Sports and general market definition and market power appendices

Annex 4 to Pay TV Statement

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

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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 sports and movies.

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1.2 Some of these appendices deal with topics that only relate to our assessment of sports whereas some material relates to both sports and movies. Material that solely relates to movies is discussed in Annex 5.

Appendix 2

The importance of football

Introduction

2.1 Content is important to pay TV subscribers. For example, we commissioned a further survey[1] which was conducted in October-November 2009, and which asked subscribers which features of their current TV service were most important to them. Three quarters of Sky Sports subscribers mentioned content as among the three most important aspects of their service.[2] Of these subscribers, 62% mentioned Sky Sports 1, 2 or 3 or sports generally as important (47% of all Sky Sports subscribers).

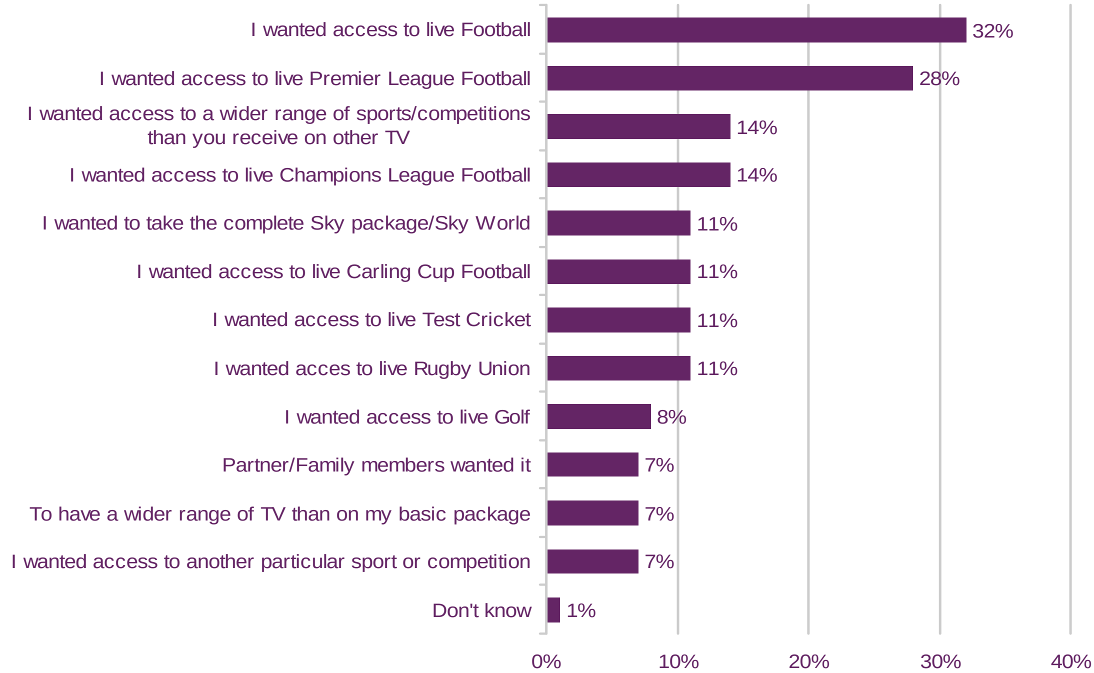
2.2 In this appendix we set out the evidence used in our previous pay TV consultations that shows that the right to show a large number of live football matches between popular teams, and particularly Premier League football, is important for a pay TV proposition. This is because many subscribers (inframarginal and marginal combined) want to watch a large number of matches involving Premier League teams regularly throughout the season. The evidence includes consumer surveys, relative rights values, internal documents and the experience of Setanta.

Survey evidence

2.3 We asked people who subscribe to Sky Sports their reasons for initially subscribing; the results are shown in Figure 1. The two most-mentioned (unprompted) reasons were access to live football in general, followed by access to live Premier League football.

[1] CAPI Omnibus TNS.
[2] *Q.15 Which THREE features of your current TV service from ... are most important to you ? Base: All with Sky, Virgin, Wright Cable, Tiscali or BT Pay TV service. On average, respondents mentioned only two features.*

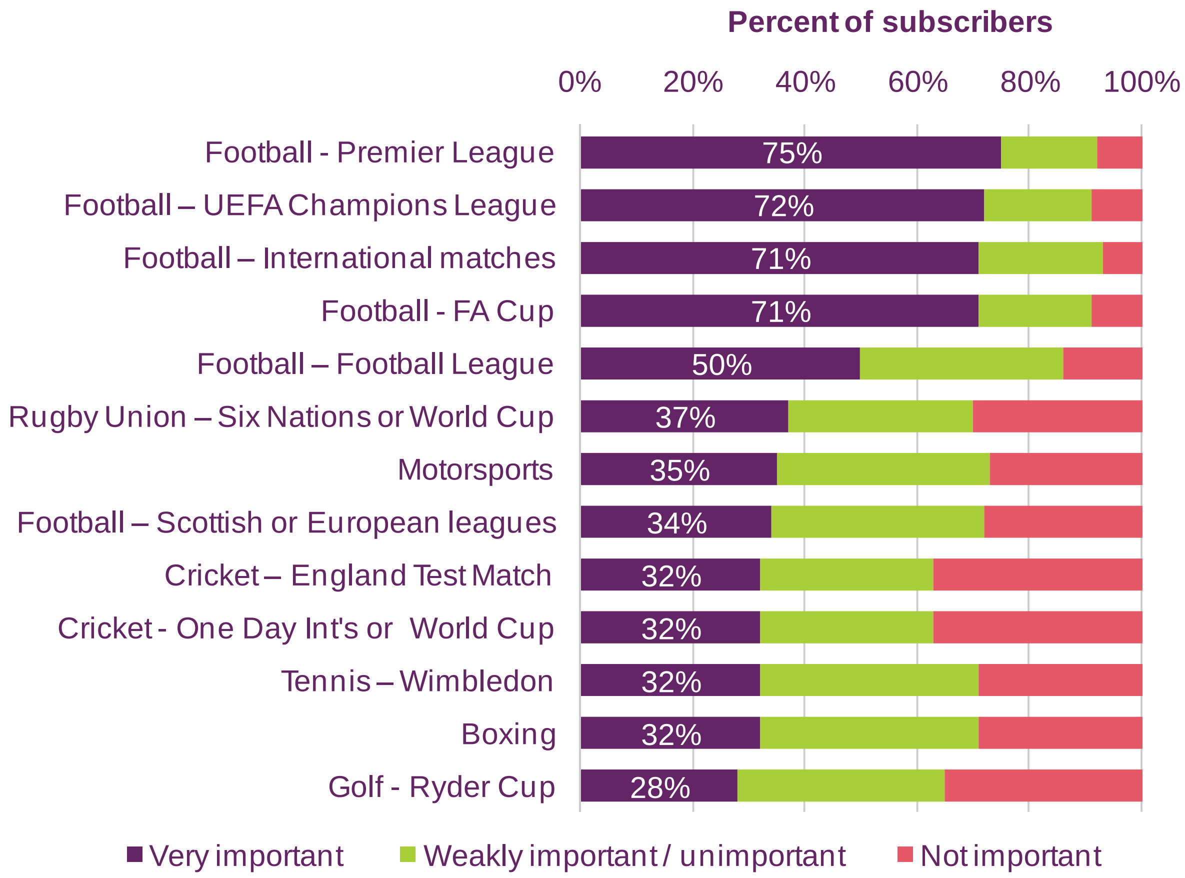
Figure 1 Reasons why subscribers initially subscribed to Sky Sports



Q9 What would you say are the reasons why you initially subscribed to Sky Sports? Why else?
Base: All adults aged 15+ who subscribe to Sky Sports and solely/jointly responsible for making purchasing decision regarding supplier for TV service (274)
Source: As presented in Figure 15 of Annex 10 of our Second Pay TV Consultation, Ofcom willingness to pay omnibus research, fieldwork carried out in April-July 2008

2.4 We also asked Premium Sports channel subscribers about the importance of key sports on TV. Figure 2 shows that they thought football in general was the most important sport, and that the most important sporting competition was the Premier League (75% said the Premier League was very important). In contrast, the highest rated non-football event (namely “Rugby Union – Six Nations or World Cup”) was only considered “very important” by 37% of subscribers.

Figure 2 Importance of key sports on TV for premium sports channel subscribers



Source: As presented in Figure 10 of our Third Pay TV Consultation, Ofcom sport conjoint research, April 2008

Base: All premium sports channel subscribers who watch sport at least once a week (1904)

2.5 Other football events were also very popular, namely UEFA Champions League ("very important" to 72% of respondents), international matches (71%) and FA Cup matches (71%). We note that two of these categories (Champions League matches and FA Cup matches) feature Premier League teams.

2.6 Figure 2 emphasises the particular importance of football compared to other sports. However, in contrast to Figure 1, it suggests that there is little difference between live Premier League matches and some other competitions. To investigate whether this is really the case we have considered rights prices, internal documents and changes in Setanta's subscriber numbers.

Rights prices

2.7 The much higher amounts paid for live Premier League Rights compared to rights for any other sporting events (Figure 3) clearly demonstrate that live Premier League matches are far more attractive to broadcasters than any other sporting event. The total amount paid for the live Premier League Rights to the 2007/08-2009/10 seasons was **[✂]** which is an average of **[✂]** per annum[3]. The winning bids for the live

[3] Calculated using the figures set out in the Confidential Report to the European Commission on the Award of Packages B, E and F, 10 May 2006, KPMG and Confidential Report to the European Commission on the Award

Premier League Rights to the 2010/11 to 2012/13 seasons totalled **[✂]** which is an average of **[✂]** per annum[4]. In contrast, the average annual amount paid for live Champions League rights is £85m (less than 20% of the annual amount currently paid for live Premier League rights) and that for both the FA Cup and England home international football matches is £106m (also less than 20%)[5] [6]. The annual amount paid for the Six Nations Rugby Union tournament is £40m (less than 10%)[7]. Given the sheer scale of the difference in the amounts that broadcasters pay for the rights to other sports events, as compared to the live Premier League Rights, this is strong evidence of the particularly desirable characteristics of live Premier League matches.

