Pay TV statement

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Statement

Publication date: 31 March 2010

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Section 1

Summary

Overview

1.1 After three rounds of consultation, we have made three decisions:

- To require that Sky Sports 1 and 2 are offered to retailers on platforms other than Sky's, at prices set by Ofcom.
- To approve Sky and Arqiva's request for Sky to offer its own pay TV services on digital terrestrial TV ('Picnic'), but conditional on a wholesale must-offer obligation on Sky Sports 1 and 2 being in place, with evidence that it has been effectively implemented. This conclusion is also conditional on any movies channels included in Picnic being offered to other digital terrestrial TV retailers.
- To consult on a proposed decision to refer two closely related movie markets – for the sale of premium movie rights and premium movie services – to the Competition Commission. This is with a view to asking the Competition Commission to remedy those competition concerns which we have identified, particularly in relation to the restricted exploitation of subscription video-on-demand movie rights, but which we cannot adequately address using our sectoral powers.

1.2 The pay TV sector has delivered substantial benefits to consumers since its emergence in the early 1990s. More than 12 million consumers now pay to access a greater choice of content, at higher quality, and with a greater degree of control than has historically been available from free-to-air broadcasters. Sky has been at the forefront of this development and has delivered substantial benefits to millions of consumers in the UK.

1.3 Pay TV services have to date been delivered primarily via satellite and cable networks. However, this investigation comes at a time of disruptive change in the way content is distributed. For example, digital terrestrial TV offers the scope for pay TV to be delivered via aerials, and new broadband networks could offer consumers an unprecedented choice of content, and the ability to access that content on demand.

1.4 The ability to provide such services depends not just on technology, but on access to content that consumers want to watch. Live high-quality sports and recent Hollywood movies retain an enduring appeal for many consumers. Access to this content has driven the historical development of pay TV, and we believe that it will remain crucially important for the development of new platforms and new services.

1.5 For many years Sky has held the exclusive rights to broadcast first-run Hollywood movies and many of the most sought-after premium sports. We have now concluded that Sky has market power in the wholesale of certain channels including this content. However, the position differs between sport and movies:

- Sky's position in sport arises from the unique ability of broadcast TV to reach a large live audience, and Sky's control of the live broadcast rights for many of the most important sports. This is unlikely to change in the next few years.

- The position in movies is more complex, since there are a variety of ways consumers can purchase movies content, and the importance of linear channels is starting to reduce. Looking forward, we expect video-on-demand to become increasingly important. However Sky controls not only all the major linear channel movie rights, but also all of the rights that would be required to develop a subscription video-on-demand service for first-run Hollywood movies.

1.6 Sky exploits its market power by limiting the wholesale distribution of its premium channels, with the effect of restricting competition from retailers on other platforms. This is prejudicial to fair and effective competition, reducing consumer choice and holding back innovation by companies other than Sky. In the case of movies the fact that Sky also owns but barely uses the subscription video-on-demand rights denies competitors the opportunity to develop innovative services.

1.7 We have decided that we should use our powers under section 316 of the Communications Act to ensure fair and effective competition by requiring Sky to offer the most important sports channels – Sky Sports 1 and Sky Sports 2 – to retailers on other platforms:

- Given that we cannot expect commercial agreement between Sky and other retailers, we have set a price for standard-definition versions of these channels at a level that should allow an efficient competitor to match Sky's retail prices. The calculations are based on Sky's own retail costs, adjusted for scale so as to allow for a market with several competitors rather than a single provider.

- We have set a wholesale price for each of Sky Sports 1 and 2, when sold on a standalone basis, which is 23.4% below the current wholesale price to cable operators. Most consumers currently buy packages which include both channels, and the wholesale price for the service bundle which applies in those circumstances has been reduced by 10.5%.

- In calculating these prices, we have taken into account the additional retail revenue generated by Sky from its Multiroom service enhancement, and have also taken into account any associated costs. Other retailers will be free to develop their own service enhancements, including offering Multiroom-type services, by using the same underlying wholesale product at no additional cost.

- We have not set a price for high-definition versions of Sky Sports 1 and 2. We have accepted Sky's argument that high-definition services are a relatively recent innovation, and that pricing flexibility will help promote future innovation. We instead require Sky to offer contractual terms for supply of these channels on a fair, reasonable and non-discriminatory basis.

- We have provided guidance on a number of non-price matters such as security, to ensure that the remedy is implemented as quickly as possible.

1.8 We have decided it would not be appropriate to impose a similar obligation on Sky's movies channels. We have concerns over restricted distribution of movies channels, but our main forward looking concern relates to the sale of video-on-demand rights. We cannot adequately address this concern under section 316 (which relates primarily to linear channels). Instead we believe we should make a reference to the Competition Commission under the Enterprise Act 2002, and as required by statute, we are consulting on that proposed decision.

1.9 We have decided to consent to Picnic, subject to a wholesale must-offer obligation on Sky Sports 1 and 2 being in place, and evidence that it has been effectively implemented. This conclusion is also subject to any movies channels included in Picnic being offered to other DTT retailers. These conditions will allow consumers to benefit from access to Picnic, whilst also ensuring fair and effective competition.

1.10 We expect these decisions to deliver substantial benefits to consumers.

- The most immediate benefit will be felt on digital terrestrial television. Ten million Freeview households will, if they so choose, be able to access the most attractive sports content via their existing aerials, and competition between Sky and other retailers should ensure a wide range of packages, including lower-priced entry-level bundles.

- Improved access to 'must-have' content will incentivise investment in new means of distributing content, such as faster broadband networks. In the longer term this will result in a range of innovative new services for consumers.

- We also expect to see improved choice of wider bundles which include broadband, voice and TV services, with a variety of suppliers able to compete effectively across all three of these key communications markets.

1.11 In deciding what it is appropriate to do to ensure fair and effective competition, we are particularly mindful of the benefits that Sky has historically delivered to consumers, both through investment and innovation on its own platform, and its willingness to make long-term investments in UK sport. That is why we have deliberated carefully on these issues over the course of three consultations. We believe, however, that our remedy is appropriate:

- Although we acknowledge that Sky is opposed to the remedy, we see the reasons for this opposition as being related to its strategic incentives to protect its retail business. We do not expect the remedy to reduce Sky's wholesale revenues. Sky already wholesales Sky Sports 1 and Sky Sports 2 to cable operators, and has expressed a willingness to extend wholesale supply to other platforms, including in prior discussions with Ofcom. The potential negative impact of the relatively modest price decrease we are implementing should be more than offset by market expansion effects.

- We have designed the remedy to minimise the potential risk of any negative impact on the value of sports rights. The wholesale revenue available to Sky to pay for sports rights should not be reduced, and should in fact increase as the market expands. The other broadcasters whose bidding behaviour has driven rights values in the past should not be materially affected. And in the longer term the emergence of new retailers, with significant numbers of subscribers, should increase competition for rights, given the various benefits associated with direct control of those rights.

1.12 Similar interventions have succeeded in other countries. In the US in particular, the Program Access Rules have enabled market entry by new satellite and IPTV platforms.

1.13 Our sports channels remedy and our decision on Picnic both come into effect immediately, with a view to both Sky and its competitors being able to launch new services in time for the start of the next football season in August.

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

1.14 We started this investigation in early 2007 after having received a major submission from BT, Setanta, Top Up TV and Virgin Media.

1.15 We have assessed whether competition in the sector is effective in delivering the following benefits to consumers:

- Choice of platform and content:
  - Choice for consumers of platform and of content once platform selection is made.
  - Switching between retailers and platforms should not be artificially difficult.
  - Generation and availability of a broad range of high-quality content: a variety of content should continue to be generated and made available to consumers on all platforms.
- Innovation:
  - In platform services, for example in terms of interactivity, set-top box functionality such as DVR capabilities, or VoD options.
  - In retail service bundling, packaging and pricing.
- Pay TV services priced competitively and efficiently:
  - Prices which give consumers good value and allow efficient producers to earn a reasonable return on their investment.
  - A sufficient variety of price points / bundles to allow consumers to tailor their purchases to meet their preferences.

1.16 An effectively competitive market should provide consumers with choice, innovation and competitive pricing. We have assessed the market against this benchmark, and have considered whether we need to act in order to ensure fair and effective competition, as provided for in section 316 of the Communications Act 2003.

1.17 The early parts of our investigation took a broad overview of the pay TV sector. We characterised the historic evolution of pay TV in terms of three major phases:

- The birth of pay TV and the development of analogue satellite and cable services in the late 1980s and 1990s.
- The transition to digital services at the end of the 1990s.
- The rapid take-up of digital multichannel TV during the 2000s, driven particularly by Sky's pay satellite service and the success of free-to-air digital terrestrial TV.

1.18 We are now moving into a new period of potentially disruptive technological change, as new means of distributing video content offer consumers greater control over what they watch and when they watch it. For example:

- The success of free-to-air digital terrestrial TV means that a large number of consumers are now familiar with multichannel TV, have an easy migration path to pay TV services provided via their existing TV aerial, and may be willing to take that path given a suitable choice of retail packages.

- New broadband access networks allow consumers to access a variety of video-on-demand services, over closed IPTV platforms, and also over the open internet. Current generation broadband supports a limited range of such services, but sufficient to demonstrate their potential. A key driver of investment in superfast broadband is the ability to distribute video content in greater volumes and at higher quality than is currently possible.

1.19 Despite these technological changes, some underlying characteristics of the pay TV sector remain. Particular content holds enduring appeal for large numbers of viewers and is concentrated on pay TV – live top-flight sports and first-run Hollywood movies. Access to this content remains key for the development of any new platform, and is critical to ensuring effective competition.

1.20 Other characteristics of the sector also have the potential to affect competition:

- Some pay TV businesses are vertically integrated between wholesale and retail activities. This can be efficient but can also create incentives to act in a way which can limit competition.

- Content aggregation – the assembly of programmes into channels, and channels into bundles – is important and generally beneficial as a means of delivering attractive retail packages in an efficient manner. However, it can also contribute to market power.

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

1.21 Our review of market power has focused on the two most important types of content – sports and films. We have reviewed a very wide range of evidence on both.

1.22 In sports, Sky has market power in the wholesale and retail markets for packages including 'Core Premium Sports' channels (Sky Sports 1 and 2 and ESPN).

- These channels contain a distinctively large amount of the most attractive live sports, shown regularly through the year. The most significant of these is live coverage of Premier League football, but a number of other important events are also shown on these channels.

- We consider whether there are substitutes for these channels, mainly by comparing the channels' characteristics with the characteristics of potential substitutes, but noting that the extent of substitutability is affected by the fact that prices for Sky Sports 1 and 2 appear to be above competitive levels.

- The closest substitute is sports on free-to-air channels, but the most attractive events shown on these channels are either infrequent or offer lower volumes of content. Our conclusion on market power is in any case largely independent of where the market boundary is drawn. Even if we were to include sports broadcasting on free-to-air as well as pay TV, Sky's market share would still be above 60%.

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

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

- These channels contain a wide range of recent popular movies, including all of the films from the six Major Hollywood Studios shown in the first pay TV window[1].

- We consider whether there are substitutes for these channels, mainly by comparing their characteristics with the characteristics of potential substitutes. We conclude that there are no close substitutes, implying that that Sky has a market share of 100%.

- However, this market share figure substantially overstates the degree of market power held by Sky. There are a variety of other ways of watching films, and the aggregate constraint from these may be significant. Retail DVDs and films on free-to-air channels are the two types of service that offer the strongest constraint, as they are the closest substitutes that are of significant scale.

- We have assessed the strength of this aggregate constraint by calculating market shares under a variety of assumptions for the market boundary. Considering the constraint to be as strong as it plausibly could be, Sky would have a market share of around **[✂]** [30 to 50]%. However this figure understates the degree of market power held by Sky, since it treats moderate substitutes as if they were close substitutes.

- Our view that Sky has market power is directly supported by evidence that Sky's wholesale prices for movies channels are above the competitive level. This evidence is independent of the precise market definition or market shares.

- Sky also purchases exclusive subscription video-on-demand rights for movies in the pay TV window from all of the Major Hollywood Studios. A subscription video-on-demand service showing the same movies in the same window would appear to be the closest substitute for Sky's Core Premium Movies channels. If, as expected, subscription video-on-demand services increasingly replace linear channels, Sky's position is likely either to be maintained or to become more powerful, particularly due to the advantages of subscription video-on-demand over linear channels.

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

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

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

1.25 Our review of these negotiations reveals lengthy and ultimately fruitless discussions over a number of years between Sky and other pay TV operators over possible wholesale of Sky's premium channels. This impasse has remained despite, as Sky agrees, there being an immediate financial benefit to Sky from wholesale supply. We believe this is because Sky is acting on two strategic incentives – to protect its retail business on its own satellite platform, and to reduce the risk of stronger competition for content rights.

1.26 Sky's behaviour in negotiation has been to respond to requests for wholesale supply with counter-offers to retail its channels on behalf of other retailers. Sky's position has been that it would be unwilling to enter into a wholesale deal unless it could be shown that it would be better off than under a retail arrangement. We accept that other parties' preference for supply should not automatically take precedence over Sky's preferences. There are however legitimate reasons for the reluctance of third parties to enter into retail deals with Sky, and where it has been evident that no retail deal would be reached, Sky appears to have preferred to be absent from the relevant platform rather than to pursue wholesale supply.

1.27 An outcome where Sky was the dominant retailer of premium content across all platforms would not in any event ensure fair and effective competition, as Sky would still have the incentive and ability to manage competition in favour of its own platform(s). Practical examples such as Sky By Wire on Tiscali / TalkTalk's TV platform bear out this concern, where Sky's prices are high compared to those on satellite, and premium take-up is low as a result.

1.28 Sky already wholesales standard definition versions of premium channels to Virgin Media, as a result of a commercial agreement reached in the early 1990s when the negotiating positions were more evenly balanced, and following the competition case concluded by the Office of Fair Trading in 2002. However, more recent negotiations over the supply of new services to Virgin Media reveal a similar pattern to that set out above. The non-supply of these services to Virgin Media – especially high-definition versions of Sky's premium channels – prevents fair and effective competition.

1.29 Sky supplies standard-definition versions of its premium channels to Virgin Media at a price it believes is compliant with an ex post competition law margin squeeze test. Application of this test means that retailing based on this wholesale price should be profitable at Sky's scale, and at the level of the entire bundle of basic and premium channels. However, Virgin Media's scale – particularly in terms of premium subscribers – is much smaller than Sky's, so it is unsurprising if prices set on such a basis do not enable Virgin Media to compete effectively with Sky. This contributes to Virgin Media having little incentive to sell premium channels to existing basic subscribers, which in turn contributes to the low take-up of these channels on Virgin Media's platform.

1.30 More generally, to the limited extent that Sky enters into any discussions about wholesale pricing with any other retailer, these discussions centre on the prices which Sky currently sets to Virgin Media via the rate-card. We do not believe it to be a reasonable expectation for retailers other than Sky to be prepared to pay the rate-card price for Sky's Core Premium channels, as these prices would not allow them to compete effectively. The rate-card prices are set so as to allow a retailer with Sky's scale to compete effectively, and there is only room in the market for one such retailer.

1.31 We acknowledge that the pay TV sector has delivered substantial benefits to consumers, both through investment in high-quality content and through innovative services, many of which have been driven by Sky. However, in a well-functioning market it is fair and effective competition that drives consumer benefits. The current restricted distribution of key content prejudices fair and effective competition, reducing choice of platforms and retail packages and dampening innovation.

- Consumers with a preference for platforms other than satellite or cable – such as the ten million households with digital terrestrial television – are currently unable to access Sky's premium channels at all.

- Consumers on cable can access Sky's premium channels, but in standard definition only, without the associated interactive services, and purchased from a retailer whose incentive is to use the channels solely as a retention tool, rather than as a source of added value.

- While there are a large number of package combinations in the market, consumers have less variety of price points available to them than we would expect to see in an effectively competitive market. In particular, consumers who want an entry-level pay TV package rather than a 'big mix' are under-served by current offerings.

- Bundles of TV and telecommunications services are becoming increasingly important. This is partially because regulation has been successful in ensuring that retail telecommunications markets are competitive. However, if pay TV markets are not effectively competitive, there is a risk that the forms of reduced choice we set out above will extend into these wider bundles.

- Although there has been considerable innovation in the sector, much of it has historically been of a type that suits Sky's satellite platform. Sky is unlikely to innovate in ways which are suited to platforms other than its own. This is a particular concern looking forward, given the significant benefits we see for consumers in the effective exploitation of new distribution technologies.

- In particular, new broadband networks will have the ability to offer consumers an unprecedented choice of content, and access to that content on demand. This is a significant driver for investment in superfast broadband, but new content distribution platforms will not develop if they are denied access to key 'must-have' content.

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

A wholesale must-offer remedy on sports

1.32 We have decided that an appropriate way to ensure fair and effective competition is to put in place a wholesale must-offer obligation on Sky Sports 1 and 2 under section 316 of the Communications Act, by including a condition to this effect in the relevant channel licences. This, we believe, will bring about greater choice and innovation, to the benefit of consumers.

1.33 We have rejected BT / Setanta / Top Up TV / Virgin Media's (the 'Four Parties'[2]) suggestion for operational separation of Sky. Only structural separation – i.e. full

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

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

1.34 We have also, at this point, set aside the possibility of a substantial intervention in the way sports rights are sold, which would have the intention of significantly reducing market power. We acknowledge that this is in principle an attractive means of eliminating any potential competition concern at source. It would not be as immediately disruptive as structural separation of Sky, but has the same advantage as structural separation, in that it potentially permanently changes Sky's incentives and its ability to act on those incentives.

1.35 However, a remedy which places severe limits on content aggregation may also risk a number of less desirable consequences. For example, it might result in reduced convenience for some consumers, who might have to take multiple subscriptions or purchase multiple set-top boxes to get the content they want, and it could result in artificial depression of rights values, if splitting up content rights created packages for which there was limited bidding competition. Careful design of rights packages would be essential to minimise these risks.

1.36 Our current view is therefore that a remedy which addressed our competition concerns by placing severe limits on content aggregation, in order to eliminate market power at source, would be disproportionate. We might need to revisit this question if a regulated wholesale must-offer obligation proved ineffective.

1.37 It might still be appropriate to take specific targeted action in the case of the Premier League. We noted in our previous consultation that the commitments made by the Premier League to the European Commission will not apply to the sale of its rights from the 2013 / 2014 season onwards. We may therefore need to revisit the compliance of the Premier League's arrangements with competition law. We can certainly see benefit in establishing certainty prior to the next auction given the changes that have taken place since the last commitments were given to the European Commission. We will continue to keep under review the need for action on this issue.

1.38 We conclude that imposing an obligation on Sky to offer to wholesale its Core Premium Sports channels, Sky Sports 1 and 2 – a wholesale must-offer remedy – is the most appropriate way to ensure fair and effective competition in light of our findings on the effects of the restricted distribution of Core Premium Sports channels:

- A wholesale must-offer obligation will directly target restricted distribution.

- The obligation is proportionate: costs are likely to be low, and we expect them to be offset by market expansion effects.

- Sky already wholesales to Virgin Media, and has told us it is willing to wholesale if it cannot retail. It was also prepared to commit to wholesaling to other retailers in discussions with us in late 2007 and early 2008. Wholesaling is therefore not a radical departure from Sky's existing business practice, and is certainly not as "extreme" as Sky has suggested in its submissions to us.

- The obligation will seek to replicate the outcome we would expect in an effectively competitive market, where channel providers assemble a wide range of content and have an incentive to distribute it widely. The restricted distribution of Sky's channels, arising from Sky's vertical integration and its market power, contrasts for example with the wide distribution of ESPN's premium channel, and with the fact that that the original cable distribution deals were made at a time when Sky had less market power.

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

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

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

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

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

- IPTV and video-on-demand offer new means of accessing content, with significant potential consumer benefits in terms of greater choice of content and control over when and how to watch it.

- IPTV and video-on-demand will be enhanced by large-scale investments in superfast broadband. However, such investment only makes sense if it is possible to develop the sorts of services that can exploit their capabilities.

- Such services focus on content; movies content is important for video-on-demand services generally, and subscription video-on-demand movie rights are among the most important sets of video-on-demand rights.

1.42 We therefore consider that a linear channel wholesale must-offer remedy on all platforms would not by itself be an effective forward-looking solution to our competition concerns, which focus on the limited exploitation of subscription video-on-demand rights. At the same time, our powers under section 316 of the Communications Act 2003 are limited in relation to subscription video-on-demand services, while action under Competition Act 1998 is unlikely to be effective as a means of addressing our concerns. We are therefore consulting on a proposed decision to refer two closely related movie markets – for the sale of premium movie rights and premium movie services – to the Competition Commission. This is with a view to asking the Competition Commission to remedy those concerns which we have identified. This is set out in a separate document[3].

1.43 We have also considered whether to put in place a wholesale must-offer remedy immediately until any reference to the Competition Commission reaches a conclusion. We have concluded that it would not be appropriate to put in place an interim wholesale must-offer remedy for all Sky's movies channels on all platforms, because of the likely lack of demand for linear movies channels on existing platforms over the relevant time horizon.

1.44 However, we would have a specific concern if Sky were to launch a service on digital terrestrial TV during this interim period which contained Core Premium Movies channels as well as Core Premium Sports channels. We address this in our separate statement on Picnic[4], where we conclude that a launch by Sky on digital terrestrial TV should be subject to any such channels being made available to other digital terrestrial TV retailers first.

Concerns regarding high prices

1.45 As noted above, our analysis of whether Sky has market power has included a review of its pricing and profitability. This review has shown that Sky has earned high returns for a sustained period. The riskiness of Sky's early investments will have demanded such returns for a period. However, despite the fact that Sky's more recent investments have entailed lower levels of risk, Sky's returns remain at a high level and appear unlikely to be competed away in the future.

1.46 We have considered whether we should take action specifically to address this finding, and we have concluded in the case of sports that we should not. To do so would require us either to set wholesale prices on a cost-plus basis, or intervene to place severe restrictions on the way rights are sold. Both such approaches carry risks, including a risk that we might artificially reduce the value of sports rights. It might be possible to address these risks by appropriate design of any remedy, but we do not believe that the level of harm to consumers that we have currently identified in this process justifies the risks of intervening in these ways at this point in time.

1.47 In any case, while the remedy which we have put in place is not intended to reduce the overall prices of those sports packages which are currently in the market, it is intended that more effective distribution of sports channels should result in new packages being made available. These should offer consumers a wider variety of price points and bundles to choose from, including new entry-level packages. Much of the market expansion which we expect to occur as an immediate result of our remedy results from increased consumer take-up of these packages.

1.48 In the case of movies we note that a further reason for considering a subscription video-on-demand-related remedy is that it could potentially tackle concerns over high wholesale profitability. The margins that we see Sky making appear to be highest in

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

[4] http://www.ofcom.org.uk/consult/condocs/picnic/statement/.

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

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

1.49 Taking into account both quantifiable and non-quantifiable benefits and costs to consumers and industry participants, the remedy we are putting in place has a positive effect.

1.50 There is always risk associated with new regulation, which is why we have taken care to design our remedy to minimise negative effects on the market.

- One of our primary reasons for putting a remedy in place is to ensure fair and effective competition between different retailers, in order to deliver both retailing and platform-related innovation for consumers. We acknowledge the risk that regulation in a fast-moving market can reduce innovation, and in this particular case that it could restrict innovation by Sky. We believe the design of our remedy addresses this concern, not only because it is likely to enable Sky to maintain and most likely increase its wholesale revenues, but also because we have modified our remedy to address specific concerns, for example by allowing pricing flexibility in the case of Sky's most important recent innovation – high definition.

- There could be a risk to the value of the content rights held by sports bodies. Again, we have designed our remedy specifically to minimise any negative impact, through for example the approach we have adopted to pricing.

- After several years of prolonged but ultimately fruitless commercial negotiations between Sky and others, we believe regulation to be necessary and that the licence conditions imposed are in the best interests of consumers.

1.51 **Consumers** will benefit substantially from the remedy we are putting in place, in terms of choice and innovation.

- Consumers will be able to make a freer choice of platform without being restricted by the unavailability of Sky's Core Premium channels on particular platforms or distribution technologies. Ten million digital terrestrial TV homes will potentially have access to premium content, the majority for the first time.

- Moreover, they will potentially have the choice of a wider range of types of package, as different retailers innovate by packaging premium channels in different ways. We expect this to include a wider range of lower-cost entry-level bundles, including for example those proposed by Sky for its Picnic service, as well as through competing services from other retailers.

- The benefit that we expect will accrue to consumers as a result of this increased choice is considerable. We expect to see around 1.6 million additional consumers of premium channels after five years. This is based on there being 1.8 million new consumers on digital terrestrial TV or IPTV, including Picnic, plus 0.3 million additional customers on cable platforms, partially offset by a reduction of 0.6 million on satellite as customers switch to digital terrestrial TV or IPTV platforms. Expressed in terms of the overall effect on consumer surplus, this translates into a £280m gain for consumers, discounted to present value, over five years. Furthermore, this static analysis excludes dynamic gains from innovation.

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

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

- We have set prices for Sky's channels at a level that will not allow other retailers to earn short-term profits at Sky's expense by simply reselling its channels. Our objective is to ensure effective competition from efficient operators that are prepared to make a substantial long-term investment in innovative pay TV services, not to support entry by firms that are either inefficient or unable to achieve sustainable scale.

- The benefits to these retailers will arise from the other services and propositions we would expect these providers to be able to offer as a result of access to premium content. These benefits are difficult to quantify with certainty, but are likely to be significant.

- In addition, our remedy should allow these retailers to compete effectively in the retail of wider bundles including non-TV services.

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

- We acknowledge that Sky will not regard the remedy as positive, or it would not have been necessary for us to impose it. We believe however that Sky's opposition is driven by two strategic incentives – to protect its retail business on its own platform(s), and to reduce the risk of stronger competition for content rights. To the extent that our remedy enhances competition between retailers on different platforms, and enhances competition for content rights, we believe these would be positive outcomes.

- We do not however believe that the remedy will be disruptive to Sky's existing business. The expected static effects on Sky include increased wholesale profits, a slight upfront reduction in wholesale revenues from Virgin Media, a reduction in satellite retail profits from customers switching to other platforms, plus the impact of Picnic (should Sky want to pursue this proposal). In terms of Sky's overall producer surplus (its total five-year profits in both retail and wholesale, discounted to present value), this is likely to translate into a net increase for Sky of more than £600m over five years.

- We acknowledge that Sky will have to bear some administrative cost of implementation, but given that this remedy largely extends the existing cable wholesale arrangement to other platforms, this cost should not be substantial.

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

- The most important competing bidders for sports rights in the past have been companies that will not take up the wholesale must-offer – free-to-air broadcasters such as the BBC, ITV, C4 and Five, and broadcasters such as ESPN and Setanta whose primary focus is on building their own wholesale business. These companies' incentives to bid are largely unaffected by our remedy.

- The incentives of platform operators / retailers such as BT and Virgin Media may be somewhat altered by the availability of our remedy. We do not however expect this to have a negative impact on rights values. Key rights holders have acknowledged in their responses to us that these companies have not historically been prepared to make significant investments in sports content, a position which is consistent with our own review of all the significant sports rights auctions in recent years.

- Our review of recent auctions indicates that there are likely to be additional determinants of Sky's bidding strategy, over and above the presence of competing bidders: first, its stated intention to invest in the quality of the sports content it buys, which in turn increases the attractiveness of the channels; second, the option for rights holders to go direct to consumers themselves, which provides a competitive constraint on Sky's bidding strategy.

- Sky already pays substantial sums for premium sports content at the same time as supplying its premium channels on a wholesale basis to cable operators. An important difference between the terms of current supply to cable operators and the terms of our remedy are the prices we have set. These prices are precisely intended not to damage Sky's ability to bid the sums it currently pays – hence the use of retail-minus pricing (i.e. where wholesale prices are worked out from the retail price rather than from wholesale costs), with a cross-check to ensure that we are not pushing prices below a cost-based price which includes a fair return on investment. As noted above, we believe that Sky's overall wholesale revenues, taking account of market expansion effects, are more likely to increase than decrease.

- The prices we have set for wholesale sports channels are unlikely to allow other retailers anything above a normal return in retailing those channels. As a result, although operators can avoid risk by taking Sky's channels, the real economic returns are at wholesale level. This, in addition to the importance of control over editorial decisions and branding, underlines why not only will Sky have an incentive to continue to bid in order to retain control over the rights, but also other operators such as BT or Virgin Media should have an incentive to gain control over the rights upstream rather than being content in the long term with wholesale access.

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

1.55 Having decided that a wholesale must-offer obligation is appropriate to ensure fair and effective competition, there are a number of important questions of scope that we have considered. In each case we have assessed the proportionality of the options, as part of our impact assessment:

- The channels covered by the remedy will be Sky Sports 1 and 2. We believe that neither Sky Sports 3 nor 4 make a material contribution to Sky's market power, given the range of content currently shown on these channels, and that access to these channels is not therefore necessary to ensure fair and effective competition.

- We recognise the risk that a potential response to the remedy from Sky could be to attempt to undermine it by shifting content onto channels not covered by the remedy. If Sky were to do this to any material extent, we would need to review the remedy and consider extending it to all of Sky's sports channels. This would not require a protracted consultation process, since the substantive issues would be the same as those on which we have concluded in this statement.

- The wholesale must-offer obligation should not extend to retailers on Sky platform(s). We are concerned about ensuring fair and effective competition between retailers on different platforms, leading to choice and innovation on non-Sky platforms, and the development of new platforms. Extending the remedy to Sky's own platform(s) would not address this concern, and could be disruptive to Sky's existing business and customers.

- We want to avoid interfering with Sky's existing platform(s), but this does not mean we expect Sky to be the sole retailer of premium content across entire distribution technologies. The remedy therefore extends to non-Sky satellite platforms such as Freesat. Similarly, if Sky develops its own IPTV or internet-based platform, we would still expect other such platforms to be included within the scope of the remedy, subject to appropriate security provisions. In particular, Sky should not expect to be the sole retailer of premium channels on any future platforms based on Project Canvas[5].

- Virgin Media is in a different position to prospective entrants, in that it already has a number of premium subscribers. We have therefore considered whether it should be included within the scope of the remedy, and receive the same wholesale price. We conclude that it should, taking account of the need to avoid distorting the market, and the fact that Virgin Media's current scale is closer to that of entrant retailers than that of Sky. Indeed, Virgin Media has not yet reached anything like the scale of premium subscriber base that we assume in our pricing model to be necessary for a hypothetical new entrant to break even.

- The wholesale must-offer obligation will not include supply for onward retail to commercial premises. The nature of competition in pubs and clubs is very different from that for residential consumers, focussing on the price of standalone sports rather than pricing and innovation across wider bundles. This is reflected in the concerns bought to us by bodies such as the Association of Licensed Multiple Retailers, which focus on price, and is illustrated also by the low level of interest in supply to commercial premises shown by other retailers. A retail-minus wholesale must-offer is the wrong remedy to deal with any concern about the absolute level of retail prices. We do however consider that this is an issue that may be relevant to a future analysis of the sale of Premier League rights.

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

- The wholesale must-offer remedy will apply to high-definition versions of the included channels. High-definition is increasingly important to effective competition, and a remedy which excluded it would become ineffective over time. Sky has suggested that including high-definition in a wholesale must-offer remedy would damage innovation. We do not believe that including high-definition would be damaging to innovation in the way Sky suggests. However, because high-definition is a relatively recent innovation and there is a degree of uncertainty as to the appropriate approach to setting a price, we have decided not to set a price for supply of these channels. Setting prices might bring about supply faster, but doing so particularly in relation to a relatively new service such as high-definition might risk harming incentives for future innovation. Instead we have included an obligation for supply to be on a fair, reasonable and non-discriminatory basis. This should allow scope for commercial negotiation, with the possibility of bringing a complaint to Ofcom as a backstop.

- The wholesale must-offer remedy covers further primary content, i.e. matches or sports events, shown via the red button, which is associated with the included channels. We would expect viewers of the included channels to have access to the same range of primary content regardless of which platform they use. However, in recognition of the additional technical requirements of delivering interactive content, we would expect the retailer to bear any incremental costs to Sky of delivering interactive content.

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

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

1.57 We need to ensure that the wholesale must-offer remedy is implemented in a way that ensures effective competition in as short a time as possible.

1.58 Given the history of fruitless discussions between Sky and other retailers, we think the regulated offer should deal with all contractual terms. In particular, we believe it is necessary to set prices for standard definition versions of the channels included in the remedy. As both our review of wholesale negotiations between Sky and potential customers and our own discussions with Sky indicate, even if Sky were to negotiate in earnest, it would be unlikely to diverge from the cable rate-card.

1.59 The rate-card appears to be set by considerations relating to the Office of Fair Trading's 2002 margin squeeze test, rather than by commercial considerations. Despite the fact that Sky could increase wholesale revenue by selling to more retailers at a reduced wholesale price, it does not do so. As our pricing analysis and our analysis of Sky's own business plan for Picnic show, relying on the current cable prices would not ensure fair and effective competition, as retailers with smaller scale than Sky's would not be able to compete effectively.

1.60 We have revisited our pricing analysis since our Third Pay TV Consultation, in light of consultation responses and made some updates to reflect the latest available data. We have decided to adopt the same underlying approach towards pricing:

- We have derived retail-minus prices by considering a discounted cashflow analysis. We have determined the wholesale price that an efficient retailer could afford to pay given efficient retail costs and the need to earn a return, while at the same time matching Sky's current retail prices. We have stayed as close as possible to Sky's own costs, as the best available proxy of an efficient competitor.

- The analysis we have carried out is to consider the characteristics of a hypothetical entrant, not in order to pre-determine what will happen in the market, but in order to establish a price which will ensure that an efficient generic company is able to compete fairly and effectively.

- The prices we have set discourage entry by companies simply reselling Sky's channels; rather they require entrants to innovate around the channels in order to build a successful business.

- We cross-check these retail-minus prices against cost-plus figures, also based on a discounted cashflow analysis, by determining the price that Sky's wholesale business would need to charge to earn a reasonable return given its input costs.

1.61 We have derived prices for competitors that would be as efficient as Sky at equivalent scale, but do not have the same scale as Sky. Given the number of subscribers Sky has built up, there is not room in the market for more than one firm to have the same scale as Sky currently has. Therefore any remedy which sets out to ensure fair and effective competition has to allow for smaller scale. However, our approach is also designed to avoid the costs of market entry by firms that are either inefficient or unable to achieve sustainable scale.

1.62 Within this overall approach, we have made some changes to ensure that the remedy is appropriate. Our Third Pay TV Consultation set out a range of principles concerning price, and the central case of our illustrative scenarios assumed three million subscribers on digital terrestrial TV. We have updated our modelling to include more up-to-date data. Our decision on price reflects satellite transmission costs rather than digital terrestrial TV, and a subscriber base of 1.5 million rather than three million. The reasons for this change are as follows:

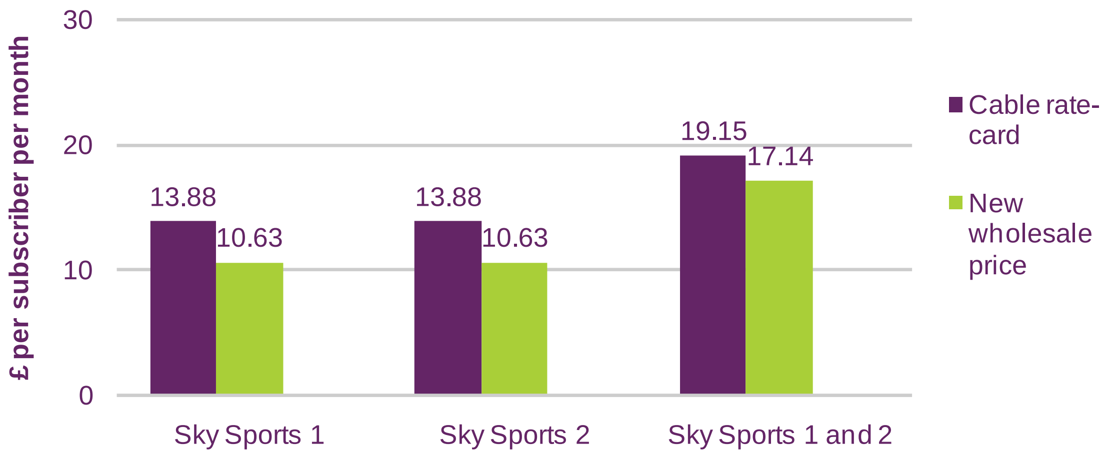
- All parties (including Sky in the context of our impact assessment) argued that our original scale assumption of three million subscribers for the competitor was unrealistically high. The effect of reducing this scale to 1.5 million subscribers is, in the presence of fixed costs, to increase retail costs per subscriber and hence reduce wholesale prices.

- Our overall aim is to stay as close as possible to Sky's own costs, as the best available proxy for an efficient retailer, while still allowing for market entry on non-Sky platforms, notably via digital terrestrial TV. In our Third Pay TV Consultation we therefore took account of the higher transmission costs of digital terrestrial TV. We have now decided that this is not necessary in order to ensure fair and effective competition, given the lower customer acquisition costs associated with digital terrestrial TV platforms in the absence of satellite dish and installation costs. We therefore derive prices based on Sky's own costs for satellite transmission.

1.63 It is clearly beneficial to consumers for competing retailers to be able to use the same wholesale input to offer differentiated retail services, thereby allowing for innovation in retail packaging, rather than for all retailers to be constrained to adopt Sky's pricing structure. We have therefore concluded that competing retailers should be able to develop their own retail service enhancements, without paying an additional wholesale charge, subject to them using the same underlying wholesale input. Consistent with this, we have included in our derivation of wholesale prices the retail revenues and costs generated by Sky from such services, specifically Multiroom services. The effect of this is that competing retailers will be able to add Multiroom services at zero incremental cost, and offer and price those services in a manner that best complements their overall proposition to retail customers.

1.64 The figure below shows our final wholesale prices, based on our updated calculations. We have set prices for three products: Sky Sports 1, Sky Sports 2, and the bundle of Sky Sports 1 and 2. These are the prices that we consider are necessary to ensure that other retailers are able to compete fairly and effectively.

Figure 1 New wholesale price for Sky Sports 1 and 2



	Sky Sports 1	Sky Sports 2	Sky Sports 1 and 2
Reduction from cable rate-card	23.4%	23.4%	10.5%
Retail margin	16.74	17.03	18.91

Source: Ofcom

1.65 The reduction relative to the rate-card is greater for single channels than for the bundle of Sky Sports 1 and 2. This reflects the fact that the Office of Fair Trading's margin squeeze test, by reference to which Sky appears to set its prices, is carried out at an aggregate level, giving Sky the freedom to set prices for some bundles high and some lower. Relatively speaking, the current wholesale prices seem to be higher for single channels than the bundle, leading to a greater reduction. Setting specific wholesale prices for each bundle allows competing retailers to be able to choose what types of retail package they wish to offer, and potentially differentiate these from Sky's, in order to ensure fair and effective competition.

1.66 Wholesale prices will track changes in retail prices over time based on a constant absolute (pounds) margin between retail and wholesale prices. We have decided not to adopt the 'ratchet' approach, of automatic downward changes but upward changes having to be approved by Ofcom. We suggested this in our Third Pay TV

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

1.67 We have put in place wholesale pricing rules to ensure competitors can replicate Sky's broader bundles which contain Core Premium Sports channels, recognising that many consumers now buy TV broadband and telephony as part of a wider bundle.

1.68 We require Sky to make available a 'reference offer', including Minimum Security Requirements for wholesale supply within six weeks of the new licence condition coming into force, which is on the day of publication of this statement. Six weeks is reasonable given the existing contract with Virgin Media and progress made on contracts with other operators.

1.69 The purpose of requiring a reference offer and Minimum Security Requirements is to minimise the amount of time it takes from the licence condition coming into force until other retailers are able to start taking wholesale supply from Sky and competing in the retail market:

- **Reference offer.** The purpose of the reference offer is to maximise the transparency of wholesale supply arrangements for prospective customers. Given the length of time over which Sky has engaged in negotiations with other retailers in the past, it is likely that allowing Sky to negotiate bespoke terms with each wholesale customer from scratch would introduce an unacceptable amount of delay into the process.

- **Minimum Security Requirements.** Apart from price, the main issue that has prolonged the process of negotiations between Sky and other retailers is platform security. It is absolutely legitimate for Sky to want to ensure that its channels are broadcast securely, but again this should not be used as a reason unduly to prolong wholesale discussions.

1.70 Our intention is not to attempt to set non-price terms ourselves, but to leave as much as possible to be decided by Sky in negotiation with its customers. We acknowledge however that this may prove impossible. As a backstop, Ofcom is prepared to resolve any complaints in a timely manner, in order that consumers can benefit as quickly as possible from our remedy.

Section 2

Introduction

Summary

2.1 We announced the opening of this investigation in March 2007, following receipt of a preliminary submission from BT, Setanta, Top Up TV and Virgin Media in January 2007.

2.2 Since opening the investigation we have published three consultations.

- First Pay TV Consultation: in December 2007 we consulted on initial views on the operation of the pay TV sector.
- Second Pay TV Consultation: in September 2008 we set out further analysis on sports and movies markets, and proposed to tackle our concerns over access to premium channels through a wholesale must-offer obligation using our powers under Section 316 ('s316') of the Communications Act 2003 ('CA03').
- Third Pay TV Consultation: in June 2009 we confirmed our views on access to premium channels and set out the details of our proposed wholesale must-offer obligation.

2.3 In this document we set out our decision on our previous wholesale must-offer proposals, amending them following our review of responses to our Third Pay TV Consultation.

2.4 We are publishing two other documents alongside this one.

- First, we are consulting on the proposed decision to make a market investigation reference to the Competition Commission ('CC') under the Enterprise Act 2002 ('EA02')[6] – a consultation on any proposed reference is required by statute. We are proposing to refer the market for the sale and purchase of upstream movie rights for the first pay TV window, and the closely related downstream market for wholesale premium movies channels to the CC for investigation.
- Second, we have concluded that Picnic (Sky / Arqiva's proposals to replace Sky's free-to-air DTT channels with a pay TV offer[7]) should be allowed to proceed, subject to a wholesale must-offer obligation on Sky Sports 1 and 2 being in place, and evidence that it has been effectively implemented. This conclusion is also subject to any Sky Movies channels included in Picnic being offered to other DTT retailers.

2.5 During the course of the investigation, we have received around 120 responses in total to our three consultations, 19 further submissions from Sky (apart from consultation responses) and seven submissions from other parties.

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[6] http://www.ofcom.org.uk/consult/condocs/movies_reference/ (the 'Movies Reference Consultation').

[7] http://www.ofcom.org.uk/consult/condocs/picnic/statement/ (the 'Picnic Statement').

Structure of this Section

2.6 This Section is set out as follows:

- Introduction.
  - Ofcom's market investigation to date.
  - Documents we have published through the course of the investigation.
- Work we have carried out since our last document.
- The consumer criteria by which we assess the pay TV market.
- The relationship between this document and our assessment of Sky's Picnic pay DTT proposal.
- Summary of views on consultation responses.
  - Pay TV operators.
  - Rights holders.
  - Other organisations.
  - Individuals or small businesses.
- Structure of the rest of the document.

Introduction

Ofcom's market investigation to date

2.7 This process began as a general investigation into pay TV markets, prompted by a request for a market investigation reference to the Competition Commission under the Enterprise Act 2002.

2.8 On 16 January 2007 we received a preliminary submission from BT, Setanta, Top Up TV and Virgin Media (the 'Four Parties'), which alleged that competition in the UK pay TV sector is not working properly, and that Ofcom should refer the industry to the CC for investigation.

2.9 Subsequently, in December 2007 we published a First Pay TV Consultation, where we set out our preliminary views on the operation of the market. This outlined some initial concerns relating to the manner in which premium content is aggregated and distributed, which we believed may restrict competition in the retail market to the detriment of consumers.

2.10 Our Second Pay TV Consultation in September 2008 analysed pay TV markets, identified some particular concerns relating to access to premium content, and consulted on the possible broad forms of remedy that Ofcom could use to address those concerns. Specifically, our concern suggested that Sky, as a vertically integrated firm with market power in a key upstream market, is likely to distribute premium content in a manner that favours its own platform and retail business thereby preventing fair and effective competition. Instead of making a reference to the CC, we proposed to tackle this concern over access to premium content by putting in place a wholesale must-offer obligation using our powers under Section 316 of the Communications Act 2003.

2.11 The Third Pay TV Consultation published in June 2009 addressed whether the restricted wholesale supply of certain premium channels was prejudicial to fair and effective competition. Here we confirmed our view that content aggregation has enabled Sky to gain a position of market power in the wholesale markets for premium sports and movies channels. In addition, we addressed our concern that Sky is acting on an incentive to restrict the distribution of premium channels, with effects on a variety of platforms including cable, DTT and IPTV.

2.12 In light of the responses to our Second Pay TV Consultation, we continued to believe that it is appropriate to deal with our concerns about restricted distribution by imposing a wholesale must-offer obligation, to ensure fair and effective competition. We also proposed to consider further the possible case for intervention in the sale of Premier League and subscription video-on-demand ('SVoD') rights.

Published documents

2.13 Ofcom has published a series of documents on the market investigation, either produced by Ofcom or by others, in order to provide transparency. In order to provide maximum clarity to readers, we describe these in chronological order below. All of the documents mentioned are available on Ofcom's website via this page http://www.ofcom.org.uk/tv/paytv/.

- On 20 March 2007, Ofcom announced that it was opening an investigation into the pay TV industry. BT, Setanta, Top Up TV and Virgin Media ('The Four Parties' / 'The Three Parties' following the demise of Setanta's UK business in June 2009) had provided Ofcom with a preliminary submission on the pay TV industry on 16 January 2007.

- On 3 July 2007, the Four Parties made a submission to Ofcom on "the need for a market investigation into the pay TV industry" (the 'July Submission').

- On 30 October 2007, Sky made a submission to Ofcom in response to the July Submission.

- On 18 December 2007, Ofcom published a first consultation on pay TV.

- The consultation closed on 26 February 2008. However, we received a number of responses after that date, the last of which was submitted by Sky on 11 April 2008, and in non-confidential form on 1 May 2008.

- During late 2007 and early 2008, Sky approached Ofcom to discuss whether there were commitments it could provide to Ofcom as undertakings in lieu of a reference to the Competition Commission under the Enterprise Act 2002. The resulting discussions are summarised in Section 9.

- On 29 February 2008 the Four Parties made a submission to Ofcom in response to Sky's submission of 30 October 2007.

- On 13 May 2008, Sky provided Ofcom with a supplement to its previous response.

- On 1 July 2008, Sky provided two further documents to Ofcom, which it had commissioned from CRA International. One was a submission on Sky's incentives to wholesale content, and the other was a further submission on comparing pay TV prices across Europe.

- On 6 August 2008, the Four Parties made a further submission to Ofcom, responding to Sky's response to our First Pay TV Consultation.

- Also on 6 August 2008, BT made a submission to Ofcom entitled "Submission on why a reference to the Competition Commission is fully justified".

- On 13 August 2008, Sky made a further submission to Ofcom entitled "An examination of LECG's arguments in relation to pay TV operators' ability to monetise the acquisition of new content".

- On 15 August 2008, Virgin Media made a supplementary submission to Ofcom, which focused on the idea that "UK pay TV consumers can be better served".

- On 16 September 2008, Sky made a submission to Ofcom in response to the Four Parties', BT's and Virgin Media's August submissions.

- On 22 September 2008, Sky provided a document to Ofcom which it had commissioned from CRA International, commenting on the submission from the Four Parties dated 6 August.

- On 24 September 2008, Sky provided a document to Ofcom entitled "A review of LECG's critique of PwC's report on the outcomes for consumers in relation to pay TV in Europe".

- On 30 September 2008, we published our second consultation on pay TV, relating to access to premium content. The consultation period closed on 9 December 2008. We received 26 responses to the consultation. One of the most substantial responses was submitted by Sky on 14 January 2009, and the final response was submitted by **[✂]** on 21 January 2009. Seven responses were submitted confidentially. Ofcom published all non-confidential responses on 4 February 2009.

- On 12 May 2009, Sky provided comments on an initial paper by Oxera setting out its methodology for assessing Sky's profitability.

- On 27 May 2009, Sky provided a submission to Ofcom responding to points made in various parties' responses to the Second Pay TV Consultation.

- On 1 June 2009, Sky provided a submission to Ofcom on market definition and market power. This submission was a supplement to its January 2009 response to Ofcom's Second Pay TV Consultation.

- On 5 June 2009, Sky provided a submission to Ofcom on platform security issues.

- Also on 5 June 2009, Sky provided a submission to Ofcom commenting on other respondents' views on the scope of the wholesale must-offer remedy proposed by Ofcom in the Second Pay TV Consultation.

- On 26 June 2009, we published our third consultation on pay TV, outlining our proposed remedies. The consultation period closed on 18 September 2009. We received over 60 responses to the consultation, 21 of these were submitted by organisations. The responses of some, such as Sky and BT, Top Up TV and Virgin Media (the 'Three Parties'), were very substantial, while we also received responses from a number of rights holders. Ofcom published all non-confidential responses on 28 October 2009.

- On 6 October 2009, Sky provided a submission entitled "A review of the evidence relied on by Ofcom as the basis for its conclusions about the scope of relevant retail markets in its Third Pay TV Consultation document" (the 'October 2009 Sky Submission').

- On 3 November 2009, Sky provided a submission entitled "Penetration of pay TV services in other European countries" (the 'First November 2009 Sky Submission').

- On 18 November 2009, Virgin Media provided a submission entitled "Modelling the profitability of a substantial increase in Virgin Media's premium subscribers" (the 'November 2009 Virgin Media Submission').

- On 19 November 2009, Sky provided a submission entitled "A submission in response to Ofcom's briefing for analysts on 22 September 2009 regarding the Pay TV Market Investigation" (the 'Second November 2009 Sky Submission').

- On 25 January 2010, Sky provided a submission entitled "A supplementary submission to Ofcom in respect of new information obtained and matters arising since Sky's 18 September 2009 response to Ofcom's Third Pay TV Consultation Document" (the 'January 2010 Sky Submission').

- On 5 February 2010, the Three Parties provided a submission entitled "Securing Premium Pay TV Channel Delivery over DTT and IPTV" – a report carried out for them by Farncombe Consulting Group.

- On 23 February 2010, Sky provided a submission entitled "A further supplementary submission to Ofcom in respect of new information obtained and matters arising since Sky's 18 September 2009 response to Ofcom's Third Pay TV Consultation Document" (the 'First February 2010 Sky Submission').

- On 25 February 2010, Sky provided a submission entitled "Trends in charges for Pay TV services, the quality of services provided to consumers and subscriber numbers" (the 'Second February 2010 Sky Submission').

2.14 We have published the non-confidential versions of supplementary submissions we have received from Sky and others alongside this document. These are available via this page: http://www.ofcom.org.uk/tv/paytv/.

Work carried out since our Third Pay TV Consultation

2.15 Since publishing our Third Pay TV Consultation in June 2009, we have reviewed consultation responses in detail and carried out a variety of analysis, in order to be able to reflect on the substantial responses to the consultation. This work has included the following:

- We have collected a wide range of information from stakeholders, to allow us to update our analysis. This includes:
    - o Further details of the commercial negotiations between Sky and other UK pay TV operators in relation to the possible wholesale supply of Core Premium channels.
    - o Updated revenue and subscriber data, to inform our analysis of market definitions and market power.
    - o Information on the negotiations between UK operators and the Major Hollywood Studios in relation to the acquisition of UK pay TV movie rights.
    - o Detailed cost data to inform our assessments of pricing and profitability.
- We have commissioned some updated market research on consumer preferences.
- We have carried out an internal update of our pricing and impact assessment models, and also engaged KPMG to subject both models to an independent external review. KPMG's report is attached to Annex 7 to this document.
- We also have engaged Oxera to carry out a further detailed review of our analysis of Sky's profitability.

Consumer criteria

2.16 Our Third Pay TV Consultation set out several criteria against which we proposed to assess competition in the market from a consumer perspective, focussing on choice, innovation and pricing[8]. We set out our views on competition concerns and consumer effects in light of these. The criteria against which we assess the effectiveness of competition in the market are as follows:

- Choice of platform and content:
    - o Choice for consumers of platform and of content once platform selection is made.
    - o Switching between retailers and platforms should not be artificially difficult.
    - o Generation and availability of a broad range of high-quality content: a variety of content should continue to be generated and made available to consumers on all platforms.
- Innovation:
    - o In platform services, for example in terms of interactivity, set-top box functionality such as Digital Video Recorder ('DVR') capabilities, or Video on Demand ('VoD') options.
    - o In retail service bundling, packaging and pricing.

[8] Third Pay TV Consultation, paragraph 7.8.

- Pay TV services priced competitively and efficiently:
    - Prices which give consumers good value and allow efficient producers to earn a reasonable return on their investment.
    - A sufficient variety of price points / bundles to allow consumers to tailor their purchases to meet their preferences.

Relationship to review of Sky's Picnic proposals

2.17 Our assessment of the proposal from Sky and Arqiva for a new pay TV service on DTT, to be called 'Picnic', has been closely linked to our pay TV market investigation. In particular, they have both considered the issue of access to premium content. A summary of our final assessment of the Picnic proposals, and its relationship to the pay TV market investigation, is provided below:

- We have decided to consent to the proposal, subject to the wholesale must-offer remedy set out in this statement having been implemented, and evidence that it has been implemented effectively. Under this remedy, Sky is required to offer the sports channel it proposes to retail on DTT – Sky Sports 1 – to other retailers of pay TV services on DTT.

- In terms of timing, we recognise that Sky may have a decisive competitive advantage if it is able to launch its service before competitors. This is even more likely to be the case if it can also offer movies, incrementally to sports, given that those competitors would not have access to Sky's movies channels.

- The most effective remedy to our concerns over movies content may be to make certain movie rights more widely available, rather than impose a wholesale must-offer remedy on movies channels, and we are therefore consulting on a reference to the CC for this purpose.

- In the meantime, we have decided that Sky should be permitted to launch Picnic only once it has concluded a wholesale agreement for the premium sports and movies channels it wishes to retail on DTT – Sky Sports 1 and Sky Movies Screen 1 – with at least one third party retailer. This requirement is designed to address the risk that Sky would have an incentive to delay providing wholesale access to these channels after it has launched, and ensure that the wholesale must-offer remedy set out in this statement is effective.

Summary of views on consultation responses

2.18 This sub-section reviews at a high level the main points expressed by stakeholders in their consultation responses, summarises our views on these points and indicates where in the remainder of the document we analyse these points in more detail.

2.19 We do not attempt here to present a full review of every point from every individual respondent, but we particularly address those where strong opposition was expressed to the views we set out in our Third Pay TV Consultation in June 2009.

2.20 This sub-section is set out grouped by type of respondent, with similar points from similar types of respondents taken together, particularly where stakeholders submitted joint or very similar views. We group responses as follows, addressed in alphabetical order in each category:

- Pay TV operators.
- Rights holders.
- Other organisations.
- Individuals or small businesses.

Pay TV operators

BT

2.21 BT's response was largely supportive of Ofcom's proposals. However, it expressed one main concern:

> "BT is concerned that Ofcom's current proposed wholesale must-offer prices do not reflect properly the cost to a new entrant of providing a competing pay TV business".

2.22 We have taken account of BT's views on what pay TV retail costs we should take into account in setting wholesale prices, along with the views of others. We have updated our calculations, taking into account the most recent data as well as consultation responses. Some of these changes have moved prices up, and some down. The details of this analysis are set out in Section 10 (wholesale must-offer terms).

Sky

2.23 Sky provided a lengthy response, disputing our analysis and recommendations at each step. The points it put to us are addressed throughout this document; this text summarises our views on each of Sky's headings contained in the summary of its response.

2.24 *"Ofcom's extreme agenda":* Sky described Ofcom as having an agenda to promote the growth of pay TV retailers on DTT and IPTV, and characterised our proposals as "extreme and unprecedented".

- Our objective throughout this process has been to ensure fair and effective competition, based on an assessment against the consumer criteria set out in detail in Section 2 of this document, and assessed in Section 8 (consumer effects) and again in Section 11 (impact of the remedy). Restricted distribution of Sky's Core Premium channels is prejudicial to fair and effective competition, as it, among other issues, constrains the ability of DTT and IPTV retailers to compete effectively.
- As we set out in detail in Section 9 (remedies), our remedy is neither extreme nor unprecedented. Sky was prepared voluntarily to commit to a largely similar arrangement, which suggests that our proposals are not in any way "extreme". Furthermore, this type of remedy does have successful precedent elsewhere, notably in the US. The US Program Access Rules, which have had an important role in enabling competition from new platforms, have a much broader scope than the remedy we are putting in place here.

2.25 *"Ofcom's recourse to its sectoral powers is unsound":* Sky's response stated that "such a departure from orthodox competition law principles renders its proposed intervention unlawful", as well as putting forward the view that the proposals were inconsistent with previous internal Ofcom policy thinking.

- As we set out in detail in Section 3 of this document (legal framework), our use of Section 316 of the Communications Act is consistent with previous thinking. We disagree with Sky as to the legality of our use of Section 316. As we set out in Section 9 (remedies), we believe it more appropriate to use Section 316 than competition law to remedy the prejudice to fair and effective competition that we have identified.

2.26 *"Ofcom's assessment of the evidence is skewed and its analytical approach defective"*: Sky said we had started with an end point in mind and selected evidence to reach that conclusion.

- We disagree with Sky's characterisation of our approach. Over the course of three years we have considered a very substantial amount of evidence, much of it from Sky as well as directly from consumers and from other industry stakeholders, and have come to a balanced view based on that evidence.

- We have modified our position in a number of key areas following consultation responses; for example we are no longer going ahead with a widespread wholesale must-offer on movies channels; we have altered our wholesale pricing analysis to take into account satellite distribution costs rather than DTT; and we are not setting a price for high-definition versions of the channels included in the remedy.

2.27 *"Ofcom has mischaracterised Sky's approach to channel distribution"*:

- We have fully assessed and understood Sky's approach to channel distribution. From our review of negotiations between Sky and other pay TV retailers and from Sky's Picnic proposal, we can see that Sky is keen to have its channels distributed on a wide variety of platforms, but only if it is able to act as the retailer on those platforms. Sky acting as the retailer on all platforms, to the exclusion of others, will not ensure fair and effective competition, as it is able to manage prices and service in favour of its own platform.

- We set out both the analysis of negotiations and our detailed views on Sky as a retailer on other platforms in Section 7 (competition issues). Our separate statement on Picnic considers competition issues relating to Picnic.

2.28 *"Ofcom's analysis suffers from a distorted perspective"*: Sky criticised us for what it saw as excessive focus on wholesale market power analysis at the expense of looking at the retail level. Sky then set out its belief that we had ignored evidence on how competition operates at the retail level, in particular pointing towards the interaction between FTA channels and pay TV.

- This is incorrect; our wholesale analysis takes into account the indirect constraints coming from the retail level.

- Our market power assessment includes a comprehensive assessment of a wide range of evidence at both the retail and wholesale levels, including material relating to the links between FTA channels and pay TV. This is set out in Sections 5 (sports) and 6 (movies).

2.29 *"Ofcom's alleged "problems""*: Sky set out a belief that our concerns around restricted distribution of premium channels and high wholesale prices should be addressed under a competition law framework, and that we had not in any case demonstrated that they had a material impact on the competitive process.

- Our powers under s316 CA03 are an appropriate competition framework to use to address our concerns, for the reasons set out in detail in this statement.

2.30 *"No restricted distribution – DTT and IPTV"*: Sky said in its response that we had not demonstrated that Sky's strategic incentives to withhold supply outweighed the static incentive to supply; that there was no evidence of Sky acting on an incentive to withhold supply; and that the absence of Sky's premium channels from DTT was readily explicable by the length of our Picnic approval process, by practical and price concerns about supply to BT and Top Up TV and by the "shadow cast by Ofcom's investigation".

- We acknowledge that Sky has at no point refused to enter into negotiations over supply of its premium channels. However, the observable fact is that it does not wholesale its premium channels to DTT and IPTV retailers, despite several years in which several different operators have attempted to negotiate supply. We believe the barriers Sky cited to be surmountable, and that the other operators appear to have been negotiating in good faith regardless of the existence of this investigation. The evidence on these points is set out in Section 7 (competition issues).

- We acknowledge the benefits associated with Sky's Picnic pay DTT proposal, as our accompanying statement makes clear, and would wish it to proceed, but believe that it would be prejudicial to fair and effective competition for it to have proceeded as proposed.

2.31 *"No restricted distribution – Virgin Media"*: Sky stated that its "wholesale pricing policy is to set prices which it believes will maximise its distribution revenue", and that its cable wholesale prices are significantly lower than the maximum allowable under the OFT's 2002 margin squeeze test. Sky also disputed our view that it was restricting distribution of HD versions of its premium channels to Virgin Media, indicating that Sky responded to Virgin Media's request for HD supply at the first "genuine opportunity", which was in May 2009.

- **[✂]**.

- Our own analysis suggests that Sky sets wholesale prices to cable which are close to the maximum allowable under the OFT's 2002 margin squeeze test. Prices set on this basis do not allow Virgin Media to compete effectively with Sky given its lower scale. The practical result is that Virgin Media has little incentive to up-sell premium channels to basic customers on Sky's current terms, suggesting that there is potential wholesale revenue which Sky is forgoing. We set this analysis out in detail in Section 7 (remedies). Although as we set out in Section 8, the effects on consumers are less on Virgin Media's cable platforms than elsewhere, because Sky's premium channels are at least available.

- Sky's assertion that it responded to Virgin Media's request for HD supply at the first genuine opportunity ignores the fact that we have seen requests from Virgin Media to Sky for wholesale supply of HD versions dating back to 2005, which, like requests from other companies for Standard Definition ('SD') supply, have yet to result in a contractual agreement. The details are also set out in Section 7.

2.32 *"Wholesale price levels are not "high""*: Sky said that we over-interpreted the report supplied to us by Oxera for our Third Pay TV Consultation in saying that wholesale prices were high. Sky also said that our cost-plus analysis was flawed, leaving no gap between retail-minus and cost-plus prices and therefore providing no evidence of high wholesale prices.

- Oxera's most recent analysis suggests that over the last five years Sky's returns have been approximately nine percentage points above its cost of capital, and that this observed difference is persistent over time. We consider that this difference is significant.

- We recognise that Sky took substantial risks in the past, most notably in the early stages of satellite pay TV in the UK. On this basis, we agree with Sky that the riskiness of its early investments will have demanded returns in excess of its cost of capital for a period. However, it does not appear that Sky's more recent investments will have required the same level of reward for risk. On a forward looking basis, we conclude that if the market is left unchanged, Sky's prices are likely to be above those required as a reward for Sky's historic risk taking.

- We have also updated our cost-plus modelling, and even taking into account those of Sky's suggested amendments that are reasonable, there remains a substantial gap between retail-minus and cost-plus prices. The detail of this analysis is set out in Section 10 and summarised in Sections 5 and 6 on movies and sports respectively.

2.33 *"Ofcom must, in seeking to justify its proposals, comply with important statutory duties"*. Sky stated that "Consumers are well served" and "Ofcom is proposing highly interventionist and unprecedented regulation, carrying with it real risks of consumer detriment".

- While consumers are indeed well served in some respects, as we set out in Section 8 on consumer effects, our concern is that they are less well served in others – particularly those consumers who would like to watch Sky's premium channels on DTT or IPTV platforms.

- We do not underestimate the risks of intervention, but as Section 11 on the impact of the remedy sets out, the benefits to consumers outweigh those risks.

- We do not agree that this kind of remedy is unprecedented, since there are several examples of this kind of regulation elsewhere in the world – for example France, Italy, Spain and the United States – some of which have been highly successful, notably the Program Access Rules in the United States, as set out in Section 9.

2.34 *"Ofcom's proposed price controls are unnecessary and disproportionate"*. Sky stated that Ofcom's rationale for imposing price control is "inadequate" and "the imposition of price control would be wholly disproportionate".

- Given the long history of unsuccessful negotiations over wholesale supply, we consider it is necessary to set wholesale prices, as we set out in Section 9 (remedies).

- As we set out in Section 10 (wholesale must-offer terms), the level of prices we have set is also necessary and proportionate to ensure the effectiveness of competition. We are now basing our assessment of likely retail costs on Sky's own satellite distribution costs. We make an adjustment for scale simply because it would be impossible for more than one operator to exist at Sky's scale, i.e. we set prices on the basis of a competitor that would be equally efficient at Sky's scale.

- We no longer include a 'ratchet' provision for changes in price over time – an aspect of our proposals in our Third Pay TV Consultation with which Sky took particular issue.

2.35 *"Ofcom's proposals to compel Sky to license its HD premium channels are unnecessary and disproportionate"*.

- Sky's public pronouncements about the importance of HD contradict the assertion that the inclusion of HD is unnecessary. HD is becoming increasingly important to consumers and therefore to competition. A remedy which did not include HD would not allow effective competition, as we set out in Section 9 (remedies).

- The assertion that including HD would result in "serious competitive distortions" seems entirely at odds with the fact that two years ago Sky was prepared to include HD channels within the scope of the wholesaling commitments it discussed with Ofcom.

- Nonetheless, we do not set a price for HD, on the grounds that this is a recent innovation, and that therefore there is a risk of regulatory error through setting the wrong level of prices, and that doing so could risk harming long-term incentives to innovate.

2.36 *"Ofcom's Impact Assessment is wholly inadequate"*.

- We carried out a comprehensive impact assessment, set out over the course of three Sections in the Third Pay TV Consultation. We clearly stated that this was the case.

- In this statement we have updated our impact assessment; it is included in Sections 9, 10 and 11.

2.37 *""Content" Remedies"*: Sky disputed our proposals to investigate further two specific interventions related to content rights.

- Our first proposal related to SVoD movies. Sky's view that concerns around SVoD are "a limited issue which does not give rise to any real consumer harm" were unsubstantiated by evidence or analysis. We set out our full views on this issue in our separate consultation on a proposed market investigation reference to the CC.

- With regard to our suggestion that we would engage in a possible further dialogue with the Premier League, Sky seems to attribute a degree of finality to our position that was not intended in our Third Pay TV Consultation. We set out our intention to establish with the Premier League how the compliance of the next auction with competition law could be ensured once the existing commitments to the European Commission expire. We took the view, and still do, that it is in the interests of all parties to establish certainty as to what is permissible ahead of that auction. We will keep under review the need to take any further action, as set out in Section 9 (remedies).

Three Parties (BT, Top Up TV and Virgin Media)

2.38 The Three Parties' joint response supported the implementation of a wholesale must-offer, but raised issues on several aspects of the proposals.

2.39 *"[Sky Sports 3 and Xtra] should also be included in the scope of the wholesale must-offer remedy"*.

- The Three Parties' reason for this position is that there is important content contained on Sky Sports 3 and 4 (formerly Xtra). We do not dispute the fact that there is content on these channels that is valued by some consumers, but we do not believe that this makes a sufficiently material contribution to Sky's market power for it to be appropriate to require wholesale of these channels in order to ensure fair and effective competition. Our full reasoning is set out in Section 9 (remedies).

2.40 *"Ofcom should ... clarify how the remedy would apply in the event that Canvas (or other DSL-based services) were to be widely deployed"*.

- We have indeed clarified this point in Section 9 (remedies). Only a Sky-operated Canvas-based platform would be excluded from the scope of the remedy but this would not preclude retailers on other Canvas-based platforms from taking up the wholesale must-offer.

2.41 *"The Parties ... believe that the detailed implementation of Ofcom's [pricing] approach needs to be adjusted in a number of respects in order to reflect the circumstances of new premium pay TV retailers"*.

- As set out above in respect of BT, we have carried out a number of adjustments which affect the wholesale must-offer price in both directions, described in Section 10 (wholesale must-offer terms), following responses from the Three Parties and others.

2.42 *"There will be a material risk to competition and the effectiveness of Ofcom's proposed wholesale must-offer remedy if the wholesale prices for Sky's premium channels do not evolve over time in such a way as to address changes in Sky's retail prices and packaging and also increases in Sky's retail costs (for example its SAC)"*.

- As we set out in Section 10 (wholesale must-offer terms), we see it as impractical to recalculate wholesale prices frequently. We would expect to do so by exception, if for example there is a major change in the content which Sky owns, or the way this is distributed across Sky's channels. We expect to carry out a fuller review commencing three years after this remedy comes into force.

2.43 *"The Parties believe that Ofcom should both adjust its cost-based cross check and make more use of it ... Ofcom should determine wholesale prices at the bottom of its range of retail-minus prices in order to minimise any discrepancy in the margins available to Sky and its competitors from the retailing of premium pay TV channels"*.

- As set out in Section 10, we have made adjustments to our cost-based cross check following consultation responses. However, the use of retail-minus pricing is the appropriate mechanism for ensuring that an appropriate retail margin is available to Sky's competitors.

2.44 *"The reasons for Ofcom not [extending the remedy to the commercial market] ... are clearly contradicted by the evidence provided by the Parties"*.

- As we set out in Section 9 (remedies), we do not believe that including retail to commercial premises in the remedy is appropriate to ensure fair and effective competition in relation to our competition concerns.

- We do not see the same level of evidence of restricted distribution in relation to commercial premises.

2.45 *"If Ofcom is still minded to authorise Picnic, it must formally consult on the actual conditions which it is intending to impose on Sky in respect of Picnic"*.

- The primary condition on which we are consenting to Picnic is that a wholesale must-offer is in place on Sky's Core Premium Sports channels, with evidence that this has been effectively implemented. We have also concluded that any Sky Movies channels included in Picnic should be offered to other DTT retailers. Our conclusions on this are set out in our Picnic Statement.

Virgin Media

2.46 Virgin Media's stand-alone response largely supported Ofcom's proposals. However, in Virgin Media's view the consumer benefits of a wholesale must-offer could only be delivered subject to three points being satisfied:

> "(i) the scope of the wholesale must-offer being extended to include Sky Sports 3 and Xtra; (ii) the relevant wholesale prices being set no higher than the bottom of the range proposed by Ofcom (rather than in the middle); and (iii) Ofcom addressing a number of specific issues relating to the detailed implementation of the wholesale must-offer".

2.47 We have set out above our view on Sky Sports 3 and 4 (previously Xtra), as this was a point also made in the Three Parties' joint response. Our full views on this are set out in Section 9 (remedies).

2.48 We have reviewed prices further since our Third Pay TV Consultation, taking into account the full range of responses. The prices we have set are not at the bottom end of the range in our consultation. Rather they are around the middle of the range. This is the reduction to the rate-card we consider necessary to ensure fair and effective competition. Our analysis is set out in Section 10 (wholesale must-offer terms).

2.49 The "specific issues" that Virgin Media referred to are largely similar to those mentioned in the Three Parties' joint response, and are addressed in Section 10 (wholesale must-offer terms).

Rights holders

2.50 Among sporting bodies, we received responses from the ECB (England and Wales Cricket Board), PGA (Professional Golfers Association) European Tour, Premier League, RFL (Rugby Football League), RFU (Rugby Football Union), and UEFA (Union of European Football Associations). These contained common threads, which are summarised or quoted here and addressed.

2.51 *"Ofcom's market definition is flawed"* (Premier League).

- The Premier League particularly highlighted the relationship between sports available on free-to-air channels and pay TV sports channels. We agree that there is a relationship, but have concluded that the quantity, quality and regularity of sports on Sky Sports channels is sufficiently differentiated from sports on FTA channels that there is not a strong constraint.

2.52 *"Ofcom's assessment of market power ... is flawed"* (Premier League).

- The Premier League stated a belief that Ofcom thought any market power warranted a remedy. This is incorrect: we are only putting a remedy in place on the basis that Sky's market power together with the incentives due to its vertical integration lead it to restrict distribution of its channels, and that the remedy is appropriate to ensure fair and effective competition, as we set out in Section 7 (competition issues) and 9 (remedies).

- Premier League also queried various detailed aspects of our market power analysis such as market shares. The full analysis is set out in Section 5, but at a high level we would note that Sky's market power is relatively independent of such details, as its market share remains high under all credible market definitions.

2.53 *"Ofcom's competition concerns are flawed and fail to identify a coherent, credible and evidenced theory of harm that identifies how consumers are adversely affected"* (Premier League).

- We do not agree – our Second Pay TV Consultation set out a clear theory of harm, backed up with substantial evidence, which we developed in our Third Pay TV Consultation and have further refined in this statement.

- We have now concluded that restricted distribution of Sky's premium channels is prejudicial to fair and effective competition, and that this affects consumers in terms of reduced choice and innovation – as set out in Sections 7 and 8 in this document. We have also concluded that Sky's wholesale prices are high – see the final part of Section 7 and Annex 3.

2.54 *"Ofcom's proposed remedy will have serious negative consequences for Sky's revenues and the value Sky places on content rights including live Premier League rights and a wide range of other sports rights. The remedy will also reduce or remove the incentives on others to bid for content rights including live Premier League rights. This will devalue Premier League rights which will harm the Premier League's member clubs, football and most importantly consumers. The same is true for other UK sports and this can only lead to less investment in UK sports, to the detriment of consumers."* This comment was made by the Premier League, but echoed the views expressed by other sports bodies.

- As we set out in detail at the end of Section 11 (impact of the remedy), we have designed the remedy specifically in order to minimise the impact on rights values, for example through the use of retail-minus pricing rather than cost-plus pricing.

- The revenue available to Sky to pay for sports rights should not be reduced, and should in fact increase. The other broadcasters whose bidding behaviour has determined rights values in the past are largely unaffected. And in the longer term the emergence of new retailers, with significant numbers of subscribers, should increase competition for rights, given the various benefits associated with direct control of those rights.

2.55 **[✂]**

Other organisations

2.56 Astrium disagreed with our approach to transmission costs in our retail-minus pricing, stating that we would neutralise the cost advantage of satellite over other technologies. As we set out in Section 10 (wholesale must-offer terms), we have now set prices based on Sky's own distribution costs and do not make an adjustment for DTT transmission.

Individuals or small businesses

2.57 Around 40 individual consumers and small businesses responded to our Third Pay TV Consultation.

- Many of these responses were broadly supportive of our proposals, questioning the lack of current choice of retailers for football fans, or highlighting the lack of premium HD channels on Virgin Media.

- A smaller number of consumers' responses were generally opposed to our wholesale must-offer proposal, indicating for example that live sport on TV was much more limited before Sky emerged, or that they did not believe that there were any problems to be resolved.

- A number of respondents to our three consultations stated their dissatisfaction with the outcome from the Premier League's commitments to the European Commission, whereby the Premier League rights were split between two retailers on satellite. Some respondents also complained of the high prices charged by Sky to commercial premises. Both of these issues are most relevant not to this statement, but to the manner in which the Premier League conducts its next rights auction, for the 2013 / 2014 season onwards.

Structure of this document

2.58 The remaining Sections of this document are set out as follows:

- Section 3: legal framework.

- Section 4: structure and characteristics of the UK pay TV market.

- Section 5: market definition of wholesale and retail markets for the sale of Core Premium Sports channels and an assessment of market power within these.

- Section 6: market definition of wholesale and retail markets for the sale of Core Premium Movies channels and an assessment of market power within these.

- Section 7: analysis of competition issues.

- Section 8: analysis of consumer effects.

- Section 9: assessment of possible remedy options.

- Section 10: terms of the wholesale must-offer remedy.
- Section 11: impact of the wholesale must-offer remedy.
- Section 12: licence conditions.

2.59 There is one annex contained within this document – a glossary of terms used.

2.60 There are a number of separate annexes to the document, which set out the details of particular parts of our analysis. These are as follows:

- Annex 2: summary of negotiations between Sky and Ofcom, December 2007 to April 2008.
- Annex 3: assessment of Sky's profitability and cost of capital.
- Annex 4: sports market definition and market power appendices.
- Annex 5: movies market definition and market power appendices.
- Annex 6: competition issues appendices.
- Annex 7: pricing analysis.
- Annex 8: impact assessment analysis.

Section 3

Legal framework

Summary

3.1 We have decided to exercise our powers under section 316 ('s316') of the Communications Act 2003 ('CA03') to insert conditions into broadcasting licences to ensure fair and effective competition.

3.2 Before proceeding under s316 we are required by section 317(2) CA03 ('s317(2)') to consider whether it would be more appropriate to proceed under the Competition Act 1998 ('CA98'). We have decided that it is more appropriate to proceed under s316 in order to address the specific competition issues we have identified in this document.

Structure of this Section

3.3 This Section is set out as follows:

- Legal framework: Sections 316 and 317.
- Responses to our consultation on the legal framework.
- Ofcom's position.

Legal framework: Sections 316 and 317

3.4 Section 316 states that:

"(1) The regulatory regime for every licensed service includes the conditions (if any) that OFCOM consider appropriate for ensuring fair and effective competition in the provision of licensed services or of connected services.

(2) Those conditions must include the conditions (if any) that OFCOM consider appropriate for securing that the provider of the service does not—

(a) enter into or maintain any arrangements, or

(b) engage in any practice,

which OFCOM consider, or would consider, to be prejudicial to fair and effective competition in the provision of licensed services or of connected services.

(3) A condition imposed under this section may require a licence holder to comply with one or both of the following—

(a) a code for the time being approved by OFCOM for the purposes of the conditions; and

(b) directions given to him by OFCOM for those purposes.

(4) In this section –

"connected services", in relation to licensed services, means the provision of programmes for inclusion in licensed services and any other services provided for purposes connected with, or with the provision of, licensed services; and

"licensed service" means a service licensed by a Broadcasting Act licence.

3.5 Section 317 provides (so far as material) that:

(1) This section applies to the following powers of OFCOM (their "Broadcasting Act powers")

(a) their powers under this Part of this Act and under the 1990 Act and the 1996 Act to impose or vary the conditions of a Broadcasting Act licence;

(b) every power of theirs to give an approval for the purposes of provision contained in the conditions of such a licence;

(c) every power of theirs to give a direction to a person who is required to comply with it by the conditions of such a licence; and

(d) every power of theirs that is exercisable for the purpose of enforcing an obligation imposed by the conditions of such a licence.

(2) Before exercising any of their Broadcasting Act powers for a competition purpose, OFCOM must consider whether a more appropriate way of proceeding in relation to some or all of the matters in question would be under the Competition Act 1998 (c. 41).

(3) If OFCOM decide that a more appropriate way of proceeding in relation to a matter would be under the Competition Act 1998, they are not, to the extent of that decision, to exercise their Broadcasting Act powers in relation to that matter.

(4) If OFCOM have decided to exercise any of their Broadcasting Act powers for a competition purpose, they must, on or before doing so, give a notification of their decision.

(5) A notification under sub-section (4) must—

(a) be given to such persons, or published in such manner, as appears to OFCOM to be appropriate for bringing it to the attention of the persons who, in OFCOM's opinion, are likely to be affected by their decision; and

(b) must describe the rights conferred by sub-section (6) on the persons affected by that decision.

(6) A person affected by a decision by OFCOM to exercise any of their Broadcasting Act powers for a competition purpose may appeal to the Competition Appeal Tribunal against so much of that decision as relates to the exercise of that power for that purpose.

(7) Sections 192(3) to (8), 195 and 196 apply in the case of an appeal under sub-section (6) as they apply in the case of an appeal under section 192(2).

(8) The jurisdiction of the Competition Appeal Tribunal on an appeal under sub-section (6) excludes—

(a) whether OFCOM have complied with sub-section (2); and

(b) whether any of OFCOM's Broadcasting Act powers have been exercised in contravention of sub-section (3);

and, accordingly, those decisions by OFCOM on those matters fall to be questioned only in proceedings for judicial review.

(9) For the purposes of this section a power is exercised by OFCOM for a competition purpose if the only or main reason for exercising it is to secure that the holder of a Broadcasting Act licence does not—

(a) enter into or maintain arrangements, or

(b) engage in a practice,

which OFCOM consider, or would consider, to be prejudicial to fair and effective competition in the provision of licensed services or of connected services.

…

(11) In sub-section (9) "connected services" and "licensed service" each has the same meaning as in section 316.

(12) References in this section to the exercise of a power include references to an exercise of a power in pursuance of a duty imposed on OFCOM by or under an enactment.

3.6 Under s316 Ofcom is therefore empowered and required, acting as sectoral regulator, to ensure fair and effective competition in relation to the provision of licensed services (or connected services).

3.7 There is a distinction between the forward looking, requirement under s316 for Ofcom to consider what it is appropriate to do to ensure fair and effective competition, by reference to our sectoral duties, and Ofcom's ex post role as a competition authority under CA98 to act against past anti-competitive behaviour, where those duties do not apply.

3.8 Sky holds television licensable content service licences under the Broadcasting Act 1990 for its premium sports and movies channels. These channels are "licensed services" for the purpose of s316. Ofcom therefore has the power to include conditions in the licences for those services that we consider appropriate for ensuring fair and effective competition in the provision of those channels, and any services provided for purposes connected with the provision of those channels.

3.9 In the Third Pay TV Consultation we explained that we considered that fair and effective competition in the provision of the licensed services is not occurring and will not occur in respect of Sky's wholesaling of channels subject to broadcasting licences. We considered it may therefore be appropriate to intervene in the wholesale of Core Premium channels to ensure fair and effective competition through the imposition of licence conditions. We consulted on the form that such licence conditions might take.

3.10 We set out below the framework for our analysis in this document of whether it is appropriate to impose conditions under s316 in order to ensure fair and effective competition in relation to the supply of Core Premium channels.

- We have assessed whether there is fair and effective competition under s316 by reference to choice, innovation and pricing (as set out above in Section 2).

- In Section 4 we set out background on the pay TV sector and the importance for retailers of pay TV products of licensed channels which contain premium content. As well as setting out an overview of the current state of the market, we consider the potential for future developments in the services provided to consumers, in order to inform our assessment of whether there will be fair and effective competition in the provision of licensed channels.

- In Sections 5 and 6 we define the markets that are relevant to a consideration of whether there is a risk that fair and effective competition in the provision of licensed channels including premium content is not occurring and will not occur. We also examine whether, in those markets, market power is held by any person.

- In Section 7 we consider, in the light of our findings on market power, whether the current position as regards the supply of the relevant licensed channels creates a position under which there is not, and is not likely to be, fair and effective competition. In doing that we refer back to the criteria set out in Section 2.

- In Section 8 we consider the significance of the effects on consumers of the position identified in Section 7, again within the framework of the criteria for assessment set out in Section 2.

- In Section 9, having identified prejudice to fair and effective competition, which results in significant harm to consumers, we consider the regulatory options open to Ofcom in order to address that issue.

3.11 Before proceeding under s316 we must, under s317(2), consider whether it would be more appropriate to proceed under CA98. Therefore, having identified that the issue is best addressed through action in relation to the wholesale supply of the relevant channels, we consider whether it would be more appropriate to proceed under CA98 or under s316.

3.12 Having concluded it would be more appropriate to proceed under s316 we then go on in the rest of Section 9, and in Sections 10 and 11, to consider the licence conditions (if any) it would be appropriate to include under s316 in order to ensure fair and effective competition. In Section 12 we set out the form of the licence conditions that we have decided to insert into the licences for the relevant channels.

Responses to our consultation on the legal framework

3.13 Sky argued (as did the Premier League) that Ofcom has failed to articulate a proper test for the exercise of its s316 powers and that insufficient consideration had been given to the materiality of any harm to the competitive process. It argued that this was particularly puzzling given the contents of an internal discussion paper produced within Ofcom in 2005, which considered the conditions under which s316 might be used (the "2005 discussion paper"). Sky agreed with much of the content of the 2005 discussion paper and argued that Ofcom's approach under this investigation was not consistent with its content[9].

3.14 Sky argued that although the Parliamentary discussion on s316 supported the idea that it could be used as a means of taking advance action where a CA98 breach had not yet occurred, the discussion did not support a scope for s316 extending to the restructuring of markets to support "policy objectives" where this was not underpinned by "broader competition law principles and policy"[10]. The Premier League also argued that although s316 might permit advance action, this did not justify the position that s316 has a different scope to CA98[11].

3.15 The Premier League argued that Ofcom had asserted "without any analysis or explanation" that s316 has a different purpose and scope to CA98. It argued that the purpose of the CA98 prohibitions was to ensure that fair and effective competition is enabled and maintained, and therefore that conduct which was not an abuse of a dominant position under CA98 could not be inconsistent with s316[12].

3.16 The Premier League argued that Ofcom had incorrectly referred to s3(1)(b) as a means of supporting an argument that s316 is broader in scope than CA98[13]. It argued that the existence of s317 underlines an overlap between s316 and CA98 and that it could not have been Parliament's intention for any form of market assessment to be built around the wording of s316[14].

Ofcom's position

3.17 We describe above the legal framework applicable to this document. Ofcom does not accept that there is any lack of clarity as to the test it is applying in this document. The "test" is set out in the provisions of s316 itself. Ofcom's analysis as to why the test is met in the circumstances of this case is set out in detail in the remainder of this document, pursuant to a detailed and rigorous economic analysis (see paragraph 3.10 above).

3.18 Sky and the Premier League both contend that the scope of s316 is restricted to preventing agreements and behaviour that would constitute breaches of CA98. We do not consider s316 is limited only to addressing such agreements or behaviour. We referred in the Third Pay TV Consultation to the discussion of s316 in Parliament. We set out the relevant passages from Hansard which demonstrate that s316 was not intended to be an ex ante application of the prohibitions contained in CA98. This mentioned:

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[9] Sky response to Third Pay TV Consultation, Section 3. See also January 2010 Sky submission, Section 2.

[10] Sky response to Third Pay TV Consultation, paragraph 3.19.

[11] Premier League response to Third Pay TV Consultation, paragraph 3.9.

[12] Premier League response to Third Pay TV Consultation, paragraphs 3.4 to 3.5.

[13] Premier League response to Third Pay TV Consultation, paragraph 3.10.

[14] Premier League response to Third Pay TV Consultation, paragraphs 3.11 and 3.12.

- "cases in which markets should be opened up to greater competition but where the legal tests required by the Competition Act are not met";

- that the Competition Act cannot be applied until "an enterprise has harmed the market by acting anti-competitively" and as such "use of sector-specific powers may be more effective, especially where advance action or action in a short time frame is required to ensure effective competition";

- that the policy behind s316 was to guarantee that Ofcom "has that same flexibility to ensure fair and effective competition" as the ITC had previously enjoyed[15].

We do not see in this discussion an attempt to limit the scope of s316 only to an ex ante form of CA98.

3.19 In setting out the legal framework again above we refer directly to the consideration of the effects that result from the identified prejudice to fair and effective competition. It is clear that the imposition of a licence condition under s316 must be justified by reference to the materiality of the problem being addressed – that assessment is a function of effects on competition and consumers identified in Sections 7 and 8 and the assessment of the appropriate remedy conducted in Sections 9 to 11.

3.20 Ofcom does not accept Sky's arguments in relation to the 2005 discussion paper. That process did not in any event result in the adoption of any policy by Ofcom and it is not therefore relevant to the conduct of the current analysis.

3.21 We recognise that the statutory provisions are brief and that therefore careful analysis is required of the specific circumstances of individual cases in order to determine whether the s316 test is met. As set out above, Ofcom considers that it has conducted a detailed and rigorous analysis, which has enabled stakeholders to understand the basis upon which s316 is used.

3.22 We analyse the applicability of s317(2) to this case in section 9.

[15] House of Commons Committee Stage (28 January 2003) Dr Kim Howells – Column 755.

Section 4

Pay TV sector overview

Summary

4.1 The pay TV sector has delivered substantial benefits to consumers since its emergence in the late 1980s. More than 12 million consumers now pay to access a greater choice of content, at higher quality, and with a greater degree of control than has historically been available from free-to-air broadcasters.

4.2 We can divide the development of pay TV into three broad phases.

- The birth of pay TV. The early years of pay TV in the UK, through the 1990s, were characterised by the development of satellite and cable services. These businesses have been based on a relatively hardware- or network-heavy model, with customers signing up to year-long contracts for several tens of pounds a month.

- The digital transition. Towards the end of the 1990s and into the 2000s, the major development was the transition to digital. This was started by Sky on satellite and by ONdigital (owned by ITV companies Carlton and Granada) on pay DTT in 1998, before the transition was further boosted by the launch and subsequent fast growth of Freeview, the free-to-air Digital Terrestrial Television (DTT), which replaced ITV Digital (formerly ONdigital) when it closed in April 2002. The advent of digital has enabled a greater range of channels, as well as different ways of delivering pay TV services.

- Rapid take-up of digital. The period after the migration from analogue to digital, between 2003 and 2008, was defined by rapid growth of Sky and Freeview. Sky was driving growth in pay TV, while Freeview was driving growth in free-to-air multi-channel TV.

4.3 At the end of 2009, Sky had 9.7 million subscribers[16], Virgin Media had 3.7 million subscribers, BT Vision had 0.5 million, and Tiscali / TalkTalk TV had approximately 50,000 subscribers. Around 9.7 million homes rely on Freeview as their primary means of TV reception, using it to access free-to-air multichannel broadcasting.

4.4 In the next phase of the development of pay TV, there is scope for disruptive change in the way content is distributed. For example, new broadband networks could offer consumers an unprecedented choice of content, and the ability to access that content on demand.

4.5 However, consumers' choice of pay TV service continues to be driven primarily not by technology, but by a desire to access particular content. In order to drive take-up of a pay TV service, the content available has to be highly attractive to a large number of consumers. It also needs to have a high degree of exclusivity to pay TV.

4.6 Consumer preferences for content change more slowly than the technological means of distribution, and live high-quality sports and recent Hollywood movies retain an enduring appeal for most consumers, as well as having a high degree of exclusivity.

[16] This includes UK and Ireland subscribers.

Access to this content has driven the historical development of pay TV, and we believe that it will remain crucially important for the development of new platforms and new services.

4.7 This is illustrated, for example, by the experience of the leading IPTV operators around the world, which have been able to develop their innovative new services on the back of access to premium content. For example, US IPTV providers, benefiting from the FCC's Program Access Rules, have reached several million subscribers.

4.8 Vertical integration continues to be a common part of pay TV business models. This can contribute to consumer benefits, but it can also alter the incentives of firms in a way which can be less beneficial.

4.9 Similarly, content aggregation is a major characteristic of pay TV businesses in the new pay TV landscape as well as the old. Consumers certainly benefit from the ability to buy bundles of different content from a single provider, but content aggregation can also be a contributing factor to market power, which can have its own negative consequences.

Structure of this Section

4.10 This Section is set out as follows:

- Historical context of the UK pay TV sector.
    - The birth of pay TV.
    - Digital transition.
    - Rapid take-up of digital.
    - Next phase.
- Current pay TV landscape.
    - Operators in the pay TV sector.
    - Free-to-air multi-channel operators.
    - Sector revenues, service availability and penetration.
    - Packages and pricing.
    - Service bundles.
- Characteristics of the pay TV sector.
    - Content aggregation and market power.
    - Vertical integration.
    - Fixed costs of content production, and the importance of price discrimination.
    - Premium content as a driver of pay TV subscriptions.

- The future of the UK pay TV sector.
    - Current trends.
    - International examples.
    - Future developments.

Historical context of the UK pay TV sector

4.11 This Section details the historical developments of the UK pay TV sector, highlighting different phases of growth. We also provided detail on the pay TV market in our First[17] and Second[18] Pay TV Consultations.

4.12 The emergence and growth of pay TV in the UK and elsewhere has historically been driven by the development of new platforms based on cable or satellite distribution technologies, and providing consumers with the option of paying for a wider choice of content than had traditionally been available from free-to-air terrestrial broadcasters. In the UK, this emergence and growth has largely happened over the last 20 years.

4.13 It is possible to distinguish three fairly distinct periods of growth in the pay TV sector:

Figure 2 Pay TV – phases of development

Source: Ofcom research

The birth of pay TV

4.14 The UK pay TV sector emerged in the middle of the 1980s but the notion of paying for delivery of PSB channels via cable was established as early as 1924[19], for homes that could not receive TV signals terrestrially.

4.15 The Cable and Broadcasting Act of 1984, which saw the liberalisation of the cable sector, allowed new channels such as Screen Sport, the Children's Channel and the Sky Channel to launch on cable systems. By 1990, there were 135 cable franchises across the UK and the sector underwent a long period of consolidation.

4.16 Planning for satellite TV began in the 1980s and by 1990 two companies – BSB and Sky Television – were competing using different satellite systems. They announced plans to merge in November of that year.

4.17 Steady growth in analogue pay TV services did not take place in earnest until the 1990s, on both satellite and cable. This growth was driven by access to premium content, and in particular the acquisition by Sky in 1992 of exclusive rights to live

[17] Annex 8, Pay TV Market Overview, First Pay TV Consultation.

[18] Para 3.1 to 3.46, Second Pay TV Consultation.

[19] Independent Television in Britain, Volume 6, page 387, Paul Bonner and Lesley Aston, 2003.

Premier League football. Sky had also acquired contracts with the Hollywood studios for access to movies (some of which it inherited from the merger with BSB).

4.18 This period also saw the launch of thematic channels based around genres such as entertainment, music and children.

Digital transition

4.19 From 1998 to the early 2000s there was a transition from analogue to digital TV, which greatly increased the range of content and value-added services that could be delivered to subscribers.

4.20 Sky migrated all of its customers from analogue satellite to digital satellite between 1998 and 2002. The switch by cable has been slower, but almost all cable TV customers now take digital services.

4.21 By Q1 1999, the number of pay TV subscribers on Sky and on cable were broadly similar (3.5 million and 3.0 million respectively). By the end of 2002, Sky had attracted 6.3 million customers while cable had 3.4 million customers[20].

4.22 The emergence of digital TV technology also facilitated the launch of new entrants, in particular ONdigital (later ITV Digital), which used the DTT platform to offer basic tier and premium channels as well as pay-per-view services. ITV Digital closed in April 2002.

4.23 Companies including HomeChoice and Kingston Communications also entered the pay TV sector by launching IPTV services over telecoms networks. The 1990s and the early 2000s also saw considerable consolidation in the UK cable sector.

Rapid take-up of digital

4.24 The period after the migration from analogue to digital was defined by rapid growth of Sky and Freeview, the free-to-air DTT platform that replaced the closed ITV Digital in October 2002. Sky was driving growth in pay TV, while Freeview was driving growth in free-to-air multi-channel TV.

4.25 By Q2 2007 there were 8.1 million Sky subscribers and 3.4 million cable TV homes. There were 9.1 million homes using Freeview as their primary means of viewing.

4.26 Pay TV was reintroduced on DTT by Top Up TV in 2004, leveraging the existing population of ITV Digital set-top boxes. Top Up TV replaced most of its linear channels by making content available via its push-VoD service, Top Up TV Anytime, which launched in August 2006.

4.27 This phase also saw consumers adopt other services enabled by the move to digital TV such as digital video recorders (DVRs), Multiroom subscriptions and video on demand.

4.28 In 2006, the UK's two largest cable operators, ntl and Telewest, merged and later rebranded to be called Virgin Media.

[20] http://www.ofcom.org.uk/static/archive/itc/uploads/ITC_multichannel_quarterly_Q4_2002.pdf

4.29 The process of switching off analogue terrestrial TV services, and moving to digital terrestrial TV, started at the end of 2007 in the pilot town of Whitehaven in the Border region[21]. The regional switchover has since progressed to the West Country, Wales and the North West of England.

4.30 In December 2009, the North West of England became the biggest single region to complete switchover. A total of 3.04 million homes are served by the Winter Hill transmitter in the Granada region, which covers the major cities of Liverpool and Manchester[22]. The UK's switchover is due to be completed by the end of 2012.

Next phase

4.31 We are now entering a period where new technologies and services are enabling fresh opportunities for the distribution and viewing of pay TV content. A future outlook for the sector is discussed later in the chapter.

4.32 Technological developments such as HDTV and, in the future, 3DTV are enhancing the physical viewing experience.

4.33 Broadband access networks have emerged as an important new means of distributing audiovisual content, either via the open internet, or various closed IPTV platforms. We are starting to see investment in new superfast broadband networks, which are likely to offer bandwidths to individual households of up to 100 Mbit/s.

4.34 Whereas traditional TV networks broadcast the same linear channels to all households, and provide a degree of choice by the broadcast of multiple channels, broadband networks potentially provide much enhanced choice, by allowing consumers to access a wide range of content on demand.

4.35 This capability is being exploited by a variety of new platforms and devices, including broadband-enabled set-top boxes, integrated digital TVs and games consoles.

4.36 The devices themselves are becoming more capable, providing more sophisticated means of navigating the available content, as well as local storage so that content can be viewed at a convenient time.

4.37 Such technologies have the potential to give consumers greatly enhanced quality, choice and convenience in how they access content.

Current pay TV landscape

Operators in the pay TV sector

4.38 Today, the main operators of satellite and cable TV services are:

- British Sky Broadcasting (Sky), which was created by the merger of Sky and BSB in 1990. It launched digital TV in 1998 and had 9.7 million subscribers at the end

[21] http://www.digitaluk.co.uk/__data/assets/pdf_file/0004/19579/11-14-07_nov_post_switch_complete_final.pdf

[22] http://www.digitaluk.co.uk/__data/assets/pdf_file/0006/42999/NORTH_WEST_WAKES_TO_A_DIGITAL_DAWN.pdf

of 2009[23]. Its Sky satellite service offers a range of free-to-air, basic and premium channels.

- Virgin Media, created by a consolidation over 13 years of the cable franchise areas created in 1984, culminating in the merger of ntl and Telewest in 2006, and the subsequent re-branding in 2007 to Virgin Media. The company had 3.7 million TV customers at the end of 2009 and offers a range of free-to-air, basic tier and premium channels.

Figure 3 Sky and Virgin Media TV subscribers by package, June 2009

[✂]

4.39 Other providers of residential pay TV services include:

- BT Vision, which offers paid-for content such as TV shows and movies on-demand via IPTV. It also offers the linear TV channels from Freeview and the ESPN subscription channel via DTT. BT Vision launched in December 2006 and had 451,000 customers at the end of December 2009.

- Top Up TV, the pay DTT service, offers a selection of content, such as TV shows and movies, on-demand. Programmes are downloaded to the hard drives of its Top Up TV Freeview+ DVRs, so-called 'push' VoD. Top Up TV also offers the linear TV channels from Freeview, via DTT, and the ESPN subscription channel, also via DTT. Top Up TV launched in 2004 and does not disclose subscriber numbers.

- TalkTalk TV[24] is the UK's only pay TV service to offer linear TV channels via IPTV (or television over DSL). Recent set-top boxes also include a DTT tuner. It also offers a wide range of on-demand content. TalkTalk TV was formerly HomeChoice, which launched in 1999 offering just VoD content. It launched linear TV channels in 2004. Internet service provider Tiscali announced plans to acquire HomeChoice in August 2006 and rebranded the service to Tiscali TV in March 2007. Tiscali UK was acquired by Carphone Warehouse in 2009. TalkTalk TV has around 50,000 subscribers[25].

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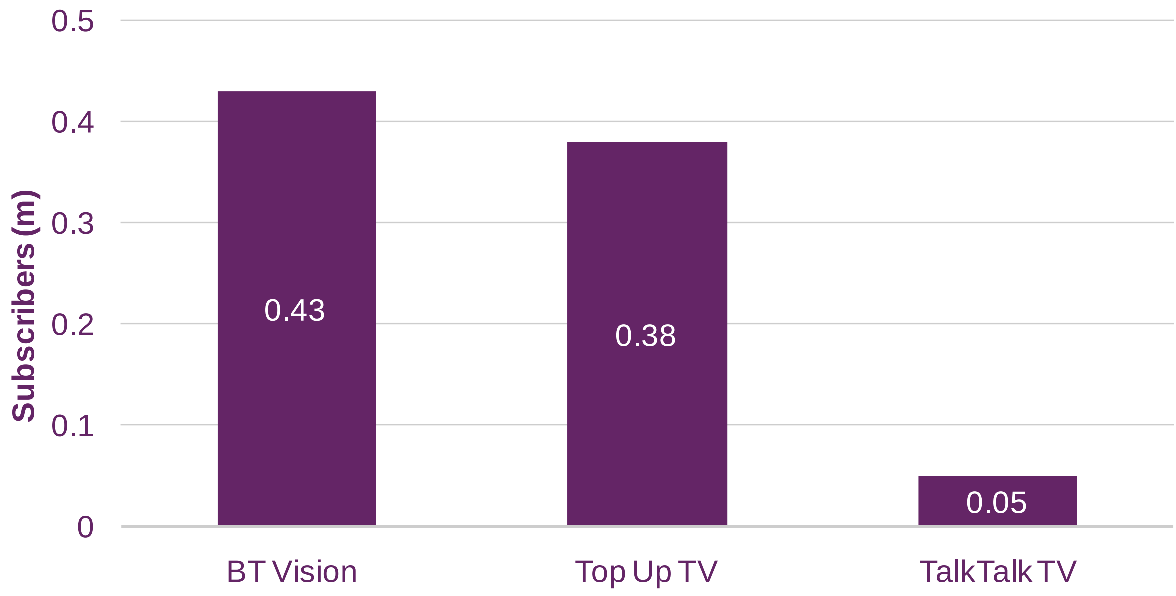
[23] This includes UK and Ireland subscribers.

[24] TalkTalk TV was previously called Tiscali TV but was rebranded in January 2010 by its owner Carphone Warehouse.

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

Figure 4 Subscribers to BT Vision, Top Up TV and TalkTalk TV, June 2009



Source: Ofcom/ Operators.

Note: BT Vision subscribers based on Q2 2009 data; Top Up TV figure is a calculation based on Ofcom consumer research as provided in Digital TV Update Q2 2009; TalkTalk TV based on public comments from July 2009.

4.40 There are other operators that offer pay services to the TV or PC. Most of these are in their infancy and have limited subscriber numbers compared to the established providers of pay TV services discussed earlier. These include:

- Fetch TV, which provides VoD via the 'open internet' to TVs. Fetch TV receivers also include DTT tuners to offer Freeview channels.

- Freewire, owned by Inuk, which offers pay TV to the student community via UK universities' JANET network.

- Sky Player, the Sky service that uses the internet to deliver subscription TV channels and on-demand content to personal computers and other devices.

- Games consoles including Sony's PlayStation 3, which offers movies and TV programmes, and Microsoft's Xbox Live service, which offers movies and Sky Player live and on-demand content. These services already have installed hardware bases in the shape of the games consoles.

4.41 Some pay TV services have closed:

- ONdigital launched a pay TV service on the newly launched DTT platform in November 1998. In 2000, ONdigital agreed a £315m three year deal with the Football League for live rights to Nationwide League matches.

- In 2001 ONdigital re-branded to ITV Digital in an attempt to boost take-up by exploiting the ITV brand. The number of subscribers to ONdigital was lower than originally hoped for but still reached a total of 1.234 million by the end of 2001[26]. ONdigital suffered from technical problems – there was a tendency for the set-top box software to crash, the platform suffered from piracy and coverage was only 50% to 60%[27]. In March 2002, Carlton and Granada put the company into administration after attempts to renegotiate the terms of the Football League deal failed.

- Kingston Interactive Television (KIT) launched in October 1999, offering linear TV channels, VoD and broadband to consumers in Hull, in the north east of England. Owned by Kingston Communications, KIT was closed in 2006 and had around 4,000 subscribers.

- Setanta Sports came to prominence in 2006 when it acquired Premier League rights for the three seasons from 2007 – 2010. It acquired a variety of other rights such as FA Cup football, England national team football, US PGA golf and Indian Premier League cricket. It closed in June 2009 after failing to find fresh capital to run the business.

- Setanta Sports operated a bouquet of premium sports channels, which were retailed to consumers on satellite, cable, DTT and IPTV. It explored a variety of novel retail models. For example, it offered its premium channels in a ‘basic’ offer on cable, including them at no extra charge to subscribers to Virgin Media’s ‘XL’ package. It also had a deal with Top Up TV under which consumers that purchased a Top Up TV Personal Video Recorder (“PVR”) and signed up to Top Up TV’s Anytime service received “free” access to Setanta’s live Premier League matches for a season.

Free-to-air multi-channel operators

4.42 Alongside pay TV services, free-to-view multi-channel services are available to UK consumers:

- Freeview launched in October 2002 as a free-to-view DTT service following the closure of ITV Digital. The original Freeview consortium included the BBC, Sky and Crown Castle (now Arqiva) but ITV and Channel 4 have since joined. Around 9.7 million homes now rely on Freeview as their primary means of TV reception.

- Freeview presents consumers with a means of accessing a wide range of channels, without a monthly subscription, and with the added convenience of using an existing rooftop antenna. Freeview now offers nearly 50 TV channels and more than 20 radio services.

- The launch of Freeview facilitated the emergence of a horizontal market for reception equipment. Set-top box prices have fallen rapidly and boxes can now be purchased for less around £15. Integrated digital televisions (IDTVs) are also widespread and now constitute the majority of sales of Freeview-enabled devices.

[26] ONdigital originally projected one million subscribers by the end of 2000, and two million by early 2003.

[27] See for example “Football in the New Media Age”, by Raymond Boyle and Richard Haynes.

- Freesat, backed by the BBC and ITV, launched free-to-view digital satellite services in May 2008. It offers a range of digital channels and high definition programming. Freesat had around 750,000 customers at the end of September 2009.

Figure 5 Comparison of UK multi-channel offers from key providers

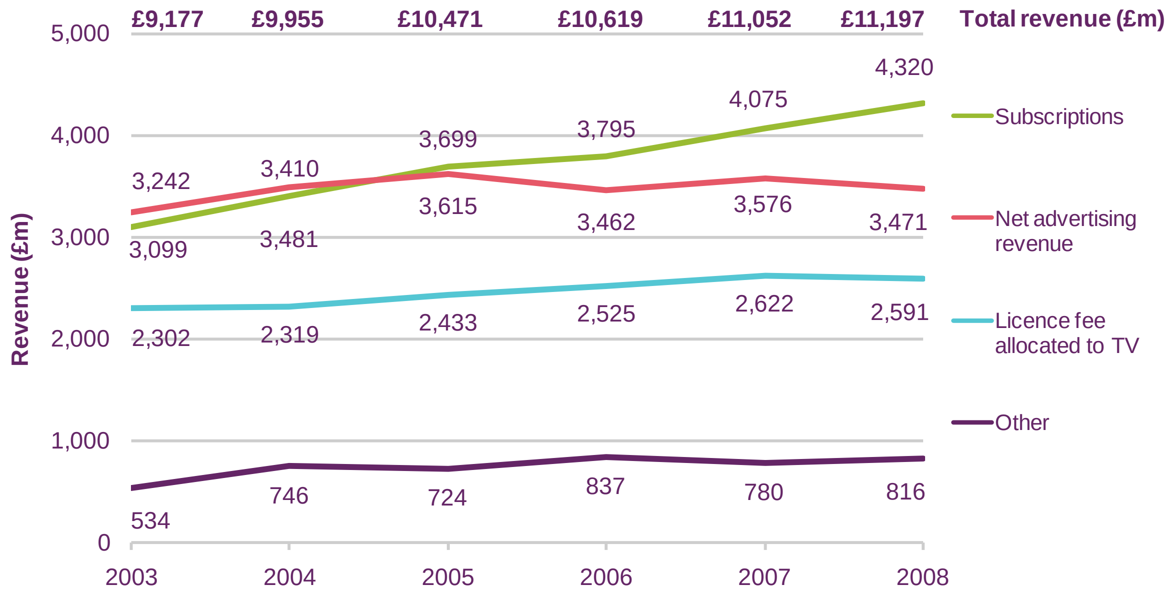
Type of household / subscriber	Sky – satellite	FreeSat	Cable	BT Vision	Talktalk / Tiscali	Freeview	Top Up TV
Linear channels	100 pay + 300 FTA	300 FTA channels	100 pay channels	Freeview channels	35 pay channels + Freeview	50 Freeview channels	ESPN + Freeview channels
VoD	**Push VoD** content downloaded onto PVR. Selection of **near VoD PPV films** e.g. 22 films available at intervals of between 15 minutes and an hour	None	Thousands of hours of **true VoD**. Free catch up, SVoD films: Picturebox. Hundreds of PPV films.	Thousands of hours of **true VoD**. Free catch up, SVoD films: Picturebox. Hundreds of PPV films.	Thousands of hours of **true VoD**. Free catch up, SVoD films: Picturebox, Filmfour . Hundreds of PPV films.	None	**Push VoD** content downloaded onto PVR. Picturebox movies: 7 films per week content.
HD	35 linear HD channels	2 channels (ITV HD accessed via red button)	7 Linear HD channels and some VoD HD services	Films and series available in HD	Limited HD content	None currently (BBC HD testing in London)	
Reception technology	Satellite dish		Cable	Existing phone line & Terrestrial TV aerial		Terrestrial TV aerial	
Coverage limitations	Coverage extends to 98% of the population. It may not be possible to erect a satellite dish if in rented accommodation, short term accommodation or flats.		Only in (largely urban) cabled areas covering 49% of the population.	Only available in BT enabled exchanges.	Only available in homes near TalkTalk unbundled exchanges.	Currently available to about 73% of the population, rising to 98.5% by 2012	
Set up costs and minimum term contract	Standard installation of £30 plus a minimum twelve month TV subscription contract of £18 - £48.50 per month	Digital STB around £50 and satellite dish installation of £80. Freesat from Sky a one off installation of £175. No subscription required.	Virgin Media standard installation of £30 for an engineer visit or install for free. Minimum term contact of 12 months.	£90 BT Vision box, or free until March 26 2010 with a subscription to Value pack on a minimum 12 month contract. Phone or broadband contract required.	TalkTalk TV standard installation of £30 and minimum eighteen month contract at £26.47 - £30.47 (including phone and broadband).	Set top box from £15. If a new aerial is required to receive DTT this could cost between £60-£180.	Set top box £40 - £70 for set top box. One month minimum TV subscription of £7 to £11.99.

Source: Operator websites and Digital UK. Note: Linear pay channels exclude +1s. Data correct as of March 2010.

Sector revenues, service availability and penetration

4.43 Subscription revenue generated by the UK pay TV sector reached £4.3bn in 2008 and was the largest single component of revenue for the UK television industry. Advertising generated £3.5bn in 2008 while public funding from the BBC's licence fee accounted for £2.6bn.

Figure 6 TV industry revenues by source

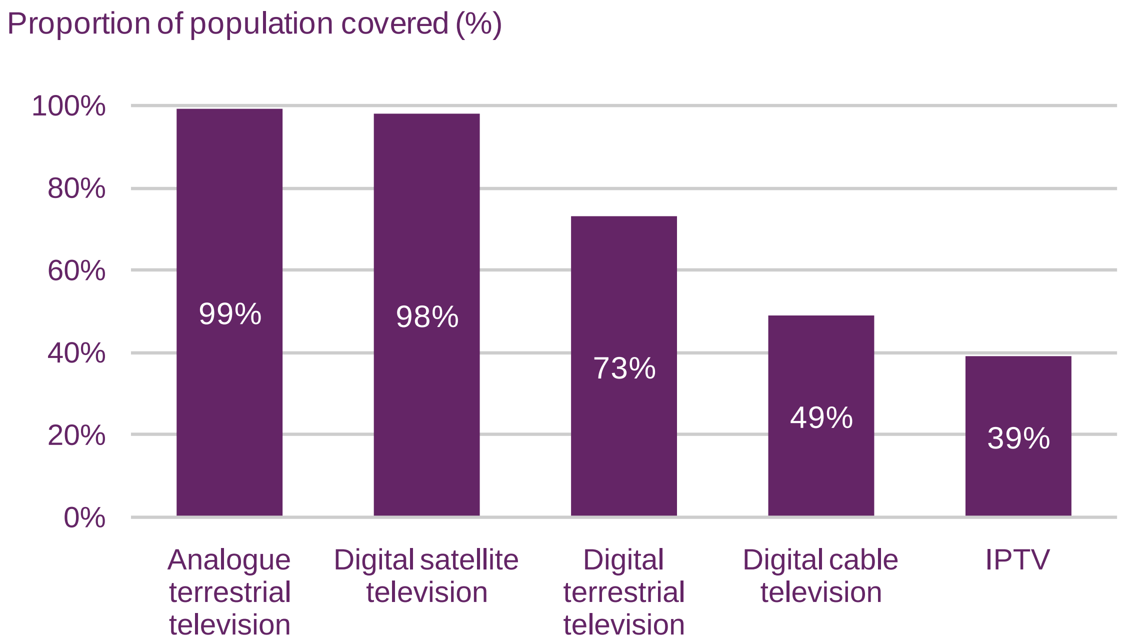


Source: Ofcom/broadcasters.

Note: Figures expressed in nominal terms and replace previous Ofcom revenue data for TV industry, owning to restatements and improvements in methodologies. 'Subscriptions' includes Ofcom's estimates of Sky, Virgin Media, BT Vision, Setanta Sports and Top Up TV television subscriber revenue in the UK (Republic of Ireland revenue is excluded). It also excludes revenue generated by broadband and telephony. 'Other' includes TV shopping, sponsorship, interactive (including premium-rate telephony services), programme sales and S4C's grant from the DCMS. The licence fee figure for 2006 has been re-stated owing to a change in the way the BBC reported its figures, which allocates a greater proportion of overheads to specific services. Totals may not equal the sum of the components due to rounding.

4.44 The UK has four main types of television platforms available to consumers: terrestrial, satellite, cable and IPTV. At the end of 2008, analogue terrestrial and digital satellite were available to 98% of the population; DTT was available to 73%; cable television 49% and linear channels over IPTV (TalkTalk TV) to 39%.

Figure 7 Availability of UK TV platforms



Source: Ofcom research, operators

4.45 Sky's satellite platform is an 'open' platform on which third-party channel operators can acquire access to the platform on a fair, reasonable and non-discriminatory basis as long as they meet a set of requirements and obtain a listing on the electronic programme guide (EPG). This is governed by Technical Platform Services guidelines[28].

4.46 Virgin Media operates a 'closed' platform where channel operators must agree terms with the cable operator to gain access.

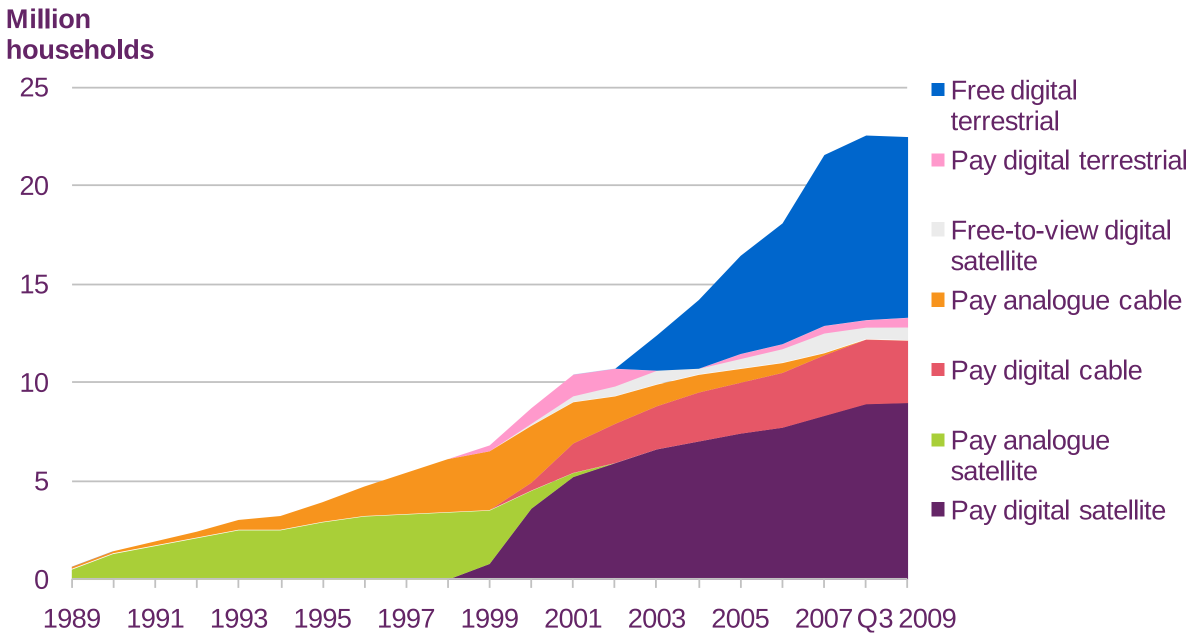
4.47 There has been increased adoption of digital television over the last decade. Nearly 90% of UK homes now receive a digital service on their main television set. Both Sky Digital and ITV Digital launched in 1998. Digital cable TV and IPTV launched in 1999.

4.48 Sky switched off its analogue satellite television service in 2001 while Virgin Media started to shut down its analogue networks on a regional basis in 2008. Analogue switchover of terrestrial television started at the end of 2007. It is progressing on a regional basis and is expected to be completed by the end of 2012.

4.49 Digital satellite is the most widely used pay platform in the UK and was in 9.5 million homes at Q3 2009. Cable TV is the second largest pay platform in 3.7 million homes at the end of 2009; cable TV has experienced slow growth over the last decade. Free-to-view DTT is in 9.7 million homes as the primary source of TV viewing.

[28] http://www.ofcom.org.uk/consult/condocs/tpsguidelines/statement/statement.pdf

Figure 8 Multi-channel TV penetration



Source: 1989-1996 data from ITC, platform operators and BARB for July of each year; 1997 from Sky and ITC reports; 1998-2007 data from Ofcom estimates, platform operators and GfK research for Q2 of each year; for 2008, the figure is based on GfK research and relates to Q4. Pay DTT data from 2005 onwards based on Ofcom estimates and, from 2007, GfK consumer research.

Packages and pricing

4.50 Providers of pay TV services offer different tiers of channels. These can be broadly split up into five types.

- First, free-to-air channels, which are free at the point of access for viewers. BBC1, BBC2, ITV1, Channel 4 and Five are the main free-to-air channels. These broadcasters also offer a range of free-to-air multi-channel services. A diverse free-to-air multi-channel sector has emerged in the last decade as broadcasters have taken advantage of lower barriers of entry, in part helped by the transition to digital broadcasting, falling costs of satellite capacity and new business models.

- Second, basic-tier channels: these channels are usually paid carriage fees based on a per-subscriber rate by the platforms that retail them. Examples of basic-tier channels include Discovery, Disney Channel, Sky One, Living TV and Comedy Central. These channels and others are usually aggregated into bundles of pay TV channels to create packages, which are sometimes genre based.

- Third, there are premium channels. These tend to include sports and movies and are generally sold as a more expensive option on top of a basic tier of channels. Such channels include Sky Movies, Sky Sports and ESPN, which can be bought by consumers in bundles or in some cases as single channels.

- Fourth, there are standalone à la carte channels that serve more niche interests, focusing on multicultural audiences, adult content or sport (football club channels), for example, which include channels such as Zee TV, Playboy TV and MUTV. Consumers would typically pay a monthly subscription for such channels.

- Fifth, pay-per-view services are available, offering individual pieces of content, such as a movie or a sporting event. A one-off fee is usually paid by a viewer to access the content.

4.51 Figure 9 illustrates the range of products available on each of the key pay TV platforms. It also outlines pricing for entry level channels and premium channels. Given that packages vary by operator, components of those packages and pricing are not directly comparable.

Figure 9 Comparison of pay TV offers from key providers

	Sky Digital	Virgin Media	Talk Talk TV	BT Vision	Top Up TV	Sky Player (online)
Entry level basic TV	£18 p/m	£11.50 p/m (M+)	£26.47 p/m (includes broadband, phone and line rental)	£30.98 p/m after offer period (includes BT broadband)	£11.99 p/m for TV Favourites. Picture Box from £7.	£15 p/m
Entry level premium and basic TV	£26 p/m	£35.50 p/m	£48.47 p/m	Sky premiums not available	Sky premiums not available	£24 p/m
Big premium and big basic TV	£48.50 p/m	£55 p/m	£59.47 p/m	Sky premiums not available.	Sky premiums not available.	£41 p/m.
ESPN	From £9 p/m	Free in XL pack or from £8 p/m	From £7.99 p/m	Free with value pack (one-off fee applies)	From £9.99 p/m	From £9 p/m
Multiroom TV	£10 p/m	£10 p/m	N/A	N/A	N/A	N/A
DVR	£49 for Sky+ HD box. Free set-up*	From £5 p/m. £75 set-up fee	Included	Included (box is usually £90)	Included – from £39.99	N/A
HDTV	Free box & £10 p/m	Max £5 p/m. £49 for box	Some on-demand HD	Some on-demand HD	N/A	N/A
VoD	Free via Sky Anytime TV (push VoD)	PPV VoD, SVoD and catch-up	PPV VoD, SVoD and catch-up	PPV VoD, SVoD and catch-up	Content is on demand (push VoD)	PPV and SVoD
Installation	Free online	From £15	£30	£15	N/A	N/A

Source: Operators. Data correct as of March 2010.

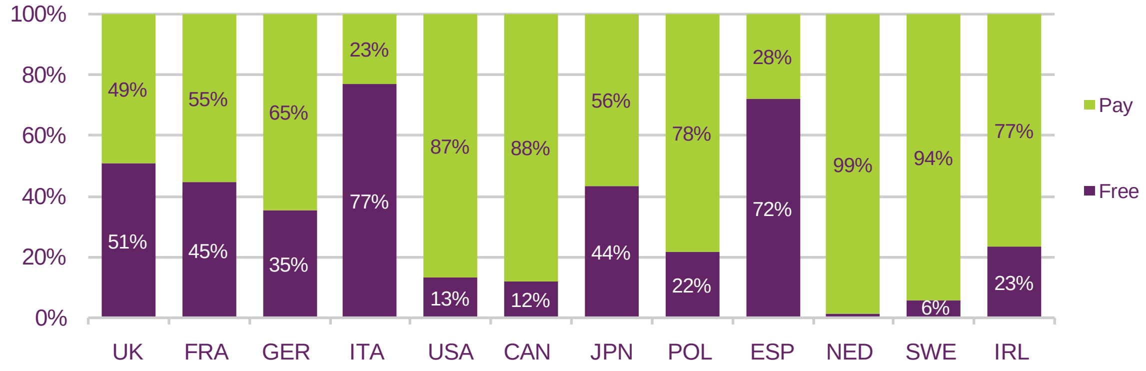
*Notes: Entry level basic represents the cheapest package that can be taken without other products, such as a phone line in Virgin Media's case. Entry level premium is one premium channel (one Sky Sports or Sky Movies channel). Prices are for standard offers. Where other products have to be taken with TV these have been included. N/A is not applicable.*If a Sky customer takes out a HD subscription they receive a free Sky+ HD receiver.*

4.52 Pay TV has historically provided a means of accessing a greater range of TV channels for a monthly subscription than is available on a free-to-air platform. At the end of 2008, 49% of UK homes subscribed to a pay TV service, a lower pay TV penetration compared to some major countries[29]. As we have said in our previous

[29] Figure 2.30, http://www.ofcom.org.uk/research/cm/icmr09/

consultations, cross country comparisons can provide useful information on the relative performance of different countries, but it is hard to draw direct comparisons because data may not always be directly comparable.

Figure 10 Pay TV versus free-to-view TV, 2008



Source: IDATE, Ofcom.

Note: figures represent household penetration and pay TV figures include TV households that subscribe to internet and telephony and get digital TV as part of the bundle.

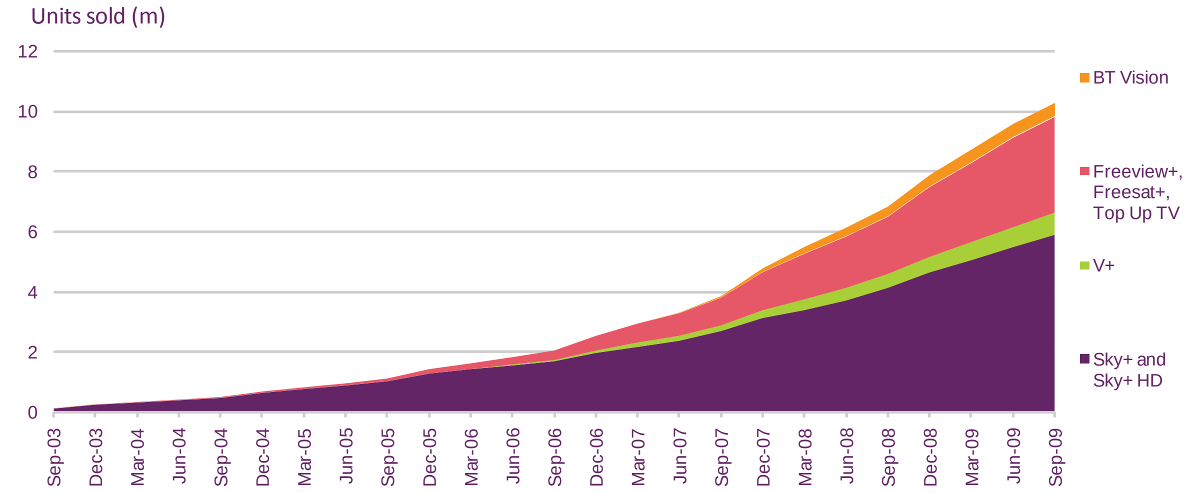
4.53 Within the last decade pay TV operators have also introduced a range of additional TV products, some of which have been enabled by developments in technology. These include:

4.54 **Multiroom TV**, which enables customers to have multiple subscriptions in the home by installing additional set-top boxes. Both Sky and Virgin Media offer Multiroom, for £10 per month on top of the standard subscription. Sky reported that 2 million subscribers took the Multiroom option at Q4 2009.

4.55 **DVRs**, also called PVRs, let viewers record programming to a hard drive on the set-top box. They also allow viewers to pause live TV. TiVo, an American company, was first to offer DVRs in the UK in October 2000, with the launch of its eponymous device that worked with satellite, terrestrial and cable television. It entered the UK with a marketing agreement with Sky. A year later Sky launched its DVR product, Sky+. This was followed in 2003 by DVRs for the Freeview DTT service and in 2006 by Telewest's TVDrive, which later became V+ following the creation of Virgin Media. Other DVR devices include Top Up TV's Freeview+, BT Vision's Vision+, Tiscali+, Freeview+ (previously Freeview Playback) and Freesat+. The '+' symbol now appears to be synonymous with digital television recorders in the UK.

4.56 By the end of Q4 2009, around eleven million DVR units had been sold or rented (in the case of Virgin Media) to UK consumers. The majority of these – nearly 6.5 million – were provided by Sky (Sky+ and Sky+ HD receivers) while 862,000 were Virgin Media V+ and 451,000 were BT Vision's Vbox. The second largest component of the DVR universe was Freeview+, Freesat+ and Top Up TV Freeview+ receivers, of which 3.2 million had been sold by Q3 2009. Figure 11 illustrates sales and rentals figures for DVRs up to Q3 2009.

Figure 11 Sales and rentals for digital video recorders (DVR)



Source: Operator results, GfK sales data and Ofcom estimates

Note: Figures represent sales and not homes. Freeview+ and Freesat+ data based on GfK and sales data. BT Vision, V+, Sky+ and Sky+ HD based on operator data. Sky+ figures include the Republic of Ireland. V+ boxes are rented to Virgin Media customers.

4.57 **High definition TV (HDTV)** provides viewers with sharper picture quality, up to five times the resolution of standard definition digital TV. HDTV was first launched in the UK at the end of 2005 on the cable network of Telewest, and was made available to customers of its TV Drive DVR. HDTV was made available to customers in the ntl cable franchise in November 2006 following the merger between the two cable companies.

4.58 Virgin Media's HD channels and on-demand HD content are now available with its V+ DVR. In March 2010, Virgin Media announced plans to launch a new HDTV set-top box, called V HD, and remove the monthly fee for customers that take Virgin Media M+ TV package. The V HD box launched on 22 March and costs £49. Installation by an engineer cost £35[30]. Also in March this year, Virgin Media signed a deal with Channel 4 to broadcast an HD version of Film 4 in HD exclusively from the summer[31]. At the end of 2009, 862,000 Virgin Media TV customers had a set-top box capable of accessing HD content.

4.59 In May 2006, Sky launched its HDTV service, which costs customers £10 per month on top of a standard subscription. In January 2009, Sky reduced the price of its HDTV receiver from £149 to £49. The company also announced that it would be employ 1,000 new staff in the year to June 2009 to help support the product drive for HDTV. In January 2010, Sky said that HDTV set-top boxes would be sold as standard and ceased providing standard definition receivers[32]. The company also

[30] http://pressoffice.virginmedia.com/phoenix.zhtml?c=205406&p=irol-newsArticle&ID=1402632&highlight=

[31] http://pressoffice.virginmedia.com/phoenix.zhtml?c=205406&p=irol-newsArticle&ID=1399781&highlight=

[32] http://corporate.sky.com/documents/pdf/press_releases/4ad9b907f137492d998022a042ac035b/280110_Interim_Results_Press_Release

said that consumers could acquire Sky+ HD box for free if they subscribed to a HD package. At the end of 2009, the Sky+ HD service had 2.1 million subscribers. In March 2010, Sky announced deals with a range of channels, such as ITV and Five, and said it planned to offer up to 50 HD channels by the end of 2010[33].

Figure 12 Selected HDTV offers from key providers/services

Provider	Distribution technology	Launch date	HD content available	Number of HD homes
Sky (Sky+ HD)	Satellite	May 2006	37 linear channels covering key genres. Some on-demand HD content available on Sky Anytime TV.	2,082,000
Freesat (Freesat HD)	Satellite	May 2008	BBC HD channel and ITV content accessed via red button.	Approx. 593,000
Virgin Media (V+ HD)	Cable	December 2005 (as Telewest's TV Drive)	7 channels plus HD programmes and films available on-demand.	862,000*
BT Vision (Vision +)	IPTV	September 2008	Films and series available in HD, which are downloaded via IPTV to BT Vision box.	451,000
TalkTalk TV	IPTV	December 2009	Selected films available in HD, which are downloaded via IPTV to Talk Talk TV box.	<50,000
BBC iPlayer	Online	April 2009	Major BBC programming available in HD to stream and download.	-
Freeview	DTT	Receivers available from early 2010.	HD services from BBC, ITV and Channel 4 available from early 2010. Five is not expected until 2012.	-

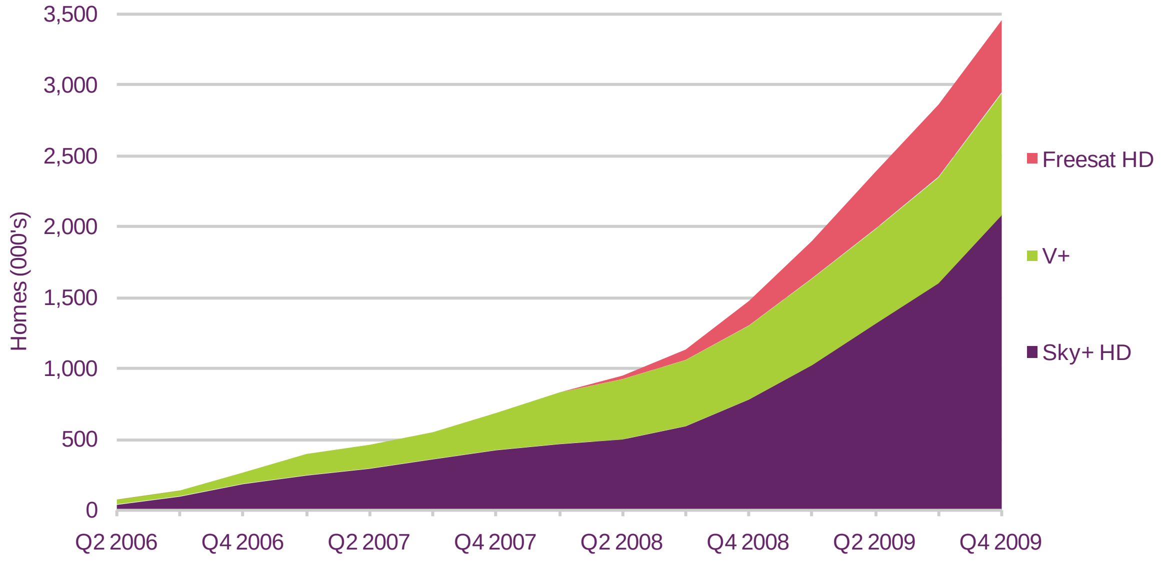
Source: Ofcom research and company data, based on latest available figures.

*Note: *Freesat data based on HD equipment sold (Freesat IDTVs could be used to access other HD services).*

4.60 At the end of 2009, around 3.5 million homes had access to HDTV channels – either subscription (on Sky and Virgin Media) or free-to-air (via Freesat), although there could be some overlap in device ownership. When accounting for homes that can receive non-linear HD programming through BT Vision and TalkTalk TV, this number increases by around 500,000 homes. Some video games consoles also offer HD video content.

[33] http://corporate.sky.com/media/press_releases/2010/HD_channel_milestone.htm

Figure 13 UK homes with linear HDTV channels: Sky, Virgin Media and Freesat



Source: Sky / Virgin Media / Freesat. Based on latest available figures.

4.61 **VoD** services allow consumers to watch programmes in a non-linear fashion and organise their viewing outside of the restrictions of a TV schedule. Content is stored on the networks of operators ready for viewing or stored locally, on the hard drive on a set-top box in the home. VoD is broadly split up into three types:

- 'Pull' VoD, sometimes referred to as 'True VoD', where the content is delivered via a two-way network (commonly used by cable and IPTV). Operators of pull VoD typically offer thousands of hours of content on demand.

- 'Push' VoD, where content is downloaded to the hard drive of the set-top box and made available to view on demand. Push VoD services are limited by the capacity available to store programming on the set-top box, as well as by the need to predict what consumers will wish to watch, so offer a significantly reduced choice of programming as compared to Pull VoD.

- Near' VoD, where multiple linear channels broadcast the same content at staggered start times.

Figure 14 Selected VoD offers from key providers

Provider	Distribution technology	VoD launch date	VoD content available	Number of VoD homes
Talk Talk TV	IPTV (pull VoD)	1999 (as HomeChoice)	Thousands of hours of VoD content. Free catch-up, SVoD films (Movies Now, Picture Box, Film4 On Demand), PPV VoD and SVoD TV packages.	<50,000
Virgin Media	Cable (pull VoD)	December 2005 (as Telewest's TV Drive)	Thousands of hours of VoD content. Free catch-up, SVoD films (Picture Box), PPV VoD and SVoD TV packages.	3.7 million
Top Up TV Anytime	DTT (push VoD)	November 2006	Over 700 shows a month available and SVoD films (Picture Box).	490,000 (Ofcom DTV Update, Q3 2009)
BT Vision	IPTV (pull VoD)	December 2005	Thousands of hours of VoD content. Free catch-up, SVoD films (Picture Box), PPV VoD and SVoD TV packages.	451,000
Sky	Satellite (nVoD & push VoD)	nVoD, March 1996; push VoD November 2007	Sky Box Office (nVoD) offers pay-per-view movies and some sport. Sky Anytime TV service offers up to 85 hours of different content.	9.4 million for nVoD; 5.3 million for push VoD*
BBC iPlayer	Online (pull VoD)	December 2007	Offers most programming from the previous seven days of the BBC schedule on demand (for streaming or download).	All homes with hardware and suitable internet connection
Sky Player	Online (pull VoD)	December 2008	Pay TV channels on demand. Premium option for Sky Sports and Movies. On demand movies also available.	All homes with hardware and suitable internet connection

Source: Operators, using latest available data.

*Note: *Sky Anytime TV data found at http://www.skymedia.co.uk/Audience-Insight/dashboard.aspx*

4.62 VoD services in the UK were first launched by HomeChoice and Kingston Interactive Television in 1999. VoD providers such as Virgin Media, BT Vision and TalkTalk TV, which employ pull VoD, are now offering thousands of hours of on-demand programming. UK cable operators ntl and Telewest launched pull VoD in early 2005 while BT Vision launched at the end of 2006. In terms of push VoD, Top Up TV launched its Anytime service in November 2006, while Sky Anytime TV followed a year later.

4.63 Historically, third-party companies aggregated content, such as movies and TV series, for VoD operators. More recently, operators have looked to aggregate the content themselves, signing deals with producers, TV channels and film studios directly.

4.64 There are a variety of business models for VoD:

- Transactional VoD allows customers to purchase content, usually on an individual ‘pay-per-view’ basis, such as movies or music videos.
- Customers can buy stand-alone VoD packages, providing unlimited access to on-demand programming in for a monthly fee, called subscription VoD (SVoD). One example of this is the SVoD film service PictureBox.
- In some cases VoD is bundled in with a linear television channel subscription, such as Virgin Media’s TV Choice service or Sky’s Sky Player service.
- Sky Player is also available on a stand-alone basis as a subscription service.

4.65 Free-to-air broadcasters are increasingly using the internet to provide on-demand access, typically to allow viewers to catch-up with programmes which have been recently broadcast on TV:

- The BBC’s iPlayer catch-up TV service received 61.5 million requests to stream/downloads radio and TV programmes across all platforms in January 2009. This figure had nearly doubled to 114.8 million in December 2009[34].
- Other similar services include ITV Player, 4oD, Demand Five, SeeSaw and Blinkbox.
- At Q1 2009, 23% of UK adults (15 years and above) with internet access at home (or 16% of all adults) said that they watch online catch-up TV[35].

4.66 The online TV market is likely to develop further as new providers enter the market, resulting in a greater range of programming available online to consumers. SeeSaw, owned by transmission company Arqiva, launched a catch-up TV service in February 2010 and Hulu, the US service backed by NBC Universal, News Corporation and Disney, has previously stated its ambitions to launch in the UK[36].

4.67 There is a close relationship between the more widespread availability of VoD services, and investment in new superfast broadband networks and new IPTV platforms.

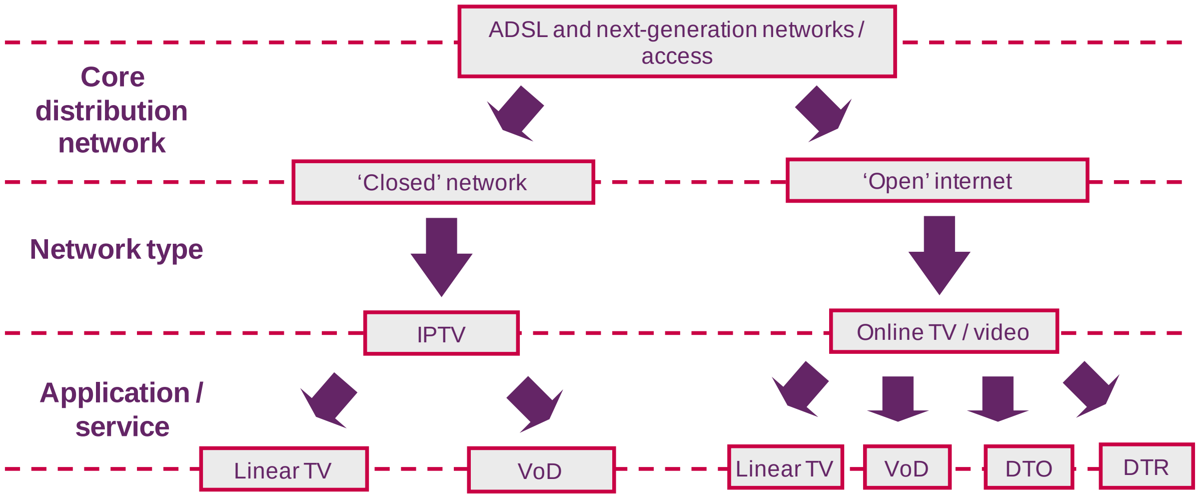
4.68 Superfast broadband networks enable the reliable and robust delivery of video services to consumers, either over the open internet, or via closed IPTV networks. This will create an environment in which high quality content can be delivered on demand, via a variety of platforms / applications, to a range of different devices, as illustrated below.

[34] http://www.bbc.co.uk/pressoffice/pressreleases/stories/2010/01_january/14/iplayer.shtml

[35] Ofcom Communications Market Report 2009, p. 267.

[36] http://paidcontent.co.uk/article/419-hulu-talking-with-possible-partners-for-uk-launch/

Figure 15 Broadband content distribution value chain



Source: Ofcom.

Note: DTR is 'download to rent', DTO is 'download to own'

4.69 However, while there appears to be a move towards two-way networks facilitated by the move towards IPTV and 'next generation access' technologies, broadcast networks are likely to continue to be utilised to deliver a volume of linear television. The combination of broadcast and unicast technologies is likely to offer attractive consumer propositions.

4.70 In particular, DTT is likely to continue to be an attractive means to deliver TV channels to the mass-market alongside a VoD service delivered via broadband. Such an approach has been proposed for the Project Canvas service backed by the BBC, ITV, BT, Channel 4, Five and Carphone Warehouse, which received provisional approval from the BBC Trust in December 2009[37]. Sky has indicated that in 2010 it plans to launch a 'pull' VoD service to its Sky+ HD set-top boxes over broadband. Its linear TV channels are distributed via digital satellite[38].

Service bundles

4.71 Consumers are increasingly buying TV and communications service in bundles for convenience and to take advantage of discounted offers. Figure 16 details the communications services and bundles available from key suppliers. Four of the 13 providers featured offer TV services as part of a bundle and these are highlighted by the shaded areas in the grid.

[37] http://www.bbc.co.uk/bbctrust/news/press_releases/2009/december/canvas.shtml

[38] http://corporate.sky.com/media/press_releases/2009/3d_tv.htm

Figure 16 Bundling service offers from major suppliers, June 2009

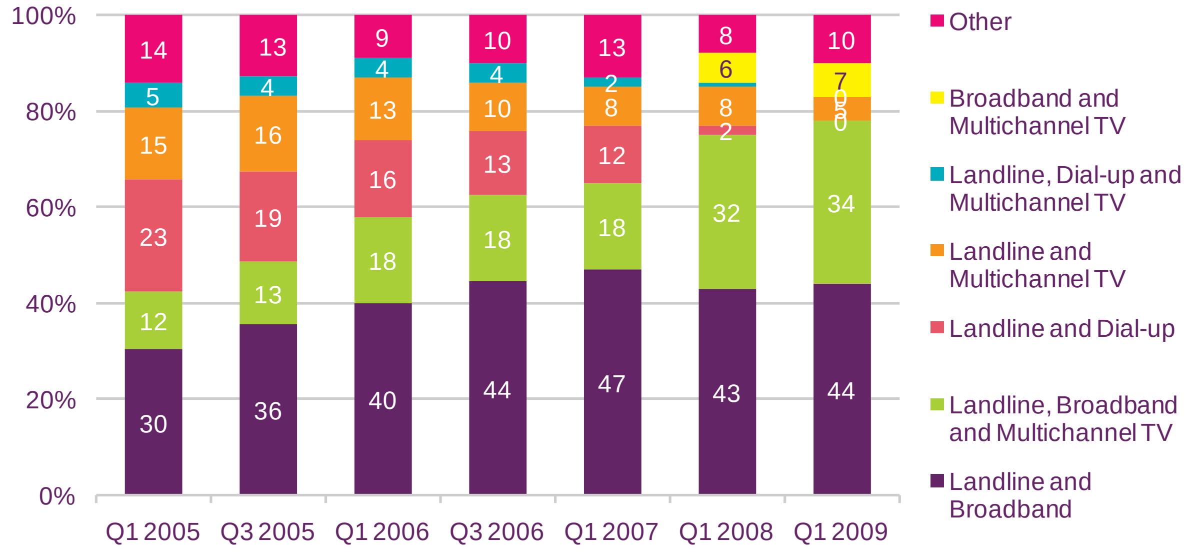
		3	AOL	Be	BT	O2	Orange	PlusNet	BSkyB	T-Mobile	TalkTalk	Tesco	Tiscali	Virgin Media	Vodafone
	Standalone broadband		Y	Y	Y	Y	Y	Y	Y		Y	Y	Y	Y	Y
	Standalone fixed voice				Y										
	Standalone TV								Y					Y	
	Broadband and phone		Y		Y		Y	Y	Y		Y	Y	Y	Y	Y
	Broadband and mobile					Y	Y					Y		Y	Y
	Phone and mobile						Y					Y		Y	Y
	Phone and TV				Y				Y				Y	Y	
	Broadband, phone and TV				Y				Y				Y	Y	
	Broadband, phone & mobile						Y					Y		Y	Y
	Phone, TV and mobile													Y	
	Broadband, phone, TV & mobile													Y	
MBB	Standalone mobile broadband	Y			Y	Y	Y			Y				Y	Y

Source: Pure Pricing.

Note: Shaded areas show operators that offer TV. Note, Tiscali and TalkTalk have been combined under TalkTalk to account for merged product.

4.72 In 2009, 44% of adults were buying communications services in bundles. When looking at the composition of bundles, Figure 17 below shows that a growing proportion of bundles purchased by consumers are to landline telephone, broadband internet and multi-channel television, sometime called a ‘triple play’. The proportion of total consumers that buy communications services in bundles who were taking these three products increased from 12% to 34% between Q1 2005 and Q1 2008.

Figure 17 Proportion of customers buying different types of bundles

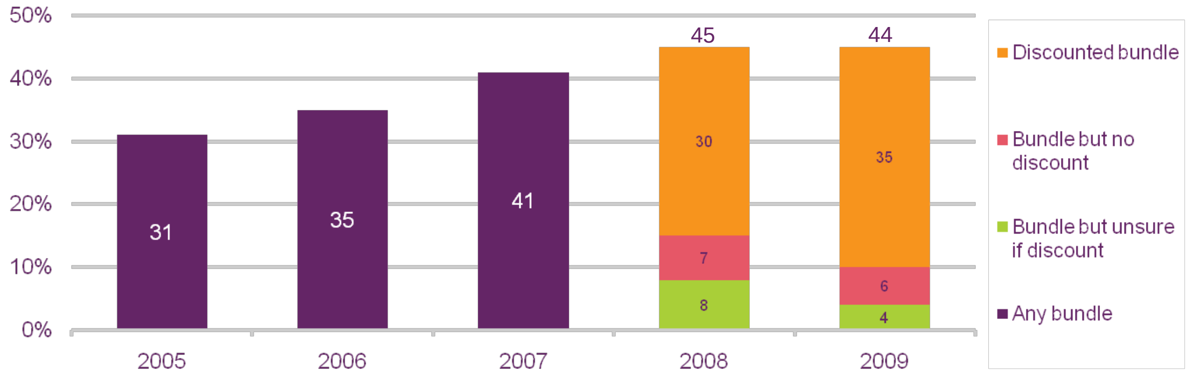


Source: Ofcom communication tracking survey

4.73 However, although triple-play bundles are increasing in importance, especially among those consumers that already buy communications services in bundles, a large proportion ([✂][39]%) of Sky's subscribers still take pay TV services on a stand-alone basis, without telecommunications services.

4.74 According to Ofcom consumer research, 44% of UK adults said that they bought communications as part of an overall deal or package from the same supplier. This has increased from 31% in 2005.

Figure 18 Percentage of consumers buying bundled services



Source: Ofcom communication tracking survey.

Base: All adults 15+ (2005, 8766) (2006, 9134) (2007, 8960) (2008, 7496) (2009, 8199). Percentages exclude people who did not know if they were on a package or not Note: Question only asked in Q1 and Q3 of 2008 and 2009. Asked all quarters in 2005 – 2007.

Characteristics of the pay TV sector

4.75 Having set out some of the history of pay TV and described the current state of the sector, we now outline some of the underlying characteristics of the structure of UK pay TV.

4.76 In our First[40] and Second Pay TV Consultations[41] we outlined the structure of the pay TV value chain. We presented a model, illustrated in Figure 19, in which the supply chain for the UK broadcasting industry consists of four layers:

- Content production, for example creating and recording content which can be broadcast.

- Wholesale channel provision, which is the aggregation of content to bundle into channels. This could include commissioning content, acquiring rights to broadcast content or buying content from other providers.

- Wholesale platform service provision, provides services to enable retailers to control the supply of content to consumers, or providing EPG services to broadcasters.

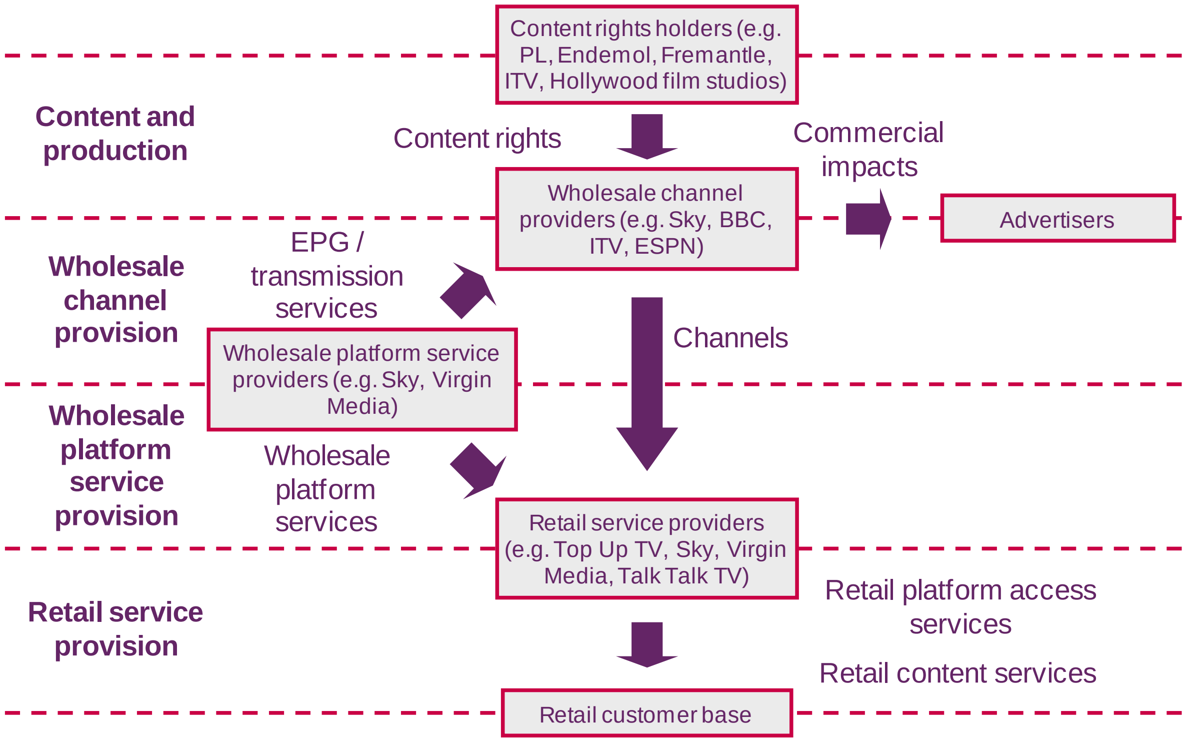
[39] Sky response dated 13 November 2009 to Ofcom information request dated 29 October 2009, question 26. Based on Sky's UK subscribers as of September 2009.

[40] Annex 8, Pay TV Consultation, December 2007.

[41] Figure 14, Second Pay TV Consultation, September 2008.

- Retail service provision, includes the bundling of channels in to packages to retail to consumers.

Figure 19 Pay TV value chain



Source: Ofcom

4.77 In the following sub-Sections we consider the following distinctive features of the pay TV sector. These include:

- Consumer preferences for content, and the particular importance of premium content as a driver of pay TV subscriptions.
- Content aggregation and the potential creation of market power.
- Fixed content production costs and the importance of price discrimination.
- Vertical integration of firms which are active in the market and the incentives this creates.

Content aggregation and market power

4.78 We set out in our Second[42] and Third[43] Pay TV Consultations that there are a number of mechanisms by which content is aggregated at different points in the value chain. These include:

- Collective selling of sports rights by sporting bodies – for example, the Premier League, UEFA, or the ECB.

[42] Second Pay TV Consultation, paragraphs 5.8 to 5.28.

[43] Third Pay TV Consultation, paragraphs 3.35 to 3.41.

- Bundling of content across different delivery technologies by rights owners. Rights tend to be sold on a non-technology-specific basis, with one set of rights covering satellite, cable, DTT and IPTV.

- Bundling of different types of movie rights (SVoD / linear channels) by movie studios.

- Sky's acquisition of movies rights from all six Major Hollywood Studios for the first pay TV subscription window, and Sky's and others' acquisition of sports rights for a variety of different events.

- Acquisition by channel operators of a variety of content to create channels, which may in some cases focus on a particular genre.

4.79 We also said that content aggregation can in principle offer benefits to consumers. For example:

- The aggregation of attractive content by broadcasters is essential in order to create channels which viewers wish to watch.

- The aggregation of channels into bundles by retailers is often necessary in order to establish a pay TV proposition which consumers wish to buy.

4.80 The collective selling of sports rights has been recognised as providing benefits to consumers. In particular, it can contribute to the sporting balance of a competition by distributing rights income more evenly among teams in a competition, which is likely to make it more attractive as a spectacle by making contests more evenly matched.

4.81 There is, however, also a risk that the aggregation of content can result in the creation of market power. This is particularly likely when it involves the aggregation within a narrow economic market of a number of pieces of content which might otherwise be full or partial substitutes for each other.

4.82 The question of whether market power exists in relation to premium sports and movies channels is discussed in Sections 5 and 6. Content aggregation is important in both cases, specifically:

- In relation to sport, the aggregation of the rights to specific sporting competitions by sporting bodies such as the Premier League, and the further aggregation by broadcasters such as Sky of the rights to different competitions.

- In relation to movies, the aggregation by Sky of rights to show the movies from all six Major Hollywood Studios.

4.83 To the extent that aggregation results in the creation of monopoly rents, these are likely to flow upstream to where the aggregation takes place. However, as discussed in our Third Pay TV Consultation[44], the existence of aggregation at different points in the value chain means that it is not always entirely clear who is likely to be the main beneficiary in practice of the aggregation process.

- Sporting bodies such as the Premier League would be expected to retain any monopoly rents associated with the aggregation of rights for competitions for

[44] Section 4, Third Pay TV Consultation.

which they are responsible. However, further aggregation of sports rights to different competitions is carried out by broadcasters such as Sky, and Sky may also have a degree of purchasing power because of its position in downstream markets, both of which might be expected to deliver some benefits to it.

- Sky is likely to be the prime beneficiary of any monopoly rents arising from the aggregation of movie rights, due to its role as the principal aggregator. However, it is also likely that the Major Hollywood Studios can extract some of the benefit from aggregation in their individual negotiations with Sky.

4.84 One important consequence of monopoly rents moving upstream is that it can become difficult to distinguish them from any scarcity rents associated with the ‘talent’ which underpins the production of high quality content. In other words, the high salaries paid to some footballers and movie stars may be an indication of market power, but could equally well reflect the scarcity value of football skills and movie talent. This makes the precise identification of monopoly profits in content markets particularly difficult.

4.85 The Premier League in its response to our Third Pay TV Consultation told us that we failed to recognise the need for content aggregation and misunderstood the effects of content aggregation. It also said that the practice is essential to ensure a meaningful product and for broadcasters to be able to provide distinct channels, programmes and bundles, and that we attempted to use content aggregation to make irrelevant, vague and unsupported assertions about the possibility that there are monopoly rents flowing upstream[45].

4.86 As explained above, we have always said that content aggregation can be beneficial for consumers, as it enables diverse content to be built into packages that appeal to consumers with varied tastes. However, at the same time content aggregation can be a contributing factor to market power, which can have its own negative consequences such as higher wholesale and retail prices.

Vertical integration

4.87 It is very common for companies involved in pay TV to be vertically integrated. This is illustrated in the diagram below, which we set out in our First and Third Pay TV Consultations, and which shows which major companies are active at which level of the value chain.

[45] See paragraphs 4.4 and 4.17 to 4.27 of the Premier League’s response to the Third Pay TV Consultation.

Figure 20 Table showing operators' participation at different levels of the value chain

	Content generation	Wholesale channel	Wholesale platform services	Retail services
BT Vision			✓	✓
Discovery	✓	✓		
Disney	✓	✓		
MUTV	✓	✓		
Sky	✓	✓	✓	✓
Top Up TV			✓	✓
Virgin	✓	✓	✓	✓

Source: Ofcom

4.88 The table highlights several types of integration:

- Integration of retail and platform operations (Sky, Virgin Media, Top Up TV, BT Vision). These companies both operate a platform and provide retail services on that platform.

- Integration of retailing and wholesale channel provision (such as Sky and Virgin Media). Such companies create channels and suites of channels that they then retail directly to their retail customers. Many also wholesale channels to other retailers, typically on other platforms.

- Integration of retailing, platform operation and wholesale channel provision (e.g. Sky, Virgin Media).

- Integration of wholesale channel provision and content origination (Disney, Discovery, MUTV). These companies produce large quantities of content – sufficient to assemble into their own branded channels.

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

- Vertical integration between retail and wholesale platform operations may ensure a close fit between the requirements of consumers and the technical platform offering.

- Vertical integration between retail and wholesale content markets may allow content to be more closely tailored to consumer preferences.

- A wholesale channel provider which is vertically integrated with an incumbent retailer may have an informational advantage because its improved understanding of consumers' willingness to pay allows it better to assess the value of the content rights that it bids for.

- Vertical integration either between retail and wholesale platform operations, or between retail and wholesale content markets, may avoid the efficiency loss associated with 'double marginalisation'. This efficiency loss may arise when a retailer purchasing content from a third-party wholesale channel provider does not see the true marginal cost of supplying content to individual consumers, which is close to zero, but instead sees a per-subscriber wholesale subscription charge. Thus, the retailer's incentive to make the content widely available is weakened. As a result, the retailer is likely to set higher retail prices and may be discouraged from promoting / advertising the channel. In contrast, a vertically integrated retailer sees the true marginal cost of content.

- Vertical integration of content origination and wholesale channel provision may avoid the transaction costs associated with negotiating agreements to supply both content rights and the rights to market and assemble a channel using the content originator's brand.

4.90 We also said that vertical integration may change the incentives on firms which determine how they transact with one another. This is because a vertically integrated firm will also take into account the impact of its actions at one level of the supply chain on other parts of its business. Absent regulation, there is a potential incentive for a firm which is vertically integrated between wholesale and retail markets to refuse to supply wholesale services to other retailers, or supply them on less favourable terms than it supplies itself.

4.91 However, it is important to recognise that whether a firm acts on this incentive depends in practice on a number of other factors. A key question which we considered in our Second Pay TV Consultation was whether Sky, as a vertically integrated wholesaler and retailer of premium content, was acting so as to restrict the wholesale distribution of this content. We return to this question in Section 7 of this document.

4.92 In its response to our Third Pay TV Consultation, the Premier League said that conditions for the assertion that vertically integrated firms have an incentive to withhold inputs are stringent, but that we failed to show that Sky's behaviour is consistent with withholding premium content and that vertical integration in itself does not require regulation[46].

4.93 Our discussion of vertical integration in Section 3 of our Third Pay TV Consultation (as well as our discussion of vertical integration above) was intended only to be an introduction to the concept of vertical integration. We recognise that vertical integration is commonplace and only problematic in certain circumstances. This poses the question whether those conditions apply in the present circumstances. We assess this question in detail in Section 7.

[46] See paragraph 4.5 of the Premier League's response to the Third Pay TV Consultation.

Fixed costs of content production and the importance of price discrimination

4.94 In our First[47], Second[48] and Third Pay TV Consultations[49] we identified that content markets have two important characteristics which in combination distinguish them from markets for physical goods and services:

- The consumption of content is non-rivalrous, in the sense that different consumers can consume the same piece of content at the same time. This means that the production costs of content can be regarded entirely as fixed costs, rather than varying with the number of consumers.

- The fixed costs of producing certain categories of content can be high. For example, the wage costs alone of the Premier League were £1.2 billion in 2007/2008[50], while the average cost for making and marketing a single Hollywood film is about $100m[51].

4.95 These characteristics create a strong incentive to distribute content to as wide a set of consumers as possible. The incentive is particularly powerful in the case of advertising-funded free-to-air broadcasting, where revenues increase with reach.

4.96 The incentives are somewhat more complex for subscription-funded pay TV broadcasting. This is because subscription revenues are also likely to increase with reach, but only if some form of price discrimination is adopted, which allows content to be distributed to additional consumers, whose marginal willingness to pay is lower than the average willingness to pay of existing consumers.

4.97 Price discrimination in these circumstances can have beneficial effects for both producers and consumers, since it can be an effective way of recovering the high fixed costs of generating content in a way that enables more consumers to take a product. Price discrimination is widespread in the pay TV sector, though it operates differently in the commercial and residential parts of the sector.

4.98 In the commercial sector, there is explicit price discrimination, in that different customers are charged different prices for access to Sky's Sports channels. In the case of 'pubs and clubs', for example, prices are based on the rateable value of premises, using this as a proxy for the value associated with distributing content to specific premises. Hotels, betting shops and offices all have their own specific pricing structures.

4.99 In the residential sector, all customers are charged the same price for the same channels, so there is no explicit price discrimination. Instead, there is a form of implicit price discrimination, which relies on the fact that retailers are likely to attract more consumers by retailing bundles which contain a variety of channels containing

[47] Paragraph 5.78, First Pay TV Consultation.

[48] Paragraph 1.23, Second Pay TV Consultation.

[49] Paragraph 3.42, Third Pay TV Consultation.

[50] According to Deloitte's Annual Review of Football Finance 2009 - http://www.deloitte.com/dtt/cda/doc/content/UK_SBG_ARFF2009_Highlights.pdf, page 2.

[51] The MPAA's Theatrical Market Statistics 2007 - http://www.mpaa.org/2007-US-Theatrical-Market-Statistics-Report.pdf, page 7.

different types of content. In such circumstances a number of consumers may be willing to pay the same aggregate price for a bundle, despite each attaching different values to different elements of the bundle.

4.100 We have previously set out an illustrative example of this effect, which we will repeat here. Consumer A values a sports channel at £10 and a movies channel at £2, and consumer B values a movies channel at £10 and a sports channel at £2. A company selling each channel individually would set the prices at £10; both consumers would buy their most preferred channel, giving total revenue of £20. However, if the company sets the price of a bundle of the two channels at £12, both consumers will take the bundle, yielding revenue of £24.

4.101 Specific examples of retail bundling in pay TV include:

- Basic channels are commonly sold in bundles rather than individually. Sky retails basic channels in a number of genre-specific entertainment packs, which can in turn be aggregated into bundles containing multiple packs. Virgin Media retails basic channels in four tiered packages, 'M', 'M+', 'L' and 'XL', containing an increasing number of channels (~45, ~65, ~100 and ~160 respectively).

- Premium channels are commonly sold in genre specific bundles ('Sky Sports Mix', 'Sky Movies Mix') as well as in mixed bundles containing both sports and movies channels.

- Premium channels are also commonly sold as part of a bundle with basic channels, via a mechanism known as 'buy-through'. This requires consumers to buy a basic package before they can buy a premium package. All of Sky's premium channels were until September 2009 subject to an enforced buy-through[52], but the same was not true of Setanta's / ESPN's premium channels[53].

4.102 As stated above, bundling as a price discrimination mechanism may be beneficial for both consumers and producers. There are, however, two potential sources of concern:

- Bundling of content in circumstances where no standalone products are available restricts consumer choice. This is a particular concern in the case of enforced buy-through, which prevents consumers who wish to purchase a stand-alone premium package from doing so.

- Bundling is a form of content aggregation, which may be associated with a degree of market power.

4.103 Our level of potential concern with bundling and price discrimination will therefore depend on the particular circumstances:

- In a situation where marginal cost of distribution is low, such practices are likely to offer overall efficiency benefits.

[52] **[✂]**

[53] Setanta went into administration on 23 June 2009, shortly after the live Premier League rights which had been held by Setanta were awarded to ESPN. ESPN has announced that it has agreed a wholesale deal with Sky for distribution on Sky's satellite platform. It also has distribution agreements with Virgin Media, Top Up TV, BT Vision and TalkTalk TV.

- If these practices take place in the context of a competitive market, they are likely to promote consumer welfare.
- In a situation where there is market power, such practices may still result in increased efficiency. However, much of the benefit is likely to accrue to the producer, away from the consumer.
- In a situation where the market power can be leveraged into other markets, it is likely to produce additional competition concerns which are likely to outweigh any compensating efficiency benefits.

Premium content as a driver of pay TV subscriptions

4.104 Here we look at what types of content are key drivers for pay TV. We examine the consumer and market based evidence on what is valued within a pay TV service and we explain that sports and movies are the genres which stand out as being among the most valued genres by consumers, and also having a high degree of exclusivity to pay TV.

4.105 In our Second Pay TV Consultation[54] we stated that the content which is likely to be most effective in driving pay TV subscriptions must have two characteristics:

- A significant appeal to a broad audience.
- Limited availability via free-to-air TV channels.

4.106 Content which has a broad appeal, but which is widely available free-to-air, such as some of the UK-originated content available via the public service broadcasters, is unlikely to drive pay TV subscriptions, since consumers are unlikely to pay a significant premium to watch programmes similar to those which they can watch for free.

4.107 The comment is frequently made in broadcasting that ‘content is king’. A number of consultation respondents agreed with the observation in our Second Pay TV Consultation that no amount of high-tech platform features could make up for an absence of attractive content, or “turn unattractive content into attractive content”. The ability to time-shift a programme, for example, is of value precisely because consumers want to watch a specific and valued piece of content in the first place.

4.108 This is not to say that platform features are unimportant – far from it. A sports fan, given the choice between a sports channel in SD and HD, may well value the enhanced definition afforded by HD sufficiently to pay extra for it; however, given the choice between that sports channel in SD and another channel which is in HD but does not contain interesting content, they are much more likely to follow the underlying content rather than the higher definition.

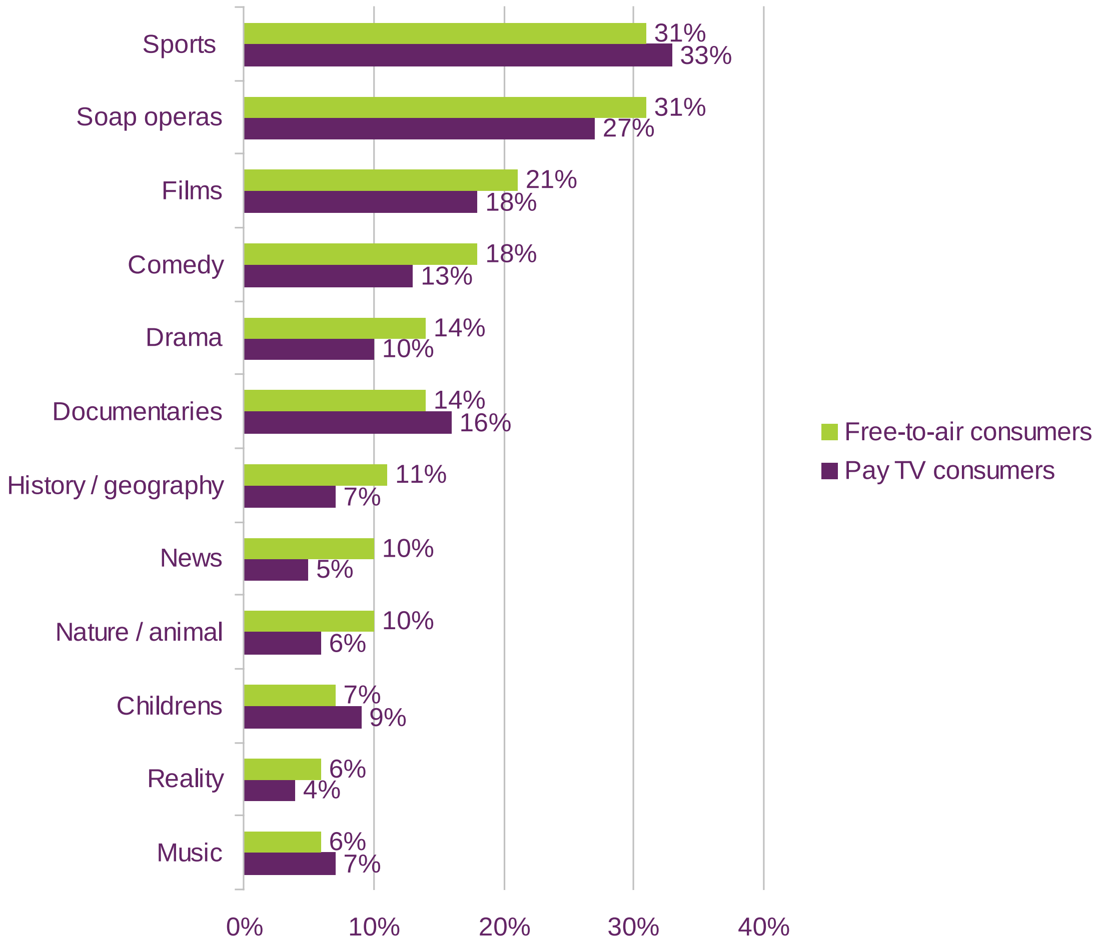
4.109 Although the general importance of attractive content to any broadcaster is straightforward to understand, the question of which specific content is most important as a driver of pay TV subscriptions is more complex. This is because the characteristics which viewers look for when deciding what programme to watch are highly subjective – the level of interest in a particular genre or a particular storyline, the attractiveness of particular actors or actresses, the degree of support for a

[54] Section 3, Second Pay TV Consultation.

particular sporting event or for a particular team, and so on. As a result, consumers have very varied preferences for different types of content. This was illustrated by the consumer research which we have set out in our previous consultation documents[55].

4.110 Figure 21 shows the genres of content that are most attractive to consumers.

Figure 21 Consumer preferences for different genres on TV



Base: All multi-channel TV household decision-makers for whom content is 'must have' (FTA 045, pay TV 947) Source: Ofcom pay TV research phase one (June / July 2006). Notes: Spontaneous mentions of programme genre among those for whom content is 'must have'.

4.111 The three genres that are most valued by consumers are sports, soap operas and movies. Of these, soap operas are widely available on free-to-air television, and so are unlikely to be a primary driver of pay TV subscriptions. The same is true of other genres which are valued by consumers, such as comedy, drama and documentaries. Sports and movies are the genres which stand out as being among the most valued genres by consumers, and also having a high degree of exclusivity to pay TV. On this basis alone we would expect them to be key drivers of pay TV subscriptions. Sky argued that our 2009 Omnibus Survey provided no support for the significance of its

[55] See in particular the charts set out in Section 4 of Annex 14 to our First Pay TV Consultation – http://www.ofcom.org.uk/consult/condocs/market_invest_paytv/annex14.pdf.

premium sports and movies channels[56]. We address Sky's arguments on this point in Annex 6, Appendix 5.

4.112 We used a variety of further evidence in our Second and Third Pay TV Consultations to analyse the importance of sports and movies content in more detail, and we set this out again below, looking at:

- Sums paid by channel providers for content rights.
- Statements made by market players.
- International examples.
- Numbers of premium subscribers in the UK.

Sums paid for content rights

4.113 The amounts paid by companies such as Sky, ESPN and similar companies abroad for exclusive rights to sports and movies content are substantial, pointing to the importance of these types of content to their businesses, for example:

- Sports programming represented 54% of Sky's programming costs in 2008/09, and 21% of Sky's entire operating expenses. This is higher than any other category of operating expenditure – marketing is the next biggest at 20%[57]. The cost of sports programming increased by 2% from 2007/08 to 2008/09 to reach £944m.

- Movies programming represented 16% of Sky's programming costs in 2008/09, and 6% of Sky's entire operating expenses. This is significantly lower than Sky's expenditure on sports programming, but is similar in magnitude to Sky's total expenditure on all third party channels (18% of programming costs) and higher than its total expenditure on its own news and entertainment channels (12% of programming costs). The cost of movie programming decreased by 1% from 2007/08 to 2008/09 to £278m[58].

Statements made by market players

4.114 The statements Sky in particular has made, both in public and private, illustrate how important sports and movies premium content, and in particular premium sports content, is in assembling a pay TV business. The most well-known of these is Rupert Murdoch's comment at the 1996 AGM of News Corp. (a major shareholder in Sky in the UK) that sport would be the "battering ram" of pay TV.

[56] Comments by Sky on consumer research undertaken by Ofcom in October and November 2009 (March 2010), paragraph 38.

[57] Page 38, http://www.sec.gov/Archives/edgar/data/932789/000095012309028302/u06991e20vf.htm page 31.

[58] Page 38, http://www.sec.gov/Archives/edgar/data/932789/000095012309028302/u06991e20vf.htm page 31.

4.115 More recently, a quote from Rupert Murdoch in a documentary aired on Sky One in June 2007[59], revealed:

> "In life, if you're building a company, you've got to take risks. And this [purchasing Premier League rights] was certainly, on the face of it, very risky. But I knew from selling newspapers or from television elsewhere that sport is the great, number one common denominator. And, of that, football [is number one]".

4.116 Sky recounted the role of sports programming in the story of its own development, the "Sky Fact Book", in 2004:

> "Sky Sports has been pushing back the boundaries of televised sport since 1991. It recognised the British public's insatiable appetite for sport and sparked a viewing revolution that has changed the way people watch it. . . . Right from the start, sport has been a major factor in the growth of multi-channel TV."

4.117 Trevor East, formerly Deputy MD of Sky Sports, and subsequently at Setanta as Director of Sport, stated in Broadcast on 26 January 2007:

> "Sky was on the verge of bankruptcy and it nearly brought the whole of the Murdoch empire down, but winning that Premiership was key to its growth. Hopefully the Premiership and other things we've got will do the same for Setanta Sports".

4.118 These quotes are somewhat historical, in that they refer to the past development of Sky. There is however evidence from information request responses that this also reflects current thinking. For example, a senior executive at Sky **[✂]** stated in a letter to the **[✂]**, on 8 February 2007, when discussing **[✂]** request for wholesale access to Sky Sports channels, that:

> **[✂]**[60].

4.119 The importance of premium sports and movies content to Sky's platform is evident from other internal documents that we have obtained[61].

- **[✂]**[62].
- **[✂]**[63].
- **[✂]**[64]**. [✂]**.

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[59] Quoted in the Guardian, Friday 22 June 2007, 'Murdoch warns on football rights'.

[60] Provided by **[✂]** in response dated 18 June 2008 to Ofcom formal information request of 9 June 2008.

[61] We also note that Sky pointed to certain comments made by Virgin Media employees in paragraphs 4.4 to 4.7 of its January 2010 Submission. We did not consider that the quotes produced had a material bearing in this context.

[62] **[✂]**. Provided by Sky in response to information request of 14 May 2008.

[63] **[✂]**. Ibid.

- **[✂]**[65].

4.120 These are echoed by various internal documents which we have obtained following various information requests to other pay TV providers:

- **[✂]**[66]. **[✂]**[67]. **[✂]**[68].
- **[✂]**[69]. **[✂]**
- **[✂]**[70]. **[✂].**
- **[✂]**[71]. **[✂]**[72]. **[✂]**
- **[✂]**[73].
- **[✂]**[74].
- **[✂]**

International examples

4.121 In previous consultation documents, we have looked at international examples of how pay TV markets operate. Annex 9 of the first Pay TV Consultation[75] focused on profiles of key pay TV markets, while Annex 11 of the Third Pay TV Consultation provided details on wholesale must-offer remedies in international markets[76].

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64 **[✂]**. Ibid.

65 **[✂]**. Ibid.

66 **[✂]**. Provided by Virgin Media in response to information request of 23 May 2008.

67 **[✂]**. Ibid.

68 **[✂]**. Ibid.

69 **[✂]**. Ibid.

70 **[✂]**. Ibid.

71 **[✂]**. Ibid.

72 **[✂]**. Ibid.

73 **[✂]**.

74 **[✂]**.

75 http://www.ofcom.org.uk/consult/condocs/market_invest_paytv/annex9.pdf

76 http://www.ofcom.org.uk/consult/condocs/third_paytv/annex11.pdf

4.122 We continue to believe that the international case studies from around Europe that we set out in our Second Pay TV Consultation illustrate the importance of sports rights in particular[77].

- Amounts paid for rights have been high in Germany, Spain, Italy and France, as in the UK.
- Changes in rights ownership in Germany and France also illustrated the importance of top-flight football rights to pay TV operators. In Germany, Premiere's subscriber numbers dropped in 2006 for the first time since 1997 on the back of the company losing rights to broadcast live Bundesliga matches.

4.123 We set out some examples here of the strong relationship between ownership of key rights and the success of pay TV retailers in major European markets. This is further reinforced by our analysis of pay TV innovations towards the end of this Section, which shows that the most successful IPTV launches round the world tend to share the common characteristic of having access to important premium content.

UK

4.124 Sky has exclusive ownership of first-run pay TV movies in the UK and exploits these rights in a bouquet of subscription-based movies channels. Sky also owns the majority of premium sports rights, including 66% of live Premier League games, all but one game per week for the UEFA Champions League and a range of other rights – see Section 5 for further details.

France

4.125 Between 2001 and 2005, TV rights to Ligue 1, France's top domestic football league, were split between competing digital satellite platforms owned by Canal Plus and Television Par Satellite ("TPS"). In 2005, Canal Plus acquired all live rights; following this, seven years of consistent growth turned to a decrease in subscriber numbers for TPS.

4.126 By 2006 the two platforms had merged, creating the country's biggest pay TV platform, called CanalSat, which also owned premium movie rights for all Major Hollywood Studios. But the company lost control of exclusive sports and movies.

4.127 France Telecom secured rights to broadcast one weekly game of the French football Ligue 1 for four years from August 2008 on a new premium channel Orange Sport, available on its Orange IPTV and digital satellite platforms. Orange also launched Orange Cinema Series, a bouquet of premium movies channels, after securing movie deals with studios including Warner Bros and MGM as well as French producers.

4.128 At the end of 2006, Orange France had 577,000 IPTV subscribers. This number had increased to 2.8 million at the end of 2009, at which time the premium channels Orange Sport and Orange Cinema Series had 663,000 subscribers, up from 130,000 a year earlier[78].

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[77] See Section 3 of our Second Pay TV Consultation for full details: http://www.ofcom.org.uk/consult/condocs/second_paytv/condoc.pdf.

[78] http://www.orange.com/en_EN/finance/invest-analysts/cons-results/att00014504/FranceTelecom_FY09Results.pdf

Germany

4.129 Sky Deutschland (formerly Premiere) owns most of the premium sports and movie rights in Germany and had 2,470,000 subscribers at the end of 2009[79]. It revised the way it calculated subscriber numbers in October 2008, which resulted in a fall in customers[80]. It offers its premium channels via its own satellite platform and to cable operators.

4.130 Consumers in Germany gain access to cable TV, particularly analogue cable, by paying a basic fee to receive around 30 channels. This can be included in the cost of renting a property and, therefore, is regarded as a utility[81]. Therefore, while we class this as pay TV in our analysis, this does not fit with the traditional definition of pay TV.

4.131 Sky Deutschland holds live pay TV rights to the top two divisions of the Bundesliga, the domestic football league, until the 2012/2013 season, across cable, satellite and broadband. It also owns a range of sports rights, including the exclusive cross-platform rights (cable, satellite, IPTV, internet and mobile) for UEFA Champions League football until 2011/2012.

4.132 In 2005, when it was Premiere, the company lost the Bundesliga football rights to cable operator Unity Media, via its Arena subsidiary. Premiere subsequently saw a fall in subscriber numbers, from 3,567,000 in 2005 to 3,260,000 in 2006. As a result, Premiere sub-licensed the rights from Arena to gain access to the football.

4.133 Deutsche Telekom's Entertain service owns the IPTV rights to Bundesliga. It had 800,000 subscribers at the end of 2009, up from 353,000 at the end of 2008.

Spain

4.134 Digital Plus is the largest pay TV provider in Spain, although it has been losing subscribers. It had 2,078,000 subscribers at the 2008 and just under 1,900,000 at the end of 2009. Digital Plus owns premium sports and movies channels under the Canal Plus brand but distributes these only on its own Digital Plus satellite platform.

4.135 Digital Plus has deals with the major studios for pay TV movie rights, which it exploits on its subscription channels. Historically, Digital Plus has held the bulk of premium pay TV sports rights. But in recent years it has faced competition for sports rights, particularly football, from Mediapro, with which it shares some rights to La Liga domestic football. Mediapro also owns rights to UEFA Champions League football, which were previously owned by Digital Plus. The two companies had various disputes over rights ownership, which were described as a 'football war'[82].

4.136 Mediapro exploits its rights on a premium channel called Gol TV, which is offered on a range of platforms such as cable operators Ono and Euskaltel as well as IPTV platforms of Orange, Jazztel and Telefonica's Imagenio. Gol TV is also available on DTT and is Spain's first pay channel on the DTT platform.

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[79] http://info.sky.de/inhalt/static/download/aktie/2009/q4_2009/english/skydeutschlandag_q4_2009_PressRelease_e.pdf

[80] http://info.sky.de/inhalt/eng/medienzentrum_news_uk_02102008.jsp

[81] TV International, 7 April 2009.

