Pay TV phase three document

Proposed remedies

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Consultation

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Contents

Section 1

Summary

1.1 This is our third publication on pay TV since starting this project in early 2007. We confirm our view that some content – various sporting events and first-run Hollywood movies – is of sufficient importance to consumers that channels including this content are in their own narrow wholesale markets; i.e. they are not replicable, and other channels are not good substitutes for them. We have added a view on retail markets for consultation, where we believe markets are similarly narrow.

1.2 We confirm our view that content aggregation has enabled Sky to gain a position of market power in these wholesale markets for premium sports and movies channels. We are now also consulting on a similar view in retail markets.

1.3 We confirm our view that Sky is acting on an incentive to restrict the distribution of premium channels, with effects on a variety of platforms including cable, DTT and IPTV. Despite lengthy negotiations and its own claims that it has an incentive to distribute its channels as widely as possible, Sky has still concluded no wholesale agreements for premium channels with non-cable retailers. This situation is not consistent with fair and effective competition. It has a detrimental effect on consumers, in the short term by reducing choice, and in the long term by dampening innovation.

1.4 We have commissioned further work on an additional potential issue arising from market power – high wholesale prices. We are now consulting on the view that: Sky appears to be making high aggregate returns; returns are higher in its wholesale business than its retail business; and margins are likely to be higher in the wholesale of movies channels than sports channels. Sky's high wholesale margins are likely to be reflected in high prices paid by consumers.

1.5 We continue to believe that it is appropriate to deal with our concerns about restricted distribution by imposing a wholesale must-offer obligation under our sectoral powers. The case for doing so does not depend on the evidence of high wholesale prices, but it is strengthened by that evidence. We are now setting out options for the specifics of this obligation. We consult in particular on a range of regulated retail-minus prices for Sky's wholesale products.

1.6 We do not believe there is a case for intervening to require far-reaching changes in the way content rights are bought and sold. We do however believe that there may be a case for more targeted interventions in relation to subscription video on demand movie rights, and in relation to the next FAPL auction.

1.7 Separating the sale of subscription video on demand movies rights from standard subscription rights could promote innovation, especially in relation to IPTV, and might also increase competitive pressure on wholesale margins. We are considering a market reference to the Competition Commission on this subject, but propose first to explore with the Hollywood studios what their current commercial plans are, and whether these would reduce the need for regulatory intervention.

1.8 In sports, the existing FAPL commitments will not apply to the 2012 auction. We therefore intend to review with the FAPL how it intends to ensure that this auction complies with competition law. That might involve exploring with the FAPL whether it is willing to provide new commitments.

Introduction: considering action under our sectoral powers

1.9 This process began as a general investigation into pay TV markets, prompted by a request for a market investigation reference to the Competition Commission ("CC") under the Enterprise Act 2002 ("EA02"). In the Second Pay TV Consultation[1] we analysed pay TV markets, identified some particular concerns relating to access to premium content, and consulted on the possible broad forms of remedy that Ofcom might use to address those concerns. Instead of making a reference to the CC, we proposed to tackle our concerns over access to premium content by putting in place a wholesale must-offer condition using our sectoral competition powers.

1.10 Further consideration and the responses to our Second Pay TV Consultation have led us to conclude that we should focus directly on considering the case for an intervention under our sectoral competition powers, contained principally in section 316 of the Communications Act 2003 ("CA03"). This requires us to "ensure fair and effective competition" in the provision of licensed services, such as premium channels.

1.11 We do have some residual concerns in relation to the sale of content rights, which we may not be able to address effectively using our sectoral competition powers. We consider whether some other form of targeted intervention might be appropriate to address these.

The importance of premium content

1.12 We continue to believe that consumers' choice of pay TV retailer is primarily influenced by the content bundles which are available from different retailers. Platform-related features may enhance the viewing experience and therefore provide added value to consumers, but they cannot compensate for content that lacks intrinsic appeal.

1.13 Live top-flight sports and first-run Hollywood movies are particularly effective in driving pay TV subscriptions because they combine broad audience appeal with a high degree of exclusivity to pay TV. The importance of these types of content is revealed by a variety of evidence including consumer research, the observed behaviour of consumers, and the observed behaviour of firms which are active in the market.

1.14 We have considered whether these types of content are likely to continue to be as important in the longer term as we believe them to be now.

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

- The same may not however be true of movie programming, since although blockbuster movies are likely to retain their appeal, the simultaneous broadcast of a small number of movies to a large number of viewers is unlikely to remain the most effective means of distribution in the longer term. It is not difficult to imagine

[1] Ofcom's second consultation document on pay TV, published on 30 September 2008 - http://www.ofcom.org.uk/consult/condocs/second_paytv/

a world in which movies are generally accessed more directly, for example via various forms of internet download.

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

Content aggregation and market power

1.16 Having reviewed evidence presented in consultation responses, we remain of the view that there are narrow economic markets for the wholesale of Core Premium Sports and Core Premium Movie channels[2], and that Sky has market power in those markets. Sky's market power is enabled by content aggregation carried out either by rights owners or by Sky, specifically:

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

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

1.17 The wholesale market for Core Premium Sports channels comprises Sky Sports 1, Setanta Sports 1[3] and Sky Sports 2. In coming to this view, we have considered a wide range of evidence, including the characteristics of the content shown on these channels, consumer preferences for such content, econometric analysis of the constraint from free-to-air TV and the observed response to price changes.

1.18 The wholesale market for Core Premium Movie channels comprises all Sky Movies channels which show movies in the first pay TV window from the Major Hollywood Studios. That includes all Sky Movies channels apart from Classics. In coming to that view, we have considered a range of evidence similar to that on sports, as well as data on alternative means of watching movies, and on the high and increasing margin of wholesale prices over costs.

1.19 One additional piece of analysis that we have carried out since our Second Pay TV Consultation is to define retail markets. Our view for consultation is that there are narrow markets for the retail of packages including Core Premium Sports and Core Premium Movie channels to residential customers. In coming to this view, we rely on much of the same evidence as for our wholesale assessment, which suggests that

[2] See section 4 for the full description of what is meant by these terms; Core Premium Sports channels are channels regularly featuring live sporting events which a significant number of consumers find highly attractive. Core Premium Movies channels are channels including movies in the first TV subscription window produced or licensed by the six major Hollywood studios.

[3] Setanta went into administration on 23 June 2009, shortly after the live FAPL rights which had been held by Setanta were awarded to ESPN. ESPN has announced that it has agreed a wholesale deal with Sky for distribution on Sky's DSat platform. It has also announced an intention to make its channel including FAPL coverage 'widely available across multiple pay-TV platforms', although at the time of writing no other details of availability across platforms other than Sky's have been announced. Our competition concerns are likely to be independent of whether Setanta Sports 1, or some other channel provided by ESPN, exists as part of the Core Premium Sports market.

demand-side substitution is unlikely. Entry by new suppliers is unlikely in the short term, because of the lack of availability of the relevant wholesale channels.

1.20 We consulted in September 2008 on a view that Sky had market power in the wholesale of Core Premium Sports and Movie channels. After taking into account additional material provided in consultation responses, we continue to believe that Sky has market power in those markets, based on evidence including Sky's high market shares, its control of key rights and the limited potential for market entry, and the absence of significant countervailing buyer power. Establishing precise boundaries for a highly differentiated sector like pay TV is difficult; as a result we have considered the out-of-market constraint from FTA TV, and concluded that this does not alter our view that Sky has market power.

1.21 We are also now consulting on the view that Sky also holds a position of market power in the markets for the retail of packages including Core Premium Sports and Movies channels. Sky's market shares are very high in the retail markets as well in wholesale, and barriers to entry in acquiring the relevant wholesale inputs are also high.

1.22 Although we believe Sky holds a position of retail market power, our competition concerns focus not on this, but on the exercise of market power at the wholesale level, as set out in the following section.

The effects of market power on competition

1.23 We have identified three potential concerns in the context of Sky's market power, which we consider in turn.

- Firstly, we are concerned that Sky, as a vertically integrated firm, with market power in a key upstream market, may distribute its premium content in a manner that favours its own platform and its own retail business. It might do so either by denying this content to other retailers and / or other platforms, or by making it available on unfavourable terms. The effect would be to reduce consumer choice, and to inhibit the growth of innovative pay TV services. The increased importance of 'triple-play' bundles creates a further risk that this distortion would extend to the other services which are included in such bundles, notably broadband and telephony services. We consider that Sky's approach to the supply of Core Premium channels creates a position under which there is not, and there is not likely to be, fair and effective competition.

- Secondly, we are concerned that Sky may exploit content rights selectively, in order to favour its own retail business and platform.

- Thirdly, we are concerned that Sky may set high wholesale prices for its content in order to maximise wholesale profits. This can be reflected in high retail prices.

Restricted distribution of Core Premium channels

1.24 Our view is that Sky appears to be acting on an incentive to restrict supply of Core Premium channels to other retailers. This incentive is likely to arise from its vertical integration between retail and wholesale activities. We think this situation is and will continue to be prejudicial to fair and effective competition.

1.25 Sky currently supplies its Core Premium channels to only one major third-party retailer, Virgin. Sky appears to believe that it is under a de facto requirement to supply Virgin due to previous competition cases. From our review of Sky's own statements, our view is that its prices to Virgin appear not to be based on a commercial calculation (e.g. weighing higher prices against greater sales volumes), but rather on Sky's view as to the highest price it can charge without coming into conflict with the OFT's 2002 margin squeeze test. At the current wholesale charges, Virgin makes an incremental loss when it sells premium channels to an existing basic subscriber.

1.26 Sky has not agreed terms for wholesale supply with retailers on other platforms. From our review of documentary evidence relating to negotiations between Sky and others, we can see that Sky's response to a request for wholesale supply is normally to propose that it should be allowed to retail on the platform in question. As a result, negotiations between Sky and other retailers have tended to consist of the retailers repeatedly asking for wholesale supply and Sky repeatedly expressing its preference for a retail deal. Where Sky has discussed prices, is has not countenanced in any meaningful way diverging from the cable rate-card. This is surprising given that our 'vertical arithmetic' calculations in our Second Pay TV Consultation indicated that it should be incrementally profitable for Sky to wholesale at a price 25% lower than the rate-card.

1.27 Our view is that Sky weighs the immediate commercial benefit of supplying other retailers against the strategic benefit of withholding supply and/or restricting the terms of supply. This view is based on documentary evidence of negotiations with third parties, and the negative outcome of those negotiations, despite Sky's having an apparent commercial incentive to agree terms. Our view is that Sky derives two strategic benefits from keeping its retail competitors weak:

- The ability to manage competition between retailers on different platforms, in order to protect the position of Sky's own satellite platform.

- The ability to prevent rival retailers from establishing a strong retail presence, which, as well as being a threat in the retail market, could strengthen their position in bidding for content rights.

1.28 Our view is that these strategic considerations also underpin Sky's relative willingness to retail its content over other platforms. If Sky were to retail across numerous platforms, this would increase the availability of Sky's content, which would be immediately beneficial both for consumers and for Sky. However, it would also allow Sky to manage retail competition so as in the longer term to protect its own platform, and its position in bidding for content rights. We do not therefore believe that a satisfactory solution to our competition concerns would be for Sky to become the only actual or potential retailer of premium content across all non-cable platforms.

1.29 Furthermore, even in the short term Sky does not have an incentive to retail its content as effectively on other platforms as on DSat, because if its Core Premium channels are purchased elsewhere it loses the revenues that it can earn by bundling them with other content and services. This lack of incentive is supported by the available evidence. Where Sky does retail on other platforms, using its 'Sky by Wire' service, the resulting retail offering has attracted very low take-up.

Restricted exploitation of content rights

1.30 The same incentives which determine how Sky distributes its channels are also likely to determine how it exploits its content rights, in the sense that Sky has an incentive to exploit its content rights in such a manner as to favour its own retail business and its own platform. The resulting selective exploitation of content rights might be a concern if it allowed Sky to protect its market power, and distort competition.

1.31 Our concern here relates to the exploitation of the rights to distribute movies via Video on Demand (VoD). These have a high strategic importance, due to the potential which we have already noted for disruptive change in the way movies are distributed. Various sets of VoD rights can be identified:

- VoD services sold on a Pay-Per-View (PPV) or Pay-Per-Download (PPD) basis. These rights are widely available, on a non-exclusive basis. However, the payment mechanisms allowed by these rights, and the associated level of prices, mean that services based on these rights have thus far not developed into a major part of the market.

- VoD services sold on a subscription service (SVoD). At present the movie studios bundle these rights with the rights to show movies on subscription linear channels, and these bundled rights are acquired on an exclusive basis by Sky. Sky does not however have the capability to exploit these SVoD rights on its own TV platform, and it does not have the incentive to develop a product based on these rights to be supplied to competing TV platforms. Sky therefore only exploits the rights via its PC-based Sky Player application, which has thus far had limited impact on the market.

1.32 We acknowledge that as a general rule competition authorities and regulators should be very cautious about intervening to change how firms exploit content rights, due to the risk that such interventions could stifle innovation. However, in the context of Sky's market power there appears to be a risk that innovation in the development of VoD services may be stifled by the manner in which the VoD rights to premium movies are currently being exploited.

High wholesale prices

1.33 We said in our Second Pay TV Consultation that the evidence of whether wholesale prices are high is less clear-cut than the evidence on channel distribution. Evidence on wholesale prices is difficult to interpret for a number of practical reasons, including the following:

- The costs of producing content are largely fixed, resulting in a marginal cost which is close to zero. The appropriate measure of competitive prices is particularly difficult to determine in such circumstances.

- Profitability analysis is made difficult by uncertainties regarding the level of capital employed, and in particular the level of intangible assets. A disaggregated profitability analysis which seeks to establish profitability in different parts of Sky's business is particularly complex because of uncertainties associated with allocating both these assets, and common costs to particular parts of Sky's business.

1.34 Nevertheless, our view was that Sky did appear to be making an operating margin on the wholesale of premium channels which was higher than its overall operating margin. We further commented that the gross margins which Sky makes on premium movie content are significantly higher than those which it makes on premium sports.

1.35 Since our last document, we have engaged Oxera to carry out a full analysis of Sky's profitability, particularly focusing on the value of Sky's intangible assets. Oxera's report is attached at Annex 9. Oxera's study applies a conceptually appropriate framework for valuing intangible assets and estimating profitability in the context of competition investigations, as set out in the Oxera 2003 report for the Office of Fair Trading and previously used by the Competition Commission.

1.36 The key conclusion is that, when modelled under a range of different assumptions, time periods and measures of profitability, Sky appears to have made an aggregate return of above 20%, significantly above its current cost of capital. We need to exercise care when interpreting historic returns during periods when Sky was developing a new business with a potentially significant risk of failure. However, Sky now has a stable and increasingly diversified business, so these considerations are less relevant on a forward-looking basis.

1.37 Oxera has also carried out a disaggregated analysis of Sky's profitability. The results are less reliable than the aggregate analysis, due to various issues associated with the allocation of costs, revenues and assets. The disaggregated analysis does however lead us to the view that:

- Wholesale returns are greater than retail returns.
- Wholesale returns are above those of appropriate comparators.
- Within wholesale, although there is uncertainty about the precise figures, it is likely that movies returns are greater than on sports.

1.38 This profitability analysis excludes any monopoly rents which may be retained by rights owners. Such monopoly rents may exist where much of the content aggregation is carried out by rights owners rather than by Sky, as is the case for example with the live FAPL rights. However, we have not attempted to estimate these, since it is likely to be extremely difficult in practice to distinguish them from any scarcity rents associated with the talent which underpins the production of high quality content. In other words, the high salaries paid to some footballers and movie stars may be an indication of market power, but could also reflect the scarcity value of football skills and movie talent.

Effects on consumers

1.39 We noted in our Second Pay TV Consultation that markets where competition is weak, and consumers are unable to exercise a real choice between suppliers, are unlikely to deliver the best outcomes for consumers. We set out several criteria against which we proposed to assess the operation of the market from a consumer perspective, focussing on choice, innovation and pricing. We think the current and future effects on choice and innovation of Sky's approach to the wholesale supply of Core Premium channels are such that we need to consider an intervention under our sectoral powers to ensure fair and effective competition in the interests of consumers.

Consumer choice

1.40 The most obvious manifestation of reduced consumer choice is the restricted availability of Sky's premium content on other platforms. The fact that consumers on a number of platforms are currently either unable to access the most valuable sport and movie content, or face restricted access, is a source of concern. We consider the effect on different groups of consumers:

- **Sky Core Premium DSat customers.** Sky has **[✂]** million such customers. We are concerned that some of these Sky customers may have chosen DSat because of the restricted availability of Core Premium channels, rather than out of a preference for the DSat platform. Services such as HD and interactivity which Sky only provides with its Core Premium channels on DSat, may also have distorted platform choice. The extent to which Sky Core Premium DSat customers have a preference for other platforms is uncertain. However, we estimate that, over the next five years, approximately one million DSat subscribers would subscribe to Core Premium channels on other platforms (for example on DTT or IPTV) if they were made available on those platforms, though naturally this would depend on the package and price on offer.

- **Basic cable customers.** Virgin Media has **[✂]** million basic TV customers, and **[✂]** million Sky Core Premium customers. The relatively low level of penetration of Sky's Core Premium channels on cable reflects Sky's wholesale price, which disincentivises Virgin Media from marketing these channels. Only **[✂]**% of cable customers currently purchase premium content, as compared to **[✂]**% a few years ago, and **[✂]**% on Sky's satellite platform. Evidence, including the recent decline in penetration of Core Premium channels on cable indicates that a substantial proportion of Virgin Media customers who do not currently subscribe to Sky's Core Premium channels may have an interest in doing so, although evidently not at current prices.

- **Other households.** Around 14 million households in the UK do not subscribe to either DSat or cable. Of these, close to 10 million are on DTT platforms, and 3 million have analogue terrestrial TV. There is clear evidence of demand for access to premium content on DTT-based platforms, from a variety of forecasts. Sky's Picnic proposals represent one such forecast, though one that is likely to be conservative, since Sky will have the incentive to design its Picnic product so as not to draw subscribers away from its satellite platform. Our view is that unmet demand on DTT-based platforms may lie in the region of two million subscribers over five years (including the one million customers who we would expect to switch from DSat, households who currently subscribe to other platforms, and households who do not currently subscribe to pay TV).

- The evidence in relation to unmet demand on IPTV is more complex, since the types of video on demand services which are best suited to IPTV platforms are still in their infancy. However, the success of the BBC's iPlayer service, and the level of interest in Project Canvas[4], suggests that the demand for pay IPTV services based on premium content may be significant. With its reliance on existing infrastructure, a flexible delivery mechanism and the option to offer converged services, and with the increasing prevalence of broadband, IPTV is likely to become an increasingly important distribution technology. It is likely for example that a service which offered access on demand to a library of first-run Hollywood movies, in return for a subscription payment, and accessible via a TV as well as a PC, would be popular with a broad range of consumers.

1.41 Consumer choice may also be restricted due to the range of retail bundles that are made available on each platform, and the associated pricing of these bundles. We would expect Sky as a retailer with market power to structure its prices so as to

[4] The proposed partnership between the BBC, ITV and BT to develop a next-generation set-top box combining Freeview with web-based delivery of on-demand content.

extract the maximum willingness to pay from all consumers, for example by encouraging them to trade up to the largest bundles.

1.42 In contrast, a more diverse downstream market would create a wider scope for disruptive innovation in pricing structures and retail packaging. This was illustrated, for example, by the entry of Setanta into the market, which resulted in the availability of a wider range of entry-level offerings, from a variety of different retailers[5]. These entry-level offerings include, for example, stand-alone premium packages, which eliminate the enforced buy-through which has **[✂]** been a characteristic of all Sky's retail offerings[6].

Platform innovation

1.43 We noted above that those customers who most value premium content are more likely to have chosen Sky's own satellite platform. This means that some consumers are likely to be on a platform which would not have been their first choice had premium content been equally available on all platforms.

1.44 This creates a risk that existing platforms may not create new capabilities, and that new platforms may not emerge at all, because of a dependence on access to premium content. This dependence might either be direct (e.g. the dependence of IPTV services on certain VoD rights) or indirect (e.g. because new platforms cannot build sufficient scale without access to premium content). Either way, there is a risk that platform innovation will be reduced.

1.45 We recognise of course that consumers on Sky's platform have been the beneficiaries of significant innovation by Sky. However, Sky clearly has an incentive to innovate in ways that play to the strengths of its own satellite platform, rather than in ways that play to the strengths of other non-Sky platforms. This is illustrated by Sky's investment in its Sky+ DVR service (which allows subscribers to a broadcast service to build up a local library of recent content) and its HD services (which exploit the high broadcast bandwidths available on satellite broadcast platforms).

1.46 It is important that future innovation is not restricted to those areas which favour Sky's existing platform. We are at a point in the development of the pay TV sector when new platforms using new distribution technologies, such as IPTV and mobile TV, could offer significant benefits to consumers. The types of innovation which these new platforms might deliver to consumers are of course difficult to predict qualitatively, and even more difficult to quantify. Based on the characteristics of these technologies, our expectation however is that they will offer consumers greater convenience and enhanced service flexibility, by allowing them to access content on demand, or when on the move. We see a real 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.

[5] Setanta went into administration on 23 June 2009, shortly after the live FAPL rights which had been held by Setanta were awarded to ESPN. ESPN has announced that it has agreed a wholesale deal with Sky for distribution on Sky's DSat platform. It has also announced an intention to make its channel including FAPL coverage 'widely available across multiple pay-TV platforms', although at the time of writing no other details of availability across platforms other than Sky's have been announced.

[6] **[✂]**.

Pricing

1.47 The analysis which has been carried out by Oxera suggests that Sky is earning and is likely to continue earning aggregate returns in excess of its cost of capital. This is likely to be reflected in high retail prices being paid by consumers.

Overview of possible remedies

1.48 As set out above, our concerns relate to Sky's approach to the wholesale supply of premium channels, restricted exploitation of content rights and high wholesale prices.

1.49 We might eliminate Sky's ability to restrict the availability of premium channels, by requiring it to provide wholesale access to particular content on regulated terms. We noted in our Second Pay TV Consultation that such a wholesale must-offer obligation would enable other operators to develop pay TV offers which include premium content, facilitating choice and innovation, and would do so without having a disruptive effect on Sky's existing business or existing consumers. It is therefore a proportionate form of intervention, and we consulted on it as our preferred way forward. We have carefully considered the arguments put forward in consultation responses, and this remains our preferred approach; the specifics of such an obligation are set out for consultation in paragraph 1.51 onwards below.

1.50 We also consider an intervention into the way rights are bought and sold, in order to eliminate or reduce Sky's market power. We noted however in our Second Pay TV Consultation that, in order for such an intervention to reduce significantly or eliminate the existing market power, it would be necessary to place severe restrictions on the ability of Sky and other firms to aggregate content. Given the acknowledged benefits to consumers of content aggregation, we were not convinced that this is the best way forward. We remain of this general view. Some more targeted intervention may however be necessary in relation to subscription video on demand movie rights, and in relation to the next FAPL auction, and we set out how we propose to proceed in paragraph 1.77 onwards below.

A wholesale must-offer obligation

1.51 We have further considered a number of specific questions relating to the potential scope and structure of a wholesale must-offer remedy.

1.52 **To which wholesalers should it apply?** We propose to apply the remedy only to those wholesalers that have market power, and appear to be acting on an incentive to restrict supply of the channels within the relevant markets. At present only Sky meets these criteria.

1.53 **Which channels should it cover?** A wholesale must-offer remedy should cover all the channels which make a material contribution to the market power which we have identified and which is being exploited. This implies that the scope of the obligation should extend to Sky Sports 1 and 2, and all the Sky Movies channels apart from Classics.

1.54 **Should a must-offer apply to retailers on all platforms?** We propose not to extend the remedy to cover retail on Sky's platforms. The primary purpose of the remedy is to address the restricted availability of Sky's Core Premium channels on non-Sky platforms, and the reduced innovation that is likely to arise from weakened inter-platform competition. Both of these concerns can be addressed by requiring Sky to supply its Core Premium channels only to retailers on non-Sky platforms.

1.55 We have considered and discounted several arguments for extending this obligation to retailers on Sky's own platform(s), specifically:

- We do not see evidence for high margins within Sky's retail business, which might require an intervention to ensure fair and effective competition.

- We acknowledge that an extension of the remedy would make it easier for alternative retailers to build up a large subscriber base, possibly increasing their ability to bid for content rights, and reducing upstream barriers to entry. We do not however believe this is necessary, since it should be possible to address Sky's existing subscribers through other platforms such as those using DTT. Furthermore, the retail subscriber base is only one of several factors which influence companies' ability to bid.

1.56 **Should a must-offer apply for the purposes of onward retail to commercial premises?** We propose not to extend the remedy to cover retail to commercial customers:

- We do not see evidence for restricted distribution of premium content to commercial premises. Concerns have been put to us about retail pricing, but to the extent that there are in fact problems with the current level of pricing, these cannot reasonably be addressed by a wholesale must-offer obligation with prices set on a retail-minus basis as we propose (see paragraph 1.59 below).

- We acknowledge that an extension of the remedy might make it somewhat easier for alternative retailers to build up revenues quickly, reducing upstream barriers to entry by avoiding the time taken to build up a base of commercial subscribers. We do not however believe the effect is likely to be sufficient for such an extension of the remedy to be appropriate.

1.57 We therefore propose to take account of concerns relating to the current level of pricing for commercial premises in our thinking on remedies relating to the way sports rights are bought and sold (see paragraph 1.77 onwards below).

1.58 **Should we set conditions of supply, particularly prices?** We believe it to be necessary for us to determine some of the conditions of supply within the offer, in particular prices. Not doing so would risk rendering the remedy ineffective for two reasons:

- The evidence of commercial negotiations to date suggests that a requirement to agree prices commercially would lead after a protracted period of negotiation to a stalemate.

- The only prices which other retailers might be able to agree with Sky are likely to be closely based on the current cable rate-card. However, as we discuss in more detail below, we do not believe this would allow competitors to Sky to build a viable business, and it would not therefore address the detriment we have identified.

1.59 **What approach should we take to setting prices?** We believe that there are a number of potential advantages associated with setting prices on a cost-plus basis, notably:

- It would allow us to set prices in a competitively neutral manner, without for example having to make any assumptions about the distribution technology used.

- It could in principle address concerns relating to high wholesale margins as well as availability of channels.

- It would avoid some of the practical difficulties associated with setting prices on a retail-minus basis, in particular those associated with retail bundling.

1.60 However, there is a major issue with cost-plus pricing in the context of pay TV, which is that it risks artificially depressing rights values. Firms are unlikely to bid vigorously for content rights if the result of doing so is to push up the future wholesale price of the channels they purchase from Sky. The approach which we have adopted is therefore to set prices on a retail-minus basis, but use current costs, which are not distorted by the existence of a wholesale must-offer, as a cross-check.

1.61 **Should a must-offer include enhanced versions of relevant channels, or associated services?** In order for the supply obligation to be effective, the channels which Sky supplies to other retailers must be of similar quality to those which it supplies to itself. Any material difference in quality would be a form of non-price discrimination, and is likely to reduce the effectiveness of the supply obligation. We have identified two areas where this principle applies:

- We propose to include HD as well as SD channels in the remedy. The difference in quality between HD and SD is already material to a significant number of consumers, and this number is likely to increase in the future.

- We propose to include additional video-streams supplied via interactive ‘red button’ services in the remedy, in circumstances where these contain actual coverage of sporting events which might normally be shown on the main channel. Examples are FAPL or UEFA Champions League matches, which might be shown in this manner due to scheduling clashes. We do not propose to include editorial content, which we see as readily replicable.

Pricing, and other conditions of supply

1.62 We have carried out a substantial piece of analysis to establish the appropriate level for wholesale prices:

- We derive retail-minus prices by considering a discounted cashflow analysis. We determine the wholesale price that an efficient retailer could afford to pay given its own retail costs and the need to earn a return, while at the same time matching Sky’s current retail prices.

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

1.63 We acknowledge that in addition to establishing the appropriate principles and methodology there is a degree of judgement to be exercised, for example, in what constitutes an ‘efficient’ entrant. We have based our analysis on Sky’s own costs, but propose the following adjustments:

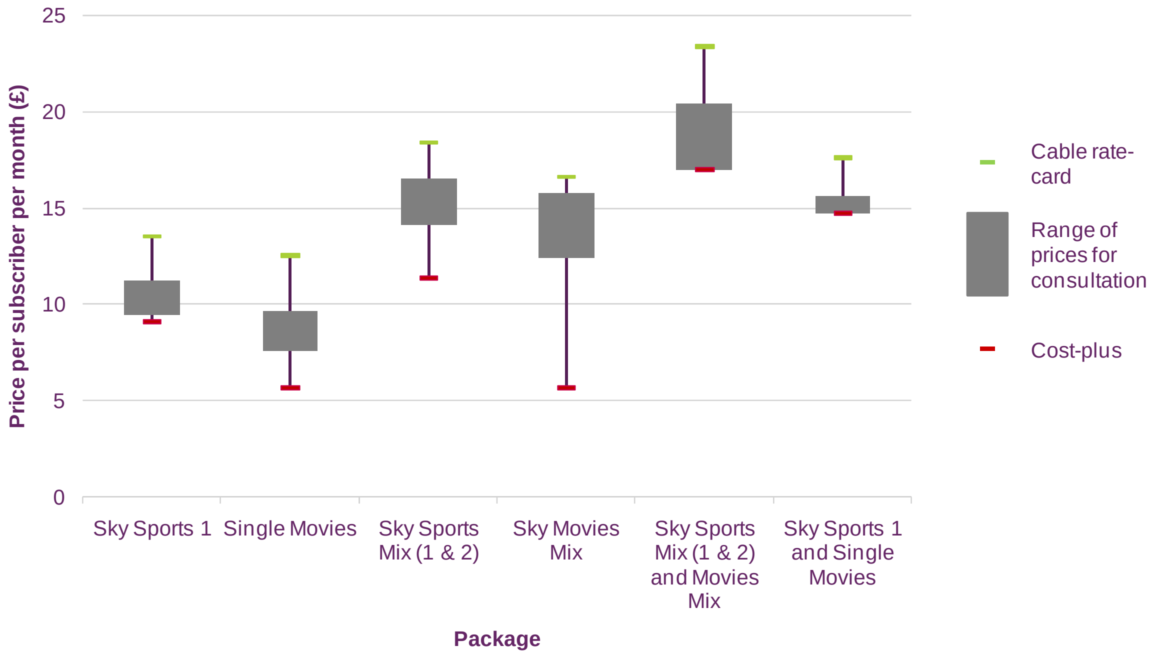
- Deriving prices for an entrant that would be as efficient as Sky at equivalent scale, but has smaller scale due to more recent entry, while avoiding the costs of market entry by inefficient sub-scale firms.

- Deriving prices which allow efficient entry using not only a satellite platform but also a DTT platform for distribution, given that DTT is the most likely technology to yield significant numbers of additional subscribers in the short to medium term.

- Putting in place wholesale pricing rules to ensure competitors can replicate Sky's broader bundles which include Core Premium channels, recognising that many consumers now buy pay TV, broadband and telephony as part of a wider bundle.

1.64 The figure below shows our proposed range of prices for consultation for each of the key wholesale products. This range of prices is below the existing cable rate-card offered to Virgin Media, and is consistent with our view that there are high wholesale margins at present. The range of prices is also above our cost-plus figures, which is designed to ensure that Sky continues to earn a reasonable return on its investment at the wholesale channel level. Indeed, our expectation is that Sky's wholesale revenues net of additional costs are likely to increase due to any reduction in wholesale charges to cable being more than offset by additional wholesale revenues associated with market expansion.

Figure 1 Chart showing range of prices for consultation for key products (£ per subscriber per month)



1.65 On the basis of the principles highlighted above, we propose that retail-minus prices should be set to allow a larger competitor to compete with Sky's retail prices, incorporating an allowance for DTT transmission costs and a reasonable return on investment. This would suggest prices roughly mid-way through our range for consultation.

1.66 We also propose to set an incremental wholesale price for HD versions of the Core Premium channels, to reflect Sky's own retail pricing structure. The range on which we are consulting is: £4.00-6.39 per subscriber per month.

1.67 There are a number of important terms not related to price that we propose to include in a wholesale must-offer:

- We propose that Sky should produce a reference offer which would set out fair, reasonable and non-discriminatory terms to form the basis of its commercial arrangements with third party retailers.
- We also propose to require Sky to provide a set of Minimum Security Requirements that are both platform and CA technology-agnostic, to protect against content piracy.
- We would expect Sky to issue a set of reasonable "Minimum Qualifying Criteria" for prospective retailers of its channels.

Proportionality

1.68 We have compared the impact of a wholesale must-offer remedy against the counterfactual of no intervention from several different perspectives:

1.69 **Consumers** would benefit from greater and freer platform choice, increased platform innovation, plus market expansion effects. A static analysis suggests an increase in consumer surplus over five years of around £370 million according to our central estimate, though this estimate is subject to a degree of uncertainty. We would expect additional dynamic benefits, due to retail and platform innovation. The effects of these are difficult to quantify, but we attach particular importance to the dynamic benefits to consumers associated with the effective exploitation of new distribution technologies, notably IPTV.

1.70 **Retailers other than Sky** would benefit from access to Core Premium channels, and be able to develop new and innovative products based on this access. Again, the dynamic benefits which we expect to arise from this innovation are difficult to quantify, but should be significant. They would however be partially offset by the duplication of fixed costs incurred during market entry. According to our static analysis, this duplication of fixed costs, together with subscriber acquisition costs as rival retailers build their subscriber bases, may result in a negative producer surplus over a five year period. This is unsurprising, reflecting the fact that our pricing analysis assumes a longer pay-back period, and that this assessment does not take account of other services and propositions we would expect these providers to offer. Our objective is to enable effective competition from efficient operators that are prepared to make a substantial long-term investment in pay TV, not to enable weak entrants to earn short-term profits at Sky's expense.

1.71 **Sky** would be subject to new regulation, and the associated administrative and compliance costs. It could also be subject to a reduction in its wholesale charges to cable and an extension of those wholesale charges to other operators. However, we expect these effects to be more than offset by additional wholesale revenues associated with market expansion. Sky's five-year producer surplus increases by around £240 million under our central estimate. In our low case, its producer surplus decreases by around £250 million, and in our high case it increases by £610 million. The proposition that our proposed intervention is beneficial for Sky, at least on a static analysis, may appear surprising, but it is consistent with our conclusion in section 6 that Sky has a static incentive to supply others even at wholesale prices well below current rate-card prices.