Figure 3 Top sports on pay TV channels or FTA TV channels by annual rights value in 2008

[✂]

Notes: The length of each bar indicates the relative rights value for each event. Not all sports rights are shown.

Group A Listed events shown. Other group A listed events include The FIFA World Cup, The Scottish FA Cup (listed in Scotland), the Grand National, the Derby, the Rugby world Cup Final. http://www.ofcom.org.uk/tv/ifi/codes/code_sprt_lstd_evts/listed_events.pdf

Source: As presented in Figure 11 of our Third Pay TV Consultation, Various sources including European TV Sports Rights 2008, rights holders. See Appendix 3 of Annex 6 of our Third Pay TV Consultation for details.

Internal documents

2.8 The importance of successfully bidding for the Live Premier League Rights is also reflected in documents that have been provided to us. **[✂]**[8]. Similarly **[✂]**[9]. **[✂]**[10] [11].

2.9 The importance of Premier League games relative to other sports was illustrated by **[✂]**This indicates that Premier League matches are more important than other events, including the FA Cup and England international football matches. **[✂]**

Figure 4 Impact of withdrawal of material event on Setanta Sports Suite carriage fee

2.10 **[✂]**[12]. **[✂]**[13].

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of Packages A, C and D, 12 May 2006, KPMG (collectively the "2006 Monitoring Trustees' Reports"). Premier League information request response dated 5 December 2008.

[4] Calculated using the figures set out in in the Confidential Report to the European Commission on the Award of Packages A, B, E and F, 17 February 2009, KPMG and Confidential Report to the European Commission on the Award of Packages C and D, 17 February 2009, KPMG (collectively the "2009 Monitoring Trustees' Reports"). Premier League response to Ofcom information request dated 2 March 2009.

[5] The annual cost of the Champions League relates to the 2006/07 to 2008/09 tournaments. The annual cost of FA Cup and England home internationals matches relates to 2008/09 to 2011/12. First Pay TV Consultation, Annex 10, page 3.

[6] Similar numbers of Champions League matches and live Premier League matches are broadcast. 138 live Premier League matches are broadcast each season. There are 125 Champions League matches, all of which are broadcast (First Pay TV Consultation, annex 10, slide numbered 7).

[7] The £40m figure relates to the period 2010 to 2013 (previously the annual cost was £30m). First Pay TV Consultation, Annex 10, pages 3 and 69.

[8] **[✂]**

[9] **[✂]**

[10] **[✂]**

[11] **[✂]**

Setanta Sports

2.11 When Setanta Sports began screening live Premier League matches its subscriber numbers increased from under 200,000 prior to 31 May 2007 to over 700,000 by 30 November 2007[14]. The only plausible explanation for this profound change in the number of Setanta Sports subscribers is that a large number of subscribers were attracted by live Premier League matches. Setanta went into administration almost immediately after the Premier League terminated its licence agreement.[15]

Summary of our view

2.12 The evidence presented above clearly shows that football is more important than other sports. Moreover, we consider that it shows that the Premier League is more important than other football competitions. This is demonstrated in particular by the amount paid for live Premier League rights compared to the live rights for other contests. That evidence is also corroborated by internal documents and the experience of Setanta Sports.

Responses to our Third Pay TV Consultation

2.13 The Premier League stated that Ofcom failed to demonstrate that live Premier League football is significantly more attractive than any other football or sports content[16]. The Premier League referred to the survey evidence presented in Figure 10 of the Third Pay TV consultation (and presented again in Figure 2 above) which stated that 75% of premium sports channel subscribers that watch at least once a week consider Premier League matches to be “very important”. The corresponding figure for UEFA Champions League matches is 72%, for international football matches is 71% and FA Cup matches is 71%. The Premier League stated that this runs contrary to the assertion that Live Premier League Rights are the most important content for Sky[17]. The Premier League stated that other sports events have the characteristics of regularity and a high value to consumers[18].

2.14 The Premier League considered that it was inappropriate to compare the average amount paid for the rights to a live Premier League match with the average amount paid for the rights to a live Champions League match. This is because some Champions League matches do not feature domestic teams. The Premier League asserted, without providing evidence, that there would be little difference in the average value of a Premier League match and the average value of a Champions League match featuring a domestic team[19].

2.15 The Premier League also asserted that the average amount paid for the rights to Champions League matches involving domestic clubs, FA Cup matches and England

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12 [✂]
13 [✂]
14 Source: Annex 1 of Setanta’s response dated 15 April 2009 to Ofcom’s information request response dated 20 March 2009.
15 “Setanta Loses Premier TV Rights”, BBC News, 19 June 2009;
“Setanta Goes Into Administration”; BBC news, 23 June 2009.
http://news.bbc.co.uk/1/hi/business/8109954.stm;
http://news.bbc.co.uk/1/hi/business/8115360.stm
16 Premier League response to Third Pay TV Consultation September 2009, paragraph 6.30.
17 Premier League response to Third Pay TV Consultation September 2009, paragraph 6.28.
18 Premier League response to Third Pay TV Consultation September 2009, paragraph 6.29.
19 Premier League response to Third Pay TV Consultation September 2009, paragraph 6.32.

home internationals will be lower because they involve fewer games per season and they are typically purchased by FTA broadcasters who pay less for them[20].

Our view on the representations that we received

2.16 We have considered the Premier League's arguments that live Premier League football is not uniquely attractive. The Premier League only advanced one positive piece of evidence in support of its position, namely the survey evidence presented in Figure 2 above in which a similar proportion of respondents indicated that Premier League matches, FA Cup matches, Champions League matches and international football matches were important (the importance of these events was markedly higher than for sports other than football). This needs to be weighed against the other evidence presented above, particularly the amounts paid for live rights set out in Figure 3.

2.17 The 138 live Premier League matches that are broadcast each season are highly attractive to final consumers and constitute a high volume of games played regularly throughout a 10 month season. While we do not dispute that other football contests may feature some highly attractive matches (as shown by the survey that the Premier League relies upon) there are fewer of them. This is reflected in their lower rights prices. The Champions League also features a large number of matches that are relatively less attractive to UK viewers (because they do not feature Premier League teams), hence the disparity in total rights prices for these tournaments.

2.18 The Premier League also argued that the values of the rights to other events are lower because they are typically purchased by FTA broadcasters who pay a lower amount for them. However, FTA broadcasters compete for those rights against pay TV broadcasters (with the exception of listed events, which only comprise a small number of matches). Accordingly, even where these events are won by FTA broadcasters, it is not clear that the broadcaster paid an artificially low price. Moreover, in the case of Champions League matches the majority of the rights are purchased by Sky. Similarly the rights to the FA Cup have previously been shared between FTA and pay TV broadcasters (Sky and the BBC until the 2007/08 season; ITV and Setanta during the 2008/09 season; ITV and ESPN from the 2010/11 season onwards)[21].

[20] Premier League response to Third Pay TV Consultation September 2009, paragraph 6.32.
[21] Given Setanta entered administration in June 2009, the 2009/10 season was primarily broadcast by ITV, although the FA did make some matches available via the internet.

Appendix 3

Approach towards carrying out market definition for bundles

Introduction

3.1 As explained in the main document, the starting points for market definition (also known as the “focal products”) are:

- The provision in the UK of (wholesale) packages including Sky Sports 1.
- The provision in the UK of (retail) packages including Sky Sports 1.
- The provision in the UK of wholesale packages containing Sky Movies 1, Sky Movies 2 or Sky Dual Movies.
- The provision in the UK of residential packages containing any of the following groups of channels: Sky Movies 1 or Sky Movies 2 or Sky Dual Movies.

3.2 Thus at both the wholesale and retail level the focal product refers to ‘packages’ of channels. This raises the question of how this bundling of channels affects the market definition analysis. The analysis in this annex applies to both the sports and movies sections.

3.3 The OFT Market Definition Guidelines state that the hypothetical monopolist test involves considering a rise in the price of the focal product[22]. We have thus considered a rise in the price of the entire package of channels that comprises the focal product.

3.4 However, for the reasons explained below, we consider that the impact of that rise in the price of the entire bundle can best be assessed by looking only at one particular element of that bundle. For example, when considering product characteristics we consider that it is informative to assess just the characteristics of one element of that bundle (Sky Sports 1, say) and whether or not there are close substitutes for that particular element. It is not necessary to consider the characteristics of the entire bundle. We adopted the same approach in the Third Pay TV Consultation[23].

Responses to the Third Pay TV Consultation

3.5 Sky stated that retail bundles include a range of services including basic pay TV channels, broadband, telephony, multiroom services, PVRs, VoD etc. Sky stated that these other services should not be disregarded for the purposes of retail market definition[24]. Rather Ofcom should consider substitutes for “the **totality** of programming that is delivered to them by subscribing to a pay TV package that includes premium sports channels” (emphasis in original)[25].

[22] OFT Market Definition Guidelines, paragraph 2.10.
[23] When carrying out our retail level assessment for both sports and movies we considered constraints on the “premium element of the bundle”. Third Pay TV Consultation, paragraphs 4.228 and 4.379.
[24] October Sky Submission, paragraph 5.
[25] October 2009 Sky Submission, paragraph A2.11(ii).

3.6 Sky also criticised Ofcom for failing to take into account the complexity of choices faced by retail consumers[26]. Sky cross referred to an earlier submission in which it characterised Ofcom's approach as assuming that a consumer's decision to subscribe to a service that includes pay TV channels depends on a small range of specific characteristics relating to premium sports and movie channels[27]. Sky highlighted that services are provided to consumers in bundles, consumers have heterogeneous preferences and that subscription is a household level decision[28]. Consumers face choices with regard to delivery platforms (including non-television ways of accessing content), pay TV packages, non-TV services such as telephony and broadband, service providers and viewing[29].

