box Office. Sky Dual Movies subscribers who watch many movies per month and/or buy it as a cheap add-on to Sky Dual Sports may find the price of PPV movies less attractive compared to Sky Dual Movies. Other Sky Movies subscribers may find the price of PPV more attractive than Sky Dual Movies.
- 2.46 As PPV services show many of the same films as Sky Dual Movies and have deals with most of the major Hollywood studios the **quality** of the films on offer are similar to those on Sky Movies. The **quantity** of films varies by PPV service. In any given week, Sky Box Office shows fewer films than Sky Movies, while Film Flex has more films (500).

request dated 12 November 2008, spreadsheet entitled "December Annex 5", cell B84 on sheet Q15 c) II.

⁴³ Source: Transmission and revenue return for BSkyB 1 January – 31 December 2008.

⁴⁴ Third Pay TV Consultation, paragraph 4.330.

⁴⁵ Third Pay TV Consultation, paragraph 4.329.

⁴⁶ Third Pay TV Consultation, paragraph 4.330.

⁴⁷ Sky response to Third Pay TV Consultation, paragraphs 5.28-5.29.

⁴⁸ October 2009 Sky Submission, paragraph 37.

⁴⁹ October 2009 Sky Submission, paragraphs A2.44-A2.46.

Other evidence

- 2.47 The characteristics evidence suggests PPV movies are similar to Sky Movies: PPV's less attractive format is counteracted by the attractive characteristic of having more recent movies. Further, [X]⁵⁰. This evidence suggests that there is a degree of substitutability between PPV movies and the Sky Movies channels.
- 2.48 However in the Second Pay TV Consultation we relied upon Virgin Media research into preferences of subscribers who were interested in a subscription Virgin Movies channel⁵¹. This research asked which features of the proposed service were 'key drivers of interest'. [X]⁵².
- 2.49 This evidence is reinforced by the amounts paid for the rights to PPV movies. In 2008, movie studios earned around £[X]⁵³ from the rights to Sky and Virgin's PPV on-demand services compared to £[X] for the linear pay TV rights⁵⁴. This is despite the strong growth in PPV services in recent years⁵⁵. The value of linear TV services to movie studios is [X] than the value of PPV services. The scale of the difference in the value of the rights suggests that pay TV retailers regard PPV services as markedly less attractive than linear movie channels. We thus consider that PPV movies are a moderate constraint on Sky Movies (i.e. outside the relevant market but still capable of exerting a reasonable constraint).

The BBC Trust's consultation on Project Canvas

- 2.50 "Project Canvas" is a proposed joint venture involving (among others) the BBC to define and promote a standards based open environment for internet-connected television devices. The aim is to make these standards openly available to device manufacturers, ISPs and content providers to drive the development of new set top boxes and other devices and services that make available linear broadcasts, on-demand audiovisual content and other internet content via television sets.
- 2.51 Sky referred to a BBC Trust consultation on Project Canvas⁵⁶ (the "Canvas MIA")⁵⁷. The Canvas MIA "assumed Canvas will likely result in the creation of a new platform which will distribute the same linear TV content as Freeview as well as providing another method of delivering nonlinear TV content"⁵⁸. Sky stated that a "key finding" in the Canvas MIA was that it would reduce the revenues of pay TV

⁵⁰ Sky response to information request received 13/11/09, question 5, annex 5, and Sky response to information request received 14/12/09 question 28, annex 2

⁵¹ Second Pay TV Consultation, paragraph 4.194.

⁵² Virgin Media response to Ofcom information request of 15 May 2007 tab 1.

⁵³ Source: Virgin Media response dated 8 April 2009 to question 12 of Ofcom's information request dated 24 March 2009; Sky response on 22 December 2008 to question 15 of Ofcom's information request dated 12 November 2008, spreadsheet entitled "December Annex 5", cell B84 on sheet Q15 c) II.

⁵⁴ Source: Transmission and revenue return for BSkyB 1 January – 31 December 2008.

⁵⁵ In 2008, the estimated value of PPV movies via TV VoD was £120m (Source: UK Film Council Statistical Yearbook 2009, table 14.1 on page 109). In 2005, this was £57m. We take this growth into account in our market power analysis by considering future shares of supply.

⁵⁶ Project Canvas is a proposed joint venture involving (amongst others) the BBC to define and promote a standards-based open environment for internet-connected television devices. The aim is to make these standards openly available to device manufacturers, ISPs and content providers to drive the development of new set top boxes and other devices and services that make available linear broadcasts, on-demand audiovisual content and other internet content via television sets.

⁵⁷ *Canvas: Market Impact Assessment*, BBC Trust, 22 December 2009. This document is available at http://www.bbc.co.uk/bbctrust/assets/files/pdf/consult/canvas/prov_conclusions/mia.pdf

⁵⁸ Canvas MIA, paragraph 3.21; footnotes omitted.

suppliers by £127m-£450m in the period up until 2015⁵⁹. Sky considered that the BBC Trust's position was "entirely inconsistent" with the analysis of retail competition in the Third Pay TV Consultation⁶⁰.

2.52 The Canvas MIA estimated that there is a "modest negative impact on the future growth of non DTT based subscription platforms ..." ⁶¹. However it is important to recognise that the figures quoted by Sky reflect the impact on all pay TV subscribers, not just subscribers to Sky Movies. In fact the Canvas MIA argues that Sky Movies (and Sky Sports) subscribers are unlikely to switch away from these channels:

- "A key constraint on the potential negative impact of Canvas on Sky and Virgin is the proportion of pay TV subscribers who consume premium content. ... Premium content on DTT is still very limited" ⁶².
- "What is clear is that a significant proportion of both Sky and Virgin's customer base subscribe to these platforms to obtain premium content which is not available on the DTT platform" ⁶³. "Canvas does not directly impact [sic] and therefore it is a reasonable hypothesis that subscribers to premium channels on either Sky or Virgin will continue have a very low propensity to churn from DTH to DTT" ⁶⁴.
- "The margin impact [on Sky and Virgin Media] ... is likely to be low. Most lost subscribers are likely to have a lower-than-average propensity to upgrade to premium channels or other higher value services" ⁶⁵.

2.53 Thus, rather than being inconsistent with the position in the Canvas MIA, we consider that our view that there are no close substitutes for Sky Movies is in fact supported by that document.

Our conclusions on PPV through a television service

2.54 As explained above, the characteristics of PPV movies are similar to those of Sky Movies. We consider that the scale of the difference in the value of the rights suggests that pay TV retailers regard PPV services as markedly less attractive than linear movie channels (see paragraph 2.49 above). We thus consider that PPV movies are a moderate constraint on Sky Movies (i.e. outside the relevant market but still capable of exerting a reasonable constraint).

Subscription VoD (SVoD) after the first pay TV window

2.55 Sky's SVoD service shows movies in the pay TV window; clearly this will not constrain Sky's prices as it is controlled by Sky. We discuss this service further in paragraph 6.211 to 6.221 in the main document. Other SVoD services, including Lovefilm and Picture Box, only show films after the first pay TV window.

⁵⁹ Sky January 2010 Submission, paragraph 7.4. This cited the Canvas MIA, paragraph 2.36.

⁶⁰ Sky January 2010 Submission, paragraph 7.5.

⁶¹ Canvas MIA, paragraph 1.13.

⁶² Canvas MIA, paragraph 8.131.

⁶³ Canvas MIA, paragraph 8.133.

⁶⁴ Canvas MIA, paragraph 8.134. Similarly paragraph 2.148 stated that "the Canvas proposition will not significantly erode the competitive advantage of platforms using the satellite or cable methods due to the greater breadth of content that they will continue to be able to offer".

⁶⁵ Canvas MIA, paragraph 8.8.

- 2.56 Lovefilm streams films over the internet through a web browser as an SVoD service which is part of its “Unlimited” online DVD rental plans, from £9.99 per month (1 disc at a time) to £15.99 per month (3 discs at a time). In 2010, it had 1,024 films/features in its catalogue⁶⁶.
- 2.57 In 2009, Picture Box offered a narrow selection of ‘recent’ movies and a broad library selection from NBC Universal on SVoD. ‘Recent’ movies form a second pay TV window, which is immediately after the first pay TV window and prior to the FTA/library window. Subscription is on a monthly basis and can be purchased on a standalone basis or tied into a TV bundle. Subscribers are able to choose from a rolling selection of 28 titles (or more depending on platform) available every month. New titles are then added weekly or daily also dependant on platform. Movies can be watched over several sittings. Picturebox offers a film subscription service for a narrower range of older films on the Tiscali / TalkTalk, DTT and BT Vision platforms. It has about [X] subscribers on TUTV and Tiscali / TalkTalk⁶⁷, less than [X] % of Sky Movies’ subscriber base.
- 2.58 On the TUTV platform there are over 28 titles available every month; however films are refreshed daily rather than weekly. Seven films are made available to view at any one time. In 2009, TUTV’s service was available on a standalone basis at £7 per month.
- 2.59 Virgin Media’s SVoD shows a choice of 28 films at any given time, with 7 new films added every Friday. Most of these are available in HD. In 2009, this service cost an extra £5 per month as part of a Virgin TV package.
- 2.60 Tiscali / TalkTalk TV also offers 28 movies at any one time and new titles are refreshed weekly; however none are available in HD. In 2009, it cost an extra £5 per month on top of Tiscali / TalkTalk TV variety pack.
- 2.61 BT Vision also shows 28 films every month, with 7 new films added each Friday. In 2009, it cost BT Vision customers £4.89 per month as a standalone service.

Our assessment of SVoD movies after the first pay TV window

- 2.62 In the Third Pay TV Consultation we said that library films were not a substitute for consumers⁶⁸.
- 2.63 Clearly SVoD movie services after the first pay TV window are less attractive than Sky Movies in terms of **timing**, as they show films after Sky Movies has shown them. SVoD movie services after the first pay TV window show a smaller **quantity** of films than Sky Movies and their **prices** are lower than Sky Movies. However, they do show some of the same films, so the **quality** of films on offer is similar.
- 2.64 Picture Box’s **format** is similar in most aspects to Sky Movies, except that it offers movies on demand. Other SVoD services after the first pay TV window are only available through a PC so we consider their format less attractive than Sky Movies.

⁶⁶ Source: <http://www.lovefilm.com> (as viewed on 22 January 2010)

⁶⁷ It is now also retailed on BT Vision. Source: [X] emails to Ofcom 29 June 2008 from Michael Rhodes and Michael Barford.

⁶⁸ Third Pay TV Consultation, paragraph 4.365; see also paragraph 4.361.

2.65 [X]⁶⁹[X]

Our conclusion on SVoD movies after the first pay TV window

2.66 SVoD services after the first pay TV window (e.g. Lovefilm and Picturebox) are distant substitutes to Sky Movies. In our judgement, their less attractive characteristics, specifically the older films that they show and the smaller range on offer, outweigh the attractive characteristics of a lower price and SVoD format. This is reflected in the number of subscribers to these services.

Disney Cinemagic

2.67 Disney Cinemagic is the only other channel that shows films from the 'first pay TV window' from a Major Hollywood studio as it shows a limited number of Disney's animated films alongside a range of children's and family-based programming. It is included within the Sky Dual Movies bundle on Sky's DSat platform or is available as a standalone channel on Virgin Media or Sky. In the Third Pay TV Consultation we concluded that Disney Cinemagic lay within the relevant market⁷⁰. Since that consultation we have carried out further analysis of the types of movies broadcast on Disney Cinemagic.

2.68 Disney Cinemagic shows movies of similar **quality** to Sky Movies, but a smaller **quantity**. In terms of **timing**, it shows very few first run movies. Over a 60 day period in 2009 we only found 3 movies on Disney Cinemagic that had a theatrical release and were one to two years old⁷¹. This low figure reflects the fact that it only shows animated movies in the pay TV window that are owned by Disney. Most of its content is 'made for TV' and older films. We therefore consider the timing of films on Disney Cinemagic in general to be less attractive than Sky Movies. As Disney Cinemagic is a movie channel it has the same **format** as Sky Movies. Disney Cinemagic as a standalone channel is available for £5 per month on Sky⁷² or Virgin Media⁷³. It is therefore available at a lower **price** than Sky Movies.

2.69 [X]

Our conclusion on Disney Cinemagic

2.70 Disney Cinemagic has far fewer first run movies than Sky Movies. This limits the extent to which consumers would substitute to this channel and suggests that it is at most a moderate substitute (i.e. outside the relevant market, but still capable of exerting a reasonable constraint).

⁶⁹ [X]

⁷⁰ Third Pay TV Consultation, paragraph 4.378.

⁷¹ Ofcom calculations using <http://www2.disney.co.uk/DisneyChannel/cinemagic/tvguide.html> filtered by "Films"

⁷² <http://www.sky.com/shop/tv/standalone-channels/disney-cinemagic/> (viewed on 09 March 2010)

⁷³ <http://all yours.virginmedia.com/html/tv/kids-channels.html> (viewed on 09 March 2010)

Appendix 3

Further details on our calculation of movies market shares

Introduction

- 3.1 This Appendix provides further details on our approach to calculating wholesale market shares, which takes into account the constraint exerted by moderate substitutes.
- 3.2 The underlying data used to calculate these market shares is set out in a confidential spreadsheet. Our calculations are based on retail revenues. However, retail revenues are not directly attributable to some broadcasters of movies, so we have calculated their shares based on a comparison of spending on movie rights.
- 3.3 We have calculated shares for the following based on retail revenues.
 - **Sky's wholesale revenue:** We use Oxera's⁷⁴ 'preference-based' estimates of Sky Movies wholesale revenue. This includes revenues from the self-supply of Sky Movies to Sky's retail arm when calculating market shares⁷⁵.
 - **Pay TV DVD retail:** In 2008, the total value of retail DVD sales of movies was £1,454m⁷⁶. However this figure includes DVD sales when films are outside the pay TV window. We obtained data on DVDs released between August 2007 and October 2007 and, for these DVDs, approximately 17% of sales occurred during the pay TV window⁷⁷. Accordingly we have assumed that 17% of total DVD sales in 2008 (i.e. £247m) is attributable to DVDs within the pay TV window.
 - **PPV movies:** Sky, Virgin Media, BT Vision, TUTV and Tiscali / TalkTalk TV retail PPV movies. We have used the retail revenues these companies earn from supplying PPV movies.
 - **DVD rental subscription packages:** The value of online DVD rental services in 2008 was estimated as £92m⁷⁸.
 - **Disney Cinemagic:** Disney provided us with details of the amount of wholesale revenue that it earned in 2009 from the supply of Disney Cinemagic in the UK⁷⁹.

⁷⁴ Oxera's report is in Annex 9 of our Third Pay TV Consultation

⁷⁵ The wholesale revenues of Sky proxy the attractiveness of its Sky Movies channels (since they reflect the number of people choosing to subscribe to such channels multiplied by a wholesale measure of their willingness to pay). Thus, as in the case of Core Premium Sports channels, it is appropriate to include revenues from self supply since otherwise a significant number of consumers that consider Sky Movies to be attractive would be omitted from our calculations.

⁷⁶ Statistical Yearbook 2009, UK Film Council, page 90.

⁷⁷ We do not have data on window associated with each particular film. Rather we assumed that the pay TV window began in month 9 and ended in month 20 for all DVDs (in this data set the month in which a DVD is first released is labelled "month 1"). Ofcom calculations based on data from The Official Chart Company.

⁷⁸ BVA Yearbook 2009, British Video Association, page 80.

⁷⁹ Disney response dated 22 January 2010 to information request dated 13 January 2010. This response did not include data for December 2009 so we uplifted the figures on a pro rata basis to generate an estimate for the entire year.

We have assumed that Disney also earned the same amount in the preceding year.

- **Legal movie downloads (to rent or own):** This is currently a nascent sector. In 2008, the estimated value of online PPV/VoD movies was £7m⁸⁰.

3.4 While some FTA broadcasters earn advertising revenues, others (notably BBC) do not. We derived market share figures for FTA and basic-tier broadcasters by calculating their spend on movie rights, compared in particular to Sky's, and applying an uplift to this spend as a proxy for retail revenues. Further details are set out in the confidential market share spreadsheet.

⁸⁰ BVA Yearbook 2009, British Video Association, page 97.

Appendix 4

The staggered expiry of Sky's contracts with the major Hollywood studios

Introduction

- 4.1 At paragraphs 6.309 to 6.319 of the main document, we explain why we consider that Sky is likely to win the majority of the Movie Rights in the future. Given Sky's history of success in bidding for these rights, we do not consider that it is necessary for us to conclude on which factors explain Sky's strong bidding position. Consultation respondents have not suggested that there is likely to be a material strengthening in the position of rival bidders in the future. However we have identified a number of factors that contribute to Sky's advantage over rival bidders:
- The delay that a new entrant would face in building a subscriber base.
 - The efficiency advantages that may flow from bidders such as Sky being vertically integrated with pay TV retailers with a significant subscriber base.
 - A range of bidder specific factors, including branding advantages in relation to movies coverage.
 - The impact of the staggered expiry of Sky's contracts with the major Hollywood studios.
- 4.2 We consider that in aggregate these four factors are likely to contribute to Sky being likely to win the majority of the Movie Rights. The first three of these factors were discussed in Appendix 8 of Annex 4, since they also apply in the case of the Live PL Rights. Below we discuss the final one of these factors, namely the staggered expiry of Sky's contracts with the Major Hollywood studios.

Staggered expiry dates

- 4.3 The existing contracts licensing the Movie Rights to wholesale channel providers terminate at different times. In our First Pay TV Consultation (at Annex 13, paragraph 5.67) and in our Second Pay TV Consultation (at Annex 7, paragraphs 3.20-3.25) we considered whether the staggered availability of Movie Rights acted as a barrier to entry.
- 4.4 In paragraphs 2.57 to 2.58 of our Second Pay TV Consultation we explained why there are circumstances in which the staggered availability of rights could act as an entry barrier. This reasoning was not challenged and we thus continue to regard it as correct. We consider that the key issue is factual, namely: is there evidence that staggered availability of rights is in fact a barrier to entry?
- 4.5 A prerequisite for the staggered availability of rights to be an entry barrier is the existence of synergies between different rights that are sold at different times. We consider that there are two possible sources of synergy between Movie Rights from different suppliers:
- Competition dampening effects from combining substitutable rights.

- Potential benefits from having sufficient content to fill a pay TV channel.
- 4.6 In terms of the first synergy, we consider that the Movie Rights from different suppliers (i.e. from different Major Hollywood Studios) are substitutable⁸¹. By aggregating a significant volume of Movie Rights, a wholesale channel provider is able to dampen the competition that would otherwise exist at the wholesale level between competing Core Premium Movie channels. Dampening competition in this way is likely to enable the wholesale channel provider to extract greater rents from retailers and ultimately final consumers. Our market definition (i.e. that the supply of Core Premium Movies channels is a relevant market) suggests that, where a single wholesaler acquires a high proportion of the Movie Rights, this effect is material⁸².
- 4.7 The second potential synergy is that a channel is more attractive to final consumers if it has a large volume of movies, for example because this reduces the number of repeats and ensures that there is sufficient regular, attractive content to fill the channel. Paragraph 3.21 of Annex 7 to our Second Pay TV Consultation discussed the minimum volume of rights needed to viably launch a Core Premium Movies channel. We consider that a broadcaster could viably enter the market with only a small amount of Movie Rights (as shown by Disney Cinemagic, which also broadcasts older films as well as non-movie content such as cartoons)⁸³. However broadcasters with a small amount of Movie Rights will generate synergies by adding further Movie Rights.
- [X]⁸⁴.
 - [X]⁸⁵[X]⁸⁶
- 4.8 In its response to the Second Pay TV Consultation, Virgin Media argued that the rights of at least three studios would be required in order to assemble “an appealing package which could be marketed as a mid-priced alternative to Sky Movies” (paragraph 4.7). This is because “The movie rights available from a single studio simply do not provide the volumes required to create an appealing package. Depending on its size, a single studio might release in the region of 20 to 25 current movies per annum ... of which ... less than half will be significant titles for which there is a strong demand. A service which might only be able to offer less than one significant title a month is unlikely to attract significant subscribers” (paragraph 4.8). Further “movie rights from more than one studio [act] as a risk pooling measure because the success of studios in producing popular titles ... will vary from year to year” (paragraph 4.10). This supports the view that there are synergies between Major Hollywood Studios’ Movie Rights.
- 4.9 We consider that synergies exist between different suppliers’ Movie Rights. Where the buyer currently has a significant amount of Movie Rights (as is the case with

⁸¹ In other words, we consider that the Major Hollywood Studios are competitors when they supply their Movie Rights.

⁸² This is also consistent with our profitability analysis in section 6 of the main document in which we conclude that Sky’s aggregate return is greater than its cost of capital and that its margin over direct costs is higher on Sky Movies than on Sky Sports.

⁸³ Similarly, in its response to the First Pay TV Consultation, Sky argued that evidence from the US shows that channels based on the Movie Rights of one or two Major Hollywood studios can be viable. Moreover, Sky argued that channels could combine movies with other content, such as sports, comedy, drama etc (e.g. HBO in the US).

⁸⁴ [X]

⁸⁵ [X]

⁸⁶ [X]

Sky), the competition dampening effect is likely to be material. Where the buyer has few Movie Rights then adding further rights is likely to disproportionately increase the attractiveness of their channel.

- 4.10 This implies that a bidder which already has a small number of Movie Rights (from one or perhaps two Major Hollywood Studios) or a bidder with a large number of Movie Rights (say from four or five Major Hollywood Studios) generates more value from an additional set of Movie Rights than an entirely new entrant. This suggests that a putative new entrant (with no Movie Rights) may face difficulties in acquiring its first set of Movie Rights. However acquiring subsequent Movie Rights may be easier. This is supported by internal Virgin Media documents which state that a benefit of an agreement with [X] is that it [X]⁸⁷.
- 4.11 Having concluded that synergies exist between different Major Hollywood Studios' Movie Rights it is then necessary to consider whether the termination dates of their agreements to license their Movie Rights are sufficiently staggered that a new entrant would face a material disadvantage.
- 4.12 Figure 2 below shows the dates on which Sky's current contracts with the Major Hollywood Studios expire. The average gap between Major Hollywood studios' agreements with Sky expiring is [X] (and obviously there is no guarantee that a rival bidder will win the next set of available rights, so in practice a new entrant may expect a longer delay in acquiring additional rights)⁸⁸.