1.72 **Rights-holders** might be affected if there were a reduction in the level of wholesale revenue available to pay for rights, or if there was a major change in the incentives faced by bidders. We have considered the likely effect of a wholesale must-offer on the willingness to pay for upstream sports and movies rights of Sky and of other bidders. Our view is that the risk of a wholesale must-offer remedy (set on a retail-minus basis) leading to a significant decrease in rights values is low.

Proposed licence conditions

1.73 Ofcom has a principal duty under section 3(1)(b) of the Communications Act 2003 (CA03) to further the interests of consumers in relevant markets, where appropriate by promoting competition. Further to this, our sector-specific competition powers as set out in section 316 of CA03 require us to ensure fair and effective competition through the use of directions or conditions attaching to broadcast licences. This is fundamentally a different power to our power to assess anti-competitive behaviour under the Competition Act 1998 (CA98). It differs from CA98 not only in the fact that we can use our sector-specific competition powers ex ante, but also in the fact that the analysis of competition is conducted by reference to our sectoral duties rather than by reference to whether the relevant tests under CA98 have been breached. The potential ability to take action ex ante to promote competition is very different from an ex post review of whether a firm has acted illegally by pursuing anti-competitive behaviour.

1.74 Before using section 316 CA03 for the purposes of a wholesale must-offer, we must consider whether it would be more appropriate to proceed under CA98 to address some or all of the concerns identified. Our current view is that it would not be more appropriate to proceed in relation to some or all of the matters in question under CA98. Section 316 allows us to look forward and apply a remedy across the whole market, neither of which CA98 would do in this case. CA98 might not allow us to implement a comprehensive remedy, even if we were successfully to bring for example a refusal to supply or margin squeeze case.

1.75 Section 11 of this document includes a draft licence condition, to put into effect the proposals we have set out above. We welcome respondents' views on this.

1.76 It will be necessary to review our proposed remedy in the future. We would not expect to do this any sooner than three years from the initial implementation of the remedy, unless there were a substantial change in circumstances, such as for example a major change in rights ownership.

Content rights

1.77 As noted above, we do not believe there is a case for intervening to require major changes in the way content rights are bought and sold. We do however believe that there may be a case for more targeted interventions in relation to subscription video on demand (SVoD) movie rights[7], and in relation to the next FAPL auction.

SVoD movie rights

1.78 The wholesale must-offer obligation which we propose above should ensure the effective distribution of movie channels across different platforms. We do however have two residual concerns in relation to premium movie content, which are the limited exploitation of SVoD movie rights, and the presence of high wholesale margins associated with Sky's movie channels.

[7] I.e. rights that allow a retailer to supply a service where consumers pay a monthly fee, but are able to watch content when they want.

1.79 Both of these residual concerns could be addressed by making the SVoD rights available transparently and separately from the linear channel rights.

- This could enable the launch of innovative new services, to the benefit of consumers.

- An SVoD service would be likely to be a closer substitute for the linear service than the current closest substitute, which is pay per view. It could therefore provide an increased constraint on wholesale margins, thereby offering the possibility of addressing our residual concerns about high wholesale margins on movies.

1.80 We commented in our last document on the possibility of disruptive change in the way movie content is distributed, enabling new and innovative services, to the benefit of consumers. And we noted that this may not therefore be a good time for a regulator to attempt to set detailed behavioural rules governing the sale of movie content rights.

1.81 We remain conscious of this risk, but we are also aware of the risk that the way in which SVoD movie rights are currently being sold may be holding back innovation, since it is placing these rights in the hands of a company which does not have an incentive to exploit them. We note in this context that **[✂]**. Both of these considerations argue in favour of some form of intervention.

1.82 If we were to intervene, it is likely that we would make a market investigation reference to the Competition Commission under the Enterprise Act 2002 (EA02). We believe that we can satisfy the threshold for making such a reference, in that we have reasonable grounds to suspect that there are features of the market that prevent, restrict or distort competition. We also believe it may be appropriate to exercise our discretion to do so, in that there may be specific forms of consumer detriment which we cannot address using our powers as a sectoral regulator or competition authority, but which the Competition Commission may be able to address using remedies which are available to it.

1.83 We are not however consulting formally on such a reference at this stage. We first wish to explore further with the studios whether their existing commercial plans are likely to result in the more effective exploitation of SVoD rights, thereby avoiding the need for regulatory intervention. We plan to do so during the consultation period for this document, and will set out our proposed way forward subsequently.

Sports rights

1.84 The wholesale must-offer obligation which we propose above should also ensure the effective distribution of sports channels across different platforms. We do however have a residual concern in relation to collective selling. There are benefits to collective selling, which have been acknowledged by competition authorities; however, we would want to ensure that these are not outweighed by concerns stemming from its role in creating market power.

1.85 The last two FAPL auctions have been governed by commitments given to the European Commission by the FAPL, which were intended to limit the effects of collective selling. These commitments will not however apply to the next FAPL auction, in 2012, and we therefore intend to review with the FAPL how it intends to ensure that the 2012 auction complies with competition law. That might involve exploring with the FAPL whether it is willing to provide new commitments.

1.86 In doing so, one option might be simply to roll over the existing commitments. These have had some beneficial elements, facilitating the entry of Setanta into the market, and the development of new retail packages, in particular entry-level packages on non-Sky platforms. However, partially offsetting this, some existing consumers on Sky's satellite platform have had to purchase an additional subscription. Moreover, the consumer benefits which have resulted from Setanta's entry into the market have not proved to be sustainable, at least in the form described above.

1.87 We would expect to take this evidence into consideration when considering any new set of commitments. We emphasise however that this does not mean that our objective in considering any new commitments would be to intervene more aggressively in order to ensure the success of a successor to Setanta such as ESPN. Rather we would consider as a national competition authority whether the continued operation of the collective selling arrangement by the FAPL appreciably prevents, restricts or distorts competition contrary to Article 81(1) EU (and Chapter 1 CA98) based on evidence of developments in the market. In examining the need for ex post intervention we are likely to include consideration of the following:

- We would wish to minimise any disruptive effect for existing consumers, by ensuring that they continue to have access to the full range of content. We would particularly wish to ensure that consumers on existing platforms continue to have access to the full range of FAPL content.

- We would want to facilitate competition. The current commitments seek to achieve this by setting aside one package of rights, providing cross-platform exclusivity in relation to a subset of matches, for new entrants. We would wish to review the effectiveness of this approach. An alternative might be a reduction in cross-platform exclusivity for some matches, most likely achieved by making a subset of matches available on both DTT and existing platforms.

- We would wish to ensure that any reduction in the exclusivity premium associated with these rights does not artificially depress their value.

- We would wish to explore mechanisms by which commercial as well as residential consumers could be protected from the detrimental effects of collective selling. For example, we might want to establish separate sets of rights for residential and commercial subscribers. This would not risk damaging rights values because the two sets of rights would not be substitutes, but could potentially offer a viable entry strategy for retailers targeting commercial consumers, as well as providing greater transparency as to profitability levels.

Next steps

1.88 We are consulting on our analysis until 18 September 2009. We will then consider all responses before making decisions on whether to intervene under our sectoral powers and whether to issue a consultation on a reference to the Competition Commission.

Section 2

Introduction and legal framework

Summary

2.1 This is our third document on pay TV. We first consulted in December 2007 on the overall structure and operation of the market, before setting out more detailed analysis of market definition and market power in September 2008, along with broad proposals for remedies.

2.2 In this document we consider whether to proceed under our sectoral powers in s316 and consider the detailed form that a licence condition under s316 might take.

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

- On 20 March 2007, Ofcom announced that it was opening an investigation into the pay TV industry. BT, Setanta, Top Up TV and Virgin Media ("The Four Parties") had provided Ofcom with a preliminary submission on the pay TV industry on 16 January 2007.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2.4 We have published the submissions we have received from Sky over the past two months alongside this document, apart from Sky’s paper on security, which remains confidential.

Introduction

2.5 This process began as a general investigation into pay TV markets, prompted by a request for a market investigation reference to the Competition Commission (“CC”) under the Enterprise Act 2002 (“EA02”). We first consulted in December 2007 on the overall structure and operation of the market.

2.6 In the Second Pay TV Consultation we analysed pay TV markets, identified some particular concerns relating to access to premium content, and consulted on the possible broad forms of remedy that Ofcom could use to address those concerns.

2.7 Instead of making a reference to the CC, we proposed to meet our concerns over access to content by putting in place a wholesale must-offer condition using our sectoral competition powers under section 316 ("s316") of the Communications Act 2003 ("CA03").

2.8 The framework we used in the Second Pay TV Consultation reflected the fact that we were conducting a broad analysis of the sector in order to inform an assessment of what form of action (if any) it might be relevant to take. In general respondents did not consider that we should make a reference to the CC in preference to taking action under s316. This is consistent with the OFT Guidelines on market investigation references[8], which require us to consider action under sectoral or CA98 powers before making any reference.

2.9 In light of responses to our Second Pay TV Consultation we now focus directly on considering the case for an intervention under our sectoral competition powers, contained principally in sections 316 to 318 CA03. We therefore set out below our legal framework for considering an intervention under s316, taking into account consultation responses.

Section 316

2.10 Section 316 provides:

> "(1) The regulatory regime for every licensed service includes the conditions (if any) that OFCOM consider appropriate for ensuring fair and effective competition in the provision of licensed services or of connected services.
>
> (2) Those conditions must include the conditions (if any) that OFCOM consider appropriate for securing that the provider of the service does not—
>
> (a) enter into or maintain any arrangements, or
>
> (b) engage in any practice,
>
> which OFCOM consider, or would consider, to be prejudicial to fair and effective competition in the provision of licensed services or of connected services.
>
> (3) A condition imposed under this section may require a licence holder to comply with one or both of the following—
>
> (a) a code for the time being approved by OFCOM for the purposes of the conditions; and
>
> (b) directions given to him by OFCOM for those purposes.

[8] OFT 511: Market investigation references (March 2006)

(4) In this section—

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

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

2.11 Under s316 Ofcom has the power, acting as sectoral regulator, to ensure fair and effective competition in relation to the provision of licensed services[9]. When analysing competition concerns within the context of s316, we therefore consider whether those concerns create a risk that fair and effective competition is not occurring, and will not occur. If that is the case, then we consider what conditions (if any) it may be appropriate to insert into licences to make certain of providing for fair and effective competition against that risk. That may involve, consistent with our principal duty under s3(1)(b), intervening, in the interests of consumers, on an ex ante basis to promote competition.

2.12 In section 8 of the Second Pay TV Consultation we set out an explanation of our s316 powers. We explained that Sky holds television licensable content service licences under the Broadcasting Act 1990 for its premium sports and movie channels. These channels are therefore "licensed services" for the purpose of s316. Ofcom therefore has the power to include conditions in the licences for those services that we consider appropriate for ensuring fair and effective competition in the provision of those channels, and any services provided for purposes connected with the provision of those channels. We explained that we considered there is a risk that fair and effective competition in the provision of the licensed services is not and will not occur in respect of Sky's wholesaling of channels subject to broadcasting licences. We considered it may therefore be appropriate to intervene in the wholesale of Core Premium channels to ensure fair and effective competition is occurring and will occur. We therefore proposed to consider further the imposition of a licence condition to ensure fair and effective competition in the form of a wholesale must-offer obligation.

2.13 We now set out below the framework for our analysis under s316 in this document:

- In section 3 we set out some of the background context to our assessment of the sector, which highlights again the importance to pay TV markets of licensed channels which include premium content.

- In section 4 we define the markets that are relevant to our consideration of whether there is a risk that fair and effective competition in the provision of licensed channels including premium content is not occurring and will not occur.

- In section 5 we consider whether Sky holds a degree of market power in those markets such that it has the ability to act in a manner which is inconsistent with the conditions for ensuring fair and effective competition. We reach the view that Sky does hold that market power in relation to the supply of Core Premium channels.

[9] Or connected services

- In section 6 we consider Sky's ability and incentive to act in a manner which is not consistent with fair and effective competition. We reach the view that Sky's approach to the wholesale supply of Core Premium channels creates a position under which there is not, and is not likely to be, fair and effective competition.
- In section 7 we consider the effects on consumers of that position. We reach the view that there is an adverse effect on the interests of consumers.
- In light of the above we consider in section 8 whether it would be more appropriate to proceed under the Competition Act 1998 ("CA98").
- Having considered that, we then go on in the rest of section 8, and in section 9, to consider the form of licence condition (if any) it might be appropriate to include under s316 to ensure fair and effective competition. In section 10 we consider whether a licence condition in that form is proportionate by reference to the purpose of s316, and in light of our duties under CA03.
- In section 11 we present for consultation a proposed form of wholesale must-offer licence condition.

Respondents' views

2.14 In response to the Second Pay TV Consultation Sky essentially argued that Ofcom's power to act under s316 is no wider in its purpose or scope than its ability to act under CA98. Specifically, it argued that before Ofcom could use its powers under s316 it should meet the same conditions as those required under a CA98 case. In addition, Sky argued that we had not set out a test for the use of s316.

2.15 Sky argued that s316 is about protecting competition, not promoting it. It argued that s316 does not confer on Ofcom the power to "promote" competition, any more than would Ofcom's general competition powers under CA98. It said the lack of a promotion role for s316 is confirmed by looking at the definition of "for a competition purpose" in s317(9), which is about preventing behaviour and conduct prejudicial to fair and effective competition. It also argued that there is no greater connection made in the statute between s316 and s3 than with any of Ofcom's other duties.

2.16 The Four Parties' response argued that Ofcom has discretion to use its sectoral competition powers under s316 both in circumstances where there is no breach of the Competition Act and in circumstances where, notwithstanding a breach of the Competition Act, it is more appropriate for Ofcom to use its sectoral powers. It was argued that Ofcom's s316 powers must be interpreted in light of Ofcom's principal duty, pursuant to s3(1)(b) CA03 to further the interests of consumers where appropriate by promoting competition, and that this competition promotion function goes significantly beyond any powers Ofcom has under CA98 to remedy anti-competitive conduct.

2.17 The Four Parties also argued that the scope of Ofcom's s316 powers must be interpreted in light of its duty to establish a single set of regulatory objectives in a converged communications environment. It was argued that in order to ensure consistency in a converged communications environment, the scope of Ofcom's s316 competition promotion role should be interpreted in the light of Ofcom's powers under CA03 to impose ex ante SMP conditions on providers of electronic communications networks and services. The ability to impose ex ante regulation on broadcasters as well as providers of electronic communications networks and services would enable

Ofcom to deal effectively with situations where competing operators were providing services which bundle broadcasting services with other products.

Ofcom's views

2.18 We set out above our framework for the assessment under s316 in this document.

2.19 We do not agree that s316 is limited in its purpose and scope in the way that Sky suggest. Specifically, in Sky's view the scope of s316 is limited to preventing agreements and behaviour that would constitute breaches of CA98. Section 316 cannot therefore be used to "promote" competition by inserting positive conditions such as a requirement to offer a channel for wholesale supply. This supposes:

- that the concept of "ensuring fair and effective competition" is no different to the concept of protecting against competition infringements under CA98; and
- that s316 cannot be used to insert conditions into licences which require positive action on the part of the licensee (as opposed to preventing agreements or behaviour from taking place).

2.20 We do not consider that the concept of "ensuring fair and effective competition" is limited to protecting against the occurrence of agreements and behaviour that would constitute breaches of CA98, rather it has a different purpose and scope. There are a number of reasons for this.

2.21 First, the drafting of s316 is not limited in the way suggested. It was open for Parliament to have drafted these provisions in such a way as to limit the scope of action to preventing conduct and behaviour that would infringe the prohibitions in the earlier statute. It did not do this. It decided that the sectoral regime for broadcasting framed in sections 316 to 318 should be based around the concept of "ensuring fair and effective competition". This is a concept which has its separate origins in the duties of the Independent Television Commission under the Broadcasting Act 1990, and which, through that, became a part of the regulatory framework for television broadcasting licences. It was this framework which Parliament preserved by using the phrase "fair and effective competition" in sections 316 to 318. Aside from being clear in the drafting, it was also made explicit by the Minister at the Department of Culture, Media and Sport when this section was discussed in Parliament:

> "Those who argue against clause [316] believe that the Competition Act is sufficient to protect against anti-competitive behaviour in broadcasting. That is a cause of fundamental disagreement. Under the prohibitions in the Competition Act—those prohibitions on which Ofcom would largely have to rely were its sector-specific powers to be removed—intervention would be allowed only if there was an abuse of a dominant position, or if agreements existed that appreciably prevented, restricted or distorted competition. We are concerned about cases in which markets should be opened up to greater competition but where the legal tests required by the Competition Act are not met …
>
> The sector-specific powers contained in the Bill can be used to supplement those contained in the Competition Act. The Competition Act cannot be applied until the regulator has reason to believe that an enterprise has harmed the market by acting anti-competitively, or that the market has been harmed by existing agreements. As such, there are situations in which the use of sector-specific powers may be more effective, especially where

> advance action or action in a short time frame is required to ensure effective competition …
>
> Our policy is to carry over the safeguards that the ITC and the Radio Authority have had to guarantee that Ofcom has that same flexibility to ensure fair and effective competition as the other broadcasting regulators had pre-Ofcom"[10].

2.22 Sections 316 to 318 therefore create a sector-specific competition regime established precisely because Parliament was not satisfied that the CA98 prohibitions would be sufficient to enable Ofcom to protect the interests of consumers in these markets. In 2006 a joint DTI/Treasury report entitled "Concurrent Competition Powers in Sectoral Regulation" asked the question "why do the Regulators have Concurrent Competition Powers?". In response it found[11]:

> "Specific sectoral regulatory regimes in relation to competition primarily reflect the need to actively inject and promote effective competition into the sector, and to address the risk that businesses in these sectors have inherited, or by virtue of the nature of the characteristics of the markets involved, possess either alone or in conjunction with others, "market power" in the markets in which they operate i.e. the ability to exercise control over the price and/or output in a particular market, and (if not placed under additional controls to other undertakings) the opportunity to use it to prevent the development of effective competition in the market …
>
> sector-specific regulation reflects the fact that there is a role for the sectoral regulator as the facilitator of market reform, seeking to promote competitive markets wherever appropriate and acting as the catalyst to produce self-sustaining, effective, competition. The emphasis here is on ensuring the appropriate market conditions are present to encourage effective competition, as opposed to the emphasis of general competition law which is to prevent anti-competitive conduct. It is for this reason that the government has implemented sector-specific regimes in sectors whilst competition was developing."

2.23 Under s3(1)(b) Ofcom has a principal duty to further the interests of consumers in relevant markets, where appropriate by promoting competition. The markets which fall under Ofcom's jurisdiction include broadcasting markets. Section 316 provides one means by which Ofcom can discharge its principal duty. Sky's limited interpretation of the purpose and scope of s316 would be inconsistent with our principal duty.

2.24 It should be noted in contrast that Ofcom's s3 CA03 duties are specifically not applied in respect of Ofcom's competition functions under CA98 and EA02. As discussed below, the Communications Act therefore provides for a clear separation between Ofcom's role as a competition authority and its role as a sectoral regulator. It would be contrary to this structure for Ofcom to regard its powers under sectoral regulation as being limited by the content of the CA98 and EA02.

[10] House Of Commons Committee Stage (28 January 2003) Dr Kim Howells - Column 755

[11] http://www.berr.gov.uk/files/file29454.pdf, (Paragraphs 2.20 and 2.26)

2.25 We do not consider that the content of conditions imposed in licences under s316 is limited to conditions which prevent the licence holder from entering into an arrangement or engaging in a practice. Section 316(1) places no such limitation on the content of conditions. Section 316(2) explains that the content of conditions inserted under s316 "include" the conditions that Ofcom consider appropriate for preventing a licence holder from entering into particular arrangements or engaging in particular practices. This does not however limit the generality of s316(1). We consider that a wholesale must-offer form of obligation falls within the scope of s316(1) and can also satisfy the requirement in s316(2).

2.26 Sky seeks to rely on s317(9) to support its position on the limited scope of s316. Section 317(9) however goes to the question which s317 is addressing, which is whether it would be more appropriate for Ofcom to proceed under CA98. It does not go to the purpose and scope of Ofcom's power under s316.

The nature of the assessment under s317

2.27 Section 317(2) requires that before taking action under s316 Ofcom must consider whether it would be more appropriate to proceed under CA98. In section 8 of the Second Pay TV Consultation we therefore considered, by reference to s317 CA03, whether it might be more appropriate to rely on CA98 to address the competition concerns identified than to take action under s316[12].

Respondents' views

2.28 Sky thought that Ofcom had pre-determined the need for its proposed remedy. It argued that the fact that the pre-determined remedy could not be achieved under CA98 was not a permissible reason to conclude that CA98 powers are not appropriate.

2.29 Sky argued that, pursuant to s317, Ofcom must first establish why CA98 powers cannot be used before resorting to sectoral powers. It argued that Ofcom had not however carried out a detailed analysis to determine whether there was, or is likely to be, an infringement of CA98. Sky argued that because in its view s316 cannot be used to promote competition (see above) this cannot be cited as a reason why it is more appropriate to use than CA98. Sky quoted the DTI report on sectoral competition powers to support the argument that we should not use sectoral powers just because the CA98 threshold is high[13].

2.30 In Sky's view the difference between s316 and CA98 is that s316 can be used prospectively. But it is limited to prevention of agreements/behaviour that would constitute a breach of CA98.

Ofcom's views

2.31 We reject the assertion from Sky that Ofcom has pre-determined the evaluation under s317.

[12] See paragraphs 8.46 to 8.52.

[13] Paragraph 4.20 of the Joint DTI/Treasury report entitled "Concurrent Competition Powers in Sectoral Regulation".

2.32 The purpose of the sectoral competition regime provided under s316 is to give Ofcom the power to impose licence conditions to make certain of providing for fair and effective competition. In doing so it must take into account its other relevant sectoral duties, including its principal duty to protect the interests of consumers, where appropriate by promoting competition. In contrast, Ofcom's role as a concurrent competition authority under the Chapter II prohibition of CA98 provides it with the power to prosecute, on an ex post basis, an undertaking that has acted unlawfully by abusing a dominant position. As discussed above, this was clearly set out in the parliamentary debate on the purpose of s316.

2.33 The test under s317 is concerned with what power it is more appropriate to proceed under. It does not require Ofcom to establish that it is not possible to use CA98 powers to address the issues concerned.

2.34 We also do not agree with the suggestion that Ofcom must, before deciding to proceed under s316, conduct a detailed examination under a CA98 framework. Even in cases where Ofcom was considering using s316 as an ex ante measure to prevent a CA98 breach (as Sky suggests), a requirement, in essence, to first conduct a CA98 case to determine the lack of a breach, would defeat the purpose of having the ex ante power.

2.35 Further, it would not serve any purpose to conduct a detailed CA98 case if s316 was being considered explicitly on the basis that the competition concerns envisaged might not result in CA98 breaches. This brings us back to the differences discussed above over the scope of s316, and the difference between "ensuring fair and effective competition" and preventing breaches of CA98 from occurring.

The duties relevant to our assessment under s316

Our position in September

2.36 In the Second Pay TV Consultation we described the duties which we considered to be relevant to the market investigation[14].

2.37 We highlighted that Ofcom has a principal duty under s3(1)(b) CA03 to further the interests of consumers in relevant markets, where appropriate by promoting competition. We said that this duty to promote competition means that we are required, where appropriate, to take a dynamic and forward-looking view of the effectiveness with which competition is expected to deliver benefits to consumers. We explained that we would carry out that assessment by reference to our statutory duties, the statutory framework and the criteria we have developed for the assessment of the industry.

Respondents' views

2.38 Sky argued that we placed an inappropriate level of emphasis on the second part of the s3(1)(b) duty, i.e. "where appropriate by promoting competition". In its view the promotion of competition does not constitute the duty – the focus of the duty is to further the interests of consumers. Sky thought that we had not properly taken into account our other duties under the Act – in particular sections 3(3), 6 and 7 – and that we should also have considered the desirability of encouraging investment and innovation.

[14] See paragraphs 2.19 to 2.23

Ofcom's views

2.39 We set out again below the duties we consider are relevant to an assessment under s316 and explain in further detail how those duties apply to the analysis in this document. It is first important to emphasise a key difference between analysis of competition issues under our role as sectoral regulator as opposed to competition authority.

Application of duties to competition issues

2.40 Under s370 and s371 CA03, Ofcom cannot apply its duties under s3 when exercising its functions as a competition authority under CA98 or EA02[15]. This carve-out created a clear separation between Ofcom's role as a sectoral regulator and its role as a competition authority. Where Ofcom addresses issues under CA98 or EA02 it does so in the same manner as the Office of Fair Trading and therefore, in particular, it does not have regard to a principal duty involving the promotion of competition. This approach helps to ensure consistency among regulators and the Office of Fair Trading when they exercise their functions.

2.41 However, where Ofcom addresses competition matters as a sectoral regulator under CA03, for instance under s316 in relation to broadcasting, it must do so by reference to the full range of its duties. Section 316 is one means by which Ofcom might act to discharge its duty under s3(1)(b).

Section 3(1)

2.42 Under s3(1)(b), Ofcom has a principal duty to further the interests of consumers in relevant markets, where appropriate by promoting competition.

Section 3(2)

2.43 By virtue of its principal duty Ofcom is required to secure under s3(2), amongst other things:

- The availability throughout the UK of a wide range of TV and radio services of high quality which appeal to a variety of tastes and interests. We therefore consider the impact that restricted availability of certain premium content may have on the offering of TV and radio services. In particular we discuss in section 7 the potential impact on innovation in relation to content by retailers seeking to compete with Sky.

- The optimal use of the electro-magnetic spectrum. This is particularly relevant in the context of DTT, where capacity is somewhat constrained.

- The availability throughout the UK of a wide variety of electronic communications services. We therefore consider the impact that restricted availability of certain premium content may have on the availability of electronic communications services. In particular we discuss in section 7 the potential impact on the emergence of new pay TV platforms.

[15] Ofcom may however have regard to any matter to which the Office of Fair Trading could have regard in carrying out the same functions.

Section 3(3)

2.44 Under s3(3)(1) Ofcom must have regard to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent, and targeted only at cases in which action is needed.

- Transparency and accountability: This is Ofcom's third consultation under its market investigation process. During this process we have published a substantial amount of information, produced by ourselves and also by stakeholders. We take these principles into account in this document, in particular in our approach to considering the appropriate form of remedies for dealing with competition concerns identified.

- Proportionality, consistency and targeting cases where action is needed: We take into account these principles in particular in section 10 where we consider the proportionality of an intervention under s316 CA03 by reference to an impact assessment and in the process of considering the options for the content of remedies for consultation.

2.45 Under s3(3)(b) we must also have regard to our own regulatory principles, which include the requirements that:

- Ofcom will operate with a bias against intervention, but with a willingness to intervene firmly, promptly and effectively where required.

- Ofcom will strive to ensure its interventions will be evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome.

- Ofcom will always seek the least intrusive regulatory mechanisms to achieve its policy objectives.

- Ofcom will consult widely with all relevant stakeholders and assess the impact of regulatory action before imposing regulation upon a market.

2.46 These principles are taken into account in sections 8 to 12 below in the assessment of potential remedies for addressing the competition concerns identified.

Sections 3(4) and 3(5)

2.47 Section 3(4) CA03 sets out certain other factors to which Ofcom should have regard in performing its principal duty of furthering the interests of citizens and consumers. Those which are most relevant in the context of this process are:

- The desirability of promoting competition in relevant markets. This further establishes that in regulating the broadcasting sector Ofcom has a duty to consider the merits of interventions designed to promote competition where we have identified issues affecting consumer interests.

- The desirability of encouraging investment and innovation in relevant markets. We include in our impact assessment and our consideration of potential remedies the potential (positive and negative) impacts on investment and innovation.

- The opinions of consumers and members of the public. We have used consumer surveys to inform our analysis where appropriate and welcome further responses to this consultation from members of the public.

2.48 Under s3(5) Ofcom must also, when performing the duty of furthering the interests of consumers, have regard to the particular interests of those consumers in respect of choice, price, quality of service and value for money. We have used this section to formulate the criteria by which the sector has been assessed and therefore to address the question of whether Ofcom needs to act to ensure "fair and effective competition" for the purposes of s316.

2.49 In the rest of this section:

- We summarise the work we have carried out since the last document.
- We discuss some of the main developments in the market since the last document was published.
- We answer some of Sky's criticisms on the running of our process.
- We set out in more detail the content of the document.
- We explain the relationship with the assessment of Sky's Picnic proposal.
- We explain the position on other issues raised by the Four Parties.

Work carried out since our Second Pay TV Consultation

2.50 Since publishing our Second Pay TV Consultation in September 2008, we have carried out a variety of work, in particular in order to be able to reflect on responses to the consultation. This work has included the following:

- We have collected a wide range of information from stakeholders, to allow us to update our analysis. This includes:
    - Updated revenue and subscriber data, to inform our analysis of market definitions and market power.
    - A document trawl covering internal and external correspondence from several parties relating to negotiations over possible wholesale channel supply.
    - The detailed cost information required for our analysis of pricing and profitability.
    - Information on the outcome of the February 2009 FAPL auction, and information on the current distribution of other important sports rights between different broadcasters.
    - Information on the current ownership of specific movie rights, and the process by which these were awarded.
- We have carried out an analysis of retail markets. This work is described in section 4.
- We engaged Oxera to carry out a more detailed review of Sky's profitability, assessed against suitable benchmarks. The Oxera report is provided at Annex 9, and discussed in section 6.

- We engaged Value Partners to carry out a review of the background to and effects of wholesale must-offer obligations in other major communications markets, to inform our further analysis of the appropriateness of such a remedy. Value Partners' final report is included here at Annex 11, and discussed in section 8.

External factors

2.51 One important event since the last document is that the FAPL has held the auction for the live rights to that competition for the 2010/11 to 2012/2013 seasons. The outcome of this was a material change relative to the previous auction in 2006, both in terms of the outcome of the auction, and the subsequent impact on the market.

2.52 In the previous auction Sky won four of the six live packages, with Setanta winning the other two. Setanta's access to this content allowed it to build a significant subscriber base, on several different platforms, both as a wholesaler and as a retailer in its own right. As of September 2008, Setanta had a retail subscriber base totalling **[✂]** (**[✂]** on satellite and **[✂]** on DTT) and a further **[✂]** wholesale subscribers on both cable and DTT.

2.53 The outcome of the February 2009 auction was that Sky won the rights to five of the six available packages, which is the maximum available to a single bidder. Setanta won the rights to the remaining package, generally recognised to be the least attractive, with the largest number of fourth pick matches.

2.54 Since February 2009, Setanta's future has become increasingly uncertain, culminating in the days before publication of this document in it losing its FAPL rights and going into administration.

- On 19 June 2009 the FAPL announced that Setanta had been unable to meet its financial obligations, and that the existing licence agreement between FAPL and Setanta had therefore been terminated, with immediate effect.

- The FAPL further announced its intention to auction the live rights which had been held by Setanta to show the 46 UK live matches for the 2009/10 season. Of these, Sky is precluded by the FAPL's commitments to the European Commission from winning both packs of 23 matches.

- On 22 June the FAPL announced that ESPN had won the rights to both packs of matches that Setanta had previously licensed for the 2009/10 season, and the one pack that Setanta had licensed for the 2010/11 to 2012/13 seasons[16]. At the same time ESPN announced that it had agreed a wholesale deal with Sky for distribution on Sky's DSat platform. ESPN also said that it intended to make its channel including FAPL coverage "widely available across multiple pay-TV platforms". At the time of writing, no other details of the availability of this channel across platforms other than Sky's are available.

- Following this, it was announced on 23 June that Setanta had gone into administration[17].

[16] http://www.guardian.co.uk/media/2009/jun/22/espn-wins-premier-league-rights

[17] http://www.guardian.co.uk/media/2009/jun/23/setanta-goes-into-administration

2.55 These recent events took place only a few days before this document was published. For that reason, much of the analysis is based on Setanta's presence in the market. We have where possible reflected on the impact of the changed position where Setanta's demise has a significant impact on our analysis.

Sky's comments on Ofcom's process

2.56 Sky argued in section 8 of its response to our Second Pay TV Consultation that there have been various procedural defects with Ofcom's process. Specifically, it argued that:

- Ofcom has approached the process with a closed mind, based on a preconceived analysis, so that the process has always been about getting to a pre-selected remedy.
- Ofcom has kept it "in the dark" about certain matters – for example its views on profitability, such that the process has not been fairly balanced.
- Ofcom has not taken sufficient time to analyse its responses or had regard to specific pieces of evidence.
- Ofcom has not allowed Sky adequate time to respond to consultation, taking into account Sky's limited resources.

2.57 We do not recognise or accept the flaws in the process which Sky has argued exist, specifically:

- We have been careful not to proceed simply on the basis of precedent established by previous investigations. We have also been careful not to take at face value allegations made by any parties to this investigation. We have instead tested each of our conclusions in an objective and transparent manner against all the evidence which is currently available.
- The evidence on which we rely, and the conclusions which we reach from that evidence, have been set out for full public consultation in December 2007 and September 2008. We have not consulted on our views outside of these public consultations, since that would have been inappropriate, except for some specific instances where we have needed to clarify our understanding of particular pieces of evidence which have been put to us.
- We recognise the need to have regard to all the evidence which is put to us, and take the necessary time to do so. It is however also important that we reach decisions in a timely manner, as Sky has itself suggested in reports relating to its Picnic application[18]. A particular concern associated with this market investigation has been the number of responses to our consultations which have been submitted late, and the number of additional submissions which have been received. A detailed chronology is set out at the beginning of this section. It includes for example a supplementary response from Sky to the analysis of market definitions and market power on which we consulted in September 2008. This supplementary response was received on 1 June 2009, almost five months after the January 2009 deadline for responses, which was itself extended to a

[18] http://www.guardian.co.uk/media/2008/sep/12/bskyb.television.

date agreed with Sky precisely in order to allow Sky adequate time to provide a full response.

- We are aware that conducting a process of this kind in itself imposes a burden on stakeholders. However, the importance of the issues at stake justifies the continuance of the investigation, and Sky itself acknowledges that the investigation must take full account of all available evidence. We have attempted to minimise the burden associated with gathering such evidence by only gathering that information which we believe to be necessary to resolve specific issues, and discussing with stakeholders the least burdensome means of gathering this evidence.

Relationship to review of Sky's Picnic proposals

2.58 Our assessment of the proposal from Sky and Arqiva for a new pay TV service on DTT, to be called 'Picnic', has been closely linked to our pay TV market investigation. In particular, they have both considered the issue of access to premium content.

2.59 In our consultation document entitled "Proposed BSkyB Digital Terrestrial Television Services", which we published on 30 September 2008, we consulted on our view that we should consent to the proposal subject to the following conditions:

- A wholesale must-offer arrangement, under which Sky would be required to supply its Core Premium channels on a suitable wholesale basis which is commercially viable, in particular, subject to certain conditions in relation to wholesale pricing.