3.7 Sky stated that the retail focal products analysed in the Third Pay TV Consultation included a vast number of bundles (over 1,800 different bundles available on Sky's DSat and cable platforms, even excluding telephony and broadband options)[30].

Our approach

3.8 As a preliminary point, and as noted at paragraphs 4.50 to 4.51 of the Third Pay TV Consultation, it is often necessary to abstract from some of the complexities of the market in order to be able to meaningfully analyse specific points. Moreover while Sky described the complexities of the market in some detail, it did not set out any arguments as to which of our findings were likely to be incorrect as a result of a failure to reflect these complexities. Nor did Sky make any positive suggestion as to how a market with such complexities should be analysed.

3.9 Sky considered that we should analyse the totality of the bundles purchased by final consumers. The conceptual approach of the SSNIP test implies that a rise in the price of the entire bundle (i.e. in the price of the entire focal product) should be considered. However, because Premier League and other football is a key driver of demand for pay TV services, we consider that it is appropriate to focus on the substitutability of sports content available elsewhere. The simplifying assumption is that other elements of the bundle, such as basic TV content and broadband, can be substituted relatively easily. In reality, some other elements of these bundles, such as Sky Movies and PVRs, are not easily substitutable elsewhere, and this will further limit the willingness of subscribers to bundles including Sky Sports to switch. We consider that, the more elements are included in a bundle, the more difficult it will be for a subscriber to find another bundled service which they see as substitutable across all the elements in the bundle. Alternatively they could substitute to an unbundled set of substitutes, but this would require finding a substitute for each of the elements of the bundle, and also of losing the convenience (and possibly the price advantage) of taking a bundle.

3.10 Sky also referred to the heterogeneity of consumer preferences. The analysis in the main document is informed wherever practical by information from surveys. These reflect how respondents actually perceive the market[31]. Moreover we have taken that heterogeneity into account in our analysis, for example by segmenting Sky Sports subscribers into four main groups to help take account of the variety in consumers' preferences and potential behaviour.

[26] Sky response to Third Pay TV Consultation, paragraph 5.21.
[27] June 2009 Sky submission, paragraph 6.4.
[28] June 2009 Sky submission, paragraph 6.5.
[29] June 2009 Sky submission, paragraph 6.6; also paragraph 6.10.
[30] October 2009 Sky Submission, paragraph 40; also Table 1.
[31] A point we made in Third Pay TV Consultation, paragraph 4.50.

3.11 Retail packages containing Sky Sports 1 may contain a number of elements:

- Non-television elements e.g. broadband.
- Basic channels.
- Other premium channels e.g. premium movie channels and other premium sports channels such as Sky Sports 2, Sky Sports 3 and Sky Sports 4.

3.12 Similarly retail packages containing Sky Movies may contain non-television elements, basic channels and other premium channels (particularly Sky Sports).

3.13 Below we explain in turn why it is reasonable to disregard various other elements of the focal product when assessing whether final consumers would switch in response to an increase in the price of the retail bundle. We do so by considering each element in turn:

- Non-television elements
- Basic channels
- Other genres of premium channels
- Premium channels in the same genre

Non-television elements

3.14 At the retail level, bundles include non-television products. For example, Sky offers a number of additional services to households that subscribe to its pay TV packages. Specifically, subscribers to Sky's television services can also purchase a range of broadband packages priced between £5 and £15 per month depending on maximum speed and monthly data allowance. Subscribers to Sky's television services can also purchase telephony from Sky for a price of £0 or £5 per month (plus call charges) depending on the calling plan adopted. There is bundling between these services (consumers taking both broadband and telephony pay £5 less per month for broadband). Sky does not offer telephony and broadband on a standalone basis – they are only available to subscribers to Sky's television bundles. In contrast, Virgin Media requires all its subscribers to take a phone line to which they can add additional services such as television, broadband, fixed line telephony and mobile telephony.

3.15 When assessing whether consumers would switch in response to a rise in the price of retail packages including premium channels we think it is appropriate to disregard non-television elements. This is because we consider consumers that take non-television products as well as premium channels are generally less likely than consumers that do not take those non-television products, to be able to find suitable substitutes (for the reasons set out in paragraph 3.9 above). Accordingly excluding non-television elements from our analysis does not cause us to draw the relevant market unduly narrowly.

3.16 Ofcom's Consumer Experience Research Report 2008 (the "CERR 2008") stated that:[32]

[32] http://www.ofcom.org.uk/research/tce/ce08/research.pdf

- Qualitative research on consumers that purchase bundles "implied that the more services that were bundled, the less interest in switching – triple-play customers were largely averse to switching because there were few alternative suppliers for their entire bundle and they were happy with their package … There were indications that the largest potential barrier to future switching was that the more services were bundled together, the higher the value the consumer placed on the bundle. This led to a lower inclination to switch and perceptions of an increasingly complex switching process, particularly if there was a need to unbundle." Further "There was some evidence to suggest that bundlers' perceptions of the switching process were a barrier to switching – but not exclusively and in varying degrees …"[33]

- Survey evidence found that those taking a bundle regarded switching as harder than those taking individual products[34]. In the third quarter of 2008, 66% of multichannel TV consumers regarded switching supplier as "very easy" and 23% regarded it as "fairly easy". The corresponding figures for consumers of bundles of products were 25% and 40%. Just 6% of multichannel TV consumers regarded switching supplier as "fairly difficult" or "very difficult" whereas 29% regarded switching a bundle as "fairly difficult" or "very difficult"[35].

Basic channels

3.17 At the retail level, bundles almost always include basic channels. The way in which basic channels are packaged varies between retailers. For example, Sky offers six basic "mixes", each consisting of a bundle of channels, for an incremental price of £1 each. Virgin Media retails basic channels in four tiered packages, 'M', 'M+', 'L' and 'XL', containing an increasing number of channels.

3.18 Figure 5 below sets out the conceptual framework that we have used when approaching this issue[36]. Consumers' preferences for basic content are measured on the vertical axis and consumers' preferences for premium content are measured on the horizontal axis. Thus, consumers located in the top right corner of the area depicted in this figure have a strong preference for both basic and premium content. Consumers located in the top left corner of this area have a strong preference for basic content but only a weak interest in premium content.

3.19 If a basic content only product were available for £16 and a bundle combining basic and premium content were available for £30 then Figure 5 shows which consumers purchase these products. Specifically:

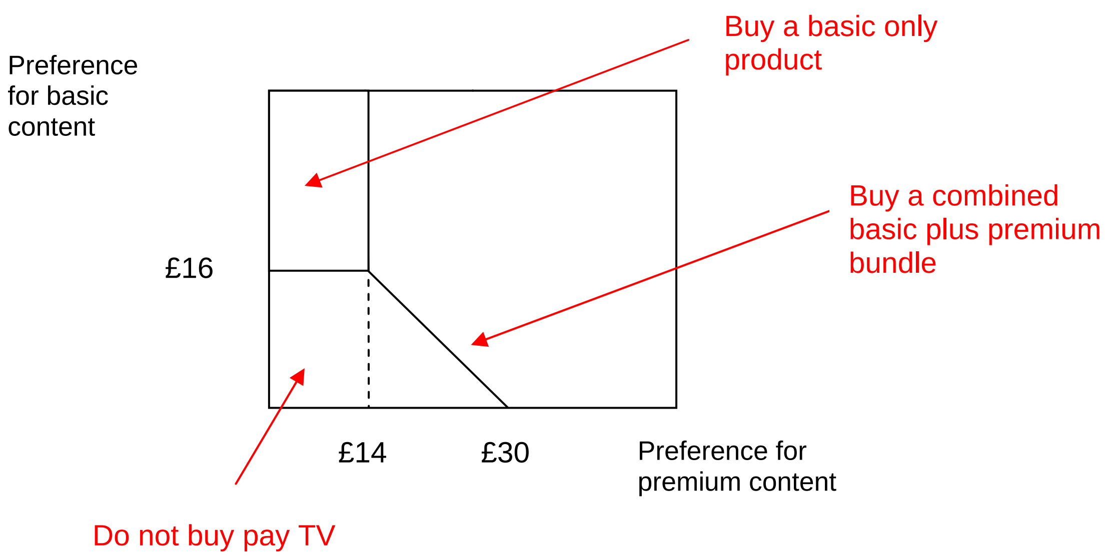
- Consumers that value basic content at least £16 but value premium content at less than £14 (the incremental cost of adding premium content to a basic only package) purchase the basic only product.

- Of the consumers that have not purchased the basic only product, those consumers with a total valuation of basic plus premium content of more than £30

[33] CERR 2008, page 96.
[34] We recognise that the survey results are less clear cut for consumers that have never switched supplier (see CERR 2008, figure 133 on page 100). However we consider those results as less reliable, given that they relate to consumers that have never switched supplier and who may thus be poorly informed about what is involved. This is supported by page 96 of the CERR 2008 which stated that the "majority of consumers appeared to be largely unaware of what might be involved in the switching process".
[35] CERR 2008, figure 132 on page 99.
[36] This framework for analysing bundling has been used in a number of academic papers. See for example Bundling, Tying and Portfolio Effects, DTI Economics paper No.1, Part 1, B Nalebuff, February 2003, pages 43-44. Available at: http://www.berr.gov.uk/files/file14774.pdf

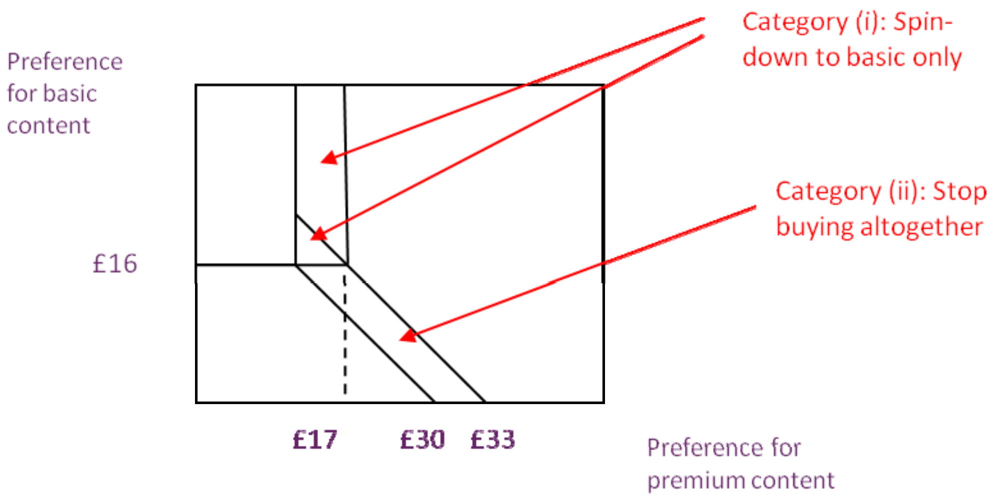
buy the combined bundle. The sloped line in Figure 5 shows individuals that value basic content at £16 or less and value basic and premium content (together) for exactly £30.

