Assessment of market power

Annex 8 to pay TV phase three document

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Section 1

Introduction

Structure of this annex

1.1 In this annex we assess the extent of market power within each of the relevant markets that we have identified. Section 5 of the main document sets out a summary of the detailed analysis in this annex.

1.2 First, we analyse the wholesale level. This section of the annex considers the following topics:

- The purpose of and approach to the assessment of wholesale market power.

- The wholesale supply of channels featuring live sporting events which a significant number of consumers find highly valuable ("Core Premium Sports channels").

- The wholesale supply of channels which include the first TV subscription window of movies produced or licensed by any of the Major Film Production Groups ("Core Premium Movie channels")[1] [2].

1.3 Second, we analyse the retail level. This section of the annex considers the following topics:

- The purpose of and approach to the assessment of retail market power.

- The supply of retail television bundles containing Core Premium Sports channels.

- The supply of retail television bundles containing Core Premium Movie channels.

1.4 Third, we set out our view as to whether the size of a vertically integrated retailer's subscriber base provides that bidder with an advantage when bidding for rights.

[1] "Major Film Production Groups" refers to Universal, Viacom, 20th Century Fox, Walt Disney, Sony and Time Warner and their wholly owned or controlled subsidiaries.
[2] We refer to Core Premium Sports channels and Core Premium Movie channels collectively as "Core Premium channels".

Section 2

Wholesale markets

Introduction

2.1 This section is structured as follows:

- First, we summarise the position in the First Pay TV Consultation and the Second Pay TV Consultation and provide a high level summary of the responses to those consultations.
- Second, we explain the purpose of assessing wholesale market power and set out the test that we have applied when carrying out that assessment.
- Third, we consider a number of overarching arguments that have been advanced by Sky.
- Fourth, we analyse the wholesale supply of Core Premium Sports channels.
- Fifth, we analyse the wholesale supply of Core Premium Movie channels.

The previous consultation documents

The First Pay TV Consultation

2.2 In the First Pay TV Consultation we defined a "'premium sports' pay TV service" as one which provides live access, often on an exclusive basis, to a specific set of highly-valued key sports events, most notably live FAPL coverage (paragraph 5.26). We stated that Sky was likely to be dominant in the "wholesaling of premium sports content" and that it was unlikely that Setanta could challenge Sky's dominance in this market in the short to medium term (Annex 13, paragraph 5.52). Note that the definition of "premium sports" kept open the question of what role is played by sports other than live FAPL matches.

2.3 In the First Pay TV Consultation we defined the primary characteristic of a "'premium movies' pay TV service" as providing access on a subscription basis to first-run movies from the Major Hollywood Studios (paragraph 5.36)[3]. We concluded that Sky was likely to be dominant in the wholesale supply of "premium movies" (Annex 13, paragraph 5.69).

2.4 The majority of consultation respondents, including the Four Parties, agreed with Ofcom's assessment of market power in the First Pay TV Consultation. However Sky strongly disagreed. The FAPL also disagreed with our analysis of market power in the "wholesaling of premium sports content".

The Second Pay TV Consultation

2.5 In the Second Pay TV Consultation we analysed the "wholesale supply of channels or packages of channels containing live FAPL matches" (Annex 7, paragraph 1.1).

[3] The Major Hollywood Studios are Disney (Buena Vista), 20th Century Fox, Paramount, Sony, Universal and Warner Bros. They are the members of the Motion Picture Association of America. The Major Hollywood Studios are a subset of the Major Film Production Groups.

We stated our view that Sky was currently dominant in the supply of such channels and was likely to be dominant for the next three to four years (Annex 7, paragraph 2.168). Note that this definition was centred on live FAPL matches and we explicitly stated that a new entrant does not require the rights to a wide range of sports in order to be viable (Annex 7, paragraph 2.75).

2.6 In the Second Pay TV Consultation we analysed the “wholesale supply of channels or packages of channels which include the first TV subscription window of film content from the [Major Hollywood Studios]” (Annex 7, paragraph 1.1). We stated that Sky was currently dominant in the supply of such channels and was likely to be dominant for the next three to four years (Annex 7, paragraph 3.43).

2.7 In relation to sports channels, the Four Parties, Virgin Media and [✂] considered that Ofcom erred in focussing on Sky’s live FAPL coverage and argued that Sky derives its market power by aggregating a portfolio consisting of a wide variety of sports content. Similarly, the BBC questioned whether our market definition was too narrow. Sky and the FAPL also argued that the relevant market was wider but for a different reason, namely that there is a range of substitutable content. In addition, Sky and the FAPL disagreed that there are barriers to acquiring the rights to live FAPL matches. The BBC, Freesat and [✂] broadly agreed with Ofcom’s assessment of market power in relation to sports channels.

2.8 In relation to movie channels, the Four Parties and [✂] broadly agreed with Ofcom’s assessment of market power in the Second Pay TV Consultation. In contrast, Sky strongly disagreed.

2.9 We report and address respondents’ arguments in more detail below as we set out the steps in our analysis.

Approach to the assessment of wholesale market power

The purpose and appropriate test for the wholesale market power assessment

2.10 We have considered the extent to which any party holds market power in the relevant wholesale markets defined in section 4 above, namely Core Premium Sports channels and Core Premium Movie channels.

2.11 In this document we are considering the case for intervention under s316 of the 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 not consistent with fair and effective competition.

2.12 The competition concerns we identify in section 6 of the main document 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 we consider that the wholesale price is unduly high) and to the high retail prices charged by Sky (which can be seen as a reflection of the unduly high wholesale prices Sky ‘charges’ its own retail arm). In order for Sky to have the ability to act in a manner which is not consistent with fair and effective competition we consider that we would have to find that Sky had market power in the wholesale markets for supply of Core Premium Sports channels and Core Premium Movie channels.

2.13 In this annex we take a cautious approach to assessing the extent of Sky's market power. 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 have a degree of market power providing it with the ability to act in a manner which is not consistent with fair and effective competition. We reach the view in this section that Sky does in fact meet that threshold.

2.14 We note however that our case is not dependent on demonstrating that the dominance threshold has been reached, and that the concerns we identify in section 6 of the main document may continue to exist in a situation where Sky does not have dominance. We also note that Sky appears to agree with this position, since it argues that dominance is not a necessary precondition for the competition concerns we have identified.

2.15 As in the Second Pay TV Consultation, we make our assessment by reference to both existing circumstances and likely future outcomes. We thus consider market power by looking at whether 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[4].

Sky's response on the appropriate legal threshold

2.16 Sky considered that Ofcom's analysis in the Second Pay TV Consultation was carried out as though Ofcom were applying Chapter II of the CA98. However, in Sky's view, dominance is unlikely to be a necessary condition for the types of issues that were identified as a concern. Rather Sky considered that a broadcaster would only need to have a degree of market power associated with the exclusive control of rights to content that is widely valued by consumers (section 7, paragraph 11.4)[5] [6].

2.17 We agree with Sky that dominance need not be a necessary precondition for the competition concerns we have identified (see paragraphs 2.11-2.14 above).

- Thus, if Sky was not dominant, this would not imply that Ofcom's competition concerns were unfounded. Our case for an intervention under s316 is therefore not reliant on a finding that Sky holds a dominant position.

- Sky is arguing that the appropriate standard is lower than dominance. As explained below, we ultimately conclude that Sky is dominant which implies that Sky would also have a sufficiently high degree of market power were its (lower) standard adopted. Accordingly, we do not accept that our use of the dominance standard impugns the analysis in relation to Sky in section 6 of the main document.

[4] Looking forward three to four years in this way is consistent with our suggestion that we would consider reviewing any requirement for Sky to make wholesale access to particular content available on regulated terms after three years of its coming into force (see paragraph 9.246 of the main document).
[5] Sky considered that a consistent application of Ofcom's approach in the Second Pay TV Consultation would imply that Setanta exceeded this threshold.
[6] In paragraph 3.13 of section 3 of its response to the Second Pay TV Consultation Sky stated that Ofcom should not be able to intervene to force supply of channels under s316 unless it meets the equivalent test for doing so under CA98, which requires a prior finding of dominance. Sky therefore appears to be arguing that competition concerns could exist without a finding of dominance but at the same time that Ofcom's powers under s316 should not be interpreted as being capable of addressing such concerns.

- We accept that concluding that Setanta is not dominant is not, in itself, sufficient to reject the possibility that Setanta's conduct may be of concern. However, as set out in paragraph 8.29 of the main document, there is actually a range of reasons why Setanta's conduct does not give rise to competition concerns.

The criteria for assessing dominance

2.18 Below we discuss the criteria for assessing dominance and address Sky's representations on these criteria.

2.19 The European Court of Justice ("ECJ") has defined dominance as "a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, customers, and ultimately of its consumers"[7].

2.20 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 (paragraph 3.2)[8]. Such constraints include:

- Competition from existing competitors.
- Competition from potential competitors.
- Countervailing buyer power ("CBP").

2.21 Below we provide a brief further explanation of each of these three types of constraint.

Existing competitors

2.22 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).[9] 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 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%[10].

2.23 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

[7] Case 27/76 *United Brands v Commission* [1978] ECR 207, paragraph 38.
[8] *Assessment of market power*, OFT, December 2004 available at http://oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft415.pdf
[9] *Aberdeen Journals Limited v Office of Fair Trading (No. 2)* [2003] CAT 11, paragraphs 309-310.
[10] Case C62/86 *AKZO Chemie BV v Commission* [1991] ECR I-3359.

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[11].

- "**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."

<u>Potential competitors</u>

2.24 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).

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

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

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

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

2.27 First, Sky relied upon the phrase "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" from the OFT Market Power Guidelines. However these guidelines need to be read in context. In particular, they explicitly identify factors such as economies of scale as potential barriers to entry (paragraph 5.6). Clearly where an incumbent enjoys economies of scale it could be characterised as being "more efficient than its potential rivals". However the OFT Market Power Guidelines, contrary to Sky's apparent narrow position, nonetheless consider that it

[11] For example, historically the duration of the contract licensing the rights necessary to cover live FAPL 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).

can be legitimate to regard them as barriers to entry. We thus consider that our approach is in accordance with the OFT Market Power Guidelines.

2.28 Second, the European Commission and Community courts have also taken a broad view of what constitutes a barrier to entry in the context of Article 82 EC Treaty[12]. Factors giving rise to efficiency advantages which have been found to constitute barriers to entry include vertical integration, brand identity and advertising, reputation and experience, innovation and technological superiority and highly developed distribution and sales networks[13]. This is illustrated by the cases set out in the following paragraphs[14].

2.29 In *United Brands v Commission*[15], the ECJ found that the main barriers to entry arose due to the scale of United Brands' production and supply of bananas. In particular, the main barriers to competitors entering the market were:

> "exceptionally large capital investments required for the creation and running of banana plantations, the need to increase sources of supply in order to avoid [unforeseen crop failure], the introduction of an essential system of logistics which the distribution of a very perishable product makes necessary, economies of scale from which newcomers to the market cannot derive any immediate benefit and the actual cost of entry made up […] of all the general expenses incurred in penetrating the market such as the setting up of an adequate commercial network, the mounting of very large-scale advertising campaigns, all [of the] financial risks, the costs of which are irrecoverable if the attempt fails […] thus, although, as UBC has pointed out, it is true that competitors are able to use the same methods of production and distribution as [UBC], they come up against almost insuperable practical and financial obstacles."[16]

2.30 In *Napier Brown – British Sugar*[17], vertical integration was also found to impede access to the market. In that case the court found that British Sugar's:

> "[well]-established, advanced and integrated operations make it difficult for a new producer, which produces on only one level of production, to operate. Thus considerable barriers to entry exist regarding the production of beet-origin sugar. Indeed, the fact that no new producer of sugar from beet origin has set up in the United Kingdom since 1936 despite the fact that BS has consistently been profitable, indicates that these barriers to entry are real and appreciable."[18]

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[12] Article 82 caselaw is relevant to the CA98 by virtue of section 60 of that Act.
[13] This is not necessarily an exhaustive list.
[14] See also the following cases: Case 85/76 *Hoffman-La Roche & Co. AG v Commission* [1979] ECR 461; Case IV/30.787 *Eurofix-Banco v Hilti* OJ (1988) L 65/19; Case 322/81 *Michelin v Commission* [1983] ECR 3461 and *Michelin (II) v Commission* [2002] OJ L 143/1; Case 1016/1/1/03 *Genzyme v OFT* [2004] CAT 4; and Case 1001/1/1/01 *Napp Pharmaceuticals v Director General of Fair Trading* [2001]. See also the Competition Commission's final market investigation reports on Groceries, Classified Directory Advertising Services, and Northern Irish Personal Banking.
[15] Case 27/76 *United Brands v Commission* [1978] ECR 207.
[16] *United Brands v Commission* paragraphs 122-123. See also Bellamy & Child *European Community Law of Competition* 6th ed. page 930.
[17] Case IV/30.178 *Napier Brown – British Sugar* OJ (1988) L 284/41.
[18] *Napier Brown – British Sugar* paragraphs 56-57.

2.31 In *AKZO v Commission*[19], the court recognised the efficiency advantages conferred on an undertaking by advertising and research and development activities:

> "factors [confirming] AKZO's predominance in the market [include the fact that] it has the most highly developed marketing organization, both commercially and technically, and wider knowledge than that of their [sic] competitors with regard to safety and toxicology."[20]

<u>CBP</u>

2.32 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.

Broader evidence advanced by Sky

Sky's consultation responses

2.33 In its response to the First Pay TV Consultation Sky argued that the framework normally used to define markets is not particularly well-suited to the marketplace in which UK TV broadcasters operate. Accordingly, Sky considered that it is appropriate to take into account a broad range of evidence when assessing market definition and market power. Sky stated that key indicators of firms holding positions of significant market power include lack of innovation, indifference to consumers' demands (including poor customer service and infrequent changes to products) resulting in significant consumer dissatisfaction, and pricing levels which suppress demand. In particular Sky referred to:

- Evidence showing, in Sky's view, an absence of excess profits.

- Material that, in Sky's view, showed that: (i) consumer choice of pay TV services is strong, and prices for such services are not out of line with those found in the rest of Europe; (ii) consumers are satisfied with the pay TV services available to them; (iii) penetration of pay TV services in the UK is among the highest in Europe; and (iv) the UK, along with France, has higher take up of innovative new products and services, such as DVRs and HD television services than other countries in Europe. Sky considered that these market outcomes are incompatible with a hypothesis that Sky holds a dominant position at the retail level.

2.34 In its response to the Second Pay TV Consultation Sky advanced two general criticisms of our approach:

- First, Sky considered that Ofcom had failed to address adequately its earlier representations that the observed market outcome, namely Sky continuing to innovate and invest, does not correspond to a market characterised by persistent dominance.

[19] Case C-62/86 *AKZO v Commission* [1991] ECR I-3359.
[20] *AKZO v Commission* paragraph 61.

- Second, Sky considered that Ofcom's analysis was driven to a very significant degree by preconceptions about "the 'right' conclusions on these matters". Furthermore it believed that the process of collection and interpretation of evidence was strongly affected by Ofcom's preconceptions.

2.35 In a late submission on 1 June 2009, Sky asserted that Ofcom's analysis gave "primacy" to market shares. Sky stated that, in this case, market shares should be treated with a high degree of scepticism: (i) since Ofcom's market definitions were unreliable; and (ii) in light of the implications of product differentiation. Sky suggested that Ofcom's analysis had understated the aggregate competitive constraint exerted by products outside of the relevant market. In the Second Pay TV Consultation we did assess market shares including products outside of the relevant market. Sky accepted that testing the sensitivities of market shares in this way could, in principle, be an "instructive exercise". However Sky criticised the way in which Ofcom had carried out this exercise. In particular, Sky criticised Ofcom's choice of which 'out of market' products to include. Sky also criticised the measures of market shares used by Ofcom, although it did not suggest alternatives.

Ofcom's position

2.36 We do not accept that we failed to address adequately Sky's arguments that observed market outcomes are inconsistent with our conclusions on market power. We previously considered Sky's arguments in paragraphs 1.10-1.16 of Annex 7 to the Second Pay TV Consultation.

2.37 We are considering whether Sky has market power by reference to the concept of dominance. A dominant position is "a position of economic strength … *affording* [an undertaking] the power to behave to an appreciable extent independently of its competitors, customers and … consumers" (emphasis added)[21]. In other words, it 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.

2.38 Below we first set out our position on profitability and second our position on consumer outcomes. We then discuss Sky's arguments concerning our use of market shares.

Profitability

2.39 In terms of profitability, we explicitly referred to our profitability analysis in support of our assessment of market power in the Second Pay TV Consultation (Annex 7, paragraph 1.12)[22]. Our profitability analysis was summarised in paragraphs 6.3 and 7.79 of the Second Pay TV Consultation and set out in fully in annex 9 of that document. These paragraphs noted that the evidence of possible high wholesale prices is less clear-cut and that it is not possible to draw strong conclusions from a review of Sky's financial performance. Nevertheless, Sky did appear to be making an operating margin on the wholesale of premium channels of just over [✂] – higher than Sky's 2008 overall operating margin of 15.2%.

[21] Case 27/76 *United Brands v Commission* [1978] ECR 207, paragraph 38.
[22] Also, as explained in paragraphs 1.8 and 1.11 of Annex 7 of the Second Pay TV Consultation, Ofcom considered that Sky's response to the First Pay TV Consultation had misrepresented Ofcom's position on profitability in that consultation.

2.40 In the Second Pay TV Consultation we considered that the evidence set out in sections 2 and 3 of Annex 7 of that document suggests that Sky does indeed possess a position of market power. In the light of that evidence, we did not accept that the (less clear cut) evidence concerning overall profitability and the level of wholesale prices justified a contrary conclusion. Furthermore, we did not accept that identifying excessive profits is a necessary condition for finding that a firm has a position of market power. Indeed, it is possible – and indeed likely – that some of the economic rents associated with exploiting content in a narrow market flow upstream to the rights providers. Under this scenario, downstream prices would still be above 'competitive' levels, but there may be no evidence of excessive downstream profitability.

2.41 Since the Second Pay TV Consultation we have conducted further analysis that provides firmer evidence that Sky's overall return is higher than its cost of capital (see section 6 of the main document). Thus, contrary to Sky's view, this new profitability evidence actually reinforces our view that Sky enjoys market power. Our further work on profitability thus supplements and reinforces the primary evidence on market power set out in this annex.

Outcomes for final consumers

2.42 In terms of outcomes for final consumers, in the Second Pay TV Consultation we explicitly referred to our analysis of consumer outcomes in support of our assessment of market power (Annex 7, paragraphs 1.14-1.16). That analysis was summarised at paragraphs 7.2-7.5 and 7.7-7.9 of the Second Pay TV Consultation. We cited a number of detrimental outcomes for consumers: (i) the restricted availability of Sky's premium content on other platforms; (ii) a restriction of consumer choice since Sky's premium content is only made available via a limited range of content bundles; and (iii) some evidence that platform innovation will be reduced. Moreover, looking ahead, we stated that we are at a point in the development of the pay TV market when new platforms using new distribution technologies, such as IPTV and mobile TV, could offer significant benefits to consumers. We saw a risk that the development of these new platforms could be held back by limited access to Core Premium channels, thereby denying consumers the associated benefits (Second Pay TV Consultation, paragraph 7.6).

2.43 We thus did not agree with Sky's view that the observed market outcome is incompatible with a hypothesis that Sky holds market power. Rather in the Second Pay TV Consultation we considered that the situation for consumers would be further improved if retailers enjoyed greater access to Sky's sports and movies channels. We did not regard this situation as being inconsistent with our view that Sky possesses a dominant position in the wholesale supply of Core Premium channels.

2.44 We maintain the view we set out in the Second Pay TV Consultation. Crucially we do not agree with Sky's view of consumer outcomes – rather we consider that there is scope for improvement if retailers enjoyed greater access to Sky's sports and movies channels at an appropriate wholesale price. This is supported by our updated analysis of the outcome for consumers as set out in section 7 of the main document. This is further supported by the impact assessment set out in section 10 of the main document.

2.45 Sky criticised us for failing to explain why "Sky continues to invest and innovate … when – on Ofcom's view – it is wholly insulated from competitive pressure …"[23] Sky's

[23] Paragraph 7.1 of Annex 6 to Sky's response to the Second Pay TV Consultation.

proposition thus appears to be that dominant firms do not engage in investment and innovation. We do not accept this proposition. For example, even where a company is dominant, if it engages in successful innovation it will increase the attractiveness of its products to its customers which enables it to increase prices or make additional sales. Further, it is not Ofcom's position that Sky does not engage in *any* innovation. Rather we consider that levels of innovation are currently lower than would be the case if other retailers had access to Sky's Core Premium channels at an appropriate wholesale price (and, in particular, innovation has been distorted since developments that are less well suited to Sky's DSat platform have been hampered). See section 7 of the main document for further details.

2.46 Finally, we do not accept that our analysis has been driven by our preconceptions in the way asserted by Sky. More generally, see paragraphs 2.57-2.58 of the main document which responds to Sky's claims about Ofcom's conduct and processes.

Ofcom's use of market shares

2.47 As a preliminary point we do not consider that we placed undue weight on market shares in the Second Pay TV Consultation. It is well established that market shares are an important indicator of market power. 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."[24] However we also carefully considered factors relevant to potential competition (such as barriers to entry) and CBP. Sky's assertion that these other factors were merely "playing a supporting role" in the Second Pay TV Consultation misrepresents the amount of weight that we placed on potential competition and CBP. These factors were, and remain, an important aspect of our analysis.

2.48 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 nonetheless exert a moderate constraint upon suppliers within the relevant market. Similarly, suppliers within the relevant market may not exert a particularly strong constraint because their products are differentiated. However we have addressed these limitations in a number of ways:[25]

- As is entirely standard, we calculate the market shares of suppliers within the relevant market. However 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 'out of market' 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

[24] Case 85/76 *Hoffman-La Roche & Co. AG v Commission* [1979] ECR 461, paragraph 41.
[25] 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). 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 careful, but that they are still a useful and meaningful indicator of market power.

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.

2.49 Sky criticised our choice of which 'out of market' products to include when calculating alternative market share figures. As explained above, we have included moderate substitutes as part of this calculation but excluded more remote substitutes. We explain below (largely by reference to the market definition section) how we have categorised particular 'out of market' products.

2.50 Moreover, as shown in paragraphs 2.80, 2.96, 2.224 and 2.230 below, the outcome of the market shares calculations are generally very stark (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 they do allow reliable conclusions to be drawn.

2.51 Sky also argued that market shares are a poor basis for evaluating its market power on the grounds that our market definitions are unreliable. We do not accept that this is the case and we address Sky's criticisms of our market definitions in section 4 of the main document.

Wholesale of Core Premium Sports channels

2.52 We consider that the wholesale supply of channels featuring live sporting events which a significant number of consumers find highly valuable is a relevant economic market. Below we assess market power within that relevant market. As explained in paragraphs 2.11-2.14 above, we conduct this assessment by reference to whether any firm is currently dominant in that relevant market and whether any firm is likely to be dominant for the next three to four years. This sub-section is structured as follows:

- We provide some background information, namely: (i) the channels within the relevant market; (ii) our position in the Second Pay TV Consultation; (iii) respondents' views on the Second Pay TV Consultation; and (iv) further developments since the Second Pay TV Consultation.

- We assess the likely strength of competition within this market both at present and over the next three to four years. This consists of our assessment of: (i) competition from existing competitors; (ii) competition from potential competitors; and (iii) CBP.

Background

The channels within the relevant market

2.53 As set out in section 4 of the main document, we consider that the relevant market is the wholesale supply of channels featuring live sporting events which a significant number of consumers find highly valuable[26]. For the reasons given in paragraphs 4.94-4.135 of the main document, the channels that lie within that relevant market are Sky Sports 1, Sky Sports 2 and Setanta Sports 1[27].

2.54 Sky Sports 1 and 2 are currently wholesaled to Virgin Media and other smaller cable companies both on a standalone basis and as part of a bundle of wholesale channels. Sky also directly retails Sky Sports 1 and 2 on its DSat platform and to customers on Tiscali's platform. Setanta Sports 1 is currently wholesaled to Virgin Media, Tiscali, Top Up TV and BT Vision either as part of a bundle of wholesale channels or as a standalone wholesale channel. Setanta also directly retails this channel on Sky's DSat platform and to DTT customers.

Our position in the Second Pay TV Consultation

2.55 We consulted on the conclusion that Sky had market power in the wholesale supply of channels or packages of channels containing live FAPL matches. Our view was that Sky was dominant and was likely to be dominant in that relevant market for the next three to four years. Our analysis suggested that entry barriers were such that market power was likely to persist. By way of background, we based that conclusion on the following:

- Sky consistently won the rights to televise live FAPL matches (the "Live FAPL Rights") since 1992, until the European Commission's intervention ensured that one company could no longer win all the rights in 2006. In the Second Pay TV Consultation, we estimated that Sky's market share (when estimated on the basis of wholesale revenues) was [✂].

- Sky's market share remained high even when we expanded our market definition to include other football contests.

- We found significant barriers to entry in acquiring the Live FAPL Rights. Sky's established subscriber base, coupled with other factors such as its vertical integration and brand strength, meant that it can afford to bid a larger amount than any other bidder.

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[26] Note that this differs from the definition adopted in the Second Pay TV Consultation, namely the wholesale supply of channels or packages of channels containing live FAPL matches, in two ways. First, we now take a wider view on what sports content is necessary for a channel to lie within the relevant market, rather than solely focusing on live FAPL matches. Second, we now exclude other components of wholesale bundles supplied with the sports channels of interest. Note that the sports channels that lie within the relevant market defined in this document (Sky Sports 1, Sky Sports 2 and Setanta Sports 1) also lay within the market defined in the Second Pay TV Consultation. See Second Pay TV Consultation, paragraphs 5.33-5.34.