- The use of simulcrypt, under which other retailers of pay TV services on DTT, using different conditional access systems, could access Sky's Core Premium channels without needing to transmit the same channels more than once, subject to suitable security requirements.

- Ancillary conditions, which would focus on our intended outcome for competition and consumers by ensuring that a wholesale must-offer arrangement is not easily manipulated to be ineffective, but commercially and technically workable.

2.60 The majority of respondents to that consultation indicated that they agree our consent to the proposal would need to be subject to regulated wholesale prices for Sky's Core Premium channels[19]. Accordingly, we are consulting on a range of wholesale prices in this consultation, in order to consider the relevant factors, before we conclude on our assessment of the Picnic proposal.

The potential use of competition powers to investigate allegations regarding Sky's conduct

2.61 The Four Parties made a variety of allegations regarding conduct by Sky in their submission of July 2007.

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[19] We received 24 responses to our second consultation on Sky's Picnic proposal, of which six are confidential in their entirety. We received four responses which contained some confidential material, but where a non-confidential version was also provided, whilst 14 responses contained no confidential material. The 18 non-confidential responses are available on our website at: http://www.ofcom.org.uk/consult/condocs/picnic/responses/.

2.62 A number of these allegations are already addressed directly in this document, and in these cases we explicitly set out whether we believe it would be appropriate to take any action under CA98, specifically:

- Allegations relating to Sky's conduct in relation to its supply of Core Premium channels are discussed in section 6.
- Allegations relating to the acquisition and usage of rights from the six major Hollywood studios are also discussed section 6.
- Allegations relating to the acquisition and usage of sports rights are discussed in section 12.
- Allegations relating to the supply of Core Premium channels to the commercial sector are discussed in section 12.

2.63 There are some other groups of allegations which we have not taken forward on grounds of administrative priority, specifically:

- Allegations relating to matters which were the subject of the High Court action between Sky and Virgin on the supply of basic channels, which has now been settled.
- Allegations relating to the supply of basic channels, which we are not focusing on at this stage given our preliminary conclusions on the market for basic channels reached in December 2007.
- Allegations which fall within the scope of existing ex ante regulation, but where we have not received a complaint in relation to compliance with this regulation.
- Allegations which related to issues where the associated consumer detriment did not warrant further attention at this stage, such as provisions in the contracts for the purchase by Sky of basic channels.

2.64 There are no other allegations relating to Sky's conduct made in the July 2007 Submission that we plan to take forward at this point.

Content of the remainder of this document

2.65 This is now the third document we have published as part of this pay TV market investigation.

2.66 We have now consulted extensively on some of the issues in this document, and received detailed responses. We set out our position in light of these responses as follows:

- Our assessment of relevant features of the market.
- Market definition for the supply of wholesale sports and movies channels.
- Our assessment of market power in these wholesale markets.
- Competition concerns arising from this market power, relating to restricted supply to downstream platforms and retailers.

2.67 We set out some new evidence and analysis, on which we invite comment, including:

- Changes in rights ownership since our last consultation, as well as some outstanding issues relating to content rights.
- An analysis of Sky's profitability.
- Retail market definitions for the supply of sports and movie channels, and an associated market power assessment, building on material presented in our first document.

2.68 We confirm our intention in principle to take forward a wholesale must-offer remedy, subject to a detailed assessment of its proportionality, and consult on:

- The terms of the proposed wholesale must-offer remedy, including price.
- Our impact assessment.
- The specific licence conditions we would put in place.
- Finally, we set out how we propose to address some residual concerns in relation to the way specific content rights are sold.

2.69 The remaining sections of this document are therefore set out as follows:

- Section 3: structure and characteristics of the UK pay TV market.
- Section 4: market definition of wholesale and retail markets for the sale of Core Premium Sports and Movies channels.
- Section 5: assessment of market power in relevant markets.
- Section 6: analysis of competition issues.
- Section 7: analysis of consumers' experience of pay TV, and the likely effect of competition issues.
- Section 8: assessment of whether to take forward a wholesale must-offer remedy.
- Section 9: the terms of a wholesale must-offer remedy.
- Section 10: an assessment of the proportionality of our proposed wholesale must-offer.
- Section 11: consultation on amended licence conditions.
- Section 12: an assessment of the options for intervening in the way content rights are bought and sold.

2.70 There are several annexes contained within this document, as follows:

- Annex 1: responding to this consultation.
- Annex 2: Ofcom's consultation principles.

- Annex 3: consultation response cover sheet.
- Annex 4: summary of consultation questions.
- Annex 5: glossary of terms used in this document.

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

- Annex 6: market definition appendices.
- Annex 7: analysis by Professor Andrew Chesher of the report produced by Professors Seabright and Magnac for Sky as part of its response to our Second Pay TV Consultation.
- Annex 8: further details of parts of the market power analysis.
- Annex 9: Oxera report on Sky's profitability and on benchmarks for returns across wholesale and retail businesses in pay TV industries across a number of countries, and non-pay TV industries in the UK.
- Annex 10: Ofcom / Brattle Group analysis of Sky's cost of capital.
- Annex 11: Value Partners report on examples of wholesale must-offer remedies in other markets: Australia, France, Italy, Singapore, Spain and the United States.

Section 3

The UK pay TV market

Summary

3.1 Pay TV has become by some distance the biggest source of revenue in the UK's TV industry, and has developed from its early years of cable and satellite offerings to an environment where there is the potential for a wide variety of services over different delivery mechanisms including IPTV and pay DTT.

3.2 However, we believe there are particular characteristics which are likely to remain little changed by the kinds of technical developments we have seen, and which are likely to affect our assessment of whether it is appropriate to take action to ensure fair and effective competition. The characteristics we focus on here are:

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

Introduction

3.3 In our First Pay TV Consultation we set out an overview of the UK pay TV market, and a number of characteristics of the market which we thought likely to influence the way in which competition operates, and services are delivered to consumers.

3.4 In our Second Pay TV Consultation we focussed on the particular importance of premium content, and the possibility that market power in the wholesale supply of premium content might restrict competition, to the detriment of consumers.

3.5 In this section we summarise our current view of those characteristics of the market which we have set out previously. In subsequent sections we consider the question of whether there is market power in the wholesale supply of premium content, and the likely effects on competition and on consumers.

Overview of the UK pay TV market

3.6 We noted in our First Pay TV Consultation that the emergence and growth of pay TV markets in the UK and elsewhere has been driven historically by cable and satellite broadcasters, providing consumers with the option of paying for a wider choice of content than had traditionally been available from free-to-air, terrestrial broadcasters.

3.7 In the UK the main cable and satellite pay TV operators are:

- Sky, created by the merger of Sky Television and British Satellite Broadcasting in 1990. Sky now has 9.3 million retail subscribers in the UK and Ireland.

- Virgin Media, created by a consolidation over 13 years of the cable franchise areas created in 1984, culminating in the merger of NTL and Telewest in 2006, and the subsequent re-branding in 2007 to Virgin Media. Virgin Media now has 3.7 million subscribers.

3.8 Pay TV services have also been provided on Digital Terrestrial Television (DTT). ONdigital launched its service in 1998. It re-branded as ITV Digital in 2001, in an attempt to exploit the ITV brand, but went into administration in March 2002, after attempts to renegotiate the terms of its rights deal with the Football League failed. The number of subscribers reached a peak of 1.2 million at the end of 2001.

3.9 Freeview was launched in 2002, using the DTT spectrum released following the failure of ITV Digital. It provided a credible free-to-air alternative for those consumers who wanted multi-channel TV but did not wish to pay for it. There are now 9.8 million Freeview-only households.

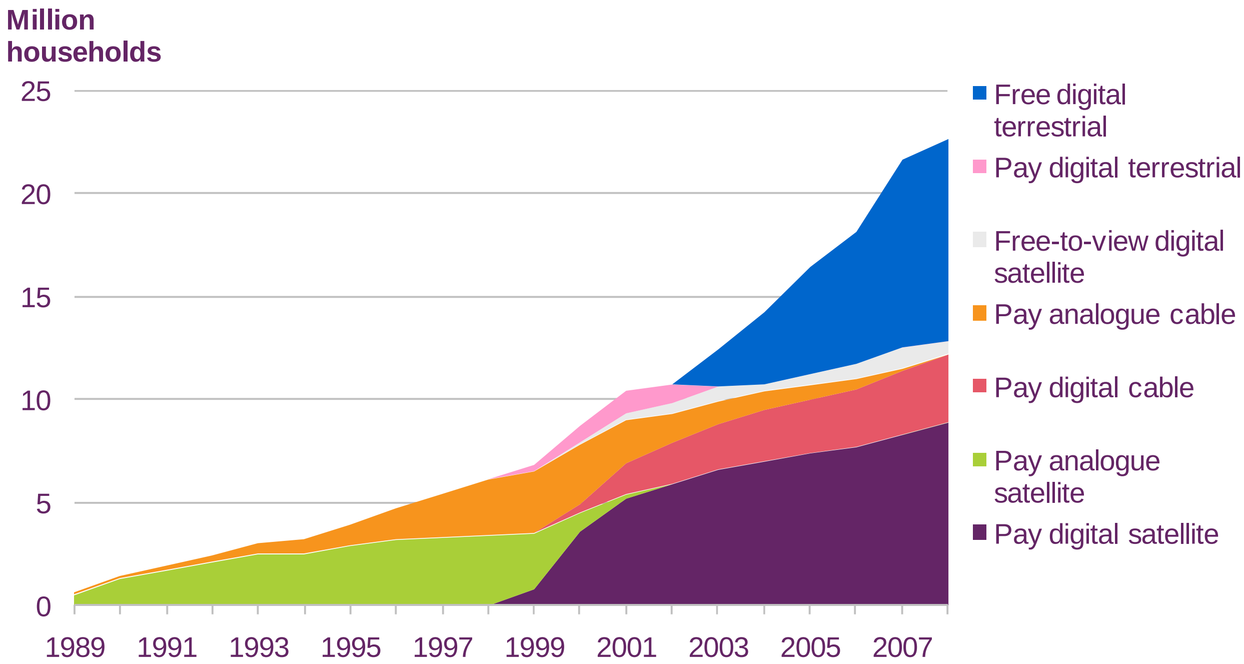
3.10 The historic growth in these pay TV and free-to-air services is illustrated in Figure 2 below. It is possible to distinguish three fairly distinct periods of growth:

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

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

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

Figure 2 Multi-channel penetration (main TV set)



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

3.11 We observed that the increased importance of retail pay TV services to consumers has been reflected in a substantial increase in the importance of the associated revenues to industry. Since 2004, pay TV subscriptions have made up the largest revenue stream within TV broadcasting. In 2008, current estimates suggest that subscriptions reached £4.6 billion, exceeding the revenue generated by TV advertising (£3.2 billion) and public funding (£2.7 billion). More recently, pay TV subscriptions appear to be relatively resilient to the current recession, continuing to rise in real terms year-on-year, while television advertising revenue experienced real-terms reductions in the final two quarters of 2008.

3.12 We noted that there have been a number of important developments recently, including:

- The consolidation and restructuring of the historically fragmented UK cable industry under the Virgin Media brand.
- The emergence of new platforms for delivering pay TV services (BT Vision, Top Up TV, Tiscali / Homechoice) based on new distribution technologies.
- New platforms are also emerging for the delivery of multichannel free-to-air services, and some of these also have the potential to deliver pay TV services (e.g. Freesat, Canvas).
- The intervention by the European Commission to change the way in which Premier League football rights are sold. The 2007/8 football season was the first since 1992 for which Sky has not owned these rights exclusively.

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

3.13 We acknowledged that the future development of the market cannot in these circumstances simply be extrapolated from the past. Our analysis of fair and effective competition must therefore take a forward-looking view, focusing on those characteristics of the market which are most likely to influence its development over the next few years.

3.14 Finally, we laid out our view of the structure of the pay TV value chain. We suggested a model, illustrated in the figure below, in which the supply chain for the UK broadcasting industry consists of four layers:

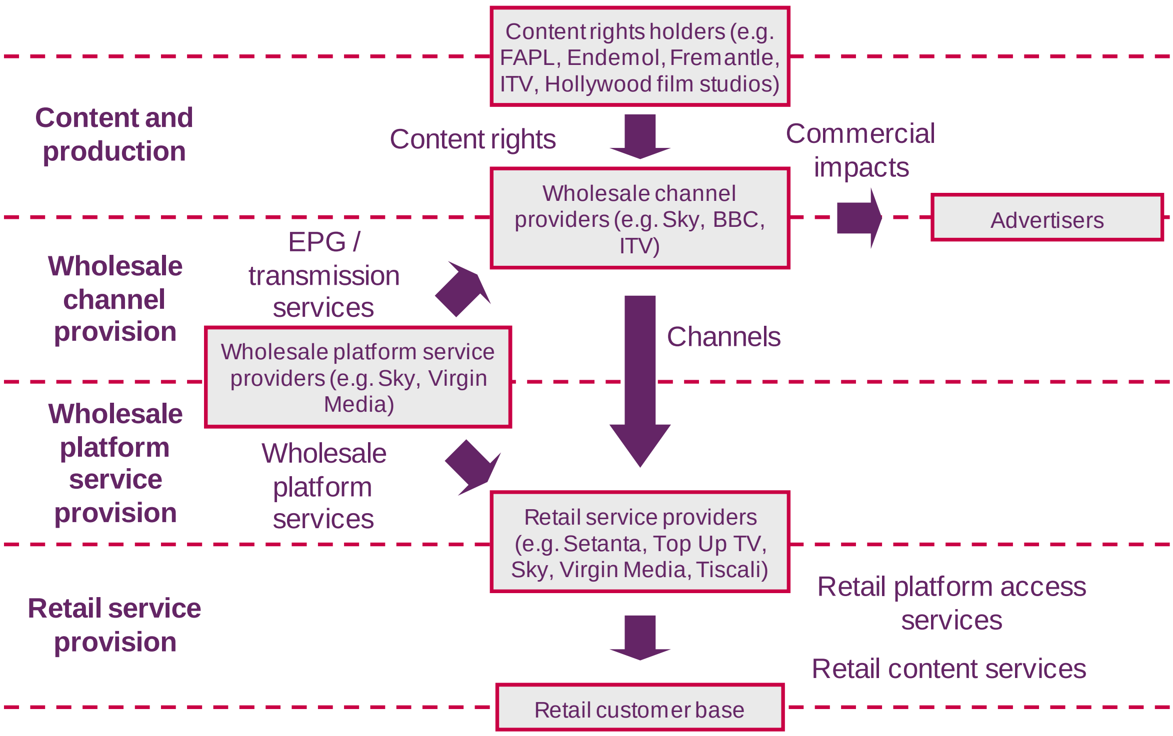
- Content production, for example creating and recording content which can be broadcast.

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

- Wholesale platform service provision, provides services to enable retailers to restrict the supply of content to consumers, or providing Electronic Programme Guide (EPG) services to broadcasters.

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

Figure 3 Pay TV value chain



Characteristics of the market

3.15 Following on from our analysis of structural characteristics of the market in our First Pay TV Consultation and our further exploration of some of these in our Second Pay

TV Consultation, we set out here a number of characteristics which influence the operation of the pay TV sector and which are therefore relevant to our assessment of whether it is appropriate to take action to ensure fair and effective competition. We set these out here:

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

Premium content as a driver of pay TV subscriptions

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

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

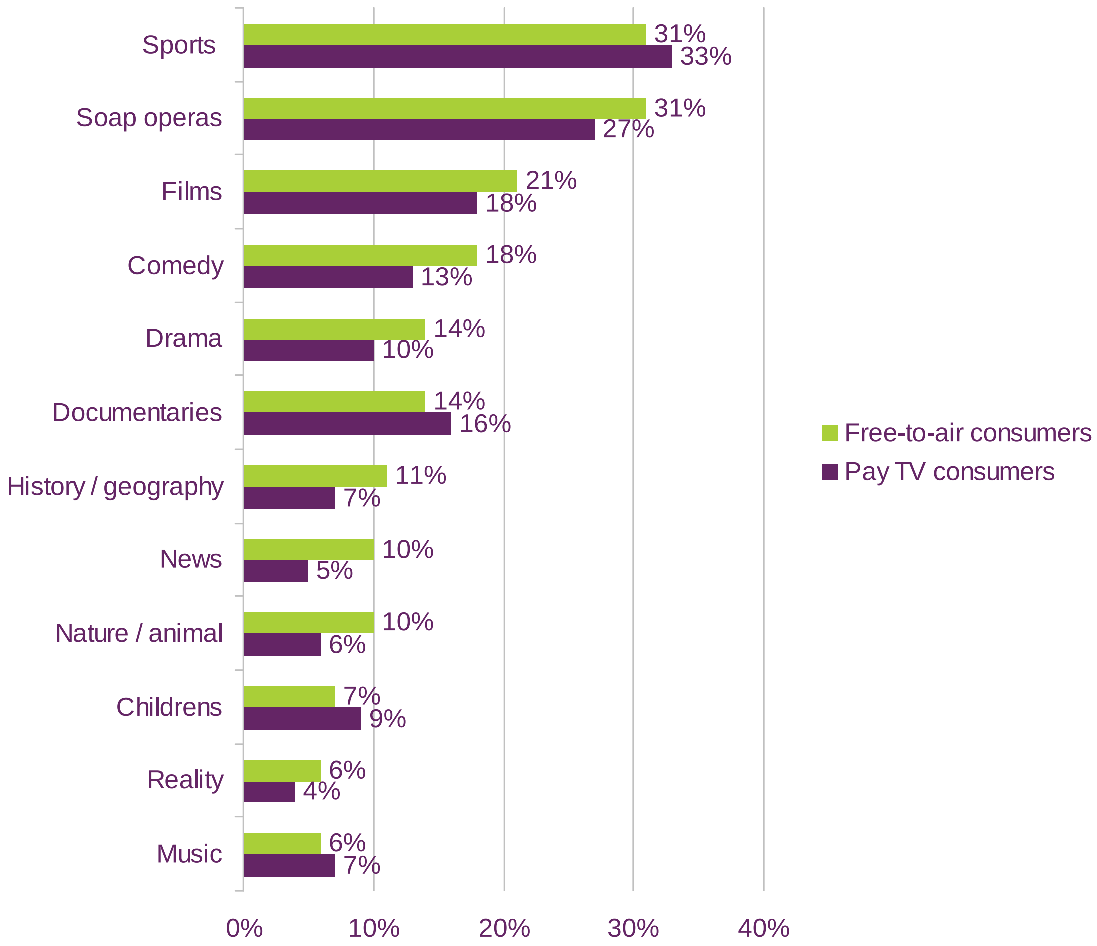
3.18 Although the general importance of attractive content to any broadcaster is straightforward to understand, the question of which specific content is most important as a driver of pay TV subscriptions is more complex. This is because the characteristics which viewers look for when deciding what programme to watch are highly subjective – the level of interest in a particular genre or a particular storyline, the attractiveness of particular actors or actresses, the degree of support for a particular sporting event or for a particular team, and so on. As a result, consumers have very varied preferences for different types of content. This was illustrated by the consumer research which we have set out in our previous consultation documents[20].

3.19 We stated in our Second Pay TV Consultation that content which is likely to be most effective in driving pay TV subscriptions must have two characteristics: a significant appeal to a broad audience, and limited availability via free-to-air TV channels. Content which has a broad appeal, but which is widely available free-to-air, such as some of the UK-originated content available via the public service broadcasters, is unlikely to drive pay TV subscriptions, since consumers are unlikely to pay a significant premium to watch programmes similar to those which they can watch for free.

3.20 Figure 4 below shows the genres of content that are most attractive to consumers.

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

Figure 4 Chart showing varied preferences (consumer research)



Base: All multi-channel TV household decision-makers for whom content is 'must have' (FTA 045, pay TV 947)

Source: Ofcom pay TV research phase one (June / July 2006)

Notes: Spontaneous mentions of programme genre among those for whom content is 'must have'.

3.21 The three genres that are most valued by consumers are sports, soap operas and films. Of these, soap operas are widely available on free-to-air television, and so are unlikely to be a primary driver of pay TV subscriptions. The same is true of other genres which are valued by consumers, such as comedy, drama and documentaries.

3.22 Sports and films are the genres which stand out as being amongst the most valued genres by consumers, and also having a high degree of exclusivity to pay TV. On this basis alone we would expect them to be key drivers of pay TV subscriptions. We used a variety of evidence in our Second Pay TV Consultation to analyse the importance of sports and movie content in more detail, and we set this out again below.

Sums paid for content rights

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

- Sports programming represented 54% of Sky's programming costs in 2007/08, and 22% of Sky's entire operating expenses. This is higher than any other category of operating expenditure – marketing is the next biggest at 18%[21]. Further, despite the recession, the amounts paid by Setanta and Sky for FAPL rights in the February 2009 auction were 4% greater than the equivalent figure in 2006.

- Movies programming represented 16% of Sky's programming costs in 2007/08, and 7% of Sky's entire operating expenses. This is significantly lower than Sky's expenditure on sports programming, but is similar in magnitude to Sky's total expenditure on all third party channels (17% of programming costs) and significantly higher than its total expenditure on its own news and entertainment channels (12% of programming costs).

Statements made by market players

3.24 The statements Sky in particular has made both in public and private illustrate how important premium content, and in particular premium sports content, is in assembling a pay TV business. The most well-known of these is Rupert Murdoch's comment at the 1996 AGM of News Corp (a major shareholder in Sky in the UK) that sport would be the "battering ram" of pay TV. More recently, a quote from Rupert Murdoch in a documentary aired on Sky One in June 2007[22], reveals that:

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

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

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

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

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

3.27 These quotes are somewhat historical, in that they refer to the past development of Sky. There is however evidence from information request responses that this also

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21 http://corporate.sky.com/documents/pdf/1ffb247d89b6490c9cd3dc7a4f24f4eb/annual_report_2008.pdf, page 31.

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

reflects current thinking. For example, a senior executive at Sky **[✂]** stated in a letter to the Vice President of Orange Home UK plc, on 8 February 2007, when discussing Orange's request for wholesale access to Sky Sports channels, that:

> "The value of our channels to a platform operator is not simply a function of the subscription that such a platform operator can earn as a distributor of packages of channels that include our channels. The mere availability of our channels on a particular platform has considerable value to the relevant platform operator that is difficult to capture through a per subscriber charging mechanic or the imposition of enforceable marketing obligations"[23].

3.28 The importance of premium sports and movie content to Sky's platform is evident from other internal documents that we have obtained.

- **[✂]**[24]. **[✂]**[25]. **[✂]**[26] **[✂]**.
- **[✂]**[27].

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

- **[✂]**[28]. **[✂]**[29]. **[✂]**[30].
- **[✂]**[31] **[✂]**[32]. **[✂]**[33] **[✂]**[34] **[✂]**.
- **[✂]**[35]. **[✂]**[36].

[23] Provided by Orange in response to formal information request of 9 June 2008.

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

[25] **[✂]**. Ibid.

[26] **[✂]**. Ibid.

[27] **[✂]**. Ibid.

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

[29] **[✂]**. Ibid.

[30] **[✂]**. Ibid.

[31] **[✂]**. Ibid.

[32] **[✂]**. Ibid.

[33] **[✂]**. Ibid.

[34] **[✂]**. Ibid.

[35] **[✂]**.

[36] **[✂]**.

- [✂].

International examples

3.30 We continue to believe that the international case studies from around Europe that we set out in our Second Pay TV Consultation illustrate the importance of sports rights in particular[37]. Amounts paid for rights were high in Germany, Spain, Italy and France, as in the UK.

3.31 Changes in rights ownership in France and Germany also illustrated the importance of top-flight football rights to pay TV operators. Premiere's subscriber numbers dropped in 2006 for the first time since 1997 on the back of Premiere losing rights to broadcast live Bundesliga matches. Similarly, seven years of consistent growth turned to a decrease in subscriber numbers for TPS in France upon it losing its rights to Ligue 1 matches.

Premium subscribers

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

Likely future developments

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

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

- The same may not however be true of movie programming, since although blockbuster movies are likely to retain their appeal, the simultaneous broadcast of a small number of movies to a large number of viewers is unlikely to remain the most effective means of distribution in the longer term. It is not difficult to imagine a world in which they are generally accessed more directly, for example via various forms of internet download. Movie download services are already available, though they have yet to be taken up by large numbers of consumers

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

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

Content aggregation and market power

3.35 We set out in our previous consultation documents a number of mechanisms by which content is aggregated at different points in the value chain. These include:

- Collective selling of sports rights by sporting bodies – for example the FA Premier League, UEFA, or the England and Wales Cricket Board.
- Bundling of content across different delivery technologies by rights owners. Rights tend to be sold on a non-technology-specific basis, with one set of rights covering satellite, cable, DTT and IPTV.
- Bundling of different types of movie rights (SVoD / linear channels) by movie studios.
- Sky's acquisition of movies rights from all six Major Hollywood Studios for the first pay TV window, and Sky's and others' acquisition of sports rights for a variety of different events.
- Acquisition by channel operators of a variety of content to create channels, which may in some cases focus on a particular genre.

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

- The aggregation of attractive content by broadcasters is essential in order to create channels which viewers wish to watch.
- The aggregation of channels into bundles by retailers is often necessary in order to establish a pay TV proposition which consumers wish to buy.

3.37 The collective selling of sports rights has been recognised as providing benefits to consumers[38]. In particular, it can contribute to the sporting balance of a competition by distributing rights income more evenly among teams in a competition, which is likely to make it more attractive as a spectacle by making contests more evenly matched.

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

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

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[38] See for example: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/02/1951&format=HTML&aged=1&language=EN&guiLanguage=en, which states that: "The Commission fully accepts that sport is not to be treated like any other sector and respects the declaration of the European Council in Nice in December 2000, which encourages a redistribution of part of the revenue from the sales of TV rights at the appropriate levels, as beneficial to the principle of solidarity between all levels and areas of sport".

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

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

3.40 To the extent that aggregation results in the creation of monopoly rents, these are likely to flow upstream to where the aggregation takes place. However, the existence of aggregation at different points in the value chain means that it is not always entirely clear who is likely to be the main beneficiary in practice of the aggregation process.

- Sporting bodies such as the FAPL would be expected to retain any monopoly rents associated with the aggregation of rights for competitions for which they are responsible. However, some further aggregation of sports rights to different competitions is carried out by broadcasters such as Sky, and Sky may also have a degree of purchasing power because of its position in downstream markets, both of which might be expected to deliver some benefits to it.

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

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

Fixed costs of content production, and the importance of price discrimination

3.42 Content markets have two important characteristics which in combination distinguish them from the markets for physical goods and services:

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

- The fixed costs of producing certain categories of content can be high. For example, the wage costs alone of the FA Premier League were £1.2 billion in 2007/2008[39], while the average cost for making and marketing a single Hollywood film is about $100m[40].

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

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

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

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

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

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

3.47 In the residential sector, all customers are charged the same price for the same channels, so there is no explicit price discrimination. Instead, there is a form of implicit price discrimination, which relies on the fact that retailers are likely to attract more consumers by retailing bundles which contain a variety of channels containing different types of content. In such circumstances a number of consumers may be willing to pay the same aggregate price for a bundle, despite each attaching different values to different elements of the bundle.

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

3.49 Specific examples of retail bundling in pay TV include:

- Basic channels are commonly sold in bundles rather than individually. Sky retails basic channels in a number of genre-specific entertainment packs, which can in turn be aggregated into bundles containing multiple packs. Virgin Media retails basic channels in three tiered packages, 'M', 'L' and 'XL', containing an increasing number of channels (~45, ~100 and ~165 respectively).

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

- Premium channels are also commonly sold as part of a bundle with basic channels, via a mechanism known as 'buy-through'. This requires consumers to buy a basic package before they can buy a premium package. All of Sky's premium channels have **[✂]** been subject to an enforced buy-through[41], but the same was not true of Setanta's premium channels[42].

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

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

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

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

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

- If these practices take place in the context of a competitive market, they are likely to promote consumer welfare.

- In a situation where there is market power, such practices may still result in increased efficiency. However, much of the benefit is likely to accrue to the producer, away from the consumer.

- In a situation where the market power can be leveraged into other markets it is likely to produce additional competition concerns which are likely to outweigh any compensating efficiency benefits.

Vertical integration

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

[41] **[✂]**.

[42] Setanta went into administration on 23 June 2009, shortly after the live FAPL rights which had been held by Setanta were awarded to ESPN. ESPN has announced that it has agreed a wholesale deal with Sky for distribution on Sky's DSat platform. It has also announced an intention to make its channel including FAPL coverage 'widely available across multiple pay-TV platforms', although at the time of writing no other details of availability across platforms other than Sky's have been announced.

Figure 5 Table showing operators' participation at different levels of the value chain

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

3.53 The table highlights several types of integration:

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

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

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

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

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

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

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

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

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

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

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

3.56 However, it is important to recognise that whether a firm acts on this incentive depends in practice on a number of other factors. A key question which we considered in our Second Pay TV Consultation was whether Sky, as a vertically integrated wholesaler and retailer of premium content, was acting so as to restrict the wholesale distribution of this content. We return to this question in section 6 of this document.

Section 4

Market definition

Summary

4.1 We remain of the view that there are narrow economic markets for the wholesale of Core Premium Sports and Core Premium Movie channels, and that Sky has market power in those markets. That market power is enabled by content aggregation carried out either by rights owners or by Sky, specifically:

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

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

4.2 The wholesale market for Core Premium Sports channels comprises Sky Sports 1, Setanta Sports 1[43] and Sky Sports 2. These channels all feature a large number of highly popular live sporting events shown regularly throughout the year, and this content distinguishes them from other channels which feature popular events less regularly or only occasionally, and/or feature less popular events. In coming to this view, we have considered a wide range of further evidence in light of responses to our Second Pay TV Consultation, including the characteristics of the content shown on these channels, consumer preferences for such content, econometric analysis of the constraint from free-to-air TV, and analysis of price changes.

4.3 The wholesale market for Core Premium Movie channels comprises all Sky Movies channels which show movies in the first pay TV window from the Major Hollywood Studios. That includes all Sky Movies channels apart from Sky Movies Classics. In coming to this view, we have considered a range of evidence similar to that on sports, as well as data on alternative means of watching movies, and on Sky's high and increasing margins on movies.

4.4 One additional piece of analysis that we have carried out since our Second Pay TV Consultation is to define retail markets. Our view for consultation is that there are narrow markets for the retail of packages including Core Premium Sports and Core Premium Movie channels to residential customers. In coming to this view, we rely on much of the same evidence as for our wholesale assessment. We believe that the characteristics of Core Premium channels are such that demand-side substitution is unlikely, and further that entry by new suppliers is unlikely in the short term, because of the lack of availability of the relevant wholesale channels.

[43] Setanta went into administration on 23 June 2009, shortly after the live FAPL rights which had been held by Setanta were awarded to ESPN. ESPN has announced that it has agreed a wholesale deal with Sky for distribution on Sky's DSat platform. It has also announced an intention to make its channel including FAPL coverage 'widely available across multiple pay-TV platforms', although at the time of writing no other details of availability across platforms other than Sky's have been announced. Our subsequent conclusions are likely to be independent of whether Setanta Sports 1, or some other channel provided by ESPN, exists as part of the Core Premium Sports market.

Introduction

4.5 In this section we define the markets that are relevant to our consideration of whether there is a risk that fair and effective competition in the provision of licensed channels including premium content is not occurring and will not occur. We discuss in turn:

- The relevant economic markets that we seek to define.
- Our overall approach to market definition.
- The wholesale market for premium sports channels.
- The retail market for premium sports channels.
- The wholesale market for premium movies channels.
- The retail market for premium movies.

Which markets do we define in this document?

Our position in our Second Pay TV Consultation

4.6 Our First Pay TV Consultation, in September 2008, put forward initial market definitions for a number of markets:

- Wholesale markets for premium sports channels and premium movies channels.
- Wholesale markets for basic tier channels.
- Retail markets for premium sports channels and premium movies channels sold to residential customers.
- Retail markets for basic tier channels sold to residential customers.

4.7 We also assessed whether the above retail markets would be likely to be platform-specific and took the view that they would not be.

4.8 Our Second Pay TV Consultation focused on competition concerns relating to the wholesaling of premium channels. As a result, in our Second Pay TV Consultation, we progressed our initial market definitions for wholesale premium channels and consulted on:

- Wholesale markets for “Core Premium Sports channels”, defined as wholesale supply of Sky Sports 1, Sky Sports 2 or Setanta Sports 1, as well as High Definition (HD) versions of these channels.
- Wholesale markets for “Core Premium Movie channels”, defined as the wholesale supply of channels including first-run movies from the Major Hollywood Studios in the first pay TV window, as well as HD versions of these channels.

Respondents’ views

4.9 Sky said that our focus on establishing upstream market power was misplaced as (a) it was unlikely to be a necessary condition for the types of issues that concerned us and (b) proper analysis of the relevant downstream market would remove our concerns. Sky also argued that our analysis was driven by our preconceptions of the right conclusions[44].

4.10 Sky argued that we placed undue emphasis on the particular characteristics of its channels and the preferences of infra-marginal customers in relation to programming content, given that product differentiation was a central mode of competition in the television sector. It said that this had led to market definitions that were essentially, descriptions of the products in which Sky had specialised[45].

4.11 Many respondents argued that we should also define retail markets:

- The Four Parties said that because the impact of any competition concerns will be felt at the retail level, we needed to define retail markets[46].
- FAPL said that as our concerns are about retail prices we should define retail markets[47].
- Virgin Media stated that retail markets should be defined to assess the impact of the proposed remedy[48].
- Sky argued that under standard competition law we needed to demonstrate that the behaviour we allege has an adverse effect on the relevant retail markets – and we should first therefore define the market[49].

Our current view

<u>Wholesale markets</u>

4.12 We are defining wholesale markets to inform our assessment of wholesale market power. A firm with market power has the ability to exploit that market power, which could lead to the type of competition concerns that we identified in our Second Pay TV Consultation. In section 5 we set out our approach to analysing market power. In section 6 we consider Sky's ability and incentive to act in a manner which is not consistent with fair and effective competition.

4.13 Our competition concerns relate specifically to the wholesale markets for Core Premium Sports channels and Core Premium Movie channels. We explain in detail below our rationale for the precise boundaries of these markets, but in summary we conclude that:

- The wholesale market for Core Premium Sports channels comprises Sky Sports 1, Sky Sports 2 and Setanta Sports 1 and the HD versions of these channels.

[44] Sky response to Ofcom's Second Pay TV consultation, section 6 paragraph 6.1 and Annex 6 paragraph 1.2.

[45] Sky response to Ofcom's Second Pay TV consultation Annex 6 paragraph 2.3.