Figure 2 Expiry dates of Sky's current contracts with the Major Hollywood Studios

[X]

Sources: Sky response dated 13 May 2008 to question 1 of Ofcom's information request dated 20 December 2007 (as amended by Sky's letter of 6 August 2008 and Sky's letter of 19 February 2009).

[X]⁸⁹

[X]

- 4.13 In paragraph 3.23 of Annex 7 of our Second Pay TV Consultation we stated that [X]. We observed that this would appear to give a new entrant a number of opportunities to acquire Movie Rights. However, new entrants have not taken advantage of this opportunity [X].
- 4.14 As noted in our Second Pay TV Consultation, it may be possible for a new entrant to reflect the synergies between different Major Hollywood Studios' Movie Rights through appropriate contractual terms. For example, a new entrant might reach an agreement with the first Major Hollywood Studio at a price that is conditional on acquiring the Movie Rights from a second Major Hollywood Studio. However since Sky has consistently won all the Movie Rights we have not observed such contractual provisions being used in practice and such arrangements would potentially be difficult to agree commercially.
- 4.15 In conclusion, we explicitly placed less weight on the staggered availability of Movie Rights in the Second Pay TV Consultation than in the First Pay TV Consultation. Nonetheless, the Second and Third Pay TV Consultations identified this as a

⁸⁷ [X]

⁸⁸ The timing of negotiations between a Major Hollywood Studio and potential bidders is not fixed. For example, [X]. This was over [X] in advance of the expiry of Warner's then agreement with Sky (in [X]). [X]

⁸⁹ See the confidential to responses to Ofcom's Information request of May 2009 [X]

material entry barrier (Third Pay TV Consultation, Annex 8, paragraph 2.271) and we maintain this position.

- 7.59 Since 2005, Sky has been engaged in negotiations of varying lengths of time for supply of its premium content with a number of different retailers. In each case, Sky has expressed a preference for retail supply, while the retailers have preferred a wholesale supply deal. While Sky has not rejected outright requests for wholesale supply, it has often countered specific wholesale proposals with retail offers of supply via its Sky By Wire service. In some cases, retailers have engaged with Sky in negotiations for retail supply on the basis that this appears to be the only genuine opportunity to access Sky's premium content. However, in most cases, neither a retail nor a wholesale deal has been reached, with parties citing a variety of reasons for the failure of negotiations.
- 7.60 In general, negotiations between Sky and retailers have included both premium sports and movies channels. However, where there has been a distinction drawn between the two, requests for the supply of Sky's premium channels have focused on the supply of premium sports channels.
- 7.61 While in some cases, discussions for wholesale supply have restarted, and are ongoing, to date agreements for the wholesale supply of Sky's premium content have not been concluded.
- A potential IPTV entrant [X] and Sky negotiated for between 18 and 24 months from around June 2006 for a supply agreement of basic and premium channels over the potential IPTV entrant's [X] digital platform. The potential IPTV entrant's [X] preference was to lead with a sports channel offering, followed by movies and basics offerings. It also preferred to enter into a wholesale supply agreement, whereas Sky's preference was a retail option, that is, providing its channels to the potential IPTV entrant [X] via its Sky By Wire (SBW) service. Sky indicated that it would be willing to negotiate a wholesale deal for the supply of its basic channels, but this did not materialise for a variety of reasons. Sky did not reject outright the potential IPTV entrant's [X] request for a wholesale deal for its premium channels. However, because of Sky's clear preference for a retail deal, the parties entered into negotiations on that basis. In March 2009, the potential IPTV entrant [X] advised Sky that it would not be proceeding with a digital TV product, due to a number of factors, and no agreement was reached⁸⁵³.
 - **BT** first approached Sky regarding distribution of Sky's premium channels on its platform in February 2007. Each party indicated that it would be willing to consider the other's preferred option (that is, BT would be willing to consider a retail deal and Sky would be willing to consider a wholesale deal). However, by March 2008 the parties had still not been able to come to an agreement, at which point the negotiations stalled. [X]⁸⁵⁴. [X].
 - **Virgin Media's** predecessors (ntl and Telewest) initially inquired about the wholesale supply of high definition versions of Sky's premium channels in 2005. However, there was no correspondence on this point between the parties until mid-2007 when Virgin Media approached Sky to request the supply of Sky's

⁸⁵³ [X] response dated 9 June 2008 to Ofcom information request, question 2; Sky response dated 20 March 2009 to Ofcom information request, question 7 / Annex 1.3.

⁸⁵⁴ Sky response to information request received 13 November 2009, question 5, annex 5, and Sky response to information request received 14 December 2009 question 28, annex 2.

premium channels on Virgin Media's off-net platform, and the supply of Sky's HD premium channels, along with other changes in their agreement. As was the case with the ITPV potential operator [X] and BT, Sky's preference was to enter into a retail (Sky By Wire) deal with Virgin Media, while Virgin Media's preference was for a wholesale deal. The correspondence continued for several months, to November 2007, but no agreement was reached. In March 2009, Virgin Media issued a request for proposals from channel providers wishing to distribute HD content over its cable platform. Sky approached Virgin Media with a proposal to supply a number of its HD channels on a wholesale basis. Sky indicated that due to Virgin Media's 5/6 channel limit, its proposal focused on the basics and sport HD channel offerings, but Sky also offered to develop "an attractive Sky Movies HD proposal for Virgin Media". [X]. We consider this issue further in paragraphs 7.291 to 7.311.

- **Top Up TV** and Sky began discussing supply of Sky's premium content over Top Up TV's DTT boxes in late 2005. Top Up TV told us that it first requested a wholesale deal in relation to the supply of Sky's premium content in December 2005, that this was done orally, and that therefore it was unable to provide us with any documentary evidence of this. We did, however, receive documentary evidence that Top Up TV attempted to obtain a wholesale arrangement with Sky in March 2006. However, Sky made it clear that it was only interested in concluding a retail deal for supply. Thereafter, while Top Up TV did attempt to obtain a wholesale agreement, the parties proceeded to negotiate on the retail supply of Sky's content. However, while that deal appeared to be close to being finalised, it was ultimately never concluded.

7.62 Figure 108 provides specific examples of:

- Retailers asking Sky for wholesale access to its Core Premium channels [X]⁸⁵⁵.
- Sky responding to such requests with counter-offers to retail its channels on the provider's platform, or rejecting specific proposals on the grounds that it would prefer a retail deal [X]⁸⁵⁶.
- Sky pointing out that it was not ruling out the possibility of a wholesale arrangement (to BT Vision in August 2007; to [X] in October 2006, February 2007, March 2008)⁸⁵⁷.

⁸⁵⁵ BT Vision response dated 26 Feb 2008 to Ofcom information request dated 20 Dec 2007, question 4(i); [X]; Sky responses dated 9 and 17 Apr 2009 to Ofcom information request dated 20 Mar 2009, questions 4 and 5; Top Up TV response dated 30 Mar 2009 to Ofcom information request dated 20 Mar 2009, question 4.

⁸⁵⁶ BT Vision response dated 26 Feb 2008 to Ofcom information request dated 20 Dec 2007, question 4(i); BT Vision response dated 9 April 2009 to Ofcom information request dated 20 March 2009, question 2; [X] response dated 18 Jun 2006 to Ofcom information request dated 9 Jun 2006, question 2; Sky responses dated 9 and 17 Apr 2009 to Ofcom information request dated 20 Mar 2009, questions 4 and 5; Top Up TV response dated 30 Mar 2009 to Ofcom information request dated 20 Mar 2009, question 4.

⁸⁵⁷ BT Vision response dated 26 Feb 2008 to Ofcom information request dated 20 Dec 2007, question 4(i); BT Vision responses dated 7 Apr 2009 and 9 Apr 2009 to Ofcom information request dated 20 March 2009, questions 1 and 2; Sky response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 5; [X] response dated 18 Jun 2006 to Ofcom information request dated 9 Jun 2006, question 2.

- [X]⁸⁵⁸.

7.63 We can see from our review of the evidence that none of these negotiations led to:

- Sky making a firm offer of a wholesale deal for its Core Premium channels.
- [X].
- Sky reaching an agreement with the other provider for the wholesale of its Core Premium channels.

Figure 108 Extracts from Sky negotiations with BT Vision, [X], Top Up TV and Virgin Media for supply of SD channels 2006 – 2009

[X]

[X]

[X]

Source: responses to information requests by Sky, BT, a potential IPTV entrant [X], Top Up TV and Virgin Media.

Sky's approach to negotiation

7.64 From our review of the evidence summarised above, we are aware of no case in which Sky has formally refused to enter into some form of dialogue with parties requesting wholesale supply of its Core Premium channels. Nor has it refused outright to agree wholesale terms. Indeed, Sky has avoided explicit refusals of wholesale supply and refutes claims that it has made such refusals. For example, [X] Figure 108⁸⁵⁹). [X]:

[X]⁸⁶⁰.

7.65 However, Sky has consistently responded 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.

7.66 [X]:

[X]⁸⁶¹

7.67 [X]⁸⁶²:

⁸⁵⁸ BT Vision response dated 26 Feb 2008 to Ofcom information request dated 20 Dec 2007, question 4(i); Sky response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 5; [X] response dated 18 Jun 2006 to Ofcom information request dated 9 Jun 2006, question 2.

⁸⁵⁹ [X] response dated 18 Jun 2008 to Ofcom information request dated 9 Jun 2008, question 2.

⁸⁶⁰ Sky response dated 8 May 2009 to Ofcom information request dated 20 Mar 2009, question 7.

⁸⁶¹ Sky response dated 8 May 2009 to Ofcom information request dated 20 Mar 2009, question 7

⁸⁶² [X].

[X]⁸⁶³.

[X]⁸⁶⁴.

7.68 In our Third Pay TV Consultation (paragraph 6.40), we said that this response to requests for wholesale supply had the same effect as an outright refusal because:

- Most competing retailers were understandably reluctant to allow Sky to retail directly to their customer bases (as described in paragraph 7.94).
- Retailers were unlikely to be in a position to be able to demonstrate conclusively to Sky that Sky would be better off under a wholesale arrangement than a retail arrangement.

7.69 In each of the cases described above, the outcome has been a collapse of negotiations. Sky has not attempted to negotiate wholesale supply arrangements after it has become clear that providers were not going to accept a retail agreement with Sky. We have seen no evidence from internal Sky documents that when Sky did not expect the other party to accept a retail deal (as in the quote in paragraph 7.66 above), it considered making a wholesale offer.

7.70 Sky argued that Ofcom was extremely partial in its view that Sky should concede its preference to retail in favour of a third party's preference to wholesale⁸⁶⁵. It argued that, by Ofcom's logic, a platform's preference for a wholesale deal could be characterised as a refusal to allow Sky's premium channels access to the platform. Sky also notes that it is required by Ofcom to allow others to retail directly to its customer base. Similarly, Sky argued that its discretion and choice as to how commercially to exploit its property should not be abrogated without proper justification, which had not been provided.

7.71 Sky provided further comments on this issue, including:

"Ofcom ... suggest[s] that, where it has not been possible for Sky to agree a retail deal with a third party, Sky should concede (immediately and without further negotiation) its preference to obtain access to other operators' platforms in favour of a third party's preference for wholesale to Sky's platforms.

Ofcom's conclusions here appear to reflect a high degree of commercial naïvety. When conflicting preferences collide (as is the case where one party wants a retail deal and the other wants a wholesale deal), there will often be a degree of stand-off. Ofcom is, in effect, suggesting that when faced with the prospect of such a stand-off, Sky should immediately capitulate and the wishes of competing retailers should always prevail. Of course, an alternative view is that the platform should capitulate. Indeed, when it comes to Sky's own DTH satellite platform, it is the preferences of the channel supplier that do prevail; because that platform is open.

⁸⁶³ Sky response dated 8 May 2009 to Ofcom information request dated 20 Mar 2009, question 7.

⁸⁶⁴ Ibid.

⁸⁶⁵ Sky response to Third Pay TV Consultation, paragraphs 6.47 to 6.55.

Sky considers that in normal circumstances, against the backdrop of a truly light touch regulator, and where both parties have something to gain from reaching a deal, commercial disputes of this type would be resolved by the parties through normal negotiation, as each side would be willing to give ground in exchange for the right minimum revenue guarantee, or other commitments⁸⁶⁶.

- 7.72 We accept that other parties' preferred form of supply should not automatically take precedence over Sky's preferences. Sky's preference for a retail deal may be legitimate in the sense that it may be based on a commercial judgement by Sky that its own revenues and profits from supply to a particular platform would be higher with a retail deal than with a wholesale deal. We consider Sky's reasons for preferring retail supply further in paragraphs 7.89 to 7.104.
- 7.73 However, there are also legitimate reasons for the reluctance of third parties to enter into retail deals with Sky. We describe these further at paragraph 7.94.
- 7.74 We agree with Sky that in normal circumstances commercial disputes of this nature should be resolved through negotiation, and we recognise that this can involve a degree of stand-off. We have not suggested that where it has not been possible to agree a retail deal Sky should offer a wholesale deal immediately and without further negotiation.
- 7.75 However, the circumstances here are not normal. Our analysis of competition effects is based on our view, set out in detail in Section 5, that Sky has market power in the wholesale supply of Core Premium channels, and that this combined with its vertical integration gives it the ability and incentive to restrict supply. Our concern is that restricted supply of these channels is prejudicial to fair and effective competition. It is because of this market power that we do not consider Sky's analogy (that a platform's preference for a wholesale deal could be characterised as a refusal to allow Sky's premium channels access to the platform) to be valid⁸⁶⁷. It is also because of Sky's market power that we do not consider that "normal circumstances" exist, in which commercial disputes can be resolved by "normal negotiation".
- 7.76 Our concern arises because Sky's assertions that it favours a retail deal (and that it will not accept a wholesale deal unless the other retailer can demonstrate, to Sky's satisfaction, that Sky will be better off under such a deal) effectively amount to a restriction of wholesale supply.
- 7.77 Even if Sky's preference for retail supply over wholesale supply can be justified by legitimate commercial considerations, we consider that Sky's actions indicate that it has a preference for **no** supply to third party retailers rather than wholesale supply. As a result, its only wholesale supply arrangements are with cable firms, which it considers itself under a regulatory obligation to supply⁸⁶⁸.
- 7.78 Sky's position on wholesale supply was also reflected in its negotiations with Ofcom in late 2007 and early 2008. As we set out in Section 9 of this document, Sky sought

⁸⁶⁶ Sky response to Third Pay TV Consultation, paragraphs 6.52 to 6.55.

⁸⁶⁷ As we note in Section 5, we do not consider that Virgin Media has countervailing buyer power with respect to Sky.

⁸⁶⁸ [X].

explicitly to exclude the baseline price of its premium channels from these negotiations.

Discussion of wholesale price during negotiations

7.79 [X].

7.80 [X]⁸⁶⁹, [X].

7.81 [X]⁸⁷⁰. [X].

7.82 [X]⁸⁷¹. [X].

7.83 BT⁸⁷² told us that it had always been willing to enter into a wholesale arrangement with Sky, albeit not at the cable rate-card prices as they were not economically viable. BT confirmed that towards the end of June 2009, BT again sought a wholesale arrangement with Sky. This approach was prompted by concerns over timing – although BT considered it likely that Ofcom would proceed with its proposed wholesale must-offer remedy, it was concerned that the remedy might not be in place in time for BT to launch premium pay TV sports services for the start of the next Premier League season (August 2010). As a consequence, BT sought to address certain issues in discussions with Sky ahead of any decision by Ofcom on a wholesale must-offer remedy – for example, the specification of minimum security requirements.

7.84 [X].

7.85 [X]⁸⁷³. Sky has argued that one of the reasons negotiations for access to its premium channels with BT have not reached a successful conclusion is that BT has been engaged in regulatory gaming. We consider this issue in paragraphs 7.134 to 7.146⁸⁷⁴. [X].

Figure 109 References to pricing in Sky negotiations with BT Vision and Orange [X]

Source: responses to information requests by Sky, BT and a potential IPTV entrant [X]

Reasons given by Sky for the failure of commercial negotiations

7.86 In response to our Second Pay TV Consultation, Sky criticised Ofcom's analysis of the possible explanations for a failure to reach agreement, on the grounds that it was

⁸⁶⁹ [X] response dated 18 Jun 2006 to Ofcom information request dated 9 Jun 2006, question 2; Sky response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 5.

⁸⁷⁰ [X].

⁸⁷¹ [X] response to Third Consultation, paragraph 6.104.

⁸⁷² [X].

⁸⁷³ [X] response dated 4 December 2009 to information request dated 29 October 2009, question 16.

⁸⁷⁴ Sky response to Third Pay TV Consultation, paragraph 6.104 to 6.106.

far too narrow and ignored other much more plausible explanations⁸⁷⁵. In our Third Pay TV Consultation, we considered that Sky's alternative explanations did not fully account for the observed restriction in supply. Sky responded with further arguments on this subject.

7.87 Sky has put forward a number of reasons for the failure of negotiations described above:

- Sky's preference for retail. Sky believes that it can maximise revenues by retailing its own premium channels, rather than wholesaling to others⁸⁷⁶.
- Reluctance to reduce prices for "inefficient entrants". A reluctance to reduce wholesale prices for an "inefficient entrant" is entirely consistent with the behaviour that would be expected of a stand-alone broadcaster that did not have its own retail business⁸⁷⁷.
- Regulatory gaming. Other retailers have been engaged in regulatory gaming⁸⁷⁸.
- Capacity. Sky was prevented from supplying on other platforms because of a lack of capacity⁸⁷⁹.
- Security. Sky has concerns about the adequacy of the conditional access security systems used by BT and Top Up TV⁸⁸⁰.

7.88 We consider each of these points in turn.

Sky's preference for retail

7.89 Sky has argued that its preference for retailing its own Core Premium channels is not due to strategic considerations, and we address that argument here. We note that this issue is related to:

- Whether negotiations have failed because Sky is unwilling to lower prices to less-efficient providers, which is discussed below (paragraphs 7.105 to 7.133).
- Whether retail by Sky would address our concerns about restricted supply of Core Premium channels (paragraphs 7.210 to 7.234).
- Our broader consideration of Sky's static and strategic incentives (paragraphs 7.170 to 7.201).

⁸⁷⁵ Sky response to Second Pay TV Consultation, Section 5, paragraph 2.36.

⁸⁷⁶ Sky response to Third Pay TV Consultation, paragraph 6.32.

⁸⁷⁷ Sky response, January 2009, Section 5, paragraph 2.35.

⁸⁷⁸ Sky response to Third Pay TV Consultation, paragraph 6.104.

⁸⁷⁹ Sky response to Third Pay TV Consultation, paragraphs 6.90-6.94.

⁸⁸⁰ Sky response to Third Pay TV Consultation, paragraphs 6.95 to 6.101.

- 7.90 In our Third Pay TV Consultation,⁸⁸¹ we considered that Sky's preference for retail was due to a desire to retain control over packaging and pricing on other platforms, and therefore to avoid losing customers from its satellite platform.
- 7.91 Sky argued that it had a strong incentive to retail its own channels, stemming from its experience of low penetration rates on cable⁸⁸². Sky said that its own success in retailing its premium packages was due to:
- Its expertise in marketing its premium channels and TV services generally.
 - Its greater incentive as a vertically integrated retailer to win additional subscribers (giving rise to both retail and wholesale margins).
 - Cable firms' focus on other products on which they earn a higher margin.
 - Other retailers' preference to market their own PPV or VoD services instead of Sky's movie channels.
 - Other retailers' desire to encourage subscribers to drop Sky channels if this was necessary to retain the customer for other services.
- 7.92 Sky argued⁸⁸³ that there was therefore an obvious commercial rationale for retailing its own channels, which was not based on any strategic incentive regarding the relative strength of rival retailers. It also noted that Setanta had chosen to retail its channels where possible.
- 7.93 While Sky has raised this point as a separate question from that of whether it should be expected to lower prices for a less efficient entrant, our view is essentially similar to that in paragraph 7.128 below – namely that wholesale supply even to a less efficient retailer is likely to be better for Sky, from a static revenue perspective, than being absent from a platform. As such, it would only make sense for Sky to restrict wholesale supply of its channels if it had a reasonable expectation that it would be able to negotiate retail supply.
- 7.94 BT, A potential IPTV entrant [X], Top Up TV and Virgin Media have shown strong resistance to allowing Sky to retail on their platforms. We asked these firms for their reasons for rejecting a retail deal with Sky, and to provide supporting evidence⁸⁸⁴:
- **BT** cited the following documentary evidence on this subject:
 - A 2007 internal note⁸⁸⁵ where BT noted that “a retail deal does not work for us” because (inter alia): (a) it wanted to compete on price; (b) it wanted to offer customers flexibility on access to content; (c) given platform investment, BT wanted to control its own bundles and margins; (d) there were potential legal

⁸⁸¹ Paragraph 6.66.

⁸⁸² Sky response to Third Pay TV Consultation, paragraphs, 6.32 to 6.33.

⁸⁸³ Sky response to Third Pay TV Consultation, paragraphs 6.32-6.33.

⁸⁸⁴ Responses to Ofcom information request, 29 October 2009.

⁸⁸⁵ [X]; Annex A to BT response dated 9 April 2009 to Ofcom information request dated 20 March 2009, question 2.

issues with agreeing retail pricing and discounts with a competitor on bundles; (e) this would lead to duplication of customer support – there would not be a one stop shop for customer queries; (f) BT did not trust Sky to price competitively against itself; (g) BT had acquired all its other content wholesale.

- A 2007 email to Sky⁸⁸⁶, noting (a) that BT's need to give customers maximum flexibility requires packaging content as both standalone and in bundles, and this is increasingly important as customers demand a range of services. BT notes the lack of retail packaging of Sky content with Tiscali services; (b) the implications of a major competitor having direct access to customers whom BT acquired at significant cost. BT asks if Sky could suggest comfort on that point; (c) that BT's platform is proprietary and complex, so it is unlikely that Sky's agents could handle platform-related queries, leading to the complexity of two different call centres; (d) that BT contests the argument that it would have a weaker incentive to retail than Sky.
- **Top Up TV** told us that it would prefer a wholesale arrangement in respect of Sky's premium channels because it would be impossible to package the premium channels with Top Up TV's basic proposition in a compelling and competitive way if Top Up TV were not the pay TV retailer. This had been demonstrated by the lack of take up of the premium pay TV offering on Tiscali's platform⁸⁸⁷.
- **Virgin Media [X]**. Virgin Media told us that retail by Sky on its platform was not attractive because:
 - [X].
 - [X].
 - [X].
 - [X].
 - [X]⁸⁸⁸.
- A potential IPTV entrant [X] was concerned about⁸⁸⁹:
 - Sky directly using data supplied to target the potential IPTV entrant's [X] customers for its own Sky services.
 - The legal relationship between Sky and the potential IPTV entrant [X] in respect of the potential IPTV entrant's [X] customer database.