Figure 5: Framework for analysing product bundles



3.20 Figure 6 shows the effect of a 10% increase in the price of the bundle containing both basic and premium content, from £30 to £33, if the basic package stays at £16.

Figure 6: Consumers' responses to an increase in the price of packages containing premium content



3.21 As shown in Figures 5 and 6, it is possible to divide into two categories the consumers that cease buying the bundle of basic plus premium content following an increase in its price.

- Category (i): some consumers just drop the premium element (they "spin down" to a basic only package). These consumers all value basic content at more than £16 (the price of standalone basic content) and value premium content between

£14 and £17 (the incremental price of premium content before and after the price rise). For consumers that value basic content at £16 or more, their decision whether or not to "spin down" **only** depends on their preferences for premium content.

- Category (ii): some consumers drop the entire bundle. These consumers value basic content at less than £16 and their decision is determined by their aggregate preferences for all elements of the bundle. For category (ii) consumers, the characteristics of both basic and premium content are relevant to their decision.

3.22 The important insight that emerges is that, for consumers that consider spinning down to a basic only package in response to an increase in the price of the bundle (category (i)), only their preferences for premium content matter (specifically, whether or not they value premium content at less than the new incremental price of £17). In order to evaluate what these consumers are likely to do in response to the price increase, it is only necessary to weigh up the strength of their preferences for premium content.

3.23 In this analysis we have focused on an increase in the price of the premium element of the bundle – i.e. we consider what happens when the bundle price increases but the basic-only price does not increase. This is because we are assessing the effect of possible market power derived from the premium element.

3.24 Accordingly, if there is evidence that the majority of price sensitive consumers fall into category (i) then it is possible to simplify the analysis and only focus on consumers' preferences for premium content. Survey evidence suggests that this is in fact the case.

3.25 Prior to the First Pay TV Consultation we conducted a survey in which we asked consumers how they would respond to a 10% price increase in the Sky Sports element of a Top Tier bundle[37] [38]:

- 11% of respondents claimed that they would drop Sky Sports but retain other elements of their pay TV bundle (specifically 7% of consumers would drop Sky Sports but keep Sky Movies and basic; a further 4% would drop both Sky Sports and Sky Movies, but keep basic). This corresponds to the response of a category (i) consumer. In addition, 5% of consumers would drop Sky Movies, but keep Sky Sports and basic.

- Only 4% of respondents would drop their Sky subscription altogether and switch to FTA television. This corresponds to the response of a category (ii) consumer.

3.26 That survey also asked consumers how they would respond to a 10% price increase in the Sky Movies element of a Top Tier bundle[39]:

- 26% of respondents claimed that they would drop Sky Movies but retain other elements of their pay TV bundle (specifically 18% reported that they would drop Sky Movies but keep Sky Sports and basic; 7% would drop Sky Sports and Sky Movies and switch to basic pay TV packages; 1% would switch to PPV movies).

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[37] Source: Ofcom phase 3 consumer research, August / September 2007. Base: 450, all subscribers to Sports and Movie Mix packages. See First Pay TV consultation, annex 13, paragraph 4.22.
[38] For the purposes of categorising consumers we have excluded those that swap from one premium sports channel to another (9% of respondents indicated that they would switch to Setanta Sports).
[39] First Pay TV Consultation, annex 13, paragraphs 4.60-4.62.

This corresponds to the response of a category (i) consumer. In addition, 4% of consumers would drop Sky Sports, but keep Sky Movies and basic.

- Only 3% of respondents would drop their Sky subscription altogether and switch to FTA television. This corresponds to the response of a category (ii) consumer.

3.27 In its response to the First Pay TV Consultation, Sky criticised this survey. It pointed out that we had asked consumers how they would respond to a 10% increase in the incremental price of Sky sports and Sky Movies, rather than an increase in the price of the whole bundle. That incremental price varied between consumers, depending on their reasons for buying the bundle[40]. The price rises we considered amounted to a 2-6% increase in the total price of the bundle[41]. Sky argued that, as a result, the survey significantly understated the amount of switching that would occur if a 5-10% SSNIP were applied to the price of the bundle as a whole[42].

3.28 We recognise that this survey overstates consumers' propensity to switch due to stated preference bias[43] and because retail prices are above the competitive level[44]. These effects may be offset to some extent because the survey may understate consumers' propensity to switch in response to a 5-10% increase in the price of the bundle as a whole. However we are not relying on this survey to estimate the magnitude of consumer switching. Rather we are attempting to understand the relative numbers of consumers in categories (i) and (ii). We consider that the weakenesses with this survey do not imply that the proportion of price sensitive consumers falling into the different categories is materially distorted.

3.29 In conclusion, the majority of price sensitive consumers fall into category (i) rather than category (ii). Whether or not these consumers cease to subscribe to premium channels only depends on their preferences for premium content. It is thus legitimate to focus the market definition analysis on whether or not there are alternatives to premium content.

Other genres of premium content

3.30 At both the retail and the wholesale level, Sky bundles its Sky Sports and Sky Movies channels. The majority of consumers **[✂]**. In line with all our previous consultations, we analyse sports and movies separately[45].

Premium channels in the same genre

3.31 At both the retail and the wholesale level, Sky Sports 1 is bundled with Sky Sports 2, 3 and 4. Indeed it is not possible to buy Sky Sports 3 and 4 at the retail level without also buying Sky Sports 1. The majority of consumers **[✂]**. In the main document we assess the extent of substitutability between different Sky Sports channels (as we also did in the Third Pay TV Consultation). In order to do so, it is necessary to look at each Sky Sports channel separately.

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[40] For example, the incremental price of Sky Sports for Top Tier subscribers that purchase that channel as a cheap add-on to their Sky Movies subscription is lower than incremental price for consumers that purchase a Top Tier bundle primarily to obtain Sky Sports.
[41] First Pay TV Consultation, annex 13, paragraphs 4.21 and 4.61.
[42] Appendices to annex 2 of Sky's response to the First Pay TV Consultation, paragraphs 7.10-7.11.
[43] Third Pay TV Consultation, paragraphs 4.136, 4.144 and 4.299.
[44] Third Pay TV Consultation, paragraphs 4.139, 4.1142 and 4.299.
[45] The OFT adopted the same approach when it defined the relevant markets in 2002. *BSkyB investigation: alleged infringement of the Chapter II prohibition*, 17 December 2002, paragraph 31. Available at: http://www.oft.gov.uk/advice_and_resources/resource_base/ca98/decisions/bskyb2

Appendix 4

Approach to market definition when input prices are above the competitive level

Introduction

4.1 In the Third Pay TV Consultation we stated that we would be concerned that retail prices are above competitive levels even in the absence of evidence that Sky was earning excessive profits. One reason for this was that owners of the rights to highly valued content should in principle be able to extract some or all of the monopoly rents from these rights, leading to prices above the competitive level, but preventing wholesalers and retailers such as Sky from making excessive profits. This would appear particularly likely in the case of Premier League and other sports rights, which are sold jointly[46].

4.2 We received a number of representations on this point and these are set out in our analysis of profitability in sections 5 and 6 of the main document. In addition, Sky advanced two arguments about the relevance of our observation. These are addressed in this appendix.

Sky's representations

4.3 Sky considered that the relevant question is "whether a firm operating at a downstream level has the power to set and maintain prices for the products that it supplies, which are substantially in excess of its own costs. Whether or not those costs are inflated as a result of the exercise of market power by its suppliers is irrelevant to this question" (emphasis removed from original)[47].

4.4 Sky also characterised as "unconventional" the proposition that, if upstream prices are above competitive levels, then there is a risk that downstream markets are defined too widely[48]. Sky considered that Ofcom quoted selectively from the OFT Market Definition Guidelines in support of this proposition[49].

Ofcom's position

4.5 The OFT Market Definition Guidelines state that:

> "When carrying out the [SSNIP] test, we assume that the hypothetical monopolist is not subject to economic regulation that would affect its pricing behaviour and that the prices of products outside of the hypothetical monopolist's control are held constant at their competitive levels. However, while not considered as part of the test, the issues of regulation and the pricing strategies of competitors would be considered as part of the overall competitive assessment"[50].

4.6 In the Second Pay TV Consultation, we interpreted this passage as implying that the correct approach is to apply the SSNIP test using the competitive level of input costs.

[46] Third Pay TV Consultation, paragraph 4.53.
[47] June 2009 Sky Submission, paragraph 5.10.
[48] June 2009 Sky Submission, paragraph 5.11; also annex 3, paragraph 1.1.
[49] June 2009 Sky Submission, paragraph 5.11 and annex 3, paragraphs 1.2-1.4.
[50] OFT Market Definition Guidelines, footnote 13 to paragraph 2.10.

We noted that otherwise, where upstream input costs are above competitive levels, taking upstream input costs as 'given' in the HMT analysis risks drawing markets excessively widely[51].

4.7 Sky disputed our interpretation of the passage from the OFT Market Definition Guidelines quoted above. Sky considered that the phrase "the prices of products outside of the hypothetical monopolist's control are held constant at their competitive levels" refers to "the pricing strategies of competitors"[52].