[27] At the time of writing, press reports indicate that Setanta has lost the rights to broadcast live FAPL matches from the 2009/10 season onwards. Those rights have reportedly been acquired by ESPN. At the time of writing it is unclear precisely how ESPN intends to exploit those rights (e.g. what other content will they be combined with) although it appears that Sky will distribute ESPN's channel on Sky's DSat platform. The future of Setanta Sports is unclear.

- We admitted that market boundaries were not clear-cut. If some other football competitions just outside our stated market represented partial substitutes for FAPL content, we noted that it might in theory be possible to assemble those into a competing offer. However we believed that no other single competition offered the same volume of highly attractive sport as FAPL. The staggered availability of rights constituted an additional barrier to entry in creating such an offer.

- We believed that the commercial balance of the relationships between Sky as a wholesaler of these channels and other retailers was strongly in favour of Sky.

2.56 We acknowledged that if the rights ownership situation were to change significantly in the future, we would revisit our assessment of market power.

Overview of the further representations received on Core Premium Sports channels

2.57 As discussed in section 4, the Four Parties and [✂] considered that Ofcom erred in focussing on Sky's live FAPL coverage and argued that Sky derives its market power in the supply of premium sports channels by aggregating a portfolio consisting of a wide variety of sports content. Similarly, the BBC questioned whether our market definition was too narrow. The FAPL also argued that the relevant market was wider, on the basis that there is a range of substitutable content. These arguments are set out and considered section 4 and section 8.

2.58 Sky considered that the Live FAPL Rights were "contestable".

2.59 The FAPL disagreed that there are barriers to acquiring Live FAPL Rights. The FAPL referred to the Commitments and stated that the European Commission has concluded that there are no longer any grounds for action and that competition in downstream markets is protected. The FAPL also disagreed with the view that the staggered availability of sports rights is a barrier to entry. It considered that the acquisition of a series of rights over time by Setanta is evidence that the staggered availability of rights actually facilities entry.

2.60 [✂] stated that Sky is able to out-bid competitors for the FAPL rights, citing the same factors that we identified in the Second Pay TV Consultation. [✂] provided no further evidence in support of its position. [✂] also claimed that Sky's advantages when bidding for rights represent a "toehold effect" that are augmented by features of the rights sale process. [✂] also considered that Sky's conduct (specifically [✂] and the margins earned by Virgin Media on bundles including Sky Sports) provided evidence that Sky is dominant.

2.61 The BBC agreed with Ofcom's assessment of market power but provided no further evidence.

2.62 Freesat agreed that Sky was dominant, as reflected by Sky's high market shares. Freesat stated that Setanta was unlikely to acquire additional packages of Live FAPL rights since Sky was vertically integrated and has an incentive to retain those rights. Freesat provided no further evidence in support of its position.

Further developments since the Second Pay TV Consultation

2.63 Since the publication of the Second Pay TV Consultation, the FAPL has sold the Live FAPL Rights for the 2010/11 to 2012/13 seasons. Sky won the rights to five of the six available packages (the maximum available to a single bidder). Setanta won the rights to the remaining package. We have also obtained details of the amounts bid in the 2006 and 2009 sales processes.

2.64 At the time of writing, press reports indicate that Setanta has lost the rights to broadcast live FAPL matches from the 2009/10 season onwards as a result of its failure to make the required payments to the FAPL. Press reports state that those rights have been re-sold by the FAPL and acquired by ESPN.

Existing competitors

2.65 This section assesses the strength of competition between existing competitors. As explained above, the channels that lie within that relevant market are Sky Sports 1, Sky Sports 2 and Setanta Sports (although going forward Setanta may be replaced by ESPN). This section is structured as follows:

- We first consider whether Setanta Sports is in fact a complement for Sky Sports 1 and 2, rather than a substitute.
- We then analyse market shares within the relevant market.
- We then discuss other evidence that has been put to us.
- Finally we consider the constraint imposed by channels outside of the relevant market.

The relationship between Sky Sports and Setanta Sports

2.66 The Four Parties stated in their response to the First Pay TV Consultation that Setanta Sports is a complement to, rather than a substitute for, Sky Sports. This is on the basis of retail prices changes in the second half of 2007. When Setanta started to broadcast live FAPL matches in August 2007 it reduced the monthly per subscriber retail price of its package of channels on Sky's DSat platform from £14.99 to £9.99. On 1 September 2007, Sky increased the monthly per subscriber retail price of various packages containing Sky Sports by between 50p and £1.50. In their joint response to the First Pay TV Consultation, Setanta and Top Up TV also stated that very few, if any, Setanta Sports subscribers on DSat do not also subscribe to Sky's premium sports channels. In other words, on Sky's DSat platform sports subscribers tend to subscribe either to Sky Sports or to Sky Sports and Setanta Sports.

2.67 Product X is a complement to product Y if, when the price of Y increases demand for X falls. Clearly if, in fact, Setanta Sports is a complement for Sky's Core Premium Sports channels then the nature of the competitive interactions between the channels is very different compared to the situation in which these products are substitutes[28].

2.68 As set out in the Second Pay TV Consultation, we do not accept the Four Parties' claims about complementarity. This is for two reasons:

- First, survey evidence is consistent with the view that these products are substitutes; and

[28] Indeed it can be detrimental to have competition between firms that each supply a complement to the others' product. This is because if one firm was considering raising its price it would not take into account the negative impact that this would have on demand for complementary products. Thus if Setanta Sports 1 and Sky Sports 1 and 2 were in fact complements, this could have significant implications for other aspects of our analysis.

- Second, the evidence relied upon by the Four Parties is partial and in any event is weak.

2.69 In terms of the first of these points, namely survey evidence, in the Second Pay TV Consultation we reported that analysis for the European Commission found that FAPL supporters have a hierarchy of preferences: [29]

- Fixtures that feature subscribers' own clubs are of highest interest ("Own Club matches").
- These are followed by matches featuring teams challenging for the title, derby matches, title deciders, relegation deciders and matches that determine who will qualify for the Champions League ("Big Matches").
- These are followed by matches that are not Big Matches or Own Club matches.

2.70 FAPL fans were asked which they might choose to watch in place of each of the three types of match. In each case, a significant proportion of respondents were willing to watch other types of match. For example, when FAPL fans are asked which type of matches they might choose to watch in place of a Big Match not shown on television, over two thirds say they would be likely to watch Own Club matches if that were available, with over half likely to watch another Big Match. A third of FAPL fans say they would be likely to watch a match that was not a Big Match or an Own Club match[30].

2.71 From the perspective of an individual viewer, both Setanta Sports 1 and Sky Sports are likely to contain a mixture of the three types of match. In the Second Pay TV Consultation we stated that this similarity in what (at the time) was considered to be the essential characteristics of Sky and Setanta's Core Premium Sports channels implies that they are likely to be substitutes. We also stated that the willingness of consumers to consider switching to a variety of different types of FAPL match, if their preferred match is unavailable, provides further evidence of substitutability.

2.72 The market definition adopted in this document differs from the market definition set out in the Second Pay TV Consultation. We now take a wider view on what sports content is necessary for a channel to lie within the relevant market, rather than solely focusing on live FAPL matches. Nonetheless we still consider that the FAPL-related evidence presented in paragraphs 2.12-2.14 of Annex 8 of the Second Pay TV Consultation and repeated above is sufficient to conclude that Setanta Sports is not a complement for Sky Sports 1 and 2:

- First, as explained in paragraphs 2.116-2.118 below and paragraph 4.80 of the main document, live FAPL matches are an important aspect of Sky Sports 1 and 2 and Setanta Sports 1's programming.
- Second, we recognise that there is a degree of narrative across the course of a FAPL season (since it is a sequence of interrelated games with interested viewers following the progress of clubs across the season as a whole).

[29] *PREMIER LEAGUE FOOTBALL Research into viewing trends, stadium attendance, fans' preferences and behaviour, and the commercial market*, European Commission, paragraph 111.2. Available at: http://ec.europa.eu/comm/competition/antitrust/cases/decisions/38173/en.pdf
[30] *PREMIER LEAGUE FOOTBALL Research into viewing trends, stadium attendance, fans' preferences and behaviour, and the commercial market*, European Commission, in particular paragraphs 111-117.

Intuitively, this characteristic means that FAPL matches are more likely to be complements than other sports where events are more self contained (such as a single cricket tour). Since the evidence set out above suggests that FAPL are in fact substitutes, notwithstanding the narrative across a particular FAPL season, this suggests that looking at other sports is unlikely to change our conclusions on substitutability.

2.73 The second of our reasons for rejecting the Four Parties' claims concerned weaknesses in the evidence relied upon by the Four Parties. The Four Parties relied upon Sky's increases in certain retail prices in September and November 2007 shortly after Setanta Sports 1 reduced its prices. As a preliminary point, we consider that simply analysing movements in prices is unlikely to be robust unless it is possible to control for changes in costs and quality. Indeed the outcome of our own analysis of prices in paragraphs 4.148-4.163 of the main document is not definitive.

2.74 Moreover we note that, in addition to the retail price rises in 2007 identified by the Four Parties, other retail prices fell.

Figure 1: Change in Sky's monthly retail prices (September/November 2007)

[✂]

Source: Comparison of the figures in annex B to Sky's 10 November 2006 response to Ofcom's 12 October 2006 information request and Sky's November 2007 response to Ofcom's 22 October 2007 information request

2.75 In addition to the retail price changes cited by the Four Parties, we have considered the pattern of changes in wholesale prices to Virgin Media. In September 2007, Sky changed the wholesale prices charged to Virgin Media. Figure 2 below sets out those price changes and shows the September 2007 price as a percentage of the September 2006 price.

Figure 2: Change in Sky's wholesale prices (September 2007)

[✂]

Source: Sky June 2008 response to Ofcom information request dated 29 May 2008

2.76 The pattern of changes in wholesale prices in September 2007 is [✂]. In particular, the wholesale price of a single Sky Sport's channel, which might be regarded as having somewhat similar characteristics to the wholesale bundle of Setanta Sports channels, [[✂]. Moreover, the Four Parties did not control for changes in the quality of Sky Sports. We thus do not consider that the (retail) price evidence presented by the Four Parties is sufficiently strong to conclude that there is complementarity (and hence no substitutability) between Sky's and Setanta's Core Premium Sports channels.

Ofcom's assessment of market shares

2.77 In order to calculate market shares we have used an estimate of the wholesale revenues earned by Sky and Setanta from the sale of Sky Sports 1 and 2 and Setanta Sports. 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).

2.78 The details of our calculations are set out in a separate confidential spreadsheet. This updates analysis done for the Second Pay TV Consultation, for example to reflect more recent data. We make four observations on the calculation of these figures:

- First, both Sky and Setanta are vertically integrated[31]. We have included revenues from the self-supply of Sky Sports and Setanta Sports to Sky and Setanta's retail arms when calculating market shares[32]. In the case of Sky, we have assumed that the wholesale prices charged to Virgin Media can be applied to sales by Sky to subscribers on its DSat platform. In the case of Setanta, we have used its wholesale revenue when it distributes its channel via other retailers plus the retail revenue it earns from its retail sales to subscribers on DTT and Sky's DSat platform. We recognise that using Setanta's retail revenues in this way will overstate its wholesale revenue and thus bias upwards our estimates of its wholesale market share.

- Second, Sky bundles its sports channels with its Sky Movies channels. Where a subscriber chooses to take Sky Sports and Sky Movies (rather than only Sky Sports) it is not appropriate to attribute the entirety of the associated wholesale revenue solely to Sky Sports. We have thus varied the proportion of the wholesale price of channel bundles that is attributed to Sky's Core Premium Sports channels; this produces a range of market share figures.

- Third, Setanta also bundles 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.

- Fourth, as set out in the market share spreadsheets, there are some gaps in our data on the number of subscribers to Sky Sports. In the case of gaps in the number of cable and DSat subscribers, we have assumed that subscribers remain unchanged from the closest month for which we have data. The small number of subscribers to Sky Sports on Tiscali's platform have been omitted, although this is likely to have a negligible impact.

2.79 Our market share estimates are set out in Figure 3 below. As explained above, it is necessary to consider what proportion of Sky's revenue from the sale of a bundle including Sky Sports and Sky Movies is attributable to Sky Sports 1 and 2. This has been done in two ways. First, an "average price approach" which allocates revenue from bundles based on the proportion of sports and movies packages in the bundle in question[33]. Second, as "incremental price" approach which uses the (approximate)

[31] A vertically integrated wholesaler could choose to earn profits at the wholesale or retail level, or both. Transfer prices may not therefore be a reliable guide to the value of the wholesale service provided.

[32] The relative wholesale revenues of Sky and Setanta proxy the attractiveness of their Core Premium Sports channels (since they reflect the number of people choosing to subscribe to such channels multiplied by a wholesale measure of their willingness to pay). It is thus appropriate to include revenues from self supply since otherwise a significant number of consumers that consider those channels to be attractive would be omitted from our calculations. For example, as shown in the confidential market share spreadsheet, [✂] of Sky's revenue from the wholesale supply of Core Premium Sports channels in the second half of 2008 came from self supply (under the average price approach (defined below) Sky's total wholesale revenue from the supply of Core Premium Sports channels is [✂] of which [✂] is earned from self supply).

[33] Thus 50% of the revenue from bundles with equal amounts of sports and movies, 67% of the revenue from dual sports/single movies bundles and 33% of the revenue from dual movies/single sports bundles is attributed to Sky Sports 1 and 2.

incremental revenue from adding Sky Sports to a wholesale bundle. The weights used under the incremental price are set out in Figure 4 below[34].

Figure 3: Market shares for the wholesale supply of Core Premium Sports channels (calculated using wholesale revenue)

	Average price approach			
	[90-100]%	[0-10]%	[80-90]%	[10-20]%
First half 2008	[80-90]%	[11-20]%	[80-90]%	[10-20]%
Second half 2008	[80-90]%	[11-20]%	[70-80]%	[20-30]%

Source: Ofcom calculations

Figure 4: Weights used for the incremental price approach

[✂]

Source: Sky response dated 13 June 2008 to question 3 of Ofcom's information request dated 29 May 2008

2.80 Sky's market share has thus fallen since Setanta began televising live FAPL matches in the second half of 2007. However Sky's market share was still above 70% in the second half of 2008.

2.81 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." It is doubtful that Setanta Sports 1 lay within the relevant market before it began screening live FAPL matches in the second half of 2007[35]. In any event, even if Setanta Sports 1 were deemed to lie within the relevant market, Setanta's revenue prior to the second half of 2008 was markedly lower[36]. As a result Setanta would have possessed a very low market share whereas Sky is likely to have enjoyed a market share close to 100%. Thus, not only did Sky enjoy a high market share in 2008, it has also enjoyed a high market share historically.

[34] For wholesale bundles that only contain Sky Sports, the entirety of the wholesale price was attributed to Sky Sports 1 and 2.

[35] 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.

[36] 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 to Setanta information request response dated 15 April 2009). 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 3 above.

2.82 Moreover, looking forward, it appears that Setanta Sports will no longer be broadcasting live FAPL matches. There has also been considerable press speculation about Setanta's viability going forward (although we take no view on this issue). This evidence suggests that Setanta Sports will be a markedly less effective constraint on Sky Sports 1 and Sky Sports 2 in the future.

2.83 Further, from the 2010/11 FAPL season onwards ESPN (which has reportedly acquired the rights previously held by Setanta) will screen 50% fewer live FAPL 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 FAPL matches its subscriber numbers increased from under 200,000 prior to 31 May 2007 to over 700,000 by 30 November 2007[37]. The only plausible explanation for this profound change in the number of Setanta Sports subscribers is that a large number of subscribers were attracted by live FAPL matches. It seems plausible that a material share of them may cease subscribing to Setanta Sports or ESPN's channel once it screens 50% fewer live FAPL matches.

- The loss of attractive content such as the live FAPL matches makes a channel less attractive to final consumers and hence less attractive to retailers. Economic theory suggests that a fall in attractiveness may well be accompanied by a fall in the wholesale price.

2.84 In summary, Sky's acquisition of additional live FAPL matches from mid-2010 onwards suggests that constraints on Sky may be weaker from that time onwards.

Other evidence advanced by consultation respondents

2.85 In its response to the First Pay TV Consultation, Virgin Media asserted that while the levels of Sky's prices might well have been higher in the absence of competition from Setanta and Freeview more generally, Sky is not subject to any "binding" competitive constraints in the provision of "premium sports" (Virgin Media did not make it clear whether its comments related to the wholesale and/or the retail level). Similarly, in their joint response to the First Pay TV Consultation, Setanta and Top Up TV stated that while Setanta Sports might be the closest substitute to Sky Sports, the degree of substitutability is nonetheless limited. In support of their views, these respondents cited the following evidence:

- Setanta and Top Up TV stated their view that Setanta Sports is currently unable to impose an effective pricing constraint on Sky Sports was supported by differences in the characteristics of the channels. In particular, in the 2007/08 FAPL season Sky provided live coverage of twice as many FAPL matches as Setanta and Sky's expenditure on the Live FAPL Rights is approximately 3.3 times Setanta's expenditure[38].

[37] Source: Setanta information request response dated 7 July 2008.
[38] Setanta/Top Up TV made a similar point in relation to sports content more generally. They stated that in 2007/08, Sky's expenditure on sports rights was approximately 4.7 times Setanta's expenditure. Further, the quantity of sports programming available on Sky Sports (including Sky Sports News) is approximately 4.8 times the quantity that is available on Setanta Sports.

- Virgin Media, Setanta and Top Up TV referred to Sky increasing the retail price of certain packages containing Sky Sports in September 2007 (see paragraph 2.66 above for details).

- Setanta stated that very few, if any, of its subscribers on DSat do not also subscribe to Sky's premium sports channels. In other words, on Sky's DSat platform, sports subscribers tend to subscribe either to Sky Sports or to Sky Sports and Setanta Sports.

2.86 We discuss this evidence below.

2.87 Setanta and Top Up TV compared the live FAPL coverage on Setanta Sports and Sky Sports. Similarly, in the Second Pay TV Consultation we looked at the volume and characteristics of the live FAPL matches broadcast on Sky Sports 1 and 2 and Setanta Sports (Annex 7, paragraphs 2.23-2.24). The Second Pay TV Consultation stated that for the Live FAPL Rights to the 2007/08-2009/10 seasons, Setanta paid £130m per annum (£2.8m per game) whereas Sky paid £438m per annum (£4.8m per game)[39]. Using this measure Sky's market share would be 77% and Setanta's market share would be 23%. The packages of Live FAPL Rights won by Setanta generally contain later 'picks' of FAPL matches and do not contain any 'first pick' FAPL matches (see Figure 7 below for further details). They are thus less attractive. In the Second Pay TV Consultation we stated that Setanta's lower market share is consistent with the fact that the live FAPL matches it broadcasts are likely to be less attractive to final consumers.

2.88 The market definition adopted in this document differs from that in the Second Pay TV Consultation. We now take a wider view on what sports content characterises Core Premium Sports channels. However, as explained in paragraphs 2.116-2.118 below and paragraph 4.80 of the main document, live FAPL matches are the most important sporting event broadcast on Core Premium Sports channels. The fact that Sky Sports features more attractive FAPL content than Setanta Sports adds weight to the market share figures presented above and supports our view that Setanta Sports exerts only a limited constraint on Sky.

2.89 Virgin Media, Setanta and Top Up TV relied on Sky's retail price increases in September 2007 in their consultation responses as evidence of the weak constraint Setanta imposes on Sky's pricing. This argument is distinct from the Four Parties' claim, based on the same data, that Setanta Sports is a complement to Sky's Core Premium Sports channels. Our position is the same as in the Second Pay TV Consultation (Annex 7, paragraph 2.26), namely that we do not rely on this evidence. As explained in paragraph 2.73 above, simply looking at prices changes is unlikely to be definitive evidence since it does not take any quality or cost changes into account. Our analysis of retail price changes in paragraph 4.148-4.163 of the main document is not definitive. Further, as set out in Figure 1 above, in addition to the retail price rises identified by consultation respondents, other retail prices fell. Moreover, as shown in Figure 2, the pattern of changes in Sky's wholesale prices in September 2007 is [✂]. The wholesale price [✂]. We thus do not consider that the observed prices changes provide strong evidence that Setanta exercises a weak constraint on Sky's pricing of its Core Premium Sports channels. Accordingly we do not rely on this evidence.

2.90 In the Second Pay TV Consultation, we considered Setanta's claim that very few, if any, of its subscribers on satellite do not also subscribe to Sky Sports. However this

[39] Calculated from December Consultation, Annex 10, page 22.

evidence is contradicted by a November 2007 survey by Ofcom found that 83% of Setanta Sports subscribers also subscribe to Sky Sports[40]. However, particularly for differentiated products such as these, the observation that most final consumers subscribe to both Sky Sports and Setanta Sports is not inconsistent with those channels constraining each other's prices, for example because the potential for switching by a relatively small group of marginal subscribers can be an effective price constraint[41].

Out of market constraints

2.91 As explained in paragraphs 4.72 of section 4, similar sports events to those broadcast on Sky Sports 1 and 2 are also screened on other channels, including free to air channels. In section 4 we weighed up whether various channels are sufficiently close substitutes to lie within the relevant market. On balance, we took the view that only Sky Sports 1 and 2 and Setanta Sports 1 lay within the relevant market, but we recognised that there was nonetheless a moderate degree of substitutability with channels outside the relevant market.

2.92 As explained in paragraph 2.48 above, we have thus considered the extent of the constraint imposed by 'out of market' products that are moderate substitutes for the wholesale supply of Core Premium Sports channels. In particular, 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. These market shares provide an upper estimate for the strength of the competitive constraint that may be exercised by products that lie somewhat outside of the relevant market but that may nonetheless act as (imperfect) substitutes[42].

2.93 Figure 5 lists the leading events for each of the major sports screened on Sky Sports 1 and 2 (namely football, cricket, golf, rugby union, rugby league and tennis). We consider that other channels are moderate substitutes for Core Premium Sports channels insofar as they feature live coverage of these events. We have not included other well-known sports such as the Olympics or Formula One motorsports because we regard them as more remote substitutes for the events broadcast on Sky Sports 1.

2.94 We have calculated market shares as if other channels were included within the relevant market to an extent reflected by these events. 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. We consider that this is a

[40] Ofcom pay TV small platforms research, November 2007. Base: Setanta subscribers on DSat (155).

[41] This point can be illustrated using the following (hypothetical) example. Suppose that there are two channels, X and Y, and that the cost of supplying a channel is zero. All subscribers value a single channel at £10/month and both channels at £14/month i.e. the incremental value of taking a second channel is only £4/month. If those channels are supplied by separate, competing firms then the price of both channels will be £4/month (since a subscriber that is already taking channel X is unwilling to pay more than £4/month for the Y channel). The channels constrain each other's pricing, even though the observed outcome is that consumers take both channels. In contrast, rather than setting a price of £4/month for both channels, a monopoly supplier of those channels could increase its profits by setting a per channel price of £10/month (consumers only take a single channel but the effect on profits of increased prices more than offsets the effects of that fall in demand).

[42] We considered the impact of including other football matches on the market definition set out in the Second Pay TV Consultation in paragraphs 2.27-2.36 of annex 7. This analysis has been updated to reflect the changes in this document to the market definition.

reasonable way to assess market shares because whilst programs featuring live Champions League football might exert some constraint on Sky Sports, other programs broadcast on ITV such as soap operas would not.

Figure 5: Leading events in the sports broadcast on Sky Sports 1 and 2

Football	Cricket	Golf	Rugby union	Rugby league	Tennis
FAPL	England one day internationals	Ryder Cup	Heineken Cup	Super League	Masters Cup
UEFA Champions League	England Test Match cricket	European PGA tour	Guinness Premiership	Challenge Cup	US Open
UEFA Cup	One day international championship	US Open	England internationals	World Cup	ATP tour
England internationals	County cricket	World Golf Championships	Six Nations		WTA tour
FA Cup		US PGA tour	Magners league		Davis Cup
Carling Cup		World Golf Championship			Wimbledon
Championship		US Masters			French Open
		The Open			Australian Open
		Scottish Open			Paris Masters
					Stella Artois Championships

Note: The Stella Artois Championships are now called the AEGON Championships.

2.95 We have calculated market shares that include out of market constraints based on the price of the rights[43]. 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 6 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)[44]. Accordingly we have interpreted the results of this analysis cautiously. However, we do have data on the most valuable sporting events (including FAPL matches) and we believe that the broad results are a useful indicator.

[43] 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 'out of market' 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 its 1 July 2009 submission on the grounds that free to air channels are "available" to more households than pay TV channels.

[44] 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).

- Second, we recognise that, in the case of listed events, the price of the rights is likely to understate the strength of free to air channels' competitive position (the restrictions on pay TV broadcasters are likely to lower the price of the rights to listed events). However the effect may not be large given the relatively small number of listed events that are relevant to this calculation[45]. We have considered the impact on market shares of uplifting the value of the rights acquired by the BBC and ITV (this uplift is applied to all the rights that they acquire, not just 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.

Figure 6: Wholesale market shares including moderate 'out of market' sports constraints (calculated using expenditure on relevant sporting events)

	Percentage uplift to amounts paid by BBC and ITV			
	None	10%	20%	50%
Sky	[60-70]%	[60-70]%	[60-70]%	[50-60]%
Setanta	[10-20]%	[10-20]%	[10-20]%	[10-20]%
BBC	[0-10]%	[0-10]%	[0-10]%	[10-20]%
ITV	[10-20]%	[10-20]%	[10-20]%	[10-20]%
Other	[0-10]%	[0-10]%	[0-10]%	[0-10]%

Source: Ofcom calculations

2.96 Sky's market share is lower under this alternative, wider market definition. However, Sky's market share remains well above the 40% threshold associated with dominance that is identified in paragraph 2.12 of the OFT Market Power Guidelines. This remains the case even when the price of the rights acquired by the BBC and ITV are uplifted by a significant amount (see Figure 6)[46]. Moreover, the factors discussed in paragraph 4.73 of the main document suggest that there is only a limited degree of substitutability between Core Premium Sports channels and channels featuring the wider selection of events listed in Figure 5 above. This implies that 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.