[82] New Media Markets, 5 September and 3 October, 2007.

4.137 Telefonica is the fastest growing pay TV provider in Spain, adding 90,486 customers in 2009 to reach 702,980[83]. Last year, Telefonica said that one of the reasons for an increase in its IPTV customer base was the addition of the Gol TV channel[84].

Italy

4.138 Sky Italia is Italy's largest pay TV provider and was formed in 2003 through the merger of Stream and Telepiu. It had 4.74 million subscribers at the end of 2009[85], up from 4.70 million subscribers a year earlier. Sky Italia owns the majority of premium sports and movie rights in Italy, which it exploits on premium channels that are also available on IPTV (Italy does not have a cable sector).

4.139 Sky Italia has also been under an obligation to provide some premium content on a wholesale must-offer basis, as a result of commitments given to the European Commission at the time of the merger between Stream and Telepiu[86].

4.140 Sky Italia has faced competition for pay TV rights in recent years, largely from Mediaset, which launched a PPV TV business called Mediaset Premium in 2005 over DTT. Consumers can 'top up' pre-pay viewing cards to pay for the TV they watch. Mediaset has acquired some rights to domestic football and some premium movies, from Universal and Warner Brothers, which it bundles together in a service called Premium Gallery. At the time of launch in January 2008, Mediaset said that the aim of Premium Gallery was to turn 'impulse buyers' into 'active users'[87]. At the end of September 2008, Mediaset Gallery had 2,471,000 'active' viewing cards in circulation, which had increased to 2,851,000 by the end of September 2009.

United States

4.141 Cable television is the most widely taken up distribution technology for accessing pay TV in the USA. In the early 1990s satellite emerged as a competing platform, helped in large part by the 1992 Cable Act and in particular the Program Access Rules, which are still in force today, and which we describe further in Section 9[88].

4.142 In the mid 2000s, IPTV / fibre services launched. In 2007, cable had a 67% share of multichannel subscribers, with the bulk of the remaining 33% taken by satellite. In 1995, cable had a 95% share of the multichannel subscriber with satellite commanding a 5% share[89].

[83] http://pressoffice.telefonica.com/documentos/nprensa/Resultados_TEF_Cierre_2009_NDP_EN.pdf

[84] http://www.telefonica.com/en/shareholders_investors/pdf/rdos09t3-eng.pdf

[85] http://www.newscorp.com/investor/download/NWS_Q2_2010.pdf

[86] As described in Annex 11 to the Third Pay TV Consultation.

[87] http://www.mediaset.it/gruppomediaset/bin/54.$plit/Premium_Gallery_print.pdf

[88] Details of the Program Access Rules are set out in Annex 11 to the Third Pay TV Consultation.

[89] FCC, Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, 16 January 2009.

4.143 By the end of 2008, cable operator Comcast was the biggest pay TV platform with 24.2 million subscribers; its nearest competitor with 17.6 million customers was satellite broadcaster DirecTV.

4.144 In terms of premium rights, no one platform has exclusivity of premium sports and movies. Rights to broadcast movies by the major US studios are split across a number of channels such as HBO, Starz, Showtime and Epix. These have wholesale deals with various cable, satellite and IPTV operators to supply their channels. Similarly in premium sports, broadcasters such as ESPN and the leagues' own channels offer channels to various platform operators.

4.145 For American football, the most valuable sports property in the USA, DirecTV holds exclusive rights to 14 live Sunday games. It is paying around $1 billion per season for so-called 'out of market'[90] TV and online rights until 2014. DirecTV first acquired 'out of market' rights to American football in 1995 and they helped the company to build its subscriber base and compete with other operators.

Premium subscribers in the UK

4.146 We have previously stated that there are substantial numbers of UK consumers that are prepared to pay a premium specifically to acquire premium sports and movies services over and above a basic service. There is little change in this picture since our Third Pay TV Consultation: over six million UK consumers are willing to take up premium channels, most of them paying a price of over £40 a month for a range of sports and movies content, compared to less than £20 for some basic services.

4.147 Figure 22 details subscriber numbers for different pay TV providers split by which packages they buy. It shows that the proportion of subscribers taking a Core Premium channel or channels is higher on Sky than on Virgin Media and TalkTalk TV.

[90] DirecTV does not offer games featuring the local team in any given region, as these rights are owned by local affiliate channels.

Figure 22 Pricing of basic and premium pay TV packages

Retailer	Packages	Total package price per month	Implied premium over basic	Subscriber numbers (as of June 2009)	Subscribers as a % of total (as of June 2009)
Sky Digital	Basic only	£18[1]	N/A	[✂]	[✂]%
	Basic + sports	£36[1]	£18	[✂]	[✂]%[2]
	Basic + movies	£34[1]	£16	[✂]	[✂]%[2]
	Basic + both	£43.50[1]	£25.50	[✂]	[✂]%[2]
Virgin Media TV	Basic only	£11.50[3]	N/A	[✂]	[✂]%[4]
	Basic + sports	£35.50[3]	£24	[✂]	[✂]%[4]
	Basic + movies	£38[3]	£26.50	[✂]	[✂]%[4]
	Basic + both	£45[3]	£33.50	[✂]	[✂]%[4]
Talk Talk TV	Basic only	£26.47[5]	N/A	[✂]	[✂]%
	Basic + sports	£55.47[5]	£29	[✂]	[✂]%
	Basic + movies[6]	£48.47[5]	£22	[✂]	[✂]%
	Basic + both[6]	£57.47[5]	£33	[✂]	[✂]%

Notes: Prices correct as of March 2010, subscribers as of June 2009. Packages are not directly comparable. Sports and Movies refer to Sky Core Premium Channels.

1 Based on a Sky entry level basic pay TV package of £18 per month.

[✂]

3 Based on a Virgin Media's M+ pay TV package (and excludes a phone line).

[✂]

5 TalkTalk TV customers must also purchase broadband and telephone with the TV Variety pack.

6 TalkTalk TV Sky Movies customers receive half of the total movies channels available on Sky.

Responses to our Third Pay TV Consultation

4.148 The BBC in its response to the Third Pay TV Consultation agreed that access to premium sports and movies content is a key to the development of a competitive pay TV offer[91].

4.149 The Premier League said that the evidence does not support the proposition that sport is the most significant or effective content in driving pay TV subscriptions. It told us that we failed to accord sufficient weight to the importance of "sport and non-sport" content when assessing consumers' content preferences and that, in particular, we wrongly disregard soap operas, which are almost equally important as sport to pay TV customers[92].

91 See page 1 of the BBC's response to the Third Pay TV Consultation.

92 See paragraphs 4.3 and 4.10 to 4.14 of the Premier League response to the Third Pay TV Consultation.

4.150 In our Second Pay TV Consultation[93], we acknowledged that soaps rated highly as 'must have' programming for both free-to-air and pay TV consumers. However, the Premier League appears to have disregarded the fact that soap operas do not fit the other characteristic of content that can drive pay TV take-up, in that they do not have a high degree of exclusivity to pay TV. The most popular soap operas, such as 'Eastenders' or 'Coronation Street', are broadcast on free-to-air channels which are made available by public service broadcasters to viewers on all platforms. Viewers do not have to pay a subscription to watch these programmes, and a retailer that required viewers to pay a subscription to do so would be unlikely to drive high levels of take-up. Premium sport and movie programming are highly attractive *and* exclusive to pay TV and do therefore act as a driver for pay TV take-up.

4.151 The Premier League asserted that, provided a pay TV platform offers attractive services (e.g. broadband) it will attract subscribers even if it does not feature Sky's channels[94]. In support of this view, Sky referred to the emergence of new pay TV platforms (e.g. BT Vision, Top Up TV, Tiscali) and new TV platforms (e.g. Freesat or Canvas-enabled platforms)[95].

4.152 We accept that consumers may value a pay TV service that can offer other attractive services, including non-TV services such as cheap broadband – this is borne out by the evidence set out earlier in this Section on take-up of bundles. Without an attractive set of content being available, consumers are likely to buy the minimum set of services necessary to qualify for the cheap broadband, and are unlikely to take up other services from that retailer.

4.153 The Premier League stated that Ofcom should assess what content retailers and broadcasters need to create a consumer offering[96]. The Premier League stated that retailers and broadcasters will seek to offer a wide variety of content to consumers and that Ofcom's analysis of wholesale substitutability should have proceeded by reference to content generally[97]. We have reviewed the availability of content generally – for example, our chart showing the attractiveness of different genres above includes a wide range of genres. However, again, we see top-flight sport and recently released blockbuster movies as being set apart from other types of content.

Likely future developments in content

4.154 We also considered whether these types of content are likely to continue to be as important for pay TV in the longer term as we believe them to be now.

- Our view was and remains that live top-flight sports programming is likely to have an enduring appeal, regardless of technical change. Broadcast media are intrinsically well suited to content which is based on mass participation in major live events, and this is unlikely to change in the foreseeable future.

[93] Para 3.42, Second Pay TV Consultation.

[94] Premier League response to the Third Pay TV Consultation, paragraph 4.7.

[95] Premier League response to Third Pay TV Consultation, paragraph 4.6.

[96] Premier League response to Third Pay TV Consultation, paragraph 5.16.

[97] Premier League response to Third Pay TV Consultation, paragraph 5.6.

- In terms of movie programming, blockbuster movies are likely to retain their appeal, but the ways in which consumers watch movies are likely to evolve. The simultaneous broadcast of a small number of movies to a large number of viewers may not be the most effective means of distribution in the longer term. Increasing availability and adoption of on-demand technologies and services are likely to mean that distribution techniques change as consumers take greater control over how they watch movies.

- It is not difficult to imagine scenarios under which movies are generally accessed more directly by consumers, for example via various forms of internet download. Movie download services are already available, though they have yet to be taken up by large numbers of consumers.

4.155 Our view is that while, as we set out below, distribution technologies may change, consumers are unlikely to change their underlying preferences for different genres of content. The strong attractiveness of premium sports and premium movies and their high degree of exclusivity to pay TV means that they are likely to remain of enduring importance to pay TV consumers and therefore, to competition.

4.156 Having established that some content can drive take-up of pay TV services, we need to establish which specific channels contain content of sufficient importance to drive take-up, and whether those channels are sufficiently concentrated in the hands of particular companies to raise possible competition concerns. This is the purpose of our market definition and market power analysis, which follows in Sections 5 and 6.

The future of the UK pay TV sector

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

- Steady growth in analogue pay TV services during the 1990s, on both satellite and cable, driven by access to premium content, and in particular the acquisition by Sky in 1992 of exclusive rights to live Premier League football.

- The migration from analogue to digital at the end of the 1990s, greatly increasing the range of content and value-added services that could be delivered to subscribers.

- Over the last five years, continued growth of Sky's satellite service and of Freeview, alongside very limited growth on cable. The key dynamic in recent years has been between Sky, driving growth in pay TV, and Freeview, driving growth in free-to-air multi-channel TV.

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

- The consolidation and restructuring of the historically fragmented UK cable industry under the Virgin Media brand.

- The emergence of new platforms for delivering pay TV services (BT Vision, Top Up TV, TalkTalk TV) based on new distribution technologies.

- The emergence of new platforms for the delivery of multi-channel free-to-air services; some of these also have the potential to deliver pay TV services (e.g. Freesat, the proposed Canvas service).

- The intervention by the European Commission to change the way in which Premier League football rights are sold. The 2007 / 08 football season was the first since 1992 for which Sky has not owned these rights exclusively.

- The increasing importance of convergence and the bundling of pay TV services with broadband and voice services.

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

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

Current trends

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

4.162 Current observations of the UK audiovisual sector suggest:

- There remains a strong appetite for watching TV and viewing levels on the whole are increasing[98].

- Consumers are demonstrating an appetite for enhanced viewing experiences. At the end of 2009, around 3.5 million homes had the reception equipment – set-top boxes and integrated digital televisions – capable of accessing HDTV channels and on-demand content[99].

- Content consumption habits are changing as on-demand services become more widespread. Such services enable consumers to take increasing control of their viewing through applications like DVRs or VoD (more than half of Virgin Media digital TV customers – 58% – regularly used VoD, including catch-up TV, at Q4 2009, up from 47% at Q4 2008[100]).

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

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

[100] http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MzMxMjl8Q2hpbGRJRD0tMXxUeXBlPTM=&t=1

- New technologies are becoming more robust. For example, increased broadband speeds and availability, coupled with more advanced delivery techniques, are enabling consumers to watch high-quality video over the internet: 23% of adults with home internet watch online catch-up TV, up from 17% a year earlier (Ofcom Communications Market Report 2009[101]).

- Portability and transferability are likely to become more important to consumers as they watch and listen to content on a greater range of devices. This is already being seen, in part helped by the take-up of devices such as Apple's iPod and iPhone.

- More consumers are buying pay TV services as part of bundles of communications services. In Q1 2009, 34% of UK adults that claimed to buy a bundle of services bought a three-product combination of TV, broadband and fixed-line telephone, up from 12% in 2005[102].

- 'Hybrid' models are becoming more common, whereby different technologies are combined to create more advanced products and services. For example, combining broadcast and broadband distribution technologies in one device to offer both linear and non-linear programming. Figure 23 describes some of the hybrid devices currently available in the UK.

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

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

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

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

Source: Ofcom, operators

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

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

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

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

[103] Third Pay TV Consultation, paragraph 7.8.

  - o Switching between retailers and platforms should not be artificially difficult.
  - o Generation and availability of a broad range of high-quality content: a variety of content should continue to be generated and made available to consumers on all platforms.

- Innovation:
  - o In platform services, for example in terms of interactivity, set-top box functionality such as DVR capabilities, or VoD options.
  - o In retail service bundling, packaging and pricing.
- Pay TV services priced competitively and efficiently:
  - o Prices which give consumers good value and allow efficient producers to earn a reasonable return on their investment.
  - o A sufficient variety of price points / bundles.

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

Figure 24 Developments in the UK pay TV sector

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

Source: Ofcom

International examples

4.166 In previous consultation documents we have drawn on international examples to understand how different pay TV markets operate[104], as well as earlier in this Section when assessing the role of premium content in pay TV. Looking beyond the UK market can also help in a defining a forward-looking assessment of pay TV.

4.167 Despite significant differences in many cases, some international markets can offer indications of how particular technologies and sectors can develop. One of the more

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

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

4.168 In the UK, IPTV has seen limited take-up even though it was among the first countries in which such platforms were launched. There are currently around 50,000 subscribers to the TalkTalk TV[105] service, while 436,000 customers had BT Vision at Q3 2009, which offers VoD over the broadband network and live television channels through the DTT service Freeview. IPTV appears to have seen reasonable take-up in markets where it has had access to a wide range of content. At Q3 2009, the top ten operators in Western Europe, using a measure of subscriber numbers all offered some form of premium sports or movies channels.

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

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

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

4.169 Telefonica's Imagenio IPTV service in Spain added 44,721 subscribers in Q3 2009, to reach 654,255. The company attributed the increase to a 'much-improved content offering after football channel Gol TV' – which broadcasts Spanish football matches - and was added to the platform's family package in the summer of 2009[106].

4.170 In Germany, Deutsche Telekom's Entertain IPTV service, which has acquired rights to domestic football, reported 885,000 subscribers at end of September 2009, up from a total of 257,000 a year earlier. The company offers live Bundesliga domestic

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

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

football after acquiring the rights to 612 first and second division games per season in November 2008[107].

4.171 While much of the growth of IPTV in France has been attributed to ‘free’ TV offered with a broadband subscription, Orange TV had attracted 596,000 subscribers to its premium sports and movies channels by Q3 2009[108]. Other IPTV providers offer the premium sports and movies channels of Canal Plus.

4.172 IPTV and fibre-based broadband TV services have also seen reasonable take-up in other regions. In the US, there were 5.5 million subscribers at the end of Q1 2009[109]. Some operators have adopted fibre technology to deliver a wide range of television services. Telecoms operators AT&T and Verizon began large-scale optical fibre network rollouts in 2006 (trials started in 2004).

4.173 Verizon’s Fios TV, for example, offers up to 125 HDTV channels, Multiroom DVR functions and premium channels[110]. In June 2009, Verizon had 3.1 million FTTH subscribers, of which 80% had a TV subscription. At the same time, AT&T had 1.6 million subscribers on its fibre network, of which 99.5% were customers to its U-verse. AT&T had an initial target of 30 million homes passed by the end of 2010 (but this has now been pushed back a year)[111].

4.174 In the US, new entrants to the pay TV sector have benefitted from Program Access Rules, under which vertically integrated cable operators are required to provide channels in which they own 5% or more to competing platforms. The introduction of Program Access Rules in 1992 helped facilitate the entry of satellite broadcasters into the multi-channel TV market, and these have now gained sizeable subscriber bases. By 2008, IPTV/fibre platforms, which also benefit from Program Access Rules, were beginning to attract significant numbers of subscribers.

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

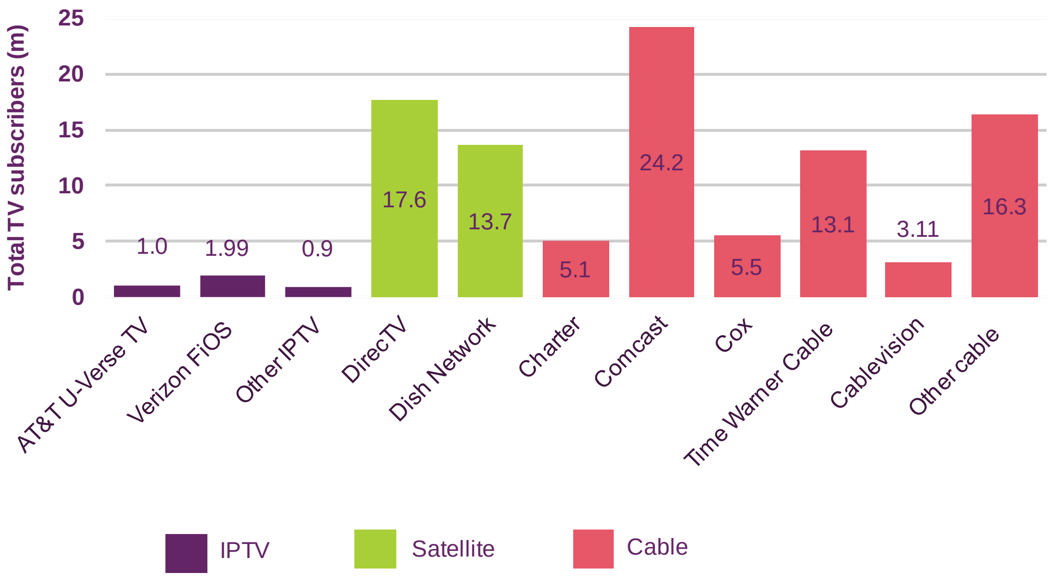
[108] http://www.variety.com/article/VR1118010552.html?categoryid=14&cs=1

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

[110] http://www22.verizon.com/Residential/FiOSTV/Details/Details.htm

[111] IDATE FTTx Watch Service 2009.

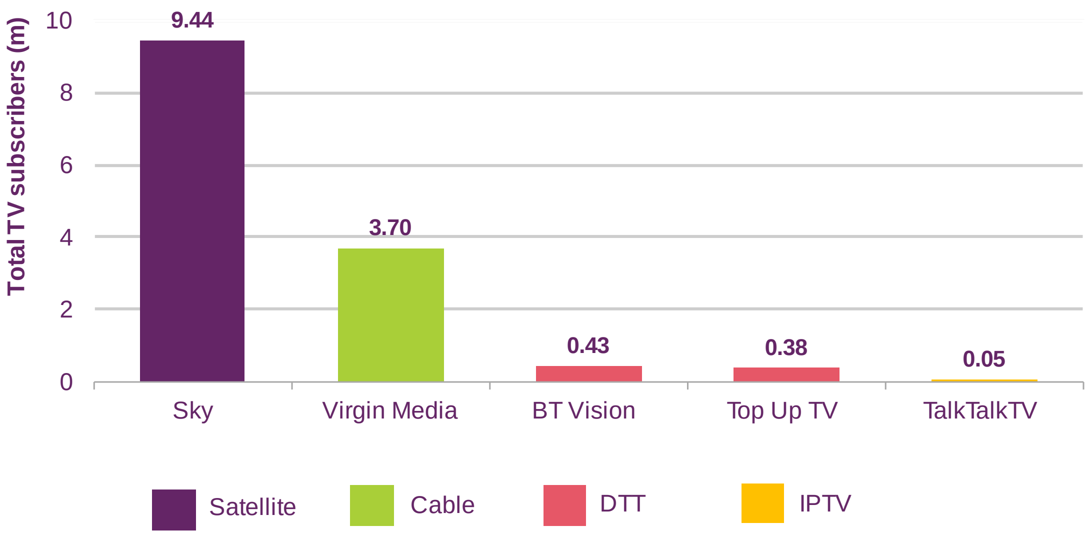
Figure 26 US multi-channel TV subscribers by platform, end 2008



Source: Informa Telecoms and Media

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

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



Source: Ofcom

4.176 Some Asian markets have also experienced rapid growth in IPTV, especially in markets where 'super fast' broadband services are available. For example, South Korea reached one million IPTV subscribers less than a year after licensed platforms launched linear TV channels on their networks (some operators previously provided only VoD on IPTV)[112]. South Korea had the second-highest average advertised broadband download speeds globally in Q3 2008, at 81Mbit/s, behind Japan, with 93Mbit/s[113].

Future developments

4.177 Within this context we have assessed the potential for future developments that could take place in the pay TV sector if there is fair and effective competition.

4.178 Figure 28 provides an overview of such developments, which draws on third-party analysis and commentary, future government policy and our own interpretation and understanding of sector trends[114].

[112] http://www.telecomskorea.com/market-7674.html

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

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

Figure 28 Potential future developments in the pay TV sector

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

Source: Ofcom

4.179 In spite of these developments, we do not see that the appeal of premium sports and movie programming will diminish in the future. Indeed, such premium programming is expected to have enduring appeal across a range of platforms and devices. We believe that premium programming will form an important part of the service proposition of a new entrant. While technology and means of distributing content will evolve, some underlying characteristics of pay TV persist, particularly in terms of the types of content that are most attractive and therefore drive take-up.

4.180 Innovation can contribute towards greater consumer choice and, flowing from this, increased satisfaction among consumers and lower prices. These were explored in our First[115] and subsequent Pay TV Consultations.

4.181 The UK pay TV sector has entered a phase where there is the potential for considerable innovation, facilitated by the emergence of new technology and

[115] First Pay TV Consultation, paragraph 2.24.

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

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

Section 5

Sports market definition and market power

Summary

5.1 Following our three consultations, and our review of the various responses to those consultations, we have concluded that Sky has market power in the wholesale and retail of packages including Core Premium Sports channels (Sky Sports 1 and 2 and ESPN). This market power is derived from Sky's control of key sports content rights. Sky Sports 1 and 2 broadcast a large share of the content that is most important to sports viewers.

5.2 Market definition is a tool for understanding whether any company has market power, but there are challenges in defining markets in a highly differentiated sector such as pay TV. In particular, the boundaries between different markets are not clear, and products just outside a defined market can exert a constraint on those inside.

5.3 We have assessed whether other ways of watching sports, and other general entertainment programming on television, either individually or in aggregate, constrain the prices of packages including Sky Sports 1. In order to do this, we have considered a wide range of evidence, including product characteristics, survey evidence, and trends in prices and subscriber numbers.

5.4 One focus of the survey evidence we have reviewed has been customers' (stated) willingness to switch to potential substitute products. We remain concerned that customers may tend to overstate their willingness to switch. Moreover, we are concerned that prices of premium pay TV sports channels may be above competitive levels, particularly in view of Sky's large share of the supply of these channels, and evidence that it is earning returns above its cost of capital. Given this, evidence (empirical or survey-based) regarding customers' willingness to switch in response to a price increase may not provide a reliable guide in determining whether there are close substitutes for channels containing significant premium sports content.

5.5 We also consider that trends in prices and subscriber numbers are unreliable, particularly in view of the difficulty in controlling for quality changes and other factors which may drive subscriber numbers.

5.6 Of the range of evidence we have examined, our comparison of product characteristics (including prices) is particularly compelling in assessing whether alternative services are substitutes to packages including Sky Sports 1. This is consistent with our approach in the Third Pay TV Consultation. Where possible, we have considered other evidence, such as survey evidence indicating the relative importance of different product characteristics to consumers.

5.7 Our analysis suggests that other services are unlikely to constrain Core Premium Sports channels to the competitive level.

- The key characteristics of Core Premium Sports channels are that they contain a large amount of live coverage of the most attractive high-quality sporting events, shown regularly throughout the year.

- A substantial majority of Sky Sports customers see football, in particular Premier League, as a very important part of their sports subscription. Premier League content is concentrated on Sky Sports channels.

- One in five Sky Sports customers are not interested in football. However, cricket, and some key events in other sports, are also concentrated on Sky Sports channels, with no good substitute on other channels.

- The closest substitute to Core Premium Sports channels is from sports programming on FTA channels. In particular, FTA channels show various content included in the DCMS's 'listed events' regime, such as Wimbledon or the Olympics. These events are very popular with viewers, but listed events are relatively few in number, individually infrequent, and even in aggregate do not provide a sufficiently regular flow of high-quality sports content. For example the Summer Olympics or football World Cup each takes place every four years. They are very popular when they do take place, but are not a substitute for a subscription pay TV service.

- Sky Sports 1 and 2 show substantially more of the most attractive live sporting events than FTA channels, more often and more regularly through the year. FTA channels may be the closest available substitutes for Sky Sports channels, but they are unlikely to constrain the price of those channels to the competitive level.

- For football fans, going to watch an event live at a stadium is an attractive alternative to viewing at home on TV, but given the cost of purchasing tickets and travelling to see events, and the limited capacity of sports stadiums, watching events live is not a close substitute for subscribing to Core Premium Sports.

- Sky has licensed the most important rights for showing in pubs and clubs as well as at home, so viewing of Core Premium Sports channels at pubs and clubs is not a competitive constraint on Sky. In any event, watching sports channels in pubs is a different experience, from the viewers' perspective, to watching that channel at home.

- We also considered whether sports fans could substitute away from Sky Sports through a combination of FTA sports and attendance at live events. However, we consider that even in combination these alternatives are a poor substitute for Sky.

5.8 Sky has a high market share (80%+) of the wholesale supply of Core Premium Sports channels. Sky would also have a market share well above 50% (around **[✂]**%) if other televised sports content (in the sports covered by Sky Sports), on basic-tier pay TV and FTA channels, were included in the market. Sky would not have a high market share if we believed that general entertainment content on FTA channels should be included in the market, but we do not consider that general entertainment content is even a moderately close substitute for sports content.

5.9 Sky's market share is a strong indicator of market power, particularly as:

- Other pay TV retailers have little if any countervailing buyer power when seeking wholesale access to Sky's channels.

- Barriers to entry are high. Sky has an unmatched record in successfully bidding for key rights, especially Premier League rights. It remains unlikely that others will bid successfully for enough Premier League rights to erode Sky's position in the foreseeable future. The main reason for this is that Sky has a large base of subscribers who are willing to pay for premium sports, and this gives it an advantage in bidding for rights.

5.10 Our conclusion that Sky has wholesale and retail market power, based on an analysis of market shares, is also supported by evidence that prices are above the competitive level.

- Analysis carried out for us by Oxera shows that Sky's overall returns are around nine percentage points above its cost of capital. This profitability gap is persistent over time, and is significant when compared with previous competition cases which linked high returns to the nature of the competitive process. It suggests that Sky benefits from significant barriers to entry, contributing to market power.

- Sky has argued that its current returns merely reflect the historic risks it has taken. We consider in Section 7 whether this is the case, and whether current levels of pricing represent a competition concern in their own right. However, even if we were to regard current levels of pricing as a fair reward for historic risks, this would not affect our conclusion that Sky currently benefits from significant barriers to entry. Indeed, it is precisely because of those barriers to entry that Sky is able to set current prices which reward it for historic risk.

- Oxera's analysis suggested that the returns are concentrated in wholesale rather than retail supply, and in premium rather than basic channels. A further disaggregated analysis shows that whilst margins are likely to be higher in movies than sports, Sky's returns from its sports channels are also likely to be above the competitive level.

- The collective selling of key sports rights creates a further risk that the retail and wholesale prices of sports channels are above the competitive level, but that the benefits flow upstream to sports rights holders, rather than being retained by Sky.

Structure of this Section

5.11 This Section is set out as follows:

- Introduction.
  - Purpose of this Section.
  - Third Pay TV Consultation.
  - Our approach to market definition.
- Overview of product characteristics and potential substitutes.
  - Televised sports.
  - Provision of premium sports services.
  - Demand for premium sports channels.
- Market definition
  - Evidence considered in defining markets.

  - Evidence relating to potential substitutes.
  - Focal products.
  - Retail market definition.
  - Other evidence.
  - Supply side substitution.
  - Conclusion on retail market definition.
- Wholesale market definition.
  - Introduction.
  - Indirect constraints.
  - Direct constraints.
  - Other evidence.
  - Wholesale supply side substitution.
  - Conclusion on wholesale market definition.
- Market power.
  - Introduction.
  - Criteria for assessing market power.
  - Our approach to assessing market power.
- Assessment of wholesale market power.
  - Broad evidence on sports wholesale market power.
  - Assessment of wholesale market shares (existing competitors).
  - Barriers to entry and expansion.
  - Countervailing buyer power.
  - Evidence that current prices are above the competitive level.
  - Conclusion on wholesale market power.
- Retail market power.

Introduction

Purpose of this Section

5.12 The purpose of this Section is to assess whether any supplier of pay TV services has **market power** in relation to the supply of packages including Sky Sports 1. This is a step in establishing whether any current arrangements or practices relating to the supply of pay TV sports channels are prejudicial to fair and effective competition.

5.13 OFT notes[116] that:

> Market power can be thought of as the ability profitably to sustain prices above competitive levels or restrict output or quality below competitive levels. An undertaking with market power might also have the ability and incentive to harm the process of competition in other ways; for example, by weakening existing competition, raising entry barriers or slowing innovation.

5.14 OFT also notes that market power arises where an undertaking does not face effective competitive pressure, and that market power is not absolute, but rather a matter of degree which will depend on the circumstances of each case[117].

5.15 In general, market power is not directly observable, but may be inferred from a range of **evidence**, most notably:

- High market shares, in a market with barriers to entry, and in the absence of countervailing buyer power.[118]
- Evidence that prices substantially exceed relevant costs or that profits substantially exceed competitive levels[119].

5.16 In order to assess whether market shares are at a level which would be indicative of market power, it is necessary to **define the market** or markets within which these products are supplied. Market definition is usually the first step in an assessment of market power.[120] However, the use of evidence that prices substantially exceed costs or that profits are above competitive levels as an indicator of market power is not dependent on the precise market definition.

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

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[116] Assessment of Market Power (the “OFT Market Power Guidelines”), OFT 415, 2004, paragraph 1.4.

[117] Ibid, paragraph 1.3.

[118] Ibid, paragraph 2.4.

[119] Ibid, paragraph 3.5; 6.5 and 6.6

[120] See Market Definition, OFT, 2004 (the “OFT Market Power Guidelines”), paragraph 2.1; http://www.oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft403.pdf

Third Pay TV Consultation[121]

Our position

5.18 In our Third Pay TV Consultation we reached a preliminary view that there was a narrow economic market for the wholesale of Core Premium Sports channels, comprising Sky Sports 1 and 2 and Setanta Sports 1 (Third Pay TV Consultation, paragraph 4.209).[122] We identified coverage on other channels of leading sports events broadcast on Sky Sports as moderate substitutes that lay outside of the relevant market but nonetheless exercised a degree of constraint on the wholesale supply of Core Premium Sports channels[123].

5.19 We considered that Sky has market power in that market[124] based on evidence including Sky's high market shares, the limited potential for market entry due to Sky's control of key rights, and the absence of significant countervailing buyer power. We considered that Sky's profitability was inconsistent with what would be expected in a competitive market[125]. We considered that Sky's market power was based on the aggregation of rights to specific sporting competitions by sporting bodies such as the Premier League, and the further aggregation by Sky of the rights to different competitions[126].

5.20 We recognised the difficulty of establishing precise boundaries for a highly differentiated sector such as pay TV. In view of this, we also considered whether including sport on FTA TV in the market would alter our conclusion. We noted that Sky would have a high market share, consistent with market power, even if this content were included.

5.21 We defined the wholesale market for Core Premium Sports channels as comprising Sky Sports 1, Sky Sports 2, and Setanta Sports 1. In coming to that view, we considered a wide range of evidence, including the characteristics of the content shown on these channels, evidence from Sky and other parties, consumer surveys, trends in pricing and subscriptions, and econometric analysis provided by Sky.

5.22 We also defined a narrow market for the retail of packages including Core Premium Sports channels to residential customers. In coming to this view, we relied on much of the same evidence as for our wholesale assessment, which suggests that demand-side substitution is unlikely. We considered that entry by new suppliers was unlikely in the short term, because of the lack of availability of the relevant wholesale channels.

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

[122] In the Third Pay TV Consultation we defined these channels as "Core Premium Sports channels". However, we have changed the definition of this term in this document to reflect Setanta's exit and ESPN's entry.

[123] Third Pay TV Consultation, paragraph 5.33; also Annex 8, paragraph 2.92.

[124] Third Pay TV Consultation, Annex 8, paragraph 2.208.

[125] Third Pay TV Consultation, paragraphs 6.201-6.202.

[126] Third Pay TV Consultation, paragraph 1.16.

5.23 We consulted on the view that Sky holds a position of market power in the wholesale and retail of packages including Core Premium Sports channels (Sky Sports 1, Sky Sports 2 and Setanta Sports 1)[127]. We based this view on Sky's high market shares in the wholesale and retail markets, and high barriers to entry in acquiring the relevant wholesale inputs. We did not consider that there was sufficient evidence to conclude that Sky enjoyed the ability to sustain retail margins that were appreciably above the competitive level independently of its position in the wholesale market.[128] Our competition concerns therefore focused on Sky's exercise of market power at the wholesale level.

Consultation responses

5.24 In response to our Third Pay TV Consultation, Sky said that Ofcom had not had proper regard to the arguments and evidence which Sky had presented with regard to market definition and market power at the **wholesale** level. Sky said it continued to rely on its previous submissions on these issues, and did not provide any further submissions on wholesale market definition or market power[129].

5.25 Sky said that our Third Pay TV Consultation had raised a large number of more significant issues relating to **retail** competition, and that it had focused on the key points of this analysis[130]. It said it was critical to bear in mind that market definition is a means to an end (i.e. assessing competition), and that the standard framework of market definition analysis was difficult to apply when products were complex and highly differentiated[131].

5.26 Sky argued that Ofcom did not systematically determine the types of evidence it should examine, consider the best ways of doing so, and apply that framework rigorously and consistently[132]. Sky also said that we had not established proper benchmarks against which evidence should be tested[133].

5.27 Sky said that Ofcom had failed to have due regard to many standard matters dealt with in a market definition exercise, including:

- An adequate focus on preferences of marginal customers: Sky said that dedicated fans of a particular events or sports are unlikely to be marginal subscribers. Rather, marginal subscribers were likely to have a moderate interest in a range of sports or sports in general;

- An adequate description of the products supplied and potential substitutes; and

[127] Third Pay TV Consultation, paragraph 4.250.

[128] Third Pay TV Consultation, Annex 8, paragraph 3.41.

[129] Sky response to Third Pay TV Consultation, 19 September 2009 paragraph 5.3 and footnote 4.

[130] Sky response to Third Pay TV Consultation, 19 September 2009 paragraph 5.4.

[131] Sky response to Third Pay TV Consultation, 19 September 2009 paragraph 5.7.

[132] Sky response to Third Pay TV Consultation, 19 September 2009 paragraph 5.13.

[133] Sky response to Third Pay TV Consultation, 19 September 2009 paragraph 5.14.

- Proper consideration of competitive constraints on the focal products used in its analysis[134].

5.28 In particular, Sky said the issue of product differentiation meant that:

- It was important to focus on the aggregate constraint provided by potential substitutes. Sky considered that Ofcom's analysis proceeded on a "pair-wise" basis;
- It was inappropriate to focus on differences in product characteristics in delineating market boundaries;
- It was likely to be simplistic to regard particular products as in or out of the market;
- It was important to focus on the underlying intended use served by differentiated products; and
- While it was likely to be possible to determine that a particular product did not comprise a relevant market, determining the scope of the market relevant to a particular product might be significantly more difficult[135].

5.29 Sky said that, in the Third Pay TV Consultation, we ignored internal Sky documents that (in Sky's view) demonstrated the range of competition constraints faced by Sky, including from parties outside of the markets defined by Ofcom[136]. Sky provided a further submission addressing in detail trends in price, quality and subscriber numbers[137].

- Sky considered that the analysis of trends in Sky's subscriber numbers in the Third Pay TV Consultation failed to have adequate regard for a wide range of significant factors (including changes in quality, the launch of new services by Sky and changes in marketing)[138].
- Sky considered that the event analysis in the Third Pay TV Consultation had "numerous significant flaws", principally in that it failed to consider relevant evidence. Sky considered that a proper event analysis would indicate that "major changes" in the intensity of retail competition have occurred in the recent past, particularly involving the emergence of Freeview. Sky stated that it had to engage in various "radical new initiatives" (e.g. re-pricing and repackaging its basic

[134] Sky response, 19 September 2009, paragraph 5.16 and October 2009 Sky Submission, paragraph 49.

[135] Sky response to Third Pay TV Consultation, paragraph 5.17(a) and 5.18. See also October 2009 Sky Submission, paragraphs 31, 34, A2.11(ii).

[136] Sky response to Third Pay TV Consultation, paragraph 5.12 and footnote 9; also paragraph 5.63-5.64.

[137] The second February 2010 Sky Submission.

[138] The second February 2010 Sky Submission, paragraph 12.

packages, marketing Sky+, investing in and marketing HD) in order to continue to grow its subscriber base[139].

5.30 In the context of the wholesale market definition for sports, Virgin Media argued that we took a narrow approach which did not reflect subscribers' choices. It said consumers valued a wide range of attractive sports and, in making purchasing decisions, chose between packages of channels, and not between individual channels. Virgin Media argued that rival retailers would require Sky Sports 3 and Sky Sports Xtra (now Sky Sports 4) to compete effectively with Sky.

5.31 Virgin Media supported our decision to define retail markets in relation to the supply of Core Premium Sports channels and Core Premium Movies channels as it addressed a gap in the logical construction of our case, and reduced the risk of understating the effects of Sky's mutually reinforcing market positions. Subject to its observations on our approach to the definition of Core Premium Sports channels, Virgin Media agreed with our approach and the market definitions proposed[140].

5.32 The Premier League considered our analysis flawed, inconsistent and selective. In particular, it said that our analysis failed to take into account attractive sports content available on FTA and failed to properly consider broadcasters' preferences[141]."

5.33 The BBC agreed with the conclusion of our Third Pay TV Consultation that "the wholesale market for premium sports contains Sky Sports 1 and Sky Sports 2." It also believed "that the need for inclusion of Sky Sports 3 and Xtra in the future should be kept under review"[142].

Our view of consultation responses

5.34 Our Third Pay TV Consultation took account of Sky's previous arguments on **wholesale** market definition. As noted above, Sky does not believe that we have had proper regard to these arguments, but has not set out its reasons for this view. We have reconsidered Sky's previous submissions on wholesale market definition where appropriate. We have also reconsidered our view of wholesale market definition in light of Sky's response to our Third Pay TV Consultation, including Sky's arguments in that response relating to retail market definition, most of which are common to retail and wholesale market definition.

5.35 As regards **retail** market definition, our view is that a number of Sky's high-level concerns above have been addressed in our previous consultations, (and are also addressed by the approach we have taken in this statement). In particular, we have recognised the limitations of market shares in a market power assessment when products are differentiated, and addressed this by considering the effect on market shares of including moderate substitutes in the market[143].

[139] The second February 2010 Sky Submission, paragraphs 34-36.

[140] Virgin Media response to Third Pay TV Consultation, paragraph 3.6.

[141] Premier League to Third Pay TV Consultation, paragraph 5.8.

[142] BBC response to Third Pay TV Consultation, p1.

[143] See, for example, paragraph 5.16 of our Third Pay TV Consultation.

5.36 We have sought to address Sky's remaining concerns by clarifying our position. More detailed comments which Sky raised have been considered in the main body of this Section.

5.37 In the remainder of this Section[144]:

- We provide an overview of our **approach**.
- In our discussion of **product characteristics and potential substitutes** (paragraphs 5.85 to 5.140) we :
  - o Briefly describe televised sports in the UK;
  - o Describe the premium sports services offered by Sky and others;
  - o Consider the key drivers of demand for these services;
  - o Identify the potential substitutes for premium sports services;
  - o Set out the scale of potential substitutes, in terms of revenues, expenditure and future potential.
- In our **market definition** assessment (paragraphs 5.141 to 5.359) we consider the extent to which premium sports services are likely to be constrained by each of these potential substitutes (having regard to their similarity in terms of important characteristics identified above, and the importance of each potential substitute). First we formally define the relevant **retail** market and then the relevant **wholesale** market.
- In our assessment of **wholesale market power** (paragraphs 5.390 to 5.589) we:
  - o consider whether **market shares** in the relevant market are evidence of market power, having regard to barriers to entry or expansion, and countervailing buyer power;
  - o set out our views on whether evidence of **prices being above the competitive level** supports or contradicts a view as to the presence of market power.
- Finally, in paragraphs 5.590 to 5.611 we assess the presence of **retail market power**.

Our approach to market definition

5.38 We begin by identifying the products which are the subject of our investigation. As discussed in Section 4, premium sports channels are an important driver of demand for pay TV, and these channels were included in the complaints which gave rise to our investigation. The most important of these premium sports channels is Sky Sports 1. Packages including Sky Sports 1 are the starting point for our analysis. In market definition terms, these packages are the "**focal product**".

5.39 For the reasons given in the analysis in this Section we consider that the relevant market comprises packages that include Sky Sports 1, Sky Sports 2 and/or ESPN

[144] Section headings are set out in paragraph 5.11.

(we refer to these three channels as "**Core Premium Sports channels**"). This is consistent with our definition of Core Premium Sports channels in our Third Pay TV Consultation (see paragraph 5.23 above).

5.40 Having identified a focal product, the next step is to consider whether any other products are close substitutes for this product, and may therefore be expected to exert a competitive constraint. The standard test for identifying close substitutes is the '**hypothetical monopolist**' test (HMT). The test seeks to establish the smallest product group such that a hypothetical monopoly provider of the products in that group could sustain prices above the competitive level. In most cases, the data which would be needed to carry out the test empirically are not available, and so it is more often seen as a conceptual framework.

5.41 A particular difficulty arises when considering whether an individual supplier of highly **differentiated** products (such as premium sports or movies channels) has market power. In this situation, the market boundary may not be well defined, so market shares need to be treated with caution as a measure of market power (see the discussion of market shares below).

5.42 In assessing potential substitutes for market definition, it is appropriate to consider the preferences of **marginal** consumers, as Sky has argued. Marginal consumers are those who would be most likely to switch in response to a price increase.[145] Marginal consumers of a product are more likely than others to see other products as close substitutes, or to be willing to stop consuming the product without substituting.

5.43 However when analysing marginal consumers it should be borne in mind that:

- The identity of marginal consumers will depend on the price level: if prices are substantially above competitive levels, those consumers who would be marginal at competitive prices will not buy, while some consumers who would be infra-marginal (i.e. unlikely to respond to a price rise) at competitive prices may be marginal at higher prices. As a result, analysis of the preferences of marginal consumers is distorted if current prices are above competitive prices. At any given price level, some customers are likely to be marginal. A firm will only be constrained to the competitive price level if a sufficient number of customers are marginal at that price level.

- Whether a subscriber is marginal or not will also depend on a range of other factors including whether other channels offer coverage of their favourite sports, their frequency of viewing, whether they also subscribe to premium movies channels, the preferences of others in the household, whether they are willing to watch sports in a pub or club, and their income.

- As such, even if (for example) a proportion of Sky Sports subscribers are primarily fans of a sport which is extensively covered on other channels, it does not follow that all of this group of subscribers will be marginal. While they may be more likely (on average) to be marginal than fans of sports which are largely available only on Sky Sports, some or even most of them may be price-insensitive, whether because they can easily afford Sky Sports, or because they have a strong demand to see as much coverage of their favourite sport as possible, and so are not satisfied with FTA coverage.

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[145] See note 19 of OFT Market Definition Guidelines.

5.44 We acknowledged the importance of focusing on marginal consumers in previous consultations[146]. In assessing the extent to which other products are substitutes for packages including Sky Sports 1, we have had regard to the preferences of different groups of consumers (e.g. fans of different types of sport). However, crucially, marginal customers are defined by their propensity to switch in response to a price increase, and not simply by the availability on other channels of content which appears to match their preferences.

5.45 In particular, even if a particular group of customers is more likely than average to be marginal, it does not follow that **all** of the customers in this group should be seen as marginal. If customers in this group are relatively price sensitive, but account for a small part of the total customer base, it may be that the number of them who would switch in response to a price rise (above competitive levels) would be large as a proportion of that customer group, but too small a proportion of the whole customer base to make such a price rise unprofitable.

Cellophane fallacy

5.46 Assessing the impact of an increase in prices under an incorrect assumption that current prices are at competitive levels is known as the ***cellophane fallacy.*** We noted in our Third Pay TV Consultation[147] that our ability to rely on an empirical application of the HMT may be compromised by this effect in the present case. We have considered this matter further given Sky's representations on product differentiation[148] and on the importance of providing "sound evidence" that the cellophane fallacy applies[149]. We remain of the view that the cellophane effect compromises the application of the HMT in this case.

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

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

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

[147] Third Pay TV Consultation, paragraph 4.24 and 4.44.

[148] For example Sky response to Third Pay TV Consultation, paragraph 5.17.

[149] For example Sky response to Third Pay TV Consultation, paragraph 5.53.

5.48 Having a differentiated product (i.e. one with unique characteristics which are important to consumers) generally allows the provider to charge a higher price than would be possible if similar or identical products were available from other suppliers. The more differentiated a product is from its closest substitutes, the more scope its provider will have to set prices above competitive levels. With a limited degree of differentiation, prices may be close to their competitive levels. However, at the other end of the spectrum, the provider of a highly-differentiated product may be able to act as a monopolist[150]."

5.49 Where products are differentiated, the focal product is generally supplied by a single firm. This is the case with the focal product we identify below (packages including Sky Sports 1), which is sold only by Sky at the wholesale level"[151]. We would expect such a firm to set its prices at the profit-maximising level, such that further price rises would be unprofitable.

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

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

5.52 Even a moderate degree of differentiation can distort the outcome of the HMT[152]. However, the more highly differentiated a product is, the further prices are likely to be above competitive levels.

5.53 In view of these considerations, we remain of the view that the cellophane effect is likely to apply in this market, and that as a result we should not place weight on evidence of Sky customers being willing to switch in response to a price increase.

5.54 **Evidence that prices are above the competitive level.** For the reasons set out in paragraphs 5.513 to 5.589 below, which we summarise briefly here, we consider that it is likely that the wholesale and retail prices of bundles including Sky Sports, and those containing Sky Movies, are appreciably above the competitive level. This is

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

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

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

supported by two pieces of evidence – Oxera's analysis of Sky's profitability and Ofcom's pricing model – and, in the case of sports, reinforced by the collective selling of rights.

5.55 We consider Oxera's work in further detail in paragraphs 5.519 to 5.573. In summary:

- Oxera's work suggests that Sky has earned a return of 21% over the past five years (based on a truncated IRR, and also supported by ROCE)[153]. This is around nine percentage points above its estimate of Sky's cost of capital over the period[154]. Previous findings by the CC and OFT suggest that this level of difference between Sky's returns and its cost of capital is significant[155].

- A disaggregation exercise by Oxera indicates that Sky earns a higher percentage return at the wholesale level than at the retail level.[156] Sky's wholesale profitability appears higher than industry benchmarks, suggesting that Sky's aggregate profitability is driven by its relatively high wholesale returns.[157]

- Oxera's work also indicated that Sky earns higher margins on premium than basic channels.[158]

- Disaggregation of sports and movies channels is complicated as many subscribers buy both for a single package price. However, it appears that Sky earns higher margins on movies services than sports services. Although margins for both are high.[159]

5.56 In addition, the "cost plus" estimates derived from Ofcom's pricing model provide an indication of the competitive price of Sky's channels, although these are subject to assumptions about cost allocation and other assumptions. We find that Sky's current wholesale prices are, on average, substantially higher than the prices generated by the cost plus approach.

5.57 Sky has argued[160] that we have not established that either the operating margin for its premium wholesale business, or wholesale charges for its premium channels, are high. It said this claim could not be based on Oxera's analysis[161] or our estimate of cost-plus prices. However, we consider that Oxera's analysis shows that Sky's wholesale prices are above the competitive level, and that this is corroborated by our pricing analysis.

[153] See paragraph 5.545 below.

[154] See paragraph 5.548 below

[155] See paragraph 5.549 below.

[156] Figure 67 below.

[157] See paragraph 5.559 below.

[158] Figure 68 below.

[159] Figure 69 below.

[160] September 2009 response, paragraph 7.4 and 7.12.

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

5.58 The collective selling of sports rights gives rise to a further risk that the wholesale prices of packages including Core Premium Sports channels are above the competitive level.

5.59 We consider that high wholesale prices are reflected in retail prices (charged by Sky and Virgin Media) which are above the competitive level.

Wholesale and retail markets

5.60 As market definition is essentially a tool for assessing competition concerns, it should be conducted in the light of the specific competition concerns that have been identified. In our Third Pay TV Consultation[162] we identified a concern that Sky, as a vertically integrated firm, with market power in a key upstream market, distributes its Core Premium channels in a manner that favours its own platform and its own retail business by denying these channels to other retailers / platforms, or by making them available on unfavourable terms. This was the concern that our proposed wholesale must-offer remedy was designed to address.

5.61 Because Sky is vertically integrated, the large majority of the supply of its Core Premium channels is to its own retail customers, and for this supply it sets a retail price, rather than a wholesale price. However, Sky also sets a wholesale price to Virgin Media, and a number of other retailers are seeking wholesale supply of its Core Premium channels. We therefore focussed in our Third Pay TV Consultation, and continue to focus, on assessing Sky's market power as a wholesaler.

5.62 However, any market power attaching to these channels clearly depends on the strength of consumer demand for them and the extent to which consumers view alternative services as substitutes. As such our assessment of the wholesale market takes considerable account of substitutability at the retail level, which we view as placing an indirect constraint on Sky's market power.

5.63 Our position remains as set out in paragraph 4.14 of the Third Pay TV Consultation. Specifically, Sky is both a wholesaler (to cable firms) and retailer of Core Premium channels. In defining markets at the wholesale level, we have considered the constraints facing a hypothetical wholesale monopolist, rather than an integrated wholesale/retail monopolist, in order to focus on effects at this level. However, we have had regard to the fact that Sky is vertically integrated where relevant.

5.64 We also consider retail market definition and market power. In particular, we consider whether (a) Sky would have any retail market power in the absence of its wholesale market power and (b) whether retail market power allows Sky to sustain prices that are higher than would prevail if it only had wholesale market power.

5.65 When defining wholesale markets it is helpful to distinguish between direct and indirect constraints. If a hypothetical wholesale monopolist increases the wholesale price of channel X there are two possible constraints.

- First, retailers may stop buying channel X and replace it with channel Y. This is known as a "direct constraint".

- Second, if retailers do not drop channel X, the wholesale price rise is likely to lead to an increase in the retail price of bundles including channel X. As a result,

[162] Third Pay TV Consultation, paragraphs 6.2 to 6.4.

final consumers may substitute away from bundles including channel X. This in turn reduces demand for channel X at the wholesale level, potentially constraining the wholesale monopolist. This is known as an "indirect constraint". Assessing indirect constraints is very similar to defining retail markets since they both entail consideration of retail substitution in response to a retail price rise.

5.66 In this document, as a matter of convenience, we have reversed the order in which we considered the markets in our Third Pay TV Consultation, considering retail markets before wholesale markets. Doing so allows us to set out the scope for demand-side switching at the customer level in the context of the retail level, which then informs our assessment of indirect constraints on wholesale market power. This is, however, a change in form and not substance – we continue to focus principally on the wholesale market.

Market shares

5.67 As we noted in our Third Pay TV Consultation,[163] in sectors which contain a variety of differentiated products there may not be a clear-cut boundary between products inside and just outside the market. We have therefore tested the sensitivity of our market share evidence by calculating market shares based both on narrow and broad market definitions.

5.68 In the market definition Section, we identify whether products are

- Close substitutes i.e. lying within the relevant market.
- Moderate substitutes i.e. lying outside the relevant market but nonetheless exerting a degree of constraint on suppliers of the focal product.
- More distant substitutes i.e. lying outside the relevant market and not exerting a material constraint on suppliers of the focal product.

5.69 As in the Third Pay TV Consultation, we estimate market shares if only close substitutes are included, and market shares if moderate substitutes are also included.

5.70 We consider that this approach is a reasonable, clear and tractable way of analysing product differentiation within a systematic framework.

5.71 While market shares can be a useful indicator of market power, they must be interpreted with caution, precisely because some products are likely to be closer substitutes than others, and market share calculations treat all products 'in' the market as equally substitutable. It is possible that a close substitute to the focal product with relatively low sales will be more (or less) of a competitive constraint than a more distant substitute with relatively high sales.

5.72 In assessing market power, the **aggregate constraint** from all substitutes therefore needs to be considered.

[163] Third Pay TV Consultation, paragraph 4.32.

Bundling

5.73 The pay TV sector is characterised by bundling at both the wholesale and retail levels. Core Premium Sports channels are included in a range of bundles alongside products such as basic channels, movies channels, broadband and telephony. In principle this could significantly complicate our analysis.

5.74 In the Third Pay TV Consultation we rejected Sky's argument that our analysis ignored the complexity of the market, noting that our analysis was informed wherever practical by surveys which reflect this complexity, and throughout by the recognition that Core Premium channels are bundled with other channels and other services. However we noted the need to abstract from these complexities in order to provide a meaningful analysis of specific points"[164]. One example of this was that we considered constraints on the premium element of the retail bundle purchased by consumers[165].

5.75 Sky said that we failed properly to take into account the complexity of choices faced by retail consumers, with regard to supplier, platform, and hardware bundles[166]." Sky argued that an analysis that abstracts from a wide range of factors relevant to the issue at hand may be tractable but is unlikely to produce meaningful results. Sky said that our focus on the premium element of the bundle was erroneous, because analysis of competitive constraints should be based on the products that were actually supplied to consumers, not components of those products[167].

5.76 In our view, a focus on the most important factors and interactions is essential to economic analysis. We recognise that care must be taken to ensure that relevant factors, which would change the outcome, are not excluded from the analysis. We have taken account of such factors which we have identified or others have brought to our attention. In its comments set out above, Sky did not provide any specific argument to support a view that we had excluded important factors from our analysis. In particular, it did not explain why a focus on the premium element of retail bundles would lead to erroneous conclusions. We discuss this issue further in Appendix 3 of Annex 4.

5.77 We therefore remain of the view in our Third Pay TV Consultation that it is appropriate to simplify aspects of our analysis and in particular to focus on the constraints on the premium element of retail bundles.

Two-sided markets

5.78 Broadcasting markets can be characterised as two-sided markets. Wholesale channel providers license their content to channel retailers and sell advertising and sponsorship to advertisers. In two-sided markets of this sort, it is not uncommon for one side of the market to pay a high price while the other side pays a low price[168].

[164] Third Pay TV Consultation, paragraph 4.50.

[165] Third Pay TV Consultation, paragraph 4.228.

[166] Sky response to Third Pay TV Consultation, paragraph 5.21.

[167] Sky response to Third Pay TV Consultation, paragraph 5.16 and footnote 14.

[168] In a perfectly competitive market the 'competitive' price is set at marginal cost. However, in two-sided markets one group of customers may receive the service at a price below the costs of production, while the other group receives the service above the costs of production.

This creates challenges for market definition for two reasons. First, the profitability of a price rise on one side of the market is affected by the interactions with the other side of the market; and second, it makes it even more difficult to identify the competitive price.

5.79 Subscription revenue is much more important than advertising and sponsorship revenue to Sky. In 2008/09 Sky earned **[✂]** from advertising and sponsorship compared to **[✂]** of subscription revenue from residential satellite subscribers[169]. Accordingly, we do not take into account the effects on advertising revenues when carrying out our market definition exercise.

Monopolistic competition

5.80 Sky argued that monopolistic competition was an appropriate framework for analysis of the pay TV sector[170]. Monopolistic competition describes a market characterised by product differentiation, so suppliers face a downward sloping demand curve,[171] but with no barriers to entry. In this model, any supernormal profit earned by firms in the market attracts new entrants. Market entry spreads customers more thinly, leaving each firm with fewer customers from which to recover its fixed costs, which eliminates supernormal profits. Sky asserted that Ofcom's benchmark was perfect competition[172].

5.81 In the Third Pay TV Consultation we rejected monopolistic competition as a relevant framework on the grounds that (a) it relied on an assumption of free entry to the market, and we saw no basis for such an assumption, and (b) Oxera's analysis of profitability demonstrated that profits had not been driven down to zero as the model implied.[173] Sky characterised this position as "unsophisticated" but did not provide further explanation[174].

5.82 As explained in paragraph 4.48 of the Third Pay TV Consultation, we have not used perfect competition as our benchmark, contrary to Sky's claims. In particular, we do not expect firms in this market to price at marginal cost as would be expected in a perfectly competitive market.

5.83 As regards monopolistic competition:

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[169] Sky's management accounts. Both these figures relate to the UK and the Republic of Ireland. We have summed the spot residential advertising figure for the UK with that for the Republic of Ireland and then added sponsorship revenue.

[170] June 2009 Sky Submission, paragraphs 4.1(d), 4.29 to 4.31.

[171] i.e. a retailer that charges a slightly higher price achieves slightly lower sales. This contrasts with perfect competition, where the demand curve is horizontal. Under perfect competition, a retailer that charges a slightly higher price is unable to sell any units whereas a retailer that sets a slightly lower price attracts the entirety of demand.

[172] Sky June 2009 Submission, paragraph 4.32

[173] Third Pay TV Consultation, paragraph 4.49.

[174] Sky response to Third Pay TV Consultation, paragraph 5.20.

- As explained in paragraphs 5.444 to 5.493 below, there are significant barriers to entry. The assumption of free entry to the market thus does not apply to the products in question.

- As explained in paragraphs 5.519 to 5.573, Oxera's analysis of profitability demonstrates that profits have not been driven down to zero – or close to zero – as is the case in models of monopolistic competition.

5.84 We therefore remain of the view that the monopolistic competition framework runs counter to the facts of the pay TV sector.

Overview of product characteristics and potential substitutes

Televised sports

5.85 Sports can be watched in a number of ways: live at sports venues, through residential TV services, or in commercial venues (e.g. pubs) which subscribe to sports packages.

5.86 In the case of sport, being able to watch the event "live", whether in person or on TV, is highly important. Whilst some highlights programmes are popular, consumers have a strong preference for live content over pre-recorded content, as demonstrated by consumer research. For instance respondents who took part in qualitative research from 2005 indicated that a live game was more valuable because much of the enjoyment is driven by first the uncertainty of the outcome of each match, and second an intangible sense of being "part of the action". Once the match is over and the outcome is known the value of watching the match is considerably reduced[175].

5.87 These consumer preferences are confirmed by the wide differential in the price of live rights compared with highlights or near live rights. For example, while the live Premier League rights were sold in 2006 for £568m, the delayed rights were sold for just £28 million and the highlights coverage for just £57m"[176].

5.88 Televised sport is important because of its unique ability to provide a very large audience with live coverage of the same event. Even the largest sports stadium can only accommodate a fraction of the audience which wants to watch a major event.

5.89 Televised sports in the UK consists of a wide range of sports, broadcast on a variety of channels, from:

- Dedicated premium pay TV channels for which consumers pay an additional charge (such as Sky Sports and ESPN);

- Dedicated basic pay TV channels (e.g. Eurosport, Extreme Sports); and

- General entertainment channels (e.g. BBC1, ITV1, Five).

[175] Ofcom's Second Pay TV Consultation, Annex 6 paragraph 5.3.

[176] First Pay TV Consultation, Annex 10, slide number 22. Further, The European Commission, in paragraph 3.1.1 of Annex I of its White Paper on Sport (COM(2007) 391 final), noted that "…sports media rights are most attractive when broadcast live because once the outcome of an event is known the value of the right declines together with viewer interest." http://ec.europa.eu/sport/white-paper/whitepaper112_en.htm

5.90 Clearly some sports are more popular than others, and within particular sports, higher-level leagues and competitions are more popular than lower-level ones. This is reflected in the prices commanded by the rights to broadcast the most popular sports content. Figure 29 shows the amounts paid for various live sporting rights by pay TV and FTA broadcasters. This shows the particular importance of live Premier League matches as well as that the majority of these rights (measured by value) are acquired by pay TV broadcasters, primarily Sky.

Figure 29 Important live sports on Pay TV and FTA TV by annual rights value

[✂]

5.91 The value of sports content is also reflected both in the wholesale prices of channels which carry it and, in the case of pay TV services, in the retail subscription prices and number of subscribers to packages containing this content[177].

5.92 As we set out in the following analysis, by far the most highly-valued TV sport content in the UK (and elsewhere) is football. Among football content, Premier League content is the most important, followed by the UEFA Champions League, FA Cup and the UEFA European Football Championships. This is evident from the value of broadcasting rights (see Figure 49), and also from the stated importance of this content to pay TV subscribers (see Figure 40).

5.93 A range of other sports are also valued by pay TV subscribers. In particular rugby union, cricket, motorsports, tennis, boxing and golf are seen as very important by some subscribers and moderately important by others[178]. In general, the appeal of a pay TV proposition to an individual person or household will depend on its having some content that is seen as highly attractive, along with a range of moderately attractive content,[179] and the relative importance of different content will vary according to tastes.

5.94 Apart from Sky Sports, coverage of sports on pay TV is limited to ESPN channels and some basic channels providing lower-value content.

5.95 However, a considerable amount of high quality sports content is available free to air, including 'listed events'. Listed events are a limited number of sports events that the UK Government considers to have a "special national resonance", and which should therefore be made available on free to air television.[180] These events are by definition very attractive to viewers, but are not broadcast with the same regularity as some other events. We have considered to what extent the price that Sky charges for its

[177] To some extent, these are less direct measures of value, in that the wholesale price of a channel which carries a range of content cannot necessarily be directly attributed to a particular sport, league, competition or event. Furthermore, the demand for a channel, and its retail price, is more difficult to assess when it is supplied as part of a package of other channels and services.

[178] Third Pay TV Consultation, Figure 10.

[179] The importance of offering both highly attractive content as well as a range of moderately attractive content is shown by Sky's conduct. Rather than just acquiring the most attractive sports content, Sky has also acquired a range of rights which it has used to assemble not one but four sports channels.

[180] For information on listed events see:
http://www.culture.gov.uk/what_we_do/broadcasting/5399.aspx, or
http://www.ofcom.org.uk/tv/ifi/codes/code_sprt_lstd_evts/.

sports channels is constrained by the availability of this content, and FTA sports content more generally.

5.96 Free-to-air channels, by definition, do not engage in price competition with pay TV services – i.e. subscribers do not have to decide how to allocate their budgets between the two, as they might between two pay TV providers, because FTA content is available whether the household subscribes to pay TV or not. However, they may compete for the amount of time a viewer allocates to watching sport on TV, and the availability of sports content on FTA is likely to affect households' willingness to pay for additional content. The extent of this effect depends on whether the content on offer from FTA channels is seen as a close substitute. While some consumers may see, for example, a particular football match or competition on FTA as an adequate substitute for football coverage on pay TV, many other consumers will wish to see both (as evidenced by the number of subscribers to premium sports channels).

5.97 Both Sky Sports and ESPN are supplied to commercial customers, most notably pubs and clubs. Pubs and clubs generally do not charge customers for watching TV. Instead, they provide this service as a way of attracting customers who buy food and drinks. Sky is the only retailer of Sky Sports and ESPN to commercial subscribers. As a result, the availability of these channels to pubs and clubs does not constrain the supply of these channels to residential Sky Sports subscribers. In any event, watching sports channels in pubs is a different experience, from the viewers' perspective, to watching those channels at home.

Provision of premium sports services

5.98 Both Sky and ESPN supply premium sports channels, i.e. channels dedicated to live sports for which final consumers pay an extra charge. Specifically Sky broadcasts four Sky Sports channels in the UK:

- **Sky Sports 1** contains a range of sports programming including live Premier League matches[181], live Test and one day cricket.
- **Sky Sports 2** broadcasts a portfolio of important sports including live Champions League matches, cricket and rugby union.
- **Sky Sports 3** contains some of Sky's less popular cricket[182], Super League rugby and tennis. There is very little top flight football[183] on Sky Sports 3. However; Sky Sports 3 broadcasts a significant amount of Sky's golf coverage.
- **Sky Sports 4** contains most of Sky's tennis coverage and a small amount of Champions League football (usually not featuring Premier League teams), golf and cricket. Prior to January 2010, Sky Sports 4 was known as Sky Sports Xtra.

5.99 Sky Sports channels are retailed by Sky on its satellite platform and TalkTalk's IPTV platform, and by cable companies, primarily Virgin Media"[184].

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[181] There were 98 live Premier League matches on Sky Sports 1 in the 2007/08 season. See Figure 47.

[182] Measured by audience.

[183] For example matches featuring Premier League teams.

5.100 Sky supplies its four channels in a number of wholesale and retail packages. As a retailer, Sky typically bundles these channels with basic channels. Figure 30 shows the basic mixes/packs that Sky retails. The price of a single mix/pack is £18 per month. This includes a standard Sky Box, Sky Broadband Base (up to 2 Mb/s with a 2Gb monthly allowance), and Sky Talk Freetime (free evening and weekend calls)[185]. It costs an additional £1 for each extra mix/pack[186] .

Figure 30 Sky's Basic Mixes/Packs

Basic Pack	Channel examples
Variety Pack	Sky 1, Bravo, Dave, Living, Paramount Comedy, Virgin 1
Knowledge Pack	Animal Planet, Discovery Channel, Nat Geo Wild, History
News Pack	Sky News, Sky Sport News, British Eurosport, CNBC Europe,
Children's Pack	Trouble, Nickelodeon, Disney Channel, Cartoon Network
Music Pack	Kerrang, MTV, The Hits, VH1
Style and Culture Pack	Discovery Real Time, Sky Arts, Star Gold, TCM

Source: http://packages.sky.com/buy/ (as of 11 January 2010)

5.101 Subscribers to these basic packages can acquire both Sky Sports 1 and Sky Sports 2 as standalone additional channels. Zero mix packages are now also currently available from Sky, whereby customers can buy premium channels without any of the Sky basic mixes/packs. These zero mix packs are £1 below taking these premium channels with a single mix[187]. As Figure 31 illustrates, **[✂]**.

Figure 31 Basic and premium packages retailed by Sky on satellite (September 2009)

[✂]

5.102 Sky also supplies a "Dual Sports" package which includes all four Sky Sports channels. Sky Sports 3 is not available on a standalone basis at the retail level and can only be acquired as part of a Dual Sports package. Sky Sports 4 is available as a standalone channel.

5.103 Of these packages, by far the most important is **[✂]** (see Figure 31 below). Of the subscribers on Sky's satellite platform that purchase Sky Sports, **[✂]** purchase **[✂]** (either on its own or in combination with a package of movies channels).

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[184] Third Pay TV Consultation, Figure 49.

[185] Note that if customers choose not to take Sky Talk Freetime, the bundle including Sky Broadband Base costs an extra £5 (i.e. £23 in total).

[186] *See http://packages.sky.com/buy/ (as of 11 January 2010)*

[187] Sky's response dated 9 December 2009 to Ofcom's 29 October 2009 Information Request (question 15); Sky response dated 18 September 2009 to Ofcom's 10 December 2009 Information Request.

5.104 Sky Sports 1, 2 and 3 are also supplied in HD format, branded as Sky Sports HD1, HD2 and HD3. Sky Sports 4 is not yet available in HD format.

Figure 32 Sky TV premium sports subscribers by package type (September 2008)

[✂]

5.105 Sky Sports SD channels, though not their HD versions, are also retailed by Virgin Media, as illustrated in Figure 33. Of Virgin Media's residential subscribers, **[✂]**[188] purchase Sky Sports. Virgin Media retails Sky Sports 1, Sky Sports 2, and "Sky Sports Collection"[189] on its cable platform with other basic TV packages ("M", "M+", "L", and "XL") and Sky Movies channels. Virgin Media retails standalone Sky Sports 1 or standalone Sky Sports 2 at between £16.50 per month (if taken with the 'XL' package) and £24 a month (if taken with the 'M' package)[190].

5.106 Alternatively, Virgin Media customers can subscribe to the "Sky Sports Collection" for between £20.50 and £26 per month, or to Sky Sports and Movies (all channels in the "Sky Movies Collection" and "Sky Sports Collection") for between £27.50 and £37 per month[191]. Again, the price depends on the basic package to which the consumer has subscribed.

Figure 33 Basic and premium packages retailed by Virgin Media (December 2009)

[✂]

5.107 Tiscali had **[✂]** residential subscribers, of which **[✂]** subscribe to Sky's premium channels (Sky Movies and/or Sky Sports)[192].

5.108 ESPN is a sports television channel owned by US sports broadcaster ESPN Inc, a leading multinational sports entertainment company. ESPN Inc is 80 percent owned by ABC, Inc., which is an indirect subsidiary of The Walt Disney Company. The Hearst Corporation holds a 20 percent interest in ESPN.

5.109 ESPN is broadcast in SD and HD format and available from Sky, Virgin Media, BT Vision, Top Up TV and TalkTalk TV. Figure 34 below shows the proportion of ESPN subscribers through each retailer. Virgin Media customers who receive ESPN free through the XL package account for **[✂]**[193] . ESPN features live Premier League

[188] Number of subscribers in December 2009. Source: Virgin Media's response dated 20 January 2010 to Ofcom's information request dated 7 January 2010, Question 1.

[189] This is equivalent to Sky's "Dual Sports" as set out in paragraph 5.102 (it comprises Sky Sports 1, Sky Sports 2, Sky Sports 3 and Sky Sports 4).

[190] See http://allyours.virginmedia.com/html/tv/sky-movies-channels.html (as viewed on 12 January 2010).

[191] See http://allyours.virginmedia.com/html/tv/sky-movies-channels.html (as viewed on 12 January 2010).

[192] September 2008 subscriber numbers provided by Tiscali / TalkTalk TV in their response dated 21 January 2010 to question 5 of Ofcom's information request dated 28 October 2009.

[193] **[✂]**.

football (although fewer matches once the 2009/10 season finishes) and will start broadcasting some FA Cup matches from the 2010/11 tournament onwards. It also features some rugby union, martial arts and North American sports.

5.110 ESPN was launched on 3 August 2009 following the exit of Setanta Sports GB, which had operated a number of channels under the Setanta Sports brand, and which went into administration in June 2009.

Figure 34 Retailers' shares of ESPN subscribers

[✂]

Source: Ofcom

Demand for premium sports channels

5.111 Here we set out our view of the nature of demand for premium sports channels. In particular we consider:

- The extent to which sports coverage is distinct from other TV content.
- Preferences of Sky Sports subscribers.
- Bundling of premium movies channels with premium sports channels.
- Potential substitutes for Sky Sports subscribers.

<u>Extent to which sports coverage is distinct from other content</u>

5.112 The Premier League disputed our view that sports content is not constrained by other television content, although it accepted that it is important for some viewers[194]. The Premier League stated that broadcasters will seek to acquire a wide range of content. Accordingly, it said that the analysis of what content is substitutable at the wholesale level should consider content generally[195]: for example, if the wholesale price of sports content were too high, whether broadcasters would switch to other wholesale content inputs.

5.113 Sky acknowledged[196] that premium sports channels were differentiated from other TV channels, and that other types of programming were less likely to be good substitutes for live sports events, at least for infra-marginal consumers. Sky did not put forward any argument that this would not also be true for marginal customers, although it did argue that marginal customers would see FTA sports content as a substitute[197].

5.114 Substantial numbers of UK consumers are prepared to pay a premium specifically to acquire premium sports and movies services over and above a basic service. There is little change in this picture since our Second Pay TV Consultation: over six million UK consumers take up premium channels, paying a price of between £15 and £35 a month for a range of sports and movies content, additional to their spending on basic

[194] Premier League response to Third Pay TV Consultation, paragraph 5.5.

[195] Premier League response to Third Pay TV Consultation, paragraph 5.6.

[196] Sky response to Third Pay TV Consultation, paragraph 5.31.

[197] Sky response to Third Pay TV Consultation, paragraph 5.33.

services (see paragraph 4.147 and Figure 22 above). Subscribers to sports channels only (i.e. not to movies channels) pay between £18 and £24 extra for these channels.

5.115 The willingness of millions of UK households (and thousands of commercial premises) to pay a substantial premium for access to this content, when they already have access to a wide range of other content from FTA and basic channels, is evidence of the distinctiveness of Sky's Sports coverage. We note (see paragraph 5.157) that in a recent survey, when respondents who did not subscribe to Sky Sports were asked why they did not subscribe, none of them mentioned non-sports content as a reason.

5.116 As we stated in the Third Pay TV Consultation[198], the importance of premium sports (and movie) content to Sky's platform is also evident from internal documents that we have obtained. The documents to which Sky was referring, and which are summarised in Appendix 1 of its response to our Third Pay TV Consultation, do not provide evidence that Sky perceives the sports content currently on FTA channels, or non-sport content, as strong competitive constraints on Sky Sports[199]. The documents indicate that Sky sees the possible acquisition by other broadcasters of key sports content rights as a threat.

- **[✂]**[200].
- **[✂]**[201].
- **[✂]**[202].

5.117 Also as set out in our Third Pay TV Consultation[203], the view in Sky's internal documents is supported by internal documents from other pay TV providers which we have obtained following information requests :

[198] Paragraph 3.28 of the Third Pay TV Consultation.

[199] The documents at Appendix 1 of Sky's response to the Third Pay TV Consultation were provided in response to an information request concerning movies only. Sky referred to further internal documents in its Second February 2010 Sky Submission, paragraph 235. Also at paragraph 3.90 of Annex 2 to Sky's Response to Ofcom's First Consultation Document, Sky pointed out to Ofcom a statement from Virgin Media in its SEC (US securities) filings. Virgin Media stated that "The level of competition is intense in each of the markets in which we compete, and we expect competition to increase….In the digital television market we compete primarily with BSkyB in providing digital pay television services. Competition increased as a result of the launch of Freeview in October 2002…." In Sky's response to the Third Pay TV Consultation, Sky asserted that we appeared to have no regard for this submission. However, in this statement, Virgin Media is referring to digital pay television services in general and not specifically premium content. We cannot use it as evidence that Freeview has increased the constraints on premium pay television services. In addition, we don't consider Virgin Media's statements as conclusive in the context of the wider range of evidence on the constraints on Sky Sports and Sky Movies.

[200] **[✂]**. Sky response dated 13 June 2008 to Ofcom information request dated 13 May 2008, question 1.

[201] **[✂]**. Ibid.

[202] **[✂]**. Ibid.

[203] See paragraph 3.29 of the Third Pay TV Consultation.

- **[✂]**[204]. **[✂]**[205]. **[✂]**[206].
- **[✂]**[207] **[✂]**.
- **[✂]**[208]. **[✂]**[209].
- **[✂]**

5.118 The importance of sports content is also evidenced by Ofcom's phase one research, as set out in Figure 21 above, showing that the three genres that are most valued by consumers are sports, soap operas and movies. Of these, soap operas are widely available on free-to-air television, and so are unlikely to be a primary driver of pay TV subscriptions. The same is true of other genres which are valued by consumers, such as comedy, drama and documentaries.

Preferences of Sky Sports subscribers

5.119 Survey evidence on subscribers' reasons for subscribing to Sky Sports (see Figure 35 below[210]) found that 32% mentioned live Football, while 28% specifically mentioned the Premier League and 14% the Champions League. Carling Cup Football, Test Cricket, rugby union and live golf were also mentioned by a substantial number of subscribers. Some expressed a more general desire for a wide range of sports content, relative to what was available on their basic service or other TV.

5.120 Survey evidence that we presented in the Second Pay TV Consultation[211] painted a broadly similar picture, in that 47% of pay TV subscribers who watched sports at least once per week were "strongly committed" to more than one sport, i.e. they watched more than one sport three times a week or more. A fifth were strongly committed to four or more sports. Only 21% did not watch any particular sport on TV three times a week or more.

[204] **[✂]**. Virgin Media response dated 11 June 2008 to information request of 22 May 2008, question 1.

[205] **[✂]**. Ibid.

[206] **[✂]**. Ibid.

[207] **[✂]**. Ibid.

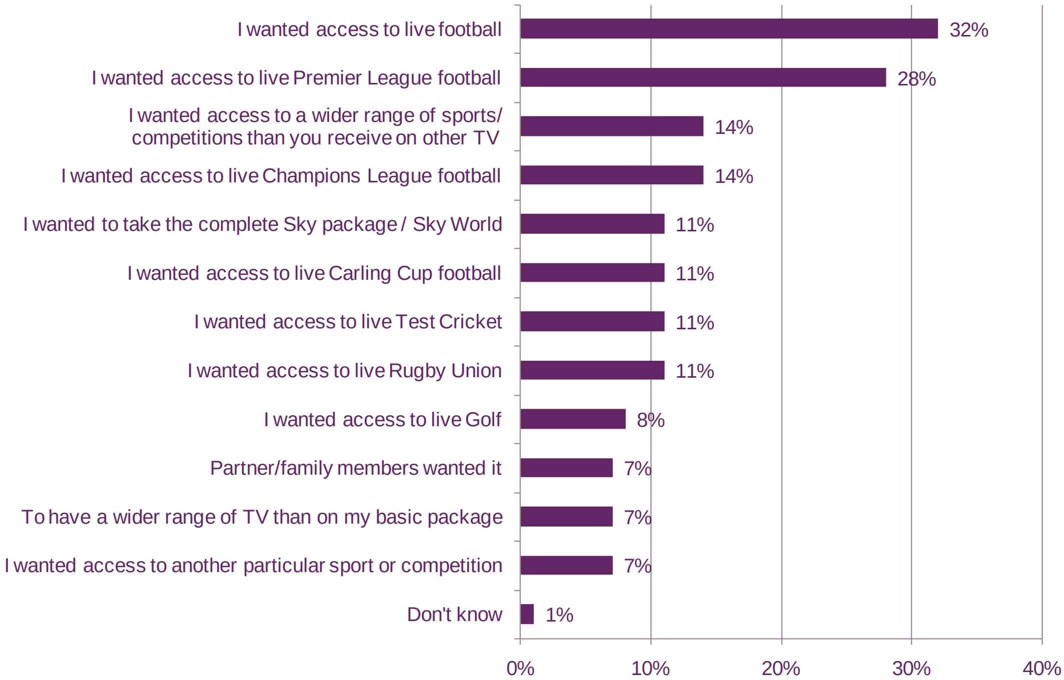
[208] **[✂]**.

[209] **[✂]**.

[210] This was presented as Figure 15 in Annex 10 to our Second pay TV Consultation.

[211] Figure 28 of Annex 10 of the Second Pay TV Consultation.

Figure 35 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: Ofcom 'willingness to pay' omnibus research, fieldwork carried out in April-July 2008

5.121 Sports events are seldom broadcast live on more than one channel. Competitions and leagues and other sports on other channels may be seen as substitutes, but a number of factors limit the degree of substitutability:

- The survey evidence cited above indicates that Sky Sports subscribers generally have strong preferences for **specific sports**, and for specific **competitions and leagues** within these sports. [212] This is further supported by the wide differences between rights payments for different sports and different competitions and leagues (see Figure 45 below);

- Consumers may be affiliated to **particular teams**, and uniquely interested in competitions and leagues where particular teams compete;

- Consumers with a strong preference for a given sport may have a strong demand for a competition or league of that sport (or sports) **in addition** to other competitions/leagues of the same sports;[213]

[212] For example, when asked how they would respond if the Premier League were withdrawn from their Sky Sports package, subscribers who attached particular importance to the Premier League were three times as likely to cancel their subscription as they were to watch other sports on Sky instead.

[213] Ofcom conducted conjoint analysis to determine which combination of sports would maximise market share, based on the proportion of respondents that would subscribe to a given package. The

- If other games/competitions/leagues are available **free to air**, a subscriber to a pay TV sports service will be able to watch them without cancelling their pay TV subscription or spending more. This is in contrast to a typical substitution decision where part of the consumer's budget is reallocated from one good to another.

5.122 Arguably, subscribers who are *not* affiliated to particular teams, or who do not have a strong demand for access to multiple competitions/leagues of the same sports, may be more likely – other things being equal – to be **marginal** consumers. However, as described in paragraph 5.43, whether a consumer is marginal depends on a range of factors, including the current price of the service.

5.123 Given the importance of **specific sports** to the subscription decision, we considered the specific sports available on Sky Sports 1 in our Third Pay TV Consultation. We continue to think this the right approach. In light of Sky's submissions regarding the minority of subscribers who do not have a strong preference for Premier League content, we have reviewed and extended our analysis of potential substitutability from the perspective of four (non-overlapping) groups of subscribers:

- Subscribers who do not watch Sky Sports regularly (8% of Sky Sports subscribers);
- Football fans (72%);
- Cricket fans, who are not football fans (4%); and
- Fans of other sports, who are not cricket or football fans (16%).

Bundling

5.124 In Section 4 we explained how bundling can be used as a form of price discrimination, for example because different consumers may be willing to pay a similar aggregate price for a bundle, despite attaching very dissimilar values to different elements of that bundle. We have considered the implications of bundling for market definition (see also Appendix 2 of Annex 4).

5.125 Sky Sports can be purchased as part of a bundle with Sky Movies, in which case its incremental retail price[214] is lower. This suggests that there are two broad categories of Sky Sports subscriber:

- Subscribers who are strongly motivated by sports content and who have less or no demand for a movies service. These subscribers purchase bundles that include Sky Sports but not Sky Movies. Accordingly they implicitly pay a comparatively high incremental price for Sky Sports. (£18 for Sky Digital subscribers – see Figure 22).
- Subscribers that are motivated by both sports and movies content. These subscribers purchase bundles including both types of content. This group will include at least some subscribers who do not value Sky Sports enough to buy it

analysis determined that the most attractive combination of seven sports included all six football events tested. (See paragraph 7.6 of Annex 10 to our Second Pay TV Consultation).

[214] That is, how much the subscriber would save by cancelling their subscription to Sky Sports, but not to other services and channels.

at the full standalone price, but who purchase Sky Sports because it is available for a comparatively small incremental price.

5.126 We investigated the preferences of the second group in further detail in our Second Pay TV Consultation. Figure 36 below shows that 22% of Dual Sports plus Dual Movies subscribers subscribe to Sky Sports because they wanted Sky Movies, and Sky Sports did not cost much extra. For these customers Sky Sports is a comparatively cheap add-on (£7.50 for Sky Digital subscribers – i.e. £25.50 for both, minus the price of movies only (£16) – see Figure 22).

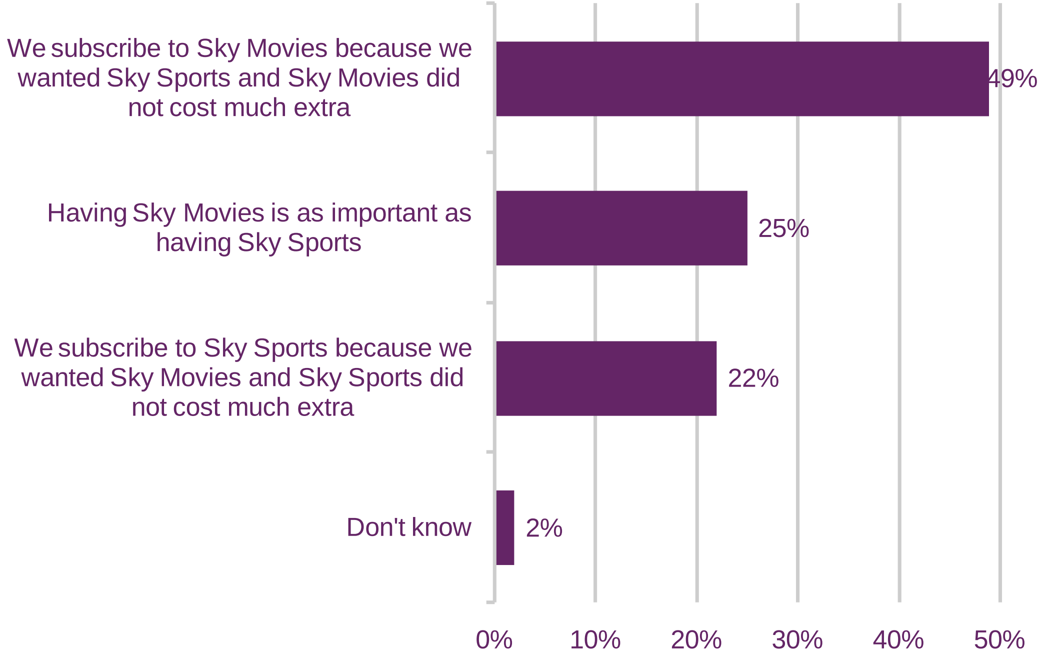
5.127 Bundling of Sky Sports and Sky Movies channels is likely to reduce the willingness of customers who take the bundled service to switch or cancel their service.

5.128 For example, suppose a particular suite of Sky Sports channels is available standalone for £18, or bundled with movies channels for £25.50 (i.e. an additional £7.50), and that the movies channels are available standalone for £16. Suppose also that a subscriber values the sports channels at £18, the movies channels at £10, and therefore the bundle at £28. In the absence of bundling, the subscriber would only take Sky Sports, and would be a marginal consumer (i.e. if the price increased they would cancel their subscription). However, this subscriber will take a bundled package if it is available, and will not cancel unless the price increases by more than £2.50. Nor will they switch to a substitute sports service unless it is at least £2.50 better value than the Sky Sports standalone service (to compensate them for the loss of the movies service).

5.129 As such, bundling will tend to reduce such subscribers' sensitivity to a price increase. It will also reduce their tendency to switch to an alternative which is only a substitute for one aspect of the service (unless the alternative service is bundled with other services which are also valued by consumers). This does not imply that the subscriber base for bundled services would necessarily be less price-sensitive than if the services were only offered standalone[215] . However, some subscribers to Sky Sports who also purchase Sky Movies as part of a bundle may be deterred from switching by the value they place on the other part of the bundle. We do not have clear evidence as to whether the perceptions of subscribers of potential substitutes differ depending on whether they are primarily subscribers to sports and see movies as a cheap add-on, or vice versa, or see both as important.

[215] Bundling attracts additional subscribers into the market (i.e. those who would not buy either product as a standalone, and it is possible that these subscribers will have a different price sensitivities than subscribers who would buy one or both products as a standalone.

Figure 36 Reasons for subscribing to Sky Movies and Sky Sports



Base: All adults aged 15+ who subscribe to Sky Movies and Sky Sports and are solely/jointly responsible for making purchasing decision regarding supplier for TV service (260)

Source: Ofcom 'willingness to pay' omnibus research, fieldwork carried out in April-July 2008 (presented in the Second Pay TV Consultation, Annex 10, Figure 17)

<u>Potential substitutes for packages including Sky Sports 1</u>

5.130 As noted in paragraphs 5.86 to 5.87, rights prices and survey evidence indicate that **non-live TV sports** are a poor substitute for live coverage from the perspective of sports fans.

5.131 While many fans are likely to see attendance at the **live event** itself as an attractive alternative to viewing it on TV, the ticket price to a single event will typically be more than a month's subscription to Sky, suggesting that live events are highly differentiated as a higher-quality, higher-price offer. In addition, the capacity of sporting venues, and the need to travel to them, greatly limits the extent to which most sports fans can substitute from Sky to attending live events. (Of course, the ticket price also reflects the limited capacity of venues.)

5.132 While viewing of Sky's premium sports channels in **commercial premises** is likely to be a substitute to subscribing for a proportion of viewers, Sky also controls the price and availability of sports in commercial premises, and so is unlikely to act as a constraint on itself. In any event, watching sports channels in pubs is a different experience, from the viewers' perspective, to watching that channel at home.

5.133 In light of the above, we consider that competition is most likely to come from live sports content provided to residences. In particular we identify the following potential substitutes for packages including Sky Sports 1:

- ESPN;
- Basic-tier sports channels such as Eurosport;
- Sport on FTA TV.

5.134 For the reasons given in paragraphs 5.112 to 5.118 above, we do not consider that non-sports programming is a close substitute for packages including Sky Sports 1.

5.135 Figure 37 below sets out the live sports which are covered on each of the main potential substitutes to Sky Sports channels.

Figure 37 Availability of live sport on Sky Sports 1 and other channels (2008)

	Event	Broadcast on Sky Sports 1	Substitutes on Sky Sports 2	Substitutes on Sky Sports 3	Substitutes on Sky Sports 4	Substitutes on Setanta[1]	Substitutes on FTA	Substitutes on basic[2] pay TV
Football	Premier League	56%	3%			41%		
	FA Cup	19%	3%			26%	51%	
	Carling Cup	54%	46%					
	The Championship	83%	11%				6%	
	England International	15%	6%			35%	44%	
	Champions League	7%	36%	6%	14%	1%	36%	1%
	UEFA Cup					2%	97%	1%
	Euro 2008						100%	
Cricket	ICC ODI Championship (non-England)	55%	33%	8%	4%			
	England Test Match	75%	11%	8%	6%			
	County Championship	45%	33%	14%	8%			
	England one day international	56%	44%		<1%			
Golf	European PGA	24%	31%	29%	9%		5%	2%
	Ryder Cup	100%						
	US Open Golf	78%	8%	14%				
	US PGA Tour & PGA Championship	10%	1%	1%		87%		
	European Tour Golf	8%	14%	20%	31%		28%	
	World Golf Championship		63%	24%	13%			
	The Open						100%	
	US Masters						100%	
	Scottish Open						100%	
Rugby Union	Heineken Cup	17%	76%	2%	2%		2%	
	Guinness Premiership	44%	53%	3%				
	England International		24%				76%	
	Six Nations						100%	
	Magners League						100%	
Rugby League	Super League	39%	28%	31%	1%			
	Challenge Cup Rugby League						100%	
	Rugby League World Cup	21%	79%					
Tennis	Masters Cup Tennis	36%	11%	16%	37%			
	US Open Tennis	5%	1%		66%			28%
	ATP & WTA Tennis		17%	4%	36%		1%	42%
	Davis Cup		15%	17%	49%		19%	
	Wimbledon						100%	
	French Open						8%	92%
	Australian Open						8%	92%
	Paris Masters Tennis				100%			
	Stella Artois Tennis						100%	

Note: 1. Setanta exited the UK market in 2009 and ESPN began broadcasting live Premier League matches later that year.

2. Eurosport and Sky1.

Source: Ofcom analysis of BARB data. This chart has been amended since the Third Pay TV Consultation to correct for the errors identified by Sky (Sky response to Third Pay TV Consultation, paragraph A2.11(i)).

5.136 The content of basic tier sports channels such as **Eurosport** is limited relative to that on Sky Sports, and this is reflected in the lower revenues and viewing figures which Eurosport commands. We consider that they offer at most a limited constraint on packages including Sky Sports 1.

5.137 Both **live sport on FTA** TV, and **ESPN**, are more significant sources of highly-valued sport on TV. In both cases, the ability to offer such highly-valued sport is to a large extent an outcome of regulatory intervention: certain "listed" events must be shown on FTA TV (as described in paragraph 5.95), while ESPN entered the market by gaining rights to Premier League matches which Sky is prevented from holding under European Commission rules.[216]

5.138 As we argue in paragraphs 5.250 to 5.252, ESPN is a close (though relatively small) substitute to Sky, particularly because of its regular broadcasting of Premier League games and other sports content. The extent of substitutability from Sky to live sport on FTA is less clear-cut because of the relative infrequency with which major live events are shown FTA for any given sport.

5.139 Our view of the closeness of substitution of these potential substitutes, and the others discussed above is covered in our discussion of market definition (paragraphs 5.141 to 5.359). Our assessment of their scale relative to Sky Sports 1 is set out in our analysis of market shares (paragraphs 5.417 to 5.443). Our conclusions on these potential substitutes are illustrated in the Figure below. As the Figure indicates, we conclude that:

- ESPN is the only independent close substitute to Sky Sports 1, and is a medium scale substitute;
- Sport on FTA is also of medium scale, but is only moderately substitutable for Sky Sports 1; and
- Non-sport on TV, the largest of the potential substitutes we considered, is a distant substitute.

[216] See paragraph [5.360].

Figure 38 Substitutes for Sky Sports

	Close substitute	Moderate substitute	Distant substitute
Large scale	[None]	[None]	• Live sports at the sports ground • Non-sport on TV
Medium scale	• ESPN	• 'Main' sports on FTA[2]	[None]
Small scale	[None]	[None]	• Non-live sports content on TV and DVD • Live sport on basic pay TV • Other sports on FTA
Owned by Sky[3]	• Sky Sports 2	• Sky Sports 3 • Sky Sports 4 • Premium sports channels in pubs & clubs	• Non-sport on Sky's other channels

Notes:

1. Scale based on our qualitative assessment.

2. We consider football, rugby union, golf, cricket, tennis and rugby league on FTA as moderate substitutes. These are the main sports shown on Sky Sports 1.

3. As these channels are owned by Sky we do not categorise their scale.

5.140 As set out in our assessment of market power, if only close substitutes are included in the market Sky has a market share of over 80% **[✂]**. If moderate substitutes are also included, Sky has a market share of around **[✂]**, well above the 50% threshold associated with a legal presumption of dominance[217]. As such, our conclusion that Sky's market shares are above the threshold for dominance does not depend on whether or not moderate substitutes are included in the market. However, it does rely on the exclusion of non-sport on TV from the market.

Market definition

Evidence considered in defining markets

5.141 To define the relevant wholesale and retail markets in respect of premium sports channels, we have considered a wide range of evidence. In Figure 6 of our Third Pay

[217] Case 62/86 *AKZO Chemie v Commission* [1991] ECR I-3359, paragraph 60.

TV Consultation, we referred to the broad categories of evidence which we have considered[218]. In summary, evidence we have considered is as follows:

- Product characteristics evidence: One method of assessing substitutability is to examine the characteristics of a particular product. We have considered a range of evidence including consumer survey data on the preferences of subscribers for Sky Sports, the amounts of different sports on different channels, and BARB TV viewing data.

- Expenditure on sports rights: In order to understand the value that broadcasters, and ultimately viewers, attach to different sports and sporting tournaments we have assessed the price of rights.

- Survey evidence on stated responses to price rises: We have considered three pieces of evidence: (i) a survey which we carried out in 2007 on consumers' stated response to a rise in the price of Sky Sports Mix, (ii) a consumer survey carried out by Sky in 2007 on the willingness of consumers to switch in response to a rise in the price of Sky Sports and Top Tier packages and (iii) a further survey carried out by Sky in 2009 on consumer switching.

- Changes in demand for Sky Sports: We have considered an econometric study commissioned by Sky (the Seabright Study) which estimated the impact of Freeview availability on demand for packages including Sky's sports channels. On 25 February 2010 Sky provided a further submission on trends in subscriber numbers, price and quality for these packages.

- Internal documents: We have considered internal papers from Sky, Virgin Media and others on the extent to which they face competition from other broadcasters and on the importance of different sports rights.

- Consultation responses: We have taken account of all respondents' views in reaching our conclusions on wholesale and retail market definition.

- Price and quality changes: We have also examined what can be inferred from observed responses to changes in price and quality over time.

- Pricing and profitability evidence: In order to determine whether Sky's prices are above the competitive level, and whether this might have an impact on our market definition assessment, we have considered (i) an analysis of Sky's profitability carried out by Oxera, and (ii) the extent to which Sky's current rate-card prices are significantly and consistently above our estimates of cost-plus prices. Profitability analysis also provides direct evidence as to the presence of market power.

Structure

5.142 This subsection is structured as follows:

- First, we set out our view of **product characteristics** as a way of comparing potential substitutes;

[218] See also Third Pay TV Consultation, paragraph 4.23.

- Second, we consider **other evidence** of relevance in assessing specific potential substitutes, including survey results and internal documents.

5.143 Next, we identify the wholesale and retail **focal products**.

5.144 In defining the markets we begin by considering the **retail market**, and then turn to the **wholesale market**[219].

Evidence relating to potential substitutes

Product characteristics

5.145 The OFT Market Definition Guidelines state that "Evidence on product characteristics may provide useful information where customer substitution patterns are likely to be influenced significantly by those characteristics. Where the objective characteristics of products are very similar and their intended uses the same this would be good evidence that the products are close substitutes"[220]. In the Third Pay TV Consultation we considered product characteristics in detail, in the light of evidence on consumer preferences, and based on this evidence we widened the relevant market to include Sky Sports 2 and Setanta Sports 1[221].

5.146 Sky said that our analysis was based on the erroneous proposition that products' characteristics had to be identical for products to be within the same relevant market[222]. Sky argued that focusing on differences in products' characteristics as delineating market boundaries inevitably produced erroneous conclusions in markets where firms supply differentiated products[223],[224]. Sky said that offering programming that is not available elsewhere was a central element of competition in the television broadcasting sector[225].

5.147 Rather, Sky stated that it was important to focus on the underlying intended use served by differentiated products[226]. Sky cross referred to an earlier submission in

[219] This ordering reflects the fact that the willingness of subscribers to switch to substitutes is a direct constraint on prices at the retail level, but also acts as an indirect constraint at the wholesale level – i.e. an independent wholesaler would be constrained from imposing a wholesale price increase by the prospect that retailers would respond by increasing their prices, leading to subscriber switching.

[220] OFT Market Definition Guidelines, paragraph 3.7.

[221] Third Pay TV Consultation, paragraphs 4.78-4.134.

[222] October 2009 Sky Submission, paragraph 46. Sky also referred to paragraph 3.5 of the OFT Market Definition Guidelines which state that products do not have to be identical to lie within the same relevant market. October 2009 Sky Submission, footnote 129 to paragraph A2.57.

[223] Sky response to Third Pay TV Consultation, paragraph 5.17(b).

[224]Sky response to Third Pay TV Consultation, paragraph 2.13.

[225] October 2009 Sky Submission, paragraph A2.9.

[226] Sky response to Third Pay TV Consultation, paragraph 5.17(d).

which it asserted that the underlying consumer demand was for audiovisual entertainment[227].

5.148 Sky presented no evidence in support of this assertion. Our view is that the “underlying intended use” of a product is a subjective matter for the consumer. The key question is whether consumers are willing to switch from one product to another in response to a change in the relative price. In principle, this can be inferred in a range of ways, such as from direct observation of consumer switching, from survey evidence, and, where switching data are unreliable, from comparison of the characteristics of alternative products.

5.149 We recognise that there are limitations to using product characteristics to define markets. We note in particular that a comparison of product characteristics which does not have regard to which characteristics are important to consumers is unlikely to be informative as to substitutability of alternative products. We have carried out an extensive assessment of potential substitutes, assessing product characteristics in the light of available evidence as to their respective importance to consumers, presenting other evidence – such as survey evidence – as to the extent to which products are seen as substitutes, and drawing together the evidence and analysis that we have previously presented.

5.150 We recognise that differentiation is central to competition in the pay TV sector. Moreover, a degree of production differentiation does not automatically confer market power. However we consider that a high degree of product differentiation will diminish the extent of substitutability between products and therefore contribute to market power.

5.151 Where a product does not meet the same consumer demand as the focal product then it will not be a close substitute. Even where a potential substitute is intended to meet the same demand, whether it is in fact a competitive constraint on the focal product depends on its relative attractiveness, taking into account both its price and its quality. In order to assess quality, it is necessary to identify which characteristics are important to consumers and then evaluate each potential substitute in the light of those important characteristics.

5.152 As part of our assessment we have had regard to the **price** of premium sports services and potential substitutes. We recognise that, in principle, products sold at different prices can potentially be close substitutes – i.e. marginal consumers may be willing to switch from a higher-quality, higher-priced product to one of a lower quality and price[228]. However, when comparing quality of different products, the price that they command can be an important indicator of the extent to which they are differentiated from one another,[229] - i.e. of how consumers value their different qualities, and therefore of the scope for substitution[230] .

[227] June 2009 Sky submission, paragraph 6.16. See also October 2009 Sky Submission, paragraph 33.

[228] We explicitly recognised this at paragraph 4.94 of the Third Pay TV Consultation.

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

[230] For the reasons set out in paragraphs 5.14 to 5.589, we consider that the current prices of Core Premium channels are likely to be above competitive levels. As discussed in paragraphs 5.46 to 5.59,

Surveys carried out since the Third Pay TV Consultation

5.153 We have considered two surveys that were not available at the time the Third Pay TV Consultation was published.

5.154 First, in response to the Third Pay TV Consultation, Sky provided a new survey of its subscribers' propensity to switch in response to a price rise[231]. This is in addition to two other surveys investigating this issue that we considered in the Third Pay TV Consultation, namely:

- A 2007 Ofcom survey (discussed at paragraph 4.136 of the Third Pay TV Consultation).

- A 2007 survey for Sky (discussed at paragraph 4.137 of the Third Pay TV Consultation).

5.155 Second, Ofcom commissioned a survey which was carried out in October/November 2009, in order to address issues raised in response to our Third Pay TV Consultation. Sky argued in its response that, given that product differentiation plays a "central role" in this case, it is "inappropriate to focus on differences in products' characteristics as delineating market boundaries"[232]. We have therefore considered the results of this survey for the purposes of market definition in order to supplement our analysis of product characteristics.

5.156 Sky provided its comments on this survey in March 2010. Our full assessment of Sky's response is set out in Appendix 5 of Annex 6. Sky criticised both our overall research methodology and the way we framed the questions. As we set out in detail in Annex 6, we are confident that our research methodology reflected best practice, for example by being cautious when interpreting responses with small sample sizes. Sky also believed that our research contradicted the views set out in our Third Pay TV Consultation, particularly on the importance of various services. We reflect on these comments in Annex 6.

5.157 Non-subscribers to Sky Sports were asked why they did not subscribe. We note that at least some of these respondents would be likely to be (marginal) customers of Sky Sports if its prices were at competitive levels. As such, they provide some insight as to the strongest perceived alternatives to Sky Sports. The responses to this question are summarised in Figure 39. Around half of non-subscribers said they were not very interested in sports, with most of the remainder saying Sky Sports was too expensive or that they would not watch it enough. Very few mentioned specific alternatives: only 2% of all respondents, and 7% of those who had recently seen a sports event, mentioned ESPN or Setanta, and only 1% said there was already enough sports available on TV (although this rose to 7% with prompting). None of the respondents mentioned non-sports content on TV without prompting[233].

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this will tend to distort an assessment of switching to substitutes in response to a marginal increase in the price. However, absolute price levels can be informative as to the strength of consumer demand and the "cellophane effect" is not relevant to such an assessment.

[231] Sky response to Third Pay TV Consultation, Annex 5.

[232] Sky response to Third Pay TV Consultation, paragraph 5.17.

[233] Non-sports content on TV was not included as a prompt.

Figure 39: Reasons for not subscribing to Sky Sports

	All		Sports viewers[1]	
	Unprompted	Prompted	Unprompted	Prompted
Not very interested in sports	49%	55%	14%	19%
Too expensive	30%	42%	53%	63%
Wouldn't watch it enough	11%	39%	12%	34%
Setanta/ESPN is enough for my needs	2%	3%	7%	8%
There is enough sports available on TV already	1%	7%	2%	7%
I watch sports in a pub/club	1%	5%	-	11%

Note: 1. Respondents who had seen a sports event in the past week.

Documentary evidence

5.158 Statements made by market players and internal Sky documents demonstrate the importance of sporting content as driver of pay TV subscriptions. We have discussed this in detail in paragraphs 4.114 to 4.120. These statements and internal documents do not suggest that there are close substitutes to premium sports content in general and Premier League football specifically – which we take to indicate the absence of such substitutes. Rupert Murdoch said at the 1996 AGM of News Corp (a major shareholder in Sky in the UK) that sport would be the "battering ram" of pay TV.

5.159 More recently, a documentary aired on Sky One in June 2007[234] quoted Rupert Murdoch as follows:

> "In life, if you're building a company, you've got to take risks. And this [purchasing Premier League rights] was certainly, on the face of it, very risky. But I knew from selling newspapers or from television elsewhere that sport is the great, number one common denominator. And, of that, football [is number one]".

5.160 Sky recounted the role of sports programming in the story of its own development, the "Sky Fact Book", in 2004:

> "Sky Sports has been pushing back the boundaries of televised sport since 1991. It recognised the British public's insatiable appetite for sport and sparked a viewing revolution that has changed the way people watch it. . . . Right from the start, sport has been a major factor in the growth of multi-channel TV."

[234] Quoted in the Guardian, Friday 22 June 2007, 'Murdoch warns on football rights'.

5.161 **[✂]**[235].

5.162 **[✂]**[236].

5.163 **[✂]**[237]**. [✂]**.

Focal products

The wholesale focal product

Position in the Third Pay TV Consultation

5.164 In the Third Pay TV Consultation, we took Sky Sports 1 as the starting point for our wholesale market definition[238]. We said that Sky Sports 1 is "particularly attractive" to pay TV retailers[239].

Responses to the Third Pay TV Consultation

5.165 We received representations on the wholesale focal product from the Premier League and Virgin Media. Sky's comments focused on the appropriate retail focal product (see paragraph 5.174 below).

5.166 The Premier League considered that our focal product was incorrect[240], that we should begin by assessing what content is necessary to create a consumer offering and that we should have proceeded by reference to content generally[241,242].

5.167 Virgin Media considered that the focal product should be "the packages of premium sports channels which are actually offered by Sky, as opposed to individual sports channels"[243]. Virgin Media considered that it was important to focus on packages since this reflected the way in which these channels are actually sold and thus the options actually available to consumers[244]. Further, in Virgin Media's view, this

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[235] **[✂]**. Sky response dated 13 June 2008 to Ofcom information request dated 13 May 2008, question 1.

[236] **[✂]**. Ibid.

[237] **[✂]**. Ibid.

[238] Third Pay TV Consultation, paragraph 4.69.

[239] Third Pay TV Consultation, paragraph 4.70.

[240] Premier League response to Third Pay TV Consultation, paragraphs 5.8.1 and 5.16.

[241] See paragraph 5.16 of the Premier League's response to the Third Pay TV Consultation.

[242] The Premier League made a number of representations that are relevant to the issue of which content is important to the success of a pay TV retailer (see Section 4 of this document).

[243] Virgin Media response dated 1 December 2009 to question 2 of Ofcom's information request dated 29 October 2009.

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

reflected the way in which Sky exercises market power across all Sky Sports channels[245].

Ofcom's view on the wholesale focal product

5.168 OFT Market Definition Guidelines state that the focal product is "the product under investigation"[246]. Our interpretation of this statement is that the choice of the focal product is closely connected with the particular competition concerns that are being analysed in a given case.

5.169 Our competition concerns arise from our view that premium sports and movies content is a key driver of demand for pay TV services, and that restricted access to this content may be a barrier to entry and expansion in the pay TV sector. The most valuable sports content (as reflected in the cost of rights) is shown on Sky Sports 1. We recognise that other channels, in particular Sky Sports 2 and ESPN, also carry attractive sports content. However, we consider it appropriate to focus on the narrowest possible starting point. We therefore consider that the focal product should be based on Sky Sports 1.

5.170 Sky Sports 1 is sold in packages with other channels and services. We consider that the focal product should be expressed in terms of packaged products, as this is what consumers actually buy (i.e. very few buy Sky Sports 1 in isolation without also subscribing to at least a basic TV package). However, given the range of packages that are available, we do not consider that any one of them could meaningfully be taken as the focal product. We therefore consider the focal product as packages which include Sky Sports 1. This is consistent with the starting point we identified in the Third Pay TV Consultation.

5.171 We considered whether Sky Sports 2 should also be included in the focal product. However, as discussed below, we conclude that Sky Sports 2 is a substitute for Sky Sports 1, so it is included in the market regardless of whether or not it is included in the focal product. We also note that packages that include Sky Sports 1 typically also include Sky Sports 2, 3 and 4.

Conclusion on the wholesale focal product

5.172 In the light of consultation responses received on this issue, we conclude that the focal product for the wholesale market definition is the provision in the UK of packages including Sky Sports 1.

<u>The retail focal product</u>

5.173 In the Third Pay TV Consultation, we identified our retail focal product as packages including any of Sky Sports 1, Sky Sports 2 and/or Setanta Sports[247].

5.174 Sky pointed out that there was a discrepancy between our focal products for the retail and wholesale markets and that this "gives rise to analytical difficulties because the focal products are different in each case. For example, in relation to premium sports

[245] Virgin Media response to Third Pay TV Consultation, paragraph 3.9(a).

[246] OFT Market Definition Guidelines, paragraph 2.9.

[247] Third Pay TV Consultation, paragraph 4.227.

services, the focal product at the wholesale level is Sky Sports 1, while at the retail level it is pay TV packages that include Sky Sports 1, Sky Sports 2 or Setanta Sports 1 (among other channels)."[248]

5.175 Virgin Media considered that Ofcom was correct to take the actual packages of channels purchased by consumers as the focal product.[249]

Ofcom's view on the retail focal product

5.176 We do not consider that the discrepancy which Sky pointed out gave rise to analytical difficulties. As Sky noted[250], the substantive analysis proceeded from a starting point that was consistent with our wholesale focal product i.e. retail packages including Sky Sports 1.

5.177 However, for consistency, we have revised our retail focal product to correspond with our wholesale focal product. Specifically, our wholesale focal product is the provision in the UK of (wholesale) packages including Sky Sports 1. Therefore the starting point for our analysis of the retail market is the provision in the UK of (retail) packages including Sky Sports 1[251].

Retail market definition

Introduction

5.178 Below we set out our analysis of the relevant retail market. In the Third Pay TV Consultation we presented our analysis of the wholesale market first, and then our analysis of the retail market. We have reversed that order in this document. This has the advantage of making the relationship between indirect constraints at the wholesale level and our retail market definition analysis clearer. This is simply a change in the form in which we present our analysis, rather than in its substance.

5.179 In our Third Pay TV Consultation we focused in particular on consumer preferences for football, cricket, rugby, tennis and golf coverage. In response to Sky's submission that in our Third Pay TV Consultation we gave insufficient attention to subscribers who do not have a strong preference for certain sports[252], we have sought to identify whether there are any segments of the minority of consumers who do not have strong preferences for Premier League content, who are more likely than others to see other options as potential substitutes. We therefore identify four distinct groups of Sky Sports subscribers and consider the characteristics of Sky Sports 1, and the likely strength of potential substitutes, from the perspective of each group's preferences (or not) for cricket, rugby and other sports.

5.180 We consider the following potential substitutes:

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[248] October 2009 Sky Submission, paragraph 22.

[249] Virgin Media response to Third Pay TV Consultation, paragraph 3.6(a); also 3.16.

[250] October 2009 Sky Submission, paragraph 72.

[251] As explained above, these bundles include other Sky Sports channels, as well as basic channels and potentially other services such as broadband etc. These other products are included only by virtue of being bundled with Sky Sports 1.

[252] October 2009 Sky Submission, paragraph A2.11(iii).

- Sky Sports 2
- Sky Sports 3
- Sky Sports 4
- ESPN
- FTA Sports
- Eurosport
- Other ways of watching live sports
- Non-live sport
- Non-sport content on TV

Description of different groups of Sky Sports subscribers

Responses to our Third Pay TV Consultation

5.181 Sky stressed the importance of focusing on marginal consumers when carrying out market definition. Sky considered that subscribers with a moderate interest in a range of sports, or sport in general, are most likely to be marginal[253] .

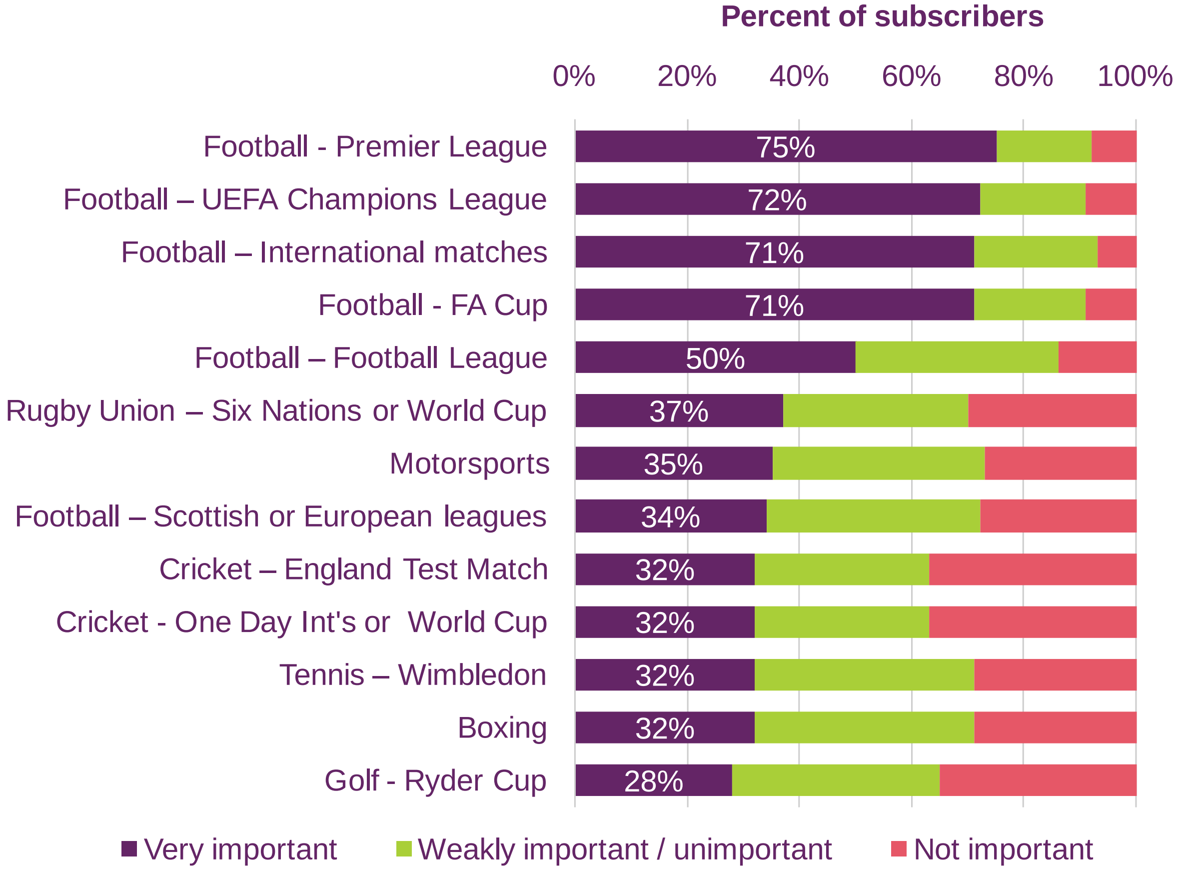
Ofcom's view on the preferences of subscribers to packages including Sky Sports 1

5.182 We recognise that because the preferences of Sky Sports subscribers vary, some are more likely to be marginal than others. In response to Sky's comments, we present information on the preferences of different groups of Sky Sports subscribers to assess which groups are more likely to be marginal[254]. In order to do this in a systematic way we have re-cut the data presented in Figure 10 of our Third Pay TV Consultation. For convenience, we represent this chart in Figure 40 below.

[253] For example October 2009 Sky Submission, paragraph 49.

[254] We analysed the preferences of all Sky Sports subscribers, rather than just those subscribers that take packages including Sky Sports 1. We do not consider that this affects our results, given that almost all subscribers to Sky Sports take Sky Sports 1.

Figure 40 Importance of key sports on TV for premium sports channel subscribers

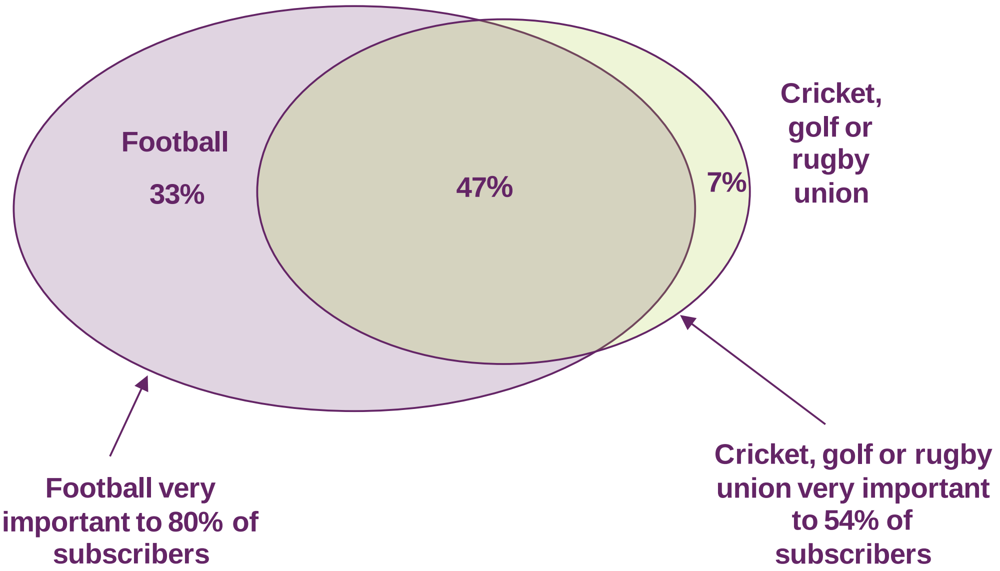


Source: Ofcom sport conjoint research, April 2008

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

5.183 We previously presented Figure 41 in the Third Pay TV Consultation to summarise evidence of consumers' overlapping preferences for sports.

Figure 41 Preferences for football, cricket, golf and rugby



Source: Ofcom Sports Conjoint research

Base: All premium sports channel subscribers who watch sport at least once a week.

5.184 Sky stated that potential substitutes considered in our Third Pay TV Consultation "may not meet the demand of consumers who want to watch substantial amounts of live Premier League football on a weekly basis … But such consumers are unlikely to be 'marginal consumers'"[255].

5.185 We have therefore revisited the data presented in Figure 41 above. This Figure related to the preferences of subscribers that watch sports at least once per week. We have separately identified consumers that do not watch sport on a weekly basis, based on the data discussed in our Second Pay TV Consultation. We have also investigated in more detail the preferences of consumers that do not have a strong interest in live football. Specifically we have characterised Sky Sports subscribers into four groups:

- The first group (Group 1) are infrequent viewers of sport.
- We have divided frequent viewers of Sky Sports (defined as watching sports at least once a week) into three groups: "football fans" (Group 2); "non-football fans who are cricket fans" (Group 3); and "non-football and non-cricket fans" (Group 4).

Group 1: infrequent viewers of sport

5.186 As we explained in our Second Pay TV consultation[256], our analysis has found that about 8% of respondents live in a household which subscribes to Sky Sports but watched sport less than once per week[257]. We excluded this group from our

[255] Sky response to Third Pay TV Consultation, paragraph 5.33.

[256] See paragraph 5.38 of Annex 6 to our Second Pay TV consultation.

[257] Ofcom pay TV research phase 3. See figure 33 of annex 14 of the First Pay TV Consultation for details.

survey[258]. We noted that around half this group (47%) said they would switch in response to a price rise and that this compares with approximately 31% of *all* subscribers who might be considered price sensitive[259].

5.187 We recognise that subscribers who are infrequent viewers of sport may have different preferences from more frequent viewers. However, as they are relatively few in number (8% of all subscribers) even if their preferences are different to those of more frequent subscribers it is unlikely to affect our conclusions on the likely substitutes for premium sports channels.

5.188 The survey result that they are more likely than average to switch in response to a price increase suggests that a disproportionate (though still small) number of them may be marginal consumers[260]. We revisit infrequent viewers in our conclusion on retail market definition.

Group 2: "football fans"

5.189 Seven in ten[261] Sky Sports subscribers regard live Premier League and live Champions League content as very important[262]. Channels that do not show a significant amount of Premier League and Champions League football are unlikely to be perceived as good substitutes for Sky Sports by these subscribers.

5.190 There is a large overlap between those Sky Sports subscribers who are interested in football and those who are interested in other sports. However even if potential substitutes featured coverage of these other sports, if they do not feature significant amounts of Premier League and Champions League matches they are unlikely to be seen as close substitutes by football fans.[263] We therefore consider the extent of football coverage on these other channels.

[258] This group was likely to include people who have no interest in sport but who live with sports fans. See Annex 10 for details.

[259] Though for the reasons set out in paragraph 5.38 of Annex 6 to our Second Pay TV Consultation, this would overstate the actual response to a SSNIP.

[260] If infrequent viewers are half again as likely to switch in response to a price rise (47% against an average of 31%), this suggests that, while accounting for 8% of consumers in total, they would account for around 12% of marginal consumers.

[261] Source: Ofcom sport conjoint research, April 2008.

[262] In terms of premium sports subscribers that watch sports at least once a week, 75% of regard Premier League as very important (Figure 40 above) and 80% regard one or more football contests as very important (Third Pay TV Consultation, Figure 12). The next most important event, as shown by rights payments, is the Champions League (see Figure 40). Given the overlap in subscribers, the amounts paid for live Champions League rights and the fact that the Champions League is effectively the level of competition above the Premier League we have considered fans of both these events together in Group 2. These are also events for which the majority of the live rights are held by Sky (although matches are not only broadcast on Sky Sports 1). We recognise that Premier League fans may be interested in other football tournaments, such as the FA Cup, and international football matches.

[263] As Figure 42 shows, some subscribers who do not regard Premier League or Championship League as very important are interested in other football content. However, for convenience we use the term "football fans" to refer to those who see Premier League and Champions League football as very important.

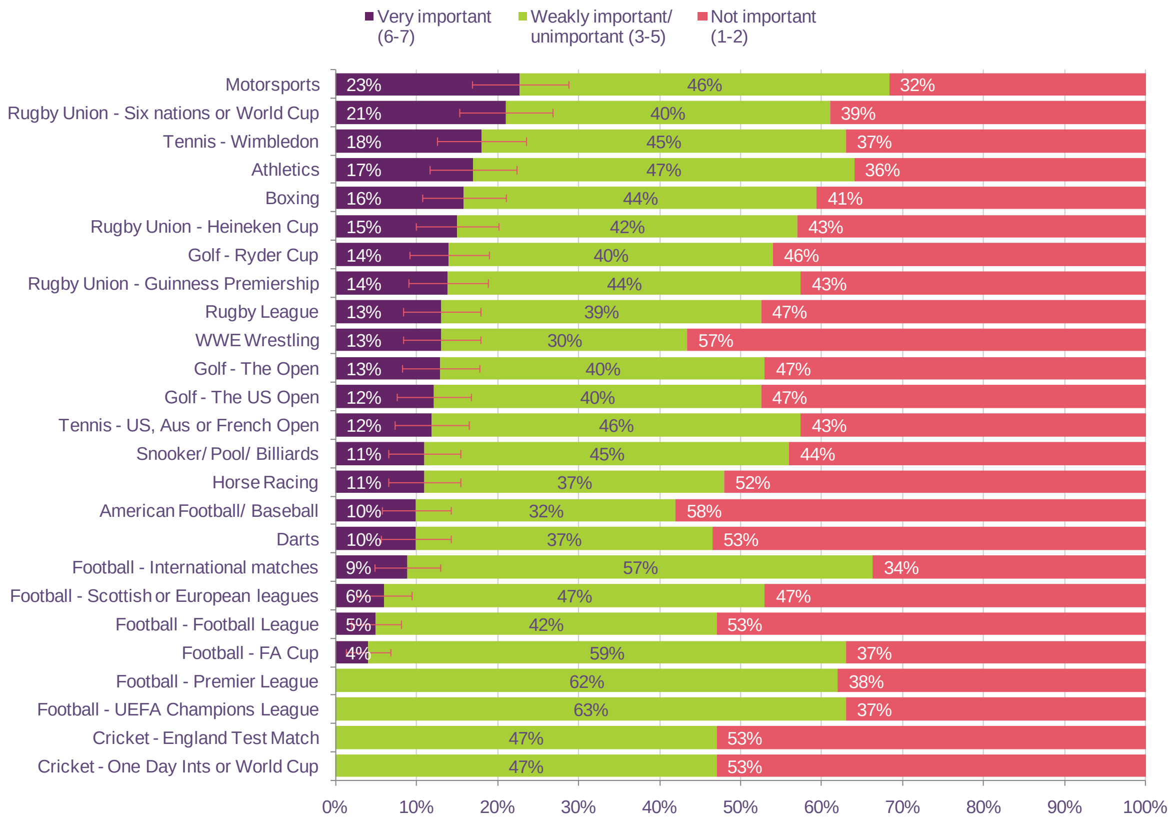
Group 3: "non-football fans who are cricket fans"

5.191 As set out in our Third Pay TV Consultation, cricket is very important for almost a third of subscribers to Sky Sports (32%)[264]. Most of them are also football fans (cricket is also important in a pay TV context because it takes place outside the football season). However, 4% of subscribers regard cricket as very important but do not regard live Premier League or Champions League content as very important. We analyse potential substitutes from the perspective of this group by considering the extent of live cricket coverage on other channels.

Group 4: "non-football and non-cricket fans"

5.192 The remaining 16% of Sky Sports viewers (who do not regard live Premier League matches, live Champions League matches, or cricket as highly important) attach importance to various other sports content such as motorsports, rugby union, tennis, athletics, boxing, golf, wrestling, and rugby league (see Figure 42 below).

Figure 42 Importance of key sports on TV for Group 4 premium sports channel subscribers



Source; Ofcom sport conjoint research, April 2008

Base: Group 4 premium sports channel subscribers who watch sport at least once a week (329)

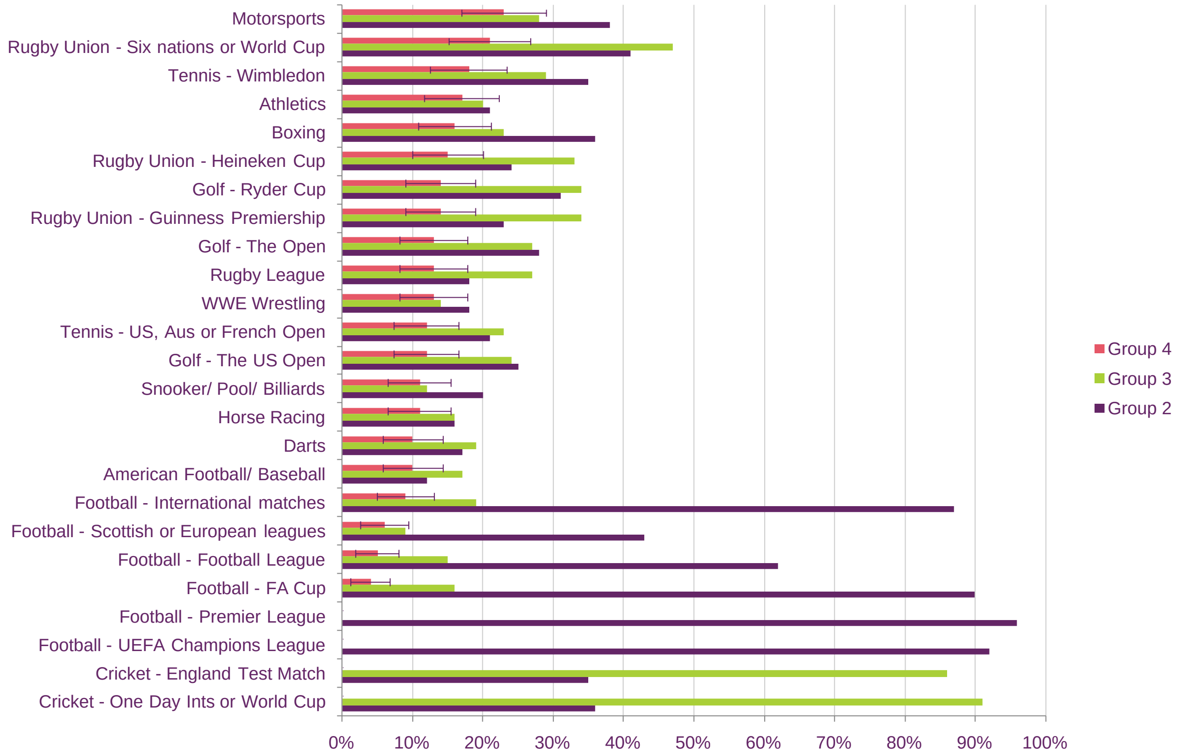
Note: Error bars show 99% confidence intervals

5.193 Figure 43 is an alternative way of presenting the data underlying Figure 40. It shows the proportion that consider each sport very important (i.e. a score of 6 or 7 out of 7)

[264] See paragraph 4.104 of our Third Pay TV Consultation.

for each of the groups that we have identified. Figure 43 illustrates the extent to which sports fans in the groups we have identified are in fact fans of more than one sport. For example, more than a third of football fans also see rugby union, motorsports, boxing, tennis and golf as important. Indeed, football fans typically attach more importance to other sports than subscribers who are not football fans.

Figure 43 Importance of key sports on TV by subscriber group (excluding infrequent viewers)



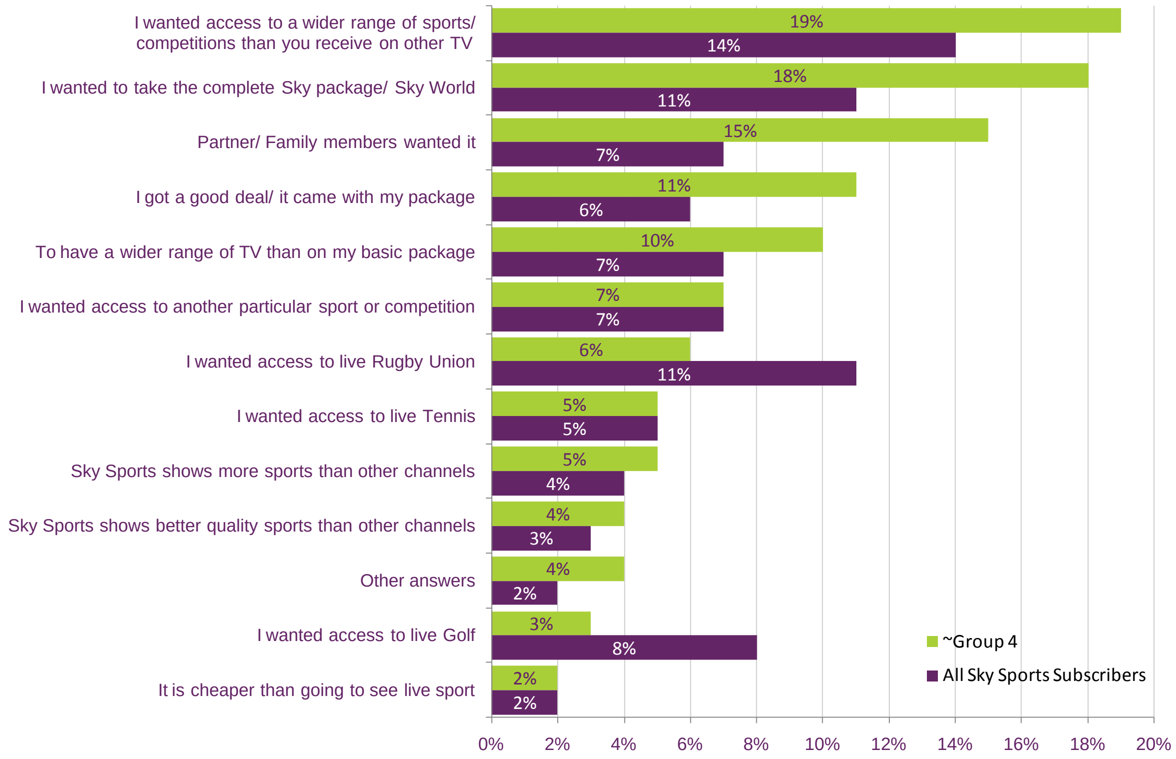
Source: Ofcom sport conjoint research, April 2008

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

Note: Error bars show 99% confidence intervals

5.194 Sky Sports subscribers in Group 4 buy Sky Sports for a variety of reasons (Figure 44). The most common reasons are that they wanted access to a wider range of sports/competitions than on other television channels, wanted to take the complete Sky package or that they got a deal, and that their partner or other family members wanted it.

Figure 44 Reason for subscribing to Sky Sports for Group 4* premium sports channels subscribers



Source: Ofcom willingness to pay omnibus research, fieldwork carried out in April-July 2008

Base: All adults aged 15+ who subscribe to Sky Sports and solely/jointly responsible for making purchasing decision regarding supplier for TV service (274)

*Note: *Group 4 defined here as Sky Sports subscribers who watch sport at least once a week and who neither wanted access to live football, nor wanted access to live cricket (124). This is a close match to the Group 4 definition that is based on how important subscribers thought these sports were.*

Premium sports channels

5.195 We begin by considering the following premium sports channels: Sky Sports 1, 2, 3 and 4, and ESPN.

Characteristics of Sky Sports 1

5.196 We now set out the characteristics of Sky Sports 1 from the perspective of the groups 2 to 4 that we identified above. We do not look at the characteristics of Sky Sports 1 from the perspective of Group 1, but we consider their preferences in our conclusion Section below (paragraph 5.333).

5.197 As illustrated in Figure 37 above, Sky Sports 1 broadcasts a range of valuable sports content including the following:

- Football: Premier League, Championship, FA Cup, Carling Cup.
- Golf: Ryder Cup, European PGA, US Open Golf.
- Cricket: One day internationals, England test match cricket, county cricket.

- Rugby union: Heineken Cup, Guinness Premiership.
- Rugby League: Super League.
- Tennis: US Open.

Group 2 ("football fans")

5.198 **Football** is the most important sport on Sky Sports 1 and on television, as reflected in the associated rights values[265]. In 2008 Sky Sports 1 showed just over half of all live televised Premier League games, a fifth of live televised FA Cup games, and a number of England internationals and Champions League games (Figure 37 above). It also showed the majority of Championship and Carling Cup matches.

5.199 By far the most important sport content on Sky Sports 1 is the Premier League. This is shown by the significantly higher rights value of the Premier League relative to other football events (Figure 45 below). The television rights of the Premier League were **[✂]** in 2008, which is **[✂]** of the total value of all football television rights.

Figure 45 Live football on pay TV channels and FTA TV channels in 2008 by rights value (rights value in brackets)

[✂]

Group 3 ("non-football fans who are cricket fans")

5.200 The total value of live **cricket** TV rights was about **[✂]**[266] in 2008. Sky schedules its cricket programming across its channels with about 60% on Sky Sports 1, 25% on Sky Sports 2 and a small amount on Sky Sports 3 and Sky Sports 4. However, around three quarters of viewing of Sky's cricket content was on Sky Sports 1[267]. In 2008 Sky Sports 1 showed three out of four England test matches, and around half of all England one-day internationals, ICC ODI Championship (non-England) matches and County Championship matches (Figure 37 above).

Group 4 ("non-football and non-cricket fans")

5.201 Several important **golf** events are broadcast on Sky Sports 1 including the Ryder Cup, most of the US Open and some of the European PGA[268].

5.202 In **rugby union**, Sky Sports 1 shows one in five Heineken Cup matches and around half of the Guinness Premiership matches.[268] The main **rugby league** content on Sky Sports 1 is Super League, of which about 40% is on the channel[268].

5.203 In **tennis**, Sky Sports 1: shows around one third of Master Cup Tennis matches and some US Open matches[268].

5.204 Overall, Sky Sports 1 includes a reasonably broad range of sports content which is generally likely to appeal to subscribers in this group. In addition, some of these

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[265] See Appendix 5 of Annex 6 in our Third Pay TV Consultation for details.

[266] See Appendix 3 of Annex 6 in our Third Pay TV Consultation for details.

[267] See paragraph 4.104 of our Third Pay TV Consultation.

[268] See Figure 37 above.

subscribers are likely to see the coverage of particular golf and rugby events on Sky Sports 1 as very important.

Whether other Sky Sports channels should be included in the market

5.205 Because Sky controls the wholesale price of all Sky Sports channels, and directly retails them to the large majority of subscribers, Sky Sports 2, 3 and 4 do not act as a competitive constraint on the supply of retail packages including Sky Sports 1 (indeed they are usually included in those packages). However, as in the Third Pay TV Consultation, we consider whether or not the other Sky Sports channels lie within the relevant market[269].

5.206 In the Third Pay TV Consultation we reached the view that Sky Sports 2 lay within the relevant market but Sky Sports 3 and 4 did not[270]. Below we set out consultation responses on this subject. We then set out some general statistics showing the relative attractiveness of these channels. Finally we consider each Sky Sports channel in turn.

Consultation responses in relation to Sky Sports 2, 3 and 4

5.207 None of the consultation responses we received suggested that Sky Sports 2 should not be included in the market.

5.208 Virgin Media said that Sky Sports 3 and 4 should be included within the relevant market[271]. This is for three main reasons.

5.209 First, Virgin Media considered that a retailer that did not have access to these channels would be placed at a significant competitive disadvantage[272]. **[✂]**[273].

- In the 2008/09 Champions League tournament Sky Sports 3 featured four matches (two featuring English teams) and Sky Sports 4 featured nine matches (five featuring English teams). Sky Sports 3 also features a number of international matches (albeit none involving England)[274]. **[✂]**[275].

- One of these channels has also featured a Premier League match of the final day of the season four times between 2005 and 2009[276].

[269] Third Pay TV Consultation, paragraphs 4.120-4.126.

[270] Third Pay TV Consultation, paragraph 4.209.

[271] Virgin Media response to Third Pay TV Consultation, paragraph 3.9. Virgin Media also considered that it would be profitable for a hypothetical monopolist to increase the price of Sky Sports 3 and 4 above the competitive level. Virgin Media response to Third Pay TV Consultation, paragraphs 3.17, 3.19.

[272] Virgin Media response to Third Pay TV Consultation, paragraph 3.21.

[273] **[✂]**

[274] Virgin Media response to Third Pay TV Consultation, Table 1.

[275] Virgin Media response to Third Pay TV Consultation, paragraph 3.24.

[276] Virgin Media response to Third Pay TV Consultation, paragraph 3.23.

- Sky Sports 3 broadcasts a significant proportion of certain golf and rugby tournaments[277]. Sky Sports 4 broadcasts a significant proportion of certain golf and tennis tournaments[278]. These channels also broadcast various other sports content including substantial amounts of "minor" sports such as motor sports and WWE wrestling[279].

5.210 Second, Virgin Media told us that our "*channel by channel*" approach fails to reflect the products consumers actually choose between (i.e. packages)[280].

5.211 Third, Virgin Media referred to our proposal in the Third Pay TV Consultation to include certain sports matches shown via the 'red button' within the scope of any wholesale must offer remedy[281]. Virgin Media asserted that this proposal was based on a concern that, without "complete coverage" of events that appear on Sky Sports 1 and 2 "a rival may not be able to compete effectively"[282]. Virgin Media considered that "corresponding issues" arise with Sky Sports 3 and 4[283].

5.212 The Three Parties, Virgin Media, **[✂]** and **[✂]** also considered that Sky Sports 3 and Sky Sports 4 are also within the relevant market for premium pay TV sports channels on the grounds that these channels should be included within the scope of any wholesale must offer remedy[284]. **[✂]**[285].

Our assessment

5.213 As noted above, Sky Sports 2, 3 and 4 do not act as a competitive constraint on Sky. However, as in our previous consultation we considered whether they should be included in the relevant market. In our view, the underlying question here is whether these channels add significantly to any market power Sky may have from its ownership of Sky Sports 1. We consider that they would only add significantly to Sky's market power if they offered sufficiently attractive content to be seen as substitutes to Sky Sports 1 by a significant number of subscribers. If they do, it is appropriate to include them in the market so they can be "counted" in the market share figures which we use as part of our assessment of Sky's market power.

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[277] Virgin Media response to Third Pay TV Consultation, paragraph 3.25(a).

[278] Virgin Media response to Third Pay TV Consultation, paragraph 3.25(b).

[279] Virgin Media response to Third Pay TV Consultation, paragraph 3.26-3.27 and Table 2.

[280] See paragraphs 3.9(a), 3.14 and 3.16 to 3.19 and 3.28 to 3.31 of Virgin Media's response to the Third Pay TV Consultation.

[281] Virgin Media response to Third Pay TV Consultation, paragraph 3.33.

[282] Virgin Media response to Third Pay TV Consultation, paragraph 3.34.

[283] Virgin Media response to Third Pay TV Consultation, paragraph 3.35.

[284] Joint Response to Ofcom's Third Pay TV Consultation by British Telecommunications Plc, Top Up TV Europe Limited, and Virgin Media Inc (September 2009), paragraph 3.4. This cross refers to Section 6 of that document which sets out various representations on the scope of the wholesale must offer remedy proposed in the Third Pay TV Consultation. Virgin Media response to Third Pay TV Consultation, paragraphs 3.9(c)-3.10, 3.36-3.48. **[✂]**.

[285] **[✂]**

5.214 In practice, it has not always been possible to distinguish between Sky's sports channels in all our measures of market shares, particularly since many people pay a single subscription for all four. However, we have done so where possible, namely in the allocation of rights values to different channels.

5.215 In assessing whether these channels are in the market, we consider it helpful to ask whether they are substitutes for Sky Sports 1 – i.e. whether they would be a competitive constraint on Sky Sports 1 if they were offered by another broadcaster. We have answered this hypothetical question in each case by considering the content supplied on each channel, and the popularity of this content to different types of subscriber, relative to the content on Sky Sports 1. We conclude, for the reasons set out below, that Sky Sports 2 should be included in the market but Sky Sports 3 and 4 should not.

5.216 Clearly all four channels have some similar characteristics in that they are all subscription channels dedicated to sports content. However, what makes Sky Sports 1, and to a lesser extent Sky Sports 2, special is the compelling nature of their content, so we consider that other channels should only be in the market if they also offer sports content which a substantial proportion of subscribers value highly (at a level that is comparable, if not equal, to Sky Sports 1).

5.217 As described above, respondents to our consultation have been particularly interested in whether Sky Sports 3 and 4 are included in the market definition. We recognise that this has implications for our remedy: if these channels add significantly to Sky's market power, there is a stronger case for adding them in the wholesale must-offer remedy. However, we note that inclusion of these channels in the market would not necessarily imply that they should be included in the remedy, or vice versa. The remedy is required to meet a different set of criteria – namely that it should be a proportionate response to our competition concerns, and that it should be expected to be effective.

5.218 Finally, the relevant question is not whether these channels give Sky any competitive advantage over competing packages which do not include them. We do not consider that this, in itself, justifies including these channels in the market (or the remedy), as many other channels and services offered by different pay TV providers offer a degree of competitive advantage. Again, the question is whether they *significantly* increase Sky's market power.

5.219 Figure 46 shows how often Sky Sports subscribers watch sport on various channels. Among Sky Sports channels (and overall) the most popular channel is Sky Sports 1, followed by 2, 3 and Xtra (now Sky Sports 4).[286] Sky Sports 3 and 4 are each watched frequently by at least half as many subscribers as Sky Sports 1.

5.220 Figure 47 shows the number of football matches featuring Premier League teams on various channels[287]. Sky Sports 1 is essentially the "home" of the Premier League,

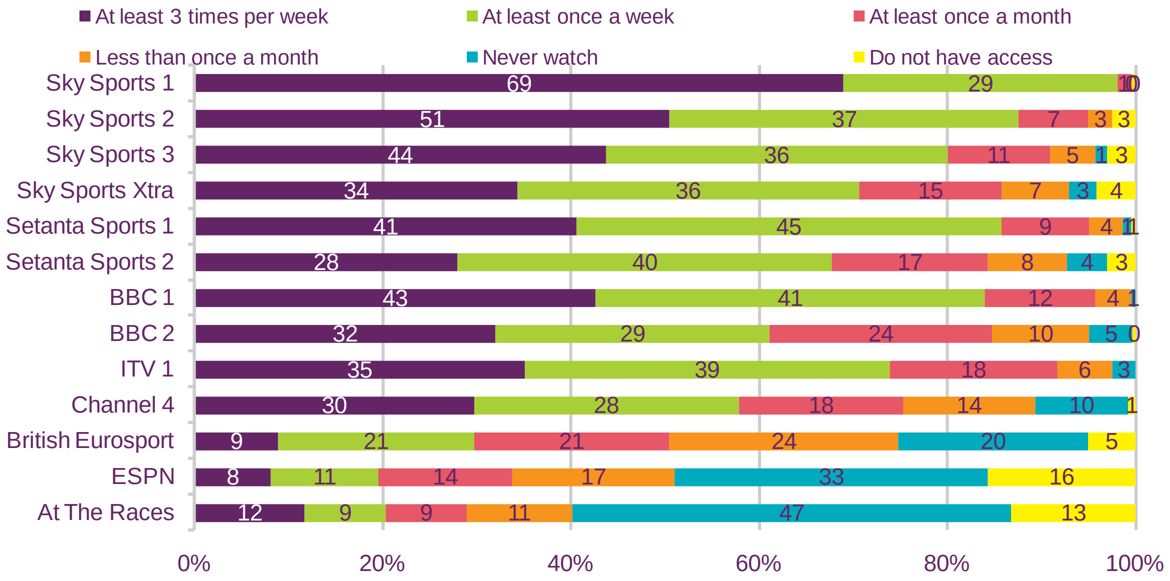
[286] The relative popularity of FTA channels is likely to reflect the fact that the question did not specify live sport, e.g. as opposed to highlights.

[287] For the 2007/08 season. In future seasons, there will be a greater number of matches on Sky Sports channels and fewer on other channels, because Sky has won the rights to an additional 23 live Premier League matches from the 2010/11 season onwards (these rights were held by Setanta in 2007/08), and also to additional Champions League from the 2009/10 season onwards (these matches were previously broadcast by ITV and will approximately halve the number of Champions League matches shown on FTA). For the 2006/07 to 2008/09 competitions, ITV had the first and second pick of the Champions League matches held on Tuesdays. Sky had the live rights to any

and Sky Sports 2 of the Champions League, for Sky Sports subscribers. Sky Sports 3 and 4 offer few occasions to watch Premier League teams.

5.221 Figure 48 shows the average audiences for Premier League and Champions League football, cricket, 'Super League' rugby league and tennis on the various Sky Sports channels. In contrast to Figure 46, it indicates that average audiences for these sports are in fact much lower on other Sky Sports channels – particularly Sky Sports 3 and 4 – than on Sky Sports 1. (One possible reason for this is that subscribers who watch other Sky Sports channels three or more times per week may watch Sky Sports 1 even more frequently, or for longer periods).

Figure 46 Frequency of watching sports by TV channel (all Sky Sports subscribers who watch weekly)



Q2 And how often do you watch sport on each of the following channels?

Base: All who subscribe to Sky Sports and watch sport at least once a week (n= 1735)

Source: Ofcom sports bundles conjoint survey, fieldwork carried out in April 2008. Repeated from September 2008 Consultation, Annex 10, Figure 13.

remaining Tuesday matches and all Wednesday matches. For the 2009/10 to 2011/12 Champions League competitions, Sky added to the number of live matches it will broadcast by winning the second pick Tuesday match from ITV.

Figure 47 Live football featuring Premier League teams (2007/08 season)

Competition	Total number of matches broadcast	Number of broadcast matches featuring PL teams	Number of matches featuring PL teams broadcasted on								
			FTA (all)	FTA (unique** occasions)	Sky Sports 1	Sky Sports 2	Sky Sports 3	Sky Sports 4	Sky Sports red button	Setanta Sports 1	Setanta Sports 2
PL	136	136	0	0	84	5	0	0	1	46	0
Champions League - qualifying	10	4	2	2	0	0	0	0	0	2	0
Champions League – post qualifying live matches*	125	43	22	12	2	13	1	3	4	0	0
FA Cup*	28	19	14	14	5	1	0	0	0	0	0
UEFA Cup	48	28	25	19	0	0	0	0	0	3	0
Carling Cup	15	13	0	0	7	6	0	0	0	0	0
Grand Total	**362**	**243**	**63**	**47**	**98**	**25**	**1**	**3**	**5**	**51**	**0**

Source: Ofcom analysis of TV schedules from TV Times and internet search

*Note: *The finals of these events are broadcast simultaneously on FTA and Pay TV.*

*** Two or more unique matches broadcast on FTA at the same time (but on different FTA channels count as one unique occasion. This also omits a small number of matches on Sky1.*

Underlying data appears to omit a small number of matches (e.g. in total there are 133 live Premier League matches per season, 92 of which are broadcast by Sky.

Figure 48 Average satellite audiences for key sports events on Sky channels in 2008 (000s)

	Average audience on Sky Sports 1	Average audience on Sky Sports 2	Average audience on Sky Sports 3	Average audience on Sky Sports 4
Premier League Football	686	480	None	None
Champions League	224	390	119	75
England Test Match Cricket	107	38	11	7
Super League rugby league	99	80	34	13
Tennis	164	13	10	15

Source: Ofcom analysis of BARB data.

Sky Sports 2

5.222 We have considered the attractiveness of packages including Sky Sports 2 from the perspective of each of the groups of consumers outlined above.

5.223 **Football fans** (Group 2): Sky Sports 2 broadcast five live Premier League matches in 2007/08. In addition to these highly attractive Premier League matches, Sky Sports 2 broadcast one third of live Champions League matches in 2008 (see Figure 37 above). Sky has acquired the rights to further Champions League and Premier League games which may be shown on Sky Sports 2 (or other channels).

5.224 **Cricket-but-not-football fans** (Group 3): Sky Sports 2 is the channel with the second largest amount of cricket on it (after Sky Sports 1) (see Figure 37). However the majority of England Test Matches are on Sky Sports 1 rather than Sky Sports 2. Moreover, the markedly lower average audience figures for Sky Sports 2 (38,000 compared to 107,000 on Sky Sports 1) suggests that the cricket matches on Sky Sports 2 are less attractive than those on Sky Sports 1 (see Figure 48).

5.225 **Other sports fans** (Group 4): Sky Sports 2 broadcasts more rugby union and tennis than Sky Sports 1 (see Figure 37). Moreover the Super League rugby league broadcast on Sky Sports 2 appears almost as attractive as that broadcast on Sky Sports 1 (a match on Sky Sports 2 attracts an average audience of 80,000 compared to 99,000 on Sky Sports 1) (Figure 48).

5.226 While Sky Sports 2 is less attractive than Sky Sports 1 overall, it nonetheless has reasonably attractive alternatives from the perspective of Groups 3 and 4. Moreover, from the perspective of Group 2 (by far the largest group) it features significant amounts of Champions League matches[288], supplemented by a small number of Premier League matches. Overall, Sky Sports 2 features an attractive combination of sports. As shown in Figure 41 above, 47% of premium sports channel subscribers that watch sports at least once a week like both football and at least one of the following sports: cricket, golf and rugby, which are also covered on Sky Sports 2.

5.227 We conclude that packages including Sky Sports 2 lie within the same market as packages including Sky Sports 1.

Sky Sports 3

5.228 It is not currently possible to purchase Sky Sports 3 except as part of a package containing Sky Sports 1. In other words, Sky Sports 3 is only available in packages that include our focal product.[289] However, Sky could decide to make this channel available separately, so we have considered whether a (hypothetical) package including Sky Sports 3 (but not Sky Sports 1) would be in the same market as packages that include Sky Sports 1 or 2, again from the perspective of different consumer groups.

5.229 **Football fans** (Group 2): very few Premier League and Champions League matches are shown on Sky Sports 3. Sky Sports 1 featured 98 opportunities to watch football involving Premier League teams in 2008, while Sky Sports 3 offered only a single opportunity to do so (see Figure 47 above).

5.230 Virgin Media also pointed to the small amount of international matches on Sky Sports 3 (two in 2006, four in 2007, two in 2008 and one in 2009). We do not consider that these represent an attractive alternative to the football broadcast on Sky Sports 1 from the perspective of Group 2. First, there are only a small number of games.

[288] Similar numbers of regular sports viewers that subscribe to premium sports channels regard Premier League matches and Champions League matches as very important: 75% and 72% respectively – see Figure 40.

[289] We recognised this in paragraph 4.124 of the Third Pay TV Consultation, where we stated that we cannot observe the notional ‘price’ that consumers pay when they access Sky Sports 3 within their Sky Sports bundle.

Second, those games are likely to be comparatively unattractive to UK viewers[290] as none of them featured England[291].

5.231 **Cricket-but-not-football fans** (Group 3): Sky Sports 3 features some cricket, but markedly less than Sky Sports 1 and 2 (see Figure 37). Moreover the cricket broadcast on Sky Sports 3 is comparatively unattractive, as shown by its much lower average audience (11,000 on Sky Sports 3 compared to 107,000 on Sky Sports 1 and 38,000 on Sky Sports 2).

5.232 **Other sports fans** (Group 4): Sky Sports 3 contains just under a third of Sky's Super League rugby league coverage (see Figure 37)[292]. However, as in the case of cricket, audience figures suggest that these matches are comparatively unattractive (see Figure 48).

5.233 Sky Sports 3 broadcasts a significant amount of tennis and golf coverage. We recognised in the Third Pay TV Consultation that it is possible that golf fans would consider Sky Sports 3 a substitute for content on Sky Sports 1, but observed that only 1% of Sky Sports subscribers highly value golf but do not value football[293].

5.234 In response Virgin Media stated that "Whilst this [1% figure] may be relevant in assessing whether subscribers would choose Sky Sports 3 and [4] as substitutes for Sky Sports 1, it is not relevant in assessing whether subscribers would choose a package including Sky Sports 3 and [4] (as well as Sky Sports 1 and 2) in preference to a package that did not include these channels"[294].

5.235 As discussed above, we consider that the key question is whether these other sports channels add significantly to Sky's market power, not whether they confer competitive advantage by making Sky's offer marginally more attractive. We consider that they would only add significantly to Sky's market power if they offered sufficiently attractive content to be seen as a substitute to Sky Sports 1 by a significant number of subscribers.

5.236 A number of respondents argued that Sky Sports 3 should be included within the relevant market because it should be included in our proposed wholesale must offer, for example to prevent "gaming" of any remedy. As discussed above, our view is that market definition and determining the scope of the wholesale must-offer are separate questions.

5.237 Respondents argued that, in the Third Pay TV Consultation, there was an inconsistency in our treatment of Sky Sports 3 as compared to primary interactive material (additional videostreams showing sports matches that are part of events

[290] **[✂]**

[291] There was a single match featuring Scotland (against Georgia in 2007), two featuring Wales (against San Marino and the Republic of Ireland, both in 2007) and two featuring Northern Ireland (against San Marino and Slovenia, in 2008 and 2009 respectively). Virgin Media response to Third Pay TV Consultation, Table 1.

[292] Virgin Media specifically referred to this Super League coverage in Virgin Media response to Third Pay TV Consultation, paragraph 3.25(a).

[293] Third Pay TV Consultation, paragraph 4.123.

[294] Virgin Media response to Third Pay TV Consultation, paragraph 3.28.

shown on Sky Sports 1 and Sky Sports 2). As explained in Section 9 of this document, our reasons for considering the inclusion of interactive services in a wholesale must-offer related to the potential risk of gaming, which we consider to be higher for interactive services than for Sky Sports 3 and 4.

5.238 **[✂]**[295]. **[✂]**[296]. **[✂]**[297]. Furthermore, the survey asked whether the sports were essential, but not whether their coverage on Sky Sports 3 and 4 was essential. As such, we do not consider that this survey demonstrates that these channels should be included in the market.

5.239 In conclusion, we consider that bundles including Sky Sports 3 would be a poor substitute for bundles including Sky Sports 1 from the perspective of most customers in each of groups 2, 3 and 4, and this channel does not add substantially to any market power Sky Sports 1 may have.

Sky Sports 4

5.240 While Sky Sports 4 is available separately at the wholesale level, consumers generally acquire it as part of retail bundles that also contain Sky Sports 1 and 2. Accordingly, as noted in paragraph 4.125 of the Third Pay TV Consultation, we cannot observe the notional ‘price’ that these consumers pay when they access the channel. When analysing Sky Sports 4 we have adopted the same approach as in the case of Sky Sports 3. We have considered whether a package including Sky Sports 4 (but not Sky Sports 1) would be a substitute for Sky Sports 1.

5.241 **Football fans** (Group 2): there is relatively little football broadcast on Sky Sports 4 (14% of Champions League coverage in 2008 and no Premier League matches – see Figure 37).

5.242 **Cricket-but-not-football fans** (Group 3): Sky Sports 4 features a small amount of cricket, markedly less than Sky Sports 1 and 2 (see Figure 37). Moreover the cricket broadcast on Sky Sports 4 is comparatively unattractive, as shown by its much lower average audience (just 7,000 on Sky Sports 4 compared to 107,000 on Sky Sports 1 and 38,000 on Sky Sports 2). We thus consider that Sky Sports 4 is a poor substitute for Sky Sports 1 from the perspective of group 3.

5.243 **Other sports fans** (Group 4): Sky Sports 4 contains very little rugby league and rugby union, a small amount of golf, namely European PGA events, a small amount of European Tour coverage and events from the World Golf Championships. Sky Sports 4 shows most of Sky’s tennis coverage. It shows about 71% of the major tennis tournaments shown on Sky channels and attracts about 52% of Sky’s total audience for tennis[298]. We recognised in the Third Pay TV Consultation that it is possible that tennis fans would consider Sky Sports 4 to be attractive but observed that only 1% of Sky Sports subscribers highly value only tennis[299].

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[295] **[✂]**

[296] **[✂]**

[297] **[✂]**

[298] Third Pay TV Consultation, paragraph 4.125.

[299] Third Pay TV Consultation, paragraph 4.127.

5.244 We received a number of representations arguing that both Sky Sports 3 and 4 should lie within the relevant market. We addressed these in paragraphs 5.234 to 5.238 above in the context of Sky Sports 3.

Conclusion on substitutability with other Sky Sports channels

5.245 In summary, we consider that Sky Sports 2 contains sufficiently attractive content to add materially to any market power Sky may have from its ownership of Sky Sports 1. Therefore packages that include Sky Sports 1 and/or Sky Sports 2 should be included in the market.

5.246 Sky Sports 2 is a substantially less attractive channel than Sky Sports 1 – particularly in view of its limited Premier League coverage, and as reflected in its lower audiences for key cricket and tennis events. However, if, hypothetically, Sky Sports 1 and 2 were provided by two independent firms, we consider that bundles including Sky Sports 2 would offer a degree of competitive constraint to bundles that include Sky Sports 1.

5.247 Sky Sports 3 shows very few Premier League and Champions League matches, markedly less cricket than Sky Sports 1 and 2, and comparatively unattractive rugby league matches. Sky Sports 4 shows relatively little football, cricket and rugby league and, if offered without other Sky Sports channels, its appeal would be limited to the small number of Sky Sports subscribers who are fans of tennis but not of other sports.

5.248 We conclude that Sky Sports 3 and 4 do not add materially to any market power from Sky Sports 1 (and 2). Were packages available that included Sky Sports 3 or 4 (but not Sky Sports 1 or 2) then they would be at best a very limited competitive constraint on packages which included Sky Sports 1 or 2. We conclude that such packages would not be included in the market. However, we note that the most popular packages include Sky Sports 3 and 4 along with Sky Sports 1 and 2, and these packages are in the market because they include Sky Sports 1 and 2. As such, our view that Sky Sports 3 and 4 are not in the market does not affect our market share calculations, either at the wholesale or retail level.

5.249 Next we analyse the following potential substitutes in turn: (i) packages including ESPN, (ii) sports broadcast on FTA and (iii) Eurosport. Although this analysis is presented sequentially (for clarity) we agree with Sky that it is the aggregate constraint exerted by all potential substitutes that is important.

Substitutability of (packages including) ESPN

5.250 ESPN was not available in its current form at the time the Third Pay TV Consultation was published. However ESPN has acquired the rights to broadcast a number of the events previously shown on the Setanta Sports suite of channels. In the Third Pay TV Consultation we included Setanta Sports 1 within the relevant market.

5.251 ESPN is the only non-Sky channel that broadcasts live Premier League matches and, in the 2009/10 season, ESPN will show 46 matches. From the 2010/11 season onwards it will broadcast 23 matches per season[300] . ESPN also broadcasts some

[300] It is not yet clear what other content the channel will include instead of the Premier League matches. Although ESPN falls within the relevant market at the time of publication, it may be that in future we would come to a different conclusion.

FA Cup, Europa League and Scottish Premier League matches. ESPN is likely to be a reasonably close substitute for Sky Sports 1 from the perspective of football fans (Group 2) (although ESPN's content is less attractive than Sky Sports 1, which is reflected in the fact that it commands a lower price and attracts fewer subscribers, leading to a considerably smaller market share than Sky Sports 1).

5.252 As described above, 72% of Sky Sports subscribers are football fans, and Premier League matches are particularly important to football fans. Since ESPN is likely to be a reasonably attractive alternative to Sky Sports for these subscribers, we conclude that it should be included in the market.

FTA sports

Consultation responses

5.253 Sky said that it faces strong competition from the combined strength of FTA broadcasters, and a vast range of high quality programming was available free[301],[302]. It said that, in total, the public service broadcasters spend over £3bn per annum on creating and acquiring programmes for their channels, including £2bn expenditure by the BBC[303]. In comparison, it said UK pay TV broadcasters spend less than £1.8bn per annum on programming, the majority of which is attributable to a narrow range of rights (live Premier League football and movies)[304].

5.254 Sky referred to an earlier submission in which it highlighted the range and regularity of sports and non-sports FTA content, including listed events[305]. Sky provided a lengthy list of the range of sports available on FTA channels throughout the year[306]. Sky said that non-sports programming was less likely to be a substitute for live sports, at least for infra-marginal consumers[307], but emphasised the importance of focusing on the preferences of marginal consumers[308].

5.255 Sky drew our attention to ITV's submission to the CC, made in the context of the CC's BSkyB / ITV merger inquiry, in which ITV discussed the strength of competition between ITV and Sky and attributed a number of innovations and prices changes by Sky to the competitive constraint exerted by FTA broadcasters[309].

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[301] Sky response to Third Pay TV Consultation, paragraphs 5.25, 5.32; also October 2009 Sky Submission, paragraph 42.

[302] Sky claimed that its view accords with Ofcom's position in the Third Pay TV Consultation, paragraphs 3.9-3.10 (Sky response to Third Pay TV Consultation, paragraph 5.26).

[303] Sky response to Third Pay TV Consultation, paragraph 5.27; also October 2009 Sky Submission, paragraph 42.

[304] October 2009 Sky Submission, paragraph 43.

[305] Sky response to First Pay TV Consultation, annex 2, paragraphs 3.18-3.22.

[306] October 2009 Sky Submission, table 2.

[307] Sky response to Third Pay TV Consultation, paragraph 5.31.

[308] Sky response to Third Pay TV Consultation, paragraph 5.32.

[309] Sky response to Third Pay TV Consultation, paragraph 5.59. In addition Sky advanced various arguments about the relevance of the CC's findings. These are considered in Annex 4, Appendix 6.

5.256 Sky also said that the study by Professor Seabright which it had submitted provided compelling evidence on the competitive constraint that the availability of FTA TV placed on retail of pay TV services[310] .

5.257 The Premier League said that the Third Pay TV Consultation wrongly excluded FTA content from the relevant market[311]. It argued that FTA channels, like Sky Sports 1, offered a large volume of regular, highly valued sporting content[312]. The Premier League provided a lengthy list of sports broadcast on FTA channels[313]. For the particular sports broadcast on Sky Sports, the Premier League provided examples of other events that are broadcast on FTA channels[314]. Moreover the Premier League said that Ofcom failed to consider other sports (such as Formula One motor racing and horseracing) that are broadcast on FTA channels but not on Sky Sports[315].

5.258 The Premier League said that it was "skewed" only to analyse sports which were broadcast on Sky Sports, given the limited number of events in each sport's calendar. If Sky acquired the rights in respect of some events then there would necessarily be fewer events available on other channels. Rather the Premier League considered that Ofcom should have considered all sports broadcast on TV[316].

5.259 The Premier League said that we presented no evidence or explanation to explain why irregular, high quality events (e.g. Wimbledon, rugby union Six Nations) are not substitutes for content broadcast on Sky Sports[317]. The Premier League referred to Figure 10 in the Third Pay TV Consultation that reported survey results in which significant numbers of consumers identified irregular sporting events as being important[318]. The Premier League said that the Third Pay TV Consultation was inconsistent in that it referred to one-off sporting events on Sky Sports (e.g. the US Open tennis) but did not include equivalent events on FTA channels (e.g. Wimbledon)[319].

5.260 Virgin Media agreed with the position in the Third Pay TV Consultation that FTA broadcasts are unlikely to be a sufficient constraint on packages including Sky Sports[320].

[310] Sky response to Third Pay TV Consultation, paragraph 5.54.

[311] Premier League response to Third Pay TV Consultation, paragraphs 5.39-5.40.

[312] Premier League response to Third Pay TV Consultation, paragraph 5.19, 5.38.

[313] Premier League response to Third Pay TV Consultation, Annex 1.

[314] Premier League response to Third Pay TV Consultation, paragraphs 5.20, 5.22.

[315] Premier League response to Third Pay TV Consultation, paragraphs 5.21, 5.31, 5.34.

[316] Premier League response to Third Pay TV Consultation, paragraph 5.35.

[317] Premier League response to Third Pay TV Consultation, paragraphs 5.29-5.30.

[318] Premier League response to Third Pay TV Consultation, paragraph 5.30.

[319] Premier League response to Third Pay TV Consultation, paragraph 5.32.

[320] Virgin Media response to Third Pay TV Consultation, paragraph 3.6(b).

Our current view

5.261 We address Sky and the Premier League's arguments about the relevance of the CC's BSkyB / ITV merger inquiry in Appendix 6 of Annex 4. As explained in that appendix, the CC was assessing the likely impact of a merger between Sky and ITV. As such, its analysis was not focused around premium pay TV channels. Furthermore, while assessing the likely effect of a merger, it is generally appropriate to take current prices as competitive prices. However, when assessing competition outside the context of a merger, this approach raises the Cellophane Fallacy issue. In conclusion, we do not consider that the CC's findings are relevant in the context of this investigation.

5.262 We consider the Seabright Study in paragraphs 5.306 to 5.322 below.

5.263 One of the key distinctions between pay TV and FTA is that live football is shown more regularly on the Sky Sports channels (in aggregate) than on FTA channels.

5.264 Figure 49 below illustrates how the most expensive sports rights are divided between FTA and pay TV channels. This shows that Premier League is by far the most important sport: the value of Premier League rights exceed those of all other football contests combined.

Figure 49 Top sports on pay TV channels or FTA TV channels by annual rights value in 2008 (where rights value exceeds £5 million per year)

[✂]

5.265 As explained above, Sky Sports subscribers generally have strong preferences for specific sports, and for specific competitions and leagues within these sports, coverage of which is exclusive to Sky Sports 1. We therefore consider that coverage of sports not shown on these channels (e.g. Formula 1) is unlikely to have substantial competitive impact. We have thus focussed on the constraint exerted by FTA coverage of the main sports broadcast on Sky Sports 1 (football, rugby union, rugby league, cricket, golf and tennis) (the "**Main Sports**").

Football fans

5.266 FTA broadcasts some live top flight football, albeit no live Premier League. FTA TV also shows some important football content such as FA Cup (of which the final is listed), UEFA Champions League and UEFA Cup matches. However overall, we consider that football coverage on FTA is significantly less attractive for the following reasons:

- As shown in Figure 49 above, the value of the amounts paid by FTA broadcasters for live football rights is markedly less than the amounts paid by Sky, reflecting the relative quality and quantity of matches. Specifically, in 2008 Sky paid **[✂]** for the rights to football matches whereas FTA broadcasters paid a total of just **[✂]**.[321] The BBC "Strategic Review" of March 2010 proposed that the BBC would cap the amount it spends on sports rights at 9% of its license fee income (p. 57) and that the volume of sport broadcast on BBC2 would be reduced.

[321] **[✂]**

- A much larger number of matches featuring Premier League teams are broadcast on Sky Sports 1 (a total of 98). A further 25 are shown on Sky Sports 2. 47 such games were shown by FTA broadcasters. In March 2008, Sky won the rights to an increased number of Champions League matches[322] and as mentioned above, from the 2010/11 season onwards Sky will also broadcast an additional 23 Premier League matches. We therefore expect the disparity between matches featuring Premier League teams on Sky Sports 1 and 2, and FTA to increase.

- No live Premier League matches at all are available from FTA broadcasters.

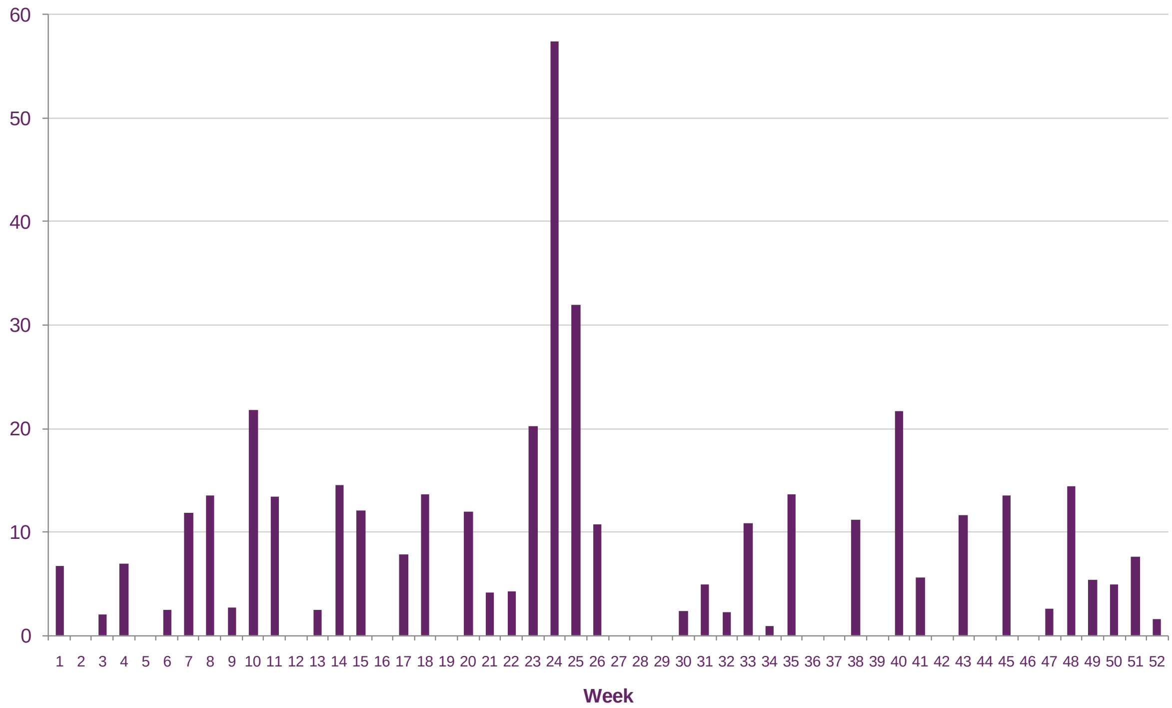
- Matches are broadcast much more regularly on Sky Sports 1 and 2 than on FTA channels. This reflects the regularity of matches that the Premier League tournament in particular provides. Figure 50 and Figure 51 below set out the hours of football per week on FTA channels and on the Sky Sports channels in 2008[323]. (The Euro 2008 international tournament was held in June and broadcast FTA.)

- While European Football Championship and World Cup matches are highly attractive, and are broadcast FTA, these competitions are only held every four years. We consider that this is too infrequent for FTA broadcasters to provide an effective alternative to Sky Sports.

[322] For the 2006/07 to 2008/09 competitions, ITV had the first and second pick of the Champions League matches held on Tuesdays. Sky had the live rights to any remaining Tuesday matches and all Wednesday matches. For the 2009/10 to 2011/12 Champions League competitions, Sky added to the number of live matches it will broadcast by winning the second pick Tuesday match from ITV.

[323] The tournaments that are included are the Premier League, Champions League, the UEFA Cup, the Championship, the FA Cup, the Carling Cup and Euro 2008 as well as England internationals.

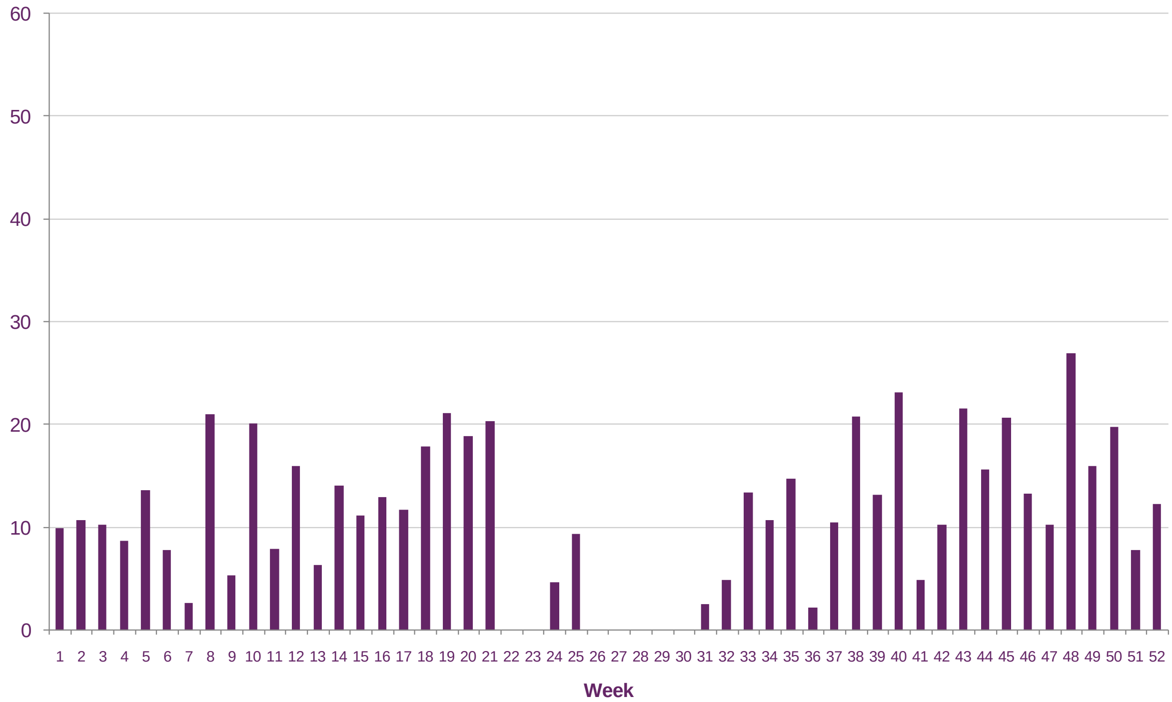
Figure 50 Hours of football per week on FTA channels in 2008



Source: Ofcom analysis of BARB data.

Note: The high density of coverage in June 2008 related to the European Championships.

Figure 51 Hours of football per week on all Sky Sports channels in 2008



Source: Ofcom analysis of BARB data.

5.267 We thus consider that FTA sport content is markedly inferior to that of Sky Sports for football fans. This is further demonstrated by the fact that, despite this content being available free, many households pay a substantial premium to view Sky Sports. Accordingly, from the perspective of this group of Sky Sports subscribers, FTA sport is not a close substitute.

Cricket-but-not-football fans

5.268 Live cricket is only available on the Sky Sports channels. We consider that FTA is not a close substitute from the perspective of Group 3 Sky Sports subscribers.

Other sports fans

5.269 Aside from football and cricket, FTA channels broadcast a range of sports, including:

- Rugby union: approximately three quarters of England international matches were broadcast FTA in 2008 (see Figure 37 above) as well as a considerable number of Welsh, Scottish and Northern Irish international matches. In particular, the highly popular but brief (scheduled over five weekends each year) Six Nations tournament is broadcast by the BBC, and Magners League rugby and the EDF Energy Cup are also broadcast FTA. The RFU told us that the BBC has contracted to broadcast far more rugby union internationals and that the vast majority of rugby union viewed in Great Britain is on free to air television[324].

- Rugby league: FTA TV broadcasts the Challenge Cup, of which the final is listed.

- Golf: FTA channels broadcast some important golf content such as the European PGA, European Tour golf, the Open and the US Masters.

- Tennis: FTA channels exclusively broadcast Wimbledon (of which the finals are listed), and the Stella Artois tournament, and non-exclusively broadcast Davis Cup and a small number of French and Australian Open matches.

5.270 In addition, FTA broadcasts a range of other sports such as athletics and Formula One motor racing.

5.271 We consider that FTA sports content may be a closer substitute for fans of certain sports other than football and cricket – in particular, rugby union, rugby league, golf and tennis. We return to the issue of whether material numbers of Group 1 and Group 4 subscribers would switch away from Sky Sports in response to a SSNIP in paragraphs 5.283 to 5.289 below as part of our assessment of the aggregate constraint facing Sky.

Conclusion on FTA sports

5.272 FTA sports is a poor substitute for football and cricket fans, but may be a closer substitute for other fans – those of golf, rugby league, rugby union and tennis, or those who do not have a strong preference for specific sports. Overall, we do not consider that FTA is a close substitute for Sky Sports 1.

[324] The RFU stated that the Scottish Rugby Union, Irish Rugby Union and Welsh Rugby Union have current agreements that provide that all Scotland's, Ireland's and Wales' Autumn International test matches (in addition to the Six Nations) are on free to air television. This means that the vast majority of domestic rugby union internationals in the UK are on FTA television. Source: RFU response to Third Pay TV Consultation, paragraphs 16-19.

5.273 However, we have considered, in our discussion of market power, whether including FTA sports in the market would change our conclusions.

Other potential substitutes

Live sport on basic pay TV channels (Eurosport and Sky1)

5.274 Live sport is shown on channels included within some basic pay TV packages. We specifically consider Eurosport and Sky1 as potential substitutes.

- In 2008 Eurosport had rights to games in a number of tennis tournaments, including the US Open, ATP, WTA Tour, the French Open, and the Australian Open. It also had the rights to some European PGA Golf.

- In 2008 Sky1 broadcasted one Champions League match and one UEFA Cup match.

- As these channels are included in packages of basic pay TV channels, they are clearly less expensive than packages including Sky Sports 1.

5.275 For football fans, live sport on basic pay TV channels is a poor substitute. Eurosport does not broadcast football including English teams and Sky1 only broadcast two major matches in 2008.

5.276 There is no live cricket on Eurosport or Sky1, and so these channels are not a substitute for cricket fans.

5.277 For other sports fans, there is some attractive live sport on basic pay TV channels. Eurosport broadcasts some of the US, Australian and French Open Tennis tournaments. Around 12% of Sky Sports subscribers who are not football or cricket fans consider these tournaments to be very important.

5.278 Overall, looking at all consumer groups in aggregate, we consider live sport on basic pay TV channels to be at best a distant substitute to Sky Sports 1.

Other ways of seeing live sports

5.279 Sky also highlighted a number of other ways in which consumers could access sports content[325]:

- Accessing live sports content via sports channels broadcast in pubs, watching sports channels at a friend's house, listening to the radio; and

- Accessing non-live sports content such as delayed coverage (e.g. delayed Premier League coverage available from BT Vision, football club websites and football club's own channels) or highlights programmes.

5.280 Sky argued that:

> "It seems probable that marginal consumers are those who have a moderate interest in sport, and can be attracted to subscribe to a service that includes premium sports channels if it offers good value for money;

[325] Sky response to Third Pay TV Consultation, paragraph 5.32.

otherwise they are content to rely on the rich array of sports programming available to them for free to fulfil their demand for such programming"[326].

5.281 Sky did not offer any evidence for this assertion. Packages including Sky Sports 1 are sold at a considerable premium. As such, subscribers – both marginal and infra-marginal – evidently place a high value on the content it offers,[327] notwithstanding the alternatives which are available to them elsewhere. While we would expect marginal customers to be attracted to a premium sports service only if it offered good value for money, we would expect that to be true of all customers.

5.282 We note, as described in paragraph 5.157, that sports fans who do not subscribe to Sky Sports mainly say that this is because it is too expensive – very few cite alternative means of viewing sports. This appears to contradict Sky's view that such sports fans are "content" with free sports programming.

Conclusion on potential substitutes

5.283 Sky said that in our Third Pay TV Consultation we failed adequately to consider the aggregate constraint imposed by live sports programming on FTA and basic pay TV channels (October 2009 Sky Submission, paragraph 37).