4.8 We remain of the view that our interpretation of OFT's guidelines is valid. In particular, we do not consider that there is any basis for the narrower interpretation which Sky prefers.

4.9 As discussed in Section 5, we conclude that Sky's prices are indeed above competitive levels, and this conclusion is based on Oxera's analysis of Sky's profitability, and our pricing model. This finding is not based on Sky's input costs being above competitive levels. As such, even if we accepted that these costs should be treated as being competitive, we would still conclude that Sky's retail prices are above competitive levels. This conclusion does not depend on our interpretation of the OFT's guidelines.

4.10 Furthermore, we note that the upstream cost of Premier League and other sports rights is closely related to downstream market conditions. In particular, these rights are valuable to broadcasters precisely because of the large number of sports fans who have a strong demand for this content, who do not see other sports or TV content as close substitutes, and who are therefore willing to pay a premium for them.

4.11 We therefore consider that it is valid, for the purpose of market definition, to have regard both to Sky's profitability, and to these upstream costs, in assessing whether packages including Core Premium sports channels should be seen as belonging to a separate market from other sports or TV content. We remain of the view that this is also consistent with the OFT's guidelines.

[51] Second Pay TV Consultation, annex 6, paragraph 1.8.
[52] June 2009 Sky Submission, annex 3, paragraph 1.4.

Appendix 5

Further evidence on sports market definition

Introduction

5.1 This appendix discusses the following pieces of evidence which we have considered as part of our retail market definition analysis for sports:

- Observed response to changes in the retail price of Sky Sports
- Changes in Sky Sports subscriber numbers given the growth in Freeview

Observed response to changes in the retail price of Sky Sports

Position in previous consultations

5.2 In the First Pay TV Consultation we looked at average real annual changes in the retail prices of Sky Sports channels on DSat since 2000 and changes in subscriber numbers over that period. In the light of consultation responses we carried out additional analysis for our Second Pay TV Consultation to consider data for the period up until 2008. We noted that there had been some increase in the quality of the packages on offer[53]. In the Third Pay TV Consultation we carried out further analysis for example to consider different measures of inflation[54].

5.3 In the Third Pay TV Consultation we said that the evidence on Sky Sports subscriber numbers and prices pointed towards a degree of constraint but added that a definitive judgement was difficult because there was evidence that quality had also changed[55]. We did not rely on this material as part of our market definition and market power assessment in the Third Pay TV Consultation because the pattern of retail price changes was mixed and because the analysis was unable to control for cost and quality changes[56].

Consultation responses

5.4 The Premier League considered that in the Third Pay TV Consultation we had admitted that this evidence did not support our market definition[57]. The Premier League stated that this evidence pointed to a wider market definition[58].

5.5 Sky asserted that the analysis in the Third Pay TV Consultation was inadequate[59] and did not comprise robust evidence[60]. We received further representations on this issue in the Second February 2010 Sky Submission. **[✂]**

[53] In particular, the amount of programming on the Sky Sports channels had increased, although this was partially offset by the loss of some key content. There were also more basic tier channels and subscribers could obtain additional services such as broadband, or Sky Anytime.
[54] Third Pay TV Consultation, paragraphs 4.147-4.162.
[55] Third Pay TV Consultation, paragraph 4.162.
[56] Third Pay TV Consultation, annex 8, paragraph 2.89.
[57] We assume that this is a reference to paragraph 4.162 of the Third Pay TV Consultation where we said that this evidence “continues to point towards a degree of constraint on premium sports channels”.
[58] Premier League September 2009 Response, paragraph 5.42.

Figure 7 Sky's assessment of changes in price, quality and subscriber numbers (January 2004 – September 2009)

5.6 [✂][61] [✂][62] [✂][63] [✂][64] [✂][65] [✂][66] [✂][67] [✂][68] [✂][69]

5.7 [✂][70] [✂][71] [✂][72] [✂][73]

5.8 [✂][74] [✂][75]

5.9 [✂][76].

Ofcom's view

5.10 We recognise that simply considering changes in retail prices is inconclusive, particularly as it is not possible to control robustly for changes in other key factors (costs, quality etc). This difficulty is emphasised by the further analysis set out in the Second February 2010 Sky Submission. Since we consider this evidence to be inconclusive, arguing neither for or against a particular market boundary, we do not rely on it for the purposes of market definition.

Impact of Freeview availability on Sky Sports subscription levels

Position in previous consultations

5.11 One way to consider whether two products are close substitutes for each other is an 'event analysis' which examines, for example, the impact of the entry or exit of a firm within the markets being assessed. If we observe a strong response from incumbents or from existing consumers when a new product joined the market, then this might be evidence that the incumbent's product and the new entrant's product were close substitutes.

5.12 In the Third Pay TV Consultation we thus presented evidence on changes in the number of Sky Sports subscribers and the number of households that possess DTT services such as Freeview for the period since 2000[77]. We said that if sport on Freeview were a close substitute for Sky Sports then we would have expected the trend in Sky Sports subscriber numbers to have been impacted by the (substantial) growth in Freeview but that this did not appear to have happened[78]. We recognised that the FTA offering has improved in recent years as additional channels have

[59] October 2009 Sky Submission, paragraph A2.13(ii).
[60] October 2009 Sky Submission, paragraph A2.14.
[61] Second February 2010 Sky Submission, paragraph 19.
[62] Second February 2010 Sky Submission, paragraphs 159-162.
[63] Second February 2010 Sky Submission, paragraphs 164-167, 170.
[64] Second February 2010 Sky Submission, paragraphs 168-169.
[65] Second February 2010 Sky Submission, paragraphs 171-172.
[66] Second February 2010 Sky Submission, paragraphs 173-175.
[67] Second February 2010 Sky Submission, paragraph 176.
[68] Second February 2010 Sky Submission, paragraph 176.
[69] Second February 2010 Sky Submission, paragraph 176.
[70] Second February 2010 Sky Submission, paragraphs 28, 83.
[71] Second February 2010 Sky Submission, paragraphs 85-117.
[72] Second February 2010 Sky Submission, paragraphs 124-128.
[73] Second February 2010 Sky Submission, paragraphs 129-131.
[74] Second February 2010 Sky Submission, heading prior to paragraph 205.
[75] Second February 2010 Sky Submission, paragraph 207.
[76] Second February 2010 Sky Submission, paragraph 29.
[77] Third Pay TV consultation, paragraphs 4.163-4.166 and 4.182-4.4.184.
[78] Third Pay TV Consultation, paragraph 4.166.

become available[79], but said that if Freeview were a strong substitute we might expect Sky Sports to have lost subscribers (given that it does not appear to have lowered prices/margins)[80].

5.13 Overall we considered that the growth of FTA channels had not sufficiently constrained Sky's pricing of Sky Sports for FTA channels to be included in the same market[81].

Sky's response

5.14 Sky argued that our analysis in the Third Pay TV Consultation was unreliable in that it fails to control for changes in other relevant variables (such as price, quality, marketing expenditure) and that we had failed to specify the counterfactual i.e. how the number of pay TV subscribers would have changed absent the observed growth in Freeview[82,83]. Sky considered that the proposition underlying this analysis is that one would expect either to see a competitive response from Sky or for the number of Sky Sports subscribers to decline[84]. Sky claimed that such a competitive response was observable as the quality of packages including Sky Sports has increased over time while subscriber numbers remained broadly flat over the past four years[85].

5.15 The Second February 2010 Sky Submission **[✂]**[86] **[✂]**[87] **[✂]**[88]

Ofcom's view

5.16 A necessary, but not sufficient, condition for Freeview to lie within the same retail market as packages including Sky Sports is for changes in the attractiveness and availability of Freeview to affect packages including Sky Sports (for example, by prompting changes in pricing, subscriber numbers, quality etc). If Freeview has had an impact then that doesn't necessarily imply that the impact is strong enough for these products to be close substitutes. However if Freeview has not had an impact it implies that they are not substitutes.

5.17 We recognised in the Third Pay TV Consultation that the number of Sky Sports subscribers will depend on a number of factors, such as the price/quality combination it offers[89]. As explained above, we agree that simply considering changes in Sky's subscriber numbers is inconclusive in this case, particularly as it is unlikely to be possible to control robustly for other key factors (e.g. costs, quality). We thus do not rely on trends in Sky Sports subscriber numbers for the purposes of market definition.

5.18 With regard to Sky's argument that it has responded to increased competition by re-packaging its services, engaging in innovation, launching new services, etc, it is crucial to recognise that current prices are likely to be above the competitive level

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[79] Third Pay TV Consultation, paragraph 4.172.
[80] Third Pay TV Consultation, paragraph 4.183.
[81] Third Pay TV Consultation, paragraph 4.184.
[82] In a related point, Sky criticised Ofcom for failing to examine whether the quantity of sport on FTA channels has grown over the last decade (October 2009 Sky Submission, paragraph A2.16). This is relevant to the extent to which the quality of FTA channels has changed.
[83] October 2009 Sky Submission, paragraph 76; also October 2009 Sky Submission, paragraph A2.20 and Second February 2010 Sky Submission, paragraphs 222-225.
[84] October 2009 Sky Submission, paragraph A2.18.
[85] October 2009 Sky Submission, paragraph A2.19.
[86] Second February 2010 Sky Submission, paragraph 230.
[87] Second February 2010 Sky Submission, paragraph 234.
[88] Second February 2010 Sky Submission, paragraph 235.
[89] Third Pay TV Consultation, paragraph 4.166.

(see paragraphs 5.515 to 5.591 and 6.329 to 6.337 of the main document. As a result, other products will appear more attractive than they would do if Sky's prices were at the competitive level. Those other products may well exert a considerable constraint on Sky at current prices and, as a result, Sky considers that it needs to engage in various forms of marketing and innovation in order to maintain its position. However this reflects the effects of the cellophane fallacy and is not relevant for the purposes of market definition.