2.97 Thus even when 'out of market' constraints are taken into account, existing competitors do not exert a strong constraint upon Sky. This is shown by its high

[45] 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.
[46] In order for Sky's market share to drop to 40%, the value of the live sport broadcast by the BBC and ITV would need to be uplifted by approximately [✂] [over 200%].

market share (as set out in Figure 6) which, as explained above, will also tend to overstate the competitive constraint imposed by these moderate substitutes for Core Premium Sports channels. Moreover, as shown by the magnitude of the market share figures presented above, this is not a borderline case. Thus, while a degree of further constraint will be exerted by more remote 'out of market' substitutes, that further constraint is too weak to alter our view on existing competitors.

Ofcom's conclusion on existing competitors

2.98 While Sky's share of wholesale revenues has declined from 100% following the entry of Setanta Sports, we calculate that it is still over 70% (see paragraph 2.80 above).

- As noted above, the OFT Market Power Guidelines state that it is unlikely that an undertaking will be individually dominant if its share of the relevant market is below 40% (paragraph 2.12). In the light of Setanta's historic market share (particularly in comparison to that of Sky), our current conclusion is that successor's to Setanta are unlikely to possess a dominant position in this relevant market during the next three to four years[47].

- In contrast, our current conclusion in relation to Sky is that its market shares are a strong indication of it possessing market power and in fact create a presumption that it possesses a dominant position in the relevant market[48]. Moreover, if Sky retained this high market share over the next three to four years, we would expect any market power (and dominance) to be retained over that period.

- We recognise the challenges in defining the boundaries of relevant markets within this sector and that products outside of the relevant market can exercise some degree of competitive constraint. We have thus considered market shares taking into account a wider range of sporting events, including certain events broadcast on free to air channels. While we have treated these results cautiously (given gaps in the underlying data), Sky's market share remains high (well over 50%). We consider that this is a further indicator of Sky's very strong wholesale position. These alternative market share figures will overstate the strength of the competitive constraint exercised by 'out of market' products and thus understate the extent of Sky's market power. Looked at in the round, we consider that these measures support our view that Sky faces limited constraints from existing competitors when wholesaling Core Premium Sports channels. This is consistent with Sky possessing market power (and in fact a dominant position) in that relevant market.

2.99 Accordingly in the analysis of entry and expansion barriers and CBP that follows, we focus on the position of Sky.

Entry by potential competitors and expansion by existing competitors

2.100 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

[47] Setanta is particularly unlikely to possess a dominant position during the next three to four years given that it will broadcast 50% fewer live FAPL matches from the 2010/11 season onwards (see paragraphs 2.82-2.83 above). See also the discussion of entry barriers below.
[48] 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.

price down, at least in the long term[49]. Below we explain why there are, and, in the absence of further regulatory intervention will remain, important barriers to entry in this market.

2.101 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[50]. 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.

2.102 Below we first discuss the Live FAPL Rights and in particular we explain:

- The sale process for the Live FAPL Rights.
- Why, in order to materially undermine its wholesale position, Sky would need to lose the majority of the Live FAPL Rights.
- Why Sky is likely to win the majority of the Live FAPL Rights.

2.103 We then discuss the rights to other relevant live sporting events, namely football (other than live FAPL matches), rugby union, rugby league, cricket, golf and tennis.

Sale process for the Live FAPL Rights

2.104 The Live FAPL Rights are sold by the FAPL. The Live FAPL Rights to each particular game are exclusive, although highlights and various delayed rights are also available. Until the 2007/08 FAPL season, all the available Live FAPL 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 FAPL concerning the sale of various media rights, including the Live FAPL Rights[51].

2.105 The Commitments apply for the six seasons from 2007/08 onwards, or two rounds of bidding (Commitment 11.4). The Commitments require six packages of live rights, each for 23 matches, to be made available (Commitments, schedule 1). Each FAPL season is divided into 38 "rounds" of 10 matches. In each round, three or four matches are broadcast live. Different packages allow a 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.

[49] *Assessment of market power*, OFT, December 2004, paragraph 3.3, second bullet.
[50] As was the case when Setanta began broadcasting live FAPL matches in 2007, following its acquisition of the Live FAPL Rights (see footnote 36 above).
[51] For more details, see: http://ec.europa.eu/comm/competition/antitrust/cases/index/by_nr_76.html#i38_173

Figure 7: The six packages of Live FAPL 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

2.106 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).

2.107 In the 2006, the FAPL sold the rights to the 2007/08 to 2009/10 seasons. [✂]. In light of those bids, the FAPL chose to award three packages of Live FAPL Rights 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 FAPL awarding a fourth package of Live FAPL Rights to Sky (A) and two packages to Setanta (C and D).

2.108 In 2009, the FAPL sold the rights to the 2010/11 to 2012/13 seasons. As in 2006, [✂]. This time, the FAPL chose to award four packages of Live FAPL Rights 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 FAPL awarded a fifth package to Sky (C) and the final package to Setanta (D).

<u>In order to materially undermine Sky's wholesale position, Sky would need to lose the majority of the Live FAPL Rights</u>

2.109 We are assessing the extent of market power held by Sky by reference to the question of whether it possesses a dominant position in the wholesale supply of Core Premium channels. Under this framework we therefore consider whether potential competition is sufficiently strong to materially undermine the wholesale position suggested by Sky's market shares. This has two important implications.

2.110 First, the focus is on the relevant market. 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 (annex 6, paragraph 6.1). Sky thus appears to be referring to a different relevant market to the one that we have defined; the only example of entry/material expansion in the wholesale supply of Core Premium Sports channels in recent years has been Setanta Sports 1. We thus do not consider that Sky's claim is relevant.

2.111 Second, the relevant issue is not whether small scale entry is possible or viable (for example by a channel that only broadcasts a small number of sports events). Rather the question is whether entry *on sufficient scale to materially undermine Sky's wholesale position* is likely.

2.112 There is support for our view that entry needs to be on a sufficient scale to undermine any dominant position in the OFT Market Power Guidelines. These 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.

2.113 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. Specifically, we consider that Sky is likely to maintain its wholesale position if it wins the majority of the Live FAPL Rights. By "majority" we mean:

- Either any five packages of Live FAPL Rights; or

- Four packages including package A (which contains 23 first pick games and is the most attractive package).

2.114 In other words, as a minimum, rival wholesalers (in aggregate) would have to win:

- Either two packages of live FAPL Rights including package A; or

- Any three packages of Live FAPL Rights[52].

2.115 The evidence supporting our view is set out below. First, we discuss the evidence demonstrating the particular importance of the Live FAPL Rights. Second, we set out the evidence showing that Sky's wholesale position will be sustained unless Sky loses multiple packages of Live FAPL Rights. Third, we explain why package A is particularly important.

2.116 In terms of the first issue, we consider that the particular attractiveness of the Live FAPL Rights is demonstrated by the following evidence:

- There are a small number of football rights that appeal to a particularly large number of consumers. Winning these rights would enable broadcasters to create a channel that appeals to a particularly large proportion of Sky Sports

[52] We recognise that this may underestimate the amount of Live FAPL 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 FAPL 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.

subscribers[53]. This is shown by survey evidence. For example, 75% of premium sports channel subscribers considered that live FAPL matches were "very important" (Second Pay TV Consultation, Annex 6, Figure 17)[54]. In contrast, the highest rated non-football event (namely "Rugby Union – Six Nations or World Cup") was only considered "very important" by 37% of subscribers. We recognise that certain other football events were also very popular, namely UEFA Champions League ("very important" to 72% of respondents), international matches (71%) and FA Cup matches (71%). However, as set out in paragraph 4.80 of the main document, the FAPL has specific characteristics (in terms of regularity and number of highly attractive matches) which makes it particularly attractive when creating a mass market wholesale sports channel.

- The particular attractiveness of the Live FAPL Rights is demonstrated by the much higher amounts paid for Live FAPL Rights compared to rights for any other sporting events. The total amount paid for the Live FAPL Rights to the 2007/08-2009/10 seasons was [✂] which is an average of [✂] per annum[55]. The winning bids for the Live FAPL Rights to the 2010/11 to 2012/13 seasons totalled [✂] which is an average of [✂] per annum[56]. 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 FAPL rights) and for both the FA Cup and England home international football matches is £106m (also less than 20%)[57]. The annual amount paid for the Six Nations rugby union tournament is £40m (less than 10%)[58]. Given the sheer scale of the difference in the amounts that broadcasters pay for the rights to other sports events, as compared to the Live FAPL Rights, this is strong evidence of the particular desirable characteristics of live FAPL matches.

- The importance of successfully bidding for the Live FAPL Rights is reflected in documents that have been provided to us. [✂][59]. Similarly [✂][60].

- The particular attractiveness of the Live FAPL Rights is also reflected in [✂][61].

[53] Clearly there are other sports rights that are highly valued by a much smaller number of consumers and it may be viable to launch a channel based around those rights. However such a channel is less likely to have the wide appeal that would significantly erode Sky's market share and exert such a strong constraint on Sky Sports 1 and 2 as to erode its wholesale position.
[54] Other surveys produced similar results – see paragraph 4.90 of the main document.
[55] 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"). FAPL information request response dated 5 December 2008.
[56] Calculated using the figures set out in in the *Confidential Report to the European Commission on the Award of Packages A, B, E and F*, 17 February 2009, KPMG and *Confidential Report to the European Commission on the Award of Packages C and D*, 17 February 2009, KPMG (collectively the "2009 Monitoring Trustees' Reports"). FAPL response to Ofcom information request dated 2 March 2009.
[57] 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.
[58] 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.
[59] [✂].
[60] [✂].
[61] The press speculation about Setanta's viability following the loss of a single package of Live FAPL Rights also highlights the importance of these rights.

Figure 8: [✂]

2.117 Turning to the second issue, the available evidence suggests that Sky's wholesale position will be maintained unless Sky loses multiple packages of Live FAPL Rights.

- Setanta acquired two packages of live FAPL 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 FAPL rights varies dramatically based on number of packages won". [✂][62].
  - Second, [✂][63].
  - Third, [✂][64].

2.118 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). The importance of first pick matches is highlighted by contemporaneous documents. [✂][65].
- [✂][66]. Similarly [✂][67].

<u>Sky is likely to win the majority of the Live FAPL Rights</u>

2.119 Following the recent sale of the Live FAPL Rights for the 2010/11 to 2012/13 seasons, further Live FAPL 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 very short term.

2.120 Moreover even when the rights to later FAPL 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 2.113 above, Sky is likely to maintain its wholesale position if it wins the majority of the Live FAPL Rights).

2.121 Our view is strongly supported by the historical evidence. Prior to the European Commission's intervention, Sky had always won all of the Live FAPL Rights. While the Commitments currently prevent the FAPL from awarding all the Live FAPL 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

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62 [✂].
63 [✂].
64 [✂].
65 [✂].
66 [✂].
67 [✂].

"contestable", in practice there are significant barriers to other parties winning sufficient rights away from Sky.

2.122 This is confirmed by more detailed analysis of the bids submitted in 2006 and 2009.

2.123 First, it is confirmed by [✂] i.e. that Sky will retain the majority of the Live FAPL Rights[68].

Figure 9: [✂]

2.124 We recognise that [✂]. However, as shown in Figure 7 above packages C and D both generally feature less attractive FAPL 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 [✂][69]. Further, [✂][70]. 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 FAPL Rights and its wholesale position will not have been materially undermined.

2.125 Second, in 2009 [✂] is consistent with our view that Sky is likely to retain the majority of the Live FAPL Rights.

Figure 10: [✂]

2.126 Indeed there is evidence that [✂][71].

<u>Factors that explain why Sky is likely to win the majority of the Live FAPL Rights</u>

2.127 We have received a number of explanations for Sky's persistent success in bidding for the Live FAPL Rights. For example, the Four Parties have argued that Sky's success reflects the size of its DSat's retail subscriber base and the impact of the staggered expiry rates of rights agreements for different sporting contests.

2.128 Given the clear historic position, we do not consider that it is necessary for us to form a concluded view on which factors explain Sky's strong bidding position for the Live FAPL Rights, particularly as consultation respondents have not argued to us that there is likely to be a material strengthening in the position of rival bidders in the future. Nonetheless below we set out evidence in support of the following factors:

- Branding advantages enjoyed by Sky.
- 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.

2.129 We do not have a settled view on the relative importance of each of these different factors, although as explained in paragraphs 4.35-4.37 below there is some evidence that the third of these factors is relatively less important than the others. However, we

[68] [✂] 2009 Monitoring Trustees' Reports.
[69] [✂].
[70] [✂].
[71] [✂].

consider that in aggregate these factors are likely to contribute to Sky being likely to win the majority of the Live FAPL Rights.

2.130 As noted in the Second Pay TV Consultation, if the ownership of the Live FAPL Rights were to change significantly in the future we would revisit our assessment of market power.

Branding advantages enjoyed by Sky

2.131 As explained in the Second Pay TV Consultation, we consider that Sky enjoys a branding advantage over other potential bidders. In Annex 10 of the Second Pay TV Consultation we presented conjoint analysis of the results of an April 2008 Ofcom survey. This indicated that, were all the 138 FAPL matches that are screened live available from Setanta then on average consumers would value that content at £42/month. If that same content were available from Sky, consumers would value it at £57.50/month (i.e. 37% more)[72]. The effect of Sky generating more consumer value from its channels is that Sky is likely to be able to outbid rival bidders for the Live FAPL Rights.

2.132 There are a number of possible explanations for this finding. First, it may reflect a consumer preference for Sky's coverage (such as match analysis and commentary). [✂][73]. Second, it may reflect the brand that Sky has established over the course of several years. These explanations are supported by Sky's research and the relative amounts spent on advertising. Based on data from Nielsen Media Research, we estimate that, in 2007, spending on the main advertising categories was £115m by Sky, £51m by Virgin Media, £11m by Setanta and £13m by BT Vision[74]. Moreover these figures exclude other forms of marketing carried out by Sky, including set-top box subsidies etc.

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

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

[73] [✂].

[74] Figures reflect estimated expenditure on outdoor, press, radio, cinema and TV advertising. If direct mail and door drops are included the overall pattern of expenditure (including the relative positions of the different firms) is unchanged. These figures do not include online advertising or the cost of producing advertisements and running a marketing operation.

Delays for new entrants in building a subscriber base

2.134 As explained in the Second Pay TV Consultation, there is evidence that, were a firm to acquire Live FAPL Rights for the first time, there would be a delay while it built up a subscriber base to comparable levels to those that could be attained by the current rights holder(s). This delay reduces the value of the Live FAPL Rights to a potential new entrant. As a result, the incumbent rights holder(s), such as Sky and Setanta, are likely to be able to outbid potential new entrants.

2.135 This reasoning is consistent with Sky's successful record in bidding for Live FAPL Rights, [✂] and the failure of any new entrants to win Live FAPL Rights in 2009. We recognise that this reasoning, in isolation, is not consistent with Setanta winning a second package in 2006 (one package was guaranteed to a new entrant since the Commitments prevented Sky winning all six packages) and the fact that Setanta (i.e. the incumbent) lost one of its packages in 2009. However we consider that this emphasises that there are a number of factors that explain Sky's strong bidding position for the Live FAPL Rights. As explained above, we do not have a settled view on the relative importance of each of these different factors.

2.136 Figure 11 shows the number of paying Setanta Sports subscribers on Sky's DSat platform at the end of each month. This updates a chart presented in the Second Pay TV Consultation. The number of Setanta Sports subscribers has increased substantially, from under 200,000 prior to 31 May 2007 to over 700,000 by 30 November 2007. However not all of this subscriber increase had occurred by the end of August 2007, the month in which Setanta began broadcasting live FAPL matches. [✂][75].

2.137 Ofcom considers that this data clearly shows that, where a firm acquires the Live FAPL Rights for the first time, there is a delay whilst it builds up its subscriber base. [✂].

Figure 11: Paying Setanta Sports subscribers on Sky's DSat platform

[✂]

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

2.138 The O&O NTL Report identified "consumer inertia/loyalty to Sky Sports" as a factor that depresses the "non Sky rival['s] value" from a package (slide 9). This report attempted to assess the extent of this inertia. [✂]. This report identified "the inertia of Sky Sports subscribers" as one reason why "the maximum value to Sky … for every package is always greater than a rival pay TV bidder" (slide 49). This provides further evidence that a firm that wins the Live FAPL Rights for the first time may attract markedly fewer subscribers than the incumbent channel provider. See also the discussion of retail switching costs in paragraphs 3.45-3.51 below.

2.139 We received a number of responses to the First Pay TV Consultation that are relevant to this issue.

2.140 BT Vision asserted that a new entrant is unlikely to be able to build-up a DSat customer-base comparable to Sky's within the space of, say, three years. BT Vision

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

did not provide any evidence to support this assertion. Setanta/Top Up TV stated that Sky will be able to monetise rights more quickly than an entrant because of its existing subscriber base[76]. Their arguments appear to be predicated upon an assumption that an entirely new entrant faces a delay in building up its subscriber base, although Top Up TV/Setanta did not make this explicit. Virgin Media referred to the discussion of barriers to retail switching in the First Pay TV Consultation. The March 2008 LECG report asserted that there is significant customer inertia (footnote 5). The Four Parties' August 2008 submission acknowledged that the level of switching costs does not impede consumers subscribing to alternative pay TV services (paragraph 5.11). However they nonetheless considered that a new channel is unable to readily and rapidly match Sky's subscriber base (paragraph 5.15).

2.141 Sky's response to the First Pay TV Consultation and the October 2007 CRA report stated that the costs to taking up a channel on the platform that a household currently subscribes to are likely to be negligible, especially as premium channels are "add-ons" to an existing subscription. The April 2008 CRA report reiterated this point and argued that low intra-platform switching costs imply that any delays in building a subscriber base are limited and hence barriers to entry are low. Further, it cited paragraph 3.56 of the First Pay TV Consultation in support. This paragraph referred to German pay TV operator Premiere's loss of subscribers following its loss of certain football rights. Sky stated that, provided that a new entrant can match the quality of an incumbent's channels, consumers will be willing and able to switch to that new entrant's channel. Sky stated that this is particularly true where consumers have an interest in watching a specific event (such as the FA Cup), and are thus likely to follow that content to another channel[77]. Sky asserted in an October 2007 submission that even if it could add a new channel to its existing channel bundles, this would only produce additional revenues insofar as it reduced churn or increased the number of subscribers, as Sky has limited ability to increase prices. Sky did not provide any evidence in support of these claims.

2.142 We considered Sky's counterarguments in the Second Pay TV Consultation and our view has not changed. We agree that the costs to taking up an additional channel on the platform that a household currently uses are likely to be negligible. However this does not imply that a new entrant faces no delays in building up its subscriber case. Rather, as explained above, inertia, hesitation by some consumers and lower awareness of a new entrant (compared to Sky) appear to be more plausible explanations for a delay in take up of a new entrant's channel, rather than tangible impediments. We regard Setanta's subscriber numbers as strong evidence that, where a new entrant wins rights from the incumbent and then directly retails the resulting channel, there is a delay while it builds up its subscriber base. The April 2008 CRA Report's reference (without providing any figures) to the experience in Germany does not provide strong evidence to counter Setanta's actual experience in the UK market.

[76] Top Up TV/Setanta claimed that Sky can include new content either on existing pay TV channels or as part of a retail bundle with existing channels and increase prices immediately to reflect that additional content. They did not explain why Sky enjoys this advantage over existing competitors, such as Setanta, who already have a portfolio of content and channels.

[77] Sky's October 2007 response and the April 2008 CRA report stated that the ability to monetise rights faster, even if it arises, is unrelated to vertical integration.

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

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

2.144 The logic and evidence underpinning this line of reasoning is somewhat complicated. For clarity we thus set it out separately in section 4 of this annex. Moreover since the Second Pay TV Consultation we have obtained data on [✂]. As explained in section 4 of this annex, this new information has led us to place less weight on this factor than we did in the Second Pay TV Consultation.

Bidder specific factors

2.145 There is some evidence to suggest that other factors affect the specific circumstances of particular bidders.

2.146 In particular, free to air broadcasters have a very different funding model, being much more dependent on advertising or public funding (such as the TV licence fee). As a result their willingness to pay for the Live FAPL Rights may differ very substantially from pay TV broadcasters[78]. For example, [✂][79] Bids of this order of magnitude (i.e. [✂]) are lower than Sky's bids for even the cheapest package of Live FAPL Rights (i.e. [✂]).

2.147 Other factors that may limit the ability or willingness of particular bidders to outbid Sky for the Live FAPL Rights are:

- Their ability to obtain funding. [✂][80].
- How they wish to position their business. [✂] [81].

Respondents' arguments that entry barriers are low

2.148 Sky considered that the Live FAPL Rights are "contestable". 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 FAPL Rights in 2006.
- Sky considered that there are a large number of potential entrants.

[78] Indeed in 2002 the Director General of Fair Trading considered that "… certain content will only appear on premium sports channels, due to their inherent funding characteristics". *BSkyB investigation: alleged infringement of the Chapter II prohibition*, Decision of the Director General of Fair Trading, 17 December 2002, paragraph 80. Available at: http://www.oft.gov.uk/advice_and_resources/resource_base/ca98/decisions/bskyb2
[79] [✂].
[80] [✂].
[81] [✂].

- Sky's argued that the price of the Live FAPL Rights in 2006 implies that bidders were closely matched.

2.149 In its response to both the First Pay TV Consultation and the Second Pay TV Consultation, the FAPL argued that the Commitments address any entry barriers.

2.150 We address Sky and the FAPL's arguments in turn below.

The number of Live FAPL Rights packages Sky won in 2006

2.151 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 FAPL Rights can be won by rival bidders in the future. We considered this argument in the Second Pay TV Consultation and stated that Sky is likely to win the majority of the available Live FAPL Rights but that there is a degree of uncertainty about whether it wins four or five packages (Annex 7, paragraphs 2.67-2.68). This view is confirmed by [✂]. 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 FAPL Rights. Moreover, in 2009 Sky did in fact win the maximum five packages available to it [✂].

The range of potential bidders

2.152 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[82]. 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.

2.153 In the Second Pay TV Consultation we stated that the relevant question is not whether there are a large number of potential bidders for the Live FAPL Rights but whether those bidders are likely to successfully acquire those rights. We considered that rival bidders are unlikely to be successful (Annex 7, paragraph 2.149). As explained in paragraphs 2.120-2.126 above, Sky is likely to win the majority of the Live FAPL Rights and that reasoning applies even if there is a range of potential bidders ([✂]).

2.154 In the Second Pay TV Consultation we also observed that other firms may attempt to acquire the Live FAPL Rights, since there is a chance that the bidder with the greatest willingness to pay (Sky) does not win (Annex 7, paragraph 2.69). Moreover, the Commitments mean that rival bidders will be able to acquire at least one package of Live FAPL Rights. [✂][83]. Our view on this particular point has developed since the Second Pay TV Consultation since, as explained in paragraph 2.125 above, [✂]. This suggests that the new sale format in 2006 (pursuant to the Commitments) may

[82] 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 [✂].

[83] [✂]

well have attracted additional bidders because the novelty of its format meant that the result was less predictable. [✂]. [[✂][84].[✂][85].

The price of Live FAPL Rights

2.155 In its response to the First Pay TV Consultation, Sky argued that the increase in the price of the Live FAPL Rights is inconsistent with the view that these rights are not "contestable". Figure 12 depicts the amounts paid for the Live FAPL Rights[86].

Figure 12: The amounts paid for the Live FAPL Rights

FAPL seasons	Total amount paid per season	Number of live FAPL matches	Average price per match
1997/98 to 2000/01	£168m	60	£2.80m
2001/02 to 2003/04	£430m	106	£4.06m
2004/05 to 2006/07	£341m	138	£2.47m
2007/08 to 2009/10	£[✂]	138	£[✂]
2010/11 to 2012/13	£[✂]	138	£[✂]

Source: December Consultation, Annex 10, page 19 and 2006 and 2009 Monitoring Trustees' Reports

2.156 The average per match price of the Live FAPL Rights is broadly similar in for the 2001/2 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 First Pay TV Consultation and the Second Pay TV Consultation, competition between bidders was relatively weak in 2003 (when the Live FAPL Rights for the 2004/05 to 2006/07 seasons were sold), in particular due to the collapse of ITV Digital in May 2002. Internal documents support this view: [✂][87]. Similarly [✂][88].

2.157 We consider that the much larger amounts paid in 2006 and 2009 (for the Live FAPL 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 FAPL Rights. First, a comparison with 2003 is not a comparison with a competitive sale process. Second, [✂].

Impact of the Commitments

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

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[84] [✂].
[85] [✂].
[86] This updates Figure 8 of Annex 7 in the Second Pay TV Consultation to use the actual amounts bid for the Live FAPL Rights in 2006 and 2009 (rather than an estimate).
[87] [✂].
[88] [✂].

protected" (paragraph 6.8). The Commitments Decision states that the Commitments "considerably improve the scope for ex ante competition for the rights … [The] increase in the number of live TV rights packages … will permit greater competition in the acquisition of those rights … The ban on conditional bidding makes a further contribution to levelling the playing field …" (paragraph 40).