[46] The Four Parties' response to Ofcom's Second Pay TV Consultation section 3 page 5-7.

[47] FAPL response to Ofcom's Second Pay TV Consultation Annex 1 section 2 page 36-37.

[48] Virgin Media response to Ofcom's Second Pay TV Consultation s1 paragraph 5.1-5.18.

[49] Sky response to Ofcom's Second Pay TV Consultation section 4 paragraph 2.1-2.4.

- The wholesale market for Core Premium Movie channels comprises Sky Movies Action & Thriller, Sky Movies Comedy, Sky Movies Drama, Sky Movies Family, Sky Movies Premiere, Sky Movies Premiere+1, Sky Movies SciFi & Horror, Sky Movies Screen 1, Sky Movies Screen 2, Sky Movies Modern Classics, Sky Movies Indie and Disney Cinemagic and the HD versions of these channels.

4.14 Sky is both a wholesaler (to cable firms) and retailer of Core Premium channels. In defining markets at the wholesale level, we have considered the constraints facing a hypothetical wholesale monopolist, rather than an integrated wholesale/retail monopolist, in order to focus on effects at this level. However, we have had regard to the fact that Sky is vertically integrated where relevant.

Retail markets

4.15 The competition concerns we outline in section 6 below do not rest on the existence of retail market power – indeed, as we explain in that section, our concerns derive from the potential exercise of market power at wholesale level. However, it is clear that the effects of those concerns are felt downstream. This means that an assessment of the relevant downstream markets can be helpful to assess the impact of concerns about upstream markets on downstream markets.

4.16 In assessing wholesale market definition and market power, we have had regard to the *indirect constraint* on the prices of a hypothetical wholesale monopolist that could arise if (a) wholesale price increases were to be passed on in retail prices and (b) subscribers were to respond to these retail price increases by switching to other services. This is distinct from the *direct constraint* that could arise from pay TV service providers responding to an increase in wholesale prices by choosing to retail other channels (demand-side substitution), or by an alternative supplier responding to a wholesale price increase by entering the market and supplying the same content as the wholesale monopolist (supply-side substitution), both of which we also consider.

4.17 With its focus on the willingness of subscribers to switch to alternative TV content, the analysis of indirect constraints is closely related to retail market definition. Our assessment of the indirect constraints on wholesale markets makes clear that the downstream markets for bundles containing Core Premium channels are strongly differentiated[50].

[50] The main added variable in the assessment of indirect constraints is the extent to which an increase in wholesale prices would be passed through into higher retail prices. In general, a less than 100% pass-through rate implies that substitution at the wholesale level due to consumer switching is weaker than at the retail level, and this would tend to reinforce the conclusion of a limited indirect constraint on wholesale prices. In the present case, Sky determines two sets of prices for its premium channels: its own retail prices, and the wholesale rate-card prices which are paid by cable firms. It does not face a decision as to how much of its own wholesale price increase it will pass through in its own retail price. It simply sets the optimum retail price, taking into account both subscriber price sensitivity and the impact on its cable rate-card price. Sky sets the cable rate-card by reference to its interpretation of a margin squeeze test (see section 6), suggesting that (a) if Sky increases its own retail price it is likely to increase the rate-card price by the same amount and (b) the rate-card price is unlikely to allow cable firms scope to absorb any increase, so any increase in rate-card price is likely to be passed on in the retail prices of cable firms. We therefore consider that the pass-through rate is likely to be at or close to 100%.

4.18 In that context, the key question is whether TV packages that contain premium channels are in narrow markets, or in a broad market with other TV products such as FTA TV, or alternative formats such as DVD.

4.19 Therefore our focal products for investigation of retail markets are:

- Retail packages containing Core Premium Sports channels.
- Retail packages containing Core Premium Movie channels.

Approach to defining markets

4.20 The standard tool for defining markets is the Hypothetical Monopolist Test (HMT)[51]. The HMT considers whether it would be profitable for a hypothetical monopoly provider of the relevant product to increase the price of that product by a small amount. However, as we explained in our previous consultation documents, there are a number of specific challenges associated with applying this framework to broadcasting markets. The challenges we outlined included:

- The difficulty of assessing switching behaviour when prices may be above competitive levels, and, related to this, the difficulty of identifying the competitive price (see paragraphs 4.25 to 4.31 below).
- The highly differentiated nature of the products in question (see paragraph 4.32).
- The fact that broadcasting markets are two-sided (see paragraph 4.33).

Our views in our Second Pay TV Consultation

4.21 While these challenges are not unique to broadcasting, the fact that they exist jointly makes it particularly important to consider a wide range of evidence in assessing the relevant markets. We considered – and continue to consider – this evidence in aggregate, rather than relying on any one specific piece of evidence in isolation.

4.22 Such an approach is consistent with OFT guidelines on market definition[52], previous case law[53] and the views of respondents to our previous consultation documents. For

[51] The HMT attempts to find the narrowest range of products for which a hypothetical monopolist would be able to sustain prices above their competitive level. We begin by considering a single product or narrow range of products and assess whether a monopolist provider would be able profitably to impose a Small but Significant Non-transitory Increase in Prices (SSNIP) above the competitive level. The monopolist could be prevented from raising prices either by its customers switching to alternative products (demand side substitution), or by the entry of alternative suppliers who would be able rapidly and with minimal sunk investment to switch production to the supply of the products under consideration (supply side substitution). If the monopolist is constrained from raising prices, we widen the scope of the products under consideration by including the next closest substitute and repeating the thought experiment. We iteratively widen the range of products under consideration until we consider that a monopolist of all the products under consideration would no longer be able to raise prices for a sustained period.

[52] OFT Guidelines on Market Definition, 2004,

http://www.oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft403.pdf.

[53] For example, in Aberdeen Journals the OFT considered a wide range of evidence in coming to its conclusion on market definition, including product characteristics, the inconclusive economic and

example, in response to our First Pay TV Consultation Sky said that the standard framework of market definition was not well suited to broadcasting markets where there are significant levels of product differentiation, economic rents are present and there are rapid changes in technology[54]. It suggested that we undertake "a careful analysis of a broad range of evidence"[55]. Figure 6 below sets out the types of evidence Sky suggested we use in our assessment of market definition and market power.

4.23 Our evidence base included:

- An assessment of the key characteristics of the relevant products, drawing on survey evidence on consumer preferences for those products.
- Evidence from the undertakings active in the markets, for example from their actual behaviour, from internal strategic papers and from market analysis.
- Our application of the Hypothetical Monopolist Test, which drew on surveys of consumers' responses to price rises and estimates of price elasticity, including a willingness to pay survey commissioned by Ofcom and a conjoint study supplied by Sky.
- Patterns in price changes or relative prices.
- Customer reactions to past price changes.
- The impact of the growth of multi-channel FTA services on demand for pay TV services.

4.24 In our previous consultation document we explained our approach to applying the HMT to wholesale channel provision and the way in which we assess the indirect constraint from retail subscribers. In the following paragraphs, we summarise our position on the various challenges associated with defining broadcasting markets, set out the responses to that position and then provide our current view.

Prices above competitive levels

4.25 The HMT should be performed with prices at competitive levels[56]. If a firm has already raised prices above competitive levels, we would expect to observe higher levels of switching in response to a further price increase, as consumers would switch to other products even though they are relatively poor substitutes. This is

econometric analysis, statements made by the allegedly dominant undertaking and its competitors and the conduct of the undertaking and its competitors. This decision on market definition (Decision of the Director General of Fair Trading in Case No. CA98/14/2002, (16 September 2002)) was upheld by the CAT on appeal (Aberdeen Journals v OFT [2003] CAT 11).

[54] Sky response to Ofcom's First Pay TV Consultation Annex 2 paragraphs 1.50 – 1.51

[55] Ibid paragraphs 1.50 and 1.52

[56] See, for example, OFT Market definition guidelines paragraph 5.4.

known as the cellophane fallacy[57]. If we were to assess markets based on observed switching in such circumstances, markets would be drawn too broadly.

4.26 In broadcasting markets it can often be difficult to identify the competitive price. In economic models, the competitive price is often equated with (some measure of) marginal cost. However, in broadcasting markets, a large proportion of production costs are fixed, and marginal costs are very low. We would therefore expect competitive prices to be well above marginal cost, but it is very difficult to assess just how much higher they will be. Nonetheless it is conceptually correct to conduct market definition at ‘competitive’ prices. Where it is not possible to estimate the ‘competitive’ price, we assess evidence of switching cautiously, as high switching is consistent with both substitution to alternative products at competitive prices or prices being above competitive levels.

4.27 In our Second Pay TV Consultation we assessed whether current prices may be above competitive levels using a number of sources of evidence. This included our assessment of Sky’s profitability, an examination of wholesale margins for Sky’s premium channels, and finally consideration of whether prices might be above competitive levels even absent evidence of high profitability for Sky itself.

4.28 Our assessment of Sky’s aggregate profitability was inconclusive[58]. The results were consistent with either normal profits or the presence of supernormal profits, depending on the assumptions used in the analysis.

4.29 When we looked more specifically at the margins on the wholesale supply of premium sports and movie channels[59], we found that gross margins appeared to be in the region of **[✂]**% to **[✂]**% for Sky’s sports channels and **[✂]** to **[✂]**% for its movie channels. Operating margins for Sky’s wholesale premium channel business (combining both sports and movies) appeared to be around **[✂]**%, compared with a figure of around 20% for Sky’s pay TV business as whole. While not conclusive, these margins appeared high for an asset-light wholesale channel business.

4.30 We also explained that while high profits for Sky were likely to point strongly to a conclusion that downstream prices were above the competitive level, they were not a necessary condition. 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.

4.31 In summary, we remained concerned that the cellophane fallacy was likely to be a problem when assessing the switching behaviour of Sky customers.

Differentiated products

4.32 In markets which contain a variety of differentiated products, such as some broadcasting markets, there may not be a clear-cut boundary between products that lie just inside the market and products that lie just outside the market. The assessment of market power does not rely on the precise drawing of market

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[57] This term arises from a US case involving cellophane products (US v EI Du Pont deNemours & Co [1956] 351 US 377.)

[58] See section 7 and annex 9 of the Second Pay TV Consultation for full details.

[59] See section 6 and annex 9 of the Second Pay TV Consultation for full details.

boundaries, as products just outside the market can exert a competitive constraint. We therefore tested the sensitivity of our market power assessment to our market definitions by calculating market shares based on a variety of differing assumptions regarding the precise boundary.

Two-sided markets

4.33 Broadcasting markets can be characterised as two-sided markets. For example, wholesale channel providers license their content to channel retailers and sell advertising and sponsorship to advertisers. In two-sided markets of this sort, it is not uncommon for one side of the market to pay a high price while the other side pays a low price[60]. This creates challenges for market definition for two reasons. First, the profitability of a price rise on one side of the market is affected by the interactions with the other side of the market; and second, it makes it even more difficult to identify the competitive price. In our previous consultation documents we explicitly – and cautiously – ignored the effects on advertising markets of a price rise to retailers, noting that we would as a result err on the side of defining markets slightly too broadly[61].

Application of HMT to wholesale channel provision

4.34 In our Second Pay TV Consultation we identified specific issues that arise when defining wholesale markets: in particular, we need to consider both the direct constraints on the hypothetical monopolist from the retailers it supplies, and the indirect constraints imposed by the final consumers of the retail product that uses the wholesale product as an input. A retailer purchasing from a monopolist wholesaler faces a number of choices in response to a price rise:

- It can seek to pass on the cost increase to its consumers, some of whom will switch away – this imposes the indirect constraint on the hypothetical monopolist.
- It can seek to absorb the cost increase.
- It can seek to identify alternative wholesale inputs.

4.35 In practice the first of these issues tends to mean that wholesale markets will often be defined more narrowly than retail markets. A 10% rise in wholesale input prices – even if fully passed through to retail prices – will entail a less than 10% rise in retail prices because the input cost is likely to be one cost among several. Hence fewer end consumers will substitute away as a result of a 10% wholesale price increase than would in response to a 10% retail price increase. A 10% wholesale price increase is therefore more likely to be profitable, meaning that our market definition might settle on a smaller set of products.

[60] In a perfectly competitive market the ‘competitive’ price is set at marginal cost. However, in two-sided markets one group of customers may receive the service at a price below the costs of production, while the other group receives the service above the costs of production.

[61] A wholesale price rise to a retailer if fully passed through to consumers is likely to lead viewers to switch away with a consequent downward effect on advertising revenues. Excluding this effect means that we would be likely to over-estimate the profitability of a wholesale price increase giving a slight bias towards defining markets too broadly. However, the importance of subscription revenues relative to advertising revenues for premium channels suggests that this effect is likely to be relatively small.

Respondents' views

4.36 Sky commented that:

- We did not consider a wide range of evidence[62].
- Our approach was mechanistic[63].
- The approach to assessing critical loss was flawed[64].
- Our approach was a selection of pair wise comparisons when in fact we should consider constraints in aggregate[65].

4.37 Sky also stated that our approach to assessing whether focal products comprise separate markets was unreasonable for two reasons.

> "First [Ofcom's test] clearly involves a reversal of the burden of proof: rather than Ofcom demonstrating that prices are not constrained to competitive levels, the burden is placed on Sky to overturn Ofcom's 'beliefs' that they are not constrained in this way .
>
> Second, it does so in a situation in which it is unlikely that Sky would be able to overturn Ofcom's 'beliefs' because Ofcom sets out no views as to what it considers "the competitive level" (or "competitive levels") for prices to be, and it is not otherwise clear what the competitive level of prices should be."[66]

4.38 With respect to the particular challenges of defining wholesale markets, Sky said that the practice of retail bundling means that the per subscriber input cost of one channel is a relatively small proportion of the retail price[67]. On this test we would find that Fox News, National Geographic and Living were supplied in separate markets.

4.39 Sky argued that our analysis comprised a series of *ad hoc* and inconsistent exercises[68]. Sky said that our concern about the cellophane fallacy had led us to abandon the hypothetical monopolist test (HMT), but without considering carefully how we should, instead, structure our analysis[69]. Sky also argued that there is an

[62] Sky response to Ofcom's Second consultation, annex 6 paragraph 7.2.

[63] Ibid, annex 6 paragraph 2.3.

[64] Ibid, annex 6 paragraphs 5.2-5.3.

[65] Ibid, annex 6 paragraph 7.1.

[66] Ibid, annex 6 paragraphs 2.10 – 2.18.

[67] Ibid, annex 6 paragraph 5.4.

[68] Sky Response of 1 June 2009 to Ofcom's Second Pay TV Consultation "Additional comments on Ofcom's analysis of market definition and market power in the pay TV review" paragraph 3.19.

[69] Ibid, paragraph 3.18 b (i).

inconsistency between our recognising uncertainties in the precise market boundary, and our view that having a loose or vague market definition is unhelpful[70].

4.40 Sky argued that we failed to consider that the framework of monopolistic competition – in which prices are above marginal costs but economic profits have been driven down to zero – might be an appropriate one in this sector[71]. It says Ofcom's implicit benchmark model appears to be one of perfect competition.

4.41 Sky said that our model of consumer decision making was simplistic and in stark contrast to the complexity of the market environment, with the result that our analysis was devoid of merit. It argued that our approach was one in which subscription decisions were attributable to preferences in relation to a small range of specific characteristics, and principally access to Core Premium channels[72]. Sky said this was wholly divorced from the reality of consumer decision making, given that services were bundled, that consumers had heterogeneous preferences, and that decisions were made by households rather than individuals.

4.42 FAPL argued it is "essential" that we identify the competitive price if we consider current prices above competitive levels[73].

Our current view

Analytical framework

4.43 We recognise that the application of the HMT, and hence of critical loss analysis is only one tool in assessing consumers' likely responses to a price rise. Moreover, critical loss analysis is most appropriately applied in merger situations to consider whether post-merger prices would be higher than pre-merger prices – i.e. where the pre-merger price can generally be taken as the competitive price. It is less suitable for analysis of cases where the competitive price is unknown, and which are therefore potentially subject to the cellophane fallacy.

4.44 We therefore acknowledge that the scope to apply the HMT empirically in the present case is compromised by the cellophane effect. However, the HMT can also be thought of as a conceptual framework for assessing a broad range of evidence in order to identify the competitive constraints on firms in the market.

4.45 For the reasons set out in paragraphs 4.26 and 4.33 it can be difficult to identify the competitive price from which to apply an increase. Nonetheless this does not mean that we should automatically assume that current prices are at competitive levels.

4.46 Instead, we weigh up a broad range of evidence in the round and treat evidence of switching in response to current price changes with caution. Our approach is consistent with OFT guidance.

> "the possibility that market conditions are distorted by the presence of market power … will be accounted for when all the evidence of

[70] Ibid, paragraph 3.25.

[71] Ibid, paragraphs 4.29 – 4.32.

[72] Ibid, paragraphs 6.3 – 6.5.

[73] FAPL response to Ofcom's Second Pay TV Consultation paragraph 5.9.

market definition is weighed up in the round. For example, where prices are likely to differ substantially from their competitive levels, caution must be exercised when dealing with the evidence on switching patterns as such evidence may not be a reliable guide to what would occur in normal competitive conditions"[74].

4.47 As noted, Sky said that we were inconsistent, in recognising uncertainties in the precise market boundary, but having the view that a loose or vague market definition is unhelpful. We have carefully considered the possible implications of different market definitions, but ultimately we sought to be specific in the market definition that we have adopted.

4.48 As regards Sky's view on the framework for monopolistic competition, we have not used perfect competition as our benchmark, as Sky claims. We would not expect firms in this market to price at marginal cost as would be expected in a perfectly competitive market. We recognise that a degree of product differentiation is inevitable, and valued by consumers, but that this product differentiation will tend to raise prices above competitive levels.

4.49 However, we reject Sky's argument that monopolistic competition is a relevant framework on the grounds that (a) this framework relies on an assumption of free entry to the market, and we see no basis for such an assumption here, and (b) Oxera's analysis of profitability (see paragraphs 6.169 to 6.207) demonstrates that profits have not been driven down to zero – or close to zero – as the monopolistic competition model implies.

4.50 We also reject Sky's argument that our analysis ignores the complexity of the market. Our analysis is informed wherever practical by information from surveys which reflect the complexity of the market, and throughout by the recognition that Core Premium channels are bundled with other channels and other services, and sold to consumers with heterogeneous preferences. However it is often necessary to abstract from these complexities in order to provide a meaningful analysis of specific points.

4.51 In making this criticism, Sky described the complexities of the market in some detail[75]. However it did not set out any arguments as to which of our findings were likely to be incorrect as a result of a failure to reflect these complexities. Nor did Sky make any positive suggestion as to how a market with such complexities should be analysed.

Evidence that prices are above competitive levels

4.52 Sky describes our concerns about a possible cellophane effect as well-founded. It said that using the HMT was difficult in such circumstances[76]. As we explained above, evidence that Sky is earning supernormal profits would point strongly to prices being above competitive levels. We present in section 6 new evidence on

[74] OFT Guidelines on Market Definition, 2004, paragraph 5.4.

http://www.oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft403.pdf.

[75] Sky response of 1 June 2009 to Ofcom's Second Pay TV Consultation "Additional comments on Ofcom's analysis of market definition and market power in the pay TV review" paragraphs 6.5 – 6.11

[76] Ibid, paragraphs 4.18 – 4.25.

Sky's profitability that supports this view[77]. This suggests that in aggregate Sky has been making returns in excess of 20%, based on a variety of different calculation methods. This is in comparison with a likely cost of capital of 10.3%. Moreover, these returns are likely to be concentrated in the wholesale part of Sky's business, lending further credence to the idea that we should be worried about the cellophane fallacy.

4.53 Evidence that Sky is earning excessive profits supports a view that retail prices are above competitive levels. However we should be concerned that prices are above competitive levels even in the absence of evidence of excessive profits, for two reasons:

- Even if prices were moderately above competitive levels, this could be enough to skew the results of a hypothetical monopolist test, such that they could not be relied upon. As such, the cellophane effect could exist even if prices are not far enough above competitive levels to create excessive profits.

- Owners of the rights of highly valued content could in principle be able to extract some or all of the monopoly rents from these rights, leading to prices above the competitive level, but preventing wholesalers and retailers such as Sky from making excessive profits. This would appear particularly likely in the case of FAPL and other sports rights, which are sold jointly. Movie rights are sold in a more disaggregated way, with Sky negotiating separately with each of the major Hollywood studios. However, we consider that it is likely that a proportion of the rents created by aggregating rights at the wholesale level are shared with the Major Hollywood Studios. It requires strong assumptions for a rights holder to receive none of the rents created by its rights (namely that the buyer, i.e. the wholesale channel provider, has a position of absolute strength in any negotiations).

4.54 We consider market definition and market power under a range of definitions, and in Section 5 we assess evidence that other market features, such as entry or buyer power, would be likely to limit Sky's market power.

Evidence base used to assess markets

4.55 Figure 6 illustrates the broad range of evidence we have examined in coming to our conclusions on market definition and market power. While Sky has emphasised the importance of considering a broad range of evidence, it described our approach – which was to consider such a broad range – as a series of ad hoc exercises. However, in assessing all the evidence we have borne in mind its relevance to the question of whether a hypothetical monopolist could sustain prices above competitive levels – i.e. the HMT.

[77] Sky cited analysis by PwC as evidence that prices for pay TV services in the UK were in line with those in other European countries (Sky Response of 1 June 2009 to Ofcom's Second Pay TV Consultation "Additional comments on Ofcom's analysis of market definition and market power in the pay TV review" 5.16.). We considered this evidence in our Second Pay TV Consultation (see paragraphs 7.63 and 7.71). We noted that differences between countries mean that comparing a price in one country with a price in another country is fraught with difficulties. We therefore consider the evidence that we set out in Section 6 to be more helpful in assessing Sky's profitability.

Figure 6 Examples of evidence used in our assessment of market definition and market power

Evidence Sky suggested we review	Examples of evidence used in our assessment of market definition and market power
Evidence as to firms' behaviour	• Analysis of price and quality changes, • Analysis of changes in margins over variable costs • Assessment of bidding behaviour for key rights and the observed outcome of rights sale processes
Evidence on market outcomes for consumers	• Assessment of market power relies on our broader assessment of consumer outcomes
The extent to which suppliers of different types of products view each other as rivals (for example, as based on internal documents and public statements)	• Views of firms in the market on movies from internal strategic papers and from market analysis • Consultation respondents' views on the scope of the markets
Firms' profitability	• We have commissioned new analysis of Sky's profitability
Competition between TV channels (both free to air and pay television) for audiences **The effect of supply of pay TV services on the suppliers of free to air television services, and vice versa** **The impact of growth of multichannel free to air services on pay TV providers**	• Extensive consideration in market definition sections of consumers preferences for content found on FTA and pay TV • Assessment of the sensitivity of market shares to including certain FTA content • Review how the growth in popularity of Freeview has affected demand for pay TV
Relevant features of the economic context in which pay TV services are provided, for example high fixed costs and the existence of consumer acquisition costs	• Fixed costs are considered in discussion of critical loss • Analysis of the extent of retail switching costs
	Additionally we have considered: • Surveys on consumer preferences for sports content and the extent of switching costs • Surveys on the price, and use of alternative products – DVDs, internet downloads – and an assessment of their impact on market shares • Use of internal documents to understand how suppliers view different products and the strength of rivals • Assessment of consumer price sensitivity • Information on value of sports rights and availability of sports on various TV channels • Information on viewing of films on TV

Source: Sky response to First Pay TV Consultation, Annex 2, paragraph 1.53

Retail bundling

4.56 With respect to Sky's specific criticism relating to retail bundling, our view is that Sky mischaracterises our assessment of the constraints on suppliers of premium channels. The assessment of critical loss only considers the indirect constraint from final consumers switching away as a result of a full pass though of the price rise. However, we also separately consider the opportunity for direct demand side substitution, or direct supply side substitution.

4.57 To take Sky's example as an illustration, if Fox News (a 24 hour news channel) was to impose a carriage fee price rise on retailers, a retailer such as Sky or Virgin could switch away to alternative substitute 24 hour news channels – for example Sky News, BBC News, CNN, or CNBC. Alternatively, other channel suppliers might be incentivised to enter the market in response to a price rise. In this case, direct demand side substitution would be likely to constrain a channel wholesaler.

Relevance of previous findings

Our position in the Second Pay TV Consultation

4.58 In our first consultation we reviewed a number of recent previous findings of other UK and European competition authorities in their investigations into TV markets. We stated that previous decisions can help identify relevant issues, but they do not negate the need for a full review of the relevant markets based on available evidence.

4.59 A number of previous findings from other competition authorities[78] have found that rights to show certain types of TV content are in narrow markets and that the joint selling of these rights can lead to competition concerns downstream.

4.60 With respect to FAPL, the Commission Decision on the joint selling of media rights[79] found that TV rights to premium football events that are played regularly throughout the year were themselves a relevant market.

4.61 There have been several findings from other competition authorities that consider that the upstream provision of movies in the first pay TV window is in a narrow content market[80].

4.62 The Competition Commission set out its conclusions on market definition in its investigation into the acquisition by Sky of a 17.9% stake in ITV (the 'Competition

[78] For example, Commission decision COMP C.2-37.398 Joint selling of commercial rights of the UEFA Champions League, or Commission decision COMP/C.2/37.217 Joint selling of media rights of the German Bundesliga.

[79] Case COMP/C-2/38.173.

[80] For example, Commission decisions, Case No COMP/M.3595 - Sony / MGM (2005), *Case No* COMP/M.2050 – Vivendi / Canal+ / Seagram (2000), or COMP/M.2876, Newscorp/Telepiù (2003).

Commission's 2007 Findings')[81]. The Competition Commission identified a market for all TV including VoD[82]. It also noted that the market was highly differentiated.

4.63 Since the First Pay TV Consultation another finding by the European Commission[83] found that the provision of FTA and pay TV services to end users are in distinct product markets in Germany and Austria. The Commission found for example that from a viewer's perspective the "premium" content on pay TV is not substitutable with content found on FTA TV, as it is often broadcast on pay TV before being broadcast on FTA TV.

Responses to our consultations

4.64 In response to our First Pay TV Consultation Sky stated that "there is no such concept as "precedent" in relation to market definition, but only past cases which may provide some assistance in a new assessment." [84]

4.65 The FAPL, however, stated that Ofcom "erroneously [failed] to follow the precedent set" in the Competition Commission's 2007 Findings.

Our current view

4.66 In our view, it is important to carry out the market definition exercise afresh, having regard to the specific concerns that are being investigated and using recent data that are relevant to our investigation. This general approach is consistent with previous practice[85] and the relevant OFT guidelines[86].

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

- First, the Competition Commission was considering a different competition issue and so examined the relevant market for a different focal product. Given the Competition Commission's reference question (a merger between a FTA TV broadcaster and a pay TV broadcaster), the Competition Commission did not (and did not need to) consider the specific question of whether premium sports or premium movie channels are constrained by other pay TV or FTA content.

- Second, the Competition Commission was considering whether the relevant merger situation gave rise to a substantial lessening of competition. Accordingly, it was appropriate for the Competition Commission to perform the SSNIP test from pre-merger prices. In contrast, for the purposes of the current investigation it

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

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

[83] An investigation in relation to a merger between News Corp and Premiere. COMP/M.5121/Newscorp/Premiere.

[84] Sky response to Ofcom's December 2007 consultation Annex 2 paragraph 1.24.

[85] For example Coca-Cola v Commission [2000] CMLR 467.

[86] OFT Guidelines on Market Definition, 2004, paragraph 5.7 – 5.9.

is appropriate – although challenging – to conduct the HMT from competitive prices.

4.68 We agree with Sky that that previous cases should not be treated as precedent in our current assessment of markets. We do not consider the CC's or other findings directly relevant to our current assessment and have conducted our assessment afresh based on a wide range of evidence.

Assessment of markets for the wholesale of premium sports channels

4.69 In our Second Pay TV Consultation we set out our view that the relevant economic market for the wholesale of Core Premium sports channels comprised Sky Sports 1, Sky Sports 2 and Setanta Sports 1. The most important of these channels is Sky Sports 1 and this is the starting point for our analysis. It is a channel wholesaled as a stand-alone premium sports channel, or within wider bundles of channels, for example with Sky Sports 2, 3 and Xtra or Sky Movies channels. The channel contains a range of valuable sports programming including certain key live broadcasts such as live FAPL matches[87], live Test and one day cricket.

4.70 Sky Sports 1 has a number of characteristics that make it particularly attractive to a pay TV retailers. In particular:

- It contains a very significant volume of live[88] sports content.
- Much of that sports content is highly valued by subscribers – as reflected both in the preferences of those subscribers and in the amounts paid for the underlying rights.
- It shows live events that are available both frequently and regularly, including, most notably live FAPL. This regularity is particularly important for building and sustaining a subscription pay TV offering.

4.71 Sports content is also broadcast on other dedicated sport channels (such as the other Sky Sports channels, Setanta Sports channels, Eurosport channels or Extreme Sports) and general entertainment channels (such as BBC1, ITV1 or Sky One). A wide variety of sport is available on FTA channels. However, premium sports channels differ from these channels because they have access to the most valuable and regularly-broadcast sports rights such as live FAPL.

4.72 Figure 7 illustrates the key content that is available on Sky Sports 1 and on the most likely substitutes for Sky Sports 1:

- Sky Sports 1 accounts for the majority of FAPL content (two thirds of games broadcast and about 59% of hours broadcast)[89], along with the Carling Cup and

[87] There were 87 live matches on Sky Sports 1 in the 2007/08 season.

[88] In our Second Pay TV consultation we set out evidence of why we believed that consumers have a strong preference for live content over pre-recorded content. This was illustrated by the value of live and pre-recorded coverage. For example, while the live FAPL rights were sold in 2006 for £568m, the delayed rights were sold for just £28 million and the highlights coverage for just £57m. See Ofcom's Second Pay TV consultation Annex 6 paragraph 5.3.

[89] Our analysis of BARB data indicates that on average the programme length of Setanta's live Premier League coverage was longer than Sky's.

the Championship, although Sky Sports 2 also has significant football content. Matches from some major football events, notably the FA Cup final, England home international games, Euro 2008 and the UEFA Cup are available free to air.

- Sky Sports 1 and 2 show the majority of major cricket events, with Sky Sports 3 and Xtra accounting for the remainder.

- Several major golfing events are shown on Sky Sports 1, 2, 3 and Xtra, Setanta shows the US PGA Tour, while other events are shown free to air. Rugby league shows a similar split between the Sky Sports channels (for the World Cup and Super League) and free to air (for the Challenge Cup Rugby League).

- Sky has rights to several tennis tournaments, and shows most of this content on Sky Sports 3 and Xtra. Wimbledon is shown free to air, while a number of other tournaments are on basic tier pay TV.

Figure 7 Availability of live sport on Sky Sports 1 and other channels (2008)

Sport	Event	Broadcast on Sky Sports 1	Substitutes on Sky Sports 2	Substitutes on Sky Sports 3	Substitutes on Sky Sports Xtra	Substitutes on Setanta	Substitutes on FTA	Substitutes on basic tier
Football	Premier League	56%	3%			41%		
	FA Cup	19%	3%			26%	51%	
	Carling Cup	54%	46%					
	The Championship	83%	11%				6%	
	England International	15%	6%			35%	44%	
	Champions League	7%	36%	6%	14%	1%	36%	1%
	UEFA Cup					2%	97%	1%
	Euro 2008						100%	
Cricket	ICC ODI Championship (non-England)	55%	33%	8%	4%			
	England Test Match	75%	11%	8%	6%			
	County Championship	45%	33%	14%	8%			
	England one day international	56%	44%		0%			
Golf	European PGA	24%	31%	29%	9%		5%	2%
	Ryder Cup	100%						
	US Open Golf	78%	8%	14%				
	US PGA Tour	10%	1%	1%		87%		
	European Tour Golf	8%	14%	20%	31%		28%	
	World Golf Championship		63%	24%	13%			
	The Open						100%	
	US Masters						100%	
	Scottish Open						100%	
Rugby Union	Heineken Cup	17%	76%	2%	2%		2%	
	Guinness Premiership	44%	53%	3%				
	England International		24%				76%	
	Six Nations						100%	
	Magners League						100%	
Rugby League	Super League	39%	28%	31%	1%			
	Challenge Cup Rugby League		11%				89%	
	Rugby League World Cup	21%	79%					
Tennis	Masters Cup Tennis	36%	11%	16%	37%			
	US Open Tennis	5%	1%		66%			28%
	ATP Tennis		24%	4%	55%			17%
	WTA Tour Tennis		19%	5%	35%		2%	40%
	Davis Cup		15%	17%	49%		19%	
	Wimbledon						100%	
	Tennis WTA tour							100%
	French Open						8%	92%
	Australian Open						8%	92%
	Paris Masters Tennis				100%			
	Stella Artois Tennis						100%	
	Tennis ATP tour							100%

Source: Ofcom analysis of BARB data.

4.73 Some events cannot be shown on Sky Sports 1 because they are 'listed events' which must be carried by one of the PSB broadcasters. 'Listed events' are a limited number of sports events that the UK Government considers 'key' as they have a "special national resonance"[90]. However, while these events are undoubtedly important, they are not available on a regular basis and would therefore be unlikely to drive subscriptions to a pay TV business.

[90] For information on 'listed events' see for example: http://www.culture.gov.uk/what_we_do/broadcasting/5399.aspx, or http://www.ofcom.org.uk/tv/ifi/codes/code_sprt_lstd_evts/.

4.74 FTA broadcasters also hold a number of other highly valued live rights (either exclusively or with pay TV operators). The growth in the number of FTA digital channels has considerably increased the ability of FTA broadcasters to broadcast a wide range of sport and to cover sporting events in greater depth. Being less capacity constrained may mean FTA channels are able to compete more directly with premium sports channels. FTA broadcasters like the BBC or ITV are now able to devote extended, in-depth coverage of a wide variety of sporting events on their digital channels[91]. Figure 8 below illustrates how key sports rights are shared between FTA and pay TV channels.

Figure 8 Important live sports on pay TV and FTA TV by rights value

[✂]

Notes: The length of each bar indicates the relative rights value for each event. Only sports rights of greater than £5m are included on the chart.

Source: Various sources including European TV Sports Rights 2008, rights holders. See Appendix 3 of Annex 6.

4.75 The key question for our analysis is to what extent content found on other channels constrains the pricing of Sky Sports 1. Given a small but significant increase in the wholesale price of Sky Sports 1 from the competitive level, would a downstream firm switch to an alternative wholesale input, absorb the price increase or pass the increase onto its subscribers? In the event of the latter, would those subscribers switch to other channels[92]? We consider a range of alternatives to Sky Sports 1, including other pay TV channels (Setanta Sports 1, Sky Sports 2, Sky Sports 3, Sky Sports Xtra, Eurosport) and FTA channels. From the perspective of assessing Sky's market power, the scope for substitution to FTA channels is a key question, as including FTA in the market would indicate a materially lower market share for Sky.