⁸⁸⁶ [X]; Annex A to BT response dated 9 April 2009 to Ofcom information request dated 20 March 2009, question 2.

⁸⁸⁷ Top Up TV response dated 17 November 2009 to Ofcom information request dated 29 October 2009.

⁸⁸⁸ Annex 1 to Sky response dated 17 April 2009 to Ofcom information request dated 20 March 2009, question 4. Virgin Media response dated 18 November 2009 to Ofcom information request dated 29 October 2009.

⁸⁸⁹ A potential IPTV entrant's [X] response 25 November 2009 to Ofcom information request dated 29 October 2009, file 1 of 2.

- The potential IPTV entrant's [X] obligations to market to its customers on Sky's behalf.
 - Sky's ownership of intellectual property rights in certain data and [X]'s ability to use the data.
- 7.95 Tiscali TV / TalkTalk TV is an exception to this, in that (when it was owned by Video Networks) it accepted a deal whereby Sky would retail to its customers. However, this came after Tiscali / TalkTalk had expressed a strong preference for a wholesale agreement. Tiscali / TalkTalk has since emphasised this to us, indicating that “[X]”⁸⁹⁰.
- 7.96 Tiscali / TalkTalk (then owned by Tiscali) has also said that:
- “[X]”⁸⁹¹.
- 7.97 [X]⁸⁹².
- 7.98 In summary, and consistent with our analysis in our previous consultations⁸⁹³, competitors are deterred from agreeing a retail deal with Sky by the prospect of giving Sky access to their customer bases, a loss of flexibility and control, the potential for customer confusion, and the negative perception of Sky By Wire on TalkTalk / Tiscali.
- 7.99 As discussed in paragraphs 7.222 to 7.232, Sky's offer on TalkTalk appears unattractive relative to Sky's satellite service, offering a small discount for a substantially inferior service. As an indication of the outcome, penetration of the service among TalkTalk customers is very substantially lower than Sky has achieved on satellite.
- 7.100 We do not see clear evidence that Sky would be the most effective retailer for consumers of its Core Premium channels on other platforms. Other retailers have strong reservations about allowing Sky to retail on their platforms – and these reservations have been expressed to Sky by BT, Top Up TV, Virgin Media and A potential IPTV entrant [X].
- 7.101 Moreover, these concerns appear reasonable. While it may be theoretically possible to overcome some of the issues contractually – such as the flow of customer information – others appear less surmountable, because they introduce inefficiency into the competitor's business – including limitations on the ability of the competitor to bundle effectively, and/or exploit economies of scope. Competitors' negative impression of the proposition of Sky retailing on their platforms appears to be informed by TalkTalk / Tiscali's experience of Sky By Wire.

⁸⁹⁰ Ofcom meeting with Tiscali, 10 December 2008.

⁸⁹¹ Tiscali response dated 3 September 2007 to Ofcom information request dated 18 July 2007, question 9.

⁸⁹² Tiscali response dated 13 November 2009 to Ofcom information request dated 28 October 2009, question 2.

⁸⁹³ See Second Pay TV Consultation, paragraphs 6.128 to 6.130.

7.102 We can clearly see that Sky has a preference for retail, and that other retailers would prefer a wholesale arrangement. There are almost certainly legitimate arguments on both sides.

7.103 However, in our view, Sky faces a considerable static cost in not being present on other platforms. Nonetheless, the prospect of those other platforms accepting Sky as a retailer appears very unlikely. This suggests that whatever reasons Sky has for resisting wholesale agreements, such a position is unlikely to be due to an expectation that it will soon be allowed to retail on these platforms. Therefore, we consider that notwithstanding the considerable static cost in not being present on other platforms, it appears that Sky would prefer to be absent from a platform than to wholesale.

7.104 **Our view:** We therefore conclude for the reasons set out above that, while Sky may have an interest in retailing on other platforms, the failure of negotiations for wholesale supply cannot reasonably be attributed to this preference.

Reluctance to reduce prices for “inefficient entrants”

7.105 In response to our Second Pay TV Consultation, Sky criticised Ofcom⁸⁹⁴ for setting out two possible explanations for a failure to supply – i.e. Sky intentionally withholding supply, and Sky not being willing to lower the price to a level that any retailer would be prepared to pay – and not properly analysing how the reasons for a failure to supply might affect possible remedies.

7.106 Sky argued that Ofcom could not argue that failing to agree to lower rates provides evidence that Sky is “acting” on an incentive to “distribute its premium content in a manner that favours its own platform and its own retail business”⁸⁹⁵.

7.107 Sky further argued that the 2002 OFT Decision established that Sky’s own retail business could afford to pay the wholesale rates charged to cable operators and remain profitable⁸⁹⁶. It said that the fact that other retailers might not be prepared to pay them cannot be used as evidence that Sky is favouring its own platform. If Sky were to offer new retailers terms which were below the price at which it wholesales to Virgin Media (or notionally to itself on its own platform) then it would disadvantage Virgin Media (or its own downstream retail operation) and would discriminate in favour of other retailers.

7.108 Sky said that, under Ofcom’s proposed intervention:

“Sky would need to set its wholesale prices below the levels currently charged to Virgin Media to levels which Ofcom considers new and less efficient entrants might be able to “afford” (whatever that may mean in practice). This is not an outcome that would be expected in a competitive market. A stand-alone broadcaster that did not have its own retail business could not be expected to reduce its wholesale price to accommodate such entrants in the way Ofcom proposes”⁸⁹⁷.

⁸⁹⁴ Sky response to Second Pay TV Consultation, Section 5, paragraph 2.31, page 69.

⁸⁹⁵ Sky response to Second Pay TV Consultation, Section 5, paragraphs 2.32 to 2.33.

⁸⁹⁶ Sky response to Second Pay TV Consultation, Section 5, paragraphs 2.34.

⁸⁹⁷ Sky response to Second Pay TV Consultation, page 6.

7.109 Sky said that such a broadcaster would distribute its channels to third party platforms so as to maximise aggregate wholesale revenues⁸⁹⁸. As such it would have no incentive to reduce its wholesale prices to cater for a new retailer that was less efficient than established retailers, and would be concerned about the less-efficient entrant taking sales away from its more established (wholesale) customers.

7.110 In our Third Pay TV Consultation⁸⁹⁹, we cited a number of arguments against Sky's claim that supply is restricted because other firms are less efficient than established retailers. We noted that⁹⁰⁰:

- Sky had not sought to establish whether or not other suppliers were efficient.
- Even if other firms were less efficient there is an opportunity cost to Sky in being absent from a platform.
- Our analysis of Sky's business model for Picnic indicated that the proposed service would not be profitable if Sky charged Picnic the wholesale rate-card price.

7.111 We now consider each of these points in turn.

7.112 **Establishing whether others are efficient.** We noted that Sky had not sought to reach agreements for the wholesale supply of its premium channels to third parties who have requested such supply. As such, it had not taken the opportunity to establish whether or not these suppliers were efficient. We said that we would expect a non-integrated wholesaler to engage in detailed price negotiations, in order to establish whether entrant retailers were more efficient than its more established wholesale customers.

7.113 Sky argued that:

“In placing particular emphasis on whether a retailer was efficient, Ofcom appears to have missed the point. Whether a retailer needed such a price cut because they were less efficient or simply because they wanted to secure a higher margin is not relevant. The issue is, whether, faced with a retailer that would not agree to its offer, a non-integrated broadcaster might decide not to reduce its wholesale price to that retailer. It is clear that BT was offered Sky's channels on rate-card terms and did not agree to those prices. Sky did not need to determine whether BT was likely to be efficient as it was apparent at the time that in order to reach an agreement Sky would need to reduce its prices below the cable rate-card⁹⁰¹.”

⁸⁹⁸ Sky response to Second Pay TV Consultation, Section 5, paragraph 2.35.

⁸⁹⁹ Third Pay TV Consultation, paragraph 6.69.

⁹⁰⁰ We also noted that Sky's argument was inconsistent regarding inter-platform switching. Sky disputed this interpretation of its comments. We remain of the view that there was indeed some inconsistency; however as Sky argues (Sky response to Third Pay TV Consultation, paragraph 6.75), even if short-term switching was limited, there might still be a long-term effect in terms of the choice of platform by people coming to pay TV for the first time.

⁹⁰¹ Sky response to Third Pay TV Consultation, paragraph 6.78.

7.114 However, our view was that:

“Sky has not sought to reach agreements for the wholesale supply of its premium channels to third parties who have requested such supply. As such, it has not had the opportunity to establish whether or not these suppliers are efficient. We would expect a non-integrated wholesaler to engage in detailed price negotiations, in order to establish whether entrant retailers were more efficient than its more established wholesale customers”⁹⁰².

7.115 As such, our emphasis was not on different interpretations of retailer efficiency; rather it was on whether Sky had sought to reach agreements with third parties. Our concern is that Sky has not been prepared to engage in serious discussions to establish whether third party suppliers are efficient and willing to retail at a lower margin. In our view, even if the rate-card were to be taken as the appropriate price, Sky has not generally sought to establish whether other retailers would be willing to pay this price.

7.116 **Opportunity cost of non-supply.** There is an opportunity cost of non-supply in cases where being available on new platforms results in an expansion of the market. In such cases there may even be an incentive to price discriminate between platforms if that is necessary to benefit from market expansion. While this outcome might be hard to specify through negotiation, it is the sort of arrangement we might expect from a competitive market.

7.117 Even if other firms were less efficient than Sky at retailing its Core Premium channels, or required a higher margin than would be allowed by the rate-card, there is an opportunity cost to Sky in being absent from a platform while it tries (largely unsuccessfully to date) to negotiate access as a retailer. Wholesale supply to an arguably less-efficient retailer is likely to be better for Sky, from a static revenue perspective, than being absent from the platform. In our quantitative impact assessment analysis, we estimate that, if Sky agreed to wholesale Core Premium Sports channels to third party retailers on DTT/IPTV, it would earn revenues of around £240 million per annum after five years. This estimate is based on (a) a regulated wholesale price for Sky Sports 1&2 of £17.14 (i.e. around £2 below the rate-card price) and (b) third-party DTT/IPTV premium subscribers of 1.2 million after five years. This does not take account of a reduction in Sky’s satellite subscriber numbers. In our base case, we estimate that Sky’s wholesale arm would be £740m better off over five years, and its satellite retail arm would be £70m worse off over five years. For more detailed analysis of the expected impact of the remedy on Sky, see Section 11.

7.118 Sky argued that this point seemed to have nothing to do with whether it would make sense for a non-vertically-integrated broadcaster to reduce its price, and was therefore not relevant⁹⁰³. Sky said the point related instead to whether, even where Sky felt that it would be a more successful retailer than the platform operator, it should nevertheless agree to supply at wholesale terms whilst it tries to secure retail access. Sky said it had dealt with this question in its arguments, summarised in paragraphs 7.70 to 7.71 above, that it should not be expected to concede its preference for retail in favour of a third party’s preference for wholesale.

⁹⁰² Third Consultation, paragraph 6.69.

⁹⁰³ Sky response to Third Pay TV Consultation, paragraph 6.79.

- 7.119 In considering whether a non-vertically integrated broadcaster would have an incentive to reduce its price, we are asking whether the inefficiency (or, as Sky would have it, insistence on a higher margin) of other retailers is a justification for the restricted supply of Core Premium channels. The revenues lost by being absent from a platform are a relevant consideration for Sky (as they would be for non-vertically-integrated broadcaster), even if that platform could only be reached through a less-efficient retailer.
- 7.120 The separate question of whether Sky should be expected to wholesale rather than retail, as it prefers, is discussed in paragraph 7.70 to 7.77.
- 7.121 **Picnic evidence.** We have reviewed Sky's business plans for its proposed Picnic service, to establish whether, as a form of new entrant, Picnic would be profitable using the rate-card. In our Third Pay TV Consultation, we took the view that it would not⁹⁰⁴. This view was based on making a number of adjustments to the model as submitted by Sky. The most important of these were taking into account transmission costs as a retail cost (which Sky treated as a wholesale cost) and stripping out margin contribution from customers that did not take a TV product. Our conclusion was that over Sky's modelling period of [X] years, Picnic would only be profitable if it paid a wholesale charge [X]% below the cable rate-card.
- 7.122 Sky disputed our analysis in its response to our Third Pay TV Consultation⁹⁰⁵, and suggested a number of further adjustments to the model which it believed were reasonable and would result in Picnic's business plan being profitable. In particular, Sky argued that we should use a 10-year NPV model with a terminal value as in our pricing analysis; pointed towards a lower wholesale price for capacity-constrained platforms; suggested that we should have left inflation out of our calculation of basic costs; and argued that we should remove two thirds of the transmission costs we had allocated to Picnic. Sky's comments are set out in Appendix 3 to this Section (in Annex 6).
- 7.123 Following Sky's response, we have considered our analysis further, and have introduced a further level of detail, making this analysis more consistent with our pricing work (set out in Section 10 of this document). Our adjustments are set out in Appendix 3 to this Section (in Annex 6). Of particular note, we have extended our modelling period to include 10 years and a terminal value; made adjustments to the inflation we apply to the wholesale price of Sky's basic channels; expensed subscriber acquisition costs and capital expenditure in the year in which they are incurred, rather than amortising over assets' lifetimes; and taken a market-based transmission cost rather than Sky's much lower historic costs. We have also considered the effect of stripping out the relevant common costs that we believe should be allocated to standalone broadband and telephony. The full analysis and review of the various adjustments we have made is set out in Appendix 3 to this Section (in Annex 6). In summary, however:
- If Picnic paid the wholesale price that Sky currently charges for its premium channels, it would make a loss of £[X]m on a discounted cash flow basis⁹⁰⁶. In

⁹⁰⁴ Third Pay TV Consultation, paragraph 6.69, third bullet.

⁹⁰⁵ Sky response to Third Pay TV Consultation, paragraphs 6.80-6.89.

⁹⁰⁶ We have modelled cash flows over 10 years and added a terminal value to capture ongoing value in the business.

order to break even, Picnic would have to pay £[X], which is [X] less than the cable rate-card price (£17.59) for its premium channels.

- These figures include the contribution from all of Picnic's broadband and telephony subscribers – including those who do not take any TV products. However it could, on this basis, afford to pay [X]⁹⁰⁷ [X].
- Excluding cashflows and allocated common costs from standalone telephony and broadband customers, would mean that Picnic could only break even by paying a wholesale price of £[X] ([X]% less than the cable rate-card price⁹⁰⁸).
- Excluding cashflows from the telephony and broadband elements of dual-play and triple-play bundles, but allowing for these activities to contribute a proportion of Picnic's common costs, gives a break-even wholesale price of £[X] under a conservative approach ([X]% less than the cable rate-card price) or £[X] under a less conservative approach.
- Picnic exploits the fact that Sky has its own telecommunications network, which is used to provide a wide range of broadband and voice services to residential and business consumers. The Picnic business model appears to pay for the incremental costs associated with use of this network, including access charges and out-payments to other operators, as well as some equipment costs. It does not however appear to make a contribution to the fixed costs associated with this network. This means that operators without such a network may be unable to compete with Picnic. BT may also be constrained in its ability to compete, in circumstances where it has market power, since it would not be permitted to purchase access to its network paying only incremental costs.

7.124 This analysis has two main implications:

- Picnic would be unprofitable at cable rate-card prices, even when taking into account cashflows from standalone broadband and telephony subscribers.
- For a DTT-based entrant, facing market-based transmission costs and seeking to recover its costs of pay TV services through its pay TV business⁹⁰⁹, the rate-card would not allow cost recovery.

7.125 Given that there are a large number of consumers who buy their pay TV services stand-alone (although triple play take-up is increasing), prices which only worked for a pure triple-play business model would limit competition. It is therefore not surprising that companies negotiating with Sky have sought to obtain a discount to the cable rate-card.

7.126 **Our view:** As noted, Sky has argued that a stand-alone broadcaster that did not have its own retail business could not be expected to reduce its wholesale price to accommodate entrants in the way Ofcom proposes.

⁹⁰⁷ Sky response to Third Pay TV Consultation, paragraph 6.84.

⁹⁰⁸ Note that this analysis is not directly comparable to our pricing analysis in Section 10, since it is derived from Sky's Picnic business plan.

⁹⁰⁹ "Costs of pay TV services" refers to TV direct costs and allocation of common costs to TV services.

- 7.127 In our view, Sky's approach to wholesale supply differs considerably to that which we would expect from a stand-alone broadcaster. The only independent retailers it supplies are Virgin Media and smaller cable firms. It considers itself under a regulatory obligation to supply these firms (see paragraph 7.241), and [X]. Sky argued in its response to our Third Pay TV Consultation that these prices are comfortably below the margin squeeze level, but has not shown us how it made this calculation⁹¹⁰.
- 7.128 As such, Sky's rate-card prices are a response to the regulatory environment rather than commercial circumstances. It does not follow that they are the prices which a stand-alone broadcaster would charge. We recognise that, whereas such a broadcaster may have scope to price discriminate between platforms, Sky has concerns about the regulatory risk of doing so. However, even if discounting the rate-card to new wholesale customers meant that Sky would have to extend the same discount to cable firms, we would expect a standalone broadcaster to weigh the loss of revenues from a price cut to cable against the additional revenues from being present on a new platform. Our impact assessment indicates that on a static analysis Sky could increase its revenues by discounting its rate-card and wholesaling to more platforms. However, Sky does not appear to have considered this option in its negotiations with independent retailers.
- 7.129 Our analysis of Picnic's profitability supports our view that the current rate-card prices are higher than those needed for a rival retailer to be able to compete⁹¹¹. We consider that this is also true of the discounted cable rate-card price [X].
- 7.130 Furthermore, Sky has made only limited attempts to establish the willingness of other retailers to pay for Core Premium Channels and may have been doing so in response to the regulatory environment. In particular, it offered the rate-card to BT in the course of this investigation (see Figure 108 above). [X],⁹¹² [X]⁹¹³.
- 7.131 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 premium channels, as these prices would not allow them to compete effectively. This is indicated by our pricing analysis, as set out in Section 10. A plausible competitor would not be able to generate a return which would cover its cost of capital over a 10-year period plus a terminal value if paying the current rate-card price. The rate-card prices are close to what we would expect under an ex post margin squeeze test – i.e. assuming Sky's own scale. No entrant would have Sky's scale; nor would we expect one to be able to reach Sky's scale, given Sky's current subscriber numbers relative to the likely number of total pay TV households in the UK.
- 7.132 ESPN provides an example of a stand-alone broadcaster of core premium channels. Unlike Sky, it has very quickly agreed terms with both BT and Top Up TV. In failing to agree terms with these retailers, Sky appears to have foregone considerable wholesale revenues in recent years.

⁹¹⁰ Sky response to Third Pay TV Consultation, paragraph 6.110.

⁹¹¹ As we noted in our Third Pay TV Consultation, paragraph 8.74.

⁹¹² [X]; [X].

⁹¹³ [X].

7.133 We conclude that the lack of wholesale supply of Core Premium Channels cannot be attributed to retailers being unwilling to pay a commercial price for these channels.

Regulatory uncertainty and gaming

7.134 In response to our Second Consultation, Sky argued that parties requesting wholesale supply were engaged in regulatory gaming⁹¹⁴. Referring to its negotiations with BT on wholesale access, Sky said that Ofcom could not ignore the fact that BT's failure to agree to the terms might be explained by BT's desire to seek to secure more favourable terms via a regulatory route⁹¹⁵.

7.135 [X]⁹¹⁶. Sky said its view that BT was trying to game the regulator was evidenced by [X]. Sky said that BT's counter offer of 21 December 2007 proposed a [X]% discount against the wholesale price of Sky Sports 1 and a wholesale price for Sky Movies 1 that was [X]⁹¹⁷.

7.136 In support of its statement⁹¹⁸, Sky said that:

- BT had asked for wholesale supply for the first time only three weeks before Ofcom formally opened its Pay TV Review.
- In November 2007, BT had said that it was interested in playing a long regulatory game and that accepting a deal for the supply of Sky's channels, on the basis of the current cable rate-card, was not in its interests, as that would prejudice BT's efforts in respect of seeking regulatory access to Sky's premium channels.
- During Sky's discussions with Ofcom between December 2007 and April 2008, it was Sky's understanding that Ofcom did not wish Sky to engage in separate discussions with BT (or any other current or potential retailer of Sky's premium channels) on the subject of potential wholesale terms.

“During the course of the remainder of 2008, and for the first part of 2009, there was limited engagement with BT in respect of negotiating a commercial wholesale arrangement. Sky considers that the reason for this was the fact that BT's senior management was not inclined to negotiate commercial wholesale terms with Sky and instead preferred to await the outcome of Ofcom's investigation. [X].

- [X].

7.137 Contrary to Sky's third comment above, Ofcom did not express a wish for Sky to refrain from commercial negotiations for third party supply.

⁹¹⁴ Sky response to Second Pay TV Consultation, Section 5, paragraph 2.37.

⁹¹⁵ Sky response to Second Pay TV Consultation, Section 1, page 10.

⁹¹⁶ Sky response to Second Pay TV Consultation, Section 5, paragraph 2.37

⁹¹⁷ Sky response to Second Pay TV Consultation, Section 5, paragraph 2.38

⁹¹⁸ Sky response dated 13 November 2009 to Ofcom information request of 29 October 2009, question 5.

7.138 [X]⁹¹⁹.

7.139 [X]:

- [X].
- [X].
- [X].

7.140 [X].