5.284 In the Third Pay TV Consultation we recognised that FTA TV broadcasts important football, golf, rugby union, and rugby league content. However we stated that FTA cannot match the regularity and quantity of sport found on Sky Sports 1, 2 or Setanta Sports 1[328].

5.285 From the perspective of football and cricket fans (who make up three quarters of Sky Sports subscribers) other services are unlikely to be close substitutes for packages including Sky Sports 1 because they lack sufficient volume and regularity of high quality live football and cricket coverage. FTA TV cannot match the regularity and quantity of these sports broadcast on Sky Sports 1.

5.286 For other sports fans the position is more balanced. The golf, rugby union, rugby league and tennis content on other channels appears broadly comparable in quality and volume to that on Sky Sports. Whether this content on other channels is an effective substitute for that on packages including Sky Sports 1 depends on the nature of demand by Group 4 subscribers. They may have strong preferences for specific sporting leagues or competitions within their preferred sports (in which case the leagues/competitions covered elsewhere may not be seen as close substitutes for Sky). Alternatively they may wish to see as much coverage of their preferred sports as possible (in which case leagues/competitions covered elsewhere may be

[326] Sky response to Third Pay TV Consultation, paragraph 5.33.

[327] At least this is the case for those who buy sports as a standalone, or who buy sports and movies but are primarily interested in sports. Those who are primarily interested in movies, or interested in both to a similar degree, may see sports as a relatively cheap add-on. While some of this latter group may be less interested in sports than primary sports subscribers, they also pay a lower incremental price for sports (in that if they dropped sports they would still subscribe to movies, and so make only a limited saving). As such they are not necessarily more likely to be marginal consumers.

[328] Third Pay TV Consultation, paragraph 4.134.

seen as complementary[329] to those on Sky rather than as substitutes). Or they may simply wish to view a certain amount of the sport and consider FTA as a substitute.

5.287 Figure 42 indicates that Group 4 subscribers were in fact less likely than average to have mentioned access to rugby union or golf as reasons for subscribing to Sky Sports: rather, most viewers of these sports are also football fans. The most common reasons given by Group 4 subscribers related to wanting a range of sports coverage, or TV more generally, or because a partner or family member wanted Sky Sports.

5.288 On this basis, a subset of the 16% of subscribers who make up Group 4 can be described as viewers who are not football or cricket fans, who are not subscribing to Sky Sports in order to watch another specific sport, and who do not have any family members with a strong demand for Sky Sports. This is not to say that packages including Sky Sports 1 are not differentiated from the perspective of these viewers, as they are still paying a substantial premium for it. However, in terms of the specific characteristics which they value, this group, and those who are infrequent viewers, may see packages including Sky Sports 1 as less highly differentiated than other subscriber groups.

5.289 As discussed in paragraph 5.43, whether a subscriber is marginal or not depends on a range of factors, including the current price. If, as Sky asserts, members of this group were disproportionately likely to be marginal subscribers, the impact of their switching would be limited by the size of the group (a subset of 16% of subscribers). Even if, for example, 25% of subscribers in this category would switch in response to a 5% price rise (implying a very high level of price sensitivity), they would account for only 4% of total subscribers, which would not in itself be enough to prevent such a price increase from being profitable.

Other evidence

<u>Stated response to a SSNIP</u>

5.290 In order to assess the likely indirect constraint that consumers place on wholesalers of premium channels we have considered their likely response to a price rise. High levels of switching to other products in response to relatively small increases in prices from competitive levels could indicate that the products were in a broad market. Conversely, low switching could be evidence of narrow markets. However, as we have explained previously, where prices are above competitive levels we would expect to observe a higher level of switching in response to a price rise, and in this case high switching could be consistent with narrow markets.

5.291 In our First Pay TV Consultation we reported our survey evidence (the "**2007 Ofcom Survey**") on consumers' stated response to hypothetical price rises of the premium sports channel element of a consumer's bundle (i.e. Sky Sports Mix)[330]. The evidence suggested that although large numbers of subscribers might switch or change their subscription in response to a price rise, many chose to keep the sports element of the package. We stated that such responses might be subject to 'stated preference bias', so they should be interpreted with caution. The relatively small samples in Ofcom's willingness to pay survey (40 for Movies Mix only, 147 for Sports Mix only and 95 for Sports and Movies Mix) means that the confidence intervals

[329] This term has a specific economic meaning which is not intended here.

[330] First Pay TV Consultation, paragraph 5.31.

around the estimates of elasticity are wide and the results are sensitive to changes in assumptions used.

5.292 In response to our First Pay TV Consultation, Sky presented results of a study it commissioned on the **[✂]**[331] **[✂]**[332]. Sky claimed **[✂]**[333].

5.293 We presented elasticity estimates derived from this study that suggested that it would be profitable for Sky to increase prices (Third Pay TV Consultation, Figure 17 and 24). The results of Sky's conjoint study suggested that both a wholesale and a retail price rise for Sky Sports and Movies Mix and Sky Sports packages would be likely to be profitable. Sky's conjoint estimate continued to point to narrow wholesale and retail markets.

5.294 Our view was that this additional evidence was less likely to be subject to stated preference bias, although our concerns about whether we had assessed a price rise from competitive levels remained. Nonetheless, the evidence from Sky's Conjoint Study and from the central estimates of our own willingness to pay survey suggested that a SSNIP on Sky's wholesale channels could indeed be profitable.

5.295 The conclusion we reached in our Third Pay TV Consultation was that we interpret evidence on consumer price elasticity with caution[334]. This is because we would expect any profit maximising firm to price up to the point at which a further price increase is just unprofitable.

Sky's response to the Third Pay TV Consultation

5.296 Sky criticised the elasticity estimates used in the Third Pay TV Consultation[335], and said that our rejection of our own consumer research analysis presented in the First Pay TV Consultation was selective[336].

5.297 Sky said that the data we used from **[✂]**, was not reliable for the purpose of a SSNIP test[337]. Sky said the fact that **[✂]** was further evidence that this study was unreliable[338].

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[331] Conjoint analysis asks respondents to choose between a series of products with different sets of features. The trade-offs made are analysed to assess the relative importance of each of the different features.

[332] See Annex 6, Appendix 4, Second Pay TV Consultation for details. Sky conjoint: **[✂]** supplied to Ofcom by Sky in July 2007.

[333] Sky response to Ofcom's First Pay TV Consultation, Annex 2, paragraph 2.17.

[334] See paragraph 4.142 of our Third Pay TV Consultation.

[335] October 2009 Sky Submission, paragraph 64.

[336] See paragraph 5.46 of Sky's main response to the Third Pay TV Consultation.

[337] See paragraph 5.47 of Sky response to Third Pay TV Consultation and paragraphs 64, A1.9, A1.10 and A1.22 to A1.28 of October 2009 Sky Submission.

[338] October 2009 Sky Submission, paragraphs A1.4 , A1.27-A1.28.

5.298 Accordingly, Sky commissioned Human Capital and KAE to undertake consumer research (the “2009 Sky Survey”)[339], which found higher levels of switching than the 2007 Ofcom survey and **[✂]**[340].

Ofcom’s conclusion on stated response to a SSNIP

5.299 The results of the 2009 Sky Survey suggest that, at current prices, further price rises may be unprofitable[341]. However there are a number of limitations to this analysis.

5.300 Most importantly, we would expect true consumer preferences to be such that further price rises would always be unprofitable. This is because Sky is the only supplier of the focal product, and we would expect it to be setting prices such that a further price rise would be unprofitable[342]. In these circumstances, consumer research is unlikely to be informative as to the market boundaries.

5.301 Moreover, as set out in paragraph 5.114, we consider that current retail prices are above the competitive level, which increases consumers’ sensitivity to further price rises (i.e. the cellophane fallacy).

5.302 In addition, in previous consultations we identified the risk of “stated preference bias”[343] i.e. the tendency of survey respondents to exaggerate their willingness to switch in response to a price rise[344]. In connection with a separate issue, Sky stated that this bias “can be overcome by careful framing of questions and asking consumers follow-up questions about their certainty about their answers. It has been found that such a bias can be substantially eliminated by focusing on the responses of consumers who state that they are ‘definitely sure’ that they would undertake a proposed course of action”[345]. In support, Sky cited an academic paper (the “CBM Paper”)[346]. The 2009 Sky Survey attempted to correct for this form of bias in the way in which survey questions were framed (for example, by using “cheap talk” scripts)[347]

[339] See Annex 5 to Sky’s response to the Third Pay TV Consultation.

[340] See paragraph 5.49 of Sky’s response to the Third Pay TV Consultation.

[341] This depends on precisely how the critical loss factors are calculated.

[342] We made this point in Third Pay TV Consultation, paragraph 4.142. Moreover, paragraph 4.145 states that we interpreted this analysis cautiously given the risk of the cellophane fallacy.

[343] We highlighted the problem of stated preference bias in paragraphs 4.136, 4.139 and 4.144 of the Third Pay TV Consultation, where we noted that it was likely to be more problematic with our 2007 survey than with Sky’s 2007 survey.

[344] Sky’s response to the Third Pay TV Consultation Sky response to Third Pay TV Consultation refers to this effect as “hypothetical bias” at paragraph 11.106, third bullet. Annex 5 of the Sky response to Third Pay TV Consultation refers to this effect as “inertia bias” (in that annex the term “hypothetical bias” has a different meaning).

[345] Sky response to Third Pay TV Consultation, paragraph 11.106. This was in the context of a separate survey conducted by Freeview which we do not rely on in this section.

[346] *Approaches to Mitigating Hypothetical Bias*, Champ P, Bishop R, Moore R.

[347] Sky response to Third Pay TV Consultation, annex 5, page 35. See also the discussion of question framing on page 32.

and by asking respondents whether they were "probably sure" or definitely sure" and excluding those that answered "probably sure"[348].

5.303 Stated preference bias means that the number of survey respondents answering positively is likely to be unduly high. Disregarding the responses of those that are less sure about their answer will reduce the number of positive answers but does not mean that the bias is eliminated. Excluding those that are "probably sure" but not those that are "definitely sure" appears an arbitrary cut off point. We also have a number of concerns about the reliability of the CBM Paper cited by Sky[349] [350].

5.304 We are concerned that, notwithstanding Sky's efforts to address stated preference bias, this remains a fundamental problem with surveys of this type. While Sky has cited a number of cases where competition authorities have relied on such surveys,[351] and we ourselves placed some weight on the 2007 Sky Survey in the Third Pay TV Consultation, we consider that there is still significant uncertainty about the reliability of the results of the Sky Conjoint Study, and the Sky 2009 Survey. This is in addition to our primary concern, set out above, about the cellophane fallacy.

5.305 Overall, therefore, we consider this type of evidence to be inconclusive in this case.

The Seabright Study

Background

5.306 In 2008, Sky commissioned a study which considered the extent to which geographical variation in availability of DTT services explains demand for Sky's TV services (the "**Seabright Study**")[352]. The study suggests that "post code districts that have higher access to Freeview also have [statistically] significantly lower levels of subscriptions to Sky's pay TV services, and to a degree that implies Freeview is an important competitive constraint upon Sky"[353].

5.307 The results of the model are set out in Figure 52 below. The model predicts that in a given area, if DTT availability increased by 20%, then, if that area had average take up for Sky's channels, there would be a **[✂]** proportionate decline in Sky Sports

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[348] Sky response to Third Pay TV Consultation, Annex 5, page 35.

[349] There are three issues that suggest that the CBM Paper is of limited relevance to this case. First, the CBM Paper argues that respondents that were "definitely sure" (and thus not excluded) had similar experience, attitudes and demographics to a control group. However it does not discuss the demographics etc of those eliminated by this question. Second, this paper studies a public good and states that stated preference bias is greater for public goods than private. This casts doubt on its relevance for private goods, such as Sky's channels. Third, response rates in the CBM Paper are low (25-33%).

[350] Note that Sky did not rely on the CBM Paper in support of the approach adopted in the 2009 Sky Survey. Rather that paper cited a number of different academic papers (Sky response to Third Pay TV Consultation, annex 5, pages 17-21), which we do not discuss here.

[351] Sky response to Third Pay TV Consultation, Annex 5, pages 13-14.

[352] Sky response to Second Pay TV Consultation, Annex 5.

[353] *The effect of DTT availability on households' willingness to subscribe to Sky's pay TV services: Report of an econometric study*, Paul Seabright, 13 January 2009, paragraph 15.

subscribers, an **[✂]** decline in Sky Movies subscribers and a **[✂]** decline in Sky Sports plus Sky Movies subscribers (**[✂]**).

Figure 52 Impact of DTT and cable availability on different types of premium subscriptions given a 20% increase in availability of DTT and cable

		Basic only		Movies only		Sports only		Sports and Movies	
(1)	**Current level of subscriptions in average post-code**	[✂]		[✂]		[✂]		[✂]	
(2)	**Impact on premium Sky subscriptions from a 20% increase in availability of Freeview and cable**	DTT	cable	DTT	cable	DTT	cable	DTT	cable
		-1.63%	-0.96%	-0.21%	-0.18%	-0.52%	-0.38%	-0.37%*	-0.46%
(3)	**Proportionate impact on total subscriptions**	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

** not significantly different from zero*

Source: Sky response to Ofcom's Second Pay TV Consultation Annex 5 part 1, table 2 and 4

5.308 We instructed Professor Andrew Chesher to assess the Seabright Study. His report (the "Chesher Report") was attached at Annex 7 of the Third Pay TV Consultation.

5.309 In the Third Pay TV Consultation, we recognised that the Seabright study shows some interaction between demand for Freeview and pay TV – as, indeed, one would expect. However, we stated that it does not model the effect of a price increase, and as such does not provide direct evidence that Freeview is a constraint on the prices of premium sports channels[354]. Moreover in the Third Pay TV Consultation we set out a number of other concerns and observations on the Seabright Study[355].

Sky's response to the Third Pay TV Consultation

5.310 Sky considered that the Seabright Study provides strong evidence of the constraint imposed by the availability of FTA television[356]. Sky disputed Ofcom's rejection of the Seabright Study[357] and the authors of that study also submitted a response (the "Seabright Response") in which they argued that the Third Pay TV Consultation misrepresented the Seabright Study[358]. Sky also criticised our presentation of the

[354] See paragraphs 4.172 to 4.184 of the Third Pay TV Consultation.

[355] Third Pay TV Consultation, paragraphs 4.176-4.179.

[356] Sky response to Third Pay TV Consultation, paragraph 5.54.

[357] Sky response to Third Pay TV Consultation, paragraph 5.55.

[358] *The Effect of DTT Availability on the Demand for Sky: A Response to Ofcom*, T Magnac and P Seabright, 17 September 2009, paragraph 1. Contained within Annex 3 of the Sky response to Third Pay TV Consultation.

contents of the Chesher Report (but not the report itself)[359]. The Seabright Response considered that there is no substantive disagreement with the Chesher Report itself[360].

5.311 The Seabright Response acknowledged that the Seabright Study did not model the impact of an increase in the retail price of Sky's services. However it rejected Ofcom's view that the Seabright Study does not provide "direct evidence" that Freeview constrains the price of Sky Sports and Sky Movies[361]. The Seabright Response referred to the Seabright Study's conversion of the impact of the availability of DTT into equivalent changes in price and in consumers' willingness to pay for Sky's products. The Seabright response considered this provides evidence of a constraint on the price that Sky can charge for those services[362].

5.312 The Seabright Response also disputed that its methodology was equivalent to estimating the effect of an infinite increase in the price of Freeview for **all** consumers. It stated that there is nothing implausible about a finite change in demand resulting from an infinite change in the price of Freeview to only some consumers[363].

5.313 The Seabright Study compares the propensity of households to subscribe to Sky's services in areas where DTT is available with areas where DTT is not available. Sky stated that, even if its prices were above the competitive level, then this would affect take-up of Sky's services in both types of area. While this could affect the magnitude of the impact of DTT availability, Sky considered it implausible that it could generate such an effect where it otherwise would not exist[364].

5.314 Sky's response to the Third Pay TV Consultation also addressed a number of the other points raised in the Third Pay TV Consultation e.g. on the effects of controlling for spatial correlation[365] and the impact of Setanta Sports being available on DTT[366].

5.315 The Premier League asserted, without further explanation, that we failed to provide a plausible reason for not considering the Seabright Study's findings[367].

Ofcom's view

5.316 We acknowledge that the Chesher Report itself provides the most accurate reflection of Professor Chesher's views. We continue to rely upon that report. However, we do

[359] Sky response to Third Pay TV Consultation, paragraphs 5.55, A3.5, A3.7; Seabright response, paragraphs 1, 3-6, 10.

[360] Seabright Response, paragraphs 2, 10.

[361] Third Pay TV Consultation, paragraph 4.181.

[362] Seabright Response, paragraph 7.

[363] Seabright Response, paragraph 8.

[364] Sky response to Third Pay TV Consultation, paragraph A3.13.

[365] Sky response to Third Pay TV Consultation, paragraphs A3.10-A3.11.

[366] Sky response to Third Pay TV Consultation, paragraph A3.14.

[367] Premier League response to Third Pay TV Consultation, paragraph 5.7.

not consider it necessary to engage in detailed argument about the presentation of the Chesher Report. This is because we consider the implications of the Seabright Study for the purposes of market definition to be inconclusive for the reasons set out below.

5.317 The well-established conceptual framework for market definition involves assessing the magnitude of consumers' response to price rises. We accept that the Seabright Study shows some interaction between Freeview and packages including Sky's premium channels. However, it does not consider switching in response to changes in price. We accept that the interaction with Freeview has an effect on households' willingness to pay for packages including Sky Sports and Sky Movies, and thus the retail price that can be charged for those packages[368]. However it is entirely unclear how large that price effect is. It is therefore difficult to interpret the strength of the interaction between Freeview and Sky's channels identified in this study. In other words, it is entirely unclear whether or not the magnitude of the effects identified in the Seabright Study implies that sufficient consumers would switch in response to a SSNIP.

5.318 Indeed, an increase in the availability of Freeview in an area is equivalent to a fall in the price of Freeview from infinity for some households[369], rather than a rise in the price of packages including Sky Sports 1.

5.319 The Seabright Study converted the impact of changes in the availability of DTT into equivalent changes in price and in consumers' willingness to pay. Specifically the process carried out in the Seabright Study was as follows:

- Suppose that a 20% change in DTT availability leads to a 5% fall in overall demand for a particular Sky bundle.
- Given a particular assumption about the elasticity of demand, it is possible to work out what percentage change in price would also lead to a 5% fall in demand. For example:
  - If the elasticity of demand were assumed to be 1 then a 5% increase in prices would lead to a 5% fall in demand.
  - If the elasticity of demand were assumed to be 2 then a 2½% increase in prices would lead to a 5% fall in demand.
- Having calculated what price change causes the same change in demand as a 20% change in DTT availability, the Seabright paper then converts that change in price into a change in consumers' willingness to pay.

5.320 These further calculations all rest upon the assumptions made about the own price elasticity of demand for Sky's products. However if we knew the elasticity of demand for packages including Sky Sports 1 and for packages including Sky Movies then we could use that elasticity directly to assess whether or not Sky's pricing is constrained.

[368] A point also made in paragraph 7 of the Seabright Response.

[369] Paragraph 8 of the Seabright Response states that the methodology in the Seabright Report is not equivalent to estimating an infinite price change "for **all** consumers" (emphasis added). We agree and, contrary to the Seabright Response's assertion, did not suggest that this was the case in the Third Pay TV Consultation. However it is equivalent to an infinite price change for those households that gain or lose access to Freeview.

However in this case we do not have reliable elasticity estimates. Rather we are considering the Seabright Study to see whether we can infer (in a qualitative sense) from its results how elastic demand is likely to be and therefore whether a SSNIP is likely to be profitable. The changes in willingness to pay reported in the Seabright Study depend on its assumptions about what the elasticity of demand is, rather than the underlying data on consumer behaviour. We thus do not consider that these estimated changes in willingness to pay provide useful further information for the purposes of market definition.

5.321 In addition, the attractiveness of switching away from packages including Sky Sports or Sky Movies once DTT becomes available depends on the price that Sky charges for its channels. The higher that price, the more attractive DTT will appear (all other things being equal). As explained in paragraphs 5.513 to 5.589 we consider that the retail prices of packages including Sky Sports and packages including Sky Movies are likely to be above the competitive level. As a result, the magnitude of the switching estimated in the Seabright Study is likely to be overstated, relative to the amount of switching that would occur if Sky's prices were at the competitive level.

5.322 Overall, we accept that the report shows that the quality and quantity of FTA content available has an effect on demand for packages including Core Premium Sports channels. However, the study measures the impact (on Sky subscriber levels) of the presence or absence of alternative services. For market definition, the appropriate measure is the impact of a change in the relative prices of substitutes on demand for the focal product. As such, for our purposes, the study does not address the most important question – it does not tell us how strong the constraint is. In our view, interpreting this study as offering a measure of substitutability can be expected to exaggerate the extent to which FTA services constrain Sky. We therefore consider that this evidence is inconclusive.

Trend data

5.323 We consider evidence relating to price trends and subscriber numbers in Appendix 5[370].

5.324 In summary, as regards observed responses to changes in the retail price of Sky Sports, 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 difficult is emphasised by the further analysis set out in the Second February 2010 Sky Submission. Since we consider this evidence to be inconclusive we do not rely on it for the purposes of market definition.

5.325 Similarly, as regards changes in Sky Sports subscriber numbers given the growth in Freeview, 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. 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). This difficulty is emphasised by the further analysis set out in the Second February 2010 Sky Submission. We thus do not rely on trends in Sky Sports subscriber numbers for the purposes of market definition.

5.326 We therefore consider that this evidence is inconclusive.

[370] This analysis takes into account the Second February 2010 Sky Submission.

Supply side substitution

5.327 At the retail level, supply side substitution refers to the possibility that a retailer rapidly enters the relevant market with a closely substitutable product.

5.328 Virgin Media agreed with the position in the Third Pay TV Consultation that supply side substitution was unlikely[371].

5.329 In principle, a firm could enter the relevant retail market as part of a process of supply side substitution in one of three ways:

- It could license Sky Sports 1 and/or 2.
- It could license ESPN (the channel).
- It could license its own sports channel.

5.330 We consider the first two possible forms of entry in paragraph 5.600 below as part of our assessment of barriers to entry at the retail level.

- We do not consider that supply side substitution by acquiring Sky Sports 1 and/or Sky Sports 2 is feasible. Non-cable retailers have been unable to secure wholesale supply of Sky Sports 1 or Sky Sports 2 (see Section 7 of this document). In any event, if a competing retailer supplied bundles including Sky Sports 1/ Sky Sports 2 then a key input (namely Sky Sports) is acquired from Sky.[372]
- There are fewer obstacles to entering the relevant market by acquiring ESPN. In particular, ESPN has reached distribution agreements with Sky, Virgin Media, Top Up TV and BT Vision. However, barriers to expansion mean that such entry is likely to only exert a limited constraint upon Sky.

5.331 In terms of launching an attractive new sports channel, we consider that there are significant barriers to entry. These are discussed below as part of our assessment of wholesale market power. As a result, entry via this route is not feasible even over longer timescales than typically considered for the purposes of supply side substitution.

5.332 In conclusion, we do not consider that supply side substitution is feasible in this market.

Conclusion on retail market definition

5.333 We have assessed the aggregate constraint imposed by all substitutes on the supply of the focal product, namely the provision in the UK of packages including Sky Sports 1. The characteristics evidence shows:

- While consumers that watch Sky Sports less than once a week (Group 1) are probably the most likely to see alternative services as substitutes, they are

[371] Virgin Media response to Third Pay TV Consultation, paragraph 3.6(c).

[372] While this may constrain the extent to which Sky can earn profits at the retail level, it will not, as we shall see below, act as a constraint on the margin that Sky is able to earn at the wholesale level.

relatively few in number (8% of all subscribers)[373]. Accordingly, even if a relatively high proportion of them were marginal subscribers they would be unlikely to constrain Sky's prices.

- For consumers who are football fans (Group 2) the only close substitutes are ESPN and Sky Sports 2. It is thus reasonable to conclude that, while some Group 2 subscribers would be willing to switch from Sky Sports 1 to ESPN and Sky Sports 2, few of these consumers would switch to other channels.

- For consumers who are cricket fans but who are not football fans (Group 3) the only close substitute is Sky Sports 2. It is thus reasonable to conclude that, while some Group 3 subscribers would be willing to switch from Sky Sports 1 to Sky Sports 2, few of these consumers would switch to other channels.

- Consumers who are not fans of either cricket or football, but who attach importance to other sports content (Group 4) may have a higher propensity to switch to other channels. However, on balance we think that any such switching is unlikely to constrain the price of packages including Sky Sports 1 to the competitive level.

5.334 Our inferences from the characteristics evidence are supported by the pricing/profitability evidence below, which implies the relevant market is sufficiently narrow for Sky to enjoy market power.

5.335 As set out above, we consider that taken in the round, the other evidence, including the Seabright Study, is inconclusive. In particular, the Seabright Study measures the impact of the presence or absence of alternative services on subscriptions to Sky, rather than measuring the impact of a change in the relative price, which is the appropriate measure for market definition. We consider that the consumers' propensity to switch, as reported in the 2009 Sky Survey, is overstated because currently retail prices are likely to be above the competitive level.

5.336 Accordingly we remain of essentially the same view as in our Third Pay TV Consultation, that the relevant market comprises the provision in the UK of packages including Sky Sports 1 and/or Sky Sports 2 and/or ESPN. We consider that coverage of football, cricket, golf, tennis, rugby union and rugby league on FTA channels is at most a moderate substitute for such packages, rather than a close substitute. Coverage of other sports on FTA channels and coverage of non-sports content are distant substitutes.

Wholesale market definition

Introduction

Wholesale products

5.337 Sky wholesales Sky Sports 1, Sky Sports 2, Sky Sports 3 and Sky Sports 4 to Virgin Media at its "rate-card" prices, as set out at Figure 53. Sky does not currently supply Virgin Media with any HD versions of these channels.

5.338 While some of these channels are available on a standalone basis, there is extensive bundling at the wholesale level, including with Sky Movies channels. As set out in

[373] See paragraph 5.38 of Annex 6 to the Second Pay TV Consultation.

Figure 53, the possible sports configurations are (i) standalone Sky Sports 1 (known as "single sport"); (ii) standalone Sky Sports 2 (also known as "single sport" and sold for the same wholesale price as Sky Sports 1); (iii) Sky Sports 1, 2 and 3 (known as "dual sports"). Each of these three configurations is also available bundled with various movie packages. In addition, Sky Sports 4 (Xtra) is available at the wholesale level on a standalone basis or as a free (to subscribers) service.

Figure 53 Sky's cable rate-card

Package supplied	Monthly wholesale charge (per subscriber)
Single Sport (Sky Sports 1 or Sky Sports 2)	£13.88
Single Movies + Single Sport	£17.99
Dual Sports (Sky Sports 1, Sky Sports 2 and Sky Sports 3)	£19.15
Dual Movies + Single Sport	£20.20
Single Movies + Dual Sports	£21.36
Top Tier (Dual Movies + Dual Sports)	£24.16
Sky Sports Xtra (as a standalone service)	£4.50
Sky Sports Xtra (as free service)	£1.24

Source: Residential premium wholesale rate-card (applicable from 1 September 2009)

5.339 In our Second Pay TV Consultation we identified specific issues that arise when defining wholesale markets: in particular, we need to consider both the direct constraints on the hypothetical monopolist from the retailers it supplies, and the indirect constraints imposed by the final consumers of the retail product that uses the wholesale product as an input. A retailer purchasing from a monopolist wholesaler faces a number of choices in response to a price rise:

- It can seek to pass on the cost increase to its consumers, some of whom will switch away – this imposes an indirect constraint on the hypothetical monopolist.
- It can seek to absorb the cost increase.
- It can seek to identify alternative wholesale inputs.

5.340 In practice the first of these issues tends to mean that wholesale markets will often be defined more narrowly than retail markets. A 10% rise in wholesale input prices – even if fully passed through to retail prices – will entail a less than 10% rise in retail prices because the input cost is likely to be one cost among several. Hence fewer end consumers will substitute away as a result of a 10% wholesale price increase than would in response to a 10% retail price increase. A 10% wholesale price increase is therefore more likely to be profitable, meaning that our market definition might include a smaller set of products.

Indirect constraints

5.341 In paragraph 5.336, we defined the relevant retail market as comprising the provision in the UK of packages including Sky Sports 1 and/or Sky Sports 2 and/or ESPN. The supply of ESPN will therefore act as an indirect constraint on Sky Sports 1 and/or Sky Sports 2. In our retail market definition (paragraph 5.336), we also considered coverage of the Main Sports on FTA channels as a moderate substitute, albeit outside of the relevant market. The Main Sports on FTA will therefore act as a moderate indirect constraint on Sky Sports 1 and/or Sky Sports 2.

5.342 If there are no direct constraints, then as explained in paragraph 5.340 above, the boundaries of the wholesale market will be no wider than the retail market.

Direct constraints

5.343 Direct constraints refer to retailers simply ceasing to acquire Sky Sports 1. If a retailer were to do this, it could:

- Replace Sky Sports 1 with another sports channel (or channels); and/or
- Replace Sky Sports 1 with non-sports content.

Direct substitution to another sports channel

5.344 Our analysis of the indirect retail constraint indicated that there are no close substitutes for content found on premium sports channels[374]. We do not consider therefore that there are likely to be any wholesale products that a retailer could substitute to in the event of a small but significant increase in the carriage fee.

5.345 Furthermore, we observe that retailers (i.e. cable companies) have not previously dropped Sky Sports channels even when the wholesale price has increased. Our conclusion is therefore that wholesale demand side substitution is unlikely to be a significant constraint. We recognise that retailers could react in other ways to an increase in the price of wholesale packages including Sky Sports 1 (e.g. Sky referred to retailers responding by reducing marketing – see paragraph 5.497 below). We address these issues as part of our analysis of buyer power below.

Direct substitution to non-sports content

5.346 The Premier League argued that retailers and broadcasters can choose from a wide variety of content and that their preferences are not necessarily the same as the preferences of individual (final) consumers[375]. The Premier League said that broadcasters will seek to acquire a wide range of content. Accordingly, the analysis

[374] Appendix 9 to Annex 6 to Ofcom's Second Pay TV Consultation describes alternative sport channels. These include niche a la carte channels such as MUTV or Chelsea TV; channels that are either provided FTA such as Fight Network or sportsXchange; channels contained within a basic tier subscription such as Eurosport, Motors TV, Attheraces.

[375] Premier League response to Third Pay TV Consultation, paragraph 5.8.2.

of what content is substitutable at the wholesale level should consider content generally[376].

5.347 We accept that retailers' preferences are not necessarily the same as final consumers' preferences. Products do not need to appeal to the same group of final consumers to be direct constraints (e.g. a car retailer could be a Volvo or a Ferrari dealership). The key test is whether the alternative input (e.g. Ferraris) is more profitable if the price of the input the retailer currently acquires (e.g. Volvos) rises.

5.348 We have therefore considered what channel a retailer would replace Sky Sports with (i.e. how attractive is the alternative to Sky Sports).

5.349 We consider that direct constraints are weak for the following reasons.

5.350 Sky Sports 1 (and 2) are highly attractive to large numbers of intra-marginal consumers (see Section 4, and Appendix 2 of annex 4). Oxera estimated that, in 2008, Sky's wholesale revenue from the supply of Sky Sports was **[✂]**. This shows how important these channels are and how difficult they would be for a retailer to replace with something of comparable attractiveness.

5.351 In contrast the alternatives are likely to be unattractive:

- A retailer could replace Sky Sports with whatever is the most profitable of the channels that it currently does not supply (the marginal channel). For satellite/cable retailers (which have large capacity), the marginal channel is by definition less profitable than the least profitable channel currently retailed, and will be of much less value in attracting and retaining retail customers than Sky Sports channels.

- Alternatively, a retailer could attempt to launch its own sports channel. This is unlikely to be feasible given the barriers to entry described below.

5.352 Furthermore, we note that the main retailer of Sky Sports 1 is Sky itself, which accounts for around **[✂]** of retail supply. Sky (as a retailer) is unlikely to seek to constrain itself (as a wholesaler) by responding to an increase in its own nominal wholesale price by dropping its own channels. As such, the scope for any such direct constraint is limited to switching by Virgin Media. As set out above, Virgin Media has not switched in response to price rises. **[✂]** of its subscribers take Sky Sports and as set out in paragraph [5.117] **[✂]**.

<u>Evidence that current prices are above the competitive level</u>

5.353 As explained in paragraph 5.513 to 5.589, there is evidence that current wholesale prices are above the competitive level. This is further evidence that indirect constraints are weak.

Other evidence

5.354 We previously considered observed responses to wholesale price changes. In the Second Pay TV consultation we stated that, although the wholesale price of the Sky Sports and Movies Mix **[✂]** in real terms since 2005, it was still **[✂]** than it was in 2002. The price of Sky Sports Mix has **[✂]** since 2002 and in September 2008 was

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[376] Premier League response to Third Pay TV Consultation, paragraph 5.6.

[✂] than it was in 2002. We continued to rely on this analysis in the Third Pay TV Consultation. We accepted that the quality of Sky Sports channels may have changed over time but noted that the changes in quality are far more limited when considered for the wholesale product than for retail packages comprising Sky Sports channels. In addition, we noted that these wholesale price changes have occurred despite the rapid increase in penetration of DTT. Taken together, we believed this evidence pointed to a weak constraint on the wholesale pricing of Sky's premium sports channels[377].

5.355 Sky argued that this analysis was unreliable since it failed to control for changes in other relevant variables (such as price, quality and marketing expenditure) and that we had failed to specify the counterfactual[378]. Sky submitted extensive further representations on this issue in the Second February 2010 Sky Submission.

5.356 For the reasons set out at the retail level (see paragraph 5.325) we regard this endnote as inconclusive and do not rely on it.

Wholesale supply side substitution

5.357 Supply side substitution is unlikely. As discussed in the market power Section below, there are significant barriers to entry at the wholesale level.

5.358 Sky suggested that a retailer may reduce its marketing effort in response to a price increase of Sky Sports[379], resulting in a decrease in subscribers on that retailer's platform, and less wholesale revenue for Sky. We note that (a) this would not constrain Sky where Sky itself is the retailer, (b) our view is that Sky's wholesale price to Virgin Media is constrained by the margin squeeze test, (c) Virgin Media has told us that it already has a weak incentive to promote Sky's channels, and it is not clear that Virgin Media has significant scope to reduce its marketing of these channels, (d) if Virgin Media did reduce its marketing effort, this could well be an opportunity for Sky to win more retail customers. We therefore reject this argument.

Conclusion on wholesale market definition

5.359 We conclude that the relevant wholesale market is the wholesale supply in the UK of (i) wholesale bundles including HD and/or SD and/or interactive versions of Sky Sports 1 and/or Sky Sports 2 and (ii) wholesale bundles including ESPN. Elsewhere in this document, the definition "**Core Premium Sports channels**" ("**CPSCs**") refers to these channels.

[377] Third Pay TV Consultation, paragraph 4.208.

[378] October 2009 Sky Submission, paragraph 76; also October 2009 Sky Submission, paragraph A2.20.

[379] June 2009 Sky Submission, Annex 1 3.34 to 3.37.

Market power

Introduction

Overview of responses to the Third Pay TV Consultation

5.360 Sky said that, in the time available, it had focused on responding to key points of Ofcom's analysis of the retail level[380]. Sky said that it continues to rely on its previous submission in relation to wholesale market power[381]. Sky considered that it is necessary to analyse competition at the retail level[382]. Sky said that retail competition was robust and that the analysis in the Third Pay TV Consultation was "cursory", "directed at the wrong questions" and "extremely weak" [383].

5.361 The Premier League considered that our analysis of market power unduly focused upon live Premier League matches[384]. The Premier League did not accept that Sky could have wholesale market power as a result of its acquisition of the Premier League's rights[385]. The Premier League said that Ofcom's analysis of wholesale market power was "inconsistent" with the position of the European Commission and "internally inconsistent" [386]. The Premier League considered that the position on retail market power in the Third Pay TV Consultation was "vague and inconclusive" and thus "cannot be relied upon" [387].

5.362 Virgin Media supported the position in the Third Pay TV Consultation that Sky possesses market power at the wholesale level[388]. Virgin Media characterised our position in the Third Pay TV Consultation as being that Sky holds a position of market power at the retail level[389]. Virgin Media supported the view that Sky is not constrained by competitors at the retail level and that final consumers lack countervailing buyer power[390].

5.363 The Three Parties continued to rely on their earlier submissions in support of their view that Sky possesses market power at the retail and wholesale levels[391].The

[380] Sky response to Third Pay TV Consultation, paragraphs 5.3 to 5.4.

[381] Sky response to Third Pay TV Consultation, paragraph 5.3.

[382] Sky response to Third Pay TV Consultation, paragraphs 5.1 to 5.2.

[383] Sky response to Third Pay TV Consultation, paragraph 5.5.

[384] Premier League response to Third Pay TV Consultation, paragraph 6.4.

[385] Premier League response to Third Pay TV Consultation, paragraph 6.3.

[386] Premier League response to Third Pay TV Consultation, paragraphs 6.4 to 6.6.

[387] Premier League response to Third Pay TV Consultation, paragraphs 6.54.

[388] Virgin Media response to Third Pay TV Consultation, paragraph 4.2.

[389] Virgin Media response to Third Pay TV Consultation, paragraph 4.6.

[390] Virgin Media response to Third Pay TV Consultation, paragraph 4.6.

[391] Three Parties response to Third Pay TV Consultation, paragraph 3.2.

Three Parties characterised our position in the Third Pay TV Consultation as being that Sky holds a "dominant position" at the retail level and agreed with this purported position[392].

5.364 The BBC agreed that "Sky has market power in the wholesale markets for premium sports and movies channels"[393]. In addition, the BBC considered that "Sky's market power in the wholesale and retail provision of (in particular) premium sport content is augmented by its role in distributing premium sport content for other wholesalers and retailers, such as Setanta/ESPN. This additional source of power allows Sky to limit the availability of premium sport content to competing platforms"[394].

5.365 In the market definition Section we first define retail markets and then define wholesale markets. This is because the process of retail market definition informs the wholesale market definition (it overlaps significantly with the assessment of indirect constraints). In assessing market power, however, we begin with the wholesale level because our competition concerns rest on the existence of wholesale market power.

5.366 Our assessment is structured as follows:

- We explain how market power is assessed with regard to existing competitors (market shares), potential competitors, and countervailing buyer power;
- We set out consultation responses on our approach to assessing market power, and our current view;
- We consider broader evidence – on profitability, consumer outcomes and international comparisons – as to the presence or absence of market power.

Criteria for assessing market power

5.367 Below we discuss the criteria for assessing market power and address Sky's representations on these criteria.

5.368 The OFT guidelines on the application and enforcement of Articles 81 and 82 EC Treaty and the Competition Act 1998 (the "OFT Market Power Guidelines") state that, when assessing market power, it is helpful to consider the strength of any competitive constraints i.e. market factors that prevent an undertaking from profitably sustaining prices above competitive levels[395]. Such constraints include:

- Competition from existing competitors.
- Competition from potential competitors.
- Countervailing buyer power ("CBP").

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[392] Three Parties response to Third Pay TV Consultation, paragraph 4.4. In support of their claim the Three Parties cited paragraph 5.134 of the Third Pay TV Consultation.

[393] BBC response to Third Pay TV Consultation, p1.

[394] BBC response to Third Pay TV Consultation, p2.

[395] OFT Market Power Guidelines, paragraph 3.2.

5.369 Below we provide a brief further explanation of each of these three types of constraint.

Existing competitors

5.370 The OFT Market Power Guidelines state that, in general, market power is more likely to exist if an undertaking has a persistently high market share (paragraph 4.2).[396] Further, it is unlikely that an undertaking will be individually dominant if its share of the relevant market is below 40% (paragraph 2.12). The European Court of Justice has stated that dominance can be presumed in the absence of evidence to the contrary if an undertaking has a market share persistently above 50%[397].

5.371 We recognise that market shares are not conclusive evidence of the constraint exerted by existing competitors. At paragraph 4.5, the OFT Market Power Guidelines identify several reasons for this. Reasons which are particularly relevant to the wholesale markets we are analysing are:

- "**Bidding markets** – Sometimes buyers choose their suppliers through procurement auctions or tenders … In these types of markets, an undertaking might have a high market share at a single point in time. However, if competition at the bidding stage is effective, this currently high market share would not necessarily reflect market power." We recognise that the possibility that high market shares are a relatively temporary phenomenon is particularly relevant in this case for two reasons. First, we are considering whether any firm is likely to be dominant in the relevant markets for the next three to four years. Second, the duration of the agreements licensing the rights used as inputs when supplying Core Premium channels in principle might allow third parties to win a significant market share over a relatively short time period[398].

- "**Product differentiation** – Sometimes the relevant market will contain products that are differentiated. In this case undertakings with relatively low market shares might have a degree of market power because other products in the market are not very close substitutes."

Potential competitors

5.372 The likely constraint from potential competitors is stronger when barriers to market entry and expansion are lower. 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).

5.373 In response to both the Second Pay TV Consultation and the Third Pay TV Consultation we received representations upon the nature of the obstacles to entry

[396] *Aberdeen Journals Limited v Office of Fair Trading (No. 2)* [2003] CAT 11, paragraphs 309-310.

[397] Case C62/86 *AKZO Chemie BV v Commission* [1991] ECR I-3359.

[398] For example, historically the duration of the contract licensing the rights necessary to cover live Premier League matches has been three or four years. As a result, in principle, every three or four years firms' share of the relevant market could shift dramatically (although as explained below we do not consider that this will occur in practice).

that we identified and their consequences for our subsequent analysis. These points are addressed in Appendix 3 and 9 of Annex 4.

CBP

5.374 The OFT Market Power Guidelines state that the strength of buyers and the structure of the buyers' side of the market may constrain the market power of a seller (paragraph 6.1). CBP refers to the relative strength of the buyer (in this case, a retailer) in its negotiations with a prospective seller (such as Sky). CBP exists when a particular purchaser is sufficiently powerful in respect to a seller to influence the price charged for the good or service in question.

Our approach to assessing market power

Why we assess market power

5.375 Sky said that:

- It is necessary to analyse competition within the market in which competition concerns arise, namely the retail market[399].
- Where the competition concern stems from the existence of market power, it is necessary to demonstrate that Sky is dominant[400].
- At the retail level, it is wrong to assess whether any firms have market power. Rather the focus should be on identifying the competitive constraints faced by retailers of a number of different pay TV services[401].

5.376 Sky also said that the burden of proof lies with Ofcom to establish the scope of the relevant markets based on evidence that is of a high standard[402].

Joint response by the Three Parties

5.377 The Three Parties agreed "with Ofcom's confirmation in its Third Pay TV Consultation Document that: "... an assessment of the relevant downstream markets can be helpful to assess the impacts of concerns about upstream markets on downstream markets""[403].

Virgin Media's response

5.378 Virgin Media considered that the purpose of retail market definition is analysing Sky's retail market power since (i) Sky's market power at the wholesale level is reinforced

[399] Sky response to Third Pay TV Consultation, paragraph 5.1; also paragraphs 5.2, 5.6.

[400] Sky response to Third Pay TV Consultation, paragraph 3.29.

[401] Sky response to Third Pay TV Consultation, paragraph 5.9.

[402] October 2009 Sky Submission, paragraph 7.

[403] Three Parties response to Third Pay TV Consultation, paragraph 4.2.

by its retail market power;[404] (ii) it informs the assessment of competition concerns;[405] and (iii) it informs the assessment of remedies[406].

Our view

Approach towards assessing wholesale market power

5.379 We are considering whether we need to impose licence conditions under Section 316 of CA03 to ensure fair and effective competition. It may be appropriate to impose licence conditions to ensure fair and effective competition in situations where the competition concerns involved do not derive from a position of dominance. We consider in this document whether the extent of Sky's market power is such that it has the ability to act in a manner which is prejudicial to fair and effective competition.

5.380 The competition concerns we identify in Section 7 relate to the unavailability of Sky's channels to third parties at an appropriate wholesale price (either because Sky does not supply those channels or because the wholesale price is unduly high) and to the high wholesale and retail prices charged for Sky's channels. For Sky to have the ability to act in a manner which is prejudicial to fair and effective competition Sky would have to have market power in the wholesale supply of those channels.

5.381 In this Section we consider whether Sky has market power and we analyse the extent of market power by reference to the dominance standard that applies under the CA98 Chapter II prohibition. If Sky meets that threshold it will clearly have a degree of market power providing it with the ability to act in a manner which is prejudicial to fair and effective competition. We reach the view in this Section that Sky not only has market power but that it meets that threshold.

5.382 As we explained in paragraph 5.9 of the Third Pay TV Consultation, we consider that our case is not dependent on demonstrating that the dominance threshold has been reached. We also said that Sky appeared to adopt a similar position in its response to the Second Pay TV Consultation[407]. In its response to the Third Pay TV Consultation, Sky claimed that this "misrepresents" its position and that dominance is necessary for an intervention under s316 in this particular case[408]. We continue to take the view that the concerns we identify in Section 7 may continue to exist in a situation where Sky does not have dominance. While Sky claimed that this is inconsistent with a 2005 internal Ofcom document, as explained in paragraph 3.20 we do not consider that that document has any bearing on the current case since it did not result in an Ofcom policy on this matter.

5.383 However, the question is academic because we do conclude that Sky possesses a dominant position at the wholesale level.

5.384 We make our competition assessment by reference to both existing circumstances and likely future outcomes. We thus consider market power by looking at whether

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[404] Virgin Media response to Third Pay TV Consultation, paragraph 3.5(a).

[405] Virgin Media response to Third Pay TV Consultation, paragraph 3.5(c).

[406] Virgin Media response to Third Pay TV Consultation, paragraph 3.5(b).

[407] Third Pay TV Consultation, annex 8 paragraphs 2.16-2.17 including footnote 6.

[408] Sky response to Third Pay TV Consultation, paragraph 3.29.

any firm is currently dominant in the relevant markets and whether any firm is likely to be dominant in the relevant markets for the next three to four years[409].

Approach towards assessing retail market power

5.385 As we explained in paragraph 4.15 of the Third Pay TV Consultation, our competition concerns do not rest on the existence of retail market power[410]. Rather they derive from the potential exercise of market power at the wholesale level. We recognised that the effects of those upstream concerns are felt downstream and therefore the assessment of the relevant downstream markets can be helpful to assess the impact of concerns about upstream markets on downstream markets.

5.386 However it is important to be very careful when drawing inferences from Sky's position at the retail level. As we explained in the Third Pay TV Consultation, applying the standard dominance test at the retail level is "somewhat artificial" and the "double counting" of market power risks giving a misleading impression (we return to this issue in our observations on retail level market power below)[411].

5.387 At current prices, alternatives to packages including Sky Sports are more attractive than they would be if retail prices were at the competitive level. Accordingly the constraints on Sky's current retail prices are much stronger than the constraints facing Sky if its retail prices were at the lower competitive level. We thus consider that Sky's proposed approach, namely "identifying in a systematic way the competitive constraints faced by retailers of … pay TV services that include premium sports and/or premium movies channels" [412], overstates the constraints that Sky would face if retail prices were at the competitive level.

5.388 This same issue also applies to the Three Parties' view that assessing retail market power informs the analysis of both competition concerns and appropriate remedies, i.e. that downstream retail market outcomes are likely to affect Sky's upstream market power.

5.389 Virgin Media said it was necessary to assess retail market power since, in its view, it reinforces Sky's market power at the wholesale level. As discussed above, we consider factors at both the retail level and at the upstream rights level when assessing whether or not Sky possesses wholesale market power, but that assessment does not turn on whether or not Sky has market power at other levels of the supply chain[413].

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[409] Looking forward three to four years in this way is consistent with our expectation that we would start reviewing any requirement for Sky to make wholesale access to particular content available on regulated terms no later than three years of its coming into force (see Section 9).

[410] Moreover, as explained in paragraphs 3.8-3.19 of annex 8 of the Third Pay TV Consultation, it is not straightforward to apply the concept of retail market power to Sky.

[411] Third Pay TV Consultation, annex 8, paragraphs 3.10 and 3.15.

[412] Sky response to Third Pay TV Consultation, paragraph 5.9.

[413] For example, the Four Parties' original submission on 1 July 2007 stated that "Sky's downstream leadership confers upon Sky two important competitive upstream advantages. First, it provides Sky with significant economies of scale which reduce its (content and other) costs per subscriber. Second, it provides Sky with access to a large base of subscribers to whom content can be sold immediately upon the rights becoming available" (Section 4, paragraph 3.3). To assess these advantages it is

Assessment of wholesale market power

5.390 Our view, as set out in further detail below, is that Sky's share of the wholesale market for Core Premium Sports channels, at between **[✂]**% and **[✂]**% (depending on the treatment of moderate substitutes), is consistent with it having market power, and indeed a dominant position, in this market. Sky's market power also appears to be persistent, for example it has enjoyed a high (or even 100%) share of the relevant market for a long period of time.

5.391 Sky's market power does not derive only from its control of Premier League rights, but these are by far the most significant set of rights. We believe that Sky is likely to maintain its wholesale market power if it retains the majority of the Live Premier League Rights. By "majority" we mean: either any five packages of rights to televise live Premier League matches (the "Live Premier League Rights"); or four packages including package A (which contains 23 first pick games and is the most attractive package). This view is based on Setanta's failure to challenge Sky's position when it (Setanta) had access to two packages, and on internal ntl and **[✂]** documents.

5.392 Sky is likely to retain the majority of these rights because:

- Further Live Premier League Rights will not become available until the 2013/14 season;
- Sky is likely to win the majority of these rights when they become available, for the reasons set out below.

5.393 Our expectation that Sky will win these rights in future is based on:

- Sky having consistently won these rights in the past;
- **[✂]**;
- **[✂]**

5.394 The reasons for Sky's success in bidding for Live Premier League Rights are likely to be:

- Sky's established subscriber base, which allows it to monetise content rights more effectively than other bidders.
- The delay that a new entrant would face in building a similar subscriber base;
- Efficiency advantages from vertical integration;
- A range of bidder specific factors including branding advantages enjoyed by Sky.

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necessary to consider whether economies of scale exist, whether third parties can match them etc. However it is not necessary to form a view on whether or not Sky has a dominant retail position.

Broad evidence on sports wholesale market power

Sky's response to the Third Pay TV Consultation

5.395 Sky said that evidence that competition is strong includes prices that offer a reasonable return on investment and innovation and that encourage high take-up of services[414]. Sky considered that it was clear that the outcomes delivered by suppliers in the UK audiovisual sector were consistent with markets being competitive[415].

5.396 Sky stated that wide product variety, good consumer satisfaction, strong innovation and cost minimisation (i.e. avoiding wasteful inefficiency) are market outcomes that would be expected if competition were strong[416]. Sky considered that, judged against these criteria, the observed outcomes are consistent with competition being strong[417].

5.397 Sky referred to international comparisons set out in two reports prepared by PwC which, in Sky's view, show that UK consumers are well served. Sky considered that these findings are inconsistent with our views on retail competition. Sky said that our response to PwC's findings was implausible[418].

5.398 Sky advanced similar representations in response to past consultations[419].

Ofcom's position on the broader evidence presented by Sky

5.399 A firm which has very high market power has a dominant position. The ECJ has defined dominance as "a position of economic strength … affording [an undertaking] the power to behave to an appreciable extent independently of its competitors, customers and … consumers"[420]. Our interpretation of these words is that market power is characterised by the ability to behave independently rather than the exercise of that ability. Thus, even under the higher threshold of dominance, it is not necessary to demonstrate the existence of appreciable detrimental effects (such as high profitability or negative outcomes for final consumers) to find that an undertaking possesses a dominant position.

5.400 As explained in paragraphs 5.513 to 5.589 below above, we consider that the retail prices of packages including Sky Sports 1 are appreciably above the competitive level. Thus, contrary to Sky's claim that evidence on consumer outcomes suggests that the relevant markets are competitive, the evidence on pricing supports the

[414] Sky response to Third Pay TV Consultation, table 5.1.

[415] Sky response to Third Pay TV Consultation, paragraph 5.44.

[416] Sky response to Third Pay TV Consultation, table 5.1.

[417] Sky response to Third Pay TV Consultation, paragraph 5.44; Sky cross-referred to Section 8 of that response.

[418] Sky response to Third Pay TV Consultation, paragraph 5.61.

[419] Third Pay TV Consultation, paragraph 2.33; see also Ofcom's response at paragraphs 2.39 to 2.46.

[420] Case 27/76 *United Brands v Commission* [1978] ECR 207, paragraph 38.

conclusion that Sky enjoys wholesale market power[421]. The pricing evidence thus provides direct evidence that the constraint exerted by competitors to Sky is insufficient to constrain Sky's wholesale prices to the competitive level i.e. that Sky does in fact possess wholesale market power.

5.401 In restricting access to its channel, Sky creates outcomes where both choice and innovation are reduced, to the detriment of final consumers (as compared to the situation where its channels are widely available at an appropriate price). We discuss this issue in further detail in Section 8, which sets out our assessment of consumer outcomes[422].

5.402 We thus do not agree with Sky's view that the observed market outcome is incompatible with a hypothesis that Sky holds market power. Crucially we do not agree with Sky's view of consumer outcomes – rather we expect that consumer outcomes would be substantially better if retailers had greater access to Sky's sports and movies channels at an appropriate wholesale price. This is further supported by the impact assessment set out in Sections 9 to 11.

5.403 Sky also referred to various reports prepared by PwC. As well as the international evidence we rely on in Section 11, we consider this in Section 8, as part of our assessment of consumer outcomes. In summary:

- **Innovation**: While the UK has a good record of innovations which suit the satellite platform, such as HD and PVRs, spend on VoD which is more suited to other platforms is in line with other countries. While the high level of digital penetration in the UK reflects a positive outcome for consumers, this is in large part as a result of government policy on use of spectrum. The evidence on cross country comparisons is consistent with our view that greater retail competition could increase the scope for greater innovation and wider take up of innovative services. However, we recognise the difficulties in comparing cross country data and we are therefore cautious when drawing conclusions from this evidence.

- **Pricing**: We do not dismiss cross-country price comparisons out of hand. However, even highly sophisticated econometric studies of consumer outcomes in different countries are seldom if ever wholly reliable given the wide range of country-to-country differences that could affect the results. In our view PwC's report cannot support Sky's conclusion that the price in the UK is consistent with comparable packages in other countries given the range of factors that can affect price that were not taken into account by PwC (as PwC recognised: Section 8 below).

- **Premium channel penetration**: **[✂]** We would caution against drawing strong conclusions from the experience of just four countries. Furthermore, we see no basis for **[✂]**.

[421] A point also made in Third Pay TV Consultation, Annex 8, paragraph 2.41.

[422] Our impact assessment also demonstrates that consumers would be better served if Sky's current conduct were changed.

Assessment of wholesale market shares (existing competitors)

Treatment of market shares

5.404 The importance of market shares as an indicator of market power is well established. For example, the ECJ has held that "although the importance of market shares may vary from one market to another the view may legitimately be taken that very large market shares are in themselves, and save in exceptional circumstances, evidence of the existence of a dominant position"[423].

5.405 However, market shares should be interpreted with caution, particularly where products are differentiated. We have considered the following points and arguments, and our view on each is set out below[424].

- Whether market shares are reliable when market boundaries are uncertain (due to product differentiation);
- Whether, with differentiation, market shares will understate or overstate market power;
- Whether this market is a bidding market;
- The appropriate basis for measuring market shares;
- Other factors relevant to market power.

Uncertain market boundaries

5.406 In its 1 June 2009 submission Sky stated that "the central problem raised by product differentiation … is that it is not possible to establish a "clear-cut boundary" for the market that is a *meaningful* basis for the calculation of firms' market shares" (paragraph 4.9; emphasis in original). The Premier League said that market shares were of limited use in "complex" markets and markets characterised by product differentiation[425].

5.407 As highlighted by Sky, where there is a great deal of product differentiation this brings to the fore several limitations of relying on market shares. Market shares need not reflect the strength of the competitive constraint exerted by a particular supplier. Suppliers that lie outside of the market may exert a moderate constraint upon suppliers within the relevant market. Similarly, suppliers within the relevant market may not exert a particularly strong constraint on each other because their products are differentiated.

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[423] Case 85/76 *Hoffman-La Roche & Co. AG v Commission* [1979] ECR 461, paragraph 41.

[424] In paragraphs 2.66-2.76 of annex 8 of the Third Pay TV Consultation we considered responses to the First Pay TV Consultation that claimed that Setanta Sports was a complement for Sky Sports, rather than a substitute. Since respondents have not persisted with these arguments we do not repeat these issues in this document.

[425] Premier League response to Third Pay TV Consultation, paragraph 6.14.

5.408 However we have addressed these limitations in a number of ways:[426]

- While we calculate the market shares of suppliers within the relevant market in the standard way, we also supplement this with a discussion of the closeness of substitution between those suppliers, and interpret market shares in the light of this discussion.

- To reflect the potential constraint imposed by products outside of the relevant market, we have also calculated market shares including those products that are likely to exert a moderate constraint. In other words, we calculated alternative market share figures that take into account products that lie outside of the relevant market but are nonetheless moderate substitutes for Core Premium channels. As highlighted in the Second Pay TV Consultation, it is important to treat these market share figures with a degree of caution since they will overstate the strength of the constraint exerted by these moderate substitutes.

- We have not calculated market shares taking into account products that are more remote substitutes for Core Premium channels. Market shares that include more remote substitutes would be an unreliable guide to the constraints facing wholesale suppliers of Core Premium channels, since they will significantly misrepresent the strength of the constraint exerted by those remote substitutes. While it is not the case that remote substitutes impose absolutely no constraint on the wholesale supply of Core Premium channels, we consider that that constraint is too weak to alter our conclusions.

5.409 Moreover, as shown below, the outcome of the market shares calculations are generally very clear (specifically, Sky generally has a very high market share). While we accept that market shares are only a proxy for the extent of the constraints facing a particular firm, the results are sufficiently clear cut that uncertainty as to the precise market boundary does not prevent a conclusion from being drawn.

Effect of differentiation on competition

5.410 In the Third Pay TV Consultation we said that the existence of product differentiation will tend to dampen the strength of direct competition between suppliers[427]. Sky disagreed with this view, but did not provide reasons for its position, other than with reference to its arguments around monopolistic competition[428].

5.411 We consider Sky's views on monopolistic competition in paragraphs 5.80 to 5.84. As noted there, we remain of the view that this model is not a reliable basis for assessing market power in the present case. As such, we remain of the view that product differentiation will tend to dampen the strength of direct competition between suppliers.

[426] We do not accept that product differentiation means that it is impossible to calculate meaningful market shares. Rather, our view is that it is necessary to interpret market shares carefully, but that they are still a useful and meaningful indicator of market power.

[427] Third Pay TV Consultation, Annex 8, paragraph 3.52.

[428] Sky response to Third Pay TV Consultation, paragraph 5.20.

Whether this market is a bidding market

5.412 The Premier League stated that markets for the acquisition of sports content rights were "bidding markets", where market shares are temporary and fluctuate. Firms with a small (current) market constraint can impose a competitive constraint since what matters is whether they are able to submit a credible bid. Accordingly, in such markets, market shares are inconclusive[429].

5.413 We do not accept the Premier League's characterisation of the market for the wholesale supply of packages including Core Premium Sports channels as a "bidding market". As discussed below, market shares are broadly stable. Moreover, as we discuss below as part of our analysis of barriers to entry, we believe that Sky enjoys a persistent advantage when bidding for the Live Premier League Rights. Thus, even in the upstream market in which these rights are supplied, Sky's position is more stable than would be expected in a bidding market.

Appropriate measurement

5.414 The Premier League said that calculating market shares in an "all-TV broadcasting market" based on revenues was particularly inconclusive and that Ofcom should also have assessed market shares by reference to advertising impacts[430].

5.415 The Premier League did not explain why advertising impacts were an appropriate measure of market power. We note that comparing advertising impacts will ignore the fact that pay TV channels, particularly premium channels, charge substantial subscription fees, and this will tend to limit their advertising impacts. The ability of these channels to command such fees is a reflection of their value to customers, and hence of their potential market power. This approach is consistent with the OFT Market Power Guidelines which state that "Often value data will be more informative, for example, where goods are differentiated" (paragraph 4.7). See also our discussion of two-sided markets in paragraphs 5.79 to 5.80, in which we explain that subscription revenue is much more important to Sky than advertising revenue.

Other factors

5.416 As highlighted in paragraph 2.47 of the Third Pay TV Consultation, we also carefully considered factors relevant to potential competition (such as barriers to entry) and countervailing buyer power – these factors are an important aspect of our analysis.

Market shares

5.417 The firms active within the market for the wholesale of Core Premium Sports channels until shortly before publication of the Third Pay TV Consultation were Sky and Setanta. Setanta exited the market in June 2009. Since the second half of 2009, the active firms are Sky and ESPN (which has acquired the Premier League rights previously held by Setanta).

5.418 Sky had a high (revenue) market share compared to Setanta in 2008. In the second half of 2009 it is very likely that Sky will have a higher market share. This is because

[429] Premier League response to Third Pay TV Consultation, paragraph 6.15; also paragraph 6.16, 6.18, 6.36

[430] Premier League response to Third Pay TV Consultation, paragraph 6.14

ESPN's revenue in the second half of 2009 was around **[✂]** of Setanta's revenue in the second half of 2008. Setanta's revenue was **[✂]** in the second half of 2008, whereas ESPN's revenue was **[✂]** in the second half of 2009.

5.419 We have not yet obtained the data necessary to calculate market shares for the whole of 2009. In order to calculate 2008 market shares we have used an estimate of the wholesale revenues earned by Sky and Setanta from the sale of the Sky Sports channels and Setanta Sports.

5.420 The wholesale revenue figures used for Setanta are the same as those used in our Third Pay TV Consultation. We have used its wholesale revenue when it distributed its channel via other retailers plus the retail revenue it earned from its retail sales to subscribers on DTT and Sky's satellite platform. We recognise that using Setanta's retail revenues in this way will overstate its wholesale revenue and thus bias downwards our estimates of Sky's wholesale market share[431].

5.421 Setanta also bundled Setanta Sports 1 with other channels (for example with Setanta Sports 2 and Setanta Golf on cable). We have assumed that the entirety of the revenue from such bundles is attributable to Setanta Sports 1, which will tend to overstate Setanta's market share.

5.422 We have used three different estimates of Sky Sports wholesale revenue calculated by Oxera in Annex 9 of our Third Pay TV Consultation (Tables A2.11 and A2.15): a "preference based approach"; using the incremental price of Sky Movies; and using the incremental price of Sky Sports.[432] The full details of our calculations are set out in a separate spreadsheet which we have not published as it is based on confidential information.

5.423 Our market share estimates under the three different revenue allocation approaches for Sky Sports are presented in Figure 54 below.

5.424 Sky's market shares on the basis of a narrow market definition are well above the 50% threshold associated with a legal presumption of dominance. As such, they are consistent with its having very high market power, and indeed a dominant position, in the supply of Core Premium Sports channels.

Figure 54 [✂]

Past and future market shares

5.425 Paragraph 4.3 of the OFT Market Power Guidelines state that "The history of the market shares of all undertakings within the relevant market is often more informative than considering market shares at a single point in time, partly because such a snapshot might not reveal the dynamic nature of a market."

5.426 Figure 55 below shows trends in the number of Sky Sports subscribers on Sky's satellite platform since 2000. This shows that the number of Sky Sports subscribers **[✂]**. We accept that trends in Sky's market share over time need not be the same as trends in its subscriber numbers, but the two variables will be positively correlated.

[431] We have done this because the data we have does not allow us to calculate Setanta's wholesale revenues from self-supply.

[432] For further details of these three approaches, see paragraph 5.562 to 5.563 below.

These subscriber number figures thus suggest that Sky's historic position has been one of strong market power.

Figure 55 Subscribers to packages containing Sky Sports channels on satellite

[✂]

5.427 We have explored this issue in further detail by exploring estimated shares of supply of close substitutes i.e. products within the relevant market. In Annex 8, Figure 3 of our Third Pay TV Consultation, we presented market share figures for Setanta. Whilst the precise market shares depend on the details of the calculation, Setanta's market share was consistently less than 25% albeit rising over time. It is doubtful that Setanta Sports 1 lay within the relevant market before it began screening live Premier League matches in the second half of 2007[433]. In any event, even if Setanta Sports 1 were deemed to have been within the relevant market, Setanta's revenue prior to the second half of 2008 was markedly lower[434]. As a result Setanta would have possessed a very low market share whereas Sky is likely to have enjoyed a market share 80 to 90%. Not only did Sky enjoy a high market share in 2008, it has also enjoyed a high market share historically.

5.428 The market shares calculated in our spreadsheet only cover the year 2008. In particular, given that ESPN only recently entered the market, we do not yet have a full 6 months' worth of data available from them. However, Figure 56 below sets out an indication of how Sky's share of the relevant market has changed over time. While the precise figures in this chart are subject to uncertainty, we consider that it gives a broad indication of the pattern of changes in Sky's share of supply.

Figure 56 Indicative changes in shares of supply (close substitutes only)

[✂]

5.429 We consider that ESPN revenues are likely to grow in the next few years. Nonetheless, it is likely that Sky's market share will remain high. **[✂]**. ESPN is currently generating about **[✂]** in its first half year with Premier League rights than Setanta was in its first half year with Premier League rights. And ESPN's business plan suggests that in the first half of its second year of Premier League rights, it will generate about **[✂]** the revenue that Setanta generated in the first half of its second year of Premier League rights.

5.430 **[✂]** the fewer rights that ESPN will hold relative to Setanta. Specifically, from the 2010/11 Premier League season onwards ESPN will screen 50% fewer live Premier League matches than Setanta did in 2007/08 and 2008/09. This is because Sky won the rights to 23 of the games previously broadcast by Setanta. As a result, Sky's market share is likely to rise in the future (compared to its current level). When Setanta 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[435]. The only plausible explanation for this profound change in the number of

[433] At that time Setanta did not possess a number of the rights to attractive sporting events that it now holds, in particular certain England international football matches and certain FA Cup matches.

[434] For example, in January 2008, Setanta's total retail and wholesale revenue was **[✂]**. In contrast, Setanta's total retail and wholesale revenue in January 2007 was **[✂]** i.e. less than **[✂]** of the figure a year later (Source: Annex 2 of Setanta response dated 15 April 2009 to Ofcom information request dated 20 March 2009, question 2). This is evidence that Setanta's market share prior to the second half of 2007 would be much lower than the shares presented in Figure 54 above.

[435] Setanta response dated 7 July 2008 to Ofcom information request dated 27 June 2008.

Setanta Sports subscribers is that a large number of subscribers were attracted by live Premier League matches. It seems plausible that a material share of them may cease subscribing to ESPN's channel once it screens 50% fewer live Premier League matches.

5.431 In summary, Sky's acquisition of additional live Premier League matches from mid-2010 onwards suggests that constraints on Sky may be weaker from that time onwards.

5.432 We have also compared the live Premier League coverage on Setanta/ESPN and Sky Sports. For the Live Premier League Rights to the 2007/08-2009/10 seasons, Setanta paid £130m[436] per annum or £2.8m per game (which were then bought by ESPN) whereas Sky paid £438m per annum or £4.8m per game.[437] Using this measure Sky's market share would be 77% and Setanta/ESPN's market share would be 23%. The packages of Live Premier League Rights won by Setanta generally contain later 'picks' of Premier League matches and do not contain any 'first pick' Premier League matches (see Figure 60 below for further details). Thus, as we explained in the Third Pay TV Consultation, the live Premier League games broadcast by Setanta were generally less attractive to final consumers than those broadcast by Sky. We consider that this applies equally to ESPN, which acquired the rights formerly held by Setanta to the 2009/10 Premier League season (and lost half of those rights to Sky in subsequent seasons).

Market shares based on a market including close and moderate substitutes

5.433 As explained above, our view on market definition is that coverage of the Main Sports on FTA channels is a moderate substitute, albeit outside of the relevant market. The Main Sports are those sports which Sky Sports 1 and 2 primarily broadcast, namely football, rugby union, rugby league, cricket, golf and tennis.

5.434 In order to assess the competitive constraint from these moderate substitutes, we have calculated market shares as if **leading events** in the sports that are broadcast on Sky Sports 1 and 2 were within the relevant market.[438].

5.435 Figure 57 lists the leading events for each of the Main Sports screened on Sky Sports 1 and 2. We consider that other channels are moderate substitutes for Core Premium Sports channels insofar as they feature live coverage of these events[439].

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[436] We have not used how much ESPN paid for the rights as their value may be distorted because they were bought under distress circumstances. See Appendix 10 to Annex 4.

[437] Calculated from First Pay TV Consultation, Annex 10, page 22.

[438] We considered the impact of including other football matches on the market definition set out in paragraphs 2.27-2.36 of annex 7 of the Second Pay TV Consultation. This analysis has been updated to reflect the changes in this document to the market definition.

[439] We calculate market shares for the year 2008. We have not included the 2008 UEFA European Football Championship (also known as "Euro 2008") in these figures. As explained above, this event is only held on a quadrennial basis and is therefore its presence of FTA channels is unlikely to result in these channels being even moderate substitutes for packages including Core Premium Sports channels. In any event, the value of the all the rights (not just the live television rights) to Euro 2008 was £55m (First Pay TV Consultation, annex 10, page 3). Even if this event were included it would not changes the inferences that we draw from market shares. This is because the amounts spent on the live television rights to Euro 2008 are small in comparison to the amounts that Sky spends on sports rights. In particular, in that year Sky spent just under £440m per annum on the Live Premier League Rights (First Pay TV Consultation, annex 10, page 22).

We have not included other popular sports events such as the Olympics or Formula One motorsports because we regard them as more distant substitutes for the events broadcast on Sky Sports 1[440].

5.436 We have calculated market shares based on the price of the rights to these events.[441] For example, ITV broadcasts UEFA Champion League matches as well as a range of other programs. The market share measures discussed below would reflect the Champions League component of ITV's output but would not include other programs.

Figure 57 Leading events in the sports broadcast on Sky Sports 1 and 2

	Football	Cricket	Golf	Rugby union	Rugby league	Tennis
Only on Sky/ESPN	FAPL	England one day internationals* England Test Match cricket* One day international championship* County cricket*	Ryder Cup* US Open* World Golf Championships* US Open* US PGA tour	Heineken Cup* Guinness Premiership* Other England internationals*	Super League* World Cup*	US Masters * Paris Masters*
On both Sky/ESPN & FTA/Eurosport	UEFA Champions League Championship Carling Cup		European PGA tour Scottish Open			US Open ATP tour Davis Cup
Only on FTA/Eurosport	UEFA Cup England internationals FA Cup	Twenty/20 Champions League	US Masters	Six Nations Magners league	Challenge Cup	WTA tour Wimbledon French Open Australian Open AEGON Championships

Source: Ofcom search of http://www.livesportontv.com for events between 23/02/2009 and 22/02/2010 (except for 2008 Ryder Cup and 2008 Rugby League World Cup which are not annual events)

Note: Listed events are marked with a red box.

England internationals exclude junior events.

[440] The Premier League drew our particular attention to the attractiveness of Formula One (paragraph 5.21 of its response). We disagree that Formula 1 is a substitute for key football, cricket, rugby, tennis or golf content.

[441] We have not used revenue as a measure of market share because of the difficulties in disaggregating advertising revenues in order to identify the revenue associated with the sporting events of interest. Unlike the Second Pay TV Consultation, we have not used audience figures to calculate market shares including moderate constraints. This measure has limited accuracy (comparing viewers between free to air and pay TV channels is imperfect since free to air channels will attract viewers with only a weak preference for the event in question) and thus we considered that recalculation on this basis would not add material value to our analysis. Sky also criticised the use of audience share measures in footnote 46 of the July 2009 Sky Submission on the grounds that free to air channels are "available" to more households than pay TV channels.

The Stella Artois Championships are now called the AEGON Championships.

** Only on Sky Sports*

5.437 The price of the rights reflects the value of that sporting event to the broadcaster which, in turn, proxies the attractiveness to viewers. The details of our calculations are set out in a separate, confidential spreadsheet and summarised in Figure 59 below. We make three observations on these calculations:

- First, the data on the price of the rights to sporting events is incomplete (particularly for tennis tournaments)[442]. Accordingly, as in the Third Pay TV Consultation, we have interpreted the results of this analysis cautiously. However, we do have data on the most valuable sporting events (including Premier League matches) and we believe that the broad results are a useful indicator.

- Second, we recognise that the restrictions on pay TV broadcasting are likely to lower the price of the rights to listed events. However relatively few listed events are relevant to this calculation[443]. In our Third Pay TV Consultation we uplifted the value of rights acquired by the BBC and ITV for all the Main Sports. Here we have considered the impact on market shares of uplifting the value of the rights acquired by the BBC and ITV only for tournaments that contain listed events. As Figure 58 indicates, Sky's market share is not very sensitive to our assumptions[444] regarding the uplift of listed events.

- Third, we have estimated the price paid for rights to sports broadcast in 2008. Where rights contracts straddle several years we have converted the overall payment into an average annual cost.

[442] Specifically, we lack data on the price of the rights to England away international football matches, the Magners League (rugby union), the Rugby League World Cup and several tennis tournaments (Masters Cup, ATP Tour, WTA Tour, Davis Cup, Paris Masters and the Stella Artois Championships).

[443] The relevant "Group A" listed events are the FA Cup Final, the Wimbledon Tennis Finals, the Rugby League Challenge Cup Final and the European Football Championship Finals.

[444] These sensitivities are not based on specific evidence of the impact of listing on rights values.

Figure 58 Wholesale market shares including moderate constraints (calculated using expenditure on relevant sporting events)

	Percentage uplift to amounts paid by BBC and ITV for tournaments that include listed events				
	None	**10%**	**20%**	**50%**	**100%**
Sky	[60-70]%	[60-70]%	[60-70]%	[60-70]%	[50-60]%
Setanta	[10-20]%	[10-20]%	[10-20]%	[10-20]%	[10-20]%
BBC	[0-10]%	[0-10]%	[0-10]%	[0-10]%	[0-10]%
ITV	[10-20]%	[10-20]%	[10-20]%	[10-20]%	[10-20]%
Other	[0-10]%	[0-10]%	[0-10]%	[0-10]%	[0-10]%

Source: Ofcom calculations

5.438 Even if moderate substitutes were included in the market, Sky's market share would be well above the 50% associated with the legal assumption of dominance[445]. Our view is that substitutability between Core Premium Sports channels and channels featuring the wider selection of events listed in Figure 57 above is limited. As such, the above market share figures will tend to overstate the competitive constraint imposed by these channels, since it assumes they exercise an equivalent constraint to a Core Premium Sports channel.

Effect of including all live sports

5.439 We have also considered approximately what Sky's share of supply would be if we widened the market beyond the moderate substitutes set out above and included all live sports on television.

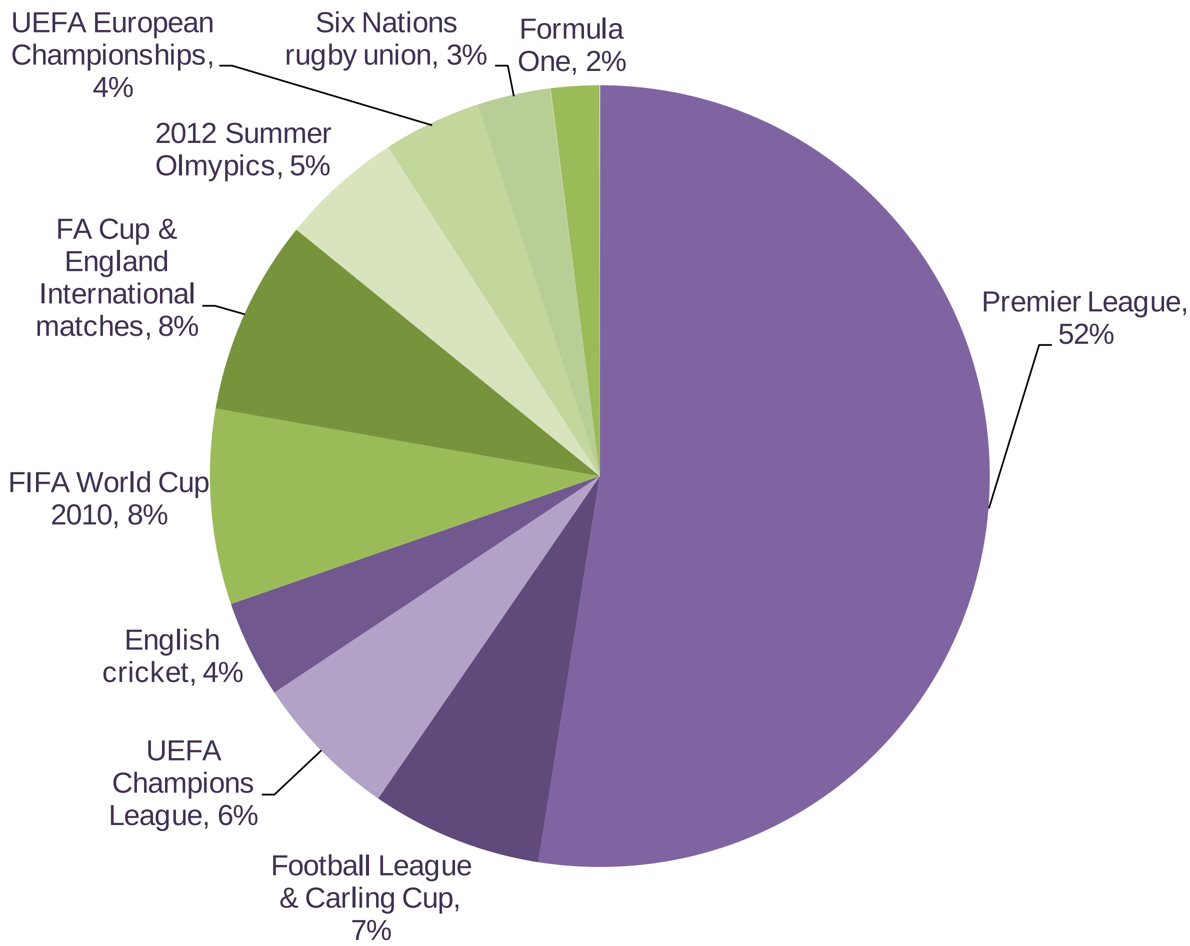
5.440 One way to estimate Sky's share if the relevant market included the supply of all live sports programming on television would be to look at its share of total expenditure on sports programming. We have not carried out this exercise. However, **[✂]**[446]. Further, in the First Pay TV Consultation we presented data on the ten most valuable sports rights properties. Sky accounts for all or a high proportion of the expenditure on four of those events[447]. Those four events account for 69% of expenditure on the top ten events – see Figure 59 below.

[445] In order for Sky's market share to drop to 50%, the value of the tournaments that contain listed events broadcasted live by the BBC and ITV would need to be uplifted by approximately **[✂]** [over 200%].

[446] **[✂]**. **[✂]**.

[447] Namely the Premier League (52% of the top ten by value), the Football League and the Carling Cup (7%), the UEFA Champions League (6%), and English cricket (4%).

Figure 59 Top ten UK sports rights properties (by value per season/event)



Source: First Pay TV Consultation, annex 10, slide 4.

Note: Events for which Sky accounts for all or a high proportion of the expenditure are shown in purple. Other events are shown in green.

5.441 Figure 59 emphasises that the value of rights to other sporting events are small in comparison to the amounts paid for the Live Premier League Rights. In the 2006 Premier League sale, Sky accounted for 77% of payments for the Live Rights and Setanta accounted for 23%[448]. Sky's share will be higher in the future, as Sky won the rights to an additional 23 live Premier League games from the 2010/11 season onwards.

5.442 We thus consider that Sky would continue to hold a high market share even if the relevant market was broader than the moderate substitutes that we have identified and instead included all live sports broadcast on UK television.

Conclusion on market shares

5.443 Sky's high market shares, even when moderate substitutes are taken into account, are considerably above the 50% threshold, indicating that it faces little competitive

[448] Third Pay TV Consultation, annex 8, paragraph 2.87.

constraint. Moreover Sky's position appears to be persistent, as shown by its ability to sustain high market shares. Furthermore, these market shares will tend to understate Sky's market power, because they overstate the competitive constraint imposed by moderate substitutes for Core Premium Sports channels.

Barriers to entry and expansion

5.444 Where entry barriers are low, it may not be profitable to sustain prices above competitive levels because this would attract new entry which would then drive the price down, at least in the long term[449].

5.445 In its response to the Second Pay TV Consultation, Sky stated that entry and expansion in "television broadcasting" is relatively straightforward and that this is shown by the "massive proliferation of television channels" in the UK over the past ten years[450].

5.446 However the only example of entry or material expansion in the wholesale supply of Core Premium Sports channels in recent years has been Setanta Sports 1, and this only occurred after an EC intervention which prevented Sky from winning all Live Premier League rights, as described below.

5.447 Our assessment of market power depends on whether entry *on sufficient scale to materially undermine Sky's wholesale position* is likely. Below we explain why there are, and, in the absence of further regulatory intervention will remain, important barriers to such entry in this market[451] .

5.448 As a general point, we note that entry is risky, given the high sunk costs in obtaining sports content, particularly before access to a subscriber base has been secured. As noted in paragraph 4.133 of the Second Pay TV Consultation, press reports indicated that Setanta incurred losses of €100 million from 2005 to 2007. Setanta's director of corporate development said that "when you're launching and expanding, you typically incur the costs before you get any money from your subscriber base"[452]. Setanta exited the market in June 2009.

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[449] *Assessment of market power*, OFT, December 2004, paragraph 3.3, second bullet.

[450] Sky response to Second Pay TV Consultation, Annex 6, paragraph 6.1.

[451] OFT Market Power Guidelines state that:

"New entry is not simply about introducing a new product to the market. To be an effective competitive constraint, a new entrant must be able to attain a large enough scale to have a competitive impact on undertakings already in the market" (paragraph 5.37).

"When assessing whether and to what extent market power exists, it is helpful to consider the strength of any competitive constraints, i.e. market factors that prevent an undertaking from profitably sustaining prices above competitive levels" (paragraph 3.2; emphasis in original). "The lower are entry barriers, the more likely it is that potential competition will prevent undertakings already within a market from profitably sustaining prices above competitive levels" (paragraph 5.2). In other words, when considering competition from potential entrants, it is informative to consider whether they exert a sufficiently strong constraint to limit prices to the competitive level. It is thus a question of degree, rather than simply whether potential entrants exert some competitive constraint.

[452] http://www.independent.ie/business/irish/expansion-sees-setanta-losses-head-for-8364100m-1088013.html.

5.449 In order to enter this market it is necessary to acquire the rights to live sporting events that a significant number of consumers find highly valuable. Similarly, material changes in a wholesale channel provider's portfolio of sports rights can lead to a very significant expansion (or contraction) in that broadcaster's market share[453]. Thus barriers to acquiring rights also act as barriers to expansion. Our analysis therefore focuses on whether there are obstacles to acquiring the rights to certain key sporting events.

Live Premier League Rights

5.450 Our previous consultations have identified acquisition of Live Premier League rights as a barrier to entry and expansion. Here we set out the sale process for these rights, our views as to the importance of these rights in sustaining Sky's market power, and our views as to the likelihood that Sky will continue to win the majority of these rights in the absence of regulatory intervention.

The sale process

5.451 The Live Premier League Rights are sold by the Premier League. The live rights to each particular game are exclusive, although highlights and various delayed rights are also available. Until the 2007/08 season, all the available live rights had been won by Sky since the early 1990s. However, in March 2006, the European Commission adopted a decision (the "Commitments Decision") to accept binding commitments (the "Commitments") from the Premier League concerning the sale of various media rights, including the Live Premier League Rights[454].

5.452 The Commitments apply for the six seasons from 2007/08 onwards, or two rounds of bidding (Commitment 11.4). Each season is divided into 38 "rounds" of 10 matches. In each round, three or four matches are broadcast live. The Commitments require six packages of live rights to be made available (Commitments, schedule 1). Each of these packages gives the holder 23 "picks" of these matches. Different packages allow first, second, third and/or fourth pick of those matches (see Figure 7 below). A first pick match is likely to be more attractive to final consumers than a fourth pick match.

Figure 60 The six packages of Live Premier League Rights sold in 2006 and 2009

	Package						
	A	B	C	D	E	F	Total
No. of first pick matches	23				5	10	38
No. of second pick matches		23		8		7	38
No. of third pick matches			23		9	6	38
No. of fourth pick matches				15	9		24

Source: First Pay TV Consultation, Annex 10, page 22

[453] As was the case when Setanta began broadcasting live Premier League matches in 2007, following its acquisition of the Live Premier League Rights.

[454] For more details, see: http://ec.europa.eu/comm/competition/antitrust/cases/index/by_nr_76.html#i38_173.

5.453 The Commitments set transparency and non-discrimination conditions for the bidding process (Commitment 7.2). No one bidder is allowed to acquire all six packages (Commitment 3.2) and packages must be bid for on a standalone basis i.e. the amount bid cannot be conditional on the number of packages that a bidder wins (Commitment 7.5).

5.454 In the 2006, the Premier League sold the rights to the 2007/08 to 2009/10 seasons (the “2006” sale). **[✂]**. In light of those bids, the Premier League chose to award three rights packages to Sky (B, E and F) and to hold a second round of bidding for the remaining three packages (A, C and D). That second round was **[✂]** and resulted in the Premier League awarding a fourth package to Sky (A) and two packages to Setanta (C and D).

5.455 In February 2009, the Premier League sold the rights to the 2010/11 to 2012/13 seasons (the “initial 2009 sale”). As in 2006, **[✂]**. This time, the Premier League chose to award four packages to Sky (A, B, E and F) after that initial round. A second round of bidding was held for the remaining two packages. **[✂].** As a result, the Premier League awarded a fifth package to Sky (C) and the final package to Setanta (D).

5.456 In June 2009, the Premier League terminated its agreement to license the Live Premier League Rights to Setanta as a result of Setanta failing to make payments specified under that agreement. The Premier League held a revised round of bidding for the rights to packages C and D for the 2009/10 season (the “2009” resale) and both of these packages were awarded to ESPN. For the reasons given in Appendix 10 to Annex 4, we consider that the special circumstances of the June 2009 resale mean that the prices paid are an unreliable guide to the attractiveness of these packages. The rights to package D for the 2010/11 to 2012/13 seasons that had been awarded to Setanta were instead awarded to ESPN.

5.457 **[✂]**[455]. This supports the evidence set out in Appendix 8 of Annex 4 that Sky’s vertical integration with the largest pay TV retailer, and its resulting access to a large established subscriber base, provides it with a material advantage when bidding for rights.

Why these rights are important to Sky’s market power

5.458 First, we discuss the evidence demonstrating the particular importance of the Live Premier League Rights. Second, we set out the evidence showing that Sky’s wholesale position will be sustained unless Sky loses multiple packages of Live Premier League Rights. Third, we explain why package A is particularly important.

5.459 The importance of live Premier League matches is shown by survey evidence, the amounts paid for rights and internal documents (as shown in Appendix 2 of Annex 4). The Premier League disputed this material and its arguments are set out in that Appendix.

5.460 The Premier League considered that focusing on the Live Premier League Rights in this way is inconsistent with Ofcom’s market definition since the channels within the relevant market contain a wider range of sports content than just live Premier League matches[456]. Further the Premier League did not consider that Sky possesses

[455] **[✂]**

[456] Premier League response to Third Pay TV Consultation, paragraphs 6.3 and 6.31.

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[457]. Appendix 11 of Annex 4 explains why we do not consider that our position is incompatible with that of the European Commission.

5.461 While the channels in the relevant market show a wider range of sports content, we consider that a focus on Live Premier League rights is appropriate because access to these rights is central to the viability of these channels[458].

5.462 Turning to the second issue, the available evidence suggests that Sky's wholesale position will be maintained unless Sky loses multiple packages of Live Premier League Rights.

- Setanta acquired two packages of live Premier League Rights in 2006 and, as shown by the market share figures presented above, Sky has maintained a very high market share. This is notwithstanding Setanta's success in winning various other sporting rights (including the rights to other popular football contests, such as FA Cup and England international matches).

- Our view reflects contemporaneous documents produced by parties that bid in 2006.

    - First, a document produced by ntl in 2006 stated that the "Potential exploitation of Premier League rights varies dramatically based on number of packages won". **[✂]**[459].

    - Second, **[✂]**[460].

    - Third, **[✂]**[461].

5.463 In addressing Setanta's failure to undermine Sky's high market share, the Premier League reiterated its arguments that market shares are largely irrelevant because this is a "bidding market"[462]. This argument is set out and addressed in paragraphs 5.412 to 5.413 above.

5.464 The particular importance of package A is indicated by the following evidence:

- Package A includes 23 first pick matches (61% of the 38 first pick matches available).

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457 Premier League response to Third Pay TV Consultation, paragraph 6.4.

458 This is evidenced by Setanta's exit from the market shortly after losing half its Premier League rights; ESPN only entered the market when it acquired Premier League rights.

459 **[✂]**.

460 **[✂]**.

461 **[✂]**.

462 Premier League response to Third Pay TV Consultation, paragraph 6.35

- The importance of first pick matches is highlighted by contemporaneous documents. **[✂]**[463].

- **[✂]**[464]. **[✂]**[465].

Sky is likely to win the majority of the Live Premier League Rights

5.465 Following the recent sale of the Live Premier League Rights for the 2010/11 to 2012/13 seasons, further Live Premier League Rights will not become available until the 2013/14 season (the rights to this and subsequent seasons will probably not be sold until 2012). Entry is thus not possible in the short term.

5.466 Moreover even when the rights to later Premier League seasons become available, we consider that Sky is likely to win the majority of those rights. This implies that Sky's wholesale position will not be materially undermined by potential competition from new entrants (as explained in paragraph 5.391 above, Sky is likely to maintain its wholesale position if it wins the majority of the Live Premier League Rights).

5.467 Our view is strongly supported by the historical evidence.[466] Prior to the European Commission's intervention, Sky had always won all of the Live Premier League Rights. While the Commitments currently prevent the Premier League from awarding all the Live Premier League Rights to Sky, Sky nonetheless won the majority of those rights in both 2006 and 2009. We regard this as clear evidence that, contrary to Sky's claims that these rights are "contestable", in practice there are significant barriers to other parties winning sufficient rights away from Sky.

5.468 This is confirmed by more detailed analysis of the bids submitted in 2006 and 2009.

5.469 First, it is confirmed by **[✂]**.

- **[✂]**

- **[✂]**

- **[✂]** i.e. that Sky will retain the majority of the Live Premier League Rights[467].

Figure 61 Difference between Sky's bids and second highest bids for the Live Premier League Rights

[✂]

5.470 We recognise that **[✂]**

- **[✂]**.

[463] **[✂]**.

[464] **[✂]**.

[465] **[✂]**.

[466] See also the analysis in Appendix 11 of Annex 4 explaining why Sky may have an advantage over other bidders for these rights.

[467] **[✂]**. 2009 Monitoring Trustees' Reports.

- **[✂]**.
- **[✂]**. However, as shown in Figure 60 above packages C and D both generally feature less attractive Premier League matches (C consists of twenty three third choice picks; D consists of eight second choice picks and fifteen fourth choice picks).
- This is confirmed by **[✂]**[468].
- Further, **[✂]**[469].
- Moreover, even if Sky fails to win packages C and D (as occurred in 2006), it will still have retained the majority of the Live Premier League Rights and its wholesale position will not have been materially undermined.

5.471 Second, in 2009 **[✂]** is consistent with our view that Sky is likely to retain the majority of the Live Premier League Rights.

Figure 62 Number of serious bids for the Live Premier League Rights in 2006 and 2009

[✂]

5.472 Indeed there is evidence that **[✂]**[470].

5.473 We have received a number of explanations for Sky's persistent success in bidding for the Live Premier League Rights. For example, the Four Parties have argued that Sky's success reflects the size of its satellite retail subscriber base and the impact of the staggered expiry dates of rights agreements for different sporting contests.

5.474 Given the clear historic position, we do not consider that it is necessary for us to form a conclusive view on which factors explain Sky's strong bidding position for the Live Premier League Rights. Nonetheless, in Appendix 8 of Annex 4 we set out evidence in support of the following factors:

- 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 enjoyed by Sky.

5.475 We discuss these factors in more detail in the Appendix. 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.

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[468] **[✂]**.

[469] **[✂]**.

[470] **[✂]**.

Representations on whether Sky is likely to win the majority of the Live Premier League Rights

5.476 Sky considered that the Live Premier League Rights are "contestable"[471]. In its response to the First Pay TV Consultation Sky advanced a number of arguments in support of its position:

- Sky considered that Ofcom's position was not consistent with Sky winning four rather than five packages of Live Premier League Rights in 2006.
- Sky considered that there are a large number of potential entrants.
- Sky's argued that the price of the Live Premier League Rights in 2006 implies that bidders were closely matched.

5.477 In its response to previous consultations the Premier League argued that the Commitments address any entry barriers. In response to the Third Pay TV Consultation, the Premier League advanced a number of arguments:

- That Ofcom failed to set out adequate evidence to support the view that Sky is likely to win the majority of the Live Premier League Rights[472].
- That Live Premier League Rights are contestable as evidenced by **[✂]**, the entry of Setanta and the entry of ESPN[473].
- **[✂]**[474]
- That, in "bidding markets", historic bidding patterns are largely irrelevant[475].
- That given the difficulty of attempting to predict the future Ofcom should not rely on previous outcomes to predict the outcome the next time the Live Premier League Rights are sold[476].
- That inadequate evidence was presented to justify such predictions.[477]

5.478 That the fact that Sky has consistently placed high bids for the acquisition of the Live Premier League Rights demonstrates that it is subject to competitive constraints when acquiring those rights.[478] **[✂]**[479]Accordingly, the Premier League considered

[471] Sky response to First Pay TV Consultation, Annex 3, heading 6.

[472] Premier League response to Third Pay TV Consultation, paragraph 6.43; also 6.44-6.45.

[473] Premier League response to Third Pay TV Consultation, paragraph 6.49.

[474] **[✂]**

[475] Premier League response to Third Pay TV Consultation, paragraph 6.2.

[476] Premier League response to Third Pay TV Consultation, paragraph 6.2; also 6.39.

[477] Premier League response to Third Pay TV Consultation, paragraph 6.2.

[478] Premier League response to Third Pay TV Consultation, paragraph 6.17.

[479] **[✂]**

that the 2009 sale does not demonstrate anything about the likelihood of Sky winning the Live Premier League Rights in the future[480]. **[✂]**

- **[✂]**[481]
- **[✂]**
- **[✂]**
- **[✂]**

5.479 We consider the first 2009 Premier League auction as reliable evidence. If the "special features" that the Premier League identified did have any significant effect on the 2009 auction, this would be inconsistent with Sky bidding more in the 2009 auction than in 2006 for the 4 packages (out of 6) that it won in 2006. Though Setanta was on the brink of insolvency, there were still other potential bidders. There is no evidence that wider economic conditions that the Premier League referred to significantly affected other bidders more than Sky. It may have reduced the value of all bidders, but it did not necessarily put Sky in a stronger position to win overall. The BBC's position to bid was still strong as in the most recent funding settlement (in January 2007), the licence fee was agreed for a six-year period (i.e. up until 2012). In Section 11, we detail the likely effect of our remedy on rights values. We have deliberately designed our remedy to minimise the effects on rights-holders. We consider that our remedy will not significantly alter Virgin Media and BT's incentives to bid for live Premier League rights. We address the Premier League's other arguments and Sky's arguments in turn below. We also consider the relevance of the 2009 Resale in Appendix 10 of Annex 4.

The number of Live Premier League Rights packages Sky won in 2006

5.480 In its response to the First Pay TV Consultation, Sky has argued that its failure to win a fifth package in 2006 is evidence that the Live Premier League Rights can be won by rival bidders in the future.

5.481 We considered this argument in the Second Pay TV Consultation and said that Sky is likely to win the majority of the available Live Premier League Rights but that there is a degree of uncertainty about whether it would win four or five packages[482].

5.482 This view is confirmed by **[✂]**.

5.483 We thus do not consider that the outcome of the 2006 sale undermines our conclusion that Sky is likely to win the majority of the Live Premier League Rights. Moreover, in 2009 Sky did in fact win the maximum five packages available to it **[✂]**.

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480 [Premier League response to Third Pay TV Consultation, paragraph 6.42]

481 **[✂]**

482 Second Pay TV Consultation, Annex 7, paragraphs 2.67-2.68.

The range of potential bidders

5.484 In its response to the First Pay TV Consultation, Sky stated that there is a wide range of potential entrants, including both other broadcasters and upstream rights holders[483]. Sky noted that vertical integration by sports bodies is common in the US and that the Scottish Premier League considered establishing its own channel in 2002. Sky noted that while a significant financial outlay would be required to acquire large tranches of rights in a short time period, many entities have access to such funding e.g. Disney/ESPN or BT Vision.

5.485 As explained in previous consultations, the relevant question is not whether there are a large number of potential bidders for the Live Premier League Rights but whether those bidders are likely to acquire those rights. We considered that rival bidders were unlikely to be successful. As explained in paragraphs 5.465 to 5.469 above, Sky is likely to win the majority of the Live Premier League Rights even if there is a range of potential bidders **[✂]**.

5.486 The Commitments ensure that at least one package of Live Premier League Rights will be acquired by a rival bidder. **[✂]**[484].

5.487 **[✂]**. This suggests that the new sale format in 2006 (pursuant to the Commitments) may well have attracted additional bidders because the novelty of its format meant that the result was less predictable, **[✂]**. **[✂]**[485]. **[✂]**[486].

The price of Live Premier League Rights

5.488 In its response to the First Pay TV Consultation, Sky argued that the increase in the price of the Live Premier League Rights is inconsistent with the view that these rights are not contestable. Figure 63 depicts the amounts paid for the Live Premier League Rights[487].

Figure 63 The amounts paid for the Live Premier League Rights

[✂]

5.489 The average per match price of the Live Premier League Rights is broadly similar for the 20011/2 to 2003/04 seasons and the 2007/08 to 2012/13 seasons. In contrast the price for the 2004/05 to 2006/07 seasons appears to be comparatively low. However, as discussed in the Third Pay TV Consultation, competition between bidders was relatively weak in 2003 (when the Live Premier League Rights for the 2004/05 to

[483] As explained in the final bullet of paragraph 2.93 of Annex 7 of the Second Pay TV Consultation, Sky also argued that new entrants, with few or no sports rights, might value additional rights more than an incumbent. We rebutted this argument in paragraphs 2.96-2.97 of Annex 7 of that consultation and we continue to rely on that rebuttal. In any event, Sky's argument is not supported by the **[✂]**.

[484] **[✂]**.

[485] **[✂]**.

[486] **[✂]**.

[487] This updates Figure 8 of Annex 7 in the Second Pay TV Consultation to use the actual amounts bid for the Live Premier League Rights in 2006 and 2009 (rather than an estimate).

2006/07 seasons were sold), in particular due to the collapse of ITV Digital in May 2002. Internal documents support this view: **[✂]**[488].

5.490 We consider that the much larger amounts paid in 2006 and 2009 (for the Live Premier League Rights to the 2007/08 to 2012/13 seasons) is likely to reflect greater competition between bidders than in 2003. However we do not consider that this implies that Sky faced such close competition that it was likely to lose the majority of the Live Premier League Rights.

- First, a comparison with 2003 is not a comparison with a competitive sale process.
- Second, **[✂]**.

Other sports rights

5.491 In paragraphs 2.160 to 2.166 of Annex 8 of the Third Pay TV Consultation we considered whether there are barriers to acquiring the rights to other sports.

- We said that our analysis of the Live Premier League Rights was sufficient to conclude that entry and expansion will not materially undermine Sky's wholesale position[489].
- We observed that Sky has, in the round, been fairly successful when bidding for sports rights. However, both FTA and other pay TV broadcasters (primarily Setanta) have also successfully acquired the rights to a number of attractive sporting events. The pattern differs between sports. We stated that it is not clear that there are particular obstacles to third parties acquiring the rights to live golf, rugby union, rugby league and (especially) tennis matches. However, historical evidence suggests that Sky is more likely to be successful in retaining or acquiring live football and (especially) cricket rights[490].
- We noted that the factors, such as Sky's established subscriber base, that may give Sky an advantage when bidding for Live Premier League Rights are likely to also be relevant when considering whether Sky is likely to retain the live rights to non-Premier League sporting events. However, we recognise that rival bidders may enjoy advantages of their own, as is shown by the more mixed pattern of winners of other sporting rights. For example, free to air broadcasters are able to attract larger audiences (allowing a sport to raise more money from sponsorship) and free to air coverage may help maintain the profile and inclusiveness of a sport[491].

5.492 Given the importance of live Premier League rights for successful entry or expansion in Pay TV, we have not considered in detail whether there are obstacles to acquiring the rights to other sports.

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[488] **[✂]**

[489] See Third Pay TV Consultation, paragraph 2.160.

[490] See Third Pay TV Consultation, paragraph 2.165.

[491] See Third Pay TV Consultation, paragraph 2.166.

Conclusion

5.493 Given Sky's high current market share, entrants will only materially undermine the wholesale position possessed by Sky if they (in aggregate) win a large amount of rights away from Sky. We consider that Sky is likely to maintain its wholesale position if it wins the majority of the Live Premier League Rights. By "majority" we mean:

- Either any five packages of Live Premier League Rights; or
- Four packages including package A (which contains 23 first pick games and is the most attractive package).

5.494 In other words, as a minimum, rival wholesalers (in aggregate) would have to win:

- Either two packages including package A; or
- Any three packages of Live Premier League Rights[492].

Countervailing buyer power

5.495 The only major independent purchaser of Sky Sports 1 and 2 is Virgin Media. We have considered whether Virgin Media is likely to exert sufficient CBP to offset Sky's seller power over the next three to four years.

Representations on CBP

5.496 In the previous consultations we indicated that, on balance, Virgin Media had a degree of CBP but was unlikely to constrain Sky's market power.

5.497 In its response to the First Pay TV Consultation, Sky argued that platforms such as those of Virgin Media and BT Vision were closed, so a channel provider could not access that platform's customers without the agreement of a platform operator. In a later submission, Sky also argued that a retailer might reduce its marketing effort in response to a price increase of Sky Sports[493], leading to a fall in subscribers and wholesale revenues.

5.498 In its response to the First Pay TV Consultation, Virgin Media said it did not have any buyer power in its relationship with Sky. In particular, Virgin Media argued that its dealings with Sky cannot reasonably be described as 'negotiations', as revealed by the wholesale prices and the terms and conditions imposed by Sky. In particular, Virgin Media said that "Sky can choose to set its retail and wholesale prices such that Virgin Media makes a very low retail margin or a loss on selling Sky's premium channels" and referred to Sky "refusing to supply" high definition programming, interactive services and related content.

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[492] We recognise that this may underestimate the amount of Live Premier League Rights that competitors would need to win in order to materially undermine Sky's wholesale position. For example, it could be argued that Sky would still maintain its position if it holds just three packages of Live Premier League Rights. The cautious view that we have adopted about the extent of entry required may thus be biased towards concluding that Sky is not dominant.

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

Responses to our July 2008 information requests

5.499 In July 2008 we asked Virgin Media and Sky a number of detailed questions regarding negotiations between the two parties over the supply of Sky Sports and Sky Movies by Sky to Virgin Media. We asked the parties about the extent of their dependence on one another and about the commercial relationship between the companies in respect of Sky's premium channels.

5.500 In its response to our information request, **[✂]**.

5.501 Sky also argued **[✂]**.

5.502 In its response to our request, **[✂]**.

5.503 Virgin Media said that it "does not consider the possibility of declining to purchase Sky Sports and Sky Movies channels". It believed that if it did not acquire the channels it would lose significant business, and its pay TV proposition would be undermined. Subscribers that value these channels would be likely to acquire pay TV services from Sky, which would further entrench Sky's market position. Virgin Media believed that these circumstances demonstrate the lack of bargaining power it has in relation to Sky Sports and Sky Movies[494]. It contended that the closed nature of its platform does not convey buyer power, as it feels "obliged" and does not have a "real economic choice" but to offer popular channels to customers.[495]

Our assessment of CBP

5.504 Paragraph 6.2 of the OFT Market Power Guidelines set out four conditions that are relevant to the assessment of CBP. Three of these conditions are particularly relevant to our analysis and we have been mindful of these conditions in assessing whether retailers of pay TV services possess CBP in respect of Sky:

- The buyer is well informed about alternative sources of supply and could readily, and at little cost to itself, switch substantial purchases from one supplier to another while continuing to meet its needs.

- The buyer could commence production of the item itself or 'sponsor' new entry by another supplier (e.g. through a long-term contract) relatively quickly and without incurring substantial sunk costs.

- The buyer is an important outlet for the seller (i.e. the seller would be willing to cede better terms to the buyer in order to retain the opportunity to sell to that buyer).

5.505 Virgin Media is the UK's second largest retailer of pay TV services, and, as a closed platform provides Sky with access to some subscribers it otherwise could not reach. We also consider that Virgin Media is a well-informed buyer, likely to be aware of any alternative options available to it.

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[494] Virgin Media response dated 18 July 2008 to information request dated 2 July 2008, paragraphs 2.2.1 to 2.2.4.

[495] Virgin Media response dated 18 July 2008 to information request dated 2 July 2008, paragraphs 2.3.1 to 2.3.4.

5.506 However, we remain of the view that Virgin Media has little if any buyer power in relation to Sky's premium channels because:

- The importance of Sky's premium content to consumers is such that Virgin Media does not have available adequate alternative sources of supply.

- In our view, Sky does not negotiate wholesale prices or terms with Virgin Media. We consider that the terms on which Virgin Media is supplied reflect the regulatory environment rather than any commercial pressure on Sky from Virgin Media.

- **[✂]**[496]. **[✂]**

- Virgin Media has not been able to negotiate a wholesale price that enables it to earn a higher margin on all bundles including Sky Sports and/or Sky Movies.

- Virgin Media was unable to secure the supply of Sky's basic-tier channels between March 2007 and November 2008.

- Our competition issues analysis concludes that Sky has an incentive to weaken or eliminate Virgin Media as a competitor. Given that benefit to Sky of continuing to supply Virgin Media appears marginal in the long term, it is not clear that Sky would be negatively affected if Virgin Media dropped Sky Sports. As such Virgin Media does not have a lever to extract better terms from Sky.

- Even if Virgin Media had buyer power, it only accounts for around **[✂]** of retail supply of Sky Sports. As such Virgin Media is unlikely to be able to constrain Sky to set a lower retail price to subscribers who purchase Sky Sports from Sky.

Conclusion on countervailing buyer power

5.507 In summary, our view is that while Virgin Media is a significant outlet for Sky, the commercial balance of the relationship is strongly in favour of Sky. Furthermore, around **[✂]** of Sky's supply is direct to subscribers, where there is no scope for buyer power to arise. We conclude that no party exercises sufficient buyer power to counter Sky's seller power in the wholesale supply of Core Premium Sports channels.

Summary

5.508 As described in paragraphs 5.417 to 5.424 and Figure 54, Sky has a market share of around **[✂]** which is consistent with very high market power, and indeed a position of dominance. Even if moderately close substitutes are included in the market, Sky still has a share of around **[✂]** [above 50%], which creates a presumption of dominance.

5.509 Access to premium sports content – in particular Live Premier League rights – is a barrier to market entry and expansion. Sky will retain its market power as long as it retains the rights to at least five of the six packages of Live Premier League rights (or four packages if one of them is package A).

[496] **[✂]**

5.510 Most of Sky's subscribers are subscribed directly to Sky, limiting the scope for countervailing buyer power. In addition, the importance of Sky Sports to Virgin Media, and Sky's approach to supplying Virgin Media, indicate that Virgin Media has little if any buyer power over Sky.

5.511 As a result, our analysis based on market definition and market shares provides strong evidence in support of our view that Sky is dominant, and is likely to remain dominant in the absence of regulatory intervention.

5.512 Next we consider whether the current prices of packages including Sky Sports channels are above the competitive level, with reference to evidence as to Sky's profitability and costs, and in particular the cost of Premier League rights.

Evidence that current prices are above the competitive level

5.513 We now assess empirical evidence as to **whether wholesale and retail prices are constrained** to the competitive level because a substantial number of customers would stop buying if prices were raised above this level. In our Third Pay TV Consultation we argued that evidence of high profits supported a view that retail prices were above competitive levels.[497] As we discuss below, if the wholesale price charged by Sky to other pay TV retailers for its channels is above the competitive level then the retail price of bundles including those channels is also likely to be above the competitive level.

Position in the Third Pay TV Consultation

5.514 In the Third Pay TV Consultation, we stated that evidence that Sky is earning supernormal profits would point strongly to prices being above competitive levels. We presented evidence on Sky's profitability prepared by Oxera that supported the view that prices were above competitive levels[498]. We stated that, even absent such evidence that Sky were earning high profits, we would be concerned that retail prices were above the competitive levels because rights holders may be extracting monopoly rents via high rights prices. We stated that this is particularly likely in the case of sports rights which are sold collectively, such as the Live Premier League Rights[499].

Responses on whether current prices are above the competitive level

5.515 Sky stated that there is not strong evidence that prices are above the competitive level[500], either in Oxera's report or Ofcom's estimate of cost-plus prices[501].

[497] Third Pay TV Consultation, paragraph 4.53.

[498] Third Pay TV Consultation, paragraph 4.52.

[499] Third Pay TV Consultation, paragraph 4.53.

[500] Sky response to Third Pay TV Consultation, paragraph 5.53. See also 6 June 2009 Sky Submission, paragraphs 5.14-5.15. In Sky also submitted detailed representations on the profitability analysis carried out by Oxera. These representations are set out and addressed in Annex 2.

[501] Sky response to Third Pay TV Consultation, Section 7.

Accordingly Sky considered that it was inappropriate for Ofcom to rely on the cellophane fallacy[502].

5.516 The Premier League made a similar point[503] [504]. The Premier League noted the profitability evidence prepared by Oxera but stated that it was not in a position to comment on this analysis or its conclusions[505].

5.517 Sky characterised the proposition that the collective sale of sports rights raises the price of such rights above competitive levels as an assertion and "simplistic"[506].

5.518 Similarly, the Premier League considered that the suggestion in the Third Pay TV Consultation that rights owners might be extracting monopoly rents was "baseless speculation"[507].

- The Premier League stated that the attractive product is created by the league and is superior to whatever product might be sold by individual football clubs[508].

- The Premier League referred to its member clubs' substantial costs (particularly wages) and cited paragraph 3.41 of the Third Pay TV Consultation which highlighted the difficulties in distinguishing whether footballers' salaries were an indication of market power or reflected scarcity rents[509].

Oxera's analysis of Sky's profitability

5.519 In our Third Pay TV Consultation Document, we presented Oxera's assessment of Sky's profitability. This assessment informs both our understanding of current prices and, directly, our assessment of market power. Companies earning returns above

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502 Sky response to Third Pay TV Consultation, paragraph 5.53.

503 Premier League response to Third Pay TV Consultation, paragraphs 4.26, 5.8.5, 5.15, 5.48, 5.50

504 The Premier League also said that our conclusions on the level of wholesale pricing were inconclusive (Premier League response to Third Pay TV Consultation, paragraph 5.10 and footnote 39). In support, the Premier League cited paragraphs 4.28, 4.30 of the Third Pay TV Consultation. However, these paragraphs summarised our position in the Second Pay TV Consultation. The Premier League did not refer to paragraph 4.52 of the Third Pay TV Consultation in which we referred to new analysis provided by Oxera subsequent to the Second Pay TV Consultation. The Premier League's claim that our conclusions are inconclusive thus does not accurately reflect our position in the Third Pay TV Consultation.

505 Premier League response to Third Pay TV Consultation, paragraph 7.36.

506 June 2009 Sky Submission, paragraphs 5.14-5.15. In addition, footnote 78 to paragraph 5.15 of this submission stated that characterising the collective sale of sports rights by sports bodies as tantamount to cartelisation has a poor track record before the courts as shown by, for example, *Racecourse Association & Others v OFT*, [2005] CAT 29.

507 Premier League response to Third Pay TV Consultation, paragraphs 4.23 and 5.14. The Premier League also advanced arguments concerning the comparability of the price of the rights to different sports events (Premier League response to Third Pay TV Consultation, paragraph 6.32). These arguments are relevant to the further evidence that we present on this point (see below).

508 Premier League response to Third Pay TV Consultation, paragraph 5.14.

509 Premier League response to Third Pay TV Consultation, paragraphs 4.23-4.24.

their cost of capital for a sustained period may constitute evidence of barriers to entry and of the exploitation of market power through charging high prices to consumers[510].

5.520 Annex 3 sets out the conclusions of our assessment of Sky's profitability, informed by a second report we commissioned from Oxera, which is included in the Annex. The Annex sets out our position on profitability in the Third Pay TV Consultation; summarises the responses we received; describes the further analysis we and Oxera have carried out in order to address those responses and sets out our conclusions from this analysis. It also considers in more detail alternative measures of profitability such as total shareholder returns analysis, again in order to address consultation responses.

5.521 In its first report, Oxera also carried out an assessment of Sky's profitability at a disaggregate level. It considered specifically the profitability of Sky at the level of retail and wholesale, premium and basic channels and sports and movies channels.

5.522 Below we first summarise Oxera's results on Sky's aggregate profitability. We then summarise Oxera's work on disaggregating those results. Finally we set out the implications of this profitability analysis for our assessment of whether the retail prices of bundles including Sky Sports 1 and/or Sky Sports 2 are currently above the competitive level.

Sky's aggregate profitability

5.523 In assessing Sky's profitability at an aggregate level, Oxera used the truncated IRR methodology, in which the initial asset value is treated as a cash outflow and the residual value at the end of the period is treated as a cash inflow. We explained that in a competitive market with freedom of entry and exit, we would not expect the IRR to substantially exceed the cost of capital in the long run. An IRR substantially above the cost of capital could indicate the existence of barriers to entry and market power.

5.524 In our Third Pay TV Consultation we reported[511] that Oxera's "aggregate profitability analysis suggests that... under the base case scenario the IRR ranges from 20% to 28%". Oxera also found that its estimates of ROCE supported the IRR results, particularly in the period 2004-2008.

5.525 We explained that the cost of capital was the relevant benchmark for Oxera's estimates of Sky's profitability under the IRR approach. Our forward looking cost of capital at the time was 10.3%[512], which we also thought was a reasonable estimate of Sky's cost of capital in the last few years, including the 2004-2008 period. We observed that Sky's returns as measured using the IRR methodology were higher than its cost of capital, and we believed that this would continue if the pay TV sector was left unchanged.

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

[510] Annex 12 to Third Pay TV Consultation, paragraph 1.1

[511] Third Pay TV Consultation, paragraph 6.186.

[512] Third Pay TV Consultation, paragraph 6.193.

- Several respondents agreed with the IRR approach used by Oxera and commented that it was conceptually appropriate in the context of a competition investigation. (See Annex 3, paragraphs 1.13-1.15)

- However, Sky, and its advisor Professor Grout, made a series of challenges to the profitability analysis and the conclusions that Ofcom drew. Sky's main challenges were that the IRR methodology was not appropriate; that its returns could be above its cost of capital as a result of its ongoing risk taking and innovation and that alternative measures of profitability (such as shareholder returns analysis) do not support a finding that Sky's returns have been abnormally high. (See Annex 3, paragraph 1.17)

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

5.528 We also asked Oxera to help us consider the challenges made by Sky and Professor Grout about the use of IRR in profitability analysis. Sky and Professor Grout suggested that the IRR is not well suited to assessing the question of whether returns are persistently and significantly above the cost of capital[513] and that there were issues with asset valuation which meant the IRR could be biased.[514] Sky also questioned the robustness of the IRR calculation.[515]

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

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

5.531 Sky / Professor Grout also carried out an assessment of Sky's profitability based on shareholder returns and concluded that "approaching Sky's profitability through this stock market evidence does not support a case that Sky is abnormally profitable."[517]

[513] Sky response to Third Pay TV Consultation, paragraph 4.45

[514] A report on profitability, September 2009 page 2.

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

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

[517] Sky response to Third Pay TV Consultation, paragraph 4.84

5.532 In Annex 3 we explain that, informed by Oxera's second report, we do not think that an analysis of shareholder returns is an appropriate way to assess Sky's economic profitability. This is because shareholder returns can only measure returns based on shareholder expectations at two points in time, rather than the economic returns earned by Sky, which is the relevant measure for our competition assessment.

5.533 If high returns are already reflected in the share price at the first of these points in time, these will not be revealed by an analysis based on shareholder returns. As discussed in more detail below, there is evidence that Sky's subsequent high returns were largely already captured in its valuation at flotation.

5.534 An analysis based on shareholder returns also suffers from practical limitations related to the choice of appropriate time period and benchmark which means it is not a robust measure of returns.

5.535 In our Third Pay TV Consultation we included a chart which showed the value of Sky's asset base under different valuation approaches[518]. This is shown in Figure 64 below, with values updated for 2009.

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

[✂]

5.536 As noted in our Third Pay TV Consultation, Oxera said in its first report that "from flotation up to 2008, the estimated market value of Sky's assets was significantly higher than the estimated replacement cost value[519]". It appears that the market perceived that the value of Sky's future cash flows would substantially exceed the underlying replacement cost of the assets. This illustrates the difference between IRR analysis and TSR analysis which is that IRR helps assess the relationship between prices and costs, while TSR captures the relationship between prices and expectations.

5.537 Professor Grout, on behalf of Sky, argued that because total shareholder returns since flotation had underperformed the market, this is evidence that Sky was not abnormally profitable. However, the reason why the IRR is greater than the TSR in Sky's case is because the value of the assets used in the TSR analysis is significantly greater than the value of the assets in the IRR analysis. This reflects the difference in what the two measures are capturing. TSR estimates returns to shareholders, so the asset value reflects the market value of assets, which is the NPV of present and future investments. The IRR on the other hand estimates returns relative to the costs incurred by Sky in building its asset base and uses the replacement cost value of assets.

5.538 This observed difference between the market and replacement cost value of assets is consistent with the economic characteristics of Sky's investments. Oxera's report demonstrates that the costs to Sky of acquiring additional subscribers are significantly lower than the value of additional cash flows generated by these subscribers over their lifetime. Oxera says that its analysis shows that "it is reasonable to expect that the market valuation at flotation incorporated this

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[518] Third Pay TV Consultation, Figure 58

[519] Oxera first report, page 26.

significant expected difference between the lifetime cash flows of subscribers and their acquisition costs."[520]

5.539 Sky / Professor Grout also compared Oxera's estimate of Sky's ROCE to the ROCEs of firms previously investigated by the CC and concluded that Sky's book value ROCE appeared comparatively small[521]. We explain in Annex 3 that we do not consider that this analysis is relevant to the assessment of Sky's profitability. Oxera points out that a "high ROCE based on historical cost asset values is not the only indicator that a company may be operating against the public interest. Therefore a strong relationship between the level of ROCE and the conclusions of the CC with respect to profitability would not be expected"[522].

5.540 Oxera also notes in its second report that the analysis does not attempt to control for factors that could reduce the comparability of ROCE as a measure of economic profitability between different competition cases. For example, Oxera's calculation of Sky's ROCE was based on a definition of capital employed equal to total assets rather than a common definition of capital employed which deducts current liabilities. Sky's calculated ROCE would have been considerably higher if current liabilities had been removed from the definition of capital employed – 45% over the period 2004-2008 rather than 29% excluding current liabilities[523].

5.541 Finally, even if the ROCEs were all comparable and based on the same definition of capital employed, we do not agree with Professor Grout that the data implies that Sky's book value ROCE is comparatively small.

5.542 Sky, and its advisor PwC, also argued that Oxera's benchmarking analysis in its first report had no value because the comparators it used were not relevant[524]. In Annex 3 we note further benchmarking analysis from Oxera which suggests that the difference between Sky's ROCE and cost of capital is greater than 95% of the companies in the FTSE 350 Index over the period 2004-2008. Oxera's view is that this analysis addresses Sky's concerns around the choice of comparators.

5.543 We also note that Oxera's approach to selecting comparators in its first report is similar to the approach adopted by the CC in Classified Advertising Directory Services (see Annex 3, paragraph 6.5).

5.544 Overall we consider that the evidence on benchmarking supports the conclusions from our central analysis on Sky's IRR, which we set out below, although we recognise the difficulties with benchmarking of this kind.

Have Sky's returns exceeded its cost of capital?

5.545 As in its first report, Oxera estimated Sky's returns using a truncated IRR methodology, with the ROCE being used as a cross check. Figure 65 shows the updated estimates of the IRR under the depreciated replacement cost (DRC)

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[520] Oxera second report, page 18.

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

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

[523] Oxera second report, Section 3.5.

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

approach to valuing assets which Oxera used in its first report[525]. The values in this table range from 21% to 28%. In that report, Oxera explained its view that this is the conceptually appropriate approach to valuing Sky's assets.

Figure 65 Updated estimates of the IRR

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

5.546 The updated estimates suggest that over the past five years (2005-2009) under the base case DRC scenarios, the IRR was around 21%. This is marginally higher than the returns presented in Oxera's first report, where returns over the period 2004-2008 were around 20%. Oxera's updated estimates of Sky's ROCE support these IRR estimates, especially in the period 2005-2009[526].

5.547 We asked Oxera to consider the difference between Sky's returns and its cost of capital (the 'profitability gap') since it floated on the stock exchange in 1994. Oxera has estimated IRRs for Sky in three different time periods and compared this to its estimate of Sky's average cost of capital over the period[527].

5.548 Figure 66 shows estimates of the profitability gap between Sky's IRR based on DRC asset values and its average cost of capital over the corresponding period. Estimates of the profitability gap range from 8% to 15%.

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

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

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

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

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

[526] See Section 2.1 of Oxera's second report.

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

- In the classified directory advertising services market enquiry, the CC estimated Yell's profitability gap in the range -2% to 12% based on a comparison of truncated IRRs and ROCEs to the cost of capital. The CC said "we conclude, based on the truncated IRR estimates, that Yell's profits were high over the five years to 31 March 2006 and in excess of its WACC[528].

- In the CC's inquiry into the supply of banking services to SMEs, it identified a profitability gap of 9%, 10% and 12% in 1998, 1999 and 2000 respectively for the four largest clearing groups and considered that this indicated excessive profitability. The CC said "In our view, such a level of excess profits is unjustified and must be regarded as excessive."[529]

- When the OFT assessed BSkyB's profitability in its 1996 inquiry, an "excess return" of 10.3% was considered high and, according to the OFT, could not be sustained in a competitive market[530]. Oxera's analysis suggests that this gap has indeed been sustained.

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

Sky's disaggregate profitability

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

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

- Returns for Sky wholesale activities appear higher than for Sky retail activities. These results seem to hold under a number of cost allocation approaches and sensitivity checks.

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

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

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

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

- At the wholesale level, returns for premium channels appear higher than for basic channels. However, this should be interpreted with care, given the adopted allocation approaches.

- The evidence was not sufficiently robust to conclude on the profitability of movies and sports channels, although the analysis seems to provide some weak evidence that movies channels may have higher margins than sports channels[532].

5.554 Oxera's analysis suggested that returns for Sky's wholesale activities were higher than for Sky's retail activities. Figure 67 shows the results of this analysis for the period 2004-2008. This shows that returns based on IRR, ROCE and ROS were all higher for wholesale than for retail[533].

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

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

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

5.555 This analysis indicates that the significant profitability gap we identified for Sky as a whole from our IRR analysis is likely to be driven by returns from Sky's wholesale business. Consequently we consider that Sky's wholesale returns are high.

5.556 This conclusion is consistent with our understanding of the operation of the market described above: Sky determines the optimal retail price based on the demand conditions it faces. For its own retail consumers, it charges this price directly; for the retail consumers of its wholesale customers, it is able to enforce a higher retail price by setting a high wholesale price.

5.557 We then need to assess whether the wholesale profitability (and hence price) of premium channels is higher than for basic channels, and to consider any differences between sports and movies profitability.

5.558 We consider first the split between premium and basic. In this case revenue allocation between premium and basic channels is straightforward, since Sky's wholesale prices and hence wholesale revenues for its premium channels exclude

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

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

basic channels. For the allocation of costs common to basic and premium channels, Oxera adopted two alternative approaches[534]:

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

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

5.559 Oxera's analysis of the profitability of basic and premium channels suggested that, at the wholesale level, the profitability of premium channels was higher than for basic channels, and this relationship was consistent under different approaches to cost allocation. Figure 68 shows the results of Oxera's ROS analysis in the period 2004-2008. Its analysis of margins over direct costs was also consistent with these results, with margins on premium channels estimated at **[✂]**% compared to **[✂]**% for basic channels[535].

Figure 68 Estimates of ROS for basic and premium channels, 2004-2008[536]

	Common cost allocation	
Wholesale ROS	**Approach 1**	**Approach 2**
Basic	✂	✂
Premium	✂	✂

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

> "On balance, it would seem appropriate not to draw firm conclusions about Sky retail's profitability compared with the retail comparators. However, the evidence that Sky's aggregate profitability may be driven by its relatively high wholesale returns is further reinforced in light of the above analysis."[537]

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

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

[536] Source: Oxera first report, Table 5.2.

[537] Oxera first report, page 53.

5.561 We recognise the difficulty in identifying comparator companies for Sky, but we consider that these profitability results are supportive of the view that the retail and wholesale prices for Sky's premium channels are above competitive levels.

5.562 We have further sought to identify whether there are marked differences in profitability – and hence the extent to which prices are above competitive levels – between premium sports channels and premium movies channels.

5.563 Such an analysis is complicated by the fact that a large proportion of Sky's consumers purchase Sky Sports and Sky Movies together as part of a bundle. We therefore need to disaggregate revenues for these consumers. In principle, there are two extreme approaches to this disaggregation:

- The first assumes that all subscribers purchase the bundles primarily for access to the sports channels. Under this approach, Oxera assumes all subscribers effectively pay the standalone wholesale price for sports channels and the incremental wholesale price for movies. Hence if sports channels were available for £15 without movies and for £20 with movies, this approach would allocate 75% of revenues to the sports channels and 25% to the movies channels.

- The second approach assumes that all subscribers purchase the bundles primarily for access to the movies channels. If movies channels were available for £15 without movies, and for £20 with sports, 75% of the revenues would be allocated to movies.

5.564 A middle ground is to look more closely at the preferences of subscribers. Oxera's "preference based" approach draws on the Ofcom consumer survey carried out as part of the Second Pay TV Consultation which assessed the weights consumers attached to sports and movies channels, and repeated above in Figure 36[538]. In this survey, around 49% of subscribers purchasing both sports and movies stated that they purchased the bundle primarily for sports channels, so for these subscribers, revenues were allocated using the first of the two extreme approaches described above. Around 22% of subscribers stated that they purchased the bundle primarily for movies, so for these subscribers, revenues were allocated using the second of the extreme approaches. For the remaining 27% of subscribers, revenues were allocated equally between sports and movies.

5.565 Oxera's results are presented in Figure 69. The table sets out both the return on sales and margins over direct costs[539] for the wholesale sports and movies business under different cost and revenue allocations:

- The first two columns show the results using the 'preference based' revenue allocation under two alternative cost allocation bases: first using Oxera's own high level cost allocation and second using the more detailed cost allocation carried out by Analysys Mason.

[538] See Annex 10, Second Pay TV Consultation.

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

- While the results of the allocations are similar at an aggregate level, we consider that the detailed assessment carried out by Analysys Mason (built up line by line from Sky's management accounts) as set out in the second column is likely to be the more reliable measure.

- The final two columns show the results of an incremental prices approach to revenue allocation, under Oxera's high level cost allocation approach. We consider that this incremental approach provides the upper and lower ends of the range for the allocation of revenues between sports and movies channels.

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

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

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

Source: Oxera first report.

5.567 We turn now to the question of whether the profitability gap that we observe in relation to Sky's aggregate business is evidence that the prices of retail and wholesale bundles including Sky Sports 1 and/or Sky Sports 2 that it supplies are above the competitive level.

5.568 Oxera interpreted its disaggregated profitability analysis cautiously, in the sense that it drew inferences about relative margins rather than absolute margins. We agree that this analysis does not allow us to identify robustly what the precise margin on different Sky products is. In relation to sports channels, the range of estimates produced by Oxera is, in and of itself, inconclusive. Under the incremental prices approach from Figure 69, the lower estimate of the wholesale margin over direct costs for sports channels could be **[✂]** (manifestly not above the competitive level) and the return on sales could be **[✂]**.

5.569 That said, to sustain the proposition that Sky's sports margins are negative, we would need to believe a very extreme allocation of revenues to movies – and as a consequence, believe that movies margins over direct costs were **[✂]**.

5.570 We therefore attach considerably more weight to the preference based allocation of revenues than to the other two measures which are, by construction, very much extreme figures. We consider that the most reliable measure of Sky's wholesale sports margin over direct costs is likely to be the preference based figure using Analysys Mason's cost allocation of **[✂]**. This corresponds to **[✂]**.

5.571 Figure 70 shows the evolution over time of wholesale ROS and margins over direct costs underlying the averages presented in Figure 69. The ROS and margins over direct costs for sports in particular have shown a general upward trend.

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

[✂]

5.572 At first sight, **[✂]** for wholesale sports channels may not appear especially high. However, there is evidence that Sky's return on wholesale packages is materially higher than would be expected in a competitive market.

- Sky's wholesale business is relatively "asset-light". A **[✂]** is a material return on assets for such a business: Figure 67 above shows that Sky's wholesale business in aggregate earned a return on sales of **[✂]** consistent with an IRR of **[✂]**.

- This view is reinforced by the level of the margin over direct costs (an average of **[✂]** for sports over the past five years) which appears substantial for a business with few assets and relatively few common costs.

- In addition, over the period 2003 to 2007, Sky's preference based return on sales (using Analysys Mason's detailed cost allocation) is **[✂]** for sports and **[✂]** for movies, compared with wholesale ROS figures for the wholesale comparators identified by Oxera of -0.6% to 8.4%. Even though these comparators are imperfect, they support the view that Sky's return on the wholesale supply of Sky Sports is high[540].

5.573 We accept that the profitability evidence in relation to the wholesale supply of Sky Sports is less clear-cut than in the case of Sky Movies. However, on balance, our overall conclusion from Oxera's analysis is that it indicates that prices are above the competitive level for Sky's sports channels.

<u>Ofcom's pricing model</u>

5.574 As noted above, Sky and its advisors raised a number of objections to Oxera's analysis. While we believe those objections have been addressed in Oxera's subsequent analysis, we have also, as in our Third Pay TV Consultation, considered whether other evidence is consistent with the Oxera results.

5.575 In order to calculate regulated wholesale prices for Sky's Core Premium channels in our Third Pay TV Consultation, we developed a pricing model. We describe this model – and the updates we have made to it to address consultation responses – in

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

more detail in Annex 7. The model enables us to draw some inferences about the extent to which prices for those channels may be above competitive levels.

5.576 The pricing model calculates wholesale charges for Sky's premium channels under two approaches: a "retail-minus" approach and a "cost-plus" approach. The cost-plus approach considers Sky's direct and indirect costs of producing and making available the relevant channels. Wholesale cost-plus charges are determined at a level that permits Sky to recover relevant wholesale costs as well as a reasonable return on capital employed.

5.577 In a competitive market where barriers to entry are low, firms would not profitably be able to sustain prices that are appreciably above their costs, including an allowance for the cost of capital. Accordingly our "cost plus" estimates can provide good estimates of the competitive price of Sky's channels[541] – subject to three caveats:

- First, the cost plus figures require a number of assumptions about common cost and revenue allocation. They also depend in part on Oxera's estimates of Sky's wholesale asset base, so this analysis is not completely independent of Oxera's analysis. In other words, if Oxera's analysis underestimates the size of Sky's wholesale asset base, this will result in the level of returns derived from our own pricing model being an overestimate.

- Second, our "base case" cost plus figures assume a flat profile of (real) wholesale prices over time, but they are set on the basis of a ten year cashflow model (including a terminal value). Because some costs are fixed while subscriber numbers are assumed to grow, the constant wholesale prices tend to recover more costs in future years than in earlier years. Put differently, the profile of cost recovery is skewed towards later years. For this reason, we have compared an alternative profile of cost plus charges which directly tracks the way in which costs are incurred.

- The cost plus estimates generated by our pricing model relate to Sky Sports 1 and Sky Sports 2 only. They are thus not an estimate of the costs of providing bundles including Dual Sports packages, which also feature Sky Sports 3 and 4. However we consider that this is unlikely materially to affect our conclusions, particularly given the magnitude of the differences between the price Sky charges and our cost estimates. In support of our view that the costs of Sky Sports 3 and 4 are likely to be relatively low we note that live Premier League matches are by far the most expensive sports rights acquired by Sky (see Figure 72 below) but Sky Sports 3 and 4 feature almost no live Premier League matches.

5.578 Figure 71 below compares Sky's current rate-card prices with the cost-plus estimates produced by Ofcom's pricing model. The "margin" figures in the final column indicate the extent to which wholesale rate-card prices may be above a cost-based estimate (including a return on investment) of the competitive level.

[541] As explained below we consider that the cost to Sky of sports rights may also be above the competitive level, because monopoly rents are being passed upstream to participants in those sports. Our cost plus estimates reflect the current amounts Sky pays for sports rights. Accordingly those estimates are likely to overstate the true resource costs (scarcity rents) of those rights.

Figure 71 Price and estimated cost of wholesale bundles including Sky Movies and Sky Sports, 2009/10

Wholesale package	Current rate card price £	Estimated cost-plus charge (flat in real terms) £	Estimated cost-plus charge (following profile of operating costs) £	Margin of rate-card price over cost plus charge (following profile of operating costs)
Sky Sports 1 & 2	19.15	11.36	12.23	57%
Sky Movies mix	16.59	4.53	5.09	226%
Sky Sports 1 & 2 and Sky Movies mix	24.16	15.80	17.23	40%
Weighted average – all packages	21.16	12.55	13.66	55%
Weighted average - sports only packages	18.77	11.17	12.02	56%
Weighted average - movies only packages	16.01	4.53	5.09	214%

Source: Ofcom wholesale pricing model.

Note: Cost-plus figures do not include costs of Sky Sports 3 and 4.

5.579 As shown in Figure 71, Sky's current wholesale rate-card prices are, without exception, significantly above the estimates of the competitive price generated by our pricing model. In our view, the magnitude of the difference is sufficiently large to outweigh the potential caveats identified above – and indeed the second caveat is already addressed by use of a profiled cost plus number.

5.580 The table supports Oxera's view that Sky's wholesale movies business is likely to be more profitable than its wholesale sports business, but also suggests that both businesses are highly profitable. For example:

- The rate-card price for the most popular mixed bundle (Sky Sports Mix and Sky Movies Mix) is 42% above the cost plus estimate.
- The rate-card price for the most important sports bundle (Sky Sports 1&2) is 57% above the cost plus estimate.

- Both of these figures appear broadly consistent with the **[✂]**% margin figure quoted above for Sky's wholesale sports channels from the Oxera analysis[542].

- The rate-card price for the most important movies bundle (Sky Movies Mix) is 226% above the cost plus estimate.

<u>The price of sports rights</u>

5.581 As set out in paragraph 4.53 of the Third Pay TV Consultation, owners of the rights of highly valued content should in principle be able to extract some or all of any monopoly rents from these rights. If this occurred it would mean that retail prices were above the competitive level regardless of whether wholesalers and retailers such as Sky were earning high profits.

5.582 The Live Premier League Rights, like a number of other sporting rights, are sold collectively[543] and in our Third Pay TV Consultation, we argued that this meant they were likely to be priced above the competitive level.

5.583 Both Sky and the Premier League disputed the proposition that the collective way in which sports rights are sold implies that the price of those rights is above the competitive level. We accept that collective selling by sports bodies does not necessarily infringe competition law or lead to detrimental effects for consumers. However, as the European Commission has stated:

> "A joint selling arrangement is a horizontal agreement which prevents the individual clubs each having a relatively small market share from individually competing in the sale of sports media rights. One price is applied to all rights collectively which constitutes price-fixing. In addition, the number of rights available in the upstream acquisition markets is often reduced which may create barriers to entry on downstream broadcasting markets and may lead to access foreclosure in these markets."[544]

5.584 We have considered the amounts paid for the Live Premier League Rights in comparison to all other sporting rights to be notable. Figure 72 below shows aggregate rights values (across all channels) for selected sports.

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[542] While the figures from our pricing model serve a similar purpose to the Oxera margin results presented in Figure 69, they are not directly comparable. First, the figures from our pricing model relate to a more recent time period (2009/10). Margins have risen in recent years: Oxera's figures are averaged over several years, and include some early years in which margins were lower. The two most recent figures for sports margins over direct costs are **[✂]** and **[✂]** for 2006/7 and 2007/8 respectively. Second, the cost plus figures in Figure 71 already include a reasonable return on investment – i.e. a measure of normal profits. Hence the "margin" shown in the table is a measure of additional profits over and above that reasonable return. Oxera's margin figures include both the reasonable return and any additional profits. Third, as noted above, the cost plus figures do not include the costs of Sky Sports 3 and 4 – although inclusion of these costs would not alter our conclusions. Fourth, the Oxera margin results show margins over direct costs, whereas our cost plus figures include an allocation of common costs. Sports margins over allocated costs from Oxera's analysis were **[✂]** for 2006/7 and **[✂]** for 2007/8.

[543] Third Pay TV Consultation, paragraph 4.53.

[544] The European Commission also acknowledged that joint selling may create "efficiencies". *White paper on sport* COM(2007) 391, annex I, Section 3.1.3.1.1. Available at: http://ec.europa.eu/sport/white-paper/whitepaper112_en.htm#2.

Figure 72 Top sports on pay TV and FTA channels by annual rights value in 2008 (where rights value exceeds £5m pa)

[✂]

5.585 As shown in this chart, the amounts paid for Live Premier League Rights dwarf the amounts paid for any other sports rights. 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[545]. The winning bids for the Live Premier League Rights to the 2010/11 to 2012/13 seasons totalled **[✂]** which is an average of **[✂]** per annum[546]. 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, yet for a similar total number of games) and that for both the FA Cup and England home international football matches is £106m (also less than 20%)[547]. The annual amount paid for the Six Nations rugby union tournament is £40m (less than 10%)[548].

5.586 While it is clear that very large amounts are paid for live Premier League rights, we recognise that determining the extent to which that price reflects monopoly profits is exceptionally difficult. These difficulties are highlighted by the arguments advanced by the Premier League:

- The Premier League suggested that the price of the Live Premier League Rights reflects the high costs incurred by Premier League clubs and that high wages for football players may reflect scarcity rents.

- The Premier League asserted 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[549].

5.587 We recognised in the Third Pay TV Consultation document, and again in Section 4 of this document that it is extremely difficult to distinguish monopoly profits from the scarcity rents associated with footballing talent. It is therefore not possible to conclude definitively whether or not the price of sports rights, including Live Premier League rights, is above the competitive level.

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[545] 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 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.

[546] Calculated using the figures set out 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 dated 5 December 2008 to Ofcom information request dated 7 November 2008, questions 6 and 9.

[547] 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.

[548] 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.

[549] Premier League response to Third Pay TV Consultation, paragraph 6.32.

5.588 However we do consider that the manner in which sports rights are sold is highly relevant to our market definition, and assessment of market power. In our view, the collective selling of sports rights gives rise to a material risk that the retail prices of packages including Core Premium Sports channels are above the competitive level. Collective selling therefore means that there is a risk that the cellophane fallacy applies and thus that switching data needs to be interpreted cautiously. This would be the case even if there were no evidence of high returns within Sky's own business.

5.589 We recognise that Sky has argued that this issue is not relevant to our assessment of market power[550]. This argument is considered in Appendix 4 of Annex 4. As explained in that Appendix, we remain of the view that the SSNIP test should be applied using the competitive level of input costs to Sky's business.

Conclusion on wholesale market power

5.590 In conclusion, we have reached the view that Sky has market power in the wholesale of Core Premium Sport channels. In fact Sky is dominant in this market and is likely to be dominant for the next three to four years.

Retail market power

<u>Our views in the Third Pay TV Consultation</u>

5.591 We calculated market shares based on the proportion of revenues earned by Sky, Virgin Media, Setanta, Top Up TV and BT Vision from the supply of retail television bundles containing Core Premium Sports channels. While the available data had some limitations, Sky clearly accounted for a very high proportion (around **[✂]**) of the market, so we considered the overall conclusion that Sky had a high market share to be reliable. On a measure which included more distant substitutes (namely sports on FTA channels), Sky still possessed a high market share.

5.592 Lack of access to Sky's Core Premium Sports channels was a significant barrier to entry and expansion in the market, and there was no offsetting buyer power. As such, Sky's high market share and the presence of entry barriers led to the conclusion that Sky had a dominant position in the retail market.

5.593 However, this did not imply that Sky had any additional market power, over and above its position at the wholesale level, by virtue of its retail position. In particular, it did not imply any additional scope to raise retail prices above the level that would prevail if Sky had only wholesale market power.

5.594 To assess whether Sky had such additional market power, we distinguished between retail prices being above the competitive level due to (a) high wholesale prices and (b) high retail **margins**. In Sky's case the retail margin would be the total margin it earns on retail sales, minus the wholesale margin it earns on sales to Virgin Media. On this point, we argued that:

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[550] 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 in original). June 2009 Sky Submission, paragraph 5.10.

- Sky cross-checks its wholesale prices so as to pass a margin squeeze test, so it was unlikely to allow an excessive retail margin.

- Similarly, Sky would not have an incentive to increase its retail prices without also increasing its wholesale prices to Virgin Media, keeping retail margins broadly constant.

5.595 Accordingly we did not consider that there was sufficient evidence to conclude that Sky could sustain retail margins appreciably above the competitive level.

Responses to the Third Pay TV Consultation

5.596 The Premier League asserted that the conclusions in the Third Pay TV Consultation were vague and inconclusive and therefore cannot be relied upon (Premier League response to Third Pay TV Consultation, paragraphs 6.51-6.54).

5.597 Virgin Media characterised Ofcom's position in the Third Pay TV Consultation as being that Sky was not constrained by existing competitors or "out-of-market" constraints, and that there would be insufficient retail competition to constrain Sky even if it did not have market power at the wholesale level of the supply chain. Virgin Media agreed with this purported position.[551]

Our conclusion

5.598 As set out in our Third Pay TV Consultation, Sky has a very high share of a retail market for the supply of retail television bundles containing Core Premium Sports channels. In the first half of 2008, Sky had at least a **[✂]** share of revenues, while Virgin Media had **[✂]%** and others had one per cent.

5.599 We have calculated current market shares based on incremental prices (i.e. the price of a package which includes Core Premium Sports channels, over the basic package price), and also based on subscriber numbers, as shown in Figure 73. Virgin Media's XL basic package includes ESPN so we have considered market shares both including and excluding Virgin Media XL customers. Across all of these measures, Sky's market share ranges from **[✂]** [60-90]%.

Figure 73 Market shares in the supply of retail television bundles containing Core Premium Sports channels

[551] Virgin Media response to Third Pay TV Consultation, paragraph 4.6.

	Sky	Virgin Media	Other
All Core Premium Sports Channel packages	[70-80]%	[20-30]%	[0-10]%
All Core Premium Sports Channel packages, excluding Virgin Media's XL basic that includes ESPN	[80-90]%	[10-20]%	[0-10]%

	Sky	Virgin Media	Other
All Core Premium Sports Channel packages	[60-70]%	[20-30]%	[0-10]%
All Core Premium Sports Channel packages, excluding Virgin Media's XL basic that includes ESPN	[80-90]%	[0-10]%	[0-10]%

Source: Ofcom calculations

Notes:

1. Market shares are based on incremental revenues.

2. September 2009 subscriber numbers are used for all packages containing Sky Sports 1 and/or Sky Sports 2 (except for those from “Sky by Wire” and small cable operators where June 2009 figures were the latest figures available).

3. Sky Sports satellite price based on the incremental price of Sky Dual Sports on top of the variety pack.

4. Sky Sports “Sky by Wire” price based on the price charged by Sky for Sky Dual Sports.

5. Virgin Media’s price of Sky Sports and ESPN based on their incremental price of on top of Virgin Media’s M+ pack.

6. ESPN’s satellite price based on the incremental price of ESPN on top of the variety pack (March 2010).

7. Top Up TV’s and TalkTalk’s price of ESPN are £9.99 as advertised on their websites (March 2010). BT Vision currently offers ESPN free with its TV packs as a promotional tool; we have valued ESPN on BT Vision at £10, consistent with its price on other platforms.

5.600 Our Third Pay TV Consultation also estimated market shares if moderate constraints were included. The approach was based on channel providers’ shares of spending on leading events in the main sports on Sky Sports 1 and 2 (football, cricket, tennis, golf, rugby union and league), split by retailers according to subscriber numbers. On this measure Sky still possessed a high market share **[✂]**.

5.601 Turning to barriers to entry, ESPN has quickly reached agreements with a number of retailers. However, we consider that a competitor carrying ESPN, but not Sky’s Core Premium channels, would not offer sufficiently attractive content to act as a strong constraint on Sky’s retail prices. As described in Section 7, no independent retailers have obtained wholesale access to Sky’s Core Premium channels in recent years, despite a number of attempts to negotiate such access with Sky.

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

5.603 In light of Sky's high market share, the presence of significant barriers to entry, and the lack of buyer power, we remain of the view expressed in our Third Pay TV Consultation[552] that Sky holds a position of retail market power.

5.604 However, as in our Third Pay TV Consultation, we consider that this does not imply any additional scope for Sky to raise retail prices above the level that would prevail if it only had wholesale market power. Another way of thinking about it is that, even if retail competition were to increase, there may be a limited impact on retail prices because Sky could continue to restrict competition through charging high wholesale prices to other retailers.

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

- That wholesale monopolist is capable of significantly increasing wholesale prices and thereby increasing retail prices appreciably above the competitive level. Moreover if that wholesaler were vertically integrated with one of the retailers, the vertically integrated firm would also have the ability to increase its retail price (along with that of all other retailers) above the competitive level. Applying the standard approach to assessing market power, one might conclude that the vertically integrated firm is dominant at both the wholesale and retail level.

- However in this example the source of the market power is clearly the firm's wholesale position. Because the retail market is assumed to be competitive, no retailer (including the vertically integrated firm's retail arm) has the ability to earn an excessive or indeed a positive retail margin.

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

5.607 Footnote 13 of the OFT's guidelines on market definition also states that[553]:

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

5.608 This standard approach to assessing market power would apply if the wholesale level of the supply chain were competitive i.e. if wholesale prices and supply arrangements reflected the outcome of a competitive wholesale market. In such circumstances, it is only the actions of retailers that can potentially increase retail prices above the competitive level[554]. Clearly this is a somewhat artificial test since Sky is dominant in the wholesale supply of Core Premium channels.

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[552] Third Pay TV Consultation, paragraphs 1.22 and 5.3.

[553] In annex 3 of the June 2009 Sky Submission, Sky disagreed with our interpretation of these guidelines. We do not accept Sky's criticisms. See Appendix 4 of Annex 4.

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

5.609 Sky raised these issues in its response to the First Pay TV Consultation.[555] CRA, on behalf of Sky, noted that Ofcom had concluded that Sky had significant market power in the retail of sports channels because it had "better sports content" but this same source of market power was also used to justify Ofcom's view that Sky had market power at the wholesale level. CRA argued that this was a "double counting" of market power.

5.610 We agree there is a risk of giving a misleading impression, for the reasons described above. As set out in our previous consultation[556], we do not consider that Sky has an incentive to set retail margins above competitive levels:

- First, Sky said that its wholesale prices are set at a level at which no margin squeeze can occur **[✂]**[557]. This suggests that Sky's wholesale prices are unlikely to allow a high retail margin to be earned. Accordingly, even if retail prices were appreciably above the competitive level, this would reflect high wholesale prices rather than the exercise of retail market power.

- Second, it may be more attractive for Sky to earn a high margin on Sky Sports at the wholesale level rather than at the retail level. A £1 increase in Sky's retail margin only increases its revenue from consumers that it directly supplies. Also, by increasing Sky's retail price relative to that charged by Virgin Media, consumers are more likely to switch away from Sky's retail business. In contrast, a £1 increase in Sky's wholesale margin (including the implicit wholesale price that it charges its own retail business) increases its revenue both from consumers it supplies indirectly via Virgin Media as well as from consumers it directly supplies.

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

Conclusion on retail market power

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

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

[556] Third Pay TV Consultation, paragraph 3.40.

[557] **[✂]**.

Section 6

Movies market definition and market power

Summary

6.1 Sky has market power in the wholesale of Core Premium Movies channels, due to its holding of exclusive rights to broadcast movies from the Major Hollywood Studios in the first pay TV subscription window. However, Sky's Core Premium Movies channels are not as highly differentiated as its Core Premium Sports channels, particularly because pay TV movies are available on other popular formats such as DVDs and FTA channels, before, during and after their appearance on Sky's Core Premium Movies channels.

6.2 Sky also purchases exclusive SVoD rights for movies in the first pay TV subscription window from all of the Major Hollywood Studios. An SVoD service showing the same movies in the same window would appear to be the closest substitute for Sky's Core Premium Movies channels. If, as expected, SVoD services increasingly replace linear channels, Sky's position is likely either to be maintained or to become more powerful, particularly due to the advantages of SVoD over linear channels.

6.3 Core Premium Movies services allow subscribers to see a wide range of relatively recent (and less recent) movies from the most popular studios on TV for a monthly fee. No other available service combines all of these features. We have assessed the competitive constraint these services face, both from other ways of watching movies and from non-movies content. In assessing potential substitutes we have focused on the characteristics of alternative offers (timing, quality, quantity, format and price) and the preferences of viewers with regard to these characteristics.

6.4 The potential substitutes we considered include cinema, pay-per-view video-on-demand, subscription video-on-demand, and DVD rental. However, of the potential substitutes we have identified, the most important – in terms of their scale and the likelihood that consumers would see them as substitutes – are retail movie DVDs, movies on free-to-air TV and general entertainment programming. While premium SVoD services are not yet fully developed, they are a potentially important constraint in future. Our view is that:

- The format of Sky Movies gives subscribers ongoing and immediate access to a wide range of recent movies. The relative inconvenience of buying DVDs is likely to limit the degree of substitutability. In addition, for subscribers who watch more than two or three recent movies on Sky in a month, it is unlikely that buying these movies on DVD instead would be a cost-effective alternative. As such we do not consider that retail DVDs are a close substitute for Sky Movies. However, we recognise that Sky faces a moderate constraint from DVDs – particularly from those that are sold at a discounted price during the pay TV window.

- A large number of movies are shown on free-to-air TV, and **[✂]**. However, because of the importance of timing to viewers, the later date at which movies come onto FTA and basic channels puts these channels at a significant disadvantage to Sky Movies. The fact that Sky Movies subscribers already have free access to movies on FTA and (in the vast majority of cases) basic channels, but are willing to pay a substantial premium for Sky Movies, indicates the extent to which Sky Movies is differentiated. As such, we do not see this content as a close substitute for Sky Movies, but recognise that it constrains Sky to some degree.

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

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

- PPV VoD. The ability to pay monthly sets subscription movies channels apart from PPV – an otherwise apparently close substitute. The low total revenue from PPV movies compared to linear pay TV suggests that consumers have a strong preference for a subscription service.

- SVoD. Premium subscription VoD services could provide a very similar experience to subscribing to a linear channel, but with added convenience, and are likely to be a close substitute, particularly given that the rights are for the same window as linear channels. However, the content rights that would enable the delivery of such a service are currently controlled by Sky, so this does not affect our market power assessment.

6.6 We conclude that the relevant market is "pay TV packages including Core Premium Movies channels"; Core Premium Movies channels being defined as all Sky Movies channels[558]. Sky has a 100% share of this market – in other words it faces no close substitutes. However we have also considered what Sky's market share would be once the impact of moderate constraints is taken into account. If we were to include moderate substitutes (in particular, movies on FTA and basic channels, and retail DVDs sold during the first pay TV subscription window) Sky's market share would fall substantially.

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

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

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

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

- Much of the consumer survey switching data that we have reviewed seems to point to a broad market. However, our concern that prices are above the competitive level is even stronger for movies than sport. We mainly draw on Oxera's analysis that Sky as a whole consistently makes returns substantially above its cost of capital, as well as our own wholesale pricing analysis. Both of these pieces of analysis suggest that the profitability of Sky's premium wholesale activities is high, and that the profitability of its wholesale movies activities is higher than for sport. As a result we place very limited weight on switching data in attempting to draw a market boundary.

- Moreover, Sky's persistently high returns are directly indicative of market power[559], and this is not dependent on the precise market definition or market shares. Under our central case (a preferences based allocation of revenues between sports and movies, and a detailed allocation of costs based on our pricing model) we find that Sky makes a return on sales for wholesale movies channels of **[✂]**%, and a margin over direct costs of **[✂]**%. These estimates are subject to some uncertainty, but are materially higher than would be expected in a competitive market.

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

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

Structure of this Section

6.12 This Section is set out as follows:

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

[559] OFT Market Power Guidelines para.6.6.

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

Introduction

Purpose of this Section

6.13 The purpose of this Section is to assess whether any supplier of pay TV services has **market power** in relation to the supply of premium movies channels. As with the supply of sports channels, this is a step in establishing whether any current arrangements or practices relating to the supply of pay TV movies channels are prejudicial to fair and effective competition.

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

- High market shares, in a market with barriers to entry, and in the absence of countervailing buyer power.

- Evidence that prices substantially exceed relevant costs or profits substantially exceed competitive levels.

6.15 In order to assess whether market shares are at a level which would be indicative of market power, it is necessary to **define the market** or markets within which these products are supplied[560]. However, the use of evidence that prices substantially exceed costs, or that profits are above competitive levels, as an indicator of market power, is not dependent on market definition.

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

Third Pay TV Consultation[561]

Our position

6.17 In our Third Pay TV Consultation we reached a preliminary view that there was a narrow economic market for the wholesale of "**Core Premium Movies channels**"[562], defined as channels including movies in the "first TV subscription window" produced or licensed by the six Major Hollywood Studios, and that Sky has market power in this market. We considered that Sky's market power is enabled by the aggregation by Sky of rights to show the movies from all six Major Hollywood Studios[563]. Our market definition included all Sky Movies channels apart from Sky Movies Classics.

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

http://www.oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft403.pdf

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

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

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

6.18 We considered that Sky had market power in that market based on evidence of high market shares and little potential for entry or countervailing buyer power, and also on the high and increasing margin of wholesale prices over costs.

6.19 We also defined narrow markets for the retail of packages including Core Premium Movies channels to residential customers. In coming to this view, we relied on much of the same evidence as for our wholesale assessment, which suggests that demand-side substitution is unlikely. We considered that entry by new suppliers is unlikely in the short term, because of the lack of availability of the relevant wholesale channels.

6.20 We consulted on the view that Sky also holds a position of market power in the retail of packages including Core Premium Movies channels. We based this view on Sky's high market shares, and high barriers to entry in acquiring the relevant wholesale inputs. Although we believed Sky holds a position of retail market power, our competition concerns focused on the exercise of market power at the wholesale level.

Consultation responses

6.21 Sky made a number of comments which applied both to our analysis of sports and movies, and these are set out in paragraphs 5.25 to 5.34 of the previous Section. Sky also referred to a set of internal documents which it provided to us in response to an information request relating specifically to movies. Sky said that the Third Pay TV Consultation ignored internal Sky documents that (in Sky's view) demonstrated the range of competitive constraints on Sky's business[564].

6.22 Virgin Media agreed with our analysis and conclusions in relation to Core Premium Movies channels and provided no substantive further representations on this issue[565].

6.23 The BBC agreed that "Sky has market power in the wholesale markets for premium sports and movies channels"[566].

6.24 **[✂]**[567].

Our view of consultation responses

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

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

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

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

566 BBC response to Third Pay TV Consultation, p1.

567 **[✂]**.

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

Our approach to market definition

6.26 We begin by identifying the products which are the subject of our investigation. As discussed in Section 4, premium movies channels are, along with premium sports channels, a key driver of demand for pay TV, and these channels were included in the complaints which gave rise to our investigation. We therefore consider Sky's premium movies channels as the starting point for our analysis. In market definition terms, these channels are the "**focal product**".

6.27 We have generally adopted the same approach to defining markets for movies channels as for sports channels, as set out in paragraphs 5.39 to 5.85 of the previous Section, in particular in relation to:

- The hypothetical monopolist test (see paragraph 5.41).
- Differentiated products (see paragraph 5.42).
- Marginal customers (see paragraphs 5.43 to 5.46). Factors that determine whether a subscriber to movies channels is marginal will include how convenient they consider other means of watching movies to be, how many films they watch, what type of film they watch (e.g. the most recent films), whether they also subscribe to premium sports channels, the preferences of others in the household, and income.
- The cellophane fallacy (see paragraphs 5.47 to 5.60): along with the arguments raised in Section 5, we note in particular that, as with Sky Sports, Oxera's profitability analysis indicates that Sky in aggregate earns a return above its cost of capital and we conclude that Oxera's disaggregated analysis suggests that prices are above the competitive level for Sky Movies. Indeed the profitability of Sky Movies appears greater than for Sky Sports.
- Wholesale and retail markets (see paragraphs 5.61 to 5.67).
- Market shares (see paragraphs 5.68 to 5.73).
- Bundling (see paragraphs 5.74 to 5.78).
- Two-sided markets (see paragraphs 5.79 to 5.80).
- Monopolistic competition (see paragraphs 5.81 to 5.84).

Overview of product characteristics and potential substitutes

Distribution of movies content

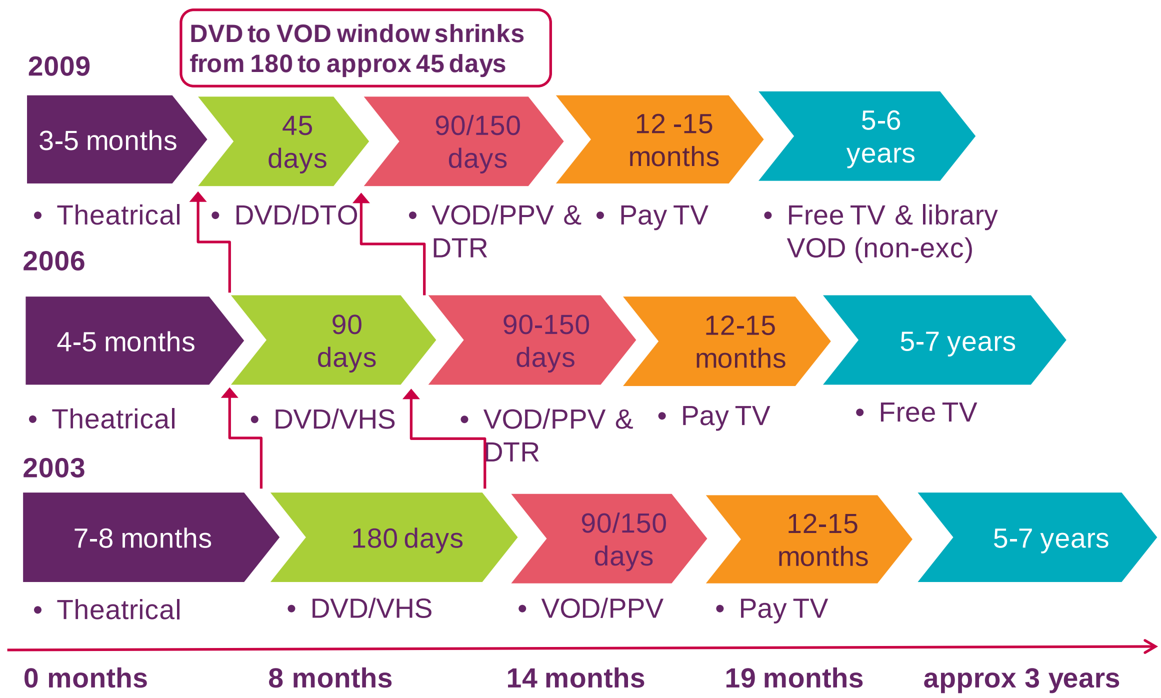
6.28 From the time of their initial release, movies are sold in a series of different formats in distinct or overlapping time periods known as "windows". Typically a movie has a cinema release, then a DVD retail/rental window, then it will be shown on pay-per-view TV, then on premium subscription pay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

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

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

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

Figure 74 Movie Windows



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

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

6.31 As the figure shows, in recent years, some of the movie windows have been getting shorter. For example, since 2003 the DVD window has shifted from 7-8 months to 3-5 months after the theatrical release[569]. The delay between cinematic release and the first pay TV window has also reduced[570]:

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

- In addition, **[✂]**[572].

6.32 **Cinematic release**: films are first released at the cinema often accompanied by very substantial and costly marketing and promotional campaigns. Average ticket prices were £5.20 in 2008[573]. Screen Digest reported that the cinema release "is regarded as a marketing platform and most distributors will not make profit at this stage"[574]. However, cinema release is important to consumers: research conducted by Sky reported that "films were most special at the cinema, closely followed by owning films on DVD"[575].

6.33 **DVD retail:** consumers purchase DVDs in order to obtain permanent access to a number of specific favourite films within a film library of their own. Sky's consumer research[576] showed that DVD retail was perceived as offering very good value as it provides the benefits of permanent ownership of an extremely popular delivery

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

569 The Odeon cinema group threatened not to show the film "Alice in Wonderland" in protest against Disney's plan to shorten the theatrical run by bringing forward the DVD release date: see "Odeon ends Alice in Wonderland boycott", guardian.co.uk, 25 February 2009.

570 Third Pay TV Consultation, paragraphs 4.295-4.296.

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

572 **[✂]**

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

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

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

576 Ibid.

mechanism. The average price of a DVD movie was about £7.36 in 2008[577], although the range of prices is wide – particularly as prices typically fall by more than half after the initial release period (see Figure 90). Just over a quarter of DVDs (27%) are bought as gifts rather than for personal or family use[578].

6.34 **DVD rental:** consumers can rent DVDs to access recently released films on a temporary basis. Sky's research found that "renting films is still reasonably popular (even amongst Sky Subscribers) with renters welcoming variety, the mid week deals and improved window"[579]. Consumers can choose to rent from traditional over the counter stores or – increasingly – from online subscription services. The majority of rentals (by value) are still over-the-counter rentals but the quantity and value of online subscription rentals is growing rapidly. Typical prices to rent latest release films are around £3.75 over the counter (although there may be discounts to this headline price) and around £2.40 online[580].

6.35 **Pay per view** (PPV): a number of TV retailers including Virgin Media, Sky, TalkTalk TV and BT Vision offer PPV movies, allowing consumers a convenient way to access new movies.

6.36 PPV services based on 'Pull VoD' or 'True' VoD[581] are possible on Virgin Media's cable network and TalkTalk TV's and BT's IP networks. Sky's satellite service provides both 'Push VoD'[582] and 'Near' VoD PPV services[583]. These services differ in terms of both pricing and the number of films available:

- In 2008 Sky offered a total of around 400 films (including HD) priced at £3.99 per film on its PPV NVoD service[584]. Only a small fraction of these films were available at any one time.

- In 2008, Virgin Media offered a catalogue of around 500 films on its PPV VoD service. New releases were priced between £2.50 and £3.50 and library titles were priced between 50p and £2[585]. Virgin Media's PPV VoD service offers more films at any one time than Sky's PPV NVoD service.

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

[578] Source: British Video Association Yearbook 2009 page 73.

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

[580] Source: British Video Association Yearbook 2009 page 80.

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

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

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

[584] UK Film Council Statistical Yearbook 2009, page 106.

[585] Film Council Statistical Yearbook 2009, page 106.

6.37 We estimate that Sky's revenue from PPV NVoD services was **[✂]** in 2008 and Virgin Media's revenue from PPV VOD services was **[✂]** in 2008[586]. Taking into account the fact that there are markedly more subscribers to Sky's satellite platform than to Virgin Media's cable platform[587], these revenue figures suggest that cable subscribers are more likely to purchase PPV VoD services than satellite subscribers are likely to purchase PPV NVoD services.

6.38 **Internet Download**: Downloading content to watch from the internet offers consumers a wide range of content that can be accessed relatively easily and viewed at their convenience. Content can be downloaded legally from the internet either to watch on a one-off basis (also known as download to rent or rental VOD) or to retain permanently (also known as download to own). Suppliers include Apple (via its iTunes store) and Blinkbox. Movies can also be downloaded illegally using file sharing applications such as Bit Torrent.

6.39 **Pay TV Subscription Services:** Sky Movies and Disney Cinemagic show films in the first pay TV subscription window from the six Major Hollywood Studios. Sky also has contracts with several independent distributors and other movie studios (see paragraph 4.276 in the Third Pay TV Consultation). Consequently, Sky's premium movies channels provide the first opportunity for viewers to watch the vast majority of the most popular films on a linear TV channel.

6.40 In addition, two types of Subscription VoD (SVoD) service are also available. First, Sky's SVoD service shows movies during the first pay TV subscription window. This is available via the Sky Player service and can be accessed via a subscriber's PC, or on TV via an Xbox **[✂]**[588]. Second, there are various other SVoD services not owned by Sky that show films after the first pay TV subscription window, e.g. Picturebox.

6.41 **FTA Channels:** FTA channels and other basic tier subscription channels show a wide variety of older films. In 2007 there were 2,182 film transmissions on the main terrestrial channels, 20,271 film transmissions on FTA multi-channels and 34,782 transmissions on subscription movies channels[589].

Provision of premium movies channels

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

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

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

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

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

6.43 Sky offers twelve premium movies channels. Until recently, eight were, broadly speaking, genre-specific, while two (Sky Movies Screen 1 and Sky Movies Screen 2) put “the best of Sky Movies in one place”, and two (Sky Movies Premiere and Sky Movies Premiere +1) show a small number of major new releases (five per week)[590].

6.44 All these channels are available in both SD and HD except for Sky Movies Classics and Sky Premiere +1, which are only available in SD. They are aggregated into 3 packages:

- **Sky Movies 1**: Sky Movies Comedy, Sky Movies Family, Sky Movies Classics, Sky Movies Modern Greats, Sky Movies Showcase.
- **Sky Movies 2**: Sky Movies Action and Thriller, Sky Movies Sci-Fi and Horror, Sky Movies Indie, Sky Movies Drama, Sky Movies Crime and Thriller.
- **Sky Movies Pack (Sky Dual Movies / Sky Movies Mix)**: Sky Movies 1 and Sky Movies 2, Sky Premiere and Sky Premiere +1.[591]

6.45 These channels, taken together, show all of the films from the six Major Hollywood Studios, among others, in the “first pay TV subscription window”.

6.46 As shown in Figure 31 below, Sky retails Sky Movies 1, Sky Movies 2 and Sky Dual Movies in bundles with other basic packages (mixes) and Sky Sports packages. **[✂]**[592].

6.47 **[✂]**[593] As shown in that Figure, Virgin Media retails Sky Movies 1, Sky Movies 2, Sky Dual Movies, on its cable platform with other basic TV packages (“M”, “M+”, “L”, and “XL”) and Sky Sports channels[594]. Virgin Media retails Sky Movies 1 or standalone Sky Movies 2 at between £16.50 per month (if they are taken with the ‘XL’ package) and £28 a month (if taken with the ‘M’ package).[595]

6.48 Alternatively, Virgin Media customers can subscribe to the ‘Sky Movies Collection’[596] (comprising Sky Movies 1, Sky Movies 2, Sky Movies Premiere and Sky Movies Premiere +1) for between £19.50 and £30 per month, or to Sky Sports and Movies (including all channels in the Sky Movies Collection) for between £27.50 and £37 per

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

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

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

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

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

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

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

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

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

Demand for premium movies channels

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

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

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

Extent to which movies are distinct from other TV content

6.52 As set out in Section 4, movies are the genre other than sports which stands out as being amongst the most valued by consumers and which also has a high degree of exclusivity to pay TV[597].

6.53 Around 15% of Sky's premium subscribers take Sky Movies as a standalone product (i.e. without Sky Sports). Of those who subscribe to Sky Sports and Sky Movies, (55% of all premium subscribers), half (i.e. over 25% of premium subscribers) do so either primarily because of Movies, or see both Sports and Movies as important. In total then, around 40% of Sky premium subscribers (15% plus 25%) see Movies as an important part of their subscription.

6.54 The willingness of millions of UK households to pay a substantial premium for access to this content, when they already have access to a wide range of other content from FTA and basic channels, is evidence of the distinctiveness of Sky's movies coverage. We consider this point further in our assessment, below, of non-movies content as a substitute for movies content.

Characteristics of premium movies services

6.55 As we set out in our Third Pay TV Consultation,[598] Sky Movies services combine a number of important characteristics relating to the quantity and quality of the films shown and the timing and format of release[599]. We also considered price carefully in relation to potential substitutes for Sky Movies and we remain of the view that this is also important. We therefore consider again the importance to Sky Movies

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

[598] See paragraph 4.256 in our Third Pay TV Consultation.

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

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

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

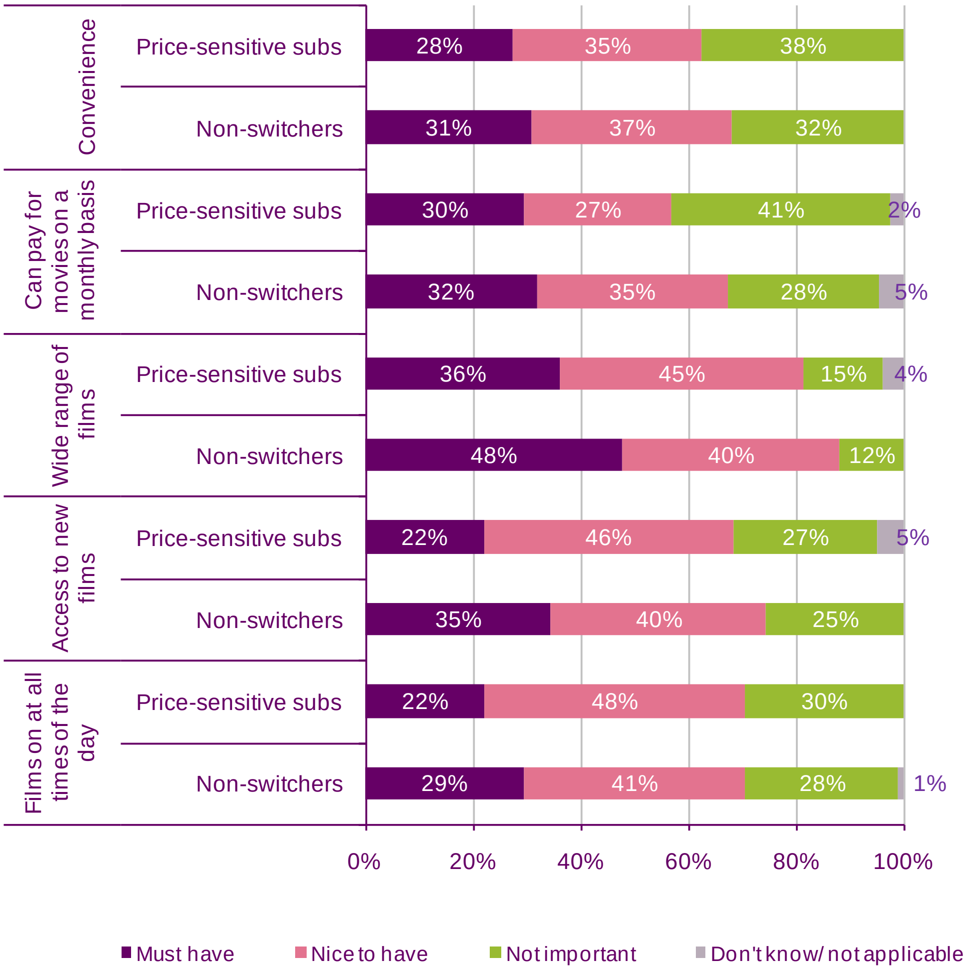
Quantity of films

6.56 The quantity of films is important to subscribers, because having more movies available (particularly at the same time) increases the likelihood that there is a film that the consumer wants to watch. The Figure below sets out the preferences of subscribers to Sky Movies, specifically splitting out the views of price sensitive subscribers. It shows that 36% of price sensitive consumers said that a wide range of movies is "must have" and another 45% said it is "nice to have" For those subscribers that are not price-sensitive, the corresponding figures are 48% and 40% respectively[600]. From our survey evidence this appears to be the most important characteristic to Sky Movies subscribers.

6.57 In addition, having movies available at all times of the day is "must have" to a minority (22%) of price sensitive consumers and "nice to have" for 48% of price sensitive consumers. Digital video recorders arguably reduce the importance of having movies available at all times of day, but do not reduce the importance of overall choice.

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

Figure 75 Preferences of subscribers to Sky Movies



Base: All Sky Movies subscribers (203)

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

Quality of films

6.58 In our Third Pay TV Consultation we said that Sky's premium movies channels also show a large quantity of films that are of particularly high quality (at least in terms of box office success). We also noted that Sky has exclusive agreements with the six Major Hollywood Studios to exploit their films in the first pay TV subscription window and that these films accounted for 80% of UK box office revenues[601].

6.59 Sky argued in response to our Third Pay TV Consultation that we gave insufficient weight to the quality of films as distinct from timing[602]. As we said, we agree that quality is important. Many of the films viewed on Sky Movies are those that had large box office revenues (Figure 76). Sky describes Sky Premiere as "home of the biggest

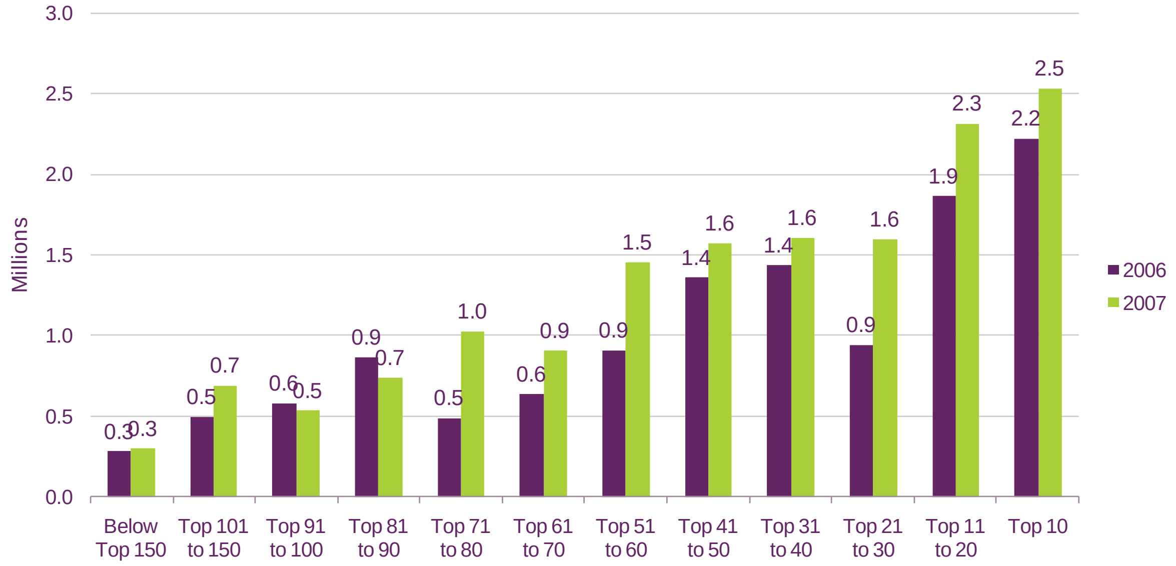
[601] Paragraph 4.274 to 4.275.

[602] October 2009 Sky Submission, paragraph 95.

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

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

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

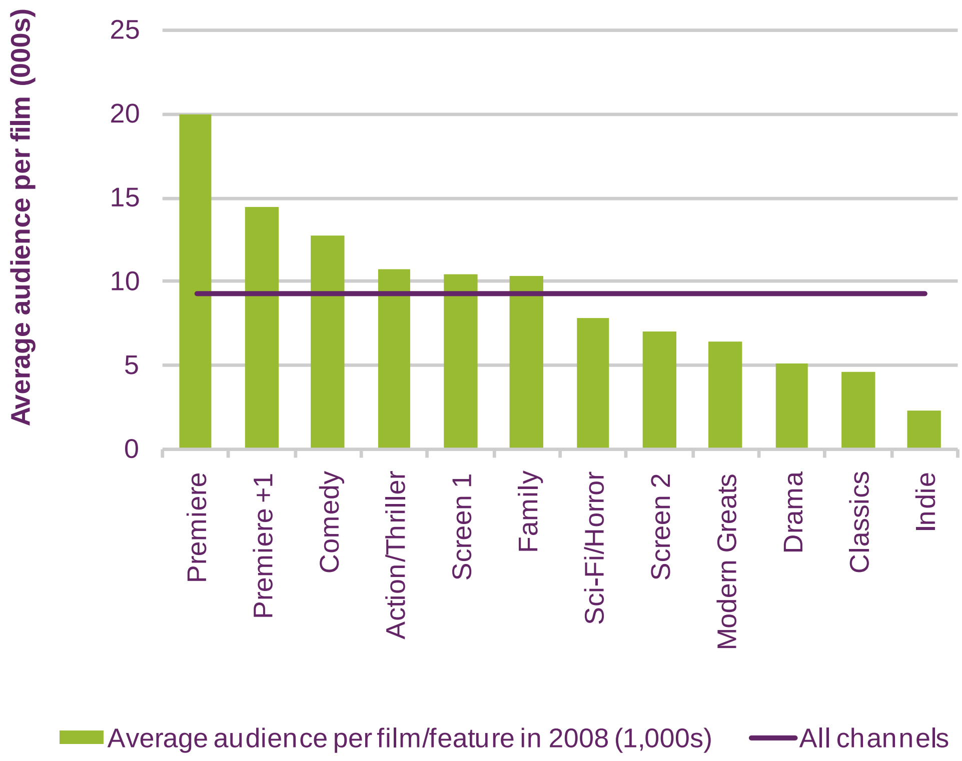


Sources: BARB viewing data for 2008, http://boxofficemojo.com/intl/uk/yearly.

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

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

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



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

Timing

6.61 Consumers typically value a given film more the closer it is to its release date. Sky accepted this[604], but also stated that an older movie may be valued more highly than another (different) film that is more recent for example because viewers consider the older film to be higher quality. Sky gave a number of examples in support of this proposition, including viewer data showing that a repeat on Channel 4 attracted a greater number of viewers (among households with Sky Movies) than the first showing of a more recent film on Sky Movies[605].

6.62 While some older films may be more attractive than some newer films, most films are more attractive when they are closer to their release date. As we noted at paragraphs 4.282 to 4.285 of our Third Pay TV Consultation, all other things being equal, more recent movies are more attractive. As stated in paragraph 4.270 of the Third Pay TV Consultation, this is in part because significant marketing occurs around the time of the initial cinema release which increases the awareness of a film[606]. The value of

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

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

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

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

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

- Internal research supplied to us by Sky[607], **[✂]**.
- A survey carried out for Virgin Media asked consumers for which genre of content they would consider paying more than their current subscription. This Virgin Media survey found that “new” movies was the most popular movie genre for both Virgin Media and Sky subscribers (cited by **[✂]**% and **[✂]**% of subscribers on each platform). This was significantly above “classic movies”, cited by only **[✂]**% of subscribers on both cable and Sky[608].
- **[✂]**. This provides further evidence on the importance of newer films.
- In addition, in our survey 22% of price sensitive consumers responded that access to new films is a “must have” and 46% say it is “nice to have” (Figure 75).

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

6.65 As we noted at paragraphs 4.291 and 4.292 of our Third Pay TV Consultation, the value of newer films is also reflected in the higher audience received for newer films (see the Figure below). According to our analysis, movies from the pay TV window[610] accounted for about 60% of all viewing on Sky Movies in 2008. In other words, viewing was disproportionately focused on recent films.