2.159 We do not accept the FAPL's view that the Commitments address any barriers to entry:

- Our view that Sky is likely to outbid rivals and acquire the majority of the Live FAPL Rights is consistent with the Commitments Decision. The factors listed in paragraph 2.128 (branding advantages, avoiding a delay in building a subscriber base, the effects of vertical integration) mean that greater industry profits are generated if Sky wins the Live FAPL Rights. The bidder that generates the greatest industry profits would be expected to win in a competitive auction/bidding process. Thus there is no inconsistency between the position in the Commitment Decision, namely that the Commitments increase competition for the Live FAPL Rights, and our view that Sky (i.e. the bidder that generates the highest industry profits from those rights) is likely to win the majority of those rights.

- In any event the Commitments Decision was published in March 2006. It predates the 2006 and 2009 sales of the Live FAPL Rights. In our analysis above we have taken into account information that did not exist at the time the Commitments Decision was published. Clearly it would be entirely appropriate for us to take a different view to the Commitments Decision if that view were based on more up to date information (although, as noted in the preceding bullet point, we consider that our position is in fact consistent with the Commitments Decision).

Rights to other sports

2.160 As explained in section 4 of the main document, the relevant market is the wholesale supply of channels featuring live sporting events which a significant number of consumers find highly valuable. The sporting events in question are wider than just live FAPL matches. However, as explained in paragraphs 2.113 and 2.120 above, we consider that our analysis of the Live FAPL Rights is sufficient to conclude that entry and expansion will not materially undermine Sky's wholesale position.

2.161 Further, if a third party were to acquire sufficient rights to live FAPL matches, it might not need to acquire the rights to other sporting contests in order to impose a strong competitive constraint upon Sky's Core Premium Sports channels. For example, [✂][89][90].

2.162 Accordingly we have considered barriers to the acquisition of other live sports events in less detail. However we recognise that a new entrant could increase the attractiveness of its channel(s), and thus the strength of the competitive constraint that it exerts on Sky's Core Premium Sports channels, by winning the rights to other sports. For example, [✂][91]. The attractiveness of UEFA Champions League rights is also supported by the survey evidence: 72% of premium sports channel subscribers

[89] [✂].
[90] [✂].
[91] [✂].

considered that “UEFA Champions league” was “very important” (Second Pay TV Consultation, Annex 6, Figure 17). Similarly, [✂][92].

2.163 Sky Sports 1 features live football, rugby union, rugby league, cricket, tennis and golf. Figure 13 sets out which broadcaster(s) currently hold the rights to various live football, rugby, cricket, tennis and golf events. Where known it summarises the position in the previous rights agreement and in any agreements to license these rights in the future and also sets out an estimate of the annual cost of those rights. This chart does not reflect the very recent developments regarding Setanta’s loss of its Live FAPL Rights to ESPN going forward.

[92] [✂].

Figure 13: Leading events in the sports broadcast on Sky Sports 1

Event	Total annual value of live rights	Previous rights holder(s)	Current rights holder(s)	Future rights holder(s)
FOOTBALL				
FAPL	£569m	Sky (2004-2007)	Sky + Setanta (2007-2010)	Sky + Setanta (2010-2013)
FA Cup	£106.3m	BBC + Sky (2004-2008)	ITV + Setanta (2008-2012)	
England (home) internationals			ITV + Setanta (2008-2012)	
UEFA Champions League	£85m	ITV + Sky (2003-2006)	ITV + Sky (2006-2009)	ITV+Sky (2009-2012)
Carling Cup	[✂]		Sky (2006-2009)	Sky + BBC (2009-2012)
Football League Championship			Sky (2006-2009)	Sky + BBC (2009-2012)
UEFA Cup (1)	[✂]		ITV (2006-2009) (quarter finals onwards)	

Event	Total annual value of live rights	Previous rights holder(s)	Current rights holder(s)	Future rights holder(s)
CRICKET				
One day international championship	£52m	Channel 4 + Sky (2003-2005)	Sky (2006-2009)	Sky (2010-2013)
England Test Match		Channel 4 + Sky (2003-2005)	Sky (2006-2009)	Sky (2010-2013)
County cricket		Channel 4 + Sky (2003-2005)	Sky (2006-2009)	Sky (2010-2013)
England one day international			Sky (2006-2009)	

Event				
	[✂]		BBC (2006-2009)	BBC (2010-2013)
Guinness Premiership	[✂]		Sky (2005-2010)	Sky + Setanta (2010-2013)
England Internationals	[✂]		Sky (2005-2010)	Sky (2010-2015)
Heineken Cup	[✂]		Sky (2006-2010)	
Magners League			Setanta (2007-2010)	

Event	Total annual value of live rights	Previous rights holder(s)	Current rights holder(s)	Future rights holder(s)
RUGBY LEAGUE				
Super League	[✂]		Sky (2004-2008)	Sky (2009-2013)
Challenge Cup Rugby		BBC (2005-2008)	BBC (2009-2011)	
Rugby League World Cup			Sky + BBC (2009-2011)	

Event	Total annual value of live rights	Previous rights holder(s)	Current rights holder(s)	Future rights holder(s)
TENNIS				
Wimbledon	[✂]	BBC	BBC (2005-2009)	BBC (2010-2014)
French Open (2)	[✂]		BBC (2008-2011)	
Australian Open (2)	[✂]		Eurosport + BBC (2008-2011)	
US Open tennis	[✂]		Eurosport + Sky (2007-2012)	
Masters Cup Tennis			Sky (2008-2010)	
Davis Cup			Sky	
Paris Masters tennis			Setanta	
Stella Artois tennis			BBC (2008-2009)	
WTA tour				
ATP tour				

Event	Total annual value of live rights	Previous rights holder(s)	Current rights holder(s)	Future rights holder(s)
GOLF				
European PGA	[✂]			
Ryder Cup			Sky (2004-2008)	Sky (2009-2012)
World Golf Championship				Sky (2009-2012)
Scottish Open			Sky + BBC (2004-2008)	Sky + BBC (2009-2012)
US PGA Tour	[✂]		Setanta (2007-2012)	
The Open	[✂]		BBC (2007-2011)	
US Open	[✂]		Sky (2005-2009)	
US Masters	[✂]	BBC (2007)	BBC (2008-2010)	
US PGA Championship		Sky (2004-2006)	Sky (2007-2016)	
European Tour Golf			Sky + BBC (2004-08)	Sky + BBC (2009-2012)

Rights that were solely won by Sky are highlighted in dark grey. Rights that were jointly won by Sky and another bidder are highlighted in a lighter shade of grey.

Note (1): The rights to matches in the UEFA Cup prior to the quarter finals are sold by clubs and have been won by a range of broadcasters. Note (2): The value of the rights to the French Open and Australian open tennis tournaments include rights payments from Eurosport; given that this channel is broadcast across Europe, those payments may not solely relate to the right to broadcast in the UK.

2.164 The pattern of broadcasters that have won these other live rights is less clear cut than for live FAPL matches. Taking each of the sports listed in Figure 13 in turn:

- Live football (other than FAPL matches): football is the sport that is attractive to the largest number of sports channel subscribers (see Figure 17 to Annex 6 of the Second Pay TV Consultation). Sky has been fairly successful when bidding for live football rights. For example, in March 2008, Sky won the rights to an increased number of Champions League matches[93]. However it has failed to secure other important rights, particularly the rights to FA Cup matches and England international matches which were won by ITV and Setanta.

- Live cricket: Sky has a very strong track record. Prior to 2006, Sky shared the rights with Channel 4. Since then Sky has won all the main cricket rights.

- Live golf, rugby union and rugby league: the pattern here is mixed, with rights being won by the BBC, Setanta and Sky. For example, Setanta operates a dedicated golf channel (Setanta Golf) and managed to win some of the Guiness Premiership rights from Sky[94]. The BBC has also won the rights to a number of leading events.

- Live tennis: compared to the other sports set out in Figure 13, Sky tends to win relatively fewer rights to live tennis tournaments.

2.165 Thus 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. Based on Figure 13, 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 this Figure suggests that Sky is more likely to be successful in retaining or acquiring live football and (especially) cricket rights[95].

2.166 In paragraphs 2.128-2.147 above we discuss a number of factors, such as Sky's strong brand, that may give Sky an advantage when bidding for Live FAPL Rights. These factors are likely to also be relevant when considering whether Sky is likely to retain the live rights to non-FAPL sporting events (and hence whether Sky's wholesale position is in fact constrained by potential competitors). 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

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[93] 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.
[94] From the 2010/11 season, Setanta will broadcast 46 live matches per season and Sky will broadcast 23.
[95] As explained in paragraph 2.95 above, very few listed events are relevant to this analysis.

money from sponsorship) and free to air coverage may help maintain the profile and inclusiveness of a sport[96].

Other purported entry barriers identified by consultation respondents

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

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

2.168 We discuss these factors in turn below.

The staggered availability of sports rights

2.169 The rights to different live sports events are sold at different times and the existing contracts terminate at different times. In the First Pay TV Consultation (at Annex 13, paragraph 5.47) and in the Second Pay TV Consultation (at Annex 7, paragraphs 2.52-2.62) we considered whether the staggered availability of sports rights acts as a barrier to entry.

2.170 A prerequisite for the staggered availability of rights to be an entry barrier is the existence of synergies between different rights that are sold at different times. Specifically, it relies upon the value to a wholesale channel provider of holding the rights to both X and Y being greater than the sum of the values of holding X individually and Y individually. As a result, a firm that already holds the rights to X potentially has an advantage when bidding for the rights to Y. This raises the question of the source of that synergy between different rights:

- One possible synergy stems from the increased profits from dampening competition that suppliers can earn by combining substitutable rights. In other words, synergies exist between substitutable rights (from the perspective of a broadcaster) because combining those rights creates market power.
- Another possible synergy arises because a channel is more attractive to viewers if it broadcasts a range of live sporting events.

2.171 We have received submissions pertaining to both of these factors.

[96] For example, the England and Wales Cricket Board was criticised for its 2005 agreement to sell the live rights for the 2006 to 2009 seasons to Sky, since live matches were no longer available on free to air. See for example http://news.bbc.co.uk/1/hi/uk_politics/4667094.stm

2.172 As discussed in the Second Pay TV Consultation (Annex 7, paragraph 2.54), the Four Parties asserted that a "premium channel" requires a range of "premium content" because consumers have a preference for variety. The Four Parties also asserted that Sky has an incentive to combine substitutable sports rights. In its response to the First Pay TV Consultation, Sky disputed that the staggered availability of rights acted as an entry barrier and advanced a number of arguments in support of its position, including that Ofcom had failed to failed to identify either substitutable or complementary rights that are sold by different rights holders and at separate times (see paragraph 2.55 of Annex 7 of the Second Pay TV Consultation).

2.173 In paragraphs 2.57-2.58 of the Second Pay TV Consultation we explained why there are circumstances in which the staggered availability of rights could act as an entry barrier. This reasoning was not challenged and we thus continue to regard it as correct. Rather we consider that the key issue is factual, namely is there evidence that the staggered availability of rights is in fact a barrier to entry?

2.174 As in the Second Pay TV Consultation, we agree with Sky that, in order to rely on this 'staggering' argument it is necessary to provide an indication of which rights synergies exist between and an explanation for why those synergies arise. It is also necessary to consider how large those synergies are, in order to understand whether the staggered availability of sports rights is likely to have a material effect.

- In terms of the first effect identified above (namely competition dampening), as explained in paragraphs 4.102-4.114 of the main document we consider that there is a degree of substitutability between different events in the same sport (e.g. between two football contests). Accordingly this effect potentially arises when combining the rights to different events in the same sport. However, it is most likely to be material where a bidder would attain a large proportion of the rights to contests in a particular sport. In contrast, where rights are more widely spread (as may be the case for tennis tournaments, say) acquiring the rights to one more tournament may not create a material degree of market power. The degree of substitutability between events in different sports is much weaker (e.g. between a rugby tournament and a tennis tournament). Accordingly, we do not think that this effect is relevant when considering rights to events in different sports.

- In terms of the second effect identified above, combining content that is not closely-substitutable into a channel can effectively smooth consumers' preferences. This enables more effective price discrimination and thus increases the revenue generated from that content[97]. We refer to this as the "preference smoothing effect"[98]. The preference smoothing effect is more likely to be material when consumer preferences are heterogeneous (in contrast, if all consumers had identical preferences then this synergy disappears). This is the case in the pay TV industry – consumers have widely varying preferences for content (see First Pay TV Consultation, Annex 14, paragraphs 4.10-4.17). Thus, where acquiring the rights to a particular event would fill in a 'gap' in a

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

[98] As noted in the First Pay TV Consultation, this type of bundling can frequently lead to an expansion of output and efficiency gains.

broadcaster's coverage (by enabling it to appeal to a new segment of consumers) that broadcaster may have an advantage when bidding for those rights.

2.175 In order to substantiate this concern it would be necessary to come to a firmer view on the strength of these factors. It would also be necessary to analyse the termination dates of rights agreements since the larger the gap between rights becoming available the larger this effect will be. Further, it is important to recognise that different bidders will be affected differently. For example, as shown in Figure 13 above, broadcasters such as the BBC, ITV and Setanta already have the rights to a number of live sporting events and thus the staggered availability of sports rights would affect them differently, as compared to an entirely new entrant[99]. We have not carried out this further analysis since, as explained in paragraph 2.160 above, we consider that our analysis of the Live FAPL Rights is sufficient to conclude that entry and expansion will not materially undermine Sky's wholesale position. Accordingly, whilst we recognise that in theory the staggered availability of sports rights is capable of acting as a barrier to entry, we do not rely on it in this document.

The duration of rights contracts

2.176 As discussed in paragraph 2.140 above, the Four Parties considered that a new entrant would face a delay in building up its subscriber base to levels comparable to those of the former incumbent rights holder. In addition, BT Vision and Virgin Media argued that the short duration of contracts does not give new entrants sufficient time to build up a subscriber base in order to earn a return and effectively compete with the incumbent. Virgin Media added that even a temporary delay in developing a critical mass of subscribers reduces the value of the revenue streams generated by the rival premium channel broadcaster over the duration of the rights contract. Similarly, Setanta and Top Up TV stated that a three year rights agreement is too short for a new entrant to realise a return on its expenditure.

2.177 As discussed in paragraphs 2.134-2.142 above, we agree that where a new entrant wins rights from the incumbent and then directly retails the resulting channel, there is a delay while it builds up its subscriber base. As a result, this depresses the value of those rights to the new entrant. However, as we explained in the Second Pay TV Consultation, this effect occurs regardless of the duration of the rights agreement – even if the duration were longer, the valuation of that rights agreement would still be reduced by an amount that reflects the initial delay in building up subscriber numbers. Accordingly we do not accept consultation respondents' claims that the duration of rights contracts creates a further barrier to entry.

The terms that Sky would agree with wholesalers in return for distributing their channels on its DSat platform

2.178 BT Vision and Virgin Media stated that if a new entrant entered into a wholesale agreement with Sky pursuant to which Sky distributed the new entrant's content on Sky's DSat platform then it would have to cede to Sky a significant portion of the revenues that would be generated from the content in question. Virgin Media stated that this would materially disadvantage the third party in its bidding for the rights in the first place. Moreover, BT Vision and Virgin Media added that it is unlikely that Sky

[99] For example, the competition dampening synergy is more relevant to broadcasters with a large proportion of rights to a particular sport whereas the preference smoothing effect is more relevant to recent entrants with rights to only a limited range of sports.

would assist its rivals by agreeing wholesale terms that might cause Sky to be outbid for content rights.

2.179 As set out in the Second Pay TV Consultation, we agree that an increase in the retailer's share (i.e. Sky's share) of the revenues earned from a channel (or, equivalently, a decrease in the wholesale price that the wholesale channel provider is able to charge the retailer) will reduce the amount that the wholesale channel provider is willing to pay for the underlying rights. However BT Vision and Virgin Media omit a second important consequence: that an increase in Sky's share as a retailer would also make winning the underlying rights less attractive for Sky as a wholesaler.

2.180 To illustrate, consider the following hypothetical example. Suppose that firm A is a vertically integrated retailer and wholesaler on a particular platform and that B is a potential new entrant wholesale channel provider that is considering bidding for the rights to a particular piece of content in competition with A. Assume for simplicity that there are no retail or wholesale costs other than the fee the wholesale channel provider charges the retailer. If A retails a channel built around a particular piece of content, it attracts 1m subscribers each of which pays £10.

- Now suppose that, in the event that B wins the rights and begins wholesaling the channel to A, A is able to extract 70% of the value of that content. In other words, of the £10m retail revenue generated when A distributes B's channel, A receives £7m. This is equivalent to a wholesale price of £3/subscriber. Since B only receives £3m from the sale of its channel, it is willing to pay a maximum of £3m for the underlying rights. In other words, as highlighted by BT Vision and Virgin Media, because A is able to extract a significant proportion of the value of the channel this depresses the amount that B is willing to bid for the rights.

- Note, however, that A earns £7m even if it does not win the rights. Because not winning the rights is fairly attractive to A, this depresses the amount that A is willing to pay for the rights. Specifically, if A wins the rights then it earns £10m i.e. A increases its profits by £3m if it wins the rights. A is thus willing to pay a maximum of £3m for the underlying rights i.e. the same amount as B. Thus, when bidding for the rights, in this simple example B is not at a disadvantage relative to A[100].

2.181 We thus maintain the position set out in the Second Pay TV Consultation. Absent further reasoning, Ofcom does not accept that the ability of a particular retailer to extract a large proportion of the retail revenue generated by a channel in itself gives that retailer's wholesale arm an advantage when bidding for content rights.

Uncertainty about the level of conditional access charges on Sky's DSat platform

2.182 BT Vision stated that there is uncertainty over the CA charges that retailers on Sky's DSat platform will pay and that this uncertainty disadvantages new entrants when bidding for content. Specifically, BT Vision stated that Sky has reserved the right, in

[100] Varying the split of the amount earned between the vertically integrated wholesaler and the third party retailer will not generate an advantage for the vertically integrate firm. In contrast, varying the amount generated will do so: a crucial assumption in this example is that the total amount earned from the channel (£10m) is unaffected by the identity of the channel wholesaler. This issue is discussed in section 4 of this annex, which considers whether a vertically integrated retailer-wholesaler is able to generate more total revenue than if the retailer and wholesaler were separate entities.

CA contracts with third parties, to change its CA charges on 90 days' notice and, in certain circumstances, on shorter notice.

2.183 As explained in the Second Pay TV Consultation, Sky Subscriber Services Limited ("SSSL") is required to provide technical platform services ("TPS"), which include CA, on fair, reasonable and non-discriminatory ("FRND") terms. Ofcom has published guidelines on how it will assess Sky's compliance with its FRND obligation in the event of a dispute (the "TPS Guidelines")[101]. While SSSL may have a degree of discretion in how it interprets its FRND obligation, we consider that this discretion is limited by the TPS Guidelines. In particular, paragraph 8.16 of the TPS Statement states that "The [TPS Guidelines] make clear that … Sky should publish a rate card or methodology by which charges are determined, that charges should apply for a period of a minimum of a year and that Sky should give TPS customers three months notice before changing its prices. This should provide TPS customers with more predictability of pricing." Further, BT Vision has provided no evidence in support of its claims. Accordingly we maintain the view set out in the Second Pay TV Consultation, namely that uncertainty about CA charges does not constitute a material barrier to entry.

The risks to rights holders of selling their rights to new entrants

2.184 Virgin Media stated that there may be significant risks to owners of premium content in selling their content to a new wholesale channel or retail platform. For example ONdigital (later rebranded ITV Digital) acquired live rights from the Football League in 2000 but ceased broadcasting during the contract term, with significant negative consequences for the Football League clubs.

2.185 As explained in the Second Pay TV Consultation, it is important to distinguish between two issues: first, the division of risk (e.g. the risk that a rights purchaser goes into administration) between the parties involved; and second, the magnitude of that risk, wherever it may lie.

2.186 With regard to the first issue, we consider that the example cited by Virgin Media (namely ONdigital) demonstrates that there is scope for addressing the issue of risk sharing contractually. In that case it was suggested that the Football League did not extract sufficient guarantees from ONdigital's parent companies in the event that ONdigital went into administration. However there are a number of ways of facilitating risk sharing, including the use of up front payments or guarantees by other firms (such as banks or larger parent companies). It is not clear why the division of risk, in itself, necessarily provides Sky with an advantage over rival bidders.

2.187 With regard to the second issue, we accept that it is plausible that some bidders for rights may be regarded as more risky than others (e.g. because their ability to successfully operate a wholesale channel provision business is unproven). However we recognise that some of the potential rival bidders to Sky for rights are well known companies with established presence in a number of lines of business (e.g. Virgin Media, BT Vision). Moreover, Setanta was able to acquire the Live FAPL Rights in 2006. It is thus not clear whether the magnitude of the risks of selling rights to such firms are materially higher than dealing with Sky, although we accept that it is intuitively plausible that Sky may enjoy such an advantage over an entirely new business. At this stage we thus regard the magnitude of any advantage enjoyed by

[101] *Provision of Technical Platform Services: Guidelines and Explanatory Statement*, Ofcom, 21 September 2006 (the "TPS Statement"). Available at: http://www.ofcom.org.uk/consult/condocs/tpsguidelines/statement/statement.pdf

Sky over new or less well established firms as unproven. Thus, while this argument may be plausible in theory, in the absence of suitable evidence we do not rely on it at this time.

"Toehold" effects

2.188 [✂] response to the Second Pay TV Consultation stated that when a bidder in an auction has an ownership stake in the asset being sold or "some other advantage", even if only a relatively small one, it will be more likely to win the auction than competitors. One reason for this is that any small initial advantage may be multiplied by the operation of the "winner's curse". [✂] asserted (without further explanation) that Sky's pre-existing rights and pre-existing customer base generate such effects.

2.189 [✂] referred to this advantage as a "toehold" although we do not use this terminology[102]. Academic analysis provides some theoretical support for [✂] argument[103]. In an ascending auction, where one party bids aggressively (relative to the private information that it holds about the value of the asset being sold) then a good response is for other parties to bid less aggressively (relative to the private information that they hold about the value of the asset being sold). Otherwise, if they manage to outbid the aggressive party by putting in a relatively high bid they are likely to have bid more than the asset is worth (the so-called "winner's curse"). Where one bidder has an advantage over others it will tend to bid more aggressively. The risk of suffering the winner's curse means that rivals are likely to bid less aggressively. As a result, the initial advantage becomes magnified. However this effect can be mitigated by the design of the auction process – for example, by using a first price sealed bid auction[104].

2.190 We recognise that the "winner's curse" effects identified by [✂] may magnify the impact of the advantages that Sky enjoys when bidding for the Live FAPL Rights (as set out in paragraph 2.128 above). However it is not clear to what extent the design of the FAPL sale mitigates this effect ([✂] did not consider the design of the sale process in its representations)[105]. Similarly, we have not looked in any detail at how the rights to other sports are sold. Indeed, as set out in Figure 13 above, a variety of bidders win the rights to other sports suggesting that Sky does not always enjoy an advantage over rival bidders. Accordingly, we do not rely on the "winner's curse" effect identified by [✂].

Current conclusion on barriers to entry and expansion

2.191 We are assessing whether Sky possesses market power. As explained in paragraphs 2.11-2.14 above, we do so by reference to the question of whether it possesses a dominant position in the wholesale supply of Core Premium Sports channels. Our view on whether potential competition is sufficiently strong to undermine the market power suggested by Sky's market shares is as follows:

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[102] Academic papers have referred to an ownership stake in the asset being auctioned as a "toehold". See for example, *Auctions with Almost Common Values: The "Wallet game" and its Applications*, P Klemperer, European Economic Review May 1999, section 4 (the "Klemperer 1998 Paper") (available at: http://www.nuff.ox.ac.uk/users/klemperer/papers.html). However this is not relevant to this case since Sky does not own a stake in the bodies that sell sports rights. Accordingly, for clarity, we do not adopt [✂] "toehold" terminology.

[103] See section 3 of the Klemperer 1998 Paper.

[104] See section 6 of the Klemperer 1998 Paper.

[105] In 2006 and 2009 the FAPL ended bidding on some packages after the initial round [✂]. It thus differs from the simple ascending auction set out in the Klemperer 1998 Paper, in which "winner's curse" effects are likely to be strongest.

- We consider that Sky is likely to maintain its wholesale position if it wins the majority of the Live FAPL Rights.

- Following the recent sale of the Live FAPL Rights for the 2010/11 to 2012/13 seasons, further Live FAPL 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 very short term.

- Even when the rights to later FAPL seasons become available, we consider that Sky is likely to win the majority of those rights. This reflects a number of advantages that Sky is likely to enjoy 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 in fact supports the view that Sky holds a dominant position.

Countervailing buyer power

2.192 The only major independent purchaser of Sky Sports 1 and 2 is Virgin Media, although a number of other parties have sought to retail these channels. We have considered whether these actual and potential buyers are likely to exert sufficient CBP to offset Sky's seller power over the next three to four years.

2.193 This sub-section is structured as follows:

- First we set out the representations that we have received.

- Second, we set out the key evidence we received in response to an information request in July 2008.

- Finally we set out our assessment of CBP.

<u>Representations on CBP</u>

2.194 In the First Pay TV Consultation we indicated that, on balance, Virgin Media does have a degree of CBP but that it is unlikely to be sufficient to constrain Sky's ability to exercise market power. In its response to that consultation, Sky noted that certain platforms, such as those of Virgin Media and BT Vision, are closed. Sky argued that this gives rise to a potentially significant 'hold-up' problem. Specifically, a wholesale channel provider is less able to recoup its expenditure in content and acquire customers for its channel unless it can agree terms to access platforms. In respect of closed platforms, a channel provider, including Sky, faces the risk that an agreement to supply a channel to customers on that platform will not be agreed (or will only be agreed on unfavourable terms).