7.141 We have carried out an extensive examination of correspondence between Sky and BT (and others), and of internal documents, in order to assess incentives of both sides of these negotiations. BT engaged in detailed discussions with Sky from March to September 2007, in which it sought to address Sky's concerns about security of pay TV channels on BT's platform, and to reach a wholesale agreement for Sky's premium channels. In response to information requests, BT has provided us with notes of its meetings with Sky and emails to Sky on this subject over the period. [X], the papers provide no evidence that BT is not conducting a commercial negotiation in earnest⁹²⁰.

7.142 As regards the specific discussions raised by Sky in paragraph 7.136 above, we regard the evidence as inconclusive, as Sky and BT appear to have conflicting notes of the same meetings.

7.143 As regards price negotiations between Sky and BT:

- It is normal business practice for a party to a price negotiation, to have counter-offered with a price substantially below Sky's original offer.
- BT's differing view of the appropriate price had a basis in its assessment of the planned Picnic retail price⁹²¹.
- It is possible that BT would have agreed to a higher price than that which it quoted. However Sky did not respond by offering a discount of less than 40%. Instead it claimed that its rate-card prices were fair and reasonable, and that if it offered a discount to BT, it would also have to offer a discount to cable providers [X]⁹²².
- [X].

7.144 We recognise that the prospect of regulatory intervention by Ofcom could have the potential to influence commercial negotiations between parties such as Sky and BT. Indeed, while there is disagreement between Sky and BT as to what was said by BT

⁹¹⁹ [X].

⁹²⁰ BT response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009

⁹²¹ Evidenced by a note from BT of a meeting on 8 January 2008.

⁹²² BT response dated 26 February 2008 to Ofcom information request dated 20 December 2007, Annex 3.

executives in the course of negotiations, evidence from Sky does indicate that BT had regard to a possible regulatory outcome during its negotiations with Sky.

- 7.145 Sky's claim of regulatory gaming, in response to our Second Consultation, mentioned only BT. In responding to our Third Pay TV Consultation, Sky also noted that Top Up TV had ceased completely to engage with Sky during Ofcom's investigation⁹²³.
- 7.146 As described in paragraphs 7.58 to 7.63, we have reviewed documents relating to negotiations between Sky and Top Up TV, Orange and Virgin Media (for offnet IPTV), which also failed to reach an agreement for wholesale supply. Our view is that these documents do not support the notion that the failure to reach agreement was ultimately due to regulatory gaming on the part of any of these firms.
- 7.147 **Our view:** We conclude that the lack of wholesale supply of Core Premium channels cannot be attributed to regulatory gaming by third parties.

Capacity

- 7.148 In response to our Second Pay TV Consultation, Sky argued that other than Tiscali, which carried Core Premium Sky channels, no IPTV platform currently in existence was capable of delivering linear channels. In particular, neither BT nor [X] had launched an IPTV network with this capability. As such, there was "no commercial urgency to reach agreement as none of the new entrants currently have any means by which to distribute Sky's channels".⁹²⁴
- 7.149 In our Third Pay TV Consultation we recognised that there were challenges to developing an IPTV service. However, we considered that Sky's view that there was no commercial urgency was somewhat at odds with the repeated requests by other retailers for a wholesale deal. The investment in developing an IPTV network is substantial, and BT and [X] would reasonably wish to secure rights to retail Core Premium channels on their networks before making this investment. The fact that TalkTalk is already distributing a number of Sky's linear channels, including live sport, is evidence that IPTV distribution is possible over BT's copper access network. We were not aware of any technical reason why other operators could not develop an equivalent IPTV capability in a relatively short time frame which would allow linear channels to be distributed to the majority of their broadband customers. In any case, regardless of the precise capabilities of a particular operator's IPTV network, it is quite possible, indeed likely, that live sports channels would be delivered via DTT videostreams to a hybrid IPTV / DTT set-top box like BT's, rather than using the IPTV feed.
- 7.150 Sky also argued that it could not broadcast its premium channels via DTT without first securing DTT capacity. It said it had no means by which it could offer its channels to any of the DTT retailers for distribution⁹²⁵. It argued that, as its Picnic application was pending, it had no means by which to facilitate the provision of its channels either to itself or to any other retailer over the DTT platform. However, we noted that a third party retailer such as Top Up TV would have scope to use one of its own video

⁹²³ Sky response to Third Pay TV Consultation, paragraph 6.105.

⁹²⁴ Sky response to Second Pay TV Consultation, Section 5, paragraph 2.39.

⁹²⁵ Sky response to Second Pay TV Consultation, Section 5, paragraph 2.41.

streams for premium channels, or purchase capacity from another broadcaster and use it to carry Sky's premium channels.

- 7.151 In its response to our Third Pay TV Consultation⁹²⁶, Sky criticised our view that a third party retailer such as Top Up TV could use one of its own video streams for premium channels. Sky said "This displays a fundamental lack of understanding of the commercial reality, as it is Sky and not the DTT retailer who is expected to pay for such capacity". It said that Top Up TV had offered to procure the necessary capacity, but only if Sky paid £[X] per annum for that capacity. Sky said that it would reasonably want to use the capacity it had already committed to on DTT to supply its premium channels, as envisaged in the Picnic business plan, rather than paying for additional capacity. Sky also said that it remained unclear whether Sky would be entitled to be the provider of its premium channels via capacity which Top Up TV proposed to sublet from Five. Finally, it noted that BT first offered to procure DTT capacity as late as July 2009, and that previously Sky's discussions with BT were premised on Sky securing approval from Ofcom to change its DTT channel line-up.
- 7.152 Our view remains that the failure to supply Core Premium Channels for retail over IPTV was not due to a lack of capacity, for the reasons set out above. Sky has not challenged this view.
- 7.153 As regards retail over DTT, we note that lack of DTT capacity did not prevent Sky from negotiating a DTT retail deal with Top Up TV over a period of months (from December 2005 to June 2006). We have reviewed the correspondence from that negotiation, and note the following statements from internal Sky emails (April 2006)⁹²⁷:

[X].

"[X]"

- 7.154 In our view, this correspondence indicates that the failure of negotiations was not due to a capacity barrier. Similarly, we have seen no evidence that the failure of negotiations with BT was due to a failure to obtain capacity. As noted in paragraph 7.61 above, BT is currently seeking to secure capacity on DTT, and this is the basis of its request for access to Sky's channels.
- 7.155 As set out in Appendix 2 in Annex 6, there are a number of different scenarios under which Sky could have supplied its premium channels on a wholesale basis to a DTT retailer under the Multiplex licensing regime.
- 7.156 **Our view:** We conclude that the lack of wholesale supply of Core Premium channels cannot be attributed to capacity constraints.

Security

- 7.157 In response to our Second Consultation, Sky argued that [X]. It said that ensuring that Sky's channels were distributed in a secure manner was fundamental to Sky's

⁹²⁶ Sky response to Third Pay TV Consultation, paragraphs 6.90 to 6.94.

⁹²⁷ Sky response dated 8 May 2009 to Ofcom information request dated 20 March 2009, Annex 1.6 and 1.7.

business model, and that it would be irresponsible for Sky to distribute its channels on any platforms that were not secure⁹²⁸.

- 7.158 In our Third Pay TV Consultation, we recognised that Sky's concerns about security were genuine, and this was reflected in its internal documents and correspondence with parties including [X]⁹²⁹. [X]⁹³⁰.
- 7.159 However we noted that Sky has been willing to discuss retail supply on DTT while failing to engage in discussion about wholesale supply, despite security issues arising in respect of both arrangements (i.e. the same Conditional Access system would be used regardless of whether supply was wholesale or retail). [X]⁹³¹.
- 7.160 On the basis of this evidence, we did not consider that Sky's past reluctance to engage in negotiations for wholesale supply could be explained solely by its concerns about security.
- 7.161 In response to our Third Pay TV Consultation, Sky said that in addition to its own security concerns, Sky needed to comply with onerous security obligations in its agreements with movie studios, and which cover non-Sky platforms used to deliver Sky's movie channels⁹³².
- 7.162 Sky reiterated that it had extensively discussed its security concerns with BT and Top Up TV⁹³³. Sky noted that both BT and Top Up TV still used a version of Nagra which Sky considered to be unsecure. It argued that regardless of whether or not a commercial deal had progressed further, it was clear that Sky would not actually supply its channels until its security concerns were met⁹³⁴.
- 7.163 Our review of correspondence between parties does not support a view that the failure of negotiations can be explained by insurmountable security concerns. Indeed Sky conducted detailed negotiations for retail supply, and seeking to address security concerns was a part of these negotiations.
- 7.164 While we might expect parties to upgrade their security as part of a deal with Sky, we would not expect them to do so prior to negotiating a deal. We also note that Sky did not present security issues as insurmountable when negotiating with Ofcom. As set out at Appendix 2 in Annex 6, Sky stated that it would be necessary for legacy Nagra Mediaguard systems to be upgraded to the more recent Nagra Merlin system, accepting that the latter were capable in principle of providing adequate security.

⁹²⁸ Sky response, Section 5, paragraph 2.42.

⁹²⁹ [X]; Sky response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 3.

⁹³⁰ [X].

⁹³¹ Sky response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 3; [X]. However it is not clear why Sky would have less control over security as a retailer than as a wholesaler, and this has not been the basis of Sky's arguments to us.

⁹³² Sky response to Third Pay TV Consultation, paragraph 6.96.

⁹³³ Sky response to Third Pay TV Consultation, paragraph 6.97.

⁹³⁴ Sky response to Third Pay TV Consultation, paragraph 6.101.

- 7.165 **Our view:** We conclude that lack of wholesale supply of Sky's Core Premium channels cannot be attributed to security concerns.
- 7.166 Looking forward, we take account of Sky's security concerns in Section 9 on the scope of a wholesale must-offer remedy.

Conclusion on reasons given by Sky for failure of negotiations

- 7.167 Our view is that if Sky had been motivated purely by a desire to maximise its commercial revenues, it might well have sought retail access to other platforms, but, in the light of a clear and widely-held reluctance by other, smaller, providers to agree to such access, it would have pursued, or at least engaged constructively with requests for, wholesale arrangements rather than accepting an ongoing situation in which it was absent from those platforms. In doing so, we would have expected Sky to seek to establish whether other retailers were efficient by offering wholesale prices to them, and also to consider the option of reducing its wholesale price in order to attract more customers. Finally, we would have expected Sky to engage with retailers to seek to resolve capacity and security issues, and that resolving such issues would have been possible.
- 7.168 We consider that several other retailers have sought to engage with Sky, and that they had, and have, an incentive to reach agreement with Sky as soon as possible. While some regulatory gaming has taken place on both sides, we do not consider that the failure of negotiations can be attributed to the actions of other retailers.
- 7.169 We conclude that the reasons Sky put forward do not adequately explain the lack of wholesale supply of Core Premium channels.

Sky's incentives

- 7.170 To this point, we have detailed the failure of negotiations between Sky and others for the wholesale supply of Core Premium channels. We have referred to our view, based on our modelling of retail costs and analysis of the Picnic business model, that Sky's rate-card price would be unlikely to allow a third party retailer to make a positive margin on these channels. We have addressed Sky's other arguments as to why negotiations have failed, namely regulatory uncertainty and gaming, security issues, and capacity issues. We have concluded that none of these factors satisfactorily explains why Sky has not reached agreement with BT, Top Up TV, and A potential IPTV entrant [X] or in the case of off-net supply Virgin Media for wholesale supply of its Core Premium channels.
- 7.171 We now set out our views on Sky's incentives to wholesale to third parties. In analysing Sky's incentives, we distinguish between:
- Short term commercial **static incentives** which Sky might have to restrict wholesale supply of its Core Premium channels – i.e. the trade-off Sky would face between increased wholesale revenues as new-to-Sky subscribers accessed Sky's channels on other platforms, and the loss of retail margins from existing Sky satellite subscribers switching to other platforms (including lost revenues on other services which Sky bundles with its pay TV channels).
 - **Strategic incentives** such as any concern Sky might have that wholesaling its channels to other platforms would weaken its position in relation to competitors – whether in terms of downstream retail presence, or bidding for content rights.

- 7.190 Our view remains that Sky has a static incentive to wholesale to DTT retailers, although again we note that this should be treated with caution due to factors excluded from our 'vertical arithmetic' calculations, as set out in paragraph 7.175 above.
- 7.191 However, the evidence from negotiations set out above shows a strong reluctance on Sky's part to negotiate a wholesale deal. Indeed Sky has only offered to wholesale to third parties when there has been a prospect of regulatory intervention if it did not do so, and its only existing wholesale supply (to cable firms, primarily Virgin Media) is to firms from which it could not withdraw supply without a considerable risk of regulatory intervention.
- 7.192 To the limited extent that Sky enters in to any discussion as to wholesale pricing, these centre on the prices which Sky currently set to Virgin Media via the rate-card. None of the negotiations which we reviewed have led to Sky offering prices below the rate-card for its Core Premium channels.
- 7.193 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. This is shown by our pricing analysis, as set out in Section 10. A plausible competitor would not be able to generate a return which would cover its cost of capital over a 10-year period plus a terminal value if paying the current rate-card price. The rate-card prices are close to what we would expect under an ex post margin squeeze test – i.e. assuming Sky's own scale. No entrant would have Sky's scale; nor would we expect it to be able to reach Sky's scale, given Sky's current subscriber numbers relative to the likely number of total pay TV households in the UK.
- 7.194 Sky's approach to supplying Virgin Media, set out in paragraphs 7.248 to 7.259, provides further evidence of Sky's reluctance to supply as a wholesaler. Sky does not appear to consider the scope to increase wholesale revenues by setting a lower wholesale price to Virgin Media. In addition, Sky initially responded to requests by Virgin Media for HD and interactive versions of its Core Premium channels by raising security issues and proposing a retail arrangement (i.e. similarly to its response to request for supply by other providers) even though Sky already has a wholesale arrangement with Virgin Media for its SD Core Premium channels (see paragraphs 7.299 to 7.311 below).
- 7.195 When it is clear that a third party will not accept a retail deal, Sky has allowed negotiations to break down rather than seeking to negotiate terms for wholesale supply. On the basis of this evidence, we consider that if there is no prospect of a third party agreeing a retail deal, Sky would rather be absent from that party's platform indefinitely than agree to a wholesale deal.
- 7.196 In our view, the essence of Sky and CRA's criticism is that we have not demonstrated the presence of a specific dynamic mechanism which would unambiguously give Sky an incentive to restrict supply.
- 7.197 Our Second Pay TV Consultation discussed a number of mechanisms which were put forward as explanations of Sky's behaviour, notably that:
- A bidder that is vertically integrated with the leading retailer on the platform with the greatest number of likely subscribers to a Core Premium channel is able to

access those subscribers more efficiently; it is thus in a stronger position than vertically integrated bidders on other platforms or independent bidders⁹⁵³.

- If bidders for rights are more evenly matched (e.g. in terms of their retail presence) then there is a greater possibility that a proportion of key rights will be won by a firm other than Sky. This could lead to an increase in competition between wholesale suppliers of Core Premium channels⁹⁵⁴.
- Refusing to supply premium content to rival retail platforms diminishes the total size of those platforms' subscriber bases. As a result, those platforms lose economies of scope between retailing basic-tier and premium packages i.e. their average costs increase, placing them at a competitive disadvantage to Sky.⁹⁵⁵

7.198 CRA's criticisms of the mechanisms we discussed are considered in Annex 6. We accept that no one of these possible mechanisms can be demonstrated *prima facie* to be the primary basis of Sky's incentive to restrict supply. We also consider it highly unlikely that they could be quantified, or that the "balancing exercise" proposed by Sky could ever be conducted with an acceptable degree of confidence.

7.199 However, we do not accept Sky's view that such a balancing exercise is crucial to our position. Rather, our view that Sky has a strategic incentive to restrict supply is primarily based on our observation of Sky's actual behaviour:

- Sky has restricted wholesale supply of its Core Premium channels despite having an apparent static commercial incentive to supply them.
- As we have argued above, this behaviour cannot be satisfactorily explained by the commercial and practical rationales that Sky has put forward.
- We have identified credible strategic reasons for Sky's behaviour.

7.200 We therefore conclude that Sky is acting on a strategic incentive to restrict wholesale supply of its Core Premium channels.

7.201 We remain of the view that Sky derives two strategic benefits from keeping its retail competitors weak:

- The ability to manage competition between retailers on different platforms, in order to protect the position of Sky's own satellite platform. We note in particular that this gives Sky an incentive to prevent a rival establishing a presence on DTT. Similarly, if Sky itself develops a presence on DTT, it will have an incentive to protect its DTT business against rivals, whether on DTT or other platforms.
- The ability to prevent rival retailers from establishing a strong retail presence, which, as well as being a threat in the retail market, could strengthen their position in bidding for content rights. We note that rival retailers may not currently be the strongest challengers for rights, but they could be so in future, making it

⁹⁵³ See Second Pay TV Consultation, Annex 8, paragraph 2.36. We also considered that rights prices were likely to be lower where competition between bidders was weaker.

⁹⁵⁴ See Second Pay TV Consultation, Annex 8, paragraph 2.38.

⁹⁵⁵ See Second Pay TV Consultation, Annex 8, paragraph 2.41.

beneficial for Sky to avoid the risk of them growing to become stronger challengers.

Whether Sky retailing on other platforms would address our competition concerns

7.210 Next we consider the important distinction between wholesale and retail supply to other platforms by Sky, and consider whether our concerns would be met by Sky retailing its Core Premium channels on other platforms.

Evidence on practical examples of Sky retailing on other platforms

7.219 We have considered two of the longest-standing examples of Sky retailing its Core Premium channels in detail. These are:

- Sky Player – Sky’s on-demand service to the PC.
- Sky By Wire – Sky’s service offered to TalkTalk TV customers, which Sky has also suggested to other pay TV retailers as an alternative to a wholesale arrangement.

7.220 At launch, **Sky Player** was delivered over the internet for viewing on PCs rather than TV screens. Sky last year launched Sky Player on the Xbox games console and has also struck deals with a TV manufacturer (Cello) and providers of hybrid set-top boxes (IP Vision and 3 View). The service was previously only made available to Sky satellite subscribers, but is now also available on a stand-alone subscription basis, without a dish. Despite its attractive content, Sky Player has some features which may be generally seen as unattractive to TV subscribers:

- There is some evidence that consumers find PC viewing less attractive than TV viewing. For example, Essential Research recently conducted qualitative research among consumers with different levels of VoD use⁹⁷⁵, and reported that “The act of viewing television on a computer screen was universally regarded as less satisfying than on a TV set, owing to factors such as screen size, sound quality and the physical placement of the computer in the household”.
- Depending on the user’s connection speed, Sky Player’s picture quality may be lower than TV. As discussed in paragraph 7.294 in the context of HD services, we consider that, while content is a key driver of demand for pay TV services, where the same content is available on two platforms, other features, including picture quality and the means of viewing content, are likely to be important in driving the platform choice.

7.221 As illustrated in Figure 110, Sky Player packages closely mirror Sky’s satellite packages in structure i.e. they require a buy-through from basic. Prices are £2 to £3 cheaper than similar satellite packages. In our view, this is a small discount when one considers the difference in viewing experience between PC and TV, and the fact that Sky Player customers do not receive a free set top box – and may need to upgrade to a higher capacity (and more expensive) broadband package.

⁹⁷⁵ Source: qualitative research conducted by Essential Research, December 2009. The findings were based on twelve focus groups with 7-8 participants in each.

Figure 110 **Retail prices for Sky Player and Sky's satellite service, January 2010**

Sky Player offer	Sky Player price	Sky satellite offer	Sky satellite price
Entertainment Pack	£15.00	1 Mix	£18.00
Entertainment Pack + Movies Pack	£32.00*	1 Mix + Movies Pack	£34.00
Entertainment Pack + Sports Pack	£34.00**	1 Mix + Sports Pack	£36.00
Entertainment Pack + Sports Pack + Movies Pack	£41.00	1 Mix + Sports Pack + Movies Pack	£43.50

Source: <http://www.sky.com/quickbuy/build>

<https://skyplayer.sky.com/vod/content/Home/content/l/l/content/registerEntitlementPack.do?after.login=true>

Note: Prices correct at 11 January 2010.

7.222 Turning to **Sky By Wire**, key elements of Sky's arrangement with TalkTalk TV (and previously Tiscali) are as follows⁹⁷⁶.

- Sky sets retail prices and the terms on which its channels can be bundled and marketed by Tiscali / TalkTalk TV.
- Tiscali / TalkTalk TV provides transmission and subscriber management services for the channels, and receives [X].

7.223 In our Second Pay TV Consultation (paragraphs 6.23 to 6.25) we compared Sky's 6 Mix package with Tiscali's Variety Pack. In response, Sky argued that its 1 Mix package was a more appropriate comparator⁹⁷⁷. As Figure 111 below illustrates, on this basis prices on Tiscali for packages including Sky Core Premium channels were between £1.01 and £5.01 cheaper than packages on Sky with the same Sky Core Premium channels.

⁹⁷⁶ TalkTalk TV was previously Tiscali TV, and before that Homechoice (operated by Video Networks).

⁹⁷⁷ Sky response to Second Pay TV Consultation, Section 5, paragraph 2.47.

Figure 111 Comparison between Sky and Tiscali prices as set out in the Second Pay TV Consultation and by Sky in its responses

	Ofcom Second Pay TV Consultation		Sky response to Second and Third Pay TV Consultations	
	Sky	Tiscali	Sky	Tiscali
Basic mix	6 Mix	Variety pack	1 Mix	Variety pack
Basic tier channels	Over 100 pay channels +	8 pay channels +	22 pay channels + 18 time shifted channels	8 pay channels +
On demand	Sky Anytime (Sky+ STB only)	Catch up on demand	Sky Anytime (Sky+ STB only)	Catch up on demand
FTA channels	200 FTA	26 FTA channels+ Freeview	200 FTA channels	26 FTA channels+ Freeview
Phone	- Free evenings and weekends - Line rental	- Free evenings - Line rental	- Free evenings and weekends - Line rental	- Free evenings - Line rental
Broadband	2Mb	8Mb	8Mb	8Mb
Basic only	£27.00	£19.99	£32.00	£19.99
Price – Single Sports	£38.00	£41.99	£43.00	£41.99
Price – single movies	£38.00	£41.99	£41.00	£41.99
Price – Sports Mix	£46.00	£46.49	£51.00	£46.49
Price – Sports Mix and single movies	£50.00	£49.99	£55.00	£49.99

Source: Second Pay TV Consultation, Figure 36. Sky response to Second Pay TV Consultation, Section 5, paragraphs 2.45 to 2.53; Sky response to Third Pay TV Consultation, paragraphs 6.135 to 6.137.