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

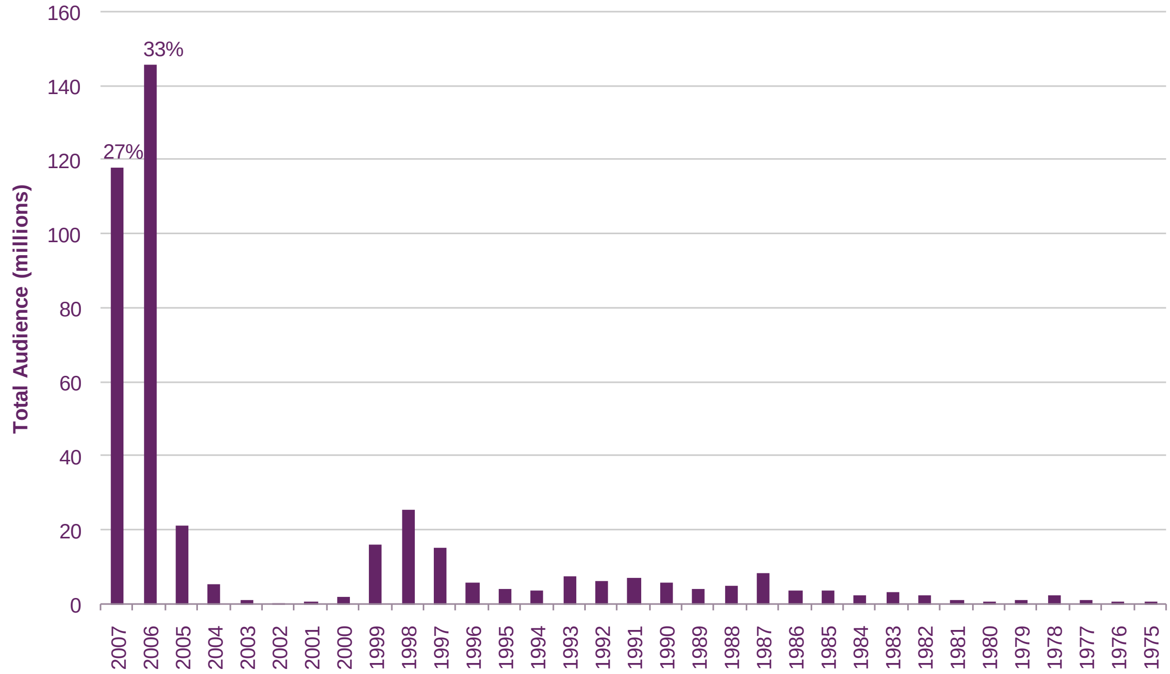
[607] Sky’s third response to Ofcom’s questions of 29 May 2008, **[✂]**.

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

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

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

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



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

Format

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

- They offer a high degree of convenience: 28% of price sensitive consumers say that the “convenience of not going to the DVD shop” is “must have” and another 35% say it is “nice to have” (Figure 75).

- The subscription price structure of Sky Movies is also important to price sensitive consumers. Figure 75 shows that paying monthly was “must have” for 30% of price sensitive consumers and “nice to have” for another 27%.

6.67 Sky disputed the importance of a subscription price structure and “the inconvenience associated with movie rental” for “marginal subscribers” such as subscribers that watch only one or two movies in the first pay TV subscription window per month[611].

6.68 Sky’s revenues from the sale of Sky Movies are an order of magnitude higher than its revenue from the supply of PPV movies[612]. While there is clearly a wide range of factors that influence the revenue earned by these two services, we consider that the

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

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

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

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

Price

6.70 Sky said that a product with relatively less attractive characteristics ('lower quality') but at a cheaper price can be an effective substitute[613].

6.71 We recognise that close substitutes can have different prices (and similarly products which are not substitutes for each other may happen to have the same price). To take a simple example, a battery with 10 hours' life and priced at £1 may be a very close substitute for one with 50 hours' life priced at £5. On the other hand, if we observed a battery with 5 hours' life priced at £10 we would need an explanation for the high price. We might infer that that battery served a different purpose from the cheaper batteries. However, for many products, including pay TV movies channels, product quality is far more complex and subjective than battery life.

6.72 The 'quality'[614] of pay TV movies channels and their potential substitutes is a combination of their different characteristics including the quality, quantity and timing of the movies they offer, and the format of the service. As such, when comparing product quality of different offers, the price that they command can be an important indicator of the extent to which they are differentiated from one another,[615] and therefore of the scope for substitution.

6.73 In this respect, consumers who subscribe to Sky Movies have already demonstrated their willingness to pay a substantial premium for those channels, suggesting that the presence of content on FTA and basic channels is not a strong substitute.

Bundling with sports

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

[613] October 2009 Sky Submission, paragraph 94.

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

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

6.75 Figure 36 in Section 5 shows that 49% of Top Tier subscribers subscribe to Sky Movies because they wanted Sky Sports, and Sky Movies did not cost much extra. For these customers Sky Movies is a comparatively cheap add-on[616].

Potential substitutes for premium movies channels

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

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

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

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

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

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

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

Internal Sky documents

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

6.82 **[✂]**

- **[✂]**[617].
- **[✂]**[618] .
- **[✂]**[619]
- **[✂]**[620].

6.83 **[✂]** With regard to DVDs:

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

6.84 With regard to free-to-air movies:

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

[617] **[✂]**

[618] **[✂]**

[619] **[✂]**

[620] **[✂]**

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

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

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

[624] **[✂]**

- **[✂]**. This stated that on average there are 20 titles on a Saturday on Freeview and 228 titles over a two week period[627].

- In addition, numerous internal documents identify free to air content, particularly Freeview, as a rival to Sky (e.g. "As the FTA proposition gets stronger it becomes increasingly hard to attract and retain customers to pay TV"[628]). **[✂]**[629].

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

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

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

6.88 **[✂]**.

Survey evidence

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

6.90 In order to supplement our analysis of product characteristics, we have therefore also considered the results of a survey that we conducted in November/December 2009[632]. We asked non-subscribers to Sky Movies why they did not subscribe. We would expect some of these respondents to be marginal customers of Sky Movies at

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

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

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

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

629 **[✂]**

630 **[✂]**

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

632 See paragraphs **Error! Reference source not found.** to 5.158 for more details.

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

6.91 The responses are summarised in the Figure below.

Figure 79 Reasons for not subscribing to Sky Movies

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

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

6.92 The survey results provide support for the view that DVDs and free-to-air movies are likely to be the closest substitutes for Sky Movies (although again this does not imply that they are close in an absolute sense). None of the survey respondents mentioned non-movies content as an unprompted response[633].

Scale of potential substitutes

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

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

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

Figure 80 Revenues from pay movie services (2008)

[✂]

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

- There has been a small decline in revenues associated with films on TV. According to Screen Digest the value of the FTA window is forecast to be broadly flat over the period 2006-2011[634].

- VoD and SVoD services have been relatively unimportant to date. However, as we discuss in Section 7, our view is that there is considerable scope for these services to grow in popularity if they are able to provide sufficiently attractive content. In particular, premium SVoD services accessible via the television have the potential to be highly attractive.

- Revenues from over the counter DVD rentals are falling sharply, but this is partly offset by increases in PPV and online DVD rentals.

Figure 81 Value of films from different formats, nominal figures

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

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

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

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

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

Figure 82 Rights expenditure and programming costs on movies, 2008

[✂]

Source: Broadcasters' licence returns to Ofcom.

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

Conclusion

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

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

Figure 83 Substitutes for Sky Movies

	Close substitute	Moderate substitute	Distant substitute
Large scale		• Movies on other FTA and basic channels	• Non-movie TV content • Other retail DVDs • Cinema
Medium scale		• Retail DVDs in pay TV window • Online DVD rental • PPV VoD	• OTC DVD rental
Small scale	• SVoD on TV in pay TV window (currently only via Xbox/PC)	• Disney Cinemagic • SVoD on PC in pay TV window	• SVoD on TV, after pay TV window

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

[635] Confidential 2008 broadcaster returns to Ofcom.

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

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

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

- We begin with an assessment of potential retail substitutes, and conclude on the definition of the **relevant retail market**.

- We consider the presence of retail substitutes as 'indirect constraints' in assessing the **relevant wholesale market**.

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

Evidence base used to define markets

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

- Product characteristics evidence: One method of assessing substitutability is to examine the characteristics of a particular product. We have considered a range of characteristics evidence including data submitted by Sky on types of films broadcast on Sky's movies channels, BARB data on the characteristics and viewing figures of different channels, consumer survey evidence on viewing habits and consumer survey evidence on the preferences of subscribers to Sky Movies. We have also extensively assessed the characteristics of potential substitutes to Sky's movies channels.

- Survey evidence on stated responses to price rises: We have considered three pieces of evidence: (i) a survey which we carried out in 2007 on consumers' stated response to a rise in the price of Sky Movies Mix, (ii) a consumer survey carried out by Sky in 2007 on the willingness of consumers to switch in response to a rise in the price of Sky Movies and Top Tier packages and (iii) a further survey carried out by Sky in 2009 on consumer switching.

- Changes in demand for movie formats: We have examined a range of evidence on changes in demand for different movie formats (Sky Movies, FTA movies,

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

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

- Movie viewing data: We have considered viewing data, provided to us by Sky, on a sample of consumers that ceased subscribing to Sky Movies in 2007/8.

- Internal documents: Company documents such as internal communications, studies on consumer preferences or business plans can provide useful evidence of substitution. We have considered internal papers from Sky and **[✂]** on the extent to which their respective movie products face competition from other movie formats.

- Consultation responses: We have taken account of all respondents' views in reaching our conclusions on wholesale and retail market definition.

- Movie rights: Our market definition analysis has considered revenues from the supply movies in different "windows".

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

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

- Price and quality changes: We have also examined what can be inferred from observed responses to changes in price and quality over time.

Retail market definition

The focal product

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

- Standalone Sky Movies 1 (known as "Single Movies");

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

- Sky Movies 1, 2, Sky Premiere and Sky Premiere +1 (known as "Dual Movies").

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

6.106 **[✂]**[638].

Figure 84 Sky's Movies packages

[✂]

6.107 Our starting point for product market definition is to determine the focal product (see paragraph 5.39). In the Third Pay TV Consultation we assessed retail markets for the provision of packages containing any of the following channels: Sky Movies channels (apart from Classics) and Disney Cinemagic[639]. Sky Movies Classics had too few new movies to be included within the relevant wholesale market (Third Pay TV Consultation, paragraph 4.261).

6.108 Virgin Media made no new submissions in relation to movies in response to the Third Pay TV Consultation[640]. However, in the context of sports channels, it argued that the focal product should refer to packages of premium channels as opposed to individual channels[641]. Sky stated that the approach in the Third Pay TV Consultation gave rise to analytical difficulties because the wholesale and retail focal products were different[642].

6.109 We agree with Virgin Media that we should consider packages of channels that are offered in the market, and this is the approach that we adopted at the retail level in both the Third Pay TV Consultation and in this document[643]. However when assessing constraints we consider the competitive constraints on the premium movies element of the bundle (rather than the package as a whole)[644]. Appendix 3 of Annex 4 explains why, having considered consultation responses, we remain of the view that this approach is appropriate.

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

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

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

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

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

642 6 October 2009 Sky Submission, paragraph 22.

643 Third Pay TV Consultation, paragraph 4.379.

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

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

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

6.112 As explained above, Sky Movies 1 and 2 consist of five channels each and Sky Dual Movies consists of twelve channels. We recognise that the characteristics of Sky Movies 1 and 2 are somewhat different from the characteristics of Sky Dual Movies: they have seven fewer channels and lack Sky Movies Premiere (which broadcasts major new releases). Packages containing Single Movies are thus likely to be less attractive to movie fans[645]. However in 2008 **[✂]** of subscribers to Sky Movies on Sky's satellite platform took a package containing Dual Movies rather than a package containing Single Movies[646]. In the analysis that follows we focus on the characteristics of Sky Dual Movies (i.e. all twelve Sky Movies channels).

Substitution analysis

<u>Our approach in the Third Pay TV Consultation</u>

6.113 In the Third Pay TV Consultation we considered a range of evidence, including product characteristics[647]. We stated that "access to new films is an important feature of premium movies" and inferred that "channels containing older films or other film content are likely to be a weak substitute" [648]. Further, "consideration of the different characteristics of DVDs and premium movies" was part of our evidence that retail DVD sales are a "relatively weak substitute" for premium movies channels[649].

6.114 We also relied on a range of other evidence including wholesale margins[650], estimates of demand elasticities based on survey responses[651] and analysis of sales volumes[652].

<u>Consultation responses</u>

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

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

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

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

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

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

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

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

[652] Third Pay TV Consultation, paragraphs 4.376 and 4.400.

6.116 Sky argued that it is important to focus on the preferences of marginal consumers[653] and that marginal consumers may have different preferences to other consumers[654].

6.117 Sky said that only a small proportion of the movies shown on Sky Movies are 'Hollywood blockbusters' (e.g. 10% of the films shown in 2006/07). It said that approximately 60% of the films shown on Sky Movies were library movies[655].

6.118 **[✂]**[656]

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

Our current view

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

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

Sky Dual Movies

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

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

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

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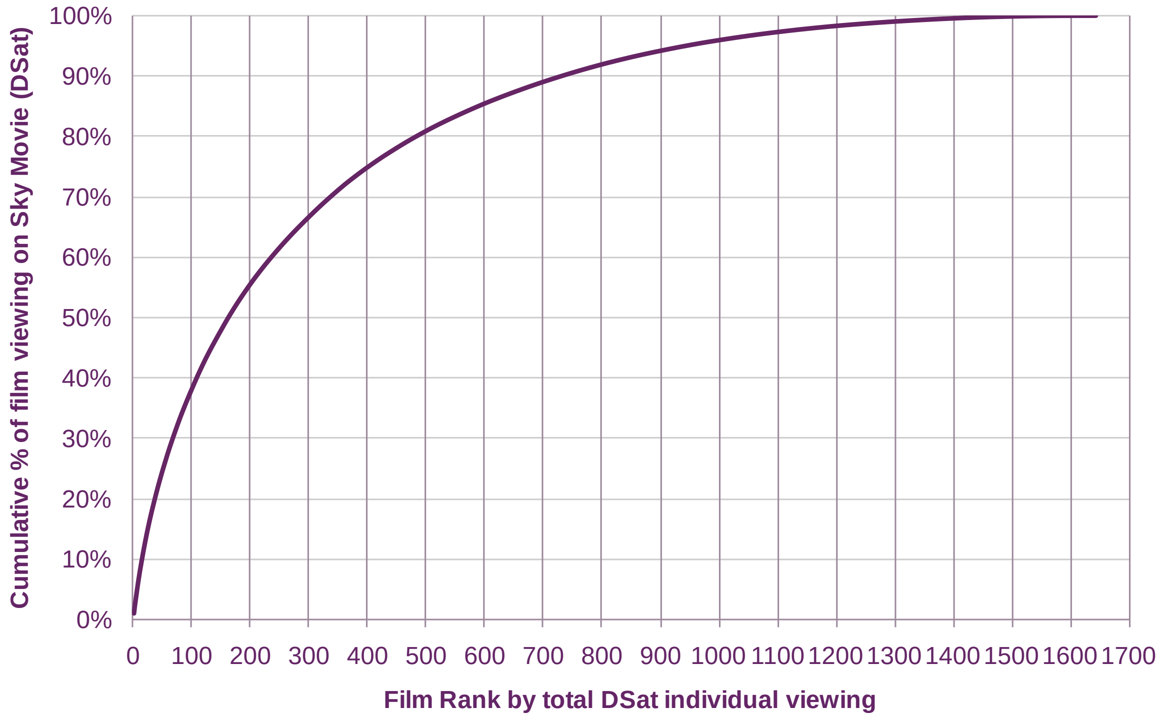
[653] Sky September 2009 Response, paragraph 5.16; also 5.32.

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

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

[656]**[✂]**.

Figure 85 Distribution of film viewing on Sky Movies in 2008



Source: BARB viewing data (2008)

6.124 Unsurprisingly, viewing also tends to be concentrated on movies that were box-office successes. Movies that were in the top 60 films (measured by box office receipts) in either 2007 or 2006 accounted for 54% of viewing of recent movies and 32% of overall viewing despite representing only 5% of the titles broadcast on Sky Movies[657].

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

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

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

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

- Thus films that are either relatively old or did not have a material presence in cinemas accounted for half of all viewing on Sky Movies. Such films are relatively unattractive individually (they account for well over half the films shown on Sky Movies but only half of all viewing), but do have some value in aggregate.

- This suggests that Sky Movies subscribers attach particular value to recent box-office successes, but also value access to a wide range of movies content.

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

- "To access a wider range of movies than you receive on other TV" (37%),

- "I got a good deal/it came with my package" (23%),

- "To watch recently released movies" (19%) and

- "To have a wider range of TV than available with my basic package" (17%).[659]

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

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

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

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

- Sky Movies channels showed 1,446 different films in 33,978 slots in 2007[660].

- Sky Movies channels showed 1,500 different films in 39,238 slots in 2008.[661]

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

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

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

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

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

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

6.132 Screen Digest estimates that US films typically account for around 35% of films released at UK cinemas but for up to 80% of UK box office revenues[664].

6.133 The particular importance of the Major Hollywood Studios is also illustrated by the lower viewing figures for Sky Indie compared to the other Sky Movies channels (see Figure 77above).

6.134 Sky Dual Movies shows a significant number of films that previously appeared in the cinema and were box office successes.

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

[✂]

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

6.135 **Timing:** The majority of movie viewings on Sky Dual Movies are of new releases – around twelve months after their cinema release, and before they are available on other TV channels or services[665]. As noted above, this content is supplemented with older films.

6.136 **Format:** Sky Dual Movies is a television service, delivered to people in their homes. It is available on a pay monthly subscription basis. Films on Sky Movies are not interrupted by advertisement breaks – instead these are concentrated before and after films. This is likely to increase the attractiveness of films on Sky Movies relative to other channels (with the exception of the BBC).

6.137 **Price:** The retail price of Sky Dual Movies is set out in the following Figure (this is based on the data presented in Figure 22).

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

[665] As shown in Figure 78 above.

Figure 87 Pay TV packages and pricing

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

Source: Ofcom, operators.

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

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

- The majority of Sky Dual Movies subscribers also subscribe to Sky Sports. Some of these subscribers are primarily interested in movies, others in sports. For a subscriber who is willing to pay the standalone price for Sky Sports, the “true” price of Sky Dual Movies is arguably the *incremental* price of the Top Tier package, above the Sky Sports standalone price.

- Comparing Sky Dual Movies with potential substitutes such as movies on DVD entails comparing access to a single movie with the option to access a large number of movies. One way of addressing this is to consider the price per movie viewed on Sky Dual Movies.

- We have two estimates of the number of movies viewed per month:

  - BARB viewing data shows that there were 471m film views on Sky Movies through the satellite platform in 2008. In September 2008, [✂] households subscribed to Sky Movies on Sky’s satellite platform[666]. These households thus account for an average of [✂] film viewings per month (e.g. one person watching [✂] films per month, two people watching an average of [✂] films each).

  - Sky provided viewing data for former Sky Movies subscribers. This data suggested that, prior to ending their Sky Movies subscription, those

[666] Sky response dated 12 November 2008 to Ofcom information request.

households watched 2-3 movies per month[667] [668]. This is not necessarily inconsistent with BARB data. For example, a household of three people[669] watching three movies per month would account for nine viewings per month, similar to that recorded by BARB.

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

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

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

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

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

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

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

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

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

- First, one of the attractive features of the subscription price structure of Sky Movies is that the incremental cost of watching a film is zero. Subscribers (and their families) can thus control their expenditure and watch as many movies as they like without incurring any extra cost. Sky Movies thus gives subscribers the option to watch additional films costlessly if they wish to do so. This option value is not reflected in the above calculations but we consider it is likely to be important to a significant proportion of Sky Movies subscribers. The greater popularity of subscription movies over PPV illustrates the extent of this preference.

- Second, they relate to relatively infrequent viewers of movies and are not representative of the average price paid per film by a typical Sky Movies subscriber. Rather they are 'upper bounds' for prices per film.

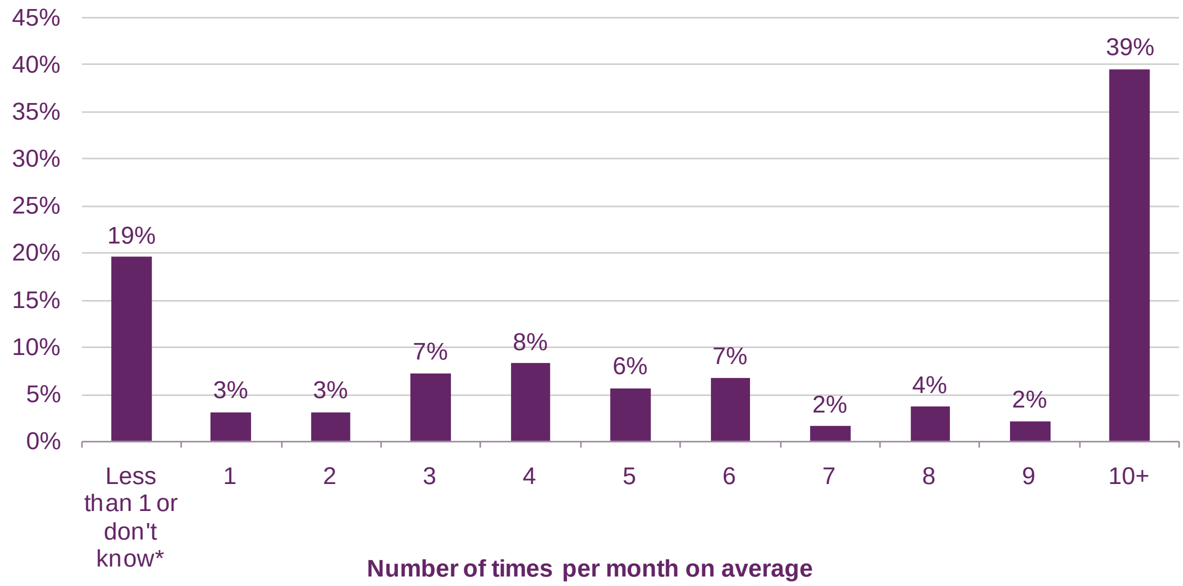
  - Figure 88 below sets out the number of times per month that households that subscribe to Sky Movies watch films on the channels that are now part of the Sky Movies suite of channels. Our survey first asked respondents whether their household watches films on these channels on a regular basis. Respondents that answered "yes" to this initial question were then asked a follow up question asking how frequently they did so. 19% of respondents did not answer "yes" to the initial question. It is unclear whether this is because they watch these channels irregularly or whether they did not know (for example because they do not know the viewing habits of other household members).

  - A further 13% of households that subscribe to Sky Movies reported that they watch Sky Movies one to three times per month on average.

  - The median number of films watched (by one or more members of the household) is six per month, assuming that the 19% of respondents described in the first bullet above watch six or fewer films per month. This implies that the average price per film is £1.25 for Top Tier households that buy Dual Movies as a cheap add-on to Dual Sports (i.e. using an incremental price of £7.50) and just over £2.50 for Top Tier households that buy Dual Sports as a cheap-add-on (i.e. using an incremental price for movies of £16). This indicates that, compared to the typical price of a DVD, Sky Movies is a relatively cheap way of watching a large number of films for a typical subscribing household.

  - An alternative approach would be to base our comparison on BARB data. In this case, if a movie is watched by several member of the household, each person counts as a separate viewing. BARB suggests that the average price-per-person-viewing for Sky Movies is between 75p (based on an incremental price of £7.50) and £1.60 (based on an incremental price of £16). By way of comparison, if a DVD costing around £7.50 were watched by three members of a household, this would mean an average price-per-person viewing of £2.50. Again, this suggests that Sky Movies is a relatively cheap way of watching a large number of films for a typical subscribing household.

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



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

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

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

Assessment of potential substitutes

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

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

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

- Going to the cinema to see the most appealing new releases and/or as a social event.

- Buying recent DVDs for a range of possible reasons (e.g. because they particularly enjoyed the film in the cinema, or missed seeing it in the cinema), or receiving them as gifts.

- Watching movies when they first appear on pay TV (if a subscriber) or on FTA TV.

- Watching a range of older movies on pay TV, FTA TV, or on (usually discounted) DVDs.

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

6.144 We also recognise that assessing the attractiveness of potential substitutes may involve trading off different characteristics (e.g. trading off older or low quality films for a cheaper price[670], or an older, high quality film for a more recent, lower quality film[671]). We therefore assess potential substitutes with respect to all five key characteristics in addition to other relevant evidence.

<u>Movies on retail DVDs</u>

6.145 In our Third Pay TV Consultation we argued that DVD sales were a relatively remote substitute for Core Premium Movies channels, as evidenced by their very different characteristics and the pattern of retail price changes[672] (i.e. we noted that the growth in volume, and reduction in prices, of movie DVDs did not appear to have had an impact on Sky Movies subscriptions).[673]

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

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

[671] October 2009 Sky Submission, Table 3.

[672] Third Pay TV Consultation, paragraph 5.90.

[673] Third Pay TV Consultation, paragraph 4.335.

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

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

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

6.147 Sky commented on our observation that the price difference between Sky Movies and retail DVDs had widened since 2000,[677] arguing that a decline in Sky Movies subscribers may be a consequence of this,[678] and also suggesting that this analysis failed to control for changes in the quality of Sky Movies[679].

6.148 Most, if not all, of the movies shown on Sky Movies at any given time are also available on DVD along with many other movies, so DVDs match Sky Movies for **quality**, and exceed it in quantity. However, a subscriber to Sky Movies can watch an almost unlimited number of movies for no extra price, while each additional DVD watched represents an additional purchase. As a result, for customers who wish to watch a large number of movies, and particularly recent releases, DVDs may be a poor substitute. We return to this issue in our discussion of price.

6.149 The main advantage of the DVD **format** over Sky Movies is *permanence*, which allows repeated viewing or giving to others.[680] In contrast, the main advantage of Sky Movies over DVDs is their relative *immediacy,* as subscribers can have access to a range of movies without planning to watch them in advance. As noted in Figure 75, 28% of price sensitive subscribers regard the convenience of not having to go to a shop for DVDs as “must have” and a further 35% regard it as “nice to have”. The fact that a Sky Movies subscription allows access to a large *volume* of movies, whereas the purchase of a DVD typically allows access to only one, can also be seen as an aspect of the format. Like Sky Movies, DVD movies are also available in HD for a higher price (i.e. on Blu-Ray).

6.150 Taking these aspects of permanence, immediacy and volume together, we consider that Sky Movies is significantly differentiated from DVDs.

6.151 As regards **timing**, films are released on DVD approximately four months after they are released theatrically and approximately eight months before they are available on Sky Movies. As the Figure below shows, the majority of DVD sales take place in the first month of release.

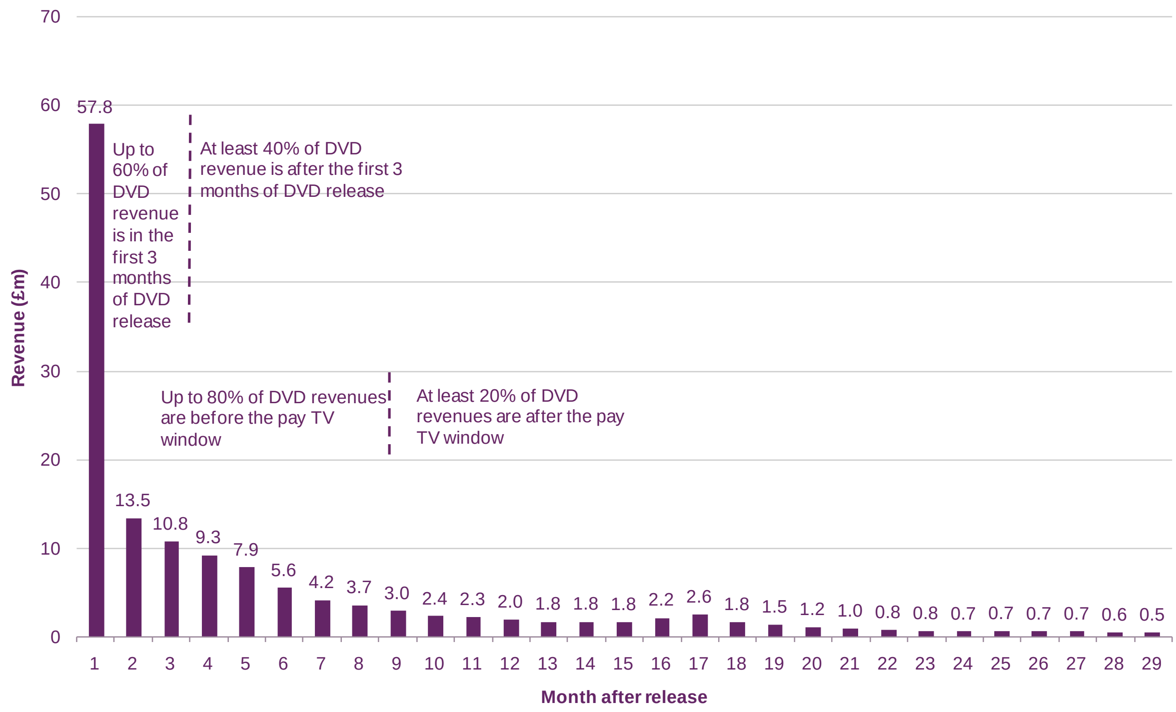
[677] Paragraph 4.335 of the Third Pay TV Consultation.

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

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

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

Figure 89 Revenue from retail DVD sales over time



Source: The Official UK Charts Company

6.152 As shown by the Figure below, the retail **price** of DVDs declines sharply from around £12 to £14 in the first month to £8 in the fifth month after release[681] . By the time a film first appears on Sky Movies the average retail DVD price is £6.50-£7.50. The price continues to decline during the first pay TV subscription window. In 2008, almost 180m movie DVDs were sold and the value of these sales was £1,321m[682], suggesting that the average price of a movie DVD in 2008 was £7.36.

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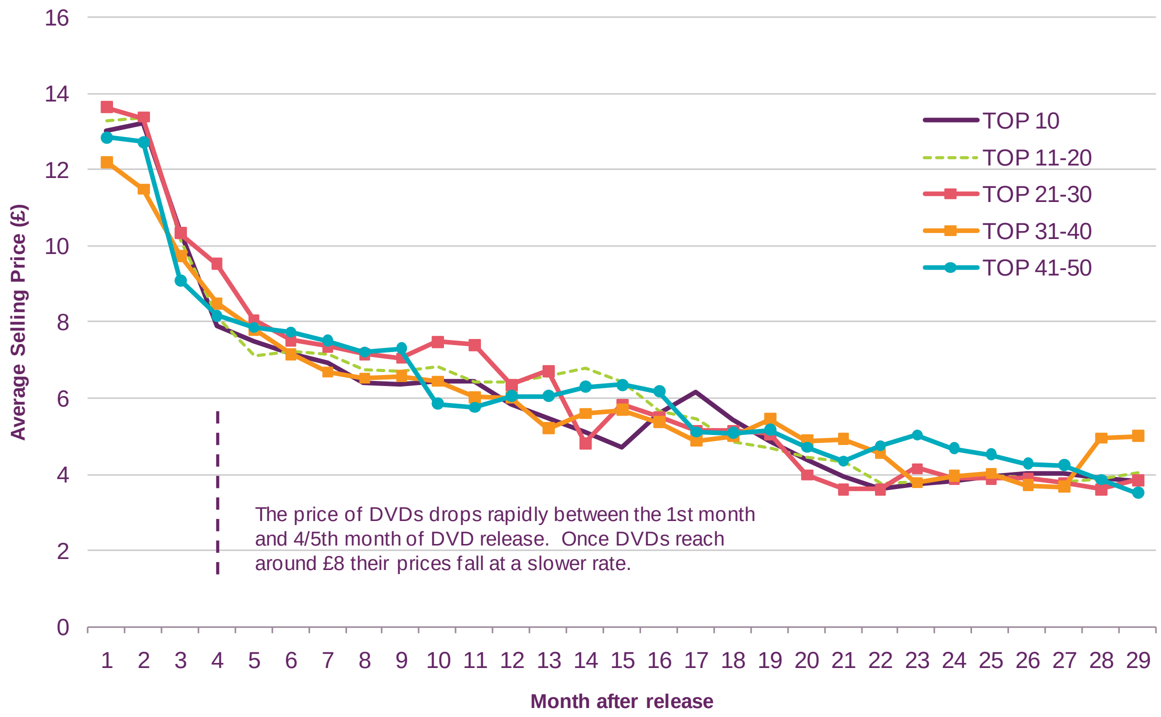
[681] This additional information was gathered to address the arguments raised in Sky's response to the Third Pay TV Consultation.

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

Figure 90 Retail price of DVDs over time



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

Source: The Official UK Charts Company.

Analysis of prices

6.153 Because DVD prices decline after release, the relative price of films viewed on DVD compared to films viewed on Sky Movies depends on the time of purchase. If, for example, a consumer bought 2-3 DVDs per month of a similar age to the films on Sky Movies, they would pay £12-£21 per month[683]. In contrast, if bought close to the time of release, the DVDs would cost twice as much. Older DVDs would be slightly cheaper. These effects are illustrated in the table below.

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

Figure 91 Illustrative example of cost of buying films on DVD

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

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

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

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

6.155 DVDs within the first pay TV subscription window (i.e. with the same age as movies on Sky Movies) ("Pay TV DVDs") account for around 17% of total DVD sales[684]. In arguing that DVDs were substitutes, Sky focused on these Pay TV DVDs. Whether these movies are substitutes to Sky Movies depends on a subscriber's reason for purchasing Sky Movies and frequency of viewing:

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

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

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

6.156 Figure 88 above indicates that at most 22% of Sky Movies subscribers are **irregular viewers** of movies (i.e. watch fewer than two movies per month on Sky Movies). For these irregular viewers, Pay TV DVDs will be cheaper than a standalone Sky Movies subscription but may not be cheaper than Sky Movies if it is purchased as an add-on to a Sky Sports subscription. However, in practice, consumers may not explicitly take account of the cost per view of movies (based on their expected viewing patterns) when deciding whether to join or continue with a subscription service. As noted above, direct price comparisons do not reflect the value to subscribers of being able to watch as many movies as they like without incurring any extra cost, and as such these comparisons will tend to overstate the closeness of substitutability.

6.157 19% of ***non*-subscribers** to Sky Movies mentioned DVDs as a reason for not subscribing to Sky Movies[685]. The number of marginal consumers in this group (non-subscribers) is unclear. It is likely that some non-subscribers would be marginal consumers if prices were at competitive levels.

6.158 We accept that the evidence here is not clear-cut. However if we consider that marginal Sky Movies subscribers are no more likely than non-subscribers to see DVDs as a substitute, this suggests that at most around one in five marginal consumers may see retail DVDs for movies shown within the first pay TV subscription window as a substitute for Sky Movies. In our view, this is not sufficient to conclude that Pay TV DVDs are a close substitute for Sky Movies, although it may suggest that they are a moderate substitute.

Trend data

6.159 In the Third Pay TV Consultation we analysed changes in the number of Sky Movies subscriptions between 2000 and 2008 in the light of the growth in total retail sales of DVDs over that period. The number of Sky Movies subscriptions **[✂]** in the period 2000-2004, **[✂]** in the period 2004-2008. We noted the widening price differential between DVDs and Sky Movies, and said that Sky's ability to sustain this price difference without customers switching to DVDs was evidence that retail DVDs and premium movies packages were in separate markets (Third Pay TV Consultation, paragraph 4.335)[686].

6.160 Sky argued that a similar analysis that we carried out in relation to sports channels was unreliable since it failed to control for changes in other relevant variables (such as price, quality, marketing expenditure) and that we had failed to specify the counterfactual[687].

6.161 We recognise that the range of factors which may affect Sky's subscriber numbers means that strong inferences should not be made from a simple comparison. We

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

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

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

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

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

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

Sky's internal documents

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

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

- One slide was titled "The value of Sky Movies has been undermined by the availability of DVDs at discount prices **during its licence period**" (emphasis added).

- That slide stated that "Approximately 20% of UK VHS and DVD sales of **[✂] have occurred** during **Sky's 'exclusive' licence period**" (emphasis added) and "The price of the title is currently well below its initial retail price"[688].

Conclusion on DVD retail

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

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

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

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

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

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

- Pay TV DVDs: Sales of Pay TV DVDs and packages including Sky Movies have significant differences in format; Sky Movies also allows immediate access. In terms of price, Sky Movies is likely to be cheaper – its subscription price structure allows subscribers to watch as many movies as they like without incurring any extra charge. We thus consider DVD sales within the first pay TV subscription window to be a moderate substitute for Sky Movies i.e. outside the relevant market but still capable of exerting a reasonable constraint.

- Other DVDs: We consider DVD purchases in the first few months to be very different in nature from a subscription to Sky Movies and thus a distant substitute i.e. outside the relevant market. Similarly DVDs after the first pay TV subscription window are likely to be distant substitutes. This is supported by **[✂]**.

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

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

6.171 Sky told us in response to our Third Pay TV Consultation that it faces strong competition from the combined strength of FTA broadcasters[689]. It considered that a vast range of high quality programming is available free of charge[690], pointing out that the top ten films shown free to air in 2007 had an average audience of 6.9 million viewers and an average audience share of 33%[691]. Sky presented various pieces of evidence in support of its position which we set out and consider below.

6.172 Our assessment of the evidence relating to the substitutability of movies on FTA and basic channels is structured as follows[692]:

- First, we set out our analysis of the characteristics of movies on FTA and basic channels.

- Second, we set out various other pieces of evidence we considered for the purposes of market definition (internal Sky documents, trend data, viewing data on former Sky Movies subscribers, the Seabright Study).

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

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

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

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

6.173 Finally we set out our conclusions on the extent to which FTA/basic movies channels and movies on other FTA and basic channels pose a constraint on Sky Movies.

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

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

6.175 We have evaluated movies on FTA and basic channels in terms of each of the important characteristics set out above.

6.176 In terms of **timing**, Sky Movies is more attractive than films on FTA and basic channels. New to TV films account for around 40% of the films shown on Sky Movies and 60% of viewing[693],[694]. We recognise that the remaining 40% of the film viewing on Sky Movies is of older films and so is more comparable with the older films shown on other channels. However, our view is that demand for Sky Movies is primarily driven by the availability of new-to-TV movies.

6.177 Overall FTA and basic channels show a similar selection of films to Sky Movies, albeit at a later date after release. Accordingly we would expect the average **quality** to be similar to Sky Dual Movies. Individually FTA and basic channels have fewer movies than Sky Movies[695],[696],[697]. However, looking at these channels in aggregate, the position on the **quantity** of movies is somewhat more nuanced. Overall there is a greater number of unique film titles on general entertainment channels than on Sky

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

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

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

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

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

Movies[698]. However, taking repeats into account, there are markedly more films on Sky Movies[699].

6.178 FTA/basic movies channels and movies on other FTA and basic movies channels clearly have the same **format** as Sky Dual Movies, in that they are shown on linear TV channels and an additional film can be viewed with no additional cost (unlike, say, PPV).

6.179 FTA movies are free. Consumers have to pay for basic TV channels, but they are less expensive than Sky Movies, and movies channels may be seen as a free add-on to subscribers who have a basic TV package for other reasons. While the **price** of movies on FTA/basic is clearly more attractive than that of Sky Movies, the fact that Sky Dual Movies commands a premium of around £7.50 per month as an add-on to Sport, and around £16 per month as a standalone service, indicates that consumers place considerable value on the different characteristics of Sky Movies – i.e. that it is highly differentiated.

6.180 Overall, films on FTA and basic channels are materially inferior to Sky Movies. In particular, these channels do not show new films that are from the first pay TV subscription window. They mainly show library movies. Sky highlighted the importance of price, as a cheaper but low quality product can in principle be an effective substitute for a more expensive but higher quality product[700]. However, the extent of the price difference suggests that there is no significant constraint – Sky Movies subscribers appear prepared to pay a substantial premium for the superior timing and quantity of movies that they receive as compared with what is available on FTA and other basic channels. This is supported by viewing data which shows that Sky Movies subscribers prefer new films[701]. Survey evidence[702] and **[✂]**[703] also suggest that new films are a strong driver of demand for Sky Movies. Library movies on other channels do not satisfy this demand.

6.181 In its response to our Third Pay TV Consultation, Sky provided viewing data that showed that a repeat of an older film on Channel 4 attracted a higher audience amongst households with Sky Movies than the premiere of a new film on Sky Movies[704]. Given that Sky only provided a single, and therefore unrepresentative, sample, we do not consider that this affects our view that, when looked at as a whole,

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

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

[700] October 2009 Sky Submission, paragraph 94.

[701] See paragraph 6.65.

[702] See paragraphs 6.61 and 6.63.

[703] **[✂]**.

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

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

Internal Sky documents

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

Trend data

6.183 In our Third Pay TV Consultation we considered changes in the total audience for films on FTA and basic tier channels and in the audience of subscription movies channels, both of which declined between 2003 and 2007[705]. We considered that the evidence did not point towards substitution from subscription channels to basic and FTA channels – rather it pointed to an overall decline in movie viewing on linear channels[706].

6.184 In response, Sky argued that the relevant figures for 2008 showed that total viewing of movies on television rose[707] i.e. that the decline identified in the Third Pay TV Consultation reversed in 2008. Sky added that, even if demand for watching movies on all television channels had declined, it would not support the view in the Third Pay TV Consultation that movies on FTA and basic channels fail to effectively constrain packages including premium movies channels[708].

6.185 We have updated the trend data that was previously set out in Figure 33 of the Third Pay TV Consultation to reflect the 2008 data highlighted by Sky. See Figure 98 below (which forms part of our forward looking analysis of shares of supply). Sky is correct that overall viewing rose sharply in 2008, driven by higher viewing of movies on basic channels and on channels such as ITV2, BBC3 and Film4. Viewing on subscription movies channels was almost unchanged from 2007.

6.186 In paragraphs 5.355, in relation to sports, we discuss our reasoning in the Third Pay TV Consultation on changes in demand for various means of viewing live sports content. In response, Sky argued that such analysis is unreliable as it fails to control for changes in other relevant variables (such as price, quality, marketing expenditure) and that we had failed to specify the counterfactual[709]. This comment is also relevant to the interpretation of changes in the audience for movies on different categories of channel. Indeed we made a similar point in the Third Pay TV Consultation in the context of PPV[710]. In particular, we agree that many other variables affect the

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

[706] Third Pay TV Consultation, paragraph 4.318.

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

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

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

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

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

Viewing behaviour of former Sky Movies subscribers

6.187 In its June 2009 submission, Sky said that it gathers data on the amount of viewing on the main television set in 33,000 households. Sky identified 434 households that (i) subscribed to a package including Sky Movies in a twelve month period ("Year 1"); (ii) downgraded to a package that did not contain Sky Movies at some point in the next twelve month period ("Year 2"); and (iii) did not subsequently restore Sky Movies to their subscription in the following twelve months ("Year 3"). Sky compared quarterly viewing by these households in Year 1 and Year 3[711]. It stated that this data showed that:

- For the households that downgraded, overall viewing of movies fell from Year 1 to Year 3 but viewing of movies on channels other than Sky Movies increased. Sky interpreted this as indicating that these downgrading households replaced some of their viewing of Sky Movies with viewing of movies on other channels (6 June 2009 Sky submission, annex 4, paragraph 1.6 and figure 1).

- Total TV viewing increased for all Sky households between Year 1 and Year 3. However, it increased slightly more amongst the households that downgraded in two of the quarters. Sky interpreted this as indicating that the downgraders also replaced viewing of movies with viewing of non-movies programming (6 June 2009 Sky submission, annex 4, paragraph 1.7 and figure 2).

6.188 In the Third Pay TV Consultation, we said there was no evidence that this downgrading was a response to pricing or the availability of FTA movies and other content[712]. We also stated that Sky's results appear counter-intuitive, because lapsed Sky Movies subscribers appeared to increase their overall television viewing despite having a smaller range of TV programming available to them. This led us to doubt the reliability of Sky's analysis[713].

6.189 Following publication of the Third Pay TV Consultation, Sky continued to regard its viewing data as strong evidence of the substitutability of Sky Movies with movies on other channels and with non-movies content[714]. We remain of the view that this evidence is inconclusive[715]. As we explained in our Third Pay TV Consultation, there is no evidence that this downgrading was a response to the pricing of Sky Movies or the availability of other content. Indeed, we would expect a Sky Movies subscriber who cancelled their subscription to watch more movies on other channels[716].

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

[712] Third Pay TV Consultation, paragraphs 4.319-4.320.

[713] Third Pay TV Consultation, paragraph 4.319.

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

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

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

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

The Seabright Study

6.190 As set out in Section 5, paragraphs 5.257 and 5.311 to 5.315, Sky considered that the Seabright Study provides compelling evidence of the constraint imposed by the availability of FTA television.

6.191 The model presented in the Seabright Study predicts that in a given area if DTT availability increased by 20%, take up of packages including Sky Movies (but not Sky Sports) would decline by 0.21 percentage points and take up of packages including Sky Sports and Sky Movies would decline by 0.37 percentage points. The latter figure is not statistically significant from zero. If the area had average take up of packages including Sky Movies (only) and packages including Sky Movies with Sky Sports (**[✂]** and **[✂]** respectively), this would represent approximately **[✂]** and **[✂]** proportionate declines respectively[717].

6.192 For the reasons set out in paragraphs 5.317 to 5.323, we do not consider that the Seabright study can be relied upon to demonstrate that pay TV services are constrained by FTA TV.

Our conclusions on other films on FTA and basic channels

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

6.194 We therefore consider that these channels lie outside the relevant market, although we recognise that there is likely to be a moderate degree of substitutability with Sky Movies.

Non-movies content on television

6.195 Sky criticised our Third Pay TV Consultation for failing to consider adequately the extent to which non-movies programming is a substitute for services that include Sky Movies[718]. Sky stated that the supply of premium pay TV packages is likely to be constrained by basic-only TV packages[719]. In support of this proposition Sky stated that **[✂]** of its current basic-only subscribers have previously subscribed to premium content. Similarly **[✂]** of current Dual Sports, **[✂]** of current Dual Movies

[717] Third Pay TV Consultation, Figure 21.

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

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

and **[✂]** of current Top Tier subscribers have previously been basic-only subscribers[720].

Characteristics evidence on non-movies content

6.196 Viewers have access to a wide variety of programming other than movies, including soap operas, comedies, drama (both one off and as part of an ongoing series), nature etc. Such programming is broadcast on both free to air channels, including the main PSBs' channels, as well as on pay TV channels (e.g. the Discovery Channel, Living, G.O.L.D., Sky1).

6.197 Non-movies content is first released on television, unlike movies (where the first opportunity to view a film is generally in the cinema). A substantial share of non-movies content is part of TV series. Non-movies content is typically interspersed with advertising breaks (with the exception of programmes broadcast by the BBC), whereas there are no adverts during a film on Sky Movies.

6.198 In terms of the product characteristics which we have set out above, non-movies content comprises a large quantity of content, with a combination of new broadcasts and repeats. Some of this content is of high quality. However, as the underlying content is fundamentally different from that on Sky Movies (unlike the other potential substitutes we have considered), there is no clear basis of comparison of Sky Movies and non-movies content in terms of these characteristics. We recognise that there is some high quality general entertainment content on TV which has production values comparable to some movies – and, unlike movies, it generally has the advantage, at its first TV broadcast – of not having previously appeared in the cinema or on DVD.

6.199 As such it is necessary to consider other evidence as to likely substitutability. Clearly, in some circumstances, a TV viewer will choose between watching a movie or other content, depending on the relative attractiveness of what is on TV, and some genres (e.g. high quality dramas) may be seen as a closer substitute for movies than others. However, the key question is the extent to which access to the wide range of recent and library films offered by Sky Movies is seen as distinctive by viewers who also have access to a wide range of other content.

6.200 The price of Sky Movies, relative to other services, gives a strong indication of the answer to this question. Televised non-movies content is significantly cheaper to subscribers than Sky Movies. In particular, a substantial amount of non-movies content is available from FTA broadcasters. Some attractive content, particularly certain US drama series such as *Lost* and *24*, for example, is only available on pay TV channels such as Sky1. However the price of subscribing to a pay TV bundle that includes Sky1 is very substantially less than the price of subscribing to a pay TV bundle that includes Sky Movies. In particular, as set out in paragraph 5.101 above, the incremental cost of adding a "mix" of channels including Sky1 is only £1.

6.201 Sky Movies subscribers have access to vast amounts of non-movies content, both on FTA television and as part of the basic component of their pay TV bundle[721]. However these subscribers choose to pay a significant extra amount each month in order to have access to Sky Movies, for example an extra £16 per month on top of Sky's basic channels for standalone Sky Dual Movies on satellite (or £7.50 for

[720] October 2009 Sky Submission, paragraph A3.1.

[721] Sky offers six "mixes" of basic channels to its subscribers. As shown out in Figure 31 above, **[✂]**.

existing Sky Sports subscribers). This suggests that Sky Movies is highly differentiated from other basic content[722].

Internal Sky documents

6.202 Of the internal documents provided by Sky in response to Ofcom's information request of 29 May 2008, there was only a single specific reference to substitutability between Sky Movies and non-movies content[723]. In contrast there were multiple references to DVDs and movies on other channels[724]. This suggests that Sky is more concerned about alternative ways of watching movies, than television programming in general[725].

Survey evidence provided by Sky

6.203 **[✂]**[726]. **[✂]**[727]. **[✂]**.

Figure 92 Preferences of price sensitive subscribers

[✂]

6.204 **[✂]**.

- **[✂]**[728]. **[✂]**.
- **[✂]**.

6.205 **[✂]**.

- **[✂]**[729]. **[✂]**.
- **[✂]**.

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

723 As noted above, a 2005 internal Sky document states that for "Films on TV … their competition is not just other windows, but all other TV programmes that happen to be on (including first run drama etc)". **[✂]**, 1 July 2005, Sky, slide 6. Provided at tab 5 of Sky's response dated 1 July 2008 to question 10 of Ofcom's information request dated 29 May 2008. We note that Sky's response dated 19 March 2010 to Ofcom's letter of 11 March 2010 suggests that Sky may hold further documents which suggest substitutability between Sky Movies and non-movies content. Sky did not provide these in response to our information request.

724 See paragraph 6.83 and 6.84 above.

725 **[✂]**

726 **[✂]**

727 **[✂]**

728 **[✂]**

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

Viewing behaviour of former Sky Movies subscribers

6.206 In support of the proposition that non-movies programming is a substitute, Sky referred to viewer data for former Sky Movies subscribers that it provided in its June 2009 submission[730]. It considered that the data shows that these households replaced some of their viewing of Sky Movies with viewing of non-movies on other channels[731].

6.207 These data are described and analysed in paragraphs 6.187 to 6.189 above. We continue to regard this evidence as inconclusive and unreliable for the purposes of market definition[732].

Expenditure by the PSBs

6.208 Sky stated that, in total, the PSBs spend over £3bn on creating and acquiring programmes for their channels, including £2bn expenditure by the BBC, and that it is "implausible" that they exert only a moderate constraint on pay TV retailers[733].

6.209 In particular, as explained at paragraphs 6.196 to 6.201, non-movies content on television satisfies a different demand from Sky Movies. Accordingly the amounts spent on these two types of programming do not provide reliable evidence for the purposes of market definition.

Ofcom's conclusion on non-movies content

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

Subscription VoD (SVoD) in the pay TV window

Description of SVoD movies

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

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

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

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

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

6.212 Sky currently owns most of the SVoD rights for movies in the first pay TV subscription window. It buys these rights together with the linear rights for the same films.[734] **[✂]**[735].

6.213 There are usually a number of conditions attached to the SVoD rights acquired by Sky. First **[✂]**[736]. **[✂]**[737]. **[✂]**[738]. **[✂]**[739].

6.214 Currently, Sky only exploits its SVoD film rights through Sky Player. This internet based VoD service shows films through a PC, Mac or Xbox 360. Sky offers SVoD films for free as part of a Sky Dual Movies subscription on Sky's satellite platform. For other consumers, Sky offers it as part of bundle with Sky Movies Screen 1, Sky Movies Screen 2 and basic content on Sky Player for £32 per month (£17 per month extra on top of the £15 it charges for Sky Player basic content)[740]. In 2008, Sky's SVoD service had 400 films in its catalogue from all the Major Hollywood Studios[741].

6.215 In 2009, Sky announced the launch of a "comprehensive 'pull' video-on-demand … service next year, to provide Sky+HD customers with additional choice …" Sky indicated that this service will use the broadband capability of existing Sky+HD boxes. Sky has not yet announced further details on how the service will be priced or packaged or which consumers will be eligible for the service[742]. **[✂]**[743].

Representations on SVoD

6.216 **[✂]**[744] **[✂]**[745]. **[✂]**[746].

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

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

[736] **[✂]**.

[737] **[✂]**.

[738] **[✂]**.

[739] **[✂]**.

[740] Source: http://skyplayer.sky.com/ (as viewed on 22.01.2010).

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

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

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

[744] **[✂]**

[745] **[✂]**

[746] **[✂]**

Ofcom's assessment of SVoD movies

6.217 Sky's SVoD service on its Sky Player platform shows a smaller **quantity** of films to Sky Dual Movies. In terms of **timing**, Sky's SVoD service features movies from the first pay TV subscription window. Sky's SVoD service features the same type of movies that it shows on Sky Dual Movies. The **quality** of the films shown on the two services is thus likely to be comparable.

6.218 In some respects, SVoD is a more attractive **format** than a linear subscription TV channel, since it gives consumers the freedom to decide when to watch a particular film. It is equivalent in that the movie is delivered to the home without the need for advance planning and in that it is available on a subscription basis. However where an SVoD service is only available through a PC or other non-TV device, as is currently the case with Sky Player, it is likely to be less attractive than watching Sky Movies via a television set.

6.219 For households that do not subscribe to Sky's satellite service, the incremental monthly **price** of Sky's SVoD films service is £17 on top of its Sky Player basic content. This is currently more expensive than the £16 incremental cost of buying Sky Dual Movies through satellite on top of Sky's basic TV packs. The lowest total monthly price of Sky's SVoD service (bundled with other content) is £32. This is slightly cheaper. But this bundle contains less basic content, for example, it does not include Sky1[747].

Conclusion on SVoD movies in the pay TV window

6.220 Sky's current SVoD service, available via Sky Player, will not act as a constraint on Sky Dual Movies, as Sky provides it. Its inclusion within the market will therefore not affect our conclusions on market power. In any event, as a service delivered via PCs (rather than the main television set) we consider that it is a moderate substitute for Sky Movies.

6.221 However, an SVoD service that was available on TV via a standard set-top box, and that featured films in the first pay TV subscription window is highly likely to be a close substitute for Sky Movies, although we recognise that this would depend on the price at which that service was sold.

- **[✂]**

- It would have similar characteristics to Sky Movies (in terms of quantity, quality and timing of films) and a format that is likely to be more attractive than Sky Movies (namely VoD rather than a linear channel). This view is consistent with submissions made by Virgin Media[748].

- Such an SVoD service does not exist at present (although see footnote 588 to paragraph 6.40). **[✂]**.

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

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

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

Other potential substitutes

Cinema

6.222 Sky argued in its October 2009 Response that cinema is a substitute[749]. In Appendix 2 to Annex 5 we set out our full assessment of the evidence relating to the substitutability of cinema.

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

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

- The nature (or format) of films at the cinema is very different: they are watched communally, outside the subscriber's own home. In our view, the cinema is more of an 'event' or a 'night out' for consumers and is very different in nature from watching films at home.

- Cinema is not usually paid for by subscription; moreover, while films are available earlier in the cinema, the price is markedly higher (particularly where multiple people wish to watch the same film).

- These differences in characteristics limit the extent to which consumers would switch to viewing movies at the cinema, which suggests that this is a distant substitute and outside the relevant market. **[✂]**.

Online DVD rental

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

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

Over-the-counter DVD rental

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

[749] Paragraph 50 of Sky's October 2009 response.

[750] Third Pay TV Consultation, paragraph 4.394.

6.228 While we recognise that there is a degree of substitutability between OTC DVD rental and Sky Movies, we consider that, as with retail DVDs, the relative inconvenience of renting DVDs is likely to limit the degree of substitutability, particularly for frequent viewers of recent movies on Sky Movies. Also, the format for payment lacks the certainty of a fixed monthly subscription[751]. As such, we do not consider OTC DVD rental to be a close substitute to Sky Movies. However, we have considered it as a moderate substitute.

Movie downloads

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

- Legal downloads can either be on a download to own basis or a download to rent basis (the former having some similarities with DVD sales and the latter having similarities with PPV and DVD rental). As in the Third Pay TV Consultation, we consider that the current constraint from legally downloading content from the internet is weak, but may grow over time. We consider legal downloads as moderate substitutes.

- In our Second and Third Pay TV Consultations we noted a study which indicated that 4% of people had illegally downloaded content over a one-month period.[752] This group was strongly biased towards students, who are relatively unlikely to subscribe to pay TV services (48% were in school or further education). As in the Third Pay TV Consultation, we do not consider that this constraint is strong.

PPV through a TV service

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

6.231 In our Third Pay TV Consultation, we noted that there is some evidence that premium movies on PPV may be substitutable for linear channels carrying premium movies[753], but that the data should be interpreted cautiously[754]. We considered VoD likely to be a less close substitute for Sky Movies than a subscription service (we discuss SVoD movies separately)[755].

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

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

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

[753] Third Pay TV Consultation, paragraph 4.330.

[754] Third Pay TV Consultation, paragraph 4.329.

[755] Third Pay TV Consultation, paragraph 4.330.

6.233 The characteristics of PPV movies are similar to those of Sky Movies: PPV's less attractive format is counteracted by the attractive characteristic of having more recent movies.

6.234 However, as set out in the Second Pay TV Consultation, Virgin Media research into preferences of subscribers who were interested in a subscription Virgin Media Movies channel[756] asked which features of the proposed service were 'key drivers of interest'. **[✂]**[757]. We take the view that this important difference in format between PPV and linear channels implies that they are moderate substitutes.

6.235 This evidence is reinforced by the amounts paid for the rights to PPV movies. In 2008, movie studios earned around **[✂]**[758] from the rights to Sky and Virgin Media's PPV on-demand services compared to **[✂]** for the linear pay TV rights[759]. This is notwithstanding the strong growth in PPV services in recent years[760]. The value of linear TV services to movie studios is **[✂]** higher than the value of PPV services. The scale of the difference in the value of the rights suggests that pay TV retailers do regard PPV services as markedly less attractive than linear movies channels. We thus consider that PPV movies are a moderate constraint on Sky Movies (i.e. outside the relevant market but still capable of exerting a reasonable constraint).

SVoD movie services after the first pay TV subscription window

6.236 In Appendix 2 to Annex 5 we set out our full assessment of the evidence relating to the substitutability of SVoD movie services after the first pay TV subscription window (e.g. Lovefilm and Picturebox).

6.237 SVoD services after the first pay TV subscription window are distant substitutes to Sky Dual Movies. In our judgement, their less attractive characteristics, specifically the older films that they show and the smaller range on offer, outweigh the attractive characteristics of a lower price and SVoD format. This is reflected in the number of subscribers to these services.

Disney Cinemagic

6.238 In Appendix 2 to Annex 5 we set out our full assessment of the evidence relating to the substitutability of Disney Cinemagic.

6.239 In the Third Pay TV Consultation we concluded that Disney Cinemagic lay within the relevant market[761]. Since that consultation we have carried out further analysis of the

[756] Second Pay TV Consultation, paragraph 4.194.

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

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

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

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

[761] Third Pay TV Consultation, paragraph 4.378.

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

Assessment of the aggregate impact of the potential substitutes considered above

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

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

Characteristics of combinations of products

6.242 Sky has stressed the importance of the aggregate constraint exerted by potential substitutes. For example, Sky stated that, rather than subscribe to Sky Movies, consumers could rely on alternatives such as a combination of FTA television, DVDs and VoD services[762].

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

6.244 It thus adds support for our approach to the assessment of market power, in which we have considered the impact of including a fairly wide range of moderate substitutes within the relevant market to assess their impact on our market share estimates[763].

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

[762] October 2009 Sky Submission, paragraph 31.

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

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

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

Survey evidence on sensitivity to price increases

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

Observed response to retail price changes and Sky Movies subscriber numbers

6.248 In previous consultations, we analysed changes in the number of subscribers to Sky Movies channels since 2000[764]. As part of this analysis we considered changes in the retail price of packages including Sky Movies since 2002[765]. We concluded that the decline in subscriber numbers did not point clearly to an effective competitive constraint from other products[766].

6.249 Sky stated that the Third Pay TV Consultation referred to evidence on changes in the retail price of Sky Movies (taken from the First Pay TV Consultation) that was contradicted by pricing evidence in the Second Pay TV Consultation[767]. Moreover Sky asserted that the discussion of this evidence was unduly brief and unsound[768].

6.250 Simply considering changes in retail prices or Sky's subscriber numbers is inconclusive, particularly as it is not possible to control robustly for other key factors such as costs and quality. Moreover, the current retail price of bundles including Sky Movies is likely to be above the competitive level. As a result, consumers' response

[764] Third Pay TV Consultation, paragraphs 4.303-4.304.

[765] Third Pay TV Consultation, paragraph 4.305.

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

[767] October 2009 Sky Submission, paragraphs 90-91.

[768] October 2009 Sky Submission, paragraph 92.

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

Overall conclusion

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

Supply side substitution

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

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

Conclusion on retail market definition

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

- The relevant market at the retail level comprises retail bundles including Sky Movies.

- Moderate substitutes that lie outside the relevant market are PPV, Disney Cinemagic, FTA/basic movies channels, movies on other FTA channels, online DVD rental and retail Pay TV DVDs.

- OTC DVD rental, DVD retail purchases outside the first pay TV subscription window, non-movies programming on television and cinema are distant substitutes that lie well outside the relevant market.

Wholesale market definition

Wholesale products and the focal product

6.255 Sky supplies Sky Movies 1, Sky Movies 2, and Sky Dual Movies on a wholesale basis to Virgin Media on the basis of the existing rate-card, as set out in the Figure below.[769] Sky does not supply Virgin Media with any HD versions of these channels.

6.256 While some of these Sky Movies packages are available on a standalone basis, there is extensive bundling at the wholesale level, reflecting the bundles available at the retail level (see paragraphs 6.104 to 6.106).

Figure 93 Sky wholesale rate-card to cable operators

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

Source: Sky, Virgin Media

6.257 In the Third Pay TV Consultation the focal product for our assessment of the wholesale market was the suite of Sky Movies channels[770]. Although Virgin Media made no further submission in relation to movies market definition,[771] its submissions in relation to sport appear relevant to this issue. In the case of sports, Virgin Media considered that the focal product should refer to packages of premium sports channels (Virgin Media's emphasis) as this reflects the way in which these channels are actually sold and thus the options actually available to consumers[772].

6.258 As we explained in relation to sports, we consider that Virgin Media's arguments have merit. We also consider that we should adopt a consistent approach when analysing both sports and movies channels. Accordingly, we consider that the focal product should reflect the products actually purchased by Sky's wholesale

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

[770] Third Pay TV Consultation, paragraph 4.255.

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

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

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

Direct and indirect constraints

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

Indirect constraints

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

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

Direct constraints

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

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

Direct substitution to another movies channel

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

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

Direct substitution to non-movies content

6.265 In response to our Third Pay TV Consultation, the Premier League made submissions in relation to sport which are equally relevant to our consideration of movies. The Premier League considered that retailers and broadcasters can choose from a wide variety of content and that their preferences are not necessarily the same as the preferences of individual (final) consumers' preferences[773]. The Premier League stated that broadcasters will seek to acquire a wide range of content. Accordingly, the analysis of what content is substitutable at the wholesale level should consider content generally[774].

6.266 We accept that retailers' preferences are not necessarily the same as final consumers' preferences as noted in paragraph 5.347.

6.267 We have therefore considered what channel a retailer would replace Sky Movies with (i.e. how attractive is the alternative to Sky Movies?).

6.268 Sky Movies are highly attractive to large numbers of inframarginal consumers. We estimate that Sky's retail revenue from the supply of Sky Movies was over **[✂]**[775]. This shows how important these channels are and how difficult they would be for a retailer to replace with something of comparable attractiveness.

6.269 In contrast the alternatives are likely to be unattractive:

- A retailer could replace Sky Movies with whatever is the most profitable of the channels that it currently does not supply (the marginal channel). For satellite/cable retailers (which have large capacity), the marginal channel is likely to generate low returns (it will be less profitable than the least profitable channel currently retailed).

- Alternatively, a retailer could attempt to launch its own movies channel. This is unlikely to be feasible – see the analysis of wholesale barriers to entry below.

6.270 Furthermore, the main retailer of Sky Movies is Sky itself, which accounts for around **[✂]** of retail supply. Sky (as a retailer) is unlikely to seek to constrain itself (as a wholesaler) by responding to an increase in its nominal wholesale price by dropping its own channels. As such, the scope for any such direct constraint is limited to switching by Virgin Media.

Wholesale supply side substitution

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

Conclusion on wholesale market definition

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

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

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

[775] Ofcom's confidential market share spreadsheet.

Assessment of wholesale market power

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

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

- High market shares, in a market with barriers to entry, and in the absence of countervailing buyer power. As we discussed in paragraph 6.97, in a market with differentiated products the strength of competition depends on both the scale of competitors and the closeness of competition. A simple market share calculation does not reflect the fact that some competitors are closer substitutes than others. As we explain below, the evidence on Sky's market shares suggests that Sky has market power in the wholesale market for wholesale bundles including Sky Movies.

- Evidence that prices substantially exceed relevant costs or that profits substantially exceed competitive levels. As explained in paragraph 6.9 above, we consider that the retail prices of bundles including Sky Movies are appreciably above the competitive level. Thus, contrary to Sky's claim that evidence on consumer outcomes suggests that the relevant markets are competitive, the evidence on pricing supports the conclusion that Sky enjoys wholesale market power[776]. The pricing evidence thus provides direct evidence that the constraint exerted by competitors to Sky is insufficient to constrain Sky's wholesale prices to the competitive level i.e. that Sky does in fact possess wholesale market power.

6.275 We consider each of these in turn.

Existing wholesale competitors

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

6.277 This Section is structured as follows:

- First, we consider the strength of competition within the relevant market.

- Second, we consider the constraint imposed by moderate substitutes outside the relevant market.

- Third, we set out evidence of how third parties view Sky's position.

- Fourth, given that our market power assessment is forward looking, we test whether our analysis is robust to possible future changes in the next few years.

- Fifth we consider representations that we have received on this issue.

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

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

Close existing competitors

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

Moderate existing substitutes

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

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

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

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

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

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

[779] 2008 transmission and revenue returns to Ofcom.

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

6.283 However, this approach assumes that the relative costs of Sky Movies content compared to FTA and basic movies content reflects their relative value to final consumers. This may not be the case.

6.284 Sky is able to command a large premium for its content as shown by its movie margins over direct costs (paragraph 6.336). In contrast, Channel 4's margin over all its programming costs (not just movies content) is 30%[780] and ITV1's margin is 15%[781]. Sky's premium is partly because it can charge for its content. It may also be able to negotiate costs down with the movie studios through its stronger buyer power. This means the relative value of Sky Movies and other movies content on TV may not be reflected in their relative costs.

6.285 We use the "revenue-based" approach as another way to estimate the relative value of FTA and basic movies content. Comparing market shares by revenue is preferable to comparing input costs. To reflect the revenue that the FTA and basic movies content is likely to generate, we uplift their costs by 30%. This is consistent with the margin that Channel 4 earns across all its programming content and is double ITV's margin. Under this approach, Sky has a market share of **[✂]** if we include all moderate substitutes[782].

6.286 Both the "revenue-based" and "cost-based" approaches may not reflect the relative value to consumers of commercial FTA movies content and Sky Movies. This is because commercial FTA revenue (and therefore FTA movie expenditure) only directly reflects the value that advertisers place on this content in drawing in an audience. While the two are related, alternative funding models (such as advertising rather than direct charges to viewers) can differ in their ability to extract value from content.

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

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

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

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

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

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

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

6.287 Under the "revenue based" approach, if we only include TV-based moderate constraints, Sky has a market share of **[✂]**[60-70]%. Taking out all the PSB channels (but not Film 4) gives Sky a market share of **[✂]**[90-100]%.

6.288 There are difficulties in attributing wholesale revenues to Sky Movies when it is wholesaled in a bundle with Sky Sports. In the description of our profitability analysis we allocate revenue either using a "preference based approach", or using the incremental price of Sky Movies, or using the incremental price of Sky Sports. The Figure above presents market shares using the "preference based approach". The Figure below shows Sky's market shares under all the approaches.

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

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

Source: Ofcom calculations.

6.289 As discussed in paragraph 5.564, the two incremental price approaches give extreme allocations of revenues to Sky Movies. These two incremental price approaches give Sky a "revenue-based" market share of **[✂]**[30-60]% and "cost-based" market shares of **[✂]**[30-50]%. These give an indication of the lower and upper bounds of Sky's market share when we include all moderate substitutes.

6.290 As explained in our market definition analysis above, we consider it reasonable to include DVD sales from within the first subscription pay TV window as a moderate constraint (Pay TV DVD sales). But we recognise that the line we draw around the first subscription pay TV window is not precise. It could be that only DVDs within the first few months of the pay TV window are a moderate constraint. Or it could be that DVDs sold either side of the pay TV window are also moderate constraints. Given this uncertainty, the large value of retail DVD sales and their potential impact on the shares of supply presented above, we have considered sensitivities around the treatment of retail DVD sales.

6.291 At one extreme, we only include DVDs sold in the first four months of the first subscription pay TV window. We estimate that this accounts for around 7%[783] of DVD revenues. At the other extreme, we include DVDs sold five or more months after release. We estimate that this accounts for around 36%[783] of DVD revenue. The Figure below presents Sky's market shares under these two extremes.

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

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

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

Source: Ofcom calculations.

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

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

<u>Evidence from third party documents</u>

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

6.295 **[✂]**:

- **[✂]**.
- **[✂]**.
- **[✂]**[785].

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

[785] **[✂]**.

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

Representations

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

- Previously, when calculating market shares including moderate substitutes, we included online DVD rentals but not DVD retail sales. In its 1 June 2009 submission Sky asserted that this is inconsistent as there is no difference in the strength of our reasoning on the extent to which these products are substitutes (paragraph 4.16). As explained in paragraph 6.251 above, we consider that online DVD rentals and some retail DVDs (Pay TV DVDs) are moderate substitutes for packages including Sky Movies. We remain of the view that other retail DVDs are distant substitutes that lie outside the market.

- In its response to the Second Pay TV Consultation, Sky argued that focusing on putative market shares understates the extent of the competitive constraints on its channels. We accept that looking at market shares alone might not be a reliable guide to market power[786]. However, we nonetheless consider that the high market shares set out above, in conjunction with the evidence on the extent of substitutability presented as part of our market definition analysis, indicates that existing competitors only impose a weak constraint on Sky's movies channels. Moreover the shares of supply including moderate substitutes that are presented above include products that lie outside the relevant market[787]. Accordingly these market shares will tend to *overstate* the extent of the competitive constraint exerted by these products, rather than understating it.

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

[786] OFT Market Power Guidelines, paragraph 4.3.

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

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

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

Ofcom's conclusion on existing competitors

6.299 Our conclusion on existing competitors is as follows:

- Sky's share of the relevant market is 100%, which indicates that it has market power (and potentially a dominant position[790]). If this share is retained over the next three to four years, we would expect that market power to be retained over that period.

- We recognise that products outside the relevant market can exercise some degree of competitive constraint. Taking moderate substitutes into account reduces Sky's share of supply. Including moderate substitutes reduces Sky's share of supply to **[✂]**, as shown in Figure 92. However these alternative market share figures will overstate the strength of the competitive constraint exercised by moderate substitutes and thus understate the extent of Sky's market power.

- We recognise that these market share figures do not reflect the competitive constraint exerted by more distant substitutes. However we do not consider that this is a sufficiently borderline case for the effect of more remote substitutes to alter our conclusion.

- Moreover, for the reasons set out in paragraphs 5.47 to 5.60 and 6.27 above and 6.329 to 6.337 below, we consider that retail prices are currently above the competitive level. This, in itself, is strong evidence that Sky is not significantly constrained by existing competitors and possesses market power.

- Looked at in the round, we consider that these measures are supportive of our view that Sky possesses a high market share that is consistent with it possessing market power in the wholesale supply of bundles including Sky Movies and that it in may have a dominant position in that market.

Barriers to entry and expansion

6.300 Where entry barriers are low, it may not be profitable to sustain prices above competitive levels because this would attract new entry which would then drive the price down, at least in the long term[791]. We believe that there are important entry barriers and in the absence of further regulatory intervention these will remain.

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

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

6.303 Below we explain:

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

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

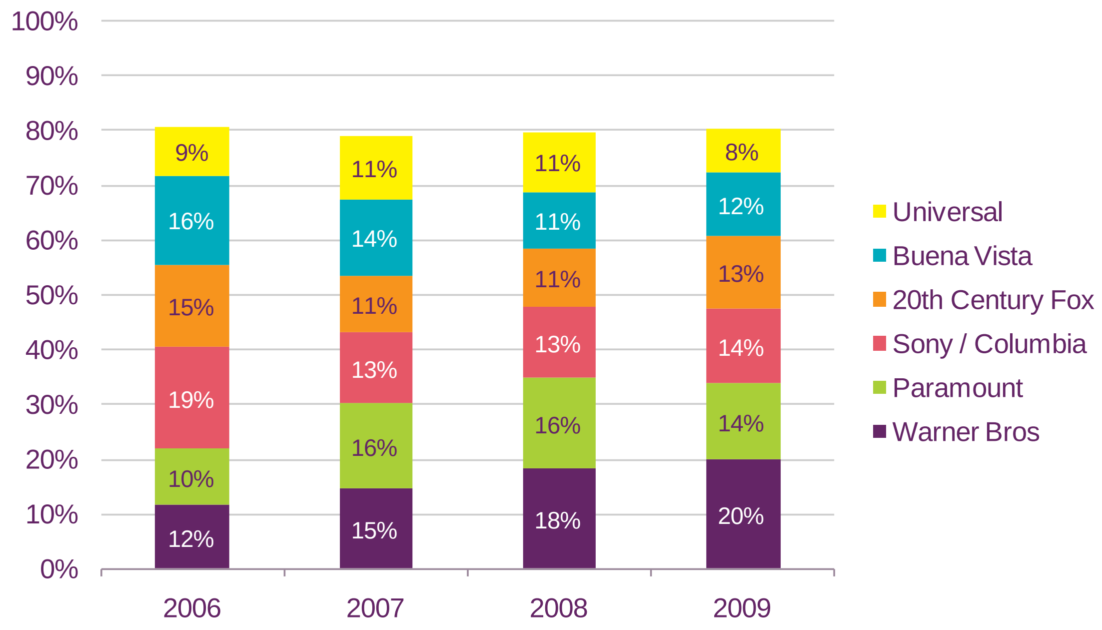
- The sale process for the Movie Rights.
- Why, in order to materially undermine Sky's wholesale position, Sky would need to lose the majority of the Movie Rights.
- Why Sky is likely to retain the majority of the Movie Rights.

Sale process for the Movie Rights

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

6.305 To illustrate the relative sizes of the Major Hollywood Studios, the Figure below sets out the six largest US distributors' share of US box office receipts. Each of these distributors is controlled by a Major Hollywood Studio. As in the Third Pay TV Consultation, we treat this as an indicator of the Major Hollywood Studios' shares of supply although we accept that they are not definitive[792].

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



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

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

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

6.306 It is important to distinguish between the minimum viable scale for entry (e.g. could a wholesaler with only a small amount of content enter this market) and the scale of entry necessary materially to undermine Sky's wholesale position. As noted in paragraph 5.13 above (in the context of the Live Premier League Rights), the central issue is whether potential entry by competitors and the potential expansion of existing competitors prevent Sky from profitably sustaining wholesale prices above the competitive level and/or harming the process of competition (e.g. by weakening existing competition, raising entry barriers or slowing innovation).

6.307 Given the strength of Sky's current position, small-scale entry and expansion is unlikely materially to undermine its wholesale position, since Sky would still enjoy a high market share. This is the case even if (small) entrants have a viable business. For example, even if a new entrant acquired the rights from one or perhaps two Major Hollywood Studios, then this might only reduce Sky's market share by some 10-25% (based on Figure 97 above)[793]. Thus, even if entry on this scale were viable it is unlikely to be sufficient materially to undermine Sky's wholesale position. Rather, it would require a large shift from the status quo to undermine Sky's position materially.

6.308 Accordingly we consider that the wholesale position held by Sky would not be materially undermined unless Sky lost the majority of the Movie Rights. It is difficult to be precise about what is meant by "majority" in this context, particularly as the importance of a Major Hollywood Studio's Movie Rights will vary from year to year depending on its slate of films. We would certainly regard Sky as having lost the majority of the Movie Rights if it lost 50% of the rights, measured by the Major Hollywood Studio's box office receipts in a particular year[794]. This would probably require the loss of two to four Major Hollywood Studios' Movie Rights, depending on the identity of the Major Hollywood Studios in question and what other Movie Rights are acquired[795].

Sky is likely to win the majority of the Movie Rights

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

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

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

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

6.310 Our view is strongly supported by the historical evidence. Over a period of almost 20 years Sky has never lost any of the Movie Rights. We regard this as clear evidence, contrary to Sky's claims that these rights are "contestable", that in practice there are significant barriers to other parties winning sufficient rights away from Sky.

6.311 Further evidence that new entrants are not in a position to outbid Sky is provided in internal documents. In particular, on a number of occasions Virgin Media has considered purchasing the Movie Rights, including entering into discussions with a Major Hollywood Studio. However on each occasion Virgin Media ultimately decided that it was **[✂]**.

6.312 For example, **[✂]**[796]. **[✂]**[797].

6.313 A further possibility that we have considered is that Sky might not lose the movie rights to another bidder, but that a Major Hollywood Studio might decide to exploit its rights directly, by for example developing its own movie channel. Indeed this is what Disney has done (to a very limited degree) with Disney Cinemagic. Similarly in its response to the First Pay TV Consultation, Sky argued that most of the Movie Rights owners are already active in the television sector internationally. For example, Time Warner is involved in broadcasting in the US. Sky thus regarded the owners of the Movie Rights as potential entrants and stated that they could form joint ventures to combine their rights.

6.314 We consider that a Movie Rights holder that wished to directly exploit its rights in the UK faces material barriers to entry:

- As explained in paragraphs 6.307 to 6.308 above, direct distribution by a single Major Hollywood Studio would be insufficient to materially undermine Sky's wholesale position.

- In paragraph 6.315 below we set out a number of factors that suggest that Sky has an advantage over other firms seeking to acquire the Movie Rights. These factors also apply to Major Hollywood Studios. For example, a single Major Hollywood Studio is likely to lose the synergies from aggregating Movie Rights if it directly exploited its own rights alone (see paragraphs A3.5 to A3.10 of Appendix 4 of Annex 5). Whilst that Major Hollywood Studio might be able to develop a more compelling proposition if it combined its content with that of other Movie Rights holders, this is made difficult by the staggering of their contracts with Sky (see Appendix 4 of Annex 5). Any agreement which they did reach to sell their content jointly might also be subject to review under competition law.

- Evidence of these entry barriers is the failure of any rights holder to directly exploit their rights in this way, apart from Disney Cinemagic (which only shows a limited category of its own first-run movies).

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

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

[796] **[✂]**.

[797] **[✂]**.

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

- The impact of the staggered expiry of Sky's contracts with the Major Hollywood Studios. (See Appendix 4 of Annex 5).

- The efficiency advantages (such as greater certainty about wholesale income) that flow from bidders such as Sky being vertically integrated with pay TV retailers with a significant premium movie subscriber base[798]. Any competitor for the bids would face a delay in establishing such a subscriber base – or would have to negotiate access to Sky's subscriber base. (See Appendix 8 of Annex 4).

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

Consultation responses

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

Conclusion on barriers to entry and expansion

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

- We consider that Sky is likely to maintain its wholesale position unless it loses the majority of the Movie Rights.

- We consider that Sky is likely to win the majority of the Movie Rights that become available. This reflects a number of advantages that Sky enjoys when bidding for these rights. These advantages constitute barriers to entry and expansion from the perspective of competitors seeking to enter the relevant market.

- Accordingly we consider that potential competition is not strong enough to prevent Sky exercising the market power suggested by its market shares. The weakness of potential competition is consistent with Sky possessing market power, and potentially a dominant position.

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

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

Countervailing buyer power

6.320 The only major independent purchaser of Sky Movies channels is Virgin Media, although a number of other parties have sought to acquire these channels. We have considered whether these buyers (actual and potential) are likely to exert sufficient CBP to offset Sky's seller power over the next three to four years.

6.321 As with our assessment of direct wholesale demand side substitution for premium sports channels, Sky argued that we failed to have regard to the argument that a retailer reallocating sales effort away from particular channels, rather than dropping those channels, could act as a constraint on the wholesale price[799]. In particular it cited the example of Virgin Media reallocating marketing effort to its PPV VoD service.

6.322 In our previous consultations we concluded that Sky is in a very powerful bargaining position as regards retailers. We indicated that, while Virgin Media is likely to have some CBP, this is likely to be limited. Responses to our previous consultations on CBP did not draw a distinction between sport and movies channels. We consider that the points set out above in Section 5 on this issue apply equally here. We recognise that cable operators offer on demand PPV films that are, to an extent, an alternative to Sky Movies[800,801].

6.323 Our overall position on CBP with respect to movies is the same as that for the wholesale supply of bundles including Core Premium Sports channels. Virgin Media is the most likely retailer to exercise CBP over Sky. While Virgin Media is a significant outlet for Sky, the commercial balance of the relationship is strongly in favour of Sky (this is for the reasons summarised in relation to Core Premium Sports channels above). Furthermore, around **[✂]**% of Sky's supply is direct to subscribers, where there is no scope for buyer power to arise. We therefore believe that no party exercises sufficient buyer power to counter Sky's seller power in the wholesale supply of bundles including Core Premium Movies channels.

<u>Summary</u>

6.324 As described in paragraph 6.278, Sky has a 100% market share in the market for bundles including Core Premium Movies channels, which is consistent with very high market power, and indeed a position of dominance. Even if moderately close substitutes are included in the market (thereby overstating their importance), Sky still has a share of between 30-40% and 40-50%, which is consistent with market power and potentially dominance.

6.325 Lack of access to premium movies content is a barrier to market entry and expansion. Sky will retain its market power as long as it retains the rights to the majority of these rights.

6.326 Most of Sky's subscribers are supplied directly by Sky, limiting the scope for countervailing buyer power. In addition, the importance of Sky Movies to Virgin

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

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

[801] **[✂]**

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

6.327 As a result, our analysis based on market definition and market shares provides strong evidence in support of our view that Sky has market power and indeed a dominant position in the wholesale supply of bundles including Core Premium Movies channels, which is likely to persist in the absence of regulatory intervention.

6.328 Next we consider whether the current prices of packages including Sky Movies channels are above the competitive level, with reference to evidence as to Sky's profitability and costs.

Whether current prices are above competitive levels

6.329 Our Third Pay TV Consultation presented evidence that prices were above competitive levels[802].

6.330 We said that, even absent evidence that Sky were earning high profits, we would be concerned that retail prices were above the competitive levels because rights holders may be extracting monopoly rents via high rights prices. While we considered this to be less likely in the case of the Movie Rights than in the case of sports rights, we nonetheless stated that it is likely that a proportion of the rents created by aggregating rights at the wholesale level are shared with the studios[803].

6.331 As noted in paragraph 5.58, Sky has argued[804] that we have not established that either the operating margin for its premium wholesale business, or wholesale charges for its premium channels, are high. It said this claim could not be based on Oxera's analysis[805] or our estimate of cost-plus prices.

6.332 We remain of the view that the retail prices of bundles including Sky Movies are appreciably above the competitive level. This is supported by two pieces of evidence[806]:

- Oxera's analysis of Sky's profitability.
- Ofcom's pricing model, which corroborates Oxera's analysis.

6.333 As explained above, the likelihood that retail prices for bundles including Sky Movies are above competitive levels has two implications. First, it provides direct evidence that Sky has market power. Second, it implies that consumers' propensity to switch at current prices will be overstated.

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[802] Third Pay TV Consultation, paragraph 4.52.

[803] Third Pay TV Consultation, paragraph 4.53.

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

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

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

Oxera's analysis of Sky's profitability

6.334 We have highlighted above the difficulties of disaggregating the profitability of Sky's wholesale sports and movies business, but in line with our conclusions in Section 5, we believe that Sky earns high margins in both businesses, and that those margins are likely to be higher in movies than in sports. We consider that the most reliable measure of Sky's wholesale movies margin over direct costs is the preference based figure using Analysis Mason's cost allocation. As Figure 61 shows, this implies a margin of **[✂]** and **[✂]**.

6.335 This finding is backed up by comparing Sky's current rate-card prices for its most popular wholesale channels to the estimates of the costs of providing those channels (including an allowance for a reasonable return on investment) that come from our pricing model. While we no longer intend to use our pricing model to set actual prices for Sky's wholesale movies channels, the model provides useful information on the costs Sky incurs in supplying those channels. Differences between those costs (which include a reasonable return) and Sky's current rate-card prices are therefore evidence that prices are likely to be above the competitive level.

6.336 As Figure 67 shows, rate-card prices for the most popular package (Sky Sports Mix and Sky Movies Mix) are 42% above the cost plus estimate. The figure for the Sky Movies Mix is 230%. These figures are substantially above the 5-10% increase in prices above the competitive level normally considered for the purposes of the SSNIP test. Moreover they are particularly striking given **[✂].**

6.337 This is evidence that the retail price of bundles including Sky Movies is likely to be above the competitive level. It also suggests directly that Sky has market power in relation to its wholesale movies products.

Forward looking assessment of market shares

6.338 The OFT Market Power Guidelines state that "The history of the market shares of all undertakings within the relevant market is often more informative than considering market shares at a single point in time …" (paragraph 4.3). Moreover our market power assessment looks into the future to consider whether Sky is likely to be dominant for the next three to four years. In the Third Pay TV Consultation we noted that Sky's wholesale supply of Sky Movies may well be subject to a strengthening competitive constraint over the next three years[807].

6.339 We have considered how Sky's market power might have changed in the past and how it might change in the future. As in the Third Pay TV Consultation, we have not calculated market shares (including moderate substitutes) prior to 2007. Instead we discuss past changes in market power qualitatively.

6.340 There is some evidence that suggests that Sky's market power may have declined in recent years:

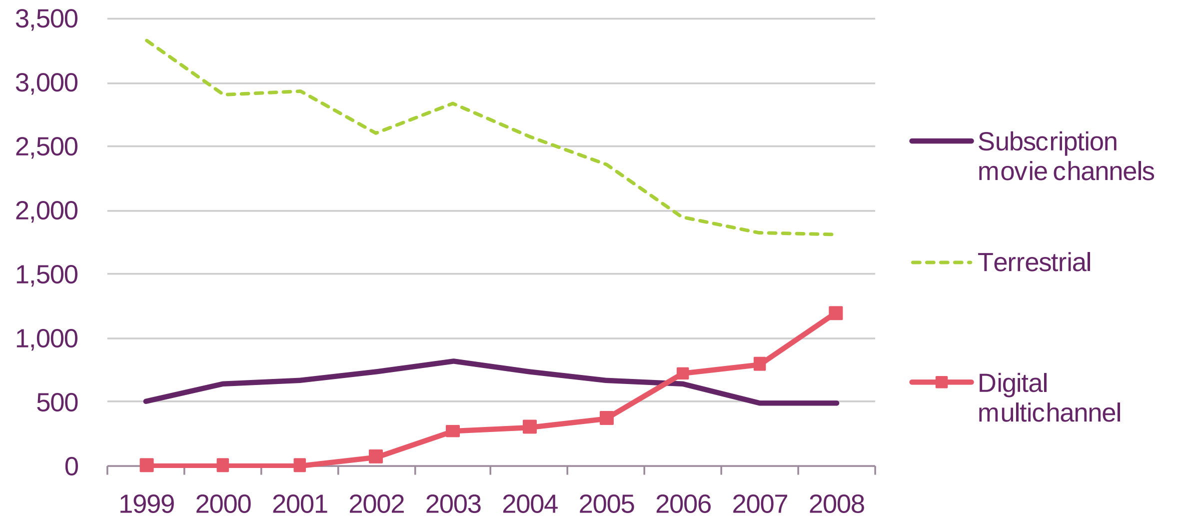
- As shown in Figure 98 and Figure 99 below, there has been a decline in viewing of subscription movies channels equivalent to about 330 million views (or 40%) since a peak in 2003. While audiences on terrestrial channels have also fallen, viewing of films on other digital channels has risen. As a consequence, Sky's share of viewing of films has fallen from a peak of 22% in 2002 to 14% in 2008.

[807] Third Pay TV Consultation, paragraph 2.238.

- As shown in Figure 100 below, **[✂]** since 2005 while Sky's expenditure has fallen. While **[✂]**, this suggests that this constraint has strengthened in recent years. However, the BBC is planning to reduce its spending on movies in future[808].

- Although less important, in recent years other means of watching movies such as subscription online DVD rental services and movie downloads have also emerged.

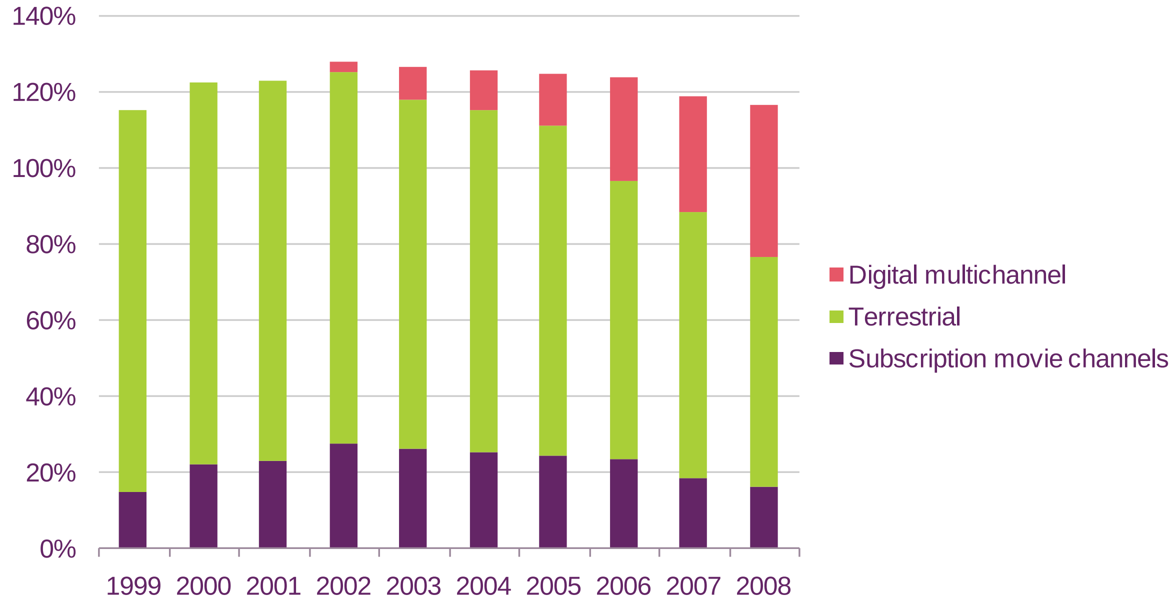
Figure 98 Total audience for films on TV (not PPV) (1999-2008)



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

808 http://www.bbc.co.uk/bbctrust/assets/files/pdf/review_report_research/strategic_review/strategy_review.pdf.

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



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

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

[✂]

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

[✂]

6.341 Our market power assessment is forward looking. It is thus important to consider the impact of recent trends and prospective future changes, in particular **[✂]**. We have thus estimated what Sky's share of supply might be in the future[809]. These figures include moderate substitutes for packages including Sky Movies. Specifically:

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

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

  - Under the 'high' scenario we have assumed that Sky's revenue increases by 5% annually until 2013. This implies that Sky Movies revenue in 2013 would be **[✂]**. This scenario takes a more aggressive view of the possible impact of **[✂]**.

- We have also made the following assumptions about other products:[810]

  - In 2008, Disney's revenue from the wholesale supply of Core Premium Movies channels was **[✂]** (see confidential market share spreadsheet). We have assumed that this remains unchanged in 2013.

  - In 2008, the estimated value of online DVD rental services was £92m[811]; in 2005 it was £46m. Over 3 years it has therefore grown at an average annual rate of 26%[812]. We assume that this growth rate slows to an average of 13% per year from 2008 to 2013[813]. This assumption implies retail revenues from online DVD rental services in 2013 would be £169m.

  - In 2008, the estimated value of legal downloads movies was £7m[814]. If this figure grows at 50% per year then revenues from legal downloads would be £53m in 2013[815].

  - In 2008, the estimated value of PPV movies via TV VoD was £120m[816]; in 2005 this was £64m[817]. Over 3 years it has therefore grown at an average annual rate of 23%. We assume that this growth rate slows down to an average of 12% per year from 2008 to 2013.

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

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

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

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

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

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

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

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

- o In 2008, the estimated value of DVD retail was £1,454m[818]; in 2005 this was £1399m. Over 3 years it has therefore grown at an average annual rate of approximately 1%. We assume the same growth rate for Pay TV DVD retail.

- o In 2008, the estimated value of film on free multichannel and terrestrial TV was £546m[819]; in 2005 this was £410m[820]. Over 3 years it has therefore grown at an average annual rate of 10%. We therefore assume a 10% annual growth rate until 2013.

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

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

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

Source: Ofcom calculations

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

Conclusion on wholesale market power

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

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

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

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

Retail market power

Our views in the Third Pay TV Consultation

6.345 We calculated market shares based on the proportion of revenues earned by Sky and Virgin Media from the supply of retail television bundles containing Core Premium Movies channels. While the available data had some limitations, Sky clearly accounted for a very high proportion (around **[✂]**) of the market, so we considered the overall conclusion that Sky had a high market share to be reliable. On a measure which included some moderate substitutes (namely PPV, online DVD rental services and legal movie downloads), Sky still possessed a high market share (around **[✂]**). On an alternative measure that looked at broadcasters' expenditure on rights to movies Sky has a share of **[✂]**.

6.346 Lack of access to Sky's Core Premium Movies channels was a significant barrier to entry and expansion in the market, and there was no offsetting buyer power. As such, Sky's high market share and the presence of entry barriers led to the conclusion that Sky had a dominant position in the retail market. However we stated that the finding of retail 'dominance' (applying this test) is not a necessary precondition for the competition concerns set out in the Third Pay TV Consultation. Rather those competition concerns centred on Sky's conduct at the wholesale level[821].

6.347 However, this did not imply that Sky had any *additional* market power, over and above its position at the wholesale level, by virtue of its retail position. In particular, it did not imply any additional scope to raise retail prices above the level that would prevail if Sky had only wholesale market power.

6.348 To assess whether Sky had such additional market power, we distinguished between retail prices being above the competitive level due to (a) high wholesale prices and (b) high retail margins. In Sky's case the retail margin would be the total margin it earns on retail sales, minus the wholesale margin it earns on sales to Virgin Media. On this point, we argued that:

- Sky set its wholesale prices to avoid a margin squeeze test, so it was unlikely to allow an excessive retail margin,

- Similarly, Sky would not have an incentive to increase its retail prices without also increasing its wholesale prices to Virgin Media, keeping retail margins broadly constant.

6.349 Accordingly we did not consider that there was sufficient evidence to conclude that Sky could sustain retail margins appreciably above the competitive level.

Responses to the Third Pay TV Consultation

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

[821] Third Pay TV Consultation, paragraph 5.154.

even if it did not have market power at the wholesale level of the supply chain. Virgin Media agreed with this purported position[822].

Our conclusion

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

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

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

Source: Ofcom calculations

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

6.352 Our Third Pay TV Consultation also estimated market shares if "out of market" constraints were included. As was the case with our analysis of wholesale market shares, these market shares depend on the treatment of movies broadcast on FTA and basic channels. As explained as part of our wholesale analysis above, we have used two approaches: a cost based approach and a revenue based approach. If all moderate substitutes are taken into account, Sky has a retail market share of **[✂]** [80-100]%. This is markedly higher than any of the other moderate competitors listed in Figure 102.

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

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

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

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

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

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

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

6.355 In light of Sky's high market share, the presence of significant barriers to entry, and the lack of buyer power, we remain of the view expressed in our Third Pay TV Consultation[823] that Sky holds a position of retail market power.

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

[823] Paragraphs 1.22 and 5.3.

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

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

- That wholesale monopolist is capable of significantly increasing wholesale prices and thereby increasing retail prices appreciably above the competitive level. Moreover if that wholesaler were vertically integrated with one of the retailers, the vertically integrated firm would also have the ability to increase its retail price (along with that of all other retailers) above the competitive level. Applying the standard approach to assessing market power, one might conclude that the vertically integrated firm is dominant at both the wholesale and retail level.

- However clearly in this example the source of the market power is the firm's wholesale position. Because the retail market is assumed to be perfectly competitive, no retailer (including the vertically integrated firm's retail arm) has the ability to earn an excessive retail margin.

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

6.359 Footnote 13 of the OFT's guidelines on market definition also states that[824]:

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

6.360 This standard approach to assessing market power would apply if the wholesale level of the supply chain were competitive i.e. if wholesale prices and supply arrangements reflected the outcome of a competitive wholesale market. In such circumstances, it is only the actions of retailers that can potentially increase retail prices above the competitive level[825]. Clearly this is a somewhat artificial test since Sky is dominant in the wholesale supply of Core Premium channels.

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

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

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

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

6.362 We agree that there is a risk of giving a misleading impression, for the reasons described above. As set out in our previous consultation[827], we do not consider that Sky has an incentive to set retail margins above competitive levels:

- First, Sky said that its wholesale prices are cross-checked so as to satisfy the conditions of the margin squeeze test **[✂]**[828]. This suggests that Sky's wholesale prices are unlikely to allow a high retail margin to be earned. Accordingly, even if retail prices were appreciably above the competitive level, this would reflect high wholesale prices rather than the exercise of retail market power.

- Second, it may be more attractive for Sky to earn a high margin on Sky Movies at the wholesale level rather than at the retail level. A £1 increase in Sky's retail margin only increases its revenue from consumers that it directly supplies. Also, by increasing Sky's retail price relative to that charged by Virgin Media, consumers are more likely to switch away from Sky's retail business. In contrast, a £1 increase in Sky's wholesale margin (including the implicit wholesale price that it charges its own retail business) increases its revenue both from consumers it supplies indirectly via Virgin Media as well as from consumers it directly supplies.

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

<u>Conclusion on retail market power</u>

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

[827] Third Pay TV Consultation, paragraph 3.40.

[828] **[✂]**

Section 7

Competition issues

Summary

7.1 Our key concern is that the restriction of supply of Sky's Core Premium channels to other retailers is prejudicial to fair and effective competition. This concern is heightened due to the great significance that obtaining supply of Core Premium channels has to pay TV retailers' ability to compete effectively. Our concern would not be assuaged if Sky could retail its channels on all platforms.

7.2 We also have concerns about:

- The terms of Sky's supply to Virgin Media of its Core Premium channels.
- High prices for these channels.
- The restricted exploitation of SVoD movie rights which Sky holds.

7.3 We set out each of our concerns below, except those related to the sale of SVoD rights. We have continuing concerns over the restricted exploitation of the SVoD movie rights which Sky holds, but we cannot adequately address this concern under our sectoral powers, so are instead consulting separately on a proposal to make a reference to the Competition Commission under the Enterprise Act 2002. See our Movies Reference Consultation, published today.

7.4 Sky's Core Premium channels are not currently available widely on a wholesale basis. Sky wholesales premium channels to cable operators (primarily Virgin Media) but to no other firms. A number of operators – including Tiscali[829], Virgin Media (for delivery in areas not covered by its cable network), BT Vision, Top Up TV and **[✂]** have tried and failed to obtain wholesale access to Sky's premium channels. Despite lengthy negotiations and the apparent opportunity for Sky to increase its revenues and profits, wholesale supply has not been agreed; nor does it appear that much meaningful progress has been made towards agreement.

7.5 To the limited extent that Sky enters into any discussions as to wholesale pricing, these centre on the prices which Sky currently sets to Virgin Media via the rate-card. None of the negotiations which we reviewed have led to Sky offering prices below the rate-card for its Core Premium channels. We do not believe it to be a reasonable expectation for retailers other than Sky to be prepared to pay the rate-card prices for Sky's Core Premium channels, as these prices would not allow them to compete effectively. The rate-card prices are based on a retailer with Sky's scale, and there is only room in the market for one such retailer.

7.6 In contrast, ESPN's premium channel is wholesaled to retailers on a variety of platforms, and these arrangements were completed in a matter of weeks.

7.7 This evidence of non-supply, together with Sky's market power and its vertical integration, suggests that Sky is acting on a strategic incentive to restrict supply, in

[829] Tiscali TV was previously branded as Homechoice and provided by Video Networks, and is now branded as TalkTalk TV following an acquisition by TalkTalk / CPW.

order to favour its own satellite platform as well as protect its position when bidding for key content rights in the upstream market. The operation of fair and effective competition is prejudiced both by the absence of wholesale supply to new competitors and by the terms of supply to Virgin Media. The results are a distortion of platform choice, and reduced innovation.

7.8 Sky has a clear preference for retailing – rather than wholesaling – over others' platforms, and argues that this would be more efficient than allowing the platform operators to retail Sky's channels. We recognise that retail by Sky on other platforms may have some efficiency benefits arising from its vertical integration as a wholesaler/retailer, and that it would provide improved access to Sky's premium channels. However, we do not consider that retail by Sky across all platforms as an alternative to wholesale access will ensure fair and effective competition, for several reasons:

- When Sky retails over other platforms it is unlikely to compete as vigorously as an independent retailer, because doing so could undermine its satellite platform. Its incentive is to use its access to subscribers on other platforms to its advantage, by managing inter-platform competition so as to favour its own platform. This is borne out both by Sky's performance as a retailer on the TalkTalk / Tiscali platform and by Sky Player's pricing relative to satellite. This would not address our concerns about distorted choice and reduced innovation resulting from the prejudice to fair and effective competition.

- As other retailers have argued, requiring customers on a platform to subscribe to two different services in order to have basic and premium content could result in inefficiency and customer frustration.

- Most competing retailers are unwilling to allow Sky to retail on their platforms, for a range of reasons including the scope for inefficiency, and concerns about allowing Sky access to their customer bases.

Our view

7.9 Our view is that Sky is deterred from withdrawing supply to Virgin Media by the prospect of lost wholesale revenues from an established customer base, and regulatory risk. However, although the risk of withdrawal of supply may be low, we consider that the terms of Sky's existing supply to Virgin Media have the effect of weakening Virgin Media's ability to compete with Sky. The non-supply of the various enhanced or alternative versions of Sky's premium channels to Virgin Media – in particular HD – is and will remain of significant prejudice to fair and effective competition. The challenges Virgin Media faces as a result of Sky's wholesale rate-card prices are not a competition concern of the same magnitude as those created by the absence of supply to other retailers. However, they nonetheless create a situation in which consumer choice is likely to be distorted.

7.10 Our analysis of whether Sky has market power has included a review of its pricing and profitability. This review has shown that Sky has earned high returns for a sustained period. We have explained in Section 5 that Sky's profitability appears largely to be driven by its wholesale business, and as a consequence that its wholesale prices, and retail prices, are above competitive levels. The riskiness of Sky's early investments will have demanded prices that could deliver returns in excess of Sky's cost of capital for a period. However, despite the fact that Sky's more recent investments have entailed considerably lower levels of risk, Sky's returns remain at a high level and appear unlikely to be competed away in the future.

Structure of this Section

7.11 This Section is set out as follows:

- Introduction.
- Distribution of Core Premium channels.
  - o Background.
  - o The importance of Core Premium channels in driving demand for pay TV.
  - o New requests for wholesale supply of Sky's Core Premium channels.
  - o Supply of Sky's Core Premium channels to cable TV providers.
  - o Wholesale supply for retail to commercial premises.
- Pricing of Core Premium channels.
  - o Our view in previous consultations, and responses.
  - o Our view on pricing and profitability of Core Premium channels.

Introduction

7.12 In this Section and the next, we set out our views on competition in pay TV, and whether competition is delivering good outcomes for consumers in terms of choice, innovation and pricing[830].

7.13 The Core Premium channels are "licensed services" for the purposes of s316 CA03. Based on our analysis so far in Sections 4 to 6, and the analysis in the present Section, we have come to the conclusions that:

- Sky has market power in the wholesale and retail supply of bundles including Core Premium Sports and Movies channels.
- This market power is likely to continue for next three to four years.
- As a vertically-integrated supplier with upstream market power, Sky is able to act in a manner which is prejudicial to fair and effective competition.

7.14 In our Second Pay TV Consultation we consulted on two primary concerns:

- That Sky would distribute its premium channels in a manner that favours its own platform and retail business, either by denying these channels to other retailers / platforms, or by making them available on unfavourable terms.
- That Sky would set high wholesale prices.

7.15 Our Third Pay TV Consultation set out three concerns:

[830] Third Pay TV Consultation, paragraph 1.39.

- That Sky was likely to be acting on a strategic incentive to restrict wholesale supply of its channels to other retailers, in order to prevent them from becoming sufficiently established in the market to pose a challenge to Sky's market power as a wholesaler and retailer of Core Premium channels, and in order to prevent them pulling subscribers away from its satellite platform.

- That Sky may set high wholesale prices for its content, with the effect of keeping retail prices high.

- Unavailability of services based on particular types of SVoD rights, as a particular case of Sky favouring its own platform and retail business.

7.16 In this Section we begin by setting out our position on the distribution of Core Premium channels. We describe the way these channels are currently distributed. Next we review our position on this issue in our previous consultations, and in light of responses to our Third Pay TV Consultation. We set out the history of negotiations between Sky and other retailers for wholesale supply of these channels, and consider a series of arguments Sky has put to us as to why these negotiations have not had a successful outcome. On the basis of this assessment, we consider whether Sky is acting on an incentive to restrict wholesale supply of its Core Premium channels, and in particular whether it may have strategic reasons for restricting supply. We then consider the impact of restricted supply on competition, and whether retail by Sky on other platforms would address our competition concerns.

7.17 Next we consider the terms of supply of Sky's Core Premium channels to cable firms, and Virgin Media in particular. We assess Sky's incentives with regard to supplying these channels to Virgin Media. We consider the way in which Sky sets wholesale prices, and the effect of these prices on Virgin Media's incentives. We also consider whether Sky has sought to avoid supplying its interactive and HD services to Virgin Media. We consider whether the terms of supply to Virgin Media have had an impact on premium channel take-up among Virgin Media's subscribers.

7.18 We then review evidence, and set out our view, on the supply of Core Premium channels to commercial premises.

7.19 Finally, we set out our view on whether Sky's market power enables it to set high wholesale and retail prices.

7.20 Our concerns about SVoD rights are not discussed in detail in this document. We do have continuing concerns over the restricted exploitation of the SVoD movie rights which Sky holds, but we cannot adequately address this concern under our sectoral powers, so we are instead consulting separately on whether we should make a reference to the Competition Commission under the Enterprise Act 2002. (See our Movies Reference Consultation, published today).

Distribution of Core Premium channels

7.21 We begin by describing the history and current distribution of Core Premium channels. Against this background, we consider the following issues relating to the distribution of Sky's Core Premium channels:

- The importance of these channels in driving demand for pay TV services.

- Whether Sky acts on an incentive to restrict the wholesale supply of these channels to other retailers and/or to platforms other than satellite.

- Whether Sky's argument that it is willing to retail its Core Premium channels on other platforms addresses our competition concerns.
- Whether the resulting position is prejudicial to fair and effective competition.
- Whether the terms of Sky's wholesale supply of these channels to cable firms, particularly Virgin Media ensure fair and effective competition.

Background

7.22 In this sub-section we summarise the history and current distribution of Core Premium channels.

7.23 Sky purchased the rights to live Premier League matches from the point of the creation of the Premier League for the 1992 / 1993 season. Sky has since won rights to a range of other sports content, including Rugby League's English (Guinness) Premiership (1994), FA Cup (2000), and UEFA Champions League (2003). Sky and BSB between them purchased the movie rights from all six Hollywood studios prior to their merger in 1990 as BSkyB, which brought all six studios' rights together.

7.24 Sky first entered into commercial deals with cable operators for the supply of its sports and movies channels in the early 1990s. The first of these deals was with TCI, a US company which had both cable operations (through its associate, Telewest) and channels in the UK. The deal gave Telewest access to Sky's premium sports and movies channels, but also gave Sky access to TCI's basic channels; the availability of TCI's channels gave Sky an additional incentive to conclude this deal, as a means of being able to assemble a compelling basic package. David Chance, a former Sky executive who led the negotiations, has commented that being able to include more channels in the Sky package was an important consideration for Sky at the time[831].

7.25 In 1996, the Director General of Fair Trading (the "Director") conducted a review under the Fair Trading Act 1973 of the wholesale pay TV market following complaints raised by some cable operators[832]. The Director concluded that premium programming rights gave Sky a powerful position in the wholesale pay TV market and that Sky's acquisition of premium programming had created a barrier to entry into the market.

7.26 The Director also concluded that Sky was dominant in the supply of sports and movies channels in the UK pay TV market. To meet the Director's concerns, Sky gave the Director non-statutory undertakings (the "1996 Undertakings") in July 1996 regarding the terms it offered to cable operators for supplying its channels. Sky undertook to supply certain channels separately, and to publish a rate-card showing its wholesale prices for cable companies, with a discount structure approved in advance by the Director.

7.27 Following a 2002 investigation under the Competition Act 1998, the OFT decided[833] that there were insufficient grounds to find that Sky had abused a dominant position

[831] "Sky High", Matthew Horsman, page 111.

[832] The Director General's Review of BSkyB's Position in the Wholesale Pay TV Market, December 1996, http://www.oft.gov.uk/shared_oft/reports/media/oft179.pdf

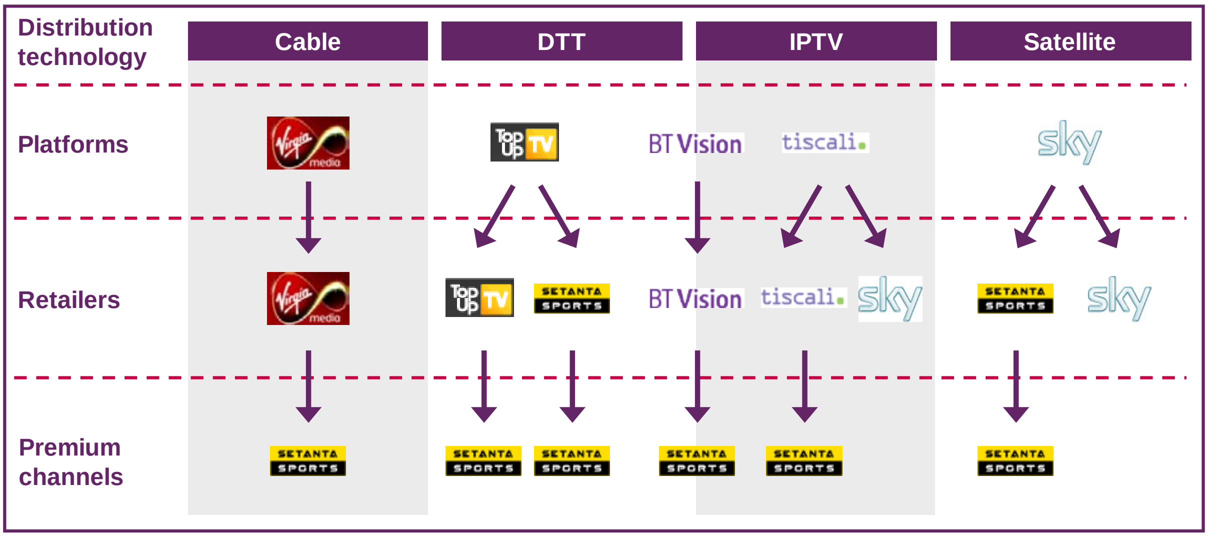
[833] CA98/20/2002, 17 December 2002.

by exercising a margin squeeze on distributors of its premium channels. Since 2002, Sky has continued to supply cable operators, primarily Virgin Media, at a price which it believes is compliant with the test laid down by the OFT (see paragraph 7.267).

7.28 In late 1998, Carlton Communications and Granada launched ONdigital, an 18-channel DTT service. From launch, the service included two Sky Sports and two Sky Movies channels as well as FilmFour (Sky was originally part of the consortium but was required to withdraw by the ITC, on competition grounds). Analysts at the time believed that Sky was charging ONdigital similar prices for its premium channels as those charged to cable operators[834]. The service was rebranded as ITV Digital in 2001, but went into administration in 2002. Various reasons have been given for the failure of ONdigital/ITV Digital, including poor management, strong competition from Sky, and overpayment for Football League rights[835].

7.29 Setanta acquired rights to Premier League matches with effect from the 2007/08 football season, as well as other rights such as the Scottish Premier League. Setanta both retailed its channels directly, and wholesaled them to other retailers, as illustrated in Figure 105.

Figure 105 Distribution of Setanta premium channels at the start of June 2009



Source: Ofcom

Note: by 'retailer' we mean the entity that sets retail prices

7.30 In February 2009, the Premier League announced that Setanta had won only one of the six Premier League packages offered for sale for 2010-2013, apparently contributing to a loss in investor confidence in Setanta. In June, Setanta lost the rights to broadcast English Premier League and Scottish Premier League matches, having failed to pay for these rights. Setanta Sports GB went into administration later that month. Setanta continues to operate in Ireland and other countries outside Europe.

834 "BDB bid is narrow favourite", New Media Markets, 5 June 1997.

835 See for example "ITV Digital goes broke", BBC News, 27 March 2002 (http://news.bbc.co.uk/1/hi/business/1896732.stm).

7.31 ESPN began negotiations for the wholesale supply of its channels to Sky in **[✂]**, and reached agreement on **[✂]** 2009[836]. Unlike Setanta, ESPN does not retail its channels directly to consumers, and so is dependent on wholesale agreements with other retailers. On 22 June 2009, Premier League announced that ESPN had been awarded the two packages of rights containing a total of 46 matches that were available for the 2009/10 season, as well as a package of 23 matches per season from 2010/11 to 2012/13[837].

7.32 Around this time (i.e. late June) ESPN commenced formal negotiations for wholesale supply to Virgin Media, Top Up TV and BT, in each case reaching agreement around six weeks later. In August 2009 ESPN negotiated a wholesale deal with Tiscali / TalkTalk TV in **[✂]** weeks[838].

7.33 Since securing the Premier League rights described above, ESPN has also won rights to broadcast football matches from the Scottish Premier League, the FA Cup, UEFA Europa League, World Cup qualifiers, and others. It has also secured rights to other sports content including rugby union.

<u>Current distribution of Core Premium channels</u>

7.34 Sky's premium channels are available through four routes:

- Directly from Sky as a retailer on satellite.
- On cable via retailers Virgin Media, Wight Cable and Smallworld.
- On Tiscali's IPTV network, but retailed by Sky.
- From Sky as a retailer via Sky Player over the internet.

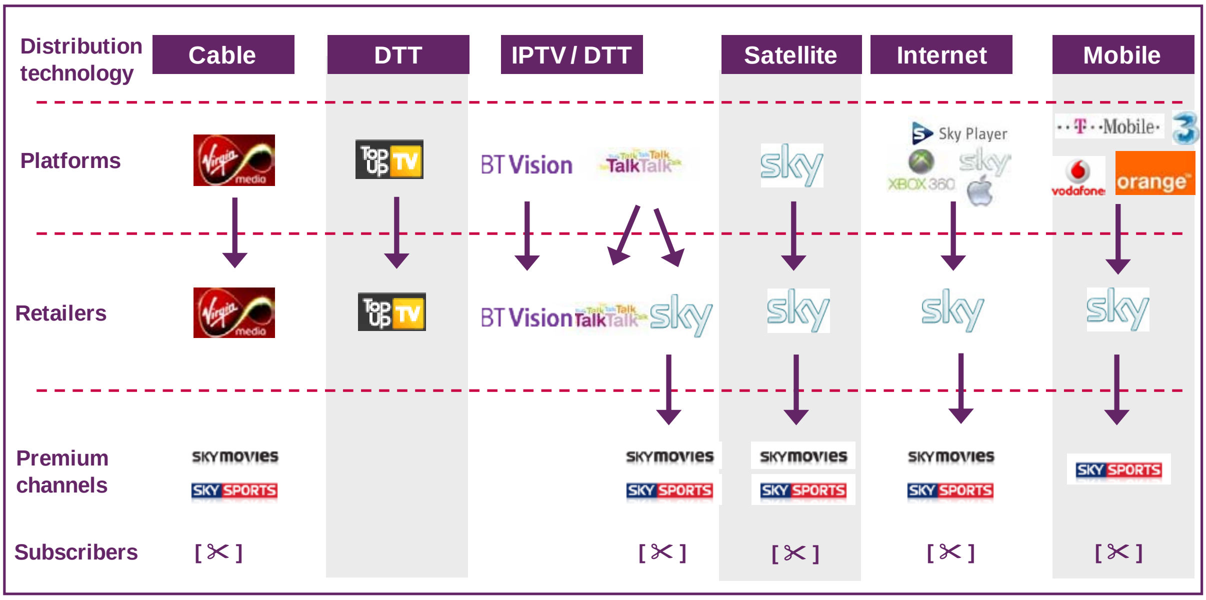
7.35 Sky has conducted negotiations with various other parties for the provision of its Core Premium channels in recent years, but none of these negotiations has led to an agreement for wholesale supply. Sky has concluded agreements to retail over some platforms, such as IPVision's Fetch TV service. Figure 106 below shows the various major platforms and retailers where Sky premium channels are available and through which retailers.

[836] ESPN response dated 9 December 2009 to Ofcom information request of 29 October 2009.

[837] http://www.premierleague.com/page/Headlines/0,,12306~1698362,00.html

[838] ESPN responses dated 30 July 2009 and 21 August 2009 to Ofcom information request of 10 July 2009.

Figure 106 Distribution of Sky premium channels



Source:

Sky premium – satellite: Sky response 28 October 2009 to Ofcom Information request of 13 October 2009 Q1, Annex 1

Cable premium: Virgin Media response to Ofcom Information request of 7 January 2010 Q1,

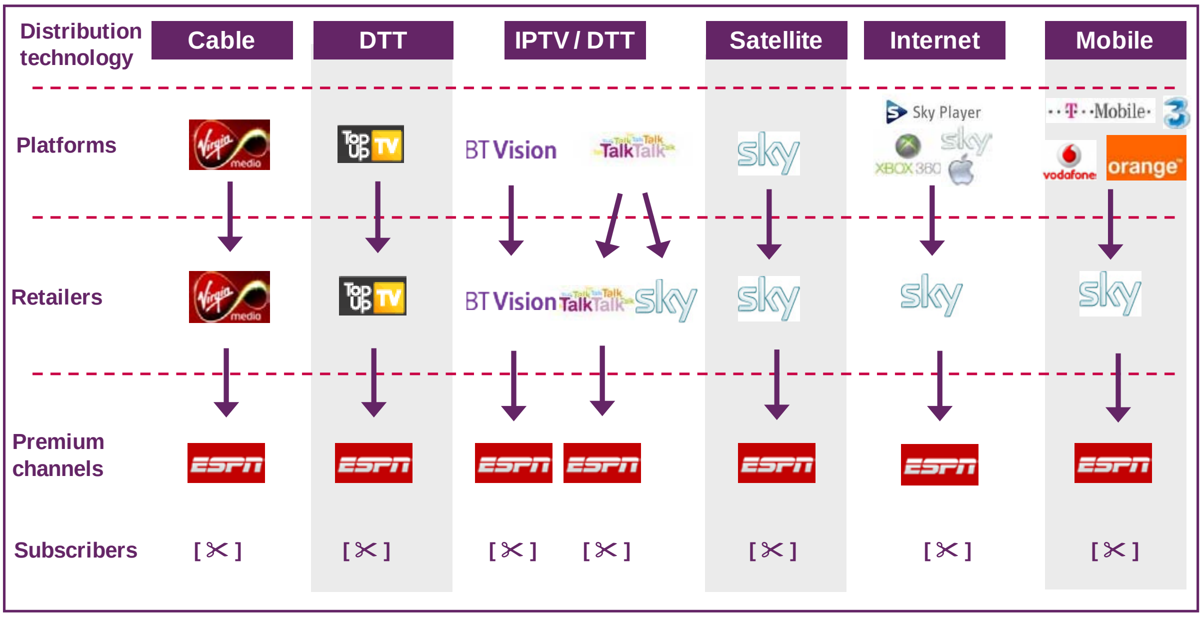
Sky Player premium: Sky response to 28 October 2009 Ofcom Information request of 13 October 2009 Q31, Annex 4

Sky premium – Mobile: Sky response 28 October 2009 to Ofcom Information request of 13 October 2009 Q31, Annex 4

Sky premium – Tiscali: Tiscali response 13 November 2009 to Ofcom Information request of 29 October 2009 Question 5.

7.36 Figure 107 below that shows the same information for ESPN's premium channels. As the figures show, Sky's premium channels are available through two major retailers, whereas ESPN's channels are available through five different major retailers. Setanta's distribution was similar to ESPN's, except that it also retailed directly via Top Up TV's DTT platform and Sky's satellite platform.

Figure 107 Distribution of ESPN premium channels



Source: ESPN response of 19 February 2010 to Ofcom information request of 13 January 2010

Sky Player premium: Sky response 28 October 2009 to Ofcom Information request of 13 October 2009 Q31, Annex 4

Mobile – Mobile: Sky response to Ofcom Information request of 13 October 2009 Q31, Annex 4

7.37 In addition to residential supply, pay TV services including Sky's Core Premium channels are also supplied to commercial premises – mostly pubs and clubs, but also hotels, offices and holiday parks, among others. These channels are not available to commercial premises on other platforms – i.e. the availability of Sky's Core Premium channels on cable is limited to residential customers.

The importance of Core Premium channels in driving demand for pay TV

7.38 As discussed in Section 4, sports and movies are the genres which stand out as being amongst the most valued genres by consumers, and also having a high degree of exclusivity to pay TV. On this basis alone we would expect them to be key drivers of pay TV subscriptions. Further evidence supports this view, and highlights that sport in particular is key to demand for pay TV services:

- Over **[✂]** million UK households pay a premium for sports and movies channels, often of more than £25 per month.
- Sports and movies account for 70% of Sky's programming costs, sports alone counting for 54%[839].
- Sky has described sport as being a major factor in the growth of multichannel TV, and key to Sky's own growth. Internal documents from Sky and other parties support this view.

[839] See paragraph 4.112.

- Setanta, and pay TV operators in other countries, have lost market share as a result of losing key sports rights.

New requests for wholesale supply of Sky's Core Premium channels

7.39 In this sub-section we focus on new requests for wholesale supply of Sky's SD Core Premium channels. Sky's current wholesale supply of these channels to cable firms is discussed in paragraphs 7.236 to 7.348.

Overview

Our position in previous consultations

7.40 In our Second Pay TV consultation, we considered that Sky had the incentive to restrict the supply of its Core Premium channels to other retailers and other platforms, and we further believed there was evidence that Sky was acting on this incentive:

- A number of firms, seeking to establish new retail businesses and / or new platforms, had sought to purchase access to Sky's premium channels on wholesale terms, but none of these had been successful. Having reviewed the available correspondence between those new entrants and Sky, we concluded that no commercially agreed wholesale deals appeared imminent, despite evidence of negotiations going on for several years.

- We analysed the incentives we believed Sky faced to wholesale its channels to competing retailers and / or on competing platforms. Our conclusion was that there were a number of incentives which might motivate Sky against supplying other retailers at a wholesale price which those other retailers were prepared to pay.

7.41 We noted the divergence of views between Sky, which said that the failure to agree wholesale terms reflected its greater efficiency as a retailer, and other retailers who argued that Sky withheld access to its channels to undermine competitors. We noted that our primary concern was the foreclosure of competition from new platforms, and the resulting loss of innovation, and that this would be a concern under either explanation[840].

7.42 In our Third Pay TV Consultation (paragraphs 6.90 to 6.96), we set out our view that Sky had strongly and successfully resisted attempts by other retailers to secure wholesale deals. Sky had not **[✂]**, or pursued wholesale supply on other platforms even when there had clearly been no prospect of the retailer agreeing to let Sky retail on its platform.

7.43 We conducted a "Vertical Arithmetic" analysis to determine whether, in static commercial terms, Sky had an incentive to wholesale to other platforms (including cable). In our Second Consultation we estimated that Sky did not have a static incentive to supply. We revised this analysis in the light of responses to that consultation, particularly from Sky. In revised form, the analysis indicated that Sky would have a static incentive to supply (i.e. that Sky's revenues would decrease if it withdrew supply to cable firms, and increase if it wholesaled to others). However, we considered that Sky's behaviour in responding to requests for wholesale supply

[840] Paragraphs 6.18 to 6.20 of the Second Pay TV Consultation.

suggested either that it did not have a static incentive to supply, or that the net increase in wholesale revenue was outweighed by other factors.

7.44 In particular, we considered that Sky had a strategic incentive to restrict wholesale supply of its channels to other retailers, in order to prevent them from becoming sufficiently established in the market to pose a challenge to Sky's market power as a wholesaler and retailer of Core Premium channels, and in order to prevent them pulling subscribers away from its satellite platform. We also considered that Sky was likely to be acting on that incentive.

7.45 We said that Sky's argument that other firms would be less efficient in retailing its channels was not supported by evidence, because it had not sought to determine whether such retailers would be more efficient, and, according to our analysis of the Picnic business model, Sky failed its own efficiency test.

7.46 We did not consider that negotiations for wholesale supply had failed simply because of regulatory gaming by parties other than Sky, or that practical considerations explained the lack of wholesale supply. We noted that the example of Setanta, which entered the market as a wholesaler and agreed terms across a range of platforms, offered a stark contrast to that of Sky.

7.47 We therefore considered that Sky's approach to the wholesale supply of Core Premium channels created a position under which there was not, and was not likely to be, fair and effective competition.

Consultation responses

7.48 In response to our Second Pay TV Consultation, Sky did not accept that there was any evidence that it had restricted supply of its premium channels, and argued that it had not refused to supply its premium channels to retailers on new platforms[841]. Sky also argued that there was no evidence to suggest that it had an incentive to restrict supply[842]. Sky therefore saw no grounds upon which Ofcom could properly find that Sky was more likely than not to restrict the supply of its premium channels in the future[843].

7.49 In response to our Second Consultation, BT, A potential IPTV entrant **[✂]**, Top Up TV and Virgin Media told us that retailers and platform operators could not get sufficient access to Sky's premium sports and movies channels.

- A potential IPTV entrant **[✂]** described **[✂]** Sky's "de facto refusal to provide its premium content on a wholesale basis, preferring instead to offer its own Sky-by-Wire service or not have a commercial agreement in place at all"[844].

- Virgin Media said that Sky had refused wholesale supply of Sky Sports and Sky Movies for Virgin Media's off-net IPTV service[845].

841 Sky response to Second Pay TV Consultation, Section 5, paragraphs 2.16 to 2.44.

842 Sky response to Second Pay TV Consultation, Section 5, paragraphs 2.2 to 2.15.

843 Sky response to Second Pay TV Consultation, Section 3, paragraphs 4.2 to 4.4.

844 **[✂]** confidential response to Second Pay TV Consultation, page 3 and paragraph 6.1.

845 Virgin Media response to Second Pay TV Consultation, 18 December 2008, Annex 1, Question 14.

- Tiscali noted that there had been no extension to Sky wholesaling beyond the existing arrangement with Virgin Media despite negotiations with other parties going on for some time[846].

7.50 Sky also criticised our analysis in the Third Pay TV Consultation, arguing that we had not established that it had an incentive to restrict supply of its premium channels. Sky said that:

- Sky has an incentive to distribute its channels widely, but it has a strong preference to retail its channels itself[847].

- Ofcom had performed a significant *volte-face* in accepting Sky did not have a “static” incentive to restrict supply. Ofcom’s (new) reliance on a view that Sky had a strategic incentive to restrict wholesale supply did not take account of Sky’s earlier critique of this view[848].

- Ofcom did not demonstrate that Sky had, in fact, restricted the supply of its premium channels, either to cable or to others. Sky had offered Ofcom commitments to make its channels available on a wholesale basis, and had also offered BT its channels on a wholesale basis[849]. That these discussions (and others) did not lead to wholesale supply was due to failure to agree wholesale prices, lack of capacity on DTT, concerns about platform security, and regulatory uncertainty caused by Ofcom.

- Ofcom had failed to demonstrate that Sky’s alleged conduct was more likely than not to result in a material impact on the competitive process[850].

7.51 We consider Sky’s response in more detail below. Other pay TV providers, including BT, Top Up TV and Virgin Media, generally agreed with Ofcom’s arguments[851], but did not respond in detail on this subject.

Outline

7.52 In the remainder of this sub-section we describe the responses to our consultations on these issues, and set our conclusions in light of those responses.

7.53 We begin by setting out the history of negotiations between Sky and other parties for the wholesale of Sky’s Core Premium channels. We also consider discussions on pricing between Sky and other parties. We note in particular that these negotiations have not led to the establishment of supply arrangements.

7.54 We consider a number of reasons given by Sky for the failure of negotiations. In particular we consider:

[846] Tiscali response to Second Pay TV Consultation, page 1 (non-confidential version).

[847] Sky response to Third Pay TV Consultation, paragraph 6.32.

[848] Sky response, paragraph 6.13.

[849] Sky response, paragraphs 6.62 to 6.69

[850] Sky response, paragraphs 6.122 to 6.139.

[851] Joint response to Third Pay TV Consultation by BT, Top Up TV and Virgin Media, paragraph 1.

a) Whether Sky's argument that it had a legitimate preference for retailing on other platforms means that it should not be expected to agree wholesale supply with other retailers.

b) Sky's arguments, related to the above point, that retailers who were seeking access to its channels would have cannibalised more efficient retailers.

c) Whether the failure of negotiations can be explained by regulatory gaming on the part of other retailers.

d) Whether retail supply by these other parties was feasible, given capacity limitations.

e) Whether Sky's security concerns explain the failure of negotiations.

7.55 We then consider Sky's incentives with regard to the wholesale supply of its Core Premium channels. We revisit our view that Sky had a 'static' commercial incentive to supply (i.e. that wholesale supply to other parties would have increased its revenues and profits), and consider the evidence that it had a strategic incentive to restrict supply in order to protect its market power.

7.56 We then consider, in the light of this, whether the current position regarding the wholesale supply of Core Premium channels is prejudicial to fair and effective competition.

Negotiations for the supply of Sky's Core Premium channels

7.57 This sub-section is set out as follows:

- We first summarise the facts of Sky's negotiations with prospective wholesale customers.
- We analyse Sky's negotiating approach.
- We discuss the extent to which price has been discussed as part of the negotiations.

Summary of negotiations

7.58 Several pay TV retailers have sought agreements for the wholesale supply of Sky's pay TV channels in recent years. In our consultations we reviewed correspondence between Sky and others for the distribution of Sky's basic and premium channels. Figure 108 illustrates the negotiations for supply of standard definition Core Premium channels that have taken place between Sky and BT Vision, a potential IPTV entrant **[✂]**, Top Up TV and Virgin Media[852]. In summary however:

7.59 Since 2005, Sky has been engaged in negotiations of varying lengths of time for supply of its premium content with a number of different retailers. In each case, Sky has expressed a preference for retail supply, while the retailers have preferred a wholesale supply deal. While Sky has not rejected outright requests for wholesale supply, it has often countered specific wholesale proposals with retail offers of supply

[852] For offnet delivery; negotiations between Sky and Virgin Media for high definition channels are discussed later in this section.

via its Sky By Wire service. In some cases, retailers have engaged with Sky in negotiations for retail supply on the basis that this appears to be the only genuine opportunity to access Sky's premium content. However, in most cases, neither a retail nor a wholesale deal has been reached, with parties citing a variety of reasons for the failure of negotiations.

7.60 In general, negotiations between Sky and retailers have included both premium sports and movies channels. However, where there has been a distinction drawn between the two, requests for the supply of Sky's premium channels have focused on the supply of premium sports channels.

7.61 While in some cases, discussions for wholesale supply have restarted, and are ongoing, to date agreements for the wholesale supply of Sky's premium content have not been concluded.

- A potential IPTV entrant **[✂]** and Sky negotiated for between 18 and 24 months from around June 2006 for a supply agreement of basic and premium channels over the potential IPTV entrant's **[✂]** digital platform. The potential IPTV entrant's **[✂]** preference was to lead with a sports channel offering, followed by movies and basics offerings. It also preferred to enter into a wholesale supply agreement, whereas Sky's preference was a retail option, that is, providing its channels to the potential IPTV entrant **[✂]** via its Sky By Wire (SBW) service. Sky indicated that it would be willing to negotiate a wholesale deal for the supply of its basic channels, but this did not materialise for a variety of reasons. Sky did not reject outright the potential IPTV entrant's **[✂]** request for a wholesale deal for its premium channels. However, because of Sky's clear preference for a retail deal, the parties entered into negotiations on that basis. In March 2009, the potential IPTV entrant **[✂]** advised Sky that it would not be proceeding with a digital TV product, due to a number of factors, and no agreement was reached[853].

- **BT** first approached Sky regarding distribution of Sky's premium channels on its platform in February 2007. Each party indicated that it would be willing to consider the other's preferred option (that is, BT would be willing to consider a retail deal and Sky would be willing to consider a wholesale deal). However, by March 2008 the parties had still not been able to come to an agreement, at which point the negotiations stalled. **[✂]**[854]. **[✂]**.

- **Virgin Media's** predecessors (ntl and Telewest) initially inquired about the wholesale supply of high definition versions of Sky's premium channels in 2005. However, there was no correspondence on this point between the parties until mid-2007 when Virgin Media approached Sky to request the supply of Sky's premium channels on Virgin Media's off-net platform, and the supply of Sky's HD premium channels, along with other changes in their agreement. As was the case with the ITPV potential operator **[✂]** and BT, Sky's preference was to enter into a retail (Sky By Wire) deal with Virgin Media, while Virgin Media's preference was for a wholesale deal. The correspondence continued for several months, to

[853] **[✂]** response dated 9 June 2008 to Ofcom information request, question 2; Sky response dated 20 March 2009 to Ofcom information request, question 7 / Annex 1.3.

[854] Sky response to information request received 13 November 2009, question 5, annex 5, and Sky response to information request received 14 December 2009 question 28, annex 2.

November 2007, but no agreement was reached. In March 2009, Virgin Media issued a request for proposals from channel providers wishing to distribute HD content over its cable platform. Sky approached Virgin Media with a proposal to supply a number of its HD channels on a wholesale basis. Sky indicated that due to Virgin Media's 5/6 channel limit, its proposal focused on the basics and sport HD channel offerings, but Sky also offered to develop "an attractive Sky Movies HD proposal for Virgin Media". **[✂]**. We consider this issue further in paragraphs 7.291 to 7.311.

- **Top Up TV** and Sky began discussing supply of Sky's premium content over Top Up TV's DTT boxes in late 2005. Top Up TV told us that it first requested a wholesale deal in relation to the supply of Sky's premium content in December 2005, that this was done orally, and that therefore it was unable to provide us with any documentary evidence of this. We did, however, receive documentary evidence that Top Up TV attempted to obtain a wholesale arrangement with Sky in March 2006. However, Sky made it clear that it was only interested in concluding a retail deal for supply. Thereafter, while Top Up TV did attempt to obtain a wholesale agreement, the parties proceeded to negotiate on the retail supply of Sky's content. However, while that deal appeared to be close to being finalised, it was ultimately never concluded.

7.62 Figure 108 provides specific examples of:

- Retailers asking Sky for wholesale access to its Core Premium channels **[✂]**[855].

- Sky responding to such requests with counter-offers to retail its channels on the provider's platform, or rejecting specific proposals on the grounds that it would prefer a retail deal **[✂]**[856].

- Sky pointing out that it was not ruling out the possibility of a wholesale arrangement (to BT Vision in August 2007; to **[✂]** in October 2006, February 2007, March 2008)[857].

- **[✂]**[858].

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[855] BT Vision response dated 26 Feb 2008 to Ofcom information request dated 20 Dec 2007, question 4(i); **[✂]**; Sky responses dated 9 and 17 Apr 2009 to Ofcom information request dated 20 Mar 2009, questions 4 and 5; Top Up TV response dated 30 Mar 2009 to Ofcom information request dated 20 Mar 2009, question 4.

[856] BT Vision response dated 26 Feb 2008 to Ofcom information request dated 20 Dec 2007, question 4(i); BT Vision response dated 9 April 2009 to Ofcom information request dated 20 March 2009, question 2; **[✂]** response dated 18 Jun 2006 to Ofcom information request dated 9 Jun 2006, question 2; Sky responses dated 9 and 17 Apr 2009 to Ofcom information request dated 20 Mar 2009, questions 4 and 5; Top Up TV response dated 30 Mar 2009 to Ofcom information request dated 20 Mar 2009, question 4.

[857] BT Vision response dated 26 Feb 2008 to Ofcom information request dated 20 Dec 2007, question 4(i); BT Vision responses dated 7 Apr 2009 and 9 Apr 2009 to Ofcom information request dated 20 March 2009, questions 1 and 2; Sky response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 5; **[✂]** response dated 18 Jun 2006 to Ofcom information request dated 9 Jun 2006, question 2.

[858] BT Vision response dated 26 Feb 2008 to Ofcom information request dated 20 Dec 2007, question 4(i); Sky response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 5; **[✂]** response dated 18 Jun 2006 to Ofcom information request dated 9 Jun 2006, question 2.

7.63 We can see from our review of the evidence that none of these negotiations led to:

- Sky making a firm offer of a wholesale deal for its Core Premium channels.
- **[✂]**.
- Sky reaching an agreement with the other provider for the wholesale of its Core Premium channels.

Figure 108 Extracts from Sky negotiations with BT Vision, [✂], Top Up TV and Virgin Media for supply of SD channels 2006 – 2009

[✂]

[✂]

[✂]

*Source: responses to information requests by Sky, BT, a potential IPTV entrant **[✂]**, Top Up TV and Virgin Media.*

Sky's approach to negotiation

7.64 From our review of the evidence summarised above, we are aware of no case in which Sky has formally refused to enter into some form of dialogue with parties requesting wholesale supply of its Core Premium channels. Nor has it refused outright to agree wholesale terms. Indeed, Sky has avoided explicit refusals of wholesale supply and refutes claims that it has made such refusals. For example, **[✂]** Figure 108[859]). **[✂]**:

> **[✂]**[860].

7.65 However, Sky has consistently responded to requests for wholesale supply with counter-offers to retail its channels on behalf of other retailers. Sky's position has been that it would be unwilling to enter into a wholesale deal unless it could be shown that it would be better off than under a retail arrangement.

7.66 **[✂]**:

> **[✂]**[861]

7.67 **[✂]**[862]:

> **[✂]**[863].
>
> **[✂]**[864].

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[859] **[✂]** response dated 18 Jun 2008 to Ofcom information request dated 9 Jun 2008, question 2.

[860] Sky response dated 8 May 2009 to Ofcom information request dated 20 Mar 2009, question 7.

[861] Sky response dated 8 May 2009 to Ofcom information request dated 20 Mar 2009, question 7

[862] **[✂]**.

[863] Sky response dated 8 May 2009 to Ofcom information request dated 20 Mar 2009, question 7.

7.68 In our Third Pay TV Consultation (paragraph 6.40), we said that this response to requests for wholesale supply had the same effect as an outright refusal because:

- Most competing retailers were understandably reluctant to allow Sky to retail directly to their customer bases (as described in paragraph 7.94).

- Retailers were unlikely to be in a position to be able to demonstrate conclusively to Sky that Sky would be better off under a wholesale arrangement than a retail arrangement.

7.69 In each of the cases described above, the outcome has been a collapse of negotiations. Sky has not attempted to negotiate wholesale supply arrangements after it has become clear that providers were not going to accept a retail agreement with Sky. We have seen no evidence from internal Sky documents that when Sky did not expect the other party to accept a retail deal (as in the quote in paragraph 7.66 above), it considered making a wholesale offer.

7.70 Sky argued that Ofcom was extremely partial in its view that Sky should concede its preference to retail in favour of a third party's preference to wholesale[865]. It argued that, by Ofcom's logic, a platform's preference for a wholesale deal could be characterised as a refusal to allow Sky's premium channels access to the platform. Sky also notes that it is required by Ofcom to allow others to retail directly to its customer base. Similarly, Sky argued that its discretion and choice as to how commercially to exploit its property should not be abrogated without proper justification, which had not been provided.

7.71 Sky provided further comments on this issue, including:

> "Ofcom ... suggest[s] that, where it has not been possible for Sky to agree a retail deal with a third party, Sky should concede (immediately and without further negotiation) its preference to obtain access to other operators' platforms in favour of a third party's preference for wholesale to Sky's platforms.
>
> Ofcom's conclusions here appear to reflect a high degree of commercial naïvety. When conflicting preferences collide (as is the case where one party wants a retail deal and the other wants a wholesale deal), there will often be a degree of stand-off. Ofcom is, in effect, suggesting that when faced with the prospect of such a stand-off, Sky should immediately capitulate and the wishes of competing retailers should always prevail. Of course, an alternative view is that the platform should capitulate. Indeed, when it comes to Sky's own DTH satellite platform, it is the preferences of the channel supplier that do prevail; because that platform is open.
>
> Sky considers that in normal circumstances, against the backdrop of a truly light touch regulator, and where both parties have something to gain from reaching a deal, commercial disputes of this type would be resolved by the parties through normal negotiation, as each side

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[864] Ibid.

[865] Sky response to Third Pay TV Consultation, paragraphs 6.47 to 6.55.

would be willing to give ground in exchange for the right minimum revenue guarantee, or other commitments"[866].

7.72 We accept that other parties' preferred form of supply should not automatically take precedence over Sky's preferences. Sky's preference for a retail deal may be legitimate in the sense that it may be based on a commercial judgement by Sky that its own revenues and profits from supply to a particular platform would be higher with a retail deal than with a wholesale deal. We consider Sky's reasons for preferring retail supply further in paragraphs 7.89 to 7.104.

7.73 However, there are also legitimate reasons for the reluctance of third parties to enter into retail deals with Sky. We describe these further at paragraph 7.94.

7.74 We agree with Sky that in normal circumstances commercial disputes of this nature should be resolved through negotiation, and we recognise that this can involve a degree of stand-off. We have not suggested that where it has not been possible to agree a retail deal Sky should offer a wholesale deal immediately and without further negotiation.

7.75 However, the circumstances here are not normal. Our analysis of competition effects is based on our view, set out in detail in Section 5, that Sky has market power in the wholesale supply of Core Premium channels, and that this combined with its vertical integration gives it the ability and incentive to restrict supply. Our concern is that restricted supply of these channels is prejudicial to fair and effective competition. It is because of this market power that we do not consider Sky's analogy (that a platform's preference for a wholesale deal could be characterised as a refusal to allow Sky's premium channels access to the platform) to be valid[867]. It is also because of Sky's market power that we do not consider that "normal circumstances" exist, in which commercial disputes can be resolved by "normal negotiation".

7.76 Our concern arises because Sky's assertions that it favours a retail deal (and that it will not accept a wholesale deal unless the other retailer can demonstrate, to Sky's satisfaction, that Sky will be better off under such a deal) effectively amount to a restriction of wholesale supply.

7.77 Even if Sky's preference for retail supply over wholesale supply can be justified by legitimate commercial considerations, we consider that Sky's actions indicate that it has a preference for **no** supply to third party retailers rather than wholesale supply. As a result, its only wholesale supply arrangements are with cable firms, which it considers itself under a regulatory obligation to supply[868].

7.78 Sky's position on wholesale supply was also reflected in its negotiations with Ofcom in late 2007 and early 2008. As we set out in Section 9 of this document, Sky sought explicitly to exclude the baseline price of its premium channels from these negotiations.

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[866] Sky response to Third Pay TV Consultation, paragraphs 6.52 to 6.55.

[867] As we note in Section 5, we do not consider that Virgin Media has countervailing buyer power with respect to Sky.

[868] **[✂]**.

Discussion of wholesale price during negotiations

7.79 **[✂]**.

7.80 **[✂]**[869], **[✂]**.

7.81 **[✂]**[870]. **[✂]**.

7.82 **[✂]**[871]. **[✂]**.

7.83 BT[872] told us that it had always been willing to enter into a wholesale arrangement with Sky, albeit not at the cable rate-card prices as they were not economically viable. BT confirmed that towards the end of June 2009, BT again sought a wholesale arrangement with Sky. This approach was prompted by concerns over timing – although BT considered it likely that Ofcom would proceed with its proposed wholesale must-offer remedy, it was concerned that the remedy might not be in place in time for BT to launch premium pay TV sports services for the start of the next Premier League season (August 2010). As a consequence, BT sought to address certain issues in discussions with Sky ahead of any decision by Ofcom on a wholesale must-offer remedy – for example, the specification of minimum security requirements.

7.84 **[✂]**.

7.85 **[✂]**[873]. Sky has argued that one of the reasons negotiations for access to its premium channels with BT have not reached a successful conclusion is that BT has been engaged in regulatory gaming. We consider this issue in paragraphs 7.134 to 7.146[874]. **[✂]**.

Figure 109 References to pricing in Sky negotiations with BT Vision and Orange

[✂]

*Source: responses to information requests by Sky, BT and a potential IPTV entrant **[✂]***

Reasons given by Sky for the failure of commercial negotiations

7.86 In response to our Second Pay TV Consultation, Sky criticised Ofcom's analysis of the possible explanations for a failure to reach agreement, on the grounds that it was far too narrow and ignored other much more plausible explanations[875]. In our Third

[869] **[✂]** response dated 18 Jun 2006 to Ofcom information request dated 9 Jun 2006, question 2; Sky response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 5.

[870] **[✂]**.

[871] **[✂]** response to Third Consultation, paragraph 6.104.

[872] **[✂].**

[873] **[✂]** response dated 4 December 2009 to information request dated 29 October 2009, question 16.

[874] Sky response to Third Pay TV Consultation, paragraph 6.104 to 6.106.

[875] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.36.

Pay TV Consultation, we considered that Sky's alternative explanations did not fully account for the observed restriction in supply. Sky responded with further arguments on this subject.

7.87 Sky has put forward a number of reasons for the failure of negotiations described above:

- Sky's preference for retail. Sky believes that it can maximise revenues by retailing its own premium channels, rather than wholesaling to others[876].
- Reluctance to reduce prices for "inefficient entrants". A reluctance to reduce wholesale prices for an "inefficient entrant" is entirely consistent with the behaviour that would be expected of a stand-alone broadcaster that did not have its own retail business[877].
- Regulatory gaming. Other retailers have been engaged in regulatory gaming[878].
- Capacity. Sky was prevented from supplying on other platforms because of a lack of capacity[879].
- Security. Sky has concerns about the adequacy of the conditional access security systems used by BT and Top Up TV[880].

7.88 We consider each of these points in turn.

Sky's preference for retail

7.89 Sky has argued that its preference for retailing its own Core Premium channels is not due to strategic considerations, and we address that argument here. We note that this issue is related to:

- Whether negotiations have failed because Sky is unwilling to lower prices to less-efficient providers, which is discussed below (paragraphs 7.105 to 7.133).
- Whether retail by Sky would address our concerns about restricted supply of Core Premium channels (paragraphs 7.210 to 7.234).
- Our broader consideration of Sky's static and strategic incentives (paragraphs 7.170 to 7.201).

7.90 In our Third Pay TV Consultation,[881] we considered that Sky's preference for retail was due to a desire to retain control over packaging and pricing on other platforms, and therefore to avoid losing customers from its satellite platform.

[876] Sky response to Third Pay TV Consultation, paragraph 6.32.

[877] Sky response, January 2009, Section 5, paragraph 2.35.

[878] Sky response to Third Pay TV Consultation, paragraph 6.104.

[879] Sky response to Third Pay TV Consultation, paragraphs 6.90-6.94.

[880] Sky response to Third Pay TV Consultation, paragraphs 6.95 to 6.101.

[881] Paragraph 6.66.

7.91 Sky argued that it had a strong incentive to retail its own channels, stemming from its experience of low penetration rates on cable[882]. Sky said that its own success in retailing its premium packages was due to:

- Its expertise in marketing its premium channels and TV services generally.
- Its greater incentive as a vertically integrated retailer to win additional subscribers (giving rise to both retail and wholesale margins).
- Cable firms' focus on other products on which they earn a higher margin.
- Other retailers' preference to market their own PPV or VoD services instead of Sky's movie channels.
- Other retailers' desire to encourage subscribers to drop Sky channels if this was necessary to retain the customer for other services.

7.92 Sky argued[883] that there was therefore an obvious commercial rationale for retailing its own channels, which was not based on any strategic incentive regarding the relative strength of rival retailers. It also noted that Setanta had chosen to retail its channels where possible.

7.93 While Sky has raised this point as a separate question from that of whether it should be expected to lower prices for a less efficient entrant, our view is essentially similar to that in paragraph 7.128 below – namely that wholesale supply even to a less efficient retailer is likely to be better for Sky, from a static revenue perspective, than being absent from a platform. As such, it would only make sense for Sky to restrict wholesale supply of its channels if it had a reasonable expectation that it would be able to negotiate retail supply.

7.94 BT, A potential IPTV entrant **[✂]**, Top Up TV and Virgin Media have shown strong resistance to allowing Sky to retail on their platforms. We asked these firms for their reasons for rejecting a retail deal with Sky, and to provide supporting evidence[884]:

- **BT** cited the following documentary evidence on this subject:
  - o A 2007 internal note[885] where BT noted that "a retail deal does not work for us" because (inter alia): (a) it wanted to compete on price; (b) it wanted to offer customers flexibility on access to content; (c) given platform investment, BT wanted to control its own bundles and margins; (d) there were potential legal issues with agreeing retail pricing and discounts with a competitor on bundles; (e) this would lead to duplication of customer support – there would not be a one stop shop for customer queries; (f) BT did not trust Sky to price competitively against itself; (g) BT had acquired all its other content wholesale.

[882] Sky response to Third Pay TV Consultation, paragraphs, 6.32 to 6.33.

[883] Sky response to Third Pay TV Consultation, paragraphs 6.32-6.33.

[884] Responses to Ofcom information request, 29 October 2009.

[885] **[✂]**; Annex A to BT response dated 9 April 2009 to Ofcom information request dated 20 March 2009, question 2.

  - A 2007 email to Sky[886], noting (a) that BT's need to give customers maximum flexibility requires packaging content as both standalone and in bundles, and this is increasingly important as customers demand a range of services. BT notes the lack of retail packaging of Sky content with Tiscali services; (b) the implications of a major competitor having direct access to customers whom BT acquired at significant cost. BT asks if Sky could suggest comfort on that point; (c) that BT's platform is proprietary and complex, so it is unlikely that Sky's agents could handle platform-related queries, leading to the complexity of two different call centres; (d) that BT contests the argument that it would have a weaker incentive to retail than Sky.

- **Top Up TV** told us that it would prefer a wholesale arrangement in respect of Sky's premium channels because it would be impossible to package the premium channels with Top Up TV's basic proposition in a compelling and competitive way if Top Up TV were not the pay TV retailer. This had been demonstrated by the lack of take up of the premium pay TV offering on Tiscali's platform[887].

- **Virgin Media [✂]**. Virgin Media told us that retail by Sky on its platform was not attractive because:

  - **[✂]**.
  - **[✂]**.
  - **[✂]**.
  - **[✂]**.
  - **[✂]**[888].

- A potential IPTV entrant **[✂]** was concerned about[889]:

  - Sky directly using data supplied to target the potential IPTV entrant's **[✂]** customers for its own Sky services.
  - The legal relationship between Sky and the potential IPTV entrant **[✂]** in respect of the potential IPTV entrant's **[✂]** customer database.
  - The potential IPTV entrant's **[✂]** obligations to market to its customers on Sky's behalf.

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886 **[✂]**; Annex A to BT response dated 9 April 2009 to Ofcom information request dated 20 March 2009, question 2.

887 Top Up TV response dated 17 November 2009 to Ofcom information request dated 29 October 2009.

888 Annex 1 to Sky response dated 17 April 2009 to Ofcom information request dated 20 March 2009, question 4. Virgin Media response dated 18 November 2009 to Ofcom information request dated 29 October 2009.

889 A potential IPTV entrant's **[✂]** response 25 November 2009 to Ofcom information request dated 29 October 2009, file 1 of 2.

- o Sky's ownership of intellectual property rights in certain data and **[✂]**'s ability to use the data.

7.95 Tiscali TV / TalkTalk TV is an exception to this, in that (when it was owned by Video Networks) it accepted a deal whereby Sky would retail to its customers. However, this came after Tiscali / TalkTalk had expressed a strong preference for a wholesale agreement. Tiscali / TalkTalk has since emphasised this to us, indicating that "**[✂]**"[890].

7.96 Tiscali / TalkTalk (then owned by Tiscali) has also said that:

> "**[✂]**"[891].

7.97 **[✂]**[892].

7.98 In summary, and consistent with our analysis in our previous consultations[893], competitors are deterred from agreeing a retail deal with Sky by the prospect of giving Sky access to their customer bases, a loss of flexibility and control, the potential for customer confusion, and the negative perception of Sky By Wire on TalkTalk / Tiscali.

7.99 As discussed in paragraphs 7.222 to 7.232, Sky's offer on TalkTalk appears unattractive relative to Sky's satellite service, offering a small discount for a substantially inferior service. As an indication of the outcome, penetration of the service among TalkTalk customers is very substantially lower than Sky has achieved on satellite.

7.100 We do not see clear evidence that Sky would be the most effective retailer for consumers of its Core Premium channels on other platforms. Other retailers have strong reservations about allowing Sky to retail on their platforms – and these reservations have been expressed to Sky by BT, Top Up TV, Virgin Media and A potential IPTV entrant **[✂]**.

7.101 Moreover, these concerns appear reasonable. While it may be theoretically possible to overcome some of the issues contractually – such as the flow of customer information – others appear less surmountable, because they introduce inefficiency into the competitor's business – including limitations on the ability of the competitor to bundle effectively, and/or exploit economies of scope. Competitors' negative impression of the proposition of Sky retailing on their platforms appears to be informed by TalkTalk / Tiscali's experience of Sky By Wire.

7.102 We can clearly see that Sky has a preference for retail, and that other retailers would prefer a wholesale arrangement. There are almost certainly legitimate arguments on both sides.

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[890] Ofcom meeting with Tiscali, 10 December 2008.

[891] Tiscali response dated 3 September 2007 to Ofcom information request dated 18 July 2007, question 9.

[892] Tiscali response dated 13 November 2009 to Ofcom information request dated 28 October 2009, question 2.

[893] See Second Pay TV Consultation, paragraphs 6.128 to 6.130.

7.103 However, in our view, Sky faces a considerable static cost in not being present on other platforms. Nonetheless, the prospect of those other platforms accepting Sky as a retailer appears very unlikely. This suggests that whatever reasons Sky has for resisting wholesale agreements, such a position is unlikely to be due to an expectation that it will soon be allowed to retail on these platforms. Therefore, we consider that notwithstanding the considerable static cost in not being present on other platforms, it appears that Sky would prefer to be absent from a platform than to wholesale.

7.104 **Our view:** We therefore conclude for the reasons set out above that, while Sky may have an interest in retailing on other platforms, the failure of negotiations for wholesale supply cannot reasonably be attributed to this preference.

Reluctance to reduce prices for "inefficient entrants"

7.105 In response to our Second Pay TV Consultation, Sky criticised Ofcom[894] for setting out two possible explanations for a failure to supply – i.e. Sky intentionally withholding supply, and Sky not being willing to lower the price to a level that any retailer would be prepared to pay – and not properly analysing how the reasons for a failure to supply might affect possible remedies.

7.106 Sky argued that Ofcom could not argue that failing to agree to lower rates provides evidence that Sky is "acting" on an incentive to "distribute its premium content in a manner that favours its own platform and its own retail business"[895].

7.107 Sky further argued that the 2002 OFT Decision established that Sky's own retail business could afford to pay the wholesale rates charged to cable operators and remain profitable[896]. It said that the fact that other retailers might not be prepared to pay them cannot be used as evidence that Sky is favouring its own platform. If Sky were to offer new retailers terms which were below the price at which it wholesales to Virgin Media (or notionally to itself on its own platform) then it would disadvantage Virgin Media (or its own downstream retail operation) and would discriminate in favour of other retailers.

7.108 Sky said that, under Ofcom's proposed intervention:

> "Sky would need to set its wholesale prices below the levels currently charged to Virgin Media to levels which Ofcom considers new and less efficient entrants might be able to "afford" (whatever that may mean in practice). This is not an outcome that would be expected in a competitive market. A stand-alone broadcaster that did not have its own retail business could not be expected to reduce its wholesale price to accommodate such entrants in the way Ofcom proposes"[897].

7.109 Sky said that such a broadcaster would distribute its channels to third party platforms so as to maximise aggregate wholesale revenues[898]. As such it would have no

[894] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.31, page 69.

[895] Sky response to Second Pay TV Consultation, Section 5, paragraphs 2.32 to 2.33.

[896] Sky response to Second Pay TV Consultation, Section 5, paragraphs 2.34.

[897] Sky response to Second Pay TV Consultation, page 6.

[898] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.35.

incentive to reduce its wholesale prices to cater for a new retailer that was less efficient than established retailers, and would be concerned about the less-efficient entrant taking sales away from its more established (wholesale) customers.

7.110 In our Third Pay TV Consultation[899], we cited a number of arguments against Sky's claim that supply is restricted because other firms are less efficient than established retailers. We noted that[900]:

- Sky had not sought to establish whether or not other suppliers were efficient.

- Even if other firms were less efficient there is an opportunity cost to Sky in being absent from a platform.

- Our analysis of Sky's business model for Picnic indicated that the proposed service would not be profitable if Sky charged Picnic the wholesale rate-card price.

7.111 We now consider each of these points in turn.

7.112 **Establishing whether others are efficient.** We noted that Sky had not sought to reach agreements for the wholesale supply of its premium channels to third parties who have requested such supply. As such, it had not taken the opportunity to establish whether or not these suppliers were efficient. We said that we would expect a non-integrated wholesaler to engage in detailed price negotiations, in order to establish whether entrant retailers were more efficient than its more established wholesale customers.

7.113 Sky argued that:

> "In placing particular emphasis on whether a retailer was efficient, Ofcom appears to have missed the point. Whether a retailer needed such a price cut because they were less efficient or simply because they wanted to secure a higher margin is not relevant. The issue is, whether, faced with a retailer that would not agree to its offer, a non-integrated broadcaster might decide not to reduce its wholesale price to that retailer. It is clear that BT was offered Sky's channels on rate-card terms and did not agree to those prices. Sky did not need to determine whether BT was likely to be efficient as it was apparent at the time that in order to reach an agreement Sky would need to reduce its prices below the cable rate-card"[901].

7.114 However, our view was that:

> "Sky has not sought to reach agreements for the wholesale supply of its premium channels to third parties who have requested such

[899] Third Pay TV Consultation, paragraph 6.69.

[900] We also noted that Sky's argument was inconsistent regarding inter-platform switching. Sky disputed this interpretation of its comments, We remain of the view that there was indeed some inconsistency; however as Sky argues (Sky response to Third Pay TV Consultation, paragraph 6.75), even if short-term switching was limited, there might still be a long-term effect in terms of the choice of platform by people coming to pay TV for the first time.

[901] Sky response to Third Pay TV Consultation, paragraph 6.78.

> supply. As such, it has not had the opportunity to establish whether or not these suppliers are efficient. We would expect a non-integrated wholesaler to engage in detailed price negotiations, in order to establish whether entrant retailers were more efficient than its more established wholesale customers"[902].

7.115 As such, our emphasis was not on different interpretations of retailer efficiency; rather it was on whether Sky had sought to reach agreements with third parties. Our concern is that Sky has not been prepared to engage in serious discussions to establish whether third party suppliers are efficient and willing to retail at a lower margin. In our view, even if the rate-card were to be taken as the appropriate price, Sky has not generally sought to establish whether other retailers would be willing to pay this price.

7.116 **Opportunity cost of non-supply.** There is an opportunity cost of non-supply in cases where being available on new platforms results in an expansion of the market. In such cases there may even be an incentive to price discriminate between platforms if that is necessary to benefit from market expansion. While this outcome might be hard to specify through negotiation, it is the sort of arrangement we might expect from a competitive market.

7.117 Even if other firms were less efficient than Sky at retailing its Core Premium channels, or required a higher margin than would be allowed by the rate-card, there is an opportunity cost to Sky in being absent from a platform while it tries (largely unsuccessfully to date) to negotiate access as a retailer. Wholesale supply to an arguably less-efficient retailer is likely to be better for Sky, from a static revenue perspective, than being absent from the platform. In our quantitative impact assessment analysis, we estimate that, if Sky agreed to wholesale Core Premium Sports channels to third party retailers on DTT/IPTV, it would earn revenues of around £240 million per annum after five years. This estimate is based on (a) a regulated wholesale price for Sky Sports 1&2 of £17.14 (i.e. around £2 below the rate-card price) and (b) third-party DTT/IPTV premium subscribers of 1.2 million after five years. This does not take account of a reduction in Sky's satellite subscriber numbers. In our base case, we estimate that Sky's wholesale arm would be £740m better off over five years, and its satellite retail arm would be £70m worse off over five years. For more detailed analysis of the expected impact of the remedy on Sky, see Section 11.

7.118 Sky argued that this point seemed to have nothing to do with whether it would make sense for a non-vertically-integrated broadcaster to reduce its price, and was therefore not relevant[903]. Sky said the point related instead to whether, even where Sky felt that it would be a more successful retailer than the platform operator, it should nevertheless agree to supply at wholesale terms whilst it tries to secure retail access. Sky said it had dealt with this question in its arguments, summarised in paragraphs 7.70 to 7.71 above, that it should not be expected to concede its preference for retail in favour of a third party's preference for wholesale.

7.119 In considering whether a non-vertically integrated broadcaster would have an incentive to reduce its price, we are asking whether the inefficiency (or, as Sky would have it, insistence on a higher margin) of other retailers is a justification for the

[902] Third Consultation, paragraph 6.69.

[903] Sky response to Third Pay TV Consultation, paragraph 6.79.

restricted supply of Core Premium channels. The revenues lost by being absent from a platform are a relevant consideration for Sky (as they would be for non-vertically-integrated broadcaster), even if that platform could only be reached through a less-efficient retailer.

7.120 The separate question of whether Sky should be expected to wholesale rather than retail, as it prefers, is discussed in paragraph 7.70 to 7.77.

7.121 **Picnic evidence.** We have reviewed Sky's business plans for its proposed Picnic service, to establish whether, as a form of new entrant, Picnic would be profitable using the rate-card. In our Third Pay TV Consultation, we took the view that it would not[904]. This view was based on making a number of adjustments to the model as submitted by Sky. The most important of these were taking into account transmission costs as a retail cost (which Sky treated as a wholesale cost) and stripping out margin contribution from customers that did not take a TV product. Our conclusion was that over Sky's modelling period of **[✂]** years, Picnic would only be profitable if it paid a wholesale charge **[✂]**% below the cable rate-card.

7.122 Sky disputed our analysis in its response to our Third Pay TV Consultation[905], and suggested a number of further adjustments to the model which it believed were reasonable and would result in Picnic's business plan being profitable. In particular, Sky argued that we should use a 10-year NPV model with a terminal value as in our pricing analysis; pointed towards a lower wholesale price for capacity-constrained platforms; suggested that we should have left inflation out of our calculation of basic costs; and argued that we should remove two thirds of the transmission costs we had allocated to Picnic. Sky's comments are set out in Appendix 3 to this Section (in Annex 6).

7.123 Following Sky's response, we have considered our analysis further, and have introduced a further level of detail, making this analysis more consistent with our pricing work (set out in Section 10 of this document). Our adjustments are set out in Appendix 3 to this Section (in Annex 6). Of particular note, we have extended our modelling period to include 10 years and a terminal value; made adjustments to the inflation we apply to the wholesale price of Sky's basic channels; expensed subscriber acquisition costs and capital expenditure in the year in which they are incurred, rather than amortising over assets' lifetimes; and taken a market-based transmission cost rather than Sky's much lower historic costs. We have also considered the effect of stripping out the relevant common costs that we believe should be allocated to standalone broadband and telephony. The full analysis and review of the various adjustments we have made is set out in Appendix 3 to this Section (in Annex 6). In summary, however:

- If Picnic paid the wholesale price that Sky currently charges for its premium channels, it would make a loss of £**[✂]**m on a discounted cash flow basis[906]. In order to break even, Picnic would have to pay £**[✂]**, which is **[✂]** less than the cable rate-card price (£17.59) for its premium channels.

[904] Third Pay TV Consultation, paragraph 6.69, third bullet.

[905] Sky response to Third Pay TV Consultation, paragraphs 6.80-6.89.

[906] We have modelled cash flows over 10 years and added a terminal value to capture ongoing value in the business.

- These figures include the contribution from all of Picnic's broadband and telephony subscribers – including those who do not take any TV products. However it could, on this basis, afford to pay **[✂]**[907] **[✂]**.

- Excluding cashflows and allocated common costs from standalone telephony and broadband customers, would mean that Picnic could only break even by paying a wholesale price of £**[✂]** (**[✂]**% less than the cable rate-card price[908]).

- Excluding cashflows from the telephony and broadband elements of dual-play and triple-play bundles, but allowing for these activities to contribute a proportion of Picnic's common costs, gives a break-even wholesale price of £**[✂]** under a conservative approach (**[✂]**% less than the cable rate-card price) or £**[✂]** under a less conservative approach.

- Picnic exploits the fact that Sky has its own telecommunications network, which is used to provide a wide range of broadband and voice services to residential and business consumers. The Picnic business model appears to pay for the incremental costs associated with use of this network, including access charges and out-payments to other operators, as well as some equipment costs. It does not however appear to make a contribution to the fixed costs associated with this network. This means that operators without such a network may be unable to compete with Picnic. BT may also be constrained in its ability to compete, in circumstances where it has market power, since it would not be permitted to purchase access to its network paying only incremental costs.

7.124 This analysis has two main implications:

- Picnic would be unprofitable at cable rate-card prices, even when taking into account cashflows from standalone broadband and telephony subscribers.

- For a DTT-based entrant, facing market-based transmission costs and seeking to recover its costs of pay TV services through its pay TV business[909], the rate-card would not allow cost recovery.

7.125 Given that there are a large number of consumers who buy their pay TV services stand-alone (although triple play take-up is increasing), prices which only worked for a pure triple-play business model would limit competition. It is therefore not surprising that companies negotiating with Sky have sought to obtain a discount to the cable rate-card.

7.126 **Our view:** As noted, Sky has argued that a stand-alone broadcaster that did not have its own retail business could not be expected to reduce its wholesale price to accommodate entrants in the way Ofcom proposes.

7.127 In our view, Sky's approach to wholesale supply differs considerably to that which we would expect from a stand-alone broadcaster. The only independent retailers it supplies are Virgin Media and smaller cable firms. It considers itself under a

[907] Sky response to Third Pay TV Consultation, paragraph 6.84.

[908] Note that this analysis is not directly comparable to our pricing analysis in Section 10, since it is derived from Sky's Picnic business plan.

[909] "Costs of pay TV services" refers to TV direct costs and allocation of common costs to TV services.

regulatory obligation to supply these firms (see paragraph 7.241), and **[✂]**. Sky argued in its response to our Third Pay TV Consultation that these prices are comfortably below the margin squeeze level, but has not shown us how it made this calculation[910].

7.128 As such, Sky's rate-card prices are a response to the regulatory environment rather than commercial circumstances. It does not follow that they are the prices which a stand-alone broadcaster would charge. We recognise that, whereas such a broadcaster may have scope to price discriminate between platforms, Sky has concerns about the regulatory risk of doing so. However, even if discounting the rate-card to new wholesale customers meant that Sky would have to extend the same discount to cable firms, we would expect a standalone broadcaster to weigh the loss of revenues from a price cut to cable against the additional revenues from being present on a new platform. Our impact assessment indicates that on a static analysis Sky could increase its revenues by discounting its rate-card and wholesaling to more platforms. However, Sky does not appear to have considered this option in its negotiations with independent retailers.

7.129 Our analysis of Picnic's profitability supports our view that the current rate-card prices are higher than those needed for a rival retailer to be able to compete[911]. We consider that this is also true of the discounted cable rate-card price **[✂]**.

7.130 Furthermore, Sky has made only limited attempts to establish the willingness of other retailers to pay for Core Premium Channels and may have been doing so in response to the regulatory environment. In particular, it offered the rate-card to BT in the course of this investigation (see Figure 108 above). **[✂]**,[912] **[✂]**[913].

7.131 We do not believe it to be a reasonable expectation for retailers other than Sky to be prepared to pay the rate-card price for Sky premium channels, as these prices would not allow them to compete effectively. This is indicated by our pricing analysis, as set out in Section 10. A plausible competitor would not be able to generate a return which would cover its cost of capital over a 10-year period plus a terminal value if paying the current rate-card price. The rate-card prices are close to what we would expect under an ex post margin squeeze test – i.e. assuming Sky's own scale. No entrant would have Sky's scale; nor would we expect one to be able to reach Sky's scale, given Sky's current subscriber numbers relative to the likely number of total pay TV households in the UK.

7.132 ESPN provides an example of a stand-alone broadcaster of core premium channels. Unlike Sky, it has very quickly agreed terms with both BT and Top Up TV. In failing to agree terms with these retailers, Sky appears to have foregone considerable wholesale revenues in recent years.

7.133 We conclude that the lack of wholesale supply of Core Premium Channels cannot be attributed to retailers being unwilling to pay a commercial price for these channels.

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[910] Sky response to Third Pay TV Consultation, paragraph 6.110.

[911] As we noted in our Third Pay TV Consultation, paragraph 8.74.

[912] **[✂]**; **[✂]**.

[913] **[✂]**.

Regulatory uncertainty and gaming

7.134 In response to our Second Consultation, Sky argued that parties requesting wholesale supply were engaged in regulatory gaming[914]. Referring to its negotiations with BT on wholesale access, Sky said that Ofcom could not ignore the fact that BT's failure to agree to the terms might be explained by BT's desire to seek to secure more favourable terms via a regulatory route[915].

7.135 **[✂]**[916]**.** Sky said its view that BT was trying to game the regulator was evidenced by **[✂]**. Sky said that BT's counter offer of 21 December 2007 proposed a **[✂]**% discount against the wholesale price of Sky Sports 1 and a wholesale price for Sky Movies 1 that was **[✂]**[917].

7.136 In support of its statement[918], Sky said that:

- BT had asked for wholesale supply for the first time only three weeks before Ofcom formally opened its Pay TV Review.

- In November 2007, BT had said that it was interested in playing a long regulatory game and that accepting a deal for the supply of Sky's channels, on the basis of the current cable rate-card, was not in its interests, as that would prejudice BT's efforts in respect of seeking regulatory access to Sky's premium channels.

- During Sky's discussions with Ofcom between December 2007 and April 2008, it was Sky's understanding that Ofcom did not wish Sky to engage in separate discussions with BT (or any other current or potential retailer of Sky's premium channels) on the subject of potential wholesale terms.

  > "During the course of the remainder of 2008, and for the first part of 2009, there was limited engagement with BT in respect of negotiating a commercial wholesale arrangement. Sky considers that the reason for this was the fact that BT's senior management was not inclined to negotiate commercial wholesale terms with Sky and instead preferred to await the outcome of Ofcom's investigation. **[✂]**.

- **[✂]**.

7.137 Contrary to Sky's third comment above, Ofcom did not express a wish for Sky to refrain from commercial negotiations for third party supply.

7.138 **[✂]**[919].

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[914] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.37.

[915] Sky response to Second Pay TV Consultation, Section 1, page 10.

[916] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.37

[917] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.38

[918] Sky response dated 13 November 2009 to Ofcom information request of 29 October 2009, question 5.

[919] **[✂]**.

7.139 **[✂]**:

- **[✂]**.
- **[✂]**.
- **[✂]**.

7.140 **[✂]**.

7.141 We have carried out an extensive examination of correspondence between Sky and BT (and others), and of internal documents, in order to assess incentives of both sides of these negotiations. BT engaged in detailed discussions with Sky from March to September 2007, in which it sought to address Sky's concerns about security of pay TV channels on BT's platform, and to reach a wholesale agreement for Sky's premium channels. In response to information requests, BT has provided us with notes of its meetings with Sky and emails to Sky on this subject over the period. **[✂]**, the papers provide no evidence that BT is not conducting a commercial negotiation in earnest[920].

7.142 As regards the specific discussions raised by Sky in paragraph 7.136 above, we regard the evidence as inconclusive, as Sky and BT appear to have conflicting notes of the same meetings.

7.143 As regards price negotiations between Sky and BT:

- It is normal business practice for a party to a price negotiation, to have counter-offered with a price substantially below Sky's original offer.
- BT's differing view of the appropriate price had a basis in its assessment of the planned Picnic retail price[921].
- It is possible that BT would have agreed to a higher price than that which it quoted. However Sky did not respond by offering a discount of less than 40%. Instead it claimed that its rate-card prices were fair and reasonable, and that if it offered a discount to BT, it would also have to offer a discount to cable providers **[✂]**[922].
- **[✂]**.

7.144 We recognise that the prospect of regulatory intervention by Ofcom could have the potential to influence commercial negotiations between parties such as Sky and BT. Indeed, while there is disagreement between Sky and BT as to what was said by BT executives in the course of negotiations, evidence from Sky does indicate that BT had regard to a possible regulatory outcome during its negotiations with Sky.

[920] BT response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009

[921] Evidenced by a note from BT of a meeting on 8 January 2008.

[922] BT response dated 26 February 2008 to Ofcom information request dated 20 December 2007, Annex 3.

7.145 Sky's claim of regulatory gaming, in response to our Second Consultation, mentioned only BT. In responding to our Third Pay TV Consultation, Sky also noted that Top Up TV had ceased completely to engage with Sky during Ofcom's investigation[923].

7.146 As described in paragraphs 7.58 to 7.63, we have reviewed documents relating to negotiations between Sky and Top Up TV, Orange and Virgin Media (for offnet IPTV), which also failed to reach an agreement for wholesale supply. Our view is that these documents do not support the notion that the failure to reach agreement was ultimately due to regulatory gaming on the part of any of these firms.

7.147 **Our view:** We conclude that the lack of wholesale supply of Core Premium channels cannot be attributed to regulatory gaming by third parties.

Capacity

7.148 In response to our Second Pay TV Consultation, Sky argued that other than Tiscali, which carried Core Premium Sky channels, no IPTV platform currently in existence was capable of delivering linear channels. In particular, neither BT nor **[✂]** had launched an IPTV network with this capability. As such, there was "no commercial urgency to reach agreement as none of the new entrants currently have any means by which to distribute Sky's channels".[924]

7.149 In our Third Pay TV Consultation we recognised that there were challenges to developing an IPTV service. However, we considered that Sky's view that there was no commercial urgency was somewhat at odds with the repeated requests by other retailers for a wholesale deal. The investment in developing an IPTV network is substantial, and BT and **[✂]** would reasonably wish to secure rights to retail Core Premium channels on their networks before making this investment. The fact that TalkTalk is already distributing a number of Sky's linear channels, including live sport, is evidence that IPTV distribution is possible over BT's copper access network. We were not aware of any technical reason why other operators could not develop an equivalent IPTV capability in a relatively short time frame which would allow linear channels to be distributed to the majority of their broadband customers. In any case, regardless of the precise capabilities of a particular operator's IPTV network, it is quite possible, indeed likely, that live sports channels would be delivered via DTT videostreams to a hybrid IPTV / DTT set-top box like BT's, rather than using the IPTV feed.

7.150 Sky also argued that it could not broadcast its premium channels via DTT without first securing DTT capacity. It said it had no means by which it could offer its channels to any of the DTT retailers for distribution[925]. It argued that, as its Picnic application was pending, it had no means by which to facilitate the provision of its channels either to itself or to any other retailer over the DTT platform. However, we noted that a third party retailer such as Top Up TV would have scope to use one of its own video streams for premium channels, or purchase capacity from another broadcaster and use it to carry Sky's premium channels.

[923] Sky response to Third Pay TV Consultation, paragraph 6.105.

[924] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.39.

[925] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.41.

7.151 In its response to our Third Pay TV Consultation[926], Sky criticised our view that a third party retailer such as Top Up TV could use one of its own video streams for premium channels. Sky said "This displays a fundamental lack of understanding of the commercial reality, as it is Sky and not the DTT retailer who is expected to pay for such capacity". It said that Top Up TV had offered to procure the necessary capacity, but only if Sky paid £**[✂]** per annum for that capacity. Sky said that it would reasonably want to use the capacity it had already committed to on DTT to supply its premium channels, as envisaged in the Picnic business plan, rather than paying for additional capacity. Sky also said that it remained unclear whether Sky would be entitled to be the provider of its premium channels via capacity which Top Up TV proposed to sublet from Five. Finally, it noted that BT first offered to procure DTT capacity as late as July 2009, and that previously Sky's discussions with BT were premised on Sky securing approval from Ofcom to change its DTT channel line-up.

7.152 Our view remains that the failure to supply Core Premium Channels for retail over IPTV was not due to a lack of capacity, for the reasons set out above. Sky has not challenged this view.

7.153 As regards retail over DTT, we note that lack of DTT capacity did not prevent Sky from negotiating a DTT retail deal with Top Up TV over a period of months (from December 2005 to June 2006). We have reviewed the correspondence from that negotiation, and note the following statements from internal Sky emails (April 2006)[927]:

> **[✂]**.
>
> "**[✂]**"

7.154 In our view, this correspondence indicates that the failure of negotiations was not due to a capacity barrier. Similarly, we have seen no evidence that the failure of negotiations with BT was due to a failure to obtain capacity. As noted in paragraph 7.61 above, BT is currently seeking to secure capacity on DTT, and this is the basis of its request for access to Sky's channels.

7.155 As set out in Appendix 2 in Annex 6, there are a number of different scenarios under which Sky could have supplied its premium channels on a wholesale basis to a DTT retailer under the Multiplex licensing regime.

7.156 **Our view:** We conclude that the lack of wholesale supply of Core Premium channels cannot be attributed to capacity constraints.

Security

7.157 In response to our Second Consultation, Sky argued that **[✂]**. It said that ensuring that Sky's channels were distributed in a secure manner was fundamental to Sky's business model, and that it would be irresponsible for Sky to distribute its channels on any platforms that were not secure[928].

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[926] Sky response to Third Pay TV Consultation, paragraphs 6.90 to 6.94.

[927] Sky response dated 8 May 2009 to Ofcom information request dated 20 March 2009, Annex 1.6 and 1.7.

[928] Sky response, Section 5, paragraph 2.42.

7.158 In our Third Pay TV Consultation, we recognised that Sky's concerns about security were genuine, and this was reflected in its internal documents and correspondence with parties including **[✂]**[929]. **[✂]**[930].

7.159 However we noted that Sky has been willing to discuss retail supply on DTT while failing to engage in discussion about wholesale supply, despite security issues arising in respect of both arrangements (i.e. the same Conditional Access system would be used regardless of whether supply was wholesale or retail). **[✂]**[931].

7.160 On the basis of this evidence, we did not consider that Sky's past reluctance to engage in negotiations for wholesale supply could be explained solely by its concerns about security.

7.161 In response to our Third Pay TV Consultation, Sky said that in addition to its own security concerns, Sky needed to comply with onerous security obligations in its agreements with movie studios, and which cover non-Sky platforms used to deliver Sky's movie channels[932].

7.162 Sky reiterated that it had extensively discussed its security concerns with BT and Top Up TV[933]. Sky noted that both BT and Top Up TV still used a version of Nagra which Sky considered to be unsecure. It argued that regardless of whether or not a commercial deal had progressed further, it was clear that Sky would not actually supply its channels until its security concerns were met[934].

7.163 Our review of correspondence between parties does not support a view that the failure of negotiations can be explained by insurmountable security concerns. Indeed Sky conducted detailed negotiations for retail supply, and seeking to address security concerns was a part of these negotiations.

7.164 While we might expect parties to upgrade their security as part of a deal with Sky, we would not expect them to do so prior to negotiating a deal. We also note that Sky did not present security issues as insurmountable when negotiating with Ofcom. As set out at Appendix 2 in Annex 6, Sky stated that it would be necessary for legacy Nagra Mediaguard systems to be upgraded to the more recent Nagra Merlin system, accepting that the latter were capable in principle of providing adequate security.

7.165 **Our view:** We conclude that lack of wholesale supply of Sky's Core Premium channels cannot be attributed to security concerns.

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[929] **[✂]**; Sky response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 3.

[930] **[✂]**.

[931] Sky response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 3; **[✂]**. However it is not clear why Sky would have less control over security as a retailer than as a wholesaler, and this has not been the basis of Sky's arguments to us.

[932] Sky response to Third Pay TV Consultation, paragraph 6.96.