4.76 In the following pages we set out evidence on the constraint faced by a wholesaler of premium sports channels. We describe:

- Indirect constraints, looking at product characteristics and consumer preferences, consumers' response to a SSNIP and the potential constraint from FTA TV.
- The potential for supply side substitution.
- Direct demand side substitution.
- Changes to wholesale prices.

4.77 Finally we conclude on markets for wholesaling of premium sports channels.

[91] For example in 2007 the BBC Interactive channel offered live coverage of the FIFA Women's World Cup, Moto GP, World Match Play golf, the Snooker Grand Prix, World Championship snooker, the Australian and French Tennis Opens and the Africa Cup of Nations football competition. ITV4 broadcast extensive live coverage of Rugby Union World Cup matches featuring non-UK teams, the Grand Slam of darts and the Tour de France.

[92] Switching costs from a pay TV product to FTA TV are normally very low and are unlikely to create a barrier to switching. For example, it generally only takes a phone call for subscribers to pay TV services to discontinue their subscription and switch to a FTA service. Sky made the same point at paragraph 3.47 of Annex 2 to its response to our First Pay TV Consultation.

Evidence on indirect constraints

Consideration of product characteristics and consumer preferences

Our position in the Second Pay TV consultation

4.78 In the Second Pay TV Consultation we set out the results of our analysis of consumer preferences and product characteristics to assess whether other sport on TV is likely to be a substitute for sport in the Sky Sports Mix. We found that subscribers have overlapping preferences for multiple sports but they have particularly strong preferences for FAPL and other top flight football[93]much of which is found on Sky Sports 1 and 2. The specific characteristics of FAPL content meant that other substitutes on FTA TV were likely to be a poor substitute for Sky Sports. We found that preferences for football of marginal consumers were similar to the preferences of infra marginal consumers[94].

4.79 We recognised the importance of other sports on Sky Sports channels. We found that a significant minority highly valued other content on Sky Sports for which there were few substitutes on FTA, for example Cricket, rugby union and rugby league. However, we focused primarily on football as the most important characteristic of premium sports channels.

4.80 We argued that our survey data and analysis of product characteristics indicated that matches featuring FAPL teams are very important to subscribers. For example our survey on subscriber preferences found that 75% of consumers think FAPL football is very important and that these consumers are unlikely to find close alternatives on FTA TV[95]. While there are a number of competitions that subscribers consider important, including four that feature FAPL teams, FAPL itself is the most important competition, since it features FAPL teams playing matches regularly through the season. However, we recognised that other football competitions featuring FAPL teams where matches are scheduled regularly through the season may be considered a substitute for FAPL for some consumers. For example, consumers place a high value on the UEFA Champions League, which includes matches shown on premium sports channels as well as FTA.

4.81 A critical question for us, however, was whether the football matches featuring FAPL teams on FTA TV are a sufficiently strong substitute for premium sports channels. On balance we considered the relatively low number of matches featuring FAPL teams on FTA TV meant that FTA was likely to be regarded as a weak substitute for live football featuring FAPL teams on premium sports channels.

4.82 We therefore concluded that live FAPL games played regularly throughout the season represented a distinctive characteristic of premium sports channels. However, we recognised that the market could be somewhat broader, including all competitive games featuring FAPL teams (including matches on FTA TV from either UEFA Champions League UEFA Cup, or the FA Cup).

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93 By top flight football we mean matches from FAPL, FA Cup, Carling Cup, UEFA Cup and England internationals.

94 Ofcom's Second Pay TV Consultation Annex 6 paragraphs 5.35 – 5.38.

95 A further 10% of subscribers highly value either cricket, rugby union or rugby league for which there are limited alternatives on FTA TV.

Respondents' views

4.83 The FAPL argued that Ofcom failed to recognise that other important sports, or other content found on TV are substitutes for content (including FAPL) found on premium sports channels. The FAPL continued to dispute the conclusion that the sports content on FTA TV does not constrain pay TV. It argued for example that:

- Other non-sport content is substitutable for sport[96].
- The market should include other sport content found on FTA TV as it is likely to appeal to premium sports subscribers[97].

4.84 It argued in particular that the market is at least as wide as to include UEFA CL, FA Cup and England internationals.

4.85 A number of respondents agreed with Ofcom that FAPL was an essential element of a premium sports channel but were of the view that we failed to recognise other important sports bundled with FAPL.

4.86 A number of respondents believed the market was wider than channels that included FAPL – although many argued this point from the perspective of a potential remedy rather than the underlying characteristics of the products in question. Specifically:

- Freesat[98] also believed that the wholesale Core Premium Sports channel market was narrowly defined. It felt that the definition should include pay TV channels which carry major international cricket and rugby, which also have significant appeal to a broad audience.
- Five[99] believed the market included the full range of channels making up Sky's premium sports package.
- **[✂]**[100] argued that focusing solely on FAPL would overlook the demand for other sports provided within the Sky Sports package and in the event that that led to a narrowly defined wholesale must-offer remedy, it would encourage Sky to move key content onto other channels within its sports portfolio.
- **[✂]**[101] suggested that Ofcom expand its market definition to include all sports broadcast on Sky's premium channels. It said that our market definition did not take account of the broad range of other valuable sports content found on Sky Sports. This would mean that the whole portfolio of Sky Sports channels would become subject to any wholesale must-offer remedy. **[✂]** believed this would "increase the range and quality of premium content available to potential rival pay TV retailers".

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[96] FAPL response to Ofcom's Second Pay TV Consultation paragraphs 4.13 and 5.27.

[97] Ibid, paragraphs 5.27.

[98] Freesat response to Ofcom's Second Pay TV consultation page 3.

[99] Five response to Ofcom's Second Pay TV consultation page 3.

[100] **[✂]**.

[101] **[✂]** response to Ofcom's Second Pay TV consultation pages 2-6.

- Virgin Media suggested that other important sports included cricket, ruby golf, boxing, darts and others[102]. Furthermore it submitted evidence which suggested that a range of other sports including, international rugby, football league, rugby league, cricket, snooker, euro football, boxing, golf, club rugby, SPL, county cricket, horse racing, darts, WWE wrestling and American football were each important to a significant minority of consumers[103].
- **[✂]**[104].

4.87 BT, Setanta, TUTV and Virgin Media[105] all stated that Ofcom's approach to defining the relevant wholesale market for premium sports channels resulted in an overly narrow focus on channels containing live FAPL matches. While the Four Parties agreed that access to live FAPL coverage is a necessary condition for effective competition in the retailing of premium sports channels, it is not a sufficient condition. The Four Parties believed that Sky's market power at the retail and wholesale levels results from Sky's control of a portfolio of sports rights. The Four Parties suggested that Ofcom revisit its approach to market definition and market power to reflect the fact that Sky's market power (at both the wholesale and the retail levels) in the supply of premium sports channels is derived from its aggregation of a range of sports content.

4.88 **[✂]** believed that the definition of what constitutes a core product may be too narrowly construed, especially in relation to premium sports content. It suggested that the definition should be broadened to include Sky Sports 3 and Sky Sports Xtra. This would reflect more accurately the key commercial drivers in terms of content. **[✂]** expressed its concern over possible content shifting and that technical barriers could be used by Sky to disadvantage access to key content by third party platforms.

4.89 Virgin Media submitted evidence (see Figure 9) which, although it agreed with Ofcom that FAPL is the most important single event, suggested that our research exaggerated its importance. For example, of households that watched Sky Sports in February 2009 it showed that around 10% did not watch any football in February 2009). Clearly, FAPL is not an essential characteristic for these subscribers.

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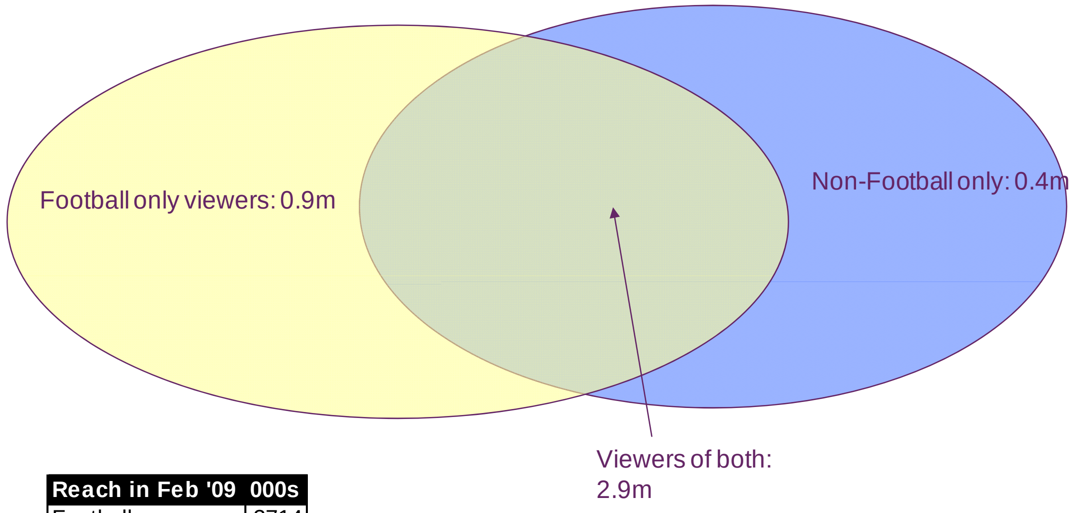
[102] Virgin Media response to Ofcom's September 2008 Pay TV Consultation paragraph 3.55.

[103] Virgin Media response to Ofcom's September 2008 Pay TV Consultation Annex 2 page 21.

[104] Ibid page 19.

[105] The Four Parties' response to Ofcom's September 2008 Pay TV Consultation paragraphs 4.5, 4.9b, and 4.40.

Figure 9 "Proportion of Sky Sports households reached by only football, only non-football or both in February 2009"



Reach in Feb '09	000s
Football	3714
Non-football	3289
Both	2863

Source: BARB/TNS; February '09
PayTV homes, 10+ cons. min reach
Sky Sports 1,2,3 and Xtra

Source: Virgin Media response to Ofcom's information request dated 24th March 2009 question 2b

Reach defined as households who watch at least 10 minutes of continuous content each

4.90 Virgin Media presented survey evidence underlining the importance of non-football sports when consumers select their premium sports package. It found that football is the most important[106] sport and FAPL is the most football event. However, Virgin Media's survey suggested that FAPL was considered important by 47% of consumers[107]. Over half of this group[108] also considered other non-football sports to be equally important.

4.91 Virgin Media found that after FAPL, both international football and UEFA CL are also important. In terms of other sports cricket, rugby union, motor sports, tennis, golf, boxing, rugby league and snooker are all important second tier sports.

4.92 Virgin Media also provided survey evidence which suggests that given the choice consumers would prefer to access a channel showing a range of sports (including FAPL) for £[✂] than an FAPL only channel for £[✂][109]. We agree with Virgin Media that this demonstrates that consumers value a range of sports on TV.

[106] Virgin Media response to Ofcom's September 2008 Pay TV Consultation Annex 2 page 13 and 14. 'Important' defined as anyone who considers a sport to be rated greater than 75/100, where 100 equals essential.

[107] Ibid.

[108] Virgin ibid, 26% of the 47%.

[109] Ibid page 26.

4.93 Sky argued that Ofcom exercised insufficient caution in relation to the reliability of its consumer survey evidence[110].It said:

- Our view that the preferences of marginal and infra-marginal subscribers was flawed[111].
- There was no evidence that the number and regularity of football matches determined consumer switching behaviour.
- We failed to consider that a lower quality product at a cheaper price could be an effective substitute.

Our current view

4.94 We have considered whether our market definition for premium sports channels should be drawn more widely than we expressed in the Second Pay TV Consultation to include either other specific sports or any other sports on TV. In doing so we have considered the characteristics Sky Sports 1 and potential substitutes and we have examined survey data on preferences of subscribers for premium sports channels for the content on these channels.

4.95 We recognise the limitations of consumer survey evidence in establishing the strength of consumer preference. We also recognise that products with different characteristics can form part of the same relevant market and that lower quality products can compete on price with better quality products. Sky Sports 1 broadcasts a range of valuable sports content including the following:

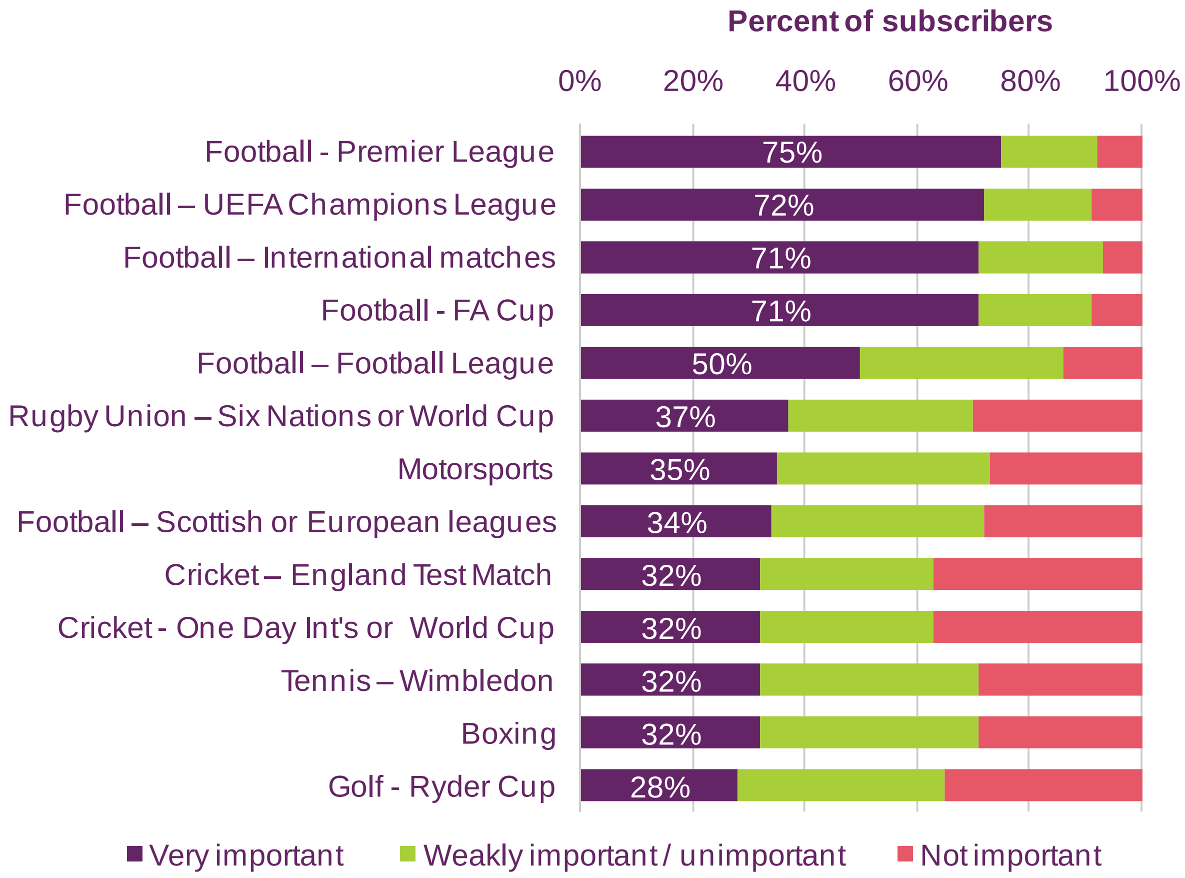
- Football: FAPL, Championship, FA Cup, Carling Cup.
- Golf: Ryder Cup, European PGA, US Open Golf.
- Cricket: One day internationals, England test match cricket, county cricket.
- Rugby Union: Heineken Cup, Guinness Premiership.
- Rugby League: Super League.
- Tennis: US Open.

4.96 These sports are highly valued by subscribers, and consequently attract the highest rights values. Figure 10 shows the percentage of subscribers who watch sport at least once a week who consider specific sports important; Figure 11 below shows the aggregate rights values (across all channels) for these sports.

[110] Sky Response of 1 June 2009 to Ofcom’s Second Pay TV Consultation “Additional comments on Ofcom’s analysis of market definition and market power in the pay TV review” page 8 table 1 (d).

[111] Sky Response of 1 June 2009 to Ofcom’s Second Pay TV Consultation “Additional comments on Ofcom’s analysis of market definition and market power in the pay TV review” Annex 1 2.33 – 2.42.

Figure 10 Importance of key sports on TV for premium sports channel subscribers



Source: Ofcom sport conjoint research, April 2008

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

Figure 11 Top sports on pay TV channels or FTA TV channels by annual rights value in 2008 (where rights value exceeds £5 million per year)

[✂]

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

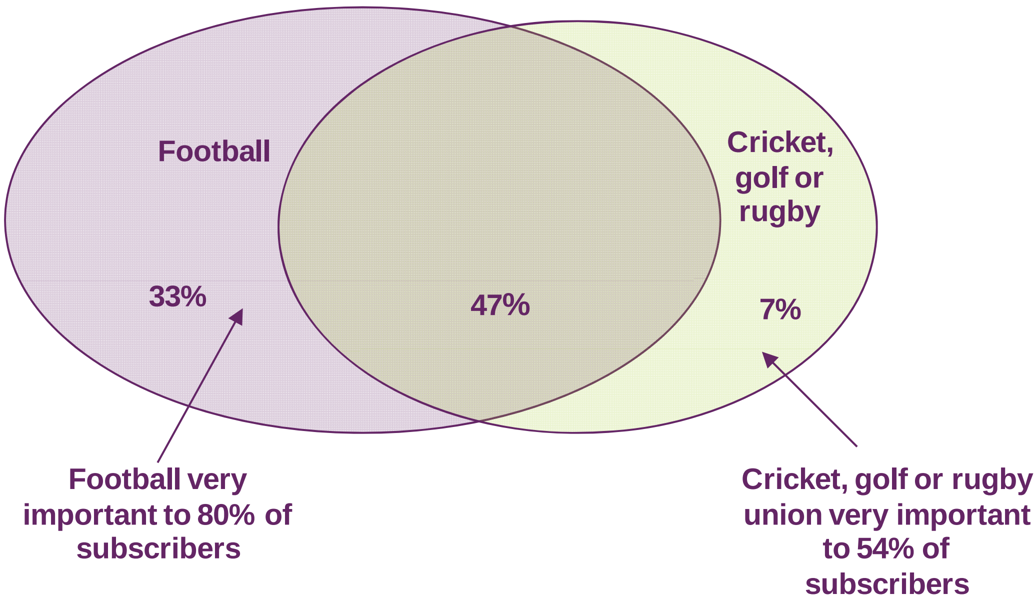
Group A Listed events shown. Other group A listed events include The FIFA World Cup, The Scottish FA Cup (listed in Scotland), the grand National, the Derby, the Rugby world Cup Final. *http://www.ofcom.org.uk/tv/ifi/codes/code_sprt_lstd_evts/listed_events.pdf*

Source: Various sources including European TV Sports Rights 2008, rights holders. See Appendix 3 of Annex 6 for details.

4.97 Consumers tend to have very strong preferences for a range of specific sports or events. For example we found that 87% consider at least one of the most valuable sports on Sky Sports 1 as 'very important' to their TV package, including for example, football (FAPL, Championship football, or foreign leagues), cricket, golf or the

Guinness Premiership[112]. The figure below summarises evidence of consumers overlapping preferences for sports.

Figure 12 Preferences for football cricket, golf or rugby



Source: Ofcom Sports Conjoint research

4.98 By contrast, very few subscribers found events from only a single (non-football) sport to be important[113]:

- 1% consider only cricket as important.
- 1% consider only golf as important.
- 1% consider only Guinness Premiership rugby union as important.

4.99 Our research suggests that although football is the key sport on Sky Sports 1, other sports on that channel are important to significant minorities of consumers. For example Figure 12 shows that 54% considered events from at least one of cricket, golf, rugby union or rugby league to be very important. The vast majority of this group also consider football very important.

4.100 We analysed BARB data for 2008 to consider what live sport (including football) on TV would substitute for content found on Sky Sports 1.

4.101 We assessed whether close substitutes for these above sports are available on alternative channels: Setanta Sports 1, other Sky channels, other FTA channels or other sports channels. Finally we set out the implications for market definition.

4.102 **Football** is clearly the most important sport on Sky Sports 1. It is also by far the most important sport on TV with total rights values amounting to £[✂]m per year in 2008[114]. Sky Sports 1 contains a significant amount of FAPL, FA Cup, and some

[112] Ofcom sports conjoint research, see Annex 10 to Ofcom's Second Pay TV Consultation

[113] Ofcom Sports conjoint research, See Annex 10 of Ofcom's September 2008 for details.

[114] See Appendix 5 of Annex 6 for details.

England international games and UEFA CL games which are considered very important by between 70% and 75% of subscribers[115]. Additionally it contains most Championship games considered very important by 50% of subscribers, and some Carling Cup matches. Figure 13 below sets out the key live football on TV by channel and rights value. FAPL is by far the most valuable single football event.

Figure 13 Live football on pay TV channels and FTA TV channels in 2008 by rights value (rights value in brackets)

[✂]

Notes: The length of each bar indicates the relative rights value for each event. Not all sports rights are shown. Where the share of rights value across channels is unknown, we pro rata the value of each event by the hours of broadcasting across the each channel.

Source: Various sources including European TV Sports Rights 2008, rights holders. See Appendix 3 of Annex 6 for details

4.103 There are a variety of football competitions featuring Premier League teams or England matches on other channels which subscribers to Sky Sports 1 might consider a substitute:

- Until June 2009 Setanta broadcast a significant amount of FAPL, and a limited amount of other top flight football (from tournaments featuring Premier League teams or England matches). ESPN has now won the FAPL rights that Setanta previously licensed.

- Sky Sports 2 shows a significant amount of UEFA CL and a limited amount of other top flight football (from tournaments featuring Premier League teams or England matches).

- FTA TV also shows some important football content such as FA Cup (of which the final is listed), UEFA CL and UEFA Cup.

4.104 **Cricket** is very important for a significant minority of consumers (32%[116]). It is also important to retailers of pay TV as a way of managing subscriber churn outside the football season. The total value of live cricket TV rights was about £**[✂]**m[117] in 2008. Sky schedules its cricket programming across its channels with about 60% on Sky Sports 1, 25% on Sky Sports 2 and a small amount on Sky Sports 3 and Xtra. About three quarters of viewing of Sky's cricket content was on Sky Sports 1.

4.105 The closest substitute channel for cricket on Sky Sports 1 is Sky Sports 2, which contains some test match, county and one day international cricket.

4.106 There are several **golf** events broadcast on Sky Sports 1 which are considered very important by a minority of subscribers who watch sport at least weekly. These include the Ryder Cup which is considered important by 28% of subscribers, the US Open, considered important by 23% of subscribers, and the European PGA.

[115] Ofcom Sports conjoint research, See Annex 10 of Ofcom's September 2008 for details.

[116] Ibid. 32% of subscribers who watch sport at least once a week consider Test cricket as very important to their package.

[117] See Appendix 3 of Annex 6 for details.

4.107 There is a significant amount of live golf found on other Sky channels, Setanta and FTA which could be considered a close substitute for golf on Sky Sports 1. For example:

- Sky Sports 2 contains coverage of the European PGA Tour. It also broadcasts events from the World Golf Championships.
- Sky Sports 3 also contains European PGA events and some US Open coverage, European Tour events and events from the World Golf Championships.
- Sky Sports Xtra contains European PGA events and a small amount of European Tour coverage and events from the World Golf Championships.
- Setanta contains a significant amount of US PGA golf.
- FTA channels have some important golf content such as the European PGA, European Tour golf, the Open and The US Masters.

4.108 **Rugby Union** is considered very important by 22%-37%[118] of subscribers who watch sport at least once a week. The total rights value is about £**[✂]**m[119]. Sky Sports 1 shows 18% of Heineken Cup matches and 44% of Guinness Premiership matches. The Heineken Cup contains the top European teams, and the Guinness Premiership contains the top England teams. Both events are tournaments played throughout the season.

4.109 There are a range of channels that contain content that could substitute for top flight rugby union played throughout the season:

- Sky Sports 2 broadcasts the majority of Heineken Cup games (78%) and Guinness Premiership games (53%).
- There is also some rugby union found on FTA. This includes the highly valued but brief Six Nations (scheduled over five weekends each year), a number of England international matches, Magners League rugby and the EDF Energy Cup.

4.110 **Rugby league** is considered very important by 17%[120] of subscribers who watch sport at least once a week. The total value of rights is about £**[✂]**m[121]. The key rugby league content on Sky Sports 1 is coverage of Super League of which about 40% is on the channel.

4.111 Several other channels also broadcast rugby league:

- Sky Sports 2 broadcasts about 30% of Sky's Super League coverage.
- Sky Sports 3 broadcasts about 30% of Sky's Super League coverage.

[118] Ofcom Sports conjoint research, See Annex 10 of Ofcom's September 2008 for details.

[119] See Appendix 3 of Annex 6 for details.

[120] Ofcom Sports conjoint research, See Annex 10 of Ofcom's September 2008 for details.

[121] See Appendix 3 of Annex 6 for details.

- FTA TV broadcasts the Challenge Cup (of which the final is listed).

4.112 **Tennis** is considered important by 20%[122] of subscribers who watch sport at least once a week[123]. Those subscribers consider at least one of US, French or Australian Opens important. However, there is only a small amount of tennis on Sky Sports 1: 14 hours of the US Open. Our research indicated that the French, US and Australian Opens were considered important to about 20% of subscribers. The majority of tennis programming shown by Sky is shown on Sky Sports 2 and Xtra.

4.113 The following tennis can be found on other channels:

- Sky Sports 2, 3 and Xtra show coverage of the WTA Tour, the ATP tour, the Davis Cup, the US Open and the Masters Cup.
- FTA channels exclusively broadcast Wimbledon (of which the finals are listed), and the Stella Artois tournament, and non-exclusively broadcast Davis Cup and a small number of French and Australian Open matches.
- Eurosport broadcasts WTA Tour Tennis, US Open, ATP tennis, the French and Australian Open and the ATP Tennis tour.

4.114 The above assessment shows that for each of the six main sports shown on Sky Sports 1, there is a range of potential substitutes both on other pay channels and on FTA channels. The assessment of likely substitutes for Sky Sports 1 as a channel is complicated because Sky Sports 1 is a bundle of content. This presents two issues:

- Although football is highly valued by a significant majority of subscribers, tastes for other sports are heterogeneous. Different consumers will value different elements of the bundle and therefore consider different products as substitutes.
- Most consumers have preferences for more than one sport. Therefore consumers would switch to the bundle which best reflects their preferences for multiple sports.

4.115 A critical part of this assessment is the fact that subscribers tend to value two or more sports. As noted above in Figure 12, 33% of subscribers to Sky Sports 1 only value football. Less than 1% of subscribers only value one of either cricket, rugby union or golf. Almost half (47%) of subscribers who watch sport at least once a week value football plus at least one other sport. To determine whether other channels are a substitute for Sky Sports 1, we therefore need to assess whether those other channels can provide sufficient quantities of multiple sports, including, but not necessarily limited to football.

4.116 **[✂]**.

4.117 **[✂]** Figure 14.

[122] Ofcom Sports conjoint research, See Annex 10 of Ofcom's September 2008 for details .Wimbledon is important to about 32% of subscribers.

[123] **[✂]**. See Appendix 3 of Annex 6 for details.

Figure 14 [✂]

[✂]

4.118 **[✂]**.

Assessment of the constraint on Sky Sports 1 from other channels

4.119 As we set out in our Second Pay TV Consultation, the strength of constraint from other channels will depend on:

- The importance of the content on Sky Sports 1.
- The closeness of the substitutes on other channels.
- The quantity and quality of content on other channels.

4.120 As we set out in our first and second consultations **Setanta Sports 1**[124] appears to be the closest substitute for Sky Sports 1.

- It contains a significant amount of the FAPL content which is most valued by consumers and is unavailable on any other channel.
- It also broadcasts other valuable football such as FA Cup, and England internationals and Scottish Premier League.
- Additionally, it broadcasts a significant amount of golf which is very important to around 30% of subscribers.

4.121 **Sky Sports 2** also appears to be a close substitute for Sky Sports 1. It broadcasts a portfolio of important sports that broadly reflect the offering on Sky Sports 1. As illustrated in Figure 7:

- It shows a significant amount of important football some FAPL games, a significant amount of UEFA CL, some Carling Cup, England internationals, and Championship football.
- It shows a significant amount of highly valued cricket and golf.
- It broadcasts more rugby union and tennis than Sky Sports 1.

4.122 **Sky Sports 3** contains some of Sky's less popular cricket[125], Super League and tennis. It tends to attract markedly lower audiences than Sky Sports 1 or 2 when covering these sports. As can be seen from Figure 8 below, average audience on Sky Sports 3 is considerably lower than Sky Sports 1 and 2.

[124] See paragraph 2.54.

[125] Measured by audience.

Figure 15 Average audience for key sports events on Sky channels in 2008 (000s)

	Average audience on Sky Sports 1	Average audience on Sky Sports 2	Average audience on Sky Sports 3	Average audience on Sky Sports Xtra
Cricket	107	38	11	7
Super League rugby	99	80	34	13
Tennis	164	13	10	15

Source: Ofcom analysis of BARB data

4.123 There is very little top flight football[126] on Sky Sports 3. However; Sky Sports 3 broadcasts a significant amount of Sky's golf coverage. It is possible that golf fans would consider Sky Sports 3 a substitute for content on Sky Sports 1. However, although 20% of subscribers highly value golf, only 1% of subscribers highly value golf but do not value football.

4.124 It is difficult to know whether consumers would consider switching to Sky Sports 3 as we cannot observe the notional 'price' that consumers pay when they access the channel within their Sky Sports bundle. However, given the relatively low amount of top flight football shown on this channel compared with either Sky Sports 1, 2, Setanta Sports 1 or FTA we consider that it would be a relatively weak substitute even at a very low notional price.

4.125 **Sky Sports Xtra** contains most of Sky's tennis coverage and a small amount of CL football (usually not featuring FAPL teams), golf and cricket. It shows about 71% of the major tennis tournaments shown on Sky channels and attracts about 52% of Sky's total audience for tennis.

4.126 There is no retail price for Sky Sports Xtra as it is bundled 'free' in retail packages but the wholesale price is £1.20[127]. Given the low amount of football, golf and cricket on Sky Sports Xtra compared with Sky's other channels it is likely that the channel would only appeal to the small proportion (1%) of subscribers to Sky Sports 1 who highly value only tennis. We consider it would be a relatively weak constraint on Sky Sports 1 at the wholesale level (either as a direct wholesale demand side substitute, or as an indirect constraint on Sky Sports 1).

4.127 **FTA** broadcasters show some highly valued sport which could potentially substitute for the content found on Sky Sports 1. For example, there is some live top flight football. FTA also broadcasts some of the sports considered important by fewer subscribers such as golf, rugby union and tennis. However there is much less content than found on premium sports channels such as Sky Sports 1 and 2 and the content is scheduled relatively infrequently compared with content found on dedicated sports channels.

[126] For example matches featuring FAPL teams.

[127] The wholesale price of Sky Sports 1 or 2 is £13.48. Though most wholesale subscribers take Sky Sports Mix (Sky Sports 1, 2 & 3) for which the wholesale price is £18.39 or £23.40 if bought with Sky Movies Mix. Source: Sky response to Ofcom information request of 29 May 2008.

4.128 In our Second Pay TV Consultation we set out why we considered that football on FTA would be a relatively weak constraint on the Sky Sports channels. This was because – as shown in Figure 16 below – although some of the content can match the quality of that found on the Sky Sports channels, it does not match the quantity of regularly available content throughout the season.

Figure 16 Live football featuring Premier League teams on TV (2007/08 season)

Competition	Total number of matches broadcast	Number of broadcast matches featuring FAPL teams	Number of matches broadcast on FTA featuring FAPL teams	Number of matches broadcast on premium channels featuring FAPL teams	Number of unique occasions to watch FAPL teams	
					FTA	Premium
FAPL	138	138	0	138	0	136
Champions League						
- Qualifying	10	4	2	2	2	2
- Post qualifying live matches	125	43	22*	22*	13	14
FA Cup	28	19	14*	6*	14	6
UEFA Cup	49	28	25	3	19	3
Carling Cup	15	13	0	13	0	13
Total	**365**	**245**	**63**	**184**	**48**	**174**

*Note: * The finals of these events are broadcast simultaneously on FTA and pay TV.*

Source: Ofcom analysis of TV schedules from TV Times and internet search

4.129 For the same reasons, while we recognise that FTA broadcasts some rugby union, rugby league and golf (considered important by fewer subscribers than football), it cannot match premium sports channels in terms of regularity and quantity of programming. We therefore consider that Sky Sports 2 and Setanta Sports 1 are likely to be closer substitutes than FTA for Sky Sports 1, for those subscribers who highly value sports. We consider the constraint from FTA channels further in paragraphs 4.163 to 4.184.

4.130 **Eurosport** is retailed within bundles of basic tier content. It broadcasts a range of sports. However it does not broadcast live top flight English football, cricket, rugby union, or rugby league. We therefore consider it would be a poor substitute for the 84% of Sky Sports subscribers who value these sports highly.

Conclusion on assessment of characteristics and preferences

4.131 The evidence above identifies the key content that is available on Sky Sports 1 and considers the potential substitute channels that would enable consumers to access a similar range of high quality content. Inevitably a degree of judgement is required in assessing the precise extent of substitutability, and as we noted in the introduction to this Section, TV content is, in any case, highly differentiated. Nevertheless, our analysis suggests that:

- Setanta Sports 1 is likely to be the closest substitute for Sky Sports 1[128]. It contains significant amounts of live top-flight football including FAPL (which is the

[128] See paragraph 2.54.

most important content, especially when assessed by rights values) and England internationals, and also live golf;

- Sky Sports 2 also appears to be a reasonably close substitute for Sky Sports 1 as it contains a significant amount of top flight football (UEFA Champions League), cricket, golf, rugby union and rugby league.

4.132 We therefore conclude that our assessment of consumer preferences and characteristics suggests both of these channels are likely to lie within the same market as Sky Sports 1.

4.133 The relatively low amount and quality[129] of football, cricket, and rugby union on Sky Sports 3 and Xtra suggest these channels are not a close substitute for Sky Sports 1, 2 or Setanta Sports 1 and are likely to lie outside the relevant wholesale market. We consider that other content (general entertainment on TV for example) would be a more distant substitute than sports channels given that subscribers have very strong preferences for specific sports.