2.195 In its response to the First Pay TV Consultation, Virgin Media stated that Ofcom has erred in concluding that Virgin has some CBP, stating that it does not have any buyer power in its relationship with Sky. In particular, Virgin 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 referred to Sky "refusing to supply" high definition programming, interactive services and related content.

2.196 Virgin stated that the strength of its bargaining position depends on the attractiveness of acquiring Sky's content relative to not acquiring that content. Virgin asserted that Sky has a major influence over both these issues since: "Sky's retail and wholesale margins from premium packages are determined by Sky. As a result, 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." In its response, Virgin Media stated that the margin on its XL package of basic-tier channels is greater than the margin when it supplies a subscriber with that XL package plus Sky Sports and/or Sky Movies.

Responses to our July 2008 information request

2.197 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.

2.198 In its response to our information request, [✂].

2.199 Sky also argued [✂].

2.200 In its response to our request, [✂].

2.201 Virgin Media stated 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. Virgin Media also stated that, if it did not acquire Sky Sports and Sky Movies, subscribers that value these channels would be expected 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. 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.

Our assessment of CBP

2.202 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).

2.203 We maintain the view set out in the First Pay TV Consultation and the Second Pay TV Consultation that Virgin Media has a degree of CBP in relation to the licensing of Sky Sports and Sky Movies. Virgin Media is the UK's second largest retailer of pay TV services, and is likely to provide Sky with access to some subscribers it otherwise could not reach. We believe that the closed nature of the cable platform increases Virgin Media's buyer power to some extent, as it affords broadcasters no outside option for accessing the cable customer base (beyond serving these households through other platforms). We also consider that Virgin Media is a well-informed buyer, likely to be aware of any alternative options available to it.

2.204 However, we also retain our view that Virgin Media's buyer power in relation to Sky's premium channels is limited. In coming to this view, we have been mindful of the following considerations:

- First, the importance of Sky's premium content to consumers. We believe that Virgin Media is under significant commercial pressure to offer its customers a content offering that is competitive with that of Sky. This conveys a degree of seller power on channel providers with attractive content – power which increases in line with the content's desirability. As stated in paragraphs 3.21-3.34 of the main document, we believe that Sky Sports 1 and 2 are important drivers of the take-up of pay TV services and that access to Setanta Sports is not an adequate alternative. Virgin Media does not have available adequate alternative sources of supply to replace Sky Sports while continuing to meet its customers' needs since channels outside of the relevant market are poor substitutes (for the reasons set out in section 4 of the main document) and since access to Setanta Sports alone is insufficient. As discussed in paragraphs 2.100-2.191 above, we believe that there are substantial barriers to entry upstream and, in particular, Sky is likely to retain the majority of the Live FAPL Rights. Virgin Media thus cannot quickly achieve or sponsor entry on sufficient scale to replace Sky Sports. This vulnerability leaves Virgin Media in a comparatively weak position with respect to Sky.

- Second, [✂]. Sky has stated [✂][106]. Sky also stated that its wholesale prices are set at a level at which no margin squeeze can occur ([✂]), but did not acknowledge that a *range* of such prices exists. Meaningful negotiation with the cable operators might be expected to place a degree of downward pressure on Sky's wholesale rates, and it is clear that Sky would not expect *lower* wholesale prices to [✂][107]. We accept that the regulatory environment may affect Sky's wholesale pricing *structure*, and the upper *limit* of its rates, but [✂][108].

- Third, evidence from Virgin Media of its weak bargaining position. In February 2008, Virgin Media provided Ofcom with a number of internal documents relating to its proposals to acquire sport and movie content rights. Several of these documents reflect the internal view of Virgin Media and its predecessor companies of their negotiating positions with Sky (and how these might be changed by successfully acquiring the Live FAPL Rights). [✂]. We would expect the creation of Virgin Media from the merger of NTL and Telewest to have

[106] [✂].

[107] A lower bound on Sky's wholesale charges may exist for the avoidance of prices that might breach predation rules.

[108] [✂] the bargaining process between Setanta and Virgin Media for cable carriage of Setanta's channels, documents relating to which have been provided to Ofcom. The documents show that the two parties put forward proposals and counter-proposals, eventually reaching a negotiated settlement on pricing and packaging which satisfied both parties.

somewhat increased cable's buyer power with respect to Sky. However, we do not believe that the merger has fundamentally improved Virgin Media's negotiating position, not least as it has not directly addressed its reliance on content controlled by Sky.

- Fourth, Virgin Media's inability to negotiate lower wholesale prices that would mitigate its concerns about Sky's pricing. As explained in paragraph 6.113 of the main document, the current combination of wholesale charges and incremental retail price means that Virgin Media earns a higher margin on some basic-tier bundles than on bundles that include Sky Sports and/or Sky Movies (although this is not the case for all bundles). 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. This indicates that Sky's wholesale charges have not been effectively constrained by Virgin Media's CBP.

- Fifth, Sky's vertical integration. In any negotiation, the strength of a party's position depends on the negative consequences for it if it fails to strike a deal. As noted in paragraph 6.107 of the main document, it is unclear whether a failure to reach a supply agreement with Virgin Media would be unprofitable for Sky, at least in the long term. Our vertical arithmetic indicates that failing to supply Virgin Media would be costly to Sky given the current terms of supply. However, there is evidence that Sky weighs short-term revenue considerations against its strategic incentive to weaken or eliminate Virgin Media as a competitor. In any event, even if it is unprofitable for Sky to fail to supply Virgin Media, the costs to Sky will be partially mitigated by its vertical integration, since at least some Virgin Media subscribers will respond by switching to Sky's retail business. This strengthens Sky's position when dealing with Virgin Media.

2.205 Virgin Media has argued that its failure to secure the supply of Sky's basic-tier channels between March 2007 and November 2008 is evidence of a lack of buyer power on Virgin Media's part. We recognise the merit in Virgin Media's point the fact that Virgin Media can choose from a considerably wider range of basic-tier channels than Core Premium channels suggests that we should not seek to draw strong parallels between them. Our view that Virgin Media lacks CBP in relation to the Core Premium Sports channels does not rely on Virgin Media's failure to purchase Sky's basic-tier channels in 2007-2008.

2.206 In relation to retailers other than cable, we are aware of several retailers that have sought wholesale access to Sky Sports and Sky Movies but have not been able to reach commercial agreements. This contrasts with the example of Setanta, which has very quickly agreed wholesale deals with Virgin Media, BT Vision, Tiscali and Top Up TV[109]. We set out the evidence we have reviewed on these negotiations in section 6 of the main document. We believe that the successive instances where commercial agreements have not been reached are at least indications that Sky does not consider these retailers to be essential outlets for its content. As such, we do not believe that these retailers would be able to exercise significant CBP with respect to Sky even if Sky were to wholesale Sky Sports to them.

Conclusion on countervailing buyer power

2.207 In summary, our view is that Virgin Media is the most likely retailer to exercise CBP over Sky. However, while Virgin Media is a significant outlet for Sky, the commercial balance of the relationship is strongly in favour of Sky. We therefore believe that no

[109] Setanta also has an exclusive wholesale agreement with Sky in respect of commercial customers.

party exercises sufficient buyer power to counter Sky's seller power in the wholesale supply of Core Premium Sports channels.

Conclusion on market power in the wholesale supply of Core Premium Sports channels

2.208 In the light of Sky's very high and sustained market shares, the existence of barriers to entry and limited prospects for CBP, we consider that Sky holds market power in the wholesale supply of Core Premium Sports channels. In fact we consider that Sky holds a dominant position in that market, and that it is likely to be dominant for the next three to four years.

Wholesale of Core Premium Movie channels

2.209 We consider that the wholesale supply of channels which include the first TV subscription window of movies produced or licensed by any of the Major Film Production Groups is a relevant economic market[110]. Below we assess market power within that relevant market. As explained in paragraphs 2.11-2.14 above, we conduct this assessment by reference to whether any firm is currently dominant in this relevant market and whether any firm is likely to be dominant for the next three to four years. This sub-section is structured as follows:

- We provide some background information, namely: (i) the channels within the relevant market; (ii) our position in the Second Pay TV Consultation; (iii) respondents' views on the Second Pay TV Consultation; and (iv) further developments since the Second Pay TV Consultation.

- We assess the likely strength of competition within this market both at present and over the next three to four years. This consists of our assessment of: (i) competition from existing competitors; (ii) competition from potential competitors; and (iii) CBP.

Background

The channels within the relevant market

2.210 As explained in paragraph 4.378 of the main document we consider that the following channels that are wholesaled by Sky lie within the relevant market: Premiere, Premiere +1, Comedy, Family, Action/Thriller, Sci-Fi/Horror, Drama, Screen 1, Screen 2, Modern Greats and Indie[111]. In addition, Disney Cinemagic is the first subscription channel to broadcast animated movies produced by Disney and, on balance, we consider that Disney Cinemagic also lies within the relevant market. Our position has thus changed since the Second Pay TV Consultation, in which we took the view that only Sky's suite of channels lay within the relevant market.

2.211 Sky currently bundles its channels into two main packages. Sky Movies 1 features Comedy, Family, Screen 1 and Modern Greats (and Classics). Sky Movies 2 features

[110] Note that this differs from the definition adopted in the Second Pay TV Consultation, namely the wholesale supply of channels or packages of channels which include the first TV subscription window of film content from the Major Hollywood Studios. First, it includes a wider range of movies than just those licensed by the Major Hollywood Studios. Second, it excludes other components of wholesale bundles supplied with relevant movie channels.

[111] The Sky channel Classics does not lie within the relevant market since it broadcasts less recent films (i.e. films that are not within first TV subscription window).

Action/Thriller, Drama, Sci-Fi/Horror, Screen 2 and Indie. Households taking both packages (known as the Movie Pack) also receive Premiere and Premiere +1.

2.212 Sky Movies 1 and 2 are currently wholesaled to Virgin Media and other smaller cable companies both on a standalone basis and as part of a bundle with Sky Sports. Sky also directly retails Sky Movies 1 and 2 on its DSat platform and directly retails Comedy, Family and Modern Greats (and Classics) to customers of Tiscali. Disney Cinemagic is currently wholesaled by Disney to Sky, Virgin Media and Tiscali. Sky retails that channel on its DSat platform as a standalone channel (in May 2009 the price was £4.89) and it is also included in Sky's Movie Pack. Disney Cinemagic is also retailed as a standalone channel by Virgin Media and Tiscali on their respective platforms (in May 2009 the price was £5)[112].

Our position in the Second Pay TV Consultation

2.213 We consulted on the conclusion that Sky had market power in the wholesale supply of channels or packages of channels which include the first TV subscription window of film content from the Major Hollywood Studios. Our view was that Sky was at that time dominant and was likely to be dominant in that relevant market for the next three to four years. By way of background, we based that conclusion on the following:

- We considered that Sky was the only supplier within the relevant market, giving Sky 100% market share (in the Second Pay TV Consultation we did not identify Disney Cinemagic as lying within the relevant market).

- Sky's market share remained high even when we expanded our market definition slightly, to include for example pay-per-view ("PPV") movies or DVD rental services.

- We believed that the bidding advantages that we set out in the context of the wholesale supply of sport channels also applied to movie content. These meant that Sky can afford to bid a larger amount than any other bidder for the studios' rights. That, in conjunction with the staggered availability of rights, created a significant barrier to entry.

- We believed that the commercial balance of the relationships between Sky as a wholesaler of these channels and other retailers was strongly in favour of Sky.

2.214 We acknowledged that there was the possibility of disruptive change in the way the studios monetise their rights in the future. We acknowledged that any major change in the pattern of rights ownership, or in the means by which the studios monetise their rights, would constitute a material change in circumstances and we would need then to revisit our assessment of market power.

Overview of the further representations received on Core Premium Movie channels

2.215 Sky considered that the rights necessary to enter the relevant market were "contestable". As discussed in section 4 of the main document, Sky highlighted a number of changes such as to the windowing of films and increasing penetration of new ways of obtaining movies. Sky stated that Ofcom's forward looking assessment of these developments focused on the potential impact on market shares, rather than on the intensity of competitive constraints. Sky stated that since 2006 these changes

[112] Virgin Media, Sky, Tiscali, Top Up TV and BT Vision also provide some video on demand services, but we believe that these lie outside the relevant economic market.

have reduced the number of subscribers to Sky Movies as well as lowering Sky Movies' share of viewing amongst subscribers to that channel. Sky also stated that the real price of Sky Movies has fallen since late 2006.

2.216 The Four Parties broadly agreed with the approach in the Second Pay TV Consultation to market definition and the assessment of market power in respect of Core Premium Movie channels.

2.217 Virgin Media considered that a viable commercial offering would require the rights from at least three Major Hollywood Studios. Virgin Media considered that the staggered expiry dates of the agreements between Sky and each of the Major Hollywood Studios were a barrier to entry. Virgin agreed with the analysis in the Second Pay TV Consultation explaining why Sky was able to outbid rivals. Virgin Media considered that this conclusion was supported by Virgin Media's repeated failure to outbid Sky for the rights.

2.218 [✂] agreed that Sky was dominant. [✂] considered that Sky is able to outbid rivals for the exclusive licensing deals with the Major Hollywood Studios. [✂] did not explain why Sky is able to outbid rivals.

2.219 Tiscali believed that future developments that could change market function and boundaries included increased use of VoD and different ways to view familiar premium content via the internet, on PC or TV. It also noted the potential for content owners to monetise their rights directly.

<u>Further developments since the Second Pay TV Consultation</u>

2.220 Since the publication of the Second Pay TV Consultation, [✂][113].

Existing competitors

2.221 This section assesses the strength of competition between existing competitors. As explained above, apart from Sky's channels, only Disney Cinemagic lies within the relevant market. This section is structured as follows:

- First, we consider the strength of competition between channels within the relevant market.

- Second, we consider the constraint imposed by channels outside of the relevant market.

<u>Constraints within the relevant market</u>

2.222 We have updated our market share calculations to take into account the inclusion of Disney Cinemagic within the relevant market.

2.223 We have estimated market shares by calculating the proportion of the revenues earned by Sky and Disney from the wholesale supply of Core Premium Movie channels (as noted in paragraph 2.77 above this measure is consistent with the OFT Market Power Guidelines). The details of our calculations are set out in a separate confidential spreadsheet and the results are set out in Figure 14 below. We make two observations on the calculation of these figures:

[113] [✂].

- First, Sky is vertically integrated. We have included revenues from the self-supply of Sky Movies to Sky's retail arm when calculating market shares[114]. We have assumed that the wholesale prices charged to Virgin Media can be applied to sales by Sky to subscribers on its DSat platform.

- Second, Sky bundles its Sky Movies channels with its Sky Sports channels. Where a subscriber chooses to take Sky Sports and Sky Movies, rather than just Sky Movies, it is not appropriate to attribute all of the associated wholesale revenue solely to Sky Movies. Varying the proportion of the wholesale price of channel bundles that is attributed to Sky's Core Premium Movie channels produces a range of market share figures. We have calculated wholesale market shares in two ways. First, an "average price approach" which allocates revenue from bundles based on the proportion of sports and movies packages in the bundle in question[115]. Second, as "incremental price" approach which uses the (approximate) incremental revenue from adding Sky Movies to a wholesale bundle. The weights used under the incremental price are set out in Figure 15 below[116].

Figure 14: Market shares for the wholesale supply of Core Premium Movie channels (calculated using wholesale revenue)

	Average price approach		Incremental price approach	
	Sky	Disney	Sky	Disney
Second half 2007	[90-100]%	[0-10]%	[90-100]%	[0-10]%
First half 2008	[90-100]%	[0-10]%	[90-100]%	[0-10]%
Second half 2008	[90-100]%	[0-10]%	[90-100]%	[0-10]%

Source: Ofcom calculations

Figure 15: Weights used for the incremental price approach

[✂]

Source: Sky response dated 13 June 2008 to question 3 of Ofcom's information request dated 29 May 2008

[114] The relative wholesale revenues of Sky and Disney proxy the attractiveness of their Core Premium Movie channels (since they reflect the number of people choosing to subscribe to such channels multiplied by a wholesale measure of their willingness to pay). Thus, as in the case of Core Premium Sports channels, it is appropriate to include revenues from self supply since otherwise a significant number of consumers that consider Sky Movies to be attractive are omitted from our calculations. For example, as shown in the confidential market share spreadsheet, [✂] of Sky's revenue from the wholesale supply of Core Premium Movie channels in the second half of 2008 came from self supply (under the average price approach (defined below) Sky's total wholesale revenue from the supply of Core Premium Movie channels is [✂] of which [✂] is earned from self supply).

[115] Thus 50% of the revenue from bundles with equal amounts of sports and movies, 67% of the revenue from single sports/dual movies bundles and 33% of the revenue from single movies/dual sports bundles is attributed to Sky Movies.

[116] For wholesale bundles that only contain Sky Movies, the entirety of the wholesale price was attributed to Core Premium Movie channels.

2.224 We estimate that Sky's market share has remained stable at over 90% with Disney accounting for the remainder. Disney's market share is so low in comparison to that of Sky that the choice of the average price approach or the incremental price approach does not materially affect our overall conclusions. This strongly suggests that Disney Cinemagic is a weak constraint on Sky's Core Premium Movie channels. This is consistent with the characteristics of Disney Cinemagic. As discussed in paragraph 4.257 of the main document, Disney Cinemagic only features a small number of first run movies and the majority of its output is targeted at children which suggests that it is not a particularly close substitute for Sky Movies.

2.225 In the light of Disney's very small market share (particularly in comparison to that of Sky), clearly Disney is unlikely to possess a dominant position in this relevant market at present or during the next three to four years. Our subsequent analysis thus focuses on the position of Sky within this relevant market.

Out of market constraints

2.226 As explained in paragraph 4.377 of the main document, certain other ways of viewing movies may constrain Sky to a degree. We recognised that there was a moderate degree of substitutability between Core Premium Movie channels and PPV movies, DVD rental subscription packages and library films. On balance, we took the view that these services lay outside the relevant market but they nonetheless are moderately close substitutes for Sky Movies.

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

2.228 We calculated Sky's market share under four alternative market definitions:

- Impact of PPV movies. We observe in paragraphs 4.325-4.330 of the main document that PPV movies may offer a reasonably close substitute for some consumers. PPV movies are retailed by Sky, Virgin Media, BT Vision, Top Up TV and Tiscali. We have calculated market shares as if PPV movies were included in the relevant market using the retail revenues earned from supplying PPV movies. Combining wholesale revenues (for Core Premium Movie channels) with retail revenues (for PPV movies) in this way is likely to overstate the position of PPV movies.

- Impact of DVD rental subscription packages. We observe in paragraphs 4.341-4.342 of the main document that DVD rental subscription packages (such as those supplied by Lovefilm) may also offer a close substitute for some consumers, although they lack the convenience associated with both subscription and PPV TV services. The value of online DVD rental services in 2008 was estimated as £92m[117]. We have calculated market shares as if online DVD rental packages were included in the relevant market using the retail revenues earned from online DVD rental services. As noted above, combining wholesale and retail revenues in this way is likely to overstate the position of online DVD rental services.

[117] BVA Yearbook 2009, British Video Association, page 80.

- Legal movie downloads (to rent or own). Legal movie downloads is currently a nascent sector. In 2008, the estimated value of online PPV/VoD movies was £7m[118]. We have used this figure to calculate market shares as if legal movie downloads were included in the relevant market. As noted above, combining wholesale and retail revenues in this way is likely to overstate the position of legal movie downloads.

- Library films. Less recent films are broadcast on a variety of channels, including Sky Movies, free to air channels and basic-tier channels (for example, Bravo which is ultimately owned by Virgin Media). We have calculated market shares as if library film content were included in the relevant market. This has been done based on expenditure on movies rather than revenues. This is because of the difficulties in calculating the revenues attributable to movie content for free to air channels or channels which only feature a small number of films. Further, we would expect expenditure to proxy the attractiveness of movies to viewers (for example, less recent films are less attractive to viewers but command a lower rights price). These figures do not include Disney Cinemagic.

2.229 Sky's market share if these out of market constraints were included in the relevant market is summarised in Figures 16-17 below.

Figure 16: Wholesale movie market shares if moderate 'out of market' constraints were included in the relevant market (calculated using revenue data)

	Sky	Disney	Virgin Media	Others
Including PPV	[90-100]%	[0-10]%	[0-10]%	[0-10]%
Including online DVD rental services	[80-90]%	[0-10]%	[0-10]%	[10-20]%
Including legal movie downloads	[90-100]%	[0-10]%	[0-10]%	[0-10]%
Including all of the above	[80-90]%	[0-10]%	[0-10]%	[10-20]%

Source: Ofcom calculations. Sky's wholesale revenue from the wholesale supply of Core Premium Movie channels was calculated using the average price approach.

Figure 17: Wholesale market shares including moderate 'out of market' constraints (calculated using expenditure on rights to movies)

	Sky					
	[50-60]%	[✂]%	[✂]%	[✂]%	[✂]%	[✂]%
2008	[50-60]%	[✂]%	[✂]%	[✂]%	[✂]%	[✂]%

Source: Ofcom calculations

2.230 Sky's market shares taking into account moderate 'out of market' substitutes remain high. Sky has a market share of [✂] [80-90%] if PPV movies, DVD rental subscription packages and legal movie downloads are taken into account. Sky also

[118] BVA Yearbook 2009, British Video Association, page 97.

has a market share of [✂] [50-60%] if library films are taken into account. Thus, based on these market share figures alone, movies broadcast on free to air channels would appear to impose a stronger constraint on Sky Movies than PPV movies, online DVD rentals and movie downloads. However, as explained in paragraph 4.318 of the main document, we consider that the characteristics of PPV movies and online DVD rentals are closer to those of Sky Movies. These services allow access to more recent movies whereas, in contrast, movies broadcast on FTA channels tend to be older (as explained in paragraph 4.318 of the main document consumers have a revealed preference for more recent films).

2.231 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. As discussed in section 4 of the main document, Sky provided material to support its argument that its Sky Movies channels are constrained. For example, Sky set out evidence that the number of subscribers to Sky Movies had fallen as has the real price.

2.232 We accept that looking at market shares alone might not be a reliable guide to market power[119]. However, we nonetheless consider that the high market shares set out above, in conjunction with the evidence on the extent of substitutability presented in section 4 of the main document, indicate that existing competitors only impose a weak constraint on Sky's movies channels. In particular, the alternative means of watching movies set out above lie outside of the relevant market (for the reasons set out in section 4 of the main document, we do not consider that Sky's evidence justifies the inclusion of these products within the relevant market). Accordingly the use of market shares will tend to *overstate* the extent of the competitive constraint exerted by these products, rather than understating it. Moreover, while Sky's market share is declining, this decline is from a very high level. Accordingly, while the evidence presented by Sky suggests that the intensity of competitive constraints may have increased in recent years, this does not imply that Sky no longer has market power, or that it is no longer dominant.

2.233 Figure 27 in the main document shows the value of films in different formats. This shows that demand for movies across all formats appears to have declined. Demand for over the counter DVD rentals and Sky Movies appear to be declining but this is offset by increased demand for PPV and online DVD rentals (albeit from small bases). Since the Second Pay TV Consultation we have obtained further evidence, [✂]:

- [✂].
- [✂].
- [✂] [120].

2.234 We consider that this evidence is consistent with our analysis above of market shares including 'out of market' constraints: while Sky's Core Premium Movie channels are subject to greater competitive constraints than was previously the case, Sky remains in a strong position.

[119] OFT Market Power Guidelines, paragraph 4.3.
[120] [✂].

2.235 Moreover, as set out in paragraph 4.370 of the main document, the [✂]. As noted in paragraph 4.371 of the main document, this is consistent with the view that Sky's wholesale prices are not constrained to competitive levels.

2.236 Our market power assessment looks into the future to consider whether Sky is likely to be dominant for the next three to four years. Given the recent sharp growth in online DVD rentals and legal downloads, we have also estimated what Sky's share of supply would be if that growth continues. Specifically:

- In 2008, Sky's revenue from the wholesale supply of Core Premium Movie channels was [✂] (under an average price approach; see confidential market share spreadsheet). We have assumed that Sky's revenue declines by 5% annually for the next four years. This implies that Sky's revenue in 2012 would be [✂].

- In 2008, Disney's revenue from the wholesale supply of Core Premium Movie channels was [✂] (see confidential market share spreadsheet). We have assumed that this remains unchanged in 2012.

- In 2008, the estimated value of online DVD rental services was £92m; this is 27% higher than the £77m value in the preceding year[121]. If this 27% growth were maintained for the next four years then retail revenues from online DVD rental services in 2012 would be £239.3m.

- In 2008, the estimated value of online PPV/VoD movies was £7m[122]. If this figure grows at 100% for the next four years then revenues from legal downloads would be £112m in 2012.

2.237 Given these assumptions, Sky's share of supply in 2012 would be [✂] [50-60%] (taking into account Core Premium Movie channels, online DVD rental services and legal downloads). While Sky's market share is still fairly high, it has declined by a material amount (under these assumptions). Moreover this [✂] [50-60%] figure does not take into account the constraint imposed by other television channels that broadcast movies (see Figure 17 above). On the other hand, these future market shares will tend to overstate the strength of the competitive constraint exerted by products outside of the relevant market.

2.238 Projecting future market shares (particularly for relatively new services like legal movie downloads) is an inherently speculative exercise. We thus only put limited weight on the [✂] [50-60%] share of supply in 2012 calculated above. The key implication that we draw is that Sky's Core Premium Movie channels may well be subject to a strengthening competitive constraint over the next three years. However, as noted above, Sky's position is currently strong and thus even if there is further erosion of that position it does not imply that Sky will no longer have market power, or that it will cease to be dominant.