[933] Sky response to Third Pay TV Consultation, paragraph 6.97.

[934] Sky response to Third Pay TV Consultation, paragraph 6.101.

7.166 Looking forward, we take account of Sky's security concerns in Section 9 on the scope of a wholesale must-offer remedy.

Conclusion on reasons given by Sky for failure of negotiations

7.167 Our view is that if Sky had been motivated purely by a desire to maximise its commercial revenues, it might well have sought retail access to other platforms, but, in the light of a clear and widely-held reluctance by other, smaller, providers to agree to such access, it would have pursued, or at least engaged constructively with requests for, wholesale arrangements rather than accepting an ongoing situation in which it was absent from those platforms. In doing so, we would have expected Sky to seek to establish whether other retailers were efficient by offering wholesale prices to them, and also to consider the option of reducing its wholesale price in order to attract more customers. Finally, we would have expected Sky to engage with retailers to seek to resolve capacity and security issues, and that resolving such issues would have been possible.

7.168 We consider that several other retailers have sought to engage with Sky, and that they had, and have, an incentive to reach agreement with Sky as soon as possible. While some regulatory gaming has taken place on both sides, we do not consider that the failure of negotiations can be attributed to the actions of other retailers.

7.169 We conclude that the reasons Sky put forward do not adequately explain the lack of wholesale supply of Core Premium channels.

Sky's incentives

7.170 To this point, we have detailed the failure of negotiations between Sky and others for the wholesale supply of Core Premium channels. We have referred to our view, based on our modelling of retail costs and analysis of the Picnic business model, that Sky's rate-card price would be unlikely to allow a third party retailer to make a positive margin on these channels. We have addressed Sky's other arguments as to why negotiations have failed, namely regulatory uncertainty and gaming, security issues, and capacity issues. We have concluded that none of these factors satisfactorily explains why Sky has not reached agreement with BT, Top Up TV, and A potential IPTV entrant **[✂]** or in the case of off-net supply Virgin Media for wholesale supply of its Core Premium channels.

7.171 We now set out our views on Sky's incentives to wholesale to third parties. In analysing Sky's incentives, we distinguish between:

- Short term commercial **static incentives** which Sky might have to restrict wholesale supply of its Core Premium channels – i.e. the trade-off Sky would face between increased wholesale revenues as new-to-Sky subscribers accessed Sky's channels on other platforms, and the loss of retail margins from existing Sky satellite subscribers switching to other platforms (including lost revenues on other services which Sky bundles with its pay TV channels).

- **Strategic incentives** such as any concern Sky might have that wholesaling its channels to other platforms would weaken its position in relation to competitors – whether in terms of downstream retail presence, or bidding for content rights.

Our position in previous consultations, and earlier responses

7.172 In our Second Pay TV Consultation we said[935] that our ‘vertical arithmetic’ analysis indicated that Sky would have an incentive to supply its Core Premium channels to DTT retailers at prices as low as **[✂]**% below the cable rate-card. We emphasised that this result was purely indicative, and that Sky’s incentives were highly sensitive to its wholesale price.

7.173 In response to our Second Consultation, Sky argued that there was no reason to presume that Sky had a greater incentive to refuse to supply new or smaller pay TV retailers than it did to withdraw its premium channels from Virgin Media[936]. Sky argued that the outcome of Ofcom’s own vertical arithmetic analysis of supply on DTT supported its position that it has an incentive to supply its premium channels to other retailers [937]. Sky agreed that the precise results were indicative rather than definitive, but said they provided no evidence or basis on which to conclude that Sky has an incentive to withhold supply of its premium channels[938].

7.174 In response to our Second Consultation, other retailers, and the BBC, argued that Sky had an incentive to restrict supply. These arguments tended to focus on Sky’s strategic, rather than static, incentives:

- BT said that due to its vertical integration Sky had limited incentives to wholesale those channels to third parties on any basis that would allow those third parties to deliver lower prices and innovation[939].
- BT said the prevention of downstream competition had long-term impacts upstream that were very difficult to quantify, and that Ofcom might understate the incentives for Sky not to provide wholesale services[940].
- Tiscali agreed that Sky had incentives to favour its own retail operation[941].
- Virgin Media said that Sky had no incentive to engage in constructive and timely commercial negotiations, and could be expected to adopt every strategy at its disposal to delay and limit the development of retail competition[942].
- The BBC said that there were a number of incentives which might motivate Sky against supplying its channels to competing retailers and/or competing platforms,

[935] Paragraph 6.112.

[936] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.9.

[937] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.8.

[938] Sky response to Second Pay TV Consultation, Annex 7, paragraph 3.10 (non-confidential).

[939] BT response to Second Pay TV Consultation, Q18.

[940] BT response to Second Pay TV Consultation, Q19.

[941] Tiscali response to Second Pay TV Consultation, page 1 (non-confidential version).

[942] Virgin Media response to Second Pay TV Consultation, paragraph 6.1 (a) (non-confidential version).

in particular the desire to prevent the emergence or growth of potential retail or platform competitors.

7.175 In our Third Pay TV Consultation we agreed with Sky's reading of our Second Pay TV Consultation on static incentives. We noted that our view should be treated with caution as it does not take account of effects such as the risk to Sky's wider retail business of any lost revenue from bundling, or the risk to Sky that any discount offered to DTT retailers would also have to be offered to cable retailers.

7.176 In the Second Pay TV Consultation (Annex 8) we considered various reasons – other than the static commercial incentives described above – why Sky might have a **strategic incentive** to restrict supply. In particular we considered that, in a contest for rights to TV content, a firm which was the leading retailer on a pay TV platform would have an advantage over other bidders, and that this advantage would be greater the larger the firm's subscriber base. In view of this, we considered that Sky would have a strategic incentive to restrict supply in order to prevent rival retailers from bidding against it for content rights, forcing Sky either to pay higher prices for those rights or to lose the rights – and hence, potentially, its wholesale market power in respect of premium content.

7.177 Sky advanced a number of criticisms of our view that it had a strategic incentive to withhold supply from new wholesale customers[943]:

- It was inconsistent with Ofcom's view that Sky was able easily to win all available content rights in which it was interested.
- Sky would be incurring a significant loss in wholesale revenue in the hope that, at best, it can secure a small saving in the amount it pays for rights.
- According to Ofcom's view, Sky only gains an advantage against retailers who are integrated with platforms, so withholding would lead to no benefit when bidding against the likes of Setanta, ESPN / Disney or the terrestrial broadcasters, amongst others.
- Any platform operator wanting to retail premium channels would be more likely to bid for content rights itself if it did not have wholesale access to Sky's channels.

7.178 In our Third Pay TV Consultation (paragraph 6.63) we said that, taking these points in turn:

- We did not consider it inconsistent to argue that Sky's advantage in bidding for content rights is a significant entry barrier, but also that it has an incentive to prevent an entrant from building up a subscriber base which would eventually enable it to challenge Sky in bidding for content.
- We had seen no evidence that the "saving" Sky secures in the amount it pays for rights – i.e. the difference between what it pays and what it would have to pay if it were bidding against a strong competitor – was small.
- We recognised that restricting supply will not give Sky an advantage in bidding against retailers who are not integrated with platforms, and that this includes some of its strongest current competitors in bidding for rights.

[943] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.15.

- We recognised that Sky's fourth point above may have merit. **[✂]**. However, we considered that this may not necessarily give Sky an incentive to supply channels to wholesale customers other than Virgin Media. Wholesale access could well be a stepping stone to building a sufficient subscriber base in order to be in a position to bid for rights. We said that if wholesale access were withheld from the start, a competitor would find it difficult to become established, and it is unlikely that a completely new entrant would be in a position to challenge Sky in bidding for content.

7.179 We accepted that while a large existing subscriber base might provide some advantage in bidding for rights, it was one of a number of factors that influenced the ability and incentive for a firm to compete aggressively for rights[944].

7.180 However, we considered that Sky's strategic incentives were clear in its strongly demonstrated preference for retailing rather than wholesaling to others[945].

- If it retails, it can benefit not only from its own satellite subscribers, but also from subscribers on other platforms whose customers are less likely to subscribe via satellite. Sky can influence the movement of subscribers between platforms through its retail packaging and pricing, thereby ensuring that it as far as possible locks consumers into its core satellite platform. At the same time it minimises the likelihood that others can strengthen their position in bidding for rights by building a large subscriber base.

- On the other hand, if it wholesales to others, it still gets the wholesale revenue associated with subscribers on other platforms, but loses the control over cross-platform retail packaging and pricing, which means that it faces a greater risk of losing customers from its satellite platform, and it also runs the risk that others may grow to present more of a challenge in competing for rights upstream.

7.181 Our view was therefore that Sky derived two strategic benefits from keeping its retail competitors weak:

- The ability to manage competition between retailers on different platforms, in order to protect the position of Sky's own satellite platform.

- The ability to prevent rival retailers from establishing a strong retail presence, which, as well as being a threat in the retail market, could strengthen their position in bidding for content rights[946].

7.182 We noted that this tied in very clearly with what we saw from the evidence – despite the apparently available wholesale revenue, Sky shows no willingness to enter into a wholesale agreement, instead consistently holding out for a retail deal, even if this leads to a breakdown of negotiations.

7.183 We also cited evidence from our review of internal Sky documents relating to Sky's supply of channels to Virgin Media (described in paragraphs 7.248 to 7.250 below) that Sky weighs short-term revenue considerations against its strategic incentive to

[944] Third Pay TV Consultation, paragraph 6.64.

[945] Third Pay TV Consultation, paragraph 6.65.

[946] Third Pay TV Consultation, paragraph 6.66.

weaken or eliminate Virgin Media as a competitor. We would expect Sky to take a similar approach in deciding whether to supply its Core Premium channels to other retailers.

Responses to our Third Pay TV Consultation

7.184 In its response to our Third Pay TV Consultation[947], Sky argued that Ofcom had moderated its allegation, from saying that Sky had an incentive to restrict supply to saying that it had a strategic incentive to restrict wholesale supply, following our conclusion that Sky did not have a static incentive to restrict supply. Sky said that this change should materially affect Ofcom's conclusions on Sky's overall incentives, but that Ofcom had failed to amend its conclusion[948].

7.185 Sky also argued that in order to demonstrate a strategic incentive it was necessary to identify mechanisms linking short-run conduct with a long-term ability to compete. It said that Ofcom had appeared to acknowledge this in the Second Consultation, but had failed to conduct any such analysis, or to address a CRA paper which Sky submitted and which concludes that "none of the strategic mechanisms identified by Ofcom stands up to closer economic scrutiny"[949].

7.186 Sky argued that it was not sufficient to claim that Sky had strategic incentives not to supply and that, rather, Ofcom would need to show that these strategic incentives were so strong as to outweigh Sky's static incentives to supply. Sky said that having failed to assess the strength of the alleged strategic incentives, Ofcom could not conduct this crucial balancing exercise[950].

7.187 As regards the specific dynamic mechanisms, Sky said that Ofcom appeared to accept, implicitly, that several of its earlier arguments were flawed. Sky noted[951] that in the Third Pay TV Consultation Ofcom referred only to one of the three dynamic mechanisms which it had previously identified, namely the incentive to prevent rival retailers from bidding for content rights. Sky repeated its view that conferring long-term security of supply on other platforms would reduce the risk that rivals would feel the need to bid for rights upstream. In support of this view, Sky cited the views of Premier League, the text of a 2003 internal Sky presentation (see paragraph 7.249), and a statement by the CEO of Virgin Media to the effect that Virgin Media had made the right decision in focusing on the regulatory debate, rather than competing head-on and acquiring premium content.

7.188 Sky said our assertion that a completely new entrant would be unlikely to challenge Sky in bidding for rights was "clearly utter nonsense", and cited Setanta and ESPN as examples of new entrants with no subscriber base or platform, who had competed with Sky for sports rights.

[947] Sky response to Third Pay TV Consultation, paragraph 6.6 to 6.16.

[948] The distinction between "supply" and "wholesale supply" is addressed in paragraphs 7.210 to 7.235.

[949] Sky response to Third Pay TV Consultation, paragraph 6.14.

[950] Sky response to Third Pay TV Consultation, paragraph 6.15.

[951] Sky response to Third Pay TV Consultation, paragraphs 6.28 to 6.31.

7.189 Sky also said[952] that it was illuminating and surprising that Ofcom did not in the Consultation Document make any reference to the further paper by CRA (submitted by Sky in its response to the Second Consultation Document), which examined critically Ofcom's assessment of strategic effects and concluded that none of the strategic mechanisms identified by Ofcom stood up to closer economic scrutiny.

Our view

7.190 Our view remains that Sky has a static incentive to wholesale to DTT retailers, although again we note that this should be treated with caution due to factors excluded from our 'vertical arithmetic' calculations, as set out in paragraph 7.175 above.

7.191 However, the evidence from negotiations set out above shows a strong reluctance on Sky's part to negotiate a wholesale deal. Indeed Sky has only offered to wholesale to third parties when there has been a prospect of regulatory intervention if it did not do so, and its only existing wholesale supply (to cable firms, primarily Virgin Media) is to firms from which it could not withdraw supply without a considerable risk of regulatory intervention.

7.192 To the limited extent that Sky enters in to any discussion as to wholesale pricing, these centre on the prices which Sky currently set to Virgin Media via the rate-card. None of the negotiations which we reviewed have led to Sky offering prices below the rate-card for its Core Premium channels.

7.193 We do not believe it to be a reasonable expectation for retailers other than Sky to be prepared to pay the rate-card price for Sky's Core Premium channels, as these prices would not allow them to compete effectively. This is shown by our pricing analysis, as set out in Section 10. A plausible competitor would not be able to generate a return which would cover its cost of capital over a 10-year period plus a terminal value if paying the current rate-card price. The rate-card prices are close to what we would expect under an ex post margin squeeze test – i.e. assuming Sky's own scale. No entrant would have Sky's scale; nor would we expect it to be able to reach Sky's scale, given Sky's current subscriber numbers relative to the likely number of total pay TV households in the UK.

7.194 Sky's approach to supplying Virgin Media, set out in paragraphs 7.248 to 7.259, provides further evidence of Sky's reluctance to supply as a wholesaler. Sky does not appear to consider the scope to increase wholesale revenues by setting a lower wholesale price to Virgin Media. In addition, Sky initially responded to requests by Virgin Media for HD and interactive versions of its Core Premium channels by raising security issues and proposing a retail arrangement (i.e. similarly to its response to request for supply by other providers) even though Sky already has a wholesale arrangement with Virgin Media for its SD Core Premium channels (see paragraphs 7.299 to 7.311 below).

7.195 When it is clear that a third party will not accept a retail deal, Sky has allowed negotiations to break down rather than seeking to negotiate terms for wholesale supply. On the basis of this evidence, we consider that if there is no prospect of a third party agreeing a retail deal, Sky would rather be absent from that party's platform indefinitely than agree to a wholesale deal.

[952] Sky response to Third Pay TV Consultation, paragraph 6.14.

7.196 In our view, the essence of Sky and CRA's criticism is that we have not demonstrated the presence of a specific dynamic mechanism which would unambiguously give Sky an incentive to restrict supply.

7.197 Our Second Pay TV Consultation discussed a number of mechanisms which were put forward as explanations of Sky's behaviour, notably that:

- A bidder that is vertically integrated with the leading retailer on the platform with the greatest number of likely subscribers to a Core Premium channel is able to access those subscribers more efficiently; it is thus in a stronger position than vertically integrated bidders on other platforms or independent bidders[953].

- If bidders for rights are more evenly matched (e.g. in terms of their retail presence) then there is a greater possibility that a proportion of key rights will be won by a firm other than Sky. This could lead to an increase in competition between wholesale suppliers of Core Premium channels[954].

- Refusing to supply premium content to rival retail platforms diminishes the total size of those platforms' subscriber bases. As a result, those platforms lose economies of scope between retailing basic-tier and premium packages i.e. their average costs increase, placing them at a competitive disadvantage to Sky. [955]

7.198 CRA's criticisms of the mechanisms we discussed are considered in Annex 6. We accept that no one of these possible mechanisms can be demonstrated *prima facia* to be the primary basis of Sky's incentive to restrict supply. We also consider it highly unlikely that they could be quantified, or that the "balancing exercise" proposed by Sky could ever be conducted with an acceptable degree of confidence.

7.199 However, we do not accept Sky's view that such a balancing exercise is crucial to our position. Rather, our view that Sky has a strategic incentive to restrict supply is primarily based on our observation of Sky's actual behaviour:

- Sky has restricted wholesale supply of its Core Premium channels despite having an apparent static commercial incentive to supply them.

- As we have argued above, this behaviour cannot be satisfactorily explained by the commercial and practical rationales that Sky has put forward.

- We have identified credible strategic reasons for Sky's behaviour.

7.200 We therefore conclude that Sky is acting on a strategic incentive to restrict wholesale supply of its Core Premium channels.

7.201 We remain of the view that Sky derives two strategic benefits from keeping its retail competitors weak:

[953] See Second Pay TV Consultation, Annex 8, paragraph 2.36. We also considered that rights prices were likely to be lower where competition between bidders was weaker.

[954] See Second Pay TV Consultation, Annex 8, paragraph 2.38.

[955] See Second Pay TV Consultation, Annex 8, paragraph 2.41.

- The ability to manage competition between retailers on different platforms, in order to protect the position of Sky's own satellite platform. We note in particular that this gives Sky an incentive to prevent a rival establishing a presence on DTT. Similarly, if Sky itself develops a presence on DTT, it will have an incentive to protect its DTT business against rivals, whether on DTT or other platforms.

- The ability to prevent rival retailers from establishing a strong retail presence, which, as well as being a threat in the retail market, could strengthen their position in bidding for content rights. We note that rival retailers may not currently be the strongest challengers for rights, but they could be so in future, making it beneficial for Sky to avoid the risk of them growing to become stronger challengers.

<u>Impact on competition of restricted wholesale supply</u>

7.202 Sky argued that the relevant retail market included pay and free to air television services[956], and that within this market effective competition would not be eliminated if Sky did not offer to wholesale its channels to new retailers. Sky argued that even if the relevant market were limited to retailing of pay TV, effective competition would not be eliminated by a failure to agree wholesale terms with any new retailer, because competition would still exist between Sky, Virgin Media, BT Vision and Tiscali TV.

7.203 As discussed in Sections 5 and 6, we do not accept that the presence of free to air television is sufficient to ensure that Sky faces effective competition. We also consider that, because of the power of Core Premium channels in driving demand for pay TV, the effect on competition of other pay TV providers who do not have access to these channels is relatively limited. As a result, we do not consider that the presence of these other providers and Virgin Media is sufficient to ensure fair and effective competition given our findings above on Sky's restriction of wholesale supply.

7.204 As noted in Section 4, we consider that the pay TV sector is in a period of development, particularly facilitated by IPTV and greater broadband speeds and penetration. This change has the potential to open up choice in technology and services and bring down barriers for consumers and competitors.

7.205 Emerging broadband-enabled platforms and devices, including set-top boxes, integrated digital TVs and games consoles, are giving consumers greater control and convenience through services such as video on demand. Meanwhile, developments such as HDTV and, in the future, 3DTV are enhancing the viewing experience.

7.206 However, consumers' choice of pay TV service continues to be driven by content – and in particular by premium sports and movies channels. As we discuss in the following Section, restricted availability of Sky's Core Premium channels, which remain a key driver of pay TV demand, makes it harder for firms with innovative services to enter the market. As a result, innovative services may be delayed or blocked, to the detriment of consumers.

7.207 Our Third Pay TV Consultation set out our concerns that platform choice is currently limited, and that this will be exacerbated as the potential choice of platforms

[956] Sky response to Third Pay TV Consultation, paragraph 6.124.

increases[957]. It also set out our concerns that lack of access to core premium channels limits the prospects of other firms, their willingness to take risks in delivering innovative services, and their ability to finance such innovation. We noted that Sky was in a much stronger position than any other to be a large-scale innovator, but that it was a mature business with a natural incentive to favour only those innovations which do not threaten its customer base. We considered that this would to inhibit development of, for example, next generation networks and mobile TV services which would otherwise seek to use premium sports and movies content to drive growth[958].

7.208 Sky has argued that Ofcom would need to show that retail supply by Sky on other platforms could be expected to materially harm the competitive process, but that Ofcom has inappropriately sought to demonstrate that if Sky's channels were not available on a third party platform the competitive process is harmed[959].

7.209 Our conclusion remains, on the basis of the analysis above, that the restricted supply of Core Premium channels by Sky is prejudicial to fair and effective competition. The relevant question to address at this point is not whether retail supply by Sky would materially harm the competitive process (which we consider to be already harmed by the restricted supply of Core Premium channels). Rather, it is whether retail supply by Sky would address our conclusion that there is a prejudice to fair and effective competition. We discuss this question below.

Whether Sky retailing on other platforms would address our competition concerns

7.210 Next we consider the important distinction between wholesale and retail supply to other platforms by Sky, and consider whether our concerns would be met by Sky retailing its Core Premium channels on other platforms.

Our position in previous consultations, and earlier responses

7.211 In our Second Pay TV Consultation (paragraph 1.29), we recognised that Sky retailing its channels directly to other platforms was likely to improve the availability of Sky's channels. We also recognised that Sky might have the ability to retail its channels as effectively on other platforms as it did over its own platform. However, while we believed that Sky would prefer to retail rather than wholesale its channels on other platforms, we did not believe that it had the incentive to retail on those platforms as effectively as on its own platform[960]. We said that this view was supported by the available evidence, which suggested that where Sky did retail on other platforms, using its Sky By Wire service, the resulting retail offering was of lower quality, was sold at a higher price than similar offerings on its own platform, and had been taken up by only a small proportion of potential subscribers[961].

7.212 We noted that Sky retailing on other platforms could potentially put the platform operator at a disadvantage even in its basic business, as Sky would have an

[957] Third Pay TV Consultation, paragraph 7.81

[958] Third Pay TV Consultation, paragraphs 7.101 to 7.102.

[959] Sky response to Third Pay TV Consultation, paragraph 6.125.

[960] Second Pay TV Consultation, paragraphs 6.120 to 6.121.

[961] Second Pay TV Consultation, paragraphs 6.122 to 6.127.

opportunity to try to migrate customers to its satellite platform in the event that it stopped retailing on the alternative platform. We also noted that if Sky retails premium sport and movies on another's platform, this deprives the platform operator of some of the pricing flexibility that Sky is able to take advantage of on its own satellite platform[962].

7.213 It was clear that our concerns in the Second Pay TV Consultation related specifically to the restriction of wholesale supply. Indeed, we explained that it was unlikely that a satisfactory answer to our competition concerns would be for Sky to become the only actual or potential retailer of premium channels across all platforms[963]. However Sky's response repeatedly argued that it did not have an incentive to restrict supply to its Core Premium content[964], but it made this argument without distinguishing between wholesale supply and retail supply. In our Third Pay TV Consultation we noted that Sky had failed to have regard to our focus on wholesale supply[965].

7.214 Our Third Pay TV Consultation considered whether retail by Sky on other platforms would have an equivalent effect to retail by other providers[966]. We noted that we would have concerns about a situation where Sky was the retailer across multiple platforms, rather than wholesaling to other retailers. In particular, we noted our desire to see fair and effective competition between retailers on different platforms. We said that Sky would have a weaker incentive to compete aggressively than alternative providers, because the scope for bundling on satellite would give it an incentive to favour the satellite platform. We noted that Sky By Wire and Sky Player appeared to offer evidence of such an effect.

7.215 Sky said its preferred strategy was to maximise revenue from its premium channels by distributing them across all secure platforms[967]. However our review of negotiations with third parties showed that Sky had generally been unwilling to engage in discussion with third party providers about the possibility of wholesale supply, and that Sky consistently linked the potential for wholesale supply with the potential for retailing by Sky. We concluded from this that Sky did not, and would not, assess requests for wholesale supply without linking this to the development of its own retail business.

7.216 In our Third Pay TV Consultation, we said that Sky's satellite offer and Sky By Wire on Tiscali were not directly comparable, in part because the basic channels differed between the packages[968]. Tiscali, in response to our Second Consultation, said that Sky priced its Sky By Wire service too high for Tiscali to achieve any significant take-up[969]. From our analysis of the offers, it was not clear whether Sky By Wire offered

[962] Second Pay TV Consultation, paragraph 6.128.

[963] Second Pay TV Consultation, paragraph 6.2.

[964] See for example Sky response to Third Pay TV Consultation, paragraph 6.6.

[965] Third Pay TV Consultation, paragraph 6.83

[966] Third Pay TV Consultation, paragraph 6.85 to 6.89.

[967] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.2.

[968] Third Pay TV Consultation, paragraph 6.86.

[969] Tiscali response to Second Pay TV Consultation, page 1.

poorer value to viewers than Sky on satellite. However, we noted (as we had in our Second Pay TV Consultation[970]) that the number of Tiscali customers who subscribed to Sky By Wire was small compared to the popularity of Sky's premium channels on satellite, suggesting that the Sky By Wire service was relatively unattractive. Out of **[✂]** Tiscali TV subscribers in June 2008, only **[✂]**% took the Sky By Wire product, while **[✂]**% of Sky satellite customers, and around **[✂]**% of Virgin Media customers, took Sky Sports or Movies.

7.217 In its response, Sky argued that Tiscali prices were generally lower than Sky's, and significantly lower than prices of similar packages retailed by Virgin Media. Sky compared its own Variety pack and that of Tiscali's. It estimated it paid **[✂]** per subscriber per month for the 30 channels which it included and Tiscali did not, and **[✂]** per month (in other packages) for the five channels which Tiscali included and Sky did not[971]. Therefore the cost difference due to the different channel line-up equated to around **[✂]** per subscriber per month. It said its previous analysis had shown that aside from single movies Tiscali prices were between £1.01 and £5.01 cheaper per month, and the difference in basic content was unlikely to undermine this conclusion[972].

7.218 Sky also disputed our view that low penetration of Sky channels on Tiscali's platform was evidence of weak competition by Sky when retailing on other platforms[973]. Sky said that comparisons between platforms were likely to be different over time, and that low penetration may simply reflect Tiscali's immaturity as a platform. It referred back to material provided in its response to our Second Pay TV Consultation in which it indicated that in 2004 nearly half of Tiscali TV (then Homechoice) subscribers took a Sky premium package[974], and that one third of subscribers to Kingston Interactive Television (an IPTV service) subscribed to a Sky premium package retailed by Sky by the end of 2005, when Kingston Communications announced the closure of the service.

Evidence on practical examples of Sky retailing on other platforms

7.219 We have considered two of the longest-standing examples of Sky retailing its Core Premium channels in detail. These are:

- Sky Player – Sky's on-demand service to the PC.
- Sky By Wire – Sky's service offered to TalkTalk TV customers, which Sky has also suggested to other pay TV retailers as an alternative to a wholesale arrangement.

7.220 At launch, **Sky Player** was delivered over the internet for viewing on PCs rather than TV screens. Sky last year launched Sky Player on the Xbox games console and has also struck deals with a TV manufacturer (Cello)and providers of hybrid set-top boxes

[970] Paragraph 6.127.

[971] Sky response to Third Pay TV Consultation, paragraph 6.135.

[972] Sky response to Third Pay TV Consultation, paragraph 6.136.

[973] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.51 to 2.53.

[974] However, Figure 113 below shows that by January 2005 only **[✂]**% of Tiscali's subscribers took Sky By Wire.

(IP Vision and 3 View). The service was previously only made available to Sky satellite subscribers, but is now also available on a stand-alone subscription basis, without a dish. Despite its attractive content, Sky Player has some features which may be generally seen as unattractive to TV subscribers:

- There is some evidence that consumers find PC viewing less attractive than TV viewing. For example, Essential Research recently conducted qualitative research among consumers with different levels of VoD use[975], and reported that "The act of viewing television on a computer screen was universally regarded as less satisfying than on a TV set, owing to factors such as screen size, sound quality and the physical placement of the computer in the household".

- Depending on the user's connection speed, Sky Player's picture quality may be lower than TV. As discussed in paragraph 7.294 in the context of HD services, we consider that, while content is a key driver of demand for pay TV services, where the same content is available on two platforms, other features, including picture quality and the means of viewing content, are likely to be important in driving the platform choice.

7.221 As illustrated in Figure 110, Sky Player packages closely mirror Sky's satellite packages in structure i.e. they require a buy-through from basic. Prices are £2 to £3 cheaper than similar satellite packages. In our view, this is a small discount when one considers the difference in viewing experience between PC and TV, and the fact that Sky Player customers do not receive a free set top box – and may need to upgrade to a higher capacity (and more expensive) broadband package.

Figure 110 Retail prices for Sky Player and Sky's satellite service, January 2010

Sky Player offer	Sky Player price	Sky satellite offer	Sky satellite price
Entertainment Pack	£15.00	1 Mix	£18.00
Entertainment Pack + Movies Pack	£32.00*	1 Mix + Movies Pack	£34.00
Entertainment Pack + Sports Pack	£34.00**	1 Mix + Sports Pack	£36.00
Entertainment Pack + Sports Pack + Movies Pack	£41.00	1 Mix + Sports Pack + Movies Pack	£43.50

Source: http://www.sky.com/quickbuy/build

https://skyplayer.sky.com/vod/content/Home/content/l/l/content/registerEntitlementPack.do?after.login=true

[975] Source: qualitative research conducted by Essential Research, December 2009. The findings were based on twelve focus groups with 7-8 participants in each.

Note: Prices correct at 11 January 2010.

7.222 Turning to **Sky By Wire,** key elements of Sky's arrangement with TalkTalk TV (and previously Tiscali) are as follows[976].

- Sky sets retail prices and the terms on which its channels can be bundled and marketed by Tiscali / TalkTalk TV.

- Tiscali / TalkTalk TV provides transmission and subscriber management services for the channels, and receives **[✂]**.

7.223 In our Second Pay TV Consultation (paragraphs 6.23 to 6.25) we compared Sky's 6 Mix package with Tiscali's Variety Pack. In response, Sky argued that its 1 Mix package was a more appropriate comparator[977]. As Figure 111 below illustrates, on this basis prices on Tiscali for packages including Sky Core Premium channels were between £1.01 and £5.01 cheaper than packages on Sky with the same Sky Core Premium channels.

Figure 111 Comparison between Sky and Tiscali prices as set out in the Second Pay TV Consultation and by Sky in its responses

	Ofcom Second Pay TV Consultation		Sky response to Second and Third Pay TV Consultations	
	Sky	**Tiscali**	**Sky**	**Tiscali**
Basic mix	6 Mix	Variety pack	1 Mix	Variety pack
Basic tier channels	Over 100 pay channels +	8 pay channels +	22 pay channels + 18 time shifted channels	8 pay channels +
On demand	Sky Anytime (Sky+ STB only)	Catch up on demand	Sky Anytime (Sky+ STB only)	Catch up on demand
FTA channels	200 FTA	26 FTA channels+ Freeview	200 FTA channels	26 FTA channels+ Freeview
Phone	- Free evenings and weekends - Line rental	- Free evenings - Line rental	- Free evenings and weekends - Line rental	- Free evenings - Line rental
Broadband	2Mb	8Mb	8Mb	8Mb
Basic only	£27.00	£19.99	£32.00	£19.99
Price – Single Sports	£38.00	£41.99	£43.00	£41.99
Price – single movies	£38.00	£41.99	£41.00	£41.99
Price – Sports Mix	£46.00	£46.49	£51.00	£46.49
Price – Sports Mix and single movies	£50.00	£49.99	£55.00	£49.99

Source: Second Pay TV Consultation, Figure 36. Sky response to Second Pay TV Consultation, Section 5, paragraphs 2.45 to 2.53; Sky response to Third Pay TV Consultation, paragraphs 6.135 to 6.137.

7.224 However, the basic package price on Tiscali was £12.01 cheaper than that on Sky. The inclusion of Sky Core Premium channels substantially reduces the price discount on Tiscali relative to Sky. Put differently, a Tiscali basic subscriber would have to pay substantially more to add Core Premium channels than a Sky basic subscriber. For example, a Sky basic subscriber paying £32 would have to pay an extra £11 to get

[976] TalkTalk TV was previously Tiscali TV, and before that Homechoice (operated by Video Networks).

[977] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.47.

Single Sports, but a Tiscali basic subscriber, paying £19.99 would have to pay an extra £22 for Single Sports. If we use the basic-only price as an indicator of the relative quality, this would suggest that Sky's basic package is of somewhat higher quality than Tiscali (i.e. far more than the 75p suggested by Sky).Figure 112 compares Sky's current prices with those of TalkTalk TV. A basic service on Sky is currently £34, and that of TalkTalk TV is £26.47, a difference of £7.53. When Sky's Core Premium channels are added, TalkTalk's prices are either £1.97 or £5.97 higher than Sky's for all packages. An upgrade to Single Sports would cost an extra £9 per month for a Sky basic subscriber, but an extra £22.50 for a TalkTalk TV subscriber.

Figure 112 Comparison between Sky and TalkTalk prices as of January 2009

	Current prices		
	Sky	**TalkTalk TV**	**Price difference (TalkTalk TV price minus Sky price)**
Basic mix	1 Mix	Variety pack	
Basic tier channels	22 pay channels + 18 time shifted channels	8 pay channels +	
On demand	Sky Anytime (Sky+ STB only)	Catch up on demand	
FTA channels	200 FTA channels	26 FTA channels+ Freeview	
Phone	- Free evenings and weekends - Line rental	- Free evenings - Line rental	
Broadband	10Mb	8Mb	
Basic only	£34.00	£26.47	-£7.53
Price – Single Sports	£43.00	£48.97	£5.97
Price – single movies	£42.00	£47.97	£5.97
Price – Sports Mix	£52.00	£53.97	£1.97
Price – Sports Mix and single movies	£56.00	£57.97	£1.97

Source: company websites

7.225 The figure below illustrates changes in the penetration of the Sky By Wire service on TalkTalk / Tiscali's platform over time. Penetration **[✂]**, but has typically ranged between [less than 15%] **[✂]**% and [less than 15%] **[✂]**% since 2005.

Figure 113 Subscribers to Sky By Wire (any channel) as a percentage of total TalkTalk TV / Tiscali TV customers, 2005-2009

[✂]

Source: Tiscali response of 1 April 2009 to information request of 20 March 2009 and TalkTalk response of 21 January 2010 to information request of 29 October 2009.

Our view

7.226 We continue to take the view that Sky retailing widely on all platforms would not satisfactorily resolve our concerns about restricted distribution of Sky's Core Premium channels.

- Put most simply, it would not ensure fair and effective competition between retailers on different platforms, delivering choice, innovation and competitive prices to consumers, as there would only be one retailer of these important channels across platforms.

- In particular, Sky, as a retailer on non-satellite platforms, would have a weaker incentive to compete than alternative providers. The reason for this is that Sky would be likely to have more capacity and functionality on its own satellite platform than on other platforms, giving it more scope to sell bundled services on satellite.

- From a consumer perspective, a choice of Sky retailing on one platform vs. Sky retailing on another platform represents only a partial choice (i.e. of platform, but not of retailer).

- Having several retailers delivering pay TV services to the same consumer risks losing efficiencies for example from bundling and economies of scope.

7.227 These concerns are borne out by the evidence we see from the two practical examples we have focused on here – Sky Player and Tiscali / TalkTalk TV / Sky By Wire.

7.228 The evidence from Sky Player supports the view that if Sky retailed on other platforms, it would take care not to offer a more attractive package (in either quality or price) than was available on its satellite platform. An independent retailer would not face such a constraint. If Sky Player were competing independently against Sky's satellite offer (or if an independent wholesaler were seeking to maximise its revenues from supplying both platforms), we would expect the price difference to be greater, given the smaller range of channels, PC-only distribution, lack of a free set-top box and lower quality picture of Sky Player.

7.229 The relatively high prices which Sky sets for its channels on Sky By Wire on TIscali / TalkTalk TV's platform, **[✂]**, also support this view.

7.230 Sky has consistently set unattractive prices for Sky By Wire on Tiscali / TalkTalk TV relative to similar bundles on Sky's satellite platform. The much higher mark-up for premium channels than on Sky is not explained by cost differences – **[✂]**.

7.231 Sky argued that price comparisons between Tiscali and Virgin Media were more relevant than between Tiscali and Sky[978]. However, we do not consider that such a comparison provides any insight into whether prices on other platforms would be lower with Sky as a wholesaler or with Sky as a retailer. This is because in our view Virgin Media's retail prices for packages including Sky Core Premium channels are strongly affected by the wholesale prices which Sky charges Virgin Media for those channels. As we note below, we consider that the terms of Sky's existing supply to Virgin Media have the effect of weakening Virgin Media's ability to compete effectively with Sky. Virgin Media's retail prices are a reflection of the wholesale prices it pays to Sky. As such, Virgin Media's retail prices cannot be used as a benchmark for retail prices that would prevail if Core Premium channels were supplied through a wholesale arrangement in a manner that ensured fair and effective competition.

7.232 We can see the effect of these relatively unattractive prices in the penetration of Sky By Wire channels on Tiscali / TalkTalk TV's platform:

[978] Sky response to Third Pay TV Consultation, paragraph 6.137.

- Penetration has been consistently low, averaging **[✂]**% over the period from the beginning of 2005 to October 2010. The latest figure stands at **[✂]**%. During the period, the monthly figure has never been more than **[✂]**%. This is very low compared to penetration on Sky's satellite platform, which has consistently been well above 60%. Even on Virgin Media's cable platform, where penetration has declined consistently in recent years, the figure is currently **[✂]**%.

- None of Sky's arguments as to why penetration may be lower convinces us that Sky By Wire is competing vigorously with Sky on satellite and that some other factor is keeping take-up low. The argument that penetration varies over time seems not to explain the issue, as although penetration has varied between **[✂]**% and **[✂]**%, it has never risen to be anywhere near penetration on Sky's own platform, remaining less than a fifth of satellite penetration since at least January 2005. The figures quoted by Sky for penetration in 2004 differ significantly from those provided by Tiscali / TalkTalk TV. Finally, the idea that penetration reflects Tiscali / TalkTalk TV's immaturity as a platform is not credible given that we can see such low penetration persisting over a five-year timeline. While total subscribers may be low (and indeed have generally been low for Tiscali / TalkTalk TV – peaking at **[✂]**) we see no reason why penetration to a particular service, as a proportion of total subscribers on the platform, should be low in the early stages of a platform's development.

7.233 We note the evidence from other parties which indicates that any attempt to mandate access to Sky as a retailer on platforms operated by its retail competitors would face strong resistance from those competitors, and give rise to the practical issues described in paragraph 7.94 (although these would not arise if Sky were the platform operator).

7.234 We conclude that Sky retailing premium channels across multiple platforms, rather than wholesaling to other retailers, would not address the prejudice to fair and effective competition resulting from Sky's restricted wholesale supply of Core Premium channels.

Supply of Sky's Core Premium channels to cable TV providers

7.235 As noted in paragraph 7.34, Sky currently supplies its Core Premium channels to Virgin Media, Wight Cable and Smallworld. We focus on supply to Virgin Media, which is the only major UK cable provider. In this sub-section, we address the following issues:

- Whether Sky has an incentive to withdraw supply of its standard definition (SD) Core Premium channels to cable firms, or supply them in a way that limits Virgin Media's ability to compete fairly and effectively. We discuss our revisions of our Vertical Arithmetic model following responses to the Second Pay TV Consultation. We consider Sky's reasons for supplying Virgin Media and review relevant internal documents.

- How Sky's rate-card prices are set, their effect on Virgin Media's incentives, and the impact on competition.

- Whether Sky has sought to avoid supplying its premium HD and interactive content to Virgin Media, and if so whether this is prejudicial to fair and effective competition.

- The low penetration of Core Premium channels on Virgin Media compared to satellite.

7.236 Virgin Media's negotiations with Sky for Offnet delivery of Sky's Core Premium channels are set out in Figure 108 above, and included in the subsequent discussion of Sky's response to requests for new supply.

Sky's incentives to supply to Virgin Media

7.237 There are several possible aspects to the question of Sky's incentives with regard to supplying Virgin Media:

- Whether Sky is likely to withdraw wholesale supply in the foreseeable future.
- Whether Sky would have an incentive to withdraw wholesale supply from Virgin Media if it could do so without the risk of regulatory intervention.
- Whether Sky has an incentive to restrict Virgin Media's ability to attract subscribers to Core Premium channels, via the terms of its wholesale supply.

7.238 By way of context, we have seen no evidence that Sky is likely to withdraw wholesale supply to Virgin Media in the foreseeable future. Sky currently considers itself under a must-supply obligation as regards Virgin Media[979]. Whether Sky would supply Virgin Media in the absence of this obligation is unclear, and depends on the terms of supply. We therefore focus on the questions of whether Sky would have an incentive to withdraw supply in the absence of regulatory risk, and whether it has an incentive to limit Virgin Media's ability to compete, particularly through pricing and the non-supply of HD and interactive services

Sky's incentive to withdraw supply from Virgin Media

Our position in previous consultations

7.239 In our Second Consultation, we considered that Sky had an incentive to withdraw the wholesale supply of its Core Premium channels from Virgin Media, based on our Vertical Arithmetic analysis, which estimated the impact of such a withdrawal on Sky's wholesale and retail revenues[980].

7.240 In its response to our Second Consultation, Sky argued that the prospect of Sky withdrawing its premium channels from Virgin Media was remote[981]. Sky argued that it had supplied cable operators prior to a regulatory obligation to do so, that it would be subject to significant regulatory risk if it were to withdraw its premium channels from Virgin Media without objective justification, and that such withdrawal would result in immediate commercial loss and adverse publicity[982].

[979] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.6(b).

[980] Second Pay TV Consultation, paragraph 6.96.

[981] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.7.

[982] Sky response to Second Pay TV Consultation Section 5, paragraph 2.6.

7.241 Sky also argued that the effect of past competition enquiries into Sky's business was that Sky "already operated under a de facto 'must supply' requirement in relation to cable".[983]

7.242 In our Third Pay TV Consultation we noted that in light of this de facto must supply arrangement, we could not interpret the fact of Sky's current supply to Virgin Media as evidence of an ongoing commercial incentive to supply, whatever may have been its original incentive in the 1990s[984]. In particular, we could not regard it as evidence that Sky currently had a commercial incentive to supply Virgin Media which outweighed any strategic incentive to withdraw supply. We noted that the terms on which cable operators were initially offered Sky's channels prompted intervention by the OFT.

7.243 We revised our Vertical Arithmetic analysis in the light of criticisms from Sky (summarised below). On the basis of our revised estimates, we accepted that Sky appeared to have a positive static commercial incentive to supply Virgin Media[985].

7.244 However, we also presented documentary evidence, which in our view strongly indicated that Sky had an incentive to limit Virgin Media's effectiveness as a retail competitor[986].

Vertical arithmetic

7.245 Sky criticised the part of Ofcom's vertical arithmetic model which analysed the effects on Sky's revenues on supplying or withdrawing supply from Virgin Media[987]. Among other points, Sky argued that:

- **[✂]**.
- **[✂]**.
- Even if long-term switching were to occur, withdrawal of supply would be initially loss-making, and would only be profitable over a long time, which would not be attractive to Sky given market uncertainty.
- The figures in the model indicated a net increase in premium channel subscribers if it withdrew supply, which was unlikely in practice.

7.246 Our Third Pay TV Consultation presented a version of our Vertical Arithmetic analysis which had been revised in response to earlier criticisms from Sky[988]. The revised analysis showed that if Sky withdrew its Core Premium channels from Virgin Media the impact on Sky's revenues would be negative for up to 12 years (a longer period than we had previously estimated). This suggested that, at current prices, Sky was

[983] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.6(b).

[984] Third Pay TV Consultation, paragraph 6.101.

[985] Third Pay TV Consultation, paragraph 6.99.

[986] Third Pay TV Consultation, paragraph 6.103 to 6.105.

[987] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.11, pages 64 to 66.

[988] Third Pay TV Consultation, paragraph 6.99.

likely to have a stronger incentive to supply to Virgin Media than we had previously estimated. However, we noted that:

- The prices at which Sky supplies to Virgin Media, discussed below, are an important factor in this calculation: Virgin Media has argued that at current prices it does not have an incentive to compete aggressively in the retail of Core Premium channels[989]. If Sky were required to supply to Virgin Media at a lower price, its wholesale revenues could increase or decrease (depending on whether the lower price attracted a sufficiently greater volume of new cable subscribers to counter the lower per-subscriber price), but its revenues as a retailer would tend to decrease if this led to switching from Sky to Virgin Media.

- Our Vertical Arithmetic analysis merely compares revenue streams from wholesaling and retailing. It does not take account of Sky's strategic incentives.

7.247 We have not carried out any further revisions to this analysis. We remain of the view that, in static commercial terms, it indicates that Sky has an incentive to supply to Virgin Media, subject to the caveats set out above.

Documentary evidence of Sky's incentives

7.248 Our Third Pay TV Consultation described documents which Sky disclosed during High Court proceedings[990], **[✂]**.

7.249 **[✂]**:

> **[✂]**.

7.250 **[✂]**:

> **[✂]**[991].

7.251 In response to our Third Pay TV Consultation, Sky said[992] that Ofcom had considered that "two of the many thousands of Sky internal documents that have been provided to Ofcom" suggested that Sky weighed static incentives against a strategic incentive to weaken or eliminate Virgin Media. It said that neither document was evidence of such a proposition.

7.252 Sky argued that the first document was visibly in early draft form, and said it was never circulated or shared with any of Sky's senior management. It said that the first two quotes above related to static incentives, and that the reference to finishing off cable was not linked to Sky's wholesale strategy. It said that the document was suggesting that Sky should compete very aggressively at the retail level, not to modify its wholesale strategy of supplying its premium channels to cable. It said the document made no link between Sky's wholesale strategy and retail competition.

[989] Virgin Media response paragraph 6.12, 6.13.

[990] Sky High Court documents, disclosed to Ofcom in October 2008. Third Pay TV Consultation, paragraph 6.103 to 6.105.

[991] **[✂]**.

[992] Sky response to Third Pay TV Consultation, paragraph 6.18.

7.253 We would not expect Sky to set out such views in many of its internal communications. As regards the first document, while it is clearly not in final form, neither is it obviously an early draft as Sky claims. We do not consider that we can reliably ascertain which Sky employees saw or contributed to it.

7.254 As for its content, we consider that the first two quotes above are important evidence that Sky has an incentive to prevent Virgin Media from operating as an effective retail competitor, whether that is primarily due to static or strategic considerations. In particular, **[✂]**. We consider that this contradicts Sky's assertion that the document does not link wholesale and retail concerns. Indeed, given the apparent wish to eliminate competition from cable, it would be surprising if Sky did not make such a link. The document identifies **[✂]**. This is the context in which "finishing off" cable is discussed. The reasons for such a wish are indicated in a further quote from this document:

> "**[✂]**".

7.255 Sky argues that the second document concerns Sky1 and is therefore not relevant to a discussion of premium channels. It also argues that the document is discussing static, rather than strategic incentives.

7.256 We recognise that a static calculation relating to Sky1 would not be informative of Sky's incentives with regard to Core Premium channels. **[✂]**. In addition, in our view the fact that Sky is concerned about non-exclusivity of Sky1 (and willing to forego wholesale revenues to protect this exclusivity) suggests that it would be even more concerned about a loss of exclusivity in the supply of Core Premium channels which are the key drivers of demand for pay TV subscriptions.

7.257 Sky argued that this evidence was outweighed by Sky's actual behaviour around this time, in seeking to negotiate the terms of wholesale supply agreements with ntl and Telewest which would have rewarded uplifts in the sales of Sky's channels with reductions in Sky's rate-card prices. We consider this issue under the following heading.

7.258 Finally, Sky argued[993] that it was not clear how Virgin Media would be weakened if a significant number of Virgin Media customers took a basic-only service as a result of Sky's wholesale pricing. Sky said[994] there was no suggestion (and there is no plausible reason why this might be the case) that this loss might be mitigated because these basic only subscribers, who could have elected to take premium channels from Virgin Media, would somehow be more likely to switch to Sky.

7.259 In contrast to Sky's position, we consider that if Virgin Media is unable to offer packages which include Sky's Core Premium channels at a price which is competitive with satellite, Virgin Media will face considerable difficulty in attracting pay TV subscribers with an interest in these channels. This is likely to lead both to Virgin Media customers switching to Sky, and to new-to-market customers choosing Sky over Virgin Media. We asked Sky to provide us with any relevant strategy documents relating to the supply or potential supply of its Core Premium channels to Virgin Media or other cable retailers since January 2006. **[✂]**[995]. We take this as

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[993] Sky response to Third Pay TV Consultation, paragraph 6.26.

[994] Sky response to Second Pay TV Consultation, Section 5, paragraph 2.28.

[995] Sky response (14th April 2009) to final Ofcom information request, question 6.

indicating that Sky has not reconsidered its strategy towards supplying its Core Premium channels to cable retailers in more than three years. This is consistent with Sky's view that it is under a *de facto* must supply arrangement (see paragraph 7.241 above).

Pricing of Sky's Core Premium channels to Virgin Media

Previous consultation

7.260 In our Third Pay TV Consultation (paragraph 6.110), we said that Sky charged Virgin Media the highest prices which Sky believed met the conditions of a margin squeeze test, leaving Virgin Media with limited incentive to promote Sky's Core Premium channels to its customers. We reasoned that as a result, people with a strong demand for these services were more likely (and increasingly likely over time) to choose satellite, and that Sky's reluctance to supply services such as HD tended to exacerbate this effect. We therefore considered that Sky's approach to the wholesale supply of Core Premium channels created a position in which there was not, and there was not likely to be, fair and effective competition in the wholesale of Core Premium channels and the retail supply of bundles which included Core Premium channels.

7.261 We consider Sky's approach to pricing in this sub-section, and the effect of this on Virgin Media's incentives in the following sub-section.

Sky's approach to wholesale pricing

7.262 Sky told us that since 2002 it had continued to supply cable operators at a price which it believed was compliant with the test laid down by the OFT[996]:

> **[✂]**.

7.263 In our Third Pay TV Consultation, we noted that the threshold at which a margin squeeze abuse occurred was necessarily high. In other words, rather than entering into negotiations to establish a mutually beneficial price, our understanding was that Sky has, for the past seven years, been setting its price level by calculating the price just below an abusive price, as determined by the OFT in 2002. We said that Sky appeared to present the margin squeeze price as a floor beneath which it would not negotiate, either with cable retailers or others.

7.264 In its response to our Third Pay TV Consultation[997], Sky said that it did not suggest that its prices were just sufficient to pass the range of prices in the OFT's test. It described this claim as objectionable. Sky said that its wholesale prices comfortably passed the range of prices in the OFT test, and estimated that its retailing business had earned at least £**[✂]** above the OFT threshold over the last eight years.

7.265 In November 2008, Ofcom asked Sky **[✂]**[998]. **[✂]**[999].] Following its response to the Third Pay TV Consultation, and in the context of the arguments from Sky in the

[996] Sky response of 28 July 2008 to information request of 2 July 2008.

[997] Sky response to Third Pay TV Consultation, paragraph 6.110.

[998] Ofcom information request, 12 November 2008, question 6.

[999] Sky response dated 9 December 2008 to Ofcom information request dated 12 November 2008, question 6.

paragraph above, Ofcom asked Sky to provide supporting evidence for its assertion that its rate-card comfortably passed the range of prices in the OFT test, **[✂]**[1000]. **[✂]**.

7.266 In response, Sky **[✂]**[1001]. **[✂]** (see paragraph 7.264). Our own calculations indicate that Sky's rate-card price is close to the maximum it could charge while meeting the test.

7.267 As noted above, Sky told us that in 2003/04 it sought to negotiate the terms of wholesale supply agreements with ntl and Telewest which would have rewarded uplifts in the sales of Sky's channels with reductions in Sky's rate-card prices. Sky said that Telewest declined to enter into the agreement due to an unspecified concern, but that by the end of 2003 Sky had "reached the point at which it was prepared to agree in principle a discount structure for Telewest (subject to regulatory comfort being given)"[1002]. In 2004 Sky conducted similar negotiations with ntl, but Ofcom did not provide Sky with the legal comfort it needed and Sky concluded that "it would not be prudent to enter into the proposed agreement with ntl and risk subsequent censure"[1003]. Sky said it also offered to wholesale Sky Sports Xtra to ntl and Telewest in 2003, and reached agreement with both.

7.268 Virgin Media had no copies of external correspondence relating to these discussions between Sky and Telewest, although **[✂]**.[1004]

7.269 As regards negotiations with ntl, Virgin Media told us that:

> "**[✂]**"[1005].

Effect of wholesale pricing on Virgin Media's incentives

7.270 Virgin Media told us that, as a result of Sky's high wholesale prices, it made a negative margin on Sky Sports, reducing the value of a "base offer" subscriber by around 17%, while subscription to Sky Movies increased the value of such a subscriber by 5%, which Virgin Media described as "marginal"[1006]. Figure 114 provides weighted average incremental retail prices for Sky's Core Premium channels on Virgin Media, compared to the wholesale price, and the resulting margin available to Virgin Media. This is consistent with the view that Virgin Media earns a negative incremental margin for Sky Sports, a small positive incremental margin for Sky Movies, and a negative incremental margin for a combined package.

[1000] Ofcom information request dated 29 October 2009.

[1001] Sky response dated 13 November 2009 to Ofcom information request dated 29 October 2009, question 4.

[1002] Sky response to Third Pay TV Consultation, paragraph 6.22.

[1003] Sky response to Third Pay TV Consultation, paragraph 6.23.

[1004] Virgin Media response dated 1 December 2009 to information request dated 29 October 2009, question 5.

[1005] Ibid.

[1006] **[✂]**.

Figure 114 Incremental price, rate-card and margin of Sky's packages on Virgin Media

	Price increment (£)	Wholesale rate-card charge (£)	Margin over wholesale rate-card (£)
Sky Sports Mix	17.89	20.39	-2.50
Sky Movies Mix	16.95	16.59	0.36
Sky Sports Mix & Sky Movies Mix	23.49	25.40	-1.91

Notes: Excluding VAT at 17.5%, weighted average across Virgin Media's packages

The rate-card price of Sky Sports Mix includes the price of Sky Sports Xtra which is charged as a separate price.

Prices and subscriber numbers are for Virgin Media's M, L and XL digital products. Prices and subscriber numbers for analogue, legacy and other packages are not included in this calculation. Prices are as of January 2010. Subscriber numbers are as of June 2009.

7.271 Figure 115 shows that Virgin Media's incremental prices are considerably higher than Sky's for its M package. Figure 117 shows that the additional price of Sky Core Premium channels is lower for Virgin Media's XL customers than for its M package customers, although they are still higher than the additional price to Sky customers.

Figure 115 Package prices for Sky (1 Mix) and Virgin Media (M)

	Sky	Virgin Media (with phone or broadband)*	Virgin Media (as stand alone TV)*
Basic	£18.00	£5.50	£11.50
Basic + Sky Sports	£36.00 (+£18)**	£29.50 (+ £24)	£35.50 (+£24)
Basic + Sky Movies	£34.00 (+£16)	£32.00 (+£26.50)	£38.00 (+£26.50)
Basic + Sky Sports and Movies	£43.50 (+£25.50)	£39.00 (+£33.50)	£45.00 (+ £33.50)

Notes: Prices correct as of March 2010. Packages are not directly comparable. Sports and Movies refer to Sky Core Premium Channels.

Based on a Sky entry level basic pay TV package of £18 per month.

Based on a Virgin Media's M+ pay TV package (and excludes a phone line).

Figure 116 Package prices for Sky (6 Mix) and Virgin Media XL

	Sky	Virgin Media (with phone or broadband)*	Virgin Media (as stand alone TV)*
Basic	£23.00	£23.00	£29.00
Basic + Sky Sports	£41.00 (+£18)**	£43.50 (+ £20.50)	£49.50 (+£20.50)
Basic + Sky Movies	£39.00 (+£16)	£42.50 (+£19.50)	£48.50 (+£19.50)
Basic + Sky Sports and Movies	£48.50 (+£25.50)	£50.50 (+£27.50)	£56.50 (+ £27.50)

Source: Ofcom, company websites

Note: Updated 22 February 2010

** For Virgin Media's XL*

***Figures in parentheses show additional cost above basic package prices*

7.272 Sky argued[1007] that a third party platform operator did not have the same incentives as Sky to invest in marketing Sky's channels, and that this could be exacerbated where the third party had higher margin products such as telephony and broadband.

7.273 In our Third Pay TV Consultation[1008], we noted that Virgin Media's view was supported by the evidence that:

- If one of its basic customers upgraded to Sky Sports, the value of that customer would fall by around 17%.
- Reflecting this, Virgin Media offered its sales staff much lower commission (one "sales commission point") for adding Sky Sports or Movies than for selling a basic package (six points) or upselling to its XL TV package (ten points).

7.274 We also presented a comparison of the incremental price of Sky Core Premium channels on Virgin Media and the rate-card charge for these channels, which supported Virgin Media's assertion that it earned a negative (incremental) margin on these channels[1009]. A comparison of Sky and Virgin Media's retail prices showed that the incremental retail price of packages including these channels was higher on Sky than on Virgin Media.

7.275 Sky said[1010] that even if it set prices which Ofcom considered to be high, the reason was to maximise revenues, not to restrict supply. It said Ofcom's inference that Sky's

[1007] Sky response to Pay TV complaint, October 2007, paragraphs 4.17(b) and (c).

[1008] Paragraph 6.113.

[1009] Third Pay TV Consultation, paragraph 6.114.

[1010] Sky response to Third Pay TV Consultation, paragraphs 6.108, 6.109.

prices were set so that Virgin Media did not have an incentive to market Sky's channels appeared to be based on our belief that Sky's prices just met the conditions of a margin squeeze test, and our claim that Sky acknowledged that Virgin Media did not have an incentive to market these channels. It said neither of these statements had any basis in fact.

7.276 In our pricing analysis, wholesale prices calculated using an approach similar to the OFT's 2002 margin squeeze test, are on average above Sky's current wholesale rate-card[1011]. This calculation is based on Sky's scale. Virgin Media, by contrast, has fewer than **[✂]**% of Core Premium channel subscribers[1012] (albeit that Sky and Virgin Media have a similar number of basic subscribers). We recognise that Sky did not say that third party retailers (such as Virgin Media) did not have an incentive to invest in Sky's channels[1013], but rather that they did not have the same incentive as Sky. Sky said this was because Virgin Media incurred an incremental cost per subscriber for selling Sky's channels, whereas Sky incurred no such incremental cost. (This is the double marginalisation effect, described in paragraph 4.88).

7.277 We recognise that any wholesale supply arrangement will give rise to weaker incentives to sell to marginal customers than a vertically-integrated firm would have (because of double marginalisation). However, given the high fixed costs at wholesale level, we would expect a vertically-separate wholesaler to have a strong incentive to expand the market. As such, we would expect such a wholesaler to set prices to Virgin Media which would maximise revenues, taking account of the risk of cannibalisation from satellite. It would not set satellite retail prices and then use those prices to calculate wholesale cable prices according to a margin squeeze test.

7.278 Sky said[1014] that it had acquiesced to a proposal by Virgin Media to provide Sky's premium channels to UK residential customers via a Luxembourg subsidiary of Virgin Media. Sky argued that this showed it had supported actions which increased Virgin Media's incentives to invest in marketing Sky channels. Sky has not argued that it faced any costs as a result of this change of arrangement. Nor did Sky mention any objective reason it could have given for refusing Virgin Media's request. While it appears that Sky did not unreasonably obstruct Virgin Media in this matter, we do not see this as positive evidence that it has attempted to strengthen Virgin Media's incentives to market Sky's channels.

7.279 Sky further argued that Virgin Media's particularly poor recent performance in selling Sky's Core Premium channels was likely to have been due in part to a focus on other priorities, such as restructuring its debt, rebranding its services, upgrading its network, launching 50Mbps broadband, improving customer services, consolidating its billing system and integrating Virgin Media Mobile[1015].

7.280 It is not clear how the efforts of Virgin Media's sales staff in selling Sky channels has been affected by the company being focused on other priorities. Indeed, if one of these priorities has been to improve customer services, one might have expected this

[1011] See Figure 115 in Section 10.

[1012] As at June 2009.

[1013] We erroneously attributed this view to Sky in paragraph 6.111 of the Third Consultation.

[1014] Sky response, footnote 98.

[1015] Sky response to Third Pay TV Consultation, paragraph 6.113.

to lead to greater success in upselling additional channels. Nor has this apparent lack of focus led to a reduction in Virgin Media's broader customer base.

7.281 Despite its claim that Virgin Media's focus has been on other priorities, Sky argues that Virgin Media undertakes significant marketing of Sky's premium channels in order to attract new customers[1016]. In support of this claim, Sky provided us with examples of Virgin Media's recent marketing material.

7.282 Most of the Virgin Media marketing material provided by Sky mentions Sky Sports and Movies, with varying degrees of prominence. This is not surprising given that, as we have argued, this content is a key driver of demand for pay TV. However, we note that in almost all of the marketing material provided by Sky, Virgin Media does not mention the price of Sky's Core Premium channels, but notes that they are available "for an additional monthly charge" (or similar wording). In our view, this approach is consistent both with Virgin Media recognising the need to signal the availability of Sky's Core Premium channels to prospective customers, and with it being unable to promote them at competitive prices. In contrast, recent marketing material from Sky aimed at Virgin Media's customers[1017] highlights a price comparison which includes Sky Movies 1.

7.283 Sky further argued that the profit which Virgin Media makes by upgrading its basic customers is a function of how Virgin Media sets its basic TV pricing. It noted that the price of Dual Sports ranged from £26 per month with Virgin Media's M tier to £19 per month when purchased through the XL tier[1018].

7.284 Sky is correct that the incremental price of its Core Premium channels varies considerably between different Virgin Media offers, as illustrated in Figures 113 and 114 above. However, even Virgin Media's XL package has a higher incremental price than Sky, and this is reflected in substantially lower penetration rates.

7.285 Sky is also correct that Virgin Media's profit from upgrading its basic customers is partly a function of its basic TV pricing. If Sky's wholesale prices are at a level that complies with an ex post margin squeeze test, then it should be profitable for a firm of Sky's scale to supply an equivalent bundle of basic and premium content. In principle, if Virgin Media were of the same scale as Sky, it would be able to match Sky's incremental retail prices for premium channels by cutting the price of its standalone basic packages.

7.286 However, even if Sky passes the margin squeeze test on a bundle which is based on its scale, Virgin Media is likely to struggle to compete at this wholesale price because of its smaller scale. As we have explained above, any competitor – Virgin Media included – would be unlikely to be able to achieve Sky's current scale, given Sky's current share of the market. There is only room in the market for one firm with Sky's current scale.

7.287 Sky told us that it had sought to increase Virgin Media's incentive to sell Sky's premium channels by offering lower wholesale prices in return for improved

[1016] Sky acknowledges that Virgin Media has not made similar efforts to market Sky's premium channels to its (Virgin Media's) basic subscribers.

[1017] "11 reasons to say 'goodbye' to Virgin Media (and 'hello' to Sky), September 2009.

[1018] Sky response to Third Pay TV Consultation, paragraph 6.114.

performance. Sky referred to an earlier document it had sent us[1019] which in turn referred to a 2007 correspondence, initiated by Virgin Media, which sought an "improved relationship in respect of Sky's content".

7.288 **[✂]**[1020]. **[✂]**[1021]: **[✂]**.

7.289 **[✂]**, we note that (a) regulatory approval was not a legal requirement, and in the previous negotiations with ntl and Telewest, Sky's view of the regulatory comfort it needed differed from that of the cable firms, (b) we consider Sky's argument that Virgin Media controls its own basic prices, and therefore its margin on premium channels, to be spurious; and (c) it was impossible for Virgin Media to verify Sky's claim that it was able to make a profit on its own notional wholesale price (and it is also impossible for us to verify this claim: see paragraph 7.265).

7.290 We conclude that the high wholesale prices Virgin Media pays limit its incentive and ability to compete effectively with Sky in selling premium channels, and that this contributes to its low penetration of premium subscribers.

<u>Supply of Sky's HD Core Premium channels and interactive services to Virgin Media</u>

7.291 Our Third Pay TV Consultation noted a further potential concern relating to the non-supply of Sky HD services to Virgin Media[1022]. **[✂]**[1023].

7.292 **[✂]**[1024], **[✂]**.

7.293 As Sky pointed out[1025], in the Second Pay TV Consultation[1026] we noted that the quality of content was of primary importance in attracting viewers. We said that content was more important than platform features (such as EPGs, DVRs, VoD and HD), which added to convenience or, in the case of HD, to technical quality. We noted that if customers did not want to watch a programme, then the ability to watch it in HD would not change their minds.

7.294 In our Third Pay TV Consultation we noted that this view was set out in the context of discussing the importance of premium content, and we continued to see Core Premium content as a key driver of platform choice. However, where the same content was available on two platforms, as Sky's Core Premium content is on satellite and cable, then the customer's choice would be determined by other factors, such as the availability of that Core Premium content in HD..

[1019] Paragraph 5.12 of Annex 5.1 of Sky's Response to the Complaint.

[1020] Sky response to info request dated 17/04/09 Annex 1 question 4.

[1021] Sky letter 30 August 2006.

[1022] Third Pay TV Consultation, paragraph 6.115.

[1023] Virgin Media response to Second Pay TV Consultation, paragraph 7.38.

[1024] Sky response to Second Pay TV Consultation, Section 7, paragraph 8.6.

[1025] Sky response to Second Pay TV Consultation, Section 7, paragraph 8.6.

[1026] Paragraph 3.36.

7.295 In this context, we said, the availability of services such as HD could well make the difference between a customer choosing one platform or another. As such they could be of crucial importance to the competing platform providers.

Evidence of the importance of HD content

7.296 In the course of its response to our Second Consultation, Sky commented that "Such has been the consumer demand for HD that Sky+ HD is the fastest selling additional TV product ever offered by Sky"[1027]. Sky has recently promoted this service with the slogan "High Definition. Now it's for everyone". A recent Sky marketing pamphlet sent to Virgin Media customers[1028] included an illustration comparing the 34 HD channels available from Sky (including Sky's Core Premium channels) with the seven HD channels available from Virgin Media.

7.297 **[✂]**[1029].

7.298 Our 2009 Omnibus Survey indicated that around three in ten Sky HD customers saw HD as crucial. Similarly, three in ten respondents to the survey would not have chosen their pay TV provider (in most cases Sky) if HD services had not been available. Again similarly, two in ten HD customers said they would not consider downgrading to SD even if the price difference went up to £30 a month. These results support the view that a substantial minority of customers see HD as important, and this is likely to mean that having limited HD content would put Virgin Media at a competitive disadvantage[1030].

Negotiations for supply of Sky's HD Core Premium channels

7.299 Sky told us that in March 2009 Virgin Media had sent it a Request for Proposal which stated that Virgin Media was "now keen" to receive proposals from HD content providers.[1031] Sky said it had replied, **[✂]**.

7.300 **[✂]**.

7.301 **[✂]**[1032] **[✂]**.

7.302 Both Sky and Virgin Media provided us with correspondence relating to negotiations between the Sky and Virgin Media and, earlier, Sky and ntl, which included discussion of HD supply, notably:

[1027] Sky response to Second Pay TV Consultation, Section 2, paragraph 2.22.

[1028] "11 reasons to say 'goodbye' to Virgin Media (and 'hello' to Sky), September 2009.

[1029] High Court proceedings.

[1030] Sky said this survey provided no support at all to the view that its HD services were of sufficient importance to warrant regulatory intervention. (Comments by Sky on consumer research undertaken by Ofcom in October and November 2009 (March 2010), paragraph 54). We address Sky's arguments in Annex 6, Appendix 5.

[1031] Sky response to Third Pay TV Consultation, paragraph 6.118.

[1032] Virgin Media response dated 25 November 2009 to Ofcom information request dated 29 October 2009.

- **[✂]**[1033].
- **[✂]**[1034].
- **[✂]**[1035].
- **[✂]**:
  - **[✂]**.
  - **[✂]**.
  - **[✂]**.
  - **[✂]**.

7.303 **[✂]**[1036] **[✂]**.

7.304 Discussions between Virgin Media and Sky are ongoing. At the time of publication no agreement has been reached.

Our view

7.305 **[✂]**.

7.306 In our view, Virgin Media's 2007 request for wholesale supply of Sky's HD channels was a genuine opportunity for Sky to make its HD premium channels available to Virgin Media. Sky's response raised security issues and questioned whether such a deal (either with a wholesale or with a self-retail model) would be worth the endeavour given Virgin Media's public statements ascribing very little value to HD. However, nothing in the response indicates that it would not have been possible for Sky to take advantage of this opportunity had it wished to do so.

7.307 Instead of engaging with this opportunity, Sky's response raised a series of obstacles to a wholesale agreement taking place, and put the onus firmly on Virgin Media to overcome them.

7.308 Moreover, in its written response Sky did not make any concrete proposals, or even suggestions, as to how Virgin Media could address its concerns.

7.309 Likewise it is not clear how Virgin Media could have demonstrated to Sky's satisfaction that sufficient extra revenue would be generated by the proposal, or that Sky would be better off under a wholesale arrangement than a retail arrangement, given the inherent uncertainty of launching a new service.

[1033] Sky response dated 1 December 2009 to Ofcom information request dated 27 November 2009, Annex 7 to Question 27.

[1034] Virgin Media response dated 21 February 2008 to Ofcom information request dated 20 December 2007, Annex 8.

[1035] Sky response dated 17 April 2009 to Ofcom information request dated 20 March 2009, Annex 1, question 4.

[1036] Information request response, 1 December 2009.

7.310 While Sky's response left open the possibility of further discussion of these issues, we consider that it also signalled that Sky would be unlikely to take a constructive approach in any such discussions. Sky's repeated emphasis on a remark made by a Virgin Media executive at a trade conference further indicates its negative view of the proposal.

7.311 Negotiations between Sky and Virgin Media since early 2009 appear to have developed considerably from Sky's position in 2007. However, these have not yet led to agreement, and, as Virgin Media notes, Sky's security concerns have not yet been resolved. It is unclear whether Sky would have an incentive to reach an agreement following the conclusion of Ofcom's market review.

7.312 Our view is that, given the increasing importance of HD as a means of viewing premium content, the non-supply of the HD versions of Sky's Core Premium channels to Virgin Media is and will prevent Virgin Media from competing effectively.

Interactive services

7.313 **[✂]**[1037].

7.314 The red button allows consumers to watch their preferred football match in circumstances where scheduling clashes means that more matches are being played than can be broadcast on linear channels. Sky argues that the impact of this small, since few Premier League matches are only available only through the red button [1038]. However, the situation is different for Champions League matches. Eight Champions League group matches take place on the same evening, to which Sky has the rights to all but one. It is therefore not possible for Sky to show all the matches via the linear channels and Sky shows several each week via the Red Button. These matches are not available to Virgin Media subscribers because the Core Premium channels supplied to Virgin Media do not include interactive capability.

7.315 Our consumer research indicates that Player Cam is of less importance to subscribers, since it does not provide access to a different match. It allows viewers to watch a match from the viewpoint of a particular player.

7.316 Our 2009 Omnibus Survey found that, while 70% of Sky customers did not think red button features were important, 10% would not have chosen Sky if these features had not been available, and 26% would not give them up to save £10 a month. In our view this indicates that, while interactive services are important to a proportion of Sky customers, they are relatively less important than HD services. To some degree, this is reflected in a recent Sky mail shot to Virgin Media customers, which mentions that Sky subscribers can "enjoy different camera angles, various statistics and catch up with match highlights via the Sky Sports interactive button", but which gives less prominence to this service than to HD[1039].

[1037] Virgin Media response to Third Pay TV Consultation paragraph 7.49.

[1038] Sky response to Third Pay TV Consultation, paragraph 9.90 to 9.92).

[1039] Sky argued that the Survey results were unlikely to provide a reliable indication of the value of interactive services to subscribers (Comments by Sky on consumer research undertaken by Ofcom in October and November 2009 (March 2010), paragraph 73). We address Sky's arguments in Annex 6, Appendix 5.

7.317 We consider that Sky's reluctance to allow access to interactive services, in particular to coverage of football matches which are subject to scheduling clashes, is also likely to inhibit the effectiveness of Virgin Media as a competitor to Sky's satellite service.

Outcome among Virgin Media subscribers

7.318 We consider that the level of pricing on the cable rate-card and the availability of additional services together contribute to the fact that subscription to Sky's Core Premium channels is much lower among Virgin Media than Sky customers. In 2008, only **[✂]**% of Virgin Media customers subscribed to Sky premium channels, down from **[✂]**% in 2000. Penetration of Sky premium channels **[✂]** among Sky subscribers, but remains much higher than among Virgin Media subscribers (**[✂]**% in 2008, **[✂]**% in 2002) – and Sky's total absolute number of premium subscribers **[✂]**.

7.319 **[✂]**[1040] **[✂]**.

Figure 117 Number and penetration of subscribers to Sky's premium channels on satellite and cable

[✂]

7.320 As shown in Figure 6 of our Second Pay TV Consultation, the result is that while Sky and Virgin Media have **[✂]** of basic-only customers, Sky accounts for **[✂]** of premium customers.

7.321 We see various different drivers of the difference in penetration between cable and satellite[1041]:

- Some consumers might choose cable in order to take telephony or broadband services; this is likely to have been particularly true in the early period shown in the chart above, when Sky did not offer triple-play bundles. It may be the case that for these people content is of lesser importance than for those people who choose satellite. This is likely to explain some of the difference. However, it does not explain why penetration would have decreased over time.

- Some of the difference in penetration may be due to more people with a strong demand for premium channels choosing satellite in the first place – i.e. content driving the choice of platform – rather than Sky being intrinsically more effective than Virgin Media in promoting premium channels to customers who have already signed up to the platform.

- We can see from retail prices that bundles including Core Premium channels are higher via Virgin Media than via Sky (see Figure 115 and Figure 116 above), suggesting that Sky's offer is more likely to be attractive to new customers.

- For existing basic customers, the incremental price of Core Premium channels is higher, making it less immediately attractive for a customer to add Core Premium channels. As we have set out, Virgin Media appears not to have a strong incentive to try to sell Core Premium channels to existing basic subscribers.

[1040] Telewest merged with ntl in 2006, and the merged firm was rebranded as Virgin Media in 2007.

[1041] Sky argued that our 2009 Omnibus Survey confirmed that Virgin Media was able to compete effectively with Sky. (Comments by Sky on consumer research undertaken by Ofcom in October and November 2009 (March 2010), paragraph 38). We address Sky's arguments in Annex 6, Appendix 5.

7.322 **[✂]**.

Our view

7.323 Our view is that Sky is deterred from withdrawing supply to Virgin Media by the prospect of lost wholesale revenues from an established customer base, and regulatory risk.

7.324 However, although the likelihood of withdrawal of supply may be low, we are concerned about the effect on competition of a number of features of Sky's existing supply to Virgin Media. This view is based on:

- Internal documents from Sky indicating that it has an incentive to weaken Virgin Media's effectiveness as a competitor.
- Sky's wholesale prices are, in our assessment, close to the highest Sky could charge while passing a margin squeeze test based on Sky's scale. Virgin Media's scale is much smaller than Sky's, so it is unsurprising that prices set on such a basis do not allow Virgin Media to compete effectively with Sky.
- One specific consequence of this approach to pricing is that Virgin Media's incremental margin on the SD versions of Sky's Core Premium channels is negative. Virgin Media therefore has little incentive to sell premium channels to an existing basic subscriber. This is reflected in the relatively weak incentives offered to Virgin Media sales staff for selling Sky Core Premium channels.
- The failure, to date, of negotiations between Virgin Media and Sky for the wholesale of HD versions of Sky's Core Premium channels, and also interactive services.

7.325 In combination, these factors contribute to the substantially lower penetration of Sky Core Premium channels on Virgin Media's platform as compared with Sky's own penetration.

7.326 We have a particular concern that the non-supply of HD versions of Sky's Core Premium channels, and also interactive services, prevents Virgin Media from competing effectively.

7.327 The challenges Virgin Media faces as a result of Sky's wholesale rate-card prices are not a competition concern of the same magnitude as those created by the absence of supply to other retailers. However, they nonetheless create a situation in which consumer choice is likely to be distorted.

Wholesale supply for retail to commercial premises

7.328 While the discussion to this point has focused on supply to residential subscribers, pay TV services including Sky's Core Premium channels are also supplied to commercial premises – mostly pubs and clubs, but also hotels, offices and holiday parks, among others.

Our position in previous consultations, and earlier responses

7.329 In our Third Pay TV Consultation, we cited a range of views and evidence that had been put forward by third parties on this subject:

7.330 The Association of Licensed Multiple Retailers (ALMR), a trade body which represents licensed retailers (who comprise the majority of commercial pay TV subscribers) told us that competition was limited in the supply of pay TV services to commercial subscribers, and that this was leading to poor outcomes for consumers. It noted that even Setanta's channels, which included the only Core Premium content other than Sky's, were only available to commercial subscribers through Sky's retail service[1042].

7.331 Virgin Media told us that **[✂]**[1043]. Given these issues, and its experience in negotiating with Sky over the residential rate-card, Virgin Media was pessimistic about successfully negotiating with Sky over its wholesale commercial rates[1044].

7.332 Setanta[1045] and Top Up TV[1046] told us that they would be interested in supplying pay TV services to commercial premises. **[✂]**[1047].

7.333 Setanta told us that it had agreed to allow Sky to retail its channels to commercial premises because **[✂]**[1048].

7.334 **[✂]**[1049] **[✂]**[1050].

7.335 **[✂]**[1051] **[✂]**[1052] **[✂]**[1053] **[✂]**.

7.336 Top Up TV told us that it had made several efforts to negotiate access to premium channels for commercial (and residential) subscribers, but that Sky had failed to offer

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[1042] Response to Second Pay TV Consultation Document, page 2.

[1043] Virgin Media response dated 8 April 2009 to Ofcom information request dated 24 March 2009, question 16.

[1044] Virgin Media response dated 8 April 2009 to Ofcom information request dated 24 March 2009, question 17.

[1045] Setanta response dated 15 April 2009 to Ofcom information request dated 20 March 2009, question 5.

[1046] Top Up TV response dated 8 May 2009 to Ofcom information request dated 20 March 2009, question 7.

[1047] Sky Business subscription revenues were £**[✂]** in 2007/08.

[1048] Setanta response dated 15 April 2009 to Ofcom information request dated 20 March 2009, question 7.

[1049] Setanta response dated 15 April 2009 to Ofcom information request dated 20 March 2009, question 7.

[1050] Setanta response dated 15 April 2009 to Ofcom information request dated 20 March 2009, question 5.

[1051] **[✂]** response dated 2 April 2009 to Ofcom information request dated 20 March 2009, page 1.

[1052] Response to Ofcom information request dated 20 March 2009.

[1053] Response to Ofcom information request dated 20 March 2009.

Top Up TV a deal[1054]. In its offer of a retail deal to Top Up TV in January 2006, Sky stipulated that the arrangement would exclude commercial subscribers[1055].

7.337 Our view was that the supply of Core Premium channels to commercial premises was somewhat less attractive to potential third party retailers than supply to residential customers. We considered that the scope to bundle Core Premium channels with other services was likely to be far more limited. For example, customers to a public house would care about whether it had Sky Sports or Setanta, but were likely to be far less interested in other features such as the range of basic channels carried, interactive services, and inclusion of other services such as broadband in the package. Therefore it would only make commercial sense to supply the commercial sector if there were a sufficient margin on Core Premium channels for the retailing of these channels to be viable on a standalone basis – competition in this area is more likely to be limited to simple resale rather than innovation in a wider bundle.

7.338 We noted that Virgin Media had not actively marketed Sky premium channels to commercial premises since 2006 **[✂]**. **[✂]**.

7.339 We said that the gradual exit of Virgin Media from supply to commercial premises – in contrast with the residential sector, where Virgin Media faces broadly similar terms of supply from Sky – appeared consistent with our view[1056]. The difference between the two was that in the residential sector when Virgin Media supplied a customer with Core Premium channels this was as part of a broader package, and it was profitable for Virgin Media to supply these channels as part of this package rather than lose the customer, even if it would prefer to retain the customer without providing Core Premium channels.

7.340 Finally, we noted that in our review of documents from Sky and third party retailers, commercial premises did not appear to have been an important part of negotiations for wholesale supply. While it is understandable that the focus of discussion would be on residential supply, if other retailers had a genuine interest in supplying commercial premises we would have expected to see this more strongly reflected in the documentation.

Responses to our Third Pay TV Consultation

7.341 ALMR did not respond to our Third Pay TV Consultation.

7.342 Virgin Media argued that the lack of interest among retailers, and limited ability to make a margin, which we described were a direct result of the difficulties retailers would have in reaching economic terms with Sky for wholesale supply of premium channels, based on their experience in negotiating with Sky as regards residential customers[1057].

[1054] **[✂]** response dated 30 Mar 2009 to Ofcom information request dated 20 Mar 2009; question 6.

[1055] Sky response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 3; Top Up TV response dated 30 Mar 2009 to Ofcom information request dated 20 Mar 2009 question 4.

[1056] Third Pay TV Consultation, paragraph 6.139.

[1057] Virgin Media response to Third Pay Consultation, paragraph 5.6.

7.343 Virgin Media also argued that the competition concerns were greater in the commercial market than the residential market as Sky had a stronger market position in the former[1058].

Our view

7.344 It is not unreasonable of third parties to expect that they would face similar difficulties in negotiating wholesale supply of Sky's Core Premium channels for retail to commercial premises as they have faced on the retail side. However, we note that, with the apparent exception of Top Up TV, third party retailers have not sought to negotiate wholesale supply with Sky for retail to commercial premises.

7.345 One reason for this is the difficulty, which we have described above, of adding value to a commercial service by bundling Core Premium channels with other channels and services.

7.346 Similarly, we note that Virgin Media has reached a view on the scope for negotiating better rates on the commercial side based on its experience on the residential side. It did not seek to renegotiate terms for supply of its Core Premium channels to commercial premises **[✂]**.

7.347 It is likely that a sufficiently deep wholesale discount would induce Virgin Media to market its retail service to commercial customers, and also induce other retailers to develop such services. However, we conclude that given the greater size of the residential sector, and the greater scope in that sector for bundling Core Premium channels with a range of other services, innovation is more likely to be promoted by effective competition in the residential sector than in the commercial sector.

7.348 In addition, we consider that barriers to the retail of Core Premium channels are less likely to lead to distorted consumer choice in the commercial sector than in the retail sector, because patrons of commercial premises are unlikely to have a preference as to which platform (satellite, cable etc) is being used to provide these channels.

Pricing of Core Premium channels

Our view in previous consultations, and responses

7.349 Our analysis of pricing is set out in our discussion of market definition and market power (see in particular paragraphs 5.512 to 5.588). Here we consider whether our pricing evidence gives rise to a competition concern. We noted in our Second Pay TV Consultation that the wholesale market power which we had identified might be exploited not only by restricting distribution of premium content, but also by setting wholesale prices above competitive levels.

7.350 We noted that Sky effectively controlled the retail prices of its Core Premium channels. It can set its own retail prices at an optimal (profit maximising) level, and set its wholesale price to cable operators which will require them to charge the same or a similar price (see paragraphs 7.262 to 7.269). If we were to consider Sky's retail business as a purchaser of wholesale content at rate-card prices from its wholesale business, then this retail business would face the same constrained returns as a retailer. Under this interpretation, if Sky were to earn monopoly profits we would expect these to be extracted at the wholesale level.

[1058] Virgin Media response to Third Pay Consultation, paragraph 5.6.

7.351 Our Third Pay TV Consultation set out analysis by Oxera of whether Sky was earning returns above its cost of capital.

7.352 In our Third Pay TV Consultation we said that, when looking at Sky's historic returns, we need to be aware that returns may appear above the cost of capital, but this could reflect an outcome where ex post actual returns are above ex ante expected returns purely because a risky business has succeeded. We said that in the early part of the period we looked at, Sky's business model was unproven and there may have been substantial downside risks for which investors needed to be compensated. We said that when thinking about more recent returns, for example the 2004-2008 time period, concerns about potential failure are less relevant[1059].

7.353 Sky argued that it had a strong and consistent track record of being an innovator and successfully executing risky investments and suggested that this was the main explanatory factor for its profitability gap. In a subsequent submission[1060], Sky also argued that we had taken a "more tempered position" in public statements at a briefing to analysts in September 2009, and that this was "clearly significant given Ofcom's reliance in the Consultation Document on its strong conclusions that wholesale prices are 'high'".

Our view on pricing and profitability of Core Premium channels

7.354 One of Sky's main challenges in its response to our Third Pay TV Consultation was that its returns could be above its cost of capital as a result of its ongoing risk taking and innovation. We commissioned Oxera to help us consider and respond to Sky's comments, including this argument. Annex 3 describes in more detail the responses we received on the issue of Sky's profitability and the conclusions from our analysis. Oxera's report can also be found as an appendix to Annex 3.

<u>Why have Sky's returns exceeded its cost of capital?</u>

7.355 In Section 5, we have set out the evidence from Oxera's analysis that Sky's ex post returns have persistently and significantly exceeded its cost of capital. As we have explained there, this is prima facie evidence of barriers to entry. A more nuanced question is whether Sky's ex post returns reflect successful risk taking. This would not change our view on whether Sky currently benefits from barriers to entry that enable it to charge prices above the competitive level, but it informs our assessment of the extent of any consumer harm, and the potential risks to innovation from any intervention.

7.356 An analogy can be drawn with the patents which are available to firms who make high-risk investments (e.g. in pharmaceuticals), and which protect new products from competition for a period in effect to compensate investors for the risk that many of their investments will fail. The patent is a means of creating a barrier to entry that enables a firm to take risks that ultimately benefit consumers. The firm that is protected by the patent clearly has market power, but that market power is appropriate as a means of incentivising investment.

7.357 Sky's performance suggests that it is has benefited from barriers to entry absent any such patent protection. This benefit is demonstrated by the gap between its ex post

[1059] Third Pay TV Consultation, paragraphs 6.191 to 6.192.

[1060] November 2009 Sky Submission, paragraph 5.3.

returns and the ex ante cost of capital. However, this could reflect an outcome where ex post actual returns are above ex ante expected returns because Sky had been a successful risk taker.

7.358 Sky argued that it had a strong and consistent track record of being an innovator and successfully executing risky investments and suggested that this was the main explanatory factor for its profitability gap.

7.359 We asked Oxera to consider the extent to which the observed profitability gap could be explained by Sky's continuous successful risk-taking and innovation. Oxera's analysis is set out in more detail in Annex 3, but Oxera summarised its views and conclusions as follows:

> "To assess whether [Sky's continuous successful risk-taking and innovation] is a reasonable interpretation of the profitability gap, this report analyses the economic characteristics of Sky's investments, the persistency of returns over time, and the performance of Sky relative to expectations. The evidence shows that over the last ten years or so Sky's pay-TV activities do not exhibit features that are typical of markets with successful innovations and risk-taking (i.e. uncertain demand, long payback periods and large upfront costs being invested). In other words, the profitability gap observed over the period 2005 to 2009 cannot be explained by such factors during this period or during the period since its flotation"[1061].

7.360 In line with Oxera's conclusions, we recognise that Sky took substantial risks in the past, most notably in the early stages of satellite pay TV in the UK. Similarly, the upgrade to digital in 1998-2000 was potentially risky, though less so than its original market entry. Since then Sky has continued to innovate, most recently through its investment in HD, but these investments have involved substantially less risk. Sky has made a substantial commitment to HD, but the amount of capital at risk has been considerably smaller than was the case historically. Furthermore, much of its expenditure has been on set-top-box subsidies which are incurred at the point of sale and therefore scale directly with the number of subscribers that take the service.

7.361 On this basis, we agree with Sky that the riskiness of its early investments will have demanded returns in excess of its cost of capital for a period. However, we do not agree that such returns would be required on an ongoing basis unless there was evidence of continued significant risk-taking.

7.362 Oxera's analysis suggests that more recent investments and innovations have involved considerably less risk. Nonetheless, Sky has continued to earn returns materially above its cost of capital, Consequently we consider that the more recent profitability gap between Sky's IRR and its cost of capital is likely to go beyond the necessary rewards for significant risk-taking.

Are Sky's returns likely to remain above its cost of capital?

7.363 Having concluded that Sky is earning returns above its cost of capital, and that this cannot be explained by Sky's risk taking and innovation, we have not found any evidence to suggest that this is likely to change in the next few years[1062]. For

[1061] Second Oxera report, page iii.

[1062] See Annex 3, Section 5.

example, when we consider analyst forecasts of Sky's profits, we do not find any evidence that Sky's profitability in aggregate or in its pay TV business is expected to reduce from current levels. Sky's total EBITDA is forecast to grow by around 10-15% per annum over the next three to four years[1063], with operating profits in Sky's pay TV business forecast to grow by 6%-11%[1064] per annum in the same period.

7.364 We continue to believe that if the pay TV market is left unchanged, Sky's future returns are likely to exceed its cost of capital.

<u>What does this mean for pricing of Core Premium channels?</u>

7.365 The analysis presented above shows that Sky's returns have been significantly above its cost of capital for a number of years, and are likely to continue to be so for the foreseeable future. As we have explained in Sections 5 and 6, these returns are concentrated in Sky's wholesale business – as we would expect given Sky's position in the market. They point to wholesale and retail prices for Sky's Core Premium Channels which are above the competitive level, and to sustained barriers to entry. The extent to which prices are above the competitive level appears greater in movies than in sports.

7.366 Although Sky's historic risk-taking in its development of digital satellite TV may have demanded returns above its cost of capital for a period, it does not appear that Sky's more recent investments will have required the same level of reward for risk. On a forward-looking basis, we conclude that Sky's prices are likely to be above those required as a reward for historic risk taking.

[1063] Source: Bloomberg (consensus of analysts' reports 22 March 2010).

[1064] Source: Recent analyst forecasts for JP Morgan (24 August 2009); Morgan Stanley (4 November 2009); Cazenove (10 December 2009); RBS (1 February 2010) and Investec (29 January 2010).

Section 8

Consumer effects

Summary

8.1 The pay TV sector has delivered substantial benefits to consumers since its emergence in the late 1980s. Sky in particular has been, and continues to be, an innovative firm with many satisfied customers, which has driven much of the benefits derived from pay TV over an extended period.

8.2 Recent technological advances have created opportunities for fundamental changes in the delivery of pay TV services. For example, new broadband networks can offer consumers an unprecedented choice of content over a range of media, and greater flexibility in the way that content is consumed (e.g. through on-demand services).

8.3 However, the scope for successful new services to emerge depends not just on access to technology, but also on retailers being able to offer TV content that consumers want to watch. If the rights to the most popular content are controlled by a single firm, that firm will have very considerable power to set the pace and direction of future developments in the sector. Sky's control of key sports and movie rights allows it to exercise such power.

8.4 At the beginning of this investigation, we set out criteria for judging whether competition in pay TV was delivering positive outcomes for consumers. These were:

- Choice:
  - o Consumers should have a choice of platform, and a choice of content on each platform.
  - o Switching between retailers and platforms should not be artificially difficult.
  - o A broad range of high-quality content should continue to be generated and made available to consumers on all platforms.
- Innovation:
  - o In platform services, for example in terms of interactivity, set-top box functionality such as DVR capabilities, or VoD options.
  - o In retail service packaging and pricing.
- Pricing:
  - o Pay TV services should be priced competitively and efficiently, giving consumers good value and allowing efficient producers to earn a reasonable return on their investment.
  - o The variety of price points / bundles should allow consumers to tailor their purchases to meet their preferences.

8.5 As described in the previous Section, we conclude that restricted access to key content means that competition in pay TV is not fair and effective. This has a negative impact on choice, innovation and price.

8.6 **Choice**. While there is a relatively wide range of options for basic-tier TV, consumers wanting Core Premium channels have a choice of only two retailers – Sky or Virgin Media (and those outside cable areas do not have any choice of retailer beyond Sky). We have some concern about the terms on which these channels are supplied to Virgin Media, which create a situation in which consumer choice is likely to be distorted. However, the channels are at least supplied.

8.7 More fundamentally, consumers with a preference for other platforms, or who do not want a “big” pay TV package – such as the ten million households with DTT services – are currently unable to access Sky’s premium channels. The development of new platform technologies should open up a wider choice of operators to consumers, but this will not happen if those operators are denied access to key content.

8.8 Although a substantial proportion of consumers still buy pay TV services on a stand-alone basis, bundles of pay TV and telecommunications services are becoming increasingly important. Particularly on a forward-looking basis, therefore, restricted distribution of Core Premium channels limits choice of triple-play bundles.

8.9 **Innovation**. In coming years we should see numerous opportunities for innovation in how TV is packaged and delivered, through developing technologies such as IPTV and DTT. Developments such as the proposed Canvas service or NGA should enable new and innovative ways of packaging content. However, restricted availability of Sky’s Core Premium channels prevents pay TV retailers with new innovative services from entering the market or expanding their customer base. As a result, innovative services may fail or be delayed, to the detriment of consumers.

8.10 While the UK pay TV sector has seen considerable innovation, much of which has been driven by Sky, it has not seen innovation of a type that challenges Sky’s business model – such as significant take-up of hybrid DTT / IPTV models with a strong VoD component. Instead, the TV innovations that Sky has pursued, unsurprisingly, are those which favour satellite – HD making use of satellite’s capacity availability, or DVRs mitigating some of satellite’s inability to offer true VoD.

8.11 **Price**. Based on our assessment of competition and profitability, we have concluded that the wholesale and retail prices of premium sports and movies channels are above competitive levels. Clearly, this has a negative effect on consumers.

Structure of this Section

8.12 This Section is set out as follows:

- Introduction.
  - Our position in our previous consultations.
  - Responses to our Third Pay TV Consultation.
  - Outline of the remainder of this Section.
- Choice.

  - Introduction.
  - Importance of Core Premium channels.
  - Preferences for platforms.
  - Restricted wholesale supply to DTT retailers.
  - Restricted wholesale supply to other platforms.
  - Limited range and variety of packages.
  - Restricted supply of HD versions and interactivity features of Core Premium channels.
  - Restricted ability and lack of incentive for Virgin Media to retail premium channels.
  - Distorted choice of bundles.
  - Summary of conclusions on choice.
- Innovation.
  - Introduction.
  - Innovation in pay TV in the UK.
  - Cross-country comparison of innovation.
- Pricing.
  - Price levels.
  - Range and variety of prices.
- Consumer satisfaction and take-up of services.
  - Satisfaction.
  - Penetration of digital pay TV.
  - Conclusion.

Introduction

8.13 In the previous Sections we assessed markets for wholesale supply of Core Premium channels. We have concluded that Sky has market power in the wholesale and retail supply of Core Premium Movies channels and Core Premium Sports channels.

8.14 We have also concluded that Sky has restricted wholesale supply of its Core Premium channels to third party retailers and that the terms of its wholesale supply to Virgin Media lead to Virgin Media having limited ability and little incentive to compete with Sky in the retail of these channels. In addition, it has not yet supplied HD versions or interactive features of its Core Premium channels to Virgin Media. We have set out evidence that Sky is making returns significantly above its cost of capital. Sky's approach to the supply of Core Premium channels is prejudicial to fair and effective competition in the wholesale supply of bundles which include Core Premium Sports channels or Core Premium Movies channels.

8.15 In this Section we set out the effects on consumers flowing from our conclusions on our competition concerns. We find that Sky's approach to the wholesale supply of its Core Premium channels leads to significant distortion of consumer choice in the retail markets for Core Premium channels. Furthermore, scope for innovation in retail platform services is significantly hampered by lack of wholesale supply of Core Premium channels. Our assessment of profitability indicates that consumers pay high prices for their channels.

Our position in our previous consultations

8.16 In our Second and Third Pay TV Consultations[1065], we said that competition in pay TV was likely to be weakened by restricted distribution of Core Premium channels. We argued that markets where competition is weak, and consumers are unable to exercise a real choice between suppliers, are unlikely to deliver the best outcomes for consumers in terms of choice, innovation and price. We considered that this was being manifested, and would be manifested, in pay TV markets in several ways.

8.17 The most obvious manifestation of the restricted availability of Sky's Core Premium channels was **reduced consumer choice of platform.** We found that choice of platforms is already limited as Core Premium channels are unavailable on DTT, the UK's most popular distribution technology. We said that we believed that platform choice was already likely to have been distorted, since consumers who in principle would prefer to view Sky's Core Premium channels over DTT do not have this as a choice[1066].

8.18 We also said that while we should be cautious about being too precise about the reasons for the much lower penetration of premium channels on Virgin Media's platform than on Sky's, it appears that the platform choice of people subscribing to premium channels has been distorted in favour of satellite and away from cable over time[1067].

8.19 Looking forward, we said our concerns would be exacerbated as the choice of platforms increases. The chances of these **new platforms** developing fully to the benefit of consumers are likely to be limited by the restricted availability of Sky's Core Premium channels[1068].

8.20 We explained in our previous consultations that **Sky does not currently supply HD** versions of its premium channels to Virgin Media. This degrades the quality of Sky's Core Premium channels which it supplies to Virgin Media compared with the versions it offers to its own retail customers which limits Virgin Media's ability to effectively

[1065] See Ofcom's Second Pay TV consultation Section 6 and Section 7, and Ofcom's Third Pay TV Consultation Section 6 and Section 7.

[1066] Ofcom's Third Pay TV Consultation, paragraphs 7.60, 7.64, 7.66 to 7.69.

[1067] Ofcom's Third Pay TV Consultation, paragraphs 7.61 to 7.63, 7.81.

[1068] Ofcom's Third Pay TV Consultation, paragraphs 7.73 to 7.74, 7.81.

compete with Sky in the retail market[1069]. The non-supply of **interactive features** (the 'red button') has a similar effect.

8.21 We also identified a risk that **platform innovation would be reduced**. Access to the Core Premium channels which Sky currently controls is highly important to new entrants or to other firms planning to expand (as, indeed, was the case when Sky entered the market). Without access to this content, the overall prospects for such a firm are likely to be greatly diminished, and so is the likelihood that it will be willing to take a risk on substantial innovation, and secure finance for the necessary investment[1070].

8.22 We found that Sky's returns were greater than its cost of capital, and that these returns were particularly concentrated at the wholesale level of the business. We said that if Sky earned high wholesale margins, this would tend to be reflected in **high prices for its retail and wholesale subscribers**. We recognised that historically some of the gap between Sky's IRR and cost of capital might reflect returns on risky investments; we did not believe that ongoing high returns were justified[1071].

Responses to our Third Pay TV Consultation

Overall approach

8.23 Sky said that Ofcom did not set out clearly the purpose of the Section which described the effects on consumers of restricted supply of its channels. It therefore found it difficult to comment on its content[1072]. Sky inferred that the purpose of the Section on consumer effects was to consider whether Ofcom's proposed intervention was justified in order to address the consumer harm we identified[1073].

8.24 BT agreed that Ofcom had correctly identified the three consumer effects that result from a wholesale must-offer remedy: lower prices, greater choice and greater innovation[1074].

Choice of platform

8.25 Sky argued that it distributes its Core Premium channels widely: on satellite, cable, Tiscali / TalkTalk TV, over the internet, on Xbox360 and on four out of the five 3G networks[1075, 1076]. DTT is the only platform where Sky's Core Premium channels are

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[1069] Ofcom's Third Pay TV Consultation paragraphs 7.57 to 7.58.

[1070] Ofcom's Third Pay TV Consultation paragraphs 7.101 to 7.103.

[1071] Ofcom's Third Pay TV Consultation paragraphs 7.104 to 7.107.

[1072] In November 2009, eight weeks after the end of the consultation period, Sky sent a further submission entitled "Penetration of premium pay TV services in other European countries".

[1073] Sky response to Third Pay TV Consultation 8.4.

[1074] BT response to Third Pay TV Consultation paragraph 2.3.

[1075] It is planning to distribute its channels on **[✂]** and Fetch TV and it recently launched an iPhone application to enable subscribers to watch channels over wireless networks. See: Sky response to Third Pay TV Consultation paragraph 8.10 and http://corporate.sky.com/media/press_releases/2009/sky_player_fetch_TV.htm.

unavailable, and this was because Ofcom has not approved the DTT licence variation to enable "Picnic"[1077]. Therefore, any alleged unmet demand on DTT cannot be used as evidence that Sky's approach to wholesaling has caused consumer harm. Instead it is Ofcom's current regulation that prevents premium channels from being broadcast via DTT[1078].

8.26 Sky said that Ofcom presented no evidence that lack of wholesale supply of Sky's channels to Tiscali / TalkTalk TV has contributed to the lack of success of IPTV. Sky[1079] noted our view[1080] that for IPTV to become an effective alternative to satellite, cable and DTT, its cost base would have to reduce, and argued that this was inconsistent with Tiscali / TalkTalk TV's view that the lack of success of IPTV was related to Sky's channels.

8.27 BT said restricted wholesale supply of Sky's Core Premium channels currently distorts consumer choice of platform and potentially excludes some subscribers from the market (for example, those who do not have access to cable and cannot erect a satellite dish)[1081]. Looking forward, the restricted supply of Sky's Core Premium channels will limit the development of sustainable pay TV platforms which would further restrict choice[1082]. It believed that the emergence of a more competitive retail market will benefit consumers by offering them greater choice of platforms that better reflect consumers' preferences[1083].

Supply of premium channels to Virgin Media

8.28 Sky considered that it was untenable that Ofcom could describe the availability of its Core Premium channels to Virgin Media as "restricted" given that the channels are supplied on a wholesale basis. It agreed that there is unmet demand for premium channels on Virgin Media[1084], but disagreed with Ofcom on the cause. Its view was that it cannot be said that there is a lack of awareness about Sky's Core Premium channels as existing subscribers will be aware of advertising to attract new subscribers[1085] and the channels will be seen on the EPG[1086]. To the extent that there is unmet demand for Sky's channels, this demand must be relatively weak and

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[1076] Sky response to Third Pay TV Consultation paragraph 8.10.

[1077] Sky response to Third Pay TV Consultation paragraph 8.11. We discuss the reasons why Sky retailing on Picnic would not mitigate our concerns in more detail in Section 7.

[1078] Sky response to Third Pay TV Consultation paragraphs 8.11 to 8.12.

[1079] Sky response to Third Pay TV Consultation paragraph 8.20.

[1080] Third Consultation, paragraph 9.132.

[1081] BT response to Third Pay TV Consultation, footnote 5.

[1082] BT response to Third Pay TV Consultation paragraph 2.10.

[1083] BT response to Third Pay TV Consultation paragraph 2.11.

[1084] Sky response to Third Pay TV Consultation paragraph 8.14.

[1085] See for example Sky response to Third Pay TV Consultation Appendix 3.

[1086] Sky response to Third Pay TV Consultation paragraph 8.15.

therefore any lost consumer surplus is relatively low[1087]. Sky said that one of the reasons for relatively low penetration on Virgin Media compared with Sky is piracy[1088].

Restricted supply of HD and interactivity

8.29 Sky did not comment on the consumer harm resulting from the restricted supply of its Core Premium HD channels or interactivity features of Core Premium channels to Virgin Media. However it said that a wholesale must-offer remedy was not appropriate for a new innovative service like HD[1089,1090]. In the context of the application of a remedy, Sky said that consumers place relatively little value on interactivity[1091,1092].

8.30 Virgin Media said that refusal to supply enhanced, interactive or HD services or on-demand content to Virgin Media means that customers on the cable platform are denied access to those features and services[1093].

Impact of restricted supply on innovation

8.31 Sky noted Ofcom's view[1094] that the scale and depth of innovation, and the technologies that would play the greatest role in the future of the sector, were at present uncertain. Sky agreed with this view, but said that, for this reason, Ofcom's speculative theories of future harm could not support intervention[1095].

8.32 Sky said that the lack of innovation on non-satellite platforms simply reflected the fact that "no other market participant had been willing to invest in its platform (including content) to the extent that Sky has"[1096].

8.33 Sky said that the fact that Sky has often innovated first has not harmed the process of innovation. For example, it said that many of the innovations pioneered by Sky (e.g. HD or DVRs) have been copied on other platforms[1097].

[1087] Sky response to Third Pay TV Consultation paragraph 8.17.

[1088] Sky response to Third Pay TV Consultation paragraph 8.19.

[1089] We discuss Sky's comments on whether it is appropriate to include HD within a wholesale must-offer remedy in paragraphs 9.266 to **Error! Reference source not found.**.

[1090] Sky response to Third Pay TV Consultation paragraphs 9.63 to 9.70.

[1091] Sky response to Third Pay TV Consultation paragraph 9.87.

[1092] We discuss this in more detail in paragraphs 9.287 to 9.297.

[1093] Virgin Media response to Third Pay TV Consultation paragraph 6.2b.

[1094] Third Pay TV Consultation, paragraph 7.20.

[1095] Sky response to Third Pay TV Consultation paragraph 8.7.

[1096] Sky response to Third Pay TV Consultation paragraph 8.23.

[1097] Sky response to Third Pay TV Consultation paragraph 8.24.

8.34 Sky argued that Ofcom's concerns over the development of mobile TV are not well founded given Sky was the first to launch a mobile service in the UK and has worked closely with industry players to encourage the development of mobile TV[1098].

8.35 Finally, Sky argued that even if Ofcom had demonstrated that lack of supply of Core Premium channels to new platforms would harm innovation, a wholesale obligation would be inappropriate, because certainty of retail supply would be sufficient to mitigate any concerns over lack of innovation[1099].

8.36 Virgin Media said that the low margin it earned on Sky's Core Premium channels limited its ability and incentive to innovate[1100].

8.37 BT said that lack of wholesale access to Core Premium channels inhibits the growth of new platforms. It highlighted the significant costs involved in developing new platforms and said that without access to subscribers to Core Premium channels, platforms would be unable to recover these costs. It thought that a more competitive retail market would benefit consumers through greater innovation[1101].

8.38 BT said that the restricted wholesale supply of Sky's Core Premium channels limited the choice of packages, bundles and price points that are available to consumers who wish to buy Core Premium channels[1102].

High wholesale prices

8.39 Sky referred to its second PwC report to demonstrate that prices in the UK were in line with other countries and said that high levels of pay TV penetration in the UK were further evidence that price levels were reasonable[1103,1104].

8.40 Virgin Media said that prices were higher than in other European countries referring to a study by LECG that it had previously submitted[1105].

Satisfaction and market outcomes

8.41 Sky claimed that positive market outcomes showed that the market is working well for consumers and that Ofcom needed to provide clear evidence of serious harm to

[1098] Sky response to Third Pay TV Consultation paragraph 8.34.

[1099] Sky response to Third Pay TV Consultation paragraph 8.36.

[1100] Virgin Media response to Third Pay TV Consultation paragraph 6.4.a&d.

[1101] BT response to Third Pay TV Consultation paragraphs 2.10 and 2.20.

[1102] BT response to Third Pay TV Consultation paragraph 2.11.

[1103] Sky response to Third Pay TV Consultation paragraph 8.38 and footnote 56 of Section 8.

[1104] We discuss Sky's comments on the Oxera profitability analysis that we presented in our Third Pay TV Consultation in Annex 3 to this statement.

[1105] Virgin Media response to Third Pay TV Consultation paragraph 6.5.c.

consumers to justify intervention[1106]. It referred to a range of evidence which, in its view, illustrated that pay TV markets in the UK are working well.

8.42 Sky said it was an omission not to consider evidence of consumer satisfaction in our Third Pay TV Consultation given our justification for intervention is the potential adverse effect on consumers. Sky questioned Ofcom's reasons for discarding evidence on consumer satisfaction[1107].

8.43 Sky said that given penetration of digital pay TV is relatively high in the UK, it cannot be argued that there are significant levels of consumer exclusion from a lack of platform choice or high prices[1108].

Outline of the remainder of this Section

8.44 In the reminder of this sub-section we consider the responses to our consultation in more detail and conclude on whether significant consumer harm is likely to result from the competition concerns we have concluded upon[1109]. As in our Third Pay TV Consultation[1110], our conclusions will inform our later discussion of what remedies would be a proportionate means of addressing any consumer harm we identify[1111].

8.45 Below, we set out the evidence on which we base our conclusion, considering in turn:

- Choice.
- Innovation.
- Pricing.
- Consumer satisfaction and take-up of services.

8.46 Figure 118 sets out in summary form the effect of each competition issue on different groups of consumers, particularly in terms of choice and pricing. The impact of greater innovation is less easily attributable to specific groups of consumers, because:

- Innovation could happen on any platform.

[1106] Sky response to Third Pay TV Consultation, paragraph 8.7.

[1107] Sky response to Third Pay TV Consultation, paragraph 8.43.

[1108] Sky response to Third Pay TV Consultation, paragraph 8.44.

[1109] See Section 7 of this document.

[1110] See for example Third Pay TV Consultation paragraph 7.9 and 8.7. We disagree with Sky's assertion that we did not clearly set out the purpose of the Section on Consumer Effects, Section 7 of the Third Pay TV Consultation (see paragraph 7.23). Notwithstanding the fact that Sky said the purpose of the Section was not made clear, and that therefore its comments should not be treated as exhaustive, it correctly identified that the purpose was to consider the extent of consumer harm, which would then inform an assessment of what remedies might be proportionate. See Sky Response to Ofcom's Third Consultation, paragraph 8.4.

[1111] See Sections 9, 10 and 11 of this document.

- An innovative service may attract both new-to-market consumers and subscribers from existing pay TV services.

- Innovation by one provider may stimulate other providers (and create opportunities for copycat service improvements on other platforms), so an improved rate of innovation may benefit consumers across different platforms.

Figure 118 Effects of competition issues by consumer group

Subscription type (households / subscriptions)	Restricted supply on DTT and new platforms	Terms of supply to Virgin: low margin, no HD or interactivity	High wholesale prices
Satellite basic [✂]	None	None	Unmet demand
Satellite premium [✂]	Distorted platform choice	Distorted platform choice	High prices
Cable basic [✂]	None	Unmet demand	Unmet demand
Cable premium [✂]	Distorted platform choice	Unmet demand for HD / interactivity	High prices
Terrestrial, IPTV and free-to-view satellite (13.4m)	Distorted platform choice	None	Unmet demand

Subscriber data sources:

Sky premium – satellite: Sky response to Ofcom Information request dated 13 October 2009 Q1, Annex 1.

Sky basic – satellite: Sky response to Ofcom Information request of 13 October 2009 Q1, Annex 1.

Cable premium: Virgin Media response to Ofcom Information request of 7 January 2010 Q1.

Cable basic: Virgin Media response to Ofcom Information request of 7 January 2010 Q1.

Terrestrial, Freesat, other platforms: Ofcom: Digital Television Update – 2009 Q3.

Choice

Introduction

8.47 In Section 2[1112] we set out the criteria by which we judge whether TV markets are functioning well for consumers. We said we would expect to see:

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

- Switching between retailers and platforms should not be artificially difficult.

[1112] See paragraph 2.16.

- Generation and availability of a broad range of high-quality content: a variety of content should continue to be generated and made available to consumers on all platforms.

8.48 Against some of these criteria, it is clear that the TV markets are functioning well for consumers. Pay TV has helped deliver a wide variety of high quality content and we believe that this will continue. Twenty years ago consumers only had access to four or five channels. Consumers now have access to a range of high quality content from a range of broadcasters. Pay TV operators have also invested substantially in content. Sky has been central to this, as we can see from the data we set out in Section 4 on expenditure on content.

8.49 In addition to analogue broadcast TV, viewers can access satellite, cable, IPTV and DTT services, although cable and IPTV have more limited coverage. Cable's coverage is 49% of households and IPTV's coverage is 39% and it largely overlaps with cable[1113]. Looking forward there are likely to be new internet delivered services such as Canvas which will be able to deliver a wide range of content on-demand direct to the TV.

8.50 As we set out in paragraphs 5.142 to 5.146 of our Third Pay TV Consultation, though the costs of switching between retailers and platforms vary, if switching does not require purchase or installation of equipment, the cost to households and/or retailers will be limited. Where new equipment is required, the cost will vary. Whether it is seen as significant or not will depend on the context – for example switching costs may be at a level which would not prevent entry by a substantially better service, but which may limit competition at the margin (e.g. because consumers would not switch to a similar service at a slightly lower prices). However, restricted supply of Core Premium channels limits the scope for switching, because many subscribers would not switch to a service which did not carry them.

8.51 Different platforms have different technical characteristics, coverage and costs. Sky[1114] and BT[1115] have told us that some consumers have a preference for particular delivery platforms. Where supply of content is restricted to specific platforms, consumer choice of platform is distorted as consumers have to trade off their preference for platform features over their preference for content. Sky supplies SD versions of its Core Premium channels to cable firms, but without interactivity features or, to date, HD versions of the channels.

8.52 As the range of platforms and devices grows, the potential choice for consumers is also growing. If provision of Core Premium channels continues to be limited as we have described, the difference between this potential choice and the actual choice for consumers will widen.

8.53 In well functioning markets operators compete with each other to attract customers by differentiating their products from each other. In such markets consumers are offered a wide array of choice as firms attract new consumers to the market and try to win each other's customers. However Sky's control over the content that is a key driver of demand for pay TV, namely Core Premium channels, means that

[1113] Both cable and IPTV target major conurbations.

[1114] Sky response to Ofcom's Second Pay TV Consultation Section 5, paragraph 2.2.

[1115] BT response to Ofcom's Second Pay TV Consultation paragraph 2.11.

consumers can be denied their preferred choice of retailer, package or platform. Sky's enduring market power in wholesale markets for Core Premium channels means that the normal competitive process is not effective to improve outcomes for consumers.

8.54 In the sub-sections below we summarise our evidence on consumers' preferences for Sky's Core Premium channels and preferences for platform characteristics that we set out in Sections 4, 5 and 6. We then describe six sources of distortion of choice that result from Sky's approach to supplying its channels.

- Restricted wholesale supply to DTT retailers.
- Restricted wholesale supply to other platforms.
- Limited range of packages available to consumers.
- Lack of supply of interactivity features on Core Premium channels and lack of supply of HD Core Premium channels.
- Restricted ability and lack of incentive for Virgin Media to retail Core Premium channels.
- Potential for Sky to distort triple play bundles.

Importance of Core Premium channels

8.55 As we have set out in previous Sections, channels that show live premium sports and recent blockbuster movies are key drivers of demand for pay TV as they are highly valued by consumers and broadcasters. For example in Section 4 we have described the importance to consumers of certain types of premium sports and movies content, such as live Premier League football, or recent Hollywood blockbusters[1116]. We have cited evidence on consumers' preferences, the price of rights for certain sports and movies rights, and the statements of industry players. We have then explained that Sky aggregates the majority of this highly valuable content on its Core Premium channels: Sky Sports 1 and 2; and Sky Movies channels.

8.56 In Sections 5 and 6 we have set out our evidence that the aggregation of the majority of live premium sports content and recent blockbuster movies on just a few channels means that marginal consumers have few close alternatives for these channels. In the case of sports we have said though some live sport is broadcast on FTA, it is only a moderate substitute for the content on Sky Sports 1 and 2 or ESPN. In the case of Sky Movies, we have recognised that consumers have a wide range of options for watching new blockbuster movies, but have concluded that the relevant market comprises retail bundles including Sky Movies. We have said that PPV Movies, Disney Cinemagic, FTA / basic movie channels, movies on other FTA channels, online DVD rental and retail Pay TV DVDs are moderate substitutes, but that they lie outside the relevant market.

8.57 The importance of premium content and the lack of close substitutes for Core Premium channels, mean that there is a significant impact on consumers where supply of these channels is restricted.

[1116] Paragraphs 4.103 to 4.155.

Preferences for platforms

8.58 In Section 4 we have set out some of the characteristics of different TV platforms[1117]. When choosing a TV service consumers will trade off the different options available to them. Important factors in consumers' decisions, in addition to availability and price, appear to include:

- Choice of channels; if consumers value a wide choice of channels, Sky or Virgin Media may be appropriate.
- The availability of true VoD content; if consumers value this feature Virgin Media, Tiscali / TalkTalk TV or BT Vision may be appropriate.
- Ease of set up and no minimum term contract; if consumers value these features then Top Up TV may be appropriate.

8.59 In response to our previous consultations BT and Sky both told Ofcom that consumers have preferences for particular platform features. Sky said that it "believes that making its content available across a variety of platforms increases demand because a significant number of consumers have strong preferences as to which platform they use, or are restricted as to which platforms are available to them"[1118]. BT said in response to our Third Pay TV Consultation that "[e]ach platform technology has different strengths and weaknesses, which will appeal more closely to the preferences of different groups of consumers"[1119].

Restricted wholesale supply to DTT retailers

8.60 The previous two sub-sections have set out the importance of Sky's premium channels to subscribers and consumer preferences for different platforms. In this sub-section we consider whether the restricted wholesale supply of the channels to retailers on DTT has led to significant consumer harm because many consumers are unable to subscribe to their preferred channels on the platforms that they want to. As we have set out in Section 7, distribution of Sky's Core Premium channels is limited to certain platforms and in particular is excluded from the most popular platform: DTT[1120].

8.61 The historic importance of terrestrial television means that, despite the increasing importance of new distribution technologies, DTT still has several important characteristics – high coverage, widespread availability of DTT-capable receivers, and low set-up costs.

- **Coverage.** DTT has high coverage of 73% of homes pre-digital switch-over rising to 98.5% of homes by 2012[1121].

[1117] Paragraphs 4.38 to 4.73.

[1118] Sky response to Ofcom's Second Pay TV Consultation Section 5, paragraph 2.2.

[1119] BT response to Ofcom's Second Pay TV Consultation paragraph 2.11.

[1120] Paragraphs 7.34 to 7.35.

[1121] Figures refer to England only. Coverage varies around the country and only 90% of homes will be able to receive all channels by 2012. Source: Ofcom fact sheet on coverage No. 3. http://www.ofcom.org.uk/research/tv/reports/dsoind/factsheets/no3factsheet.pdf

- **Availability of DTT receivers.** Approximately 18.2 million homes (or 71% of all homes) have DTT on at least one set in their house and 9.7 million (or 38%) use DTT on the main set[1122]. It is therefore clearly an important distribution technology for TV retailers wishing to enter or expand.

- **Set-up costs.** For most homes the set-up costs of DTT are low. Consumers can buy a set top box and plug it directly into their existing TV aerial without the need for specialist assistance (for example to erect a satellite dish or to connect to a cable network)[1123].

8.62 The high coverage provided by DTT means that for many households it is currently the only potential alternative to satellite TV. The non-availability of premium content on DTT, together with the fact that only around half of all homes are in areas where cable or IPTV is available[1124], means that around half of UK households only have a single option[1125] for subscribing to a traditional broadcaster's pay TV service which includes premium content. We recognise that it is possible to subscribe to Sky's channels via a broadband connection, and for some this may be a viable alternative. However, the low take up (in October 2009 there were only **[✂]**[1126] subscribers to Sky Player) suggests it is currently not an attractive alternative for most households. This is supported by recent qualitative research (see paragraph 7.208).

8.63 Even where other distribution technologies are available, the low set up costs on DTT as compared to other distribution technologies mean that it is a particularly important platform for TV retailers hoping to sell services to new consumers.

8.64 This is illustrated by DTT-based pay TV retail offerings, such as those offered by Top Up TV, and Sky's Picnic proposal.

8.65 It is also illustrated by the fact that some retailers whose primary focus is on IPTV transmission technologies, such as Tiscali / TalkTalk TV and BT Vision, have adopted hybrid platforms which also exploit DTT. These platforms offer linear channels via DTT alongside content delivered via IPTV. Looking forward this may become an increasingly important model for retailers who wish to offer both linear channels and on-demand content, for example delivered using the proposed Canvas service.

8.66 There is evidence from a range of sources that there is unmet demand for Sky's Core Premium channels on DTT:

- Sky's business plan for Picnic estimated (in April 2008) that around **[✂]** households would subscribe to premium content on its proposed Picnic service

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[1122] Source: Ofcom, Digital Progress Report, Digital TV, Q3 2009. http://www.ofcom.org.uk/research/tv/reports/dtv/dtv_2009_q3/dtv_2009_q3.pdf

[1123] See Figure 5 for a description of the set up costs.

[1124] Cable is available to 49% of households and IPTV is available to 39% of households. Both platforms target major conurbations and there is likely to be significant overlap in each platform's availability.

[1125] Some of these households may not be able to access Sky satellite either, because of technical or other restrictions.

[1126] Sky response to question 31 of Ofcom Information request dated 13 October 2009 Q1, Annex 4, within three years of launch, an equivalent of around **[✂]** per cent of DTT households, and **[✂]** within five years[1127].

- Early research for Sky relating to its planned Picnic service suggested that a proportion of customers for the proposed service would come from Sky's satellite customers[1128]. **[✂]**.

- A recent UBS[1129] report found that around 15% of DTT households (about 1.5 million) would be "very interested" in a "best of Sky" service on DTT, and around a further 20% (or 2 million) "somewhat interested".

- A survey by O&O[1130]found that:

  - There was potential demand for Sky's premium channels from Freeview households. O&O asked respondents for their interest in "a package of premium Sky services including Sky Sports 1&2 and the main Sky Movies channels". At a price of £25, 13% were interested; at a price of £15, 18% were interested.

  - Switching from cable and satellite to DTT: O&O suggest that, at a DTT premium price of £25, 6% of Sky customers and 4-5% of Virgin Media customers would be likely to switch away from their services. Three quarters of those switching from Sky, and half of those switching from Virgin Media, would be premium subscribers.

- One recent study[1131] by Execution Noble assessed the propensity of current subscribers to Sky's premium channels on Sky and Virgin Media to switch to BT Vision if it were to offer Sky Sports 1 for £15:

  - About 10% of Sky's premium sports subscribers might consider switching to Sky Sports 1 on BT Vision; and only 17% would definitely switch[1132]. Looking at the overall subscriber base, about 5% of all Sky and 4% of Virgin Media customers might consider switching to BT Vision[1133].

[1127] Sky response to question 3 of Ofcom's information request of 29 October 2009.

[1128] Spot Market Sizing Debrief, Incite Marketing Planning, May 2007; Quantitative Omnibus Research Findings, Sky, January 2007.

[1129] UBS Investment research, 3 August 2009 "The Sky is still blue, just bigger". Figures based on visual interpretation of Chart 4.

[1130] "Battling for the Media Consumer 2009 – UK Media in the On Demand Age", Oliver & Ohlbaum Associates, December 2009, slides 8 to 10. Survey conducted by Fly Research; internet survey of 2600 UK consumers, representative of the UK population.

[1131] Execution Noble, Company Insight, Media, 08 February 2010, "BSkyB, All change, no change", and Company Insight, Telecommunications, 08 February 2010, "Virgin Media, Solid outlook for 2010".

[1132] Execution Noble, Company Insight, Media, 08 February 2010, "BSkyB, All change, no change", and Company Insight, Telecommunications, 8 February 2010, (figure 2, "maybe"); (figure 2, "definitely").

[1133] Backtesting has been used to adjust the responses from the survey to consumers' actual behaviour.

- o About 3% of Virgin Media consumers would consider switching to BT Vision[1134].

8.67 In the quantitative part of our impact assessment, we estimate that by the end of the fifth year of the proposed remedy, DTT / IPTV retailers would serve 1.8 million customers taking Core Premium channels. Of these, we estimate that Picnic would serve around **[✂]** customers. We estimate that Sky would serve around 0.6 million fewer customers taking Core Premium channels on satellite.

8.68 If Picnic alone was to retail on DTT / IPTV, we would expect fewer subscribers to Core Premium channels on the platforms, with Picnic serving **[✂]** households. We would expect more retailers, offering greater variety to consumers, to attract more consumers to the market; additionally, non-Sky retailers will have a greater incentive to compete aggressively for customers, as they do not risk cannibalising an existing premium subscriber base.

Conclusion on distortion from lack of supply on DTT

8.69 The surveys highlight the potential unmet demand for Sky's Core Premium channels on DTT. This data (which is also discussed in our impact assessment[1135]) suggests that a significant number of households who do not subscribe to satellite or cable services would like to have access to Sky's Core Premium channels on DTT. There may be a number of reasons why consumers might prefer to take premium channels via DTT:

- They might not want or cannot have a satellite dish.
- They might not want to be tied into a long-term subscription.
- They might be more attracted to the kinds of low-cost packages typical of DTT, with low switching costs from existing free-to-air terrestrial services.

8.70 Additionally, a small percentage of current Core Premium channel subscribers on cable and Sky would be likely to switch to DTT.

8.71 Consumers that either prefer DTT or are unable or unwilling to take satellite or cable are worse off because Sky has restricted wholesale supply of its Core Premium channels to DTT retailers[1136]. In Section 7 we set out why, if Sky were able to retail on other DTT platforms, this would not be sufficient to alleviate the concerns that we observe[1137]. We also discuss Sky's entry onto DTT through Picnic in our separate statement[1138].

[1134] Execution Noble, Company Insight, Media, 8 February 2010, Company Insight, Telecommunications, 08 February 2010, "Virgin Media, Solid outlook for 2010", page 6 and figure 5.

[1135] See Section 11.

[1136] The research tests consumers' likely demand for premium channels on DTT at various prices. The actual level of unmet demand will depend on the final price offered in the market.

[1137] Paragraphs 7.210 to 7.234.

[1138] See Picnic Statement.

8.72 We therefore conclude that the restricted wholesale supply of Core Premium channels to DTT-based platforms has substantially restricted consumer choice and will continue to do so.

Restricted wholesale supply to other platforms

8.73 In the Third Pay TV Consultation[1139] we said that our concerns over lack of supply of premium channels on DTT extended to platforms on other distribution technologies where Sky has not offered wholesale supply (such as IPTV where Sky did not offer to wholesale its Core Premium channels to a potential IPTV entrant **[✂]**[1140]). We said that Tiscali / TalkTalk TV (which carries Sky's Core Premium channels on its IPTV platform, but effectively as Sky's agent[1141]) had attributed the lack of success of IPTV to a lack of wholesale access to premium content[1142].

8.74 Sky said that it was untenable to equate unavailability of Sky's channels on DTT with the supply of channels to Tiscali / TalkTalk TV on a Sky By Wire basis[1143]. It said that Tiscali / TalkTalk TV's relative lack of success cannot be attributed to lack of supply of Sky's channels and that a more likely explanation might be its high costs which prevent it from being an effective alternative to existing platforms[1144]. Sky referred to an assessment of the transmission costs of different distribution technologies elsewhere in the Third Pay TV Consultation[1145] to suggest that "Ofcom clearly states its view that IPTV is not currently an effective alternative to existing distribution technologies and is unlikely to become an important distribution technology until its cost base is reduced"[1146].

8.75 BT highlighted the fixed costs involved in entering TV markets with a new platform. It said it was only by achieving revenue scale that the fixed costs of developing pay TV platforms and propositions can be recovered. It said that without access to Sky's Core Premium channels it would be unable to build scale required to recover those costs[1147].

Conclusions

8.76 The restricted supply of Sky's Core Premium channels to other (non-DTT based) platforms also limits consumer choice. Consumers who have preferences for particular platform features, and a demand for these channels, have to make a trade-off between platform and content. This means that some consumers will choose a

[1139] Ofcom's Third Pay TV Consultation paragraphs 7.71 to 7.73.

[1140] In Section 7 we also note that Sky has refused so supply Virgin Media's IPTV service.

[1141] Ofcom's Third Pay TV Consultation, paragraph 7.71.

[1142] **[✂]**

[1143] Sky response to Third Pay TV Consultation paragraph 8.13.

[1144] Sky response to Third Pay TV Consultation paragraph 8.20.

[1145] Ofcom's Third Pay TV Consultation paragraph 9.132.

[1146] Sky response to Third Pay TV Consultation paragraph 8.20.

[1147] BT response to Ofcom's Third Pay TV Consultation paragraph 2.10.

platform that would not otherwise be their first choice, while others will have their preferred platform but no access to Sky's Core Premium channels.

8.77 For the reasons set out in Section 7, self-retail by Sky on other platforms is not sufficient to mitigate our concerns[1148]. As we said in that Section, Sky is pricing on Tiscali / TalkTalk TV with a view to protecting its satellite business. For example the price of adding Sky Sports Mix to any of Sky's basic bundles is £18, whereas the price of adding Sky Sports Mix to any of Tiscali / TalkTalk TV's basic bundles is £29[1149]. If the price differential of Sky and Tiscali / TalkTalk TV's basic packages reflects differences in quality and characteristics of the products then the difference in the cost of adding Sky Sports on each platform is striking, particularly considering that the quality of the channels on Tiscali / TalkTalk is lower than on satellite (as interactive features are not available). Sky's pricing on Tiscali / TalkTalk TV is likely to distort choice. For example, some customers who would otherwise choose Tiscali / TalkTalk TV (at the price that an efficient independent retailer would set) are either using the less-preferred satellite platform (distorted choice) or not buying (unmet demand). We therefore attribute the poor penetration of Sky's channels on Tiscali / TalkTalk TV in large part to Sky's attitude to supplying as the retailer.

8.78 Our comment on the effectiveness of IPTV[1150] should be seen in its context, which was an assessment of the prospects of entry over different technologies when setting transmission costs for a single (platform neutral) wholesale must-offer price. Clearly, IPTV services are already present in the market. While it is true that IPTV may have higher average transmission costs than satellite, it has different features and capabilities – most obviously true VoD – which satellite is unable to offer.

8.79 Furthermore, the ability of IPTV to compete is illustrated by the relative success of IPTV in other countries (such as France, Sweden, or the US)[1151]; and the relatively low price of Tiscali / TalkTalk TV's smallest basic IPTV bundle (£26.47) compared with an equivalent bundle on Sky (£32)[1152]. Our view is therefore that there is potential for increased choice through the further development of IPTV services, and that the extent of such development is constrained by the lack of wholesale access to premium channels.

8.80 We therefore conclude that the restricted wholesale supply of Core Premium channels to non-DTT platforms has substantially restricted consumer choice and will continue to do so.

[1148] Paragraphs 7.210 to 7.234.

[1149] Prices accessed on 17 February 2010 at http://www.talktalk.co.uk/tv/buy-talktalk-tv/sports/ and http://www.sky.com/quickbuy/build

[1150] Ofcom's Third Pay TV Consultation paragraph 9.132.

[1151] For example, IPTV penetration in 2008 was 13% in France and 10% in Sweden, compared with 0.2% in the UK. Source: World Television Markets – Idate (2008). In the US in 2009 there were approximately 5.5m subscribers to IPTV (see paragraphs 4.169 to 4.171 above). As we set out later in this Section we interpret international comparisons with care, as there can a range of historical contextual reasons for differences in penetration.

[1152] Packages equivalent to those cited by Sky in its response to Ofcom's Second Pay TV Consultation Section 5, Table 1.

8.81 We recognise that Sky's Core Premium channels are retailed by Sky through other platforms such as Xbox 360, Fetch TV, broadband-enabled TVs and the internet (via Sky Player). Sky has indicated that it intends to supply its channels via other platforms (such as **[✂]**)[1153]. They are also available via mobile services in areas with a 3G connection. However, as we set out above[1154], where Sky self retails on other platforms it has the incentive to set prices so as not to disadvantage its own platform (as illustrated by Sky Player pricing)[1155]. As a result, current demand for these services is very low (for example in October 2009 there were **[✂]** Sky Player subscribers[1156], so the availability of Sky's channels on these platforms would not mitigate any concerns about the lack of availability on DTT or other platforms).

Limited range and variety of packages

8.82 In our Second Pay TV Consultation we said that retail package innovation around premium channels was limited in the UK. We found that consumer choice may be restricted if that content is only made available via a limited range of content bundles[1157]. For example, we observed that though Sky offered a wide range of content bundles, the pricing of these encouraged consumers to trade up to a small number of 'big mixes'. We said that the continued prevalence of enforced buy-through[1158], and the lack of smaller, entry level "pay TV light" premium packages in the UK (Setanta being the only obvious exception) were examples of the lack of choice for consumers[1159]. We said this led to consumer harm as subscribers were denied the choice of TV package that would best suit their needs[1160].

8.83 In response to our Second Pay TV Consultation Sky said that Setanta's entry into the market and its different business model were evidence that the market was working well for consumer and was competitive[1161]. Sky pointed to the 1,764 different bundles that if offered to consumers and in particular to the popularity of its smaller packages of basic genre mixes as evidence that consumers had a choice of content[1162]. It drew on a report from PwC[1163] which found that the retail of channels on a standalone or à la carte basis or "pay TV light" services was not common in Europe[1164].

[1153] Sky response to Third Pay TV Consultation paragraph 8.10.

[1154] Paragraphs 7.210 to 7.234.

[1155] See paragraphs 7.220 to 7.221.

[1156] Sky response to question 31 Ofcom information request of 31 October 2009.

[1157] Ofcom's Second Pay TV Consultation paragraph 7.33.

[1158] Ofcom's Second Pay TV Consultation paragraph 7.48.

[1159] Ofcom's Second Pay TV Consultation paragraph 7.34.

[1160] Ofcom's Second Pay TV Consultation paragraph 7.54.

[1161] Sky response to Ofcom's Second Pay TV Consultation, Section 5, paragraph 3.40.

[1162] Sky response to Ofcom's Second Pay TV Consultation, Section 2, paragraph 2.27 and Section 5 paragraphs 3.38 to 3.39.

[1163] Annex 1 of Sky's response to Ofcom's Second Pay TV Consultation.

[1164] Sky response to Ofcom's Second Pay TV Consultation, Section 5, paragraph 3.47.

8.84 In response to our Third Pay TV Consultation BT said that there was a "standardised" approach to the business model adopted by pay TV operators which it described as:

- "A set top box is provided free in return for a commitment to a monthly subscription.
- Bundling of basic channels into category bundles with a large number of channels.
- 'Buy-through' to premium channels, requiring customers to subscribe to at least one package of basic channels before being eligible to subscribe to premium channels"[1165].

8.85 BT argued[1166] that this business model restricts consumer choice in terms of packages and price points offered compared with a more competitive retail distribution market. It said the aim of the existing business model was to allow incumbent retailers to maximise monthly subscription revenue.

8.86 **[✂]**[1167]:

- **[✂]**.
- **[✂]**.
- **[✂]**.
- **[✂]**.

8.87 BT highlighted the potential increase in competition that could be enabled by Canvas where multiple retailers will be able to access consumers via the service. The more intense competition would mean that "[c]onsumers will be able to choose between any Canvas affiliated ISPs on the basis of their own individual choice criteria – e.g. range of content, nature of market propositions, pricing, innovation, customer service, experience of the organisation in the past, etc." [1168].

Conclusions

8.88 The narrow range of retailers supplying Sky's Core Premium channels limits the variety of packages on offer to consumers. In particular it limits the availability of entry-level packages, which might provide a reduced range of channels, at a lower price than the large bundles which are purchased by most of Sky's existing customers[1169].

8.89 There are a number of reasons why package choice is limited which we discuss in turn below:

[1165] BT response to Ofcom's Third Pay TV Consultation, paragraph 2.22.

[1166] BT response to Ofcom's Third Pay TV Consultation, paragraph 2.23.

[1167] BT response to Ofcom's Third Pay TV Consultation, paragraphs 2.23 to 2.24.

[1168] BT response to Ofcom's Third Pay TV Consultation paragraph 2.20.

[1169] **[✂]**% of Sky's premium subscribers take all six basic mixes (at September 2009).

- Where Sky retails on other platforms it is unwilling to offer prices that cannibalise sales from its satellite platform.
- Where Sky retails on its own platform it has an incentive to maximise revenues by designing pricing structures which incentivise consumers to purchase larger rather than smaller bundles.
- New entrants would have an incentive to target different parts of the market without fear of cannibalising existing revenues.
- The content is not wholesaled to some platforms, which means retailers cannot offer packages designed to suit the platform's characteristics.
- There is limited competition in the retail supply of Core Premium channels.

Cannibalising satellite sales

8.90 As we have said in Section 7, where Sky retails on other platforms, it sets prices so as not to cannibalise satellite sales[1170]. We have said that Sky's pricing on Tiscali / TalkTalk TV and the Sky Player service are both examples where the prices are designed not to offer a more attractive package (in either quality or price) than is available on its satellite platform. For example the price of adding Sky Sports Mix to any Tiscali / TalkTalk TV package is £29.00, whereas the price of the same channels to any Sky bundle is £18[1171]. The price for Premium channels on Sky Player is only slightly cheaper than the price for a similar bundle on satellite, despite Sky Player's lower costs (for example lower transmission costs, and no implicit set-top box subsidy included within the retail price), a lower quality picture[1172] and a narrower range of channels and services offered.

Availability of entry-level packages

8.91 The availability of entry level packages has increased in recent years. In 2005, before Sky introduced its current genre basic mixes, **[✂]**% of Sky's subscribers took the equivalent of Sky's Six Mix (its biggest basic package) and there was a "buy through clause" when premium channels were wholesaled, which prevented them being sold on a stand-alone or à la carte basis. Now **[✂]**% of Sky's premium subscribers take a lower basic tier package including a small number (almost **[✂]**) who choose to take premium channels on a stand-alone basis[1173] and there is no longer a buy-through clause for its wholesale customers.

[1170] Paragraphs 7.210 to 7.234.

[1171] Prices accessed on 17 February 2010 at http://www.talktalk.co.uk/tv/buy-talktalk-tv/sports/ and http://www.sky.com/quickbuy/build

[1172] Sky Player is delivered as an "over the top" internet service and so does not have the quality of service associated with traditional broadcast platforms such as satellite. The user is more likely to experience interruptions or may need to select a lower quality version of the service to avoid interruptions (in Sky Player PC the user is manually able to select "high", "medium" or "low" quality corresponding to 1800 Kbit/s, 1200Kbit/s and 600Kbit/s – the fact that this functionality is provided indicates that some customers will need to select the lower quality feed).

[1173] Sky introduced zero mix in September 2009, after one month the total number of subscribers taking this package was **[✂]**.

8.92 However, Sky's current price structure encourages consumers to buy the larger basic mixes, typically bundled with a ("free") set-top box. There is only £6 difference between Sky's largest and smallest basic package when taken with premium channels (customers can take additional basic channels in increments of £1). The low price differential encourages subscribers to trade up to large mixes. On Virgin Media the price difference between the packages including the biggest and smallest basic bundles (when taken with premium channels) is slightly wider at between £11.50 and £17.50[1174]. If channels were retailed in more competitive markets we might observe different price structures and in particular we might see more attractively priced entry level packages. For example, consumers might be able to choose between low priced packages which excluded any set-top box subsidies or higher priced packages which included set-top box subsidies. Alternatively retailers might choose different business models with lower marketing costs and lower prices for consumers.

8.93 Entry-level premium channels and services, provided by retailers other than the main provider of Core Premium Channels, are increasingly available in a number of markets in Europe and we discuss some of these in Section 4. Since Sky's PwC report the sector has developed further. For example:

- Orange TV offers entry-level premium channels in France, launching an Orange Sport Channel in August 2008 and Orange Cinema in November 2008. The two services had attracted 663,000 subscribers by Q4 2009, from 130,000 a year earlier[1175].

- Mediapro launched its Gol TV premium channel in Spain in 2009, which had attracted one million subscribers within its first three months of operation. The premium sports channel costs around €15 a month and broadcasts a range of football, including Spanish La Liga and UEFA Champions League. The channel is available on platforms including DTT, cable and IPTV[1176].

- There is also evidence of established providers of Core Premium Channels looking to cater for an entry-level market for premium sports and movies, Canal Plus in France last year said that it would test weekend subscriptions for around half the price of a standard subscription[1177].

8.94 If new entrants had wholesale access to Core Premium channels and had the freedom to set retail prices, market the channels and discount in order to win customers, retailers might offer new types of packages. For example, we might see 'season ticket' offers where channels are retailed on a stand-alone basis and paid for with an annual fee (like for example Setanta's season ticket or Sky's PremPlus PPV service). Alternatively, retailers could bundle a year's subscription to a premium channel "for free" with a set-top box as Top Up TV did with Setanta[1178].

[1174] Depending on the package chosen correct. Source: http://allyours.virginmedia.com/websales/service.do?id=1 correct at 16 March 2010.

[1175] http://www.orange.com/en_EN/press/press_releases/att00014543/CP_FY09_EN.pdf

[1176] http://www.broadbandtvnews.com/2009/12/15/gol-tv-reaches-viewing-milestone/

[1177] http://www.digitaltveurope.net/news_articles/jun_09/19_jun_09/canal_plus_launching_weekend-only_pay_tv_package

[1178] http://www.digitalspy.co.uk/digitaltv/a118941/free-setanta-for-new-top-up-customers.html

Lack of wholesale access on some platforms

8.95 The particular characteristics of a platform may determine the service that can be offered over it. For example, DTT is relatively capacity constrained (compared with satellite for example). However the one-off set up costs are low (as most consumers can simply plug a set-top box into an existing TV aerial), so retailers on this platform might be more inclined to offer smaller, cheaper packages of channels without the need for long term contracts. **[✂]**[1179].

8.96 By contrast, Sky's services on platforms other than satellite – such as its Sky Player service and its retail offering via Tiscali / TalkTalk TV – appear to be designed to minimise any competitive constraint on Sky's core satellite offering. As we have explained in Section 7, Sky's prices for both of these services represent considerably poorer value than its satellite offering.

8.97 Some consumers may prefer such a limited, lower-priced service to paying more for a larger suite of channels on a longer contract (e.g. on satellite or cable). As another example, a one-to-one service, such as cable, may be better suited for offering VoD services than a one-to-many service such as satellite and so, other things being equal, may be able to offer such a service more cheaply.

8.98 Looking forward, our concerns are amplified as the scope for new retailers to enter using technologies such as Canvas is increased. New retailers could use this new technology to package the channels in bundles that are currently unavailable. For example, mobile phone operators might offer bundled services of mobile and TV.

Lack of competition inhibits range of prices

8.99 Finally, the current structure of retail markets for Core Premium channels means that Sky is not incentivised to offer a wide range and variety of prices and price structures to subscribers. In Sections 5 and 6 we have said that Core Premium Movie and Sports channels are supplied in narrow retail markets where Sky is by far the largest incumbent retailer with a market share of 68% to 85% in the case of Core Premium Sports channels and 38% to 92% in the case of Core Premium Movie channels (depending on the measure used)[1180]. In an effectively competitive market, each retailer would be more strongly incentivised to create packages and price structures designed to attract customers from rivals. For example, Tiscali / TalkTalk TV said **[✂]**[1181].

Conclusion

8.100 We therefore conclude that the lack of wholesale access to Sky's Core Premium channels leads, and will continue to lead, to significant consumer harm in that it inhibits the range and variety of packages on offer to consumers. This means that some consumers chose a package that does not closely reflect their preferences, or that they chose not to consume.

8.101 We have a particular concern this may result in limited availability of entry-level packages, which might provide a reduced range of channels, at a lower price than

[1179] See paragraph 8.86 above.

[1180] See paragraphs 5.597 to 5.598, and 6.351.

[1181] TalkTalk response to Ofcom information request of 28 October 2009 questions 1 and 2.

the large bundles which are purchased by most of Sky's existing customers. This means that some existing customers may be paying more than they would in an effectively competitive market, because they would be better off purchasing smaller packages of channels. It also means that there is likely to be a level of unmet demand among other potential consumers, in particular the 10 million households whose primary means of viewing TV is via free-to-air platforms such as Freeview.

8.102 If there were effective retail competition in the provision of core premium channels we would expect to see a wider range of bundles, packages and price points offered to consumers as set out **[✂]**[1182].

Restricted supply of HD versions and interactivity features of Core Premium channels

Consultation responses on HD and interactivity

8.103 In the Third Pay TV Consultation we explained that Sky does not supply HD or interactivity services to Virgin Media[1183]. Consumers who value these features in respect of Core Premium channels are faced with a choice of having to subscribe to Sky on satellite (even if they prefer the cable platform); or subscribe to cable without access to interactivity or linear HD channels; or in the case of movies and HD use another service such as PPV HD movies or HD DVDs.

8.104 In response to our consultation Sky said that interactivity was not "indispensible" for retailers. It added:

> "This is simply and clearly demonstrated by the fact that [interactivity features] have been available only on Sky's DTH satellite platform for many years, without any demonstrable impact on competition in any relevant downstream market. If the lack of availability of such services on other platforms was likely to have a significant impact on their ability to compete with Sky, it would be expected that there would be clear and compelling evidence of such an effect – in fact, such an effect would have been expected to have manifested itself a long time ago"[1184].

8.105 Sky said that evidence from Ofcom and Sky supported the view that consumers place relatively little value on such services. Sky referred to evidence provided in response to Ofcom's First Pay TV Consultation[1185].

> "In Ofcom's Phase 1 [from June / July 2006] interactivity was rated as "important" by only 14% of respondents, and of those, only 27% (or 4% of all respondents) rated it as "must have" … Only 2% of respondents mentioned "angles/sports/matches" (i.e., services which are associated with Sky's sports channels) as an important interactive service, and only a third of those rated it as "must have";

[1182] See paragraph 8.86 above.

[1183] Ofcom Third Pay TV Consultation paragraph 6.115 to 6.124.

[1184] Sky response to Third Pay TV Consultation, paragraph 9.86.

[1185] Sky response to First Pay TV Consultation Section 2, paragraph 10.35 to 10.36.

and in Phase 3 of its consumer research [from September 2007], Ofcom found that only 3% of respondents listed interactive services as a reason for choosing their provider, and this figure was no higher for those taking sports or movies.

Sky's own data is consistent with that of Ofcom and shows that, **[✂]**."

HD

8.106 HD is clearly a technology suited to watching the highly valued sports and movies content found on Sky's Core Premium channels. This is illustrated by the high propensity of HD subscribers to take Core premium channels. **[✂]**% of HD subscribers take premium channels, whereas only **[✂]**% of SD subscribers take premium channels[1186].

8.107 The ability to view HD channels is of growing importance to consumers. Approximately 17.9 million 'HD-ready' sets had been sold in the UK by Q1 2009 and 33% of households – around 9 million – in the country claimed to have a HD set at the end of 2008[1187]. Around 3.5 million homes were capable of receiving HD at the end of September 2009, either because they subscribed to Sky+ HD or Virgin Media's V+ service; or because they had a Freesat HD set-top box or integrated digital television (IDTV)[1188].

8.108 Our recent research finds that HD is important for a significant minority of premium subscribers. For example:

- 48% of satellite HD premium subscribers (equivalent to about **[✂]** of all premium subscribers) considered HD either important or crucial[1189].
- Three in ten HD subscribers (31%) wouldn't have chosen their pay TV provider (in most cases Sky) if HD services hadn't been available. Again similarly, 16% of Sky HD customers would not consider downgrading to SD even if the price difference increased from £10 currently up to £30 a month (while another 4% "don't know")[1190].

8.109 The growing importance of HD can also be gauged by industry participants. For example, according to a recent report by Informa, the president of Astra (the satellite

[1186] Source: Annex 1 of Sky response to question 1 of Ofcom's information request dated 13 October 2009 and Annex 4 of Sky response to question 26 of Ofcom's information request dated 29 October 2009.

[1187] Ofcom Communications Market Report 2009, pages 75 and 76.

[1188] See Section 4.

[1189] Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009. Satellite HD premium subscribers sample size = 97.

[1190] Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009. HD subscribers sample size = 213. Sky HD subscribers sample size = 191.

operator) claimed that Sky could switch off its SD service by 2018[1191]. In Italy, Sky Italia is reported to have stopped selling SD packages to new subscribers and now only sell packages with HD channels[1192]. We consider the importance of HD for retailers further in Section 9[1193].

Interactivity

8.110 The evidence quoted by Sky[1194] suggests that few subscribers consider interactivity the *only* reason for subscribing to pay TV. Among Sky Sports satellite customers who responded to a recent Ofcom-commissioned survey: [1195]

- 82% were aware of the interactive features included in the service, and over half of these used them.

- Amongst Sky Sports subscribers, the most popular uses were watching different live Champions League matches (36%) and digital text services (22%)[1196].

- Interactivity was an important consideration in platform choice for 9% of satellite Sky Sports subscribers or **[✂]** subscribers. One in four said that the availability of interactive services had influenced their choice of pay TV provider.

- Interactive features were worth at least £1 per month to 70% of customers, and around one in four were willing to pay at least £10 for them.

8.111 While this evidence indicates that interactive services are not highly valued by all customers, a substantial minority of Sky's premium customers would be reluctant to switch to a service which did not have them.

Conclusions

8.112 HD is already important to a large number of consumers, and this importance is expected to increase with time, to the extent that it may replace SD as the standard means of viewing content. Sky has stopped offering SD set-top boxes. This importance is illustrated not just by the level of take-up of HD services on Sky's existing platform, but also by the priority attached by various broadcasters to making HD services available on DTT (such as BBC, ITV, Channel 4 and S4C) and on Freesat (such as BBC and ITV).

[1191] He is quoted as saying "It is unlikely to come straight from them, but if I listen to our sources then Sky will be able to switch off its standard-definition broadcasts by between 2016 and 2018." New Media Markets, 18 November

[1192] See for example a Morgan Stanley note on the TMT Conference, November 23 2009, page 4. See also: http://www.sky.it/abbonarsi/promozioni/index.shtml?ref=corporatetab.

[1193] Paragraphs 9.266 to **Error! Reference source not found.**.

[1194] See paragraph 8.105.

[1195] Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009.

[1196] Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009. Sky Sports subscribers sample size = 326.

8.113 Consumers who value watching Core Premium channels in HD and have a preference for platforms other than Sky's satellite platform will clearly face a detriment by not being able to consume HD Core Premium channels on their chosen platform. Lack of access to HD Core Premium channels will therefore become a barrier to entry and expansion as HD transmission increasingly becomes the standard for delivery of premium channels. The consumer harm we identify therefore relates not just to Virgin Media, where Sky have restricted supply of its HD channels[1197], but potentially to any platform, whether IPTV or DTT, that seeks access to those channels.

8.114 We conclude that the restricted supply of HD Core Premium channels to Virgin Media results, and will continue to result, in significant harm to consumers because it limits choice. This contributes to the low penetration of Core Premium channels on Virgin Media. We would have similar concerns if HD versions of these channels were not made available to other providers.

8.115 Interactive features of Core Premium channels do not in our view have the same importance as HD. However, they are important to a significant number of consumers. We disagree with Sky when it states that the lack of supply of interactivity has demonstrably had no effect on downstream competition. The restricted supply of interactivity weakens Virgin Media's offering as compared to Sky and will have limited Virgin Media's ability to compete for customers.

8.116 We acknowledge that relatively few subscribers see interactivity as the *most important*[1198] reason for subscribing. However, it is a service that is used by almost half of Sky Sports subscribers, and it was an important consideration in choice of platform for 9%. As such, a substantial number of Sky Sports subscribers who use interactivity would consider Virgin Media's product technically inferior to Sky's. Around **[✂]** Sky Sports subscribers on Sky's satellite platform considered it an important feature in determining their platform choice. The lack of supply of interactivity therefore also contributes to the low penetration of Core Premium channels on Virgin Media.

Restricted ability and lack of incentive for Virgin Media to retail premium channels

8.117 In the previous Section we concluded that Sky's current wholesale prices restrict the ability of Virgin Media to compete with Sky. Sky supplies premium channels to Virgin Media at a price it believes is compliant with an ex post margin squeeze test, i.e. Sky's own retail business is profitable at the level of the whole bundle on the basis of this wholesale price. Virgin Media is unable to compete effectively with Sky at the rate-card price because of its smaller scale, and the wholesale price gives Virgin Media little incentive to sell premium channels to an existing basic subscriber. In the sub-section below we consider whether:

- Virgin Media's lack of incentive leads to unmet demand and low awareness of Sky's channels.
- Unmet demand is likely to be a significant source of consumer harm.

[1197] See paragraphs 7.297 to 7.311.

[1198] Or a "must have" feature.

- Piracy explains low penetration of premium channels on cable.

<u>Virgin Media's incentive to sell Core Premium Channels</u>

Our previous consultation

8.118 In the Third Pay TV Consultation we set out that **[✂]**[1199].We said that the lack of incentive to market the channels to existing subscribers leads to unmet demand among Virgin Media's subscribers.

8.119 We said the unmet demand for Sky's channels can be seen in the low rates of penetration of Core Premium channels on cable compared with Sky. For example, penetration of Sky's Core Premium channels on Virgin Media was only **[✂]** of that on satellite, and had fallen substantially in recent years. Penetration of this content on satellite had also fallen, but the gap in penetration between the two platforms has widened.

Responses to our consultation

8.120 In response to our Third Pay TV Consultation Sky agreed with Ofcom that Virgin Media's incentive to sell premium channels led to unmet demand (at current prices) for its premium channels on Virgin Media[1200]. For example, Sky pointed out[1201] that if subscribers call Virgin Media to downgrade parts of their package Virgin Media's customer service advisors will have an incentive to steer subscribers into dropping Sky's premium channels which earn low margins rather than other products where Virgin Media earns a higher margin.

8.121 Sky stated that it "can [not] credibly be said that consumers are unaware of [the] availability [of its Core Premium channels on Virgin Media]"[1202]. Sky supplied a range of evidence documenting Virgin Media's marketing activity which was aimed at new subscribers and encouraged them to subscribe to Sky's Premium channels.[1203]

8.122 Sky stated[1204] that to the extent that there is unmet demand for Sky's Core Premium channels among Virgin Media basic tier customers their demand must be relatively weak. Sky therefore concluded that any lost consumer surplus in respect of those customers is likely to be low. Sky did not supply any specific evidence supporting these claims.

8.123 Sky also drew attention to comments by Neil Berkett[1205], the Chief Executive of Virgin Media, when announcing its Q3 2009 results; announcing its agreement with TiVo

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[1199] Ofcom's Third Pay TV Consultation paragraph 6.113. See also paragraphs 7.262 to 7.290.

[1200] Sky response to Third Pay TV Consultation paragraph 8.14.

[1201] Sky response to Third Pay TV Consultation paragraph 6.32e.

[1202] Sky response to Third Pay TV Consultation paragraph 8.15.

[1203] Sky response to Third Pay TV Consultation Appendix 3.

[1204] Sky response to Third Pay TV Consultation paragraph 8.17.

[1205] January 2010 Sky Submission, paragraphs 6.4 to 6.5 and First February 2010 Sky Submission, Section 2.

and in an interview with the Financial Times. Mr Berkett reported that Virgin Media had been successful in “significantly differentiating and monetising [Virgin Media’s] compelling consumer proposition”. He said that:

> “The superiority of [Virgin Media’s] fibre optic network combined with TiVo’s capabilities, will allow us to offer consumers the most significantly advanced and compelling TV service available in the UK, and we believe will do to the TV market what Virgin Media has done to the high speed broadband market”.

8.124 In the article Mr Berkett described Virgin Media’s strategy when competing with rivals such as Sky or BT. He said its strategy was to differentiate its broadband product by offering fast download speeds, and to innovate on its TV platform by offering a wide variety of VoD services which exploited Virgin Media’s capacity to carry large volumes of data traffic. He then said that Virgin Media would continue to grow by securing VoD content deals and offering a service with TiVo which will “allow it to offer a breadth of video content that rivals cannot match.”

8.125 Sky said that the statements indicate that:

> “Virgin Media has not been deterred by Sky’s wholesale pricing policy from pursuing what it considers to be a successful competitive retailing strategy; and
>
> Virgin Media considers that it offers a compelling differentiated consumer proposition whose success does not depend in any way on Sky’s wholesale pricing policy[1206]”.

Our view

8.126 We remain of the view that Sky’s wholesale prices to Virgin Media affect its incentive to sell the channels[1207]. We agree with Sky that Virgin Media’s sales staff have limited incentive to sell the channels to subscribers and in some circumstances may have an incentive to persuade existing subscribers to cancel their subscription to Sky’s premium channels. This leads to unmet demand for the channels on Virgin Media which is evidenced by the relatively low penetration rate of premium channels on Virgin Media. While, as Sky points out, Virgin Media’s focus is on attracting high value customers, it has not been successful in attracting significant numbers of high value subscribers to Sky’s premium sports and movie channels. On the contrary, it has lost many of these subscribers over recent years.

8.127 We have considered whether the lack of incentive to market Sky’s channels means some customers are unaware that the channels are offered by Virgin Media for the reason stated by Sky[1208]. Our research corroborates Sky’s assessment that

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[1206] First February 2010 Sky Submission, section 2. Sky made the same points, based on comments from Virgin Media’s Chief Financial Officer, in its January 2010 Submission (paragraphs 4.4 to 4.7). In section 5 of the same January submission, it pointed out further statements from Virgin Media about the company’s “focus...on attracting high value customers, who buy more from us and stay with us longer”. It claimed that “[it] is evident, therefore, that Virgin Media does not consider that Sky’s wholesale prices have acted as a deterrent”.

[1207] Paragraph 7.291.

[1208] See paragraph 8.120.

consumers are *not* unaware of the availability of its premium channels on Virgin Media. Although overall awareness of the availability of the channels on Virgin Media is lower[1209] this is concentrated in subscribers with low interest in sport[1210].

- Of Virgin Media basic subscribers who had watched sport in the last week 85% were aware Sky Sports was available on Sky's satellite platform and 81% were aware the channels were available on Virgin Media[1211].

- Virgin Media subscribers also have a high awareness that Sky Movies is available on Virgin Media. 88% of Virgin Media basic tier subscribers who had an interest in movies were aware that the channels could be received on Virgin Media (based on a small sample size)[1212].

8.128 However, the low margin offered to Virgin Media appears to affect its incentive to market to new subscribers. We acknowledge that Virgin Media uses Sky's channels in its marketing to attract new subscribers, but see evidence that the marketing is less effective than Sky's. For example, our recent omnibus survey revealed that the platform choice of a significant minority of Sky's satellite Premium channel subscribers may be distorted. For example when asked why they chose Sky over Virgin Media: 39% of Sky Sports subscribers on Sky (who considered Virgin Media) said "I wanted to get Sky Sports"; and 15% of Sky Movies subscribers on Sky (who considered Virgin Media) chose Sky over Virgin Media to access Sky Movies channels despite the fact that the channels are available on Virgin Media, albeit without HD and interactivity features (based on a small sample size)[1213].

8.129 We have also considered whether the lost consumer surplus from unmet demand is likely to be low as Sky suggests. If Virgin Media basic subscribers tended to have a higher interest in sports or movies than Sky basic subscribers it might indicate that Sky's approach to supplying Virgin Media led to unmet demand which caused significant consumer harm.

8.130 With respect to consumers' interest in sports, Virgin Media's basic tier subscribers had watched more sports events than Sky's basic tier subscribers. For example, 39% of Virgin Media basic subscribers had watched at least one live sport event in the last week including 8%[1214] who had watched at least four live sport events in the last

[1209] Than awareness of the availability of the channel on Sky among Virgin Media subscribers.

[1210] We cannot rule out the possibility that increasing the margin available to Virgin Media would increase its incentive to actively market premium sports channels and therefore increase the overall level of interest in sport among subscribers.

[1211] Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009. Virgin Media basic tier subscribers who have watched sport in the past week sample size = 59.

[1212] By interest in Movies we mean decision makers who had seen at least three films from the list of fifteen current films. Source: Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009. Virgin Media decision makers who have watched 3+ popular films (sample size = 44, apply caution).

[1213] Source: Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009. Sky Sports satellite subscribers who considered Virgin Media sample size = 53. Sky Movies satellite subscribers who considered Virgin Media sample size = 45. Apply caution due to small sample.

[1214] Of Virgin Media basic subscribers. Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009. Virgin Media basic tier subscribers sample size = 160.

week. Sky basic-only subscribers are less likely to have watched live sport: 23% had watched at least one sporting event and 4% had watched at least four live events[1215].

8.131 One plausible explanation of the relatively low penetration of Sky's premium channels on Virgin Media is the availability of alternative means of watching sports, for example ESPN is provided 'free' within XL bundles. However, our research indicated that relatively low numbers of subscribers said that the availability of sport on other channels was a reason why they did not subscribe to Sky Sports. For example, only 10% of Virgin Media subscribers who did not have Sky Sports said there was enough sport on TV, and 6% said ESPN was enough[1216]. We therefore think that while the availability of alternative substitutes on Virgin Media may be a contributory factor to the low penetration, it cannot fully explain the differential in take up on Sky and Virgin Media.

8.132 Turning to movies, our research revealed little difference in interest in movies between Virgin Media basic customers and Sky basic customers indicating that any lost consumer surplus may be lower. For example, 69%[1217] of Virgin Media basic tier subscribers had seen at least one film from our list of 15 recent films, and 26% had seen three or more. The equivalent figures for Sky's basic tier subscribers were very similar: 64% of Sky basic tier subscribers had watched at least one movie and 27% had watched three or more.

- As with sports, we have considered whether the availability of alternative means of watching movies explains the low percentage of Virgin Media subscribers that take Sky Movies. However, a low percentage of Virgin Media subscribers without Sky Movies considered that alternative ways of viewing movies was a reason why they did not subscribe to Sky Movie channels. For example 19% said they would watch DVDs instead, 13% cited films on TV, 6% cited the cinema [1218].

- These responses were similar to Sky subscribers without Sky Movies: 18% said they watch DVDs instead, 10% cited films on TV and 5% said they watch films at the cinema instead[1219]. We do not think, therefore, that the availability of alternative ways to watch movies is a significant cause of the relatively low levels of penetration on Virgin Media compared with Sky.

8.133 We conclude that the relatively high interest in sports among Virgin Media subscribers suggests that there could be significant consumer detriment resulting from unmet demand for premium sports channels. The unmet demand on Virgin

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[1215] Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009. Sky basic tier subscribers sample size = 230.

[1216] Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009. Virgin Media subscribers without Sky Sports sample size = 165.

[1217] Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009. Consumers were asked if they had seen any of a list of films that had been released within the last two years. Virgin Media basic tier subscriber sample size = 160, Sky basic tier subscriber sample size = 230.

[1218] Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009. Virgin Media subscribers without Sky movies sample size = 185.

[1219] Source: Ofcom Pay TV decision makers survey, conducted by TNS, October-November 2009. satellite subscribers who do not have Sky Movies. Sample size = 355.

Media for Sky's premium channels is illustrated by **[✂]**[1220]. Interest in movies is similar for both Sky and Virgin Media basic subscribers which suggests that Sky's supply of its Core Premium channels to Virgin Media may not lead to significant consumer harm from unmet demand but will nonetheless distort consumer choice at the margin.

8.134 Mr. Berkett's comments indicate that Virgin Media has been able to build a successful business despite the low margin that it earns on wholesale premium channels, and that it has sought to differentiate its TV product from its rivals. However, this does not necessarily imply (as Sky argues) that the low margin offered to Virgin Media does not lead to unmet demand and consumer harm that we describe above. Furthermore, the context of the comments is important: it would be improbable for Mr Berkett to have highlighted Virgin Media's weaknesses in statements clearly targeted at the investment community.

<u>Piracy</u>

8.135 Sky stated that one reason that premium penetration may be lower on the cable platform compared with Sky is a higher rate of piracy. **[✂]**[1221]. **[✂]**[1222]. We have seen no evidence that piracy occurs on a sufficient scale to explain the difference in penetration on the platform.

<u>Conclusion on the impact of the low margin offered to Virgin Media</u>

8.136 The low margin offered to Virgin Media contributes to unmet demand for Core Premium channels. This could be because Virgin Media might advise customers who contact Virgin Media's call centres to discuss the price of their package to downgrade their premium subscription (as Sky suggests). Alternatively, it could affect Virgin Media's incentive to market the channels to new subscribers. There is some evidence that the unmet demand could lead to consumer detriment, particularly for consumers interested in premium sports channels.

8.137 While this is not a competition concern of the same magnitude as our concerns about withholding supply to other retailers, it nonetheless creates a situation in which consumer choice is likely to be distorted. The implication – supported by the evidence set out above – is that the extent of consumer harm arising from Sky's wholesale pricing to Virgin Media also appears to be lower than that arising from restricted supply.

Distorted choice of bundles

8.138 In our Second and Third Pay TV Consultations[1223], we noted that the increased importance of 'triple-play' bundles creates a further risk that the distortion of

[1220] See for example **[✂]**.

[1221] Sky response dated 9 December 2009 to question 9 of Ofcom Information request dated 29 October 2009.

[1222] Virgin Media response dated 1 December 2009 to question 10 of Ofcom Information request dated 29 October 2009.

[1223] Ofcom Second Pay TV Consultation paragraph 6.1 and Ofcom Third Pay TV Consultation paragraph 7.75 to 7.80.

consumer choice would extend to the other services which are included in such bundles, such as broadband and telephony services.

8.139 We said that where Sky bundles additional products with Core Premium channels, there is a risk that it can leverage its upstream market power to distort downstream competition. Our concern is that efficient providers of the additional products may be unable to compete with Sky because they do not have access to the relevant upstream input.

8.140 In response to our Third Pay TV Consultation BT observed that bundles of pay TV and other telecoms products such as broadband, telephony and access lines are increasingly popular for consumers[1224]. For example BT said that **[✂]**%of customers who left BT chose a bundled service and **[✂]** of these included a pay TV element. Indeed Sky is leading the growth of bundles that include TV. Figure 119 shows that since 2007, a year after Sky broadband's launch, Sky has consistently taken between a third and two thirds of all quarterly net broadband additions.

8.141 BT said that it was concerned that without access to Sky's Core Premium channels other providers would not be able to effectively compete with Sky in the provision of such double or triple play bundles[1225]. BT said that while Sky (and other providers) has regulated access to BT's copper access network, BT and other providers are unable to compete with Sky in the provision of bundles of Sky's Core Premium channels and broadband or phone products.

8.142 We agree that more consumers are buying their TV in wider bundles with broadband or telephony products[1226]. Economies of scope could enable operators to offer more attractively priced bundles (compared with a similar self-selected bundle) and reduce customer churn[1227]. Consumers benefit by being able to buy all their services from one provider (and therefore face lower transaction costs). We observe that Sky has successfully entered into the double and triple play market: it has an impressive share of net broadband additions since it entered the market in 2006 as illustrated in Figure 119 below. This has increased the choice and range of providers, packages and price points available to consumers.

[1224] BT response to Ofcom's Third Pay TV Consultation paragraph 2.26.

[1225] BT response to Ofcom's Third Pay TV Consultation paragraph 2.26.

[1226] See for example: Ofcom's Consumer Experience research report. Figure 65. http://www.ofcom.org.uk/research/tce/ce09/research09.pdf . It shows that the proportion of consumers buying communications services in bundles has increased since 2005.

[1227] See for example: http://www.analysysmason.com/About-Us/News/Insight/Quadruple-play-bundles-in-for-the-long-haul/

Figure 119 Sky share of net broadband additions (%)

Source: Ofcom / operators

8.143 However, we remain concerned that without wholesale access to Core Premium channels consumer choice of TV sold in wider bundles (for example with broadband, phone or another product) could be distorted. Sky's restricted supply of Core Premium Channels could be harmful for two reasons.

- First, customers with a preference for triple play bundles including Core Premium channels will have their choice restricted as only Sky and Virgin Media will be able to offer such bundles.

- Second, if efficiencies such as economies of scope or reduced churn mean that Sky is able to offer lower priced packages, consumers will be less willing to self-assemble bundles of Core Premium channels, telephone and broadband. This could reduce the ability of alternative providers to effectively compete with Sky in related telephone and broadband markets for the six million households who currently subscribe to Sky's Core Premium channels.

8.144 Furthermore, as we said in our Third Pay TV Consultation, there is a more general concern over the potential that Sky could leverage its market power into related markets whether broadband, phone or indeed any other product that is bundled with Core Premium Channels. The nature of this concern depends on the way in which the additional products are priced. Where the incremental price of an additional product is at or above its long run incremental cost, we would not have a concern. Efficient rival providers of the additional product would be able to compete, and consumers would have an undistorted choice between taking the additional product from Sky or from an alternative provider.

8.145 However, if the incremental price of an additional bundled product were less than its (long-run) incremental cost, then potential competitors for the bundled product would not be able to compete on equivalent terms. To match Sky's incremental price, they would be obliged to price a standalone product below cost. Furthermore, they would not be able to compete for the bundle because they would not have access to the relevant wholesale channels. In other words, the bundle would not be replicable.

8.146 In this context, we note that setting incremental prices below incremental cost may nonetheless be profitable for Sky (even absent any wider strategic considerations). A low price for an additional product may attract more subscribers to Sky's Core Premium pay TV offering, and these additional revenues may offset any losses associated with the additional product. However, our concern in this area is not so much about Sky deliberately pricing below cost in the hope of future recoupment, but the exclusion of efficient competitors in downstream markets.

8.147 We have not undertaken a detailed analysis of Sky's incremental costs and incremental prices to confirm whether or not any of Sky's current bundles would give rise to concerns of this sort. If Sky's bundles were properly replicable, then such concerns would not arise. We discuss this issue in more detail in Section 10.

Summary of conclusions on choice

8.148 As we set out above[1228] consumers are well served against some of the criteria by which we judge the effectiveness of competition in the market. For example the current markets generate a wide range of high-quality content. Consumers also have a wide and growing variety of platforms on which to access content. However, restricted supply of the key drivers for a pay TV retailer, Core Premium Movie and Sports channels, leads to the distortions of choice which cause significant consumer harm.

8.149 Our concerns about choice relate not only to the current situation for consumers, but also in particular to how the pay TV sector is likely to develop in future. In terms of current concerns, choice of platforms is already limited by the restricted availability of Core Premium channels. We believe platform choice is likely to have been distorted, since consumers who in principle would prefer to view Core Premium channels on DTT do not have this choice.

8.150 This concern is exacerbated as we look forward to the future. We are at a point where the potential choice of platforms is increasing and is set to increase further. The chances of these options developing fully to the benefit of consumers will be limited by the restricted availability of Core Premium channels (including HD).

8.151 A lack of wholesale access to Sky's Core Premium channels inhibits the range and variety of packages on offer to consumers. This means that some consumers choose a package that does not closely reflect their preferences, or that they choose not to consume. In particular there appears to be limited availability of entry-level packages. This means that some existing customers may be paying more than they would in an effectively competitive market, for content that they do not want. It also means that there is likely to be a level of unmet demand among other potential consumers, in particular the 10 million households whose primary means of viewing TV is via free-to-air platforms such as Freeview.

8.152 There is some evidence that the low margin offered to Virgin Media leads to unmet demand. Virgin Media is unable to compete effectively with Sky at the rate-card price because of its smaller scale, and the wholesale price gives Virgin Media little incentive to sell premium channels to an existing basic subscriber. However, we are not as concerned about this distortion of consumer choice compared with the restricted availability to Sky's Core Premium Channels to retailers on DTT or to new retailers wishing to enter.

[1228] Paragraphs 8.48 and 8.50.

8.153 We have concluded that the restricted supply of HD to Virgin Media results, and will continue to result, in significant harm to consumers because of the way it limits choice. On a forward looking basis our concerns are amplified as new competing retailers, using a variety of other distribution technologies might be dissuaded from entering or expanding by the restricted availability of HD Core Premium channels. We have a similar concern in relation to interactivity.

8.154 We also have a concern that market power in Core Premium channels will distort choice of wider bundles, as bundling becomes more widespread.

8.155 We recognise that in effectively competitive markets companies compete by trying to differentiate their product from their rivals. This competitive process benefits consumers as they are offered greater choice of products which closely reflect their preferences. However, Sky's enduing market power in the markets for the wholesale supply of Core Premium channels and the high barriers to entry in these markets[1229] mean that the competitive process will not be effective, and will not therefore result in greater choice for consumers in retail markets for Core Premium channels.

8.156 In the following Section we also describe how Sky's approach to supplying its content restricts the availability of retailers to price and package Core Premium channels in innovative ways. This limits the range and variety of packages and price points that consumers would be able to access, compared with the case where Core Premium Channels were supplied to retailers on a wholesale basis.

8.157 We consider on the basis of the above that Sky's approach to the wholesale supply of Core Premium channels results, and is likely to result in future, in significant consumer harm.

Innovation

Introduction

8.158 Innovations in the way TV is produced and supplied have transformed how consumers watch TV in ways that were unimaginable only twenty-five years ago. The switch to digital broadcasting which enables hundreds of linear channels to be transmitted and received; the wide availability of devices that can store hundreds of hours of content; and the ability to request specific content on-demand at the consumer's convenience are all innovations that have produced clear consumer benefits. Television is a sector where firms have been able to take risks to invest in innovative products and where they can successfully reap appropriate rewards.

8.159 We consider that the potential for innovation should be an important criterion by which we assess the functioning of the pay TV market[1230]. We cannot predict the precise nature of future innovation, but we would be concerned if competitive conditions impeded the ability or incentive of providers to innovate either in platform services, such as interactivity, set-top box functionality, DVR capabilities, or VoD options; or in retail service bundling, packaging and pricing.

8.160 In Section 4 we have set out our evidence on the importance of certain types of content for pay TV retailers: live football, and other key live sport; and recent

[1229] See paragraphs 5.390 to 5.589 and 6.273 to 6.344.

[1230] Paragraph 2.16.

Hollywood blockbusters[1231]. A significant proportion of this TV content is concentrated on a few channels controlled by Sky: Sky Sports 1 and 2, and Sky Movies channels. In this statement we set out our view that the restricted supply of Sky's Core Premium channels will harm consumers as it will reduce competition to innovate both in terms of platform services, and in the range and variety of prices and packages on offer to consumers.

8.161 As we have set out in Section 4, it is our view that access to the Core Premium channels which Sky currently controls is highly important to new entrants or to other firms planning to expand (as, indeed, was the case when Sky entered the market)[1232]. Without access to this content, such a firm will not be able to compete effectively and so will not be willing to take a risk on substantial innovation, and secure finance for the necessary investment.

8.162 In this sub-section we consider responses to the Third Pay TV Consultation and our conclusion on the extent to which innovation in the UK is impeded by restricted supply of Core Premium channels.

8.163 In our Third Pay TV Consultation we described the UK's good record on innovation in TV[1233] and particularly in innovations that favour the satellite platform. We recognised Sky's record as an innovator[1234].

8.164 However, we were concerned that Sky would tend to favour only those innovations – in platform enhancement, and in pricing and packaging – which do not cannibalise its existing customer base and which tend to support its incumbent advantages over potential entrants. We concluded that this would inhibit the development of other services and platforms which could otherwise use Core Premium content to drive demand, such as next generation networks, and mobile TV services.

Responses to our consultations

8.165 In response to our Third Pay TV Consultation Sky agreed that the UK's record on innovation was strong. It also agreed "pay TV markets are part of a sector where there is considerable scope for innovation and profound changes in consumer experience" and that the nature and type of future innovations in the pay TV markets are at present uncertain[1235].

8.166 However, it described Ofcom's future theories of harm as speculative, and said that given the inherent unpredictability of pay TV markets they cannot support intervention.

8.167 Sky responded to the point that it would tend to innovate in ways that favour its platform stating that:

[1231] Paragraphs 4.103 to 4.154.

[1232] Paragraphs 4.103 to 4.154.

[1233] Ofcom's Third Pay TV Consultation paragraph 7.84 and Figure 61.

[1234] Ofcom's Third Pay TV Consultation paragraph 7.102.

[1235] Sky response to Third Pay TV Consultation paragraph 8.7.

- Ofcom was not alleging that innovation on non-satellite platforms has been poor in an absolute sense[1236].
- The reason why innovations on satellite were greater than those not suited to satellite was simply that "no other market participant had been willing to invest in its platform (including content) to the extent that Sky has"[1237].
- The pace and scope of introduction of services such as VoD by rivals, which we characterised as not being suited to the satellite platform, had at any rate been good[1238].

8.168 Sky said there was no evidence that its approach to innovation would harm the process of innovation more generally. In fact many of Sky's innovations are later adopted more widely, and other innovations have been developed by third parties independently of access to Sky's premium channels[1239].

8.169 Virgin Media made two observations of how the low margin offered by Sky affected its incentive and ability to innovate. First it said that "[b]y wholesaling its premium channels at uneconomic rates, Sky effectively forces Virgin Media to follow Sky's pricing model leading to less innovation in how pay TV services are packaged and priced"[1240]. Second, it said that "the uneconomic terms imposed on cable reduces the ability of Virgin Media to invest in research and development of new products and services"[1241].

8.170 BT said that lack of wholesale access to Sky's Core Premium channels would limit the scope for innovation. It highlighted the significant fixed costs to establishing new platforms or to developing new services. It said that without access to Sky's Core Premium channels the potential market for pay TV retailers is significantly limited and retailers would not be able to recoup their investment[1242].

8.171 BT thought that innovation would be encouraged by the emergence of a "thriving market of competing pay TV platforms"[1243]. It identified innovations in technology and platforms, as well as in packaging of TV that could be impeded without wholesale access to Sky's channels.

8.172 In terms of platform innovation BT said that platforms using Canvas will be able to offer enhanced viewer experiences to consumers, offering them the opportunity to interact with each other and with content on-demand that is not possible with

[1236] Sky response to Ofcom Third Pay TV Consultation paragraph 8.23.

[1237] Sky response to Ofcom Third Pay TV Consultation paragraph 8.23.

[1238] Sky response to Ofcom Third Pay TV Consultation paragraph 8.23.

[1239] Sky response to Ofcom Third Pay TV Consultation paragraph 8.24.

[1240] Virgin Media response to Third Pay TV Consultation paragraph 6.4.a.

[1241] Virgin Media response to Third Pay TV Consultation paragraph 6.4.d.

[1242] BT response to Ofcom Third Pay TV Consultation paragraph 2.10.

[1243] BT response to Ofcom Third Pay TV Consultation paragraphs 2.9, 2.11.

traditional broadcast platforms (such as satellite or DTT)[1244]. It thought that new platforms could offer more integrated VoD and linear TV channels. Canvas-based platforms, for example, would be able to offer a variety of non-linear content, including catch-up, archive and on-demand content. It also said **[✂]**[1245].

8.173 BT said that if Sky's Core Premium channels were supplied to other retailers, Core Premium channel subscribers would benefit from being able to buy TV content in ways that they currently cannot. It contrasted the current "standardised approach" of offering pay TV with alternative models that could prove popular. It said currently almost all consumers receive subsidised set top boxes in return for a commitment to a monthly subscription to *bundles* of channels, and that generally consumers are required to 'buy through' a bundle of basic tier channels to purchase premium channels. However by creating more retail competition, operators could experiment with new business models which give consumers greater choice and lower price points for access to premium channels and bundled services. **[✂]**[1246].

8.174 It considered that retail access to Sky's Core Premium channels (for example on a Sky By Wire basis) would not be sufficient to encourage innovation, pointing to the low numbers of subscribers on Tiscali / TalkTalk TV's network.

Canvas

8.175 Sky considered the recent "Public Value Assessment" published by the BBC Trust in its assessment of the proposal to invest in Project Canvas[1247] supported its arguments that lack of access to Sky's premium channels would not make substantial innovation on new platforms less likely[1248]. It said that none of the potential benefits of Canvas depended on access to Sky's content. Sky also drew attention to the finding that Canvas could impose competitive pressure on Sky and Virgin Media, suggesting that it was "entirely inconsistent both with Ofcom's analysis of retail competition in the [Third] Consultation Document and with Ofcom's argument in the [Third] Consultation document that the development of new platforms depends upon regulated access to Sky's premium channels".

8.176 Respondents had differing views on the potential effects of having multiple retailers each using Canvas technology to sell content including Sky's Core Premium channels to consumers. BT highlighted the potential benefits that would result from competitive retail markets. For example, BT considered that access to Sky's Core Premium channels would allow the emergence of competing pay TV operators using the Canvas service. This would encourage innovation as each retailer competes to exploit the different capabilities, and "competing operators find newer, quicker and cheaper ways to take advantage of technological capabilities". It added that:

> "An open platform with published standards will allow anyone to create a service or application bringing the creativity and innovation associated with the openness of the internet to the creation of TV

[1244] BT response to Ofcom Third Pay TV Consultation paragraphs 2.9, 2.15.

[1245] BT response to Ofcom Third Pay TV Consultation paragraph 2.17.

[1246] BT response to Ofcom Third Pay TV Consultation paragraphs 2.22 to 24.

[1247] http://www.bbc.co.uk/bbctrust/our_work/television/canvas_provisional_conclusions.shtml

[1248] January 2010 Sky Submission, paragraphs 7.1 to 7.5.

> content and services. *Therefore, consumers will benefit in terms of more choice, more price competition and more innovation even within the Canvas platform, as well as across other competing platforms. Consumers will be able to choose between any Canvas affiliated ISPs on the basis of their own individual choice criteria – e.g. range of content, nature of market propositions, pricing, innovation, customer service, experience of the organisation in the past,* etc."[1249](*emphasis added).*

8.177 By contrast Sky thought that there would be no discernable benefit in multiple retailers reselling Sky's Core Premium channels using Canvas technology. Instead, it highlighted "clear detriments" that would result. For example it said multiple sellers would lead to "consumer confusion, marketing inefficiency, and the reduced infrastructure and content investment incentives identified by Ofcom[1250]".