5.19 Sky presented a separate analysis of variations in its subscriber numbers that attempts to control for other factors (the "Seabright Study"). We discuss this study in the main document, at paragraphs 5.308 to 5.324.

Appendix 6

Relevance of previous market definition findings

Introduction

6.1 There have been a number of investigations into TV markets by UK and European competition authorities, including the upstream markets for certain rights[90]. In particular, the Competition Commission (the "CC") set out its conclusions on market definition in its investigation into the acquisition by Sky of a 17.9% stake in ITV (the "Competition Commission's 2007 Findings")[91]. The CC identified a market for all TV including VoD[92]. It also noted that the market was highly differentiated. This appendix discusses the relevance of the CC's findings to this case. This appendix is relevant to market definition for both sports and movies.

Representations on previous market definition findings

6.2 Sky asserted that Ofcom's approach has been influenced by previous narrow market definitions found by competition authorities[93]. Sky stated that such past decisions tend to come from other countries with different market circumstances or predate developments such as the widespread availability of DVDs or rises in the number of free to air channels[94].

6.3 Sky also stated that Ofcom had disregarded the broad market definition found by the CC[95]. Sky disagreed with Ofcom's reasons for not relying on the Competition Commission's 2007 Findings[96].

6.4 Sky quoted the Competition Commission's counsel in the Court of Appeal hearing on that case as arguing that FTA services posed a constraint to Sky's prices. Sky said it took this as a fact, and noted that it was a key finding which the Tribunal had not challenged.[97]

6.5 The Premier League said that Ofcom failed to provide a plausible reason for not taking into account the Competition Commission's 2007 Findings[98] [99].

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[90] For example, Commission decision COMP C.2-37.398 Joint selling of commercial rights of the UEFA Champions League; Commission decision COMP/C.2/37.217 Joint selling of media rights of the German Bundesliga; Commission decisions, Case No COMP/M.3595 - Sony / MGM (2005), *Case No* COMP/M.2050 – Vivendi / Canal+ / Seagram (2000), or COMP/M.2876, Newscorp/Telepiù (2003). An investigation in relation to a merger between News Corp and Premiere. COMP/M.5121/Newscorp/Premiere. Case COMP/C-2/38.173.

[91] Competition Commission (2007) Investigation into the acquisition by Sky of a 17.9% stake in ITV, http://www.competition-commission.org.uk/inquiries/ref2007/itv/index.htm.

[92] Competition Commission's report to SoS (BERR) 2007 paragraph 4.30.

[93] Sky response to Third Pay TV Consultation, paragraph 5.37.

[94] Sky response to Third Pay TV Consultation, paragraph 5.38.

[95] Sky response to Third Pay TV Consultation, paragraph 5.37; see also 25 January 2009 Sky Submission, paragraphs 4.2-4.3.

[96] Sky response to Third Pay TV Consultation, paragraph 5.57-5.58.

[97] January 2010 Sky Submission, paragraphs 4.2 and 4.3.

[98] Premier League September 2009 Response, paragraph 5.7.

[99] The Premier League also made a number of representations concerning the March 2006 European Commission decision to accept binding commitments from the Premier League concerning the sale of various media rights. This decision and the Premier League's representations in relation to it are considered in appendix 11 below.

Our view of the relevant of previous market definition findings

6.6 As set out in paragraph 4.66 of the Third Pay TV Consultation, it is important to carry out the market definition exercise afresh, having regard to the specific concerns that are being investigated and using recent data that are relevant to our investigation. This general approach is consistent with previous practice[100] and the relevant OFT guidelines[101] [102].

6.7 Moreover, there are two specific reasons why the Competition Commission's 2007 Findings in particular are of limited relevance to the current investigation.

6.8 First, the CC was considering a different competition issue and thus appears to have examined the relevant market starting from a different focal product. It is well established that starting from a different focal product can lead to different market definition conclusions[103]. Given the CC's reference question (a merger between a FTA TV broadcaster and a pay TV broadcaster), the CC did not (and did not need to) consider the specific question of whether packages containing premium sports or premium movie channels are constrained by other pay TV or FTA content, although it did briefly comment on this matter. Specifically:

- The CC "first looked at evidence of switching between pay-TV providers" and concluded that "this suggests that pay-TV packages are likely to be reasonable substitutes for one another. We therefore consider all pay-TV to be in the same relevant market"[104].

- The CC "next looked at whether FTA services would provide a constraint to a monopolist of pay-TV attempting to raise prices ... by a small but significant amount from current levels"[105].

- The CC explicitly stated that "In our view, it is likely that the FTA offer is a closer substitute to packages which include only basic channels than those which include basic and premium channels. As such, FTA services may be a relatively weaker constraint on those packages which include premium channels."[106]

- The CC then went on to consider "whether the product market should be defined more widely than FTA and pay-TV"[107].

6.9 Second, the CC was considering whether the relevant merger situation gave rise to a substantial lessening of competition. Accordingly, it was appropriate for the CC to perform the SSNIP test from pre-merger prices.[108] For example, paragraph 4.20 of the Competition Commission's 2007 Findings referred to a hypothetical monopolist "attempting to raise prices ... by a small but significant amount from **current** levels" (emphasis added). In contrast, for the purposes of the current investigation it is

[100] For example Coca-Cola v Commission [2000] CMLR 467.
[101] OFT Guidelines on Market Definition, 2004, paragraph 5.7 – 5.9.
[102] Sky made a similar point in its response to the First Pay TV Consultation. Sky stated that "there is no such concept as "precedent" in relation to market definition, but only past cases which may provide some assistance in a new assessment." Sky response to Ofcom's December 2007 consultation Annex 2 paragraph 1.24.
[103] For example, see OFT Market Definition Guidelines, footnote 31 to paragraph 3.11 and footnote 41 to paragraph 5.10.
[104] Competition Commission's 2007 Findings, paragraph 4.15.
[105] Competition Commission's 2007 Findings, paragraph 4.16.
[106] Competition Commission's 2007 Findings, paragraph 4.20.
[107] Competition Commission's 2007 Findings, paragraph 4.22.
[108] See Merger references: Competition Commission Guidelines (June 2003) (CC2), paragraph 2.10 (including box).

appropriate to conduct the HMT from competitive prices. As set out in the main document, we consider that current retail prices are likely to be above the competitive level. As a result, switching behaviour at current prices is amplified in comparison to the amount of switching that would be observed at the competitive price (the so called cellophane fallacy).

6.10 Accordingly we do not consider the CC's findings directly relevant to our current assessment and have conducted our assessment afresh based on a wide range of evidence.

Appendix 7

The concept of entry barriers

Introduction

7.1 This appendix addresses arguments by Sky that the types of entry barriers identified by Ofcom are inappropriate. Specifically:

- In its response to the Second Pay TV Consultation, Sky argued that our approach to entry barriers was inconsistent with the OFT Market Power Guidelines.

- In its response to the Third Pay TV Consultation, Sky claimed that entry barriers were not of the type that the European Commission has identified as a requirement for ex ante regulation.

7.2 This annex is relevant to our analysis of both sports and movies.

The concept of an entry barrier for the purposes of competition law

Sky's representations

7.3 The OFT Market Power Guidelines state that "Entry barriers are factors that allow an undertaking profitably to sustain supra-competitive prices in the long term, without being more efficient than its potential rivals" (paragraph 5.3).

7.4 In its response to the Second Pay TV Consultation, Sky cited this quote from the OFT Market Power Guidelines. Sky argued that Ofcom's approach to entry barriers was mechanistic and inconsistent with the OFT Market Power Guidelines. In particular, Sky considered that most of the factors that Ofcom had cited in the Second Pay TV Consultation described ways in which Sky was more efficient than its rivals. The implication of Sky's position appears to be that Ofcom erred in relying on these factors when assessing barriers to entry.

Ofcom's position

7.5 As a preliminary point, Ofcom is considering action under s316 of the CA03. However we have considered whether Sky's representations accurately reflect the legal position under Article 81/82 EC and the CA98.

7.6 Contrary to Sky's claims, we consider that our approach, namely taking a broad view of what constitutes an entry barrier, is appropriate. This is for the following two reasons that are discussed in further detail below:

- The quotes relied upon by Sky need to be placed in context. This reveals that Sky's apparent narrow view of what constitutes an entry barrier is not supported by the OFT Market Power Guidelines.

- The European Commission and Community courts have also taken a broad view of what constitutes a barrier to entry in the context of Article 82.

Entry barriers identified in the OFT Market Power Guidelines

7.7 Sky relied upon the phrase from the OFT Market Power Guidelines that "Entry barriers are factors that allow an undertaking profitably to sustain supra-competitive prices in the long term, without being more efficient than its potential rivals". However these guidelines explicitly identify factors such as economies of scale as potential barriers to entry (paragraph 5.6). Clearly where an incumbent enjoys economies of scale it could be characterised as being "more efficient than its potential rivals". However the OFT Market Power Guidelines, contrary to Sky's apparent narrow position, nonetheless consider that it can be legitimate to regard them as barriers to entry. We thus consider that our approach is in accordance with the OFT Market Power Guidelines.

The European position

7.8 The European Commission and Community courts have also taken a broad view of what constitutes a barrier to entry in the context of Article 82 EC Treaty[109]. Factors giving rise to efficiency advantages which have been found to constitute barriers to entry include vertical integration, brand identity and advertising, reputation and experience, innovation and technological superiority and highly developed distribution and sales networks[110]. This is illustrated by the cases set out in the following paragraphs[111].

7.9 In *United Brands v Commission*[112], the ECJ found that the main barriers to entry arose due to the scale of United Brands' production and supply of bananas. In particular, the main barriers to competitors entering the market were:

> "exceptionally large capital investments required for the creation and running of banana plantations, the need to increase sources of supply in order to avoid [unforeseen crop failure], the introduction of an essential system of logistics which the distribution of a very perishable product makes necessary, economies of scale from which newcomers to the market cannot derive any immediate benefit and the actual cost of entry made up […] of all the general expenses incurred in penetrating the market such as the setting up of an adequate commercial network, the mounting of very large-scale advertising campaigns, all [of the] financial risks, the costs of which are irrecoverable if the attempt fails […] thus, although, as UBC has pointed out, it is true that competitors are able to use the same methods of production and distribution as [UBC], they come up against almost insuperable practical and financial obstacles"[113].