7.224 However, the basic package price on Tiscali was £12.01 cheaper than that on Sky. The inclusion of Sky Core Premium channels substantially reduces the price discount on Tiscali relative to Sky. Put differently, a Tiscali basic subscriber would have to pay substantially more to add Core Premium channels than a Sky basic subscriber. For example, a Sky basic subscriber paying £32 would have to pay an extra £11 to get Single Sports, but a Tiscali basic subscriber, paying £19.99 would have to pay an extra £22 for Single Sports. If we use the basic-only price as an indicator of the relative quality, this would suggest that Sky's basic package is of somewhat higher quality than Tiscali (i.e. far more than the 75p suggested by Sky). Figure 112 compares Sky's current prices with those of TalkTalk TV. A basic service on Sky is currently £34, and that of TalkTalk TV is £26.47, a difference of £7.53. When Sky's Core Premium channels are added, TalkTalk's prices are either £1.97 or £5.97 higher than Sky's for all packages. An upgrade to Single Sports would cost an extra £9 per month for a Sky basic subscriber, but an extra £22.50 for a TalkTalk TV subscriber.

Figure 112 Comparison between Sky and TalkTalk prices as of January 2009

	Current prices		Price difference (TalkTalk TV price minus Sky price)
	Sky	TalkTalk TV	
Basic mix	1 Mix	Variety pack	
Basic tier channels	22 pay channels + 18 time shifted channels	8 pay channels +	
On demand	Sky Anytime (Sky+ STB only)	Catch up on demand	
FTA channels	200 FTA channels	26 FTA channels+ Freeview	
Phone	- Free evenings and weekends - Line rental	- Free evenings - Line rental	
Broadband	10Mb	8Mb	
Basic only	£34.00	£26.47	-£7.53
Price – Single Sports	£43.00	£48.97	£5.97
Price – single movies	£42.00	£47.97	£5.97
Price – Sports Mix	£52.00	£53.97	£1.97
Price – Sports Mix and single movies	£56.00	£57.97	£1.97

Source: company websites

7.225 The figure below illustrates changes in the penetration of the Sky By Wire service on TalkTalk / Tiscali's platform over time. Penetration [X], but has typically ranged between [less than 15%] [X]% and [less than 15%] [X]% since 2005.

Figure 113 Subscribers to Sky By Wire (any channel) as a percentage of total TalkTalk TV / Tiscali TV customers, 2005-2009

[X]

Source: Tiscali response of 1 April 2009 to information request of 20 March 2009 and TalkTalk response of 21 January 2010 to information request of 29 October 2009.

Our view

7.226 We continue to take the view that Sky retailing widely on all platforms would not satisfactorily resolve our concerns about restricted distribution of Sky's Core Premium channels.

- Put most simply, it would not ensure fair and effective competition between retailers on different platforms, delivering choice, innovation and competitive prices to consumers, as there would only be one retailer of these important channels across platforms.
- In particular, Sky, as a retailer on non-satellite platforms, would have a weaker incentive to compete than alternative providers. The reason for this is that Sky would be likely to have more capacity and functionality on its own satellite platform than on other platforms, giving it more scope to sell bundled services on satellite.

- From a consumer perspective, a choice of Sky retailing on one platform vs. Sky retailing on another platform represents only a partial choice (i.e. of platform, but not of retailer).
 - Having several retailers delivering pay TV services to the same consumer risks losing efficiencies for example from bundling and economies of scope.
- 7.227 These concerns are borne out by the evidence we see from the two practical examples we have focused on here – Sky Player and Tiscali / TalkTalk TV / Sky By Wire.
- 7.228 The evidence from Sky Player supports the view that if Sky retailed on other platforms, it would take care not to offer a more attractive package (in either quality or price) than was available on its satellite platform. An independent retailer would not face such a constraint. If Sky Player were competing independently against Sky's satellite offer (or if an independent wholesaler were seeking to maximise its revenues from supplying both platforms), we would expect the price difference to be greater, given the smaller range of channels, PC-only distribution, lack of a free set-top box and lower quality picture of Sky Player.
- 7.229 The relatively high prices which Sky sets for its channels on Sky By Wire on Tiscali / TalkTalk TV's platform, [X], also support this view.
- 7.230 Sky has consistently set unattractive prices for Sky By Wire on Tiscali / TalkTalk TV relative to similar bundles on Sky's satellite platform. The much higher mark-up for premium channels than on Sky is not explained by cost differences – [X].
- 7.231 Sky argued that price comparisons between Tiscali and Virgin Media were more relevant than between Tiscali and Sky⁹⁷⁸. However, we do not consider that such a comparison provides any insight into whether prices on other platforms would be lower with Sky as a wholesaler or with Sky as a retailer. This is because in our view Virgin Media's retail prices for packages including Sky Core Premium channels are strongly affected by the wholesale prices which Sky charges Virgin Media for those channels. As we note below, we consider that the terms of Sky's existing supply to Virgin Media have the effect of weakening Virgin Media's ability to compete effectively with Sky. Virgin Media's retail prices are a reflection of the wholesale prices it pays to Sky. As such, Virgin Media's retail prices cannot be used as a benchmark for retail prices that would prevail if Core Premium channels were supplied through a wholesale arrangement in a manner that ensured fair and effective competition.
- 7.232 We can see the effect of these relatively unattractive prices in the penetration of Sky By Wire channels on Tiscali / TalkTalk TV's platform:
- Penetration has been consistently low, averaging [X]% over the period from the beginning of 2005 to October 2010. The latest figure stands at [X]%. During the period, the monthly figure has never been more than [X]%. This is very low compared to penetration on Sky's satellite platform, which has consistently been well above 60%. Even on Virgin Media's cable platform, where penetration has declined consistently in recent years, the figure is currently [X]%.

⁹⁷⁸ Sky response to Third Pay TV Consultation, paragraph 6.137.

- None of Sky's arguments as to why penetration may be lower convinces us that Sky By Wire is competing vigorously with Sky on satellite and that some other factor is keeping take-up low. The argument that penetration varies over time seems not to explain the issue, as although penetration has varied between [X]% and [X]%, it has never risen to be anywhere near penetration on Sky's own platform, remaining less than a fifth of satellite penetration since at least January 2005. The figures quoted by Sky for penetration in 2004 differ significantly from those provided by Tiscali / TalkTalk TV. Finally, the idea that penetration reflects Tiscali / TalkTalk TV's immaturity as a platform is not credible given that we can see such low penetration persisting over a five-year timeline. While total subscribers may be low (and indeed have generally been low for Tiscali / TalkTalk TV – peaking at [X]) we see no reason why penetration to a particular service, as a proportion of total subscribers on the platform, should be low in the early stages of a platform's development.

7.233 We note the evidence from other parties which indicates that any attempt to mandate access to Sky as a retailer on platforms operated by its retail competitors would face strong resistance from those competitors, and give rise to the practical issues described in paragraph 7.94 (although these would not arise if Sky were the platform operator).

Supply of Sky's Core Premium channels to cable TV providers

7.235 As noted in paragraph 7.34, Sky currently supplies its Core Premium channels to Virgin Media, Wight Cable and Smallworld. We focus on supply to Virgin Media, which is the only major UK cable provider. In this sub-section, we address the following issues:

- Whether Sky has an incentive to withdraw supply of its standard definition (SD) Core Premium channels to cable firms, or supply them in a way that limits Virgin Media's ability to compete fairly and effectively. We discuss our revisions of our Vertical Arithmetic model following responses to the Second Pay TV Consultation. We consider Sky's reasons for supplying Virgin Media and review relevant internal documents.
- How Sky's rate-card prices are set, their effect on Virgin Media's incentives, and the impact on competition.
- Whether Sky has sought to avoid supplying its premium HD and interactive content to Virgin Media, and if so whether this is prejudicial to fair and effective competition.
- The low penetration of Core Premium channels on Virgin Media compared to satellite.

7.236 Virgin Media's negotiations with Sky for Offnet delivery of Sky's Core Premium channels are set out in Figure 108 above, and included in the subsequent discussion of Sky's response to requests for new supply.

Sky's incentives to supply to Virgin Media

7.237 There are several possible aspects to the question of Sky's incentives with regard to supplying Virgin Media:

- Whether Sky is likely to withdraw wholesale supply in the foreseeable future.
- Whether Sky would have an incentive to withdraw wholesale supply from Virgin Media if it could do so without the risk of regulatory intervention.
- Whether Sky has an incentive to restrict Virgin Media's ability to attract subscribers to Core Premium channels, via the terms of its wholesale supply.

7.238 By way of context, we have seen no evidence that Sky is likely to withdraw wholesale supply to Virgin Media in the foreseeable future. Sky currently considers itself under a must-supply obligation as regards Virgin Media⁹⁷⁹. Whether Sky would supply Virgin Media in the absence of this obligation is unclear, and depends on the terms of supply. We therefore focus on the questions of whether Sky would have an incentive to withdraw supply in the absence of regulatory risk, and whether it has an incentive to limit Virgin Media's ability to compete, particularly through pricing and the non-supply of HD and interactive services

⁹⁷⁹ Sky response to Second Pay TV Consultation, Section 5, paragraph 2.6(b).

7.246 Our Third Pay TV Consultation presented a version of our Vertical Arithmetic analysis which had been revised in response to earlier criticisms from Sky⁹⁸⁸. The revised analysis showed that if Sky withdrew its Core Premium channels from Virgin Media the impact on Sky's revenues would be negative for up to 12 years (a longer period than we had previously estimated). This suggested that, at current prices, Sky was likely to have a stronger incentive to supply to Virgin Media than we had previously estimated. However, we noted that:

- The prices at which Sky supplies to Virgin Media, discussed below, are an important factor in this calculation: Virgin Media has argued that at current prices it does not have an incentive to compete aggressively in the retail of Core Premium channels⁹⁸⁹. If Sky were required to supply to Virgin Media at a lower price, its wholesale revenues could increase or decrease (depending on whether the lower price attracted a sufficiently greater volume of new cable subscribers to counter the lower per-subscriber price), but its revenues as a retailer would tend to decrease if this led to switching from Sky to Virgin Media.
- Our Vertical Arithmetic analysis merely compares revenue streams from wholesaling and retailing. It does not take account of Sky's strategic incentives.

7.247 We have not carried out any further revisions to this analysis. We remain of the view that, in static commercial terms, it indicates that Sky has an incentive to supply to Virgin Media, subject to the caveats set out above.

Documentary evidence of Sky's incentives

7.248 Our Third Pay TV Consultation described documents which Sky disclosed during High Court proceedings⁹⁹⁰, [X].

7.249 [X]:

[X].

7.250 [X]:

[X]⁹⁹¹.

7.251 In response to our Third Pay TV Consultation, Sky said⁹⁹² that Ofcom had considered that "two of the many thousands of Sky internal documents that have been provided to Ofcom" suggested that Sky weighed static incentives against a strategic incentive to weaken or eliminate Virgin Media. It said that neither document was evidence of such a proposition.

⁹⁸⁸ Third Pay TV Consultation, paragraph 6.99.

⁹⁸⁹ Virgin Media response paragraph 6.12, 6.13.

⁹⁹⁰ Sky High Court documents, disclosed to Ofcom in October 2008. Third Pay TV Consultation, paragraph 6.103 to 6.105.

⁹⁹¹ [X].

⁹⁹² Sky response to Third Pay TV Consultation, paragraph 6.18.

- 7.252 Sky argued that the first document was visibly in early draft form, and said it was never circulated or shared with any of Sky's senior management. It said that the first two quotes above related to static incentives, and that the reference to finishing off cable was not linked to Sky's wholesale strategy. It said that the document was suggesting that Sky should compete very aggressively at the retail level, not to modify its wholesale strategy of supplying its premium channels to cable. It said the document made no link between Sky's wholesale strategy and retail competition.
- 7.253 We would not expect Sky to set out such views in many of its internal communications. As regards the first document, while it is clearly not in final form, neither is it obviously an early draft as Sky claims. We do not consider that we can reliably ascertain which Sky employees saw or contributed to it.
- 7.254 As for its content, we consider that the first two quotes above are important evidence that Sky has an incentive to prevent Virgin Media from operating as an effective retail competitor, whether that is primarily due to static or strategic considerations. In particular, [X]. We consider that this contradicts Sky's assertion that the document does not link wholesale and retail concerns. Indeed, given the apparent wish to eliminate competition from cable, it would be surprising if Sky did not make such a link. The document identifies [X]. This is the context in which "finishing off" cable is discussed. The reasons for such a wish are indicated in a further quote from this document:

"[X]".

- 7.255 Sky argues that the second document concerns Sky1 and is therefore not relevant to a discussion of premium channels. It also argues that the document is discussing static, rather than strategic incentives.
- 7.256 We recognise that a static calculation relating to Sky1 would not be informative of Sky's incentives with regard to Core Premium channels. [X]. In addition, in our view the fact that Sky is concerned about non-exclusivity of Sky1 (and willing to forego wholesale revenues to protect this exclusivity) suggests that it would be even more concerned about a loss of exclusivity in the supply of Core Premium channels which are the key drivers of demand for pay TV subscriptions.
- 7.257 Sky argued that this evidence was outweighed by Sky's actual behaviour around this time, in seeking to negotiate the terms of wholesale supply agreements with ntl and Telewest which would have rewarded uplifts in the sales of Sky's channels with reductions in Sky's rate-card prices. We consider this issue under the following heading.
- 7.258 Finally, Sky argued⁹⁹³ that it was not clear how Virgin Media would be weakened if a significant number of Virgin Media customers took a basic-only service as a result of Sky's wholesale pricing. Sky said⁹⁹⁴ there was no suggestion (and there is no plausible reason why this might be the case) that this loss might be mitigated because these basic only subscribers, who could have elected to take premium channels from Virgin Media, would somehow be more likely to switch to Sky.

⁹⁹³ Sky response to Third Pay TV Consultation, paragraph 6.26.

⁹⁹⁴ Sky response to Second Pay TV Consultation, Section 5, paragraph 2.28.

7.259 In contrast to Sky's position, we consider that if Virgin Media is unable to offer packages which include Sky's Core Premium channels at a price which is competitive with satellite, Virgin Media will face considerable difficulty in attracting pay TV subscribers with an interest in these channels. This is likely to lead both to Virgin Media customers switching to Sky, and to new-to-market customers choosing Sky over Virgin Media. We asked Sky to provide us with any relevant strategy documents relating to the supply or potential supply of its Core Premium channels to Virgin Media or other cable retailers since January 2006. [3<]⁹⁹⁵. We take this as indicating that Sky has not reconsidered its strategy towards supplying its Core Premium channels to cable retailers in more than three years. This is consistent with Sky's view that it is under a *de facto* must supply arrangement (see paragraph 7.241 above).

⁹⁹⁵ Sky response (14th April 2009) to final Ofcom information request, question 6.

7.262 Sky told us that since 2002 it had continued to supply cable operators at a price which it believed was compliant with the test laid down by the OFT⁹⁹⁶:

[REDACTED].

7.263 In our Third Pay TV Consultation, we noted that the threshold at which a margin squeeze abuse occurred was necessarily high. In other words, rather than entering into negotiations to establish a mutually beneficial price, our understanding was that Sky has, for the past seven years, been setting its price level by calculating the price just below an abusive price, as determined by the OFT in 2002. We said that Sky appeared to present the margin squeeze price as a floor beneath which it would not negotiate, either with cable retailers or others.

7.264 In its response to our Third Pay TV Consultation⁹⁹⁷, Sky said that it did not suggest that its prices were just sufficient to pass the range of prices in the OFT's test. It described this claim as objectionable. Sky said that its wholesale prices comfortably passed the range of prices in the OFT test, and estimated that its retailing business had earned at least £[REDACTED] above the OFT threshold over the last eight years.

7.265 In November 2008, Ofcom asked Sky [REDACTED]⁹⁹⁸. [REDACTED]⁹⁹⁹.] Following its response to the Third Pay TV Consultation, and in the context of the arguments from Sky in the paragraph above, Ofcom asked Sky to provide supporting evidence for its assertion that its rate-card comfortably passed the range of prices in the OFT test, [REDACTED]¹⁰⁰⁰. [REDACTED].

7.266 In response, Sky [REDACTED]¹⁰⁰¹. [REDACTED] (see paragraph 7.264). Our own calculations indicate that Sky's rate-card price is close to the maximum it could charge while meeting the test.

7.267 As noted above, Sky told us that in 2003/04 it sought to negotiate the terms of wholesale supply agreements with ntl and Telewest which would have rewarded uplifts in the sales of Sky's channels with reductions in Sky's rate-card prices. Sky said that Telewest declined to enter into the agreement due to an unspecified concern, but that by the end of 2003 Sky had "reached the point at which it was prepared to agree in principle a discount structure for Telewest (subject to regulatory comfort being given)"¹⁰⁰². In 2004 Sky conducted similar negotiations with ntl, but Ofcom did not provide Sky with the legal comfort it needed and Sky concluded that "it would not be prudent to enter into the proposed agreement with ntl and risk

⁹⁹⁶ Sky response of 28 July 2008 to information request of 2 July 2008.

⁹⁹⁷ Sky response to Third Pay TV Consultation, paragraph 6.110.

⁹⁹⁸ Ofcom information request, 12 November 2008, question 6.

⁹⁹⁹ Sky response dated 9 December 2008 to Ofcom information request dated 12 November 2008, question 6.

¹⁰⁰⁰ Ofcom information request dated 29 October 2009.

¹⁰⁰¹ Sky response dated 13 November 2009 to Ofcom information request dated 29 October 2009, question 4.

¹⁰⁰² Sky response to Third Pay TV Consultation, paragraph 6.22.

subsequent censure¹⁰⁰³. Sky said it also offered to wholesale Sky Sports Xtra to ntl and Telewest in 2003, and reached agreement with both.

7.268 Virgin Media had no copies of external correspondence relating to these discussions between Sky and Telewest, although [X].¹⁰⁰⁴

7.269 As regards negotiations with ntl, Virgin Media told us that:

“[X]”¹⁰⁰⁵.

Effect of wholesale pricing on Virgin Media’s incentives

7.270 Virgin Media told us that, as a result of Sky’s high wholesale prices, it made a negative margin on Sky Sports, reducing the value of a “base offer” subscriber by around 17%, while subscription to Sky Movies increased the value of such a subscriber by 5%, which Virgin Media described as “marginal”¹⁰⁰⁶. Figure 114 provides weighted average incremental retail prices for Sky’s Core Premium channels on Virgin Media, compared to the wholesale price, and the resulting margin available to Virgin Media. This is consistent with the view that Virgin Media earns a negative incremental margin for Sky Sports, a small positive incremental margin for Sky Movies, and a negative incremental margin for a combined package.

Figure 114 Incremental price, rate-card and margin of Sky’s packages on Virgin Media

	Price increment (£)	Wholesale rate-card charge (£)	Margin over wholesale rate-card (£)
Sky Sports Mix	17.89	20.39	-2.50
Sky Movies Mix	16.95	16.59	0.36
Sky Sports Mix & Sky Movies Mix	23.49	25.40	-1.91

Notes: Excluding VAT at 17.5%, weighted average across Virgin Media’s packages

The rate-card price of Sky Sports Mix includes the price of Sky Sports Xtra which is charged as a separate price.

Prices and subscriber numbers are for Virgin Media’s M, L and XL digital products. Prices and subscriber numbers for analogue, legacy and other packages are not included in this calculation. Prices are as of January 2010. Subscriber numbers are as of June 2009.

¹⁰⁰³ Sky response to Third Pay TV Consultation, paragraph 6.23.

¹⁰⁰⁴ Virgin Media response dated 1 December 2009 to information request dated 29 October 2009, question 5.

¹⁰⁰⁵ Ibid.

¹⁰⁰⁶ [X].

7.271 Figure 115 shows that Virgin Media's incremental prices are considerably higher than Sky's for its M package. Figure 117 shows that the additional price of Sky Core Premium channels is lower for Virgin Media's XL customers than for its M package customers, although they are still higher than the additional price to Sky customers.

Figure 115 Package prices for Sky (1 Mix) and Virgin Media (M)

	Sky	Virgin Media (with phone or broadband)*	Virgin Media (as stand alone TV)*
Basic	£18.00	£5.50	£11.50
Basic + Sky Sports	£36.00 (+£18)**	£29.50 (+ £24)	£35.50 (+£24)
Basic + Sky Movies	£34.00 (+£16)	£32.00 (+£26.50)	£38.00 (+£26.50)
Basic + Sky Sports and Movies	£43.50 (+£25.50)	£39.00 (+£33.50)	£45.00 (+ £33.50)

Notes: Prices correct as of March 2010. Packages are not directly comparable. Sports and Movies refer to Sky Core Premium Channels.

Based on a Sky entry level basic pay TV package of £18 per month.

Based on a Virgin Media's M+ pay TV package (and excludes a phone line).

Figure 116 Package prices for Sky (6 Mix) and Virgin Media XL

	Sky	Virgin Media (with phone or broadband)*	Virgin Media (as stand alone TV)*
Basic	£23.00	£23.00	£29.00
Basic + Sky Sports	£41.00 (+£18)**	£43.50 (+ £20.50)	£49.50 (+£20.50)
Basic + Sky Movies	£39.00 (+£16)	£42.50 (+£19.50)	£48.50 (+£19.50)
Basic + Sky Sports and Movies	£48.50 (+£25.50)	£50.50 (+£27.50)	£56.50 (+ £27.50)

Source: Ofcom, company websites

Note: Updated 22 February 2010

** For Virgin Media's XL*

***Figures in parentheses show additional cost above basic package prices*

7.272 Sky argued¹⁰⁰⁷ that a third party platform operator did not have the same incentives as Sky to invest in marketing Sky's channels, and that this could be exacerbated where the third party had higher margin products such as telephony and broadband.

7.273 In our Third Pay TV Consultation¹⁰⁰⁸, we noted that Virgin Media's view was supported by the evidence that:

- If one of its basic customers upgraded to Sky Sports, the value of that customer would fall by around 17%.
- Reflecting this, Virgin Media offered its sales staff much lower commission (one "sales commission point") for adding Sky Sports or Movies than for selling a basic package (six points) or upselling to its XL TV package (ten points).