8.178 BT highlighted some of the innovative features that Canvas would enable. For example it would deliver the integration of TV and communications into a converged user experience. Consumers could benefit by being able to participate actively in the TV experience (for example by voting, gaming, contributing to the content).

8.179 However, BT considered that in order that Canvas can develop as a compelling pay TV service, it was essential that operators wishing to use the platform gained wholesale access to Sky's premium channels. Otherwise TV operators would be less able to recover the costs of investment in platforms and propositions, as they would be denied access to a significant proportion of potential subscribers who value premium channels[1251].

Superfast Broadband (Next Generation Access)

8.180 BT said superfast broadband could bring consumer benefits to Core Premium Channel subscribers saying that "one of the key drivers of fibre usage is HD video content and HD sports channels in particular"[1252]. However, BT cited superfast broadband as an example of an innovation where the fixed costs of investment were high, and that access to subscribers to Core Premium channels would be necessary to deliver the investment. It added that "in every country in the world investing in fibre, the investment in superfast broadband is heavily dependent on TV subscriptions. Pay TV is the primary source of additional revenue per user necessary to pay for such infrastructure investments"[1253].

Conclusions

8.181 In the Sections below we set out our conclusions on the impact of restricted supply of Core Premium channels on innovation, taking into account the above responses. We consider in turn:

[1249] BT response to Ofcom Third Pay TV Consultation paragraph 2.20.

[1250] First February 2010 Sky Submission, paragraph 3.9.

[1251] BT response to Ofcom Third Pay TV Consultation paragraph 2.18.

[1252] BT response to Ofcom Third Pay TV Consultation footnote 8.

[1253] BT response to Ofcom Third Pay TV Consultation paragraph 2.21.

- The record of innovation in the UK.
- The effect of restricted supply of Core Premium channels on innovation.
- Forward looking concerns relating to the effect of restricted supply on incentives to innovate.

The record of innovation in the UK

8.182 The record of innovation in the UK is strong and Sky has played a central role in developing innovative services. This is illustrated in the Figure below which updates our table that we presented in the Third Pay TV Consultation showing major innovations that have taken place in the pay TV sector in recent years on Sky and other platforms.

8.183 A variety of different platforms have been responsible for the introduction to the UK of different technologies. For example:

- TiVo was first to offer DVRs in the UK in October 2000, with the launch of its eponymous device that worked with satellite, terrestrial and cable television. It entered the UK with a marketing agreement with Sky, and a year later Sky launched its DVR product, Sky+.
- VoD services in the UK were first launched by HomeChoice and Kingston Interactive Television in 1999.
- HDTV was first launched in the UK at the end of 2005 on the cable network of Telewest. Sky launched its HDTV service in May 2006, and HDTV was made available to customers in the ntl cable franchise in November 2006.

8.184 Sky has been instrumental in driving uptake in the UK of several of these important innovations, and this is the case even where it has not been responsible for their initial introduction. Sky may not have been the first to market with either a DVR or HD, but it is clearly Sky that has turned both of these innovations into mass market successes.

8.185 We recognise that those innovations which are popularised on the satellite platform may be adopted on other platforms. This is illustrated by the success of the Sky+ DVR service, which has been followed by a number of other similar services on other platforms (Virgin Media's V+, Freeview+, BT Vision's Vision+, Tiscali+, and Freesat+), to the extent that the '+' symbol now appears to be synonymous with digital television recorders in the UK.

8.186 Where Sky has not driven the take-up of new services, other platforms have been less successful in doing so. This is illustrated for example by the lack of success experienced by both HomeChoice (now TalkTalk TV) and Kingston Interactive Television in driving the take up of their VoD services, despite being first to market with these services.

Figure 120 Innovations by Sky and other pay TV providers, 1997 to 2010

Year	Sky	Other providers
1997	Sky Box Office	
1998	Sky Digital rolled out	ONdigital (later ITV Digital) launches
1999		Homechoice (since Tiscali TV, now Talk Talk TV) launches
2000		PVR - TiVo launches personal video recorder (PVR)
2001	PVR – Sky+ launches to Sky Digital customers.	
2004	Sky By Wire - TV services retailed directly by Sky over Tiscali's fixed line networks.	Top Up TV – pay TV service via DTT. It offered Freeview viewers a number of extra channels on a subscription-basis.
2005	Sky Mobile TV - over 25 channels contained in four packages are streamed to the subscriber's mobile phone. 3G phone required.	Telewest and NTL (now Virgin Media) launch TV-VoD services (pull VoD) and PPV (including premium movies) and SVoD (shows and series). Telewest (now Virgin Media) – HD and DVR service, now called V+, available from £49 to £99. FilmFlex – transactional VoD film service launches on cable networks
2006	Sky HD – requires a Sky+ HD box. Sky by broadband (a.k.a. - Sky Anytime on PC, Sky Player) - enables premium customers to download sports and movies to their PCs at no extra cost.	BT Vision - a pay TV and VoD service. Top Up TV Anytime -the company changed its business model into a VoD (push VoD).
2007	Sky Anytime – VoD service available to some Sky+ and Sky+ HD customers (push-VoD).	Setanta Sports (with FAPL) – was available on all pay TV platforms in the UK closed in June 2009.
2008	Sky Player - online subscription TV service offering live TV and VoD on SVoD and PPV basis.	
2009	Sky Player on Xbox 360 - using 'over the top' internet delivery.	ESPN launched a subscription sports channels Fetch TV – offers on-demand content to its bespoke DVR set-top boxes using 'over the top' internet delivery. Freeview HD. launched regionally from end 2009,
2010	*Sky Player on Fetch TV –to owners of Fetch TV set-top boxes using 'over the top' internet delivery.* *Sky+HD to offer 'pull' VoD* *Sky 3DTV – Sky announced plans to launch a 3DTV channels via its existing Sky+HD boxes in 2010.*	*Freesat iPlayer – pull VoD services using 'over the top' internet delivery.* *Project Canvas a VoD service for Freeview that will use 'over the top' internet delivery.*

Note: Italics denote expected innovations

The effect of restricted supply of Core Premium channels on innovation

8.187 Section 4 described some of the potential innovations we may see in the near future. For example, we noted that new broadband networks might allow consumers to access a wider choice of content on demand. We identified the potential for greater portability of devices and transferability of content between devices. We also identified a trend towards hybrid devices which combine a traditional broadcasting platform with an IP platform (such as the proposed Canvas service). These types of technologies would be able to provide a more interactive and participatory viewing experience where viewers can talk, text, game or otherwise interact during broadcasts. Where supply of the most important content is restricted, then firms wishing to enter or expand will face a lower incentive to innovate on such devices or platforms.

8.188 An assessment of the scope for future innovation is necessarily forward looking and difficult to predict. However we can make the following observations on how lack of supply of Core Premium channels is likely to affect innovation which we discuss below.

8.189 **Certain types of content lend themselves directly to certain types of innovation**. For example, a Hollywood movie produced to be viewed in a cinema is more likely to lend itself to HD viewing than a general entertainment programme produced for TV, whilst an interactive betting application or a 'player-cam' service only makes sense in the context of specific sports programming.

8.190 Sky's impressive track record in innovation is direct evidence of the importance of Core Premium Channels as an enabler of innovation. **[✂]**% of Sky subscribers purchase Sky Sports either with or without Sky Movies, and a total of **[✂]**% of Sky subscribers are premium subscribers. These subscribers are disproportionately likely to take HD, Sky+ or Multiroom:

- **[✂]** of HD subscribers, for example, are also subscribers to Sky Sports. If we include movies, **[✂]**% of HD subscribers are premium subscribers.
- **[✂]**% of Sky+ subscribers are also subscribers to Sky Sports. **[✂]** are premium subscribers.
- **[✂]**% of Multiroom subscribers are also subscribers to Sky Sports. **[✂]** are premium subscribers[1254].

8.191 We consider the services were pioneered by Sky partly because it retailed directly to over **[✂]**% of Core Premium subscribers who valued these services. As a result of Sky restricting access to subscribers to Core Premium channels, other retailers are less likely to develop innovative services that particularly appeal to these subscribers.

8.192 **There are scale economies to investment in innovation**: Rival retailers wishing to enter the market or expand by offering new innovative services will face a lower incentive to do so without access to Sky's Core Premium channels. This is because without access to Core Premium channels rival retailers are denied access to up to half of all pay TV subscribers (and much more than half of pay TV revenues) and firms will therefore be less able to recover the fixed costs of investment in innovation.

[1254] Sky's response to Q26 of our request of 29th October 2009.

Sky agrees that a lack of investment has limited innovations on other platforms compared with satellite[1255].

8.193 Furthermore, restricted access of Sky's Core Premium channels might cause harm to platforms, beyond foregoing the opportunity to supply potential subscribers. For example, in negotiations for carriage of Sky's channels via a potential IPTV entrant **[✂]**, a senior executive at Sky **[✂]** outlined the additional benefits that carriage of Sky's Core premium channels brings to platforms (for example on branding), beyond appealing to potential subscribers[1256]. We disagree with Sky that other retailers were unwilling to invest in their platforms. Sky itself has pointed out that Top Up TV and BT Vision have invested heavily to launch their platforms[1257]. **[✂]**[1258]. BT has made a very substantial public commitment to invest in deployment of a new NGA network, providing superfast broadband to 40% of UK households at an estimated cost of £1.5 billion[1259].

8.194 However, the scope for further growth and investment is likely to be impeded by the lack of supply of Core Premium channels. For example, after several years of operating and despite the heavy investment in marketing the new entrants such as Top Up TV, BT Vision or TalkTalk TV have only captured around **[✂]**[1260] subscribers between them (equivalent to about **[✂]**% of Sky's subscriber base).

8.195 We are mindful that some of the benefits of greater innovation enabled by firms reaching the necessary economies of scale are to some extent dampened as more firms enter the market. While it is not possible to predict the market structure that is most likely to deliver the optimal level of innovation, our view is that a competitive market is much more likely to deliver innovations than a market dominated by a single provider.

8.196 **Lack of wholesale access to premium channels has meant that retailers are unable to package in innovative ways** which will distort consumers' choice of packages and lead to unmet demand for Core Premium channels. For example, **[✂]**[1261] **[✂]**. In its response to our consultation **[✂]**[1262].

[1255] Sky response to Ofcom Third Pay TV Consultation paragraph 8.23.

[1256] See paragraph 4.117.

[1257] Sky response to Ofcom Second Pay TV Consultation Section 5 paragraphs 3.8 and 3.9.

[1258] BT response to Ofcom's Pay TV consultation paragraph 2.5.

[1259] See for example BT press release dated 09 July 2009.

[1260] Sources: BT response to Ofcom's Third Pay TV Consultation, paragraph 2.5, Tiscali / TalkTalk TV response dated 13 November 2009 to question 3 of Ofcom's information request dated 29 October 2009, Top Up TV's response dated 28 November 2008 to question 1 of Ofcom's information request dated 12 November 2008. Note that subscriber data is taken from October 2009 except Top Up TV which is based on data from October 2008.

[1261] Tiscali / TalkTalk TV response dated 13 November 2009 to question 2 of Ofcom's information request dated 28 October 2009.

[1262] **[✂]** response to Ofcom's Third Pay TV Consultation paragraph 2.24 to 2.25.

Superfast broadband, IPTV and VoD

8.197 As discussed in Section 4, superfast broadband, IPTV, and VoD are a set of closely linked technological innovations which have the potential to deliver significant benefits to consumers:

- Superfast broadband networks (i.e. NGA) use various types of fibre network (Fibre to the Home (FTTH) or Fibre to the Cabinet (FTTC)) to deliver greater bandwidth to consumers.
- IPTV platforms use IP technology to deliver TV content to consumers, either in the form of linear channels, or individual items of video content.
- VoD allows individual items of video content to be delivered on demand.

8.198 In the US for example, Verizon's Fios (NGA) service supplies a wide selection of premium channels, HD channels and VoD content over an FTTH network to 3.1 million subscribers.

8.199 IPTV has also proved popular in other countries such as US, France and Germany where access to premium content is not restricted. In Section 4 we have referred to Telefonica in Spain; Freebox TV, Orange TV and Neuf TV in France; and T-Home Entertain in Germany which all offer IPTV services that have high levels of take-up and access to premium channels[1263].

8.200 These are services which can only be delivered if they reach a significant scale. Scale is particularly important in the context of major new investments in superfast broadband, since the key attributes of these networks are that they provide a very high capacity and have a very high level of fixed cost. Scale is also a material factor affecting investment in new IPTV platforms.

8.201 The investment necessary to deliver superfast broadband will in part depend on the ability to attract a wide range of TV subscribers including subscribers to Core Premium channels. For example in our statement on the provision of superfast broadband we observed that HDTV and IPTV services have played a role in driving demand for NGA services in Europe[1264]. On this basis we consider that access to Sky's Core Premium channels is likely to prove important, albeit as one of several potential drivers of demand. Without access to Sky's Core Premium channels development of NGA networks and services will be impeded.

8.202 Superfast broadband networks and IPTV are capable of delivering both linear channels and VoD. VoD services are of particular interest, since they potentially offer consumers greater choice of content, and control over when it is viewed, than is provided by traditional broadcast platforms.

8.203 VoD is a particular example of a delivery mechanism that does not favour satellite. Instead VoD plays to the strengths of the broadband networks operated by BT and

[1263] Paragraphs 4.164 to 4.172.

[1264] Delivering super-fast broadband in the UK, Promoting investment and competition, 3 March 2009, page 68. See for example: http://www.ofcom.org.uk/consult/condocs/nga_future_broadband/statement/statement.pdf. Page 68.

Virgin Media. Sky has a considerably weaker incentive to encourage the development of VoD services.

8.204 While wholesale access to Sky's (linear) Core Premium channels would not lead to the specific content on those channels being provided via VoD, it may still be important as a means of allowing other content to be offered via VoD. This is particularly relevant to hybrid IPTV / DTT platforms, whose DTT offering may depend critically on access to Core Premium channels, and which may also offer a variety of additional VoD services. Both sets of services may be necessary, in order to provide a compelling bundle to individual consumers, and in order that the platform as a whole reaches a viable scale.

Canvas

8.205 Canvas provides a more specific example of the type of innovation that will be affected by the restricted distribution of Sky's Core Premium Channels.

8.206 Canvas is proposed to be a new open technology that will offer any retailer the ability to offer content over an IP network. Retailers wishing to use the technology will be able to combine services offered over Canvas with other TV and non-TV services on new platforms.

8.207 Some of the benefits of Canvas are likely to occur regardless of whether retailers have access to Sky's Core Premium channels. For example the BBC Trust's Public Value Assessment of Canvas argued that it would "enhance the [DTT] free to air offering, helping ensure parity with alternative platforms and delivering the benefits of greater choice"[1265]. However, the scope for innovation will be significantly reduced if retailers are unable to access Sky's Core Premium channels. Retailers will face a lower incentive to invest in new and innovative services using Canvas if they are denied access to the significant proportion of high-value consumers who are willing to pay for Core Premium channels.

8.208 We disagree with Sky's view that competition among firms using Canvas to supply Core Premium channels will not have any discernable benefits. Wholesale access to Core Premium channels will encourage entry via Canvas, and the existence of multiple retailers competing for consumers will incentivise operators to offer new and innovative services or packages.

8.209 We reject Sky's view that a wide choice of suppliers would cause harm to consumers as they would be confused at having to choose their preferred provider. Ofcom's view is that consumers benefit from having a choice of provider. We believe consumers are well served by competitive markets with a range of suppliers where firms differentiate themselves from rivals in order to attract consumers.

8.210 We recognise that in markets with multiple providers there will be some duplication of costs, such as marketing, and in our impact assessment we weigh up the potential benefits from greater retail competition and wider choice, against factors such as duplication of costs[1266].

[1265] BBC Trust, 2010, Canvas proposals Provisional conclusions and public consultation: http://www.bbc.co.uk/bbctrust/assets/files/pdf/consult/canvas/canvas_consultation.pdf

[1266] See Section 11.

Sky as a retailer

8.211 We do not think that Sky retailing its channels on other platforms is sufficient to dispel our concerns. As we set out in Section 7, Sky's approach to retailing on other platforms means that other platforms are disadvantaged compared with Sky[1267].

Forward-looking concerns

8.212 Looking forward, an effectively competitive environment with more players is likely to incentivise innovation within the markets. Sky's position as the largest incumbent wholesaler of channels sold within narrow markets means that it is insulated from the normal competitive pressures which usually spur innovation, whereas in a competitive market threat of exit or entry by rivals provides an ongoing incentive to innovate. Furthermore, the existence of more competitors who cater to different sub-sections of the market would be likely to lead to more innovation, as each tries to differentiate its product.

8.213 We recognise that Sky has a continuing incentive to innovate in order to grow the market, for example by selling new services to its existing consumers, or by attracting new consumers to its platform from free-to-air platforms such as Freeview. It also has an incentive to innovate to attract new consumers to its platform from cable.

8.214 However Sky's position as a large incumbent means it will not innovate where it might cannibalise revenues from existing subscribers, and will typically only engage in those innovations that will tend to favour its own platform.

8.215 By contrast in an effectively competitive retail market all firms have a strong incentive to innovate, both to attract customers from their rivals and to expand the market. The incentive not to innovate in a manner that cannibalises existing revenues falls away if all firms have the same opportunity to innovate and target each other's customers.

8.216 Sky did not refute this point in our Third Pay TV Consultation. It responded that[1268] even if innovation on satellite is greater than on other platforms, the absolute level of innovation on other platforms (such as true VoD) is not low in an absolute sense. Our view is that there is no absolute scale against which the level of innovation can be measured, but that a market which is effectively competitive will normally drive substantially higher levels of innovation than one which is not, for the reasons set out above.

Impact of the low margin on Virgin Media's incentive to innovate

8.217 We have considered Virgin Media's claims that the low margin on Core Premium channels has a significant impact on Virgin Media's incentive and ability to innovate (in terms of product or package):

- On the **incentives to innovate in pricing and packaging** referred to by Virgin Media, in principle we accept that a small change to Virgin Media's margin could increase its incentive or ability to innovate in packaging and pricing if the result of the innovation was to increase demand of Core Premium channel subscribers. However, Virgin Media offered no evidence of how it might innovate in terms of

[1267] For example, the cost of adding Sky Sports Mix on Sky is £16 where the cost of adding Sky Sports Mix to a TalkTalk TV bundle is £27.50. See paragraphs 7.210 to 7.234.

[1268] Sky response to Ofcom Third Pay TV Consultation paragraph 8.22 to 8.24.

package and prices if its margin were increased. We therefore do not consider that the low margin offered to Virgin Media has a significant impact on the range and variety of prices that it would offer to consumers. Virgin Media already has access to the channels, so in principle should already be able to use them to develop its own innovations. Other platforms on the other hand are less able to innovate because they are unable to gain access to the Core Premium channels.

- Regarding **the ability of Virgin Media to invest in research and development,** we accept that if a small change in Virgin Media's margin will expand take up in premium channels then it will have an impact on its incentive or ability to invest in research and development. However, Virgin Media has provided no evidence on why it believes that a small change in its variable input costs will affect its returns to investment from existing subscribers.

Conclusion

8.218 We recognise Sky's role in driving forward certain innovations. However, the restricted supply of Core Premium channels diminishes the scope for other retailers to invest in innovative products or services to enter or expand in the market. IPTV, Canvas and NGA are all examples of innovative ways of delivering TV services which will be constrained if retailers are unable to access potential consumers of Core Premium channels.

8.219 We therefore conclude that the prejudice to fair and effective competition arising from restricted supply of Core Premium channels will lead to a negative impact on innovation in platform services causing significant consumer harm.

Cross-country comparison of innovation

8.220 In response to Ofcom's Third Pay TV Consultation Sky stated that the UK was "one of the leading European countries in terms of the development and penetration of innovative products and services including VoD HD and DVRs"[1269]. In its view the UK's relatively good performance implied that we would need to demonstrate "serious harm to consumers in order to justify intervening"[1270]. Sky criticised Ofcom[1271] for failing to meaningfully engage with the evidence presented on the UK's relative performance in innovation (for example the reports by PwC[1272]).

8.221 As we said in our previous consultations cross country comparisons can provide useful information on the relative performance of different countries in take up of innovation. However, we need to be cautious in drawing strong conclusions from the data because:

- There are challenges in comparing pay TV across counties including those discussed in Sky's PwC report: definition problems, the different country specific contextual factors and difficulties of comparing quality between different countries.

[1269] Sky response to Ofcom's Third Pay TV Consultation paragraph 8.6.d.

[1270] Sky response to Ofcom's Third Pay TV Consultation paragraph 8.7.

[1271] Sky response to Ofcom's Third Pay TV Consultation Section 8 footnote 11.

[1272] Sky Response to Ofcom's First Pay TV Consultation Annex 1, and Sky Response to Ofcom's Second Pay TV Consultation Annex 1.

- It is often not possible to source comparable publicly available data. For example Sky's PwC report pointed out that, in the context of VoD, "penetration data are not typically available across all surveyed countries on a reliable and consistent basis"[1273].

- Results may be sensitive to the selection of countries for inclusion. For example, Sky's PwC report excluded the USA, Canada and Ireland.

8.222 Notwithstanding the above caveats to international comparisons, in the paragraphs below we consider the evidence provided in response to our consultation on the UK's relative level of innovation in:

- Digital TV.

- HD.

- DVRs.

- VoD.

Digital TV

8.223 One measure of innovation that might indicate whether market conditions encourage innovation is the penetration of digital services. For example in the late 1990s and early 2000s both Sky and Virgin Media invested in upgrading their legacy analogue networks to digital.

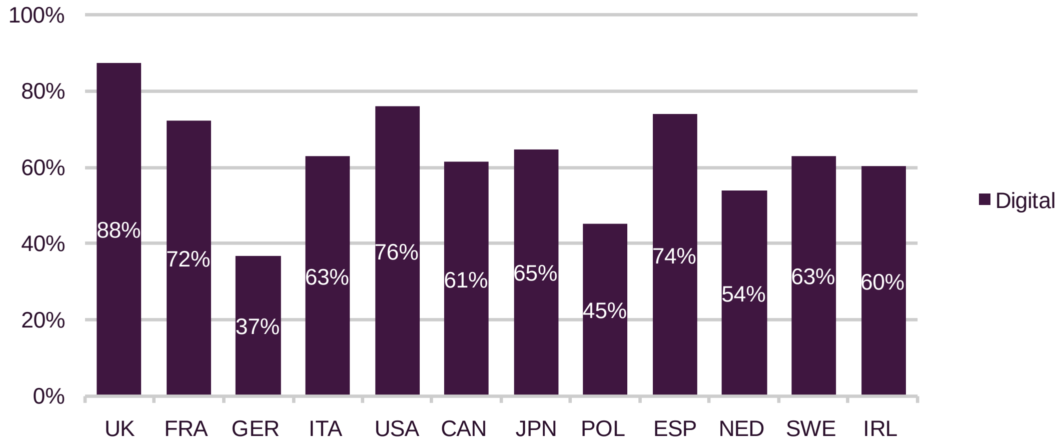
8.224 According to Ofcom's International Communications Market Report 2009 (ICMR), the UK leads all other countries in the survey[1274] in the proportion of households that have converted to digital. In 2008, 88% of UK households had access to digital TV (whether on FTA or DTT platforms). The USA was ranked next with 76% of households (see below).

8.225 The popularity of Freeview has contributed to the high level of digital penetration in the UK. In contrast other countries, such as Germany, have a legacy of high penetration of analogue cable networks. While the UK has relatively good penetration of digital TV, this is not solely due to 'market outcomes'. The high digital penetration is in large part as a result of UK Government policy on Digital switch-over to promote efficient use of spectrum. It is therefore difficult to infer that the UK's relatively high penetration of digital services is solely as a result of existing competitive conditions.

[1273] Part 1 Annex 1 to Sky's non-confidential response to Ofcom's Second Pay TV Consultation "The outcomes for consumers in relation to pay TV in Europe" page 67.

[1274] The other countries are Ireland, Sweden, Netherlands, Spain, Poland, Japan, Canada, USA, Italy, Germany, and France. See for example: http://www.ofcom.org.uk/research/cm/

Figure 121 Digital TV penetration, 2008



Source: World Television markets 2008 (IDATE)

<u>HD</u>

8.226 HD is an example of an innovation which though first offered in the UK by Telewest, has been heavily promoted by Sky on its satellite platform. Sky has invested in programming, subsidising HD set top boxes and marketing to drive take up. It is an innovation that suits the relatively cheap transmission costs of the satellite platform compared with other broadcast platforms such as DTT or IPTV. The UK has a high level of penetration of HD compared with other European countries showing it has been relatively quick to adopt the service.

8.227 Sky provided data showing that the UK had introduced HD in 2006 (in line with the average of other countries in its survey). Sky's survey showed the UK had the second highest penetration of HD (second to France), and the highest number of HD channels[1275]. However, Sky's sample excluded the US and Canada both of which had significantly higher rates of HD penetration than the UK (10% and 17% respectfully compared with the 5% in the UK in 2008)[1276]. Similarly, the US and Canada had a higher number of HD channels (103 and 60 respectively in 2008) compared with the UK (34 in 2008)[1277]. The relatively high level of HD penetration in the US and Canada is partly due to the greater differential between SD and HD broadcasts in the US compared with Europe. As the costs of transmission have reduced other distribution platforms such as Virgin Media, Tiscali / TalkTalk TV and Freeview now offer HD channels.

<u>DVRs</u>

8.228 Sky pioneered the use of DVRs in the UK in partnership with TiVo. Sky was instrumental in investing to drive take up and this has led to the UK's relatively high level of DVR penetration. The central role of Sky is illustrated by the fact that the '+'

[1275] Annex 1 to Sky's response to Ofcom's First Pay TV Consultation "The outcomes for consumers in relation to pay TV in Europe" pages 45-47, 50.

[1276] Number of households paying for HD, by platform and country, end 2008. Source: World Television Markets – Idate (2008).

[1277] Source: World Television Markets – Idate (2008).

symbol, which was first used by the Sky+ service, now appears to be synonymous with DVRs in the UK.

8.229 Sky's PwC report noted that the UK had the highest rate of DVR penetration of any country surveyed[1278]. Penetration in the UK was 8%, almost twice as high as the nearest comparators (France and Norway, who both had penetration of about 4%). Our analysis of more recent data[1279] corroborates the finding that the UK still has the highest level of DVR penetration of most European countries. Both the UK and Ireland (which was excluded from Sky's study) have penetration levels of about 20%. However, penetration of DVRs is much lower in the UK than in the US (where it is currently 35%).

VoD

Previous consultations

8.230 In the Second Pay TV Consultation we said that VoD is a particular example of a delivery mechanism that does not favour satellite. As noted in our Second Pay TV Consultation, VoD services accounted for a smaller proportion of pay TV revenues in the UK than in other countries including Spain, the US and France[1280].

8.231 In response to the Second Pay TV Consultation Sky criticised the data cited by Ofcom on spend on VoD services. It said:

> "The Screen Digest data in Figure 37 of the [Second] Consultation Document includes revenue from a range of services other than VoD services. In particular, as indicated in the notes below the table, they include subscription revenues from the provision of DVRs. Accordingly, countries in which operators have dropped such subscriptions – such as in Sky's case – will be shown to perform 'worse' on the Screen Digest metric, even though having no DVR subscription charge means that consumers are better off"[1281].

8.232 In response to our Second Pay TV consultation Sky provided further data on supply of VoD services setting out that the UK was the first country in its sample to introduce true VoD (on the HomeChoice platform in 2000[1282]), four years earlier than the sample average of 2004[1283]. Sky acknowledged that it was unable to find more meaningful data on penetration.

[1278] Annex 1 to Sky's non-confidential response to Ofcom's First Pay TV Consultation "The outcomes for consumers in relation to pay TV in Europe" page 50.

[1279] Source: Screen Digest.

[1280] Ofcom's Second Pay TV Consultation Figure 37.

[1281] Sky Response to Ofcom's Second Pay TV Consultation Section 5, paragraph 3.55.

[1282] HomeChoice has since been rebranded Tiscali TV and now TalkTalk TV.

[1283] Annex 1 to Sky's response to Ofcom's Second Pay TV Consultation "The outcomes for consumers in relation to pay TV in Europe" pages 72 and Appendix 4 page 100.

8.233 In our Third Pay TV Consultation[1284] we noted that because Sky's measure of VoD innovation did not assess penetration it was not sufficient to refute our assertion that spend on VoD services accounted for a smaller proportion of pay TV revenues in the UK than in other countries.

8.234 In response to our Third Pay TV Consultation Sky said that:

> "Ofcom asserts that the PwC report does not establish that [Ofcom's] conclusions on VoD are flawed because the PwC report does not include data on the take-up of VoD services … Ofcom might be justified in taking this view in circumstances where it had other data which showed that take-up of VoD services in the UK was relatively low. However, Ofcom has no such data. … [The second PwC report was the] only reliable evidence of the speed of innovation in relation to the introduction of VoD… There is no evidence that development of VoD services have [sic] been generally less effective than other types of innovation which are alleged to be more suitable to DTH"[1285].

Our view

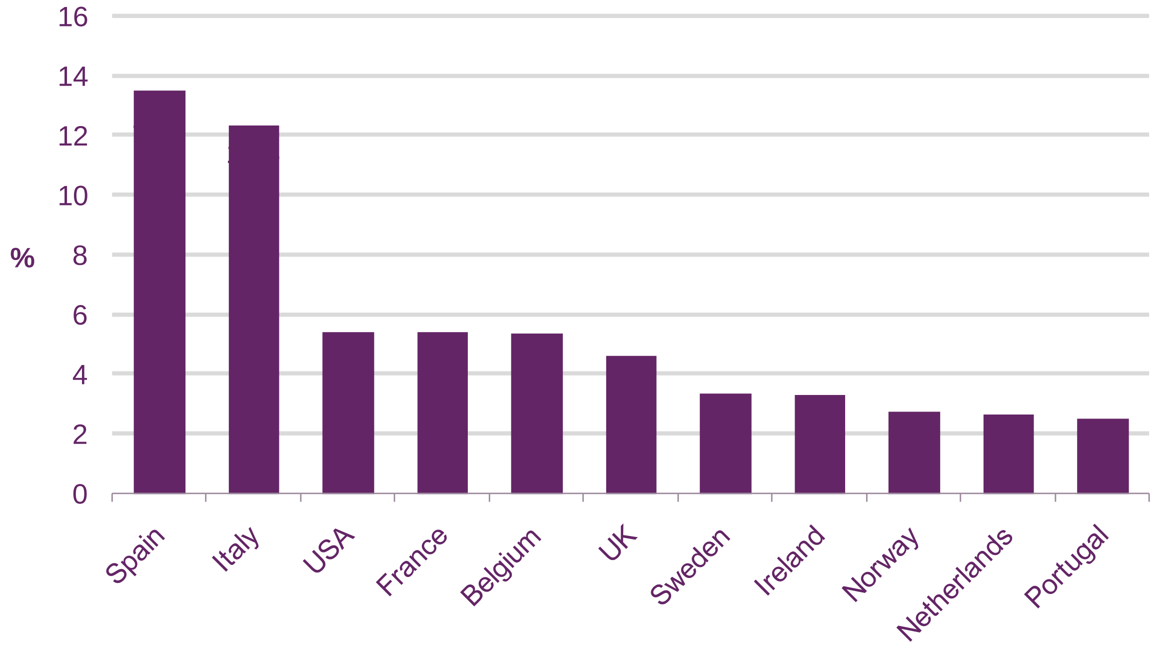
8.235 We have reviewed spend data on on-demand services given the comments Sky made in its responses to Ofcom's Second and Third Pay TV Consultations. In Figure 122 we set out a cross-country analysis of spend on VoD as a percentage of all TV subscription spend. We have excluded DVR revenues as a proportion of pay TV revenues as Sky suggested in its response to our Second Pay TV Consultation.

8.236 We find that spend on VoD is in line with most other countries but is lower than Spain or Italy. In the UK VoD spend accounts for 4.6% of total pay TV revenue whereas it accounts for 12.3% in Italy and 13.5% in Spain. We should treat these estimates with caution, since VoD services are new in most markets. They are also constrained in many markets, including the UK, by the quality of the broadband networks on which they rely. We accept that spend on VoD services does not account for a smaller proportion of pay TV revenues in the UK than most other countries.

[1284] Ofcom's Third Pay TV Consultation paragraph 7.90.

[1285] Sky response to Ofcom's Third Pay TV Consultation paragraph 8.30.

Figure 122 Spend on VoD as a proportion of TV subscription revenue



Source: Screen Digest

Conclusions on cross country comparison of innovation

8.237 As we have explained above, digital penetration, take-up of DVRs and take-up of HD are all high in the UK when compared with other countries. Sky has played a significant role in driving these successes, although digital penetration has also been driven by Government policy and the successful adoption of Freeview.

8.238 By contrast, spend on VoD as a proportion of total subscription revenue is more in line with international comparisons (although well below leaders such as Spain and Italy). This may reflect the fact that VoD does not play to the strengths of Sky's satellite platform, so that it has only been promoted by smaller platforms and is available to only a sub-set of subscribers. We have also described in Section 4 the fact that innovation in IPTV services has been considerably more limited in the UK as compared to a number of other countries and our view that this is partly a result of lack of access to premium content.

Summary of conclusions on innovation

8.239 Access to Core Premium channels, which Sky controls, is important for any firm wanting to expand or enter into the market. Around half of all pay TV subscribers currently take Sky's Core Premium channels. The prospects of firms who are unable to access these channels are limited as they are denied access to a large number of potential subscribers. Firms who are unable to access all subscribers may find that they cannot reach the required scale to recover the fixed costs of research and development and launching new innovative products. This is likely to limit the scope for future innovation.

8.240 We recognise Sky's role as an innovator. However, looking forward it appears that Sky's market power in the wholesale markets for premium channels and the position this affords it in the retail markets means that the UK will not have a competitive environment that incentivises innovation. Sky's role as the biggest retailer of Core

Premium Sports channels means that it will avoid innovations that could cannibalise revenues from its own satellite platform. By contrast, in an effectively competitive environment all firms will be equally incentivised to offer new innovative services.

8.241 Looking forward, non-content-related barriers to entry in setting up pay TV services are decreasing, and the possibilities for different types of platform are multiplying through new technology. However, restricted availability of Sky's Core Premium channels, which remain a key driver of pay TV demand, makes it harder for firms with innovative services to enter the market. As a result, innovative services are likely to be delayed or blocked, to the detriment of consumers. We do not believe this can be addressed by Sky retailing on other platforms, due to its incentive to favour its own platform – it is not credible in our view that other platform operators would enter the market, and attempt to compete with Sky, if the only way they could do so was by giving Sky access to their own retail customers.

8.242 Our analysis of cross country comparisons demonstrates that the UK has a strong record on some innovations, particularly those that favour the satellite platform such as HD. The UK's performance in VoD and IPTV is less strong.

8.243 We consider on the basis of the above that Sky's approach to the wholesale supply of Core Premium channels results, and is likely to result in the future, in significant consumer harm.

Pricing

8.244 In this Section we set out our evidence of whether the competition concerns we concluded on in Section 7 lead to consumers paying high prices. We said that in an effectively competitive market we would expect to see pay TV services priced such that:

- Prices give consumers good value and allow efficient producers to earn a reasonable return on their investment.
- There are a sufficient variety of price points / bundles to allow consumers to tailor their purchases to meet their preferences.

8.245 We address these two points below under separate headings: price levels and range and variety of prices.

Price levels

8.246 In Section 7 we have described the evidence we have used to assess whether prices for consumers are high[1286].

8.247 The paragraphs below summarise the evidence that we have gathered on:

- Sky's profitability.
- Cross country econometric analysis of prices from the Four Parties supported by LECG.
- Cross country comparison of prices from Sky supported by PwC.

[1286] See paragraphs 7.354 to 7.366.

Sky's profitability

8.248 In our Second Pay TV Consultation[1287] we considered evidence on Sky's profitability to assess whether prices for consumers were high. We concluded that due to difficulties in gathering data, and ambiguities relating to cost and revenue allocation, time periods, and asset valuations it was not possible to draw strong conclusions.

8.249 In the Third Pay TV Consultation we took the view that evidence supplied by Oxera of high wholesale margins implied that consumers pay high prices. We said that Oxera's analysis indicates that Sky may earn higher margins for Sky Movies Channels than Sky Sports channels. However, we cautioned that this did not necessarily mean that retail prices paid by subscribers to Core Premium Sports are better value than those paid by subscribers to Core Premium Movies. Rather, it may be that upstream content providers of sports content, such as the Premier League have been more effective in capturing monopoly rents from Sky than movie content providers, such as Hollywood studios. We said that in view of Sky's control over the Core Premium channels which would be essential for an entrant or other player to challenge its current position, we saw no prospect that competition would be effective in the foreseeable future, such as to drive down prices.

8.250 We recognised that in some circumstances consumers' interests can best be served by allowing firms to take risks in order to establish a strong market position based on an innovative product, and subsequently to earn high returns as a reward for those risks. Sky took on substantial risk in establishing its pay TV business in the late 1980s and early 1990s, and in switching its service to digital in the late 1990s. Since then Sky has continued to invest in new services such as HD.

8.251 However, we said that given the time that has passed since Sky made its riskiest investments in the UK pay TV market, we did not consider that ongoing high prices could be justified by Sky's history of investment.

Four Parties' LECG report

8.252 The Four Parties provided an econometric analysis by LECG which they claimed showed that prices in the UK were higher than other European countries.

8.253 In our Second Pay TV Consultation we cautioned that differences between countries meant that comparing a price in one country with a price in another country is fraught with difficulties. Such differences can take many forms:

- Historical: differences in the development of markets.
- Political: these influences are particularly relevant as broadcasting tends to have attracted considerable attention from governments, such as in the form of public service broadcasting.
- Preferences: different nationalities may have very varying preferences for content, for example for one sport over another.
- Socio-demographic.

[1287] Ofcom's Second Pay TV Consultation paragraph 7.63 to 7.79.

8.254 In our Second Pay TV Consultation we reviewed the evidence from the LECG supplied by the Four Parties, and asked Professor Andrew Chesher to provide expert advice on its methodology[1288]. Our view was that LECG's analysis did not support its conclusion that prices in the UK were relatively high. This was because of definitional issues and the problems of capturing all the country specific effects in an econometric cross-sectional analysis of a small number of countries.

Sky's PwC Report

8.255 In response to the First Pay TV Consultation Sky provided a PwC report (updated in response to our Second Pay TV Consultation) which compared the prices of similar packages in a number of different countries and found that prices in the UK were in line with other comparator countries[1289]. The report compared the price of four different types of packages across a number of countries. The analysis suggested that, of the countries surveyed, prices in the UK were lower than average (by 12%) for one of the packages and higher than average for the other three packages (by between 6% to 10%). The analysis also showed that there was a wide variation in prices for apparently similar products. For example, a package of inclusive sports content was €69.66 in **[✂]** and a supposedly similar quality package was €9.40 in **[✂]**.

8.256 PwC cautioned that when interpreting its analysis differences in packages meant it was difficult to accurately compare packages. It said:

> "Overall, there is a wide range of prices and choice available across countries, and as we have argued, it is not valid to compare prices alone. We have attempted to make comparisons across countries based on prices and choice. We have attempted to account for quality in our choice metric by including only pay TV channels. While the international channels and movies channels are broadly comparable (although some differences may still remain), sports channels may differ in the underlying quality of the top tier national football league and the number of games shown. A fully comprehensive assessment of price and choice would need also to take the quality of local pay TV channels into account"[1290].

8.257 In our Second Pay TV Consultation we said that Sky's PwC report provided only a partial comparison of prices with other countries as it did not cover lower priced entry packages from DTT providers, for example. In some markets prices can in fact be seen to be much lower – such as Italy (Mediaset), Germany (Premiere Flex), and Sweden (Boxer).

Responses to our Third Pay TV Consultation

8.258 Sky said that Ofcom had rejected the first Sky / PwC report "submitted by Sky in support of the position that retail prices are consistent with prices for comparable packages in other countries"[1291]. Sky also said that Ofcom had not questioned PwC's

[1288] Second Pay TV Consultation paragraph 7.63 to 7.71.

[1289] Annex 1 of Sky's response to First Pay TV Consultation, page 37.

[1290] Sky response to Ofcom's First Pay TV Consultation Annex 1 paragraph 3.4.

[1291] Sky response to Ofcom's Third Pay TV Consultation paragraph 8.38

conclusions and had not provided any evidence that contradicted PwC's conclusions[1292].

8.259 Virgin Media cited the evidence from LECG which suggested that prices for pay TV are higher in the UK compared to other jurisdictions[1293].

Our view

Sky profitability

8.260 As we have set out in Annex 3 we have considered a range of evidence that suggests that the wholesale and retail prices of Sky's Core Premium Channels are above competitive levels. Our analysis has concluded that Sky is earning returns significantly above its cost of capital, and that these returns are concentrated in Sky's wholesale premium sports and movies channels.

8.261 We have also explained that while the riskiness of Sky's early investments will have demanded returns in excess of its cost of capital for a period, we do not agree that such returns would be required on an ongoing basis unless there was evidence of continued significant risk-taking. Oxera's analysis suggests that more recent investments and innovations have involved considerably less risk, yet Sky has continued to earn returns materially above its cost of capital and appears likely to do so over the next few years. Consequently we consider that the more recent profitability gap between Sky's IRR and its cost of capital is likely to go beyond the necessary rewards for significant risk-taking.

Four Parties' LECG report

8.262 Virgin Media did not provide any further evidence or analysis to support its view that LECG's analysis indicated that prices in the UK were higher than other countries. The problems that we identified with the analysis remain. In particular we said that[1294]:

- There were data definition issues with the analysis, particularly regarding the measurement of service and programme quality, which continued to hinder interpretation of the LECG results.

- We said that in a mature market with a long history of pay TV provision, demand for high quality high-cost programming may develop. A relationship between an average price of the sort calculated by LECG and a market share variable may arise but without there necessarily being any consumer harm. The case for consumer harm would be stronger if there were evidence for higher prices in the UK relative to other countries for TV packages of similar quality.

- It remains the case that much of the variation in important explanatory variables is at the country level. The data came from a relatively small number of countries across which there are many differences not captured in the explanatory

[1292] Sky response to Ofcom's Second Pay TV Consultation Section 5 paragraph 3.60 and Sky response to Ofcom's Third Pay TV Consultation paragraph 8.38.

[1293] Virgin Media response to Ofcom's Third Pay TV Consultation paragraph 6.5.c.

[1294] Ofcom's second Pay TV Consultation paragraph 7.69.

variables employed. The interpretation placed on the results by LECG is one of many that could be advanced and it is not safe to conclude, as LECG proposes, that differences in retail pay TV prices are “due in large part to certain differences in market structure”.

8.263 We therefore have not changed our view since the Second Pay TV Consultation that the LECG report does not demonstrate that prices are relatively high in the UK.

Sky’s PwC Report

8.264 We agree with PwC that international comparisons are difficult to make for the reasons quoted in paragraph 8.256 above. PwC pointed out that each package varies in a number of country-specific ways, each of which could affect the price[1295]. For example it cited: package structure, whether TV is bundled with other non-TV services, number of local FTA channels, number of neighbouring FTA channels, the number and quality of pay channels included within the bundle. Additionally, the price will be affected by a number of other factors such as: the quality of FTA channels, the amount of sport or movies shown on pay TV, the amount of sport or movies on FTA, listing rules, the country specific demand for different sports or movies, the distribution technology, the initial up front set up costs, set top box or other equipment costs and subsidies, differences in customer service, the discounts off headline prices, differences in content input prices, levels of government subsidy[1296]. PwC’s comparison did not attempt to control for these differences (nor did it state that it could) beyond trying to select ”similar” types of pay TV package.

8.265 Indeed Sky’s proposed methodology for assessing whether prices in the UK were “out of line” with prices in Europe is striking given its criticism of analysis presented by Ofcom in our First Pay TV Consultation[1297]. In response to the analysis which assessed consumer response to changes in prices over time (in the context of assessing evidence on the scope of markets) Sky emphasised the need for an econometric model to isolate the interaction between the variables of interest from the wide range of other factors that are also likely to affect them. Sky described Ofcom’s approach as wholly inadequate as a method of reaching well-supported, evidence-based conclusions and argued that “no evidential weight could be placed on it”.

8.266 We do not automatically dismiss cross-country price comparisons out of hand. However, even highly sophisticated econometric studies are seldom if ever perfect or free of interpretation, let alone high-level comparisons of headline prices. Where markets are complex, any data must be interpreted with caution. In our view PwC’s report cannot support Sky’s conclusion that the price in the UK is consistent with comparable packages in other countries given the range of factors that can affect price that were not taken into account by PwC. Sky does not appear to have applied

[1295] Sky response to Ofcom’s First Pay TV Consultation paragraphs 3.3.3 to 3.3.4.

[1296] In contrast, other metrics such as penetration of HD or DVR are more easily compared across countries.

[1297] Sky response to Ofcom’s First Pay TV Consultation. Annex 2, Appendix 5, paragraphs 5.9 to 5.11.

sufficient caution when interpreting PwC's analysis of prices; nor did it acknowledge PwC's caveat when citing the analysis in its responses[1298].

Conclusions on price levels

8.267 We have considered a wide range of evidence on whether consumers in the UK pay high prices for their services. We remain of the view that our analysis presented in Annex 3 is a more reliable measure of the extent to which consumers pay high prices than either the Four Parties' LECG report or Sky's PwC report. Both Sky's PwC report and the Four Parties' LECG study attempt to make cross-country comparisons of price levels in the UK relative to other countries though they come to opposite conclusions. We consider the Four Parties' LECG econometric study cannot support its conclusions as it does not capture all the country specific causes of variation in prices. For the reasons set out above, the less sophisticated price comparison approach in Sky's PwC report cannot assess the quality-adjusted prices across countries.

8.268 As we have set out in Section 7, the evidence indicates that Sky is earning returns above its cost of capital and this implies consumers are paying high prices[1299].

8.269 Clearly, it is not in the interests of customers to pay higher prices than would prevail under effective competition. Sky's wholesale market power is reflected both in its own retail prices on satellite and other platforms, and in the wholesale prices it charges to cable firms. As a result, the competition issue we have identified in relation to prices has an effect on subscribers to Sky Core Premium channels on all platforms where they are available.

8.270 High prices are detrimental both to subscribers who pay them, and households who do not currently subscribe to these channels, but who would do so at competitive prices.

Range and variety of prices

8.271 The narrow range of retailers offering Sky's Core Premium channels limits the range and variety of packages and bundles on offer[1300]. We have acknowledged that Sky and Virgin Media already offer consumers a wide choice of packages (for example Sky offers 1,764 distinct bundles just on its satellite platform). However, Sky's position of retail market power[1301] means that:

- Where Sky retails on other platforms it is unwilling to offer prices that cannibalise sales from its satellite platform.

[1298] For example at Sky's response to Ofcom's First Pay TV Consultation Part 2 paragraph 4.4, or paragraph 5.8, or Part 3 paragraph 8.6, or Sky response to Ofcom's Second Pay TV Consultation Section 2, paragraph 4.4, or Section 5 paragraph 3.60, or Sky's response to Ofcom's Third Pay TV Consultation paragraph 8.6.e or paragraph 8.38,

[1299] See paragraphs 7.349 to 7.366.

[1300] See paragraphs 8.82 to 8.102.

[1301] In Sections 5 and 6 we said that Sky has retail market power in markets for bundles including Sky Movies channels and bundles that include Sky Sports 1, Sky Sports 2 and ESPN.

- Where Sky retails on its own platform is has an incentive to maximise revenues by designing pricing structures which incentivise consumers to purchase larger rather than smaller bundles.
- New entrants would have an incentive to target different sections of the market without fear of cannibalising existing revenues.
- The content is not wholesaled to some platforms, which means retailers cannot offer packages designed to suit those platforms' characteristics.
- There is a lack of competition in the retail supply of Core Premium channels which meant that retailers are not incentivised to create a wide range of product bundles for subscribers.

8.272 We conclude that a lack of wholesale access to Sky's Core Premium channels leads, and will continue to lead, to significant consumer harm in that it inhibits the range and variety of packages on offer to consumers. This is because some consumers choose a package that does not closely reflect their preferences, or they choose not to consume. We also conclude that if there were greater retail competition in the provision of core premium channels we would expect to see a wider range of bundles, packages and price points offered to consumers.

Consumer satisfaction and take-up of services

8.273 In response to our Third Pay TV Consultation Sky provided a range of evidence which it said indicated that the market was functioning well[1302]. It said that faced with this evidence we would have to have clear evidence of serious consumer harm to justify intervention.

8.274 Sky cited the following evidence of positive market outcomes for consumers which we consider in turn[1303]:

- High consumer satisfaction.
- Relatively high penetration of digital pay TV in the UK compared to the rest of Europe.
- Relatively high premium channel penetration in the UK compared to the rest of Europe[1304].
- DVR take-up.

[1302] Sky response to Third Pay TV Consultation, paragraph 8.6. Also see paragraphs 8.41 to 8.43.

[1303] Sky also cited the UK's relative performance in innovation, (including VoD, HD and DVRs delivering strong benefits for consumers), consumers being well served in terms of content choice (range of channels) and pricing as evidence of positive market outcomes. We address these issues elsewhere in this document, above at paragraphs 8.82 to 8.102 and 8.246 to 8.270.

[1304] Sky November 2009 Submission.

Satisfaction

8.275 In the First and Second Pay TV Consultations we found that consumer satisfaction was high. However we expressed caution about using such satisfaction data, due to the difficulty of establishing a suitable benchmark, and the fact that only those that already participate in the market can express a view[1305]. In our Third Pay TV Consultation we expressed caution over the use of satisfaction data to assess whether our competition concerns led to distorted platform choice or impeded innovation because:

> "Customers may well express high levels of satisfaction if a service is provided at a quality and price they have come to expect, but that does not rule out the possibility that a change in the market, through greater price competition or more innovation, would greatly increase consumer welfare"[1306].

8.276 The two Figures below show that overall satisfaction is high: 90% of satellite subscribers were either very or fairly satisfied (57% / 33% very / fairly); 87% of cable subscribers were very or fairly satisfied (55% / 32% very / fairly).

8.277 Satisfaction with value for money is much lower, with only 34% / 37% very / fairly satisfied with value for money. On satellite and cable, 19% and 27%[1307] respectively say they are "fairly dissatisfied" or "very dissatisfied" with value for money. Consumers' attitudes have been informed by a history of receiving TV services free at the point of use, funded by public subsidy, and this may affect their view of value for money.

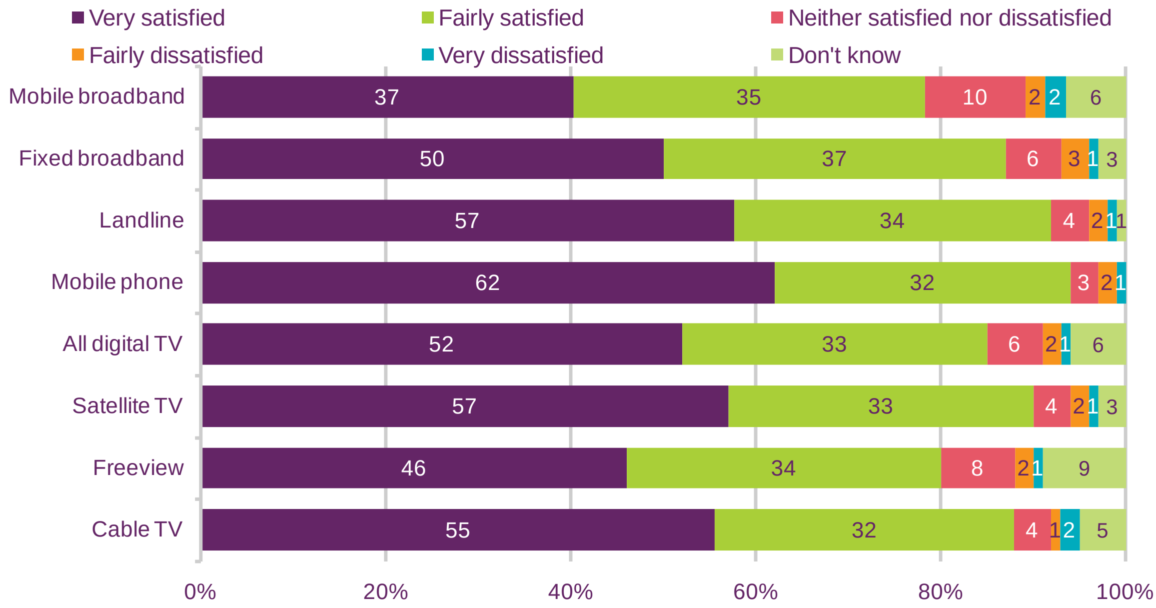
8.278 In comparison, 94% of customers are satisfied with their mobile telephone services, and 80% are satisfied with the value for money of these services.

[1305] First Pay TV Consultation, paragraphs 4.5, 4.7. Second Pay TV Consultation, paragraph 7.83. Third Pay TV Consultation, paragraph 7.48.

[1306] Ofcom's Third Pay TV Consultation paragraph 7.48.

[1307] Caution – low base size.

Figure 123 Satisfaction with services from main supplier (%)



Source: Ofcom communications tracking survey, quarter 1 2009

Base: All with each service: digital TV as main TV (2632), Satellite (2211), Freeview (2102), Cable (822). Mobile broadband (643), Fixed broadband (3491), Landline (5151), Mobile phone (5273)

Note: Those who answered 'don't know' are not shown on the chart.

Figure 124 Satisfaction with value for money from main supplier (%)

Source: Ofcom decision making survey 2009

Base: All adults who are decision makers for fixed broadband not in a bundle of services (352), landline not in a bundle of services (781), mobile phone not in a bundle of services (1231), digital TV not in a bundle of services (837), Satellite TV not in a bundle of services (385), Freeview not in a bundle of services (408), Cable TV not in a bundle of services (43) – low base size for cable TV, apply caution.*

Responses to our consultations

8.279 Sky stated that it was an omission not to conduct further analysis of consumer satisfaction[1308]. It said that consumers have reference points, in the form of other communications services, which allow them to put pay TV services into context.

8.280 Sky argued that when considering whether to apply a remedy to the pay TV sector "Ofcom cannot simply set all the good outcomes … to one side, as it has done, and decide that it must intervene because it wants to see some different market structure that it thinks might be better"[1309]. Sky cautioned that regulatory interventions inevitability lead to costs, and that interventions can risk jeopardising existing positive market outcomes.

Our view

8.281 We see high reported customer satisfaction as a positive sign, and our concerns would be greater if a larger number of customers were expressing dissatisfaction with the quality or value of their services. However, we consider that high rates of satisfaction do not demonstrate that competition is operating fairly and effectively in the market.

8.282 Consumer expectations are likely to be informed to a considerable extent by customers' previous experience of market performance. Pay TV customers may be able to compare some aspects of their service (e.g. reliability, customer services, billing) with services they receive in different markets. However, for other aspects of service (such as enhanced delivery mechanisms), and price, making comparisons to other services is more difficult and there is little scope for customers to form an objective view of what range of choices, what innovations and what prices would prevail in a more competitive market.

8.283 Competition could also deliver better outcomes for those consumers who, because the services which are currently available do not meet their needs or are not competitively priced, do not subscribe to pay TV, or subscribe to a relatively limited service. Our analysis of consumer choice[1310] confirms that there may be a potential cohort of *excluded* consumers which could signify the potential for significant consumer harm[1311].

Penetration of digital pay TV

8.284 Sky stated that "penetration of digital pay TV in the UK is amongst the highest in Europe"[1312]. Sky's PwC report stated that the UK had one of the highest rates of

[1308] Sky response to Ofcom's Third Pay TV Consultation paragraph 2.15 fourth bullet, paragraph 8.43.

[1309] Sky Response to Ofcom's Third Pay TV Consultation paragraph 3.15.

[1310] Paragraphs 8.66 to 8.68.

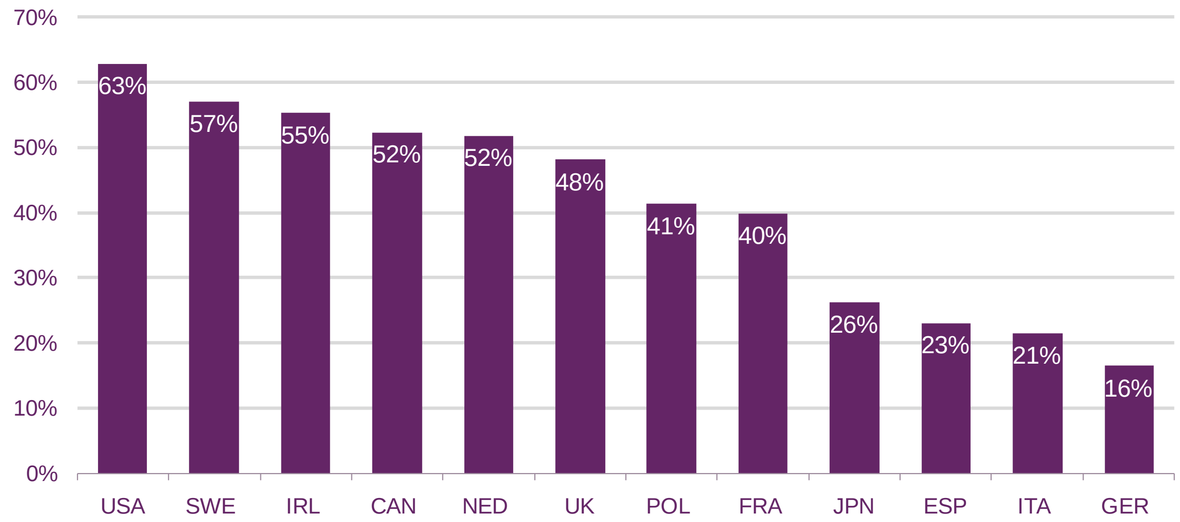
[1311] For example, in response to Ofcom's Second Pay TV Consultation Sky stated that "Ofcom states that it is concerned that high levels of satisfaction amongst existing consumers could fail to take account of the views of those people who are excluded because of high prices or lack of package choice. This is again where data on pay TV penetration can be insightful. If the number of people taking pay TV services were very low then Ofcom's argument might have some validity." Sky response to Ofcom Second Pay TV Consultation, paragraph 3.63.

[1312] Sky response to Third Pay TV Consultation paragraph 8.6b.

digital pay TV penetration in Europe around 45%, which is above the sample average of around 22%[1313]. Sky said that given "pay TV penetration is relatively high (as Ofcom accepts) it cannot be credibly argued that any legitimate concern could exist as to consumer exclusion on a large scale due to, for example, lack of platform choice or high prices"[1314].

8.285 A different and more recent data set[1315] indicates that the UK was ranked sixth out of the 12 countries sampled in Ofcom's International Communications Market Review (ICMR) for penetration of digital pay TV in 2008. Three of the five countries ranked higher than the UK (USA, Canada and Ireland) were excluded from Sky's PwC report. However, cross-country differences are likely to reflect many country-specific factors, such as the relative strength of the FTA sector, rather than the characteristics of the pay TV sector.

Figure 125 Proportion of households taking digital pay TV, 2008



Source: Ofcom / Idate. IPTV or Cable TV, included in digital pay TV figures TV households who subscribe to Internet and telephony plans and get digital TV "for free" as consumers still pay for a TV service.

Premium channel penetration

8.286 Sky provided evidence that the UK had higher rates of premium sport penetration than France, Germany, Italy or Spain. Sky said that this illustrated its incentive to distribute its premium channels widely and that the UK delivers positive outcome for consumers. It also claimed the data contradict Ofcom's claims that (a) prices are excessive; and (b) there is significant unmet demand. In recognising the difficulties of comparing data Sky described its estimates as "upper bounds"[1316] for penetration of premium pay TV services.

[1313] Annex 1 to Sky's response to Ofcom's First Pay TV Consultation "The outcomes for consumers in relation to pay TV in Europe" page 42. Based on visual interpretation of charts.

[1314] Sky response to Ofcom's Third Pay TV Consultation paragraph 8.44.

[1315] Ofcom / Idate.

[1316] November 2009 Sky Submission.

8.287 We would caution against drawing strong conclusions from the experience of just four countries. Furthermore, we disagree with Sky that its estimates of penetration in other countries are "upper bounds"[1317].

8.288 A high penetration of premium sports channels in the UK compared to other countries may also reflect differences in the importance attached to that content by audiences in different countries (for example the particular importance of Premier League coverage to UK viewers) and differences in the level of exclusivity to pay TV (for example compared to the availability in Germany of 'near-live' delayed rights to Bundesliga on FTA TV).

Ofcom's view

8.289 As with all cross country comparisons we need to interpret the data cautiously. High penetration could indicate that consumers are well served or that prices are low, but equally it could be caused by other country specific cultural or contextual factors.

[1317] For example, Sky's analysis excluded 2.9 million potential subscribers from its estimate of penetration in Italy because it was "unclear" whether the active pre-pay cards were owned by consumers who actively used the service. If these consumers were included Italy's penetration could exceed the UK's[1317]. Sky also excluded Gol TV ("a new premium sports channel (devoted entirely to football)"), from its estimate of premium penetration in Spain. We also note that it excluded Orange Cinema and Orange Sport from its estimate of premium penetration in France.

Section 9

Remedies

Summary

A wholesale must-offer remedy on sports

9.1 We have decided that an appropriate way to ensure fair and effective competition is to put in place a wholesale must-offer obligation on Sky Sports 1 and 2 under section 316 of the Communications Act, by including a condition to this effect in the relevant channel licences. This, we believe, will bring about greater choice and innovation, to the benefit of consumers.

9.2 We have rejected BT / Setanta / Top Up TV / Virgin Media's (the 'Four Parties'[1318]) suggestion for operational separation of Sky. Only structural separation – i.e. full divestment – could address the underlying issue of incentives. Structural separation is however a costly and highly interventionist form of remedy, which we believe to be disproportionate in current circumstances, given the availability of other remedies.

9.3 We have also, at this point, set aside the possibility of a substantial intervention in the way sports rights are sold, which would have the intention of significantly reducing market power. We acknowledge that this is in principle an attractive means of eliminating any potential competition concern at source. It would not be as immediately disruptive as structural separation of Sky, but has the same advantage as structural separation, in that it potentially permanently changes Sky's incentives and its ability to act on those incentives.

9.4 However, a remedy which places severe limits on content aggregation may also risk a number of less desirable consequences. For example, it might result in reduced convenience for some consumers, who might have to take multiple subscriptions or purchase multiple set-top boxes to get the content they want, and it could result in artificial depression of rights values, if splitting up content rights created packages for which there was limited bidding competition. Careful design of rights packages would be essential to minimise these risks.

9.5 Our current view is therefore that a remedy which addressed our competition concerns by placing severe limits on content aggregation, in order to eliminate market power at source, would be disproportionate. We might need to revisit this question if a regulated wholesale must-offer obligation proved ineffective.

9.6 It might still be appropriate to take specific targeted action in the case of the Premier League. We noted in our previous consultation that the commitments made by the Premier League to the European Commission will not apply to the sale of its rights from the 2013 / 2014 season onwards. We may therefore need to revisit the compliance of the Premier League's arrangements with competition law. We can certainly see benefit in establishing certainty prior to the next auction given the changes that have taken place since the last commitments were given to the European Commission. We will continue to keep under review the need for action on this issue.

[1318] The Four Parties have since become the 'Three Parties', with the demise of Setanta's UK operations in June 2009.

9.7 We conclude that imposing an obligation on Sky to offer to wholesale its Core Premium Sports channels, Sky Sports 1 and 2 – a wholesale must-offer remedy – is the most appropriate way to ensure fair and effective competition in light of our findings on the effects of the restricted distribution of Core Premium Sports channels:

- A wholesale must-offer obligation will directly target restricted distribution.
- The obligation is proportionate: costs are likely to be low, and we expect them to be offset by market expansion effects.
- Sky already wholesales to Virgin Media, and has told us it is willing to wholesale if it cannot retail. It was also prepared to commit to wholesaling to other retailers in discussions with us in late 2007 and early 2008. Wholesaling is therefore not a radical departure from Sky's existing business practice, and is certainly not as "extreme" as Sky has suggested in its submissions to us.
- The obligation will seek to replicate the outcome we would expect in an effectively competitive market, where channel providers assemble a wide range of content and have an incentive to distribute it widely. The restricted distribution of Sky's channels, arising from Sky's vertical integration and its market power, contrasts for example with the wide distribution of ESPN's premium channel, and with the fact that that the original cable distribution deals were made at a time when Sky had less market power.
- This type of remedy has been implemented and been effective elsewhere in the world. We are cautious about making comparisons between countries, given the inevitable differences between different national markets, but we note in particular the role played in the United States by the Program Access Rules. These have played a significant role in the development of first satellite and now IPTV challengers to cable's dominant position.

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

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

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

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

- IPTV and video-on-demand offer new means of accessing content, with significant potential consumer benefits in terms of greater choice of content and control over when and how to watch it.

- IPTV and video-on-demand will be enhanced by large-scale investments in superfast broadband. However, such investment only makes sense if it is possible to develop the sorts of services that can exploit their capabilities.

- Such services focus on content; movies content is important for video-on-demand services generally, and subscription video-on-demand movie rights are among the most important sets of video-on-demand rights.

9.11 We therefore consider that a linear channel wholesale must-offer remedy on all platforms would not by itself be an effective forward-looking solution to our competition concerns, which focus on the limited exploitation of subscription video-on-demand rights. At the same time, our powers under section 316 of the Communications Act 2003 are limited in relation to subscription video-on-demand services, while action under Competition Act 1998 is unlikely to be effective as a means of addressing our concerns. We are therefore consulting on a proposed decision to refer two closely related movie markets – for the sale of premium movie rights and premium movie services – to the Competition Commission for further consideration of the issue. This is set out in a separate document[1319].

9.12 We have also considered whether to put in place a wholesale must-offer remedy immediately until any reference to the Competition Commission reaches a conclusion. However, we have concluded that it would not be appropriate to put in place an interim wholesale must-offer remedy for all Sky's movies channels on all platforms, because of the likely lack of demand for linear movies channels on existing platforms over the relevant time horizon.

9.13 However, we would have a specific concern if Sky were to launch a service on digital terrestrial TV during this interim period which contained Core Premium Movies channels as well as Core Premium Sports channels. We address this in our separate statement on Picnic[1320], where we conclude that a launch by Sky on digital terrestrial TV should be subject to any such channels being made available to other digital terrestrial TV retailers first.

Concerns regarding high prices

9.14 As noted above, our analysis of whether Sky has market power has included a review of its pricing and profitability. This review has shown that Sky has earned high returns for a sustained period. The riskiness of Sky's early investments will have demanded such returns for a period. However, despite the fact that Sky's more recent investments have entailed lower levels of risk, Sky's returns remain at a high level and appear unlikely to be competed away in the future.

9.15 We have considered whether we should take action specifically to address this finding, and we have concluded in the case of sports that we should not. To do so would require us either to set wholesale prices on a cost-plus basis, or intervene to place severe restrictions on the way rights are sold. Both such approaches carry

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[1319] http://www.ofcom.org.uk/consult/condocs/movies_reference/.

[1320] http://www.ofcom.org.uk/consult/condocs/picnic/statement/.

risks, including a risk that we might artificially reduce the value of sports rights. It might be possible to address these risks by appropriate design of any remedy, but we do not believe that the level of harm to consumers that we have currently identified in this process justifies the risks of intervening in these ways at this point in time.

9.16 In any case, while the remedy which we have put in place is not intended to reduce the overall prices of those sports packages which are currently in the market, it is intended that more effective distribution of sports channels should result in new packages being made available. These should offer consumers a wider variety of price points and bundles to choose from, including new entry-level packages. Much of the market expansion which we expect to occur as an immediate result of our remedy results from increased consumer take-up of these packages.

9.17 In the case of movies we note that a further reason for considering a subscription video-on-demand-related remedy is that it could potentially tackle concerns over high wholesale profitability. The margins that we see Sky making appear to be highest in the movies part of its business, and this is something we would expect the Competition Commission to consider, in a market reference.

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

9.18 Having decided that a wholesale must-offer obligation is appropriate to ensure fair and effective competition, there are a number of important questions of scope that we have considered. In each case we have assessed the proportionality of the options, as part of our impact assessment:

- The channels covered by the remedy will be Sky Sports 1 and 2. We believe that neither Sky Sports 3 nor 4 make a material contribution to Sky's market power, given the range of content currently shown on these channels, and that access to these channels is not therefore necessary to ensure fair and effective competition.

- We recognise the risk that a potential response to the remedy from Sky could be to attempt to undermine it by shifting content onto channels not covered by the remedy. If Sky were to do this to any significant extent, we would need to review the remedy and consider extending it to all of Sky's sports channels. This would not require a protracted consultation process, since the substantive issues would be the same as those on which we have concluded in this statement.

- The wholesale must-offer obligation should not extend to retailers on Sky platform(s). We are concerned about ensuring fair and effective competition between retailers on different platforms, leading to choice and innovation on non-Sky platforms, and the development of new platforms. Extending the remedy to Sky's own platform(s) would not address this concern, and could be disruptive to Sky's existing business and customers.

- We want to avoid interfering with Sky's existing platform(s), but this does not mean we expect Sky to be the sole retailer of premium content across entire distribution technologies. The remedy therefore extends to non-Sky satellite platforms such as Freesat. Similarly, if Sky develops its own IPTV or internet-based platform, we would still expect other such platforms to be included within the scope of the remedy, subject to appropriate security provisions. In particular, Sky should not expect to be the sole retailer of premium channels on any future platforms based on Project Canvas[1321].

- Virgin Media is in a different position to prospective entrants, in that it already has a number of premium subscribers. We have therefore considered whether it should be included within the scope of the remedy, and receive the same wholesale price. We conclude that it should, taking account of the need to avoid distorting the market, and the fact that Virgin Media's current scale is closer to that of entrant retailers than that of Sky. Indeed, Virgin Media has not yet reached anything like the scale of premium subscriber base that we assume in our pricing model to be necessary for a hypothetical new entrant to break even.

- The wholesale must-offer obligation will not include supply for onward retail to commercial premises. The nature of competition in pubs and clubs is very different from that for residential consumers, focussing on the price of standalone sports rather than pricing and innovation across wider bundles. This is reflected in the concerns bought to us by bodies such as the Association of Licensed Multiple Retailers, which focus on price, and is illustrated also by the low level of interest in supply to commercial premises shown by other retailers. A retail-minus wholesale must-offer is the wrong remedy to deal with any concern about the absolute level of retail prices. We do however consider that this is an issue that may be relevant to a future analysis of the sale of Premier League rights.

- The wholesale must-offer remedy will apply to high-definition versions of the included channels. High-definition is increasingly important to effective competition, and a remedy which excluded it would become ineffective over time. Sky has suggested that including high-definition in a wholesale must-offer remedy would damage innovation. We do not believe that including high-definition would be damaging to innovation in the way Sky suggests. However, because high-definition is a relatively recent innovation and there is a degree of uncertainty as to the appropriate approach to setting a price, we have decided not to set a price for supply of these channels. Setting prices might bring about supply faster, but doing so particularly in relation to a relatively new service such as high-definition might risk harming incentives for future innovation. Instead we have included an obligation for supply to be on a fair, reasonable and non-discriminatory basis. This should allow scope for commercial negotiation, with the possibility of bringing a complaint to Ofcom as a backstop.

- The wholesale must-offer remedy covers further primary content, i.e. matches or sports events, shown via the red button, which is associated with the included channels. We would expect viewers of the included channels to have access to the same range of primary content regardless of which platform they use. However, in recognition of the additional technical requirements of delivering interactive content, we would expect the retailer to bear any incremental costs to Sky of delivering interactive content.

9.19 Given the history of fruitless discussions between Sky and other retailers, we think the regulated offer should deal with all contractual terms. In particular, we believe it is necessary to set prices for standard definition versions of the channels included in the remedy. As both our review of wholesale negotiations between Sky and potential

[1321] Project Canvas is a proposed joint venture between the BBC and various other operators, intended to combine broadcast content with broadband content, delivering both through the television.

customers and our own discussions with Sky indicate, even if Sky were to negotiate in earnest, it would be unlikely to diverge from the cable rate-card.

9.20 The rate-card appears to be set by considerations relating to the Office of Fair Trading's 2002 margin squeeze test, rather than by commercial considerations. Despite the fact that Sky could increase wholesale revenue by selling to more retailers at a reduced wholesale price, it does not do so. As our pricing analysis and our analysis of Sky's own business plan for Picnic show, relying on the current cable prices would not ensure fair and effective competition, as retailers with smaller scale than Sky's would not be able to compete effectively.

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

Structure of this Section

9.22 This Section is set out as follows.

- Introduction.
- Remedy options.
  - Consultation responses on remedy options.
  - No action.
  - Structural remedies.
  - Intervention at the rights level.
  - Regulating wholesale access to Core Premium channels.
- Whether it is more appropriate to proceed under CA98 or s317(2).
  - Ofcom's conclusions on the s317 test.
- Scope of a wholesale must-offer remedy.
  - Our position our Third Pay TV Consultation.
  - Which wholesalers should be included in a wholesale must-offer remedy?
  - Which channels should be included in a wholesale must-offer remedy?
  - Which platforms should be eligible for a wholesale must-offer remedy?
  - Should a wholesale must-offer remedy be available for onward supply to commercial premises?
  - Should we set prices under a wholesale must-offer remedy?

  - o How should we approach setting prices for a wholesale must-offer remedy?
  - o Should a wholesale must-offer remedy include enhanced versions of the channels – HD and interactive?

- Review provisions.
  - o General review provisions.
  - o Content moving between channels.

Introduction

9.23 Sections 5 and 6 have set out our views on market power. Sections 7 and 8 have then established what we believe to be the competition issues and consumer effects that exist. In this Section we begin our assessment of whether it is appropriate to take any action to remedy these issues.

9.24 This Section read in conjunction with the subsequent Sections, 10 and 11, constitutes our regulatory impact assessment, as defined in s7 CA03.

9.25 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in s7 CA03, and means that generally we have to carry out impact assessments where our proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in our activities. However, as a matter of policy we are committed to carrying out and publishing impact assessments in relation to the great majority of our policy decisions. For further information about our approach to impact assessments, please refer to our guidelines[1322].

9.26 Our approach to assessing the overall impact of our proposed remedy comprises four main components:

- A qualitative assessment of the various remedy options. This is set out in this Section, and explains why we believe that a wholesale must-offer remedy with prices determined on a retail-minus basis is the most appropriate solution to the concerns we have identified.

- A qualitative assessment of the detailed design and implementation issues relating to the wholesale must-offer remedy. This includes the rationale for the more specific details of the pricing arrangements and non-price terms set out in Section 10.

- A quantitative and qualitative assessment of the static effects of the preferred option, including the specific prices that we are setting. This appears in Section 11.

[1322] http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf.

- A qualitative assessment of the dynamic effects of the remedy – effects which by their nature cannot be reliably or readily quantified. This also appears in Section 11.

Remedy options

9.27 We continue to believe that requiring Sky to wholesale a subset of its premium channels is an appropriate way to proceed, in order to remedy the competition concerns we have identified.

9.28 Sections 5 and 6 have set out our view that Sky has market power in the wholesale supply of Core Premium Sports and Movies channels. In Section 7, we have identified two ways in which the current situation is prejudicial to fair and effective competition:

- Restricted distribution of Sky's Core Premium channels.

- High wholesale prices for Sky's Core Premium channels.

9.29 In Section 8 we have examined the significant effects that these issues have on consumers.

9.30 Through the course of this investigation we have considered a range of possible options for how to proceed. The possible options that we have considered for action to address the issues identified are:

- No action.

- Structural remedies.

- Intervention at the rights level.

- Directly addressing the restricted distribution of Core Premium channels, including possible commitments from Sky.

9.31 We explain why we do not believe any of the first three of these options is appropriate. We then consider why it is appropriate to address directly the restricted distribution of Core Premium channels.

9.32 First, however, we summarise briefly the key arguments that have been put to us in response to our previous consultations on the issue of possible remedies.

Consultation responses on remedy options

9.33 In our Second Pay TV Consultation, we set out a range of options:

- Take no further action. We recognised the risks of regulation and the need for a proportionate response to our concerns. However, we felt that taking no action would have been to ignore the real concerns we had over the future of competition.

- Intervene to eliminate upstream market power. We set out the possibility of changing the way rights were sold at the upstream level, for example through a behavioural rule on the Premier League or the Major Hollywood Studios. We said that these kinds of approach could risk reducing the benefits that accrue from content aggregation, and observed some practical reasons why it would not be appropriate to propose such action at that time. In particular, the European Commission's remedy on Premier League had not played out fully, and we noted the possibility of medium-term disruptive changes in the way movies content was distributed.

- Intervene to eliminate the incentive to exploit upstream market power. We explored the possibility of either operational or structural separation of Sky, but dismissed it on grounds of proportionality, and because it might not be sufficient to address our concerns regarding Sky's incentives.

- Intervene to reduce the ability to act on these incentives. We said that the most targeted remedy would be to place an obligation on Sky to supply the same wholesale product it supplied to itself to others, and to do so in a manner which did not unduly discriminate (a wholesale must-offer obligation).

9.34 Sky disputed this approach, arguing in response to our proposals that there is no justification for new regulation. Sky emphasised that Ofcom has a legal obligation to ensure that its regulation is, among other things, targeted only at cases in which action is needed. It believed that the proposed regulation failed this test.

9.35 Others agreed with the general approach of a wholesale must-offer remedy. For instance, BT believed that a wholesale must-offer remedy represented the first step towards enabling it to compete with Sky in the retail market, although it stated that this would not be a complete solution to all the competition issues it had identified in pay TV. **[✂]** agreed with this position, supporting a wholesale must-offer remedy, but saying that on its own it would not be an adequate solution. The Four Parties also took this approach, saying that Ofcom's proposed remedy would facilitate greater competition in pay TV.

9.36 These views were further developed by responses to our Third Pay TV Consultation, which put forward a wide range of observations on whether a wholesale must-offer remedy was an appropriate method of tackling the concerns we identified.

9.37 Sky characterised our proposal as "interventionist and unprecedented new regulation"[1323], which did not reflect a proportionate response or adhere to best regulatory practice. Much of this criticism was related to our impact assessment, as Sky believed Ofcom's analysis of the impact of a wholesale must-offer remedy was "fundamentally flawed".

9.38 Alongside Sky's objections, the supplementary analysis of Professor Cave on behalf of Sky also disputed our approach. Sky / Professor Cave's analysis emphasised the "mutability" of TV channels in comparison to telecoms networks and warned of an unhealthy co-dependency between new entrants and Ofcom as a result of ex ante price regulation.

9.39 Both **[✂]** a potential IPTV retailer and the Three Parties supported the proposal of a wholesale must-offer remedy in principle, but believed the proposals needed to be adjusted to promote fair and effective competition. Similarly, **[✂]** agreed this

[1323] Sky response to Third Pay TV Consultation, p. 174. Sky made similar points in paragraphs 8.1 to 8.4 of the January 2010 Sky Submission, drawing attention to the CAT's judgment (handed down on 16 October 2009) in Barclays Bank PLC v. Competition Commission.

approach was an appropriate response, but emphasised that the wholesale price must be set at the right level with the correct mechanisms in place.

9.40 The BBC stated that a wholesale must-offer remedy implemented effectively by Ofcom would help address the concerns regarding new entrants, who currently find it difficult to compete and thrive in the pay TV sector.

9.41 In contrast, various sporting bodies disagreed with our approach on the basis that a wholesale must-offer remedy could have a damaging impact on their ability to invest in sport. The response of the RFU was indicative of this concern, as it claimed the incentives to bid for sports rights will diminish and the value of sports rights will drastically reduce. This was echoed by the Premier League, which warned that a wholesale must-offer remedy would devalue rights significantly and depress the quality of content available to consumers.

No action

9.42 Through our competition and consumer analysis in Sections 7 and 8, we have identified a situation which is prejudicial to fair and effective competition. Therefore we need to consider further whether there is any action we can take to resolve this which is proportionate. We might still decide that there are no proportionate remedies, as the impact of each of the possibilities would leave the market in a worse position than it is in now.

9.43 In this case, the types of costs that could result from a wrongly targeted intervention are:

- Unintended consequences, such as effects on programme-making.
- Undue implementation costs imposed on regulated firms.
- Damage to prospects for innovation.

9.44 Sky in particular, along with the Premier League and other rights owners, expressed a strong view that the costs of our proposals in the Third Pay TV Consultation would outweigh the benefits. Our view has been to the contrary, but the possibility of doing nothing further has been an option that we have considered at each stage of our remedy assessment. Our weighing-up of the costs and benefits is set out over the course of this Section and the next two.

Structural remedies

9.45 Separation of Sky was proposed to us, but early in our investigation we indicated that it would be disproportionate, a view we have kept throughout.

9.46 The Four Parties' July 2007 Submission included three broad remedy propositions – channel access, restrictions on content acquisition, and modifying Sky's vertical structure. The Four Parties took the view that:

> "Trying explicitly to regulate a company against the grain of its economic incentives will always be both costly and difficult. The only

way to address Sky's incentive effectively is to modify its vertical structure"[1324].

9.47 The Four Parties envisaged operationally separating Sky into "SatCo" (distribution operations) and "ChannelCo" (channel operations and content acquisition). This type of remedy would need to be carried out either by the Competition Commission following a market investigation reference under EA02, or accepted as undertakings in lieu of a reference to the Competition Commission.

9.48 There are several types of separation that might be considered:

- Accounting separation.
- Operational separation.
- Structural separation / divestment.

9.49 Neither accounting separation nor operational separation would have any effect on Sky's incentives to distribute its Core Premium channels. Where accounting separation and operational separation have been used elsewhere – for example in the case of BT – they have been used in conjunction with existing access remedies, primarily to provide transparency as to price and non-price discrimination respectively. They can be an effective means of enforcing existing access remedies, but they are not replacements for those access remedies.

9.50 Only structural separation – i.e. full divestment – could address the underlying issue of incentives. Structural separation is however a costly and highly interventionist form of remedy. While there may be circumstances where seeking an intervention of this type would be justified, we set out a belief in our Second Pay TV Consultation that it would be disproportionate in this case[1325]. We set out two reasons for this view:

- The level of benefits currently being delivered by Sky to consumers, and the possibility that these might be put at risk by disruptive structural changes to Sky's business.
- The fact that Sky's current market position reflects its willingness to invest private capital in what was initially a highly risky business, and the need to ensure that investment is not deterred in future.

9.51 It continues to be our view that structural separation would be disproportionate compared to other remedies available to us, while operational and accounting separation would not result in any change to Sky's incentives, a view which is backed up by the lack of dispute to this point in response to our Second Pay TV Consultation.

Intervention at the rights level

9.52 In the case of movies, we are consulting separately on a proposal to make a reference to the Competition Commission under EA02, which could result in a rights-

[1324] July 2007 Submission, Part 5, paragraph 3.1.

[1325] Second Pay TV Consultation, paragraphs 8.30 to 8.34.

level intervention. We discuss this further later in this Section (see paragraphs 9.153 to 9.154).

9.53 On sports, however, we consider the merits of a rights-level intervention here.

9.54 A rights-level intervention could in theory have two main effects, on distribution and on pricing.

- A rights-level intervention could limit the extent of market power that one wholesale channel provider could use to distort competition, or even eliminate it entirely.

- As a result, greater competition between wholesale channel providers would tend to reduce any monopoly profits in the value chain, and thereby reduce wholesale and retail prices. Such an outcome would also tend to increase the share of industry profits going upstream.

9.55 The most obvious forms of rights level intervention limit the amount of content that can be acquired by a single broadcaster at the wholesale level of the value chain, either by targeting the sale process for specific rights, or by targeting specific purchasers. For example:

- In our Second and Third Pay TV Consultations, we described the possibility of intervening to eliminate upstream market power at source, by putting in place a rule which prevents a particular rights holder from selling more than a given proportion of its rights to a single bidder[1326]. For example, we set out in our market power assessment the importance of live Premier League content to Sky's market power. If Sky were to be unable to win, say, more than a third of live Premier League matches, that would substantially reduce the extent of Sky's market power.

- The Four Parties, in their July 2007 Submission, suggested something rather broader than this: a rule which limited the share of a particular genre of content – sports, or live football – that one wholesale channel provider could purchase[1327].

9.56 In response to our Third Pay TV Consultation, Sky argued that:

- Ofcom's proposed intervention into the way Premier League rights are bought and sold was "motivated by the desire to address the perceived existence of market power"[1328].

- The entry of Setanta into the market was not a consequence of the European Commission's commitments, while the eventual demise of Setanta does not provide evidence of these commitments being insufficient[1329].

[1326] Second Pay TV Consultation, paragraphs 8.25 ff.

[1327] July 2007 Submission, Part 5, paragraph 2.15 (b).

[1328] Sky response to Third Pay TV Consultation, Annex 6, paragraph A6.22.

[1329] Sky response to Third Pay TV Consultation, Annex 6, paragraph A6.25.

- The removal of cross-platform exclusivity would have profound consequences, such as the need for cross-platform broadcasters to create bespoke versions of their channels[1330].

9.57 Conversely, the Three Parties believed that since previous commitments given to the Premier League by the European Commission were so unsuccessful, an additional intervention was needed by Ofcom in time for the 2012 auction.

9.58 **[✂]** also agreed that Ofcom should take an active role in devising a new and more effective remedy for the next auction of Premier League rights.

9.59 **[✂]** A potential IPTV entrant considered it more suitable to impose a suitable wholesale must-offer obligation first, before addressing the issue of Premier League rights.

9.60 We acknowledge that a remedy that was capable of significantly reducing market power, such as splitting Premier League rights into (for example) thirds, would in principle be an attractive means of eliminating any potential competition concern at source. It would not be as immediately disruptive as structural separation of Sky, but has the same advantage as structural separation, in that it permanently changes Sky's incentives and its ability to act on those incentives. It therefore addresses our competition concerns without the need for continued supervision that is entailed by other types of remedies such as a wholesale must-offer obligation.

9.61 However, a remedy which places severe limits on content aggregation does risk a number of less desirable consequences[1331]:

- In general, content aggregation has positive effects, as we have identified in Section 4 of this document. Any remedy which prevents or restricts aggregation to the extent that would be necessary to eliminate market power is also likely to risk sacrificing some of these benefits. For instance, splitting live Premier League rights into thirds might result in some consumers paying higher prices, due to a reduction in the efficiencies associated with content bundling.

- It might also result in reduced convenience for some consumers, who might have to take multiple subscriptions or purchase multiple set-top boxes to get the content they want. In principle we would expect wholesale channel providers without market power to have an incentive to wholesale their sports channels widely to all downstream retailers, thus eliminating this concern. There is however a risk that this outcome would not emerge in practice, particularly if the intervention failed adequately to address market power.

- It could result in artificial depression of rights values, if splitting up the rights created packages for which there was limited bidding competition. This might reduce investment in content, resulting in the content available to consumers reducing in quality. Careful design of rights packages would be essential to minimise this risk.

[1330] Sky response to Third Pay TV Consultation, Annex 6, paragraph A6.33.

[1331] Note that this discussion of a possible rights-level intervention is purely theoretical, because we have not opened a Competition Act 1998 investigation into the subject. We do not know what remedies might result from such an investigation.

- There are acknowledged benefits associated with aggregation in the form of collective selling of sports content. These were recognised in the White Paper on Sport published by the European Commission in 2007[1332], which stated that collective selling has "the potential of improving the media product and its distribution to the advantage of football clubs, broadcasters and viewers"[1333]. The Commission identified three types of benefits:
  - The creation of a single point of sale provides efficiencies by reducing transaction costs for football clubs and media operators.
  - Branding of the output creates efficiencies as it helps the media products to get wider recognition and hence wider distribution.
  - The creation of a league product: this is a product that is focused on the competition as a whole rather than the individual football clubs participating in the competition. This is attractive to many viewers.
- Furthermore, the splitting of Premier League rights into thirds might not fully address concerns relating to Sky's market power. As the Premier League is not the sole source of Sky's market power, Sky might be able to retain its market power by maintaining or augmenting the wide range of alternative content rights that it has. Consequently, this outcome might suggest the need for a more intrusive rights level remedy, either targeting the sale process for some other important rights as well as Premier League, or limiting the total amount of sports content that can be acquired by a single purchaser.
- Real-life examples illustrate the difficulties associated with rights-level interventions. Rights-level interventions have been used in various European markets to attempt to limit the market power-enabling effects of collective selling of sports rights. For instance, in 1999 the Italian Competition Authority ('AGCM') banned collective selling by Serie A clubs, but discovered that this caused problems with the competitive balance of the league. Subsequently the ban was repealed by a legislative decree in January 2008[1334].
- Similarly, in 2002 the Spanish Competition Authority ('SDC') imposed a number of conditions on the sale and acquisition of premium football rights in accepting the merger to create Digital+[1335]. This included a limitation on the duration of contracts of football rights of three years or less and a waiver of purchase options for these rights. However, these expired along with the general merger conditions in November 2007.

9.62 Our view is that a remedy which addressed our competition concerns by placing severe limits on content aggregation, in order to eliminate market power at source, would be disproportionate, given the availability of less intrusive remedies such as regulated wholesale-must-offer obligations. We might need to revisit this question if a regulated wholesale-must-offer obligation proved ineffective.

[1332] http://ec.europa.eu/sport/white-paper/index_en.htm.

[1333] Annex I: Sport and EU competition rules, paragraph 3.1.3.1.1.

[1334] http://www.agcm.it/eng/index.htm

[1335] See Value Partners Study, Annex 11 to Third Pay TV Consultation.

9.63 There are rights-level remedies which stop short of attempting to eliminate market power. The commitments given by the Premier League to the European Commission up until the 2012/2013 season are one such example. These commitments split the available rights into six packages and prevented any single bidder from acquiring all six. As our market power assessment shows, another channel provider licensing one sixth, or even one third, of live Premier League rights does not have a significantly reducing impact on Sky's market power, and concerns over Sky's exercise of its market power continue to exist in the face of the remedy.

9.64 Rather, both the intention and the impact of this remedy have been to create an opportunity for entry based on a subset of the Premier League rights, at both the wholesale and retail level. Setanta, and subsequently ESPN, were able to use these rights to expand the quality of content on their channels. Both companies then wholesaled those channels to a variety of different retailers, whilst Setanta also used its channels to become a pay TV retailer on DTT as well as on Sky's satellite platform.

9.65 However, although the remedy did enable market entry, Setanta's business model did not prove to be sustainable. The reasons for this were complex and not solely due to the nature of the remedy, but this outcome is relevant to the design of future remedies.

9.66 ESPN has adopted a somewhat different business model, and in particular appears to have chosen to compete less aggressively with Sky. For example, ESPN appears to compete less aggressively for certain content rights than Setanta (notably the rights to Scottish Premier League[1336]), and **[✂]**. This strategy may increase its chances of success, but may also reduce the benefits that flow to consumers from competition.

9.67 Furthermore, while the availability of both Setanta and ESPN's channels on DTT attracted a significant number of new consumers of pay TV services, it also resulted in some consumers losing access to services. In particular, Sky subscribers that wanted to see the full set of live televised Premier League matches had to add an extra subscription to their original Sky Sports subscription, or pay extra to Sky in order to do so[1337].

9.68 By way of contrast, a wholesale must-offer form of remedy also enables market entry, albeit only at the retail level. It does so not by placing artificial limits on content aggregation, but by ensuring that key content, once aggregated, is available to consumers on a variety of platforms. This achieves a similar result in terms of retail market entry.

9.69 Another type of less intrusive remedy is one which places specific restrictions on the way rights are sold in order to make them more contestable. This type of remedy is included in the commitments given to the European Commission by the Premier

[1336] In 2008, Setanta signed a four year agreement for live SPL rights worth £125m. After Setanta went into administration in June 2009, Sky and ESPN confirmed a joint agreement for these rights worth only £65m over five years (http://www.guardian.co.uk/football/2009/jul/16/spl-espn-sky-tv-deal). This reduction in revenue led some SPL football clubs to consider bidding for the rights themselves.

[1337] The price of these additional packages varies by platform and package, but a typical additional subscription would be around £10. In the case of Setanta, customers on satellite that wanted all available live Premier League matches had to take subscriptions from two companies. In the case of ESPN, customers can subscribe to both Sky Sports channels and ESPN from Sky.

League; the commitments ensure an open bidding process for rights licensing. As we set out in our Second Pay TV Consultation, the risks for consumers associated with this type of remedy are low, but on its own we would not expect this to be sufficient to address the competition issues identified.

9.70 In our Third Pay TV Consultation (Section 12) we observed that it might still be appropriate to take specific targeted action in the case of Premier League and movies. It is relevant to consider Premier League football because the current commitments given by the Premier League to the European Commission expire at the end of the 2012 / 2013 season.

9.71 We described that even if we were to proceed with a wholesale must-offer obligation as set out in that document, we would consider engaging further with the Premier League to ensure that future auctions for rights from the 2013 / 2014 season onwards complied with competition law. One possibility we described was that we could attempt to explore mechanisms by which commercial as well as residential subscribers were protected from the detrimental effects of collective selling, for example by establishing separate sets of rights for commercial and residential customers. This could potentially offer a viable entry strategy for retailers targeting commercial customers, as well as providing greater transparency as to profitability levels, but without risking damaging rights values because the two sets of rights would be unlikely to be strong substitutes.

9.72 In its response the Premier League took the view that:

> "It is for the PL to determine its future packaging in compliance with competition law. The PL will not countenance any attempt by Ofcom, or any of the potential bidders for the rights, to try and determine its future rights packaging"[1338].

9.73 It therefore does not appear at this stage that it will be seeking to open discussions on voluntary commitments. We may therefore need to revisit the compliance of the Premier League's arrangements with competition law. We can certainly see benefit in establishing certainty prior to the auction given the changes that have taken place since the last commitments were given to the European Commission. We will continue to keep under review the need for action on this issue.

Regulating wholesale access to Core Premium channels

9.74 In light of the above we consider that it is more appropriate to address the competition issues identified by directly addressing the restricted distribution of Core Premium channels. As explained in Section 3, we consider that it is possible to do this by putting a licence condition into the broadcasting licences for the channels concerned, requiring an offer to be made for the wholesale supply of each relevant channel.

9.75 There are a number of reasons why we believe this is an appropriate way to proceed in relation to our concern over restricted distribution of Core Premium channels.

- Requiring wholesale access to channels is targeted specifically at the concern we have identified.

[1338] Premier League response to Third Pay TV Consultation, paragraph 12.41.

- This type of remedy would replicate the behaviour we would expect in a competitive market.
- Costs are likely to be low and are potentially offset by market expansion effects.
- This type of remedy exists elsewhere.
- Sky already wholesales to Virgin Media, and was prepared to commit to wholesaling to other retailers.

9.76 There are however some limitations to the effectiveness of this remedy, notably:

- As with any behavioural remedy, it requires continuous regulatory supervision, and is susceptible to gaming.
- It can address concerns regarding restricted distribution of channels, but cannot address concerns regarding the level of pricing unless wholesale prices are set based on costs, which in turn risks materially damaging the value of content rights.

<u>Requiring wholesale access to channels is targeted specifically at the concern we have identified</u>

9.77 While the two types of remedy we discuss above would seek to make structural changes in various parts of the sector, requiring wholesale access to particular channels is specifically directed at remedying the competition concerns we have identified.

9.78 The purpose of requiring wholesale access is to remove the ability of Sky to act on its strategic incentives in a way which results in restricted distribution of Core Premium channels and therefore which prejudices fair and effective competition.

9.79 For this approach to be effective we need to ensure that it takes account of the fact that Sky has a continuing incentive to restrict distribution.

<u>This type of remedy would replicate the behaviour we would expect in a competitive market</u>

9.80 Absent some of the key market characteristics which exist in pay TV, such as vertical integration and Sky's market power, we would expect channels to be wholesaled widely across a range of distribution platforms. As we have set out in Section 7, considering the high fixed costs at wholesale level, we would expect a wholesaler to have a strong incentive to expand the market. In the case of Sky's Core Premium channels, this is not happening at the moment – distribution of these channels is being restricted. Requiring wholesale access seeks directly to reflect the practices we would expect to observe in a competitive market.

9.81 Sky's market power and its vertical integration between wholesale channel provision and retail service provision are key drivers of Sky's ability to restrict distribution. An effective remedy requiring wholesale supply prevents this outcome from taking place.

9.82 Sky already has a business model under which it wholesales Core Premium channels to Virgin Media. Further, wholesale supply is normal in the case of basic channels. Not only do companies like Discovery and MTV Networks (Viacom) distribute their channels widely across a range of channels, but Sky itself wholesales its Sky1 channel to others, and purchases channels from other vertically integrated channel operators / retail service providers like Virgin Media.

9.83 We would certainly not claim that this regulation is without costs, nor is it a 'minor' intervention, as Sky presents us as having argued[1339]. We consider the likely costs of our proposals carefully throughout this and the next two Sections. Wholesaling of channels is a standard way of doing business in pay TV. Indeed, Sky itself has said that "Sky does, in fact, have an incentive to supply its channels via these [new] platforms"[1340]. Or alternatively, "if Sky could not retail then it would certainly consider wholesale supply"[1341].

Costs are likely to be low and are potentially offset by market expansion effects

9.84 Requiring wholesale access is unlikely to impose great costs on Sky or the sector as a whole. Indeed, a countervailing feature of this type of remedy against any costs of intervention is that its purpose is to extend the distribution of the channels that it covers, increasing wholesale revenue as the market expands.

9.85 We carry out our full assessment of the proportionality of a wholesale requirement over the remainder of this and the next two Sections.

This type of remedy exists elsewhere

9.86 There are various examples of remedies requiring wholesale access to channels elsewhere in the world. We have cited various examples in previous consultations[1342].

9.87 We are cautious about using international examples. The many contextual differences between markets can make direct comparisons dangerous. There may be factors that exist in other European markets or further afield which have had a material impact on the current environment, and which do not exist in the UK. As an example, Germany has a strong history of distributing TV via cable networks, meaning that the gap in breadth of channel offering between analogue offers and newer digital services is smaller than in the UK, where the history focuses on terrestrial distribution. However, the fact that remedies requiring wholesale access exist successfully elsewhere shows that this kind of remedy is not a dramatic and "unprecedented new regulation" in the way that Sky suggests[1343].

9.88 The Programme Access Rules ('PAR') in the US, originally implemented in 1992, have been extended twice, in 2002 and 2007 (and are now under further review). They are a particularly informative example of what this kind of remedy can achieve.

[1339] Sky response to Second Pay TV Consultation, Section 7, paragraph 6.17.

[1340] Sky response to Second Pay TV Consultation, Section 1.

[1341] Sky response to Third Pay TV Consultation, paragraph 6.9 (b).

[1342] For example, Annex 11 to our Third Pay TV Consultation.

[1343] For example, Sky states at Section 3, paragraph 1.6 of its response to our Second Pay TV Consultation, that "Ofcom's preferred remedy [is] highly unusual". Or at Section 7, heading 6(c) of the same response: "the radical, unprecedented and interventionist nature of [Ofcom's] proposals".

- The FCC has emphasised the positive impact PAR has had on competition, enabling the US multi-channel market to develop and forcing both incumbent cable operators and new entrants to innovate. In the opinion of Steven Broeckaert, Senior Deputy Chief at the Federal Communications Commission ('FCC'), PAR has achieved "a tremendous amount of good in the US allowing competition to develop"[1344]. When extending PAR, the FCC has expressed its belief that exclusivity prohibitions were still necessary to let a fully competitive environment develop, while the nascent market for IPTV would still need PAR in order to grow.

- The latest extension of PAR has been challenged by some cable operators, with Cablevision and Comcast appearing before the US Court of Appeals in September 2009 to appeal the FCC's decision. The Court of Appeals will announce a decision in early spring, but the FCC has argued that PAR will remain in place for its full five year duration (until 2012).

9.89 There are a number of other examples of wholesale must-offer obligations in major European markets.

- In France, following the creation of Canal+ France in 2006 through the merger of Canal Sat and TPS, Canal+ was required to wholesale attractive content to third party retailers[1345].

- In Italy, the European Commission imposed a number of conditions on the merger of Stream and Telepiu to form Sky Italia in 2003, in the form of commitments given by the merged entity[1346]. The conditions included a wholesale must-offer obligation on seven premium sports and movies packages.

- In Spain, the Spanish Competition Commission ('SDC') required the newly merged satellite operator, Digital+, to wholesale both some thematic channels and one channel including premium first-run movies.

9.90 Often however, where the obligations have run into difficulties, this has been the result of the way they have been executed rather than the principle.

- The effectiveness of wholesale must–offer remedies has been restricted by the lack of definition of precise terms of supply, especially the setting of prices. For example, in Italy the remedy imposed on Sky Italia by Agcom (the Italian regulator) did not initially include a price. Consequently, establishing a price had to wait until the dispute resolution process was able to determine it. The retrospective view of Agcom on this process highlights the benefit of a clearly defined pricing rule:

[1344] Interview with Steven Broeckaert, Senior Deputy Chief, Policy Division, Media Bureau, Federal Communications Commission, 19 November 2009.

[1345] Value Partners' report (Annex 11 to Third Pay TV Consultation), page 17 ff.

[1346] European Commission: Regulation No 4064/89 Merger Procedure Case No COMP/M.2876 Newscorp/Telepiu, as quoted in Value Partners' report (Annex 11 to Third Pay TV Consultation, page 6 ff.

> "If we were to design it [the wholesale must-offer remedy on Sky Italia] again, we would be more explicit about the pricing rule and not give as much autonomy to Sky"[1347].

- The experience of the SDC in Spain in setting a wholesale must-offer obligation within the Spanish pay TV market also illustrates similar risks. In this case, a poorly defined wholesale must-offer was left open to interpretation through its vague language, allowing Sogecable (the cable company under the obligation) to reduce investment and programme quality on the channel it had supplied as its "premium channel". As the Value Partners study suggests, this experience demonstrates how wholesale must-offer remedies can be limited in their effectiveness due to a lack of clarity over what constitutes a "premium channel".

<u>Sky was prepared to commit to wholesaling to other retailers</u>

9.91 In late 2007 Sky approached Ofcom to discuss whether there were commitments it could provide to Ofcom to enable an early resolution of our process. Ofcom's view was that the commitments, if accepted, would have acted as undertakings in lieu of a reference to the Competition Commission under EA02. Sky told us that it approached Ofcom "in an attempt to end the stasis arising from Ofcom's various reviews and investigations, which were causing Sky's plans to launch its 'Picnic' offering via DTT to be held up"[1348]. The outcome of this could have been to allow for early resolution of both our market investigation and Picnic processes.

9.92 A series of discussions took place between December 2007 and April 2008, during which we discussed a detailed set of pricing proposals and made significant progress on a number of different issues. Annex 2 sets out Ofcom's understanding of the commitments that Sky was willing to offer, and the context within which it was willing to offer them. Annex 2 is based on a document which was provided to Sky in February 2008, and takes account of the changes to this document which were proposed by Sky.

9.93 The commitments that Sky was willing to make included a commitment to supply Sky Sports 1 plus Sky's premium movies channels on a wholesale basis for retail to residential subscribers, subject to various eligibility criteria. High definition variants of qualifying channels would have been included in the offer, starting no less than **[✂]** after the Picnic launch date.

9.94 The fact that Sky was prepared to commit to wholesaling its channels to other retailers shows that a wholesale supply obligation is not an extreme requirement or one which departs dramatically from the normal workings of commercial dealings between companies. If a wholesale supply obligation were indeed as "interventionist and unprecedented" as Sky claims, it seems unlikely that Sky would have been prepared to offer commitments to wholesale.

9.95 In its response to our Third Pay TV Consultation, Sky argued that we should have accepted the commitments it proposed, and that that would have removed our concerns. For example, Sky said in criticising our impact assessment that:

[1347] Value Partners' report (Annex 11 to Third Pay TV Consultation), page 16.

[1348] Sky response to Third Pay TV Consultation, paragraph 1.14.

> "Had Ofcom accepted the proposed wholesaling commitments Sky offered to Ofcom in December 2007, it is entirely plausible that ... Sky's premium channels would also by now be available from other DTT based retailers"[1349].

9.96 The main reason that we were unable to reach agreement at the time was price. Sky stated at the start of the discussions that it expected the baseline wholesale prices for these channels to be those applicable to Virgin Media, and that this was not something it was willing to discuss. This proved to be a material constraint on the scope of our discussions[1350].

9.97 Sky did however state that it was willing to provide a discount based on the incremental subscribers above specified levels of platform penetration. The proposed discount would equal **[✂]**% at **[✂]**% platform penetration. This discount structure was designed to ensure that there was no 'windfall gain' to Virgin Media, and that Virgin Media would only benefit from reduced prices if it increased its platform penetration above its current level.

9.98 Ofcom's view at the time was that this pricing proposal was not likely to address our competition concerns with the degree of certainty that was required for us to be able to consult on accepting undertakings in lieu of a reference to the Competition Commission:

- We were primarily concerned that at moderate levels of platform penetration, the price that was on offer would not have enabled a retailer on DTT, with the scale that such a retailer would be likely to be able to achieve, to compete with Sky.

- We were also concerned that retailers other than Sky would have had a strong incentive to achieve very high levels of platform penetration for Sky's content, in order to benefit from an average price at which they were competitive. There was a high risk that this would effectively have turned them into pure resellers of Sky's content. As a consequence, platform operators would have had a strong incentive not to introduce other services onto their platforms, because doing so might have reduced the platform penetration of Sky's content, unless doing so could have generated sufficient margin to offset the lost discount from Sky. This would have been likely to reduce incentives to innovate[1351].

- These points can be illustrated by reference to the prices which we now set out in Section 10.

[1349] Sky response to Third Pay TV Consultation, paragraph 1.76.

[1350] In paragraphs 4.8 to 4.17 of the November 2009 Sky Submission, Sky set out further details of its view of the negotiations. It argued that the "discussions ultimately foundered because it became apparent that Ofcom was determined to secure wholesale price cuts which went beyond the significant discounts that Sky had already offered".

[1351] In the November 2009 Sky Submission, Sky stated that we could not "credibly allege that Sky sets its prices so that Virgin Media does not have an incentive to market Sky's channels, but then cite a concern that retailers would be over-incentivised to resell Sky's channels as grounds for rejecting the wholesale pricing structure proposed by Sky". It is clear from the discussion set out here that our concerns about resale related to the nature of the discount structure and its potentially constraining impact on the strategies and incentives to innovate of potential purchasers of Sky's channels.

- o We have decided there that the standalone wholesale price for Sky Sports 1 should be reduced from £13.88 to £10.63, a reduction of 23%. Under the discount structure which Sky proposed, this reduction could only be achieved with a platform penetration in excess of 90%.

- o We have decided that the wholesale price for Sky Sports 1 plus Sky Sports 2 should be reduced from £19.15 to £17.14, a reduction of 10.5%. Under the discount structure which Sky proposed, this reduction could be achieved with a more reasonable platform penetration, of about **[✂]** [30-40]%. However, Sky did not propose to include Sky Sports 2 within the scope of its offer, and so did not propose to apply the discount structure to this bundled price.

9.99 Additionally, a number of non-price issues were outstanding at the point in time when the discussions broke down. These included the nature of various ancillary commitments related to premium sports channels other than Sky Sports 1, the acceptability of Sky's proposal that there should only be a single retailer of its content on each platform, and the question of how a platform should be defined in order to apply the discount structure and eligibility criteria set out above. Our view at the time was that most of these were capable of resolution through further discussion, though this cannot of course be certain.

9.100 The result was that while what was on offer from Sky might have delivered some benefits to consumers, we were not confident that it would have enabled effective competition (either between different DTT-based platforms, or between platforms on DTT and other platform technologies). We were not in a position to accept Sky's proposed commitments because we did not consider they would provide a comprehensive solution to our competition concerns and their adverse effects on consumers.

The risk of gaming and the need for continued regulatory supervision

9.101 We are conscious that a wholesale supply obligation is susceptible to gaming. We consider there is potential for gaming as follows:

- The movement of content between regulated and unregulated channels.

- Changes in costs which might require frequent changes in regulated prices.

- Delay in implementing wholesale access, due for example to disputes over non-price terms.

9.102 These concerns have been highlighted by Sky as well as by Sky's competitors. Sky has noted the costs associated with maintaining such a regime, whilst Cave / Sky has noted the particular difficulties created by the 'mutability' of the wholesale product being regulated.

9.103 We do not underestimate these difficulties, but believe that they can be addressed such that this remedy is preferable to the alternative solutions set out above. We will need to review the effectiveness of such a remedy in practice, and we discuss the process for such a review at paragraphs 9.302 to 9.306 below.

Inability to address concerns relating to the level of pricing

9.104 Before considering the issue of the appropriate legal instrument to address the restricted distribution of Core Premium channels, we assess whether we can address concerns relating to the level of pricing through a wholesale access obligation.

9.105 The primary concern that a wholesale access obligation would be designed to address is restricted distribution of Core Premium channels. However, the level of Sky's wholesale and retail pricing is also prejudicial to fair and effective competition, which is to the detriment of consumers, particularly as we look forward, as we have set out in Section 7 and 8. High returns were likely to have been a necessary reward for the significant risks Sky took early on. More recent risks have been of a different (much smaller) scale, but returns have nonetheless remained at high levels – levels which appear to go beyond the necessary reward for historic risk.

9.106 The only means by which a wholesale access obligation can effectively address such concerns is by setting prices on a cost-plus basis. However, this risks artificially depressing rights values, since it gives firms an incentive to reduce the regulated wholesale price through their behaviour in auctions.

9.107 Alternatively, it might be possible to address concerns regarding the level of prices by intervening at the rights level, as discussed at paragraphs 9.53 to 9.73 above. Such interventions are likely to be a more effective means of addressing concerns about the level of pricing than a wholesale access obligation set on a cost-plus basis, but bring with them other risks, particularly in the case of sports rights.

9.108 This means that in deciding to proceed with a wholesale access obligation rather than a rights level intervention we are balancing two considerations:

- The extent of the consumer detriment for which we have evidence.
- The risk that any intervention could have unintended consequences.

9.109 The balance is different for sport and movies:

- For sport, the evidence of detriment is lower, although we do have a potential concern about high prices within rights bodies as well. The risk of unintended consequences is higher.
    - o As we set out in our discussion of possible rights-level interventions, that route to addressing high prices brings with it risks of negative consequences through disruption to consumers.
    - o It would also be possible to address this concern by using cost-plus prices driven down to the cost floor plus an appropriate margin for the wholesaler. However, for all the reasons set out later in this Section, it would not be in the long-term interests of consumers for us to do this. The risk of artificial depression of rights values risks in turn jeopardising the continued generation of a wide range of high-quality content, which was one of our criteria for assessing the functioning of the pay TV sector.
    - o We would not however rule out future action, and are in any case keeping under review the need to ensure that the 2012 Premier League auction complies with competition law.
- For movies, the evidence of detriment is greater, since margins appear higher in movies. Similar risks are associated with a cost-plus wholesale must-offer as in

sports, but it may be possible to put in place another type of remedy, particularly one which makes use of the likely constraint from SVoD movies services to reduce current margins. However, as we have set out, such remedies are outside our powers – hence our proposed reference to the Competition Commission for a market investigation.

Whether it is more appropriate to proceed under CA98 – s317(2)

9.110 We consider in this sub-section whether a more appropriate way to proceed in order to address some or all of the concerns identified in this document would be under CA98 as opposed to s316 CA03.

9.111 S317(2) provides that:

> "Before exercising any of their Broadcasting Act powers for a competition purpose, Ofcom must consider whether a more appropriate way of proceeding in relation to some or all of the matters in question would be under the Competition Act 1998".

9.112 S317(3) further provides that:

> "If Ofcom decide that a more appropriate way of proceeding in relation to a matter would be under the Competition Act 1998, they are not, to the extent of that decision, to exercise their Broadcasting Act powers in relation to that matter".

9.113 The imposition of a licence condition under s316 requiring Sky to make wholesale offers of particular channels constitutes the exercise of a Broadcasting Act power for a competition purpose within the meaning of s317(2). We must therefore consider whether it would be more appropriate to proceed under CA98 before proceeding under s316.

Ofcom's conclusions on the s317 test

9.114 Ofcom has considered whether a more appropriate way of proceeding in relation to some or all of the competition issues which it has identified would be under CA98, and has concluded that this is not the case.

9.115 S316 allows Ofcom to shape a comprehensive solution to a general problem affecting the relevant markets, after public consultation and on the basis of careful consideration, pursuant to Ofcom's statutory duties, of the effects of intervention upon all relevant markets and stakeholders.

9.116 By contrast, proceeding under CA98 would entail the investigation, *ex post*, of specific individual instances of anti-competitive conduct. Following a finding of infringement(s), Ofcom would be limited to imposing financial penalties and giving such directions as it considered appropriate to bring the relevant infringement(s) to an end.

9.117 Such *ex post* remedies may not be as effective as the imposition of licence conditions under s316 at addressing the underlying competition issues that Ofcom has identified. In the context of refusal to supply cases, for instance, the conditions for such an abuse might arise in the context of any one of the range of issues that have to be settled before commercial agreement on wholesale of premium television channels can be reached. Tackling one instance of refusal to supply, relating to a position adopted on a particular contractual issue, would not preclude a failure to reach agreement as a result of intransigence on a separate issue.

9.118 In the circumstances of the present case, even were Ofcom able to resolve the issue of pricing for SD channels under CA98, the evidence of previous negotiations suggests that Ofcom would then face a series of further complaints covering a wide range of matters from Minimum Security Requirements to the supply of HD channels. This is unlikely to result in either the timely resolution of Ofcom's competition concerns, or the establishment of greater certainty.

9.119 In the context of Sky's current approach to the wholesale supply of its channels, proceeding under s316 allows Ofcom to set *ex ante* conditions which can provide the certainty that the potential for the bringing of potential future CA98 cases does not provide. It allows Ofcom to address with one remedy a result which might at best only emerge from a succession of CA98 cases, and which might not emerge at all.

9.120 We have therefore decided that it is appropriate to proceed under s316 in relation to the matters concerned rather than CA98. Proceeding under s316:

- allows Ofcom to consider how competition across the markets concerned can best be opened up so as to ensure that it is fair and effective;
- allows Ofcom to put in place a remedy best suited to the particular competitive conditions, taking into account our sectoral duties;
- enables an *ex ante* remedy to be put in place which can provide certainty for pay TV retailers, avoiding the potential for multiple CA98 cases.

9.121 In the remaining Sections of this document we consider the scope and form of the conditions we consider are appropriate for ensuring fair and effective competition.

Scope of a wholesale must-offer remedy

9.122 We now consider what form of wholesale must-offer, if any, it is appropriate to impose. We begin this process by considering some broad issues of scope. Under each of the headings below we evaluate, in a qualitative manner, the costs and benefits of different options.

9.123 First, however, we briefly outline the position we took on the key questions in our Third Pay TV Consultation.

Our position in our Third Pay TV Consultation

9.124 In the Third Pay TV Consultation we addressed various questions as to the right scope of a wholesale must-offer obligation:

9.125 **To which wholesalers should it apply?** We proposed to apply the remedy only to those wholesalers that have market power, and appear to be acting on an incentive to restrict supply of the channels within the relevant markets. At that time, only Sky met these criteria.

9.126 **Which channels should it cover?** We believed a wholesale must-offer remedy should cover all the channels which make a material contribution to the market power which we identified and which was being exploited. Thus, we proposed that the scope of the obligation extend to Sky Sports 1 and 2, and all the Sky Movies channels apart from Classics.

9.127 **Should a wholesale must-offer remedy apply to retailers on all platforms?** We proposed not to extend the remedy to cover retail on Sky's own platform. The primary purpose of the remedy was to address the restricted availability of Sky's Core Premium channels on non-Sky platforms, and the reduced innovation that was likely to arise from weakened inter-platform competition. Both of these concerns could be addressed by requiring Sky to supply its Core Premium channels only to retailers on non-Sky platforms.

9.128 **Should a wholesale must-offer remedy apply for the purposes of onward retail to commercial premises?** We proposed not to extend the remedy to cover retail to commercial customers as we did not see evidence for restricted distribution of premium content to commercial premises.

9.129 **Should we set conditions of supply, particularly prices?** We believed it to be necessary for us to determine some of the conditions of supply within the offer, in particular prices. Not doing so would have risked rendering the remedy ineffective for two reasons:

- The evidence of commercial negotiations to date suggested that a requirement to agree prices commercially would lead, after a protracted period of negotiation, to a stalemate.
- The only prices which other retailers might be able to agree with Sky were likely to be closely based on the current cable rate-card. However, we did not believe this would allow competitors to Sky to build a viable business, and it would not therefore have addressed the detriment we have identified.

9.130 **Should a wholesale must-offer remedy include enhanced versions of relevant channels, or associated services?** In order for the supply obligation to be effective, the channels which Sky supplies to other retailers would need to be of similar quality to those which it supplies to itself. Any material difference in quality would be a form of non-price discrimination, and would have been likely to reduce the effectiveness of the supply obligation.

Which wholesalers should be included in a wholesale must-offer remedy?

9.131 We consider that a wholesale must-offer remedy should apply to Sky, because we have found that: Sky has market power in the wholesale of Core Premium channels; it has an incentive to act on this market power, in particular due to vertical integration; and there is evidence that Sky is acting on these incentives, in terms of restricted distribution.

Which channels should be included in a wholesale must-offer remedy?

9.132 There are two separate questions under this heading:

- Should sports channels be included in the wholesale must-offer remedy, and if so which ones?
- Should movies channels be included in the wholesale must-offer remedy?

Summary

9.133 Sky Sports 1 and 2 will be included within the scope of the wholesale must-offer obligation as these channels make a material contribution to Sky's market power. We do not believe it would be proportionate to extend the remedy to include Sky Sports 3 and 4, as these channels do not include enough content that is important to consumers. Effective competition in pay TV requires a degree of product differentiation, with differing retailers assembling a range of different content, around a core set of premium channels, and that core does not in our view extend to Sky Sports 3 and 4.

9.134 However, we have recognised the potential for gaming via the transfer of content across channels and propose to keep the scope of the wholesale must-offer obligation under review to address this risk. If Sky acts in such a way that the only means of addressing the risk of gaming is by extending the obligation to Sky Sports 3 and 4, then we will consider doing so. We would not expect a protracted consultation to be required in the event that a new licence condition is necessary for Sky Sports 3 and 4, since the substantive issues would be the same as those on which we consulted in the Third Pay TV Consultation and on which we conclude here.

9.135 We will not be imposing a wholesale must-offer obligation on Sky Movies channels. Our main forward looking concern relates to the availability of services based on SVoD rights, but we have limited sectoral competition powers in relation to such services, and the content rights on which they are based. We therefore consider it is more appropriate to consult on making a market investigation reference to the Competition Commission under EA02.

9.136 It is possible that the Competition Commission will conclude that a wholesale must-offer obligation on linear channels is appropriate, either on its own or as part of a wider range of remedies. We have considered whether there is a need to impose a linear channel wholesale must-offer obligation before the Competition Commission reaches its conclusions, and do not believe this to be necessary.

Should sports channels be included in the wholesale must-offer remedy, and if so which ones?

9.137 Various respondents to our Third Pay TV Consultation argued that the scope of the wholesale must-offer remedy should be extended to cover Sky Sports 3 and Sky Sports 4.

9.138 The Three Parties, **[✂]** pointed out that although Sky Sports 3 and Sky Sports 4 overall have less attractive schedules than Sky Sports 1 and 2, they regularly feature live sporting events which a significant number of consumers find highly attractive. Virgin Media emphasised that a failure to cover those channels would undermine the ability of the remedy to promote fair and effective competition at the retail level.

9.139 Similarly, **[✂]**[1352], **[✂]** a broadcaster and **[✂]** were also of the opinion that the above channels should be included. They particularly stressed the risk that Sky might move key content onto other channels within its sports portfolio.

9.140 Sky's key argument for why it is not justified to include sports channels in a wholesale must-offer remedy is that it disputes our view of the importance of Core

[1352] **[✂]**.

Premium Sports channels to competition in pay TV. It bases this view on the notion that Ofcom "significantly underestimates the range of substitutes to consumers for the specific programming broadcast on Sky's premium sports channels"[1353]. This is essentially an argument about market definition and market power. As we set out in detail in Section 5, we do not believe the alternative ways of watching live sports constitute a substantial competitive constraint on Sky's Core Premium Sports channels.

Which current channels should be included?

9.141 We consider that a wholesale must-offer obligation should apply to those channels which are the source of Sky's market power, and where it has been demonstrated that Sky acts on the ability and incentive arising from its vertical integration to restrict supply in a manner which is prejudicial to fair and effective competition. In our Third Pay TV Consultation we proposed that the scope of the wholesale must-offer obligation should cover all Core Premium Sports channels.

9.142 We continue to believe that it is only those channels that include a substantial amount of the most important content that need to be made available to other retailers to ensure fair and effective competition. Our market definition and market power analysis shows that it is Sky Sports 1 and 2 that include the majority of the most important live sports programming. As we discuss below, this has been confirmed by the fact that it is these channels which have been sought most strongly by potential entrants[1354].

9.143 This proposal elicited strong objections, as various respondents argued that the scope of the wholesale must-offer remedy should be extended to include Sky Sports 3 and Sky Sports 4 (formerly Sky Sports Xtra).

9.144 The Three Parties, **[✂]** all stated that, despite having less attractive schedules overall, Sky Sports 3 and 4 regularly feature live sporting events which consumers find highly attractive.

9.145 Similarly, Virgin Media argued that the inclusion Sky Sports 3 and 4 would be essential for rival retailers to compete effectively with Sky. It claimed our position reflected a narrow approach to market definition, which failed to have sufficient regard for subscribers' purchasing choices. This concern was echoed by **[✂]** a broadcaster, which believed it was important for the full range of Sky Sports channels to be made available to third party retailers.

9.146 The BBC agreed with our wholesale market definition for Core Premium Sports channels, but noted the need for inclusion of Sky Sports 3 and 4 in the future should be kept under review. Conversely, **[✂]** believed these channels should be included from the outset, as it was concerned Sky could potentially game the remedy by moving content into other sports channels in its portfolio.

9.147 In light of this opposition, we have further considered the arguments put forward by the various respondents on this issue. One of the more substantial objections was raised by Virgin Media, who provided supplementary evidence alongside its response which aimed to quantify the attractiveness of sport on Sky Sports 3 and 4. This

[1353] Sky's response to Third Pay TV Consultation, Section 9, footnote 13.

[1354] **[✂]**.

consisted of consumer research by Oliver and Ohlbaum on a range of sports coverage that was deemed 'essential' to pay TV subscribers[1355]. Its conclusion emphasised that it would only take a small variation in content to significantly increase the importance of access to these channels, implying the risk of gaming is substantial enough to warrant their inclusion. This is not new evidence, as it was based on a survey carried out in 2008, prior to Virgin Media's response to our Second Pay TV Consultation.

9.148 Sky Sports 3 and 4 do indeed include some content that is of significant importance to consumers, as the Virgin Media research indicates. However, we do not believe their inclusion is required to ensure fair and effective competition. Sky's market power does in part derive from its aggregation of a range of attractive content, but we do not accept that any content Sky aggregates automatically results in the creation of market power. As we set out in Section 5, we view Core Premium Sports channels as including sufficient quality of the most important content to be a source of market power. Therefore it would not be proportionate to extend the remedy to include Sky Sports 3 and 4 on the basis that they include <u>some</u> content that is important to consumers. Instead our view is that they do not include <u>enough</u> content that is important to consumers for access to be required to ensure fair and effective competition.

9.149 We also recognise the inherent risk of gaming that excluding these channels exposes, as Sky could potentially move significant amounts of content across its sports channel portfolio. If it does so we may need to extend the obligation to Sky Sports 3 and 4, and may need to do so quickly.

Conclusion on which sports channels should be included

9.150 We have included Sky Sports 1 and 2 within the scope of the wholesale must-offer obligation as these make a material contribution to Sky's market power. Our position remains that including both Sky Sports 1 and 2 in the remedy, but not Sky Sports 3 and 4, is an appropriate to ensure fair and effective competition.

9.151 We will however keep the channel line-up under review in case of possible changes which might require changing the scope of the wholesale must-offer obligation. In particular, if Sky acts in such a way that the only means of addressing the risk of gaming is by extending the obligation to Sky Sports 3 and 4, then we will consider doing so. We would do so on the basis that those channels would then make a material contribution to Sky's market power.

9.152 We would not expect a protracted consultation to be required in the event that a new licence condition is necessary for Sky Sports 3 and 4, since the substantive issues would be the same as those on which we consulted in the Third Pay TV Consultation and on which we conclude here. We address this issue under "Review provisions" at the end of this Section.

Should movies channels be included in a wholesale must-offer remedy?

9.153 On movies we have decided not to proceed with the proposal which we set out in our Third Pay TV Consultation. We are not imposing a wholesale must-offer obligation on the Sky Movies channels alongside the sports channels. Instead, we are consulting on our proposed decision to make a market investigation reference to the

[1355] Annex 1, Virgin Media response dated 21 September 2009 to Third Pay TV Consultation.

Competition Commission under EA02. Our separate consultation on this point sets out our full view on why a reference is appropriate[1356].

9.154 It is possible that the Competition Commission will conclude that a wholesale must-offer obligation on linear channels is appropriate, either on its own or as part of a wider range of remedies. We are not therefore ruling out such an approach. As set out below, we have however concluded that a linear channel wholesale must-offer remedy is not the right course of action for us to take at this point in time, since it is not required to ensure fair and effective competition during the period before the Competition Commission reaches its conclusions.

9.155 We came to the conclusion that Sky has market power in the wholesale of Core Premium Movies channels. This market power is caused by a combination of Sky's existing market shares in linear movies channels, and the future barriers to entry associated with Sky's control over the key set of VoD rights, which are the SVoD rights in the first pay TV window.

9.156 Sky's control over the SVoD rights makes it the only company that is in a position to take advantage of developments that are allowing SVoD to expand. It removes the possibility that another pay TV retailer can diminish Sky's market power by coming in with an SVoD service to constrain the current linear channels.

9.157 A key consideration in deciding how to proceed is the relative importance of linear movies channels and SVoD services for ensuring fair and effective competition over the next few years. We summarise below the available evidence on this point.

Evidence as to the future importance of SVoD services

9.158 The Major Hollywood Studios have provided to us their respective views on the future relevance of SVoD, for example:

- **[✂]**[1357].
- **[✂]**. A content provider stated that, in its view, as on-demand services continue to proliferate and grow their customer bases, the pay TV window will eventually be predominantly SVoD-based. However, given some viewers' preference for watching programming from a linear schedule it also expected that the pay TV window will continue to include a linear component for the foreseeable future[1358].
- **[✂]**[1359].

9.159 The focus of BT's consultation responses points to its strongest interests in terms of the pay TV market being in linear sports channels and SVoD services. BT has consistently highlighted its view that SVoD services will become essential in competition with linear sports and movies channels, as well as emphasising that BT

[1356] http://www.ofcom.org.uk/consult/condocs/movies_reference/

[1357] **[✂]**.

[1358] **[✂]**.

[1359] **[✂]**.

Vision would not simply become a reseller of linear channels[1360]. For instance, in response to our Third Pay Consultation it stated:

> “BT agrees with Ofcom’s view of the capacity for these on-demand services to provide very new and innovative services and that “the enhanced level of choice this would confer is likely to be highly attractive to consumers.” In this regard, BT would emphasise the particular importance of SVoD rights in the provision of on-demand services. BT agrees with Ofcom’s statement that SVoD “offers a payment mechanism which is likely to be particularly attractive to customers” and this is supported by BT Vision’s experience: Whilst BTV provides both a subscription VoD and a pay per view (PPV) VoD service, over **[✂]**% of customer now recruited to BT Vision are doing so with a VoD subscription. This shows the high level of demand for SVoD services”[1361].

9.160 Virgin Media has also highlighted the latent demand for a first pay TV window SVoD offer in response to our Third Pay TV Consultation:

> “This lack of access to SVoD rights stifles innovation and makes it impossible for Virgin Media to provide consumers with a full SVoD movie service that would be capable of offering an effective competitive alternative to Sky's linear movie channels”[1362].

Evidence as to the demand for linear movies channels

9.161 Perhaps most significantly, where operators are pushing for a wholesale must-offer obligation, their clear focus is currently on sports channels rather than movies. **[✂]**[1363]. **[✂]**.

> “**[✂]**”[1364].

9.162 **[✂]**[1365]. **[✂]**[1366].

9.163 In addition, **[✂]** a potential IPTV entrant has stated that: “For movies, consumers’ habits are already changing. **[✂]** A potential IPTV entrant predicts that they will continue to change further... consumers’ reliance on ‘appointment to view’ movies as prescribed by the premium movie channels is likely to erode significantly”[1367].

[1360] BT response to Second Pay TV Consultation, p. 3.

[1361] BT response to Third Pay TV Consultation, paragraphs 6.1 to 6.2.

[1362] Virgin Media response to Third Pay TV Consultation, paragraph 11.5.

[1363] **[✂]**.

[1364] BT response to Third Pay TV Consultation, paragraph 2.25.

[1365] **[✂]**.

[1366] **[✂]**.

[1367] **[✂]** response to Second Pay TV Consultation, p. 6.

9.164 Virgin Media has echoed these sentiments in a supplementary submission to Ofcom, while not outlining any plans for a linear movies offering in the event of a wholesale must-offer:

> "Consumers are increasingly demanding the ability to choose what content they wish to view and at what time they watch it. They also seek the ability to control the way content is viewed (e.g. pausing, rewinding etc.). This is leading to a shift in demand away from linear television content and traditional fixed time viewing (i.e. viewers organising their activities around a broadcasting schedule) to VoD services (which deliver content in a more convenient and user friendly manner)"[1368].

9.165 The main evidence we have for the continuing importance of linear movies channels comes from Sky, which told us that:

> "Sky decided that it would include Sky Movies as part of its proposed DTT proposition because Picnic was intended to be a service with broad appeal rather than a service which might appeal to a narrow segment of the Freeview base. Sky considered that including a movie channel rather than part of Sky Sports 2 would result in higher take-up of the service ... Sky Movies would have been a day-part channel, offered from 6pm to 6am. Offering Sky Sports 2 between these hours only would often mean that some of the events broadcast on Sky Sports 2 which customers wanted to view would be missed as they would occur outside of those hours, whereas for movies most of the viewing occurs in the evening. By offering Sky Movies as a day-part only Sky was also able to offer Picnic subscribers access to the Disney Channel (which would have shared DTT capacity with the Sky Movies channel)"[1369].

9.166 However, this decision now dates back over four years, and it is possible that if Sky were designing Picnic now it would consider meeting the demand for movie content via some form of VoD.

Conclusion on whether movies should be included in a wholesale must-offer remedy

9.167 Our view in light of this evidence is that SVoD services, enabled by new distribution technologies, are likely to become increasingly important, and are likely at some point to overtake linear movies channels in importance. The precise timing is of course difficult to predict, but this leads us to focus on SVoD rights. The aim of such an approach would be to address the concern we set out in our Third Pay TV Consultation on limited exploitation of SVoD movies rights.

9.168 A further reason for considering an SVoD-related remedy is that it could tackle concerns over high wholesale margins on movies. The returns that we see Sky making are likely to be highest in the movies part of its business. As we set out below, a retail-minus wholesale must-offer remedy would not address this, and using cost-plus pricing to attempt to reduce wholesale margins brings with it a significant

[1368] Virgin Media supplementary submission, 15 August 2008, paragraph 5.9.

[1369] Sky response dated 9 December 2009 to Ofcom information request dated 29 October 2009, question 32.

risk of unintended consequences for rights generation. However, depending on any remedy which resulted from a Competition Commission reference, it might be possible to address this concern.

9.169 However, addressing this issue is likely to require consideration of remedies which lie outside the scope of Ofcom's sectoral competition powers. Firstly it may relate to services that are not part of a "licensed service"; secondly it may be more appropriate to consider intervention in the way movies rights are bought and sold. We believe it is therefore more appropriate to make a reference to the Competition Commission to consider this issue. We consider this in our separate consultation on a market investigation reference.

9.170 This does not preclude the possibility that the Competition Commission might conclude that a wholesale must-offer obligation on linear channels was appropriate, either on its own or as part of a wider range of remedies. However, our view is that it is important first to consider whether competition concerns can be addressed using a forward-looking SVoD-related remedy, and only then consider whether there are residual concerns which justify a wholesale must-offer obligation on linear channels. This holistic approach is open to the Competition Commission but not to us.

9.171 It would still be possible to put in place a transitional wholesale must-offer remedy now, until the Competition Commission's process has completed. We have concluded that Sky is also able to act on its market power by restricting distribution of Core Premium Movies channels. On the basis of this concern, we could continue with our proposal to put in place a wholesale must-offer obligation on linear movies channels, as we proposed in our Third Pay TV Consultation.

9.172 However, on balance we have come to the view that it would not be appropriate to put in place a transitional wholesale must-offer remedy across all platforms.

- DTT is the technology over which it is most likely that in the next two or so years retailers could take advantage of a wholesale must-offer remedy, given the large installed base of TV aerials and homes relying solely on DTT for multi-channel viewing, and as demonstrated by the rapid take-up of Freeview and Sky and Arqiva's proposal to launch a pay TV service on DTT. However, we do not see substantial evidence of actual demand from operators for linear movies channels, particularly in the short term. In concrete terms, **[✂]**[1370]. This is echoed in responses to our Third Pay TV Consultation.

- We recognise that this situation could change if Sky were to launch a Picnic service including a linear movies channel. We address the question of what would happen in those circumstances in our Picnic Statement[1371].

- On satellite, Freesat is not currently in a position to enable a pay TV service over its platform, **[✂]**.

- On cable, Virgin Media already has wholesale access to Sky's to those channels.

- Over the likely timeline of a Competition Commission process, IPTV platforms appear to be less well suited to carrying a full suite of movies channels.

[1370] **[✂]**.

[1371] Section 4 of our Picnic Statement.

Which platforms should be eligible for a wholesale must-offer remedy?

9.173 A wholesale must-offer remedy should only be available to retailers on non-Sky platforms. This was the position we set out in our Second and Third Pay TV Consultations, which we continue to consider it to be the appropriate approach[1372]. We distinguish between 'platform' and 'distribution technology'. In this Section we set out the meaning of these terms and the implications on the scope of the wholesale must-offer remedy.

9.174 As well as setting out the principles behind the exclusion of retailers on Sky platforms from a wholesale must-offer remedy, we clarify some of the practical implications of the overall proposal. These relate in particular to questions around the open internet and cable platforms, which we take in turn below.

9.175 In response to our Third Pay TV Consultation, both Sky and the Three Parties highlighted the need to clarify the definition of "Qualifying Platform". The Three Parties thought it might be appropriate for Ofcom to clarify how the remedy would apply in the event that the proposed Project Canvas (or a similar set of standards) were to be widely deployed. Sky said that Ofcom should explain whether it wanted to include the open internet in the definition of "Qualifying Platform". It understood that the rationale for not extending the proposed compulsory licensing regime to Sky's DTH satellite platform applied equally to the open internet.

9.176 **[✂]** A potential IPTV entrant did not support our proposal of not extending a remedy to retailers on Sky's own platform. **[✂]**. Its experience suggested that access to Sky's satellite platform is needed.

9.177 The BBC said that in the face of increasing consumer switching costs as pay TV platform operators bundle telephony and broadband with pay TV, it would expect Ofcom to wish to promote intra-platform competition on the largest pay TV platform as well as inter-platform competition. **[✂]** was concerned that introducing different sets of rules for different platforms was not compatible with the principle of fair and effective competition. Similarly, **[✂]** a broadcaster was not convinced that Ofcom's stance on this issue was consistent with its duties to promote competition.

9.178 The Premier League agreed with Ofcom that the remedy should not apply to other retailers on Sky's satellite platform. However, it also claimed Ofcom failed to deal with the specific arguments put forward by the Premier League in its response to the Second Pay TV Consultation.

<u>Principles behind exclusion of Sky platforms</u>

9.179 Extending to Sky's platforms would be a substantial additional step. If we were concerned about intra-platform competition, it might nonetheless be appropriate to include Sky's platforms, and this might be the case if for example we had evidence that Sky was currently making high retail margins. However, we do not have any such evidence.

9.180 The purpose of the wholesale must-offer remedy is to address the restricted availability of Sky's premium channels on non-Sky platforms, and the effects on innovation and choice that result. On balance, we did not believe that an additional

[1372] Third Pay TV Consultation, paragraph 8.37 to 8.52.

intervention associated with extending the obligation to Sky's platform(s) would be appropriate for ensuring fair and effective competition.

9.181 Responses to our Third Pay TV Consultation on this issue were varied in nature. The BBC was surprised that Ofcom did not address intra-platform competition issues given the importance of switching costs for consumers. Similarly, **[✂]** a potential IPTV entrant disagreed with our proposals, as it emphasised that in order to compete effectively a wider offering is needed **[✂]**.

9.182 Both **[✂]** a broadcaster and **[✂]** argued that Ofcom's stance was not consistent with its duty to ensure fair and effective competition, as Sky's satellite platform has the dominant share of UK premium subscribers. Conversely, the Premier League supported our position not to extend the remedy to Sky's platforms.

9.183 Notably there appeared to be some confusion surrounding the specific detail of our position, as the BBC argued the benefits of a wholesale must-offer should be available to other satellite platforms, such as Freesat. The Three Parties sought clarification on how the remedy would apply in the event that Project Canvas (or other IP based services) were to be widely deployed, while Sky, similarly, asked us to clarify the position in relation to the open internet.

<u>Internet distribution</u>

9.184 The proposed conditions in the Third Pay TV Consultation stated that the wholesale must-offer remedy would apply to any platform used for the distribution of programmes to residential consumers in the United Kingdom, other than a platform operated by Sky[1373].

9.185 Sky requested clarification on whether Ofcom considered the "open internet" to be included in the definition of Qualifying Platform[1374] and argued that Ofcom's reasoning for not extending the remedy to Sky's satellite platform was equally applicable to the internet as Sky already retails its services via the internet[1375].

9.186 As summarised in the Third Pay TV Consultation, Ofcom considers there to be a clear distinction between "platforms" and "distribution technologies"[1376].

9.187 Ofcom considers "distribution technologies" to be the broadcast transmission and two way telecommunications network technologies used to distribute digital (and, in some cases, analogue) media from the retailer to the target platform. These include satellite, DTT, cable, fixed line broadband and mobile broadband.

9.188 Ofcom considers "platforms" to be the set of devices or software applications under the operational control of one operator that are used to present a range of available content to the end user (e.g. through the operation of an electronic programme guide) and restrict viewing of that content to those end users that are entitled to view

[1373] Paragraph 11.10 of the Third Pay TV Consultation.

[1374] Sky response to Third Pay TV Consultation, paragraph A8.12.

[1375] Sky response to Third Pay TV Consultation, paragraphs A8.11 to A8.12.

[1376] Third Pay TV Consultation, paragraph 8.51.

it (e.g. through the operation of Conditional Access or Digital Rights Management technologies)[1377].

9.189 Traditionally, pay TV platforms have been made up of a population of hardware receivers under the operational control of a single platform operator. For example, Sky manages its platform of digital satellite receivers and BT manages its platform of hybrid DTT/IP receivers. More recently a number of software based platforms have emerged, such as Sky Player on the Xbox and PC. In these cases the platform operator does not necessarily control the underlying consumer hardware on which the platform resides and there is the possibility of multiple platforms being supported on a single piece of consumer hardware.

9.190 It is possible that each distribution technology could support a number of different platforms. For example, Sky and Freesat each operate separate platforms on satellite.

9.191 We consider the internet to be a distribution technology and not a platform. The internet is already used as the distribution technology for a number of different platforms, such as the software based Sky Player on PC platform and the hardware based Fetch TV platform.

9.192 The widespread adoption of broadband internet combined with increases in broadband speeds and improvements in video compression technologies has resulted in the internet being a viable distribution technology for on-demand content and linear TV channels. This is evidenced by the popularity of the BBC iPlayer and the presence of Sky premium sports channels via the Sky Player on PC and Xbox. The recent launch of Arqiva's SeeSaw software platform for PCs and proposals for Project Canvas (see below) indicate that internet distribution will enable a significant amount of innovation in new platforms and services in the future and, as a result, facilitate inter-platform competition.

9.193 We are concerned to ensure fair and effective competition between retailers on different platforms, driving inter-platform competition and increasing platform innovation. Preventing retailers from using the internet to distribute the Sky Core Premium Sports channels to their chosen platform would not be consistent with addressing that concern.

9.194 We do not accept Sky's argument that the reasoning by which we have decided not to include Sky's own satellite platform in the remedy is equally applicable to the internet. We do not consider them to be comparable as one is a platform and the other a distribution technology. In a similar vein, the remedy does not apply to Sky's satellite platform, but it does apply to digital satellite as a distribution technology. This is entirely consistent with the position we have taken in respect of the internet.

9.195 We therefore maintain our position as set out in the Third Pay TV Consultation that the wholesale must-offer obligation will allow retailers to distribute the Sky Core Premium Sports channels via platforms based on internet distribution (subject to Sky's Minimum Qualifying Criteria and Minimum Security Requirements).

[1377] Digital Rights Management or 'DRM' represents access control technologies designed to impose usage limitations on digital content and devices, enabling rights holders to control how their content is used. DRM can be used in online environments to replicate the functionality offered by CA in broadcast environments.

Platforms using the internet for content distribution (including Canvas)

9.196 Project Canvas is a proposed joint venture between the BBC and six other partners to develop and promote a service, based on common standards and a consistent user experience. Viewers with a broadband connection would be able to watch on their television sets on-demand services, such as the BBC iPlayer or the ITV Player, and other internet content and applications, as well as ordinary linear television channels. This would be via a set-top box or potentially iDTVs, connected to the internet. Viewers would need to have a broadband subscription but would not need to pay an additional subscription for access to the platform and its content. However, the intention would be for the platform to be sufficiently flexible to support pay TV models for additional content in the future.

9.197 In a further submission made by Sky, it argued that, if Sky were to make Sky Player available to Canvas devices, "there would equally be no justifiable basis for a wholesale must offer obligation to be extended to Canvas", nor could there be any justification for extending such an obligation to other "IP devices" or to "the open internet generally"[1378].

9.198 To the extent that Sky's arguments are based on its view of the internet as a single platform which should be excluded from the remedy, our position is set out above; i.e. the internet is a distribution technology and not a platform, and the remedy is available to retailers seeking to use internet distribution.

9.199 Sky also appears to argue that if it were to provide its Sky Player service to Canvas compliant devices there would be no justification for allowing others retailers to offer a service including the Sky Core Premium Sports channels to these devices.

9.200 Sky's argument is unclear, but it appears to be based on two possible points:

- Once Sky is able to retail on a particular device then the issues identified by Ofcom are resolved.
- In the Third Pay TV Consultation we proposed that a wholesale must-offer remedy should only be available to retailers on non-Sky platforms. Sky appears to be arguing that once Sky is able to retail on a particular device then this device effectively becomes a platform operated by Sky and hence excluded from the scope of the remedy.

9.201 On the first of these points, our position is set out in Section 7. We do not consider that the availability of a Sky retail service on a particular device is sufficient to address our concerns.

9.202 On the second point, we do not consider that by providing a retail service (such as Sky Player) to a platform of Canvas-compliant devices Sky becomes the operator of that platform, and we certainly do not consider that Sky would then become the operator of all platforms which use Canvas-compliant devices.

9.203 In this example, we would consider the Sky Player application to be a software based platform available on an underlying Canvas compliant hardware platform. This is analogous to Sky's current Sky Player platform on the PC and Xbox, i.e. Sky

[1378] Second February 2010 Sky Submission.

operates the 'Sky Player platform' but does not operate the 'PC platform' or 'Xbox platform'.

9.204 We note that the emergence of software based 'platforms within platforms' is a source of new innovation and has the potential to provide consumers with greater choice of retailers and service offerings without the need to invest in new hardware devices. Preventing new retailers from offering services to any hardware device on which Sky already has a retail service (or may choose to have in the future) would not ensure fair and effective competition.

9.205 However, we do not wish to dissuade Sky from investing in new platform innovation. We therefore maintain our position that the remedy would not extend to those platforms (whether hardware or software based) that Sky operates. For example, if Sky were to deploy and operate a new internet-based hardware platform the remedy would not require Sky to provide access to a third party retailer of the Sky Premium Sports channels. This is consistent with the approach we have adopted in respect of Sky's satellite platform.

9.206 Due to the ongoing evolution of platforms it is not possible to produce a future-proof definition of what constitutes a Sky operated platform. However, we have provided guidance in Section 10 on how we would normally interpret whether a platform was under Sky's operational control if we were required to investigate a complaint.

Cable

Supply of SD channels to cable operators

9.207 In our Third Pay TV Consultation we proposed to include Virgin Media within the scope of the wholesale must-offer remedy, on the same terms as other operators.

9.208 While Virgin Media welcomed this position, Sky on the other hand believed our position was inconsistent. It drew attention to the disparity between Virgin Media and other competitors, which would be entrants in the market for Core Premium channels. Sky believed that, as the current principal third party retailer of these channels, Virgin Media would gain an immediate and disproportionate benefit from reduced wholesale charges. It quantified this benefit as "an immediate and ongoing transfer of revenue from Sky to Virgin Media of around £110 million in the next four years"[1379].

9.209 In light of this, we have given further consideration to whether and how the wholesale must-offer obligation should apply to Virgin Media, as well as whether it should get any new prices set as part of the offer.

9.210 We set out our conclusions in Section 7 that:

- The non-supply of the various enhanced or alternative versions of Sky's premium channels to Virgin Media – in particular HD – prejudices fair and effective competition.
- Sky's rate-card prices to Virgin Media are close to the highest Sky could charge while passing a margin squeeze test based on Sky's scale. Virgin Media's scale

[1379] Sky response to Third Pay TV Consultation, paragraph 10.160.

is much smaller than Sky's, so it is unsurprising that prices set on such a basis do not allow Virgin Media to compete effectively with Sky.

- The challenges Virgin Media faces as a result of Sky's wholesale rate-card prices are not a competition concern of the same magnitude as those around HD. They nonetheless create a situation in which consumer choice is likely to be distorted, albeit not to the same extent as non-supply to new retailers, as Virgin Media customers currently have access to Sky's Core Premium channels, with broadly similar retail prices to satellite for at least some bundles.

9.211 Virgin Media is in a different position to prospective entrants, in that it already has a number of premium subscribers. However, it is not significantly different – Virgin Media has a considerably smaller base of premium subscribers than Sky, and indeed has not yet reached anything like the scale of the premium subscriber base that we assume in our pricing model to be necessary for a hypothetical new entrant to break even. Any remedy in relation to Virgin Media should reflect this position, which at first sight would suggest wholesale prices somewhat above those for the hypothetical new entrant that we have assumed in our pricing model.

9.212 However, the remedy should also be consistent with the way in which we have assessed Sky's profitability, and in particular the intangible value of Sky's asset base. As we accept for Sky, Virgin Media would need to earn a reasonable return on the intangible asset associated with its existing premium subscriber base. This effect will tend to offset Virgin Media's apparent scale advantage and reduce the amount that Virgin Media can afford to pay for Sky's wholesale channels[1380].

9.213 More generally, we need to look at this in the context of our wider remedy. An essential principle of any conditions which ensure fair and effective competition is that they do not unduly distort the market. A remedy which excluded Virgin Media could potentially distort the competitive environment against the company in the longer term, in the event that other operators reach a significant scale in the pay TV market[1381].

9.214 Having taken the view that excluding Virgin Media from the remedy risks distorting competition, we also need to consider whether Virgin Media should receive the same reduced wholesale prices on Sky Sports 1 and 2 as other operators, given its greater scale. The distorting effects of not doing so could be similar to excluding Virgin Media from the remedy entirely. In this context, two considerations are particularly important:

- All operators should face the same marginal price so that they compete, at the margin, on the same basis. While we recognise that in some circumstances a degree of price discrimination can be appropriate – for example where it enables

[1380] These two effects could in theory cancel each other out exactly. If in our pricing model we determined the value of Virgin Media's subscriber base using the same subscriber acquisition cost assumptions as for the hypothetical entrant and assumed the same overall growth path for premium subscribers, we would derive the same price for Virgin Media as for the new entrant. This would be equivalent to moving forward the flow of costs and revenues by the same amount (relative to the new entrant case), which would have no effect on the wholesale price required to set the NPV of cashflows to zero. Further details of our approach to pricing are set out in Section 10 and Annex 7.

[1381] Sky supplies its wholesale channels to other cable operators, such as Wight Cable. We have not reviewed them as part of our analysis of competition issues, but excluding them could cause the same discrimination issues as with Virgin Media.

more efficient recovery of fixed costs – there does not appear to be any sound basis for us to determine differential prices in this case[1382]. Setting regulated (marginal) prices that differed by operator would not ensure fair and effective competition.

- At least in the medium term (and beyond), all operators should face the same average price. If over a sustained period one company were to face a higher average price than its rivals while still facing the same marginal price, it would not be able to compete effectively, so this position would also not ensure fair and effective competition.

9.215 If Virgin Media's existing scale were to afford it an advantage, then allowing Virgin Media the same (average) price as smaller competitors could in principle have two negative effects.

- First, smaller competitors might be unable to compete effectively with Virgin Media because of their scale disadvantage. However, none of the smaller competitors and potential entrants that responded to the Third Pay TV Consultation expressed concern as to the effects of including Virgin Media within the scope of the remedy, at the same wholesale price as them. To the extent we have received submissions from potential entrants, these have instead focussed on the difficulties they would face if Sky were to be permitted to launch Picnic.

- Second, Sky has argued that providing Virgin Media with a reduction in the rate-card would be an expropriation of Sky's revenues for no benefit, emphasising that Ofcom has not provided sufficient justification for Virgin Media gaining the benefit of substantial price cuts. It has characterised this concern by stating a price lower than the current cable rate-card would result in a 'windfall' gain for Virgin Media[1383].

9.216 We recognise Sky's concern that the inclusion of Virgin Media in the wholesale must-offer remedy would result in Virgin Media paying less for its premium sports wholesale products than it does at the moment – although for the reasons set out above, we consider a reduction in prices to Virgin Media is appropriate to ensure fair and effective competition. Reducing the wholesale price to Virgin Media for Sky Sports 1 and 2 would result in an immediate reduction in the total wholesale revenue provided by Virgin Media to Sky of about £7m per annum.

9.217 However, if the reduction in prices also provides Virgin Media with the ability and incentive to expand the number of its subscribers that purchase those channels, then this will have two effects. Firstly, more consumers will benefit from access to premium content. Secondly, the increase in volumes should over time outweigh the decrease in price, so that Sky eventually also benefits from increased wholesale revenues. The full assessment of this effect is set out in Section 11.

9.218 We have considered the potential outcomes and believe that the balance is in favour of including cable in the remedy, and doing so at the same price as for other operators. This is for the following reasons:

[1382] As we explain in Section 10, it would be open to Sky, subject to competition law requirements, to negotiate alternative pricing structures should it wish (in addition to offering the regulated price).

[1383] Sky response to Third Pay TV Consultation, paragraph 10.171, and paragraphs 6.5 to 6.7 of November 2009 Sky Submission.

- Our primary concern is over the potential distortion to the competitive landscape if Virgin Media were to be excluded, which we view as substantial enough to warrant its inclusion. As explained above, we consider it essential that all operators face the same marginal price.

- The extent to which Virgin Media's existing scale gives it an advantage – if any – over other entrants is likely to be limited. First, it has far fewer premium subscribers than we calculate would be necessary for the hypothetical new entrant, assumed in our pricing model, eventually to reach in order to break even. And second, the advantage depends on the extent to which Virgin Media needs to earn a return on its historic investment in those subscribers – i.e. on the size of its intangible asset base. These arguments suggest that it is appropriate for Virgin Media not only to get the same marginal price as other firms, but also the same average price.

- Finally, we do not believe the inclusion of cable will have a material impact on Sky, particularly as the expansion of the pay TV market under a wholesale must-offer obligation would offset the negative effects for Sky over time.

Supply of HD channels to Virgin Media

9.219 We discuss HD as a whole later in this Section. However, it is relevant to consider the specific circumstances relating to Virgin Media's attempts to obtain wholesale supply of HD versions of Sky's premium channels. We have a clear concern around the supply of HD channels to Virgin Media. Virgin Media customers have access to SD versions of Sky's Core Premium channels. Sky currently does not supply HD versions to Virgin Media. Although discussions are ongoing between Sky and Virgin Media, it is now almost five years since Virgin Media first made a request to obtain supply of HD channels and supply has still not been agreed, **[✂]**.

9.220 Even though discussions are taking place between Sky and Virgin Media, we have limited confidence that an agreement will be successfully concluded through commercial negotiation, in light of experiences of other operators in negotiating for SD channels. Given the importance that HD capability increasingly holds for effective competition, we believe this concern is sufficiently material for it to be appropriate for a wholesale must-offer obligation on HD channels to include cable operators.

Should a wholesale must-offer remedy be available for onward supply to commercial premises?

9.221 Various respondents contested our exclusion of commercial premises from the wholesale must-offer remedy. Specifically, the Three Parties argued that the remedy should be extended to commercial premises on the basis that rival pay TV retailers could offer choice, innovation and retail price competition to commercial customers. In addition, they also emphasised their concern that Sky could potentially use its commercial profits to subsidise its activities in the downstream residential market.

9.222 Similar concerns were expressed by **[✂]** a broadcaster, which believed that the highly lucrative commercial market is a key cornerstone of Sky's premium revenues, and thus of its ability to dominate the consumer market for premium sports content.

9.223 The BBC considered that excluding this market would place retailers at a commercial disadvantage, making it more difficult for them to successfully enter the pay TV sector. Despite these reservations, it supported Ofcom's stated intention to monitor closely the situation, and take further action if necessary. **[✂]** re-affirmed its view that the remedy should apply to commercial premises, as this would have benefits of choice and lower retail prices, as well as driving competition in the sports rights market.

9.224 Virgin Media put forward some strong objections to our position on this question, stating that Ofcom's analysis of the competition issues arising in relation to commercial premises was flawed. It judged the competition concerns in the commercial market to be arguably even greater than those in relation to retail supply to residential subscribers. Alongside the emphasis it placed on the gravity of the issue, Virgin Media also disagreed with Ofcom's approach to addressing any possible competition concerns. It considered the most efficient, practical and effective means by which to do this as being part of the pay TV market investigation and not a separate action that Ofcom may pursue.

9.225 In response to Virgin Media's assessment of the competition concerns relating to commercial premises, we still do not see the same evidence of restricted wholesale supply as in the case of residential subscribers. Furthermore, this argument does not take into account the differing models of competition in the residential and commercial markets. Unlike the residential market, the market for commercial supply features limited scope for innovating around premium content. Instead the commercial model of competition is based purely around resale of content, a mechanism which only works with large retail margins.

9.226 Most respondents have not provided specific evidence to challenge this view. In fact, stakeholder submissions suggest a lack of meaningful conviction to seek wholesale supply to commercial premises from Sky. **[✂]**. Therefore, since we cannot see evidence of restricted supply to commercial premises, extending the wholesale must-offer remedy would represent a disproportionate response.

9.227 The only specific challenge to our review of the evidence relating to this question has come from Top Up TV. It argued that when Top Up TV wrote to ask Sky for terms of supply in March 2006 and May 2007, in principle this should have covered both residential and commercial subscribers[1384]. It claimed that since Sky refused to offer such terms to Top Up TV, this amounted to blocking of commercial access by Sky. We have since reviewed the evidence put forward by Top Up TV, but do not believe commercial access was restricted specifically in this instance. Both the letters cited by Top Up TV did not state explicitly that the wholesale terms it sought included supply to commercial premises. We believe the focus of these letters is clearly on the residential market.

9.228 As discussed in our Third Pay TV Consultation, the main concern that the Association of Licensed Multiple Retailers and some individual commercial customers have put to us previously has been the level of retail pricing associated with commercial supply. However, we continue to believe that extending the wholesale must-offer obligation to commercial premises, with an expanded retail margin, would not be an appropriate response. A wholesale must-offer obligation with prices set on a retail-minus basis would only address concerns relating to high retail prices if we were to artificially depress the wholesale price. This would not be a practical mechanism for achieving a specific reduction in retail prices, the degree of which would essentially be arbitrary.

[1384] Top Up TV response to Ofcom information request dated March 2009, q. 6.

9.229 Another focus of respondents' objections fell on the lucrative commercial revenues relating to commercial supply. **[✂]** a broadcaster argued that the highly lucrative commercial market is a key cornerstone of Sky's premium revenues, and thus of its ability to dominate the consumer market for premium sports content. However, we do not believe that lucrative commercial revenues are a substantial reason for intervention, as we are not intervening to remove Sky's market power itself, or to address concerns related to levels of pricing, only to ensure that restricted wholesale supply does not prevent effective competition.

9.230 We remain of the view that extending the wholesale must-offer obligation to include onward supply to commercial premises would be a significant added intervention. Therefore it could only be justified if it was appropriate for ensuring fair and effective competition. After reviewing submissions from stakeholders, we do not see evidence of restricted wholesale supply to commercial premises and we do not believe a wholesale must-offer obligation is the appropriate means to address any concerns regarding high retail prices. As a result, we consider the most appropriate response in these circumstances is to include consideration of commercial supply in any future assessment of the sale of Premier League rights under CA98.

Should we set prices under a wholesale must-offer remedy?

9.231 We believe it is necessary to set terms for the wholesale must-offer remedy, including prices, to ensure it is an effective mechanism for ensuring fair and effective competition. However, as explained later in this Section, we have decided it would not be appropriate to set prices for the supply of HD channels.

9.232 In our Third Pay TV Consultation, we consulted on an option including a range of prices, rather than assuming that prices should be decided by commercial negotiation based on a set of pricing principles. We considered setting prices would enable any potential wholesale must-offer remedy to provide an effective means of ensuring fair and effective competition, for a number of reasons:

- Evidence of commercial negotiations to date suggested that a requirement to agree prices commercially would lead, after a protracted period of negotiation, to a stalemate.
- If prices were not set, it is likely the only prices which other retailers might be able to agree with Sky would ultimately default to the current cable rate-card. We did not believe this would ensure fair and effective competition.
- International examples of wholesale must-offer remedies showed that the effectiveness of such remedies has been hampered by a lack of precise terms of supply, especially establishing price.

9.233 In response, Sky argued strongly that Ofcom had supplanted market outcomes with its own prescriptive vision for the development of DTT-based services, which we had not supported with compelling evidence or analysis. It maintained that new DTT-based premium pay TV retailers could enter the market based on the current cable rate-card, citing the Picnic business plan alongside statements from Top Up TV and BT as evidence for this[1385]. In its analysis Sky also dismissed the assumption that new platforms require scale in order to innovate, stating that this argument is speculative and ignores innovation by small firms.

[1385] Sky response to Third Pay TV Consultation, paragraphs 10.11 to 12.

9.234 Sky also disputed Ofcom's interpretation of the commercial negotiations for wholesale supply of Core Premium channels. It claimed our analysis of previous negotiations was one-sided and emphasised that negotiations can legitimately take a long period of time to conclude. As one of many potential solutions to possible stalemate, it considered alternative dispute resolution (ADR) procedures preferable to imposing *ex ante* regulation. In addition, Sky believed Ofcom had provided a selective assessment of international comparisons, which was based on a flawed reading of the Value Partners study[1386].

9.235 Sky's response was supplemented by an analysis of the proposed wholesale must-offer by Professor Cave, acting for Sky. This argued that Ofcom's proposals amounted to a misuse of *ex ante* pricing regulation in this context, citing the 'mutability' of wholesale premium channels and the risk of 'co-dependency' between new entrants and the regulator[1387].

9.236 In contrast, both Virgin Media and **[✂]** a broadcaster supported setting prices for a wholesale must-offer remedy as opposed to relying on commercial negotiations, which they believed would not provide a practical solution.

9.237 Similarly, the BBC, **[✂]** and **[✂]** [a broadcaster] deemed it necessary for wholesale prices to be regulated as, if left to negotiation, they believed Sky could potentially use both price and non-price conditions to prevent access to its Core Premium channels.

9.238 In light of these views, we have considered the outcome if we did not set prices, and have concluded that it is probable that wholesale prices would ultimately default to the current cable rate-card:

- **[✂]**[1388].
- **[✂]**.
- Our analysis of the Picnic business plan shows that it would not have been profitable at rate-card prices – as set out in Section 7.
- The inability of competing retailers to make a profit on retail of Core Premium Sports channels at the rate-card price is also confirmed by our updated pricing analysis in Section 10. As we addressed in more detail in Section 7, we do not believe this would ensure fair and effective competition, so that competitors to Sky can build a viable business, and it would not therefore address the detriment we have identified.

9.239 As noted in the previous Section, a substantial amount of time has already been spent by Sky and others on commercial negotiation over the principle of supply, without any significant progress. In response to our Third Pay TV Consultation, Sky challenged our review of negotiations as being 'one-sided'. However, the reasoning of Sky's argument was not developed beyond the basic assertion that "each side of

[1386] See Value Partners Report, Annex 11 to Third Pay TV Consultation.

[1387] See Annex 1, Sky response to Ofcom Third Pay TV Consultation.

[1388] Third Pay TV Consultation, paragraph 8.74.

the commercial negotiations has legitimate reasons for preferring its own model"[1389]. Our review of the evidence has shown Sky has consistently responded to requests for wholesale supply with counter-offers to retail its channels on behalf of other retailers, as set out in paragraph 7.57 onwards. Subsequently, in every case, the outcome has been a collapse of negotiations. Consequently, we continue to believe our assessment of the negotiations is accurate.

9.240 Sky has also challenged our analysis on the basis that the pay TV market investigation has produced a 'chilling' effect on the process of commercial negotiation with specific retailers for its Core Premium Channels. **[✂]**[1390]. **[✂]**.

9.241 As an alternative to setting prices, Sky proposed ADR procedures as one of the "more proportionate responses to prevent unreasonable delays in negotiations of carriage agreements"[1391].

9.242 We do not believe that ADR will be effective in relation to price issues in this context, because the success of ADR is heavily dependent on the motives and incentives of the parties involved to reach a commercial solution, and our experience is that non-binding ADR procedures are only appropriate when the parties entering into the negotiations have comparable negotiating strength[1392].

9.243 Our review of negotiations between Sky and competing operators shows that Sky acts on a strategic incentive to restrict wholesale supply of its channels, and has not agreed any wholesale prices. We do not therefore consider that ADR will be appropriate in these circumstances. We anticipate the only effect of not setting prices now would be a significant delay, thus resulting in a delay to ensuring effective competition.

9.244 Further evidence that ADR is not appropriate in this instance can be seen in the dispute between Sky and Virgin Media over the supply of basic channels from early 2007 to late 2008.

- Sky ceased supplying its basic channels to Virgin Media at the beginning of March 2007, when the previous contract ended. Supply was only restored in November 2008, some 20 months later, following lengthy and often acrimonious negotiations, and also following high court action. The National Consumer Council (now Consumer Focus) stated that it was considering submitting a 'supercomplaint' to Ofcom on this issue[1393].

- The National Consumer Council, with support from Ofcom, intervened behind the scenes to try to bring the two parties together for some form of mediation. Both parties said they supported this idea, but despite very extensive correspondence through the NCC between March and August 2007 it proved impossible even to

1389 Sky response to Third Pay TV Consultation, paragraph 6.49.

1390 **[✂]**.

1391 Sky response to Third Pay TV Consultation, paragraph 10.28, footnote 12.

1392 http://www.ofcom.org.uk/consult/condocs/enforcement/enforcement.pdf

1393 http://collections.europarchive.org/tna/20080804145057/http:/www.ncc.org.uk/news_press/pr.php?recordID=235, http://news.bbc.co.uk/1/hi/6421419.stm agree the terms and boundaries of any mediation with Sky and Virgin Media, let alone start the mediation process. The view of the National Consumer Council was that there had been a significant breakdown in trust between the companies, which left each reluctant to enter into any process from which they felt the other might benefit, and that prolonged disagreement about the scope of meditation (with Sky looking for a narrower framing than Virgin Media) meant there was no prospect of mediation starting.

- In theory it ought to have been in both parties' interests to come to the table and negotiate. Neither party has market power in the supply of basic channels, and both parties apparently suffered as a result of the dispute – Sky lost advertising revenue, and Virgin Media lost customers that wanted the channels. Consequently we saw no case for formal intervention at the time.

- The failure of mediation in these circumstances gives us no confidence that ADR would be appropriate in the context of premium channels, where we have concluded that Sky does have market power, and there is evidence that it is exploiting that market power by restricting distribution.

9.245 In our Third Pay TV Consultation we drew on a study of international examples of wholesale must-offer remedies that we commissioned from Value Partners to inform our analysis[1394]. In response, Sky characterised our assessment of these international comparisons as a "highly selective reading of the Value Partners study", citing the US experience as an example of where prices were not set under a wholesale must-offer obligation.

9.246 We consider the situation in the context of the PAR to be clearly different:

- In 1992 when PAR were introduced, setting prices was not deemed necessary to achieve the desired outcome of ensuring increased competition. Over the 17-year history of PAR, 23 disputes have been resolved by the FCC, using as benchmarks the large number of commercial deals that have been struck. The FCC intervenes as a last resort and will encourage the parties to continue negotiations.

- This process of dispute resolution has appeared to work well in practice, as the mere threat of complaints can sometimes see deals concluded, avoiding the complaint actually going to the FCC itself. The FCC has confirmed that in the US there are a substantial number of platform operators and channels that fall under the remit of PAR, providing a wide range of precedent deals to use as benchmarks for new agreements[1395].

- In the UK Sky has not agreed any commercially negotiated wholesale deals that can be used as price benchmarks. We do not consider that leaving prices up to commercial negotiation would be a practical approach in these particular circumstances.

9.247 In relation to the Italian example outlined in the Value Partners Study, we believe the contextual differences between the UK and Italian pay TV markets are not as

[1394] Third Pay TV Consultation, paragraph 8.74.

[1395] Interview with Steven Broeckaert, Senior Deputy Chief, Policy Division, Media Bureau, Federal Communications Commission, 19 November 2009.

relevant as characterised by Sky in its response. We cited this example as evidence of how the effectiveness of a similar remedy had been hampered by the lack of definition of precise terms of supply, especially prices[1396]. Consequently we continue to conclude that the experience of Agcom, especially its retrospective view on establishing prices, points towards setting prices as the most appropriate solution. In this instance, the remedy in place on Sky Italia did not initially include a price, so establishing a price had to wait until the dispute resolution process was able to confirm terms. Assessing this retrospectively, Agcom (the Italian regulator) reflected on this to the effect that:

> "If we were to design it [the wholesale must-offer remedy on Sky Italia] again, we would be more explicit about the pricing rule and not give as much autonomy to Sky"[1397].

9.248 Sky / Professor Cave challenged the use of ex ante price regulation in principle in the context of broadcasting markets. Sky / Professor Cave drew an analogy, or "useful point of comparison", with the EU regulatory framework for electronic communications services, but noted that content markets are explicitly excluded from this regime[1398]. It is absolutely clear, as Sky / Professor Cave indicated, that we are dealing here with a different regulatory regime from the EU framework – we therefore do not believe that regime has any binding effect in the context of considering appropriate action under s316. We have set out a framework for using s316 CA03 in Section 3 of this document, under which we have taken the view that a wholesale must-offer remedy is appropriate. There are alternatives which do not involve ex ante price regulation, as we have set out earlier in this Section, such as structural separation or intervention at the rights level, but these are much more interventionist than a wholesale must-offer. We have come to the view that a wholesale must-offer remedy with ex ante pricing is appropriate to ensure fair and effective competition.

9.249 In summary, we continue to consider that it is appropriate to set terms for the wholesale must-offer remedy, including prices, to ensure fair and effective competition. If we do not set prices, we believe that there will be a protracted period of negotiation, and that prices will eventually default to the current cable rate-card. We do not believe this will ensure fair and effective competition.

9.250 Having come to this view, there are questions about both how we should set prices, and what the prices should be. The first of these is set out in the following paragraphs. We address the second in Section 10.

How should we approach setting prices for a wholesale must-offer remedy?

9.251 Our Third Pay TV Consultation put forward the view that the appropriate approach to setting prices for a wholesale must-offer remedy would be on a retail-minus basis, using a cost-plus analysis as a cross check.

9.252 We recognised the significant advantages of cost-plus pricing as the primary method, such as allowing us to set prices in a competitively neutral manner and in principle addressing concerns relating to high wholesale margins. However, we were

[1396] Third Pay TV Consultation, paragraph 8.74.

[1397] See Value Partners' report (Annex 11 to Third Pay TV Consultation), page 16.

[1398] Sky response to Third Pay TV Consultation, Annex 1, paragraph 17.

concerned that in the context of pay TV, cost-plus pricing risks artificially depressing rights values. In light of the importance of the continued generation of high-quality content for a well functioning market, we believe the consumer detriment if rights values were to be depressed is a substantial concern.

9.253 Adopting a retail-minus approach would not give rise to the same concerns, and on this basis we still consider it the most appropriate approach in this instance.

9.254 In response, Virgin Media was broadly supportive of using the retail-minus approach, but concerned over its inability to address a weighted average of Sky's retail prices for different bundles. Similarly, the Three Parties agreed with our methodology in principle, but emphasised that any pricing mechanism would need adjustments to reflect the entry of new premium pay TV retailers into the market. One of these adjustments was that Ofcom should make greater use of the cost-plus methodology. However, Astrium was concerned that Ofcom's approach would neutralise the cost advantage that a broadcaster using a satellite platform has over those using DTT or IPTV, discouraging satellite operators from competing in the UK.

9.255 The BBC believed that adopting retail-minus, with cost-plus as a cross check, was an effective method of combining the benefits of both mechanisms. **[✂]** a broadcaster also broadly supported this approach, noting that it is reasonable for the cost-plus price to be used as a minimum floor for any wholesale prices.

9.256 Sky was equally opposed to any price setting mechanism, but challenged Ofcom's use of retail-minus as an unjustified intervention since it believed no such price control is found anywhere else in the world. However, the analysis of Sky's own advisor Professor Martin Cave (provided as an annex to Sky's main response) has seemingly contradicted Sky's assertion, by explicitly acknowledging the merits of a retail-minus approach in this context:

> "In these circumstances I can understand why, having decided to mandate a wholesale product, Ofcom chooses the retail-minus approach..."[1399].

9.257 The most significant objection came from **[✂]** a potential IPTV entrant, as it strongly disputed our proposed use of a retail-minus approach, arguing it would not tackle the substantial issue of high wholesale prices. In its view a more preferable methodology would be to rely solely on a cost-plus pricing, which **[✂]** the potential IPTV entrant noted would allow for greater differentiation and variation between pricing strategies.

9.258 The **[✂]** potential IPTV entrant response also dismissed our concern over the potential for a detrimental impact on content rights values caused by cost-plus pricing. It stated that Ofcom's assessment had failed to consider the precise nature of auctions for Premier League rights, which have historically allowed exclusivity and attracted relatively few bidders. Furthermore, **[✂]** the potential IPTV entrant argued that in an asymmetric market, where the player with market power is subjected to a wholesale must-offer obligation, competition for premium content would remain very strong.

[1399] Annex 1, Sky's response dated 21 September 2009 to Third Pay TV Consultation Document, paragraph 24, p. 6.

9.259 We remain of the view that **[✂]** the potential IPTV entrant's argument does not change our belief that cost-plus pricing may risk artificially depressing rights revenues. Our concern about the possible impact of cost-plus as a primary pricing method directly reflects the specific characteristics of the pay TV industry, where firms could, under a cost-plus approach, affect the regulated wholesale price through their behaviour in auctions[1400].

9.260 We acknowledge **[✂]** the potential IPTV entrant's argument that Premier League rights prices appear not to be set by the bidding process has some merit, but believe the risk of depressing rights values is material, especially on a forward looking basis. As emphasised throughout our previous consultations, one of our principal concerns is to ensure that consumers have continued access to a wide range of high-quality content. Since access to high-quality content risks being undermined if the ability to generate a return on the production of content is compromised, we believe this is a significant concern.

9.261 As set out in our Third Pay TV Consultation, a retail-minus approach does not give rise to the same concerns relating to rights values, since the outcome of a rights auction has no direct effect on the level of wholesale prices[1401]. Under retail-minus, changes in wholesale prices over time are not driven by the results of rights auctions, but by changes in retail prices. Under retail-minus, a bidder in an auction for rights does not see the same increase in its own wholesale channel costs if it competes vigorously for rights as it would be more likely to do under cost-plus.

9.262 In addressing **[✂]** the potential IPTV entrant's concerns, we have recognised the challenges related to the specific circumstances of the pay TV market, such as the need to use retail-minus rather than cost-plus to avoid artificially depressing rights values. We have also considered this above alongside the limitations of a retail-minus approach, as the remedy will not be used to fully engage any concerns that relate to high wholesale margins, which would have to be addressed by some other form of intervention.

9.263 We believe adopting a retail-minus approach as the primary method, with cost-plus pricing as a cross-check, will address our concerns over the restricted distribution of premium content, but will not risk artificially depressing rights revenues. We remain of the view that this potential detriment to rights values is a significant concern, and therefore consider retail-minus pricing to be the most appropriate approach.

Should a wholesale must-offer remedy include enhanced versions of the channels – HD and interactive?

9.264 Our Third Pay TV Consultation set out various enhancements to the standard SD channels that Sky offers its own retail customers and that we proposed to include within the scope of a wholesale must-offer remedy. These were:

- High-definition versions of the channels.
- Interactive services providing access to primary content, typically via a 'red button' on the TV screen. By primary content we mean footage which is directly dependent on the licensing of rights from content owners. We distinguished this

[1400] See Third Pay TV Consultation, paragraph 8.86.

[1401] See Third Pay TV Consultation, paragraph 8.82.

from editorial content, or other additional services, which could be generated by any retailer, and which we did not propose to include in the scope of the obligation.

9.265 As the paragraphs below set out, we consider that the restricted supply of HD versions of Core Premium channels and interactive content prejudices fair and effective competition. As a result, our view remains that these should both be included within the scope of the wholesale must-offer obligation.

HD

9.266 As noted above, in the Third Pay TV Consultation we proposed to include HD versions of Sky's Core Premium channels in the remedy, and to set a regulated price. This reflected our view that, according to the available evidence, the difference between SD and HD was significant, both as a driver of platform innovation and for the consumer experience.

9.267 Sky stated that an insufficient case was put forward by Ofcom for the inclusion of HD. It contested the view that HD channels are indispensable to competition by arguing that they fall into the same market as SD channels. In addition, Sky believed our approach to HD was inconsistent. It argued that it was disproportionate to include HD in a remedy which is focused on DTT, which cannot provide HD.

9.268 Similarly to Sky, Astrium claimed it would be pointless to include HD on the DTT platform, as users desiring HD content will prefer to have more channels available than DTT will ever be able to support.

9.269 In contrast to these objections, the Three Parties were broadly supportive of the proposition to include HD channels. **[✂]** a potential IPTV entrant also agreed with their inclusion on the basis that HD is important to consumers to the extent that they are likely to switch platform because of this feature. Virgin Media proposed the wholesale must-offer remedy should also be structured in such a manner as to enable it to be extended to new services in the future, such as 3DTV.

9.270 The BBC emphasised that HD is becoming the new standard for television, arguing that any wholesale must-offer remedy must include HD version of current services as well as standalone HD services.

9.271 In terms of setting prices for HD channels, Sky argued that by proposing 'intrusive price regulation' on an innovative product such as HD, Ofcom's actions would potentially reduce incentives to innovate. The analysis of Professor Cave, acting for Sky, further expanded on this point, arguing that since "basic retail-minus methodology requires new services to be made available immediately", this approach would damage returns to innovation[1402]. This was contrasted with Ofcom's approach to superfast broadband, where we deemed the setting of prices of new active products disproportionate. Concerns relating to pricing were also put forward by the Premier League, who argued that since HD is not currently available on DTT, Ofcom should not attempt to set a wholesale price for HD until the costs of a feasible new entrant on a different platform can be determined.

9.272 Our proposal is based on the view that HD is increasingly important to both consumers and competition. Therefore we believe a remedy which excluded it would

[1402] Annex 1 to Sky response to Third Pay TV Consultation, paragraph 53.

not be effective. The growing significance of HD has been emphasised by comments from Sky and others, which suggest that HD capability is increasingly being viewed as the new standard for next generation TV platforms. Public comments from Sky are indicative of this, as chief executive Jeremy Darroch has announced Sky are set to standardise its HD box platform:

> "From today, we will start selling HD enabled boxes as standard and customers will receive a box for free when they subscribe to our HD pack of channels"[1403].

9.273 This statement is reinforced by the rapid increase in Sky HD subscribers; in 2009 annual net additions stood at 482,000, more than double that of the previous year[1404]. Furthermore, comments from other industry figures have indicated this rapid rate of adoption will lead to HD replacing SD as the new standard for broadcasting. For example, SES Astra president and chief executive Roman Brausch has claimed that:

> "It is unlikely to come straight from them, but if I listen to our sources then Sky will be able to switch off its standard-definition broadcasts by between 2016 and 2018"[1405].

9.274 We also see evidence that HD is now established as an important differentiator used by Sky to distinguish its service from that of other pay TV retailers. An example of this can be found in the residential marketing deployed by Sky to directly target Virgin Media subscribers, which offers HD as one of the "11 reasons to say goodbye to Virgin Media". The significance of HD in driving new subscription had also been alluded to by Sky itself, as in a March 2009 quarterly results announcement chief executive Jeremy Darroch emphasised that "HD has been a key driver of new customers with around a quarter of HD additions in the quarter being new to Sky"[1406]. Consequently, the importance of HD as a point of differentiation in competition between Sky and other retail offers supports the view that by excluding HD versions, Sky would be supplying an inferior product to the one it supplies to its own retail arm.

9.275 While Sky's marketing push has carried forward the adoption of HD in the UK and also in Europe, it by no means invented HD internationally, as its launch followed on from success in the US and Canada, where 6% of homes already had HD by the end of 2006. We recognise that Sky has had substantial success in driving HD growth in the UK and the parallel with North America is to some extent an imperfect one, due to the lower quality of the pre-existing SD standard there relative to the UK. However, this still appears to reduce the degree of risk Sky took in launching HD in comparison to a situation where it was breaking new ground internationally, as it already had evidence that HD had the potential to work commercially.

[1403] http://corporate.sky.com/documents/pdf/press_releases/4ad9b907f137492d998022a042ac035b/280110_Interim_Results_Press_Release

[1404] Ibid.

[1405] Informa telecoms and media, 'SES sees Sky HD switch of in 2018', Angela Balakrishnan, 18 November 2009.

[1406] http://corporate.sky.com/documents/pdf/latest_results/Q3_09_Press_Release

9.276 Sky has made a substantial commitment to HD, but the amount of capital at risk has been considerably smaller than was the case historically. Furthermore, much of its expenditure has been on set-top-box subsidies which are incurred at the point of sale and therefore scale directly with the number of subscribers that take the service.

9.277 Sky emphasised that it was not reluctant to supply Virgin Media with HD channels, citing that Virgin Media only asked for proposals in March 2009 and stating it would be more than willing to offer supply. As we have set out in Section 7, our review of the discussions between Sky and Virgin Media regarding supply of HD channels shows that Virgin Media first sought supply of HD channels several years ago, and an agreement has not yet been reached.

9.278 We note that in early 2008 Sky was willing to include HD in a wholesale commitment to us, subject to a period of exclusivity from the point of agreement being reached and the subsequent launch of Picnic.

9.279 Based on the evidence presented above, alongside Sky's own pronouncements, it is evident that HD no longer represents a new innovation, and is instead more an integral part of the pay TV landscape[1407]. While we are concerned to avoid deterring future investment in innovation, we do not accept that including HD within the scope of the remedy would be damaging to innovation as Sky suggests.

9.280 Our approach to HD is informed purely by the evidence of its importance, rather than by any broader desire to regulate any new services that Sky may provide. For example, future innovative services which relate to the Core Premium channels covered by the wholesale must-offer obligation, such as 3DTV, would not automatically be included within the scope of the remedy.

9.281 We do not recognise Sky / Professor Cave's comment that "basic retail-minus methodology requires new services to be made available immediately"[1408]. We have considered the scope of a wholesale must-offer remedy carefully, and have only included within its scope those services that we consider necessary to ensure fair and effective competition. This does not mean future services would automatically be included.

9.282 Although we consider it appropriate to include HD within the scope of the remedy, to ensure fair and effective competition, we recognise that the proportionate response may not be to set a regulated price for HD supply. We acknowledge that uncertainty involved in allocating marketing costs to a product in a growth phase increases the risk of regulatory failure in setting prices, which could risk damaging innovation. In addition, there is an existing rate-card for SD channels, but this is not the case for HD, where commercial negotiations have not resulted in supply. Consequently, we believe it is appropriate to allow negotiation around the pricing of HD channels. To facilitate these negotiations, we will include an obligation to set prices for HD on FRND (fair, reasonable and non-discriminatory) terms.