7.10 In *Napier Brown – British Sugar*[114], vertical integration was also found to impede access to the market. In that case the court found that British Sugar's:

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[109] Article 82 caselaw is relevant to the CA98 by virtue of section 60 of that Act.
[110] This is not necessarily an exhaustive list.
[111] See also the following cases: Case 85/76 Hoffman-La Roche & Co. AG v Commission [1979] ECR 461; Case IV/30.787 Eurofix-Banco v Hilti OJ (1988) L 65/19; Case 322/81 Michelin v Commission [1983] ECR 3461 and Michelin (II) v Commission [2002] OJ L 143/1; Case 1016/1/1/03 Genzyme v OFT [2004] CAT 4; and Case 1001/1/1/01 Napp Pharmaceuticals v Director General of Fair Trading [2001]. See also the Competition Commission's final market investigation reports on Groceries, Classified Directory Advertising Services, and Northern Irish Personal Banking.
[112] Case 27/76 United Brands v Commission [1978] ECR 207.
[113] United Brands v Commission paragraphs 122-123. See also Bellamy & Child European Community Law of Competition 6th ed. page 930.
[114] Case IV/30.178 Napier Brown – British Sugar OJ (1988) L 284/41.

> "[well]-established, advanced and integrated operations make it difficult for a new producer, which produces on only one level of production, to operate. Thus considerable barriers to entry exist regarding the production of beet-origin sugar. Indeed, the fact that no new producer of sugar from beet origin has set up in the United Kingdom since 1936 despite the fact that BS has consistently been profitable, indicates that these barriers to entry are real and appreciable"[115].

7.11 In *AKZO v Commission*[116], the court recognised the efficiency advantages conferred on an undertaking by advertising and research and development activities:

> "factors [confirming] AKZO's predominance in the market [include the fact that] it has the most highly developed marketing organization, both commercially and technically, and wider knowledge than that of their [sic] competitors with regard to safety and toxicology"[117].

The concept of an entry barrier for the purposes of competition law

Sky's representations

7.12 A report by Professor Martin Cave, which Sky submitted in response to our Third Pay TV Consultation (the "Cave Report") stated that a prior issue is "whether wholesale premium channels satisfy the same sort of requirement for eligibility for ex ante regulation as other services subject to mandatory access."[118] The Cave Report approached this issue by considering criteria for ex ante regulation "in other sectors"[119].

7.13 By way of analogy, the Cave Report referred to a European Commission recommendation (the "Electronic Communications Recommendation") which identifies the presence of high and non-transitory entry barriers of a structural or legal/regulatory nature as one requirement for the application of ex ante regulation[120]. The Cave Report claimed that neither of these types of entry barrier (structural or legal/regulatory) is identified in the Third Pay TV Consultation. Rather the barrier to entry at the retail level was obtaining access to Sky's channels and 'strategic'[121].

Ofcom's position

7.14 As a preliminary point, in Section 9 we address Sky's arguments about the relevance of the criteria for ex ante regulation in other sectors to the application of s316 CA03.

7.15 Turning now to the specific arguments concerning the nature of entry barriers, the Electronic Communications Recommendation states that:

- "Structural barriers to entry result from original cost or demand conditions that create asymmetric conditions between incumbents and new entrants impeding or preventing market entry of the latter.". Examples may include absolute cost

[115] Napier Brown – British Sugar paragraphs 56-57.
[116] Case C-62/86 AKZO v Commission [1991] ECR I-3359.
[117] AKZO v Commission paragraph 61.
[118] Cave Report, paragraph 16.
[119] Cave Report, paragraph 16.
[120] Commission Recommendation on relevant product and service markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC, 2007. Referred to in Cave Report, paragraph 18.
[121] Cave Report, paragraph 20.

advantages, substantial economies of scale and/or economies of scope, capacity constraints and high sunk costs[122].

- "A related structural barrier can also exist where the provision of service requires a network component that cannot be technically duplicated or only duplicated at a cost that makes it uneconomic for competitors."[123]

- "Legal or regulatory barriers … result from legislative, administrative or other state measures that have a direct effect on the conditions of entry and/or the positioning of operators on the relevant market." Examples include limits on access to spectrum[124].

7.16 Paragraph 20 of the Cave Report only referred to the retail level. However, in order for Sky to have the ability to act in a manner which is not consistent with fair and effective competition we consider that we would have to find that Sky had market power in the wholesale supply of packages including Core Premium Sports channels and packages including Core Premium Movie channels. Our primary focus is thus on the wholesale level.

7.17 We consider that the advantages that Sky enjoys over rival bidders for key rights (such as delays in building a subscriber base, the advantages of vertical integration, staggered expiry dates of agreements licensing the Movie Rights) can be characterised as structural barriers to entry. These factors allow Sky to extract greater value from key rights, thus giving it an advantage over rival bidders. We thus disagree with the proposition in the Cave Report that the relevant barrier to entry is not structural[125].

7.18 In any event, we identify access to Sky's Core Premium channels as a barrier to entry or expansion at the retail level. Retailers' inability to access this important input at an appropriate price appears to be analogous to "a network component that cannot be technically duplicated or only duplicated at a cost that makes it uneconomic for competitors" in the electronic communications sector. Thus, even at the retail level, the barrier to entry/expansion that we identify appears to be a "related structural barrier" of the type set out at recital 9 of the Electronic Communications Recommendation.

122 Electronic Communications Recommendation, recital 9.
123 Electronic Communications Recommendation, recital 9.
124 Electronic Communications Recommendation, recital 10.
125 Cave Report, paragraph 20.

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, **[✂]** and the failure of any new entrants to win Live Premier League Rights in the Initial 2009 Sale[126]. Nonetheless, we recognise that other factors are at play in determining the outcome of specific Premier League package rights bids.[127]

[126] **[✂]**

[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. **[✂]**[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. **[✂]**.

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

[✂]

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. **[✂]** 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

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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 base[129]. 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 Consultation[130].
- 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 Rights[131].

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 services[134].

- One possible synergy stems from the increased profits from dampening competition if one retailer suppliers 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 content[135]. 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" namely[136]:

- 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. **[✂]**

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 subscriber[137]. 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 incentives[139]. 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 channels[140]. 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 **[✂]** is evidence of the difficulties in aligning wholesale channel provider and retailer's incentives. **[✂]**. **[✂]**. 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.

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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 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, **[✂]**

8.35 **[✂]**[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.

<u>Implications of Step 1 and Step 2</u>

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] **[✂]**

[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 **[✂]** subscribers on DSat as compared to Virgin Media's **[✂]** subscribers to those channels on its cable platform. Similarly, in June 2007 Sky retailed its Core Premium Movie channels to **[✂]** subscribers on its DSat platform as compared to Virgin Media's **[✂]** 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 platformwith the second largest number of likely subscribers. However:

- In 2006, **[✂]**[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 **[✂]**[145].

- Indeed in 2009, **[✂]**.

8.44 Our position thus remains unchanged from the Third Pay TV Consultation[146]. 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 barriers[147]. 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 BT[148]. As explained above, Sky is the most effective retail outlet on the platform with the largest number of likely subscribers to Core Premium channels[149]. 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

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[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 **[✂]**. However this does not explain why **[✂]**.
[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 Consulation, 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. **[✂]**[150].
- How they wish to position their business. **[✂]**[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 broadcasters[152]. For example, **[✂]**[153] Bids of this order of magnitude (i.e. **[✂]**) are lower than Sky's bids for even the cheapest package of Live Premier League Rights (i.e. **[✂]**).

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.

8.50 In Annex 10 of the Second Pay TV Consultation we presented conjoint analysis of the results of an April 2008 Ofcom survey. This indicated that, were all the 138 Premier League matches that are screened live available from Setanta then on average consumers would value that content at £42/month. If that same content were available from Sky, consumers would value it at £57.50/month (i.e. 37% more)[154]. The effect of Sky generating more consumer value from its channels is that Sky is likely to be able to outbid rival bidders for the Live Premier League Rights.

8.51 There are a number of possible explanations for this finding:

- First, it may reflect a consumer preference for Sky's coverage (such as match analysis and commentary). **[✂]**[155].
- Second, it may reflect the brand that Sky has established over the course of several years. These explanations are supported by Sky's research and the relative amounts spent on advertising. Based on data from Nielsen Media Research, we estimate that, in 2007, spending on the main advertising categories was £115m by Sky, £51m by Virgin Media, £11m by Setanta and £13m by BT

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[150] **[✂]**
[151] **[✂]**
[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.oft.gov.uk/advice_and_resources/resource_base/ca98/decisions/bskyb2
[153] **[✂]**
[154] Respondents all subscribed to a Sky Sports channel and/or Setanta Sports as well as expressing an interest in sports. The figure thus relate to the valuations of an average subscriber who might be described as a 'sports fan'. We consider that it is the valuation of the average potential subscriber that is relevant to the amount bid for the Live Premier League Rights, rather than the valuation of particular sub-groups of potential subscribers. We also note that consumers that are strongly committed to football would value all 138 Premier League matches at £54/month when supplied by Setanta but would value those same games at £63/month when supplied by Sky (17% more). For consumers that are weakly committed to football, the equivalent figures are £26.50 and £44 respectively (66% more).
[155] **[✂]**

Vision[156]. Moreover these figures exclude other forms of marketing carried out by Sky, including set-top box subsidies etc.

8.52 The Premier League stated that this factor lacks credibility since other potential bidders such as BT and Virgin Media are well known and successful brand names[157].

8.53 The survey evidence we presented in the Second Pay TV Consultation compares Sky with Setanta. At the time that survey was conducted (April 2008), Setanta had broadcast live Premier League matches for almost a year and prior to that it had operated a sports channel for several years. Nonetheless our survey shows that Setanta faced a significant disadvantage in relation to Sky. We recognise that it is plausible that this effect would be smaller in the case of entrants with well established brands. However this still implies that branding acts as an obstacle for firms without a strong brand, including entirely new entrants.