7.274 We also presented a comparison of the incremental price of Sky Core Premium channels on Virgin Media and the rate-card charge for these channels, which supported Virgin Media's assertion that it earned a negative (incremental) margin on these channels¹⁰⁰⁹. A comparison of Sky and Virgin Media's retail prices showed that the incremental retail price of packages including these channels was higher on Sky than on Virgin Media.

7.275 Sky said¹⁰¹⁰ that even if it set prices which Ofcom considered to be high, the reason was to maximise revenues, not to restrict supply. It said Ofcom's inference that Sky's prices were set so that Virgin Media did not have an incentive to market Sky's channels appeared to be based on our belief that Sky's prices just met the conditions of a margin squeeze test, and our claim that Sky acknowledged that Virgin Media did not have an incentive to market these channels. It said neither of these statements had any basis in fact.

7.276 In our pricing analysis, wholesale prices calculated using an approach similar to the OFT's 2002 margin squeeze test, are on average above Sky's current wholesale rate-card¹⁰¹¹. This calculation is based on Sky's scale. Virgin Media, by contrast, has fewer than [X]% of Core Premium channel subscribers¹⁰¹² (albeit that Sky and Virgin Media have a similar number of basic subscribers). We recognise that Sky did not say that third party retailers (such as Virgin Media) did not have an incentive to invest in Sky's channels¹⁰¹³, but rather that they did not have the same incentive as Sky. Sky said this was because Virgin Media incurred an incremental cost per subscriber for selling Sky's channels, whereas Sky incurred no such incremental cost. (This is the double marginalisation effect, described in paragraph 4.88).

¹⁰⁰⁷ Sky response to Pay TV complaint, October 2007, paragraphs 4.17(b) and (c).

¹⁰⁰⁸ Paragraph 6.113.

¹⁰⁰⁹ Third Pay TV Consultation, paragraph 6.114.

¹⁰¹⁰ Sky response to Third Pay TV Consultation, paragraphs 6.108, 6.109.

¹⁰¹¹ See Figure 115 in Section 10.

¹⁰¹² As at June 2009.

¹⁰¹³ We erroneously attributed this view to Sky in paragraph 6.111 of the Third Consultation.

- 7.277 We recognise that any wholesale supply arrangement will give rise to weaker incentives to sell to marginal customers than a vertically-integrated firm would have (because of double marginalisation). However, given the high fixed costs at wholesale level, we would expect a vertically-separate wholesaler to have a strong incentive to expand the market. As such, we would expect such a wholesaler to set prices to Virgin Media which would maximise revenues, taking account of the risk of cannibalisation from satellite. It would not set satellite retail prices and then use those prices to calculate wholesale cable prices according to a margin squeeze test.
- 7.278 Sky said¹⁰¹⁴ that it had acquiesced to a proposal by Virgin Media to provide Sky's premium channels to UK residential customers via a Luxembourg subsidiary of Virgin Media. Sky argued that this showed it had supported actions which increased Virgin Media's incentives to invest in marketing Sky channels. Sky has not argued that it faced any costs as a result of this change of arrangement. Nor did Sky mention any objective reason it could have given for refusing Virgin Media's request. While it appears that Sky did not unreasonably obstruct Virgin Media in this matter, we do not see this as positive evidence that it has attempted to strengthen Virgin Media's incentives to market Sky's channels.
- 7.279 Sky further argued that Virgin Media's particularly poor recent performance in selling Sky's Core Premium channels was likely to have been due in part to a focus on other priorities, such as restructuring its debt, rebranding its services, upgrading its network, launching 50Mbps broadband, improving customer services, consolidating its billing system and integrating Virgin Media Mobile¹⁰¹⁵.
- 7.280 It is not clear how the efforts of Virgin Media's sales staff in selling Sky channels has been affected by the company being focused on other priorities. Indeed, if one of these priorities has been to improve customer services, one might have expected this to lead to greater success in upselling additional channels. Nor has this apparent lack of focus led to a reduction in Virgin Media's broader customer base.
- 7.281 Despite its claim that Virgin Media's focus has been on other priorities, Sky argues that Virgin Media undertakes significant marketing of Sky's premium channels in order to attract new customers¹⁰¹⁶. In support of this claim, Sky provided us with examples of Virgin Media's recent marketing material.
- 7.282 Most of the Virgin Media marketing material provided by Sky mentions Sky Sports and Movies, with varying degrees of prominence. This is not surprising given that, as we have argued, this content is a key driver of demand for pay TV. However, we note that in almost all of the marketing material provided by Sky, Virgin Media does not mention the price of Sky's Core Premium channels, but notes that they are available "for an additional monthly charge" (or similar wording). In our view, this approach is consistent both with Virgin Media recognising the need to signal the availability of Sky's Core Premium channels to prospective customers, and with it being unable to promote them at competitive prices. In contrast, recent marketing material from Sky

¹⁰¹⁴ Sky response, footnote 98.

¹⁰¹⁵ Sky response to Third Pay TV Consultation, paragraph 6.113.

¹⁰¹⁶ Sky acknowledges that Virgin Media has not made similar efforts to market Sky's premium channels to its (Virgin Media's) basic subscribers.

aimed at Virgin Media's customers¹⁰¹⁷ highlights a price comparison which includes Sky Movies 1.

- 7.283 Sky further argued that the profit which Virgin Media makes by upgrading its basic customers is a function of how Virgin Media sets its basic TV pricing. It noted that the price of Dual Sports ranged from £26 per month with Virgin Media's M tier to £19 per month when purchased through the XL tier¹⁰¹⁸.
- 7.284 Sky is correct that the incremental price of its Core Premium channels varies considerably between different Virgin Media offers, as illustrated in Figures 113 and 114 above. However, even Virgin Media's XL package has a higher incremental price than Sky, and this is reflected in substantially lower penetration rates.
- 7.285 Sky is also correct that Virgin Media's profit from upgrading its basic customers is partly a function of its basic TV pricing. If Sky's wholesale prices are at a level that complies with an ex post margin squeeze test, then it should be profitable for a firm of Sky's scale to supply an equivalent bundle of basic and premium content. In principle, if Virgin Media were of the same scale as Sky, it would be able to match Sky's incremental retail prices for premium channels by cutting the price of its standalone basic packages.
- 7.286 However, even if Sky passes the margin squeeze test on a bundle which is based on its scale, Virgin Media is likely to struggle to compete at this wholesale price because of its smaller scale. As we have explained above, any competitor – Virgin Media included – would be unlikely to be able to achieve Sky's current scale, given Sky's current share of the market. There is only room in the market for one firm with Sky's current scale.
- 7.287 Sky told us that it had sought to increase Virgin Media's incentive to sell Sky's premium channels by offering lower wholesale prices in return for improved performance. Sky referred to an earlier document it had sent us¹⁰¹⁹ which in turn referred to a 2007 correspondence, initiated by Virgin Media, which sought an "improved relationship in respect of Sky's content".
- 7.288 [X]¹⁰²⁰. [X]¹⁰²¹: [X].
- 7.289 [X], we note that (a) regulatory approval was not a legal requirement, and in the previous negotiations with ntl and Telewest, Sky's view of the regulatory comfort it needed differed from that of the cable firms, (b) we consider Sky's argument that Virgin Media controls its own basic prices, and therefore its margin on premium channels, to be spurious; and (c) it was impossible for Virgin Media to verify Sky's claim that it was able to make a profit on its own notional wholesale price (and it is also impossible for us to verify this claim: see paragraph 7.265).

¹⁰¹⁷ "11 reasons to say 'goodbye' to Virgin Media (and 'hello' to Sky), September 2009.

¹⁰¹⁸ Sky response to Third Pay TV Consultation, paragraph 6.114.

¹⁰¹⁹ Paragraph 5.12 of Annex 5.1 of Sky's Response to the Complaint.

¹⁰²⁰ Sky response to info request dated 17/04/09 Annex 1 question 4.

¹⁰²¹ Sky letter 30 August 2006.

7.290 We conclude that the high wholesale prices Virgin Media pays limit its incentive and ability to compete effectively with Sky in selling premium channels, and that this contributes to its low penetration of premium subscribers.

Supply of Sky's HD Core Premium channels and interactive services to Virgin Media

7.291 Our Third Pay TV Consultation noted a further potential concern relating to the non-supply of Sky HD services to Virgin Media¹⁰²². [X]¹⁰²³.

7.292 [X]¹⁰²⁴, [X].

7.293 As Sky pointed out¹⁰²⁵, in the Second Pay TV Consultation¹⁰²⁶ we noted that the quality of content was of primary importance in attracting viewers. We said that content was more important than platform features (such as EPGs, DVRs, VoD and HD), which added to convenience or, in the case of HD, to technical quality. We noted that if customers did not want to watch a programme, then the ability to watch it in HD would not change their minds.

7.294 In our Third Pay TV Consultation we noted that this view was set out in the context of discussing the importance of premium content, and we continued to see Core Premium content as a key driver of platform choice. However, where the same content was available on two platforms, as Sky's Core Premium content is on satellite and cable, then the customer's choice would be determined by other factors, such as the availability of that Core Premium content in HD..

7.295 In this context, we said, the availability of services such as HD could well make the difference between a customer choosing one platform or another. As such they could be of crucial importance to the competing platform providers.

Evidence of the importance of HD content

7.296 In the course of its response to our Second Consultation, Sky commented that "Such has been the consumer demand for HD that Sky+ HD is the fastest selling additional TV product ever offered by Sky"¹⁰²⁷. Sky has recently promoted this service with the slogan "High Definition. Now it's for everyone". A recent Sky marketing pamphlet sent to Virgin Media customers¹⁰²⁸ included an illustration comparing the 34 HD channels available from Sky (including Sky's Core Premium channels) with the seven HD channels available from Virgin Media.

7.297 [X]¹⁰²⁹.

7.298 Our 2009 Omnibus Survey indicated that around three in ten Sky HD customers saw HD as crucial. Similarly, three in ten respondents to the survey would not have

¹⁰²² Third Pay TV Consultation, paragraph 6.115.

¹⁰²³ Virgin Media response to Second Pay TV Consultation, paragraph 7.38.

¹⁰²⁴ Sky response to Second Pay TV Consultation, Section 7, paragraph 8.6.

¹⁰²⁵ Sky response to Second Pay TV Consultation, Section 7, paragraph 8.6.

¹⁰²⁶ Paragraph 3.36.

¹⁰²⁷ Sky response to Second Pay TV Consultation, Section 2, paragraph 2.22.

¹⁰²⁸ "11 reasons to say 'goodbye' to Virgin Media (and 'hello' to Sky), September 2009.

¹⁰²⁹ High Court proceedings.

chosen their pay TV provider (in most cases Sky) if HD services had not been available. Again similarly, two in ten HD customers said they would not consider downgrading to SD even if the price difference went up to £30 a month. These results support the view that a substantial minority of customers see HD as important, and this is likely to mean that having limited HD content would put Virgin Media at a competitive disadvantage¹⁰³⁰.

Negotiations for supply of Sky's HD Core Premium channels

7.299 Sky told us that in March 2009 Virgin Media had sent it a Request for Proposal which stated that Virgin Media was “now keen” to receive proposals from HD content providers.¹⁰³¹ Sky said it had replied, [X].

7.300 [X].

7.301 [X]¹⁰³² [X].

7.302 Both Sky and Virgin Media provided us with correspondence relating to negotiations between the Sky and Virgin Media and, earlier, Sky and ntl, which included discussion of HD supply, notably:

- [X]¹⁰³³.
- [X]¹⁰³⁴.
- [X]¹⁰³⁵.
- [X]:
 - [X].
 - [X].
 - [X].
 - [X].

¹⁰³⁰ Sky said this survey provided no support at all to the view that its HD services were of sufficient importance to warrant regulatory intervention. (Comments by Sky on consumer research undertaken by Ofcom in October and November 2009 (March 2010), paragraph 54). We address Sky's arguments in Annex 6, Appendix 5.

¹⁰³¹ Sky response to Third Pay TV Consultation, paragraph 6.118.

¹⁰³² Virgin Media response dated 25 November 2009 to Ofcom information request dated 29 October 2009.

¹⁰³³ Sky response dated 1 December 2009 to Ofcom information request dated 27 November 2009, Annex 7 to Question 27.

¹⁰³⁴ Virgin Media response dated 21 February 2008 to Ofcom information request dated 20 December 2007, Annex 8.

¹⁰³⁵ Sky response dated 17 April 2009 to Ofcom information request dated 20 March 2009, Annex 1, question 4.

7.303 [X]¹⁰³⁶ [X].

7.304 Discussions between Virgin Media and Sky are ongoing. At the time of publication no agreement has been reached.

Our view

7.305 [X].

7.306 In our view, Virgin Media's 2007 request for wholesale supply of Sky's HD channels was a genuine opportunity for Sky to make its HD premium channels available to Virgin Media. Sky's response raised security issues and questioned whether such a deal (either with a wholesale or with a self-retail model) would be worth the endeavour given Virgin Media's public statements ascribing very little value to HD. However, nothing in the response indicates that it would not have been possible for Sky to take advantage of this opportunity had it wished to do so.

7.307 Instead of engaging with this opportunity, Sky's response raised a series of obstacles to a wholesale agreement taking place, and put the onus firmly on Virgin Media to overcome them.

7.308 Moreover, in its written response Sky did not make any concrete proposals, or even suggestions, as to how Virgin Media could address its concerns.

7.309 Likewise it is not clear how Virgin Media could have demonstrated to Sky's satisfaction that sufficient extra revenue would be generated by the proposal, or that Sky would be better off under a wholesale arrangement than a retail arrangement, given the inherent uncertainty of launching a new service.

7.310 While Sky's response left open the possibility of further discussion of these issues, we consider that it also signalled that Sky would be unlikely to take a constructive approach in any such discussions. Sky's repeated emphasis on a remark made by a Virgin Media executive at a trade conference further indicates its negative view of the proposal.

7.311 Negotiations between Sky and Virgin Media since early 2009 appear to have developed considerably from Sky's position in 2007. However, these have not yet led to agreement, and, as Virgin Media notes, Sky's security concerns have not yet been resolved. It is unclear whether Sky would have an incentive to reach an agreement following the conclusion of Ofcom's market review.

7.312 Our view is that, given the increasing importance of HD as a means of viewing premium content, the non-supply of the HD versions of Sky's Core Premium channels to Virgin Media is and will prevent Virgin Media from competing effectively.

¹⁰³⁶ Information request response, 1 December 2009.

Choice

Introduction

8.47 In Section 2¹¹¹² we set out the criteria by which we judge whether TV markets are functioning well for consumers. We said we would expect to see:

- 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.

8.48 Against some of these criteria, it is clear that the TV markets are functioning well for consumers. Pay TV has helped deliver a wide variety of high quality content and we believe that this will continue. Twenty years ago consumers only had access to four or five channels. Consumers now have access to a range of high quality content from a range of broadcasters. Pay TV operators have also invested substantially in content. Sky has been central to this, as we can see from the data we set out in Section 4 on expenditure on content.

8.49 In addition to analogue broadcast TV, viewers can access satellite, cable, IPTV and DTT services, although cable and IPTV have more limited coverage. Cable's coverage is 49% of households and IPTV's coverage is 39% and it largely overlaps with cable¹¹¹³. Looking forward there are likely to be new internet delivered services such as Canvas which will be able to deliver a wide range of content on-demand direct to the TV.

8.50 As we set out in paragraphs 5.142 to 5.146 of our Third Pay TV Consultation, though the costs of switching between retailers and platforms vary, if switching does not require purchase or installation of equipment, the cost to households and/or retailers will be limited. Where new equipment is required, the cost will vary. Whether it is seen as significant or not will depend on the context – for example switching costs may be at a level which would not prevent entry by a substantially better service, but which may limit competition at the margin (e.g. because consumers would not switch to a similar service at a slightly lower prices). However, restricted supply of Core Premium channels limits the scope for switching, because many subscribers would not switch to a service which did not carry them.

8.51 Different platforms have different technical characteristics, coverage and costs. Sky¹¹¹⁴ and BT¹¹¹⁵ have told us that some consumers have a preference for particular delivery platforms. Where supply of content is restricted to specific platforms, consumer choice of platform is distorted as consumers have to trade off their preference for platform features over their preference for content. Sky supplies SD

¹¹¹² See paragraph 2.16.

¹¹¹³ Both cable and IPTV target major conurbations.

¹¹¹⁴ Sky response to Ofcom's Second Pay TV Consultation Section 5, paragraph 2.2.

¹¹¹⁵ BT response to Ofcom's Second Pay TV Consultation paragraph 2.11.

versions of its Core Premium channels to cable firms, but without interactivity features or, to date, HD versions of the channels.

- 8.52 As the range of platforms and devices grows, the potential choice for consumers is also growing. If provision of Core Premium channels continues to be limited as we have described, the difference between this potential choice and the actual choice for consumers will widen.
- 8.53 In well functioning markets operators compete with each other to attract customers by differentiating their products from each other. In such markets consumers are offered a wide array of choice as firms attract new consumers to the market and try to win each other's customers. However Sky's control over the content that is a key driver of demand for pay TV, namely Core Premium channels, means that consumers can be denied their preferred choice of retailer, package or platform. Sky's enduring market power in wholesale markets for Core Premium channels means that the normal competitive process is not effective to improve outcomes for consumers.
- 8.54 In the sub-sections below we summarise our evidence on consumers' preferences for Sky's Core Premium channels and preferences for platform characteristics that we set out in Sections 4, 5 and 6. We then describe six sources of distortion of choice that result from Sky's approach to supplying its channels.
- Restricted wholesale supply to DTT retailers.
 - Restricted wholesale supply to other platforms.
 - Limited range of packages available to consumers.
 - Lack of supply of interactivity features on Core Premium channels and lack of supply of HD Core Premium channels.
 - Restricted ability and lack of incentive for Virgin Media to retail Core Premium channels.
 - Potential for Sky to distort triple play bundles.

Importance of Core Premium channels

- 8.55 As we have set out in previous Sections, channels that show live premium sports and recent blockbuster movies are key drivers of demand for pay TV as they are highly valued by consumers and broadcasters. For example in Section 4 we have described the importance to consumers of certain types of premium sports and movies content, such as live Premier League football, or recent Hollywood blockbusters¹¹¹⁶. We have cited evidence on consumers' preferences, the price of rights for certain sports and movies rights, and the statements of industry players. We have then explained that Sky aggregates the majority of this highly valuable content on its Core Premium channels: Sky Sports 1 and 2; and Sky Movies channels.
- 8.56 In Sections 5 and 6 we have set out our evidence that the aggregation of the majority of live premium sports content and recent blockbuster movies on just a few channels means that marginal consumers have few close alternatives for these channels. In

¹¹¹⁶ Paragraphs 4.103 to 4.155.

the case of sports we have said though some live sport is broadcast on FTA, it is only a moderate substitute for the content on Sky Sports 1 and 2 or ESPN. In the case of Sky Movies, we have recognised that consumers have a wide range of options for watching new blockbuster movies, but have concluded that the relevant market comprises retail bundles including Sky Movies. We have said that PPV Movies, Disney Cinemagic, FTA / basic movie channels, movies on other FTA channels, online DVD rental and retail Pay TV DVDs are moderate substitutes, but that they lie outside the relevant market.

- 8.57 The importance of premium content and the lack of close substitutes for Core Premium channels, mean that there is a significant impact on consumers where supply of these channels is restricted.

Preferences for platforms

- 8.58 In Section 4 we have set out some of the characteristics of different TV platforms¹¹¹⁷. When choosing a TV service consumers will trade off the different options available to them. Important factors in consumers' decisions, in addition to availability and price, appear to include:

- Choice of channels; if consumers value a wide choice of channels, Sky or Virgin Media may be appropriate.
- The availability of true VoD content; if consumers value this feature Virgin Media, Tiscali / TalkTalk TV or BT Vision may be appropriate.
- Ease of set up and no minimum term contract; if consumers value these features then Top Up TV may be appropriate.

- 8.59 In response to our previous consultations BT and Sky both told Ofcom that consumers have preferences for particular platform features. Sky said that it "believes that making its content available across a variety of platforms increases demand because a significant number of consumers have strong preferences as to which platform they use, or are restricted as to which platforms are available to them"¹¹¹⁸. BT said in response to our Third Pay TV Consultation that "[e]ach platform technology has different strengths and weaknesses, which will appeal more closely to the preferences of different groups of consumers"¹¹¹⁹.

Restricted wholesale supply to DTT retailers

- 8.60 The previous two sub-sections have set out the importance of Sky's premium channels to subscribers and consumer preferences for different platforms. In this sub-section we consider whether the restricted wholesale supply of the channels to retailers on DTT has led to significant consumer harm because many consumers are unable to subscribe to their preferred channels on the platforms that they want to. As we have set out in Section 7, distribution of Sky's Core Premium channels is limited

¹¹¹⁷ Paragraphs 4.38 to 4.73.

¹¹¹⁸ Sky response to Ofcom's Second Pay TV Consultation Section 5, paragraph 2.2.

¹¹¹⁹ BT response to Ofcom's Second Pay TV Consultation paragraph 2.11.

to certain platforms and in particular is excluded from the most popular platform: DTT¹¹²⁰.

- 8.61 The historic importance of terrestrial television means that, despite the increasing importance of new distribution technologies, DTT still has several important characteristics – high coverage, widespread availability of DTT-capable receivers, and low set-up costs.
- **Coverage.** DTT has high coverage of 73% of homes pre-digital switch-over rising to 98.5% of homes by 2012¹¹²¹.
 - **Availability of DTT receivers.** Approximately 18.2 million homes (or 71% of all homes) have DTT on at least one set in their house and 9.7 million (or 38%) use DTT on the main set¹¹²². It is therefore clearly an important distribution technology for TV retailers wishing to enter or expand.
 - **Set-up costs.** For most homes the set-up costs of DTT are low. Consumers can buy a set top box and plug it directly into their existing TV aerial without the need for specialist assistance (for example to erect a satellite dish or to connect to a cable network)¹¹²³.
- 8.62 The high coverage provided by DTT means that for many households it is currently the only potential alternative to satellite TV. The non-availability of premium content on DTT, together with the fact that only around half of all homes are in areas where cable or IPTV is available¹¹²⁴, means that around half of UK households only have a single option¹¹²⁵ for subscribing to a traditional broadcaster's pay TV service which includes premium content. We recognise that it is possible to subscribe to Sky's channels via a broadband connection, and for some this may be a viable alternative. However, the low take up (in October 2009 there were only [3<]¹¹²⁶ subscribers to Sky Player) suggests it is currently not an attractive alternative for most households. This is supported by recent qualitative research (see paragraph 7.208).
- 8.63 Even where other distribution technologies are available, the low set up costs on DTT as compared to other distribution technologies mean that it is a particularly important platform for TV retailers hoping to sell services to new consumers.