4.134 We recognise that FTA TV broadcasts important football, golf, rugby union, and rugby league content. However it cannot match the regularity and quantity of sport found on Sky Sports 1, 2 or Setanta Sports 1. We therefore think it is unlikely that FTA would be a sufficient indirect constraint on a monopolist wholesaler of these premium sports channels. However, we acknowledge that some sport set out in Figure 7 might act as a strong out of market constraint on a monopolist wholesaler of premium sports channels.

Assessing consumers' response to a SSNIP

Our position in the Second Pay TV Consultation

4.135 In order to assess the likely indirect constraint that consumers place on wholesalers of premium channels we considered their likely response to a price rise. High levels of switching to other products in response to relatively small increases in prices from competitive levels could indicate that the products were in a broad market. Conversely, low switching could be evidence of narrow markets. As we have explained previously, where prices may be above competitive levels we would expect to observe a higher level of switching in response to a price rise, and in this case high switching could be consistent with finding narrow markets.

4.136 In our First Pay TV Consultation we reported our survey evidence on consumers' stated response to hypothetical price rises of the premium sports channel element of a consumer's bundle (i.e. Sky Sports Mix)[130]. The evidence suggested that although large numbers of subscribers might switch or change their subscription in response to a price rise, many chose to keep the sports element of the package. We stated that such responses might be subject to 'stated preference bias', so they should be interpreted with caution.

[129] The quality can be measured by average audience for example.

[130] Ofcom December 2007 consultation paragraph 5.31.

4.137 In response to our First Pay TV Consultation, Sky presented results of a study it commissioned on the **[✂]**[131] **[✂]**[132]. Sky claimed **[✂]**".[133]

4.138 In our Second Pay TV Consultation we also presented evidence of consumers' willingness to pay for premium sports channels[134].

4.139 Our view was that this additional evidence was less likely to be subject to stated preference bias, although our concerns about whether we had assessed a price rise from competitive levels remained. Nonetheless, the evidence from Sky's Conjoint Study and from the central estimates of our own willingness to pay survey suggested that a SSNIP on Sky's wholesale channels could indeed be profitable.

Respondents' views

4.140 Sky argued that no evidential weight can be placed on our demand elasticity estimates derived from our willingness to pay survey[135]. Sky also argued that its own estimates of consumer responses to price rises were similarly unreliable, as they did not seek to examine spin-down in response to price increases, and because consumer research was not a perfect predictor of consumers' behaviour.[136]

4.141 FAPL argued that our conclusions from our elasticity estimates were unreliable because[137]:

- We had not provided confidence intervals around our estimates.
- The data on willingness to pay from which Ofcom's elasticities were derived underestimated consumer demand for Sky Sports channels at current prices[138].

Our current view

4.142 We interpret evidence on consumer price elasticity with caution. This is because we would expect any profit maximising firm to price where a further price increase is just unprofitable. Hence, evidence of an elastic response to further price changes may indicate that a firm is pricing at the profit maximising level regardless of whether the

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[131] Conjoint analysis asks respondents to choose between a series of products with different sets of features. The trade-offs made are analysed to assess the relative importance of each of the different features.

[132] See Annex 6, Appendix 4 of Ofcom's September 2008 consultation for details. Sky conjoint: **[✂]** supplied to Ofcom by Sky in July 2007.

[133] Sky response to Ofcom's First Pay TV Consultation Annex 2 paragraph 2.17.

[134] See Annex 10 of Ofcom's Second Pay TV Consultation for details.

[135] Sky Response of 1 June 2009 to Ofcom's Second Pay TV Consultation "Additional comments on Ofcom's analysis of market definition and market power in the pay TV review" paragraph 4.3 and Annex 5.

[136] Ibid. Annex 1 paragraph 2.8.

[137] Sky also commented on our estimates of elasticity, see Appendix 2 to Annex 6.

[138] FAPL response to our Second Pay TV Consultation page 43.

current price is constrained to competitive levels. Figure 17 shows the estimates of consumer elasticity for Sky Sports and Sky Sports and Movies Mix packages.[139]

Figure 17 Estimates of Sky Sports subscribers' elasticities and wholesale critical loss

		Sky Sports and Movies Mix	Sky Sports Mix
1	Minimum elasticity to constrain a wholesale monopolist (critical loss)	[✂]	[✂]
2	Sky conjoint estimate	[✂]	[✂]

*Source: Critical loss: see Appendix 10 of annex 6 to Ofcom's Second Pay TV Consultation; Sky conjoint: **[✂]** supplied to Ofcom by Sky in July 2007*

4.143 Sky did not provide any detailed support for its arguments about why its elasticity estimates from its Conjoint Study were unreliable. We do not consider its comments are a basis for dismissing these estimates, and we note that Sky chose to rely on them in response to our First Pay TV Consultation.

4.144 The relatively small samples in Ofcom's willingness to pay survey (40 for Movies Mix only, 147 for Sports Mix only and 95 for Sports and Movies Mix) means that the confidence intervals around the estimates of elasticity are wide and the results are sensitive to changes in assumptions used. Moreover there is a strong risk that these results will have been subject to "stated preference bias", i.e. the tendency of survey respondents to exaggerate their willingness to switch in response to a price rise. We therefore do not rely on our estimates of elasticity derived from our willingness to pay survey.

4.145 The results of Sky's conjoint study suggest that a wholesale price rise for Sky Sports and Movies Mix and Sky Sports packages would be likely to be profitable. Sky's conjoint estimate continues to point to a narrow market. For the reasons set out in paragraphs 4.43 to 4.45 and 4.52 to 4.53 we in any case interpret this analysis cautiously.

4.146 The elasticity estimates discussed above relate to demand facing Sky, as opposed to the market demand that would be faced by a hypothetical monopolist. A monopolist supplier of premium sports channels would be likely to face less price-sensitive customers than Sky does at present (because some Sky customers who have a strong demand for premium sports channels could see Setanta as a substitute). As such, with a hypothetical monopolist it is likely that elasticities would be even further below the minimum elasticity in the critical loss test – further strengthening the view that the market is narrow.[140]

[139] Where the estimated critical loss elasticity (line 1) exceeds the estimated elasticity (line 2) we conclude that consumers are not price sensitive enough to constrain a monopolist from raising prices.

[140] Sky has suggested that it sets its wholesale prices to avoid a margin squeeze infringement (source Sky response dated 28 July 2008 to Ofcom's information request dated 2 July 2008, paragraph 9).

Observed response to price changes

Our position in the Second Pay TV Consultation

4.147 In both our first and second consultation documents, we examined subscribers' responses to actual price rises. If we observed that firms were unwilling to impose price rises on their customers, or that large numbers of consumers would switch in response to price rises, we might infer that firms' pricing was constrained and markets were broad (again subject to the caveats around the cellophane fallacy). Of course, as we noted in our first consultation, it can be difficult to isolate the impact of price changes in dynamic markets where the nature of products is changing over time.

4.148 In the First Pay TV Consultation we stated that prices of Sky Sports channels on DSat had increased in real terms by on average **[✂]**[141] per year since 2000 (although prices have remained relatively stable in real terms since 2004) and at the same time the number of subscribers to those packages had increased. We noted that it was difficult to interpret the impact of price changes on subscriber numbers because the quality of the packages had changed over time. However, we concluded that on balance the evidence suggested that Sky's pricing had not been constrained to the competitive level.

4.149 In response to our First Pay TV Consultation, Virgin Media said that it found our analysis of price changes and subscriber numbers "compelling". It noted that "real increases in prices and growing subscription numbers do not suggest that Sky is subject to any effective constraint"[142].

4.150 By contrast, Sky claimed that our analysis of changes in subscriber numbers, prices and quality was insufficient to draw conclusions on market definitions. It suggested a wide range of factors affect subscriber numbers. These include quality, discounts, subscriber acquisition costs, quality of relevant substitutes, set top box subsidies, charges for related products (e.g. Sky+ or broadband) and marketing spend.

4.151 Sky also asserted that our assessment of changes in the quality of Sky Sports packages did not consider the fact that there was more live FAPL content, additional channels, additional programming, on-screen and other programming improvements, improvements to basic-tier programming, and other aspects of Sky's product offering such as 'free' broadband.

4.152 As a result we carried out additional analysis for our Second Pay TV Consultation[143] . This analysis showed that:

- Retail prices for packages containing Sky Sports had, since 2004, remained roughly constant in real terms. There was a temporary increase in the use of discounts around 2006 which was phased out in 2007.

- There had – as Sky suggested – been some increase in the quality of the packages on offer. In particular, there was more programming on the Sky Sports

[141] Depending on the precise package.

[142] Virgin response to Ofcom consultation paragraph 5.13.

[143] See Appendix 3 of Annex 6 of Ofcom's Second Pay TV Consultation.

channels, although this was partially offset by the loss of some key content. There were also more basic tier channels and subscribers could obtain additional services such as broadband, or Sky Anytime.

- The number of subscribers to packages containing Sky Sports on DSat had increased in the period 2000-2006 and had since been relatively constant as can be seen in Figure 18 below.

Figure 18 Subscribers to packages containing Sky Sports channels on DSat

[✂]

Source: Sky response to information request of 29th May 2008.

Note: Big basic includes either 5 or 6 mix basic tier packages, small basic includes 1, 2, 3 or 4 mix basic tier packages. Sports Mix also refers Dual Sports.

4.153 We explained that it was difficult to identify directly the consumer response to price changes as the quality of the product had changed over time. However, we also noted that the number of retail subscribers to packages containing Sky Sports channels on DSat had increased despite small price increases, which would point to a relatively weak constraint.

Respondents' comments on our evidence

4.154 Sky criticised our analysis of price changes for three reasons[144]. It argued that:

- We had misinterpreted the use of discounts.
- Our choice of start and end dates tended to exaggerate growth in prices. This is because price rises tend to occur once a year, and our chosen start and end point was just after a price rise. Sky stated we should instead use "directly comparable" start and end points, for example from just after a price rise to just before another price rise.
- It also said that the price deflator (GDP deflator) we had chosen was unusual because it was not reflective of consumer price inflation and it was only available on a quarterly basis whereas the Retail Prices Index (RPI) and Consumer Price Index (CPI) were available on a monthly basis.

4.155 Sky further argued that the evidence suggests it has, for some time, been unwilling to impose price rises for packages containing Core Premium Sports channels[145]. Sky argues that, according to Ofcom's test, this provides evidence that pricing is constrained and markets are broad.

Our current view

4.156 We recognise the limitations of considering consumer switching in response to price changes for an assessment of market power[146]. One reason for this is that we would

[144] Sky response to Ofcom's Second Pay TV consultation Annex 6, section 3

[145] Sky Response of 1 June 2009 to Ofcom's Second Pay TV Consultation "Additional comments on Ofcom's analysis of market definition and market power in the pay TV review" Annex 5 paragraph 2.15.

[146] See paragraph 4.25 to 4.31 for a full discussion.

expect any firm to set prices at the point where any further price increase would be unprofitable. This point may well be above the competitive price level. As such, even if Sky were unwilling to impose price increases above the current level, this would not mean that prices were constrained at the competitive level, or that markets were broad.

4.157 We have considered the average change in price of Sky's retail packages over time for Sky's most popular packages when taken with 6 mix. We have used a "directly comparable" time period as suggested by Sky (just after a price increase in 2002 to just before an increase in September 2008[147]). The results are summarised in Figure 19.

4.158 We consider the CPI and RPI minus mortgage interest and indirect taxes best reflect changes in price for consumer goods[148]. Our choice of deflator (the GDP deflator) lies between these two measures.

Figure 19 Real average annual retail price changes over time using various price deflators (2002 to 2008)

	RPI - All items	RPI - All items excluding mortgage interest payments	RPI - All items excluding mortgage interest payments and indirect taxes	RPI - All items excluding housing costs	CPI	GDP def
Sky Sports and Movies Mix	-0.3%	0.0%	0.1%	0.7%	0.9%	0.5%
Sky Sports Mix	0.3%	0.7%	0.7%	1.3%	1.6%	1.2%

Source: Sky response to Ofcom information request of 29 May 2008.

4.159 Figure 19 shows that the price of the Sky Sports Mix has increased in real terms regardless of the choice of deflator. The price of the Sports and Movies mix has increased in real terms on most measures.

4.160 The change in the use of discounts does not affect our conclusion that prices have increased a small amount over the period. Sky **[✂]**[149].

4.161 As we explained in detail in our Second Pay TV Consultation, there have been some changes in the quality of the products offered which make an assessment of quality adjusted price changes over time difficult. For example Sky introduced "free" broadband; in July 2007 Sky scrapped the £120 annual charge for subscribers who

[147] Retail prices increased in September 2008 then fell slightly in response to changes in VAT.

[148] RPI is affected by changes in council taxes or mortgage interest payments which do not reflect changes in prices of consumer goods.

[149] Sky has stated that the reduction in the availability of 'viewing package discounts' had led to a short term increase in churn. See for example: http://corporate.sky.com/documents/pdf/press_releases/26_07_07_final_results.pdf.

wanted to record programmes onto its PVR (Sky+). Additionally there have been content changes – particularly on Sky Sports channels and basic tier channels.

4.162 Taken together, we consider the evidence on Sky's premium sports subscriber numbers and prices continues to point towards a degree of constraint on premium sports channels, although we accept that the evidence on quality changes makes a definitive judgement difficult.

Assessment of the constraint from FTA TV

Our position in the Second Pay TV Consultation

4.163 The characteristics of FTA sport are discussed in paragraphs 4.127 to 4.129 where we noted that despite the high value of some FTA sports content, the infrequency with which high-quality sports content is shown FTA is likely to limit the scope for FTA sports to act as a constraint on pay TV.

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

4.165 The growth of Freeview and a greater number of basic channels featuring sport have increased availability of sports and other programming on FTA and basic tier TV. The number of households which access multi-channel TV on their main set via Freeview has increased rapidly from about one million in 2002 to over ten million, as illustrated in Figure 20. The entry of Freeview in 2002 enables us to examine the response of other TV providers and of consumers.

Figure 20 Premium sport channel subscriptions and Freeview households (Q1 2000 to Q1 2008)

[✂]

Source: Sky[150], Ofcom digital tracker survey, Setanta

4.166 If sport on Freeview were a close substitute for premium sports channels we would expect the trend in Sky Sports subscriber numbers to have been impacted by the growth in numbers of Freeview households. (We note that subscriptions to Sky will also depend on other factors, such as changes in the price/quality combination offered by Sky). However, the massive growth in popularity of Freeview since 2002 does not seem to have substantially impacted on growth in Sky Sports subscriber numbers. Indeed, there does not appear to be direct substitution away from Sky Sports as a result of the greater take-up of Freeview.

Respondents' views

4.167 Sky commissioned a study which considered the extent to which geographical variation in availability of DTT services affects demand for Sky's TV services ("the Seabright study"). The study suggests that "post code districts that have higher access to Freeview also have [statistically] significantly lower levels of subscriptions

[150] Sky response to Ofcom information request of 29 May 2008.

to Sky's pay TV services, and to a degree that implies Freeview is an important competitive constraint upon Sky".[151]

4.168 Sky stated that the "the extent of constraint on the take-up of Sky's services from the availability of DTT services is as great as the constraint from the availability of cable services in respect of premium subscriptions"[152]. It went on to say that given we found that premium TV channels offered on cable TV were likely to be in the same retail market as premium TV channels offered over DSat the study has "profound implications" for market definition.

4.169 Sky concluded that the Seabright study "confirms" that the relevant retail market is "all TV services" which included both free to air TV and pay TV services.[153]

4.170 Figure 21 summarises the estimated impact of DTT and cable availability on demand for premium channels. The table shows the current percentage of households that subscribe to each type of Sky product (line 1). It reports how this percentage would decline if DTT availability or cable availability increased by 20% in a given area (line 2). It also sets out the estimated proportionate decline in demand given an increase in the availability of DTT and cable.

4.171 The model predicts for example that in a given area if DTT availability increased by 20%, take up of Sky Sports would decline by **[✂]**%. If the area had average take up of Sky Sports (**[✂]**%), this would represent an approximately **[✂]**% proportionate decline.

Figure 21 Impact of DTT and cable availability on different types of premium subscriptions given a 20% increase in availability of DTT and cable

		Basic only		Movies only		Sports only		Sports and Movies	
(1)	Current level of subscriptions in average post-code	[✂]		[✂]		[✂]		[✂]	
(2)	Impact on premium Sky subscriptions from a 20% increase in availability of Freeview and cable	DTT	Cable	DTT	Cable	DTT	Cable	DTT	Cable
		-1.63%	-0.96%	-0.21%	-0.18%	-0.52%	-0.38%	-0.37%*	-0.46%
(3)	Proportionate impact on total subscriptions	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

** not significantly different from zero*

Source: Sky response to Ofcom's Second Pay TV Consultation Annex 5 part 1, table 2 and 4

[151] Sky response to Ofcom's Second Pay TV Consultation Annex 5 Technical Annex section4.

[152] Sky response section 4 paragraph 5.3.

[153] Sky response to Ofcom's Second Pay TV Consultation Executive Summary page 8.

Our current view

4.172 The growth in availability of FTA digital channels and the greater range and quantity of available sport means that FTA TV may now be a closer substitute for premium sports channels than ten years ago when most consumers only had access to five FTA channels. In particular, we observe that the additional digital channels mean that the PSBs are able to broadcast live sporting events in greater depth and there has been enormous growth in numbers of Freeview consumers.

4.173 At the same time, the recent capacity growth of FTA TV is only relevant to premium sport to the extent that the ownership of key content rights permits this capacity to be exploited.

4.174 We agree that that the Seabright study provides evidence that there may be substitution between FTA and premium channels. However, even if we had full confidence in the results we do not believe that the results ‘confirm’ that the current availability of DTT constrains the retail price of pay TV services.

4.175 First the study does not demonstrate whether a small increase in the price of premium packages would lead consumers to switch to FTA given the current availability of Freeview. Instead, by comparing areas where DTT is not available with areas where it is available the study effectively reports the impact on demand for Sky’s premium channels following an *infinite* increase in the price of DTT services. If DTT’s price increased infinitely or it became unavailable we might expect to observe some switching to other TV services even if they are not close substitutes.

4.176 Second, the authors of the study conclude that the relationship between DTT availability and demand for Sky’s most popular premium package (the Sports and Movies package which is taken by **[✂]**% of premium subscribers[154]) is not statistically significant[155].

4.177 Third, the study reports the impact on availability of DTT on demand for Sky’s premium channels at current prices. If Sky’s current prices are above competitive levels we would expect that the magnitude of substitution between Sky Premium and DTT would be exaggerated. For the reasons set out in paragraphs 4.52 and 4.53 we consider that Sky’s current prices may be above competitive levels so we interpret evidence of switching with caution.

4.178 Fourth, DTT includes a selection of free to air channels on Freeview and Setanta, a premium sports channel. The study does not isolate substitution between premium channels and Freeview. Some of the estimated substitution may be due to the presence of Setanta on DTT. Therefore Freeview availability may have a lower effect (or even no significant effect) on demand for premium channels than suggested by the study.

4.179 We also commissioned an independent review of the Seabright study[156]. This raised a number of concerns about the study’s methodology which we summarise in Annex 7. Taken together, these concerns suggest that the study may overstate the

[154] Sky response to Ofcom information request of 29 May 2008.

[155] The relationship between DTT availability and demand for Sky’s Sports and Movies package is not statistically significant after correcting for spatial correlation.

[156] Summarised at Appendix 4 of Annex 6 of this consultation.

relationship between demand for premium channels and availability of DTT. There are several reasons for this potential overstatement:

- The estimate of the relationship between DTT availability and demand for Sky premium channels is not robust to changes in model specification.

- The instrument chosen to treat the endogeneity of availability of DTT may be invalid as it has a role in determining demand.

- The study ignores the potential problem of endogeneity of access to cable. Without treating this problem we cannot be sure that any of the estimated coefficients are not biased.

4.180 The question for our analysis is whether FTA TV is a sufficient constraint on premium sports channels to be included within the relevant market.

4.181 We recognise that the Seabright study shows some interaction between demand for Freeview and pay TV – as, indeed, one would expect. However, it does not model the effect of a price increase, and as such does not provide direct evidence that Freeview is a constraint on the prices of premium sports channels.

4.182 Given the growth in the number of FTA channels and the increasing popularity of Freeview, we might expect that if FTA TV and premium sports channels were strong substitutes, we would observe a competitive response from Sky in the form of lower prices or margins for its Sky Sports channels, or for Sky Sports to have lost subscribers.

4.183 As we set out in paragraphs 4.200 to 4.208 below, the relationship between prices, quality and programming costs is complex. Nonetheless we observe that both the price of Sky Sports Mix packages, and **[✂]**, while the total number of subscribers to Sky Sports Mix packages has increased over this period. Oxera's analysis[157] also shows that the growth of FTA has not prevented Sky from making high profits from its pay TV channels.

4.184 Taken together we consider these factors suggest that the growth of FTA channels has not sufficiently constrained Sky's pricing of Sky Sports for FTA channels to be included in the same market.

Supply side substitution

4.185 We turn now to the question of supply side substitution. Wholesale supply side substitution would occur if a broadcaster were to introduce its own sports channel in response to an increase in the price of Sky Sports 1. The OFT guidelines[158] on market definition suggest that to be considered as a relevant constraint:

- Supply side substitution should occur within a reasonably short period of time – a year.

- Entrants should not incur substantial sunk costs.

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[157] See section 6.

[158] OFT 2004 Market Definition Guidelines paragraph 3.15

- Entry should be on a scale significant enough to affect prices.

Our position in the Second Pay TV Consultation

4.186 In our First Pay TV Consultation we explained that wholesale supply side substitution within a year without significant sunk costs was unlikely, as broadcasters would have to acquire rights and incur start up costs for their channel, both of which would be substantial.

4.187 In response, Sky stated[159] that the threat of competitive entry exists at the wholesale channel provider level. It argued that Ofcom adopted an unreasonable entry benchmark, i.e. rapid and direct replication of Sky's sports channels in order to constrain Sky's pricing. Sky argued that other modes of entry are possible, including gradual or targeted entry, or entry through differentiated content. Sky also argued that rapid entry is possible because rights to content become available on a staggered basis and are fully contestable.

4.188 Sky further argued that, although significant financial outlay would be involved in acquiring rights, many entities would have access to such funding, such as Disney / ESPN, or BT. It stated that a new entrant could limit initial investment by incrementally building subscribers. Sky suggested that Setanta's entry into the market is evidence that entry is possible[160].

4.189 UKTV said that it had considered entering the market to supply a sports channel but concluded that although it would be able to acquire rights to "less well known" sports[161] it would not be economically feasible to operate a channel based on these "less popular" sports.

4.190 We agreed that a new entrant would not have to replicate exactly existing channels in order to compete for the same consumers. However, our evidence on consumer preferences indicated that FAPL or a significant number of matches featuring FAPL teams is a key characteristic needed to compete with premium sports channels. We explained in detail in our assessment of market power why we thought that it would be highly unlikely that a rival wholesale channel provider would be able to acquire such rights in sufficient quantity.

4.191 We referred to press reports indicating that Setanta has incurred losses of €100 million from 2005 to 2007. Setanta's director of corporate development said that "when you're launching and expanding, you typically incur the costs before you get any money from your subscriber base"[162]. The scale of Setanta's losses and UKTV's assessment of entry into the market are both evidence that entry within a year

[159] Sky response to Ofcom's First Pay TV consultation, Annex 3, section 3

[160] Ibid.

[161] For example UKTV cited swimming, hockey, table tennis and sailing. UKTV response to Ofcom's First Pay TV consultation section 2

[162] http://www.independent.ie/business/irish/expansion-sees-setanta-losses-head-for-8364100m-1088013.html.

without sunk costs is unlikely[163]. For this reason we did not consider supply side substitution to be sufficient to widen markets.

Our current view

4.192 We did not receive specific responses to our Second Pay TV Consultation challenging our assessment of supply side substitution for wholesale premium sports channels. However, our view rests partly on our assessment of the barriers to entry in acquiring the necessary content. Sky's response to our consultation addresses the question of barriers to entry, and we set our views on those issues in our discussion of market power in section 5 below.

4.193 In summary, we remain of the view that entry on a significant scale within a year and without incurring sunk costs is highly unlikely.

Direct wholesale demand side substitution

Our position in the Second Pay TV Consultation

4.194 In the event of a price rise on wholesale premium sports channels a retailer could in theory substitute to alternative inputs to use in its retail packages.

4.195 In our Second Pay TV Consultation, we explained that because wholesale demand is derived from consumer demand, products that consumers would find weak substitutes are also likely to be relatively weak substitutes at the wholesale level.

4.196 Our analysis of the indirect retail constraint indicated that there are no close substitutes for content found on premium sports channels[164]. We did not consider therefore that there were likely to be any wholesale products that a retailer could substitute to in the event of a small but significant increase in the carriage fee.

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

Respondents' views

4.198 Sky argued that we failed to have regard to the argument that a retailer reallocating sales effort away from particular channels, rather than dropping those channels, could act as a constraint on the wholesale price[165]. Sky referred to its response to our First Pay TV Consultation where it said that retailers had "bargaining power" in respect to Sky as they could reallocate marketing effort from Premium Sports channels to alternative products with higher margins such as telephone or broadband

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[163] As we set out in paragraph 2.53, Setanta has been unable to make the transition from these losses to a sustainable business.

[164] Appendix 9 to Annex 6 to Ofcom's Second Pay TV Consultation describes alternative sport channels. These include niche a la carte channels such as MUTV or Chelsea TV; channels that are either provided FTA such as Fight Network or sportsXchange; channels contained within a basic tier subscription such as Eurosport, Motors TV, Attheraces.

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

even though these are not viewed as substitutes for television programming in the eyes of consumers[166].

Our current view

4.199 While we have broadened our view of the sports that are important in Core Premium sports channels, we have not changed our view of the relative importance of the channels themselves. For the reasons set out in paragraphs 4.94 to 4.134 we do not consider there are close substitutes to these channels. Therefore it remains our view that direct demand side substitution to alternative channels is unlikely to broaden markets. We assess the scope for retailers to allocate marketing effort to other products in section 5 below.

Changes in wholesale prices

Our position in the Second Pay TV Consultation

4.200 Sky contested the view, expressed in our First Pay TV consultation[167], that it had market power in the markets for premium sports and movies channels, arguing that flat or falling wholesale carriage prices for its premium channels were "strongly suggestive that Sky lacks significant market power in relation to the provision of premium sports and movies channels" [168]. For example it said:

> "Trends in wholesale charges for Sky's premium pay TV channels are set out in [ ] …. Two features of this chart are notable: charges for a package of all Sky's premium channels have been broadly flat in real terms for the past four years; there have been declines in charges for (a) Dual Movies, and (b) a single Sky sports channel over the past four years, with the declines for Dual Movies being particularly pronounced.
>
> Given very significant increases in rights costs, particularly in the case of sports channels, the obvious implication is that margins between costs and prices have narrowed in relation to Sky's channels at the wholesale level over this period."[169]

4.201 In response, we analysed the changes in wholesale prices of the most popular wholesale premium sports channel mixes – those taken by some **[✂]**% of sports subscribers[170]. We felt that the price for stand-alone Sky Sports 1 was less relevant given **[✂]**. Our analysis showed that although the wholesale price of the Sky Sports and Movies Mix **[✂]** in real terms since 2005, it was still **[✂]** than it was in 2002. The price of Sky Sports Mix has **[✂]** since 2002 and in September 2008 was **[✂]** than it was in 2002.

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[166] See Sky response to Ofcom's First Pay TV Consultation paragraph Annex 2 paragraphs 3.120 – 3.126.

[167] Paragraph 1.25.

[168] Annex 2 to Sky's non-confidential response to our December 2007 consultation paragraphs 3.131-3.132.

[169] Ibid.

[170] Our full analysis is contained in Annex 6 to Ofcom's Second Pay TV Consultation, Appendix 6.

4.202 We also examined the wholesale mark-up over programming costs. Other things being equal, if Sky faced significant wholesale competition, we would expect the wholesale mark-up over programming costs to remain constant or decline. The relationship between input costs and wholesale prices is complex, as Sky spreads the fixed costs of production over UK residential and commercial subscribers and Ireland subscribers.

4.203 We assessed a simple measure of the real programming cost per residential subscriber as a proportion of the wholesale price for Sky's most popular wholesale premium packages. As set out in Figure 22 this shows that the per subscriber cost of rights as a proportion of the wholesale price has declined for the most popular of Sky's premium packages – those taken by **[✂]**% of wholesale subscribers (Sky Sports Mix, Sky Movies Mix and Sky Sports and Movies Mix).

Figure 22 Sports and Movies programming rights cost per subscriber as a proportion of the wholesale price

[✂]

Source: Programming costs from Sky's Annual Reports 2001/02 and 2007/08, wholesale prices and subscriber numbers Sky response to information request of 29 May 2008.

Note: the analysis covers only UK and Ireland residential subscribers, not commercial subscribers. Costs are total programming costs expressed on a per UK and ROI subscriber basis as a percentage of the per subscriber wholesale price

4.204 Our analysis suggested a widening wholesale margin over per subscriber costs. Taken together, these figures led us to a different conclusion to the one reached by Sky. Our view was that there was a widening gap between average wholesale prices and costs, and that this could indicate increasing market power.

Respondents' views

4.205 Sky criticised our assessment of changes in wholesale prices[171]. It said that our conclusions were biased by the choice of start and end points of analysis. It also said that our choice of inflation deflator was "unusual" as it was only available on a quarterly basis (whereas the CPI and RPI indexes are published monthly) and it did not reflect inflation of consumer prices.

Our current view

4.206 Figure 23 shows our analysis of wholesale prices under a range of different deflator assumptions taking comparable start and end dates as Sky suggested.

Figure 23 Wholesale price changes Q2 2002 – Q2 2008

[✂]

Source: Sky response to Ofcom information request of 29 May 2008.

4.207 While it is true that real prices of Single Sport have fallen regardless of the inflation measure, this product is taken in very low volumes: fewer than **[✂]**%[172] of sports

[171] Sky response to Second Pay TV Consultation Annex 6 4.3.

[172] At October 2008, source: Virgin Media response to Ofcom information request of 18 November 2008. Question 1.

subscribers take only a single premium sports channel. For the more important products, the alternative inflation deflators suggested by Sky do not materially affect our conclusions. Indeed, the GDP deflator generates results that lie near the middle of the plausible range. Similarly, we do not agree that changing the start dates has a material effect on our analysis.

4.208 It therefore remains our view that the relevant wholesale price of Sky Sports has increased, and that there is a widening gap between the average per subscriber programming cost and the wholesale price. We accept that the quality of Sky Sports channels has changed over time but note that the changes in quality are far more limited when considered for the wholesale product than for retail packages comprising Sky Sports channels. In addition, we note that these wholesale price changes have occurred despite the rapid increase in penetration of DTT. Taken together, we believe this evidence points to a weak constraint on the wholesale pricing of Sky's premium sports channels.

Conclusion on markets for wholesaling of premium sports channels

4.209 On the basis of the evidence presented above, we have identified a relevant economic market for the wholesale supply of channels regularly featuring live sporting events which a significant number of consumers find highly attractive ("Core Premium Sports channels"). This market includes the wholesale supply of Sky Sports 1, Sky Sports 2 and Setanta Sports 1[173].

4.210 These three channels contain large volumes of regular and frequent live sporting events which a significant number of consumers find highly valuable. In particular, Sky Sports 1 contains a significant amount of live FAPL (by far the most valuable content) as well as highly valued cricket, golf, rugby union and rugby league. We include Sky Sports 2 and Setanta Sports 1 in the market on the basis that they also contain a significant quantity of valuable live sports events which are close substitutes to the sports found on Sky Sports 1. Sky Sports 2 contains significant amounts of golf, cricket rugby union and UEFA CL which substitute for content on Sky Sports 1. Setanta Sports 1 contained a substantial amount of live FAPL coverage in addition to golf.

4.211 Our research indicates that on FTA TV or basic tier TV there is some valuable live content which could substitute for sports on Sky Sports 1, 2 or Setanta Sports 1. However while some listed events shown FTA are individually very attractive to viewers, the quantity and regularity of highly valuable content is materially less than on Core Premium Sports channels and we therefore consider sport on FTA TV lies outside the relevant market.

4.212 We have highlighted the difficulties in interpreting evidence on subscribers' price sensitivity. Nonetheless, the evidence we have gathered appears to suggest that insufficient numbers of subscribers would switch to constrain a monopolist wholesaler of premium sports channels, even at current prices.

[173] Setanta went into administration on 23 June 2009, shortly after the live FAPL rights which had been held by Setanta were awarded to ESPN. ESPN has announced that it has agreed a wholesale deal with Sky for distribution on Sky's DSat platform. It has also announced an intention to make its channel including FAPL coverage 'widely available across multiple pay-TV platforms', although at the time of writing no other details of availability across platforms other than Sky's have been announced. Our subsequent conclusions are likely to be independent of whether Setanta Sports 1, or some other channel provided by ESPN, exists as part of the Core Premium Sports market.

4.213 The lack of demand-side substitutes for subscribers means it is unlikely that a retailer could switch to an alternative channel. Hence direct demand side substitution appears unlikely to constrain a hypothetical monopolist of premium sports channels.

4.214 Similarly, we do not consider supply side substitution possible in relevant timescales. New entrants would have to make significant investments in content to supply a new and sufficiently compelling sports channel. Our analysis of barriers to entry in our previous consultation document and updated in Section 5 below suggests that this type of investment is highly unlikely.

4.215 Finally, there appears to be an increasing margin between Sky's wholesale prices and wholesale sports production costs. This would also suggest that the constraint on wholesale prices of Core Premium Sports channels is limited.

4.216 We therefore proceed in this document to consider whether there is a risk that there is not, and will not be, fair and effective competition in the provision of Core Premium Sports channels.

4.217 As is often the case with market definition, the precise boundaries of this relevant market are difficult to determine with certainty. In paragraph 4.175 we reported that the evidence from the Seabright Report indicates that there may be a limited constraint from FTA TV.

4.218 There is a wide variety of content on FTA channels including other sports programming, entertainment, documentaries, shopping channels, channels devoted to arts programming etc. Sky's view is that all of these types of channels and other types of content such as DVDs or VoD services constrain wholesalers of premium sports channels. Sky believes that in the event of a price rise retailers will directly substitute to these alternative channels, or that if the price rise were fully passed through, premium sports channel subscribers would substitute to any of these other channels or other types of content.