8.54 The Premier League also asserted that, even if Sky were to enjoy a branding advantage, it does not affect a bidder's ability to submit competitive bids[158]. As explained above our survey evidence suggests that consumers would pay 37% more for a Sky branded channel than they would for the same content from Setanta. We consider this is evidence that Sky enjoys a material branding advantage, at least over entrants that lack a strong pre-existing brand.

8.55 Sky stated that an entrant would need to match the quality of an incumbent's programming in order to extract the same value from the rights, but considered that this creates positive incentives to innovate and improve quality. This may require marketing expenditure by the new entrant, although Sky noted that incumbents have typically previously engaged in such expenditure. We are not suggesting that the branding advantage identified above is unfair. However, we are identifying factors that provide Sky with an advantage over rival bidders for the Live Premier League Rights. We thus regard it as appropriate to consider branding advantages, even where they reflect Sky's more attractive coverage and/or the impact of Sky's accumulated brand-building activities.

[156] Figures reflect estimated expenditure on outdoor, press, radio, cinema and TV advertising. If direct mail and door drops are included the overall pattern of expenditure (including the relative positions of the different firms) is unchanged. These figures do not include online advertising or the cost of producing advertisements and running a marketing operation.
[157] Premier League response to Third Pay TV Consulation, paragraph 6.47.
[158] Premier League response to Third Pay TV Consulation, paragraph 6.47.

Appendix 9

Other entry barriers mentioned by consultation respondents

Introduction

9.1 Respondents to the First Pay TV Consultation and the Second Pay TV Consultation also identified a number of other purported entry barriers, namely:

- The staggered availability of sports rights (the Four Parties).
- The duration of rights contracts (the Four Parties).
- The terms that Sky would agree with wholesalers in return for distributing their channels on its DSat platform (BT Vision, Virgin Media).
- Uncertainty about the level of conditional access ("CA") charges on Sky's DSat platform (BT Vision).
- The risks to rights holders of selling their rights to new entrants (Virgin Media).
- "Toehold" effects (**[✂]**).

9.2 In our Third Pay TV Consultation we considered each of these effects and reached the following views. Our reasons are set out in Annex 8 of that consultation:

- We recognised that in theory the staggered availability of sports rights was capable of acting as a barrier to entry, but concluded we could not rely on it[159].
- We did not accept consultation respondents' claims that the duration of rights contracts creates a further barrier to entry[160].
- We did not accept that the ability of a particular retailer to extract a large proportion of the retail revenue generated by a channel in itself gives that retailer's wholesale arm an advantage when bidding for content rights[161].
- We maintained our view from the First Pay TV Consultation that uncertainty about CA charges does not constitute a material barrier to entry[162].
- We accepted that the risks to rights holders may be greater in selling rights to new entrants, but did not rely on this point in the absence of suitable evidence[163].
- We did not rely on the bidding effect identified by **[✂]** as a "toehold" effect[164].

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[159] Third Pay TV consultation Annex 8, paragraph 2.175.
[160] Third Pay TV consultation Annex 8, paragraph 2.177.
[161] Third Pay TV consultation Annex 8, paragraph 2.181.
[162] Third Pay TV consultation Annex 8, paragraph 2.183.
[163] Third Pay TV Annex 8, paragraph 2.187.
[164] Third Pay TV consultation Annex 8, paragraph 2.190.

9.3 We have not received any further arguments on these points, and we remain of the views set out in Annex 8 of our Third Pay TV Consultation.

Appendix 10

Relevance of the 2009 resale of the Live Premier League Rights

Introduction

10.1 In June 2009 the Premier League terminated its agreement to licence packages C and D of live Premier League rights to Setanta Sports. Shortly thereafter the Premier League resold the live Premier League rights to the 2009/10 Premier League season that were previously licensed to Setanta (the "2009 Resale").

10.2 As explained in the main document, we rely upon the amounts bid in the 2006 Sale and the Initial 2009 Sale. However, for the reasons set out below we do not consider that the 2009 Resale provides reliable evidence of the likely outcome when the Live Premier League Rights are sold in the future.

10.3 The Premier League **[✂]**[165] but considered that the 2009 Initial Sale was not reliable evidence about Sky's likelihood of winning the Live Premier League Rights in the future[166]. **[✂]**[167]. We consider the Premier League's arguments about the 2009 Sale in paragraphs 5.480 to 5.481. In this Appendix we consider the relevance of the 2009 Resale.

Analysis of the 2009 Resale

10.4 **[✂]**[168].

Figure 10: Bids for packages C and D in the 2009 Resale

[✂]

Figure 11: Annualised bids for packages C and D in the 2006 Sale and the Initial 2009 Sale

[✂]

10.5 **[✂]**[169]:

- **[✂]**
- **[✂]**

10.6 **[✂]**

- **[✂]**
- **[✂]**

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[165] **[✂]**
[166] **[✂]**
[167] **[✂]**
[168] **[✂]**
[169] **[✂]**

10.7 **[✂]**

10.8 **[✂]**

10.9 **[✂]**[170].

10.10 **[✂]**[171] **[✂]**[172]. **[✂]**

[170] **[✂]**
[171] **[✂]**
[172] **[✂]**

Appendix 11

Compatibility of our market power analysis with the European Commission's position

Introduction

11.1 As explained in the main document, in 2006 the European Commission accepted Commitments offered by the Premier League relating to an investigation into whether the joint sale of Premier League rights breached competition law[173]. As a result, the European Commission considered that there were no longer grounds for action and ended its proceedings against the Premier League. In this appendix we consider various representations made by the Premier League about the compatibility of our position and that of the European Commission.

The Premier League's representations

11.2 In its response to the Second Pay TV Consultation the Premier League stated that "By accepting the Commitments, the [European] Commission has concluded that there are no longer any grounds for action and that competition in downstream markets is protected"[174].

11.3 The Premier League advanced similar arguments in response to the Third Pay TV Consultation. The Premier League stated that Ofcom's view was "inconsistent" with the Commitments and that "Ofcom, as a National Competition Authority, is not entitled to depart from the views of the Commission"[175]. Specifically, the Premier League did not consider that Sky possesses wholesale market power as a result of the acquisition of the Live Premier League Rights since the Commitments were designed to address the European Commission's concerns[176]. The Premier League stated that the Commitments ensure that the sale process was fair, transparent and open to any bidder and therefore does not give Sky an advantage over other bidders[177]. The Premier League claimed that the EC Commission considered that the creation of ex ante competition (i.e. competition for the Live Premier League Rights) would prevent any winner obtaining market power downstream[178].

Ofcom's view

11.4 As a preliminary point, Ofcom is considering action under s316 of the CA03. This means that the relevant test is not whether or not there is an infringement of Article 101 EC but whether the condition is "appropriate for ensuring fair and effective competition" in the provision of licensed services. The Commitments Decision is not binding on Ofcom. Recital 13 of Council Regulation (EC) No. 1/2003 relates to commitments decisions and states that

> "Commitment decisions should find that there are no longer grounds for action by the Commission without concluding whether or not there has been

[173] Article 81 EC Treaty, now Article 101 EC Treaty.
[174] Response to second consultation from the FA Premier League, 12 December 2008, paragraph 6.8.
[175] Premier League September 2009 Response, paragraph 6.4.
[176] Premier League September 2009 Response, paragraph 6.4.
[177] Premier League September 2009 Response, paragraph 6.5; also 6.50.
[178] Premier League September 2009 Response, paragraph 6.17. The Premier League did not provide a reference to the Commitments Decision to support this claim.

or still is an infringement. Commitment decisions are without prejudice to the powers of competition authorities and courts of the Member States to make such a finding and decide upon the case."

11.5 As in previous consultations, we have considered whether our position is consistent with that of the European Commission[179].

11.6 The Commitments Decision states that the Commitments "considerably improve the scope for ex ante competition for the rights … [The] increase in the number of live TV rights packages … will permit greater competition in the acquisition of those rights … The ban on conditional bidding makes a further contribution to levelling the playing field …"[180]

11.7 In Appendix 8 above, we identify a number of factors explaining why Sky is likely to outbid rivals and win the Live Premier League Rights (bidder specific factors, avoiding a delay in building a subscriber base, the effects of vertical integration). These factors all mean that greater industry profits are generated if Sky wins the Live Premier League Rights. The bidder that generates the greatest industry profits would be expected to win in a competitive auction/bidding process. Thus there is no inconsistency between the position in the Commitment Decision, namely that the Commitments increase competition for the Live Premier League Rights, and our view that Sky (i.e. the bidder that generates the highest industry profits from those rights) is likely to win the majority of those rights.

11.8 The Commitments Decision also states that the Commitments "ensure that all the rights … will not be sold to the same purchaser … Even just one package of rights, properly balanced against the other packages, will be sufficient to give an overview "or "showcase") of the FA Premier League's season"[181]. The Commitments Decision does not state that, as a result of the Commitments, it will no longer be possible for broadcasters to attain a dominant position by acquiring the Live Premier League Rights.

11.9 Moreover, the Commitments Decision was published in March 2006. In our analysis of market power we have taken into account information that did not exist at the time the Commitments Decision was published, in particular the actual market positions attained by Setanta and ESPN and the outcomes of the various sales of the Live Premier League Rights. It would be appropriate for us to take a different view from that set out in the Commitments Decision based on more up to date information (although, as noted above, we consider that our position is in fact consistent with the Commitments Decision).

[179] The Commitments apply to the sale of the Live Premier League Rights relating to the 2007/08 to 2011/12 seasons (Commitment 11.4). They will thus no longer formally be in effect the next time the Premier League sells these rights, although the Premier League may choose to continue to behave in broadly the same manner specified in the Commitments.
[180] Commitments Decision, paragraph 40.
[181] Commitments Decision, paragraph 41.