9.283 In this context, however, we would observe that Sky, in its discussions with Ofcom (as referred to above and in Annex 2), was prepared to offer wholesale supply of HD versions at a price of £**[✂]** per subscriber per month. Clearly this offer was made in

[1407] Our April 2008 statement on the future of DTT noted "the increasing demand of HD services (e.g. on satellite and cable) which is reflected in the uptake of 'HD ready' sets". See 'Digital Television: Enabling New Services', paragraph 4.151.

[1408] Annex 1 of Sky response to Third Pay TV Consultation, paragraph 53.

different circumstances and in the context of a different SD channels price, so we would not expect the price necessarily to be identical, but we still see this figure as relevant.

9.284 For the reasons set out above we have decided that it is appropriate to include HD within the scope of the wholesale must-offer obligation, and to require HD prices to be agreed on FRND terms, rather than specify a price.

9.285 Finally, for completeness, we note that Sky's comparison of our approach regarding HD with our approach on superfast broadband is incorrect. Sky argued that we were inconsistent: we had regulated a new service in HD, but not in the case of superfast broadband, where Sky / Professor Cave said that we had granted "proper recognition to the importance of not stifling investment and innovation"[1409]. We said in our statement on superfast broadband that:

> "At this stage of market development, pricing flexibility on wholesale active products is appropriate; and
>
> For passive products, cost based pricing that reflects the level of risk incurred is appropriate.
>
> We continue to believe that these approaches to wholesale pricing are appropriate and will support investment and competition. In either case, the pricing of products must allow opportunities to recover costs and earn a reasonable rate of return on investments"[1410].

9.286 Of the two sets of products, we put in place cost-based prices on one, and on the other allowed pricing flexibility. This is in a context where the investment is considerably larger than that involved in HD, and where the product in question has been rolled out much less widely across the market than HD.

[1409] Sky response to Third Pay TV Consultation, Annex 1, paragraph 54.

[1410] http://www.ofcom.org.uk/consult/condocs/nga_future_broadband/statement/statement.pdf, paragraphs 1.31 to 1.32.

Figure 126 Comparison of superfast broadband and HD regulation[1411]

	Regulation of NGA	Regulation of HD
Supply-side risk – up-front investment	Investment of many billions of pounds in new access technologies	Investment of tens of millions of pounds
Timing of proposed intervention	Access obligations to apply to NGA as soon as it is deployed by BT, and to duct ahead of any deployment	Access obligations to apply to Sky only after a four year period of exclusivity
Approach to pricing	Pricing flexibility for bitstream products, subject to non-discrimination rule, but upstream inputs regulated on a cost-oriented basis.	Pricing flexibility, subject to non-discrimination rule, but no regulation of upstream inputs
Approach to non-price issues	Functional separation of BT, coupled with a strict form of non-discrimination (Equivalence of Inputs)	Non-discrimination rule

Interactive

9.287 Our position in the Third Pay TV Consultation regarding the inclusion of interactive services was to include within the wholesale must-offer obligation any sports matches shown live via the red button which are part of events that appear on Sky Sports 1 and Sky Sports 2. We considered the amount of content shown via the red button that fell into these criteria, including UEFA Champions League matches, was likely to be material. This approach also reflected our concern that a wholesale must-offer remedy could potentially be left open to gaming, by making premium content available via the red button rather than on the main linear channels, effectively excluding it from the scope of the remedy.

9.288 Sky noted that UEFA Champions League football has always been made available via an interactive application that is part of its 'Sky Sports Xtra' service[1412]. In Sky's view, it is therefore not part of either of the Core Premium Sports channels that Ofcom proposed to include within the scope of a wholesale must-offer obligation. Sky also emphasised that these interactive services have been available for years on Sky's satellite platform, without a demonstrable effect on competition in any downstream market.

9.289 In addition, Sky judged the risk of gaming identified by Ofcom was insufficient to pass the threshold for inclusion, as it foresaw no commercial benefit in making highly attractive programming available via interactive services. It also contested the proportionality of including primary interactive material within the scope of the remedy, stating that it would be extremely difficult, and therefore costly, for Sky to supply its interactive services to other retailers.

1411 [✂].

1412 Renamed 'Sky Sports 4' in January 2010.

9.290 In contrast, the Three Parties supported the inclusion of interactive services, but did express reservations about the impact of limiting the criteria to primary interactive content only. Specifically, they argued that third party retailers should be permitted to provide their viewers with links from Sky's Core Premium channels to editorial content on their own interactive services, or those of third parties.

9.291 The BBC also agreed with the proposal to include interactive, as did a potential IPTV entrant **[✂]**, **[✂]**.

9.292 We have considered further the importance of content available via interactive services to consumers, in particular the availability of primary interactive material such as Champions League matches. Specifically, we have analysed the following:

- BARB data on Sky Active viewing, which shows the average audience across all interactive screens for several Champions League nights was 80,000[1413].

- Within this, individual matches on interactive regularly commanded more viewers than those on Sky Sports 3, and in one instance a match on interactive had more viewers than the equivalent match on Sky Sports 1.

- Consumer research showing that the majority of respondents (43%) valued live Champions League matches as the most important feature in Sky's interactive service[1414].

9.293 This research suggests that pay TV customers attach significant value to having the ability to watch live vidoestreams of sports matches that are broadcast as part of an event shown on Sky Sports 1 or Sky Sports 2. A recent example is indicative of this, when on 29 November 2009 Sky broadcast the first half of the La Liga match between Barcelona and Real Madrid exclusively via the red button. This brought a strong reaction from cable customers who had access to Sky Sports 1 but not Sky's interactive service, and were therefore excluded from watching the first half[1415]. This reaction is illustrative of a broader concern, as excluding interactive services from a wholesale must-offer remedy would degrade the services of other retailers offering Core Premium channels.

9.294 Despite this, our main concern relating to the inclusion of interactive services in a wholesale must-offer remedy remains the potential risk of gaming, which could compromise the effectiveness of the remedy. If interactive services are excluded, premium content could be made available via the red button rather than on the main channel. We believe any material difference in quality would be a form of non-price discrimination, and will reduce the effectiveness of the wholesale must-offer obligation. The underlying principle is that the interactive feeds are part of the channels, and we would expect Sky to supply the channels to others to the same quality as it supplies itself, unless there are objective reasons not to do so.

9.295 We also recognise the requirement to balance this potential risk against the cost to Sky in providing access to its interactive services. In considering this, we have accepted that the practicalities involved in providing these interactive services may

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[1413] BARB, Multichannel network, All Individuals (4+), daypart covered: 19:30-22:00.

[1414] Ofcom consumer research on pay TV preferences, December 2009.

[1415] http://www.digitalspy.com/forums/showthread.php?t=1169329 be more extensive than we set out in our Third Pay TV Consultation. Sky has provided us with supplementary evidence that suggests the technical integration needed between Sky and third party retailers may be more involved than initially predicted, in order to ensure the interactive application is configured correctly for the retailer's platform[1416].

9.296 Our position remains that interactive material is an important part of the licensed services concerned (reflected in the fact that interactive content is regarded as part of the licensed service in the relevant channel licences). This is particularly the case for additional videostreams showing sports matches that are part of events shown on Sky Sports 1 and Sky Sports 2. We therefore consider that interactive content should be part of a wholesale must-offer remedy. This decision reflects our view that the potential gaming risk and possible degrading of competing retailers' services if interactive was excluded are both substantial concerns. We recognise the need for Sky to recover its costs, and would expect Sky to do this but within the framework of providing interactive content to wholesale customers on a fair, reasonable and non-discriminatory basis. Considering that technological developments are increasingly blurring the distinction between interactive services and platform functionality, we see the inclusion of interactive services as the forward-looking approach.

9.297 Our decision reflects the balance between the potential for non-Sky firms to have to offer a sub-standard version of the channels and the risk of gaming if interactive material were to be excluded, and the cost Sky would incur as a result of providing access to these services. We have recognised this cost to Sky is more substantial than initially predicted, but do not believe this outweighs the risk of gaming if interactive services were to be excluded. Similarly to our position on HD, we have judged that exclusion of these services would compromise the effectiveness of a remedy in ensuring fair and effective competition.

Review provisions

9.298 Here we address two issues: firstly the general review provisions we would expect as a matter of course when putting in place a new piece of regulation. Second, however, we address the issue of content potentially moving between channels.

General review provisions

9.299 We remain of the view that we should review the remedy after three years. We would expect to commence the review three years from the remedy coming into effect. However, we would not automatically expect to remove the remedy after three years. Since our view is that the market power we have identified is enduring, we envisage the removal of the remedy as unlikely.

9.300 We would only expect to remove the remedy if the circumstances at the time had changed sufficiently such that there was fair and effective competition. One way this could happen would be if Sky was no longer to have market power. However, the view from our market power assessment is that Sky's position is likely to be enduring, and the remedy is not designed in order to remove market power – rather it is designed to remove Sky's ability to act to exploit market power by restricting distribution of channels.

[1416] Sky response dated 13 November 2009 to Ofcom information request dated 29 October 2009, question 24.

9.301 Having said that, we keep in mind the possibility that the circumstances might change within the three year period. The sorts of events which might cause us to lift the regulation earlier rather than later are focused on the source of market power. If Sky were to lose a substantial portion of the rights it currently licenses, that would be likely to lead us to a different view on market power; a wholesale must-offer obligation placed on Sky would not remain appropriate under those circumstances.

Content moving between channels

9.302 We are conscious of the fact that TV channels are a collection of programming brought together for a particular point in time. We are also conscious that Sky could exploit this as a way of seeking to evade the remedy. There are two major ways in which the channels could change which might lead us to review a remedy.

- Sky could carry out a re-organisation of its channel line-up, so that the key events currently broadcast on its Core Premium Sports channels moved onto different channels. This sort of re-organisation could be perfectly legitimate business as usual.

- Sky could also move key content between channels, as a way of gaming the remedy. The risk of gaming is mitigated somewhat by Sky's own incentives. Although Sky could attempt to circumvent a wholesale must-offer remedy by moving the most important content to channels that are not covered by the remedy, by doing so it would also affect its own retail customers. Nonetheless, this risk does exist.

9.303 However, the only way to guard against either eventuality undermining the effectiveness of the remedy would be to include a much bigger set of channels in a wholesale must-offer remedy – perhaps all of Sky's sports channels, or even including its basic channels, which could in theory be the destination for some sports content.

9.304 However, the benefits of this in terms of guarding against gaming would be offset by the costs associated with extending the remedy to include the additional channels. Including Sky Sports 3 and 4 would not just cover the content that is necessary to ensure fair and effective competition, but would also pick up all the other non-core premium content that is currently shown on those channels.

9.305 A more proportionate course of action is to exclude Sky Sports 3 and 4 but to monitor the content on the channels closely. If Sky was to move any material amount of content currently broadcast on the channels within the scope of the wholesale must-offer obligation to Sky Sports 3 and 4 or indeed any other channels, then we would clearly need to consider extending the scope of the remedy to those channels, on the basis that they were now making a material contribution to Sky's market power.

9.306 We would not expect a protracted consultation to be required in the event that a new licence condition is necessary for Sky Sports 3 and 4 as a result of Sky moving content from Sky Sports 1 and 2 onto Sky Sports 3 and 4, since the substantive issues would be the same as those on which we consulted in the Third Pay TV Consultation and on which we conclude here.

Section 10

Wholesale must-offer terms

Summary

10.1 We need to ensure that the wholesale must-offer remedy is implemented in a way that ensures effective competition in as short a time as possible.

10.2 We have revisited our pricing analysis since our Third Pay TV Consultation, in light of consultation responses and made some updates to reflect the latest available data. We have decided to adopt the same underlying approach towards pricing:

- We have derived retail-minus prices by considering a discounted cashflow analysis. We have determined the wholesale price that an efficient retailer could afford to pay given efficient retail costs and the need to earn a return, while at the same time matching Sky's current retail prices. We have stayed as close as possible to Sky's own costs, as the best available proxy of an efficient competitor.

- The analysis we have carried out is to consider the characteristics of a hypothetical entrant, not in order to pre-determine what will happen in the market, but in order to establish a price which will ensure that an efficient generic company is able to compete fairly and effectively.

- The prices we have set discourage entry by companies simply reselling Sky's channels; rather they require entrants to innovate around the channels in order to build a successful business.

- We cross-check these retail-minus prices against cost-plus figures, also based on a discounted cashflow analysis, by determining the price that Sky's wholesale business would need to charge to earn a reasonable return given its input costs.

10.3 We have derived prices for competitors that would be as efficient as Sky at equivalent scale, but do not have the same scale as Sky. Given the number of subscribers Sky has built up, there is not room in the market for more than one firm to have the same scale as Sky currently has. Therefore any remedy which sets out to ensure fair and effective competition has to allow for smaller scale. However, our approach is also designed to avoid the costs of market entry by firms that are either inefficient or unable to achieve sustainable scale.

10.4 Within this overall approach, we have made some changes to ensure that the remedy is appropriate. Our Third Pay TV Consultation set out a range of principles concerning price, and the central case of our illustrative scenarios assumed three million subscribers on digital terrestrial TV. We have updated our modelling to include more up-to-date data. Our decision on price reflects satellite transmission costs rather than digital terrestrial TV, and a subscriber base of 1.5 million rather than three million. The reasons for this change are as follows:

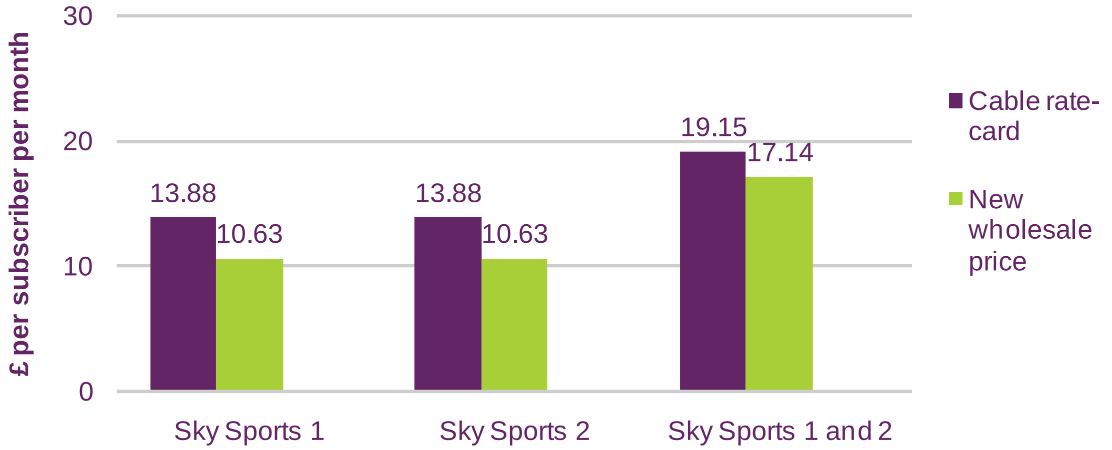
- All parties (including Sky in the context of our impact assessment) argued that our original scale assumption of three million subscribers for the competitor was unrealistically high. The effect of reducing this scale to 1.5 million subscribers is, in the presence of fixed costs, to increase retail costs per subscriber and hence reduce wholesale prices.

- Our overall aim is to stay as close as possible to Sky's own costs, as the best available proxy for an efficient retailer, while still allowing for market entry on non-Sky platforms, notably via digital terrestrial TV. In our Third Pay TV Consultation we therefore took account of the higher transmission costs of digital terrestrial TV. We have now decided that this is not necessary in order to ensure fair and effective competition, given the lower customer acquisition costs associated with digital terrestrial TV platforms in the absence of satellite dish and installation costs. We therefore derive prices based on Sky's own costs for satellite transmission.

10.5 It is clearly beneficial to consumers for competing retailers to be able to use the same wholesale input to offer differentiated retail services, thereby allowing for innovation in retail packaging, rather than for all retailers to be constrained to adopt Sky's pricing structure. We have therefore concluded that competing retailers should be able to develop their own retail service enhancements, without paying an additional wholesale charge, subject to them using the same underlying wholesale input. Consistent with this, we have included in our derivation of wholesale prices the retail revenues and costs generated by Sky from such services, specifically Multiroom services. The effect of this is that competing retailers will be able to add Multiroom services at zero incremental cost, and offer and price those services in a manner that best complements their overall proposition to retail customers.

10.6 The figure below shows our final wholesale prices, based on our updated calculations. We have set prices for three products: Sky Sports 1, Sky Sports 2, and the bundle of Sky Sports 1 and 2. These are the prices that we consider are necessary to ensure that other retailers are able to compete fairly and effectively.

Figure 127 New wholesale price for Sky Sports 1 and 2



	Sky Sports 1	Sky Sports 2	Sky Sports 1 and 2
Reduction from cable rate-card	23.4%	23.4%	10.5%
Retail margin	16.74	17.03	18.91

Source: Ofcom

10.7 The reduction relative to the rate-card is greater for single channels than for the bundle of Sky Sports 1 and 2. This reflects the fact that the Office of Fair Trading's margin squeeze test, by reference to which Sky appears to set its prices, is carried out at an aggregate level, giving Sky the freedom to set prices for some bundles high and some lower. Relatively speaking, the current wholesale prices seem to be higher for single channels than the bundle, leading to a greater reduction. Setting specific wholesale prices for each bundle allows competing retailers to be able to choose what types of retail package they wish to offer, and potentially differentiate these from Sky's, in order to ensure fair and effective competition.

10.8 Wholesale prices will track changes in retail prices over time based on a constant absolute (pounds) margin between retail and wholesale prices. We have decided not to adopt the 'ratchet' approach, of automatic downward changes but upward changes having to be approved by Ofcom. We suggested this in our Third Pay TV Consultation, but have now decided that this would involve both excessive asymmetry and uncertainty.

10.9 We have put in place wholesale pricing rules to ensure competitors can replicate Sky's broader bundles which contain Core Premium Sports channels, recognising that many consumers now buy TV broadband and telephony as part of a wider bundle.

10.10 We require Sky to make available a 'reference offer', including Minimum Security Requirements for wholesale supply within six weeks of the new licence condition coming into force, which is on the day of publication of this statement.

10.11 Six weeks is reasonable given the existing contract with Virgin Media and progress made on contracts with other operators. The purpose of requiring a reference offer and Minimum Security Requirements is to minimise the amount of time it takes from the licence condition coming into force until other retailers are able to start taking wholesale supply from Sky and competing in the retail market:

- **Reference offer.** The purpose of the reference offer is to maximise the transparency of wholesale supply arrangements for prospective customers. Given the length of time over which Sky has engaged in negotiations with other retailers in the past, it is likely that allowing Sky to negotiate bespoke terms with each wholesale customer from scratch would introduce an unacceptable amount of delay into the process.

- **Minimum Security Requirements.** Apart from price, the main issue that has prolonged the process of negotiations between Sky and other retailers is platform security. It is absolutely legitimate for Sky to want to ensure that its channels are broadcast securely, but again this should not be used as a reason unduly to prolong wholesale discussions.

10.12 Our intention is not to attempt to set non-price terms ourselves, but to leave as much as possible to be decided by Sky in negotiation with its customers. We acknowledge however that this may prove impossible, and as a backstop Ofcom is prepared to resolve any complaints in a timely manner, in order that consumers can benefit as quickly as possible from our remedy.

Structure of this Section

10.13 This Section is set out as follows:

- Introduction.
  - Our position in the Third Pay TV Consultation.

  - Responses to our consultation.
  - Issues addressed in this Section.

- Decision on the principles that should apply to the assessment of appropriate wholesale prices for a wholesale must-offer remedy:
  - Should prices be set on a linear, per subscriber, basis?
  - Should a single, non-platform-specific, price apply for each relevant wholesale product?
  - Should wholesale prices be set on the basis of retailers as efficient as Sky?
  - Should wholesale prices be set to enable sustainable entry, over the long-term?
- Decision on the options for the various components of the retail-minus calculation methodology:
  - Which retail packages and corresponding retail prices should determine the appropriate starting point?
  - What are the relevant costs for a retailer that should be deducted?
  - How should the margin and hence resulting wholesale price be calculated?
- Approach to the cost-plus calculation methodology used as a cross-check.
- Presentation of the wholesale prices that result from our decisions on the appropriate principles and calculation methodology.
- Decision on additional pricing conditions to ensure effectiveness of the remedy on an ongoing basis:
  - How should wholesale prices evolve over time?
  - How should wholesale prices be adjusted, if at all, for wider bundles?
- Decision on the options for various non-price terms:
  - Should Sky be required to produce a reference offer?
  - What terms should be included in a reference offer, in particular with respect to qualifying criteria for retailers and minimum security requirements?
  - What are the terms on which interactive content and HD versions of the channels should be available?
  - What are the appropriate technical and operational arrangements?
  - What would the process be in the event of a complaint?

Introduction

10.14 In Section 9 we began our assessment of whether it is appropriate to take any action to remedy the competition issues and consumer effects established in Sections 7 and 8, deciding that it is appropriate to put in place a wholesale must-offer remedy in order to ensure fair and effective competition. We also explained why we consider it is necessary for a wholesale must-offer remedy to cover both price and non-price terms. In particular, having evaluated the different options we set out the following conclusions:

- To apply the remedy to Sky's Core Premium Sports channels (i.e. Sky Sports 1 and Sky Sports 2) but not to other Sky Sports channels or Sky Movies channels.

- To set wholesale prices for the offer of standard definition (SD) versions of these channels using a retail-minus methodology, cross-checked against prices derived using a cost-plus methodology.

- Not to set prices for the offer of high definition (HD) versions of these channels or for the offer of interactive content, but to require Sky to offer those on a fair, reasonable and non-discriminatory (FRND) basis.

10.15 This Section, together with Sections 9 and 11, should be read as our regulatory impact assessment. In this Section we focus on what detailed price and non-price terms are appropriate to address the availability of Sky's Core Premium Sports packages to other retailers and therefore ensure fair and effective competition. In determining the detailed terms of the appropriate remedy we consider the costs and benefits of various options qualitatively as we progress through the analysis.

10.16 Before we go through the detailed analysis, we outline the position we took in the Third Pay TV Consultation and provide a summary of key points from responses.

Our position in the Third Pay TV Consultation

10.17 We were of the view that we should not only proceed to consider a wholesale must-offer remedy, but that we should include detailed terms in the scope of the remedy, price being the primary condition.

<u>Price</u>

10.18 We carried out a substantial piece of analysis to establish the appropriate level for wholesale prices:

- We derived retail-minus prices by considering a discounted cashflow analysis. We determined the wholesale price that an efficient retailer could afford to pay given its own retail costs (based largely on Sky's retail costs) and the need to earn a reasonable return, while at the same time matching Sky's current retail prices.

- We cross-checked these against cost-plus prices, also based on a discounted cashflow analysis, by determining the price that Sky's wholesale business would need to charge to earn a reasonable return given its input costs.

10.19 We proposed that retail-minus prices should be set on the basis of allowing a larger competitor (for example, reaching three million subscribers after 10 years) to compete with Sky's retail prices, incorporating an allowance for DTT transmission costs and a reasonable return on investment. This suggested prices roughly mid-way through our range for consultation.

Non-price

10.20 There were a number of important terms not related to price that we proposed to include in a wholesale must-offer remedy:

- The requirement to make a wholesale offer on FRND terms.
- Within that offer we proposed that Sky should set Minimum Security Requirements (MSRs) to protect against content piracy.
- We also proposed that Sky should set Minimum Qualifying Criteria (MQC) for prospective retailers of its channels.

Responses to our consultation

Price

10.21 Sky argued that the financial analysis that formed the basis for the level of charges for Sky's premium channels was flawed. It involved estimating the costs and revenues of a wholly unrealistic model of a hypothetical DTT operator. Correction of the errors in Ofcom's analysis, and use of a more appropriate model of a hypothetical DTT operator's business demonstrate that there is no justification for setting regulated charges for Sky's premium channels below current rate-card levels. In particular, Sky claimed that the wholesale prices proposed by Ofcom were too low. It believed that Ofcom made a number of errors in estimates of cost-plus wholesale prices. It stressed that Ofcom's methodology is "unsound" as it does not have regard to how the businesses operate or are planned in the real world, requires an extensive amount of allocation of common costs, and embodies an implicit assumption that the return on every type of service offered by a multi-product retailer should be the same. Sky argued that correcting the errors in Ofcom's cost-plus model indicated that if Sky were to charge the proposed wholesale prices, then it would earn an average operating margin over the next four years of only 8% per annum. Sky also criticised Ofcom's proposal in relation to "wider bundles". It thought it is discriminatory and that we did not make any attempt to examine the potential consequences.

10.22 The Three Parties broadly agreed with Ofcom's proposed approach to determining the wholesale prices for Sky's premium channels. They, however, believed it should be refined in a number of respects. In their view, wholesale prices at the bottom of Ofcom's range will ensure fair and effective competition. The Three Parties also highlighted the risk associated with our approach of simply taking the closest premium retail package as the starting point for the retail-minus calculation. They argued that Sky could game a remedy based upon the prices of these closest premium packages by inflating the prices for those small retail packages without suffering much churn. They also stated that the role of the cost-plus cross-check should not be limited to ensuring that the wholesale prices which are set by Ofcom permit Sky to recover efficiently incurred costs in the provision of its premium channels. They said that Ofcom should have greater regard to the prices derived via the cost-plus methodology (i) when they are noticeably lower than the retail-minus prices and (ii) when considering requests by Sky to raise its wholesale prices.

10.23 BT believed that, at a minimum, wholesale must-offer prices should be set at the bottom of Ofcom's proposed retail-minus range, with some scope to reduce the floor of the retail-minus range. BT argued Ofcom must do this to ensure that smaller scale competitors would be able to compete effectively with Sky. In terms of a new entrant, BT argued Ofcom underestimated the costs associated with entering the pay TV market when setting its wholesale must-offer prices. In particular, the appropriate cost of capital would be higher than the 10.3% Ofcom forecast, whilst new entrant DTT transmission costs would be **[✂]**% higher than those assumed by Ofcom. BT also took a view on “wider bundling”, stating that Ofcom should adjust prices by the full amount of any loss on wider bundles, but should not include profits on any products bundled into the proposition.

10.24 **[✂]** did not support Ofcom’s proposal to set linear, per subscriber prices. Commenting on Ofcom’s reluctance to adopt non-linear pricing because of the risk of creating barriers to entry, **[✂]** stressed that the barriers to entry may arise only if the entry fee was disproportionate. It further believed that the appropriate level could be easily set and was of the view that Ofcom should redesign the remedy so as to at least include the option of using a fixed fee/two part tariff. In terms of deriving starting retail prices **[✂]** favoured the approach based on Sky's lowest effective retail price for Core Premium products rather than a weighted average of Sky's retail prices for different bundles. **[✂]** also argued that our proposal to focus on deriving prices for a large scale retailer using DTT did not reflect a technology neutral approach. It also argued that it was inappropriate to derive wholesale prices for HD services on the basis of one particular distribution technology (satellite) when other technologies are appropriate for distributing HD channels. However, **[✂]** did support Ofcom in adopting the ‘ratchet’ approach where Sky could not increase wholesale prices without consent, but could lower these prices if retail prices decrease.

10.25 **[✂]** highlighted a few potential issues that it believed might lead to the wholesale price being set too high and therefore risked undermining the effectiveness of the remedy. These were: use of Sky’s cost of capital, use of Sky’s fixed and operating costs, scale and growth assumptions regarding new entrants, and use of a “weighted average” price for basic channel packages. **[✂]** also argued Ofcom should create a mechanism to respond to changing costs, including premium content rights and “gaming” from Sky. It was concerned about the lack of Ofcom thinking in this area. The BBC encouraged Ofcom to consider, when calculating the retail costs of an efficient entrant, the need to allow for a “learning period”.

Reference offer

10.26 The Three Parties thought that Ofcom should ensure that Sky promptly produces its reference offer (within one month). When determining whether that reference offer is FRND, Ofcom must ensure that it is not more onerous than industry norms established worldwide. Virgin Media expressed its view that the relevant retailers should be consulted before the terms of the offer are finalised. **[✂]** welcomed the suggestion that Sky publishes a reference offer. It commented that this should be freely available to all interested parties and not subject to non-disclosure agreements.

Minimum Security Requirements

10.27 The Three Parties, **[✂]** believed that Ofcom must specify that these MSRs may not go beyond what is common practice in pay TV markets. They insisted that we ensure that Sky does not delay over their publication and enforcement proceedings are commenced. Virgin Media thought that the relevant retailers should be consulted in advance of any MSRs proposed by Sky being implemented. Sky in turn argued that the proposal to regulate such matters is inconsistent with Ofcom’s principle of operating with a bias against regulating as this is a wholly unquantified risk. It further argued that there is a range of more proportionate solutions available, like the right to complain to Ofcom. **[✂]**'s view was that those requirements should be determined following negotiation with each platform.

10.28 The BBC stated that Ofcom should monitor the determination by Sky of MSRs, and remain ready to intervene if it appears that they are unrealistic and cannot be met by a sufficient number of parties.

<u>Minimum Qualifying Criteria</u>

10.29 Virgin Media was concerned that Sky could undermine the regime through specifying unduly onerous MQCs. It thought the industry participants should be able to comment in advance of implementation to ensure that the requirements are FRND. Similarly, **[✂]** believed that Ofcom's proposal would facilitate an unlawful refusal to supply by Sky. It suggested that this issue should be subject to Ofcom's review and public consultation.

Issues addressed in this Section

10.30 We have considered the options relating to price and non-price terms by reference to our statutory duties and the need to ensure fair and effective competition. In particular, with respect to price terms, we summarise below the main issues we have addressed when assessing the appropriate wholesale prices to include in the offer and the resulting implications.

Figure 128 Summary of the issues we have addressed when assessing the appropriate wholesale prices to include in the offer

Issues	Description	Implications for pricing
Issue 1: ensuring effective competition	Ensure access to Sky's Core Premium Sports channels at prices that enable effective competition	Wholesale prices determined on the basis of retailers as efficient as Sky at equal scale, but recognising that lower scale is a necessary consideration for there to be any competition
Issue 2: ensuring fair competition	Enable access to Sky's wholesale premium sports content with no undue discrimination	Same wholesale prices available to competing retailers on any platform (other than Sky's own platforms) regardless of distribution technology
Issue 3: promoting innovation	Enable innovation, in particular through inter-platform competition (but also retail packaging and pricing), while not encouraging inefficient entry	Wholesale prices determined for retailers as efficient as Sky (hence on the basis of satellite platform costs). These prices cross-checked taking account of other platform costs (e.g. DTT costs)
Issue 4: promoting continued investment	Ensure that investment in content by rights holders and premium sports channel providers are not compromised while ensuring fair and effective competition	Wholesale prices determined using a retail-minus methodology but cross-checked against cost-plus methodology

Principles in assessing appropriate wholesale prices

10.31 In our Third Pay TV Consultation we set out a number of principles that we considered relevant to determining appropriate wholesale prices. We discuss these principles, the responses we received to our consultation, and our resulting decisions in the paragraphs below. In summary we have decided to:

- Set linear, per subscriber prices.
- Set a single, non-platform-specific, price for each relevant wholesale product.
- Define the competitor as one which is as efficient as Sky but at smaller scale and set the margin that an equally efficient competitor but at smaller scale would need in order to recover its retail costs.
- Derive prices which enable sustainable, long-term entry by setting the wholesale margin with regard to the anticipated lifetime retail costs of an efficient competitor which reaches material scale in the longer term.

Introduction

10.32 As set out in Section 9, we have decided that:

- The wholesale must-offer remedy includes all Sky's Core Premium Sports channels.

- It is appropriate to set wholesale prices (and non-price terms) for the SD versions of these Core Premium Sports channels.

- We will set prices based on a retail-minus approach, cross-checked against prices derived using a cost-plus methodology.

10.33 Therefore, we need to determine wholesale prices for the following Core Premium Sports wholesale products:

- Sky Sports 1.

- Sky Sports 2.

- Sky Sports 1&2.

10.34 The above Core Premium Sports products are made available to Virgin Media under the current cable rate-card. Sky Sports 3 and Sky Sports 4 are also supplied to Virgin Media, but we have decided not to include these in our wholesale must-offer remedy. However, the most popular bundles include Sky Sports 3 and 4 along with Sky Sports 1 and 2, and we have concluded that these bundles are in the market because they include Sky Sports 1 and 2 (see Section 5).

10.35 In Section 9, we have also noted that HD is becoming increasingly important to competition. We have therefore decided that the wholesale must-offer remedy should include access to the HD versions of the Core Premium Sports products, but for the reasons set out in Section 9, we have decided not to set a wholesale price for HD.

Should prices be set on a linear, per subscriber, basis?

10.36 In the Third Pay TV Consultation (paragraphs 9.30 to 9.35), we proposed to put in place linear, per subscriber prices such that a retailer's payments for the wholesale channels would increase linearly with the number of its subscribers. Our proposed approach is the current industry norm. At the same time we also proposed that retailers could negotiate alternative wholesale pricing structures if they felt these were better aligned with their overall commercial objectives.

10.37 The Three Parties[1417] agreed with our proposed approach to set linear, per subscriber charges in recognition of the fact that this is the current industry norm. In addition, they also expressed a desire to be able to negotiate non-linear tariffs, as long as these are also subject to FRND conditions. In its response, Sky[1418] argued that the wholesale must-offer remedy should allow it to negotiate non-linear tariffs on the basis that, for example, this would be a more proportionate response than imposing a price control. In Section 9, we have already discussed our decision to set wholesale prices which, in our view, are necessary to safe-guard the effectiveness of the wholesale must-offer remedy. We do not repeat these arguments again in this Section.

[1417] Three Parties response to the Third Pay TV Consultation, Section 9, paragraphs 9.1 to 9.2.

[1418] Sky response to the Third Pay TV Consultation, paragraphs 10.171.

10.38 **[✂]**[1419] favoured non-linear prices on the basis that these were pro-efficiency. It cited Harbord and Ottaviani's work as support for its arguments[1420]. In addition, in its opinion non linear tariffs will only raise a barrier to entry if the "entry fee is disproportionate". In its view the level of the entry fee and how it is set are matters of detail; this can, for example, be set at a suitable level by predicting the market share in year X, with periodical reviews thereafter.

10.39 The question we need to address concerning the appropriate structure of prices is limited to the offer that is available under the wholesale must-offer remedy. In summary, for the wholesale must-offer remedy we have decided to adopt linear, per subscriber prices. However, our decision does not prohibit alternative structures being negotiated as part of commercial discussions between Sky and its wholesale customers, outside the scope of the wholesale must-offer remedy.

10.40 In principle we would agree that non-linear tariffs may be more efficient. Such an approach, for example, could allow for an up-front lump sum fee, followed by lower per subscriber fees. A pricing structure of this form would mimic more closely the structure of wholesale channel costs for Core Premium Sports packages, with high fixed costs and low marginal costs. This structure would result in pricing signals which more accurately reflect underlying cost structures and therefore would help to deliver the same benefits to other retailers as vertical integration provides for Sky (e.g. the avoidance of double marginalisation).

10.41 We see advantages in there being flexibility in pricing structures, which may have desirable efficiency properties, to allow greater innovation in retail packaging. There may be alternative pricing structures which would encourage retailers to be more efficient and effective in retailing of these pay TV services, which we would not wish to hinder. Our approach ensures that Sky has the freedom to negotiate such pricing structures commercially.

10.42 In the context of a pricing structure for a regulated offer, it is still our view that non-linear tariffs involving significant up-front fees could raise barriers for smaller competitors, which runs counter to our overall objective of ensuring fair and effective competition to remedy the effects we identified in Section 8. We also consider that a non-linear tariff would be difficult to implement in practice in conjunction with a retail-minus methodology.

10.43 In summary, for the wholesale must-offer remedy we have decided to adopt linear, per subscriber prices. However, outside the scope of this remedy, operators have the flexibility to arrange alternative pricing structures as part of their commercial negotiations with Sky if they wish to do so.

10.44 Sky may feel constrained in its ability to arrange alternative pricing structures by the application of competition law, under which undue discrimination between different providers could be regarded as abusive. In our view competition law does recognise that different purchasers in different positions might be treated differently, and that there can be more than a single price for a product. We would though expect any alternative pricing structure established in negotiation with one party to be available to other parties in a broadly similar position.

[1419] **[✂]** response to the Third Pay TV Consultation, Question 16.

[1420] **[✂]**.

Should a single, non-platform-specific, price apply?

10.45 As noted as Issue 2 in Figure 128, our requirement to ensure fair and effective competition implies that there should be no undue discrimination between purchasers of Core Premium Sports packages. Therefore, in ensuring availability of Core Premium Sports packages, we consider as a starting point that it is likely to be more consistent with fair and effective competition that a given Core Premium Sports package is available at one price for all operators, irrespective of the underlying distribution technology they use (for example, satellite, cable, DTT, IPTV).

10.46 In our Third Pay TV Consultation (paragraphs 9.52 to 9.58) we re-iterated our position that for a given wholesale product there should be one price for all retailers across all distribution technologies. We then went on to derive the wholesale price for a set of 'factory gate' products which also excluded any form of onward transmission from Sky's premises to end users. All competing retailers would therefore have access to Sky's Core Premium channels on the same basis, at the same wholesale price, regardless of the cost of their chosen distribution technology and excluding any onward transmission from Sky's premises to end users.

10.47 Most respondents agreed with our technologically neutral approach to setting wholesale prices. Sky[1421] disagreed strongly, stating that our approach seemed "somewhat disingenuous" given the determination of charges using a specific technology, DTT. Sky suggested that the proposed approach was motivated more by a wish to increase the penetration of premium channels on cable. The BBC[1422] commented that it may be useful to consider whether the methodology should allow for different entry costs on different platforms and the scale of the entrant. For instance, transmission costs on satellite vary depending on the number of transponders acquired simultaneously by an operator.

10.48 We acknowledge that in a competitive market there could be circumstances where it would be economically efficient to price discriminate between different retailers, for example, if offering content at a lower price on less efficient platforms is the only way of reaching a particular set of consumers, and hence expanding the total market. However, within the scope of a wholesale must-offer remedy, we do not consider it would be appropriate or practical for us to attempt to replicate this. Furthermore, as we have explained in Section 9, we do not consider that setting different prices to different retailers would ensure fair and effective competition.

10.49 Therefore, based on the reasoning set out in our Third Pay TV Consultation and on stakeholder responses, we have decided that under the wholesale must-offer remedy a single wholesale price for a given Core Premium Sports wholesale product should apply across all distribution technologies. Our decision ensures fair and effective competition:

- There is no undue discrimination since all retailers pay the same price for the same input product (i.e. the same Core Premium Sports packages).

- Competition is not distorted between platforms but rather competition determines which distribution technology is successful (rather than the regulator or Sky).

[1421] Sky response to Third Pay TV Consultation, Section 10, paragraphs 10.161 to 10.164.

[1422] BBC response to the Third Pay TV Consultation, page 6.

10.50 We have therefore derived a single, non platform specific price for a set of 'factory gate' products which exclude the costs of onward transmission to retail customers and are available to all retailers on the same basis. As discussed in Section 9, the same wholesale prices would also apply to Virgin Media.

10.51 Having decided to set a single wholesale price for a given wholesale product, this however does not determine uniquely what level that price should be set at. In particular, we need to consider whether our retail-minus methodology should be based on Sky's costs entirely or whether any adjustments should be made (for example to take account of smaller scale or for a different distribution technology). This question is addressed below.

Should wholesale prices be set on the basis of retailers as efficient as Sky?

10.52 Our objective is to ensure fair and effective competition; any entry that results from licence conditions we impose should therefore be efficient.

10.53 In the context of determining an appropriate wholesale must-offer price, in our Third Pay TV Consultation we proposed to consider these objectives by constructing a particular framework for a hypothetical entrant, starting from the perspective that the hypothetical entrant should be as efficient as Sky. However, in setting the retail margin we made two specific adjustments: we assumed a retailer to be a) at a smaller scale than Sky in recognition of the fact that it is unlikely to achieve Sky's scale and b) one which uses DTT as its distribution technology given this is the most likely opportunity for entry (i.e. a large scale DTT competitor). We recognised that the real world is different and that we are not able to determine what will actually happen as a result of introducing the wholesale must-offer remedy.

10.54 The Three Parties[1423] argued that adjusting only for transmission costs and scale results in wholesale prices that will not promote fair and effective competition. In their view further adjustments are required to Sky's costs in relation to cost of capital, fixed costs, churn, subscriber acquisition costs (SAC) and the cost of third party basic channels. The Premier League[1424] argued that using Sky's costs is likely to be erroneous and lead to poorly defined wholesale prices. In its view Sky is a vertically integrated provider undertaking both wholesale and retail activities, therefore there is no good reason to expect costs of an independent retailer to bear any resemblance to Sky's costs. Sky[1425] commented on the fact that a new entrant will not bear some of its costs (such as the costs of upgrading the set-top boxes of an existing subscriber base).

10.55 We first consider the adjustment proposed in our Third Pay TV Consultation concerning scale. As highlighted at Issue 1 in Figure 128, given that Sky has about 70% of pay TV subscribers (and **[✂]**% of premium pay TV subscribers), it is not feasible to ensure fair and effective competition on the basis of multiple competitors who achieve the same scale as Sky – even a single additional competitor at this scale would mean that together with Sky they would exceed the plausible number of households who would subscribe to pay TV in the foreseeable future. Ensuring fair

[1423] Three Parties response dated September 2009 to the Third Pay TV Consultation, Section 9, paragraph 9.24.

[1424] Premier League response to the Third Pay TV Consultation, Annex 2, Question 20.

[1425] Sky response to the Third Pay TV Consultation, Section 10, paragraph 10.143.

and effective competition therefore requires us to consider a benchmark which deviates from Sky's scale.

10.56 There is a degree of judgement as to what we mean by an efficient hypothetical entrant and the corresponding size of margin which enables it to recover its retail costs. Setting the scale threshold high risks low levels of market entry, and limited competition, whereas setting the scale threshold low risks high levels of entry by inefficient sub-scale firms, the costs of which could ultimately fall onto consumers. Given economies of scale, a competitor, that is as efficient as Sky at Sky's scale, will nevertheless have an inevitably lower scale in its early years and therefore have average total costs that exceed Sky's due to the presence of fixed costs. A margin based strictly on Sky's scale would not therefore enable effective competition, given that even efficient competitors will have higher average costs, jeopardising the total benefits of wider distribution and enhanced innovation that our proposed remedy is intended to produce.

10.57 The second adjustment we proposed in our Third Pay TV Consultation concerned distribution technologies. Issue 3 in Figure 128 above noted that we do not want to promote inefficient entry; however we recognise the importance of inter-platform competition and its contribution towards innovation. As discussed in our Picnic Statement, we consider that the critical stage in the development of pay TV on DTT in particular provides an opportunity for competitors for market entry in the short to medium term. While our objective is not to promote competition specifically on DTT, in ensuring fair and effective competition we are concerned to allow potential competitors to take advantage of this opportunity. The effectiveness of the wholesale must-offer remedy would therefore be questionable if it was clear that it did not enable retailers using DTT platforms to compete. If such a situation arose, we would need to consider carefully how best to address this issue.

10.58 In response to the proposal by the Three Parties that many further adjustments should be made to Sky's costs, we reiterate that our objective is to ensure fair and effective competition, whilst not promoting inefficient entry. We continue to believe that Sky is an appropriate benchmark for an efficient retailer, and deviation from Sky's costs should only be on an exceptional basis where matching Sky's efficiency is demonstrably unachievable for any other retailer. Within the context of deriving an appropriate retail margin to enable other retailers to compete effectively with Sky, we do not believe that the further adjustments identified by the Three Parties fall into this category. In addition, making further adjustments increasingly risks specifying the margin for a 'specific business' plan, which not only presents practical challenges for identifying reasonable parameters but implicitly defines the type of future competitors, rather than ensuring fair and effective competition by efficient retailers.

10.59 We are still of the view that it is appropriate to ensure entry is efficient. Therefore, our starting high-level principle is to define a hypothetical entrant which is as efficient as Sky in all respects, except where such an approach would be contrary to ensuring fair and effective competition – as is clearly the case if we were to assume the market contained multiple providers with Sky's current scale. Having defined the hypothetical entrant at a high-level, we then need to answer three specific questions which will help us with setting the relevant retail margin. Specifically:

- Whose costs do we use?
- Exactly what scale do we assume for the new entrant?
- What allowance do we provide for transmission costs?

10.60 In summary, we have decided the following in response to these three questions:

- We have used Sky's costs as the benchmark for an efficient retailer and adjusted these only for scale, given a competitor cannot be expected to achieve Sky's scale even over a period of time. We discuss our detailed approach to costing and the specific adjustments we have made to Sky's costs in paragraphs 10.120 to 10.135.

- We have derived wholesale must-offer prices on the basis of a competitor which reaches 1.5million subscribers in 10 years, having grown its subscriber base from zero when it launches premium pay TV services. This reflects a competitor who achieves approximately 10% of premium pay TV retail subscribers in the long term. We discuss our approach, stakeholder responses and our decision in respect of scale in paragraphs 10.171 to 10.183.

- We have used Sky's costs (which reflect satellite transponder capacity) when calculating the allowance for transmission costs in the retail margin, given that while competitors may adopt different distribution technologies our view is that they should be expected to achieve a similar efficiency benchmark. However, we have also sought to cross-check the resulting margin by considering relevant DTT costs to ensure DTT-based retailers can compete effectively. We discuss our approach, stakeholder responses and our decision in respect of transmission costs in paragraphs 10.160 to 10.170 .

Should wholesale prices be set to enable sustainable, long-term entry?

10.61 In our Third Pay TV Consultation (paragraphs 9.108 to 9.114) we proposed to base our analysis over a period of time, to determine whether there would be a business case for sustainable scale entry, rather than this being constrained to an analysis of a single year (for example the year of entry).

10.62 Most respondents agreed with our high level approach. We discuss these in more detail in paragraph 10.136.

10.63 We have therefore decided to adopt the approach we proposed in the interests of ensuring sustainable long-term entry. We have derived wholesale prices based on the likely future cash flows of a competitor's business case. Our approach requires us to make a number of assumptions over time, such as the subscriber growth profile for the competitor (discussed in paragraphs 10.171 to 10.183). We have also taken a view on how retail prices and wholesale prices evolve over time, assuming that these remain constant in real terms (discussed in paragraphs 10.223 to 10.251 below).

10.64 In addition, as discussed in our Third Pay TV Consultation (paragraphs 9.60-9.62), we remain of the view that our adopted approach on this issue is more appropriate for our purpose than the one adopted by the OFT in its 2002 margin squeeze case[1426].

- The OFT's analysis was carried out in a very different context from the context in which we are carrying out our analysis. The OFT undertook an ex post test for margin squeeze, where its focus was on establishing whether a purchaser that was as efficient as Sky would be able to retail its premium channels on a

[1426] BSkyB Investigation, Competition Act 1998 decision CA98/20/2002, Case CP 01916-00.

profitable basis at the current rate-card. Therefore it examined this question by looking at Sky's costs and limiting its analysis to a discrete period of a few years.

- The approach we have adopted when setting this remedy is different to the one adopted by the OFT in a number of ways. This difference in approach is driven by the purpose of our analysis. As discussed in Section 9, we have decided to impose an obligation on Sky to wholesale its Core Premium Sports channels to remedy our concerns over restricted distribution. We have also decided to set the relevant wholesale prices to ensure that the efficacy of the wholesale must-offer remedy is not reduced by lengthy negotiations. Finally, our intention is to review this remedy after three years. In this context, our analysis is forward looking and is intended to derive the wholesale price that would enable likely retailers to compete. We have looked at a hypothetical competitor's business case over time, taking a view on the likely future cashflows it may generate and the retail costs it would incur.

10.65 We discuss the methodological implications of our approach in paragraphs 10.136 to 10.144.

Methodology for the retail-minus calculation

10.66 This Section considers the methodological issues, relevant to our retail-minus calculations, which arise from adopting the principles discussed above.

10.67 The general principle of a retail-minus approach is to derive wholesale prices by asking "how much could an efficient competitor afford to pay for the wholesale channels after taking into account all of its other costs and the need to earn a reasonable return on its investment?" The resulting wholesale prices should be at a level which allows the efficient competitors to compete with the incumbent in retail markets, providing similar products at similar prices. That is not to say we would expect or desire competitors to adopt identical business models to Sky, but rather that there should be a comparable margin for retail costs to enable others to compete in retail markets. For example, the cost allowance might be used to subsidise set-top boxes or provide basic channels (following a similar business model to Sky), to package Core Premium Sports channels (without a set-top box for example) alongside new services, or to retail unbundled packages at a lower price point. Our intention is to facilitate diversity in business models and product offerings in order to provide greater choice and innovation to consumers.

10.68 The Three Parties[1427], **[✂]**[1428], **[✂]**[1429] and BT[1430] all supported the use of a retail-minus approach, with a cost-plus cross-check, to derive wholesale prices.

10.69 Professor Cave on behalf of Sky, although supportive of the retail-minus methodology in general, argued that the minus element was set with a view to a particular market structure, which is "hazardous" for a market characterised by fast

[1427] Three Parties response to the Third Pay TV Consultation, paragraph 9.

[1428] **[✂]**.

[1429] **[✂]** response to the Third Pay TV Consultation, page 5.

[1430] BT response to the Third Pay TV Consultation, Section 3, paragraph 3.2.

and unpredictable technical progress[1431]. In support of the retail-minus approach, Professor Cave on behalf of Sky noted the following[1432]:

> "…In these circumstances I can understand why, having decided to mandate a wholesale product, Ofcom chooses the retail-minus approach, in which the wholesale price generates a margin on the basis of which the competitor can substitute its own activities in place of those of the incumbent."

10.70 Sky[1433] also made a number of comments relating to our calculation methodology which we discuss in Annex 7.

10.71 The Premier League disagreed with the use of retail-minus regulation, as in its view, it is not appropriate for pay TV. It argued that, firstly, pay TV operators need to reinvest periodically in new content and the quality of content is dependent on the amount pay TV operators are prepared to bid. Therefore, it is inappropriate to set wholesale prices over a ten year horizon and it could hamper investment. Secondly, it argued that the approach results in an over-generous retail margin for already established retailers[1434].

10.72 As we have discussed in Section 9, we have decided to adopt a retail-minus methodology. Adopting a retail-minus approach as the primary method, with cost-plus pricing as a cross-check, will address our concerns over the restricted distribution of premium channels, and minimises the risk of artificially depressing content rights revenues. We remain of the view that this potential detriment to rights values is a significant concern, and therefore consider retail-minus pricing to be the most appropriate approach under these circumstances.

10.73 In Section 9 we also recognised that Virgin Media is in a different position to prospective entrants because of its existing premium subscriber base. We explained that this could mean that the wholesale price that would enable Virgin Media to break even might be different and potentially higher than the one that would be required by a prospective entrant. However, we noted that the extent of any difference – if it existed at all – was likely to be limited. Furthermore, an essential principle of any conditions which ensure fair and effective competition is that they do not unduly discriminate. A remedy which excluded cable operators or meant that they faced a higher wholesale price could potentially distort the competitive environment against them in the longer term.

10.74 As discussed in paragraph 10.60 above, we have used Sky's costs as the benchmark for an efficient retailer and adjusted these only in the case of scale, given that it is not feasible to ensure fair and effective competition on the basis of multiple competitors who achieve the same scale as Sky. We discuss this further in paragraphs 10.171 to 10.183 below.

10.75 In summary, taking account of the responses we received to our consultation, we have decided to calculate the relevant wholesale prices using a retail-minus

[1431] Sky response to the Third Pay TV Consultation, Annex 1, paragraph 57.

[1432] Sky response to the Third Pay TV Consultation, Annex 1, paragraph 24.

[1433] Sky response to the Third Pay TV Consultation, Section 10, paragraphs 10.85 and 10.107.

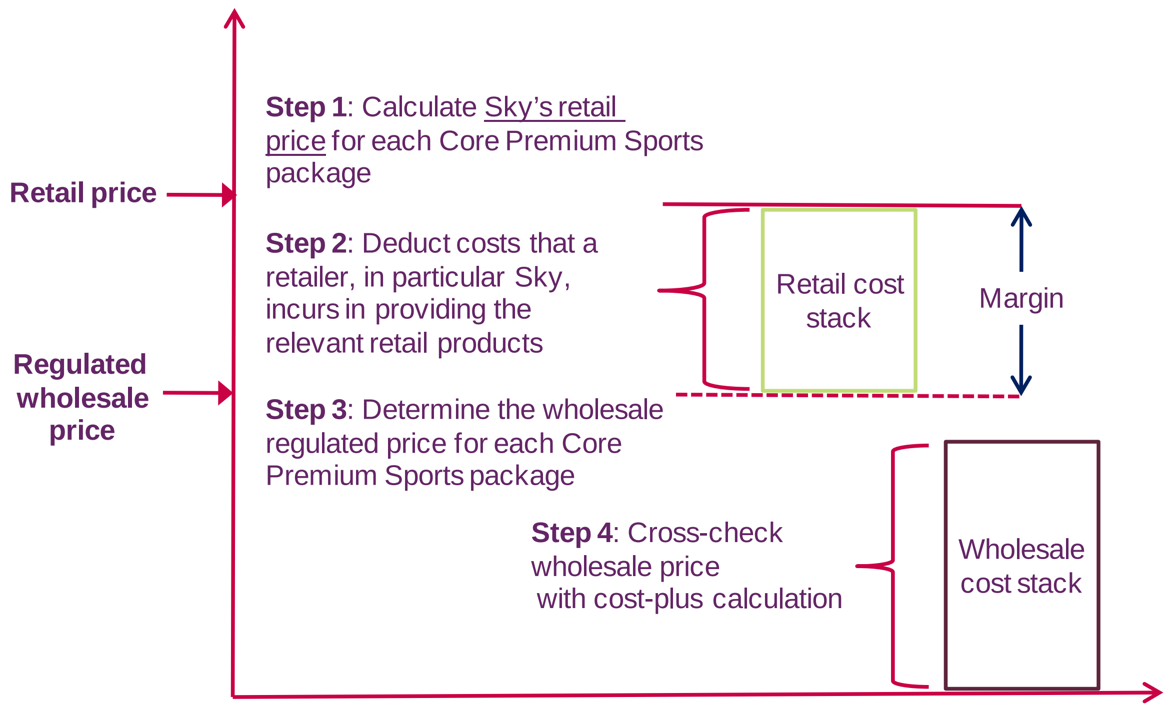
[1434] Premier League's response to the Third Pay TV Consultation, Annex 2, Question 15.

approach, based on a discounted cash flow analysis. For each relevant wholesale product, we have:

- Identified Sky's retail packages which include the Core Premium Sports channels (and no premium movies channels), and their corresponding retail prices, since these are the prices against which a retailer would need to compete.
- Assessed the costs that a retailer, and Sky in particular, incurs in providing the relevant retail packages. These include retailing costs, platform costs and the costs of providing basic channels.
- Determined the margin that should be afforded to new competitors to enable them to compete with Sky by assessing the magnitude of these costs. The wholesale price for the Core Premium Sports wholesale product is then derived by subtracting this margin from the appropriate retail price.

10.76 We have also cross-checked the wholesale prices we have derived using our retail-minus approach with prices derived from a cost-plus calculation. Our cost-plus calculation methodology is set out in paragraphs 10.184 to 10.193 of this Section.

Figure 129 Calculation of wholesale prices based on retail-minus



Which retail packages and prices should determine the starting point?

10.77 As a first step in the retail-minus calculations, we have derived a reference retail price for each of the three Core Premium Sports products (i.e. Sky Sports 1, Sky Sports 2, and Sky Sports 1 and 2). The aim is to ensure that the retailer can compete in the provision of pay TV bundles that include Core Premium Sports products, but is not forced to replicate the additional separate elements in Sky's wider packages. An immediate challenge is the lack of a unique retail price corresponding to a given Core Premium Sports wholesale product, given Sky's broad portfolio of retail offerings. Each Core Premium Sports product is bundled with a number of basic channels and a subscriber can also purchase additional TV services (such as Multiroom or pay-per view programmes) and non-TV services (such as broadband and telephony).

10.78 In addition, due to the presence of discounts, consumers may not pay the headline published price for a given retail package. We have therefore used Sky's published prices adjusted for discounts. We have calculated the average customer discount by assuming that Sky's total discounts as per its management accounts are spread equally across its subscriber base. We have then applied this discount amount to all Sky's retail prices[1435].

10.79 We have also had to consider the 'additional' products that can be bundled with the Core Premium Sports wholesale products we are setting a price for. We have taken into account four different types of additional products which can be bundled with a given Core Premium Sports wholesale product:

- Additional non-TV services (such as broadband and telephony).
- Additional TV services (such as Multiroom).
- Different packages of basic channel mixes.
- Other Core Premium channels.

Additional non-TV services: we have excluded revenues from additional non-TV services

10.80 We discussed in our Third Pay TV Consultation (paragraphs 9.73 to 9.76), that our key objective was to enable other retailers to compete in the provision of pay TV bundles that include Core Premium channels. We therefore proposed to take as our starting point the price of a stand-alone TV product. We did not include in our calculations either the revenues or costs associated with other non-TV services, such as Sky's broadband and telephony products.

10.81 Sky [1436] argued that we should measure affordability of wholesale charges based on realistic models of total costs and revenues, across all lines of business typically carried out together. It stated that this was broadly the method followed by the OFT, which also minimises the need for arbitrary common cost allocations. Similarly, the Premier League[1437] argued that we ignored the scope for retail competition where pay TV services are bundled together with broadband and/or telephony.

10.82 We have concluded that it is appropriate to exclude non-TV related revenues (such as broadband and telephony) from the calculation of the reference retail price. In our view adopting Sky's approach will result in an outcome which would not ensure fair and effective competition as explained below:

- As discussed in Section 9, our primary concern for fair and effective competition is the restricted distribution of Core Premium Sports channels (and not the

[1435] For a more detailed description of our calculation methodology see Annex 7, paragraph 7.119 to 7.120.

[1436] Sky response to the Third Pay TV Consultation, Section 10, paragraph 10.92.

[1437] Premier League response to the Third Pay TV Consultation, Annex 2, Question 21.

availability of broader services including broadband and telephony). We observe in Section 4 (Figure 3, paragraph 4.39) that while triple-play bundles are increasing in importance, a large proportion (**[✂]**%) of Sky's subscribers still take pay TV services on a stand-alone basis, without telecommunications services. Hence, the primary initial focus of setting wholesale prices is to enable potential competitors to compete in the provision of stand-alone pay TV bundles that include the Core Premium Sports wholesale products.

- Under Sky's proposal some common costs would be recovered across additional non-TV services (such as broadband and telephony), reducing the amount of common costs being recovered from the retail of Core Premium Sports products and resulting in higher wholesale prices for these. These higher wholesale prices would require competitors to offer triple play services, rather than just pay TV services, to be able to compete with Sky. We do not consider this approach would be appropriate since it would lock competitors into adopting a similar business plan to Sky across a broad set of products and therefore would be contrary to our objective of encouraging innovation. In addition, competitors would only be able to compete effectively across these wider bundles if Sky sets the incremental price of additional products above their incremental costs.

10.83 We also recognise that our approach could undermine the efficacy of the wholesale must-offer remedy in instances were Sky creates bundles of wider retail services by setting the incremental price of additional products below their incremental costs. In such circumstances, although equally efficient retailers would be able to compete in the provision of pay TV bundles, they would not be able to replicate Sky's wider bundles, for example triple play bundles including broadband and telephony. We have addressed this concern by developing an approach whereby Sky would be required to adjust its regulated wholesale prices further in the event that the incremental prices of some products are set below long run incremental costs. This is discussed in more detail in paragraphs 10.255 to 10.262.

10.84 As discussed above we have excluded revenues associated with additional non-TV services. We have only used Sky's TV-related retailing costs (Annex 7, paragraph 1.43).

Additional TV services: we have included Multiroom revenues and costs

10.85 In our Third Pay TV Consultation (paragraphs 9.77 to 9.78), we proposed to exclude both the revenues and costs associated with certain TV-related services available to Sky's customers for an additional charge. These services included Multiroom, Sky Box Office, and standalone premium channels such as MUTV and Chelsea TV. By excluding these services we assumed that the efficient competitor is not required to offer them. Therefore it would not bear these additional costs, nor would it earn the associated revenues. We also excluded the additional costs and revenues associated with the HD versions of Sky's Core Premium channels, as these were subject to a separate calculation of charges for HD channels.

10.86 In its response, Sky[1438] argued that Multiroom revenues (and costs) should be included on the basis that this service i) is related to pay TV subscription services as it enables customers to view the channels they have already subscribed to on another set-top box in their house, and ii) is permitted by the current cable rate-card.

[1438] Sky response to the Third Pay TV Consultation, Section 10, paragraphs 10.127 to 10.130.

The Three Parties did not explicitly comment on our proposed treatment of Multiroom revenues.

10.87 In summary, on the basis that Multiroom is not a different input (but relates to the right for consumers to view the channels to which they have already subscribed on an additional set-top box), we have decided to include Multiroom revenues in the calculation of the reference retail price (Option 2 below). In relation to other additional TV related service revenues (such as HD), we have continued to exclude these as discussed in our Third Pay TV Consultation.

10.88 Multiroom is a product which is available to Sky customers for £10 a month (price as of 1 January 2010). For this, customers receive the channels they have already subscribed to on one (and only one) additional set-top box in their home[1439]. In arriving at our decision in relation to Multiroom revenues (and costs) we have considered two options:

- **Option 1**: Exclude Multiroom revenues (and costs). This would mean that either a) competitors do not offer Multiroom (Option 1a) or b) they pay Sky an incremental price should they wish to offer it (Option 1b).

- **Option 2**: Include Multiroom revenues (and costs). This approach would be consistent with Sky's arguments that Multiroom is a related pay TV service which is also included in the current cable rate-card.

10.89 In the Third Pay TV Consultation we proposed to adopt **Option 1**, excluding the revenues and costs associated with Multiroom on the basis that a competing retailer is not required to offer this service. However, having given this further consideration, this approach does not necessarily mean that a competing retailer is prohibited from offering this service. Setting a wholesale price excluding Multiroom means that either:

- Option 1a: competitors should not be allowed to offer Multiroom. If they did, this would be inconsistent with the way we have derived wholesale prices. This option would be intrusive on competitors' business models and limit innovation as it would restrict how Core Premium Sports wholesale products are used once they are purchased.

- Option 1b: competitors should pay an incremental price to Sky should they wish to offer Multiroom. This would result in a 'base' wholesale price for the Core Premium Sports channels excluding Multiroom revenues and costs, but an incremental price (derived taking account of these Multiroom revenues and costs) if a competitor wished to offer Multiroom. This option would also add to the complexity of the wholesale must-offer remedy where we would need to calculate this additional incremental wholesale charge. There would also be the added requirement on Sky to keep track of and charge retailers that offer Multiroom which may be impractical and costly to implement for Sky.

10.90 We therefore consider that Option 1 has significant drawbacks. The key observation in support of **Option 2** (including Multiroom revenues and costs) is the fact that Multiroom is not a different wholesale input, in contrast to other additional TV services such as MUTV or Chelsea TV. It is clearly beneficial to consumers for competing retailers to be able to use the same wholesale input to offer differentiated

[1439] www.sky.com/quickbuy/build. In addition, for this fee customers receive access to live TV on Sky Player, again accessing only the channels they are subscribed to (see paragraph 10.332).

retail services, thereby allowing for innovation in retail packaging, rather than for all retailers to be constrained to adopt Sky's pricing structure. If this is to be the case, consistency requires that Sky's Multiroom revenues and costs should be included in the derivation of appropriate wholesale prices, and we have therefore decided to do so. This will enable competing retailers to develop their own retail service enhancements, without paying an additional wholesale charge, subject to them using the same underlying wholesale input.

10.91 For details of our calculation methodology relating to Multiroom, see Annex 7 paragraphs 1.132 to 1.135.

<u>Different packages of basic channels: we have calculated a weighted average retail price across basic channel mixes</u>

10.92 In our Third Pay TV Consultation (paragraphs 9.79 to 9.84), we proposed to calculate a starting retail price for each of the 11 Core Premium wholesale products by taking an average of Sky's retail prices for different basic channel bundles, weighted by the number of Sky's retail customers who take that number of basic channels. This was in part because, at the time, all Sky's Core Premium channels were subject to an enforced buy-though and there were no standalone premium retail packages.

10.93 In its response, the Three Parties argued that the prices resulting from our approach would not support fair and effective competition as these would be skewed to large bundles, whereas competition will focus on smaller bundles. They also argued that Sky would game the regime by altering relative retail prices[1440]. In their view the most appropriate approach would be for Ofcom to undertake a retail-minus calculation for each combination of products with basic mixes, and use the lowest resulting wholesale price. **[✂]**[1441] also agreed with the Three Parties. Virgin Media noted that we should not use standalone premium prices[1442]. In its view, although this product will provide the closest available retail product to the relevant wholesale product, using the standalone retail prices as the relevant reference prices is highly unlikely to deliver wholesale prices which will enable fair and effective competition.

10.94 On the other hand, the Premier League[1443] argued that our approach incentivises retailers to "cherry pick" Sky's most valuable customers. It presented an example of a "large" package and a "light" package where, if calculated separately, a higher wholesale price for the Core Premium channel would be derived from the "light" package. It therefore argued that calculating charges based on the weighted average price (which would be below the price derived on the basis of the "light" package alone) would allow competitors to target those Sky customers that take the "light" package without being as efficient as Sky. In response Sky would be forced to rebalance the prices of its retail packages resulting in a less efficient retail pricing structure than at present.

[1440] The Three Parties' response dated September 2009 to the Third Pay TV Consultation, Section 9, paragraphs 9.10 to 9.19.

[1441] **[✂]** response to the Third Pay TV Consultation, Question 19.

[1442] Virgin Media's response to the Third Pay TV Consultation, Section 7, paragraphs 7.17 to 7.20.

[1443] Premier League's response to Third Pay TV Consultation, Question 19.

10.95 In summary, we have decided to use a weighted average of Sky's retail prices for a given Core Premium Sports product bundled with different numbers of basic channels, as proposed in our Third Pay TV Consultation. This is on the basis that this option is best aligned with our objective of ensuring fair and effective competition, by providing competing retailers with an opportunity to innovate around Sky's Core Premium Sports channels, while not encouraging entry by retailers who are less efficient than Sky.

10.96 In arriving at our decision, we have considered the three options raised in our Third Pay TV Consultation:

- **Option 1:** Use the prices of the standalone Core Premium Sports products. In September 2009 Sky introduced a new set of retail tariffs which eliminated enforced buy-though by introducing prices for pure Core Premium channels with no basic channels bundled (i.e. zero mix product).

- **Option 2:** Calculate a wholesale price for each combination of Core Premium Sports products with basic mixes, and use the lowest resulting wholesale price. This is the approach preferred by the Three Parties.

- **Option 3:** Use a weighted average of Sky's retail prices for a Core Premium Sports product bundled with different numbers of basic channels. This is the approach we proposed in the Third Pay TV Consultation.

10.97 Our own internal analysis has shown that all of the above options result in similar wholesale prices for a given Core Premium Sports product.

10.98 Using **Option 1** would result in the 'closest' retail price for a given Core Premium Sports wholesale product, in the sense that the minimum amount of costs would need to be deducted from it in order to calculate the relevant wholesale price. It therefore has a practical attraction. However, this approach would not result in a representative price as zero mix products are relatively new, are not marketed significantly **[✂]**[1444]. As a result, Option 1 is also susceptible to gaming; Sky could increase the retail price of a zero mix product **[✂]**, whilst having increased the wholesale prices faced by its competitors. On this basis we have discounted adopting Option 1.

10.99 **Option 2** would safeguard competitors against changes in Sky's relative retail prices. It would also ensure that other retailers are able to compete with all of Sky's seven retail price points for each Core Premium Sports packages, standalone and with basic mixes. However, adopting this approach would encourage entry by retailers who are less efficient than Sky by providing them with a wholesale price derived from the one specific bundle which generates the lowest price, rather than reflecting Sky's efficiency across all basic mixes. We regard the retail of basic channels as replicable and other retailers should therefore be able to match Sky's efficiency in this respect. Furthermore, there is relatively little difference between wholesale prices derived for each combination of products with basic mixes. This is because, the cost of an additional basic package is very close to its (ex-VAT) incremental retail price and the two balance each other out when we calculate the relevant wholesale price. For these reasons we have decided that it would be disproportionate to adopt Option 2.

[1444] Sky's response dated 28 October 2009 to Ofcom information request dated 13 October 2009, Question 1.

10.100 **Option 3** would most accurately reflect the effective price for a given Core Premium Sports wholesale product. Given that we regard the retail of basic channels as replicable, we consider adopting Option 3 is sufficient to ensure fair and effective competition, without encouraging inefficient entry.

10.101 Stakeholders have raised some concerns in relation to Option 3 as noted above.

- In response to the Three Parties' arguments, we acknowledge that Option 3 would result in a set of reference retail prices which places greater weight on larger bundles. As explained above, this is because it reflects the packages actually purchased by Sky's customers and therefore most accurately reflects the effective retail price, which is also consistent with the costs we have used in our calculations (which are based on Sky's costs). We also recognise the Three Parties' concern that Sky could game the regime by altering relative retail prices.

- For example, Sky could reduce the price of smaller bundles of Core Premium Sports packages with basic mixes, relative to the larger ones. Given that very few customers take these smaller bundles[1445], this would leave the average retail price of these packages largely unchanged, resulting in the same wholesale price. As a result, the margin between the retail and wholesale prices for smaller bundles of Core Premium Sports product would be reduced, making it difficult for other retailers to compete with Sky's retail prices for these smaller packages[1446].

- However, we believe Sky's incentives to do so are constrained. At the extreme, if Sky were to compete aggressively on smaller packages, these would become better value causing its own customers to trade down from larger packages. This would result in a lower weighted average retail price which would be reflected in lower wholesale prices. Under these circumstances competitors would not be disadvantaged compared to Sky. Furthermore, we consider competing retailers would continue to have the opportunity to bundle other products and services (e.g. basic channels) with Core Premium Sports channels which would enable them to achieve a similar efficiency as Sky.

- In response to the Premier League's argument, the "cherry picking" concern appears to be the flip side of the concern raised by the Three Parties. By deriving a wholesale price on the basis of a weighted average, it is inevitable that the resulting wholesale price will be above the price which would have been derived with respect to some specific retail bundles, and below the price which would have been derived from other specific retail bundles.

- While we acknowledge the Premier League's concern in principle, as indicated above, the magnitude of the effect is small in practice[1447] and we do not believe there is a risk that Sky is unable to recover its costs. Furthermore, the Premier

[1445] For example, at June 2009, **[✂]** of Sky's Sports Pack subscribers took just one basic mix. Sky's response dated 28 October 2009 to Ofcom information request dated 13 October 2009, Question 1.

[1446] In September 2009, Sky adjusted its retail prices, reducing the prices of core premium bundles containing 1-3 basic mixes by £1 compared to bundles containing 4-6 basic mixes.

[1447] For example, for Sky Sports 1&2 the weighted average wholesale price we have calculated is £0.28 lower than the wholesale price we would have derived had we used the price of the 1 mix product as the starting retail price. Similarly, the same weighted average wholesale price is £0.08 higher than the wholesale price we would have derived had we used the price of the 6 mix product as the starting retail price.

League acknowledges that Option 3 is "practical" and does not appear to have an alternative proposal. While in theory it would be possible to set different wholesale prices for the same Core Premium Sports product depending on the number of basic channels it is bundled with (e.g. setting six different wholesale prices for Sky Sports 1, depending on how many basic mixes it is bundled with in a retail offering), we consider such an approach to be unworkable in practice.

10.102 For these reasons we have decided to adopt Option 3. For details of our calculation methodology see Annex 7.

Other Core Premium channels: we have derived prices from retail packages which include the relevant Core Premium Sports product and no other Core Premium channels

10.103 In our Third Pay TV Consultation (paragraphs 9.85 to 9.90), we proposed, for each Core Premium wholesale product, to calculate a single price by identifying the retail packages which included this Core Premium wholesale product, and no other Core Premium channels – we referred to this approach as taking the 'closest retail product'. For example, our proposal would derive the appropriate retail price for Sky Sports 1 based on the weighted average of different retail prices for Sky Sports 1 bundled with different basic mixes.

10.104 Sky[1448] disagreed with our product-by-product analysis which it claimed is bound to result in "erroneous results". In its view retailers plan their businesses on the basis of providing a wide range of services (both pay TV and non pay TV related) and the majority of costs are likely to be common between these services.

10.105 In their responses, the Three Parties[1449] and Virgin Media[1450] argued that we should adjust our methodology to establish what they regarded as a more appropriate reference retail price. They proposed that we apply retail-minus to all larger bundles containing a given Core Premium product as well as other Core Premium channels, and take the lowest price as the regulated price. For example, this would imply that the regulated wholesale price for Sky Sports 2 could be determined with reference to the larger retail bundles containing Sky Sports 1&2 (with the costs of Sky Sports 1 deducted) rather than with reference only to the retail bundles including Sky Sports 2 and no other Core Premium channels. The Three Parties also argued that we must take into account Picnic retail prices on DTT in determining the reference retail price. In their view Picnic will result in increased scope for Sky to prevent competition in the retailing of premium Pay TV channels[1451].

10.106 In summary, we have maintained the approach we proposed in the Third Pay TV Consultation and have decided to derive wholesale prices for Core Premium Sports wholesale products with reference to the closest retail product – retail packages including the relevant Core Premium Sports wholesale product and no other Core Premium channels. We set out our reasoning for this decision below.

[1448] Sky response to the Third Pay TV Consultation, Section 10, paragraphs 10.90-91.

[1449] The Three Parties' response to the Third Pay TV Consultation, Section 11, paragraphs 11.16-19.

[1450] Virgin Media's response to the Third Pay TV Consultation, Section 7, paragraphs 7.24-27.

[1451] The Three Parties' response to the Third Pay TV Consultation, Section 9, paragraphs 16.2-3.

10.107 This approach is worth contrasting with our position on basic channels included in the retail bundle. As explained in paragraphs 10.100 above, we consider the retail of basic channels to be replicable, and therefore do not believe that it is necessary for regulation to facilitate other retailers replicating Sky's basic bundles precisely, at exactly the same price point, as opposed to bundling alternative basic content or other services in order to create differentiated retail products. Therefore, in the case of basic channels, we have determined wholesale prices by taking a weighted average retail price across different basic mixes. In contrast, there is no credible competitive alternative to Sky's Core Premium channels, and hence taking a weighted average across different Sky Core Premium bundles would not ensure fair and effective competition. We therefore consider that our proposal in the Third Pay TV Consultation to take the closest retail product for each Core Premium Sports wholesale product continues to be appropriate.

10.108 As described in Section 9, we have decided that Core Premium Movies channels should not be subject to the wholesale must-offer remedy. This raises the question whether the wholesale price for a given Core Premium Sports wholesale product should be determined by taking the closest retail product, or by also taking account of prices for retail packages including Sky Movies channels. For example, should the wholesale price of Sky Sports 1 be derived from retail packages containing Sky Sports 1 (and basic channels) but no other Core Premium channels, or by also considering retail packages of Sky Sports 1 and Single Movies, and retail packages of Sky Sports 1 and Sky Dual Movies?

10.109 Unlike basic channels, we do not believe there are currently credible direct competitive alternatives to Sky's Core Premium Movies channels, and therefore we do not expect other retailers to compete directly with Sky by offering retail packages including both Core Premium Sports and Movies channels in the short term[1452]. For the purposes of determining appropriate prices available under the wholesale must-offer remedy, we therefore consider it appropriate to focus on retail packages for Core Premium Sports wholesale products consistent with the approach we proposed in the Third Pay TV Consultation (i.e. to focus on the closest retail product).

10.110 Nevertheless, we recognise that there is the potential for Sky to offer retail packages containing both Core Premium Sports and Movies channels at retail prices which are intended to make the packages which include only Core Premium Sports channels less appealing to consumers. Given that it is these latter packages which determine the wholesale prices for Core Premium Sports wholesale products, there is a risk to fair and effective competition if Sky was to reduce the price differential significantly between its sports and movies retail packages and its sports-only packages. For each Core Premium Sports wholesale product, in principle, we believe that the incremental price of adding Core Premium Movies channels in aggregate to a retail package containing Sky Sports channels should not be below the incremental costs of supplying the Core Premium Movies channels.

10.111 If the pricing structure failed this test – i.e. if Sky charged a particularly low price for its Core Premium Movies channels – then it would be able to charge a retail price for bundles including Core Premium Sports channels that was unmatchable by its rivals, even though those rivals had access to the Core Premium Sports channels at the wholesale prices we have set. This is consistent with our approach to dealing with

[1452] As explained in Section 9, rather than addressing yesterday's problem by imposing a wholesale must-offer remedy on linear movies channels, we have proposed to make a market investigation reference to the CC to consider competition in SVoD services.

wider retail bundles which include non-TV services set out in paragraphs 10.80 to 10.84. We have therefore decided to check that for each of the Core Premium Sports wholesale products, the incremental price of adding Sky Movies channels is not below the incremental cost (see paragraph 10.220). Furthermore, looking forward, we would be concerned if the incremental price of the Sky Movies channels fell below the incremental cost of supply, and will keep this position under review.

10.112 Sky raised the issue of our approach to deriving wholesale prices on a "product-by-product" basis, rather than adopting an aggregated approach across all lines of business, more closely following the OFT's methodology in its 2002 margin squeeze case[1453]. We have decided that it would not be appropriate to adopt a more aggregated approach, for example, by specifying wholesale pricing requirements that would apply in aggregate to Sky Sports 1, Sky Sports 2, and Sky Sports 1 and 2, rather than to each of the three wholesale products individually. While doing so would have the benefit of providing Sky with greater pricing flexibility at the wholesale level, allowing it to decouple its wholesale pricing structure from its retail pricing structure, we do not consider that this approach would ensure fair and effective competition. This is because a more aggregated approach would allow Sky to raise the wholesale price of a certain Core Premium Sports product if it reduced the wholesale price of another Core Premium Sports product to compensate. In particular, if would enable Sky to raise the wholesale price of Sky Sports 1 and reduce the price of Sky Sports 2 when the latter is substantially less attractive than the former, particularly in view of its limited Premier League coverage, and as reflected in its lower audiences for key cricket and tennis events (see Section 5).

10.113 Finally, we have considered the more specific concern highlighted by the Three Parties in relation to Sky Sports 2. They have suggested that the price for Sky Sports 2 should be determined by analysing the retail packages for larger bundles which include Sky Sports 1&2 and deducting the costs associated with Sky Sports 1. As discussed in paragraph 9.171 of the Third Pay TV Consultation, we acknowledge that the retail price for packages including Sky Sports 2 appear particularly high relative to costs and may suggest that the retail price reflects pricing simplicity (it is set equal to the price for Sky Sports 1 retail packages) rather than purely reflecting cost or value. However, our competition concerns are focussed more on Sky Sports 1 and Sky Sports 1&2 and we have not been provided with evidence that prospective competitors have plans to launch packages consisting of Sky Sports 2, without Sky Sports 1 in the short term. Furthermore, implementing specific adjustments of this kind and hence deviating from Sky's relative pricing structure in relation to Sky Sports 2 could alter Sky's incentives with respect to its retail pricing structure and therefore have unintended consequences. It would also be a more intrusive approach. We have therefore decided that it would not be appropriate to make a further adjustment to our calculation methodology for Sky Sports 2.

10.114 Finally, our decision is to calculate prices for the Core Premium Sports wholesale products based on Sky's satellite retail prices. Sky's Picnic offering does not yet exist and it is unclear at this stage what form a pay TV proposition from Sky on DTT would take, if any. It is therefore impractical to take account of uncertain offerings that may be brought to market in the future and whose take-up is therefore unknown.

10.115 For details of our calculation methodology see Annex 7.

[1453] Sky's response to the Third Pay TV Consultation, Section 10, paragraphs 10.89 to 10.92.

What are the relevant costs for a retailer that should be deducted?

10.116 In the above paragraphs we have identified the appropriate reference retail prices for each Core Premium Sports wholesale product. We now need to identify the corresponding costs that should be deducted in order to derive the retail-minus wholesale price.

10.117 As we have discussed in paragraph 10.60 above, our analysis is focussed on Sky's costs as the benchmark for an efficient retailer. When identifying the relevant costs to deduct we have taken a number of questions into consideration:

- How should we treat incremental and common costs in our calculations?
- Which costs should we take into account and how should we allocate these to the retailing of different Core Premium channels?
- Should we make any adjustments to reflect the higher costs that competing retailers may face?

10.118 In summary, we have decided on the following approach:

- Consistent with the proposal in our Third Pay TV Consultation, we have decided it is appropriate to deduct both incremental costs and a proportion of common costs from our reference retail prices.
- We have developed a detailed cost allocation methodology which we have used to allocate common costs between Sky's retail, wholesale and platform functions.
- We have decided that it is appropriate to focus on Sky's costs as the benchmark for an efficient retailer. In the context of ensuring fair and effective competition, the only adjustment we have applied is in the case of scale, since even a single competitor at Sky's scale is unachievable given the addressable number of pay TV subscribers. In contrast to our proposal in the Third Pay TV Consultation, we have decided not to make any further adjustments for DTT transmission costs. While we recognise that, in practice, competitors may adopt different business plans to Sky, and hence incur different types of costs on entry, we consider that Sky remains the appropriate benchmark for an efficient retailer.

10.119 We discuss the above considerations in more detail below.

We have deducted incremental costs and a portion of common costs

10.120 In the Third Pay TV Consultation (paragraphs 9.94 to 9.96), we proposed to deduct both the incremental costs associated with retailing and basic content from our reference retail price, as well as a proportion of common costs. Effectively, we developed a retail-minus methodology on a Fully Allocated Cost (FAC) basis, with fixed and common costs allocated across Sky's whole business.

10.121 In its response, Sky argued that we should measure affordability of wholesale charges based on models of all lines of business typically carried out together, "broadly the method followed by the OFT". In its view, isolating the retail business of premium subscriptions (a) is wholly abstract, (b) requires arbitrary common cost allocations, and (c) applies the unjustified assumption of the same return for all services. It argued that choosing one common cost allocation method over another is arbitrary: conclusions are wholly the product of these assumptions. Sky did not challenge individual allocations but reserved its right to do so in the future[1454]. The Premier League[1455] argued that the results were highly sensitive to common cost allocation and that Ofcom's approach was ad hoc and lacked economic rationale. Other respondents did not comment on our common cost allocation methodology.

10.122 While we recognise the arguments that have been put to us, we have decided to deduct all incremental costs associated with retailing and basic content, as well as a proportion of common costs, given our objective of ensuring fair and effective competition where competing retailers are likely to provide additional services to Core Premium Sports packages. We explain the approach in the following paragraphs.

10.123 When assessing the appropriate methodology for cost allocation we have considered three options:

- **Option 1**: Deduct only the incremental costs.
- **Option 2**: Deduct incremental costs associated with retailing and <u>all</u> of the common costs.
- **Option 3**: Deduct incremental costs associated with retailing and a <u>proportion</u> of the common costs.

10.124 **Option 1** would be broadly equivalent to implementing the Efficient Component Pricing Rule (ECPR[1456]) which aims to ensure (under some relatively strict assumptions) that a vertically integrated wholesaler/retailer is indifferent between supplying its own retail arm and a competing retailer. Under this approach, if a large proportion of retailing costs were common (for example common across retail and wholesale businesses) then we would only make a relatively small deduction for retailing costs. However, adopting the ECPR approach would mean that a competing retailer paying the resulting wholesale price would only be able to recover a small proportion of its retailing costs if it were to match Sky's retail prices, making it unviable unless it recovered all its common costs from other lines of business. We do not believe that this approach would meet our objective of ensuring fair and effective competition. Even though our definition of a hypothetical entrant assumes that it provides other products and services in addition to the Core Premium Sports packages, it may not be viable for it to recover all of its common costs from its other services.

10.125 **Option 2** would enable retail competitors selling only Core Premium Sports packages to match Sky's retail prices whilst recovering their full standalone costs of retailing. However, we do not believe this approach would lead to an efficient outcome. It would place a more significant cost burden on Sky. Existing and prospective competitors are likely to provide other products and services in addition to Core Premium Sports products (rather than acting as pure resellers) and we would expect them to be able to recover a proportion of their common costs from the sale of those other products and services.

[1454] Sky's response to the Third Pay TV Consultation, Section 10, paragraphs 10.90 to 10.95.

[1455] Premier League response to the Third Pay TV Consultation, Annex 2, Question 20.

[1456] See William J. Baumol, "Some Subtle Issues in Railroad Deregulation" (1979).

10.126 **Option 3** is the approach we proposed in the Third Pay TV Consultation given that neither of the previous two options satisfies the objective of ensuring fair and effective competition without promoting inefficient entry. In the presence of common costs, the average level of charges needs to be sufficient to allow competitors to recover all of their incremental costs and make a reasonable contribution towards their common costs. This option therefore encourages entry whereas adopting Option 1 (an incremental cost approach) in these circumstances would not allow that to happen. This will also increase the incentives competitors have to invest and innovate, as they will be able to recover their common costs over a larger number of services (and consumers) and therefore benefit from the economies of scope and scale afforded to them. These arguments point towards a methodology which takes into account all of the incremental costs and a portion of the common costs incurred in retailing Core Premium Sports packages. It is worth noting that the OFT also allowed for an allocation of common costs to Sky's retail function (where costs were common to Sky's retail and wholesale functions) in its 2002 margin squeeze case.

10.127 For these reasons we have decided to deduct all incremental costs associated with retailing and basic content, as well as a proportion of common costs. We note that Sky does not appear to disagree with the approach of allocating a proportion of common costs. The key question remaining is therefore not whether common costs should be taken into account, but the amount to be recovered from Core Premium Sports packages.

10.128 We agree with Sky that there is no uniquely correct methodology for allocating common costs and hence there is a degree of judgement involved. When allocating common costs across Sky's different business we have applied the most appropriate 'drivers'. For example, we have allocated Sky's pay TV related common costs between UK and the Republic of Ireland based on Sky's subscriber numbers in each of the two countries. This is a reasonable approach, on the basis that, for the same package (and allowing for short-term changes to exchange rates) Sky will be charging similar prices and is likely to face similar incremental costs.

10.129 We discuss our methodology in relation to common cost allocation in the paragraphs below.

<u>We have identified the costs that should be allocated to the different Core Premium Sports packages</u>

10.130 We have discussed above our decision to deduct both the incremental costs associated with retailing and basic content from our reference retail price, as well as a proportion of common costs. In terms of our detailed calculation methodology, we have then considered three further questions:

- <u>What</u> categories of costs do we need to allocate?
- To <u>which</u> parts of Sky's business should these costs be allocated?
- <u>How</u> should we allocate the relevant costs to different parts of Sky's business?

10.131 In summary, broadly consistent with our proposals in the Third Pay TV Consultation, we have decided to:

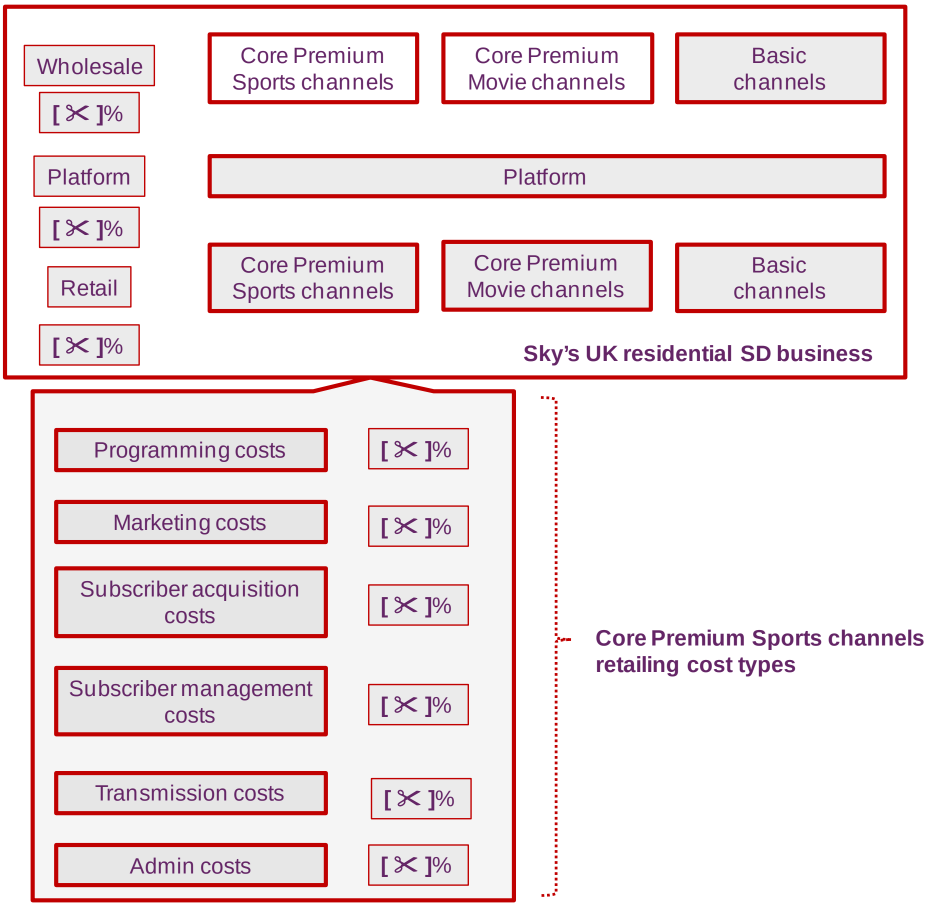
- Allocate the following main categories of retailing costs: programming costs, marketing costs, subscriber management costs, subscriber acquisition costs, transmission costs and administration costs.

- Allocate common costs to the various parts of Sky's business, which include:
  - UK and Ireland.
  - Residential and commercial.
  - Core TV and non-core TV services (e.g. Multiroom, pay-per-view).
  - Wholesale, retail and platform.
  - Basic and premium packages.
  - Premium sports and premium movies.
  - SD and HD services.
- Allocate costs based on three key measures: subscriber numbers, revenues and 'subscriber product units'[1457].

10.132 We have used Sky's costs, as stated in its budgeted management accounts for 2009/10, as our starting point. Sky's management accounts relate to Sky's business as a whole. In the retail-minus methodology our focus is to determine Sky's retailing costs in producing the SD version of the Core Premium Sports products in relation to UK residential consumers only. Firstly, we have identified the relevant pay TV retailing costs and secondly, we have apportioned these costs to Sky's different functions as well as other sub-divisions (see the Figure below).

[1457] For a detailed description of the "subscriber product unit" and how this is applied in the context of the retail-minus methodology see Annex 7.

Figure 130 Allocation of common costs across Sky's various businesses[1458]



10.133 For the retail-minus calculation, the costs that we have identified as relevant are the incremental costs and a portion of common costs that relate to the retailing of Core Premium Sports packages, basic packages and platform (i.e. the items highlighted in the Figure above). Although we are not setting a price for Core Premium Movies products, it is still appropriate to allocate common costs to these in deriving prices for Core Premium Sports products.

10.134 Consistent with the Third Pay TV Consultation (paragraph 9.106) we have also deducted the costs of Sky Sports 3 and Sky Sports 4 when deriving the wholesale price for Sky Sports 1 & 2. This is because, although Sky Sports 3 and Sky Sports 4 are not included in the remedy, they are included as bonus channels in Sky's retail packages including Sky Sports 1 & 2 (we discuss this adjustment in more detail in Annex 7).

10.135 The methodology that we have followed in relation to common cost allocation is broadly the same as the one set out in our Third Pay TV Consultation (paragraphs 9.91 to 9.107). The relevant cost categories, the methodology we have followed to allocate common costs across Sky's different businesses and our consideration of stakeholder responses are discussed in detail in Annex 7.

[1458] In Sky's management accounts the subscriber acquisition costs (SAC) are not identified as a separate cost category. These costs are drawn from the marketing and subscriber management cost categories.

How should the margin and resulting wholesale price be calculated?

10.136 Having established the reference retail prices and the retailing costs to deduct i.e. the margin, the next step is to determine the resulting wholesale prices for the Core Premium Sports packages. As discussed in paragraphs 10.61 to 10.65, in the interests of not encouraging entry which is inefficient but rather encouraging sustainable competition over the long-term, we have decided to adopt an approach which assesses the business case for a hypothetical entrant over a period of time.

10.137 A discounted cashflow (DCF) analysis is a standard approach to examining a business case over a period of time. In our Third Pay TV Consultation (paragraphs 9.108 to 9.112), we proposed to use a DCF analysis as a way of reflecting the likely business model of a retailer taking Sky's wholesale channels. In particular, in calculating wholesale charges, we proposed to take the hypothetical entrant's expected per-subscriber cashflows, including a terminal value, discounted using a rate set equal to an estimate of Sky's cost of capital. The wholesale charge for each Core Premium Sports wholesale product was then set such that the additional costs from wholesale charges take the net present value (NPV) of the entrant's cashflows to zero. That is, the NPV of retail revenues, retail costs and wholesale charges is sufficient for the hypothetical entrant to break even over its lifetime.

10.138 All of the stakeholders' responses agreed with our use of the DCF methodology to calculate the regulated wholesale prices. The Premier League[1459] argued that we have set "the level of regulated wholesale prices that would enable an hypothetical entrant to make a return discounted over 10 years equal to its estimated cost of capital" and that no rationale was provided for the ten year period. In its view, BT and Virgin Media already have established brands, which would not require 10 years to create value. In relation to the duration of the modelled period, BT argued for a shorter time period and cited a three to five-year planning horizon[1460].

10.139 Taking account of the responses we received, we have maintained the approach we proposed in our Third Pay TV Consultation; for our retail-minus calculations we have decided to model cashflows over a period of ten years, at the end of which we have included a terminal value reflecting the ongoing value of the business.

10.140 In response to the concerns raised over the duration of the modelled period, the key observation is that our analysis determines wholesale charges so that the NPV of retail revenues, retail costs and wholesale charges is sufficient for the competing retailer to break even over its lifetime. We consider that taking account of the entire lifetime of a hypothetical entrant's businesses is appropriate because our aim is to derive prices which enable effective competition from efficient operators that are prepared to make a substantial investment in pay TV, rather than to enable weak entrants to earn short term profits at Sky's expense. We would also expect prospective retailers to innovate, providing additional sources of value not captured in these calculations.

10.141 In the context of a DCF analysis, assessing a business over its lifetime means including a terminal value in the calculation. The terminal value reflects the expectation that the retail business of the efficient hypothetical entrant continues to retain value into the future, after the explicitly modelled period, as we would expect it

[1459] Premier League response to the Third Pay TV Consultation, Annex 2, Question 20.

[1460] BT's response to the Third Pay TV Consultation, Section 3, paragraphs 3.26 and 3.28.

to have established a brand and subscriber base, through which it can earn positive cashflows in future periods.

10.142 We have calculated a terminal value on the basis of forecasted future cashflows which assumes a steady state following the final year of the explicitly modelled period. Given this terminal value calculation, it is important to note that the duration of the explicit modelled period does not in itself change the NPV analysis, and hence the wholesale prices that are derived[1461]. In response to the point raised by the Premier League, the number of explicitly modelled years should at least reflect the length of time it takes for the business to reach steady state. We consider it appropriate to model a period of ten years, reflecting strong growth in subscriber numbers over the first five years of the analysis, followed by a shallow growth between years five and nine, after which a steady state is assumed for the purposes of the terminal value calculation.

10.143 A DCF approach also requires us to take a view of how retail prices and retail costs would evolve over time with respect to inflation. Consistent with our Third Pay TV Consultation, we have assumed that these remain constant in real terms. For simplicity, in calculating year one wholesale prices, we have assumed that retail margins are constant in real terms.

10.144 Finally, in order to implement the DCF approach, we have had to consider:

- The appropriate discount rate;
- The allowance for transmission costs; and
- The scale of the competing retailer.

The appropriate discount rate: we have used Sky's WACC

10.145 Within the context of a DCF analysis, we need to discount future cashflows to compensate the hypothetical entrant for incurring risks in entering the pay TV market. This raises the question as to the appropriate discount rate to use.

10.146 In our Third Pay TV Consultation (paragraphs 9.115 to 9.123) we proposed to use Sky's cost of capital. We estimated Sky's Weighted Average Cost of Capital (WACC) at 10.3%, derived using the capital asset pricing model (CAPM) approach.

10.147 In its response, Sky[1462] argued that we should apply a disaggregated WACC. It stated that the WACC of its wholesale business may be higher than that of its retail business (and that of its wholesale premium business higher than its wholesale basic business), due to the high level of fixed costs. The Premier League[1463] commented that Sky's combined cost of capital may not be relevant for a pure retailer which is likely to face different risks to a vertically integrated provider. On the other hand, the

[1461] A shorter period before the terminal value would simply mean that the relevant cashflows are less explicitly modelled, resulting in more of the entrant's business value being included in the terminal value.

[1462] Sky response to the Third Pay TV Consultation, Section 7, footnote 16.

[1463] Premier League response to the Third Pay TV Consultation, Question 20 and Annex 2.

Three Parties[1464], although supportive of a separate cost of capital for the pay TV business, argued that the cost of capital assumption would need to be increased to reflect the scale and risk profile of a new entrant. They estimated that a more appropriate WACC would be 15%.

10.148 In summary, we have decided to use Sky's WACC as the appropriate discount rate which we have estimated to be 10.3%. In coming to our decision we have taken into account the following considerations which we discuss further below:

- Should the discount rate be based on Sky's WACC?
- Should we apply a different discount rate for a retail business as opposed to a wholesale business?

10.149 In response to the Three Parties, our objective is to enable sustainable, long term entry by new retailers who are as efficient as Sky. As discussed, we have used Sky's costs as the benchmark for an efficient competitor; we do not believe it is appropriate to impose a greater regulatory burden on Sky by encouraging entry by competitors less efficient than Sky if this is not necessary to ensure fair and effective competition. The potential new retailers of Core Premium Sports packages are likely to be significant or existing non-TV retail operators, providing a range of services to existing customers. We have not been persuaded that such competitors would necessarily face systematically different risks from Sky, assuming access to Sky's content. We have therefore used Sky's cost of capital and have not made an adjustment for a potentially different risk profile.

10.150 In response to Sky's and the Premier League's submissions that it is more appropriate to apply a disaggregated cost of capital which reflects a retail business rather than Sky's business as a whole, the key question is whether Sky's retail and wholesale businesses have materially different betas (a key input parameter in the CAPM[1465]). For them to do so they would need to earn returns that were differently correlated with the rest of the market, and by implication not correlated with one another. We maintain our view set out in paragraph 9.118 of the Third Pay TV Consultation that Sky's retail and wholesale businesses are strongly correlated.

10.151 In particular, Sky argued that we should apply a higher cost of capital to its wholesale business than its retail business, due to the presence of a high level of fixed costs in the former. Sky's fixed costs in its premium sports wholesale business correspond to programming costs which are fees payable to sporting bodies for content that Sky includes in its Premium Sports channels. However, programming costs are not fixed over the long term: these are subject to contracts which are typically three to four years in duration and renewable at the end of their term (i.e. Sky has the option not to renew a contract should it choose to do so). We therefore do not consider that this is a compelling basis to justify a higher cost of capital for Sky's wholesale business.

10.152 Our approach is also consistent with the one we set out in our Cost of Capital Statement[1466]. In this statement we set out the conditions that we believed would

[1464] Three Parties' response dated September 2009 to the Third Pay TV Consultation, Section 9, paragraph 9.24 and 9.49 to 9.68.

[1465] A 'beta' is a firm-specific market risk premium.

[1466] Ofcom's overall approach to calculating the cost of capital was set out in the Cost of Capital Statement, "Ofcom's approach to risk in the assessment of the cost of capital", August 2005, http://www.ofcom.org.uk/consult/condocs/cost_capital2/statement/

need to be fulfilled in order for us to disaggregate a firm's cost of capital into different values for different activities. These conditions were that there would need to be:

- Strong reasons for thinking that the systematic risk faced by the project was significantly different from that faced by the overall company.

- Available evidence which could be used to assess variations in risk, such as:

  - The existence of, and data on, benchmark firms that are close to "pure play" comparators in terms of risk characteristics.

  - Other quantitative analysis that could be performed, such as quantified risk assessments.

  - Disaggregated financial data.

- Materiality, i.e. identifying variations in risk, and setting an adjusted rate of return, would be likely to bring about significant gains for consumers.

10.153 In relation to Sky's retail and wholesale activities, none of these conditions appears to be satisfied. We do not have sufficient quality of data in order to be able to disaggregate Sky's cost of capital for its retail and wholesale businesses, and it is far from clear that to adjust the margin available to competing retailers by doing so would create significant gains to consumers.

10.154 Based on our analysis above, we have decided to use Sky's cost of capital and not to disaggregate this between its wholesale and retail businesses. This is consistent with our proposals in the Third Pay TV Consultation.

10.155 For more details of our calculation see Annex 3, Appendix 1.

Treatment of returns at Sky's scale

10.156 As we have discussed above, within the context of a DCF analysis, discounting future per subscriber cashflows effectively incorporates a return for competitors as compensation for incurring risks in entering the pay TV market. We have set this return at Sky's WACC of 10.3%.

10.157 In addition to considering a hypothetical competitor to Sky, we have also calculated wholesale prices mirroring Sky's business at Sky's scale (see Figure 132). As discussed in our Third Pay TV Consultation (paragraphs 9.120 to 9.123), the theoretically correct approach is to consider return on investment (ROI), by setting the NPV to zero at the relevant discount rate. This is the approach we have adopted. However, if we were unable accurately to reflect a return on investment, a fallback might be to use a return on turnover (ROT) approach. In the OFT's margin squeeze test based on Sky's costs and Sky's scale, the OFT decided that it was very difficult to estimate and allocate the asset base with any precision, so adopted a ROT approach as a proxy. The figure it used for ROT in Sky's retail business was 1.5% on the basis that 1.5% was a "conservative assumption of the minimum that [Sky retail]

We implemented the same approach when updating BT's cost of capital in 2009.

http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/

might be expected to earn"[1467]. However, the OFT's test was one which the OFT judged suitable in the context of assessing whether Sky's behaviour had been illegal in the past. This is a different objective from the one which is under our consideration, i.e. that of determining appropriate forward looking wholesale prices to enable innovation and inter-platform competition.

10.158 Sky has told us that it cross-checks its wholesale prices so as to comply with a margin squeeze test applying the OFT's methodology from its Competition Act investigation in 2002, which assumed a return on turnover in Sky's retail business of 1.5%[1468]. Within our analysis, we have calculated the prices that would result from discounting future cashflows at the rate required to replicate such returns. These prices are therefore an approximation to the OFT's approach, and hence also an approximation of the maximum wholesale prices Sky could charge while remaining compliant with the margin squeeze test. In our analysis we have also incorporated Sky's opening asset base in a way which was consistent with Oxera's analysis, valuing Sky's subscriber base using current replacement cost. We stress that this is a cross-check we have performed; it is not the basis we have used for deriving wholesale prices available under the wholesale must-offer remedy.

10.159 For a detailed discussion of our methodology, see Annex 7, paragraphs 1.181 to 1.183.

Allowance for transmission costs: we have used Sky's transmission costs

10.160 In our Third Pay TV Consultation (paragraphs 9.130 to 9.137), we discussed the different distribution technologies which can be used to deliver pay TV services to the home which include satellite, cable, DTT and IPTV. We then went on to derive wholesale prices based on the costs of satellite and DTT, the former on the basis that it represents Sky's costs and hence the benchmark for retailers as efficient as Sky and the latter on the basis that it provides the most realistic opportunity for entry. Based on our assessment that new entry was most likely to be on DTT in the short to medium term, we proposed to base our wholesale prices on an efficient competitor using DTT transmission. This reflected our view that, in order to ensure fair and effective competition, the wholesale must-offer remedy needed to facilitate innovation and inter-platform competition.

10.161 The Three Parties[1469] agreed with our approach of considering wholesale prices for a DTT retailer. **[✂]**[1470] commented that our approach was not technologically neutral, but a view from Ofcom as to the likely winner. BT argued that the new entrant's transmission costs on DTT would be **[✂]** higher than those predicted by Ofcom[1471]. Sky[1472] noted that Ofcom's assumption did not reflect the outcome of a competitive

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[1467] BSkyB Investigation, Competition Act 1998 decision CA98/2012002, Case CP 01916-00, paragraph 413.

[1468] Third Pay TV Consultation, Section 9, paragraph 9.122.

[1469] Three Parties' response dated September 2009 to the Third Pay TV Consultation, Section 9, paragraph 9.26.

[1470] **[✂]** response to the Third Pay TV Consultation, Question 21.

[1471] BT response to the Third Pay TV Consultation, Section 3, paragraph 3.12.

[1472] Sky response to the Third Pay TV Consultation, Section 10, paragraphs 10.151-155.

market and that new entry would be inefficient and uneconomic. It also claimed that our view is that we do not see IPTV as a credible alternative to existing distribution technologies and that this is likely to stay the case until its cost base reduces[1473]. Furthermore Professor Cave on behalf of Sky[1474] argued that designating a DTT based competitor could give rise to spill over effects by, for example, affecting IPTV's prospects in the UK in the future. In the Premier League's[1475] view, using DTT costs resulted in a margin that was far too generous, as alternative retailers with lower costs than a DTT provider will be granted a subsidy which could distort competition.

10.162 Having considered responses to our consultation, we have decided to use Sky's satellite transmission costs in our analysis, rather than making an adjustment for DTT transmission costs as we proposed.

10.163 When coming to our decision, we have considered the following two options:

- **Option 1**: Use DTT costs when calculating the allowance for transmission costs.
- **Option 2**: Use Sky's satellite costs when calculating the allowance for transmission costs.

10.164 **Option 1** was the option we proposed in our Third Pay TV Consultation. The main advantage of this option is that it would enable inter-platform competition by ensuring a sufficient margin for competing retailers using the most likely distribution technology in the short to medium term: DTT. A key difference between satellite and DTT is the cost of transmission, which is higher in the latter case.

10.165 We have given further consideration to the costs incurred by retailers using a DTT platform which may differ materially from those using a satellite platform. While there is the potential for many differences – for example, the Three Parties have stated that set-top box subsides are likely to be lower for a DTT retailer than Sky's satellite retail business[1476] – we consider the majority of these are primarily a reflection of a retailer's business plan and assessment of consumer preferences rather than a difference necessitated by the use of a different distribution technology. We have identified two differences for a retailer using a DTT platform compared to Sky's satellite costs which we consider to be directly related to the technology: (i) higher costs of DTT transmission compared with satellite transponder capacity (as identified in the Third Pay TV Consultation) and (ii) lower SAC in the absence of satellite dish installation, given that the vast majority of homes have suitable terrestrial aerials. As a result, when using DTT costs as the costs of transmission, we have now also reduced Sky's SAC in the retail cost stack to reflect the absence of satellite installation subsidies. This means that under Option 1, although a larger allowance is given for the costs of transmission in the retail cost stack, this is counterbalanced by a lower level of SAC.

10.166 **Option 2** on the other hand is more consistent with ensuring that competitors are as efficient as Sky. Our objective is to ensure fair and effective competition, including

[1473] Sky response to the Third Pay TV Consultation, Section 8, paragraph 8.20.

[1474] Sky response to the Third Pay TV Consultation, Annex 1, paragraph 30.

[1475] Premier League response to the Third Pay TV Consultation, Question 21.

[1476] Three Parties' response to the Third Pay TV Consultation, Section 9, paragraph 9.43.

inter-platform competition and the promotion of innovation. However, it would only be proportionate to impose a remedy which promotes entry by less efficient retailers (using other distribution technologies such as DTT) if there is compelling evidence that such retail competitors cannot be expected to achieve a similar efficiency benchmark. As discussed in the paragraph above, we believe that DTT-based retailers have the opportunity to reduce other costs of retailing to compensate for higher transmission costs. Furthermore, adopting an Option 2 approach which reflects Sky's own costs addresses Sky's and the Premier League's concerns about risk to distortion of competition.

10.167 We recognise that DTT presents an opportunity for competing retailers in the short to medium term and we are concerned to allow potential competitors to take advantage of this opportunity. The effectiveness of the wholesale must-offer remedy would be questionable if it was clear that it did not enable retailers using DTT platforms to compete. We have therefore cross-checked that implementing Option 2 would still enable entry by competing retailers using non-Sky platforms, specifically DTT platforms. As described in paragraphs 10.215 to 10.216, our analysis shows that the wholesale prices we have derived for each of the Core Premium Sports products are very similar whether DTT or satellite costs are used in the retail cost stack. When undertaking this cross-check, we have also ensured that we have assumed a reasonable level of DTT transmission costs.

10.168 As for IPTV, our comment on its effectiveness[1477] should be seen in its context, which was an assessment of the prospects of entry over different technologies when setting transmission costs for a single wholesale must-offer price. We recognise that the passage quoted by Sky implied that IPTV was not an effective alternative to satellite, DTT and cable. However, our view is that the situation of IPTV is less clear-cut than this passage suggested. Clearly, IPTV services are already present in the market. While it is true that IPTV may have higher average transmission costs than satellite, the technology has key features and capabilities – most obviously true-VoD – which satellite[1478] is unable to offer. More generally, the ability of IPTV to compete is illustrated by the relative success of IPTV in other countries (such as France and Sweden)[1479]; and the relatively low price of Tiscali / TalkTalk TV's smallest basic bundle (£26.47) compared with an equivalent bundle on Sky (£32)[1480]. Our view is therefore that there is potential for increased choice through the further development of IPTV services, and that the extent of such development is constrained by the lack of wholesale access to IPTV. We also re-iterate the point that we have focussed on a DTT cross-check (rather than an IPTV cross-check) based on evidence of immediate interest in using this distribution technology (including Sky's Picnic business plan), rather than a view that IPTV may not be a credible alternative to existing technologies.

[1477] Third Pay TV Consultation, paragraph 9.132.

[1478] In this context we exclude potential satellite / IPTV hybrid services.

[1479] For example, IPTV penetration in 2008 was 13% in France and 10% in Sweden, compared with 0.2% in the UK. Source: World Television Markets – Idate (2008). As we set out later in this Section we interpret international comparisons with care, as there can a range of historical contextual reasons for differences in penetration.

[1480] Packages equivalent to those cited by Sky in its response to Ofcom's Second Pay TV Consultation, Section 5, Table 1.

10.169 Based on the above, we have decided to adopt Option 2. This option is consistent with not promoting inefficient entry whilst, subject to the cross-check using DTT transmission costs, ensuring fair and effective competition, and inter-platform competition in particular.

10.170 For details of our calculation methodology see Annex 7, paragraph 1.147 to 1.156.

Competitor's scale: we have assumed an efficient competitor with 1.5million subscribers after ten years

10.171 In determining the magnitude of retailing costs to be deducted from the reference retail price, a key question for our DCF modelling analysis is the scale of the competing retailer, as this affects the retailer's average costs. Our methodology assumes that the retailer will incur a level of fixed costs which does not change with the number of subscribers. Over and above these fixed costs the retailer incurs variable costs, primarily driven by the number of its subscribers. As the number of subscribers increases, the level of fixed costs the competitor needs to recover from each subscriber reduces, resulting in higher unit wholesale prices. Consistent with this, the retailer's average total retailing costs per subscriber will also decline as the number of its subscribers increases. Following on from this, a competitor that is as efficient as Sky at equivalent scale may, at lower scale, have average total costs which exceed Sky's. In these circumstances a small retailer will require a lower wholesale price to compete effectively with Sky.

10.172 In paragraphs 10.52 to 10.60 above, we discussed whether we should determine wholesale prices on the basis of retailers as efficient as Sky, given our objective to ensure fair and effective competition while ensuring such entry is efficient. Sky has around 70% of pay TV subscribers and about **[✂]**% of premium pay TV subscribers. It is therefore not feasible to ensure fair and effective competition on the basis of multiple competitors who achieve the same scale as Sky – even a single additional competitor at Sky's scale is impossible as together they would exceed the addressable market for pay TV subscribers. Therefore ensuring fair and effective competition requires us to deviate from Sky's scale and consider what an appropriate efficient scale would be for the purposes of our DCF analysis, from which we derive wholesale prices.

10.173 In our Third Pay TV Consultation (paragraphs 9.124 to 9.129), we proposed that the hypothetical entrant could reach between one and three million pay TV subscribers after ten years (**[✂]**). We favoured setting wholesale prices using the upper end of our proposed range. We also assumed a linear growth rate for subscriber numbers in the first nine years, reaching steady state after this period.

10.174 In its response, Sky argued that we should set wholesale prices at the cable rate-card[1481], which reflects Sky's scale. Sky[1482] also argued that in the context of the impact assessment three million pay TV subscribers on DTT was too optimistic, **[✂]**. Professor Cave on behalf of Sky[1483] also argued that Ofcom's approach was

[1481] For example, Sky told us that Picnic (i.e. in its view an efficient DTT retailer) could afford to pay the cable rate-card. Sky therefore argued that "the bottom end of the range of prices on which Ofcom is consulting should therefore be at least as high as Sky's current cable rate-card prices". Sky's response to Third Pay TV Consultation, paragraph 1.60.

[1482] Sky's response to the Third Pay TV Consultation, Section 10, paragraphs 10.147 to 10.149.

[1483] Sky's response to the Third Pay TV Consultation, Annex 1, paragraphs 27-29.

amounting to "undertaking a programme of entry assistance" where we have not only defined the type of technology the new entrant adopts (i.e. DTT), but also its size and, as a result, the number of entrants (which would be limited to one as it will be unlikely that more than one entrant could achieve three million pay TV subscribers after 10 years).

10.175 On the other hand, the Three Parties[1484], Virgin Media[1485] and BT[1486] argued that we should not set prices which discriminate against smaller new entrants and they refuted our concerns about entry by sub-scale firms. In their view entry on a smaller scale on the DTT platform is significantly more plausible over the 10 year period[1487]. Top Up TV[1488], in a presentation to Ofcom, argued that it would be more realistic to assume 1.1million subscribers after 10 years, with most growth in early years. Finally, the Premier League argued that setting a single wholesale price ignores the range of economic positions of potential entrants. Many of the firms likely to take up the wholesale offer cannot be considered small, resulting in overly generous margin [1489]. In its view, if the entrant is not expected to attract a large number of subscribers until the last three years, a considerable subsidy is required in earlier years to keep the entrant active[1490].

10.176 In summary, we have decided that it is reasonable to assume that a competing retailer, which is as efficient as Sky but has smaller scale, could reach 1.5 million pay TV subscribers after ten years. In line with stakeholder responses, we have also assumed an initial period of high growth followed by lower growth in later periods.

10.177 In determining the appropriate scale of the competing retailer, together with stakeholder responses, we have also taken into account other evidence. In particular, we have taken a number of third party projections into account. As also discussed in Section 8, there are differing views on this issue:

- **[✂]**, a broadcasting consultancy, forecasted (October 2009) a total pay TV market on DTT of **[✂]** by 2018, of which **[✂]** are premium pay TV subscribers[1491]. These forecasts are based on their understanding of the market, informed by the views of industry, and hence indirectly by any research these operators have carried out.

[1484] Three Parties' response dated September 2009 to the Third Pay TV Consultation, Section 9, paragraphs 9.33-35.

[1485] Virgin Media's response dated September 2009to the Third Pay TV Consultation, Section 7, paragraphs 7.52-53.

[1486] BT's response dated 19 September 2009 to the Third Pay TV Consultation, Section 3, paragraphs 3.6-7.

[1487] Three Parties' response dated September 2009 to the Third Pay TV Consultation, Section 9, paragraphs 9.41 to 9.44.

[1488] Top Up TV presentation to Ofcom, dated 23 September 2009.

[1489] Premier League response to the Third Pay TV Consultation, page 112, Question 21.

[1490] Premier League response to the Third Pay TV Consultation, page 109, Question 20.

[1491] **[✂]**.

- A recent UBS[1492] report found that around 15% of DTT households (about 1.5 million) would be "very interested" in a "best of Sky" service on DTT, and around a further 20% (or 2 million) "somewhat interested".

- A survey by O&O[1493]found that:

  - o There was potential demand for Sky's premium channels from Freeview households (though we do not necessarily know that it reflects demand for premium channels on DTT): O&O asked respondents for their interest in "a package of premium Sky services including Sky Sports 1&2 and the main Sky Movies channels". At price of £25, 13% were interested; at price of £15, 18% were interested.

  - o Switching from cable and satellite to DTT: O&O suggest that, at a DTT premium price of £25, 6% of Sky customers and 4-5% of Virgin Media customers would be likely to switch away from their services. Three quarters of those switching from Sky, and half of those switching from Virgin Media, would be premium subscribers.

10.178 Stakeholders have also provided confidential information on the numbers of subscribers they forecasted on their own platforms. The maximum quoted was **[✂]** pay TV subscribers by 2015, of which **[✂]**[1494] related to premium pay TV services. The minimum quoted was around **[✂]**[1495] premium pay TV subscribers by 2013. As discussed in Section 8, Sky's business plan for Picnic estimated (in April 2008) that around **[✂]** households would subscribe to premium content on its proposed Picnic service within three years of launch, an equivalent of around **[✂]** per cent of DTT households, and **[✂]** within five years.

10.179 We recognise that there is a degree of judgement to be made when defining the scale that we expect to be reached by the competing efficient retailer. Following stakeholder responses, and taking into account other evidence available to us, we are now of the view that a total market of three million additional pay TV subscribers on DTT after ten years is plausible. Hence, given DTT is the most likely short to medium term entry opportunity, it is unrealistic to assume that a single player could also reach 3million subscribers. A more appropriate scale for the competing retailer is likely to be between one and two million subscribers for pay TV channels.

10.180 We have decided that it is appropriate to assume a scale of 1.5million subscribers, which corresponds to around 10% of premium pay TV subscribers. This implies 960,000 premium channel subscribers after 10 years, assuming Sky's 64% penetration as a measure of an equally efficient competitor to Sky. By using a scale of 960,000 premium channel subscribers for the hypothetical entrant after ten years, our assumption is more aligned with stakeholder responses of what is more realistically achievable. In addition, by being slightly higher than that used by different

[1492] UBS Investment research, 3 August 2009 "The Sky is still blue, just bigger". Figures based on visual interpretation of Chart 4.

[1493] 'Battling for the Media Consumer 2009 – UK Media in the On Demand Age, Oliver & Ohlbaum Associates, December 2009', slides 8 to 10. Survey conducted by Fly Research; internet survey of 2600 UK consumers, representative of the UK population.

[1494] **[✂]** response to the Third Pay TV Consultation, Section 3, paragraph 3.37.

[1495] **[✂]**

stakeholders in their own business plans it also presents a stretching target to competitors and should avoid entry by sub-scale firms. In line with stakeholder responses, we have also assumed an initial period of high growth followed by lower growth in later periods. In terms of implementation we have adopted **[✂]**, as this was the best information available to us. In contrast, we have not adopted the specific forecast for subscriber volumes **[✂]**, or any other single submission. We are mindful that specific business plans have forecasts of take up which reflect considerations and incentives which are particular to the firm and are not necessarily appropriate in this situation. Instead we have decided on a scale of subscribers, after ten years, which reflects an assessment of a broad range of submissions, forecasts and other considerations as described above.

10.181 As our objective is to ensure sustainable long term entry, rather than promoting inefficient entry, we do not agree with stakeholder views that we should not be concerned about entry by sub-scale firms. Similarly, we also disagree that our scale assumption will, in principle, result in generous margins: even though some of the companies that might take up the must-offer terms are large in their own right, they would be in no position to take a wholesale product at a price calculated assuming a scale that they are unlikely to achieve over a plausible planning horizon.

10.182 Finally, as explained in Section 7, we have updated our model of Picnic's expected profitability in response to comments from Sky. We have found that Picnic would not be profitable at the wholesale price that Sky currently charges for its premium channels. In order to break even, Picnic would have to pay less than the cable rate-card price for its premium channels. Picnic's business model assumed that standalone telephony and broadband customers would make contributions to common costs. In addition, some of the revenues from triple-play customers in Picnic's model are attributable to telephony and broadband services. Excluding customers who do not take the Picnic TV service, and excluding the non-TV revenues from triple-play customers, further increases the difference between the maximum wholesale price such a service could pay, and the current cable rate-card price. These findings support our view that the current rate-card prices are higher than those needed for a rival retailer to be able to compete.

10.183 This is also discussed in Annex 7, paragraphs 1.169 to 1.170.

Methodology for the cost-plus calculation, as a cross-check

10.184 As we have discussed in Section 9, we have not adopted a cost-plus approach to deriving the regulated wholesale prices for Core Premium Sports packages. Firstly, this is because our focus is on calculating appropriate wholesale margins to ensure fair and effective competition, rather than wholesale prices directly. Secondly, content rights, which are the key element of the wholesale cost stack, are sold on a regular basis by auction or complex negotiation, and a cost-plus approach could undermine their value. Instead, we have used the cost-plus prices as a floor for the purpose of setting the initial wholesale prices we have calculated using a retail-minus methodology.

10.185 In our Third Pay TV Consultation (paragraphs 9.145 to 9.158), we proposed to follow a similar methodology in calculating cost-plus prices, as we proposed for prices derived using retail-minus.

10.186 In its response, Sky[1496] argued that there were a number of calculation errors relating to our cost-plus calculations, which meant that our analysis was unreliable and was not evidence of high wholesale prices. It also strongly argued that the DCF approach was not suitable for cost-plus and that we should base wholesale returns on the calculation of operating margins and then compare this to the comparator companies[1497]. In support of its arguments Sky referred to Oxera's paper for the OFT[1498], where Oxera argued that estimating profitability based on IRR would not be appropriate "[i]n industries with high intangibles and low fixed assets (e.g. trading companies and knowledge-based sectors); or where it is not possible to allocate capital between lines of business". In Sky's view both of these problems arise in relation to Sky's premium wholesale business. Further, in its view, when assessing the profitability of 'Premium Wholesale' we should take into account the analysis presented by it in response to our Second Pay TV Consultation which shows that operating margins were at the low end of the range for a number of comparator companies.

10.187 The Three Parties[1499], on the other hand, agreed with our approach and suggested that in instances where Sky had high wholesale margins we should choose a wholesale price which was at the bottom of the range we consulted on.

10.188 Consistent with our proposals in the Third Pay TV Consultation, we have decided to use a DCF approach under the cost-plus methodology. We have used this as a cross-check for the wholesale prices we have derived using our retail-minus approach. We explain our reasoning further below.

10.189 In response to Sky's concerns over the use of a DCF approach, we continue to believe that a DCF approach is appropriate for calculating cost-plus prices in these particular circumstances. The aim of the wholesale must-offer remedy is to determine forward looking wholesale prices which a) enable innovation and inter-platform competition, whilst b) at the same time ensuring that (past and future) investment into content rights is not compromised. Therefore, it is reasonable for us to base cost-plus prices on a DCF methodology, which is the standard approach to examining a business case over a period of time into the future. This is also consistent with the way in which we have calculated the retail-minus wholesale prices. A challenging aspect of adopting a DCF approach for our cost-plus analysis is the need to determine an asset base for Sky's wholesale business given the difficulties around identifying intangible assets. Our quantification of Sky's premium wholesale asset base has been informed by Oxera's profitability analysis, which has estimated the value of Sky's intangible assets. For more detail, see Annex 7.

10.190 Our DCF analysis includes an assumption of growth in the number of wholesale subscribers in coming years and determines cost-plus prices per subscriber which are constant in real terms. In light of this, we acknowledge that our DCF approach does not necessarily guarantee that the resulting aggregate revenue in each year will exceed aggregate costs in each year, particularly in earlier years when wholesale

[1496] Sky response to the Third Pay TV Consultation, Section 7, paragraphs 7.19 to 7.30.

[1497] Sky response to the Third Pay TV Consultation, Section 7, paragraphs 7.22 to 7.27.

[1498] Oxera (2003), "Assessing profitability in competition policy analysis", Economic Discussion Paper 6, Office of Fair Trading. http://www.oft.gov.uk/shared_oft/reports/comp_policy/oft657.pdf.

[1499] Three Parties' response to the Third Pay TV Consultation, Section 10, paragraphs 11.12-15.

subscriber numbers are lower and average costs per subscriber therefore tend to be higher.

10.191 In response to this concern, we have undertaken a further cross-check by deriving **cost-plus wholesale charges** which are not constant in real terms (" standard cost-plus approach") but vary with the costs incurred in each individual year ("alternative cost-plus approach"). To undertake this alternative cross-check, we have first forecasted per-subscriber wholesale costs in each year. We have then calculated the profile of wholesale prices which would track these annual wholesale costs, whilst yielding the same NPV of revenues as our standard cost-plus cross-check. The impact of this alternative method is to increase cost-plus wholesale prices in the early years, when per-subscriber costs are higher, and to reduce them in later years[1500]. The results have confirmed that, for each Core Premium Sports wholesale product, the price derived using our retail-minus approach is higher than the prices resulting from either cost-plus approach.

10.192 As proposed in the Third Pay TV Consultation, we consider the prices derived using a cost-plus approach as a floor for the initial wholesale prices calculated using a retail-minus methodology. This is designed to ensure that Sky is still able to recover all of its wholesale costs. However, in instances where Sky appears to be earning high wholesale margins, we have not adjusted retail prices towards the bottom of our range. This is because, as discussed in Section 9, the aim of the wholesale must-offer remedy is to address restricted availability of Core Premium Sports channels and enable inter-platform competition, not directly to tackle the potential high returns that Sky may be earning at the wholesale level.

10.193 For a summary of our detailed modelling approach to cost-plus and our consideration of stakeholder responses, see Annex 7. We present a high level summary of the key issues relating to our cost-plus methodology in the paragraphs below.

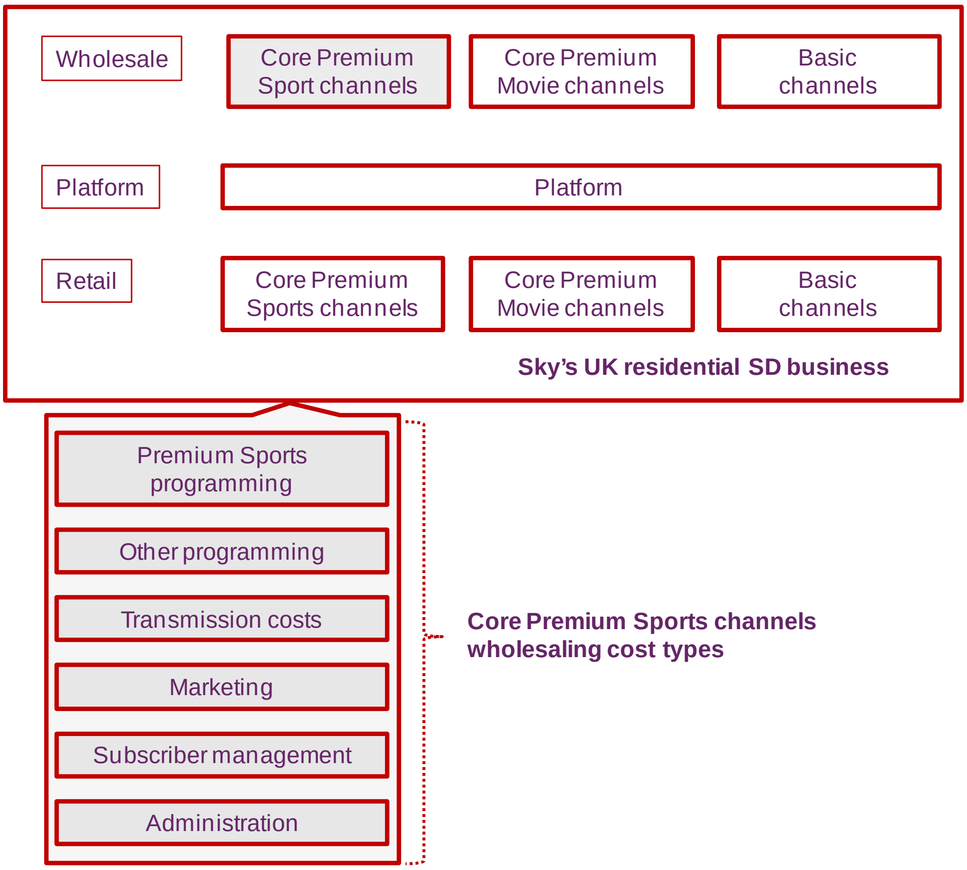
Common cost allocation under cost-plus – consistent with retail-minus

10.194 Our methodology for calculating cost-plus wholesale prices involves the following key steps:

- We have first identified the key cost categories relevant at the wholesale level and we have then allocated direct costs and a proportion of common costs to the various Sky businesses;
- Having identified those common costs relevant to the Core Premium channels as a whole, we have then allocated these costs to individual Core Premium Sports wholesale packages. Where more than one Core Premium channel is in a package (i.e. Sky Sports 1&2), we add together the allocations of common costs; and
- Finally we have calculated cost-plus wholesale prices implementing a DCF analysis over a ten year period with a terminal value.

[1500] Our analysis has indicated that for Sky Sports 1 and Sky Sports 1&2, wholesale prices calculated under the alternative cost plus approach are higher than those calculated under the standard approach up to 2011/12 (year 3), whilst for Sky Sports 2 this is true up to 2013/14 (year 5).

Figure 131 Sky's common costs for the wholesaling of Core Premium Sports



10.195 For our cost-plus methodology our focus is to determine Sky's wholesale costs in producing the SD version of the Core Premium Sports packages in relation to UK residential consumers only (see Figure 131 above):

- We have determined the cost categories we need to allocate. The main categories of wholesale costs that we have considered include programming costs, marketing costs, non-transponder transmission costs and administration costs. Within these, of particular importance are the programming costs which relate to the rights fees payable to sports bodies for content that is included in Sky's Core Premium Sports packages.

- We have allocated common costs to various parts of Sky's business as described in paragraph 10.131.

10.196 Having established the costs that are relevant to Core Premium channels as a whole, we have then determined how these costs should be allocated to each Core Premium Sports wholesale product. The majority of these costs relate to sports programming. We have adopted the approach proposed in our Third Pay TV Consultation, allocating rights costs between Sky's Core Premium Sports wholesale channels using viewer share data from the Broadcasters' Audience Research Board (BARB) for 2008.

10.197 For details of our cost allocation methodology see Annex 7, paragraphs 1.43 to 1.75.

Forecasting of costs under cost-plus

10.198 As for retail-minus, we have implemented a DCF analysis where we have explicitly modelled cashflows for a period of ten years followed by a terminal value. We have also applied a discount rate of 10.3% as a measure of Sky's WACC, used in the retail-minus calculations, given our view that wholesale and retail performance are likely to be strongly correlated. In relation to Sky's wholesale costs (including operating and capital expenditure), we have forecasted these from year to year, in proportion to inflation and wholesale premium pay TV subscriber numbers. We have treated the opening premium wholesale asset value as a cost incurred in the first year. These are consistent with our proposals in the Third Pay TV Consultation.

10.199 An important aspect of our methodology is the forecasting of the costs of sports rights. In our Third Pay TV Consultation (paragraph 9.156), we forecasted costs in proportion to inflation and subscriber numbers. In other words, we assumed that these remain constant per subscriber in real terms. In view of arguments and evidence provided by Sky, we have now updated our methodology to use Sky's forecasts from its five-year plan[1501] in the first four years of our model. We have then forecasted these costs in proportion to inflation and premium pay TV subscriber numbers (consistent with the methodology we proposed in our Third Pay TV Consultation).

10.200 For a summary of our cost forecasting see Annex 7, paragraph 1.198 to 1.216.

Wholesale prices resulting from our decisions on calculation methodology

10.201 In this Section we summarise the wholesale margins and wholesale prices we have derived for the Core Premium Sports products that we consider should be available under a wholesale must-offer remedy. In particular, we discuss the following:

- How the wholesale prices we have derived have evolved since the Third Pay TV Consultation;
- How the wholesale prices compare with the current cable rate-card. In particular we discuss the effects of our approach to treatment of returns and of adopting a different scale for the competing retailer; and
- The wholesale margins and wholesale prices we have set for the Core Premium Sports packages and the cross-checks we have performed to ensure inter-platform competition (specifically, in relation to DTT).

How have wholesale prices changed since the Third Pay TV Consultation?

10.202 We have introduced a number of changes to our calculation methodology. These changes take into account responses to our Third Pay TV Consultation and our further deliberations on certain methodological aspects of our calculations. In this Section we set out, at a high level:

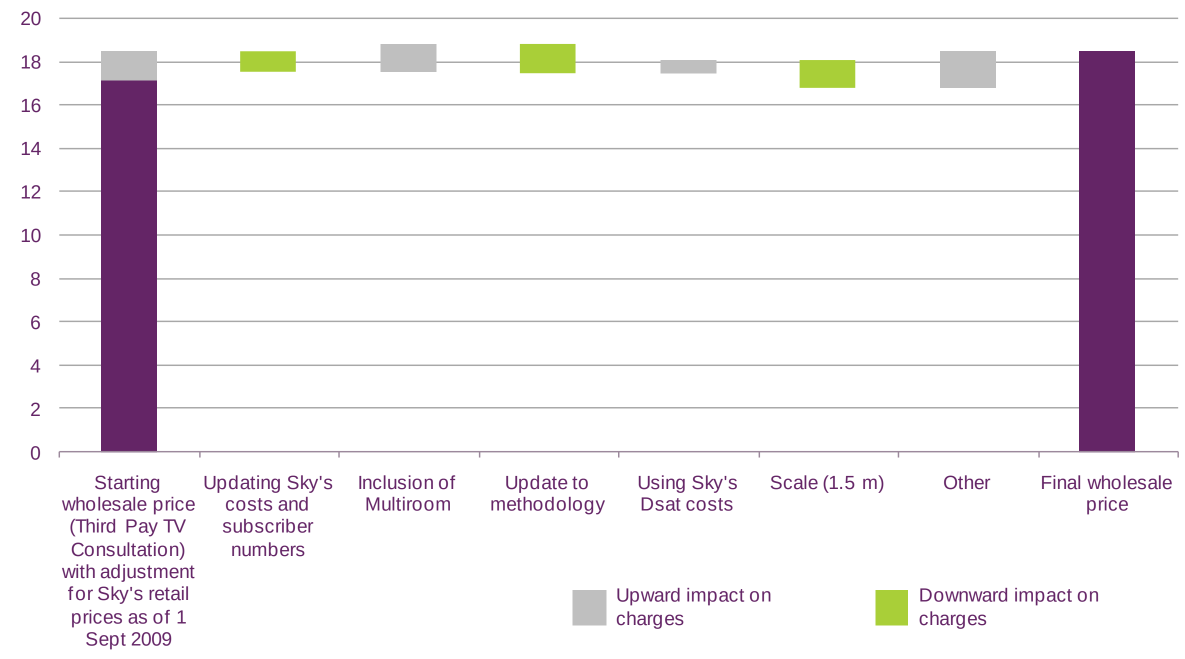
[1501] Sky has told us that its five-year plan reflects a mixture of public and aspirational targets as well as more straightforward future projections. Therefore the assumptions it contains are not always suitable for an objective forecast of future costs. However, Sky considers the assumptions in its five-year plan to be "reasonable, as a large proportion of the costs are committed or readily forecastable". See Sky response to the Third Pay TV Consultation, non-confidential Section 7, footnote 19.

- the key categories of changes we have introduced; and
- a quantification of their impact.

10.203 To illustrate these changes we have focussed on a specific set of prices that we presented in the Third Pay TV Consultation. We have considered the scenario corresponding to a larger competitor using a DTT platform (Scenario 4 in Table 64, Third Pay TV Consultation) given that we proposed retail-minus prices should be set on this basis, suggesting prices roughly mid-way through our range for consultation. We have then taken the weighted average of the prices for the different wholesale products under this scenario (presented in the final row of Table 64, Third Pay TV Consultation). The weighted average charge facilitates a comparison with the cable rate-card as described below.

10.204 Our analysis for the weighted average price is summarised in the Figure below. The proposals set out in our Third Pay TV Consultation correspond to a weighted average charge of £17.13 per subscriber per month. Sky's change in retail prices as of 1 September 2009 had the effect of increasing this to £18.42. The cumulative impact of our other adjustments is negligible, slightly increasing this weighted average wholesale price to £18.43 per subscriber per month. The weighted average price reflects the average across 11 Core Premium wholesale products and the cumulative impact of our adjustments differs depending on the wholesale product. For example, after taking account of Sky's change in retail prices, the impact of our other adjustments is also negligible for Sky Sports 1, but increases the wholesale price of Sky Sports 1&2 by £0.52 per subscriber per month. Our analysis for the weighted average price is summarised in the Figure below.

Figure 132 Impact of major 'changes' to the weighted average wholesale price



10.205 The major changes we have introduced can be categorised as follows:

- *Updates to base year data*. We have updated the starting year price and cost data in the pricing model consistent with the more recent data available to us. We have used Sky's retail prices as of 1st September 2009. On average, these retail prices have increased by £1.29. Taking this change in retail prices into account, the net impact of amendments following our Third Pay TV Consultation is minimal. We have also updated Sky's total subscriber numbers, operating and capital costs consistent with its budgeted management accounts for 2009/10, which significantly reduces wholesale prices.

- *Refinement to methodology for reference retail prices*. We have included Multiroom revenues, in light of our decision discussed in paragraphs 10.85 to 10.91.

- *Updates to cost calculation methodology*. We have introduced some methodological refinements. For example we have updated our calculation of fixed costs and SAC.

- *Decision in relation to transmission costs.* We have reflected our final position to derive wholesale prices on the basis of Sky's satellite transmission costs, rather than DTT transmission costs.

- *Decision in relation to scale*. We have reflected our final position in relation to the scale of the competing retailer. We have assumed a hypothetical entrant reaching 1.5million pay TV subscribers after 10 years.

- *Additional adjustments*. The Other category includes a number of additional adjustments and corrections to the analysis. For example, we have accurately reflected the temporary reduction in the VAT rate.

10.206 A similar analysis is presented for Sky Sports 1&2 in Annex 7, paragraph 1.184 to 1.186. A more detailed discussion of the changes we have introduced since the Third Pay TV Consultation is included in Annex 7.

10.207 Since we have introduced a number of updates and methodological improvements to the pricing model (as we have discussed above), we have also asked KPMG to conduct a final detailed review of our analysis. This review identified a small number of mechanical errors and several best practice improvements which we have now addressed. KPMG only identified two errors (one with an impact greater than £0.10) and the cumulative effect of these additional amendments increased the weighted average price calculated using retail-minus by £0.18 (this impact is included in Figure 132 above). Two further errors were identified in the cost-plus calculations, each about £0.02 in magnitude, however as these were counteracting, the net impact was negligible. The KPMG report is published alongside this Statement as part of Annex 7.

10.208 In a supplementary submission[1502], Sky suggested that we held the view that, even if there were errors in the modelling and assumptions, we would not need to consult again provided the final charges that emerged from the corrected calculations still fell within the ranges of proposed charges that we had consulted on. Sky considered that such a view was untenable, given that for a specific "objective", such as the objective that charges should allow a larger competitor to compete with Sky's retail prices, the consultation document presented a "point estimate", not a range of estimates for the charges required to allow a larger competitor to compete.

[1502] November 2009 Sky Submission, paragraphs 2.4-2.6.

10.209 We consider that Sky's description over simplifies our position and hence misrepresents our view. We consulted on a number of principles and issues of methodology which are relevant to determining wholesale prices and the scenarios presented in the Third Pay TV Consultation enabled stakeholders to see the effect on prices of those principles and of changes to particular assumptions. Sky and other stakeholders responded on those issues of principle and methodology as well as other calculation details, as a result of which we have refined our calculations as described above. As indicated in Figure 133, the wholesale prices we have determined do not differ significantly from the prices we proposed in consultation[1503].

How do the wholesale prices compare to the rate-card?

10.210 We have also compared our weighted average wholesale prices to Sky's current cable rate-card. In order to understand the differences between the prices derived under our approach and the current cable rate-card, we have developed a scenario which seeks to approximate the OFT's approach, against which Sky says it cross-checks its wholesale prices. The OFT's approach adopted a ROT of 1.5%, rather than considering the return on investment (see paragraphs 10.156 to 10.159). We have therefore modified the discount rate which applies to future cash flows in our DCF analysis so as to obtain an implied ROT of 1.5%.

10.211 To examine the impact on wholesale prices of adopting our approach we have considered a number of pricing scenarios which are summarised in the Figure below:

- Scenario 1: Current cable rate-card prices. This is the set of prices currently charged by Sky to Virgin Media, which we understand Sky cross-checks to ensure compliance with its interpretation of the margin squeeze test applied by the OFT[1504].

- Scenario 2: This is our approximation of the OFT methodology, using Sky's current costs, and a ROT of 1.5%.

- Scenario 3: This is a retail business approximating to Sky's business at Sky's scale[1505]. It incorporates a return on investment derived from applying a discount rate of 10.3% which is our estimate of Sky's cost of capital[1506]. It therefore differs from Scenario 2 in its treatment of returns.

- Scenario 4: This is a retail business approximating to Sky's business but at lower scale, assuming three million pay TV subscribers after ten years[1507]. This was the scale of a 'larger competitor' that we proposed was a reasonable basis on which

[1503] We also observe that the prices we have set for Sky Sports 1, Sky Sports 2 and Sky Sports 1&2 fall within the ranges we consulted upon in the Third Pay TV Consultation, taking account of Sky's changes in retail prices in September 2009.

[1504] This is the best of our understanding given that Sky declined to provide us with its calculations.

[1505] We use Sky's costs (including satellite transmission costs), Sky's retail prices and Sky's opening asset base at the start of the period. We include a figure for intangible assets for Sky, based on the costs of acquiring subscribers at the start of the period.

[1506] We calculate that this would imply a ROT of 2.9%.

[1507] We also assume that the hypothetical retailer incurs fixed retailing costs of about £23m per annum (including transmission of premium content over satellite).

to derive wholesale prices in the Third Pay TV Consultation. It therefore differs from Scenario 3 in terms of the scale of the retail business.

- Scenario 5: This scenario is the same as Scenario 4, but with an adjustment to reflect the costs of DTT transmission and the associated lower SAC resulting from the absence of satellite dish installation, rather than Sky's satellite transmission costs. It most closely corresponds to the 'larger competitor on DTT' scenario in the Third Pay TV Consultation which we proposed as a reasonable basis for determining wholesale prices.

- Scenarios 6: This scenario is the same as Scenario 4, but reflects a hypothetical retailer at lower scale of 1.5 million pay TV subscribers after 10 years (respectively).

- Scenario 7: This is calculated on a cost-plus basis, using the DCF approach and assuming a cost of capital of 10.3%. We have used these prices as a floor to the initial wholesale prices we have calculated using a retail-minus methodology.

10.212 As shown by the results in the Figure below our approximation (Scenario 2) produces weighted average wholesale prices which are very close to the cable rate-card.

Figure 133 Weighted average wholesale prices under alternative assumptions

	Cable rate-card	Rate-card approx'n	Satellite Sky's scale	Satellite 3m subs	DTT 3m subs	Satellite 1.5m subs	Cost-plus
Scenario	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Updated price (£ per subscriber per month)	21.16	21.67	21.12	19.68	19.06	18.43	12.55
% discount to rate-card		*2.4%*	*-0.2%*	*-7.0%*	*-9.9%*	*-12.9%*	*-40.7%*
June 2009 price (£ per subscriber per month)	20.72	18.85	18.35	17.51	17.13	16.59	13.57

10.213 It can also be observed that:

- The impact of scale effects are relatively small at larger scale (compare Scenarios 3 and 4), but become more material at smaller scale (Scenario 6 compared to Scenario 3). This is because fixed costs are a smaller proportion of total costs for a larger retailer.

- Having adjusted our approach to DTT costs recognising the absence of satellite dish installation and associated subsidies (see paragraph 10.165), the differential resulting from using DTT transmission costs rather than Sky's satellite costs on the weighted average wholesale price is small (compare Scenario 4 and 5 above). We discuss this issue further in paragraph 10.216 below.

- As discussed above, the results have confirmed that, for each Core Premium Sports wholesale product, the price derived using our retail-minus approach is higher than the prices resulting from the standard (Scenario 7) and alternative cost-plus approaches (see Section 5).

What are the wholesale prices we have set?

10.214 As discussed in paragraphs 10.52 to 10.60, we have decided to set wholesale prices for the Core Premium Sports products on the basis of Sky's costs (reflecting a retailer as efficient as Sky) but at lower scale (recognising that multiple competing retailers at Sky's scale is infeasible). For the scale adjustment, we consider a competing retailer that reaches 1.5million subscribers after 10 years is a reasonable basis on which to derive prices for the wholesale must-offer remedy.

10.215 Below we present the wholesale prices we have determined for the Core Premium Sports products (Sky Sports 1, Sky Sports 2 and Sky Sports 1&2). We also compare these to the corresponding prices under (i) the current rate-card (ii) an adjustment for DTT transmission costs and (iii) our cost-plus methodology.

Figure 134 Comparison for Sky Sports 1

	Cable rate-card	Satellite 1.5m subs	DTT 1.5m subs	Cost-plus
Updated price (£ per subscriber per month)	13.88	10.63	11.21	9.10
% discount to rate-card		*-23.4%*	*-19.2%*	*-34.4%*
June 2009 price (£ per subscriber per month)	13.48	-	-	9.07

Figure 135 Comparison for Sky Sports 2

	Cable rate-card	Satellite 1.5m subs	DTT 1.5m subs	Cost-plus
Updated price (£ per subscriber per month)	13.88	10.63	11.21	3.32
% discount to rate-card		*-23.4%*	*-19.2%*	*-76.1%*
June 2009 price (£ per subscriber per month)	13.48	-	-	3.21

Figure 136 Comparison for Sky Sports 1&2

	Cable rate-card	Satellite 1.5m subs	DTT 1.5m subs	Cost-plus
Updated price (£ per subscriber per month)	19.15	17.14	17.29	11.36
% discount to rate-card		*-10.5%*	*-9.7%*	*-40.7%*
June 2009 price (£ per subscriber per month)	18.39	-	-	11.34

10.216 There are a number of important observations to make:

- The wholesale prices we have set give rise to a discount of 23.4% and 10.5% below the current rate-card for Sky Sports 1 and Sky Sports 1&2 respectively. The greater reduction for single channels than for the bundle of Sky Sports 1 and 2 reflects the fact that the OFT's margin squeeze test, by reference to which Sky says it sets its prices, is carried out at an aggregate level, giving Sky the freedom to set some prices higher and some lower. Our analysis suggests that Sky has used this flexibility by to set cable rate-card price for Sky Sports 1&2 closer to the weighted average than the cable rate-card price for Sky Sports 1.

- The impact of making an adjustment to take account of DTT transmission costs, rather than using Sky's satellite costs, is small (less than 0.5% for Sky Sports

1&2). We have completed this cross-check to ensure that the wholesale must-offer remedy enables innovation and inter-platform competition by enabling other retailers to compete using DTT platforms in particular, given DTT is the most likely entry opportunity in the short to medium term (as discussed in paragraph 10.167). In contrast to the weighted average wholesale price, wholesale prices for Sky Sports 1, Sky Sports 2 and Sky Sports 1&2 derived using DTT transmission costs are higher than those based on Sky's satellite transmission costs. This is because, as discussed in paragraph 10.165, when using DTT transmission costs we have also adjusted SAC to reflect the absence of subsidised satellite dish installation. For the Core Premium Sports packages, there are only one or two videostreams required and so the higher transmission costs for DTT distribution are relatively modest and outweighed by the benefit of lower SAC.

- We have set the price of Sky Sports 2 to be equal to that of Sky Sports 1. The detailed retail-minus calculation for Sky Sports 2 results in a price which differs from the Sky Sports 1 price by 2p per subscriber as a result of minor differences in, for example, the number of basic mixes taken by subscribers to each premium channel. We believe it is more appropriate to mirror Sky's retail pricing structure for these two products, by setting the wholesale prices to be the same, rather than to depart from this pricing structure in order to reflect very small differences in the calculation.

10.217 In summary, the wholesale prices we have set, together with the corresponding retail margins are shown in the Figure below.

Figure 137 Wholesale prices available under the wholesale-must offer remedy

	Wholesale price (£ per subscriber per month)	Retail margin (£ per subscriber per month)
Sky Sports 1	10.63	16.74
Sky Sports 2	10.63	17.03
Sky Sports 1&2	17.14	18.91

10.218 The retail margin is slightly higher for Sky Sports 2 than for Sky Sports 1. This reflects the fact that subscribers to Sky Sports 2 retail packages on average take more basic mixes than subscribers to Sky Sports 1 and hence there are higher costs associated with more basic content. These higher costs correspond to a higher weighted average retail price for Sky Sports 2.

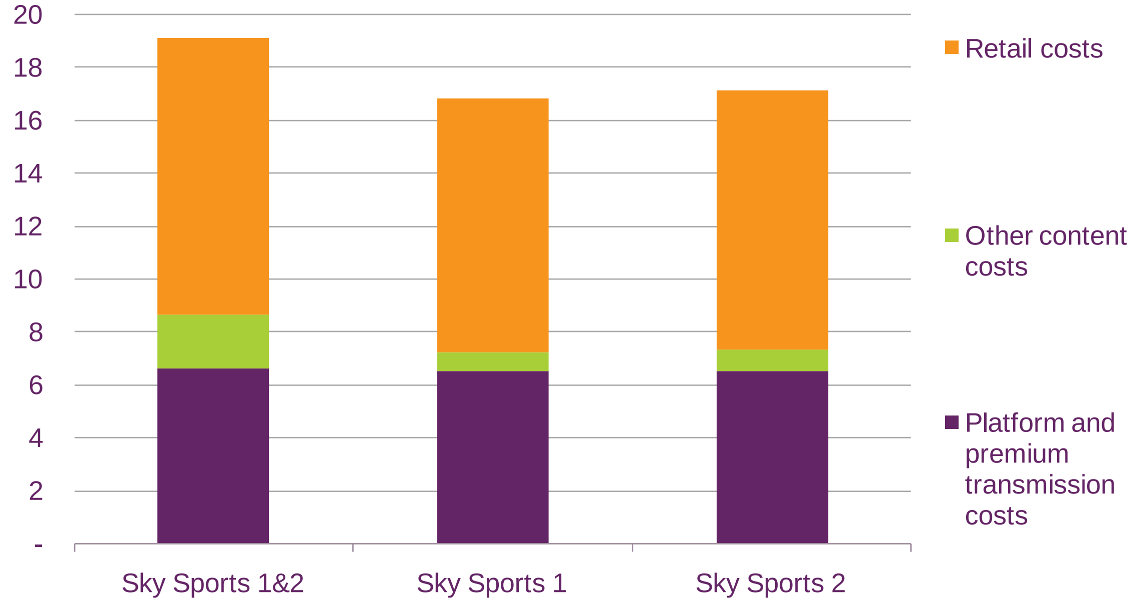
10.219 The retail margins reflect not only the costs of retailing the premium channels, but also the costs incurred at the platform level and transmission, and also the costs of other content. The Figure below reflects the breakdown of the margins into the three following components:

- Platform and premium transmission costs: this includes costs such as subscriber management, conditional access services, and smartcard costs, and the costs of transmission in relation to the premium channels. Note that we have also included Multiroom costs in this category[1508].

- Other content costs: this includes the wholesale costs of basic channels. As noted above, other content costs are higher for Sky Sports 2 than Sky Sports 1 because subscribers to Sky Sports 2 take more basic mixes on average. For Sky Sports 1&2, this component also includes the wholesale cost of Sky Sports 3 and 4, as these channels are bundled in Sky's retail price for Sky Sports 1&2 but are not included in the wholesale must-offer price.

- Retail costs: this includes the costs of retailing basic and premium channels[1509]. These are higher for Sky Sports 2 than Sky Sports 1 because subscribers to Sky Sports 2 take more basic mixes on average.

Figure 138 Breakdown of margins into platform, other content and retail costs



10.220 We have also checked that for each of the Core Premium Sports wholesale product, the incremental retail price[1510] of adding Sky Dual Movies and Sky Single Movies is not below the incremental cost. In fact our analysis has shown that for Sky Sports 1&2, on average, the incremental margin[1511] is £1.38. When calculated on the same basis, on average, the incremental margin for Sky Sports 1 is £3.82 and for Sky Sports 2 is £4.15. We discuss this in more detail in Annex 7, paragraphs 1.187 to 1.191.

[1508] The majority of cost lines that we associate with Multiroom are allocated to the Platform category.

[1509] This also includes the cost of transmission for basic channels.

[1510] Incremental price is exclusive of VAT, and after adjustments for Disney Cinemagic and discounts.

[1511] [✂].

Additional pricing conditions to ensure effectiveness of the remedy

10.221 As discussed in paragraphs 10.52 to 10.60, one of our objectives is to ensure that the wholesale must-offer remedy enables effective inter-platform competition on an efficient and sustainable basis. As proposed in the Third Pay TV Consultation, we have decided to:

- determine how prices should evolve over time; and
- determine a methodology to adjust wholesale prices for wider retail bundles.

10.222 Our reasoning and analysis of the arguments made in response to our consultation are discussed in detail below.

How should wholesale prices change over time?

10.223 Having established the initial price levels and pricing structure for the relevant Core Premium Sports packages, we also need to consider how these prices should evolve over time. As discussed in paragraph 10.143, we would expect wholesale prices to evolve over time in such a way that the margin we have set between retail and wholesale prices is maintained.

10.224 In our Third Pay TV Consultation (paragraphs 9.36 to 9.51), we proposed to review wholesale charges after three years, or after material changes to wholesale costs, retail costs or retail prices. During the three-year period, we proposed to subject wholesale charges to a 'ratchet' mechanism in response to retail price changes. Under the ratchet, following a reduction in Sky's retail prices, wholesale charges would automatically fall, but in instances where Sky's retail prices increase, the situation would be reviewed by Ofcom, albeit with a presumption that wholesale prices would increase. Finally, in response to material changes to wholesale or retail costs we proposed to re-calculate wholesale prices.

10.225 Stakeholders' responses on this issue varied. In its response, Sky argued that our proposals would lead to uncertainty[1512]. Sky would not know whether Ofcom is likely to consider a cost change 'sufficiently material' as to alter wholesale prices. In its view, our approach presented a risk to Sky participating in rights auctions. In addition, it argued that the proposed 'ratchet' would seriously distort the market, limiting Sky's price competition, efficiency and investment in quality. Professor Cave on behalf of Sky[1513] also argued that the 'ratchet' would limit potential beneficial switches of content across channels and it could also reduce incentives to acquire new channels if there is a doubt that the additional investment can be recovered through higher prices. Both Sky[1514] and Premier League[1515] argued that under the proposals a cut in Sky's retail prices would automatically be passed on to third parties through a cut in wholesale prices, limiting Sky's ability to compete for customers on price. This would be disruptive to Sky's everyday business.

[1512] Sky response to the Third Pay TV Consultation, Section 10, paragraphs 10.51-52.

[1513] Sky response to the Third Pay TV Consultation, Annex 1, paragraph 40.

[1514] Sky response to the Third Pay TV Consultation, Section 1, paragraphs 1.68-69.

[1515] Premier League response to the Third Pay TV Consultation, Annex 2, Question 17.

10.226 On the other hand, **[✂]**[1516] put forward a methodology which could be used mechanically to adjust wholesale prices for changes in Sky's costs (especially its SAC). For example, they proposed that Ofcom could publish a matrix of wholesale prices for different levels of SAC and could also place an obligation on Sky to report its SAC (and other key retailing cost categories) regularly to Ofcom. Finally, they suggested that increases in Sky's SAC of more than 50% should be regarded as a 'very major change' in Sky's cost of retailing, which would justify re-opening the wholesale pricing calculations. In their view, this methodology would avoid the need for Ofcom to take detailed pricing decisions in advance of its first triennial review of the remedy and would be less intrusive and less time consuming than the ratchet mechanism.

10.227 **[✂]**[1517] also argued that Ofcom should specify in its decision that the cost-plus wholesale prices will not represent 'hard floors' in the event that any changes (e.g. in Sky's retail prices or its SAC) result in a reduction in the wholesale prices derived under the retail-minus pricing mechanism. Finally, **[✂]** was the only respondent in favour of the 'ratchet' approach[1518].

10.228 Our retail-minus methodology, used to derive wholesale prices, reflects our objective to ensure fair and effective competition by ensuring competing retailers have a sufficient retail margin. Therefore, our starting point in principle is to ensure that wholesale prices evolve over time in such a way that the margin between retail and wholesale prices is maintained. This approach helps to address concerns over margin squeeze which would arise from a reduction in Sky's retail prices where wholesale prices remained static.

10.229 Based on stakeholder responses, and our further consideration of this issue, we have determined how wholesale prices should evolve over time by taking into account the following issues:

- How should the margin be set?
- How frequently should the wholesale margin be reviewed?
- How should the wholesale margin respond to material changes in costs (retail and wholesale)?

10.230 In summary, we have decided that:

- The margin for each wholesale product should be specified as a fixed absolute amount (in real terms) and wholesale prices should track Sky's retail prices, regardless of whether these prices increase or decrease.
- The margins should be reviewed commencing after three years, unless it becomes appropriate to review the provisions earlier in response to a material change in the operation of the market.

[1516] **[✂]**.

[1517] [✂].

[1518] [✂] response to the Third Pay TV Consultation, Question 17.

- Material changes in retail and wholesale costs should be addressed by Ofcom re-calculating the retail margin and associated wholesale price.

We have set a fixed absolute margin

10.231 In our Third Pay TV Consultation (paragraphs 9.43 to 9.46) we proposed setting the margin either as an absolute amount or as a fixed percentage of the retail price. We further discussed that the appropriate mechanism would depend on the underlying reasons for changes in retail prices, and specifically whether those changes related to changes in retail costs or wholesale costs.

10.232 Only the Three Parties[1519] commented on this aspect of our proposals. In their view if Sky's retail prices fall, wholesale prices should fall based on a fixed absolute margin, since otherwise competing premium pay TV retailers will not be able to bear the minimum level of retailing costs and therefore will not be able to compete effectively with Sky. On the other hand, if Sky's retail prices increase, they argued that wholesale prices should increase based on a fixed percentage margin so that retailers would be able to increase their marketing spend to attract more customers at the higher retail prices.

10.233 We have decided to set the margin as a fixed absolute amount for each of the three Core Premium Sports wholesale products. We have taken this decision having considered the following two options that we consulted on:

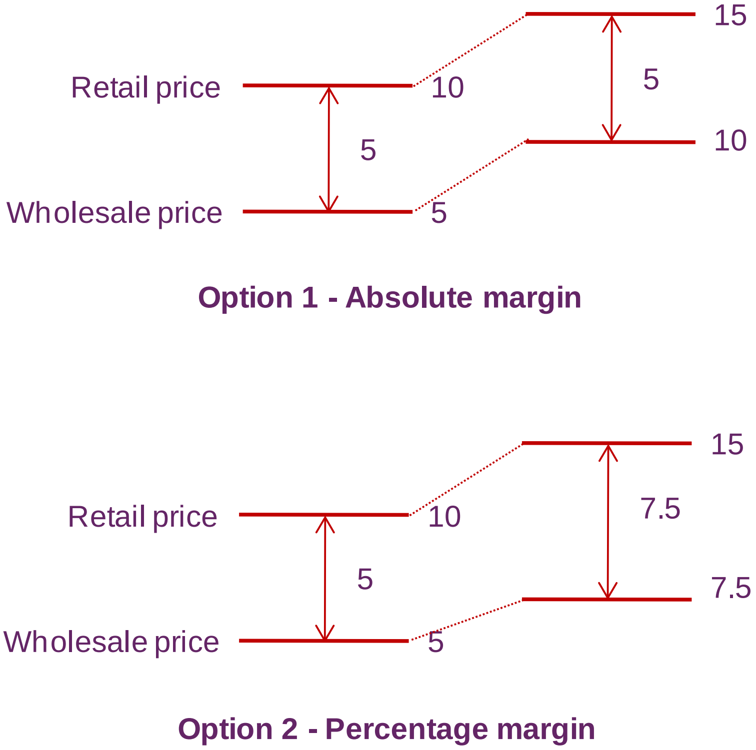
- **Option 1**: Wholesale prices track retail prices preserving an absolute margin in pounds per subscriber.

- **Option 2**: Wholesale prices track retail prices preserving the margin as a fixed percentage of the retail price.

10.234 These two approaches are summarised in the Figure below.

[1519] Three Parties' response dated September 2009 to the Third Pay TV Consultation, Section 10, paragraphs 10.25-29.

Figure 139 Stylised diagram comparing absolute and percentage margins



10.235 We recognise that neither of these options is perfect but represent pragmatic approaches to how wholesale prices should change over time.

10.236 Under **Option 1**, setting an absolute margin effectively presumes that changes in retail prices are associated with changes in wholesale costs or changes in demand conditions. It assumes that for the duration of the period over which prices are set, retail costs remain largely unchanged[1520]. This is consistent with the way in which we have determined the retail margin, and is the approach we consider least likely to distort Sky's wholesale incentives, including its incentives to invest in its wholesale product and its incentives to bid for sports rights.

10.237 Under **Option 2**, there would be a closer link between Sky's retail costs and the wholesale price. If Sky's retail costs increased (for example because of an increase in SAC or marketing costs), and it increased its retail prices by a commensurate amount, the allowed margin for its retail rivals would increase – although not by as much. To *some* extent, therefore, this approach would protect rivals against the concerns identified by the Three Parties about Sky's ability to manipulate the regulatory regime by substantially increasing its retail marketing costs.

10.238 However, Option 2 has two substantial drawbacks. First, it could have a distorting effect on Sky's wholesale incentives (as identified above), with potentially detrimental effects on rights values. Second, it would give Sky an opportunity to squeeze the available margin of its rivals by reducing its retail prices.

[1520] One consequence is the assumption that basic content costs remain largely unchanged even if the relevant reference retail price, calculated as the weighted average retail price, reflects changes in the proportions of subscribers taking different numbers of basic mixes.

10.239 For these reasons, on balance, we consider that Option 1 is the more appropriate approach.

10.240 As noted, the absolute margin for each product would change in line with inflation – that is, it would remain constant in real terms. This is consistent with the way in which we have calculated the margin in our pricing model.

10.241 We do not consider the hybrid asymmetric approach suggested by the Three Parties to be appropriate. It would lead to perverse outcomes and therefore impose unreasonable costs on Sky (for example, if Sky increased its retail prices and then reduced them to their original levels, the corresponding wholesale prices would be lower than their original starting levels).

10.242 We have also considered the methodology suggested by **[✂]** which would potentially update the wholesale prices regularly for changes in Sky's SAC (see paragraph 10.226 above). In our view, **[✂]** suggested approach would be impractical. It would require a continuous assessment of what costs are included in Sky's SAC and other cost categories. It is therefore unclear that the approach could be made to work effectively in practice. We also consider it would be unduly disproportionate and intrusive as it would increase the regulatory burden on Sky (through the various reporting requirements in relation to its SAC and other cost categories).

10.243 However, we agree with **[✂]** argument that cost-plus prices should not represent 'hard floors' for wholesale prices based on the retail-minus calculation. Our key objective is to ensure fair and effective competition by ensuring competing retailers have a sufficient retail margin. We have also confirmed, through our cross-check with prices derived from a cost-plus calculation, that our initial wholesale prices for the three Core Premium Sports wholesale products more than enable Sky to recover its wholesale costs. Moving forwards, Sky continues to have the ability to set its retail prices as it sees fit. In particular, there is no mechanism which forces Sky to reduce its wholesale prices below the cost-plus 'floor' – it continues to have the discretion to increase its retail prices rather than lower its wholesale prices.

10.244 We have also considered whether the option we adopt for specifying the margin should apply symmetrically, in relation to both an increase and a decrease in Sky's retail prices.

10.245 In the Third Pay TV Consultation we proposed implementing the 'ratchet' mechanism. Under the ratchet approach, while there would be no constraints on Sky effecting (above inflation) increases in its retail prices, these would only be reflected as increased wholesale prices following approval by Ofcom. The majority of stakeholders have expressed concerns with the implementation of the ratchet, where Sky argued that it would be disruptive to its everyday business and the Three Parties acknowledged that it would be intrusive and time consuming.

10.246 In the light of these concerns, we have decided against the implementation of the ratchet approach. It would not be a proportionate response to ensuring fair and effective competition. We acknowledge stakeholder responses that the 'ratchet' approach would be an intrusive and resource intensive remedy for both Sky and Ofcom. It would also lead to considerable uncertainty for the industry as a whole, where retailers would not have certainty over the wholesale prices and therefore would not be able to budget accordingly until Ofcom considered the evidence and reached a conclusion. In practice there are likely to be constraints on Sky raising its retail prices dramatically, such as the loss of subscribers and retail revenues, and negative publicity.

10.247 Based on the above analysis, we have decided a) to set an absolute margin (Option 1) and b) that wholesale prices should change symmetrically in response to changes in Sky's retail prices, regardless of whether Sky's retail prices increase or decrease.

10.248 In terms of implementation, for each Core Premium Sports wholesale product, we have specified a retail-minus margin and a wholesale charge consistent with that margin. For subsequent periods, wholesale prices will be determined with reference to the prevailing retail prices and the relevant regulated margin. If Sky's retail prices change, we would expect its wholesale prices to change in tandem.

10.249 In Annex 7, we have set out the mechanism which applies to changes to the wholesale must-offer price. In summary, the key steps of the mechanism are:

- Steps 1: Sky takes its ex-VAT advertised retail prices for all TV-only products containing a given Core Premium Sports product (and no other premium channels) for UK residential satellite customers. It does not include revenues from non-core subscription products. It does not reflect any expected discounts to customers, other revenues or bad debt. It calculates a weighted average of these prices, based on the proportions of UK residential satellite subscribers taking the product.

- Step 2: Sky calculates the **relevant reference retail price** for a given Core Premium Sports product by adding the additional retail price contribution from Multiroom subscriptions to the weighted average price it calculated in Step 1.

- Step 3: Sky deducts the absolute retail margin (adjusted for inflation) from the relevant reference retail price it calculated under Step 2 and derives a **new wholesale charge** for each Core Premium Sports wholesale product.

10.250 Where Sky intends to change its retail prices we therefore expect it will propose to Ofcom the resulting change to the wholesale must-offer price. Ofcom will check that the calculations comply with the methodology set out in Annex 7, and if that is the case will issue a direction under the licence condition set out in Section 12 to effect a change to the maximum price for the regulated offer.

10.251 In summary, the margins for each Core Premium Sports wholesale are:

- Sky Sports 1: £16.74.

- Sky Sports 2: £17.03.

- Sky Sports 1&2: £18.91.

<u>We will review the wholesale margins commencing after three years</u>

10.252 The wholesale margin calculations are complex and require a large amount of data as inputs. It is our view that it would be impractical and impose a large regulatory burden on Sky to do this exercise on a regular basis, e.g. annually as suggested by the Three Parties. In addition, a period of certainty will be required to ensure that the industry as a whole has had the opportunity to negotiate and implement the necessary wholesale arrangements and, in due course, evaluate their effectiveness.

This would not be possible if the wholesale charges were to be reviewed on an annual basis.

10.253 Therefore, as discussed in Section 9, we intend to commence the review three years from the remedy coming into effect. This is consistent with our proposals in the Third Pay TV Consultation (paragraph 9.241). Any review would focus on establishing whether there had been any areas of material change, such as a major change in the ownership of key rights. Only in the event of such major changes in the market, would we expect to carry out a full review of the remedy. We also acknowledge that it may be appropriate to review these provisions before this time if we were to consider that there had been a significant shift in the operation of the market.

We will consider wholesale margins in relation to material changes in Sky's costs

10.254 In the event of a material change to Sky's retail or wholesale costs, we will consider whether it would be appropriate and proportionate to re-calculate the retail margins and related wholesale prices for each of the Core Premium Sports packages. Although this could lead to some uncertainty, we believe it will only be necessary in exceptional circumstances to ensure fair and effective competition. It would be very difficult for us to determine in advance each and every condition under which we would consider reflecting a material change in Sky's retail or wholesale costs in its wholesale prices, without fettering our discretion. However, we expect that any material change in the operation of the market, which could trigger a review of the remedy, is also likely to have an impact on Sky's costs base i.e. a major change in the ownership of key rights or Sky shifting significant amounts of content between its pay TV channels (especially in cases where premium content is shifted to channels not covered by the remedy). In order to ensure fair and effective competition we would need to consider each case on its merits.

How should wholesale prices be adjusted for wider bundles?

10.255 As explained in paragraphs 10.103 to 10.114, we have derived wholesale prices for Core Premium Sports packages by starting from bundles comprising no other Core Premium Channels or non-TV services (such as broadband and telephony). In other words, we have focussed on Sky's sports-only pay TV retail bundles which include Sky Sports 1, Sky Sports 2 or Sky Sports 1&2 together with basic channels. The intention of the wholesale must-offer remedy is to allow other retailers access to Sky's Core Premium Sports packages, so that they are able to compete with Sky's retail bundles. However, we have not made any allowance for the costs and revenues of other services that Sky bundles with Core Premium Sports packages. Therefore there is a risk that competitors are not able to replicate Sky's broader bundles, for example 'triple play', including TV, broadband and telephony. We would be particularly concerned if the incremental price of an additional product in Sky's bundles was below its long run incremental cost.

10.256 In our Third Pay TV Consultation (paragraphs 9.203 to 9.208) we outlined a test that would be applied should this be an issue in the future. We proposed that where the incremental price for an additional product was less than its long run incremental cost, wholesale prices would be adjusted by adding the incremental price of the additional product and subtracting its long run incremental cost, resulting in a lower wholesale price for Core Premium channels. We further proposed to apply the adjustment to all relevant wholesale prices but to apply the adjustment only when a bundled product is sold to a material number of subscribers (for example, 5% of Sky's retail subscriber base).

10.257 In its response, Sky[1521] argued that our proposal was without basis and that the concern was unwarranted if we applied a wholesale must-offer remedy. It further argued that bundling was not an abuse per se: in its view it should be sufficient that incremental revenues exceed incremental costs from all bundled products. On the other hand, the Three Parties[1522] agreed with our proposed approach and further proposed that we should commence our analysis of the incremental costs and revenues of Sky's additional bundled products as soon as possible.

10.258 Our objective is not to prohibit bundling per se, but to ensure that Sky cannot undermine the efficacy of the wholesale must-offer remedy for Core Premium Sports products, by bundling other non-TV products in a manner that effectively reduces the margin afforded to alternative retailers when competing with Sky. Our focus is on non-TV products, as our retail-minus calculation methodology already addresses bundles containing additional content or TV services:

- Our reference retail price includes Multiroom and is also a weighted average of Sky's retail prices for the relevant Core Premium Sports packages with different numbers of basic channels (see paragraphs 10.92 to 10.102)[1523].

- We have cross-checked that the incremental price of the Core Premium Movies channels is not set below their incremental cost (see paragraph 10.220).

10.259 In relation to additional non-TV products, and having considered Sky's response, we have decided that the appropriate test is to consider whether the incremental revenues exceed the long run incremental costs from all Sky's bundled non-TV products (such as broadband and telephony). We have defined an aggregate (rather than a product-by-product) test on the basis that it encourages other retailers to be as efficient as Sky, in this respect, since we consider the wider non-TV services to be replicable. However, in this context, the aggregate test we have specified will apply to each Core Premium Sports wholesale product, bundled with non-TV products, separately. This is required to ensure fair and efficient competition, whereby competing retailers and Sky are on a level playing field with respect to the provision of Core Premium Sports wholesale products.

10.260 We recognise that the aggregate test as specified above may mean that there are specific bundles which other retailers cannot compete with directly – because the incremental price for that specific product is below its long run incremental cost. However, if there is material adoption of these packages we would expect to see this reflected in the aggregate incremental costs and incremental revenues for bundled non-TV products. In addition, we acknowledge that it would be impractical and disproportionate to apply this test on a product-by-product basis to all bundles of non-TV products, given the large number of different product variants and the practical challenge of determining the incremental costs associated with smaller additional non-TV products. An aggregate approach also means that we would not need to subject the additional products to a materiality test – products with very low take-up would have a minimal effect on the overall test.

[1521] Sky response to the Third Pay TV Consultation, Section 9, paragraphs 9.113-118.

[1522] Three Parties response to the Third Pay TV Consultation, Section 9, paragraphs 9.90-93.

[1523] As we have discussed in paragraph 10.87, we have excluded revenues and costs associated with TV related services, which we consider do not form part of Sky's core retail subscription packages. These include Sky Box Office and stand alone channels such as MUTV or Chelsea TV.

10.261 In summary, we have decided that it is appropriate to apply a downward adjustment to Sky's wholesale prices for each Core Premium Sports product, in the event that Sky prices its packages for Core Premium Sports products bundled with non-TV products such that the aggregate long run incremental costs of the non-TV products exceed their aggregate revenues. For the reasons set out paragraph 9.207 of the Third Pay TV Consultation, we have also decided that if such an adjustment should apply, it should apply to all relevant wholesale prices.

10.262 We have also considered the option of whether it would be more appropriate to rely on CA98, rather than introducing the test described above. However, as discussed in our Third Pay TV Consultation, it would not be more appropriate to proceed under CA98, and it is therefore appropriate to include it within the scope of our proposed remedy. The reason for this is that our rationale for proposing an adjustment is to ensure that Sky cannot undermine the remedy which applies to Core Premium Sports channels by bundling other products with them in a manner that reduces the margin we believe alternative retailers need to be able to compete. As explained above, we have determined that margin on the basis of an ex ante pricing rule which takes account of scale effects. It is therefore likely to be somewhat higher than the margin that might be derived under a competition law test, but it is nonetheless entirely consistent with our objective of ensuring fair and effective competition. There is a risk that this objective would be undermined if Sky could bundle additional products with Core Premium Sports channels, in a manner that is consistent with the application of competition law to the entire bundle, but reduces the margin alternative retailers need to earn on Core Premium Sports channels.

Non-price terms for the wholesale must-offer remedy

10.263 In our Third Pay TV Consultation, we said that as a result of Sky's approach to the wholesale supply of its Core Premium channels, there is not, and is not likely to be, fair and effective competition in the wholesale supply of Core Premium channels and the retail supply of bundles which include Core Premium channels.[1524] To address this concern in a proportionate manner which ensures that we meet our obligations to ensure fair and effective competition under s316(1), we proposed a wholesale must-offer remedy on FRND terms.

10.264 The licence conditions on which we consulted in the Third Pay TV Consultation (the "Conditions") required Sky to license the channels and content subject to the wholesale must-offer remedy within a reasonable time, on fair and reasonable terms and without undue discrimination. They also required Sky to produce the standard terms and conditions under which offers would be made.

10.265 We discussed above in Section 9 the comments made on the proposal that the terms of Sky's offer should be regulated given the failure to date to reach wholesale supply agreements. We concluded that it is necessary to set terms for the wholesale must-offer remedy, including prices, to ensure it is an effective mechanism for enabling fair and effective competition. We received some detailed comments from Sky and the Third Parties on the drafting of the Conditions, which we discuss below at Section 12. Other than the comments referred to in Sections 9 and 12, we did not receive any direct comments on the principles that Sky's offer should be on fair, reasonable and non-discriminatory terms, made within a reasonable time of written request and made on a non-exclusive basis as proposed in draft Condition 14A(1) of the Third Pay TV Consultation.

[1524] Third Pay TV Consultation, paragraph 8.3.

10.266 Ofcom considers that it would not be practical or proportionate to dictate specific terms and conditions of supply. We consider that, given the need to regulate offer terms in order for terms to be agreed within a reasonable timescale, the most practical means of doing so is to give Sky the flexibility to set out terms which it considers to be fair and reasonable, and give competing retailers the ability to resolve any complaints which arise in a timely manner. We have therefore decided to adopt this approach, in accordance with draft Condition 14A(1).

10.267 This Section sets out a number of further decisions and views we have reached in relation to the 'non-price' terms of supply of the Core Premium Sports channels and interactive content. We provide guidance to help stakeholders understand our views on how we would propose to interpret the Conditions set out in Section 12 if we were required to investigate a complaint. However, it should be noted that we cannot fetter our discretion ahead of receiving a complaint and all investigations would be conducted on a case by case basis taking into account the specific facts.

We require Sky to produce a reference offer within six weeks

10.268 In the Third Pay TV Consultation we proposed that Sky produce a reference offer (the "Reference Offer") setting out the standard terms and conditions under which it would supply the channels and interactive content to be made available under the proposed wholesale must-offer remedy.

10.269 Sky argued[1525] that it should have freedom to negotiate bespoke terms with each retailer and that the flexibility of this approach would result in terms which better reflected the needs of each retailer.

10.270 It is however apparent that Sky has, to date, failed to reach negotiated terms for wholesale supply of its Core Premium Sports channels (other than with cable operators), and we maintain our view that there is a significant risk that if Sky were free to negotiate terms with each retailer without the Reference Offer in place this would introduce a significant delay in agreements being reached. Production of the Reference Offer will provide transparency of the terms being offered by Sky and a starting point for negotiations, thereby accelerating the process of agreeing terms. It will not prevent Sky negotiating bespoke terms with individual retailers. We have therefore concluded that Sky should produce a Reference Offer.

10.271 Sky stated that it would need at least three months to produce a reference offer[1526]. **[✂]**[1527] considered that one month would be sufficient, and this view was supported by the Three Parties in their joint submission[1528].

10.272 We have reviewed a number of existing contracts between premium channel providers (including Sky) and pay TV platforms for both retail and wholesale supply and have concluded that (i) there are many terms which are common to a number of

[1525] Sky response to Third Pay TV Consultation, paragraphs 9.109-9.112.

[1526] Sky response to Third Pay TV Consultation, paragraphs A8.16.

[1527] **[✂]** response to Third Pay TV Consultation paragraph 5.6.

[1528] Three Parties response to Third Pay TV Consultation, paragraph 14.3.

the existing contracts and (ii) in the case of **[✂]** drafting and negotiation of heads of terms was achieved in six weeks or less. (**[✂]**[1529]).

10.273 Sky already has a wholesale supply agreement in place with Virgin Media and a retail agreement in place with Tiscali / TalkTalk TV for Core Premium Sports and Movies channels. In addition to these, it has a number of expired contracts with cable operators. **[✂]**[1530].

10.274 Sky could use these existing and legacy contracts as the basis for the Reference Offer (amended to comply with the Conditions and to reflect the guidance set out below where necessary). Such an approach should minimise the time required to draft the Reference Offer because these contracts contain many of the terms that we would expect to be included in the Reference Offer (although we have not taken a view on whether the terms in existing and legacy contracts are consistent with the requirement that terms be fair and reasonable).

10.275 Based on the evidence outlined above, we conclude that it would be reasonable to expect Sky to produce the Reference Offer within six weeks of the Conditions being imposed. We anticipate that the Reference offer will not be a fixed document and that Sky may wish to update it to take into account developments over time.

10.276 Sky argued[1531] that one of the downsides of requiring the production of a Reference Offer would be to reduce its flexibility in relation to carriage agreements, such as the ability to tailor terms and conditions to the requirements of a particular retailer.

10.277 We recognise that Sky and retailers may wish to amend the terms of the Reference Offer to reflect individual needs. We would not normally object to such changes, i.e. we would expect the terms of the Reference Offer to be negotiable. However, the terms agreed would be subject to, inter alia, Condition 14A(1)(e) which requires Sky to show no undue discrimination in the terms offered to retailers.

10.278 In addition, the requirement to produce the Reference Offer does not prevent Sky negotiating bespoke terms with retailers (as long at those terms are consistent with the Conditions). For example, we would expect Sky to continue any negotiations it had commenced with prospective retailers before the Conditions were imposed, and not delay these negotiations whilst the Reference Offer is being produced. We would though expect any bespoke terms established in negotiation with one party to be available to other parties in a broadly similar position.

10.279 Thus, whilst we require Sky to produce the Reference Offer, we do not seek to dictate the content of the terms of the offer, nor are we preventing Sky and retailers from negotiating bespoke terms. We do however consider that the Reference Offer must be capable of forming the basis of a supply agreement without the need for protracted negotiation on bespoke terms.

10.280 Virgin Media[1532] and **[✂]**[1533] said that Sky should be required to consult on the Reference Offer prior to it being finalised.

[1529] **[✂]** response **[✂]** to Ofcom information request dated 20 October 2009, question 5.

[1530] **[✂]**

[1531] Sky response to Third Pay TV Consultation, paragraphs 9.111.

[1532] Virgin Media response to Third Pay TV Consultation, paragraphs 8.67.