2.239 As explained above, while we have calculated alternative market shares including moderate substitutes for Core Premium Movie channels, we have not carried out this calculation including more remote substitutes. In particular, although we have included online DVD rentals in the above calculation, we have not included DVD retail sales. In its 1 June 2009 submission Sky asserted that this is inconsistent as

[121] BVA Yearbook 2009, British Video Association, page 80.
[122] This a 1300% increase on the 2007 figure of £0.5m. BVA Yearbook 2009, British Video Association, page 97.

there is no difference in the strength of our reasoning on the extent to which these products are substitutes (paragraph 4.16), We do not agree. We recognise that if DVD retail sales were included in the relevant market then Sky would have a fairly low market share (approximately [✂] [10-20%])[123]. However we do not place any weight on this figure. This is because DVD sales are a remote substitute for Core Premium Movie channels, as evidenced by their very different characteristics and the pattern of retail price changes (see paragraphs 4.331-4.335 of the main document)[124].

Ofcom's conclusion on existing competitors

2.240 Our conclusion on existing competitors is as follows:

- Sky's share of the relevant market is over 90% and indicates that it holds a position of market power. Indeed such high market shares create a presumption that Sky possesses a dominant position in the relevant market[125]. If this share is retained over the next three to four years, we would expect any dominance to be retained over that period.

- We recognise the challenges in defining the boundaries of relevant markets within this sector and that products outside of the relevant market can exercise some degree of competitive constraint. Taking moderate 'out of market' substitutes into account reduces Sky's share of supply. However, looking at PPV movies, online DVD rentals and movie downloads (whose characteristics are relatively closer to those of Sky Movies, although they remain outside the relevant market), Sky's market share remains well above the 50% threshold that the ECJ has stated is associated with a presumption of dominance (in the absence of evidence to the contrary). While Sky's market share is significantly lower if movies broadcast on free to air channels are taken into account, it still remains above 40%. Moreover, we recognise that these alternative market share figures will overstate the strength of the competitive constraint exercised by moderate 'out of market' 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 remote 'out of market' substitutes. However we do not consider that this is a sufficiently borderline case for the effect of more remote substitutes to alter our conclusion. 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 possessing market power in the wholesale supply of Core Premium Movie channels and, in fact, a dominant position.

Entry by potential competitors and expansion by existing competitors

2.241 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

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[123] DVD retail sales in 2008 were £2.27bn. Source: BVA Yearbook 2009, British Video Association, page 28. Under an average price approach, we calculate that Sky's revenue from Core Premium Movie channels was [✂] in 2008 and Disney's revenue was [✂] (see confidential market share spreadsheet).

[124] Similarly, while we regard legal movie downloads as a moderate substitute for Core Premium Movie channels, we consider that illegal movie downloads are a more remote substitute – see paragraphs 4.352-4.353 of the main document.

[125] 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.

price down, at least in the long term[126]. We believe that there are, and, in the absence of further regulatory intervention will remain, important barriers to entry in this market.

2.242 In order to enter this market it is necessary to acquire the rights to the first TV subscription window of movies produced or licensed by the Major Film Production Groups (the “Movie Rights”)[127] [128].

2.243 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 2.101 above). Thus barriers to acquiring Movie Rights also act as barriers to expansion. Our analysis thus focuses on whether there are obstacles to acquiring the Movie Rights.

2.244 Below we explain:

- 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

2.245 The Movie Rights are sold following negotiations between interested parties and each individual Major Film Production Group. 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 FAPL 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.

2.246 The Major Hollywood Studios are not the only suppliers of the Movie Rights (other subsidiaries of the Major Film Production Groups also supply the Movie Rights). However we consider that they are likely to be the most important suppliers of the Movie Rights.

2.247 To illustrate the relative sizes of the Major Hollywood Studios, Figure 18 repeats Figure 12 from Annex 7 of the Second Pay TV Consultation. It sets out each the Major Hollywood Studios’ share of US box office receipts. These figures relate to the films distributed by the Major Hollywood Studios and thus include films produced by subsidiaries and some small third parties. We accept that these figures do not definitively set out the Major Hollywood Studios’ market shares (these figures relate to the US rather than the UK and in any event market shares are volatile, depending

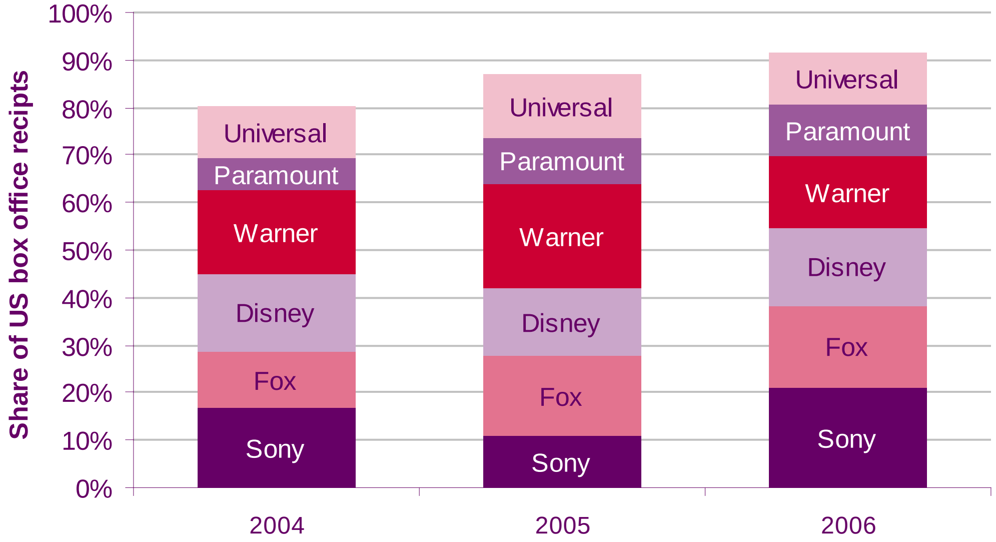
[126] *Assessment of market power*, OFT, December 2004, paragraph 3.3, second bullet.

[127] As explained in paragraphs 4.323-4.324 of the main document, a channel which includes the first TV subscription window of movies produced or licensed by any of the Major Film Production Groups would lie within the relevant market regardless of whether it is a linear channel or a subscription VoD channel. 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.

[128] This differs from the definition of the term “Movie Rights” set out in the Second Pay TV Consultation (for example at Annex 7, paragraph 3.9). This is a consequence of the change in our definition of the relevant market.

on the success of each Major Hollywood Studio's particular slate of films in a given year).

Figure 18: Major Hollywood Studios' shares of US box office receipts



Source: http://www.boxofficemojo.com, retrieved 12 March 2008.

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

2.248 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 assessing the scale of entry necessary to materially undermine Sky's wholesale position. As noted in paragraph 2.111 above (in the context of the Live FAPL 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).

2.249 Given the strength of Sky's current position, small scale entry and expansion is unlikely to materially 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 the Figure 18 above)[129]. Thus, even if entry on this scale were viable it is unlikely to be sufficient to materially undermine Sky's wholesale position. Rather, it would require a large shift from the status quo to undermine Sky's position materially.

2.250 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 mean by "majority" in this context, particularly as the

[129] 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%.

importance of a Major Film Production Group'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 Film Production Group's box office receipts in a particular year[130]. 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[131].

Sky is likely to win the majority of the Movie Rights

2.251 In principle, as Sky's current contracts with the Major Film Production Groups 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.

2.252 Our view is strongly supported by the historical evidence. Sky has always won the overwhelming majority 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.

2.253 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 [✂].

2.254 For example, [✂] [132]. [✂] [133]. [✂] [134].

2.255 A further possibility that we have considered is that Sky might not lose the movie rights to another bidder, but that a Major Film Production Group 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.

2.256 We consider that a Movie Rights holder that wished to directly exploit its rights faces material barriers to entry:

- 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

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[130] 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 'out of market' constraints presented in paragraphs 2.226-2.239 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.

[131] 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.

[132] [✂].

[133] [✂].

[134] [✂].

limited category of first run movies). This is notwithstanding the [✂] identified in paragraph 2.235 above and paragraph 4.370 of the main document.

- In paragraphs 2.257-2.273 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 Film Production Groups. For example, a single Major Film Production Group is likely to lose the synergies from aggregating Movie Rights if it directly exploited its own rights alone (see paragraphs 2.261-2.266 below). Whilst that Major Film Production Group 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 paragraphs 2.268-2.270 below). Any agreement which they did reach to sell their content jointly might also be subject to review under competition law.

- In any event, as explained in paragraphs 2.249-2.250 above, direct distribution by a single Major Film Production Group would be insufficient to materially undermine Sky's wholesale position.

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

2.257 We have received a number of explanations for Sky's persistent success in bidding for the Movie Rights. Given the clear historic position, we do not consider that it is necessary for us to form a concluded view on which factors explain Sky's strong bidding position for the Movie Rights, particularly as consultation respondents have not argued to us that there is likely to be a material strengthening in the position of rival bidders in the future. Nonetheless below we set out evidence in support of the following factors:

- The impact of the staggered expiry of Sky's contracts with the Major Film Production Groups.

- The delay that a new entrant would face in building a subscriber base.

- The efficiency advantages (such as avoiding double marginalisation and greater certainty about wholesale income) that may flow from bidders such as Sky being vertically integrated with pay TV retailers with a significant subscriber base.

- Bidder specific factors.

2.258 We do not have a settled view on the relative importance of each of these different factors, although as explained in paragraphs 4.35-4.37 below there is some evidence that the third of these factors is relatively less important than the others. However, we consider that in aggregate they are likely to contribute to Sky being likely to win the majority of the Movie Rights. These factors also suggest that there are significant barriers to a rights holder such as a Major Film Production Group exploiting its rights directly, for example by developing its own movie channel.

Staggered expiry dates

2.259 The existing contracts licensing the Movie Rights to wholesale channel providers terminate at different times. In the First Pay TV Consultation (at Annex 13, paragraph 5.67) and in the Second Pay TV Consultation (at Annex 7, paragraphs 3.20-3.25) we considered whether the staggered availability of Movie Rights acts as a barrier to entry.

2.260 In paragraphs 2.57-2.58 of the Second Pay TV Consultation we explained why there are circumstances in which the staggered availability of rights could act as an entry barrier. This reasoning was not challenged and we thus continue to regard it as correct. We consider that the key issue is factual, namely is there evidence that staggered availability of rights is in fact a barrier to entry?

2.261 As explained in paragraphs 2.170 above, a prerequisite for the staggered availability of rights to be an entry barrier is the existence of synergies between different rights that are sold at different times. We consider that there are two possible sources of synergy between Movie Rights from different suppliers:

- Competition dampening effects from combining substitutable rights.
- Potential benefits from having sufficient content to fill a pay TV channel.

2.262 In terms of the first synergy, we consider that the Movie Rights from different suppliers are substitutable. By aggregating a significant volume of Movie Rights, a wholesale channel provider is able to dampen the competition that would otherwise exist at the wholesale level between competing Core Premium Movie channels. Dampening competition in this way is likely to enable the wholesale channel provider to extract greater rents from retailers and ultimately final consumers. Our market definition (i.e. that the supply of Core Premium Movies channels is a relevant market) suggests that, where a single wholesaler acquires a high proportion of the Movie Rights, this effect is material[135].

2.263 The second potential synergy is that a channel is more attractive to final consumers if it has a large volume of movies, for example because this reduces the number of repeats and ensures that there is sufficient regular, attractive content to fill the channel. Paragraph 3.21 of Annex 7 of the Second Pay TV Consultation discussed the minimum volume of rights needed to viably launch a Core Premium Movie channel. We consider that a broadcaster could viably enter the market with only a small amount of Movie Rights (as shown by Disney Cinemagic, which also broadcasts older films as well as non-movie content such as cartoons)[136]. However broadcasters with a small amount of Movie Rights will generate synergies by adding further Movie Rights.

- [✂] [137].
- [✂] [138]. [✂] [139]. [✂] [140].

2.264 In its response to the Second Pay TV Consultation, Virgin Media argued that the rights of at least three studios would be required in order to assemble “an appealing package which could be marketed as a mid-priced alternative to Sky Movies”

[135] This is also consistent with our profitability analysis in section 6 of the main document in which we conclude that Sky’s aggregate return is greater than its cost of capital and that its margin over direct costs is higher on Sky Movies than on Sky Sports.
[136] Similarly, in its response to the First Pay TV Consultation, Sky argued that evidence from the US shows that channels based on the Movie Rights of one or two Major Hollywood Studios can be viable. Moreover, Sky argued that channels could combine movies with other content, such as sports, comedy, drama etc (e.g. HBO in the US).
[137] [✂].
[138] [✂].
[139] [✂].
[140] [✂].

(paragraph 4.7). This is because "The movie rights available from a single studio simply do not provide the volumes required to create an appealing package. Depending on its size, a single studio might release in the region of 20 to 25 current movies per annum … of which … less than half will be significant titles for which there is a strong demand. A service which might only be able to offer less than one significant title a month is unlikely to attract significant subscribers" (paragraph 4.8). Further "movie rights from more than one studio [acts] as a risk pooling measure because the success of studios in producing popular titles … will vary from year to year" (paragraph 4.10). This supports the view that there are synergies between Major Film Production Groups' Movie Rights.

2.265 We thus consider that synergies do exist between different suppliers' Movie Rights. Where the buyer currently has a significant amount of Movie Rights (as is the case with Sky), the competition dampening effect is likely to be material. Where the buyer has few Movie Rights then adding further rights is likely to disproportionately increase the attractiveness of their channel.

2.266 This implies that a bidder which already has a small number of Movie Rights (from one or perhaps two Major Film Production Groups) or a bidder with a large number of Movie Rights (say from four or five Major Film Production Groups) generates more value from an additional set of Movie Rights than an entirely new entrant. This suggests that a putative new entrant (with no Movie Rights) may face difficulties in acquiring its first set of Movie Rights. However acquiring subsequent Movie Rights may be easier. This is supported by internal Virgin Media documents which state that a benefit of an agreement with [✂] is that it [✂] [141].

2.267 Having concluded that synergies exist between different Major Film Production Groups' Movie Rights it is then necessary to consider whether the termination dates of their agreements to license their Movie Rights are sufficiently staggered that a new entrant would face a material disadvantage.

2.268 Figure 19 below shows the dates on which Sky's current contracts with the Major Hollywood Studios expire. The average gap between Major Hollywood Studios' agreements with Sky expiring is [✂] (and obviously there is no guarantee that a rival bidder will win the next set of available rights, so in practice a new entrant may expect a longer delay in acquiring additional rights)[142].

Figure 19: Expiry dates of Sky's current contracts with the Major Hollywood Studios

[✂]

Sources: Sky response dated 13 May 2008 to question 1 of Ofcom's information request dated 20 December 2007 (as amended by Sky's letter of 6 August 2008 and Sky's letter of 19 February 2009). Note that Disney and Sony exercised options to extend the term of their existing contract with Sky.

2.269 In paragraph 3.23 of Annex 7 of the Second Pay TV Consultation we stated that [✂]. We observed that this would appear to give a new entrant a number of opportunities to acquire Movie Rights. However, new entrants have not taken advantage of this opportunity [✂].

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[141] [✂].

[142] The timing of negotiations between a Major Hollywood Studio and potential bidders is not fixed. For example, [✂] in advance of the expiry of Warner's then agreement with Sky (in [✂]). [✂].

2.270 As noted in the Second Pay TV Consultation, it may be possible for a new entrant to reflect the synergies between different Major Film Production Groups' Movie Rights through appropriate contractual terms. For example, a new entrant might reach an agreement with the first Major Film Production Group at a price that is conditional on acquiring the Movie Rights from a second Major Film Production Group. However since Sky has consistently won all the Movie Rights we have not observed such contractual provisions being used in practice and such arrangements would potentially be difficult to agree commercially.

2.271 In conclusion, we explicitly placed less weight on the staggered availability of Movie Rights in the Second Pay TV Consultation than in the First Pay TV Consultation. Nonetheless the Second Pay TV Consultation identified this as a material entry barrier (Annex 7, paragraph 3.25) and we maintain this position[143].

Delays for new entrants when building a subscriber base

2.272 As explained in paragraphs 2.134-2.142 above, there is evidence that, were a firm to acquire Live FAPL Rights for the first time, there is a delay while it builds up a subscriber base to comparable levels to those that could be attained by the current rights holder(s). We consider that it is likely that a firm that acquires the Movie Rights for the first time would experience a similar delay in building up its subscriber base. This delay reduces the value of the Movie Rights to a potential new entrant. As a result, the incumbent rights holders (namely Sky for the vast majority of the Movie Rights) are more likely to be able to outbid potential new entrants.

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

2.273 In the Second Pay TV Consultation, we set out our view about the role of retail subscriber bases and asymmetries between bidders for particular rights. Specifically we considered that Sky is the most effective retail outlet on the largest platform and that third parties are unable to access that outlet as efficiently. As a result, we considered that Sky enjoyed an advantage over potential rival bidders for the Movie Rights. The logic and evidence underpinning this line of reasoning is set it out separately in section 4 of this Annex.

Bidder specific factors

2.274 We recognise that there may also be factors that affecting the specific circumstances of particular bidders. In particular, as noted in paragraph 2.146 above (in the context of the Live FAPL Rights), free to air broadcasters may have a very different willingness to pay (reflecting their different revenue streams).

Consultation responses

2.275 In general, the points made by respondents to both the First Pay TV Consultation and the Second Pay TV Consultation in relation to movie 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

[143] In contrast, we recognise that the staggered availability of sports rights is capable of acting as a barrier to entry but do not rely on it in this document (paragraph 2.175 above). This is because we have more information on the extent to which Movie Rights' contracts are staggered, the competition dampening effect is likely to be stronger (whereas between different sports it is weak) and (in contrast to sports) no party other than Sky has a material amount of Movie Rights.

Sports channels. Other consultation responses that are specific to Core Premium Movie channels have been addressed in the course of our analysis above.

Conclusion on barriers to entry and expansion

2.276 As explained in paragraphs 2.11-2.14 above, we are assessing whether Sky possesses market power in the wholesale supply of Core Premium Movie channels. 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 is likely to enjoy 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 in fact consistent with Sky possessing a dominant position.

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

Countervailing buyer power

2.278 The only major independent purchaser of Sky Movies channels is Virgin Media, although a number of other parties have sought to acquire these channels. As with Core Premium Sports 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.

2.279 In both the First Pay TV Consultation and the Second Pay TV Consultation 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. The responses to both the First Pay TV Consultation and the Second Pay TV Consultation on CBP did not draw a distinction between sport and movies channels. We consider that the points set out in paragraphs 2.192-2.206 above apply equally here. We recognise that cable operators offer on demand PPV films that are, to an extent, an alternative to Sky Movies[144]. [✂][145].

2.280 Our overall position on CBP with respect to movies is the same as that for the wholesale supply of 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). We

[144] Sky also referred to these services in its 1 June 2009 submission at Annex 1, paragraph 3.39.
[145] [✂].

therefore believe that no party exercises sufficient buyer power to counter Sky's seller power in the wholesale supply of Core Premium Movie channels.

Conclusions on market power in the wholesale supply of Core Premium Movie channels

2.281 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, we consider that Sky holds market power in the wholesale supply Core Premium Movie channels. In fact we consider that Sky holds a dominant position in that market, and that it is likely to be dominant for the next three to four years.

Section 3

Retail markets

Introduction

3.1 This section is structured as follows:

- First, we summarise the position in the First Pay TV Consultation and Second Pay TV Consultation and provide a high level summary of the responses to those consultations.
- Second, we explain the purpose of assessing retail market power and set out the tests that we have applied when carrying out that assessment.
- Third, we consider a number of overarching arguments that have been advanced by Sky.
- Fourth, we analyse the supply of retail television bundles containing Core Premium Sports channels.
- Fifth, we analyse the supply of retail television bundles containing Core Premium Movie channels.

The previous consultation documents

The First Pay TV Consultation

3.2 In the First Pay TV Consultation we considered that the "retail of packages containing premium sports channels" and the "retail of packages containing premium movie channels" were relevant markets (paragraphs 2.2-2.3 above set out the definition of "premium sports" and "premium movies" used in the First Pay TV Consultation). We considered that Sky was dominant in both these markets (Annex 13, paragraphs 5.38 and 5.63)[146].

3.3 Sky strongly disagreed that it held a dominant position at the retail level (one reason for this was that it disagreed with the market definitions set out in the First Pay TV Consultation). The Four Parties broadly agreed with Ofcom's position in the First Pay TV Consultation although they did criticise aspects of our analysis of basic-tier channels.

The Second Pay TV Consultation

3.4 In the Second Pay TV Consultation we did not define retail markets and accordingly did not formally assess retail market power.

3.5 In its response to the Second Pay TV Consultation, Sky considered that the scope and the extent of competition within the relevant downstream market(s) were

[146] In the First Pay TV Consultation, we also considered that the "retail of stand-alone basic-tier TV packages" was a relevant market. We considered that "basic pay TV services is essentially a duopoly between Sky and Virgin Media with a growing competitive fringe … Although competition between Virgin Media and Sky may not have been particularly intense historically … it is likely to be sufficient to ensure that no firm is individually dominant" (Annex 13, paragraph 5.87).

important. Similarly, the Four Parties considered that failing to assess market definition and market power in relation to the supply of premium channels at the retail level was a material omission. These arguments are considered paragraphs 4.6-4.9 of the main document.

Approach to the assessment of retail market power

3.6 We assess market power in the relevant retail markets defined in section 4 of the main document:

- Retail television bundles containing Core Premium Sports channels.
- Retail television bundles containing Core Premium Movie channels.

3.7 Retail and wholesale price levels and the extent of retail and wholesale competition are interrelated. Given that Sky is vertically integrated and (as discussed above) enjoys a dominant position in the wholesale supply of Core Premium channels, it is important to be clear about what the concept of 'retail market power' means in this context. Our assessment covers three separate issues, each of which is explained in further detail below:

- The ability to sustain retail prices appreciably above the competitive level.
- The ability to sustain retail margins appreciably above the competitive level.
- The position at the retail level if wholesale market power were not exercised.

The ability to sustain retail prices appreciably above the competitive level

3.8 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).

3.9 Footnote 13 of the OFT's guidelines on market definition also states that[147]:

> "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."

3.10 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[148]. Clearly this is a somewhat artificial test since Sky is dominant in the wholesale supply of Core Premium channels.

[147] 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

[148] 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.

The ability to sustain retail margins appreciably above the competitive level

The impact of wholesale market power on retail prices

3.11 As explained in section 2 above, we consider that Sky is dominant in the wholesale supply of Core Premium channels. That upstream dominance in the supply of a key input into the relevant retail markets has important consequences for the standard approach to assessing retail market power (namely the ability to sustain retail prices appreciably above the competitive level).

3.12 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 fiercely competitive, no retailer (including the vertically integrated firm's retail arm) has the ability to earn an excessive retail margin.

Sky's response to the First Pay TV Consultation

3.13 Sky has raised these issues. In paragraphs 47-49 of Annex 4 of Sky's response to the First Pay TV Consultation, CRA referred to the "double counting" of market power by Ofcom. For example, CRA stated that, in the First Pay TV Consultation, 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.

3.14 In that submission CRA also argued that, when evaluating a vertically integrated firm's incentives to foreclose downstream competitors, what matters is the structure of the downstream market at the time when the vertically integrated firm decides whether and on what terms to supply downstream firms. Accordingly, CRA considered that market power at the retail level must be gauged before the premium content that is the basis for market power upstream is "allocated" downstream. CRA did not explain how its favoured approach should be carried out or what the term "allocated" means in this context.

Ofcom's approach

3.15 We agree with Sky that, given the structure of the pay TV industry, such "double counting" risks giving a misleading impression. As illustrated by the example in paragraph 3.12, where a firm is vertically integrated and in a strong (dominant) position at the wholesale level it may well choose to earn any excessive returns at the wholesale level, rather than at the retail level[149]. It would do this by setting a high

[149] Clearly the ability of a vertically integrated firm to earn excessive returns at the wholesale level, rather than the retail level, depends on the strength of its wholesale position. Where a firm possesses a great deal of wholesale market power, the additional impact of its retail position may be limited. In

wholesale price (including a high implicit transfer price that is paid by its own vertically integrated retail arm). Whilst the firm may be deemed to possess retail market power under the standard approach – because it can set retail prices that are appreciably above the competitive level – the true source of that market power may in fact lie at the wholesale level. In these circumstances, a strong retail position may not give the vertically integrated firm any *additional* scope to raise retail prices above the level that would prevail if it only had wholesale market power. In other words, having a strong retail position may add little or nothing to the market power that the vertically integrated firm already enjoys at the wholesale level.

3.16 However we do not consider that CRA's approach of gauging retail market power before Core Premium channels have been "allocated" downstream is the appropriate way to address the "double counting" issue.

- First, underlying CRA's approach is the assumption that the purpose of the retail market power assessment is to "[evaluate] the vertically integrated firm's incentives to foreclose". We do not agree. The assessment of the incentives facing Sky is carried out in section 6 of the main document. Instead we consider that an informative question to ask in the context of the market power assessment is whether Sky enjoys an appreciable degree of market power at the retail level, over and above the market power it already enjoys by virtue of its dominant position at the wholesale level.

- Second, it is entirely unclear how CRA's approach would be carried out in a way that produces informative results. If CRA's intention is that the exercise would be carried out assuming that no retailers had access to Core Premium channels (because they have not yet been "allocated" downstream) then clearly it is not possible for any retailer to supply the products of interest (namely retail television bundles including Core Premium channels). If CRA's intention is instead that the exercise would be carried out assuming that all retailers had access to Core Premium channels then clearly it is not assessing the status quo. Rather it is more akin an impact assessment of the effects of potential remedies. Although this question is of some interest (see in particular paragraphs 3.42-3.61 and 3.79-3.80 below), it looks at a hypothetical situation. It does not shed light on the current operation of the market, given that not all retailers currently have access to Core Premium channels.