4.219 For the reasons set out in paragraphs 4.94 to 4.134 we do not agree with Sky. Our assessment of consumer preferences reveals that consumers subscribe to premium sports channels to access specific types of content. Live FAPL appears to be by far the most important, whether measured by consumers stated preference, or rights value or the view of retailer (as expressed in the contract for carriage of Setanta Sports on Virgin Media). Paragraph 4.102 explains that other football events featuring FAPL are also important to subscribers. There is also a range of other live sports such as cricket, golf, rugby union, rugby league or tennis that minorities of subscribers consider important.

4.220 While we think that FTA TV is not within the relevant market, when assessing whether our market power findings are robust to reasonable changes in market definitions, we consider close substitutes for the important content found on premium sports channels to be the relevant constraints. Therefore when assessing market power we consider whether our conclusions are altered by the inclusion of important football, cricket, golf, rugby union, rugby league or tennis found on FTA and basic tier TV. We find that our market power findings are not sensitive to the precise delineation of the relevant market – i.e. even if the market were drawn more widely, Sky's market share would be consistent with it possessing market power.

Retail markets for premium sports channels

Our position in the First Pay TV Consultation

4.221 In our First Pay TV Consultation we considered retail markets for packages containing premium sports channels. We identified the key drivers of demand for premium sports pay TV packages as high quality sports content, and live football content in particular, together with the availability of a wide range and choice of attractive live sports content. The characteristics of premium sports pay TV packages appear to be significantly different to those of basic-tier and FTA both in terms of the much greater number of hours of sport which are available on premium pay TV sports channels, and the quality of that content, in particular, the availability of live Premier League football.

4.222 We assessed consumers' response to a price rise which suggested that the closest substitute for premium sports channels was Setanta Sports. We assessed whether the growth in popularity of Freeview despite growth in demand for packages containing Sky Sports indicated that the two products were likely to be close substitutes. We concluded that though there is some substitution between Sky's premium channels and FTA TV it was unlikely to be sufficient to broaden markets.

4.223 We concluded that there was a narrow economic market for the retailing of premium sports channels in the UK, which does not include FTA or basic-tier TV channels noting that Setanta Sports may be in the relevant market.

Responses to our consultation

4.224 In response to our consultation, Sky[174] and FAPL[175] considered that markets for sports were broader, encompassing at least FTA channels and basic-tier TV channels. Sky thought that markets were broader still, encompassing audiovisual content from the internet and DVDs.

4.225 BT, Setanta, Top Up TV, Virgin Media, the BBC and **[✂]** all agreed with Ofcom's assessment of markets for premium sports channels. However, BT and Virgin Media considered that our analysis underestimated the importance of other sport on premium sports channels. For example, Virgin Media cited cricket, rugby union, tennis and rugby league as also being important. BT cited darts, noting that a recent match had achieved ratings of over 4.3 million on a Sky Sports channel[176].

4.226 BT, Setanta, Top Up TV and Virgin Media all agreed that our market definitions for the retail of premium sports channels should not include FTA TV or other 'basic tier' TV channels. However they considered that markets were in one respect narrower than we had suggested in our consultation. They considered that Setanta Sports was unlikely to constrain the pricing of Sky Sports to any significant degree and was thus in a separate economic retail and wholesale market to Sky Sports channels. They believed that Setanta was more likely to be a complement to Sky Sports rather than a substitute, noting for example that DSat households were likely to take Setanta in

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[174] Sky response to Ofcom's First Pay TV consultation paragraph 6.24.

[175] FAPL response to Ofcom's First Pay TV consultation paragraph 7.27.

[176] Virgin Media response to Ofcom's First Pay TV consultation paragraph 5.14 and BT response to Ofcom's First Pay TV consultation paragraph 67.

addition to (rather than instead of) Sky Sports. Furthermore, they noted that Sky Sports packages had increased in price after Setanta Sports began retailing FAPL matches in August 2007, whereas Setanta Sports had reduced in price[177]. They thought this suggested that although Setanta Sports' pricing might be constrained by Sky Sports, the constraint could be asymmetric: Setanta Sports does not provide a competitive constraint on Sky Sports.

Our current view

4.227 As noted above, the focus of our Second Pay TV Consultation was on wholesale markets, and we did not formally seek to define retail markets. However, in the light of the comments of respondents to that consultation, we now assess retail markets for the provision of packages including Core Premium sports channels. The key question for our analysis is whether FTA content or basic tier content is likely to constrain a monopolist retailer of premium sports channels.

4.228 We recognise that premium sports channels are retailed in wider bundles containing basic tier channels or movie channels, radio stations and indeed products such as phone or broadband packages. When assessing the constraints on premium sports channel retailers we consider the constraint on the premium element of the bundle. Our analysis therefore identifies products that subscribers to premium sports channels might substitute away to.

4.229 As with our assessment of wholesale markets we consider:

- Demand side substitution
  - Consumer response to price rises
  - Evidence of consumer preferences, product characteristics, and the constraint from FTA.
- Supply side substitution.
- Summary of conclusions.

Demand side substitution

Consumer response to price rises

Our position in the First Pay TV Consultation

4.230 In our First Pay TV Consultation we reported our survey evidence on consumers' stated response to hypothetical price rises. The evidence suggested that although large numbers of subscribers might switch or change their subscription in response to a price rise, many chose to keep the sports element of the package. We stated that such responses might be subject to 'stated preference bias', so they should be interpreted with caution.

[177] Joint Top Up TV and Setanta response, paragraph 3.4. Sky increased the prices of its premium sports packages by £1 (about 4%) on 1st September 2007; Setanta reduced its price by £5 to £9.99 on DSat in August 2007.

Responses to our consultation

4.231 Sky considered that Ofcom's consumer research into the likely response to a hypothetical price rise is strong evidence that consumers are very price-sensitive. It acknowledged that stated preference bias (where respondents overstate their likely responses to hypothetical questions) can be a problem with this type of research although it argued that it was not sufficient to 'reverse' the findings. In its view, we should accept that the findings indicate consumers are highly price elastic unless we provide evidence on the existence of cellophane fallacy pricing or stated preference bias. Sky believed that Ofcom's assessment of profitability suggests that prices are not excessive and are therefore competitive[178].

4.232 However, in a subsequent submission[179], Sky described our concern about the cellophane fallacy as "well founded". Sky said[180] that while the implications of the cellophane fallacy were generally recognised, there was no consensus on how to deal with it. It cited an OFT discussion paper[181] which argued that the inherent uncertainty introduced by cellophane fallacy meant one should be "conscious of the potential weakness of the dominance analysis". Sky said that this recommendation was in stark contrast to Ofcom's approach, in that Ofcom recognised the cellophane fallacy problem but had "a high degree of confidence in its conclusion that Sky holds a dominant position in each of the two narrow markets that it has defined".

4.233 BT, however, agreed with Ofcom that cellophane fallacy pricing is likely to be a problem when considering the switching responses of consumers.[182]

Our current view

4.234 We considered Sky's argument that, because of the cellophane effect, we should be cautious in concluding that Sky is dominant in the narrow markets we have defined. We recognise that the cellophane effect leads to a degree of uncertainty, and because of this uncertainty, we have not relied exclusively on analysis of stated or actual switching behaviour. Rather, we have considered a broad range of evidence.

4.235 However, we note that the cellophane effect will, if not taken into account, lead one to define markets too broadly. As such, the greater the cellophane effect, the more an analysis of switching behaviour will tend to *overstate* the breadth of the market, and therefore to *understate* the degree of dominance.

4.236 We have estimated the minimum consumer elasticity that would be required to constrain a monopolist retailer from increasing prices above current levels. For the reasons set out in paragraphs 4.43 to 4.46 we interpret evidence of consumer elasticity with caution. In order to estimate likely elasticity we examined research provided to us by Sky. The results are shown in Figure 24 below.

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[178] Sky response to Ofcom's First Pay TV consultation Annex 2paragraph2.3-2.18.

[179] Additional comments on Ofcom's analysis of market definition and market power in the pay TV review, Sky, 1 June 2009, paragraph 3.18.

[180] Ibid, paragraph 4.20.

[181] The role of market definition in market power and dominance inquiries, Economic Discussion Paper 2, OFT, July 2001.

[182] BT response to Ofcom's First Pay TV consultation paragraph58.

Figure 24 Estimates of Sky Sports subscribers' elasticities and retail critical loss

		Sky Sports and Movies Mix	Sky Sports Mix
1	Minimum elasticity to constrain a retail monopolist (critical loss)	[✂]	[✂]
2	Sky conjoint estimate	[✂]	[✂]

*Source: Critical loss: see Appendix 3 of Annex 6; Sky conjoint: **[✂]** supplied to Ofcom by Sky in July 2007*

4.237 Overall, the evidence from Sky's conjoint survey appears to suggest that insufficient subscribers would switch to an alternative product to constrain a monopolist retailer[183]. For the reasons set out in paragraph 4.144 we do not rely on our estimates of elasticity from our willingness to pay survey.

Evidence of consumer preferences, product characteristics, and the constraint from FTA

Our position in the First Pay TV Consultation

4.238 In our First Pay TV Consultation we said that the key drivers of demand for premium sports pay TV packages are high quality sports content, and live football content in particular, together with the availability of a wide range and choice of attractive live sports content. We stated that the characteristics of premium sports pay TV packages appear to be significantly different to those of basic-tier and free-to-air both in terms of the vastly greater number of hours of sport which are available on premium pay TV sports channels, and the quality of that content, in particular, the availability of live Premier League football.

4.239 We said that if the increased popularity of Freeview indicated a growing competitive constraint, we would expect to see some significant effect on the price (or quality) of Sky Sports and/or the number of subscribers. However, we have observed that the price of Sky Sports has increased in real terms in the last six years, whilst the total number of Sky Sports subscribers has continued to grow. We accepted that the very real difficulties in estimating the counterfactual meant that we cannot rule out the possibility that the price of Sky Sports has been moderated by increased competition.

Responses to our consultation

4.240 Both FAPL[184] and Sky[185] suggested that there are a wide range of rights that could substitute for FAPL, including many owned by Setanta and FTA channels. They claimed that Ofcom's consumer survey evidence demonstrates that although FAPL is

[183] This is because the reported elasticities (in line 3) are below the minimum level required to constrain a monopolist (in line 1).

[184] FAPL response to Ofcom's First Pay TV consultation paragraphs 7.31-7.35.

[185] Sky response to Ofcom's First Pay TV consultation Annex 2 paragraphs 3.20-3.22.

important to consumers, there are numerous other sports events on TV that are also important to consumers – many of which are broadcast live on FTA TV.

4.241 FAPL argued[186] that we are wrong to suggest that the highly valued popular sports on FTA TV tend to be relatively short one-off events, giving examples of a range of events that are neither short nor one-off, such as Formula 1, FA Cup, rugby Six Nations and the UEFA Champions League.

4.242 BT[187], Virgin Media[188], Top Up TV and Setanta[189] pointed out that although live FAPL is very important, other non-FAPL sports are also important in making Sky Sports channels "must stock" channels for pay TV retailers.

Our current view

4.243 When assessing evidence of retail demand side substitution the evidence we presented on the indirect wholesale constraint such as consumers preferences, product characteristics and the constraint from FTA remains relevant.

4.244 We recognise that FTA TV broadcasts important football, golf, rugby union, and rugby league. However FTA cannot match the regularity and quantity of sport found on premium sports channels. We therefore think it is unlikely that FTA would be a sufficient constraint on a retailer of these premium sports channels. As with our assessment of wholesale markets we acknowledge that the availability of some specific highly valued sports on FTA TV might act as a strong out of market constraint on a monopolist retailer of premium sports channels.

4.245 We have assessed whether Setanta Sports 1 is likely to be within the same retail market as packages that contain Sky Sports 1. In paragraph 4.120 we considered that our assessment of characteristics and preferences indicated that Sky Sports 1 was in the same wholesale market as Setanta Sports 1. This was because Setanta Sports 1 contained a significant amount of highly valued sport that is a close substitute for Sky Sports 1 (namely live FAPL). For the same reason we consider that packages containing Setanta Sports 1 are likely to be within the same retail market as packages containing Sky Sports 1[190]. Similarly we consider that packages containing Sky Sports 2 are the same retail market.

[186] FAPL response to Ofcom's First Pay TV consultation paragraph 7.35.

[187] BT response to Ofcom's First Pay TV consultation paragraphs 6.7-6.9.

[188] Virgin Media response to Ofcom's First Pay TV consultation paragraph 5.14

[189] Top Up TV and Setanta joint response to Ofcom's First Pay TV consultation paragraphs 2.6-2.15.

[190] Setanta went into administration on 23 June 2009, shortly after the live FAPL rights which had been held by Setanta were awarded to ESPN. ESPN has announced that it has agreed a wholesale deal with Sky for distribution on Sky's DSat platform. It has also announced an intention to make its channel including FAPL coverage 'widely available across multiple pay-TV platforms', although at the time of writing no other details of availability across platforms other than Sky's have been announced. Our subsequent conclusions are likely to be independent of whether Setanta Sports 1, or some other channel provided by ESPN, exists as part of the Core Premium Sports market.

4.246 We consider the significant growth in popularity of Freeview (from 1 million users in 2002 to over 10 million today) despite concurrent growth in subscribers to premium sports packages over the period suggests consumers do not view content on Freeview channels as a close substitute for premium sports channels. We acknowledge that there is a degree of retail substitution between premium channels and FTA TV as suggested by the Seabright report and noted by Sky in their response to our First and Second Pay TV Consultations. However, for the reasons set out in paragraphs 4.175 to 4.184 we consider that the Seabright report does not demonstrate that a small increase in the price of premium packages from the competitive price level would lead to consumers switching to FTA given the current availability of Freeview.

Supply side substitution

4.247 Supply side substitution is a special case of entry (see paragraph 4.185). There are some examples of retailers entering in the last few years: Setanta, BT Vision and Top Up have all recently entered the market retailing Setanta.

Our position in the First Pay TV Consultation

4.248 In the First Pay TV Consultation we considered that in the relatively short term it would be unlikely that a new entrant could enter the market without incurring sunk costs in acquiring content and customers. For this reason we do not consider supply side substitution to be sufficient to widen markets.

Our current view

4.249 To enter the market retailers need to acquire and distribute content within a short period of time. For the reasons set out in paragraphs 4.94 to 4.134 we consider that there are limited substitutes for the highly valued sport found on Sky Sports 1, Sky Sports 2 and Setanta Sports. We therefore consider that entry within a year, without incurring sunk costs is unlikely and retail supply side substitution will not broaden markets.

Conclusion on markets for retail of premium sports channels

4.250 The evidence is indicative of a narrow market for retail packages containing premium sports channels, which we define as being channels or packages of channels containing Core Premium Sports channels. Evidence on subscribers’ price sensitivity can be difficult to interpret but Sky’s evidence suggests that insufficient numbers of subscribers would switch to constrain a monopolist retailer of premium sports channels, even at current prices. Our research indicates that valuable content on Core Premium Sports channels is sufficiently important to a large enough number of consumers that the constraint from FTA channels or basic tier channels is relatively weak.

4.251 The lack of demand-side substitutes for subscribers means it is unlikely that a retailer could switch to an alternative channel. New entrants would have to make significant investments in content and acquiring subscribers to supply a channel so we do not consider that supply side substitution would broaden the market.

4.252 Our current view is therefore that the relevant market is for retail supply of Sky Sports 1, Sky Sports 2 or Setanta Sports 1[191], as well as HD versions of these channels or TV packages that contain these channels.

4.253 We therefore proceed in this document to consider whether there is a risk that there is not, and will not be, fair and effective competition in the provision of packages containing the above sports channels. As is often the case with market definition, the precise boundaries of the relevant market are difficult to determine with certainty. In the following sections we assess retail market shares including out of market constraints such as highly valued live football, rugby union, rugby league, tennis and golf on FTA TV.

Assessment of the market for the wholesale of premium movies channels

Introduction

4.254 Films are an important genre of programming for consumers. They have different characteristics to sport in that they are not viewed 'live' as they are produced. This means they can be retailed to consumers in many different formats and in different time "windows". They can be watched on traditional linear TV channels including Sky Movies channels and other basic or FTA channels. Alternatively, they can be downloaded via the open internet, bought or rented on DVD, or watched on an on-demand service. In contrast to sports content, the concept of live broadcast is not relevant (although rights to recently-released movies are important). This allows distribution over a wider range of formats, such as VoD and PVRs.

4.255 The focal product for our assessment of the wholesale market for premium movies is the suite of Sky movies channels. Sky wholesales 12 premium movie channels in three bundles:

- **Sky Movies 1**: Sky Movies Comedy, Sky Movies Family, Sky Movies Classics, Sky Movies Modern Greats, Sky Movies SD1[192].
- **Sky Movies 2**: Sky Movies Action and Thriller, Sky Movies Sci-Fi and Horror, Sky Movies Indie, Sky Movies Drama, Sky Movies SD2.
- **Sky Movies Mix**: Sky Movies 1 and Sky Movies 2, Sky Premier and Sky Premier +1.

4.256 These channels combine a number of important characteristics relating to the **quantity** and **quality** of the films shown and the **timing** and **format** of release. Specifically, the channels show all of the films from the six major Hollywood studios in the "first pay TV window". Disney Cinemagic is the only other channel that shows films from "first pay TV window" from a Hollywood Major as it shows a limited number

[191] Setanta went into administration on 23 June 2009, shortly after the live FAPL rights which had been held by Setanta were awarded to ESPN. ESPN has announced that it has agreed a wholesale deal with Sky for distribution on Sky's DSat platform. It has also announced an intention to make its channel including FAPL coverage 'widely available across multiple pay-TV platforms', although at the time of writing no other details of availability across platforms other than Sky's have been announced. Our subsequent conclusions are likely to be independent of whether Setanta Sports 1, or some other channel provided by ESPN, exists as part of the Core Premium Sports market.

[192] See Sky response to Ofcom's request of 20th March 2009 question 8. Sky also retails some HD versions of its movie channels, e.g. Sky Movies HD1, Sky Movies HD2.

of Disney's animated films alongside a range of children's and family-based programming. Sky also has contracts with several independent distributors and other important movie studios (see paragraph 4.276). Consequently, Sky's premium movie channels provide the first opportunity for viewers to watch the vast majority of the most popular films on a linear TV channel. This directly influences the range of potential substitutes for the channels.

4.257 In the following pages we set our view on the wholesale market for premium movies channels. As with wholesale sports, our analysis considers both direct and indirect constraints on a hypothetical monopoly wholesaler. We begin by describing the indirect constraint, setting out:

- The key characteristics of, and consumer preferences for, premium movies channels and potential substitutes.
- Our application of the HMT to wholesale premium movies.
- Consumers' responses to price changes, considering specifically substitution to other popular ways of viewing movies, including movies on other TV channels and DVDs.
- The potential growing constraint from online content delivery.

4.258 We then consider direct constraints, including supply and demand side substitution.

Evidence on the indirect constraint on wholesale premium movies

Characteristics of premium movies channels and potential substitutes

Background

4.259 In this section we set out our analysis of product characteristics, preferences of subscribers and views of stakeholders to consider the scope of markets for premium movie channels. Sky's premium movies channels show a combination of movies in the pay TV window, made for TV movies as well as a small amount of magazine programming[193]. Sky states that "the majority of films broadcast are either new releases (mainly from the major Hollywood studios, and also a small number of new releases from independent distributors) which have not previously been shown on FTA or subscription television channels and library films which have previously been broadcast on television channels". The UK Film Council reported that Sky Movies channels showed 1,446 different films in 33,978 slots[194] in 2007.

4.260 We estimate that the programming costs relating to Sky's Movie channels are around £**[✂]** per sub per month (not including shared common costs)[195]. Sky's wholesale prices are for £16.59 for the Movies Mix package or £12.48 for either of the single

[193] Sky response to Ofcom's First Pay TV Consultation Annex 2 paragraph 3.108.

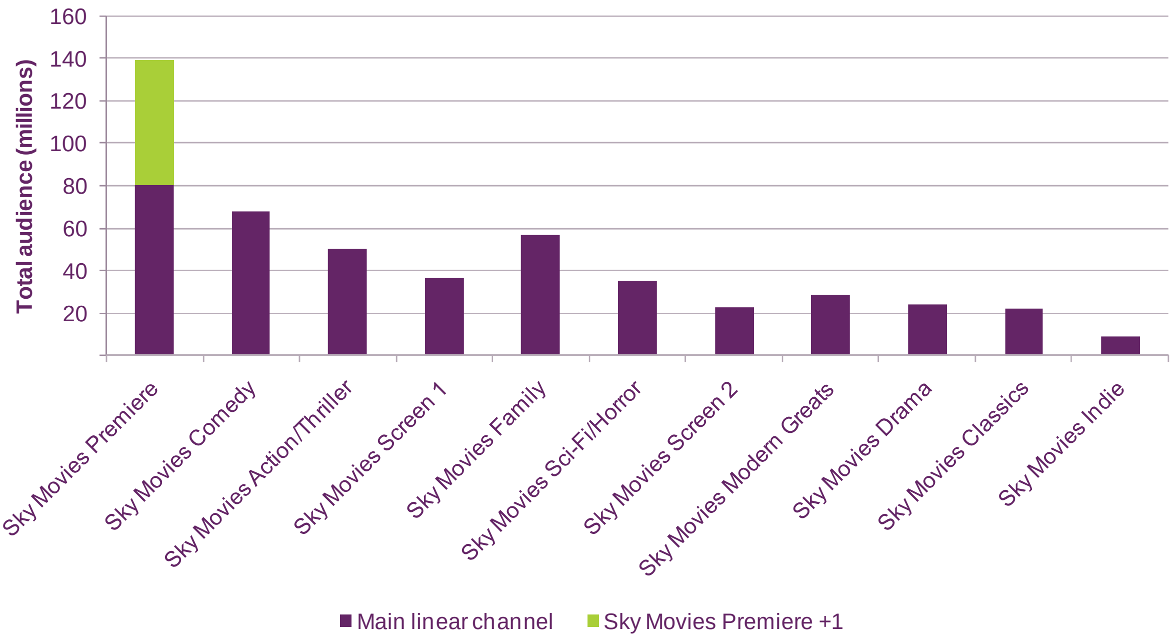
[194] Response of UK Film Council 18 May 2009 to Ofcom information request of 11 May 2009.

[195] Movies programming costs (as reported in annual accounts) per UK retail and wholesale, ROI and commercial subscribers.

movies packages[196]. Sky also wholesales its films in bundles with Sky Sports channels.

4.261 Sky Movies Premiere – which tends to show new releases before they are shown on the genre specific movie channels – is the most popular channel measured by audiences in 2008, suggesting that viewers place a relatively high value on seeing the latest films. Other popular channels in 2008 in terms of total and average audiences included Sky Movies Comedy, Sky Movies Action/Thriller, Sky Movies Screen 1 and Sky Movies Family. Appendix 1 of Annex 6 describes the characteristics of Sky Premium Movie channels. This analysis indicates that Sky Movies Premiere, Sky Movies Sci-Fi/Horror, Sky Movies SD1, Sky Movies SD2, Sky Movies Comedy, Sky Movies Family, Sky Movies Action Thriller, and Sky Movies Drama have similar characteristics in terms of the volume of new, mainstream films they broadcast. Sky Movies Modern Greats, Sky Movies Indie and Sky Movies Classics have fewer new movies. On balance we consider that the first two of these should also be included in the market, but we consider Sky Movies Classics has too few new movies to be included.

Figure 25 Total DSat audience for all films shown in 2008 by channel



Source: BARB 2008 data

Note: Total audience sums the total number of DSat viewers of all showings of films and features in 2008. Sky Premier also includes its (+1) timeshifted channel.

4.262 As highlighted above, Sky's movie channels combine a number of important characteristics: format, timing, quantity and quality. We discuss each of these in turn taking into account views of stakeholders and analysis of subscriber preferences for Sky Movies.

196 See Sky response to Ofcom's request of 20th March 2009 question 8.

4.263 Sky's movies channels enable viewers to view content on a linear television. This is of course just one way for viewers to watch films. The studios also make the same films available via a number of alternative formats.

4.264 **Cinematic release**: films are first released at the cinema often accompanied by very substantial and costly marketing and promotional campaigns. Although average ticket prices were £5.20 in 2008[197], Screen Digest reported that the cinema release "is regarded as a marketing platform and most distributors will not make profit at this stage." However, cinema release is important to consumers: research conducted by Sky reported that "films were most special at the cinema, closely followed by owning films on DVD"[198].

4.265 **DVD retail**: consumers purchase DVDs in order to obtain permanent access to a number of specific favourite films within a film library of their own. Sky's consumer research[199] showed that DVD retail was perceived as offering very good value as it provides the benefits of permanent ownership of an extremely popular delivery mechanism. The average price of a DVD was about £8.97 in 2008[200]. Just over a quarter of DVDs bought (27%) are bought as gifts rather than for personal or family use[201].

4.266 **DVD rental:** consumers can rent DVDs to access recently released films on a temporary basis. Sky's research found that "renting films is still reasonably popular (even amongst Sky Subscribers) with renters welcoming variety, the mid week deals and improved window[202]. Consumers can chose to rent from traditional over the counter stores or – increasingly – from online subscription services. The majority of rentals (by value) are still over the counter rentals but the quantity and value of online subscription rentals is growing rapidly. Typical prices to rent latest release films are around £3.75 over the counter (although there may be discounts to this headline price) and around £2.40 online[203].

4.267 **Pay per view** (PPV): a number of TV retailers including Virgin Media, Sky, Tiscali and BT Vision offer PPV movies, allowing consumers a convenient way to access new movies. The service is available to over 13 million subscribers. 'True' VoD[204] is possible on Virgin's cable network and Tiscali's and BT's IP networks. Sky's DSat service provides 'Near' VoD[205].

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[197] See for example: http://www.cinemauk.org.uk/ukcinemasector/ukcinema-industryeconomics/averageukticketprices/.

[198] Sky's third response to Ofcom information request of 29 May 2008.

[199] Ibid.

[200] British Video Association Year Book 2009 page 28.

[201] Source: British Video Association Yearbook 2009 page 73.

[202] Sky's third response to Ofcom information request of 29 May 2008.

[203] Source: British Video Association Yearbook 2009 page 80.

[204] 'True' VoD means consumers can get instant access to the film of their choice.

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

4.268 Each of these delivery mechanisms has different characteristics which will influence the degree of substitutability between them. For example, Sky's research found that:

> "Whilst watching films on television is enjoyed, it lacks the glamour and sense of occasion of the cinema or the novelty and appeal of owning DVDs. Films on TV are an interesting proposition in that their competition is not just other windows, but all other TV programmes that happen to be on (including first run drama etc.)"[206].

4.269 The studios carefully manage the **timing** of film release across these different formats, as we explained in further detail in Annex 11 of our First Pay TV Consultation. The timed availability of films across different formats (known as 'film windows') is a form of price discrimination. It enables the studios to exploit consumers' different willingness to pay for content in order to maximise revenues and recover the fixed costs of production and marketing.

4.270 New films are often valued more highly by consumers than older films. This is in part because significant marketing occurs around the time of the initial cinema release which increases the awareness of a film. The value of this marketing will diminish over time. The value of newer films is reflected in the higher audience received for Sky Movies Premier compared with the other channels (see Figure 25). Furthermore, once a consumer views a film in an earlier window its value to that consumer in later windows is likely to be diminished.

4.271 As explained above (paragraph 4.259), Sky's movie channels provide access to a wide range of new films. By contrast, FTA channels and other basic tier subscription channels show a wide variety of older films. In 2007 there were 2,182 film transmissions on the PSB channels in 2007 and 20,271 film transmissions on other digital channels and 34,782 transmissions on subscription movie channels[207].

4.272 The table below sets out the available film windows.

[206] Sky's third response to Ofcom information request of 29 May 2008.

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

Figure 26 Summary of movie windows in the UK, 2009

Window	Time of start of window (after cinema release)
Cinema release	N/A
DVD rental	4 months
DVD retail	4 months
VoD / PPV	6 to 7.5 months
Internet download	6 to 7.5 months
Pay TV subscription channels	12 months
FTA channels	24 to 27 months

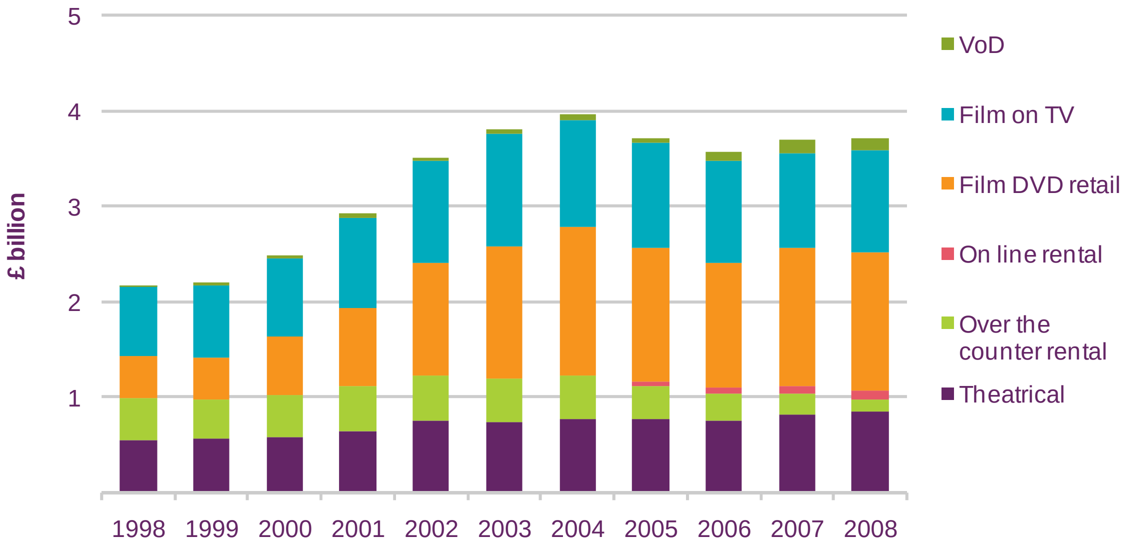
Source: Screen Digest – see Annex 11 to the First Pay TV Consultation, Figure 2

4.273 Figure 27 summarises trends in revenues associated with different film formats and windows. It shows that demand for movies across all formats appears to have declined, though with some changes in demand between the different formats. We observe:

- Revenues from over the counter DVD rentals are falling sharply, but this is partly offset by increases in PPV and online DVD rentals.
- There has been a small decline in revenues associated with films on TV. According to Screen Digest the value of the FTA window appears to be broadly flat over the period[208].

[208] See figure 10 of Annex 11 to Ofcom's First Pay TV consultation.

Figure 27 Value of films from different formats, nominal figures



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

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

4.274 Sky's premium movie channels also show a large quantity of films that are of particularly high quality (at least in terms of box office success). Specifically, Sky has exclusive rights to show films in the first pay TV window from the six major Hollywood studios. The term 'major studio' is used to refer to the Hollywood studios which are members of the Motion Picture Association of America.[209] These are[210]:

- Disney.
- Paramount.
- Sony.
- 20th Century Fox.
- Universal.
- Warner Bros.

4.275 Screen Digest estimates that the films produced by the six Major Hollywood Studios typically account for around 35% of films released at UK cinemas but for 80% of UK

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[209] Some important studios are owned by parent companies of the Hollywood majors. Newline for example (the producer of the Lord of the Rings trilogy) is owned by Time Warner, the ultimate owner of Warner Brothers. So for completeness we define "Major Film Production Groups" as any of Universal, Viacom (the ultimate owner of Paramount), 20th Century Fox, Walt Disney, Sony or Time Warner (the ultimate owner of Warner Brothers) and their wholly owned or controlled subsidiaries.

[210] See for example: http://www.mpaa.org/AboutUsMembers.asp.

box office revenues. Sky has had exclusive agreements with the current six Major Hollywood Studios to exploit their films in the pay TV window since **[✂]**[211].

4.276 Our analysis of contracts found that Sky has exclusive contracts with all six major Hollywood studios and a number of independent distributors to show films from the pay TV window[212]. **[✂]**. In our First Pay TV Consultation Screen Digest reported that as well as the six major studios Sky also had deals with Icon, Momentum and Lionsgate UK among others[213].

Our position in the Second Pay TV Consultation

4.277 In the Second Pay TV Consultation we gathered views of firms in the market in order to identify close substitutes to Sky's premium movie channels.

4.278 We stated that Sky clearly views other movie products as competitors to its premium movie channels. Sky supplied us with the results of an analysis it had commissioned of consumer views of its premium movie channels. The analysis described the increasing number of alternatives available to consumers and noted that Sky faces competition from a growing range of products. These included movies shown in the cinema, on DVD via retail and rental, PPV, new film subscription services and movies on FTA TV. This is set out in Figure 28 below.

Figure 28 Slide from Sky presentation on Sky Movies

[✂]

Source: Sky's third response to Ofcom information request of 29 May 2008 ***[✂]****"*

4.279 Sky supplied us with a number of internal papers where it noted that **[✂]**:

> "**[✂]**"[214].

4.280 A Virgin Media analysis of potential benefits and risks of launching a new Virgin Movies channel noted that there was an increasing competitive threat to subscription movie services from online DVD rentals and piracy. It also noted that some subscribers would switch from a PPV service if they were offered a Virgin Movies subscription channel[215].

4.281 We agreed that there are a wide and growing variety of potential substitutes for Sky Movies channels. The key question for our analysis was whether these potential substitutes sufficiently constrain a monopolist wholesaler of premium movie channels from imposing a price rise above competitive levels.

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

[212] **[✂]**.

[213] See Annex 10 of Ofcom's December 2008 consultation.

[214] Sky's third response to Ofcom information request of 29 May 2008, Annex 1.2.4.

[215] Virgin Media response to Ofcom information request of 15 May 2007, tab 1.

4.282 In the Second Pay TV Consultation we examined results of surveys, both commissioned by Ofcom and supplied to us by stakeholders on consumers' preferences for premium movie packages. Surveys such as these can help identify which products might be relatively close substitutes for premium movie channels. We found that Sky Movies subscribers particularly valued access to a large quantity of recent films in their film packages.

4.283 For example one of our own surveys revealed that a significant proportion of price-sensitive movie subscribers considered access to a range of films (81%), films on at all times (70%) and access to new movies (68%), as either 'nice to have' or 'must have' features of their package[216]. This suggests that older library movies (or non-movie content) found on FTA or basic-tier TV are likely to be a less good substitute for the consumers who value access to new movies. We also found that 57% of price-sensitive subscribers consider the ability to pay monthly a useful feature of their package[217].

4.284 A survey carried out for Virgin Media asked consumers which genre of content they would consider paying more than their current subscription. 'New' movies was the most popular movie genre for both Virgin Media and Sky subscribers (cited by **[✂]**% and **[✂]**% of subscribers on each platform). This was significantly above 'classic movies', cited by only **[✂]**% of subscribers on both cable and Sky[218].