¹¹²⁰ Paragraphs 7.34 to 7.35.

¹¹²¹ Figures refer to England only. Coverage varies around the country and only 90% of homes will be able to receive all channels by 2012. Source: Ofcom fact sheet on coverage No. 3. <http://www.ofcom.org.uk/research/tv/reports/dsoind/factsheets/no3factsheet.pdf>

¹¹²² Source: Ofcom, Digital Progress Report, Digital TV, Q3 2009. http://www.ofcom.org.uk/research/tv/reports/dtv/dtv_2009_q3/dtv_2009_q3.pdf

¹¹²³ See Figure 5 for a description of the set up costs.

¹¹²⁴ Cable is available to 49% of households and IPTV is available to 39% of households. Both platforms target major conurbations and there is likely to be significant overlap in each platform's availability.

¹¹²⁵ Some of these households may not be able to access Sky satellite either, because of technical or other restrictions.

¹¹²⁶ Sky response to question 31 of Ofcom Information request dated 13 October 2009 Q1, Annex 4,

- 8.64 This is illustrated by DTT-based pay TV retail offerings, such as those offered by Top Up TV, and Sky's Picnic proposal.
- 8.65 It is also illustrated by the fact that some retailers whose primary focus is on IPTV transmission technologies, such as Tiscali / TalkTalk TV and BT Vision, have adopted hybrid platforms which also exploit DTT. These platforms offer linear channels via DTT alongside content delivered via IPTV. Looking forward this may become an increasingly important model for retailers who wish to offer both linear channels and on-demand content, for example delivered using the proposed Canvas service.
- 8.66 There is evidence from a range of sources that there is unmet demand for Sky's Core Premium channels on DTT:
- Sky's business plan for Picnic estimated (in April 2008) that around [X] households would subscribe to premium content on its proposed Picnic service within three years of launch, an equivalent of around [X] per cent of DTT households, and [X] within five years¹¹²⁷.
 - Early research for Sky relating to its planned Picnic service suggested that a proportion of customers for the proposed service would come from Sky's satellite customers¹¹²⁸. [X].
 - A recent UBS¹¹²⁹ report found that around 15% of DTT households (about 1.5 million) would be "very interested" in a "best of Sky" service on DTT, and around a further 20% (or 2 million) "somewhat interested".
 - A survey by O&O¹¹³⁰ found that:
 - There was potential demand for Sky's premium channels from Freeview households. O&O asked respondents for their interest in "a package of premium Sky services including Sky Sports 1&2 and the main Sky Movies channels". At a price of £25, 13% were interested; at a price of £15, 18% were interested.
 - Switching from cable and satellite to DTT: O&O suggest that, at a DTT premium price of £25, 6% of Sky customers and 4-5% of Virgin Media customers would be likely to switch away from their services. Three quarters of those switching from Sky, and half of those switching from Virgin Media, would be premium subscribers.

¹¹²⁷ Sky response to question 3 of Ofcom's information request of 29 October 2009.

¹¹²⁸ Spot Market Sizing Debrief, Incite Marketing Planning, May 2007; Quantitative Omnibus Research Findings, Sky, January 2007.

¹¹²⁹ UBS Investment research, 3 August 2009 "The Sky is still blue, just bigger". Figures based on visual interpretation of Chart 4.

¹¹³⁰ "Battling for the Media Consumer 2009 – UK Media in the On Demand Age", Oliver & Ohlbaum Associates, December 2009, slides 8 to 10. Survey conducted by Fly Research; internet survey of 2600 UK consumers, representative of the UK population.

- One recent study¹¹³¹ by Execution Noble assessed the propensity of current subscribers to Sky's premium channels on Sky and Virgin Media to switch to BT Vision if it were to offer Sky Sports 1 for £15:
 - About 10% of Sky's premium sports subscribers might consider switching to Sky Sports 1 on BT Vision; and only 17% would definitely switch¹¹³². Looking at the overall subscriber base, about 5% of all Sky and 4% of Virgin Media customers might consider switching to BT Vision¹¹³³.
 - About 3% of Virgin Media consumers would consider switching to BT Vision¹¹³⁴.
- 8.67 In the quantitative part of our impact assessment, we estimate that by the end of the fifth year of the proposed remedy, DTT / IPTV retailers would serve 1.8 million customers taking Core Premium channels. Of these, we estimate that Picnic would serve around [X] customers. We estimate that Sky would serve around 0.6 million fewer customers taking Core Premium channels on satellite.
- 8.68 If Picnic alone was to retail on DTT / IPTV, we would expect fewer subscribers to Core Premium channels on the platforms, with Picnic serving [X] households. We would expect more retailers, offering greater variety to consumers, to attract more consumers to the market; additionally, non-Sky retailers will have a greater incentive to compete aggressively for customers, as they do not risk cannibalising an existing premium subscriber base.

Conclusion on distortion from lack of supply on DTT

- 8.69 The surveys highlight the potential unmet demand for Sky's Core Premium channels on DTT. This data (which is also discussed in our impact assessment¹¹³⁵) suggests that a significant number of households who do not subscribe to satellite or cable services would like to have access to Sky's Core Premium channels on DTT. There may be a number of reasons why consumers might prefer to take premium channels via DTT:
- They might not want or cannot have a satellite dish.
 - They might not want to be tied into a long-term subscription.
 - They might be more attracted to the kinds of low-cost packages typical of DTT, with low switching costs from existing free-to-air terrestrial services.

¹¹³¹ Execution Noble, Company Insight, Media, 08 February 2010, "BSkyB, All change, no change", and Company Insight, Telecommunications, 08 February 2010, "Virgin Media, Solid outlook for 2010".

¹¹³² Execution Noble, Company Insight, Media, 08 February 2010, "BSkyB, All change, no change", and Company Insight, Telecommunications, 8 February 2010, (figure 2, "maybe"); (figure 2, "definitely").

¹¹³³ Backtesting has been used to adjust the responses from the survey to consumers' actual behaviour.

¹¹³⁴ Execution Noble, Company Insight, Media, 8 February 2010, Company Insight, Telecommunications, 08 February 2010, "Virgin Media, Solid outlook for 2010", page 6 and figure 5.

¹¹³⁵ See Section 11.

- 8.70 Additionally, a small percentage of current Core Premium channel subscribers on cable and Sky would be likely to switch to DTT.
- 8.71 Consumers that either prefer DTT or are unable or unwilling to take satellite or cable are worse off because Sky has restricted wholesale supply of its Core Premium channels to DTT retailers¹¹³⁶. In Section 7 we set out why, if Sky were able to retail on other DTT platforms, this would not be sufficient to alleviate the concerns that we observe¹¹³⁷. We also discuss Sky's entry onto DTT through Picnic in our separate statement¹¹³⁸.
- 8.72 We therefore conclude that the restricted wholesale supply of Core Premium channels to DTT-based platforms has substantially restricted consumer choice and will continue to do so.

Restricted wholesale supply to other platforms

- 8.73 In the Third Pay TV Consultation¹¹³⁹ we said that our concerns over lack of supply of premium channels on DTT extended to platforms on other distribution technologies where Sky has not offered wholesale supply (such as IPTV where Sky did not offer to wholesale its Core Premium channels to a potential IPTV entrant [X]¹¹⁴⁰). We said that Tiscali / TalkTalk TV (which carries Sky's Core Premium channels on its IPTV platform, but effectively as Sky's agent¹¹⁴¹) had attributed the lack of success of IPTV to a lack of wholesale access to premium content¹¹⁴².
- 8.74 Sky said that it was untenable to equate unavailability of Sky's channels on DTT with the supply of channels to Tiscali / TalkTalk TV on a Sky By Wire basis¹¹⁴³. It said that Tiscali / TalkTalk TV's relative lack of success cannot be attributed to lack of supply of Sky's channels and that a more likely explanation might be its high costs which prevent it from being an effective alternative to existing platforms¹¹⁴⁴. Sky referred to an assessment of the transmission costs of different distribution technologies elsewhere in the Third Pay TV Consultation¹¹⁴⁵ to suggest that "Ofcom clearly states its view that IPTV is not currently an effective alternative to existing distribution

¹¹³⁶ The research tests consumers' likely demand for premium channels on DTT at various prices. The actual level of unmet demand will depend on the final price offered in the market.

¹¹³⁷ Paragraphs 7.210 to 7.234.

¹¹³⁸ See Picnic Statement.

¹¹³⁹ Ofcom's Third Pay TV Consultation paragraphs 7.71 to 7.73.

¹¹⁴⁰ In Section 7 we also note that Sky has refused to supply Virgin Media's IPTV service.

¹¹⁴¹ Ofcom's Third Pay TV Consultation, paragraph 7.71.

¹¹⁴² [X]

¹¹⁴³ Sky response to Third Pay TV Consultation paragraph 8.13.

¹¹⁴⁴ Sky response to Third Pay TV Consultation paragraph 8.20.

¹¹⁴⁵ Ofcom's Third Pay TV Consultation paragraph 9.132.

technologies and is unlikely to become an important distribution technology until its cost base is reduced”¹¹⁴⁶.

- 8.75 BT highlighted the fixed costs involved in entering TV markets with a new platform. It said it was only by achieving revenue scale that the fixed costs of developing pay TV platforms and propositions can be recovered. It said that without access to Sky’s Core Premium channels it would be unable to build scale required to recover those costs¹¹⁴⁷.

Conclusions

- 8.76 The restricted supply of Sky’s Core Premium channels to other (non-DTT based) platforms also limits consumer choice. Consumers who have preferences for particular platform features, and a demand for these channels, have to make a trade-off between platform and content. This means that some consumers will choose a platform that would not otherwise be their first choice, while others will have their preferred platform but no access to Sky’s Core Premium channels.
- 8.77 For the reasons set out in Section 7, self-retail by Sky on other platforms is not sufficient to mitigate our concerns¹¹⁴⁸. As we said in that Section, Sky is pricing on Tiscali / TalkTalk TV with a view to protecting its satellite business. For example the price of adding Sky Sports Mix to any of Sky’s basic bundles is £18, whereas the price of adding Sky Sports Mix to any of Tiscali / TalkTalk TV’s basic bundles is £29¹¹⁴⁹. If the price differential of Sky and Tiscali / TalkTalk TV’s basic packages reflects differences in quality and characteristics of the products then the difference in the cost of adding Sky Sports on each platform is striking, particularly considering that the quality of the channels on Tiscali / TalkTalk is lower than on satellite (as interactive features are not available). Sky’s pricing on Tiscali / TalkTalk TV is likely to distort choice. For example, some customers who would otherwise choose Tiscali / TalkTalk TV (at the price that an efficient independent retailer would set) are either using the less-preferred satellite platform (distorted choice) or not buying (unmet demand). We therefore attribute the poor penetration of Sky’s channels on Tiscali / TalkTalk TV in large part to Sky’s attitude to supplying as the retailer.
- 8.78 Our comment on the effectiveness of IPTV¹¹⁵⁰ should be seen in its context, which was an assessment of the prospects of entry over different technologies when setting transmission costs for a single (platform neutral) wholesale must-offer price. Clearly, IPTV services are already present in the market. While it is true that IPTV may have higher average transmission costs than satellite, it has different features and capabilities – most obviously true VoD – which satellite is unable to offer.

¹¹⁴⁶ Sky response to Third Pay TV Consultation paragraph 8.20.

¹¹⁴⁷ BT response to Ofcom’s Third Pay TV Consultation paragraph 2.10.

¹¹⁴⁸ Paragraphs 7.210 to 7.234.

¹¹⁴⁹ Prices accessed on 17 February 2010 at <http://www.talktalk.co.uk/tv/buy-talktalk-tv/sports/> and <http://www.sky.com/quickbuy/build>

¹¹⁵⁰ Ofcom’s Third Pay TV Consultation paragraph 9.132.

- 8.79 Furthermore, the ability of IPTV to compete is illustrated by the relative success of IPTV in other countries (such as France, Sweden, or the US)¹¹⁵¹; and the relatively low price of Tiscali / TalkTalk TV's smallest basic IPTV bundle (£26.47) compared with an equivalent bundle on Sky (£32)¹¹⁵². Our view is therefore that there is potential for increased choice through the further development of IPTV services, and that the extent of such development is constrained by the lack of wholesale access to premium channels.
- 8.80 We therefore conclude that the restricted wholesale supply of Core Premium channels to non-DTT platforms has substantially restricted consumer choice and will continue to do so.
- 8.81 We recognise that Sky's Core Premium channels are retailed by Sky through other platforms such as Xbox 360, Fetch TV, broadband-enabled TVs and the internet (via Sky Player). Sky has indicated that it intends to supply its channels via other platforms (such as [X]) ¹¹⁵³. They are also available via mobile services in areas with a 3G connection. However, as we set out above ¹¹⁵⁴, where Sky self retails on other platforms it has the incentive to set prices so as not to disadvantage its own platform (as illustrated by Sky Player pricing) ¹¹⁵⁵. As a result, current demand for these services is very low (for example in October 2009 there were [X] Sky Player subscribers ¹¹⁵⁶, so the availability of Sky's channels on these platforms would not mitigate any concerns about the lack of availability on DTT or other platforms).

Limited range and variety of packages

- 8.82 In our Second Pay TV Consultation we said that retail package innovation around premium channels was limited in the UK. We found that consumer choice may be restricted if that content is only made available via a limited range of content bundles ¹¹⁵⁷. For example, we observed that though Sky offered a wide range of content bundles, the pricing of these encouraged consumers to trade up to a small number of 'big mixes'. We said that the continued prevalence of enforced buy-through ¹¹⁵⁸, and the lack of smaller, entry level "pay TV light" premium packages in the UK (Setanta being the only obvious exception) were examples of the lack of

¹¹⁵¹ For example, IPTV penetration in 2008 was 13% in France and 10% in Sweden, compared with 0.2% in the UK. Source: World Television Markets – Idate (2008). In the US in 2009 there were approximately 5.5m subscribers to IPTV (see paragraphs 4.169 to 4.171 above). As we set out later in this Section we interpret international comparisons with care, as there can a range of historical contextual reasons for differences in penetration.

¹¹⁵² Packages equivalent to those cited by Sky in its response to Ofcom's Second Pay TV Consultation Section 5, Table 1.

¹¹⁵³ Sky response to Third Pay TV Consultation paragraph 8.10.

¹¹⁵⁴ Paragraphs 7.210 to 7.234.

¹¹⁵⁵ See paragraphs 7.220 to 7.221.

¹¹⁵⁶ Sky response to question 31 Ofcom information request of 31 October 2009.

¹¹⁵⁷ Ofcom's Second Pay TV Consultation paragraph 7.33.

¹¹⁵⁸ Ofcom's Second Pay TV Consultation paragraph 7.48.

choice for consumers¹¹⁵⁹. We said this led to consumer harm as subscribers were denied the choice of TV package that would best suit their needs¹¹⁶⁰.

8.83 In response to our Second Pay TV Consultation Sky said that Setanta's entry into the market and its different business model were evidence that the market was working well for consumer and was competitive¹¹⁶¹. Sky pointed to the 1,764 different bundles that if offered to consumers and in particular to the popularity of its smaller packages of basic genre mixes as evidence that consumers had a choice of content¹¹⁶². It drew on a report from PwC¹¹⁶³ which found that the retail of channels on a standalone or à la carte basis or "pay TV light" services was not common in Europe¹¹⁶⁴.

8.84 In response to our Third Pay TV Consultation BT said that there was a "standardised" approach to the business model adopted by pay TV operators which it described as:

- "A set top box is provided free in return for a commitment to a monthly subscription.
- Bundling of basic channels into category bundles with a large number of channels.
- 'Buy-through' to premium channels, requiring customers to subscribe to at least one package of basic channels before being eligible to subscribe to premium channels"¹¹⁶⁵.

8.85 BT argued¹¹⁶⁶ that this business model restricts consumer choice in terms of packages and price points offered compared with a more competitive retail distribution market. It said the aim of the existing business model was to allow incumbent retailers to maximise monthly subscription revenue.

8.86 [X]¹¹⁶⁷:

- [X].
- [X].
- [X].

¹¹⁵⁹ Ofcom's Second Pay TV Consultation paragraph 7.34.

¹¹⁶⁰ Ofcom's Second Pay TV Consultation paragraph 7.54.

¹¹⁶¹ Sky response to Ofcom's Second Pay TV Consultation, Section 5, paragraph 3.40.

¹¹⁶² Sky response to Ofcom's Second Pay TV Consultation, Section 2, paragraph 2.27 and Section 5 paragraphs 3.38 to 3.39.

¹¹⁶³ Annex 1 of Sky's response to Ofcom's Second Pay TV Consultation.

¹¹⁶⁴ Sky response to Ofcom's Second Pay TV Consultation, Section 5, paragraph 3.47.

¹¹⁶⁵ BT response to Ofcom's Third Pay TV Consultation, paragraph 2.22.

¹¹⁶⁶ BT response to Ofcom's Third Pay TV Consultation, paragraph 2.23.

¹¹⁶⁷ BT response to Ofcom's Third Pay TV Consultation, paragraphs 2.23 to 2.24.

- [X].

8.87 BT highlighted the potential increase in competition that could be enabled by Canvas where multiple retailers will be able to access consumers via the service. The more intense competition would mean that “[c]onsumers will be able to choose between any Canvas affiliated ISPs on the basis of their own individual choice criteria – e.g. range of content, nature of market propositions, pricing, innovation, customer service, experience of the organisation in the past, etc.”¹¹⁶⁸.

Conclusions

8.88 The narrow range of retailers supplying Sky’s Core Premium channels limits the variety of packages on offer to consumers. In particular it limits the availability of entry-level packages, which might provide a reduced range of channels, at a lower price than the large bundles which are purchased by most of Sky’s existing customers¹¹⁶⁹.

8.89 There are a number of reasons why package choice is limited which we discuss in turn below:

- Where Sky retails on other platforms it is unwilling to offer prices that cannibalise sales from its satellite platform.
- Where Sky retails on its own platform it has an incentive to maximise revenues by designing pricing structures which incentivise consumers to purchase larger rather than smaller bundles.
- New entrants would have an incentive to target different parts of the market without fear of cannibalising existing revenues.
- The content is not wholesaled to some platforms, which means retailers cannot offer packages designed to suit the platform’s characteristics.
- There is limited competition in the retail supply of Core Premium channels.

Cannibalising satellite sales

8.90 As we have said in Section 7, where Sky retails on other platforms, it sets prices so as not to cannibalise satellite sales¹¹⁷⁰. We have said that Sky’s pricing on Tiscali / TalkTalk TV and the Sky Player service are both examples where the prices are designed not to offer a more attractive package (in either quality or price) than is available on its satellite platform. For example the price of adding Sky Sports Mix to any Tiscali / TalkTalk TV package is £29.00, whereas the price of the same channels to any Sky bundle is £18¹¹⁷¹. The price for Premium channels on Sky Player is only slightly cheaper than the price for a similar bundle on satellite, despite Sky Player’s lower costs (for example lower transmission costs, and no implicit set-top box

¹¹⁶⁸ BT response to Ofcom’s Third Pay TV Consultation paragraph 2.20.

¹¹⁶⁹ [X] % of Sky’s premium subscribers take all six basic mixes (at September 2009).

¹¹⁷⁰ Paragraphs 7.210 to 7.234.

¹¹⁷¹ Prices accessed on 17 February 2010 at <http://www.talktalk.co.uk/tv/buy-talktalk-tv/sports/> and <http://www.sky.com/quickbuy/build>

subsidy included within the retail price), a lower quality picture¹¹⁷² and a narrower range of channels and services offered.

Availability of entry-level packages

- 8.91 The availability of entry level packages has increased in recent years. In 2005, before Sky introduced its current genre basic mixes, [X]% of Sky's subscribers took the equivalent of Sky's Six Mix (its biggest basic package) and there was a "buy through clause" when premium channels were wholesaled, which prevented them being sold on a stand-alone or à la carte basis. Now [X]% of Sky's premium subscribers take a lower basic tier package including a small number (almost [X]) who choose to take premium channels on a stand-alone basis¹¹⁷³ and there is no longer a buy-through clause for its wholesale customers.
- 8.92 However, Sky's current price structure encourages consumers to buy the larger basic mixes, typically bundled with a ("free") set-top box. There is only £6 difference between Sky's largest and smallest basic package when taken with premium channels (customers can take additional basic channels in increments of £1). The low price differential encourages subscribers to trade up to large mixes. On Virgin Media the price difference between the packages including the biggest and smallest basic bundles (when taken with premium channels) is slightly wider at between £11.50 and £17.50¹¹⁷⁴. If channels were retailed in more competitive markets we might observe different price structures and in particular we might see more attractively priced entry level packages. For example, consumers might be able to choose between low priced packages which excluded any set-top box subsidies or higher priced packages which included set-top box subsidies. Alternatively retailers might choose different business models with lower marketing costs and lower prices for consumers.
- 8.93 Entry-level premium channels and services, provided by retailers other than the main provider of Core Premium Channels, are increasingly available in a number of markets in Europe and we discuss some of these in Section 4. Since Sky's PwC report the sector has developed further. For example:
- Orange TV offers entry-level premium channels in France, launching an Orange Sport Channel in August 2008 and Orange Cinema in November 2008. The two services had attracted 663,000 subscribers by Q4 2009, from 130,000 a year earlier¹¹⁷⁵.

¹¹⁷² Sky Player is delivered as an "over the top" internet service and so does not have the quality of service associated with traditional broadcast platforms such as satellite. The user is more likely to experience interruptions or may need to select a lower quality version of the service to avoid interruptions (in Sky Player PC the user is manually able to select "high", "medium" or "low" quality corresponding to 1800 Kbit/s, 1200Kbit/s and 600Kbit/s – the fact that this functionality is provided indicates that some customers will need to select the lower quality feed).