10.281 There may be benefits from seeking specific views from other retailers. However, we note that we sought comments from potential retailers in our Third Pay TV Consultation. Moreover, the risk of this approach is that terms in the Reference Offer are unlikely to be acceptable to all prospective retailers. A consultative approach may result in further delay. We have therefore decided that Sky should not conduct a period of consultation on the drafting of the Reference Offer itself as this would delay engagement in negotiation on the terms with individual retailers. Whilst we expect that the Reference Offer to be sufficiently detailed such that a retailer could accept the terms without further amendment the period of negotiation provides an opportunity for individual retailers to address specific concerns with the standard terms of the Reference Offer.

10.282 **[✂]**[1534] said that the Reference Offer should be freely available to all interested parties and not subject to a Non Disclosure Agreement (NDA).

10.283 The Conditions require Sky to provide a copy of the Reference Offer to any person requesting it in writing. However, we recognise that the Reference Offer may include sensitive information, for example, relating to security requirements. For this reason Sky may choose to require a NDA to be signed by the requesting party and we do not require Sky to publish the Reference Offer on a publicly accessible website. We would expect Sky to update the Reference Offer periodically to ensure it remains compliant with the Conditions.

10.284 In summary, we have concluded that, in line with our obligation to ensure fair and effective competition, the requirement that Sky produce the Reference Offer, with the option of negotiating bespoke terms, within six weeks of the Conditions being imposed, provide it to any person who makes a request in writing (subject to, at Sky's discretion, a NDA) is the appropriate and proportionate approach.

Reference Offer to be open to any person meeting Minimum Qualifying Criteria

10.285 In the Third Pay TV Consultation we consulted on a proposed licence condition which required Sky to make the programme content available to "any person for retail by that person to residential consumers in the United Kingdom […]".

10.286 Sky argued that, in the extreme, this could allow individual consumers to request access to the wholesale programme content[1535]. However, the proposed conditions also required Sky to produce (as part of the Reference Offer) Minimum Qualifying Criteria ("MQC") that retailers must satisfy. We consider it likely that only a relatively small number of organisations will meet the MQC and Sky will not in reality have to agree terms and supply programming content to a very large number of retailers.

10.287 Requiring Sky to define the MQC (rather than Ofcom defining them) provides for the most practical approach, with Sky retaining flexibility to set fair, reasonable and non-discriminatory requirements which satisfy its own interests, whilst providing transparency to prospective retailers of the criteria that they must meet.

[1533] **[✂]** response to Third Pay TV Consultation, question 23.

[1534] **[✂]** response to Third Pay TV Consultation, question 23.

[1535] Sky response to Third Pay TV Consultation, paragraphs A8.9 and Sky's further supplementary submission to Ofcom dated February 2010.

10.288 As we stated in the Third Pay TV Consultation[1536], while documented MQC will help to provide clarity and transparency to prospective retailers, it is unlikely to be exhaustive and Sky could have additional, objectively justifiable concerns in relation to individual retailers. In these circumstances we would expect Sky to enter into commercial negotiations to resolve these concerns. Where similar issues arise with a number of individual retailers we would expect Sky to update the MQC accordingly.

10.289 The MQC would have to be compliant with the Conditions, and we would therefore consider investigating any future complaints that they were not fair, reasonable and non-discriminatory. In that context, we expect that:

- The MQC would not include a requirement that a retailer must operate its own platform.

- Any MQC relating to the financial stability of a prospective retailer would be objectively quantifiable and justifiable.

10.290 There are a number of other technical and operational requirements that Sky may wish to include in its MQC, some of which are discussed below.

<u>Offer available to retailers using Qualifying Platforms</u>

10.291 The proposed conditions in the Third Pay TV Consultation[1537] stated that the wholesale must-offer remedy would apply to any platform used for the distribution of programmes to residential consumers in the United Kingdom, other than a platform operated by Sky.

10.292 In Section 9 we clarified our position on the differences between ‘platforms’ and ‘distribution technologies’ and confirmed that the remedy would extend to those retailers intending to use the internet (and other distribution technologies) to distribute the Sky Core Premium Sports channels to any platform but would not extend to platforms operated by Sky.

10.293 We would expect Sky to list the platforms which it operates in the Reference Offer. If, in the future, Sky considers that other platforms are under its operation and should therefore be excluded from the wholesale must-offer remedy, then it should update the Reference Offer to detail the nature of the additional platform.

10.294 While we recognise that in due course Sky may operate a DTT platform (in light of its Picnic proposal), at the current time, the only platforms we are aware are operated by Sky are:

- The satellite platform for which Sky provides technical platform services (i.e. management of the Electronic Programming Guide (EPG), Conditional Access services and Access Control service).

- The SkyPlayer software based platform available on Microsoft Windows, Apple Mac and Microsoft Xbox.

[1536] Third Pay TV Consultation, paragraph 9.217.

[1537] Third Pay TV Consultation, paragraph 11.10.

- The SkyMobile TV software based platform available on the Apple iPhone and iPod Touch and on selected phones on 3G networks.

10.295 In Section 9 we noted that due to the ongoing developments in the industry it is not possible to provide a simple, future proof definition of what constitutes a platform. We recognise that this may lead to disagreement between retailers and Sky on what constitutes a platform under Sky's operation.

10.296 Whilst we are unable to provide a definition, if we were to receive a complaint relating to which platforms Sky could reasonably claim it operated and hence exclude from the remedy we would consider the characteristics that are typical in existing platforms in reaching a view. For example, Sky may be considered to be the operator of a platform if:

- It is in sole control of the range of content that is presented to the end customer of the platform, for example by operating an EPG or search function.

- It is able to restrict access to content to those end customers who are entitled to view it, for example, by operating a Conditional Access service.

- It has a direct billing/payment arrangement with the end customer (although we note that this is not the case in respect of the Sky satellite platform on which 3rd party retailers have direct billing relationships with end customers).

10.297 This is not an exhaustive or definitive set of characteristics and each complaint would be considered on a case by case basis.

10.298 As set out in Section 9, given new technology development there is likely to be an increasing number of 'platforms within platforms', in which multiple software based platforms reside alongside each other on a single hardware platform under the control of the end user (for example, in the case of a PC) or a third party (for example, in the case of games consoles such as the PS3 or XBox). As a result, the mere presence of a Sky retail service on a given end user device is unlikely to be sufficient to conclude that Sky is the operator of the underlying hardware platform.

10.299 For clarity, and as set out in the Third Pay TV Consultation[1538], while Sky's satellite platform is excluded from the remedy, satellite distribution technologies are not. As a result retailers could make use of other satellite platforms to distribute the Sky channels and content covered by the wholesale must-offer remedy (subject to those platforms meeting Sky's MQC and MSRs). Similarly, we regard the internet as a distribution technology and so the remedy is available to retailers seeking to use internet distribution to non-Sky platforms based on, for example, an underlying Canvas compliant platform.

Reference offer to include Sky's Minimum Security Requirements

10.300 Throughout our pay TV review, we have acknowledged that provision of adequate content security is necessary to protect pay TV revenues and that it is reasonable to expect any platform distributing Sky's premium channels to comply with Sky's security requirements. However, we have also been clear that perceived concerns over the quality of security arrangements on a particular platform should not be used by Sky as a reason for withholding channels subject to a wholesale must-offer

[1538] Third Pay TV Consultation, paragraph 8.52.

remedy unless these concerns are objectively justified. Therefore, we take the view that requiring Sky to include fair, reasonable and non-discriminatory MSRs in the Reference Offer without detailing their components will address its legitimate security concerns while also fulfilling our obligation to ensure fair and effective competition.

Technology agnostic MSRs

10.301 In the Third Pay TV Consultation[1539], we proposed that Sky set out the MSRs that would need to be met by platforms carrying the channels made available under the wholesale must-offer remedy and that we expected these requirements to be defined in technology and platform agnostic terms. The MSRs may include both technology and operational requirements.

10.302 **[✂]**[1540] raised concerns that Sky may include MSRs which included requirements which went beyond what is common practice in pay TV markets around the world. BT called for a firm timetable to be put in place for resolving security issues[1541]. The Three Parties suggested that Sky should be fined if it proposed MSRs which were not fair, reasonable and non discriminatory[1542] and that Sky should not be able to impose financial indemnities on retailers whose platforms have suffered from piracy[1543]. Sky questioned whether **[✂]** and **[✂]** had upgraded their platforms to the latest version of the **[✂]** conditional access system[1544].

10.303 Since the Third Pay TV Consultation, we have reviewed a number of existing and proposed wholesale and retail channel distribution contracts (**[✂]**), as well as a report from an independent consultancy (Farncombe Technologies, commissioned and submitted to Ofcom by Top Up TV and BT) which specialises in pay TV security with a view to understanding current industry practice for defining security requirements[1545]. Based on this evidence, we have concluded that it is practicable for Sky to define MSRs in largely technology agnostic terms. However, we also recognise that there may be some merit in defining variants of MSRs for platforms that predominantly use broadcast distribution technologies (such as DTT and satellite) and platforms which have a permanently connected two way interactive channel (such as broadband internet or 3G mobile) due to the additional opportunities that permanently connected platforms offer in terms of securing content.

10.304 As an example of the MSRs being defined in a way which is fair and does not show undue discrimination, we would not expect Sky to include requirements which were not supported on its satellite platform or that were not generally considered to be

[1539] Third Pay TV Consultation, paragraphs 9.218 to 9.227.

[1540] **[✂]** response dated September 2009 to Third Pay TV Consultation, paragraph 5.5.

[1541] BT response dated September 2009 to Third Pay TV Consultation, paragraph 5.4.

[1542] Three Parties response dated September 2009 to Third Pay TV Consultation, paragraph 15.7.

[1543] Three Parties response dated September 2009 to Third Pay TV Consultation, paragraph 15.8.

[1544] Sky response to Third Pay TV Consultation, paragraph 6.101.

[1545] We provided this report to Sky for its comment. Sky raised a number of specific concerns with the report and made a number of observations on the operation of conditional access systems. We have taken Sky's views into consideration in coming to a decision on the matters set out in this section.

common practice within the pay TV industry unless there were objectively justifiable reasons why such requirements were relevant to other platforms, but not to its own. Again, this reflects our obligation to ensure that there is fair and effective competition in the provision of the licensed services.

10.305 The Conditional Access (CA) technologies currently used by Virgin Media, BT Vision and Top Up TV are supplied by Nagravision ('Nagra'). In the past, Sky has expressed security concerns in relation to the technical capability of **[✂]**[1546]), **[✂]**. This is why, when we were discussing possible commitments to wholesale supply, the draft commitments (Annex 1) specified that **[✂]**. We recognised that this does not mean that platforms using **[✂]** are necessarily 100% secure or that security concerns will not arise in the future, since security is a function of the operational processes in place to address piracy as well as the CA technology in use. It does however mean that we would not expect any MSRs produced by Sky to rule out the use of **[✂]**, either explicitly or implicitly.

<u>Addressing piracy</u>

10.306 In our Third Pay TV Consultation, we acknowledged that no CA system is 100% secure and that MSRs may include requirements associated with subscriber audits and operational processes to establish the levels of any service theft and remedial action to be taken in response to a security breach[1547]. Since then, we have requested detailed information from the main pay TV providers in the UK about the state of content piracy originating from their platforms. **[✂]**. As a consequence, and to ensure that terms relating to MSRs are proportionate in the circumstances, we would not expect MSRs to require a platform to be 100% free of content piracy.

10.307 Further, we recognise that older receiver equipment within existing pay TV platforms may not be able to support the same level of security features as current generation equipment (due to technical improvements that are implemented in more recent receivers). We would expect MSRs to reflect the fact that, on existing platforms, there may be different levels of security supported on subsets of the receiver population and that replacing the legacy equipment may not be commercially viable, or proportionate given the nature and threat of any security concern.

10.308 Our review of information provided by the main pay TV operators[1548] indicates that industry common practice is to continually invest in improving security arrangements. This includes pro-actively monitoring for piracy and security threats, deploying technical counter measures, upgrading replaceable security devices (i.e. viewing cards) and pursuing convictions against those involved in service theft. We expect that Sky may include a requirement to adopt industry common practice within its MSRs.

[1546] Sky further additional submission relating to platform security issues dated June 2009, paragraph 6.3.1.

[1547] Third Pay TV Consultation, paragraph 9.227.

[1548] Sky response dated 23 December to information request dated 29 October. Virgin Media response dated December 2009 to information request dated 29 October 2009. BT response dated December 2009 to information request dated 29 October 2009. Top Up TV response dated November 2009 to information request dated 29 October 2009.

10.309 Based on our review of existing contracts[1549], we recognise that Sky may seek to include in its MSRs requirements that retailers meet with Sky on a regular basis to share intelligence about security threats, provide updates on initiatives to improve security and the status of ongoing investigations and prosecution of those involved in piracy. Ofcom considers that such initiatives could benefit industry as a whole by helping reduce piracy, and, in the long term, benefit consumers due to the reduction in lost revenues.

10.310 In the event that Sky seeks to include audit rights of security systems within its MSRs we would expect that these be drafted on a FRND basis, and in such a way as to be proportionate to any objectively justifiable security threat. As specific examples of issues where this might be unclear, we offer the following guidance:

- We would not expect Sky to require access to any commercially sensitive information relating to operation and development of the retailer's chosen security system unless it could demonstrate that this was necessary and that it had put in place appropriate safeguards to protect the confidentiality of any information that was provided.

- We would not expect Sky to require the retailer to provide Sky with access to technical information relating to the operation of its chosen security system which could be useful to someone trying to circumvent the security system (e.g. technical details of the cryptographic techniques used within the retailer's chosen Conditional Access system) unless it could demonstrate that this was necessary and that it had put in place appropriate safeguards to protect the confidentiality of any information that was provided.

- We would expect the detailed scope and evaluation criteria of any security audit to be set out in the MSRs to ensure that they are transparent and objective.

10.311 In the event that a retailer and Sky cannot agree on how security audits should be performed it may be appropriate for the parties to employ a mutually agreed third party to perform the audit.

Copy protection

10.312 Sky highlighted that it has numerous security and content protection obligations to upstream rights holders[1550]. Whilst these primarily relate to Hollywood movie studios, some may relate to owners of sports rights. It is likely that Sky will seek to ensure that retailers of the channels available under the wholesale must-offer remedy comply with the relevant requirements. Our review of existing and legacy contracts[1551] has shown that **[✂]**. If Sky does include requirements relating to copy protection in its MSRs our view is that the least interventionist approach we can adopt, which also allows us to fulfil our statutory obligations, is to require Sky to offer similar levels of flexibility as it has in the past.

[1549] The **[✂]** provided by Sky in its response dated September 2009 to the Third Pay TV Consultation, Appendix 2. **[✂]** provided by Sky in response dated December 2009, annex 9, to information request dated 29 October 2009.

[1550] Sky response to Third Pay TV Consultation, paragraph 6.96.

[1551] For example, paragraph 6.2 (f) of the **[✂]** provided by Sky in its response dated September 2009 to the Third Pay TV Consultation, Appendix 2.

Reference offer to include details of technical interconnect and operations

10.313 There are a number of technical interconnect arrangements required to enable distribution of the Core Premium Sports channels and content on retailers' platforms. We would expect Sky to include details of these arrangements in its Reference Offer.

"Factory gate" supply

10.314 In the Second Pay TV Consultation[1552], we proposed that Sky should make the channels subject to the wholesale must-offer remedy available at an interconnect point on its premises (Sky's "factory gate") such that retailers could install leased lines to transfer the channels and associated data to their own facilities before distributing to their own customers.

10.315 Virgin Media proposed that the remedy should be extended to include delivery to the retailer's premises by satellite[1553]. This is the current delivery method used to deliver Sky's channels from Sky to the Virgin Media head-end.

10.316 We recognise that Virgin Media may prefer to continue to receive the channel feeds from Sky via satellite, rather than install new leased lines. However, we do not consider that it is necessary or proportionate to extend the remedy to include wholesale delivery via satellite to address the issues we have identified. The remedy requires Sky to make the relevant channels available at its "factory gate" and the costs of onward delivery would be borne by individual retailers. We note that Virgin Media (and other retailers) are free to negotiate with Sky to take channel feeds via satellite rather than leased lines.

10.317 We would expect the Reference Offer to include details of the technical and operational arrangements which are required for a retailer to interconnect with Sky. For example, we would expect Sky to explain the following:

- The technical interface(s) that Sky will present to retailers to allow them to take delivery of the programming and associated data feeds and responsibilities for procurements and operation of equipment.
- Equipment co-location arrangements (where it is necessary for a retailer to install equipment on Sky's premises).
- Processes for implementation and test plans for implementing a link.
- The operational processes associated with the day to day operation.
- Provision of resilience and redundancy arrangements to maximise availability.

10.318 We would expect Sky to include terms that address the need to ensure that the quality of the audio and video feeds provided by Sky (for both SD and HD channels) is such that the quality of video and audio delivered to end users is maintained given the normal quality degradation that can be expected in the distribution chain.

[1552] Second Pay TV Consultation, paragraphs 9.34 to 9.38.

[1553] Virgin Media response dated September 2009 to the Third Pay TV Consultation, paragraph 8.54.

Video and audio quality experienced by consumers

10.319 Given the range of different distribution technologies and platforms on which the channels could be viewed there is likely to be a range of consumer expectations of the quality of video and audio. For example, viewers will not necessarily expect the same picture quality on a PC as they would on a TV. Consequently, it may not be proportionate or appropriate for Sky to define a single quality threshold that retailers must achieve as part of its MQC.

10.320 We would expect terms relating to the quality of video and audio to take account of the reasonable expectations of target consumers, in line with FRND principles. We note that the availability of Sky premium channels on TV, PC, XBox and iPhone, each with varying levels of picture and audio quality, is evidence that customers are willing to trade off picture and sound quality for other service characteristics and that a single, absolute quality threshold is not maintained across all platforms.

10.321 Given the ongoing development in video encoding algorithms and implementations we would not expect Sky to specify the exact compression algorithms or the encoding bit rates to be used for distribution of the wholesale must-offer channels.

Editing, re-sizing and overlay of wholesale must-offer channels

10.322 From our review of existing contracts, it appears to be common practice for the channel provider to define rules in relation to how channels can be edited, re-sized on screen and how interactive and other content can be overlaid by the retailer: e.g. rules on how channels can be shown as a "mini screen" within an EPG or how a third party interactive service can be initiated from the channel and overlaid on the channel.

10.323 Whilst it may be reasonable for Sky to include such requirements in its Reference Offer, the overlay of interactive content (particularly that delivered via broadband connections) is a key area for innovation in the TV sector. For example, in the SkyPlayer on XBox service, the viewer is able to re-size the Sky channel to allow avatars of the user and their friends to be displayed on screen. These new services have the potential to bring new innovation to TV services and benefits to consumers. Whilst we recognise that Sky may have obligations to upstream rights holders and may have guidelines on how the Sky brand can be co-located with other content, we would nonetheless expect Sky's terms in relation to this to be fair, reasonable and non-discriminatory, and that Sky would set out any particular requirements in its Reference Offer.

Other technical arrangements

10.324 In addition to the above, we would expect the Reference Offer to set out technical details relating to the implementation and operation of other technical aspects of the service. These may include (but are not limited to):

- Timely provision of accurate EPG data.
- Data associated with parental control settings (i.e. age ratings).
- Data feeds for access services (Audio Description and Subtitles).

Interactive content

10.325 In the Third Pay TV Consultation[1554], we proposed that any audio and video streams that consumers access via an interactive service linked to the wholesale must-offer channels should be included in the remedy. This included live sporting events shown "behind the red button" on Sky Sports 1 and Sky Sports 2. Section 9 sets out our decision that interactive content should be made available as part of a wholesale must-offer remedy on fair, reasonable and non-discriminatory terms and our reasoning in relation to that decision.

10.326 Sky claimed[1555] that Ofcom had not been sufficiently clear in defining the scope of the interactive content that we proposed to include in the remedy.

10.327 Evidence provided to us by Sky[1556] indicates that the nature of interactive services continues to evolve and the scheduling of events "behind the red button" is subject to frequent change. Because of this, we do not think it is practical to provide a simple, future proof definition of what interactive content should be offered by Sky under a wholesale must-offer remedy. We do however regard interactive content as part of the "licensed service" to which the remedy applies. Therefore, if we were to receive a complaint asking us to consider whether Sky had acted on a fair, reasonable and non-discriminatory basis in its approach to the interactive content in question we would normally consider the following:

- Whether the interactive content is directly accessible from a linear channel subject to a wholesale must-offer remedy on a platform operated by Sky.
- Whether the audio video stream(s) in question includes long form programming that exploits content rights that are also exploited on the linear channels available under the wholesale must-offer remedy, for example, football matches or simultaneous coverage of multiple golfers/holes in a tournament.
- Whether the functionality of the Sky interactive application (made up of, amongst other things, screen layouts, media assets and navigation logic) must be replicated on the retailer's platform in order that viewers can navigate between different audio/video streams showing relevant programming. For example, this would include menus, captions, navigation links, graphics and any configuration data required to change the set up of an application, but would not necessarily include supplementary, editorial, features such as live score boards, voting or transactional features.

10.328 Sky argued that Ofcom had underestimated the technical and operational complexity and cost associated with distributing interactive content on other platforms[1557]. **[✂]**[1558], **[✂]**.

[1554] Third Pay TV Consultation, paragraphs 8.101 to 8.111.

[1555] Sky response to Third Pay TV Consultation, paragraph 9.77 to 9.81.

[1556] Sky response dated 13 November 2009 to Ofcom information request dated 29 October 2009, question 24.

[1557] Sky response to the Third Pay TV Consultation, paragraphs 9.101-9.106.

[1558] Sky response dated 13 November 2009 to Ofcom information request dated 29 October 2009, question 24.

10.329 We recognise that there are technological and operational challenges in distributing interactive content on different platforms. As a result, we consider that a greater period of negotiation and service establishment may be required to deliver interactive content compared to linear channels. We therefore also consider it is not necessary for Sky to include standard terms on supply of interactive content in the Reference Offer.

10.330 Our review of existing and legacy contracts[1559] **[✂]**. The detailed information provided by Sky also illustrates that it has considered many of the relevant issues in advance. We will take this into account in the event we are asked to consider whether Sky has responded to a request for supply of interactive content within a reasonable time and under terms which are fair, reasonable and non-discriminatory.

10.331 Both Sky and retailers may incur costs when developing solutions to distribute interactive content on other platforms. Sky's directly attributable incremental costs are recoverable from the relevant retailer in addition to the prices for the content of channels determined above at paragraph 10.217.

10.332 Some retailers may prefer not to include interactive content in their retail services, for example, due to a high cost of implementation or technology constraints. Ofcom would not expect Sky to make the supply of the linear channels available under the wholesale must-offer remedy conditional on the retailer including interactive content in its retail service.

10.333 Should a retailer request supply of interactive content as well as supply of linear channels, due to the differing timescales which are likely to apply to agreement of detailed terms and service establishment of linear channels and interactive content, Ofcom would not normally expect the supply of the linear channels to be dependent on or delayed by the activities surrounding the supply of interactive content.

10.334 For clarity, Ofcom does not consider interactive advertisements to be subject to the Conditions.

Multiroom

10.335 The maximum prices that we have set for the Core Premium Sports channels entitle the retailer to offer Multiroom products to end customers (see paragraphs 10.85 to 10.91).

10.336 Until relatively recently Multiroom retail products simply allowed the end customer to watch the same channel packages on two set-top boxes within the same household. However, these packages are now more sophisticated. For example, customers subscribing to Sky's Multiroom offering are also able to access linear TV channels on an Xbox and up to 4 PCs (irrespective of the location within the UK of the XBox or PCs)

10.337 We recognise that the nature of Multiroom retail offerings are likely to continue to change over time, particularly as competition drives retailers to differentiate their products. We therefore do not propose to tightly define how a retailer can (and cannot) use the Sky channels within a Multiroom product. Doing so would risk unduly

[1559] For example, paragraph 6.2 (f) of the **[✂]** September 2000 provided by Sky in its response dated September 2009 to the Third Pay TV Consultation, Appendix 2.

restricting innovation and competition and would therefore not be consistent with our duty to ensure fair and effective competition.

10.338 If Sky were to include terms in the Reference Offer which constrained the characteristics of the Multiroom products retailers' could offer then these terms would have to be consistent with the Conditions. For example, we may consider that terms which prevented third party retailers offering Multiroom products with the same functionality as Sky's own retail Multiroom product are not compliant with the condition requiring no undue discrimination.

Content of channels available under the wholesale must-offer remedy

10.339 In the Third Pay TV Consultation we proposed a licence condition that would require Sky to set out in the Reference Offer "the arrangements under which changes to the content of the Licensed Service shall be notified and agreed".[1560] Sky argued that such a requirement would amount to an unwarranted infringement on Sky's editorial control.

10.340 We accept Sky's criticism that it may be unduly burdensome for it to agree changes to the content of the affected channels. We have, therefore, amended the provision such that it is restricted to requiring Sky to include in the Reference Offer proposals for the notification of material changes to the content of the channel concerned. We do not consider that it will be unduly burdensome for Sky to have to notify changes which ultimately affect the value of the product being sold. The issue of what constitutes "material" in this context can be addressed by Sky in the Reference Offer, subject to the requirement on Sky to act in a fair, reasonable and non-discriminatory manner, and will then be subject to commercial negotiation. We set out our views on the risks of Sky gaming the remedy by moving content between channels in Section 9.

Other terms in the Reference Offer

10.341 The Conditions require Sky to cover a number of specific subjects in the Reference Offer:

- Terms of payment and billing procedures, including the arrangements under which the number of subscribers shall be agreed for the purposes of calculating payments due.
- A process by which disputes between Sky and retailers will be resolved during the term of the contract, for example, how disagreements over the effectiveness of a retailer's security system will be resolved. Ofcom would expect this process to have been invoked prior to parties coming to Ofcom with a complaint.
- The duration and notice periods of the agreement. From our review of existing and legacy channel supply contracts[1561], it is evident that the typical term of these contracts is three or four years.

[1560] Third Pay TV Consultation, paragraph 11.20.

[1561] For example **[✂]** provided by Sky in its response dated September 2009 to the Third Pay TV Consultation, Appendix 2.

10.342 Sky may also wish to include in the Reference Offer the notice period and process by which wholesale price changes will be notified.

10.343 Virgin Media called for a 90 day notice period for changes to wholesale prices[1562]. **[✂]**.

10.344 Given past behaviour we would normally expect Sky to adjust its retail prices once a year (in September). We do not see any reason or evidence to suggest that Sky will change this practice and hence retailers should have a degree of certainty as to when wholesale prices might increase even if the magnitude of the change is unknown. In addition, the level of any future increase of wholesale prices under the wholesale must-offer obligation / remedy would be subject to the margin mechanism set out above in paragraphs 10.231 to 10.245. Our decision provides that before Sky brings into effect any increase in wholesale charges, Ofcom must issue a direction. Overall this process will give retailers greater certainty over price levels as well as ensuring continuity of supply by Sky.

Cross promotion and advertising of service

10.345 In the Third Pay TV Consultation, we proposed that Sky's compliance with existing Broadcasting and Cross Promotions codes would address many of the concerns that might arise with advertising and cross promotion of its channels and services from the channels available under the wholesale must-offer remedy.

10.346 The Three Parties claimed that Sky has previously refused to sell advertising air time on Sky channels and that Ofcom should impose a licence condition that requires Sky to promote all of the pay TV retail services which include the Sky channels available under the wholesale must-offer remedy[1563].

10.347 Virgin Media argued that Sky has previously ignored the Cross Promotions Code[1564] and that this demonstrates that the Code would not be effective in preventing Sky promoting its channels excessively from its Core Premium Sports channels. It claimed that Sky should be required to give equal prominence to other platforms when promoting the availability of the Core Premium Sports channels and Virgin Media should be granted the right to replace damaging cross promotions and advertising[1565].

10.348 We have explored further whether it would be proportionate to introduce additional, ex ante regulation to address potential concerns over the use of cross promotions and advertising. We have concluded that development of specific ex ante conditions would be highly complex and therefore disproportionate in the context of the obligation to ensure fair and effective competition. It is also clear that some of the issues raised by stakeholders are not uniquely associated with the introduction of the wholesale must-offer remedy. We have therefore decided that we would consider any issues that arise in relation to these matters on an ex-post basis using existing regulation.

[1562] Virgin Media response dated September 2009 to Third Pay TV Consultation, paragraph 7.103.

[1563] Three Parties response dated September 2009 to Third Pay TV Consultation, paragraph 13.5.

[1564] Virgin Media response dated September 2009 to Third Pay TV Consultation, paragraph 8.58.

[1565] Virgin Media response dated September 2009 to Third Pay TV Consultation, paragraph 8.65.

10.349 Whilst we have decided not to introduce new ex ante conditions on Sky in relation to cross promotion, we would not expect Sky to include excessive cross promotion on channels subject to the wholesale must-offer remedy, as set out in our Third Pay TV Consultation[1566]. For example, we would expect that feeds provided to retailers would not include excessive promotions of Sky channels, services and features not included in the remedy that could lead to customer confusion and the perception that the quality of their service is being degraded. To avoid such a concern Sky may choose to provide "clean feeds" to retailers i.e. versions of the channels which does not include the same level of cross promotions as those used for Sky's own platforms.

Simulcrypt

10.350 In the Third Pay TV Consultation, we proposed that simulcrypt was not a necessary element of the wholesale must-offer remedy. Rapture TV argued[1567] that existing EU regulation requires Sky to support simulcrypt. However, we do not consider that Sky is currently under such a requirement. **[✂]** argued that simulcrypt would provide significant benefits if used on digital satellite.

10.351 Having reviewed consultation responses, we have concluded that a requirement for Sky to offer simulcrypt across all broadcast platforms is neither proportionate nor necessary to ensure fair and effective competition and to address the concerns that we have identified with the market and should not, therefore, form part of the remedy. This conclusion is based on our view that retailers are able to access broadcast and broadband capacity to allow distribution of the channels at commercially viable prices.

10.352 However, we also recognise that simulcrypt can provide significant efficiencies in the use of broadcast capacity, and we would therefore expect that parties would be motivated to agree simulcrypt arrangements where technically possible and commercially material, particularly on capacity constrained platforms such as those using DTT. The use of simulcrypt on DTT is discussed further in the Picnic Statement.

3D TV

10.353 For clarity, any 3D versions of the Core Premium Sports channels are not subject to the remedy.

Service establishment

10.354 Before the commercial launch of a new retail pay TV service which includes the channels and content included in the wholesale must-offer remedy, Sky and the retailer will have to implement a number of technical and operational "service establishment" arrangements, for example, installation and test of the leased lines from the Sky "factory gate" to the retailer's premises, EPG data feeds and parental control systems. To ensure service establishment does not fall on the critical path of the service launch plan we would expect Sky to make reasonable efforts to expedite this process.

[1566] Virgin Media response dated September 2009 to Third Pay TV Consultation, paragraph 9.237.

[1567] RaptureTV response dated September 2009 to Third Pay TV Consultation, question 23.

10.355 We recognise that the beginning of the UK football season is a key date in the pay TV calendar. From our review of the time taken for ESPN to establish its new premium sports channels on DTT, satellite and cable in 2009 we consider that it is realistic to expect that Sky could agree terms and undertake and complete the service establishment process in sufficient time to allow existing pay TV retailers (who wish to take advantage of the offer) to commence their consumer offering before the beginning of the 2010 football season.

10.356 The service establishment process may be expedited by commencing it before Sky produces the Reference Offer; for example, implementing the technical solution for "factory gate" supply could be progressed in parallel with the drafting of the Reference Offer (subject to suitable cost recovery arrangements being agreed where costs are directly attributable to a retailer). Additionally, we would normally expect the service establishment process to be progressed during negotiations over the Reference Offer and during any complaint investigation (if the substance of the complaint is unrelated to service establishment). Such an approach would help ensure the service establishment time line does not sit on the critical path toward service launch. We may consider an unnecessary delay in progressing the service establishment process as a potential breach of either the licence condition which requires Sky to offer the programme content within a reasonable time (Condition 14A(1)(d)) or of the condition requiring Sky to use its best endeavours to enable a retailer who has accepted a wholesale offer to commence retailing (Condition 14A(7)).

10.357 For retailers with existing distribution agreements with Sky (whether wholesale or retail), such as Virgin Media, we would expect any transition to new contractual terms and/or new technical or operational arrangements to occur smoothly with no unnecessary disruption to consumers.

Ofcom's complaint investigation process

10.358 If a prospective retailer believes that Sky is in breach of the Conditions they are entitled to bring a complaint to Ofcom.

10.359 We would normally expect to follow our 2004 Guidelines[1568] for investigations relevant to a complaint against Sky under the wholesale must-offer remedy, and we recommend that stakeholders read these Guidelines before contacting Ofcom regarding a complaint.

10.360 We recognise that a number of prospective retailers are likely to want to launch services based on the Core Premium Sports channels before the beginning of the 2010 football season and that consumer benefits will be maximised by minimising any delay in launching new retail services. It is therefore important that complaints are resolved as quickly as possible. Due to the amount of evidence collected and

[1568] Guidelines for the handling of competition complaints, and complaints and disputes about breaches of conditions imposed under the EU Directives, July 2004. Stakeholders should also consider Ofcom's 2006 consultation on revised guidelines, which are available at http://www.ofcom.org.uk/consult/condocs/enforcement/enforcement.pdf analysis conducted by Ofcom during the course of the market investigation, we are likely to be very familiar with the majority of issues raised in a complaint. This will help us to focus the scope of any complaint and as a consequence we will aim to expedite the completion of any investigation (whilst we recognise that the timeline will ultimately be determined by the facts of the specific complaint).

10.361 It is our preference that retailers agree terms with Sky without having to bring a complaint to Ofcom. To this end, we would expect Sky and retailers to enter into a period of negotiation after the Reference Offer is published. Ofcom would not expect to initiate a complaint investigation until this period had passed or there is material evidence demonstrating that agreement will not be reached. Given the short timescales required for **[✂]** to agree terms with a number of pay TV retailers and the availability of the Reference Offer, we consider that it should be possible to agree terms within a relatively short period. However, evidence to date suggests that retailers may fail to agree terms through negotiation and that we may therefore have to resolve complaints. In these cases, the period of negotiation will help to clarify the areas of disagreement and the positions of each party.

10.362 In the event that Ofcom receives a complaint relating to the terms offered by Sky, we would need to determine whether the terms were compliant with the Conditions, and specifically, whether the terms were fair, reasonable and non-discriminatory.

10.363 Whilst each case would be considered on the specific facts, in investigating a complaint that the terms proposed by Sky were not fair, reasonable and non-discriminatory we would normally compare the proposed terms with those in existing contracts that Sky and other channels providers have with retailers and platforms. Where the terms offered by Sky appear to be materially different than those used in existing, comparable contracts we would expect Sky to provide objectively justifiable reasons for those differences. For example, we may compare the terms proposed by Sky to those already in place with cable operators.

10.364 Where complaints relate to specific technical issues, such as disagreements on whether Sky's MSRs are FRND or whether a particular security system is compliant with the MSRs, we would normally expect to employ the services of industry recognised experts to assess the claims of each party. As part of an investigation we would expect each party to provide written evidence in support of their position. In order to expedite such an investigation Ofcom has already put in place a consultancy framework agreement with industry experts.

10.365 In cases where a retailer commenced negotiations in relation to wholesale supply of the Core Premium Sports channels prior to the Conditions being imposed it may be appropriate for Ofcom to consider a complaint sooner than outlined above. This may be the case if the terms offered by Sky in its Reference Offer are not materially different from terms the retailer had been previously unable to agree with Sky (and hence a further period of negotiation would be unlikely to result in resolution).

Section 11

Impact of the remedy

Summary

11.1 Taking into account both quantifiable and non-quantifiable benefits and costs to consumers and industry participants, the remedy we are putting in place has a positive effect.

11.2 There is always risk associated with new regulation, which is why we have taken care to design our remedy to minimise negative effects on the market.

- One of our primary reasons for putting a remedy in place is to ensure fair and effective competition between different retailers, in order to deliver both retailing and platform-related innovation for consumers. We acknowledge the risk that regulation in a fast-moving market can reduce innovation, and in this particular case that it could restrict innovation by Sky. We believe the design of our remedy addresses this concern, not only because it is likely to enable Sky to maintain and most likely increase its wholesale revenues, but also because we have modified our remedy to address specific concerns, for example by allowing pricing flexibility in the case of Sky's most important recent innovation – high definition.

- There could be a risk to the value of the content rights held by sports bodies. Again, we have designed our remedy specifically to minimise any negative impact, through for example the approach we have adopted to pricing.

- After several years of prolonged but ultimately fruitless commercial negotiations between Sky and others, we believe regulation to be necessary and that the licence conditions imposed are in the best interests of consumers.

11.3 **Consumers** will benefit substantially from the remedy we are putting in place, in terms of choice and innovation.

- Consumers will be able to make a freer choice of platform without being restricted by the unavailability of Sky's Core Premium channels on particular platforms or distribution technologies. Ten million digital terrestrial TV homes will potentially have access to premium content, the majority for the first time.

- Moreover, they will potentially have the choice of a wider range of types of package, as different retailers innovate by packaging premium channels in different ways. We expect this to include a wider range of lower-cost entry-level bundles, including for example those proposed by Sky for its Picnic service, as well as through competing services from other retailers.

- The benefit that we expect will accrue to consumers as a result of this increased choice is considerable. We expect to see around 1.6 million additional consumers of premium channels after five years. This is based on there being 1.8 million new consumers on digital terrestrial TV or IPTV, including Picnic, plus 0.3 million additional customers on cable platforms, partially offset by a reduction of 0.6 million on satellite as customers switch to digital terrestrial TV or IPTV platforms. Expressed in terms of the overall effect on consumer surplus, this translates into a £280m gain for consumers, discounted to present value, over five years. Furthermore, this static analysis excludes dynamic gains from innovation.

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

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

- We have set prices for Sky's channels at a level that will not allow other retailers to earn short-term profits at Sky's expense by simply reselling its channels. Our objective is to ensure effective competition from efficient operators that are prepared to make a substantial long-term investment in innovative pay TV services, not to support entry by firms that are either inefficient or unable to achieve sustainable scale.

- The benefits to these retailers will arise from the other services and propositions we would expect these providers to be able to offer as a result of access to premium content. These benefits are difficult to quantify with certainty, but are likely to be significant.

- In addition, our remedy should allow these retailers to compete effectively in the retail of wider bundles including non-TV services.

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

- We acknowledge that Sky will not regard the remedy as positive, or it would not have been necessary for us to impose it. We believe however that Sky's opposition is driven by two strategic incentives – to protect its retail business on its own platform(s), and to reduce the risk of stronger competition for content rights. To the extent that our remedy enhances competition between retailers on different platforms, and enhances competition for content rights, we believe these would be positive outcomes.

- We do not however believe that the remedy will be disruptive to Sky's existing business. The expected static effects on Sky include increased wholesale profits, a slight upfront reduction in wholesale revenues from Virgin Media, a reduction in satellite retail profits from customers switching to other platforms, plus the impact of Picnic (should Sky want to pursue this proposal). In terms of Sky's overall producer surplus (its total five-year profits in both retail and wholesale, discounted to present value), this is likely to translate into a net increase for Sky of more than £600m over five years.

- We acknowledge that Sky will have to bear some administrative cost of implementation, but given that this remedy largely extends the existing cable wholesale arrangement to other platforms, this cost should not be substantial.

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

- The most important competing bidders for sports rights in the past have been companies that will not take up the wholesale must-offer – free-to-air broadcasters such as the BBC, ITV, C4 and Five, and broadcasters such as ESPN and Setanta whose primary focus is on building their own wholesale business. These companies' incentives to bid are largely unaffected by our remedy.

- The incentives of platform operators / retailers such as BT and Virgin Media may be somewhat altered by the availability of our remedy. We do not however expect this to have a negative impact on rights values. Key rights holders have acknowledged in their responses to us that these companies have not historically been prepared to make significant investments in sports content, a position which is consistent with our own review of all the significant sports rights auctions in recent years.

- Our review of recent auctions indicates that there are likely to be additional determinants of Sky's bidding strategy, over and above the presence of competing bidders: first, its stated intention to invest in the quality of the sports content it buys, which in turn increases the attractiveness of the channels; second, the option for rights holders to go direct to consumers themselves, which provides a competitive constraint on Sky's bidding strategy.

- Sky already pays substantial sums for premium sports content at the same time as supplying its premium channels on a wholesale basis to cable operators. An important difference between the terms of current supply to cable operators and the terms of our remedy are the prices we have set. These prices are precisely intended not to damage Sky's ability to bid the sums it currently pays – hence the use of retail-minus pricing (i.e. where wholesale prices are worked out from the retail price rather than from wholesale costs), with a cross-check to ensure that we are not pushing prices below a cost-based price which includes a fair return on investment. As noted above, we believe that Sky's overall wholesale revenues, taking account of market expansion effects, are more likely to increase than decrease.

- The prices we have set for wholesale sports channels are unlikely to allow other retailers anything above a normal return in retailing those channels. As a result, although operators can avoid risk by taking Sky's channels, the real economic returns are at wholesale level. This, in addition to the importance of control over editorial decisions and branding, underlines why not only will Sky have an incentive to continue to bid in order to retain control over the rights, but also other operators such as BT or Virgin Media should have an incentive to gain control over the rights upstream rather than being content in the long term with wholesale access.

Structure of this Section

11.7 This Section is set out as follows:

- Introduction.

- Our approach to impact assessment.
- Remedy options.
- Effects on consumers.
- Effect on firms that may take advantage of a wholesale must-offer remedy.
- Effect on Sky.
- Effect on rights-holders.
- Equality impact assessment.

Introduction

11.8 This Section sets out an assessment of the impact of the form of the wholesale must-offer remedy developed in Sections 9 and 10 above on consumers, pay TV retailers other than Sky, Sky itself and rights-holders. Specifically, it follows the analysis set out in Section 10 of the Third Pay TV Consultation, in which we concluded that there was a range of dynamic benefits to which the proposed remedy would give rise, particularly driven by greater retail and platform innovation. There was also the potential for substantial static benefits to consumers resulting from a greater ability to exercise a choice of platform.

11.9 Previous Sections have determined what is likely to be the form of remedy which is appropriate to ensure fair and effective competition. Here we assess the impact of this form of remedy. We evaluate whether, by reference to our statutory duties, the benefits of the remedy outweigh its costs and any risks it creates. The results of this analysis enable us to conclude on the final form of the remedy, including any licence conditions it may be necessary to impose.

11.10 As set out above, our approach to assessing what form of wholesale must-offer, if any, it is appropriate to impose comprises four stages:

- A qualitative assessment of the various broad remedy options. This is set out above in Section 9, and explains why we believe that a wholesale must-offer with prices determined on a retail-minus basis is the most appropriate solution to the concerns we have identified.
- A qualitative assessment of the options relating to detailed design and implementation issues relating to the wholesale must-offer. This includes the rationale for the more specific details of the pricing arrangements and non-price terms set out in Section 10.
- A quantitative and qualitative assessment of the static effects of the resulting form of the remedy, including the specific prices that we are setting and the channels to which the remedy should apply.
- A qualitative assessment of the dynamic effects of the remedy – effects which by their nature cannot be readily or reliably quantified.

11.11 As noted, much of the qualitative assessment is described in Sections 9 and 10 above. This Section focuses on the third and fourth components of our assessment. We also include a detailed annex describing our quantitative analysis – see Annex 8.

Responses to our consultation – in summary

11.12 Sky disagreed with a number of areas of our impact assessment. Sky argued that the proposed price control is not targeted at a case in which action is needed. Furthermore, it argued that we had failed to appreciate the extent and scale of potential adverse consequences that would arise from the proposed regulation, which fatally undermined our assessment of proportionality[1569]. Sky also argued that extending wholesale price reductions to Virgin Media was an inadequately justified and disproportionate response[1570]. The Cave report, provided as an annex to Sky's response, predicted an adverse effect on competition and innovation, leading to regulatory co-dependency and anti-efficiency incentives on all producers. Both Sky and Professor Cave, acting on behalf of Sky, argued that Ofcom's proposals amount to industrial planning that could, unintentionally, adversely affect efficiency and consumer welfare[1571],[1572].

11.13 Several rights-holders also disagreed with the view presented in our impact assessment that rights values would not be significantly affected by a wholesale must-offer remedy. These organisations argued that the introduction of such obligations would diminish both Sky's valuation of rights and other operators' willingness to bid for rights.

11.14 The BBC generally agreed with our impact assessment and our arguments that the wholesale must-offer remedy is a proportionate remedy. **[✂]** also agreed with the conclusions of our impact assessment. **[✂]** agreed that a wholesale must-offer remedy was justified, but said the remedy imposed by Ofcom was unlikely to ensure fair and effective competition due to material design flaws[1573].

Our approach to impact assessment

11.15 This sub-section sets out our approach to impact assessment in the Third Pay TV Consultation, the responses we received from stakeholders, and the method we now follow.

Our approach in the Third Pay TV Consultation

11.16 In the Third Pay TV Consultation, we explained that we were able to evaluate the costs and benefits of the proposed remedy, but that complete quantification was impractical. We described in quantitative terms some of the static costs and benefits of the remedy, including the effects of Sky's Core Premium channels being retailed more widely. We also explained in qualitative terms the dynamic benefits we expected to arise from greater competition such as a faster pace of innovation. We analysed in qualitative terms the merits of different aspects of the remedy, for example our proposal to set regulated prices rather than allow prices to be

[1569] Sky response to Third Pay TV Consultation, paragraph 10.4.

[1570] Sky response to Third Pay TV Consultation, paragraph 10.6.

[1571] Annex 1 to Sky response to Third Pay TV Consultation.

[1572] Sky reiterated these arguments in paragraphs 6.1 to 6.4 of the November 2009 Sky Submission.

[1573] **[✂]** response to Third Pay TV Consultation, Q.25.

determined by negotiation, and to include in the remedy HD versions of Sky's Core Premium channels.

11.17 In our analysis, we compared a scenario in which the remedy is in place with the counterfactual scenario in which there is no such obligation and the current restricted distribution of Sky's Core Premium channels continues. In our quantitative model, we sought to calculate the likely benefits to consumers and producers (in terms of consumer and producer surplus) over a five-year period, calculating Sky's surplus separately from that of other retailers. These results were subject to a range of sensitivities.

Responses to our consultation

11.18 Sky stated that we had failed in our legal duty to carry out an impact assessment that "withstands robust and profound scrutiny". Sky argued that the shortcomings were so serious that Ofcom should restart its impact assessment and re-consult. In particular, Sky made the following criticisms[1574]:

- Sky argued that the impact assessment was an "add-on undertaken at the end of [Ofcom's] policy development process"; as such, the impact assessment was not a core part of policymaking[1575].

- Sky suggested that the conclusions of the impact assessment were unclear and its methodologies and scenarios were insufficiently explained. The description was "wholly inadequate to enable consultees to give intelligent consideration and intelligent responses to Ofcom's approach"[1576]. Sky suggested that this lack of clarity extended to our quantitative model. It argued that the impact assessment was spread throughout the consultation document, leaving consultees to guess which Sections were part of the impact assessment. This issue, Sky added, extended to the results of our quantitative analysis: "estimates [were] scattered through Section 10 of the Consultation Document in such a way that it is impossible to determine Ofcom's overall view"[1577].

- Sky stated that "the fundamental flaw in Ofcom's impact assessment is that it is based on an erroneous counterfactual"[1578]. Sky suggested that the counterfactual, which assumed that Sky's Picnic service was not active, was without merit. Sky argued that, "absent Ofcom's intervention, Sky's premium channels could already be available via DTT platforms, and would be made available via such platforms in the future"[1579]. Therefore, we should have

[1574] Sky did not comment in detail on our calculations in the impact assessment. Sky stated that it had instead set out a number of observations to which we should have regard in preparing a revised impact assessment, and reserved the right to comment more fully on our analysis in the event that we chose not to re-consult. See Sky response to Third Pay TV Consultation, paragraph 11.78. Sky reiterated its views about the robustness of our impact assessment in paragraphs 7.1 to 7.4 of the November 2009 Sky Submission.

[1575] Sky response to Third Pay TV Consultation, paragraph 11.14.

[1576] Sky response to Third Pay TV Consultation, paragraph 11.24.

[1577] Sky response to Third Pay TV Consultation, paragraph 11.22.

[1578] Sky response to Third Pay TV Consultation, paragraph 11.27.

[1579] Sky response to Third Pay TV Consultation, paragraph 11.30.

compared the effects of a wholesale must-offer remedy over and above the benefits which Sky's Picnic venture would have delivered.

- Sky contended that we had considered "only a single regulatory option", the proposed wholesale must-offer remedy, which was contrary to Ofcom's own guidelines. Sky suggested that we had failed to consider "alternative, less intrusive and realistic alternatives"[1580].

- Sky asserted that we had proposed a remedy containing "numerous separable elements" which should each have been assessed in its own right. For example, Sky suggested that we should have examined Sky's HD channels separately and that the incremental benefits of including these channels was "likely, *prima facie*, to be small" [1581].

- Sky asserted that our quantitative analysis was "not supported by any relevant evidence base" and that we had taken insufficient input from external experts in demand analysis[1582]. In particular, Sky criticised our approach to estimating demand functions for pay TV services. It suggested that we should have undertaken our own research into potential demand for pay TV on DTT. Sky also argued that we had placed "no weight at all on Picnic's business plan as a source of soundly based estimates" for demand on DTT, which estimated fewer subscribers than we assumed; Sky also suggested that this business plan may have overestimated potential demand[1583]. Both Sky and the Premier League argued that our use of research undertaken by Freeview was inappropriate.

11.19 The Premier League felt that our proportionality assessment failed to justify the remedy, and that we had not identified and analysed the economic costs of the remedy[1584]. It also provided results of a modelling exercise it undertook showing what it believed would be the effect of the remedy on Sky's combined wholesale and retail revenues[1585]. The Premier League also criticised what it perceived as a lack of explanation and exposition of our quantitative analysis[1586].

Our approach now

11.20 In this Statement we adopt a similar approach to impact assessment to that which we took in the Third Pay TV Consultation. In this Section and in Sections 9 and 10 we evaluate different remedy options in turn, identifying the most appropriate option. We clearly signal those parts of the document which form part of the overall impact assessment[1587], as we did in the Third Pay TV Consultation[1588].

[1580] Sky response to Third Pay TV Consultation, paragraphs 11.37 to 41.

[1581] Sky response to Third Pay TV Consultation, paragraphs 11.42 to 44.

[1582] Sky response to Third Pay TV Consultation, paragraph 11.83.

[1583] Sky response to Third Pay TV Consultation, paragraphs 11.98 to 11.103.

[1584] Premier League response to Third Pay TV Consultation, paragraph 11.62.

[1585] Premier League response to Third Pay TV Consultation, Annex 3.

[1586] Premier League response to Third Pay TV Consultation, paragraph 10.29.

[1587] See paragraphs 9.24 to 9.17.

11.21 We believe that the impact assessment in the Third Pay TV Consultation was communicated to a sufficient level of detail to enable stakeholders to respond meaningfully to the consultation. We provided Sky with a copy of the detailed spreadsheet model underpinning our quantitative analysis[1589]. We also provided Sky with a detailed description of the model's operation. Sky acknowledged in its response that it was "broadly speaking, now able to make informed submissions on Ofcom's cost and benefit estimates"[1590].

11.22 We also do not agree with Sky that our impact assessment should have been concentrated in a single Section of the consultation. Indeed, our approach reflects the fact that the impact assessment was an integral part of our decision making process (rather than an add-on as Sky claimed)[1591].

11.23 We believe it was incorrect for Sky to suggest that we assessed only a single regulatory option against the 'do nothing' option. We did not attempt to quantify the effects of other options, such as introducing a remedy without regulated prices, because of the extent of unknown variables associated with such an option[1592]. However, we have assessed – and continue to assess – qualitatively the effects of other options (see paragraphs 9.27 to 9.109), including more intrusive options than that which we then proposed.

11.24 Sky has suggested that we should have quantified the effect of different elements of the remedy. Indeed, Sky's view[1593] appears to be that we should quantify at a detailed level every aspect of every decision that we are making, despite the clear impossibility of doing so reliably. By their very nature, effective impact assessments need to combine qualitative analysis with quantitative analysis, while always recognising the inherent limits of quantitative analysis, especially with respect to dynamic effects.

11.25 We believe that our analysis of the different remedy elements, contained in other Sections of the Third Pay TV Consultation, was sufficient not only to satisfy our duties but also to enable us to make an informed choice about the appropriateness of the proposed remedy. We remain of this view.

11.26 In the light of responses to our consultation, we have reviewed the question of whether our remedy should cover both Sky's Core Premium Sports and Movies

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[1588] Third Pay TV Consultation, paragraph 10.6.

[1589] Confidentiality prevented the disclosure of this model to other parties, but we did disclose the full model to Sky, with limited / no redactions. While we received several sets of questions from different stakeholders on the detail of our pricing model, we did not receive any additional questions on the impact assessment model from parties other than Sky.

[1590] Sky response to Third Pay TV Consultation, paragraph 11.26.

[1591] See paragraph 11.18.

[1592] For example, we would not know the commercially-negotiated wholesale price likely to result from such an option, nor the extent of delay before a negotiated agreement was reached.

[1593] Sky told us in its response that, "Ofcom fails to recognise that its regulatory proposals contain numerous, separable elements, which have their own costs and benefits attached to them, which should be assessed separately." See Sky response to Third Pay TV Consultation, heading to paragraphs 11.42 to 11.44.

channels, or only the Core Premium Sports channels. We have explained in Section 9 that we do not consider it appropriate to impose a widespread wholesale must-offer obligation on Sky with respect to its movies channels. Instead, an obligation will only be triggered for DTT retailers if Sky launches a movies channel on DTT.

11.27 The exclusion of movies channels from the set of regulated prices is **[✂]**, particularly in the short term[1594] **[✂]**[1595]. Our forward-looking concern relates to the sale of VoD rights, a concern which cannot be addressed using our sectoral powers. As a result, our analysis here focuses on the effects of introducing a wholesale must-offer on sports. We have not sought to quantify the effect of including movies in the remedy.

11.28 If movies were included in the remedy, we would expect an increase in penetration of premium movies packages on Virgin Media, with an associated rise in benefits to consumers. **[✂]**, we do not consider that including movies as well in our analysis would make a material difference to the outcome with respect to new platforms. The availability of movies channels through DTT/IPTV would therefore make little change to our quantitative assessment. The treatment of movies channels in our quantitative analysis is summarised in Annex 8.

11.29 Sky made a number of comments on the quantitative elements of the impact assessment. We accept some of these comments, and have made changes to our quantitative model in light of them. In summary, our updated model:

- Uses updated inputs from the pricing model, including those which relate to retail and wholesale prices and costs. This is in order to reflect the changes to the pricing model since the Third Pay TV Consultation described in Section 10 and Annex 7.

- Uses more up-to-date forecasts of likely demand for premium pay TV packages, particularly on the DTT platform. These third-party forecasts are summarised in Annex 8.

- Uses demand curve estimates to configure the choke prices used in our calculation of consumer surplus. In particular, we have tied the demand curve estimates more closely to relevant survey evidence.

11.30 We have also been mindful of modelling undertaken by the Premier League in response to the Third Pay TV Consultation, which it believed showed there was "no plausible scenario which would lead to Sky's combined revenues increasing following the introduction of the wholesale remedy"[1596]. The Premier League modelled the effects on Sky of market expansion, switching and price changes, but did not present any evidence to support its underlying assumptions. We also consider its conclusions to be substantially altered by updates to the model inputs, for example showing a smaller reduction to Sky's wholesale charges to Virgin Media. We explain these changes to our assumptions in Annex 8.

[1594] In Top Up TV's response dated 17 November 2009 to our information request dated 29 October 2009, Top Up TV provided an internal proposal presentation for its intended DTT offering based on Sky's Core Premium channels. **[✂]**.

[1595] **[✂]**.

[1596] Premier League response to Third Pay TV Consultation, Annex 3, page 120.

11.31 We have also commissioned an independent review of the impact assessment model by KPMG[1597].

11.32 The effects of the various revisions to the model are summarised in each of the sub-sections below. We stress that the quantitative analysis is only one part of our assessment. It has not been possible meaningfully to quantify all impacts, particularly where these are dynamic in nature. We consider the expected dynamic benefits qualitatively, and take an overall view based on both quantitative and qualitative analysis. In Annex 8 we summarise the changes made to our quantitative analysis since the Third Pay TV Consultation.

11.33 We disagree with Sky that we should have based our analysis on a counterfactual scenario in which Picnic exists, and not on a scenario absent Picnic. By the time of our Third Pay TV Consultation, Sky had publicly announced that it had suspended work on its Picnic proposals, releasing or moving the staff involved in the project. Sky announced that it would only "decide whether to reactivate the project when [it has] regulatory clarity"[1598]. It was therefore highly uncertain under what conditions Sky would choose to reactivate the project and launch Picnic.

11.34 Sky stated at a meeting held on 15 March 2010 that **[✂]**. It is clear that Picnic in the form originally proposed is no longer a credible counterfactual, and that there is considerable uncertainty as to what would constitute a credible counterfactual were Sky permitted now to retail on DTT.

11.35 The approach of not considering a hypothetical counterfactual is entirely consistent with the Merger Assessment Guidelines published by the OFT and the CC. While we recognise that the context for those guidelines is somewhat different to the situation we are assessing, they nonetheless provide an appropriate point of comparison in these circumstances. They suggest that the relevant counterfactual should be the prevailing conditions of the market unless there is a strong basis for considering otherwise:

> "The OFT's approach in practice is to presume that the prevailing conditions of competition are the relevant starting point for the counterfactual. For most cases reviewed by the OFT, such a presumption in favour of the status quo, or status quo ante in the case of completed mergers (i.e. the pre-merger situation), represents a cautious approach to determining the appropriate counterfactual (and therefore whether any prospect of SLC would be caused by the merger under consideration)"[1599].

> "As a Phase 2 body, the CC, on the other hand, will consider the most likely outcome in the market under investigation and define the counterfactual based upon its expectation. This may often, but not always, be the prevailing conditions of competition. At both Phase 1 and Phase 2, known third party events in the near future (including competitors' expansion plans and planned regulatory and legislative

[1597] For KPMG's report, please see Annex 7.

[1598] BSkyB job losses expected as Picnic is shelved, The Guardian, http://www.guardian.co.uk/media/2008/sep/12/bskyb.television

[1599] http://www.oft.gov.uk/shared_oft/consultations/OFT1078con.pdf, paragraph 4.23

changes affecting the industry) will be included in the consideration of the counterfactual"[1600].

11.36 In our view, Sky's public statements about Picnic suggested that a counterfactual absent Picnic was most appropriate, a position supported by Sky's more recent statements to us. However, we recognise that for completeness it may be valuable to consider the impact of our remedy both with and without Picnic. As a result, in our updated analysis, we now also consider a Picnic-only scenario in which no other pay TV services exist on DTT. We then estimate the impact of additional pay TV services over and above Picnic, which may be brought into the market by the wholesale must-offer remedy.

Remedy options

11.37 As we set out above, and as we have done in both the Second and Third Pay TV Consultations, we have considered a range of regulatory options, including the possibility of taking no action. This assessment is set out in detail in this document in Section 9. This approach has been contrary to Sky's assertion as mentioned above that we have failed in our duties by only assessing a single regulatory option.

11.38 This Section weighs up in both a quantified and qualitative way the form of the wholesale must-offer resulting from the analysis of options in previous Sections against taking no action. More broadly we have also assessed in a qualitative way the relative merits of other possible types of intervention. We took the view in Section 9 that structural remedies would be disproportionate. Rights-level interventions would be another type of possible intervention, but any intervention at the rights level which aimed to eliminate market power would carry with it a risk of artificial reduction of rights values, and could also result in consumer inconvenience.

11.39 Our view based on a qualitative assessment was that a wholesale must-offer obligation would in principle be an appropriately targeted way to address our concerns over restricted distribution.

Effects on consumers

11.40 As we have discussed above, we have considered three criteria to judge whether pay TV is delivering positive outcomes for consumers. These are:

- Choice of platform and content:
    - Choice for consumers of platform, and of content once platform selection is made.
    - Switching between retailers and platforms should not be artificially difficult.
    - Generation and availability of a broad range of high-quality content: a variety of content continues to be generated, and made available to consumers on all platforms.
- Innovation:

[1600] http://www.oft.gov.uk/shared_oft/consultations/OFT1078con.pdf, paragraph 4.25

   - o In platform services, for example in terms of interactivity, set-top box functionality such as PVR capabilities, or VoD options.

   - o In retail service bundling, packaging and pricing.

- Pay TV services priced competitively and efficiently:

   - o Prices which give consumers good value and allow efficient producers to earn a reasonable return on their investment.

   - o A sufficient variety of price points / bundles to allow consumers to tailor their purchases to meet their preferences.

11.41 In Section 7 we have explained that the inability of rival firms to gain access to Sky's Core Premium channels is likely to be prejudicial to fair and effective competition. We have set out how this affects consumers partly through a lack of choice with respect to platform and retailer, and partly through a reduction in the ability of firms to innovate both with respect to platform and retail activities. Our wholesale must-offer remedy is targeted exactly at addressing these sources of consumer harm.

11.42 We have also explained that we believe prices for Core Premium channels are likely to be above competitive levels, and that this effect is likely to be most pronounced with respect to movies channels. We are consulting separately on our proposed decision to refer the movies market to the Competition Commission partly as a mechanism for addressing this concern.

11.43 For sports channels, our remedy is not designed directly to address high prices. Our reasons for following a retail-minus approach are set out in Section 9. We therefore do not include in our assessment any benefits that would flow to consumers from existing packages reducing in price.

11.44 There are however two types of benefits that consumers might nonetheless receive in terms of pricing:

- Packages may become available at a greater variety of price / quality points, expanding choice to consumers, particularly in relation to entry-level packages. We include this benefit within our quantitative analysis, as part of the market expansion that we expect to occur as a result of the remedy. In other words we assume that many of the new consumers attracted into the market as a result of the remedy take advantage of new entry-level packages, especially on DTT.

- In the longer term, greater competition at the retail level may enable firms to go upstream, increasing the competitive pressure on Sky at the wholesale level in a manner that could ultimately reduce retail prices. We do not however include this benefit within our quantitative analysis.

Our position in our Third Pay TV Consultation

11.45 In our Third Pay TV Consultation we argued that, if Sky's retail competitors were able to gain access to Sky's Core Premium channels at appropriate wholesale prices under a wholesale must-offer remedy, they would be better placed to compete effectively with Sky at the retail level. We would therefore expect the remedy to deliver benefits to consumers in terms of greater platform choice and the dynamic benefits of greater platform and retail innovation. We expected only a small impact on retail prices: wholesale prices were set so that entrants were able to compete with

Sky but did not provide any additional margin which could be used to reduce prices below those of Sky. We sought to quantify the benefits of expanded choice, estimating that, over five years, our proposed remedy would deliver an increase in consumer surplus of around £370 million relative to the counterfactual[1601].

Responses to our consultation

11.46 Sky believed it was not appropriate for Ofcom to argue that benefits that were impossible to predict were a key basis for the imposition of a new regulation. Sky stated that Ofcom should demonstrate to a reasonable standard that significant incremental dynamic benefits were more likely than not to emerge, for example setting out specific types of innovations. Sky thought that innovation had not been prevented from happening in the UK, as shown by PwC's analysis, and that Ofcom's remedy was unlikely to quicken the pace of innovation at all[1602]. Sky also suggested Ofcom's policy would reduce incentives to compete on merits, distorting consumer choices in favour of DTT.

11.47 Sky also suggested that we had assumed that Virgin Media would use a reduction in wholesale price to increase premium customers. It believed this was a speculative hope which could not form a sound basis for an expectation of an expansion in demand for Sky's premium channels. It was also unlikely to fill the gap between our expected market expansion effect and the more conservative estimates implied by the Picnic business plan[1603]. In a subsequent submission, Sky referred to a public statement from Virgin Media as "perhaps indicative of an inclination on Virgin Media's part to pass any wholesale price cuts on to its customers". Sky also suggested that a public statement from BT showed that it was able to undercut Sky's retail price with no reduction to wholesale charges[1604].

11.48 Sky / Professor Cave argued that our proposed remedy could have a chilling effect on innovation and unintentionally adversely affect consumer welfare[1605].

11.49 The Three Parties considered that the wholesale must-offer remedy, subject to some adjustments set out in their response, would promote the emergence of a more balanced mix of pay TV platforms and retailers which would benefit consumers in terms of choice, price and innovation[1606]. Virgin Media also stated a number of consumer benefits arising from the remedy, specifically, lower retail prices, more flexible bundling, greater incentives on Virgin Media to market Sky's Core Premium channels, higher quality services (featuring HD and interactive content) and greater innovation[1607].

[1601] This was in a very broad range from around £100 million to £630 million. See Third Pay TV Consultation paragraph 10.40.

[1602] Sky response to Third Pay TV Consultation, paragraphs 11.127 to 11.128.

[1603] Sky response to Third Pay TV Consultation, paragraph 11.100.

[1604] Sky January 2010 Submission, paragraphs 8.5 to 8.17.

[1605] Sky response to Third Pay TV Consultation, paragraphs 10.38-39 & 10.60.

[1606] Three Parties response to Third Pay TV Consultation, paragraphs 2.9 to 2.23

[1607] Virgin Media response to Third Pay TV Consultation, paragraph 9.4.

11.50 The Three Parties, individually, provided further details on the specific activities in which they will be able to engage following the implementation of the wholesale must-offer remedy and the ways in which this will benefit consumers. BT, for example, had plans to undertake very substantial investment in its pay TV platform, particularly through its Canvas joint venture[1608]. In their response, **[✂]**[1609].

11.51 Nonetheless, BT argued that the **[✂]**[1610]. BT agreed with Ofcom that the three main benefits would be choice, lower prices and greater innovation, which would be the consequence of a thriving market featuring competition between pay TV platforms with comparable scale[1611]. It also believed that actual consumer benefits were likely to be more significant than outlined in Ofcom's assessment. BT plans to adopt a different approach to pay TV, offering a variety of options as to how the set-top box may be acquired, and featuring an ‘a la carte’ approach to all subscription services[1612].

11.52 The Premier League response implied that Ofcom failed to identify consumer harm being suffered, and quantify the extent of this harm, thus failing any proportionality assessment at the first hurdle[1613]. The Premier League also argued that retail price competition was likely to ensue, which would “logically see the wholesale price drop to, and potentially beyond, the cost plus floor”[1614]. The Premier League considered this to be “false competition subsidised by Sky”[1615]. The RFU and RFL both claimed Ofcom did not consider who, in the absence of Sky, would provide coverage for lesser matches and competitions[1616]. The PGA believed the proposed remedy would reduce innovation and alter free market dynamics to the detriment of audiences and rights-holders[1617].

11.53 **[✂]**[1618].

11.54 The BBC agreed with our impact assessment and suggested the remedy would help to address concerns regarding new entrants, which find it difficult to compete and thrive in the pay TV sector. It stated that not only were there definitely concerns that

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[1608] BT response to Third Pay TV Consultation, paragraph 2.13 to 2.21.

[1609] **[✂]** response to Third Pay TV Consultation, Section 2.

[1610] BT response to Third Pay TV Consultation, paragraph 3.37.

[1611] BT response to Third Pay TV Consultation, paragraphs 2.8 to 2.11.

[1612] BT response to Third Pay TV Consultation, paragraphs 2.22 to 2.26.

[1613] Premier League response to Third Pay TV Consultation, paragraph 11.6.

[1614] Premier League response to Third Pay TV Consultation, paragraph 10.77.3.

[1615] Premier League response to Third Pay TV Consultation, paragraph 10.40.

[1616] RFU response to Third Pay TV Consultation, paragraphs 20 to 22; RFL response to Third Pay TV Consultation, page 4.

[1617] PGA response to Third Pay TV Consultation, page 2.

[1618] **[✂]** response to Third Pay TV Consultation, page 1.

consumers did not benefit from a competitive market, but also that there is a significant risk that the situation could worsen without intervention[1619].

Our position now on the impact on consumers

11.55 We have assessed the benefits and costs likely to arise from the wholesale must-offer remedy. We have also considered the risks arising from implementation of the remedy.

- In particular, we have examined the arguments made by Professor Cave on behalf of Sky that intervention risks causing market distortions and slowing the pace of innovation.
- We have also considered at length the possible risks that rights values might be affected by this type of remedy. Any reduction to rights values could have a knock-on effect on long-term channel quality. Our assessment of this is set out in depth towards the end of this Section.
- We remain of the view that a wholesale must-offer remedy would bring substantial benefits to consumers in respect of choice and innovation, and that there may be some benefits in respect of pricing as firms offer new types of package at different price / quality points, including entry-level packages

11.56 The expected effects on consumers are summarised in the following table.

Figure 140 Summary of consumer effects

Criteria		Benefits to consumers
Choice	Wide choice of platform and content	Substantially enhanced choice as a result of new offers on alternative platforms: DTT in the short term; IPTV and other platforms in the medium term
	No artificial barriers to switching	Barriers created by lack of availability of Core Premium Sports channels removed
	Generation of a wide range of high quality content	No change
Innovation	Innovation of platforms	Medium term benefits as wider range of platform providers are able to innovate around premium content
	Innovation in retail packaging and pricing	Immediate benefits from wider range of packages and bundles – for example in triple play bundles
Pricing	Prices which give consumers good value, but allow a return on investment in content	No significant effect on average retail prices or on returns to investment in content, although longer term greater competitive intensity may bring price reductions
	A wide range of price points and bundles	Likely emergence of alternative price / quality points

[1619] BBC response to Third Pay TV Consultation, pages 2 to 3.

11.57 All of these effects rely on new firms taking advantage of the availability of Sky's Core Premium Sports channels to launch new services. As we have explained above, our approach to setting the price of Sky's Core Premium Sports channels focuses on allowing long term, sustainable entry by firms that will compete with Sky in a manner that provides greater choice to consumers and further investment in innovative new products and services. We have explicitly not sought to enable rapid entry by under-funded firms seeking to profit at Sky's expense. We reiterate that our prices have been calculated on the basis that a firm facing the same cost structure as Sky and achieving a reasonably rapid growth in subscriber numbers would earn an NPV of zero over the long term.

11.58 As a result, entry by any firm will be challenging. Success will require firms to offer attractive products that boost their subscriber acquisition rate. It will require firms to innovate technologically in order to do that – and in a manner that consumers find compelling. It will require firms to bundle pay TV with other products and services in innovative new ways, and potentially to identify new price / quality combinations that enable them to differentiate their offerings. Even if firms do all of these things, success will not be guaranteed.

11.59 The challenging nature of entry reflects in part the strong established position of Sky. This was highlighted by John Malone, the Chairman of US media conglomerate Liberty Media, which considered bidding to acquire Virgin Media in 2007[1620]. Referring to Sky's position in the market, he commented, "the bottom line issue is, can anything flourish under the Death Star? … There's a high level of radiation that's coming down … The concentration of market power that's been created means you have to scratch your head and say 'can anything compete?'"[1621].

11.60 Nonetheless, we consider that retail competitors are likely to take-up a wholesale must-offer remedy. For example:

- On DTT, Top Up TV and BT have both indicated publicly that they intend to establish themselves as retailers of Core Premium channels on DTT and hybrid DTT/IPTV platforms. Both companies have already put in place significant plans to retail Core Premium channels, including **[✂]**[1622].

- Virgin Media has stated that, "reduced wholesale prices for Core Premium channels resulting from the wholesale must-offer would enable Virgin Media to reduce retail prices and increase investment in sales and marketing, leading to more intense head-to-head competition with Sky."[1623]

[1620] Liberty Media owns stakes in a range of media and communications businesses, including QVC, Expedia, Starz Entertainment and ViaSat. It also has minority interests in Time Warner, Time Warner Cable and Sprint Nextel. (Source: http://www.libertymedia.com/company-overview.aspx.)

[1621] 'Malone considers move on Virgin Media', Financial Times, 30th July 2007. Recovered from http://www.ft.com/cms/s/0/795cdd00-3e30-11dc-8f6a-0000779fd2ac.html.

[1622] BT response dated 4 December 2009 to Ofcom information request dated 29 October 2009, question 16. **[✂]**.

[1623] Virgin Media response to Third Pay TV Consultation, paragraph 9.6.

- In the medium term retail of Sky's Core Premium Sports channels via Freesat's platform is also a possibility. **[✂]**[1624] **[✂]**.

- On IPTV, the experiences of Tiscali and a potential IPTV entrant **[✂]** suggest that their abilities to compete effectively were hindered by lack of wholesale access to Sky's channels. While the future of Tiscali TV is uncertain now that is part of TalkTalk Group, and a potential IPTV entrant **[✂]** appears to have stepped back from its pay TV ambitions, we consider that both firms would have had a much greater prospect of success had they been able to offer customers access to Sky's Core Premium Sports channels. It is also more likely that these and other firms will develop services in the future if they are able to offer these channels. We therefore consider that entry by new IPTV operators is likely in the medium term as a result of the proposed remedy.

11.61 All of these are examples of ways in which consumers may benefit from increased choice and innovation. We are also aware of potential risks of intervention, including the sorts of competitive distortions identified by Professor Cave / Sky. We discuss in more detail below the likely effects on consumers, including the costs and risks associated with intervention.

11.62 We describe these effects below before setting out, for those effects we are able to quantify, the estimated benefits and costs in quantitative terms.

Effects on choice

11.63 The examples of potential entry set out above suggest that consumers in general will benefit from increased choice, both through the ability to access highly attractive content on alternative platforms to those available today, and from the opportunity to purchase different types of packages potentially at different price / quality points.

11.64 In the short to medium term, we would expect the benefits of increased choice to lead to an increase in the consumption of premium channels – a market expansion effect:

- Consumers that have previously not taken pay TV services because their preferred content was not available on their preferred platform will be attracted to the market. Most immediately, given the statements of potential market entrants cited above, we expect this type of market expansion to take place on DTT and on hybrid DTT/IPTV platforms. One reason for this is the existence of low switching costs for consumers wishing to upgrade from free-to-air DTT services (particularly Freeview) to entry-level pay TV services on DTT.

- Greater take-up of specialised IPTV based services also appears probable over the next 2-3 years. We would expect IPTV services gradually to grow in relative importance, with today's hybrid platforms a step in this process. Given this period of transition, it does not make sense to distinguish between DTT and IPTV platforms in our estimates.

- Similarly, if premium channels are bundled in new ways with other products and services, and offered at different price / quality points, further consumers are likely to be attracted to the market.

[1624] **[✂]** response to Third Pay TV Consultation, paragraph 1.

- There may be a more modest market expansion effect on cable to the extent that cable operators have a greater incentive to migrate basic-only consumers to premium content. Cable operators will also be able to offer customers interactive services and HD versions of Sky Sports 1 and Sky Sports 2, which would be a significant improvement on the current premium cable offer.

11.65 In relation to the last of these points – market expansion on cable – Sky questioned whether Virgin Media would respond to a lower wholesale price by spending more to expand its base of subscribers to Core Premium channels[1625]. Our view is that:

- Virgin Media's marketing efforts are likely to be directed at those products on which it earns the highest gross margin.
- A reduction in wholesale charges would constitute a reduction in marginal cost and therefore an increase in Virgin Media's gross margin, making Core Premium channels more profitable relative to other products.
- This wholesale price reduction could either manifest itself directly as a price reduction to final consumers or give Virgin Media the opportunity to market its Core Premium Sports channels more aggressively.
- In either event, we would expect a greater proportion of Virgin Media's subscribers to purchase Sky Sports 1 and 2.
- Sky's willingness to offer volume discounts to Virgin Media as a mechanism for increasing the incentive on Virgin Media to sell its channels suggests – contrary to its arguments above – that it agrees with this assessment[1626].

11.66 All of these effects are likely to lead to a direct increase in the benefits accruing to consumers – an increase that may be substantial for those that have not subscribed to premium channels before. The launch of new services unambiguously increases choice, by expanding the variety of products featuring Core Premium channels. As we discuss below, market expansion is also unambiguously positive for Sky as it will lead to new sources of wholesale revenues.

11.67 Consumer choice will also be expanded through the inclusion of the HD versions of Sky Sports 1 and Sky Sports 2 on platforms where these are not currently available – to the extent of course that firms are able to secure the necessary transmission capacity. This represents another form of market expansion, though not one which we have been able to reflect explicitly in our quantitative analysis, given that we have not set a price for HD services, and do not have any certainty as to what price Sky will set.

11.68 In addition, consumers that already subscribe to Sky's Core Premium Sports channels will be able – should they wish – to switch to alternative platforms that may better suit their needs. This may include subscribers trading down to cheaper, smaller bundles. This type of switching will not increase the overall size of the wholesale market, but because consumers will only switch if they are better off on an alternative package or platform, it will also lead to an increase in consumer surplus. Such switching is likely to take place over a longer timeframe, for example as

[1625] Sky response to Third Pay TV Consultation, paragraph 11.100.

[1626] **[✂]**.

consumers move house, but there are clear consumer benefits as consumers are able to make choices that better fit their preferences – choices that are no longer restricted by the lack of availability of Sky's Core Premium Sports channels.

11.69 In the longer term, we would expect consumer choice to be expanded as a result of technological innovation by retailers and platform providers – we discuss this further below.

11.70 We have also considered how Picnic would affect our conclusions on consumer choice. We recognise that if Picnic were launched in the absence of a wholesale must-offer, it would enable consumers to access Sky's Core Premium Sports channels on DTT, and that this would represent a material benefit to consumers.

11.71 However, for the reasons set out in Section 7, we do not believe that Sky alone retailing on all platforms would ensure fair and effective competition, and would therefore not deliver the full range of benefits to consumers that we have set out above. In particular:

- The launch of Picnic in the absence of any alternative Core Premium Sports offering on DTT would offer consumers restricted choice of retailer as compared to a world of several alternative retailers – they would, as now only be able to purchase these channels from Sky or Virgin Media.

- We are also concerned that Sky would be better able to manage competition at retail level by ensuring that Picnic did not compete head-to-head with its own satellite offering. As described in Section 7, this would restrict consumer choice, the effect being to limit the projected market expansion effect[1627], and would limit the longer term potential for greater competition at the wholesale level.

- The ability of alternative platform owners to offer innovative services would be severely restricted by lack of access to Core Premium Sports channels[1628].

- Hence while we recognise that there would be some benefits to consumers in terms of wider choice by the launch of Picnic absent a wholesale must-offer, we consider that the benefits *with* a wholesale must-offer would be materially greater.

11.72 We consider the Picnic proposal more specifically in the Picnic Statement.

Effects on innovation

11.73 In Section 8, we have concluded that access to Core Premium channels is highly important to the development and expansion of pay TV operators, and that without access to this content, the appetite to undertake risky innovation is greatly diminished. We have also recognised Sky's innovation record, but concluded that Sky is likely to favour innovations which protect the value of its existing customer base. This will tend to inhibit the development of other services which could use Core

[1627] In our quantitative analysis, we estimate that there will be significantly fewer subscribers on DTT/IPTV if only Picnic is available than if Picnic and a range of other retailers offering premium channels. See paragraph 11.108 for more details.

[1628] We set out in Section 4 that premium content such as sports and movies is a highly important driver of take-up of pay TV services.

Premium channels to drive demand but which would undermine the value of Sky's existing subscriber base. We concluded that greater retail competition could increase the scope for innovation.

11.74 At present, pay TV providers other than Sky are denied access to a large and highly valuable group of subscribers – namely those subscribers that place a high valuation on Sky's Core Premium Sports channels. We explained in Section 4 that premium content such as live sports is highly important to take-up of pay TV services. We have also explained in Section 8, that restricted access to Core Premium Sports channels prevents operators both from innovating directly around that content, and from building the requisite scale to innovate more widely.

11.75 In Section 8, we show that high proportions of customers to services such as HD, Sky+ and Multiroom take premium packages. These figures illustrate the importance of Core Premium channels as an enabler of innovation, and suggest that the inability to access premium subscribers is a material obstacle to innovation. As a result, we believe that the wholesale must-offer remedy will enable greater platform and retail innovation to develop.

11.76 We maintain our position that the forward-looking benefits of platform and retail innovation are impossible to forecast with any degree of certainty. Nonetheless, in Section 4 we outlined a number of potential future developments in the UK pay TV sector, building on our analysis of future pay TV developments in our Third Pay TV Consultation. As shown in the table below, of the eight developments we highlighted, seven would be enabled or progressed by the wholesale must-offer remedy, as it would remove a critical barrier to entry in the retail market.

Figure 141 Impact of the wholesale must-offer on future developments in the UK pay TV sector

Area	Topic	Development	Impact of wholesale must-offer
Distribution	**Market entry**	Greater disintermediation of traditional broadcasters/platforms. A recent note from Credit Suisse claimed that 'the barriers to entry in the traditional broadcasting model of scarce bandwidth and platform have collapsed.'	Enabled by greater inter-platform competition
Distribution	**Market entry**	An increasing number of companies will start to deliver audiovisual services as the barriers to entry to distribute content fall away and value chains evolve. A note from Morgan Stanley (January 2010) said: 'We suspect that the paid for 'walled garden" model will instead come under increased scrutiny.'	Enabled by breakdown of content barriers to entry
Content	**Market entry**	Access to attractive content, and on equitable terms, becomes important to a greater number and range of retailers of audiovisual services. (Some new entrants – such as Joost and Babelgum - for example have encountered difficulties in securing access to high-end content).	Enabled by breakdown of content barriers to entry. Also, may in the longer term ensure greater balance in the competition for rights, with additional market participants to Sky
Content	**Viewing**	Decline in the number of linear channels (particularly time-shift '+1's) as on-demand takes more prominence and as capacity is utilised for HD.	Small effect – enabled by greater take-up of VoD
Distribution	**Standards**	Standardisation of technology will bring economies of scale to new forms of distribution, such as the delivery of video over broadband to the TV.	Enabled by greater take-up of new platforms (e.g. Canvas)
Distribution	**NGA**	High definition content sees widespread take-up via broadband as high-speed networks are launched.	Enabled by greater availability of premium sports HD channels
Distribution	**NGA**	Large scale investments in networks and infrastructure will be made to address a growing appetite for content on multiple devices.	Enabled by greater availability of premium content distributed using next generation infrastructure
Distribution	**Spectrum**	The allocation of 'digital dividend' spectrum could bring new opportunities to broadcasting, depending on the outcome of government review of what UHF spectrum is used for.	Enabled by greater availability of content distributed using digital dividend spectrum

11.77 We recognise that this identification of likely developments cannot amount to a precise prediction of the sorts of innovation that will in fact emerge. However, they are indicative of the way in which access to Sky's Core Premium Sports channels may support the development of new platforms, new delivery technologies and new retail services.

11.78 In Section 8, we highlighted technical innovation in four areas: digital TV, HD, PVR and VoD. We also looked at the development of next generation access as a technology to deliver content to consumers. We concluded that the UK has made strong progress in digital switch-over relative to other countries. We also noted that Sky has spearheaded innovation and driven impressive take-up in HD and PVRs. However, in take-up and spend on VoD, and the development of NGA for delivering IPTV, the UK is not an international leader. Greater availability of premium content provides firms with the opportunity to innovate around this content and improve the UK's international standing in developing and increasing the take-up in VoD[1629]. In addition, as entrants build scale, and expand the size of the customer base over which research and development costs can be recovered, their abilities to innovate will be strengthened. This is particularly important for investments such as NGA, which constitute a large fixed cost which must be recovered from a critical mass of customers and a range of services.

11.79 The examples of AT&T and Verizon, set out in Section 4, show the sorts of highly attractive services which can be delivered using new technologies. As we explain in that Section, IPTV operators in the US have benefitted from the Program Access Rules, under which vertically integrated cable operators are required to provide to competing platforms channels in which they own a stake of 5% or more. It is likely that the pace of innovation would have been much slower for these firms if they were unable to provide customers with access to the most attractive content.

11.80 Professor Cave, acting for Sky, argued that our proposed remedy would "weaken incentives to innovate"[1630]. This relates to the potential danger that Sky – and indeed others – will be deterred from innovation because any successful innovation will attract regulatory attention. We fully recognise this danger – it is one that Ofcom faces across many of the industries it regulates – and our approach is designed to minimise it.

11.81 There is clearly a tension between enabling other firms to access one of the enablers of future innovation while retaining the ability for Sky to earn the rewards for its own future innovation. If we were to set wholesale prices at very low levels – especially, for example, for HD – then Professor Cave / Sky's criticisms would appear justified. However, our retail-minus approach to price setting strikes a different balance: it opens up opportunities to new entrants to innovate at the retail and platform levels, while enabling Sky to continue to benefit from its own innovation at all levels. Furthermore, the remedy is designed to be the least disruptive to Sky's business, since it requires Sky to do something – distribute its premium content more widely – which it says it is in principle willing to do[1631].

11.82 Professor Cave / Sky's arguments on innovation appear to have focused on developments within premium content, rather than around it. Professor Cave writes, "If [a service] comes from [a supplier] in a standardised form, this automatically reduces the degree of competition and choice available to end users. It also discourages innovation by the access provider, since such innovation brings it diminished benefits, as it has to share all the gains with access seekers."[1632] By contrast, we believe that both Sky and new providers can innovate around premium content, delivering content using new technologies and packaging content in new

[1629] While live sport is not well-suited to delivery on-demand, greater take-up of platforms on which VoD is on offer, enabled by the availability of Core Premium Sports channels on these platforms, will help drive take-up and usage of VoD services.

[1630] Sky response to Third Pay TV Consultation, Annex 1, paragraph 4

[1631] Jeremy Darroch, Sky's Chief Executive, stated in an investors' call accompanying the release of Sky's Q1 2009/10 results that it intends to "make our content more broadly available through whatever distribution platform is available to us".

[1632] Sky response to Third Pay TV Consultation, Annex 1, paragraph 21.

ways. Indeed, it is only through such innovation that entrants can gain a competitive advantage over existing retailers of premium content.

11.83 Furthermore, we have recognised the potential risk of reducing incentives to innovate around HD by removing any ex ante regulated price. This is very much consistent with the approach we are taking with respect to Next Generation Access (NGA), where we consider that there is a strong rationale for enabling third parties to access new infrastructure, but that the riskiness of investment in that infrastructure means that would be appropriate to allow flexibility around price.

11.84 Many of Professor Cave / Sky's criticisms about the impact of our remedy on innovation related specifically to the proposed "ratchet" approach to addressing price changes over time. Recognising these criticisms, we have modified our approach to the way in which prices should change so that wholesale prices remain at a fixed absolute margin to Sky's retail prices. We believe this materially addresses these concerns.

11.85 We have also assessed how our conclusions on innovation would change if assessed against a counterfactual in which Sky launched Picnic. While we recognise that Picnic would in itself be likely to be a source of innovation on DTT, the lack of access to premium content would clearly continue to prevent other operators from offering their own innovative products and services. Hence we consider that the combination of a wholesale must-offer and Picnic would be likely to yield considerably more innovation than a situation in which Picnic was launched without a wholesale must-offer.

Effects on pricing

11.86 Our remedy is explicitly not intended to address concerns that retail prices for bundles containing Core Premium Sports channels are above competitive levels. While we consider that there is evidence that retail and wholesale prices *are* high, for the reasons set out in Section 9 we do not believe that it would be proportionate to address such a concern directly through a cost-plus wholesale must-offer. However, as we explained in the Third Pay TV Consultation, we expect in the longer term that greater competitive intensity will put downward pressure on retail costs. The remedy may also enable consumers to access cheaper entry-level packages containing premium channels (albeit at a different price / quality point).

11.87 Instead, the wholesale must-offer remedy seeks to address the restricted availability of Core Premium channels, rather than the level of retail prices. In the longer term, as other pay TV retailers build scale, they may seek to enter the wholesale market and we would expect this to put downward pressure on retail prices. Any greater competition in the wholesale market, for example resulting from several different sports channel wholesalers with different rights, will result in greater pressure on non-content rights-related wholesale costs and on wholesale margins, which should feed through to retail prices. In the short term, we expect the aggregate effects on retail prices to be small, but they may vary between operators and between different packages.

11.88 We discuss the likely effects on different operators' prices below, but note that in our quantitative analysis, we have not sought to capture any benefits arising from reductions in the overall level of prices.

11.89 **Sky**'s price levels are unlikely to be significantly affected by the remedy. We acknowledged in paragraphs 10.50 to 10.53 of the Third Pay TV Consultation that, following the reduction in its wholesale prices which would result from the wholesale must-offer remedy, Sky may adjust its retail prices. We explained that the incentive on Sky to change its retail prices is likely to depend on the way in which wholesale prices track retail prices: if the margin between retail and wholesale prices was fixed in absolute terms, Sky might respond by raising its retail prices by a small amount; if the margin was fixed in percentage terms, there could be an offsetting incentive for Sky to reduce its retail prices, again, by a small amount, since this would reduce the margin available to its retail competitors – although the direction of any change in this situation is uncertain.

11.90 We have now confirmed our intention for the margin between retail and wholesale prices to be a fixed absolute amount. We believe this will do less to limit Sky's incentives to increase its retail prices than a fixed percentage margin. However, as we set out in Section 10, a fixed percentage margin could potentially distort Sky's incentives to invest in its wholesale channels. We would expect any effect on retail prices to be extremely limited as Sky's retail demand (rather than any desire to influence wholesale prices) is likely to remain the overwhelming determinant of Sky's retail prices. Sky's wholesale customer base is likely to remain small relative to its retail customer base – after five years we project Sky to have over three times as many premium retail subscribers (including Picnic customers) as premium wholesale subscribers. (Sky's retail subscriber base is currently around 9.5 times larger than its wholesale subscriber base.)

11.91 **Virgin Media**'s price levels might reduce slightly as a result of the remedy, once it gets access to the new reduced prices. As we explained above, a reduction in Virgin Media's wholesale prices constitutes a fall in its marginal cost. In these circumstances, we would expect a small reduction in Virgin Media's retail prices for packages containing Sky's Core Premium Sports channels, and an accompanying expansion in output.

11.92 Virgin Media has made a number of statements about its likely retail prices under a wholesale must-offer.

- It made clear its expectation that "reduced wholesale prices for Core Premium channels resulting from the wholesale must-offer would enable Virgin Media to reduce retail prices and increase investment in sales and marketing, leading to more intense head-to-head competition with Sky"[1633]. Specifically, Virgin Media indicated that it "**[✂]** ..."[1634].

- Richard Branson, a shareholder in Virgin Media, wrote in October 2009 that under the wholesale must-offer proposals, some operators (though not specifically Virgin Media) "could plan to retail Sky Sports 1 at a price more than 20 per cent below the lowest price that channel can currently be bought from Sky"[1635].

11.93 We regard the specific prices set out in Virgin Media's consultation response as not necessarily being indicative of a likely outcome in the market.

[1633] Virgin Media response to Third Pay TV Consultation, paragraph 9.6.

[1634] Virgin Media response to Third Pay TV Consultation, paragraph 9.9.

[1635] 'Rein in Sky and offer the consumer a choice', Financial Times, 23rd October 2009, http://www.ft.com/cms/s/0/435c158a-bf6c-11de-a696-00144feab49a.html

- **[✂]**.

- The retail prices were quoted on the basis of the bottom of our range of wholesale prices for consultation. We are not setting prices at that level – clearly if we were, that might enable retail price reductions in a way that we do not believe to be likely on the basis of the prices we have settled on.

11.94 Mr. Branson’s comment might be seen as more indicative of what will happen, although it should still be treated with caution, for a number of reasons.

- Particularly based on the lower end of the range of wholesale prices we consulted on, a 20% reduction might be plausible, given a different approach to the price / quality trade-off compared to Sky’s own satellite offerings. Indeed, **[✂]**.

- The statement was clearly made at a general level, and care was taken not to attribute this proposition to Virgin Media’s own plans.

- It should be kept in mind that this statement was not based on any knowledge of the exact wholesale prices we now set out in this document.

11.95 In our quantified analysis, we have taken a conservative approach and assumed that Virgin Media’s retail prices are unchanged, but that there is an increase in the number of customers that subscribe to Core Premium Sports channels on cable as a result of more active and effective marketing.

11.96 **Other competitors’** price levels are unlikely to vary substantially from Sky’s on a like-for-like comparison. As explained above, we have set wholesale prices at a level that should enable entrants to compete with Sky, but would not provide a profit margin which could be forfeited in order to lower prices. As new players come into the market, some may introduce particularly attractive price propositions to stimulate interest, but our expectation is that any significantly discounted price points would not be sustained over time, and that there would not be a significant change on an aggregate basis.

11.97 It is likely, however, that entrants will bundle Sky’s content in ways which do introduce permanent new price points, including entry-level bundles packaged with minimal other pay TV content, for example excluding subsidised set-top boxes. Cost reduction could enable entrants to offer lower price points (albeit by trading off perceived product quality).

11.98 Since the consultation, BT has suggested possible price points for retail products containing Sky’s Core Premium channels. Gavin Patterson, Chief Executive of BT Retail, suggested that BT’s price for a sports package would be “somewhere in the mid teens”[1636], as compared to an entry-level price for Sky Sports 1 on Sky of £26[1637]. Mr Patterson also added that, “We are looking at a range of scenarios at the moment … But suffice to say we want to make it very attractive to customers”. Sky interpreted those remarks as indicating that our proposed wholesale price reductions

[1636] ‘BT's Gavin Patterson: Sky's football claims don't wash with me’, http://www.telegraph.co.uk/finance/newsbysector/mediatechnologyandtelecoms/7005740/BTs-Gavin-Patterson-Skys-football-claims-dont-wash-with-me.html, 16 January 2010.

[1637] This is Sky’s price for Sky Sports 1 without any basic channels, as of the date of publication.

were unwarranted, as BT's remarks suggested that it could make retail price reductions that exceeded the wholesale price reductions proposed.

11.99 We have reviewed the detail of these pricing proposals with BT, and it does not appear that there would be a substantial retail price discount relative to Sky's current prices, along the lines apparently indicated in the Sunday Telegraph article. We now understand that[1638]:

- **[✂]**.
- **[✂]**.
- **[✂]**.
- **[✂]**.
- **[✂]**.

11.100 The above analysis is broadly unchanged if we assess our remedy against a situation in which Sky launches Picnic – although inevitably that depends to some extent on the precise details of the Picnic offer. The scope for greater competitive intensity at the retail level that would be enabled by the wholesale must-offer does not vary depending on the inclusion or exclusion of Picnic in the counterfactual.

Quantitative assessment

11.101 We have updated our quantitative model estimating the impact of the wholesale must-offer remedy on consumers. The model considers the static benefits of the remedy to consumers of the wider availability of Sky's Core Premium Sports channels. Specifically it seeks to quantify the increases in consumer surplus that arise from:

- The market expansion effect on new platforms (principally DTT and IPTV)[1639]. This includes the estimated effect of Sky's Picnic service.
- The market expansion effect resulting from a higher take-up of Core Premium Sports channels on cable[1640].

11.102 The model deducts the loss of consumer surplus from consumers switching away from Sky's satellite platform – although by definition this is outweighed by consumer surplus gains on other platforms since otherwise the consumers would not have switched.

11.103 We do not attempt to quantify longer term, dynamic effects of increased innovation. Nor do we assume any benefits to consumers from potential reductions in retail

[1638] BT response dated 1 February 2010 to Ofcom information request dated 20 January 2010.

[1639] We do not quantify the effects of pay TV services on DTT platforms separately from IPTV platforms.

[1640] We have assumed an increase in the number of premium sports subscribers on cable relative to the counterfactual, but that there will be no change to the number of subscribers to packages containing premium movies channels relative to the counterfactual.

prices. Both of these effects are impossible to quantify with any precision but would be positive for consumers.

11.104 In the quantitative analysis, we make assumptions about the prices charged, and the costs incurred, by pay TV retailers. These assumptions are based on figures from the pricing model, where we calculate Sky's effective prices (for example, taking account of discounts) and fixed and variable retail costs. In the quantitative analysis, when calculating costs and benefits to producers, we assume that Sky, Virgin Media and DTT/IPTV retailers each charge these prices and incur these retail costs, scaling costs with subscriber numbers where appropriate. We have made these assumptions pragmatically, as we do not have sufficiently detailed cost data for operators other than Sky[1641]. In addition, the pricing model is based on our view of an efficient operator, using Sky's costs. We have reflected this in the impact assessment – our intention is to ensure consistency between the pricing model and impact assessment where appropriate.

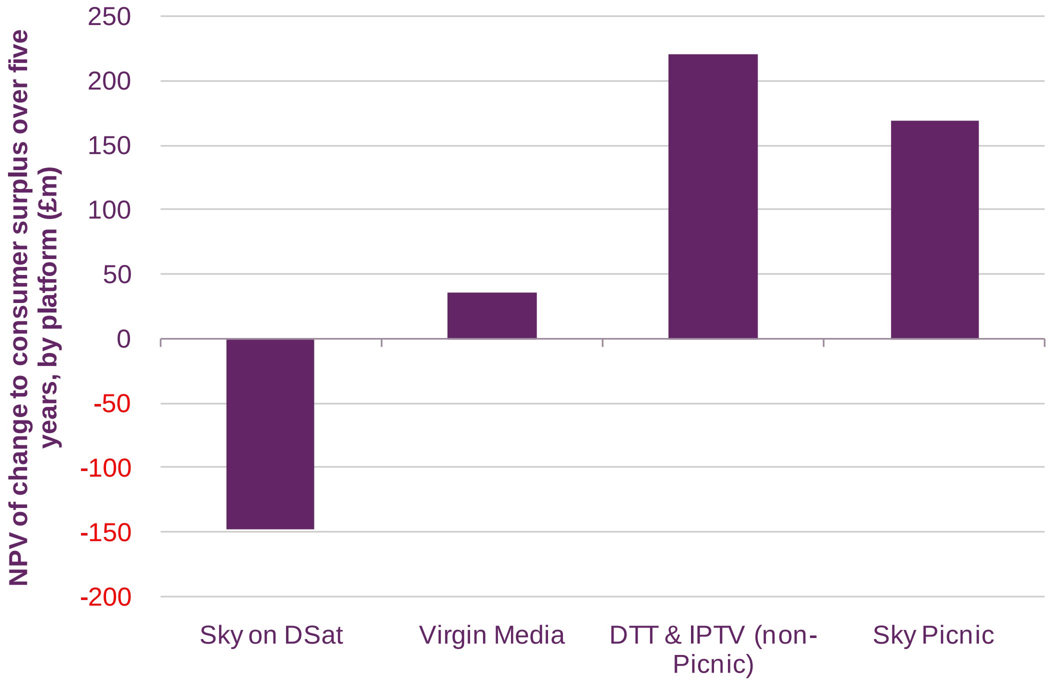
11.105 We recognise that different business models are possible, for example to offer different price / quality positions, which could imply different costs and prices for some operators. For example, some operators may choose not to subsidise up-front set-up costs. However, in our estimates of producer surplus, we have not sought to model these inevitably speculative alternatives. Nonetheless, our estimates of demand are based on a lower price-point of £25, the retail price typically used in surveys of demand for pay TV services on DTT[1642]. This price is used in our calculation of benefits to consumers.

11.106 The increase in consumer surplus we forecast in our central case is a total of £280m over five years, discounted to present value. Our sensitivity analysis suggests that this figure could lie in a very broad range from around £40m to £580m. In our central case, the increase in consumer surplus on DTT/IPTV platforms, including Picnic, is estimated to be a total of £390m, similarly discounted over five years, resulting from growth in premium subscribers. We estimate a £150m reduction in consumer surplus on the satellite platform, resulting from subscribers switching to DTT/IPTV. We estimate a £40m increase in consumer surplus on the cable platform resulting from increased take-up of Core Premium Sports channels on cable. These results are illustrated in the figure below.

[1641] We considered the option of using figures from Sky's Picnic business plan in our impact assessment. We decided against this, both because we have been able to reach a much more detailed understanding of the costs of Sky's existing retail business and because of the importance of ensuring a consistent approach between our pricing and impact assessment models.

[1642] For example, £25 was the price point used in the surveys undertaken by UBS and O&O, referenced in paragraphs 1.8 and 1.9 of Annex 8.

Figure 142 Summary of changes to consumer surplus due to wholesale must-offer



11.107 We have also quantified the effects on consumer surplus of comparing our central case against a scenario in which there is no wholesale must-offer but where Picnic launches and achieves its targeted subscriber numbers. In the Picnic-only scenario we would expect a smaller market expansion effect, with premium subscriber numbers on DTT/IPTV estimated to be around 0.7 million by the end of year 5, in line with Sky's Picnic business plan, compared to 1.8 million by that point in our central case. The impact of the wholesale must-offer when compared to the Picnic-only scenario, rather than our standard counterfactual, is a smaller increase in consumer surplus of £170m rather than £280m. This occurs as a result of the reduced market expansion effect.

Effect on firms that may take advantage of a wholesale must-offer remedy

Our position in June 2009

11.108 In our Third Pay TV Consultation, we set out our view that retailers other than Sky would benefit from access to Core Premium channels, and be able to develop new and innovative products based on this access. The benefits to these retailers would, however, be partially offset by the duplication of fixed costs incurred during market entry. They would therefore need to commit to long term, efficient and sustained entry in order to succeed.

Responses to our consultation

11.109 Many of the responses to our consultation discussed in general terms the ways in which our remedy would enable entry. We have highlighted those and our current position in the sub-Section above, 'Effects on consumers'.

11.110 In addition to these responses, Professor Cave acting for Sky suggested that the proposals could increase the dependency of "pay TV retailers" on Ofcom, and would place anti-efficiency incentives on all producers[1643]. More specifically, he considered that our remedy is likely to enable only a single alternative provider to emerge, and hence encourage co-dependency between Ofcom and that provider.

11.111 The Premier League believed Ofcom was unable to quantify the dynamic benefits of the remedy. It continued, “In fact, it is plain that its remedy may have a significant negative static effect for new entrants”[1644].

Our position now

11.112 We have described above the ways in which our remedy is likely to enable firms to offer new and innovative consumer propositions, including early launch of new services on DTT and subsequent launch on other platforms such as IPTV. This view is supported by the public statements of firms active in neighbouring markets. We have also explained that such entry will be challenging and will require firms to be both highly efficient and innovative in order to succeed.

11.113 Professor Cave / Sky highlighted the risk of co-dependency between Ofcom and – potentially – a single new entrant. The risk would be that an entrant would be reliant on Ofcom’s regulatory intervention, and that Ofcom would be reliant on that entrant for the success of its policy. Our intention is to create an environment in which entry is possible, and to minimise the scope for Sky to undermine effective entry.

11.114 While we of course recognise that our remedy will require continued oversight to ensure compliance, our focus is on ensuring fair and effective competition rather than promoting the interests of particular competitors. In addition, we determine wholesale prices on the basis that there will be more than one entrant, which reduces the risk of the success of Ofcom’s policy being dependent on a single entrant. We accept the possibility that entrants will become dependent on the wholesale must-offer remedy for their survival in pay TV. While such dependency would be an adverse consequence of our intervention, we consider that these negative aspects are outweighed by the benefits the remedy brings over the status quo.

11.115 This position is in any case no different from the position in the neighbouring markets for broadband and voice services, except that in those markets Sky is one of the companies that is dependent on Ofcom’s regulatory intervention.

11.116 We remain of the view that meaningful quantification of the dynamic benefits of our remedy is not possible. However, that does not mean that those benefits do not exist. In qualitative terms, the impact on the producer surplus of firms retailing bundles containing Core Premium Sports channels is likely to combine three effects:

- A direct effect relating to the sale of the Core Premium Sports channels themselves. Given the way that we have determined wholesale prices for those channels – where entrants break even over a long-term time horizon – the direct effect is negative over the five-year period of our impact assessment. Only if firms can significantly outperform our assumptions on subscriber growth will they be able to directly make money from the sale of Core Premium Sports channels.

[1643] Sky response to Third Pay TV Consultation, paragraph 10.39

[1644] Premier League response dated 28 September 2009 to Third Pay TV Consultation, paragraph 11.43 to 11.44

- Gains to producer surplus from the sale of other products and services that are bundled with Core Premium Sports channels.

- Gains to producer surplus from innovation related to Core Premium Sports channels – for example through innovation in platform technology[1645].

11.117 The benefits to firms entering the market are likely to relate entirely to the second and third effects, particularly in the five-year term of our quantitative assessment. Firms will only enter if they consider that they can assemble a sufficiently compelling consumer proposition to be able to grow a substantial subscriber base, sell additional products and services, and innovate in a way that differentiates themselves from their competitors. As we have stated, this will be a challenge. However, the statements of various potential entrants give us confidence that those companies believe that successful entry will be possible. The inclusion of HD versions of Sky Sports 1 and Sky Sports 2 in our remedy (albeit without a regulated price) will further enable firms to assemble attractive packages and so build subscriber volumes – assuming they are able to secure sufficient capacity to transmit those channels.

11.118 There is no change to our assessment of these effects when assessed against a counterfactual in which Picnic launches and there is no wholesale must-offer rather than a counterfactual in which Picnic does not launch and there is no wholesale must-offer.

Quantitative assessment

11.119 We have updated our quantitative model estimating the impact of the wholesale must-offer remedy on firms that may take advantage of the remedy. Over the five years of our impact assessment modelling, the wholesale must-offer remedy would be likely to lead to a decrease in producer surplus for retailers of premium channels of £390m. Our sensitivity analysis suggests that this reduction could lie in a broad range from around £420m to £290m.

11.120 The figure in our central case combines an increase in surplus for Virgin Media of £50m and a decrease in surplus for DTT/IPTV operators other than Picnic of £440m. The surplus estimate for Virgin Media is based on an expansion in its premium subscribers from around **[✂]** to around **[✂]**, an increase of 45% over five years. This equates to an increase in cable's premium penetration rate from **[✂]**% to **[✂]**%. Our forecast is based on Virgin Media's subscriber numbers for sports-only packages roughly doubling over five years. We consider this to be a realistic assumption given that as recently as 2001 there were over **[✂]** cable customers taking a package containing premium sports channels[1646].

11.121 The negative producer surplus for competing retailers might appear to be surprising, given that the main benefits we have identified arise from market entry by these retailers. This is however simply a consequence of the impact assessment outlook being just five years. By contrast, wholesale prices are determined to set to zero entrants' discounted cashflows <u>into perpetuity</u>. DTT/IPTV operators face a significant deficit in the initial growth phase due to high subscriber acquisition costs and capital expenditure and the predominance of fixed costs. We would expect annual losses to

[1645] See paragraphs 8.187 to 8.210 for a discussion of the link between premium channels and innovation.

[1646] Sky response dated 13 June 2008 to Ofcom information request dated 29 May 2008, question 4 reduce very significantly beyond entrants' second year retailing premium channels. We have also not attempted to quantify the additional benefits to producers from innovating around premium content and bundling in new and attractive ways.

Effect on Sky

11.122 We consider the ways in which the wholesale must-offer remedy may affect Sky, both in relation to its activity at the wholesale and retail levels, and with regard to any administrative burden the remedy may introduce.

Our position in June 2009

11.123 In the Third Pay TV Consultation, we stated that Sky would be subject to new regulation, and the associated administrative and compliance costs. It would also be subject to a reduction in its wholesale charges to cable and an extension of those wholesale charges to other operators. It would lose some retail subscribers to new providers of Core Premium channels. However, we expected these effects to be more than offset by additional wholesale revenues associated with market expansion.

Responses to our consultation

11.124 Sky stressed that the administrative burden on itself and Ofcom is likely to be substantial. It argued that reviews were likely to be more frequent than in telecoms markets and pointed out that Ofcom had no body of accumulated experience in broadcasting[1647]. Sky would also face costs from supplying interactive content and new services to third parties. Sky further suggested that there was a high likelihood of unintended adverse consequences and future regulatory creep.

11.125 Sky also said Ofcom was wrong to claim the remedy would increase Sky's revenues, as our counterfactual was flawed and DTT demand was overestimated. The effect of loss of revenues from Virgin Media was likely to be substantial[1648]. Sky stated that a conclusion that Sky benefits from a wholesale must-offer remedy is inconsistent with the view that Sky has an incentive to withhold its Core Premium channels[1649]. Sky also claimed the proposals were potentially harmful, as returns to Sky's premium channel business would be reduced below a reasonable level and less than similar businesses would expect to earn. Ofcom's conclusion about Sky's benefits from the remedy was inconsistent with the argument that Sky had the incentive to withhold channels.

11.126 The Premier League disagreed with Ofcom's assessment, arguing that the remedy would have serious negative consequences for Sky's wholesale and retail revenues and the value Sky places on content rights[1650].

11.127 Virgin Media agreed with Ofcom that the proposed remedy was unlikely to contribute significantly to the administrative costs currently incurred by Sky[1651]. A potential IPTV

[1647] Sky response to Third Pay TV Consultation, paragraphs 11.143 to 11.151.

[1648] Sky response to Third Pay TV Consultation, paragraph 11.142.

[1649] Sky response to Third Pay TV Consultation, paragraphs 11.117 to 11.118.

[1650] Premier League response to Third Pay TV Consultation, paragraph 11.90.

[1651] Virgin Media response to Third Pay TV Consultation, paragraph 9.23.

entrant **[✂]** also agreed with this point and highlighted the established must-offer obligations in the telecoms sector.

Our position now

11.128 While the administrative costs that Sky will face are of course important, the far more material effects relate to the more direct changes in its revenues and costs that arise from changes to the number of subscribers purchasing its Core Premium Sports channels. These will be affected in four ways.

- **Market expansion on new platforms** will unambiguously increase Sky's wholesale revenues, with little change in costs (since, in the short term at least, Sky's sports programming costs are fixed). This represents a substantial gain to Sky.

- To the extent that **Sky loses retail subscribers to rivals**, it will face a reduction in the profitability of its retail business. However as we have explained in Section 5, the majority of Sky's high profits appear to be concentrated in its wholesale business. Furthermore, Sky has argued that switching away from its platform is likely to be limited as it and cable operators will fight hard to retain customers[1652]. Hence we would expect the loss of retail profits to be small relative to wholesale gains.

- **Sky should also benefit from market expansion on cable.** The proportion of Virgin Media customers taking Sky's premium channels has declined consistently in recent years, reducing the amount of wholesale revenue to Sky. Reducing the wholesale price of Sky Sports 1 and 2 and adding other important elements such as HD should give Virgin Media both greater incentive and ability to sell Sky's premium channels to its customers.

- **On cable, there will be a short-term reduction in wholesale revenues, more than offset in the longer term by benefits from market expansion.** We recognise Sky's concern that the inclusion of cable in the wholesale must-offer would result in Virgin Media paying less for its premium sports wholesale products than it does at the moment. On the other hand, if the reduction enables Virgin Media to expand the number of its subscribers that purchase those channels, Sky will gain from an increase in volumes. Over time, we expect the second of these effects to outweigh the former. We expect the point at which wholesale revenue gains dominate to come within the first year of the remedy.

    - We expect the initial wholesale price reduction to result in an annual decrease in wholesale revenue to Sky of £7m[1653], assuming that there is no change in the number of subscribers.

[1652] Sky argued that, "loss of subscribers to rival pay TV businesses would be extremely costly to Sky and Virgin Media. As a result, it might be expected that both firms would compete fiercely to prevent such switching. This would be particularly the case for Sky, given that under Ofcom's proposed regulatory regime it would earn substantial retail margins." Sky response to Third Pay TV Consultation, paragraph 11.113.

[1653] This decrease results from reduced wholesale charges for packages containing only Core Premium Sports channels. We would not expect changes to Sky's wholesale prices for packages containing movies channels.

- This could be offset by Virgin Media up-selling premium sports channels to just over 30,000 of its existing subscribers to basic only packages. Given that Virgin Media has around 3 million such subscribers, and that the overall premium penetration on cable stood at **[✂]**% at the end of 2008/09 compared to 32% in 2000[1654], we believe that Virgin Media would have the ability to do so fairly quickly. Lower marginal prices should also give Virgin Media the incentive to market premium sports channels more effectively.

- We cannot predict with certainty how this will play out, and we acknowledge that Sky bears some of the risk associated with Virgin Media's ability to expand its subscriber base. We forecast an 8 percentage point increase in Virgin Media's premium penetration rate after five years, relative to the counterfactual. This increase in penetration from **[✂]** to **[✂]** equates to a £59m increase to Sky's wholesale revenues in the fifth year. Sensitivity analysis around this estimate suggests an increase in Virgin Media's premium penetration rate of between three and twelve percentage points, which implies an increase in Sky's wholesale revenues in the range £18m to £89m.

11.129 Overall, the combination of these effects appears likely to be positive for Sky. This is the same conclusion that we have reached from our vertical arithmetic exercise which shows that Sky has a static incentive to supply alternative retailers within a range of wholesale prices. Sky argues that this is counter-intuitive: if it could increase its profitability by wholesaling its channels, then it would have done so already. As we have explained in Section 7, we believe that Sky has a broader set of reasons for withholding supply. As we explain at paragraphs 7.190 to 7.201, Sky has a strategic incentive to protect its position at the wholesale level. Through this position, Sky is currently able to earn returns significantly in excess of its cost of capital. It is not surprising that a remedy intended to ensure fair and effective competition may cut across Sky's strategic incentives.

11.130 A related issue is the extent to which any changes to Sky's overall profitability will feed through to the amounts it pays for rights. As we explain below, we do not believe that there is likely to be a strong relationship and we expect that rights values will remain largely unaffected by the remedy. We note that any changes to the payments by Sky to the sports rights bodies would constitute a transfer between these bodies and Sky, rather than a change in the overall level of producer surplus shared between the parties. Therefore, if Sky were (against our expectation) to reduce its payments for rights, this would be to the benefit of Sky alone: it would be unlikely to feed through to the benefit of consumers.

11.131 We acknowledge that the wholesale must-offer remedy will be a new piece of regulation, which will impose a new cost of compliance on Sky. However, we take the view that this is likely to be a small cost in relative terms. We are defining a simple mechanism for changes to wholesale prices over time, which should restrict Sky's burden of compliance during the price control period. The cost to Sky at the remedy review point (i.e. after three years) is likely to be more material, as it may be required to provide updated financial and operational information and participate in a consultation process.

[1654] Virgin Media response dated 20 January 2010 to Ofcom information request dated 7 January 2010, question 1; and Sky response dated 13 June 2008 to Ofcom information request dated 29 May 2008, question 4.

11.132 However, this burden is likely to be less than for more interventionist measures – and we expect costs to be small relative to the anticipated benefits. As we have made clear when considering remedy options in Section 9, the remedy imposes significantly fewer costs on Sky than other options such as accounting or structural separation. In addition, the fact that Sky has existing wholesale relationships in place (including measures to comply with competition law), that Sky was willing in discussions with Ofcom to commit to wholesaling its channels to new retailers, and that Sky would in any event seek to supply on a retail basis on other platforms, suggests that the administrative costs for Sky are not substantial relative to the counterfactual[1655].

11.133 We believe that Sky's additional costs for supplying interactive content and high-definition channels to other parties are unlikely to be substantial and can any event be recovered from purchasers. For more analysis on this, see Section 10 on non-price terms.

Quantitative assessment

11.134 We have updated our quantitative model estimating the impact of the wholesale must-offer remedy on Sky.

11.135 We estimate the effect on Sky's surplus (i.e. its total five-year profits in both retail and wholesale, discounted to present value) as an increase of £610m; our sensitivity analysis suggests that this figure could lie in a very broad range from around -£10m to £950m.The figure in the central case is the net effect of:

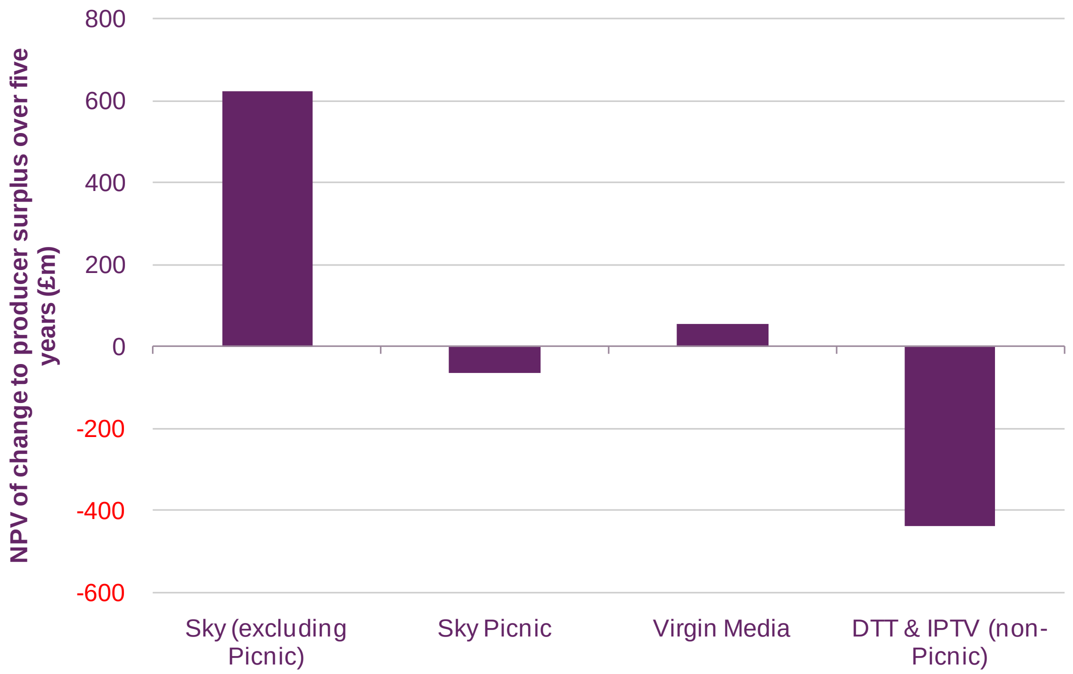
- An increase in surplus of £740m from Sky's wholesale activities. The growth in wholesale surplus results from an increased number of wholesale subscribers, who contribute carriage fees and, indirectly, advertising income.
- A £70m surplus reduction from retail activities on satellite, as some customers switch to other platforms.
- A loss of surplus due to Picnic of £60m. In the same way as other operators above, Picnic would not deliver positive value to Sky over five years due to high subscriber acquisition costs and fixed costs in the early years.
- We have assumed that Sky's premium sports rights costs do not change as a result of the wholesale must-offer remedy[1656].

11.136 We summarise the effects of the remedy on producer surplus for Sky and other operators in the figure below.

[1655] Annex 2 describes Ofcom's discussions with Sky in late 2007 and early 2008.

[1656] This differs somewhat from our position in the pricing model where, beyond rights fees forecasts provided by Sky, we forecast sports rights costs to increase in line with subscriber numbers. Increased payments for rights would represent a transfer between Sky and rights-holders and would not imply a change in overall producer surplus. Therefore, our conclusions regarding the impact assessment are not sensitive to this assumption.

Figure 143 Summary of changes to producer surplus due to wholesale must-offer



Effects on rights-holders

11.137 We also consider the potential for the wholesale must-offer remedy to impact on rights holders, and any further indirect impact on consumers.

Our position in our Third Pay TV Consultation

11.138 We set out the view that rights-holders might be affected if there was a reduction in the level of wholesale revenue available to pay for rights, or if there was a major change in the incentives faced by bidders. We therefore considered whether the value of sports and movies rights to Sky would be affected by the proposed remedy, and whether the incentives of other operators to bid for rights would be impacted.

11.139 In relation to the value of sports and movies rights to Sky, we concluded from our quantitative analysis that the direct impact of a reduction in wholesale prices was likely to be offset by the countervailing effect of market expansion. As a result, we observed that Sky's wholesale revenues may not decrease, and may even increase. We therefore took the view that Sky's valuation of rights was unlikely to be reduced.

11.140 In relation to the incentives of firms other than Sky to bid for rights, we looked at the likely effect on different categories of broadcaster.

- We took the view that the incentives of free-to-air broadcasters and pure wholesale channel providers (which are not vertically integrated with the retail level) are unlikely to change, as these operators would not be those which take advantage of a wholesale must-offer remedy.

- For operators such as Virgin Media and BT, which may take advantage of a wholesale must-offer remedy, we saw the situation as more complex. We suggested that some retailers may come to rely on wholesale access to Sky's channels rather than bid for rights, but that other operators may see the remedy as an opportunity to build a subscriber base and subsequently bid more aggressively for rights.

11.141 On balance, we concluded that the likelihood of a wholesale must-offer remedy leading to a significant decrease in rights values was low.

Responses to our consultation

11.142 Sky argued that lower rights fees were likely to result from the remedy, as Sky would have fewer incentives to invest in content, and the remedy was likely to reduce others' incentives to compete for rights[1657]. Sky asserted that the remedy might affect its incentives to bid for programming rights, as it might not be able to increase wholesale charges in response to increased rights costs[1658]. Consequently, a wholesale must-offer obligation would result in fewer incentives for Sky to invest in content, and would reduce competition for rights. Sky also stated that while we "correctly recognised" the link between cost-plus charges and bidding incentives, we had "fail[ed] to appreciate that setting prices on a retail-minus basis also affects bidding incentives"[1659].

11.143 The Premier League believed the remedy would reduce or remove the incentives for Sky and other retailers to bid for sports rights. The Premier League provided some quantitative analysis which it used to argue that Sky's revenues would fall as a result of the remedy. It also argued that other retailers' willingness to pay for rights would fall as a result of the wholesale must-offer remedy, and that this would affect both its rights and those of other rights bodies[1660]. This would devalue the rights significantly and depress the quality of content available to consumers[1661].

11.144 The RFU, RFL and PGA all argued the incentive of any broadcasters to bid for sports rights would diminish and the value of those rights to Sky would be dramatically reduced, lowering the amount each body can invest in its sport[1662]. The RFL also pointed out that if the wholesale must-offer remedy was implemented there would be a reduced incentive on any terrestrial broadcaster to buy currently valuable highlights and delayed rights packages[1663].

11.145 The ECB stressed the risk of freeloading, as it was unclear why anyone would make bids for cricket rights if they could obtain them cheaply at the wholesale level. It claimed Ofcom's consideration of the impact of the remedy on rights holders was not sufficient and Ofcom should consult further on this issue.

[1657] Sky response to Third Pay TV Consultation, paragraphs 10.57 to 10.58.

[1658] Sky response to Third Pay TV Consultation, paragraphs 10.49 to 10.52.

[1659] November 2009 Sky Submission, paragraph 6.10.

[1660] Premier League response to Third Pay TV Consultation, Section 10.

[1661] Premier League response to Third Pay TV Consultation, paragraph 1.3.6.

[1662] RFU response to Third Pay TV Consultation, paragraph 28; RFL response to Third Pay TV Consultation, page 1; PGA response to Third Pay TV Consultation, page 2.

[1663] RFL response to Third Pay TV Consultation, page 5.

11.146 The PGA believed that Ofcom did not demonstrate the necessary understanding of how the sports rights market works. It argued that our proposed remedies would not only fail to deliver the intended results, but would damage the market. By regulating the availability of Sky's channels, Ofcom would make Sky the de facto provider of sports programming, reducing Sky's incentives to innovate and restricting the ability of new broadcasters and channels to enter the marketplace. The PGA pointed out that if Sky could not differentiate itself, "it is difficult to see why Sky would continue to invest massively in improving the TV audience experience from which other platforms would immediately be able to benefit[1664]."

11.147 A number of sports bodies emphasised the risk to investment in 'grassroots' sports. For example, they commented that:

> "The reduction in the valuation of Premier League rights and other sports rights will necessarily reduce the revenues which are made available for investment in football and other sports in England and Wales, the development of grass roots sport across the country and the large number of charitable and social causes supported by rights holders such as the Premier League both domestically and around the world (...)"[1665].

> "This approach heightens our concerns that OFCOM has pre-determined its views on this subject and will seek a remedy that could have a very damaging impact on cricket in this country, particularly our ability to invest in cricket at the grassroots level"[1666].

> "RFU invests 100% of its broadcast revenues in the grassroots game. If OFCOM's proposed remedy is proceeded with, the value of those broadcast rights will dramatically diminish and the amount the RFU is therefore able to give the grassroots game will reduce correspondingly. This will have a massive impact on grassroots rugby union clubs around the country in terms of the facilities and coaching that can be provided for the grassroots"[1667].

> "The RFL invests its receipts from its broadcast rights in the game. If OFCOM's proposed action is proceeded with, the RFL is concerned that the value of those broadcast rights is likely to dramatically diminish and the amount the RFL is therefore able to distribute to the game would reduce correspondingly… At community level, any reduction would impact the facilities and coaching that could be provided by the RFL for the grassroots games"[1668].

[1664] PGA response to Third Pay TV Consultation, page 2.

[1665] Premier League response to Third Pay TV Consultation, p. 80, paragraph 11.78.

[1666] ECB response to Third Pay TV Consultation, p.1.

[1667] RFU response to Third Pay TV Consultation, p. 5, paragraph 13.

[1668] RFL response to Third Pay TV Consultation, p. 3.

11.148 A number of rights-holders subsequently wrote to Ofcom's Board, registering their concerns about our proposed actions – **[✂]**[1669]. This letter stated that:

> "**[✂]**".

11.149 We have met a number of the key sporting bodies, some of them several times, in order to understand their views in more detail.

11.150 BT argued that the opening up of pay TV markets to competition, investment and innovation through mandated wholesale access to Sky's premium channels would have implications throughout the value chain, including upstream in the way channels, programmes and rights are bought, sold and used. However, BT argued that for new business models to be commercially viable, operators such as BT would first have to recruit sufficient subscribers interested in consuming such content. Therefore, BT stated that wholesale access to Sky's premium channels is an essential pre-condition for pay TV platform operators to build a subscriber base, before considering bidding for premium content rights directly[1670].

11.151 Similarly, in their combined response, the Three Parties argued that the remedy will enable competing pay TV retailers to build up their bases of premium pay TV subscribers, increasing their abilities to bid effectively for rights in the future[1671].

Our position now

11.152 We remain of the view that our proposed remedy is unlikely to have a substantial effect on the amounts paid to sports rights bodies. As explained in Section 9 we have taken particular care to design our remedy in a way that does not depress rights values. A cost-plus remedy, for example, would create a very strong incentive for alternative retailers to avoid competing with Sky in wholesale markets; by contrast, a retail-minus remedy does not build in a link between rights fees and Sky's wholesale prices, and therefore creates no incentives for entrants to avoid bidding for rights. We set out here in more detail the effects that we believe our remedy is likely to have on rights bodies.

11.153 The amount that wholesale channel providers pay for rights depends on their own valuation of rights and the valuations of their rivals. In a competitive wholesale market, we would expect the acquirer of the rights to pay just more than the amount that the second highest bidder was prepared to pay. Since our competition concerns relate to Sky's aggregation of the majority of the most attractive sports rights, we consider here how our remedy will affect the incentives to bid for rights both of Sky's rivals and of Sky itself.

11.154 By way of context, the Figure below provides details on the bidding processes for recent sales of some of the most important sports rights. It shows in particular the identity of the bidders for the rights and the amounts paid. We discuss the implications in more detail below.

[1669] Letter of 5 March 2010. See the following for coverage of the letter: http://www.telegraph.co.uk/finance/newsbysector/mediatechnologyandtelecoms/7436639/Sky-to-challenge-Ofcom-findings.html

[1670] BT response dated 18 September 2009 to Third Pay TV Consultation, paragraphs 2.27 to 2.31

[1671] Three Parties response dated 21 September 2009 to Third Pay TV Consultation, paragraphs 2.24 to 2.27

Figure 144 Summary of recent bids for major sports rights

[✂]

[✂]

Notes:

1. Rights often cover the Republic of Ireland in addition to the United Kingdom.

2. Details only cover live TV rights. Bids for highlights, mobile, delayed coverage and radio rights are excluded unless bundled with live rights.

3. The ECB's 2010-13 rights were tendered twice, the second round being the result of the addition of extra events to the rights.

4. The Rugby Football League declined to respond to our request.

11.155 In summary, for each sports rights-holder:

- **FA Premier League** – in the most recent auction, for rights from 2010/11 to 2012/13, **[✂]**. In the previous auction, for rights from 2007/08 to 2009/10, **[✂]**[1672].

- **UEFA** (in respect of the Champions League) – in the two most recent auctions, for rights from 2006/07 to 2008/09 and 2009/10 to 2011/12, **[✂]**. ITV was successful in acquiring rights in both auctions. Ahead of both sale processes, UEFA received expressions of interest from **[✂]**[1673].

- **UEFA** (in respect of the Europa League, formerly the UEFA Cup) – Sky has not held any of the centrally-marketed live rights in the last two rights periods (2006 to 2009 and 2009 to 2012). **[✂]**[1674].

- **Football Association** (in respect of England home internationals and the FA Cup) – in the most recent auction, bids were received from Sky, Setanta and **[✂]**. Rights were successfully acquired by ITV and Setanta after they outbid a combined offer from the BBC and Sky. Following the collapse of Setanta, its rights have been sold to ITV, Sky and ESPN. In the FA's previous auction, bids were received from **[✂]** and, jointly, the BBC and Sky. In both cases, no bids for live rights were received from vertically integrated operators other than Sky[1675].

- **Football League** (in respect of the Football League and League Cup) – limited information was disclosed to us, but this shows that Sky won all rights for

[1672] **[✂]**.

[1673] UEFA response dated 11 December 2009 to Ofcom information request dated 29th October 2009, question 1.

[1674] UEFA response dated 11 December 2009 to Ofcom information request dated 29th October 2009, question 1.

[1675] FA response dated 4 February 2010 to Ofcom information request dated 13th January 2010, question 1.

2006/07 to 2008/09, while Sky and the BBC have shared rights for 2009/10 to 2011/12[1676].

- **England & Wales Cricket Board** (in respect of England and club cricket) – in the most recent auction, **[✂]**. In the previous auction, **[✂]**. In both auctions, **[✂]**[1677].

- **Premier Rugby** (in respect of the Guinness Premiership) – Sky faced competition for rights from Setanta **[✂]**. Premier Rugby awarded rights to Sky and Setanta; following the collapse of Setanta, Premier Rugby licensed Setanta's surrendered rights to ESPN[1678].

- **Rugby Football Union** (in respect of the Anglo-Welsh Cup and certain England internationals) – for the two most recent rights periods, the RFU licensed rights to Sky. **[✂]** – but only Sky made a formal offer for live rights[1679]. The RFU told us that "the negotiated sum was [concluded] only after the rights had been put out to competitive tender"[1680].

- **Six Nations Committee** – in the two most recent rights periods (2006 to 2009 and 2010 to 2013), **[✂]**. In the more recent rights period, **[✂]**. Nevertheless, the Six Nations Committee felt that, "even where a broadcaster did not make a formal bid, the possibility that it might do so constrained the behaviour of those who did bid"[1681].

- **PGA European Tour** – for live rights from 2009 to 2012, the PGA European Tour distributed a rights tender document to over 20 parties, but only received formal bids from **[✂]** and (jointly) the BBC and Sky[1682].

11.156 Having reviewed the factual position in relation to the sale process for the key rights, we now set out the likely incentives of various potential bidders in the presence of the wholesale must-offer.

[1676] Football League response dated 24 March 2010 to Ofcom information request dated 13 January 2010, question 1.

[1677] ECB response dated 11 November 2009 to Ofcom information request of 29 October 2009, question 1.

[1678] Premier Rugby response dated 20 November 2009 to Ofcom information request of 29 October 2009, question 1.

[1679] RFU response dated 13 November 2009 to Ofcom information request of 29 October 2009, question 1.

[1680] RFU response of Ofcom letter of 16 March 2010.

[1681] Six Nations Committee response dated 27 November 2009 to Ofcom information request of 29 October 2009, question 1.

[1682] PGA European Tour response dated 16 November 2009 to Ofcom information request of 29 October 2009, question 1.

Incentives of companies other than Sky to bid for rights

11.157 The table and bullet points above summarise information from numerous sports rights-holders on their rights sale processes, the identities of the parties which expressed an interest in the rights, and the actual bids received[1683]. This informs our understanding of which parties were most interested in licensing rights in the recent past. This, in turn, can aid our judgement of the likely effect of the wholesale must-offer remedy on operators other than Sky. If previous bidders were typically free-to-air broadcasters or non-integrated wholesale channel providers, then the remedy would have limited effects on competition for rights. However, if previous bidders were potential beneficiaries of the wholesale must-offer remedy – i.e. potential retailers – then the situation is more complex.

11.158 Our analysis of the information received from rights-holders set out in the Figure above suggests that Sky's competition for rights has come mostly from free-to-air broadcasters and wholesale channel providers which are not vertically integrated with platform operation[1684]. Therefore, Sky's main competition for rights has not come from firms which are likely to take advantage of the wholesale must-offer. This is true both for the most recent rights sale processes and, in the main, those which preceded them.

11.159 In the longer term, the existence of a wholesale must-offer and the resulting increase in the availability of Sky Sports channels could have some positive effects on the rights market. As we have set out in our discussion of choice above, one effect of the wholesale must-offer should be to expand both the number of customers taking Sky Sports channels and pay TV in general, as well as resulting in greater variety of customers coming into the market as they take advantage of the variety of packages and price points that are likely to be available. This should if anything be positive for rights holders, as it expands the available market for sports content.

11.160 Apart from Sky, the main bidders for rights can be divided into three broad groups:

- Public service broadcasters and other free-to-air broadcasters.
- Vertically integrated pay TV operators.
- Wholesale channel providers.

Free-to-air broadcasters

11.161 Free-to-air broadcasters' incentives to bid are unlikely to change materially in the presence of a wholesale must-offer, as the Premier League also indicated in its response to our Third Pay TV Consultation[1685]. In the past these companies have

[1683] We received information from the FA Premier League, Football Association, Football League, UEFA (in respect of the Champions League and Europa League / UEFA Cup), England & Wales Cricket Board, Premier Rugby, Rugby Football Union, Six Nations Committee and PGA European Tour.

[1684] Setanta was vertically integrated with retail in that it retailed its packages direct to residential households on satellite and some households on DTT, but it was not integrated with platform operation.

[1685] Premier League response to Third Pay TV Consultation, paragraph 11.114.

been important participants in rights auctions – indeed ITV has bought the rights to some live UEFA Champions League matches[1686].

11.162 The Premier League took the view that none of these companies would be in a position to make up the "shortfall" in rights values following implementation of the wholesale must-offer. However, to the extent that Sky's winning bids are conditioned by bids from the FTA broadcasters, this effect is likely to remain unchanged.

11.163 The Rugby Football League argued that delayed and highlights rights will be less attractive to terrestrial broadcasters given an expanded market for live rights. To the extent that this effect may exist, we would expect its impact to be small. Highlights rights are typically significantly less valuable than live rights[1687] and, in any case, we expect a net loss of free-to-air households of only 7% relative to the counterfactual.

Vertically integrated pay TV operators

11.164 Vertically integrated pay TV operators are the companies whose incentives to bid are most likely to be changed by the presence of a wholesale must-offer, but they have had little impact on auctions for major live rights in the past, so the potential negative effect of the wholesale must-offer cannot be said to be great. Therefore, if a wholesale must-offer remedy reduced Virgin Media and BT's incentives to bid for rights, it would be from a relatively low level which does not appear to determine the level of Sky's bids.

11.165 Our remedy is focused on removing a critical barrier to entry into the retail market for bundles containing Core Premium Sports channels. In the presence of this barrier to entry, retailers have little realistic alternative but to go upstream and bid for rights themselves. Hence removing the barrier may, in principle, weaken incentives to bid for content by providing an alternative mechanism for retailers to access that content. In the absence of a wholesale must-offer, a firm's willingness to pay for rights will equal the sum of the profits it expects to earn at both retail and wholesale level. A wholesale must-offer provides an alternative means of earning the expected retail profits, and therefore reduces the amount that the firm would be prepared to bid by that amount.

11.166 However, our approach to determining the price of channels under the wholesale must-offer obligation is explicitly intended to ensure that firms do not earn any profits in their retail activities higher than a normal return – i.e. in the above description, the expected retail profits are zero. Hence conceptually at least, the introduction of the wholesale must-offer should have no effect on the amounts that firms are prepared to pay for rights. Both with and without the wholesale must-offer, firms' incentives to bid for rights should be driven primarily by the ability to add value at the wholesale level by aggregating content, creating attractive channels and building brand value. The wholesale must-offer will not change that incentive.

[1686] An external factor that could affect this is that the BBC, which has been an important bidder in the past, is capping sports rights spending at 9p in every licence fee pound. http://www.bbc.co.uk/bbctrust/assets/files/pdf/review_report_research/strategic_review/strategy_review.pdf, page 5.

[1687] For example, for the upcoming rights period, Premier League highlights rights sold for £171m over three years, which is less than 10% of the £1,782m paid for live rights. Sources: The Guardian, 'BBC secures Match of the Day rights', http://www.guardian.co.uk/media/2009/jan/28/bbc-secures-match-of-the-day-rights; BBC, 'BSkyB snatches Setanta TV rights', http://news.bbc.co.uk/1/hi/business/7875478.stm.

11.167 For vertically integrated pay TV operators (or indeed for other types of companies), one part of the incentive to bid remains entirely unchanged in the presence of a wholesale must-offer. Taking a wholesale channel is never a full substitute for going upstream to bid for rights, because of the benefits the wholesaler gets from being able to impose its own brand and editorial material on top of the underlying content. As an illustration, it is hard to imagine Sky, as a strong marketing company, being happy to provide key sports to its customers via a Virgin Media or BT-branded sports channels. As the wholesaler of its sports channels, Sky gets to spread its brand to cable customers, and under the wholesale must-offer to a wider group of consumers. That same type of benefit is only available by going upstream to bid for rights, not by buying another provider's channel on a wholesale basis.

11.168 Nonetheless, we recognise that entry into the wholesale channel business is likely to be risky. If the wholesale must-offer provides a ready mechanism for retailers to avoid the risk of wholesale market entry, then there is of course a prospect of them settling for that opportunity, despite the potential to add value upstream. We note though that the presence of an existing supply arrangement with Sky has not prevented cable operators from bidding for rights in the past, albeit that they have not in recent years provided the strongest competition to Sky.

11.169 Furthermore, as we have explained in Section 5, firms currently wishing to compete with Sky at retail level have no choice but to go upstream and bid for rights themselves. Sky's bidding advantages make it extremely difficult for them to succeed – as evidenced by Sky's enduring ability to outbid its rivals. To the extent that Sky's bidding advantages relate to its activity in the retail market and the wholesale must-offer enables rivals to increase their presence in that market, we would expect that over time the wholesale must-offer may strengthen the ability of retailers to bid against Sky.

11.170 For example, BT argued that access to a larger retail subscriber base is essential for it to be able to enter the wholesale market. This is very different from the Premier League's misinterpretation of our views – it believed that "Ofcom accepts that a likely consequence of the proposed wholesale remedy is that vertically integrated platform operators, such as Virgin Media, will decide to rely entirely on the wholesale must-offer remedy"[1688]. First, this was not our view. This is a possible outcome, as we set out above, but not necessarily a likelihood over the long-term, as illustrated by our views on the ability of wholesale customers eventually to bid successfully for rights. An increased number of successful retailers could result in there being more genuine participants in rights auctions, rather than Sky standing head and shoulders above the rest.

11.171 Both Sky and the Premier League itself have acknowledged the fact that these companies have had little impact on rights auctions in the past:

> "The simple fact is that prior to the emergence of Setanta (and now ESPN) other pay TV broadcasters/platform operators/retailers have consistently demonstrated (over a period of nearly 20 years) an unwillingness to bid competitively for sports rights and have simply not wanted to invest in the development of sports channels. As a result, they have chosen to focus their businesses elsewhere"[1689].

[1688] Premier League response to Third Pay TV Consultation, paragraph 11.109.

[1689] Premier League response to Third Pay TV Consultation, paragraph 12.20.

> "The reality is that Virgin Media and BT (the other integrated retailers/platform operators) have to-date displayed no interest in seriously bidding for live sports"[1690].
>
> "The simple truth is that they [BT, Virgin Media, **[✂]** etc.] have so far not wanted to invest in content and produce their own broadcast product"[1691].
>
> "[Virgin Media and BT] have "shown no appetite to invest in content or support British sport"[1692,1693].

11.172 Sky has argued that the value of rights to Virgin Media and BT may underpin Sky's bids, even if these retail competitors do not actually bid for rights. **[✂]**[1694]. **[✂]**. The fact that these parties have not provided the main competition to Sky in recent rights auctions suggests that their valuations of rights are significantly lower than Sky's, making it not worthwhile significantly participating in auctions.

Wholesale channel providers

11.173 Wholesale channel providers' bids are unlikely to be affected in a material way by the wholesale must-offer. As we can see from the results of the key rights auctions, Setanta and now ESPN have usually been the most credible alternative bidders to Sky in recent years. These are companies whose UK businesses are largely focused on, or in ESPN's case entirely based on, wholesaling channels rather than retailing the channels themselves. They are therefore highly unlikely to want to take up a wholesale must-offer. Their business model requires them to bid for the most attractive content, in order to assemble appealing channels. This incentive will remain in the presence of a wholesale must-offer.

11.174 The underlying incentive to bid will remain, but it could nonetheless be possible that ESPN's valuation of rights could decrease. On one hand it is possible that wider availability of Sky Sports channels could reduce consumers' propensity to subscribe to ESPN. On the other hand, the expansion of the market brought about by the wholesale must-offer is likely to mean that there are more consumers who could subscribe to ESPN's channel via their new pay TV services. Regardless of the positive market expansion effect, we would not expect the potential negative effect to be material:

[1690] Premier League response to Third Pay TV Consultation, paragraph 7.22.

[1691] Premier League response to Third Pay TV Consultation, paragraph 7.28.

[1692] Quoted in the Guardian newspaper, a Sky spokesman stated, "We invest almost £1bn a year to create a top-quality sports service … It would be perverse to force us to sell it on the cheap to competitors who have shown no appetite to invest in content or support British sport." 'Cost of TV sport to tumble as Ofcom turns screw on Sky', 17th January 2010, http://www.guardian.co.uk/media/2010/jan/17/tv-sport-media-ofcom-sky

[1693] **[✂]**.

[1694] **[✂]**.

- The customers that would be most likely to stop subscribing to ESPN are those on DTT and IPTV, [✂][1695].

- ESPN customers on Sky's satellite platform would be unlikely to change their behaviour. They already have access to both Sky Sports channels and ESPN, and continue to subscribe to ESPN.

- Customers on cable [✂]. These customers currently do not pay anything extra for ESPN, as they receive it as part of their subscription to Virgin Media's XL pack.

- Although the possible downward pressure on ESPN's revenues comes from the fact that ESPN is the closest substitute for Sky Sports channels, it is still not a perfect substitute. In other words, while there are some consumers for whom the wider availability of Sky Sports channels may have an effect, there are others who still want access to both Sky Sports channels and ESPN because they for example show different Premier League matches. Fervent followers of a particular club are still likely to want access to all available matches featuring their club.

11.175 The Premier League advanced various arguments which it said backed up the idea that ESPN's valuation of rights would be reduced[1696].

- Switching away from Sky's platform would reduce the revenues available to ESPN on the satellite platform. This argument ignores the likelihood that any customers not subscribing to Sky's services that might otherwise have done must presumably subscribe to another platform. If they subscribe to another platform, they are likely to have the option of subscribing to ESPN on that other platform.

- Sky's channels being "universally available at a discounted wholesale price" / "at a subsidised price" would make it more difficult for other broadcasters to obtain a "fair wholesale price". Our wholesale prices are set at a level to allow other pay TV operators to compete effectively. This does not constrain those operators' ability or incentive to assemble the most attractive set of channels possible, by among other things paying a commercially agreed price to ESPN.

11.176 Quite apart from these various forward-looking arguments, the view of ESPN itself is highly relevant. In a meeting with us ESPN said that the impact on ESPN's business of a wholesale must-offer remedy, applied to Sky Sports, was uncertain. ESPN felt that the range of possible outcomes from the remedy meant the net effect could be beneficial or damaging to ESPN's business but it had not yet formed a view as to which was more likely[1697].

Sky's incentives to bid for rights

11.177 As we have explained above, in a competitive market, we would expect the winner of a particular set of rights to pay just marginally more than the next highest bidder.

[1695] ESPN response dated 19 February 2010 to Ofcom information request dated 13 January 2010, question 4.

[1696] Premier League response to Third Pay TV Consultation, paragraph 11.101 onwards.

[1697] Meeting between Ofcom and David Ballantine of ESPN, 28 September 2009.

However, as we have explained in Section 5, Sky has market power in the wholesale market for Core Premium Sports channels. This means that it faces relatively weak competition when bidding for rights. Hence the amount that the next highest bidder for rights is prepared to pay is often relatively low.

11.178 **[✂]**. This is consistent with our observation in Section 5 that **[✂]**. This raises important questions about the true determinants of the amounts Sky pays and hence the impact of our remedy. This evidence suggests that, in addition to the valuations of alternative bidders, there are two further determinants of Sky's bids:

- First, there is the benefit to Sky of investing in the quality of sports content. Improvements in the standard of professional sport, and the facilities in which sport is played, augment the attractiveness of Sky's sports channels. This is consistent with Sky's statements about its approach to the sports market, where it refers to sustained investment in British sport which has "benefited UK sport in so many ways over the past two decades"[1698]. Sky will continue to have a strong incentive to improve the quality of the UK sports which feature in Sky Sports programming.

- Second, there is the risk that some of the sports rights bodies will enter the wholesale market themselves, marketing their channels direct to pay TV retailers, including Sky[1699]. This option has been pursued by Dutch clubs, which created the 'Eredivisie Live' channel in partnership with the production company Endemol[1700]. While this option makes most sense for sports bodies which control very high-value rights (i.e. primarily the Premier League), it is another factor likely to place a floor on Sky's bids, and one which would not be affected by a wholesale must-offer remedy. This option was also recognised by Sky in its response to the First Pay TV Consultation[1701].

11.179 In the absence of greater competition from rivals, we see these two factors as being the more material determinants of the amounts Sky pays. More importantly, we see no reason why either of these two factors should be materially influenced by the wholesale must-offer remedy. Sky's incentives to invest in the quality of the sports content will remain largely unchanged (and possibly expanded if there is substantial market expansion), as will the incentive of rights bodies to establish their own wholesale channels.

[1698] Jeremy Darroch speech at Sports Industry Group, 9th June 2009.

[1699] This is a possibility that the Premier League is reported to have considered in the past, as a fallback option in case bids for rights failed to reach the expected level . For example, see 'Premier League planning TV channel to beat the recession', The Independent, 17th December 2008, http://www.independent.co.uk/sport/football/premier-league/premier-league-planning-tv-channel-to-beat-the-recession-1192636.html

[1700] Eredivisie Live is reported to have fallen short of its subscriber target, but to have achieved more subscribers than has previously been reached by a sports channel in the Netherlands. The channel has also licensed additional football content, such as Real Madrid TV, suggesting that this option may also place a floor on the value of other sports rights. See '350,000 for Dutch football channel', Broadband TV News, http://www.broadbandtvnews.com/2009/04/24/350000-for-dutch-football-channel/

[1701] Sky stated that "there are a range of potential entrants [at the wholesale level] including existing broadcasters and rights owners." Sky's response to First Pay TV Consultation, paragraph 10.8.

11.180 We recognise that the wholesale must-offer may have a negative impact on any drivers of Sky's bidding behaviour which stem from strategic incentives to restrict downstream competition, and as such has the potential to reduce Sky's willingness to pay for rights. However, to the extent that such bidding behaviour is determined by factors that are likely to be prejudicial to fair and effective competition, we believe any reduction in this aspect of Sky's willingness to pay for rights is acceptable. Our remedy is specifically designed to avoid distorting any non-strategic drivers of Sky's bidding behaviour.

11.181 Sky argued that our proposed ratchet mechanism for adjusting wholesale prices over time would reduce its ability to pass through rises in sports rights costs and therefore reduce its incentives to bid. As we have explained above in Section 10, we no longer propose to apply the ratchet mechanism, and instead propose that there is a more direct relationship between retail prices and wholesale prices, in which the margin between the two is set as a fixed absolute amount. Hence if Sky raises its retail prices in line with an increase in wholesale costs, the wholesale price will also rise. We believe this is a more proportionate approach to price changes and one which addresses the concerns that Sky raised about the impact of the price adjustment mechanism on rights values.

11.182 Finally, we remain of the view that the material difference between our wholesale prices and the cost-plus floor provides a substantial protection to rights values. This gap implies that Sky will continue to benefit substantially from its ownership of the sports rights. Only if we were driving wholesale prices close to the cost floor would we risk reducing Sky's ability to continue paying what it currently pays for rights.

11.183 This argument is closely related to the points set out above that the difference between our cost-plus and retail-minus figures indicates that the benefits to Sky from owning sports rights are captured at the wholesale level rather than the retail level. In the short term, our remedy will not affect these benefits and should therefore not affect Sky's willingness to bid for content; in the medium term, our remedy may enable entry at the wholesale level, which would tend to increase the intensity, and hence level, of bidding for rights.

11.184 The Premier League advanced a number of arguments in its response to our Third Pay TV Consultation as to why it believed Sky's bids for content would be reduced[1702].

- "Loss of retail revenues". Sky's ability as a wholesale channel provider to bid for rights depends on its overall revenues, both retail and wholesale, net of other non-rights costs. Our analysis shows that this total will increase at least in static terms. The Premier League's concern over retail revenue seems in any case to be largely based on a misunderstanding of our pricing analysis. It says that "the protected (excessive) retail margin will allow other retailers to significantly undercut Sky's retail prices by setting their prices below the current competitive levels". This is not the case – as we set out above in our analysis of the effects on consumers, we are setting wholesale prices precisely in order to allow other retailers to compete effectively at the same retail prices as Sky, not to undercut it.

- "Wholesale revenues earned on sales to Virgin Media will decline". In our Third Pay TV Consultation we set out the view that wholesale revenues from Virgin Media would in fact increase over time, as it would have an increased incentive to

[1702] Premier League response to Third Pay TV Consultation, paragraphs 11.82 to 11.100.

sell premium channels to its subscribers. The Premier League disputed this prospect, carrying out some modelling to indicate that this would be implausible within three years. We believe it to be relevant to consider a longer time horizon than three years, since the benefits to Sky's wholesale revenues should continue in the longer term (unless we saw fit to lift the remedy after three years, which as we set out in Section 9 would be unlikely unless there was a substantial change in the market).

- "Any market expansion in the total number of subscribers on platforms other than Sky's during the relevant period (i.e. the period covered by the sale of the rights) will be too low to offset Sky's revenue losses". We disagree with the Premier League's assessment of the likely net effect of the various impacts of the remedy, in light of the substantially positive static impact on Sky's producer surplus over five years, as set out earlier in this Section.

<u>Impact on 'grassroots' sport</u>

11.185 As noted above, a number of sports bodies emphasised the risk to investment in 'grassroots' sports. Our remedy has intentionally been designed to minimise effects on rights-holders, such that large reductions in rights values are unlikely. In light of this, there should not be a reduction in investment in grassroots sport.

<u>Conclusion on likely impact on rights holders</u>

11.186 We believe that rights-holders are unlikely to see large reductions in rights values as a result of the wholesale must-offer remedy. Our remedy has been deliberately designed to minimise the impact on rights holders, through the use of retail-minus pricing rather than cost-plus. The companies whose incentives to bid for content are most likely to change have not influenced the outcome of rights auctions. Sky's incentives to bid appear to be little changed, and our prices are set in a way that does not affect its ability to maintain its payments for rights.

Equality impact assessment

11.187 In the Third Pay TV Consultation, we considered whether we were required to undertake a full Equality Impact Assessment for the proposed remedy. On the basis of our Initial Equality Impact Assessment Screening we determined that this was not required. We did not identify any significant impacts on equality likely to result from the proposed remedy. No respondents to the consultation commented on this view. We therefore confirm our conclusion that no significant impacts on equality are likely to result, and that a full Equality Impact Assessment is not required.

Section 12

Licence conditions

Summary

12.1 Section 12 of this document includes the text of new conditions to be included in the channel licences for Sky Sports 1, Sky Sports 2, Sky Sports HD and Sky Sports 2 HD, pursuant to s316 CA03.

12.2 These become effective from today's date. As set out above, we do not expect to review these earlier than three years from this date, unless there is a material change of circumstances, such as a substantial shift in rights ownership.

Decisions

12.3 Section 3 explains the legal framework for the insertion of licence conditions under s316 CA03. This enables and requires Ofcom to insert conditions into licences which it considers are appropriate to ensure fair and effective competition in the provision of licensed services and of connected services.

12.4 At Section 9 we explained that we have decided, pursuant to s317(2) CA03 that it would not be more appropriate to proceed under CA98 in relation to the matters in question. We therefore give notice, pursuant to s317(4), that we have decided to exercise s316 for a competition purpose. Pursuant to s317(6) any person affected by this decision may appeal to the Competition Appeal Tribunal[1703].

12.5 On the basis of the analysis in this document, including in particular the impact assessment carried out in Sections 9 to 11, we conclude that it would be appropriate for Ofcom to ensure fair and effective competition by imposing licence conditions in the form resulting from the assessments made in Sections 9 and 10. We consider that a wholesale must-offer obligation in the proposed form falls within the scope of s316(1), and also satisfies the requirement in s316(2). Ofcom has therefore decided to insert conditions pursuant to s316 in the licences for Sky Sports 1, Sky Sports 2, Sky Sports HD and Sky Sports 2 HD, which require Sky to make wholesale offers in relation to those channels.

Drafting of the licence conditions

Our position in the Third Pay TV Consultation

12.6 In the Third Pay TV Consultation we set out a draft licence condition.

12.7 We explained that we can only insert licence conditions into channel licences that currently exist but that any proposed new licence, or change to an existing licence, would need to form the basis of an application to Ofcom, at which point we would review it in the context of this remedy.

[1703] Pursuant to s317(8), the jurisdiction of the Competition Appeal Tribunal on an appeal under s317(6) excludes: (a) whether Ofcom has complied with s317(2); and (b) whether Ofcom has contravened s317(3). Those decisions fall to be questioned only in proceedings for judicial review.

12.8 We explained that under Section 316(1) the regime for every licensed service shall include the conditions that Ofcom consider appropriate for ensuring fair and effective competition in the provision of licensed services or of connected services. Under s316(2) those conditions must include the conditions (if any) that Ofcom consider are appropriate for securing that the provider of a service does not engage in a practice which Ofcom consider, or would consider, to be prejudicial to fair and effective competition. We considered that a wholesale must-offer obligation in the proposed form fell within the scope of s316(1) and also satisfies the requirement in s316(2).

12.9 We also explained that pursuant to Section 3(4)(b) of the Broadcasting Act 1990, Ofcom must give notice to Sky as the licensee of a proposed variation to certain Television Licensable Content Service licences and allow it a reasonable opportunity to make representations on that proposal. Pursuant to that requirement, we set out for consultation the proposed text of a condition to be inserted into certain the licences held by Sky.

Responses to the consultation

12.10 We set out below comments which were specific to the drafting of the licence condition.

12.11 Sky argued that the draft licence condition was not sufficiently complete to provide it with a reasonable opportunity to make representations. It nonetheless made a number of detailed comments[1704].

- It pointed out that we had proposed to include the Disney Cinemagic channel when Sky does not hold a licence for that channel[1705].
- It argued there should be a transition period for the licence condition coming into force[1706].
- It pointed out that there was no definition of "Interactive Content" in the condition[1707].
- It argued that it was overly burdensome for Sky to have to make an offer to "any person" as there was no connected requirement for such persons to demonstrate that they had access to a Qualifying Platform[1708].
- It argued that "Qualifying Platforms" was not limited to "TV platforms" and was therefore too wide, and in particular would apply to the open internet[1709].

[1704] Annex 8 to Sky's response to Third Pay TV Consultation, and paragraph 2.8 of Sky's November 2009 Submission.

[1705] Sky response to Third Pay TV Consultation, paragraph A8.6.

[1706] Sky response to Third Pay TV Consultation, paragraph A8.7.

[1707] Sky response to Third Pay TV Consultation, paragraph A8.8.

[1708] Sky response to Third Pay TV Consultation, paragraph A8.9 and A8.10.

[1709] Sky response to Third Pay TV Consultation, paragraph A8.11 and A8.12.

- Sky argued that because we had not put the final Maximum Prices into the licence condition, the consultation on the condition was flawed[1710].

- Sky argued it would require a minimum of three months in order to draw up a reference offer[1711].

- Sky argued that paragraph 14A(3)(d) of the draft licence condition, which required that the reference offer include the arrangements under which changes to the content of the Licensed Service should be notified and agreed, would lead to an unwarranted infringement of Sky's editorial control. This provision was also commented on by Professor Cave on behalf of Sky, who thought this could "congeal" the status quo[1712].

- Sky thought there was a lack of clarity over how the ability to set Minimum Qualifying Criteria sat with the obligation in 14A(6) of the draft licence condition to use its best endeavours to enable someone who had accepted an offer to commence retailing the content. It also thought that best endeavours obligation went beyond the provision of "factory gate products"[1713].

- In addition to its comments on the economic issues behind the requirement in 14A(4) (discussed above at paragraphs 10.255 to 10.262) Sky also raised some drafting issues. First, it said there were drafting errors in the core calculation, which had been drafted in reverse, and in the definition of "Amount". Second, it said we had omitted the 5% materiality threshold discussed in paragraph 9.207 of the consultation. Third, it said the term "non-TV product" would cover an extremely wide range of products, including for example Sky's Protect PC services[1714].

12.12 **[✂]** argued that we should include the words "which is solely" before "operated" in the definition of "Qualifying Platform" to clarify that Sky would still be required to make an offer to wholesale channels if it supplied those channels under a platform operated partly by a third party and partly by Sky[1715].

Ofcom's position

12.13 In response to Sky's detailed points:

- There is no licence condition imposed in relation to the Disney Cinemagic channel.

- There is no transition period for the coming into effect of the licence condition. Sky was consulted on the proposed form of the licence condition in accordance

[1710] Sky response to Third Pay TV Consultation, paragraph A8.13 to A8.15.

[1711] Sky response to Third Pay TV Consultation, paragraph A8.16.

[1712] Sky response to Third Pay TV Consultation, paragraph A8.17 to A8.19.

[1713] Sky response to Third Pay TV Consultation, paragraph A8.20 and paragraphs A8.22 to A8.24.

[1714] Sky response to Third Pay TV Consultation, paragraph A8.21.

[1715] **[✂]**

with the statutory requirements. Compliance with that condition may require certain actions to be taken from this date, but the condition provides that Sky must respond to requests "within a reasonable time" and therefore already allows Sky reasonable time to comply.

- The definition of "Interactive Content" has been removed from the condition. As explained above at paragraphs 9.287 to 9.297 and 10.325 to 10.334 Ofcom considers that interactive content is a part of the licensed service and that Sky should offer to supply interactive content on fair, reasonable and non-discriminatory terms. We have therefore also clarified that the Maximum Prices do not include incremental costs directly attributable to the provision of interactive content.

- We do not consider that the drafting in 14(1)A, requiring offers to be made to any person, is unduly burdensome. As recognised in 14(3), we expect that Sky will put in place Minimum Qualifying Criteria for prospective purchasers, and anticipate that evidence concerning the ability to access a retail platform would be a reasonable requirement to include within those criteria. This point is discussed in paragraphs 10.285 to 10.290.

- We discuss above at 9.173 to 9.206 and 10.291 to 10.299 issues concerning "TV" and "non-TV" platforms.

- We do not accept Sky's argument that the consultation on the licence condition was flawed because we did not present a set of prices. We explained clearly that the prices which would apply would be those which resulted from the detailed consultation on prices set out in Section 9 of the Third Pay TV Consultation. Those prices are now incorporated in the condition below. We explain above at paragraph 10.250 the process by which the Maximum Prices within the condition will be updated.

- Our views on how long it would take for Sky to produce a reference offer are set out in paragraphs 10.268 to 10.284. We have decided that a six week period is appropriate and this is reflected in the conditions below.

- We accept Sky's criticism that it may be unduly burdensome for Sky to agree changes to the content of the affected channels and amended the provision accordingly (see paragraphs 10.339 to 10.340 for more details). We have therefore removed that wording from the condition.

- We do not consider there is a conflict between the ability for Sky to set Minimum Qualifying Criteria and the best endeavours obligation in draft condition 14(6). We discuss this above at paragraphs 10.354 to 10.357 in the context of our expectations regarding service establishment.

- We accept the first of Sky's drafting issues concerning condition 14A(4) and have amended the condition accordingly. In relation to the second and third issues, as discussed above at paragraphs 10.255 to 10.262, we agree with Sky's broader point that this test should be conducted on an aggregate, rather than product-by-product, basis. Under the aggregated approach it is not necessary to include a materiality threshold and the concern over the range of products covered is similarly negated.

- Pursuant to our discussion of distribution technologies and platforms above at paragraphs 9.173 to 9.206 and 10.291 to 10.299, we agree with the Three

Parties that it is appropriate to insert the words “solely by” into the definition of “Qualifying Platform”.

New licence conditions

12.14 It was concluded above in Sections 9 to 11 that a wholesale must-offer remedy should extend only to the following licensed services: Sky Sports 1, Sky Sports 2, Sky Sports HD and Sky Sports 2 HD. It was also decided that it was not appropriate to set a maximum price in respect of the HD channels. On the basis of this and of the decisions reached in this statement, and taking into account the responses to consultation on the proposed licence condition discussed above, we set out below the licence conditions to be inserted into the licences for Sky Sports 1, Sky Sports 2, Sky Sports HD and Sky Sports 2 HD.

Condition inserted into the Sky Sports 1 TLCS licence:

“14A Wholesale must-offer

(1) The Licensee shall offer the programme content of the Licensed Service to any person for retail by that person to residential consumers in the United Kingdom on Qualifying Platforms:

(a) upon reasonable request in writing;

(b) within a reasonable time;

(c) on a non-exclusive basis;

(d) on fair and reasonable terms;

(e) without any undue discrimination; and

(f) in accordance with the requirements of this Condition 14A and any direction issued by Ofcom under this Licence.

(2) The charges offered for supply under Condition 14A(1) shall not exceed the Maximum Prices.

(3) The Licensee shall publish by Friday 14 May 2010 standard terms and conditions under which offers shall be made further to Condition 14A(1), which shall include at least the following:

(a) charges which do not exceed the Maximum Prices;

(b) the Minimum Qualifying Criteria for potential purchasers;

(c) terms of payment and billing procedures, including the arrangements under which the number of subscribers shall be agreed for the purposes of calculating payments due;

(d) the arrangements under which material changes to the content of the Licensed Service shall be notified;

(e) a dispute resolution procedure to be used between the parties; and

(f) the duration of agreements and notice periods.

(4) If:

(a) the aggregate long run average incremental per-subscriber cost of all Non-TV Products included as part of all packages retailed to residential consumers with the Licensed Service (but not with Sky Sports 2) (the “Aggregate SS1 Incremental Cost”);

(b) exceeds the aggregate incremental per-subscriber price of those Non-TV Products included as part of those packages (the “Aggregate SS1 Incremental Price”); then

(c) the Sky Sports 1 Maximum Price shall be reduced by the amount of the difference between the Aggregate SS1 Incremental Cost and the Aggregate SS1 Incremental Price.

(5) If:

(a) the aggregate long run average incremental per-subscriber cost of all Non-TV Products included as part of all packages retailed to residential consumers with the Licensed Service and with Sky Sports 2 (the “Aggregate Bundled Incremental Cost”);

(b) exceeds the aggregate incremental per-subscriber price of those Non-TV Products included as part of those packages (the “Aggregate Bundled Incremental Price”); then

(c) the Sky Sports 1 and 2 Maximum Price shall be reduced by the amount of the difference between the Aggregate Bundled Incremental Cost and the Aggregate Bundled Incremental Price.

(6) The Licensee shall comply with any direction or request for information issued by Ofcom for the purpose of ensuring, monitoring or investigating compliance with this Condition 14A.

(7) In the event that a person accepts an offer made pursuant to Condition 14(A)(1) the Licensee shall use its best endeavours to enable that person to commence retailing of the content of the Licensed Service.

(8) For the purposes of this Condition 14A:

“Maximum Prices” means the Sky Sports 1 Maximum Price and the Sky Sports 1 and 2 Maximum Price. For the avoidance of doubt, each of the Maximum Prices excludes any incremental costs directly attributable to the provision of interactive content.

“Sky Sports 1 Maximum Price” means £10.63 per subscriber per month, and applies to the wholesale charge for the programme content of the Licensed Service where it is offered on a stand-alone basis.

“Sky Sports 1 and 2 Maximum Price” means £17.14 per subscriber per month, and applies to the wholesale charge for the programme content of the Licensed Service where it is offered as a bundle with (and only with) the programme content of Sky Sports 2.

“Minimum Qualifying Criteria” means the minimum requirements that must be satisfied by a potential purchaser requesting supply under Condition 14(A)(1), which may include requirements relating to: (a) financial standing; (b) technical standards for retail provision of content; (c) technical standards for securing wholesale supply of content; and (d) encryption and security (including allocation of liability);

“Non-TV Product” means a service which does not consist primarily in the provision of programmes.

“Qualifying Platform” means any platform used for the distribution of programmes to residential consumers in the United Kingdom, other than a platform operated solely by the Licensee.”

Condition inserted into the Sky Sports 2 TLCS licence:

“14A Wholesale must-offer

(1) The Licensee shall offer the programme content of the Licensed Service to any person for retail by that person to residential consumers in the United Kingdom on Qualifying Platforms:

(a) upon reasonable request in writing;

(b) within a reasonable time;

(c) on a non-exclusive basis;

(d) on fair and reasonable terms;

(e) without any undue discrimination; and

(f) in accordance with the requirements of this Condition 14A and any direction issued by Ofcom under this Licence.

(2) The charges offered for supply under Condition 14A(1) shall not exceed the Maximum Prices.

(3) The Licensee shall publish by Friday 14 May 2010 standard terms and conditions under which offers shall be made further to Condition 14A(1), which shall include at least the following:

(a) charges which do not exceed the Maximum Prices;

(b) the Minimum Qualifying Criteria for potential purchasers;

(c) terms of payment and billing procedures, including the arrangements under which the number of subscribers shall be agreed for the purposes of calculating payments due;

(d) the arrangements under which material changes to the content of the Licensed Service shall be notified;

(e) a dispute resolution procedure to be used between the parties; and

(f) the duration of agreements and notice periods.

(4) If:

(a) the aggregate long run average incremental per-subscriber cost of all Non-TV Products included as part of all packages retailed to residential consumers with the Licensed Service (but not with Sky Sports 1) (the “Aggregate SS2 Incremental Cost”);

(b) exceeds the aggregate incremental per-subscriber price of those Non-TV Products included as part of those packages (the “Aggregate SS2 Incremental Price”); then

(c) the Sky Sports 2 Maximum Price shall be reduced by the amount of the difference between the Aggregate SS2 Incremental Cost and the Aggregate SS2 Incremental Price.

(5) If:

(a) the aggregate long run average incremental per-subscriber cost of all Non-TV Products included as part of all packages retailed to residential consumers with the Licensed Service and with Sky Sports 1 (the “Aggregate Bundled Incremental Cost”);

(b) exceeds the aggregate incremental per-subscriber price of those Non-TV Products included as part of those packages (the “Aggregate Bundled Incremental Price”); then

(c) the Sky Sports 1 and 2 Maximum Price shall be reduced by the amount of the difference between the Aggregate Bundled Incremental Cost and the Aggregate Bundled Incremental Price.

(6) The Licensee shall comply with any direction or request for information issued by Ofcom for the purpose of ensuring, monitoring or investigating compliance with this Condition 14A.

(7) In the event that a person accepts an offer made pursuant to Condition 14(A)(1) the Licensee shall use its best endeavours to enable that person to commence retailing of the content of the Licensed Service.

(8) For the purposes of this Condition 14A:

“Maximum Prices” means the Sky Sports 2 Maximum Price and the Sky Sports 1 and 2 Maximum Price. For the avoidance of doubt, each of the Maximum Prices excludes any incremental costs directly attributable to the provision of interactive content.

“Sky Sports 2 Maximum Price” means £10.63 per subscriber per month, and applies to the wholesale charge for the programme content of the Licensed Service where it is offered on a stand-alone basis.

“Sky Sports 1 and 2 Maximum Price” means £17.14 per subscriber per month, and applies to the wholesale charge for the programme content of the Licensed Service where it is offered as a bundle with (and only with) the programme content of Sky Sports 1.

“Minimum Qualifying Criteria” means the minimum requirements that must be satisfied by a potential purchaser requesting supply under Condition 14(A)(1), which may include requirements relating to: (a) financial standing; (b) technical standards for retail provision of content; (c) technical standards for securing wholesale supply of content; and (d) encryption and security (including allocation of liability);

“Non-TV Product” means a service which does not consist primarily in the provision of programmes.

“Qualifying Platform” means any platform used for the distribution of programmes to residential consumers in the United Kingdom, other than a platform operated solely by the Licensee.”

Condition inserted into the Sky Sports HD TLCS licence:

“14A Wholesale must-offer

(1) The Licensee shall offer the programme content of the Licensed Service, to any person for retail by that person to residential consumers in the United Kingdom on Qualifying Platforms:

(a) upon reasonable request in writing;

(b) within a reasonable time;

(c) on a non-exclusive basis;

(d) on fair and reasonable terms;

(e) without any undue discrimination; and

(f) in accordance with the requirements of this Condition 14A and any direction issued by Ofcom under this Licence.

(2) The Licensee shall publish by Friday 14 May 2010 standard terms and conditions under which offers shall be made further to Condition 14A(1), which shall include at least the following:

(a) charges for supply;

(b) the Minimum Qualifying Criteria for potential purchasers;

(c) terms of payment and billing procedures, including the arrangements under which the number of subscribers shall be agreed for the purposes of calculating payments due;

(d) the arrangements under which material changes to the content of the Licensed Service shall be notified;

(e) a dispute resolution procedure to be used between the parties; and

(f) the duration of agreements and notice periods.

(3) The Licensee shall comply with any direction or request for information issued by Ofcom for the purpose of ensuring, monitoring or investigating compliance with this Condition 14A.

(4) In the event that a person accepts an offer made pursuant to Condition 14(A)(1) the Licensee shall use its best endeavours to enable that person to commence retailing of the content of the Licensed Service.

(5) For the purposes of this Condition 14A:

"Minimum Qualifying Criteria" means the minimum requirements that must be satisfied by a potential purchaser requesting supply under Condition 14(A)(1), which may include requirements relating to: (a) financial standing; (b) technical standards for retail provision of content; (c) technical standards for securing wholesale supply of content; and (d) encryption and security (including allocation of liability);

"Qualifying Platform" means any platform used for the distribution of programmes to residential consumers in the United Kingdom, other than a platform operated solely by the Licensee."

Condition inserted into the Sky Sports 2 HD TLCS licence:

"14A Wholesale must-offer

(1) The Licensee shall offer the programme content of the Licensed Service, to any person for retail by that person to residential consumers in the United Kingdom on Qualifying Platforms:

(a) upon reasonable request in writing;

(b) within a reasonable time;

(c) on a non-exclusive basis;

(d) on fair and reasonable terms;

(e) without any undue discrimination; and

(f) in accordance with the requirements of this Condition 14A and any direction issued by Ofcom under this Licence.

(2) The Licensee shall publish by Friday 14 May 2010 standard terms and conditions under which offers shall be made further to Condition 14A(1), which shall include at least the following:

(a) charges for supply;

(b) the Minimum Qualifying Criteria for potential purchasers;

(c) terms of payment and billing procedures, including the arrangements under which the number of subscribers shall be agreed for the purposes of calculating payments due;

(d) the arrangements under which material changes to the content of the Licensed Service shall be notified;

(e) a dispute resolution procedure to be used between the parties; and

(f) the duration of agreements and notice periods.

(3) The Licensee shall comply with any direction or request for information issued by Ofcom for the purpose of ensuring, monitoring or investigating compliance with this Condition 14A.

(4) In the event that a person accepts an offer made pursuant to Condition 14(A)(1) the Licensee shall use its best endeavours to enable that person to commence retailing of the content of the Licensed Service.

(5) For the purposes of this Condition 14A:

"Minimum Qualifying Criteria" means the minimum requirements that must be satisfied by a potential purchaser requesting supply under Condition 14(A)(1), which may include requirements relating to: (a) financial standing; (b) technical standards for retail provision of content; (c) technical standards for securing wholesale supply of content; and (d) encryption and security (including allocation of liability);

"Qualifying Platform" means any platform used for the distribution of programmes to residential consumers in the United Kingdom, other than a platform operated solely by the Licensee."

Annex 1

Glossary

API: Application Program Interface. A technology that facilitates exchanging of messages or data between two or more different software applications.

BARB: Broadcasters' Audience Research Board. The pan-industry body which measures television viewing.

Broadband. A service or connection generally defined as being 'always on' and providing a bandwidth greater than narrowband.

CA: Conditional Access. A technology enabling a broadcaster to restrict access to content that it has made available in a digital platform only to those customers that have been authorised to access it.

CA03: Communications Act 2003.

CA98: Competition Act 1998.

CC: Competition Commission.

CAGR: Compound Annual Growth Rate. The average annual growth rate over a specified period of time. It is used to indicate the investment yield at the end of a specified period of time. The mathematical formula used to calculate CAGR = (present value/base value) ^ (1/# of years) – 1.

Churn. The loss of customers subscribing to a particular pay TV package or retailer.

Core Premium channels. Includes both Core Premium Sports channels and Core Premium Movies channels (see individual definitions below).

Core Premium Movies channels. In this statement, the term "Core Premium Movies" channels refers to the premium movies channels included in the market as defined. There is a slight difference between the market as defined in our Third Pay TV Consultation and this statement. "Core Premium Movies" channels in this statement refers to all Sky Movies channels. Disney Cinemagic is excluded, and Sky Movies Classics included.

Core Premium Sports channels. In the Third Pay TV Consultation we defined "Core Premium Sports channels" as Sky Sports 1 and 2 and Setanta Sports 1. However, we have changed the definition of this term in this document to Sky Sports 1 and 2 and the ESPN channel to reflect Setanta's exit and ESPN's entry.

Digital switchover. The process of switching over the current analogue television broadcasting system to digital, as well as ensuring that people have adapted or upgraded their televisions and recording equipment to receive digital TV.

DSat: Digital satellite. A term used in the UK to refer to the distribution of digital content via satellite.

DTH: Direct to home. Another term for satellite distribution technology.

DTT: Digital Terrestrial Television. A digital distribution technology using terrestrial transmitters.

DVB: Digital Video Broadcasting. A set of internationally accepted open standards for digital broadcasting, including standards for distribution by satellite, cable and terrestrial.

DVB-PCF: Digital Video Broadcasting-Portable Content Format. A technical specification that is specifically designed to provide an abstraction layer between the on screen presentation and functionality of an interactive application and the underlying operating system and hardware.

DVD: Digital Versatile Disc. A high capacity CD-size disc for carrying audio-visual content. Initially available read-only, but recordable formats are now available.

DVR: Digital Video Recorder (also known as Personal Video Recorder and Digital Television Recorder). A digital TV set-top box including a hard disc drive which allows the user to record, pause and rewind live TV.

EA02: Enterprise Act 2002.

EPG: Electronic Programme Guide. A programme schedule, typically broadcast alongside digital television or radio services, to provide information on the content and scheduling of current and future programmes.

FCC: Federal Communications Commission. The US regulatory body set up in 1934 to regulate all inter-state and foreign communications by wire, radio, television and radio.

First Pay TV Consultation. The first Ofcom pay TV consultation published on 18 December 2007.

FTA: Free-to-air. Broadcast content that people can watch or listen to without having to pay a subscription.

HD: High Definition. A technology that provides viewers with better quality, high-resolution pictures.

HMT: Hypothetical Monopolist Test. An economic test used to assess whether demand-side and supply-side substitutes provide a sufficiently strong competitive constraint to be included in a relevant market.

iDTV: Integrated Digital Television. A television set which has a built in digital tuner (typically for reception of digital terrestrial TV). iDTVs remove the need for an external set-top box.

Internet. A global network of networks, using a common set of standards (e.g. the Internet Protocol)

IP: Internet Protocol. The packet data protocol used for routing and carriage of messages across the Internet and similar networks.

IPTV: Internet Protocol Television. The term used for television and/or video signals that are delivered to subscribers or viewers using Internet Protocol (IP), the technology that is also used to access the Internet. Typically used in the context of streamed linear and on demand content, but also sometimes for downloaded video.

IRR: Internal Rate of Return. The discount rate that would give a project a present value of zero.

ITC: Independent Television Commission. One of the regulators replaced by Ofcom in 2003.

Major Hollywood Studios. Refers to NBC Universal, Viacom, Fox Filmed Entertainment, The Walt Disney Company, Sony or Time Warner or their wholly owned or controlled subsidiaries. Subsidiaries of these six companies include the six members of the MPAA (namely Paramount Pictures Corporation, Sony Pictures Entertainment Inc., Twentieth Century Fox Film Corporation, Universal City Studios LLP, Walt Disney Studios Motion Pictures and Warner Bros. Entertainment Inc) as well as a number of other movie studios (e.g. Fox Filmed Entertainment is also the parent of Fox Searchlight Pictures, Sony controls Screen Gems).

MHEG5: Multimedia and Hypermedia Experts Group 5. Technology used for authoring applications for the digital terrestrial television platform.

Multi-channel. In the UK, this refers to the provision or receipt of television services other than the main five channels (BBC ONE & TWO, ITV1, Channel 4/S4C, Five) plus local analogue services. 'Multi-channel homes' comprise all those with digital terrestrial TV, satellite TV, digital cable or analogue cable, or TV over broadband. Also used as a noun to refer to a channel only available on digital platforms (or analogue cable).

Multiplex. A device that sends multiple signals or streams of information on a carrier at the same time in the form of a single, complex signal. The separate signals are then recovered at the receiving end.

MSR: Minimum Security Requirements.

OFT: Office of Fair Trading.

PAR: Program Access Rules. Introduced in by the FCC in 1992, Program Access Rules require vertically integrated cable operators to provide channels in which they own 5% or more to competing platforms.

PPV: Pay-per-view. A service offering single viewings of a specific film, programme or event, provided to consumers for a one-off fee.

Platform. A pay TV platform can be defined as the specific combination of distribution and reception technology and conditional access that enables consumers to receive broadcasts. For example, Sky on satellite, Virgin Media on its cable network, Top Up TV on DTT or BT Vision and Tiscali TV on IPTV.

PSB: Public Service Broadcasting, or Public Service Broadcaster. The Communications Act in the UK defines the PSBs to include the BBC, ITV1, Channel 4, Five and S4C.

PS3: Playstation 3.

PVR. See DVR.

ROCE: Return on Capital Employed.

ROS: Return on Sales (or operating margin). The ratio of operating profit to revenue.

SAC: Subscriber Acquisition Costs.

SD: Standard Definition. As opposed to high definition.

Simulcrypt. A technology that allows a single broadcast channel to be used with two or more conditional access systems.

STB: Set-top Box.

Second Pay TV Consultation. Ofcom's second consultation document on pay TV, published on 30 September 2008.

Service bundling. A marketing term describing the packaging together of different communications services by organisations that traditionally only offered one or two of those services.

SSNIP: Small, but significant, non-transitory increase in price. Used in the hypothetical monopolist test.

SVoD: Subscription Video on Demand. A type of VoD service that allows subscribers unlimited access to watch programmes or films whenever they choose to, not restricted by a linear schedule, for a regularly charged fee.

Time-shift. The broadcasting of a television service on more than one channel with a specified delay (typically an hour), to provide more than one opportunity for viewers to watch the service. Alternatively, the recording of programmes by viewers (using PVRs, recordable DVDs or VCRs) to watch at another time.

Third Pay TV Consultation. Ofcom's Third Pay TV Consultation document on pay TV, published on 26 June 2009.

Top-flight sport. Sports matches from the higher competitive levels of the most popular sports in the UK. For example Premier League matches, FA Cup matches, English Test cricket matches, the Ryder Cup, Six Nations rugby union.

TPS: Technical Platform Services. A group of services comprising Conditional Access, Regionalisation, Electronic Programming Guides and Access Control.

TSR: Total Shareholder Returns. The returns received by shareholders from dividend income and capital appreciation.

UEFA: Union of European Football Associations. The governing body of football in Europe.

VoD: Video on Demand. A service or technology that enables TV viewers to watch programmes or films whenever they choose to, not restricted by a linear schedule. Also Near Video on Demand (NVoD), a service based on a linear schedule that is regularly repeated on multiple channels, usually at 15-minute intervals, so that viewers are never more than 15 minutes away from the start of the next transmission.

WACC: Weighted Average Cost of Capital. The rate that a company is expected to pay on average to all its security holders to finance its assets.

WCP: Wholesale channel provider.