3.17 Instead our approach is as follows. We recognise that retail prices could be above the competitive level for two reasons:

- First, because the wholesale price is above the competitive level; and/or

- Second, because the retail margin (over and above the wholesale price) is higher than the margin that could be earned in a competitive market.

3.18 We have thus also considered whether Sky enjoys the ability to earn a retail margin that is appreciably above the competitive level. In doing so, we have taken into account Sky's wholesale position. This approach thus directly focuses on whether Sky has the ability to exercise an appreciable degree of market power at the retail level, over and above the market power it already enjoys by virtue of its dominant position at the wholesale level.

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contrast, a vertically integrated firm with a weaker wholesale position (but nonetheless a degree of wholesale market power) is likely to have less scope to extract any monopoly profits at the wholesale level and thus its retail position becomes more important to it.

3.19 It is important to be clear what is meant by the term "retail margin" in the case of a vertically integrated firm. For the purposes of this approach, the retail margin reflects the margin earned by the vertically integrated firm minus the wholesale margin that it earns on sales to third parties. Thus a rise in the wholesale margin will reduce the vertically integrated firm's retail margin unless it also increases its retail prices by a commensurate amount. Similarly a rise in the vertically integrated firm's retail prices will increase its retail margin unless it also increases wholesale prices by a commensurate amount[150].

The position at the retail level if wholesale market power were not exercised

3.20 The discussion above highlights the interrelationship between the situation at the wholesale and retail levels. Given that we have concluded that Sky possesses market power at the wholesale level, this raises the question of how strong retail competition would be if Sky did not exercise its wholesale market power[151]. For example, how strong would competition between existing retailers be in this situation (which, in turn, depends on factors such as whether there are significant switching costs which might mute retail competition)? Similarly, are there other material barriers to entry, apart from access to wholesale Core Premium channels (which is relevant to whether additional entry would occur)? Thus, in the analysis below, we identify factors that are relevant to this question[152].

3.21 We consider that this part of our analysis is relevant to our assessment of remedies in section 10 of the main document. For example, in order to evaluate the extent to which a particular remedy would increase retail innovation, it is necessary to understand how strong retail competition would be if that remedy were in place. For the avoidance of doubt, we do not consider that carrying out this analysis as part of our assessment of market power in any way prejudges our assessment of whether there are competition concerns and (if so) what remedy (if any) is appropriate. Market definition and the assessment of market power *always* look ahead to later parts of the analysis. For example, the market definition exercise is carried out to inform the assessment of a particular competition concern. However this in no way presupposes that there will subsequently be a finding that that competition concern is well founded.

Broader evidence advanced by Sky

3.22 In its responses to the First Pay TV Consultation and the Second Pay TV Consultation, Sky referred to broader evidence including the absence of excessive profits and outcomes for consumers. This evidence is addressed in paragraphs 2.36-2.46 above.

[150] We note that the wholesale price at which Sky currently sells to third parties is not necessarily the same as the price which a dominant stand-alone wholesaler would set (i.e. a wholesale channel provider that is not vertically integrated).
[151] In terms of wholesale pricing and supply arrangements (including whether or not particular retailers are supplied).
[152] A closely related question is whether Sky would enjoy market power at the retail level if the source of its wholesale market power were removed. As well as the extent of retail switching costs, differentiation and barriers to entry, evidence such as the level of market shares in this hypothetical situation would be relevant to this question. We have not carried out this alternative test, in particular because there is considerable uncertainty about what the level of market shares would be in the hypothetical situation where Sky's wholesale market power had been removed.

Retail television bundles containing Core Premium Sports channels

3.23 At least until very recently Sky, Virgin Media, Setanta, Top Up TV and BT Vision retail Core Premium Sports channels[153] [154]. Sky retails Sky Sports 1 and 2 on its DSat platform[155]. Virgin Media retails Sky Sports 1 and 2 and Setanta Sports 1 on its cable platform. Setanta retails Setanta Sports 1 on Sky's DSat platform and to customers using DTT platforms. Top Up TV and BT Vision both retail Setanta Sports 1 on their respective DTT platforms. These channels are only available as part of a bundle that includes other channels (e.g. so-called basic-tier channels or other Setanta Sports channels). Retail bundles may also include other television related components (e.g. a set top box) and non-television components (e.g. broadband, voice telephony).

3.24 In the following pages we:

- First, briefly consider whether Sky possesses a dominant position applying the 'standard' approach to assessing retail market power (namely the ability to charge retail prices appreciably above the competitive level).
- Second, consider whether Sky has the ability to charge a retail margin that is appreciably above the competitive level.
- Third, set out some factors that are relevant to the extent of retail market competition absent the exercise of wholesale market power.

The ability to sustain retail prices appreciably above the competitive level

Current retail market shares

3.25 We have estimated market shares by calculating the proportion of the 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. The details of our calculations are set out in a separate confidential spreadsheet. We make the following observations on the calculation of these figures:

- These market shares were calculated using the revenue earned from bundles rather than just the Core Premium Sports channels. This corresponds with our market definition (which refers to the "television bundles" rather than just the Core Premium Sports channels that are a component of those bundles). We have attempted to include the entire revenue earned from any retail television

[153] Setanta Sports 1, Sky Sports 1 and Sky Sports 2 are also available on Tiscali's IPTV platform and from some smaller cable retailers (Wight Cable and Smallworld Media Communications). However few subscribers access these channels from these platforms and thus we do not discuss them further in this section.
[154] Obviously this position may change following Setanta's loss of the Live FAPL Rights from 2009/10 onwards. At the time of writing, ESPN has not yet reached distribution agreements with retailers other than Sky although it has announced its intention to widely distribute its channel. Since these developments have occurred at an extremely late stage in our analysis, and given the considerable uncertainties surrounding Setanta and ESPN at the time of writing, the market share calculations set out below relate to the position prior to Setanta's loss of the Live FAPL Rights.
[155] Sky also directly retails its channels over Tiscali's IPTV platform.

bundle that includes a Core Premium Sports channel, including any mandatory non-television components[156].

- The range and complexity of pay TV retailers' retail pricing and the differing extent to which products are tied together at the retail level makes it difficult to devise a consistent, informative measure of retail revenue. For example, we have included the cost of a size "M" telephony package from Virgin Media since that product is necessary to obtain television packages from Virgin Media. However, we have not included the revenue Sky earns from its telephony packages since they are not a prerequisite for purchasing television packages from Sky. Similarly we have included the retail revenue from certain additional basic-tier TV channels such as purchasing an "XL" package rather than a "M" package from Virgin Media or purchasing additional "mixes" from Sky. However we have not included the revenue from additional services such as multiroom or PPV.

- There are a number of limitations to the data that we have been able to obtain, particularly in relation to Virgin Media. Virgin Media had difficulties providing us with comprehensive data on the prices it has charged for all the retail bundles that include Sky Sports (although it did provide data on the most popular packages, which account for 80% of subscribers to Sky Sports and Sky Movies)[157]. We have thus inferred the missing data from the prices prevailing in March 2009. Similarly, Virgin Media did not provide us with data that allowed us to identify the other components of retail bundles that include the "Setanta Bundle" (i.e. Setanta Sports purchased as additional channels). We have thus had to assume whether such subscribers take a "M" or "L" television package and whether or not they subscribe to Sky Sports and/or Sky Movies[158]. Similarly we do not have data on the price BT Vision charged for Setanta Sports prior to August 2008 and have thus assumed that the price in earlier months was the same as the August 2008 price.

- We thus accept that there are limitations with the data underlying our calculations and with our ability to compile that data. As a result of this imprecision, retail market shares should be treated as rough indicators. However, as shown below, the results of these calculations are very clear cut and we thus consider that the overall conclusions that can be drawn are reliable.

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[156] For example, Setanta Sports 1 is available on DSat as a bundle with other Setanta Sports channels for £12.99/month. We have used the entire retail revenue from that bundle. Similarly, where a household subscribes to Sky's dual sports package and one basic mix (for a price of £35.50/month) we have used the entire retail price of that bundle. A household that subscribes to Virgin Media "M" television package plus Sky's dual sports package ostensibly receives the basic "M" package for 'free' whilst paying £30/month for the additional sports channels. However that package is only available if the household purchases a phone line from Virgin Media for £11 month. Since that phone line is a mandatory component of the television bundle we have used the overall bundle price of £41/month when calculating retail market shares.

[157] Letter from Virgin Media dated 18 March 2009 commenting on Ofcom's draft information request dated 13 March 2009.

[158] We have assumed that 50% of "Setanta Bundle" subscribers take a M television package and 50% take a L television package. We have also assumed that 15% of these subscribers do not subscribe to Sky Sports or Sky Movies, 35% subscribe to Sky Sports, 5% subscribe to Sky Movies and 45% subscribe to Sky Sports and Sky Movies. This is not inconsistent with a November 2007 survey by Ofcom that found that 83% of Setanta Sports subscribers also subscribe to Sky Sports. Ofcom pay TV small platforms research, November 2007. Base: Setanta subscribers on DSat (155).

3.26 The results of our calculations are summarised in Figure 20 below. In this figure, we have aggregated the negligible retail market shares of Setanta, Top Up TV and BT Vision. Because these market shares were calculated based on the revenue earned from retail television bundles containing Core Premium Sports channels, this has the effect of depressing the market share of retailers such as Top Up TV and Setanta that supply smaller bundles for a lower price.

Figure 20: Market shares in the supply of retail television bundles containing Core Premium Sports channels (calculated on a revenue basis)

	Sky	Virgin Media	Others
2H 2007	[70-80]%	[20-30]%	[0-10]%
1H 2008	[70-80]%	[20-30]%	[0-10]%
1H 2008	[70-80]%	[20-30]%	[0-10]%

Source: Ofcom calculations

3.27 As indicated by Figure 20, Sky accounts for a very high proportion of the revenue earned from the supply of retail television bundles containing Core Premium Sports channels. Virgin Media is the only other retailer with a material market share.

<u>Retail market shares including ‘out of market constraints’</u>

3.28 As explained in section 4 of the main document, on balance we took the view that only retail television bundles including Sky Sports 1 and 2 and Setanta Sports lay within the relevant market. However we recognised that there was nonetheless a degree of substitutability with channels outside of the relevant market and thus that suppliers of other channels (including free to air channels) will exert some constraint on Sky’s retail business. In order to understand the extent of the constraint imposed by these ‘out of market’ products, we have calculated market shares as if moderately substitutable content on those other channels were within the relevant market. These market shares provide an upper estimate for the strength of the competitive constraint that may be exercised by products that lie somewhat outside of the relevant market but that may nonetheless act as (imperfect) substitutes.

3.29 As part of our analysis of the wholesale supply of Core Premium Sports channels, we presented broadcasters’ shares of expenditure on leading events in the main sports broadcast on Sky Sports 1 and 2 (namely football, cricket, tennis, golf, rugby union and rugby league). We have calculated retailers’ share of supply of these channels on the same basis – see Figure 21 below. This has been done by using subscriber numbers to split the share of the wholesale market accounted for by Sky Sports and Setanta Sports between the various retailers of those channels. Note that, unlike the market shares presented in Figure 20 above, this measure does not include other components of retail bundles such as basic channels containing no sports. However it does shed light on the strength of different retail level suppliers of sports content.

Figure 21: Market moderate ‘out of mark rights)

Sky	Virgin Media	BBC	ITV	Setanta	Other
[50-60]%	[10-20]%	[0-10]%	[10-20]%	[0-10]%	[0-10]%

Source: Ofcom calculations

3.30 On this measure Sky still possesses a high market share, although not as high as under our favoured market definition. This reflects both the inclusion of sport on other channels (including free to air channels) and the exclusion of other components of the retail bundles supplied by Sky (which increases the market share of retailers that supply much smaller bundles, such as Setanta).

<u>Barriers to entry and expansion</u>

3.31 In principle, a firm could enter the market and begin supplying retail television bundles containing Core Premium Sports channels by acquiring such channels from Sky and/or Setanta. In principle, a potential entrant might use a number of distribution technologies:

- Cable;
- Sky’s DSat platform;
- A DSat platform other than Sky’s;
- DTT; and/or
- IPTV.

3.32 However, currently Sky only wholesales its Core Premium Sports channels to itself and retailers using cable as a distribution technology. As discussed in section 6 of the main document, retailers using IPTV and DTT as a distribution technology have been unable to reach an agreement with Sky to purchase Sky Sports. We thus consider that it is very unlikely that retailers using a distribution technology other than cable will be able to acquire Sky’s Core Premium Sports channels. This lack of access to these channels acts both as a significant entry barrier and as a barrier to expansion for retailers (such as BT Vision and Top UP TV) that currently do not retail Sky’s Core Premium Sports channels.

3.33 Moreover, we do not consider that it is plausible that a new entrant retailer would use cable as a distribution technology. Virgin Media’s cable platform is currently closed i.e. Virgin Media does not permit third party retailers on that platform. Establishing a new cable network would be time consuming and extremely costly.

3.34 In contrast, Setanta has reached agreements with a number of retailers using a variety of distribution technologies. There thus seems few barriers to acquiring access to Setanta Sports 1 and this might allow new retailers to begin supplying retail television bundles containing Core Premium Sports channels (as has previously been the case for both BT Vision and Top Up TV). The same logic might also hold in relation to acquiring ESPN's channel (given that it has reportedly acquired the Live FAPL Rights previously held by Setanta).

3.35 However we consider that such potential entry would be unlikely to constrain Sky's retail prices for the supply of bundles containing Core Premium Sports channels. As explained in paragraphs 2.87-2.88 and 2.98 above and as demonstrated by the relative wholesale market shares of Sky and Setanta (see Figure 3 above), Setanta Sports 1 is less attractive to final consumers than Sky Sports 1 and 2. The same logic is likely to apply to third parties such as ESPN that acquire rights previously held by Setanta (such as the Live FAPL Rights for the 2009/10 season onwards). This will be compounded by Sky's acquisition of 50% of the games Setanta previously broadcast from the 2010/11 FAPL season onwards. Accordingly, a new entrant that only retails bundles including Setanta Sports 1 (or successor channels that acquire rights currently held by Setanta) is likely to exert a comparatively weak constraint on Sky's retail business. This view is confirmed by the negligible market shares that BT Vision and Top Up TV (which have both entered the market by acquiring Setanta Sports 1) have been able to secure, as shown in Figures 20-21 above[159].

Countervailing buyer power

3.36 Retail television bundles containing Core Premium Sports channels are supplied to individual residential households. Individual households do not possess buyer power to offset any seller power that exists.

Conclusion on the ability to sustain retail prices appreciably above the competitive level

3.37 Sky enjoys a high retail market share in the retail supply of bundles containing Core Premium Sports channels. Indeed Sky's market share is above the 50% threshold at which dominance can be presumed, in the absence of evidence to the contrary[160]. Moreover, we consider that there are significant barriers to entry and expansion, including non-cable retailers' lack of access to Sky's Core Premium Sports channels. There is no CBP. Accordingly, applying the 'standard' market power test, the conclusion is that Sky enjoys a dominant position that gives it the ability to sustain retail prices appreciably above the competitive level.

3.38 However, it is important to recognise the limitations of this conclusion. As explained in paragraphs 3.11-3.12 above, it does not imply that Sky enjoys any additional market strength (over and above its position at the wholesale level) by virtue of its retail position. The implicit assumption underpinning this 'standard' dominance test (namely that all wholesale prices are at the competitive level because the wholesale market is fiercely competitive) does not hold – rather the wholesale supply of Core Premium Sports channels is characterised by Sky's dominance. Moreover, we do not consider that the finding of retail 'dominance' (applying this test) is a necessary precondition for the competition concerns set out in section 6 of the main document. Rather those competition concerns centre on Sky's conduct at the wholesale level.

[159] Moreover, as discussed in paragraphs 3.57-3.59 below, entry by retailers using DSat, IPTV or DTT as a distribution technology is involves a number of additional costs.
[160] See also the discussion of switching costs in paragraph 3.45-3.51 below.

The ability to sustain retail margins appreciably above the competitive level

3.39 We now consider the more interesting question of whether, given the current level of wholesale prices (including the implicit wholesale price paid by Sky's retail arm), Sky enjoys the ability to sustain retail margins that are appreciably above the competitive level.

3.40 Logic and the available evidence suggests that Sky does not enjoy a material amount of market power in the retail supply of bundles containing Core Premium Sports channels, over and above its dominant position in the wholesale supply of Core Premium Sports channels:

- First, Sky stated that its wholesale prices are designed to satisfy the conditions of the margin squeeze test [✂][161]. This suggests that Sky's wholesale prices are unlikely to allow an excessive 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.

3.41 Accordingly we do not consider that there is sufficient evidence to conclude that Sky enjoys the ability to sustain retail margins that are appreciably above the competitive level.

Extent of retail competition absent the exercise of wholesale market power

3.42 Amongst other things, the discussion above highlights that:

- The inability of non-cable retailers to obtain access to Sky's Core Premium Sports channels acts as a barrier to entry and expansion.

- There is insufficient evidence to conclude that retailers are able to earn high retail margins, given that Sky's dominant wholesale position potentially enables it to reap any profits at the wholesale rather than the retail level.

3.43 This raises the question of what would be the extent of retail competition if these features were not present. In other words, what would be the extent of retail competition if retailers had access to Sky's Core premium Sports channels at an appropriate wholesale price i.e. if Sky did not exercise its wholesale market power.

3.44 Below we discuss the following factors:

- Switching costs between retailers.

- The extent of product differentiation between retailers.

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[161] [✂].

- Whether there are additional barriers to entry.

Switching costs

3.45 We discussed switching costs between retailers in the First Pay TV Consultation and the Second Pay TV Consultation[162]. We stated that these costs vary considerably and depend on which retailer a customer is switching to and from (see for example paragraphs 6.60 to 6.65 of the Second Pay TV Consultation):[163].

- Barriers to switching are lowest for consumers switching between different retailers on the same pay TV platform. For instance, switching from Sky to Setanta on Sky's DSat platform requires no hardware changes. However in paragraph 2.102 of Annex 7 of the Second Pay TV Consultation we noted the delay Setanta has experienced in building up its subscriber base and concluded that it might reflect consumer inertia and lower awareness of Setanta's services compared to those of Sky.

- The second lowest type of switching barrier is switching between platforms on the same distribution technology – for example between two different DTT-based platforms.

- We stated that switching will be more complex when switching between retailers on different platforms. However these costs are affected by the distribution technology used by the retailer that the subscriber is switching to:

    - We considered that retail customer switching costs to Sky's DSat service or Virgin Media's cable service were high. These costs include set-top box costs, installation costs, the possible inconvenience associated with the installation process and unfamiliarity with alternative platforms[164]. According to our research, 75% of Virgin Media customers and 80% of Sky subscribers claim never to have switched service provider (Ofcom pay TV consumer research phase 3, First Pay TV Consultation, Annex 14).

    - In contrast, we stated that the cost of switching to IPTV or DTT-based platforms might be somewhat less costly. IPTV or DTT-based platforms involve reduced additional changes in hardware in comparison to cable and satellite. Although changing to these platform requires a new set-top box, IPTV-based platforms use the existing telephone line and DTT-based platforms use the existing aerial.

3.46 In the Second Pay TV Consultation, we stated that further switching costs may arise due to the bundling of pay TV and other services. For example, BT Vision is only available to consumers purchasing retail broadband from BT Vision, so consumers

[162] Where retailers are unable to price discriminate between marginal and infra-marginal consumers, it is the switching costs faced by marginal consumers are particularly important in determining the strength of competition.

[163] Paragraph 5.105 of the First Pay TV Consultation referred to contractual barriers to consumers changing supplier since it is common for consumers to sign up to 12 month contracts for pay TV services. However survey evidence suggests that such contractual restrictions are not a major obstacle to switching. Only 9% of TV consumers who had considered switching supplier but had not done so gave contractual terms and conditions as a reason for not switching. *The consumer experience, 2008 research report*, Ofcom ("Consumer Experience 2008"), Figure 134 on page 101, available at: http://www.ofcom.org.uk/research/tce/ce08/research.pdf

[164] See for example paragraphs 5.29 and 5.37 of Annex 13 of the First Pay TV Consultation.

wishing to switch to or from BT Vision may also have to migrate their broadband service. This may result in additional costs and/or lead time which could discourage switching.

3.47 The finding that bundling creates additional barriers to switching is supported by more recent qualitative research for Ofcom. This found that respondents were largely looking to switch their services as a bundle rather than to unbundle and revert to using individual suppliers for each service. Larger bundles were valued more highly – indicating greater reluctance to switch. The research implied that the more services that were bundled, the less interest consumers had in switching[165].

3.48 That qualitative research also found some evidence that customers' perceptions of purchasing bundles were a barrier to switching, although not exclusively and in varying degrees. Generally, consumers with ongoing service issues would consider switching regardless of the process, whereas those just wanting a better deal may be more affected by their perception of the process. Further, the majority of consumers appeared to be largely unaware of what might be involved in the switching process and fell into two groups. First, consumers who were resistant to change, expected problems and would only consider switching if their services did not work. Second, consumers who thought the process was relatively straightforward and would consider switching just to get a better deal[166].

3.49 Figure 22 summarises the results of Ofcom research on the consumers' perceptions of the ease of switching supplier. This shows that, in the case of multichannel TV, consumers that have actually switched regarded switching as easier than those that have not switched. In contrast, consumers of bundles of services had similar views regardless of whether or not they had previously switched. Moreover they regarded switching as more difficult than multichannel TV consumers.

Figure 22: Consumer opinions on the ease of switching supplier

	Multichannel TV				Bundle	
	2008		2007		2008	
	Have never switched	Have previously switched	Have never switched	Have previously switched	Have never switched	Have previously switched
Very easy	24%	66%	21%	45%	25%	25%
Fairly easy	37%	23%	46%	35%	37%	40%
Fairly difficult	12%	3%	10%	5%	20%	18%
Very difficult	8%	3%	7%	4%	8%	11%
Don't know	19%	5%	16%	11%	10%	6%

Source: Consumer Experience 2008, Figure 132 on page 99 and Figure 133 on page 100.

165 Consumer Experience 2008, page 96.
166 Consumer Experience 2008, page 96.

3.50 Finally, certain households do not have access to some retailers' service, for example because no cable network serves their location. This acts as an absolute barrier to switching to consumers in some parts of the UK. Research for Ofcom found that, in 2008, 98% of households had access to digital satellite television, 78% had access to DTT and 47% had access to digital cable[167].

3.51 In summary, we consider that switching costs vary depending on which retailer a customer is switching to and from. There do appear to be appreciable costs to switching to a number of retailers, particularly Virgin Media and Sky's DSat business. The bundling of pay TV with other services such as broadband increases switching costs. The perception that switching is more difficult than it actually is also acts as an impediment to switching. These costs will tend to dampen the strength of the retail constraint exerted by these businesses on rival retailers. That said, switching costs (and the associated impact on competition) should not be overstated – it would be incorrect to suggest that they are very high[168].

Product differentiation

3.52 In terms of the second factor identified above, namely the extent of product differentiation between retailers, clearly access to Sky's Core Premium Sports channels would remove one key source of differentiation between retailers, namely that Sky Sports 1 and Sky Sports 2 are only available from Sky and Virgin Media. However material differences stemming from the distribution technology and business model used by different retailers would remain. For example, the lower available capacity on DTT means that DTT retailers will tend to have smaller range of channels (and are therefore likely to retail packages at a commensurately lower price). Similarly, certain services (such as video on demand) may be technically easier to deliver using cable technology. The existence of product differentiation will tend to dampen the strength of direct competition between retailers[169].

3.53 In its 1 June 2009 submission Sky stated that the "UK audiovisual sector is … highly differentiated …" Sky stated that factors that have an important bearing on the intensity of retail competition include suppliers' ownership, business strategy, legal rights and obligations, brand image and longevity (which affects accumulated knowledge and expertise). Sky did not elaborate further and did not set out any evidence to support its claims.

Barriers to entry

3.54 If market power in the wholesale supply of Core Premium Sports channels were not exercised, in principle a potential entrant could begin supplying retail television bundles containing Core Premium Sports channels using a number of distribution technologies:

[167] Consumer Experience 2008, Figure 10 on page 14.
[168] For example, as shown in Figure 22 above, of the multichannel TV consumers that had switched supplier 89% reported that it was "very easy" or "fairly easy" compared to just 6% who reported that it was "fairly difficult" or "very difficult" (2008 figures). Even for multichannel TV consumers that had never switched supplier the respective figures are 61% compared to 20%.
[169] Product differentiation is relevant to the effects if a retailer gains access to Sky's Core Premium Sports channels. The greater the extent of product differentiation, the greater the detriment to consumers that select a less attractive retailer in order to be able to obtain Core Premium Sports channels. Similarly, the more likely it is that some consumers choose to forego Core Premium Sports channels in order to remain with their favoured retailer. Thus the deadweight loss and distortion of consumer choice from limited availability of Core Premium Sports channels will be larger. See section 10 of the main document.

- Cable;
- Sky's DSat platform;
- A DSat platform other than Sky's;
- DTT; and/or
- IPTV.

3.55 As discussed in paragraph 3.33 above, in practice we do not consider that further entry using a cable as a distribution technology is likely.

3.56 In contrast, access via Sky's DSat platform is markedly easier. Sky's DSat platform is open and the terms of access are regulated by Ofcom. Indeed Setanta has chosen to retail its channels in this way.