¹¹⁷³ Sky introduced zero mix in September 2009, after one month the total number of subscribers taking this package was [X].

¹¹⁷⁴ Depending on the package chosen correct. Source: <http://allyours.virginmedia.com/websales/service.do?id=1> correct at 16 March 2010.

¹¹⁷⁵ http://www.orange.com/en_EN/press/press_releases/att00014543/CP_FY09_EN.pdf

- Mediapro launched its Gol TV premium channel in Spain in 2009, which had attracted one million subscribers within its first three months of operation. The premium sports channel costs around €15 a month and broadcasts a range of football, including Spanish La Liga and UEFA Champions League. The channel is available on platforms including DTT, cable and IPTV¹¹⁷⁶.
- There is also evidence of established providers of Core Premium Channels looking to cater for an entry-level market for premium sports and movies, Canal Plus in France last year said that it would test weekend subscriptions for around half the price of a standard subscription¹¹⁷⁷.

8.94 If new entrants had wholesale access to Core Premium channels and had the freedom to set retail prices, market the channels and discount in order to win customers, retailers might offer new types of packages. For example, we might see 'season ticket' offers where channels are retailed on a stand-alone basis and paid for with an annual fee (like for example Setanta's season ticket or Sky's PremPlus PPV service). Alternatively, retailers could bundle a year's subscription to a premium channel "for free" with a set-top box as Top Up TV did with Setanta¹¹⁷⁸.

Lack of wholesale access on some platforms

8.95 The particular characteristics of a platform may determine the service that can be offered over it. For example, DTT is relatively capacity constrained (compared with satellite for example). However the one-off set up costs are low (as most consumers can simply plug a set-top box into an existing TV aerial), so retailers on this platform might be more inclined to offer smaller, cheaper packages of channels without the need for long term contracts. [X]¹¹⁷⁹.

8.96 By contrast, Sky's services on platforms other than satellite – such as its Sky Player service and its retail offering via Tiscali / TalkTalk TV – appear to be designed to minimise any competitive constraint on Sky's core satellite offering. As we have explained in Section 7, Sky's prices for both of these services represent considerably poorer value than its satellite offering.

8.97 Some consumers may prefer such a limited, lower-priced service to paying more for a larger suite of channels on a longer contract (e.g. on satellite or cable). As another example, a one-to-one service, such as cable, may be better suited for offering VoD services than a one-to-many service such as satellite and so, other things being equal, may be able to offer such a service more cheaply.

8.98 Looking forward, our concerns are amplified as the scope for new retailers to enter using technologies such as Canvas is increased. New retailers could use this new technology to package the channels in bundles that are currently unavailable. For example, mobile phone operators might offer bundled services of mobile and TV.

¹¹⁷⁶ <http://www.broadbandtvnews.com/2009/12/15/gol-tv-reaches-viewing-milestone/>

¹¹⁷⁷ http://www.digitaltveurope.net/news_articles/jun_09/19_jun_09/canal_plus_launching_weekend-only_pay_tv_package

¹¹⁷⁸ <http://www.digitalspy.co.uk/digitaltv/a118941/free-setanta-for-new-top-up-customers.html>

¹¹⁷⁹ See paragraph 8.86 above.

Lack of competition inhibits range of prices

8.99 Finally, the current structure of retail markets for Core Premium channels means that Sky is not incentivised to offer a wide range and variety of prices and price structures to subscribers. In Sections 5 and 6 we have said that Core Premium Movie and Sports channels are supplied in narrow retail markets where Sky is by far the largest incumbent retailer with a market share of 68% to 85% in the case of Core Premium Sports channels and 38% to 92% in the case of Core Premium Movie channels (depending on the measure used)¹¹⁸⁰. In an effectively competitive market, each retailer would be more strongly incentivised to create packages and price structures designed to attract customers from rivals. For example, Tiscali / TalkTalk TV said [X]¹¹⁸¹.

Conclusion

8.100 We therefore conclude that the lack of wholesale access to Sky's Core Premium channels leads, and will continue to lead, to significant consumer harm in that it inhibits the range and variety of packages on offer to consumers. This means that some consumers chose a package that does not closely reflect their preferences, or that they chose not to consume.

8.101 We have a particular concern this may result in limited availability of entry-level packages, which might provide a reduced range of channels, at a lower price than the large bundles which are purchased by most of Sky's existing customers. This means that some existing customers may be paying more than they would in an effectively competitive market, because they would be better off purchasing smaller packages of channels. It also means that there is likely to be a level of unmet demand among other potential consumers, in particular the 10 million households whose primary means of viewing TV is via free-to-air platforms such as Freeview.

8.102 If there were effective retail competition in the provision of core premium channels we would expect to see a wider range of bundles, packages and price points offered to consumers as set out [X]¹¹⁸².

¹¹⁸⁰ See paragraphs 5.597 to 5.598, and 6.351.

¹¹⁸¹ TalkTalk response to Ofcom information request of 28 October 2009 questions 1 and 2.

¹¹⁸² See paragraph 8.86 above.

HD

- 8.106 HD is clearly a technology suited to watching the highly valued sports and movies content found on Sky's Core Premium channels. This is illustrated by the high propensity of HD subscribers to take Core premium channels. [X]% of HD subscribers take premium channels, whereas only [X]% of SD subscribers take premium channels¹¹⁸⁶.
- 8.107 The ability to view HD channels is of growing importance to consumers. Approximately 17.9 million 'HD-ready' sets had been sold in the UK by Q1 2009 and 33% of households – around 9 million – in the country claimed to have a HD set at the end of 2008¹¹⁸⁷. Around 3.5 million homes were capable of receiving HD at the end of September 2009, either because they subscribed to Sky+ HD or Virgin Media's V+ service; or because they had a Freesat HD set-top box or integrated digital television (IDTV)¹¹⁸⁸.
- 8.108 Our recent research finds that HD is important for a significant minority of premium subscribers. For example:
- 48% of satellite HD premium subscribers (equivalent to about [X] of all premium subscribers) considered HD either important or crucial¹¹⁸⁹.
 - Three in ten HD subscribers (31%) wouldn't have chosen their pay TV provider (in most cases Sky) if HD services hadn't been available. Again similarly, 16% of Sky HD customers would not consider downgrading to SD even if the price difference increased from £10 currently up to £30 a month (while another 4% "don't know")¹¹⁹⁰.
- 8.109 The growing importance of HD can also be gauged by industry participants. For example, according to a recent report by Informa, the president of Astra (the satellite operator) claimed that Sky could switch off its SD service by 2018¹¹⁹¹. In Italy, Sky Italia is reported to have stopped selling SD packages to new subscribers and now

¹¹⁸⁶ Source: Annex 1 of Sky response to question 1 of Ofcom's information request dated 13 October 2009 and Annex 4 of Sky response to question 26 of Ofcom's information request dated 29 October 2009.

¹¹⁸⁷ Ofcom Communications Market Report 2009, pages 75 and 76.

¹¹⁸⁸ See Section 4.

¹¹⁸⁹ Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009. Satellite HD premium subscribers sample size = 97.

¹¹⁹⁰ Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009. HD subscribers sample size = 213. Sky HD subscribers sample size = 191.

¹¹⁹¹ He is quoted as saying "It is unlikely to come straight from them, but if I listen to our sources then Sky will be able to switch off its standard-definition broadcasts by between 2016 and 2018." New Media Markets, 18 November

only sell packages with HD channels¹¹⁹². We consider the importance of HD for retailers further in Section 9.

¹¹⁹² See for example a Morgan Stanley note on the TMT Conference, November 23 2009, page 4. See also: <http://www.sky.it/abbonarsi/promozioni/index.shtml?ref=corporatetab>.

- 8.113 Consumers who value watching Core Premium channels in HD and have a preference for platforms other than Sky's satellite platform will clearly face a detriment by not being able to consume HD Core Premium channels on their chosen platform. Lack of access to HD Core Premium channels will therefore become a barrier to entry and expansion as HD transmission increasingly becomes the standard for delivery of premium channels. The consumer harm we identify therefore relates not just to Virgin Media, where Sky have restricted supply of its HD channels¹¹⁹⁷, but potentially to any platform, whether IPTV or DTT, that seeks access to those channels.
- 8.114 We conclude that the restricted supply of HD Core Premium channels to Virgin Media results, and will continue to result, in significant harm to consumers because it limits choice. This contributes to the low penetration of Core Premium channels on Virgin Media. We would have similar concerns if HD versions of these channels were not made available to other providers.

¹¹⁹⁷ See paragraphs 7.297 to 7.311.

The effect of restricted supply of Core Premium channels on innovation

- 8.187 Section 4 described some of the potential innovations we may see in the near future. For example, we noted that new broadband networks might allow consumers to access a wider choice of content on demand. We identified the potential for greater portability of devices and transferability of content between devices. We also identified a trend towards hybrid devices which combine a traditional broadcasting platform with an IP platform (such as the proposed Canvas service). These types of technologies would be able to provide a more interactive and participatory viewing experience where viewers can talk, text, game or otherwise interact during broadcasts. Where supply of the most important content is restricted, then firms wishing to enter or expand will face a lower incentive to innovate on such devices or platforms.
- 8.188 An assessment of the scope for future innovation is necessarily forward looking and difficult to predict. However we can make the following observations on how lack of supply of Core Premium channels is likely to affect innovation which we discuss below.
- 8.189 **Certain types of content lend themselves directly to certain types of innovation.** For example, a Hollywood movie produced to be viewed in a cinema is more likely to lend itself to HD viewing than a general entertainment programme produced for TV, whilst an interactive betting application or a 'player-cam' service only makes sense in the context of specific sports programming.
- 8.190 Sky's impressive track record in innovation is direct evidence of the importance of Core Premium Channels as an enabler of innovation. [X]% of Sky subscribers purchase Sky Sports either with or without Sky Movies, and a total of [X]% of Sky subscribers are premium subscribers. These subscribers are disproportionately likely to take HD, Sky+ or Multiroom:
- [X] of HD subscribers, for example, are also subscribers to Sky Sports. If we include movies, [X]% of HD subscribers are premium subscribers.
 - [X]% of Sky+ subscribers are also subscribers to Sky Sports. [X] are premium subscribers.
 - [X]% of Multiroom subscribers are also subscribers to Sky Sports. [X] are premium subscribers¹²⁵⁴.
- 8.191 We consider the services were pioneered by Sky partly because it retailed directly to over [X]% of Core Premium subscribers who valued these services. As a result of Sky restricting access to subscribers to Core Premium channels, other retailers are less likely to develop innovative services that particularly appeal to these subscribers.
- 8.192 **There are scale economies to investment in innovation:** Rival retailers wishing to enter the market or expand by offering new innovative services will face a lower incentive to do so without access to Sky's Core Premium channels. This is because without access to Core Premium channels rival retailers are denied access to up to half of all pay TV subscribers (and much more than half of pay TV revenues) and firms will therefore be less able to recover the fixed costs of investment in innovation.

¹²⁵⁴ Sky's response to Q26 of our request of 29th October 2009.

Sky agrees that a lack of investment has limited innovations on other platforms compared with satellite¹²⁵⁵.

- 8.193 Furthermore, restricted access of Sky's Core Premium channels might cause harm to platforms, beyond foregoing the opportunity to supply potential subscribers. For example, in negotiations for carriage of Sky's channels via a potential IPTV entrant [X], a senior executive at Sky [X] outlined the additional benefits that carriage of Sky's Core premium channels brings to platforms (for example on branding), beyond appealing to potential subscribers¹²⁵⁶. We disagree with Sky that other retailers were unwilling to invest in their platforms. Sky itself has pointed out that Top Up TV and BT Vision have invested heavily to launch their platforms¹²⁵⁷. [X]¹²⁵⁸. BT has made a very substantial public commitment to invest in deployment of a new NGA network, providing superfast broadband to 40% of UK households at an estimated cost of £1.5 billion¹²⁵⁹.
- 8.194 However, the scope for further growth and investment is likely to be impeded by the lack of supply of Core Premium channels. For example, after several years of operating and despite the heavy investment in marketing the new entrants such as Top Up TV, BT Vision or TalkTalk TV have only captured around [X]¹²⁶⁰ subscribers between them (equivalent to about [X]% of Sky's subscriber base).
- 8.195 We are mindful that some of the benefits of greater innovation enabled by firms reaching the necessary economies of scale are to some extent dampened as more firms enter the market. While it is not possible to predict the market structure that is most likely to deliver the optimal level of innovation, our view is that a competitive market is much more likely to deliver innovations than a market dominated by a single provider.
- 8.196 **Lack of wholesale access to premium channels has meant that retailers are unable to package in innovative ways** which will distort consumers' choice of packages and lead to unmet demand for Core Premium channels. For example, [X]¹²⁶¹ [X]. In its response to our consultation [X]¹²⁶².

¹²⁵⁵ Sky response to Ofcom Third Pay TV Consultation paragraph 8.23.

¹²⁵⁶ See paragraph 4.117.

¹²⁵⁷ Sky response to Ofcom Second Pay TV Consultation Section 5 paragraphs 3.8 and 3.9.

¹²⁵⁸ BT response to Ofcom's Pay TV consultation paragraph 2.5.

¹²⁵⁹ See for example BT press release dated 09 July 2009.

¹²⁶⁰ Sources: BT response to Ofcom's Third Pay TV Consultation, paragraph 2.5, Tiscali / TalkTalk TV response dated 13 November 2009 to question 3 of Ofcom's information request dated 29 October 2009, Top Up TV's response dated 28 November 2008 to question 1 of Ofcom's information request dated 12 November 2008. Note that subscriber data is taken from October 2009 except Top Up TV which is based on data from October 2008.

¹²⁶¹ Tiscali / TalkTalk TV response dated 13 November 2009 to question 2 of Ofcom's information request dated 28 October 2009.

¹²⁶² [X] response to Ofcom's Third Pay TV Consultation paragraph 2.24 to 2.25.

Superfast broadband, IPTV and VoD

8.197 As discussed in Section 4, superfast broadband, IPTV, and VoD are a set of closely linked technological innovations which have the potential to deliver significant benefits to consumers:

- Superfast broadband networks (i.e. NGA) use various types of fibre network (Fibre to the Home (FTTH) or Fibre to the Cabinet (FTTC)) to deliver greater bandwidth to consumers.
- IPTV platforms use IP technology to deliver TV content to consumers, either in the form of linear channels, or individual items of video content.
- VoD allows individual items of video content to be delivered on demand.

8.198 In the US for example, Verizon's Fios (NGA) service supplies a wide selection of premium channels, HD channels and VoD content over an FTTH network to 3.1 million subscribers.

8.199 IPTV has also proved popular in other countries such as US, France and Germany where access to premium content is not restricted. In Section 4 we have referred to Telefonica in Spain; Freebox TV, Orange TV and Neuf TV in France; and T-Home Entertain in Germany which all offer IPTV services that have high levels of take-up and access to premium channels¹²⁶³.

8.200 These are services which can only be delivered if they reach a significant scale. Scale is particularly important in the context of major new investments in superfast broadband, since the key attributes of these networks are that they provide a very high capacity and have a very high level of fixed cost. Scale is also a material factor affecting investment in new IPTV platforms.

8.201 The investment necessary to deliver superfast broadband will in part depend on the ability to attract a wide range of TV subscribers including subscribers to Core Premium channels. For example in our statement on the provision of superfast broadband we observed that HDTV and IPTV services have played a role in driving demand for NGA services in Europe¹²⁶⁴. On this basis we consider that access to Sky's Core Premium channels is likely to prove important, albeit as one of several potential drivers of demand. Without access to Sky's Core Premium channels development of NGA networks and services will be impeded.

8.202 Superfast broadband networks and IPTV are capable of delivering both linear channels and VoD. VoD services are of particular interest, since they potentially offer consumers greater choice of content, and control over when it is viewed, than is provided by traditional broadcast platforms.

8.203 VoD is a particular example of a delivery mechanism that does not favour satellite. Instead VoD plays to the strengths of the broadband networks operated by BT and

¹²⁶³ Paragraphs 4.164 to 4.172.

¹²⁶⁴ Delivering super-fast broadband in the UK, Promoting investment and competition, 3 March 2009, page 68. See for example: http://www.ofcom.org.uk/consult/condocs/nga_future_broadband/statement/statement.pdf. Page 68.

Virgin Media. Sky has a considerably weaker incentive to encourage the development of VoD services.

- 8.204 While wholesale access to Sky's (linear) Core Premium channels would not lead to the specific content on those channels being provided via VoD, it may still be important as a means of allowing other content to be offered via VoD. This is particularly relevant to hybrid IPTV / DTT platforms, whose DTT offering may depend critically on access to Core Premium channels, and which may also offer a variety of additional VoD services. Both sets of services may be necessary, in order to provide a compelling bundle to individual consumers, and in order that the platform as a whole reaches a viable scale.

Canvas

- 8.205 Canvas provides a more specific example of the type of innovation that will be affected by the restricted distribution of Sky's Core Premium Channels.
- 8.206 Canvas is proposed to be a new open technology that will offer any retailer the ability to offer content over an IP network. Retailers wishing to use the technology will be able to combine services offered over Canvas with other TV and non-TV services on new platforms.
- 8.207 Some of the benefits of Canvas are likely to occur regardless of whether retailers have access to Sky's Core Premium channels. For example the BBC Trust's Public Value Assessment of Canvas argued that it would "enhance the [DTT] free to air offering, helping ensure parity with alternative platforms and delivering the benefits of greater choice"¹²⁶⁵. However, the scope for innovation will be significantly reduced if retailers are unable to access Sky's Core Premium channels. Retailers will face a lower incentive to invest in new and innovative services using Canvas if they are denied access to the significant proportion of high-value consumers who are willing to pay for Core Premium channels.
- 8.208 We disagree with Sky's view that competition among firms using Canvas to supply Core Premium channels will not have any discernable benefits. Wholesale access to Core Premium channels will encourage entry via Canvas, and the existence of multiple retailers competing for consumers will incentivise operators to offer new and innovative services or packages.
- 8.209 We reject Sky's view that a wide choice of suppliers would cause harm to consumers as they would be confused at having to choose their preferred provider. Ofcom's view is that consumers benefit from having a choice of provider. We believe consumers are well served by competitive markets with a range of suppliers where firms differentiate themselves from rivals in order to attract consumers.
- 8.210 We recognise that in markets with multiple providers there will be some duplication of costs, such as marketing, and in our impact assessment we weigh up the potential benefits from greater retail competition and wider choice, against factors such as duplication of costs¹²⁶⁶.

¹²⁶⁵ BBC Trust, 2010, Canvas proposals Provisional conclusions and public consultation: http://www.bbc.co.uk/bbctrust/assets/files/pdf/consult/canvas/canvas_consultation.pdf

¹²⁶⁶ See Section 11.

Sky as a retailer

8.211 We do not think that Sky retailing its channels on other platforms is sufficient to dispel our concerns. As we set out in Section 7, Sky's approach to retailing on other platforms means that other platforms are disadvantaged compared with Sky¹²⁶⁷.

Forward-looking concerns

8.212 Looking forward, an effectively competitive environment with more players is likely to incentivise innovation within the markets. Sky's position as the largest incumbent wholesaler of channels sold within narrow markets means that it is insulated from the normal competitive pressures which usually spur innovation, whereas in a competitive market threat of exit or entry by rivals provides an ongoing incentive to innovate. Furthermore, the existence of more competitors who cater to different sub-sections of the market would be likely to lead to more innovation, as each tries to differentiate its product.

8.213 We recognise that Sky has a continuing incentive to innovate in order to grow the market, for example by selling new services to its existing consumers, or by attracting new consumers to its platform from free-to-air platforms such as Freeview. It also has an incentive to innovate to attract new consumers to its platform from cable.

8.214 However Sky's position as a large incumbent means it will not innovate where it might cannibalise revenues from existing subscribers, and will typically only engage in those innovations that will tend to favour its own platform.

8.215 By contrast in an effectively competitive retail market all firms have a strong incentive to innovate, both to attract customers from their rivals and to expand the market. The incentive not to innovate in a manner that cannibalises existing revenues falls away if all firms have the same opportunity to innovate and target each other's customers.

8.216 Sky did not refute this point in our Third Pay TV Consultation. It responded that¹²⁶⁸ even if innovation on satellite is greater than on other platforms, the absolute level of innovation on other platforms (such as true VoD) is not low in an absolute sense. Our view is that there is no absolute scale against which the level of innovation can be measured, but that a market which is effectively competitive will normally drive substantially higher levels of innovation than one which is not, for the reasons set out above.

Impact of the low margin on Virgin Media's incentive to innovate

8.217 We have considered Virgin Media's claims that the low margin on Core Premium channels has a significant impact on Virgin Media's incentive and ability to innovate (in terms of product or package):

- On the **incentives to innovate in pricing and packaging** referred to by Virgin Media, in principle we accept that a small change to Virgin Media's margin could increase its incentive or ability to innovate in packaging and pricing if the result of the innovation was to increase demand of Core Premium channel subscribers. However, Virgin Media offered no evidence of how it might innovate in terms of

¹²⁶⁷ For example, the cost of adding Sky Sports Mix on Sky is £16 where the cost of adding Sky Sports Mix to a TalkTalk TV bundle is £27.50. See paragraphs 7.210 to 7.234.

¹²⁶⁸ Sky response to Ofcom Third Pay TV Consultation paragraph 8.22 to 8.24.

package and prices if its margin were increased. We therefore do not consider that the low margin offered to Virgin Media has a significant impact on the range and variety of prices that it would offer to consumers. Virgin Media already has access to the channels, so in principle should already be able to use them to develop its own innovations. Other platforms on the other hand are less able to innovate because they are unable to gain access to the Core Premium channels.

- Regarding **the ability of Virgin Media to invest in research and development**, we accept that if a small change in Virgin Media's margin will expand take up in premium channels then it will have an impact on its incentive or ability to invest in research and development. However, Virgin Media has provided no evidence on why it believes that a small change in its variable input costs will affect its returns to investment from existing subscribers.

Conclusion

8.218 We recognise Sky's role in driving forward certain innovations. However, the restricted supply of Core Premium channels diminishes the scope for other retailers to invest in innovative products or services to enter or expand in the market. IPTV, Canvas and NGA are all examples of innovative ways of delivering TV services which will be constrained if retailers are unable to access potential consumers of Core Premium channels.