3.57 Entry using digital satellite transmission and reception via digital receivers other than those operated by Sky is technically feasible. The new entrant retailer would need to supply a suitable set top box (for example including CA technology or as a conditional access module inserted into a free to air satellite receiver). Satellite capacity could be obtained directly from a satellite operator or, alternatively, by acquiring an existing channel that has a pre-existing agreement giving it satellite capacity. However, establishing a significant base of set top boxes would clearly require a material lead time and incur significant costs.

3.58 Entry using DTT as a distribution technology is possible, as shown by the entry of Top Up TV and, more recently, by the entry of BT Vision. Moreover, as explained in section 10 of the main document there is likely to be a significant level of unmet demand on that platform (as also shown by Sky's proposal to launch its own service "Picnic" on DTT). However, at this stage it is not clear whether further entry is actually likely. Establishing a significant base of set top boxes would require a material lead time and involve significant costs, although we recognised that these costs will be partially mitigated since DTT consumers are typically able to use their existing aerial and internal cabling[170].

3.59 The ITV-Sky CC Report found that entry by IPTV retailers using local loop unbundling involved substantial investment costs (paragraph 4.96). Whilst Orange previously announced that it intended to launch an IPTV service (originally in 2007), it has been delayed. [✂][171]. This suggests, at least at this stage in the technical development of IPTV services, entry during the next few years may not be particularly likely.

3.60 As discussed in paragraph 9.34 of the main document, while there are some fixed costs (e.g. marketing), these are not huge, especially as a proportion of the total costs of a scale operator. We also believe that economies of scope exist between different channels and services supplied by pay TV retailers. For example, the average cost per channel of a set top box subsidy will fall the more channels that a subscriber is supplied with. This implies that existing retailers that already supply a range of channels (such as Top Up TV or BT Vision) may enjoy a cost advantage

[170] The CC previously concluded that a lack of available DTT capacity makes further entry unlikely. *Acquisition by British Sky Broadcasting Group plc of 17.9 per cent of the shares in ITV plc*, CC, report sent to Secretary of State (BERR) on 14 December 2007 (the "ITV-Sky CC Report"), paragraph 4.97.
[171] [✂].

over new entrants that only retail Core Premium Sports channels. Accordingly, new entrants may seek to also supply a range of services.

Conclusion

3.61 As discussed above, there appear to be appreciable costs involved in a consumer switching to a number of retailers, particularly Virgin Media and Sky's DSat business (although switching costs vary depending on which retailer a customer is switching to and from). There is also a degree of product differentiation as well as significant barriers to entry for retailers that are not already in the market. This suggests that, even if Sky did not exercise its wholesale market power, the intensity of retail competition might not be high, at least in the short term. In particular, the presence of switching costs suggests that there might be a time delay between any change in the way Sky behaves at the wholesale level and any resulting change in its position in the retail market.

Retail television bundles containing Core Premium Movie channels

3.62 Currently only Sky and Virgin Media retail Core Premium Movie channels. Sky retails these channels on its DSat platform and Virgin Media retails them on its cable platform[172].

3.63 The remainder of this sub-section is structured as follows:

- First, we briefly consider whether Sky possesses a dominant position applying the 'standard' approach to assessing retail market power (namely the ability to charge retail prices appreciably above the competitive level).
- Second, we consider whether Sky has the ability to charge a retail margin that is appreciably above the competitive level.
- Third, we set out some factors that are relevant to the extent of retail market competition absent the exercise of wholesale market power.

The ability to sustain retail prices appreciably above the competitive level

Current retail market shares

3.64 We have calculated market shares as a proportion of the retail revenues earned by Sky and Virgin Media from the supply of retail television bundles containing Core Premium Movie channels. These are summarised in Figure 23 below. The details of our calculations are set out in a separate confidential spreadsheet. As in the case of the analogous calculation of shares of the supply of retail television bundles containing Core Premium Sports channels, these market shares are calculated using the entire revenue earned from the bundles taking into account any mandatory components that must be acquired to purchase the bundle. The observations in paragraph 3.25 also apply here. Note also that Disney Cinemagic was not taken into account when calculating these figures, although since it is retailed by both Sky and

[172] Sky also directly retails some of its movie channels over Tiscali's IPTV platform. Tiscali also retails Disney Cinemagic on its platform. Given Tiscali's low overall subscriber numbers we believe that Tiscali is only likely to retail Disney Cinemagic to a few subscribers. Accordingly, we do not consider that Tiscali is likely to act as a significant competitive force at the retail level and thus we do not discuss it further.

Virgin Media its omission is unlikely to affect these parties' relative shares of this retail market.

Figure 23: Market shares in the supply of retail television bundles containing Core Premium Movie channels (calculated on a revenue basis)

	Sky	
	[90-100]%	[0-10]%
1H 2008	[90-100]%	[0-10]%
1H 2008	[90-100]%	[0-10]%

Source: Ofcom calculations

3.65 As shown in Figure 23, Sky accounts for a very high proportion of the revenue earned from the supply of retail television bundles containing Core Premium Movie channels.

Retail market shares including 'out of market' constraints'

3.66 As explained in paragraphs 4.377 of the main document, certain other ways of viewing movies may constrain Sky to a degree (in particular PPV movies, online DVD rental packages and library films). In order to understand the extent of the constraint imposed by these 'out of market' products, we have calculated market shares as if moderately substitutable content were within the relevant market. These market shares provide an upper estimate for the strength of the competitive constraint that may be exercised by products that lie slightly outside of the relevant market but that may nonetheless act as (imperfect) substitutes.

3.67 First, we have calculated retail market shares taking into account three other ways in which consumers can pay to watch movies: (i) PPV movies; (ii) online DVD rental services; and (iii) legal movie downloads (to rent or own). These were calculated using the retail revenue that Sky and Virgin Media earn from the supply of bundles containing Sky Movies as well as the revenues generated from the various 'out of market' products. Note that Sky's market shares will tend to rise compared to the corresponding wholesale calculations set out in Figure 16 above because, at the retail level, we are also taking into account Sky's revenue from the other (non-movie) components of Sky's retail television bundles including Core Premium Movie channels.

Figure 24: Market shares in the retail supply of bundles including Core Premium Movie channels and various moderate 'out of market' constraints (calculated using revenue data)

	Sky		
	[80-90]%	[10-20]%	[0-10]%
Including PPV and online DVD rental services	[80-90]%	[0-10]%	[0-10]%
Including legal movie downloads	[80-90]%	[0-10]%	[0-10]%
Including all of the above	[80-90]%	[0-10]%	[0-10]%

Source: Ofcom calculations

3.68 Second, in Figure 17 above we presented wholesale market shares based on broadcasters' expenditure on rights to movies (including less recent films). This measure takes into account movies screened on other channels. We have recalculated these figures assuming that the wholesale shares attributable to Sky Movies and basic channels are split between Virgin Media and Sky according to the proportions set out in Figure 23 above. Note that this measure does not include other components of retail bundles such as basic channels containing no movies. However it does shed light on the strength of different retail level suppliers of channels including movies.

Figure 25: Retail market shares in 2008 including moderate 'out of market' constraints (calculated using expenditure on rights to movies

Sky	Virgin Media	BBC	ITV	Channel 4	Channel 5
[40-50]%	[0-10]%	[✂]%	[✂]%	[✂]%	[✂]%

Source: Ofcom calculations

3.69 Taking 'out of market' constraints into account, Sky still possesses a relatively high market share, although not as high as under our favoured market definition. Note, however, as explained in paragraph 2.230 above, that movies broadcast on free to air channels are likely to be a comparatively weaker constraint than services such as PPV and online DVD rentals because they are less recent.

3.70 As noted in paragraph 2.231 above, Sky argued that focusing on putative market shares in this way understates the extent of the competitive constraints on its channels. We address Sky's argument in paragraph 2.232 above.

Barriers to entry and expansion

3.71 In principle, a firm could enter the market and begin supplying retail television bundles containing Core Premium Movie channels by acquiring such channels from Sky and/or Disney. However the analysis of barriers to entry and expansion in the retail supply of bundles including Core Premium Sports channels in paragraphs 3.31-3.35 above also applies here.

3.72 In particular, currently Sky only supplies its Core Premium Movie channels to itself and retailers using cable as a distribution technology. As discussed in section 6 of the main document, retailers using IPTV and DTT as a distribution technology have been unable to reach an agreement with Sky to purchase Sky Movies. We thus consider that it is very unlikely that retailers using a distribution technology other than cable will be able to acquire Sky's Core Premium Movie channels. This lack of access to these channels acts both as a significant entry barrier and as a barrier to expansion for retailers (such as BT Vision and Top UP TV) that currently do not retail Sky's Core Premium Movie channels[173].

3.73 Moreover, as explained in paragraph 3.33 above, we do not consider that it is plausible that a new entrant would use cable as a distribution technology. Further, whilst in principle a new entrant might seek to acquire Disney Cinemagic (as Tiscali has done), we consider that such entry (even if it occurred) would be unlikely to constrain Sky's retail prices for the supply of bundles containing Core Premium Movie channels. The weak constraint that this channel imposes on Sky Movies, and thus on retailers of Sky Movies, is demonstrated by the relative wholesale market shares of Sky and Disney (see Figure 14 above).

Countervailing buyer power

3.74 Retail television bundles containing Core Premium Movie channels are supplied to individual residential households. Individual households do not possess buyer power to offset any seller power that exists.

Conclusion on the ability to sustain retail prices appreciably above the competitive level

3.75 Sky enjoys a high retail market share in the retail supply of bundles containing Core Premium Movie channels. Under our favoured market definition, Sky's market share is well above the 50% threshold at which dominance can be presumed, in the absence of evidence to the contrary. Even if out of market constraints are taken into account, Sky's market share remains high (over 50% including PPV Movies, online DVD rental and legal movie downloads and [✂] [40-50%] including movies on other channels)[174]. Moreover, we consider that there are significant barriers to entry and expansion, including non-cable retailers' lack of access to Sky's Core Premium Movie channels. There is no CBP. Accordingly, applying the 'standard' market definition test, the conclusion is that Sky enjoys a dominant position that gives it the ability to sustain retail prices appreciably above the competitive level.

3.76 The caveats set out in paragraphs 3.38 above, as part of the assessment of retail television bundles containing Core Premium Sports channels, also apply here.

The ability to sustain retail margins appreciably above the competitive level

3.77 In paragraphs 3.39-3.41 above we considered whether Sky enjoys the ability to sustain retail margins on bundles including Core Premium Sports channels that are appreciably above the competitive level. That analysis applies equally to bundles including Core Premium Movie channels.

3.78 Accordingly we do not consider that there is sufficient evidence to conclude that Sky enjoys the ability to sustain retail margins on bundles including Core Premium Movie channels that are appreciably above the competitive level.

[173] Moreover, as discussed in paragraphs 3.57-3.59 below, entry by retailers using DSat, IPTV or DTT as a distribution technology involves a number of additional costs.
[174] See also the discussion of switching costs in paragraphs 3.45-3.51 above.

Extent of retail competition absent the exercise of wholesale market power

3.79 In paragraphs 3.45-3.61 above, as part of the assessment of retail television bundles containing Core Premium Sports channels, we considered switching costs between retailers, the extent of product differentiation between retailers and barriers to entry. That analysis applies equally to retail television bundles containing Core Premium Movie channels, subject to one additional observation.

3.80 The analysis of Core Premium Movie channels does however differ in one important respect to the equivalent analysis of Core Premium Sports channels, which is the amount of broadcast transmission capacity required to carry the full set of channels. Sky currently supplies ten distinct Core Premium Movie channels plus a time-shifted version of one of those channels (Premiere +1). Even absent the exercise of any wholesale market power in the supply of those channels, there is very likely to be insufficient capacity for a DTT retailer to carry all ten channels. Indeed Sky only proposed including a single Core Premium Movie channel (namely Screen 1) as part of its Picnic DTT service. Thus, absent the exercise of any wholesale market power, there is still likely to be a significant degree of product differentiation between DTT retailers of bundles containing Core Premium Movie channels and retailers distributing such bundles using DSat and cable. Because retailers using DTT would only be able to offer an inferior range of Core Premium Movie channels they will exert a weaker competitive constraint on DSat and cable retailers (who are likely to be able to offer the full range of these channels).

Section 4

Vertical integration and retail subscriber bases

Introduction

4.1 As explained in paragraphs 2.128 and 2.257 above, given the clear historic position, we do not consider that it is necessary for us to form a concluded view on which factors explain Sky's strong bidding position for the Live FAPL Rights and the Movie Rights. However we did highlight a number of factors which might explain Sky's strong position, including the efficiency advantages that may flow from bidders being vertically integrated with pay TV retailers with a significant subscriber base. We explain this factor in greater detail in this section.

4.2 This section is structured as follows:

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

Summary of the position in the Second Pay TV Consultation

4.3 In the Second Pay TV Consultation, we set out our view about the role of retail subscriber bases and asymmetries between bidders for particular rights. Specifically we considered that Sky is the most effective retail outlet on the largest platform and that third parties are unable to access that outlet as efficiently. As a result, we considered that Sky enjoys an advantage over potential rival bidders for the Live FAPL Rights and the Movie Rights[175].

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

Overview of the ability to access final consumers most effectively

4.5 In overview, this argument involves two steps.

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

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

TV Consultation, we considered that greater total industry profits were likely to be generated when that channel is distributed by the leading retailer on each platform.

4.7 **Step 2: vertical integration allows certain bidders to access the leading retailer on certain platforms more efficiently.** In the Second Pay TV Consultation, we considered that a third party channel provider cannot obtain access to the leading retailer on a platform as efficiently as a wholesale channel provider that is vertically integrated with that retailer. This is for a number of reasons (explained below) that we refer to as the "Access Disadvantages".

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

- An entirely independent bidder faces the Access Disadvantages on all platforms. A bidder that is vertically integrated with the leading retailer on one platform avoids the Access Disadvantages on that platform but faces the Access Disadvantages on all other platforms. An entirely independent bidder will thus be at a disadvantage compared to vertically integrated bidders.

- When assessing whether one vertically integrated wholesaler-retailer is in a relatively stronger position than another, the relative size of those firms' subscriber bases is crucial. The effect of the Access Disadvantages is larger on platforms with more subscribers. Since a vertically integrated wholesaler-retailer avoids the access disadvantages on 'its' platform, this implies that the leading retailer on the largest platform is least affected. It is thus likely to be able to outbid vertically integrated retailers on other (smaller) platforms for the Live FAPL Rights.

- In other words, Sky is the most effective retail outlet on the largest platform (Step 1) and third parties are unable to access that outlet as efficiently (Step 2).

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

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

4.10 The evidence on Step 1 was set out in paragraphs 2.80-2.108 of Annex 7 to the Second Pay TV Consultation. To recap, Step 1 relates to the importance of dealing with the leading retailer on each platform. We observe that, for the majority of pay TV platforms, there is a leading retailer on that platform i.e. a single retailer that sells all/the majority of the content retailed on that platform. Specifically, Sky is the leading retailer on its DSat platform, Virgin Media is the leading retailer on its cable platform and BT Vision is the leading retailer on its platform. The two possible exceptions are Tiscali's platform (where both Sky and Tiscali retail) and Top Up TV's platform (where both Top Up TV and Setanta retail)[176].

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

[176] In any event, Tiscali's and Top Up TV's platforms currently have comparatively few subscribers (compared to cable and Sky's DSat platform). They are thus not central to our assessment of entry barriers.

- On closed platforms there is obviously no alternative other than dealing with the leading retailer.
- On open platforms the leading retailer is likely to be able to generate greater revenue by aggregating that channel with other content and services.
- On open platforms and where the leading retailer was the previous incumbent supplier of the channel, a new entrant is likely to suffer a delay in building up its subscriber base to match that of the former incumbent.

4.12 We discuss each of these three factors in turn.

Closed platforms

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

Aggregation by the leading retailer

4.14 On open platforms the leading retailer is likely to be able to generate greater revenue by aggregating that channel with other content and services. Aggregation of such content in the hands of one retailer facilitates bundling at the retail level. As discussed in paragraph 2.174 above, bundling of content that is not closely-substitutable can allow retailers to sell more content, at different price points, to a wider range of consumers. We referred to this motivation for bundling above as the “preference smoothing effect”.

4.15 We consider that there are a number of pieces of evidence supporting our view about the benefits of bundling.

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

4.16 In addition, as discussed in paragraphs 2.170, 2.174 and 2.262 above, aggregation of the majority of closely substitutable content can increase retail prices for that content above competitive levels. For example, there is likely to be an incentive for a third party to wholesale a Core Premium Movie channel to the leading retailer, rather than directly retailing that channel in direct competition with any other substitutable Core Premium Movie channels supplied by the leading retailer. Dampening competition in this way generates higher profits for suppliers (albeit at the expense of subscribers), enabling a greater amount to be paid for the underlying rights.

4.17 Paragraphs 2.90-2.97 of Annex 7 of the Second Pay TV Consultation discussed the responses to the First Pay TV Consultation that were relevant to the aggregation of content. We do not repeat these representations here but do continue to rely upon these paragraphs of the Second Pay TV Consultation.

Delays in building a subscriber base

4.18 On open platforms and where the leading retailer was the previous incumbent supplier of the channel, a new entrant is likely to suffer a delay in building up its subscriber base to match that of the former incumbent[177].

4.19 We discussed this issue in paragraphs 2.98-2.108 of the Second Pay TV Consultation. In particularly we relied upon the time it took Setanta to build up subscribers on Sky's DSat platform after it began broadcasting live FAPL matches. We have updated this analysis and it is set out in paragraphs 2.134-2.142 above. We consider that were a firm to acquire Live FAPL Rights or the Movie Rights for the first time, there would be a delay while it built up a subscriber base to comparable levels to those that could be attained by the current rights holder(s).

4.20 In addition, both Virgin Media and Setanta/Top Up TV asserted that, if a new entrant tried to distribute its channel on DSat via a wholesale relationship with Sky then this would not resolve this problem, since that new channel would still have no subscribers at the outset. Setanta/Top Up TV did not attempt to reconcile this argument with its view that bundling allows rights to be monetised rapidly. In the Second Pay TV Consultation we did not form a view on this point, particularly as it does not matter for the purposes of establishing whether entry barriers exist:

- If it is the case that there is a delay in building subscriber numbers even when the channel is distributed by the leading retailer then that delay creates an advantage for the incumbent wholesale channel provider when bidding for those rights. This barrier to entry is discussed in paragraphs 2.134-2.142 above.

- In contrast, if this delay can be avoided by distributing that channel via the leading retailer then it provides another rationale for distributing via that retailer. However, for the reasons given at Step 2 below, a wholesaler channel provider that is vertically integrated with the leading retailer on a platform obtains access to that retailer more efficiently. As explained below, this means that Sky enjoys an advantage over rival bidders for the Live FAPL Rights and the Movie Rights.

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

4.21 We now turn to Step 2. In the Second Pay TV Consultation, we considered that a third party channel provider cannot obtain access to the leading retailer on a platform on equivalent terms to a wholesale channel provider that is vertically integrated with

[177] The effects of this delay will be exacerbated if wholesale channel providers enjoy economies of scale with respect to the number of subscribers to their content.

that retailer. This is for two reasons that we refer to as the "Access Disadvantages" namely[178]:

- Double marginalisation and aligning retailer and wholesaler incentives.
- Uncertainty about wholesale prices.

4.22 Sky and the April 2008 CRA Report argued that Sky's vertical integration does not increase barriers to entry because its DSat platform is open. Specifically, Sky claimed that it cannot restrict access to its platform. Accordingly, Sky considered that a new entrant is certain that it will be able to reach a large number of subscribers. Moreover, Sky argued that the openness of its platform also strengthens a wholesaler's bargaining position when negotiating distribution agreements with a DSat retailer.

4.23 In our view, Sky's arguments appear to go to the question of whether Sky is able to refuse access to its platform altogether. We did not and do not identify this as a barrier to entry. We thus do not regard Sky's arguments as relevant to evaluating Step 2 of the analysis presented in the Second Pay TV Consultation.

<u>Double marginalisation and aligning retailer and wholesaler incentives</u>

4.24 The first Access Disadvantage is the difficulty of aligning the retailer's and wholesaler's incentives. Wholesale prices are structured as a price per subscriber[179]. This has the effect of slightly diminishing the incentive for the retailer to attract additional subscribers by engaging in marketing/advertising or by dropping retail prices (as compared to the situation where the wholesale price is a fixed, lump sum payment). In contrast, a vertically integrated firm does not face this effect because the per subscriber wholesale price is simply an internal transfer within the firm. This is identical to the efficiency effect that can result from a vertical merger, namely avoiding so-called "double marginalisation"[180].

4.25 The benefits enjoyed by a vertically integrated firm are likely to be larger in relation to platforms with a large number of consumers that are likely to subscribe to the channel in question. In other words, the benefits of vertical integration with a retailer with 100,000 subscribers will be markedly less than in relation to a retailer with 1 million subscribers.

4.26 The submissions that we have received support the existence of such incentives[181]. In its October 2007 submission, Sky (part D, paragraphs 4.17(b)-(d)) identified these differences in incentives as one reason why other retailers have been less successful

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

[179] As noted in the First Pay TV Consultation, per subscriber fees directly address the risk for the channel provider of retail prices collapsing to near zero, given that channels are not sold exclusively.

[180] *Merger guidelines: Competition Commission Guidelines*, Competition Commission, June 2003, paragraph 4.44 and footnote 40.

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

than Sky at marketing Sky's channels[182]. BT Vision, Virgin Media, the Four Parties and the March 2008 LECG report all argued that, even if a new entrant agreed wholesale terms with Sky, Sky would not have the incentive to promote the rival channel in competition with its own channels.

4.27 The experience of [✂] is evidence of the difficulties in aligning wholesale channel provider and retailer's incentives. [✂].[✂]. This is evidence that wholesale channel providers consider that retailers have impeded their ability to successfully promote their channels. Clearly such difficulties are unlikely to arise in a vertically integrated firm.

<u>Uncertainty about wholesale prices</u>

4.28 The second Access Disadvantage is uncertainty both about the level of the wholesale price at the time the rights are bid for and whether a wholesale distribution agreement will be agreed. That uncertainty, and the associated risk that a successful bidder incurs losses because it overestimated the wholesale price that it is able to charge to retailers or because negotiations (temporarily) break down, imposes an additional cost on bidders that diminishes the expected value generated from the rights[183]. In contrast, a vertically integrated wholesaler does not face this uncertainty related cost when dealing with its retail arm – the implicit wholesale price paid by that retailer is simply an internal transfer within the firm that does not affect its overall profitability.

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

Implications of Step 1 and Step 2

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

4.31 A third party bidder that is not vertically integrated with the leading retailer on any platform is likely to generate less value from the Live FAPL Rights and the Movie Rights. If it attempts to retail directly on a particular platform then it is likely to generate less revenue (e.g. because it cannot bundle its channel with the leading

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

[183] In principle, this additional 'uncertainty cost' could be resolved if would-be bidders agree the wholesale price with retailers in advance (such agreements would need to be binding and would presumably be conditional upon the bidder winning the rights). However in practice we generally do not observe such agreements (the exception being that Setanta reached a wholesale agreement with Sky for supply to commercial premises prior to sale of the Live FAPL Rights in 2006). Indeed we would expect such agreements to be uncommon. Since they reduce the disadvantages facing rival bidders and thus intensify competition for the rights this discourages vertically integrated firms that are considering bidding for the rights from entering into such agreements.

retailer's content) (see Step 1 above)[184]. If that third party bidder instead wholesales its channel to the leading retailer, it is still likely to generate less value than the leading retailer would if the leading retailer had won the rights. This is because it faces the Access Disadvantages (see Step 2 above), namely an additional uncertainty cost and more difficulties in aligning retailer and wholesaler incentives.

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

4.33 To assist understanding of this argument, Figure 26 below sets out an illustrative example.

[184] Setanta directly retails its channels on DSat, rather than distributing them via Sky (the leading retailer on that platform). Similarly, there are multiple retailers on Top Up TV and Tiscali's platforms. However, we consider that this is explained by the magnitude of the benefits of distributing via the leading retailer (Step 1) relative to the magnitude of the Access Disadvantages (Step 2). For example, if the Access Disadvantages are large then a wholesaler may choose to directly retail its channel even though it fails to reap the benefits that come from distributing that channel via the leading retailer.

Figure 26: Illustrative example

Assumptions:

There are two pay TV platforms (X and Y) with 8m and 4m subscribers respectively. There are three firms (A, B and C) considering bidding for key rights that enable them to assemble a pay TV channel. Firm A is vertically integrated with the leading retailer on platform X. Firm B is vertically integrated with the leading retailer on platform Y.

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

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

Consequences:

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

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

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

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

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

Ofcom's current position

4.35 Since the publication of the Second Pay TV Consultation, we have gathered further information on the 2006 and 2009 sales of the Live FAPL Rights. This suggests that the ability to access final consumers more effectively (for the reasons set out above and in paragraphs 2.77-2.126 of Annex 7 of the Second Pay TV Consultation) may play less of a role in determining whether a bidder is likely to win key rights than we thought in the Second Pay TV Consultation. This is presumably because other factors are relatively more important than Sky's more efficient access to the most effective retail outlet on the largest platform. However, this does not imply that this effect does not exist at all, merely that other factors are likely to outweigh it.

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

- In 2006, [✂][185]. This is inconsistent with the predictions of the analysis in paragraphs 4.3-4.34 above and suggests that other factors were more important in influencing the amounts bid by [✂][186].

- Indeed in 2009, [✂].

4.37 We consider that this is evidence that other factors are of greater importance than certain bidders' ability to access effective retail outlet on the larger platforms more efficiently. Accordingly, as noted in paragraphs 2.129-2.258 above we place less weight on this factor than we did in the Second Pay TV Consultation.

[185] 2006 Monitoring Trustees' Reports.

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