4.285 Internal research supplied to us by Sky[219], (used when considering how to package its movie channels), noted that although consumers were often not aware of the windowing of films, the "key is premieres … all international [movie channel] offerings have a channel offering the most recent titles".

Responses to our consultation

4.286 Sky agreed with Ofcom that it was "axiomatic" that consumers value a given film more the closer it is to release[220]. Sky commented that film windows had changed citing for example:

> "the period between a film's theatrical release and its home video release has halved from around 6 months to 3 months making DVDs more attractive to consumers.
>
> The period between home video and PPV release has fallen even more dramatically: the typical period is now 45 days … whereas in 2000 it was 160 to 180 days. "

4.287 Sky notes that as the PPV window moves closer to the theatrical release it is likely to become more attractive relative to Sky Movies.

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[216] Full details of the analysis of preferences are found in Ofcom's Second Pay TV Consultation, Annex 6.

[217] See Ofcom's September 2008 consultation Appendix 7 of Annex 6.

[218] Virgin Media response to information request of 15 May 2007**[✂]**.

[219] Sky's third response to Ofcom's questions of 29 May 2008, **[✂]**.

[220] Sky response to Our September 2008 consultation Annex 3 paragraph 2.2.

4.288 [✂] noted[221] that films from other independent studios are also highly valued by consumers. For example it said that the Bond movies are distributed on TV by MGM. It argued that popular films from these studios should be included within the definition of 'Core Premium Movie channels'.

Our current view

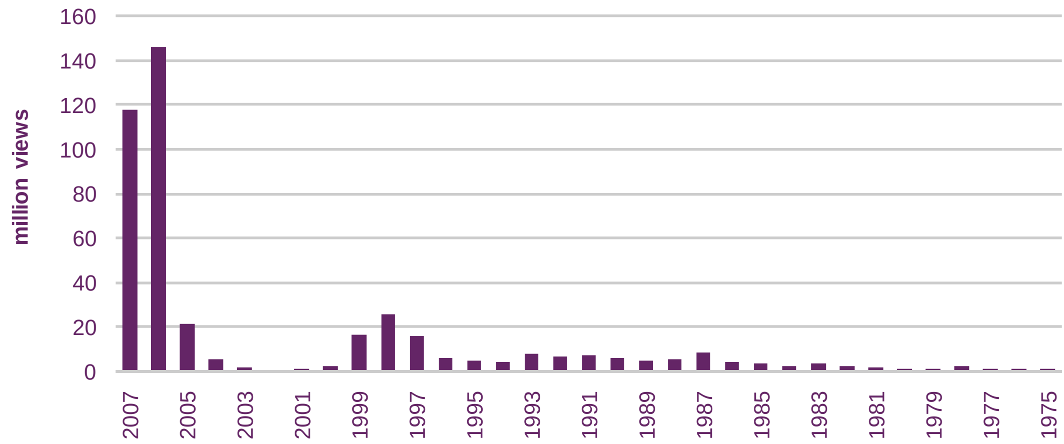
4.289 As explained above, Sky's movie channels comprise four important characteristics. Viewers can access a large quantity of high quality films for the first time on a linear subscription TV channel.

4.290 It remains our view that subscribers to Sky Movies particularly value the most recent films from the pay TV window and that films in later windows are viewed as a poor substitute. This is supported by data on viewing of Sky Movies. Figure 29 below shows that the films from the pay TV window are by far the most highly viewed by Sky customers.

4.291 Films produced in 2007 gained a total audience of 120m viewers, and films from 2006 gained an audience of 140m viewers, whereas films from any other year gained a maximum audience of 25m.

4.292 Furthermore, we found that there were just over 2,000 unique titles shown on Sky Movies in 2008 of which just over a quarter were from the pay TV window. However according to our analysis movies from the pay TV window[222] accounted for about 60% of all viewing on Sky Movies.

Figure 29 Total DSat viewing of films on Sky Movies in 2008 by year of film release



Source: BARB 2008 data

Notes: The data excludes 350 of the 2948 total films and features for which there was not a release date provided.

[221] [✂] response to Ofcom's Second Pay TV consultation page 26, response to question 9.

[222] Defined as films with a cinematic release of 2006 or 2007.

4.293 Evidence from consumer surveys (described in paragraphs 4.279 to 4.285) also points to consumers valuing a subscription service with access to a wide range of films including new movies. However, the evidence suggests that PPV offers a close substitute for some price-sensitive subscribers as it offers convenient access to a wide range of new movies. Other content including films from the library and FTA window or non movie content are likely to be weaker substitutes for the broad range of new movies found on premium movie channels.

4.294 We disagree with Sky's claim that changes to film windows have reduced the attractiveness of Sky Movies relative to films shown in the PPV or DVD windows. While we agree that the reduction in delay between theatrical release and either DVD or PPV release has made these latter windows more popular relative to the cinema release, the delay between cinematic release and the first pay TV window has also reduced.

4.295 Indeed, Sky itself stated that the start of the pay TV window had moved closer to the cinema release which had improved the value of Sky Movies. It said for example that:

> "Over the last few years, Sky has renegotiated its movie contracts so that it can show titles at an earlier date post cinematic release. In 2001 the pay TV window ran from 18 to 33 months after cinematic release; by 2007 it had moved forward by six months, typically running from 12 to 27 months after cinematic release. Therefore any film can be shown six months earlier than would have been possible in 2001, meaning that it is closer to the cinematic release and the accompanying publicity"[223].

4.296 **[✂]**.

4.297 We agree with **[✂]** that studios other than the six Major Hollywood Studios also produce valuable content. For example Weinstein produced Scary Movie 4 and Hannibal Rising and MGM distributes films from the Bond franchise. However, we consider that films from the Majors (in aggregate) remain by far the most important defining characteristic of the Sky Movies channels. In any case, our conclusions on market definition relate to the current bundles of channels that Sky wholesales and which are currently built around films from the six Majors. They are not affected by the inclusion or exclusion of a relatively small number of popular films from other studios.

Assessing consumers' response to a SSNIP

Our position in the Second Pay TV Consultation

4.298 In our Second Pay TV Consultation we estimated the minimum consumer elasticity that would be required to constrain a monopolist wholesaler of premium movie channels from increasing prices above current levels. In order to estimate likely elasticity, we commissioned a willingness to pay survey and examined research provided to us by Sky.

[223] Sky response of 9 July 2008 to Ofcom's information request of 29 May 2008 question 6 "Changes in the quantity and quality of services delivered to subscribers to Sky's packages that include Sky's sports channels, 2001/02 – 2006/07" section4 paragraph 12

4.299 As with our analysis of sports, we recognised the difficulties in interpreting data on responses to price rises given the concerns about stated preference bias and the fact that prices may be above competitive levels. The evidence from Sky's conjoint study suggested that a wholesale SSNIP on both Sky Movies and the Sky Sports and Movies mix might be profitable. Evidence from our own survey also suggested a SSNIP on the mix might be profitable, but the sample size on Sky Movies standalone was too small to provide any meaningful results[224]. However, we noted that our results for Sky Movies subscribers were less conclusive than for Sky Sports as Sky's conjoint analysis only tested a price increase of **[✂]**. Consumers might respond disproportionately less to such a small increase than they would to the 5-10% increase suggested in the standard SSNIP framework. Put differently, it is not clear that such a price rise would be considered sufficiently "significant" to give a reliable indication of likely switching levels.

Respondents' views

4.300 We did not receive any specific responses to our wholesale movies SSNIP analysis, but note that some of the FAPL's responses on our analysis for sports apply equally here. Specifically, the FAPL highlighted the fact that we had not identified the confidence intervals around our elasticity estimates.

Our current view

4.301 Figure 30 below presents our assessment of the minimum elasticity necessary to constrain a monopolist and the point estimate of elasticity. As with our analysis of elasticities of Sky Sport subscribers set out in Figure 17 and paragraph 4.142 we interpret evidence of consumer elasticity with caution. For the reasons set out in paragraph 4.144 we do not rely on our estimates of elasticity from our willingness to pay survey.

Figure 30 Estimates of Sky Movies subscribers' elasticities and wholesale critical loss

		Sky Sports and Movies Mix	Sky Movies Mix
1	Minimum elasticity to constrain a wholesale monopolist (critical loss)	[✂]	[✂]
2	Sky conjoint estimate	[✂]	[✂]

*Source: Critical loss: see Appendix 10 of annex 6 to Ofcom's Second Pay TV Consultation; Sky conjoint: **[✂]** supplied to Ofcom by Sky in July 2007*

4.302 Sky's conjoint survey suggests that insufficient subscribers would switch to an alternative product to constrain a monopolist wholesaler. We note that the likely presence of the cellophane fallacy is likely to exaggerate the number of subscribers who would switch - i.e. if prices were at competitive levels even fewer subscribers would switch.

[224] The survey was designed to elicit views of all consumers, not Sky subscribers specifically.

Consumers' observed responses to price changes

Our position in the Second Pay TV Consultation

4.303 As with sports, we examined the changes in the numbers of subscribers to Sky's movie channels over time to assess subscribers' responses to price changes. Falling subscriber numbers despite constant prices might indicate that markets are broad, because this might indicate that consumers were switching to alternative products. However, we need to consider the impact of subscribers' responses to price changes with caution, firstly because changes in quality may affect demand and secondly because prices may be above 'competitive' levels.

4.304 In our Second Pay TV Consultation we assessed numbers of subscribers to Sky Movie channels (see Figure 31 below). Although there is some seasonality in numbers of subscribers to Sky Movies channels, (there is a peak in subscribers in December each year) we identified the following trends[225]:

- The number of subscribers to Sky Movies packages (including Sky Sports and Movies Mix) **[✂]** in the period between 2000 and 2004.
- Numbers **[✂]** in the period 2004 to 2006, and **[✂]** since 2007.
- In 2008 the six month rolling monthly average number of subscribers was **[✂]**% **[✂]** than the peak (**[✂]**).
- Subscribers have become **[✂]**.

Figure 31 Subscribers to packages containing Sky Movies channels on DSat

[✂]

Source: Sky response to information request of 29th May 2008.

Note: Big basic includes either 5 or 6 mix basic tier packages, small basic includes 1, 2, 3 or 4 mix basic tier packages.

4.305 We considered changes in real retail prices for movie packages[226]. We cited evidence from Sky that the price of the Movies Mix package had remained broadly constant in real terms since 2002 and that the price of the Sports and Movies mix was only 4% higher in real terms than in 2004. We noted that prices of the latter had increased by £2 (around 5%) in nominal terms in September 2008. We noted that Sky's reduction in the use of discounts in 2006/07 meant that while headline prices had been broadly constant, average prices after discounts were likely to have increased.

4.306 We also analysed movie programming costs. Given relatively steady retail prices, reductions in per subscriber programming costs could point to a widening margin between retail prices and per subscriber programming costs of Sky's movie channels. This would suggest that movies prices might not be constrained to the competitive level. Our analysis showed a sharp reduction in per subscriber programming costs from £**[✂]** in 2000/8 to less than £**[✂]** in 2007/8. This is shown in Figure 32 below.

[225] See Ofcom's Second Pay TV consultation Appendix 3 of Annex 6 paragraph3.21.

[226] See Ofcom's Second Pay TV Consultation Appendix 3 to Annex 6 paragraph3.18 for details.

Figure 32 Per subscriber programming costs for Sky Movies

[✂]

Source: Sky annual reports, real prices at 2008 levels, Sky response to Ofcom information request of 29 May 2008.

Note: Programming cost each year to end June, divided by Sky and cable subscribers

4.307 We also examined margins on the wholesale supply of premium sports and movie channels. This analysis suggests that, depending on assumptions we make about allocating common costs, gross margins could be in the region of **[✂]**% for Sky Movies channels. This figure appeared to us potentially high for an asset-light retail channel business and could indicate that falling subscriber numbers could be consistent with high switching as a result of pricing above the competitive level.

4.308 Our conclusion was that the decline in subscriber numbers did not point clearly to an effective competitive constraint from other products.

Respondents' views

4.309 Sky provided data showing that the number of Sky Movies subscribers has declined on DSat since **[✂]** from a peak of over **[✂]** million to just over **[✂]** million, as we show in Figure 31 above. In addition, the number of Sky subscribers on cable has also declined. Sky stated that the **[✂]** proportion of DSat subscribers that take Sky Movies is evidence that **[✂]**.

4.310 Sky argued these changes in subscriptions reflected growing constraints on its movie business. It argued that the Seabright econometric study discussed above demonstrated a constraint from DTT on demand for premium movie channels[227]. It also reported a survey of new subscribers to online DVD services which indicated that **[✂]**% of new DVD rental subscribers had **[✂]**[228].

4.311 With respect to price trends, Sky's comments on our choice of price deflator, the use of discounts and the start and end dates of our analysis mentioned above in paragraph 4.205 also apply to prices of Sky Movies.

4.312 In the context of DVDs, Sky argued that we failed to recognise that product characteristics do not need to be identical for them to be considered to be supplied in the same relevant market[229]. Sky also argued that our finding that downloading of programming was at present relatively small failed to consider that such services may become an increasingly important constraint on movie channels[230]. Sky argued that we failed to recognise the potential for other types of services such as PPV to be effective substitutes[231].

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[227] The Seabright study, discussed in paragraphs 4.167 to 4.184.

[228] Sky consultation response **[✂]**.

[229] Sky Response of 1 June 2009 to Ofcom's Second Pay TV Consultation "Additional comments on Ofcom's analysis of market definition and market power in the pay TV review" Annex 1 paragraph 3.22.

[230] Ibid paragraphs 3.32 – 3.38.

[231] Ibid paragraphs 4.44 – 4.46.

4.313 Sky also presented an analysis based on 434 Sky customers who downgraded by removing Sky Movies from their subscription between April 2007 and March 2008. The results showed that these households watched more movies on FTA channels. Sky also found that the downgraders' overall television viewing increased when they dropped Sky Movies. Sky said this was strong evidence that FTA movies and other types of programming were substitutes for Sky Movies.

Our current view

4.314 The evidence that Sky presents on subscriber numbers does not materially change our analysis. As in our previous Consultation, we recognise that the decline in demand for Sky Movies could reflect an increasing competitive constraint[232] – although it is not clear from Figure 27 that there is any significant amount of switching to alternative ways of watching movies.

4.315 As noted, we recognise that product characteristics do not need to be identical for products to be included within the same relevant market. We have specifically analysed the potential substitution away from Sky Movies to various products:

- Movies shown on basic and FTA channels.
- Movies shown on SVoD / PPV.
- Purchases of DVDs.
- Rented DVDs.

4.316 **Movies shown on basic and FTA channels**: In response to our first consultation Sky specifically noted[233] that the number and variety of films on FTA TV had increased considerably since 2001. For example it stated that in 2001 there were about 8 films screened per day on terrestrial channels[234], but in 2007 there were 27 films screened per day. It stated that the constraint from FTA and basic tier TV (along with other constraints) had increased significantly[235].

4.317 Figure 33 shows viewing of films on TV. It shows that:

- There has been a decline in viewing of subscription movies channels equivalent to about 330 million views (or 40%) since a peak in 2003.
- Over the same period there has been a sharper absolute fall (of around [500 millions views]) in viewing of movies on basic tier and FTA channels.

[232] An alternative explanation is a decline in quality. Sky told us that **[✂]** (response of 9 July 2008 to Ofcom's information request of 29 May 2008 question 6).

[233] Sky response to First Pay TV Consultation Annex 2 paragraph 3.78.

[234] PSB channels and sister digital channels.

[235] Ibid 3.79.

Figure 33 Total audience for films on TV (not PPV) 1997 – 2007

Source: UK Film Council Year Book 2008, Figure 11.6

4.318 We acknowledge that the increasing availability of films either within basic tier bundles or on FTA TV may in principle provide some competitive constraint on the wholesale supply of Sky Movies channels. For example, Film4 which went FTA in July 2006 and the Universal backed Picturebox which launched on various platforms in 2006 – 2007, both show a variety of older films from the FTA or library window). However the evidence does not point towards substitution from subscription channels to basic and FTA channels – rather it points to an overall decline in movie viewing on linear channels.

4.319 As regards Sky's analysis of downgrading customers, we do not consider that this is evidence that FTA movies are a substitute for premium movies. Instead, the evidence could simply reflect that viewers who stop subscribing to premium movies have an ongoing interest in watching movies, and now have more time to spend on other activities (other than watching Sky Movies), including watching FTA movies or other content[236]. It is not evident from this analysis that the availability of FTA movies or other TV content caused these viewers to downgrade or made them more willing to do so. Furthermore, the fact that downgraders' overall television viewing increased when they dropped Sky movies appears counter-intuitive. It would appear that these viewers responded to having a smaller range of TV programming by watching more TV. This apparently anomalous result leads us to doubt the reliability of Sky's analysis.

4.320 In summary there is no evidence that this downgrading was a pricing response, or that FTA movies or other content should be included within the relevant market.

[236] Sky Response of 1 June 2009 to Ofcom's Second Pay TV Consultation "Additional comments on Ofcom's analysis of market definition and market power in the pay TV review" paragraphs 6.12 – 6.14. Sky argued that in order to count as switching in a market definition analysis, alternatives must be relevant products in the sense of fulfilling similar consumer demands. It noted that if consumers bought fewer magazines in response to a price rise, and spent the money saved on food, this would not count as relevant switching. The example of consumers watching more FTA TV 3 years after terminating their Sky Movies subscription is analogous to Sky's example of magazines and food and in the same way does not necessarily imply that the market should be broadened to include other content.

4.321 We set out our views on the implications of the Seabright econometric study for market definition above in paragraphs 4.172 to 4.184. Those arguments apply equally here: we do not believe the Seabright study provides evidence that FTA channels and premium movie channels are in the same market.

4.322 **Movies shown on SVoD and PPV:** Sky told us it considered that the relevant market included FTA, pay TV services, DVD sales and rental and pay-per-view/video on demand services.

4.323 Movies from the pay TV subscription window are not available on any SVoD service at present. As such we have seen no direct empirical evidence as to whether such a service would be a competitive constraint on linear premium movie channels. However, it seems reasonable to expect that if a similar range of premium movies (at a given time) were available over both a linear channel and an SVoD service, there would be scope for some customers to switch from the former to the latter.

4.324 Virgin Media told us[237] that it had been unable to secure non-exclusive SVoD rights with any of the Major Hollywood Studios. **[✂]**.

4.325 Sky noted[238] that Virgin Media's pay-per-view VoD proposition includes movies from the Major Hollywood Studios, via the Filmflex service, both before and after their availability on Sky's linear movie channels. Whether this has had a direct impact on demand for Sky's linear channels is unclear. The similarity of content between the two delivery mechanisms may be seen as a supporting a view of premium movies on PPV as belonging to the same market as linear movie channels.

4.326 Figure 34 shows total cable subscriber numbers from 2000 to 2008. FilmFlex – cable's on demand system for PPV movies – was launched in January 2005, replacing the Front Row nVoD service. FilmFlex was a joint venture between OGD, Walt Disney and Sony Pictures.

4.327 The figure is consistent with the view that FilmFlex may have had an impact on demand for Sky's linear movie channels on cable. The number of subscribers to Sky Movies and Sports has declined, with more customers subscribing to a sports-only offer (perhaps switching from the Movies and Sports offer – i.e. dropping movies), and fewer customers subscribing to the movies-only offer.

4.328 Data on subscriptions to Sky's DSat service also shows a reduction in subscribers to the Sky Sports and Movies package, again with an increase in subscriptions to Sky Sports Mix. However, in the case of Sky's DSat service, unlike Virgin Media, subscriptions to the Sky Movies Mix have also increased[239].

Figure 34 Subscribers to premium channels on cable, 2000 - 2008

[✂]

Sources: Sky response to Ofcom information request of 29 May 2008 and Virgin Media response to Ofcom information request of 2 July 2008

[237] Virgin Media response, paragraphs 4.19 to 4.22.

[238] Sky Response, Section 2, paragraph 2.10.

[239] See for example Figure 31.

4.329 These results can be seen as indicative that FilmFlex may have had some effect in reducing demand for Sky's premium movies channels on cable. However, they should be interpreted with caution, because:

- Other variables – such as marketing strategies and other industry and economic trends – may have had an effect on subscriptions generally, and on the differences between cable and DSat. In this regard it is notable that subscription trends on DSat and cable did not mirror one another prior to the introduction of FilmFlex.

- Any impact of FilmFlex may be exaggerated by a cellophane effect – i.e. some cable customers may have switched to FilmFlex in response to high prices for Sky Movies.

4.330 In summary, there is some evidence that premium movies on PPV may be substitutable for linear channels carrying premium movies, and we might expect SVoD, as a subscription service, to be a closer substitute to Sky Movies than PPV. However, movies from the pay TV subscription window are not currently available on SVoD. Our view is that PPV services can best be seen as an out-of-market constraint on premium movie channels at present. As discussed in the section on market power, inclusion of PPV services would not have a great impact on market share calculations.

4.331 **DVD sales**: UK revenues from DVD sales in 2007 were around £2.7 billion.[240] DVDs could be considered a substitute for Sky Movies packages by some consumers. However the products' characteristics are very different. Consumers subscribe to a movie channel in order to gain access to a wider choice of movies to be viewed on a one-off basis. DVD purchases are made with a specific movie in mind, whereas the purchase of a movie channel subscription allows a spontaneous choice from a wide range of different movies. In addition, subscribers to Sky Movies are likely to pay much less per movie viewed (provided they are watching more than one movie per month) than if they were to buy the same movies on DVD.

4.332 In response to our first consultation Sky considered the aggregate constraint from substitutes including DVD retail and rental to be strong, and noted that the reduction in price of retail DVDs reduces the attractiveness of premium movie channels. Sky also provided details of consumer research which suggested that retail DVDs are attractive to consumers as they offer "the benefits of permanent ownership of an extremely popular delivery mechanism"[241].

4.333 Internal documents[242] supplied to us by Sky also noted that by the time a film becomes available in the pay TV window, the retail price of the DVD format can have fallen from the level when it was initially released around twelve months previously. This tends to erode the value of Sky Movies. For example, the document quotes a popular film[243] whose DVD's recommended retail price was £24.99, but was being

[240] Source: UK Film Council Year Book 2008, page 83.

[241] Sky's third response to Ofcom's questions of 29 May 2008, **[✂]**.

[242] Sky's third response to Ofcom's questions of 29 May 2008, **[✂]**.

[243] 'Charlie and the Chocolate Factory'.

sold by internet retailers for £5.47 plus postage by the time the film was available to view on Sky Movies channels.

4.334 We analysed retail prices and sales of DVDs and premium movie subscriptions[244]. Similar patterns of price changes between both products would be consistent with their being substitutes; conversely, price divergence without substitution is consistent with the two products being in separate markets.

4.335 Our analysis of total retail sales of DVDs (and videos) showed total sales volume had grown significantly since 2000[245]. Over the same period the price of DVDs / videos had fallen by 33% / 43% whereas the price of premium movie subscriptions increased from 2000 to 2002 and thereafter remained relatively constant in real terms[246]. If DVD sales strongly constrained retailers of premium movie channels we would expect the growth in volume and the reduction in prices of DVD / video sales to have had an impact on Sky Movies subscriptions. **[✂]**, the number of Sky Movies subscriptions **[✂] [✂]**% in the period 2000-2004, **[✂]**% in the period 2004 – 2008. Although not conclusive, the widening price differential without significant switching is evidence that retail DVDs and premium movies packages are in separate markets.

4.336 **DVD rental**: DVD rentals provide an alternative to a DVD purchase. As explained above, consumers can choose between over-the-counter DVD rental services, typically charged on a PPV basis, and online services, typically charged on a subscription basis.

4.337 Figure 35 shows the total value of DVD rentals over the period 2000 to 2007.

[244] In Sky's Response of 1 June 2009 to Ofcom's Second Pay TV Consultation "Additional comments on Ofcom's analysis of market definition and market power in the pay TV review" paragraph 4.26, it argues that we cannot consider the relationship between two variables without using "multiple regression techniques" to determine the specific influence of any single factor. We note that multivariate analysis, while a valuable tool, necessarily introduces many assumptions in terms of the inclusion and specification of variables, and the model structure used. We recognise that it is necessary, when considering historical data, to exercise sensible caution as to the possibility that results may be affected by other factors, and this will affect the weight placed on a specific piece of evidence. But we do not consider that it is necessary to subject all numerical evidence to multivariate analysis.

[245] See Ofcom's Second Pay TV consultation Annex 6 Appendix 8.

[246] The price of 'Sky Sports and Movies Mix' has increased in real terms up to 2004 and has since remained constant.

Figure 35 Total value of DVD rentals

Source: British Video Association Year Book 2008

4.338 The chart shows a very similar overall pattern to the change in demand for Sky's premium movie channels, with a decline since 2004, although the growth from 2000 to 2004 is less marked. It also suggests that while there has been significant growth in the volume of DVD rental subscription packages, this has been at the expense of over-the-counter rentals. The chart – when read in conjunction with Figure 27 above – does not appear to suggest a strong degree of substitution between Sky Movies and DVD rentals.

4.339 This reflects the characteristics of the products. We accept that over-the-counter DVD rental services may be closer substitutes to Sky Movies packages than DVD sales, since they provide consumers with a similarly wide choice of films, to be viewed on a one-off basis. However, these rental services do not share other product characteristics with Sky Movies packages, such as the convenience with which films can be chosen, and the certainty of a fixed monthly subscription.

4.340 We gathered evidence from Lovefilm, the biggest online DVD rental firm, on its view of its close competitors. It indicated that it thought it competed with a range of other movie formats:

> "[✂]"[247].

4.341 We consider that online subscription rental models may be an even closer substitute to Sky Movies packages, since they provide the same certainty of a fixed monthly subscription, as well as a convenient means of choosing films. However they do not provide the same degree of convenience as a pay TV service, since no matter how straightforward the ordering process is, a consumer cannot view a movie until it has been delivered in the post. Consumers therefore need to be willing to plan their viewing several days in advance to be able to make effective use of such a service.

4.342 Our view is therefore that while online DVD rentals are a closer substitute to Sky Movies packages than DVD sales, they are not likely to be in the same market. Our

[247] Lovefilm response to Ofcom information request of 20 March 2009.

conclusions on market power do not depend on this conclusion, since expanding our market definition to include online DVD rentals does not materially change our assessment of market power.

4.343 For the reasons stated in paragraphs 4.157 to 4.160 we do not believe that our choice of price deflator, the start and end dates of the analysis, or our assessment of the use of discounts change our conclusion that the inflation adjusted price for Sky Movies had been broadly constant since 2002 and the price of Sky Sports and Movies Mix had been broadly constant since 2004.

4.344 Our view on the margin of prices over input costs remains as before. There has been **[✂]** in programming costs for Sky Movies channels without any significant reduction in retail prices. This does not suggest to us a strong competitive constraint on Sky's pricing of its movie channels.

4.345 Overall, while we recognise that there has been a reduction in the number of subscribers to Sky Movies over the past few years, we do not believe this provides evidence that Sky's premium movies channels are constrained to competitive levels. In particular:

- Demand for the most likely close substitutes to premium movie channels – namely movies shown on other channels and DVD rentals – has also declined.
- Real prices have remained broadly constant despite sharp falls in input costs.

The potential constraint from content downloaded over the internet

Our position in our Second Pay TV Consultation

4.346 In our Second Pay TV Consultation we considered the constraint from content downloaded over the internet.

4.347 In response to our First Pay TV Consultation Sky said that we had failed to appreciate the importance of content delivered on the internet. In particular this meant our assessment was insufficiently forward looking. For example, Sky cited the popularity of the downloadable content offered by existing broadcasters, including the BBC's iPlayer, Channel 4's 4OD service, ITV.com, and Sky's own online service (now called Sky Player)[248].

4.348 We agreed that downloading content to watch from the internet offers consumers a wide range of content that can be accessed relatively easily and viewed at their convenience.

4.349 We also commissioned a survey to understand the current level of consumption of content delivered via the internet. Our survey indicated that relatively few consumers currently download content, and that the constraint is therefore relatively weak. For example, only 13% of Sky's premium subscribers had downloaded content from the internet in the last month.

4.350 **[✂]**[249] **[✂]**.

[248] Sky response to Ofcom's December 2007 consultation Annex 6, appendix 1.

[249] Annex 21 Sky response to Ofcom request for information of 29th May.

4.351 On the other hand, we noted that Sky's decision to invest in offering content over broadband (and to renegotiate rights contracts where necessary[250]) could be a competitive response to the potential for increasing demand for downloading movie content, which would support the view that downloading content could become a more important competitive constraint.

4.352 We also considered the impact of illegal file downloading using applications such as Bit Torrent (file sharing) as a constraint on providers of premium movie channels. We quoted a study[251] which found that 4% of the population had illegally downloaded content from the internet in the last month. However, this group was overwhelmingly biased towards students who are relatively unlikely to subscribe to premium pay TV channels; 48% of all illegal downloaders were students (either at school or in further education). From these figures, it appears likely that only a small proportion of actual or potential premium channel subscribers engage in illegal downloading.

4.353 Given the relatively small numbers of subscribers who are likely to have illegally downloaded content, we did not think that this constraint was likely to be strong. Furthermore, as rights holders take action to protect their copyrights[252], we believed the constraint was likely to weaken rather than strengthen.

4.354 Downloading content could be a significant constraint in the future as popularity of downloads increase and capacity to download grows, but analysis of current consumption suggests that the current indirect constraint is relatively weak. The scale of the constraint is likely to grow as more homes have broadband internet connections and the average connection speed increases. It may also grow if it becomes more straightforward for viewers to watch content on their TV screens rather than on a computer.

Our current view

4.355 We received no further submissions which cause us to change our view on the likely constraint from downloading content from the internet, It therefore remains our view that the current constraint is weak, but that it may grow over time.

Supply side substitution

Our position in our Second Pay TV Consultation

4.356 As with premium sports, we considered the likelihood that a new entrant could enter the market within a short space of time, without incurring significant sunk costs, if the wholesale price of Sky Movies increased by a small but significant amount[253]. We

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[250] See for example Sky response to Ofcom's December 2007 consultation Annex 2 paragraph 3.135

[251] British Video Association Yearbook 2008, page 112. The study found that 8.1 million people or 17% of the population had downloaded content in the last month, of which a quarter (or just over 4% of the population) had downloaded content illegally.

[252] For example the BPI, the British Film Industry, major internet service providers (ISPs) and government have signed a memorandum of understanding which aims to significantly reduce the amount of illegal file sharing in the next three years. http://www.bpi.co.uk/index.asp?Page=news/press/news_content_file_1152.shtml.

[253] As noted above, the OFT regards supply side substitution as a special case of entry. Effectively, to broaden markets another supplier needs to be able to 'switch production' to supply the product without incurring sunk costs, within a year.

noted that a new entrant would not need precisely to replicate Sky Movies channels. As a minimum we therefore assessed whether a rival could enter with a differentiated product, for example showing films in the pay TV window from just one Hollywood studio.

4.357 Our analysis suggests that an entrant would need to invest a significant amount to create a channel containing movies from the pay TV window of just one of the six Major Hollywood Studios. For example, **[✂]**[254] **[✂]**. Clearly the investment required to launch a more compelling offering (comprising films from more than one studio) would be even greater, particularly as there is likely to be a time gap between one studio’s rights and another’s becoming available.

4.358 We also set out in our discussion of market power the barriers to entry that firms faced in gaining access to the relevant upstream inputs. We concluded that the multi-million pound investment needed to acquire rights to show films from the pay TV window even from only one studio meant that we should not widen the market to include potential entry from other premium movie channel suppliers.

Our current view

4.359 We received no further responses on our assessment of supply side substitution. It therefore remains our view that supply side substitution is unlikely to broaden our market definition.

Wholesale demand side substitution

Our position in our Second Pay TV Consultation

4.360 Given that wholesale demand is derived from consumer demand, products that consumers would find relatively weak substitutes (such as film channels that only contain older library films beyond the first TV window) are also likely to be relatively weak substitutes at the wholesale level.

4.361 Our analysis of the indirect retail constraint indicates that there are no close substitutes for channels including films in the first pay TV window from the Major Hollywood Studios that a retailer would switch to. It does not appear therefore that there are likely to be any wholesale products to which a retailer could substitute in the event of a small but significant increase in the wholesale price of Sky’s movie channels.

4.362 In particular, the constraint from providers of older films seems relatively weak as few subscribers would be willing to switch to a service with fewer films or only older films. For example, Picturebox offers a film subscription service for a narrower range of older films on the Tiscali, DTT and BT Vision platforms, but it only has about **[✂]** subscribers on Top Up TV and Tiscali[255], less than **[✂]**% of Sky Movies’ subscriber base.

4.363 We therefore concluded that demand side substitution is unlikely to be sufficiently significant to broaden our market definition.

[254] Source **[✂]**.

[255] It is now also retailed on BT Vision. Source: **[✂]**.

Respondents' views

4.364 As with our assessment of direct wholesale demand side substitution for premium sports channels Sky argued that we failed to have regard to the argument that a retailer reallocating sales effort away from particular channels, rather than dropping those channels, could act as a constraint on the wholesale price[256]. In particular it cited the example of Virgin Media reallocating marketing effort to its PPV VoD service.

Our current view

4.365 In section 4.322 to 4.330 we consider the indirect constraint imposed by PPV movies and conclude that it is likely to be seen as an out of market constraint. In the section below we therefore assess market power by including it within the relevant market. For the reasons set out in paragraphs 4.316 to 4.318 we consider older library films would not be considered a substitute for consumers. We do not therefore think that direct substitution to these services would constrain a monopolist wholesaler. This means that demand side substitution is unlikely to broaden the market. In section 5 below we consider whether retailers are able to exercise buyer power for example by reallocating marketing effort to products outside the relevant market.

Changes in wholesale prices

Our position in our Second Pay TV Consultation

4.366 In our Second Pay TV Consultation we examined Sky's claim that flat or falling wholesale prices for its premium channels are strongly suggestive that it does not have market power to set prices above competitive levels, and by implication that markets should be defined broadly[257]. Sky argued that the per subscriber wholesale carriage fees for its packages had been flat in real terms since 2004 and that the price of Movies Mix has declined.

4.367 Furthermore it argued that "given the very significant increases in rights costs, …, the obvious implication is that margins between costs and prices have narrowed in relation to Sky's channels at the wholesale level over the period".[258]

4.368 We analysed changes in wholesale prices of the most popular wholesale Movie channel mixes over time[259,260]. The wholesale price of the Sky Sports and Movies Mix has **[✂]** since 2005 but in September 2008 was **[✂]** than it was in 2002. The price of Sky Movies Mix has **[✂]** than it was in 2002.

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

[257] Annex 2 to Sky's non-confidential response to our December 2007 consultation, paragraphs 3.131-2.

[258] Ibid.

[259] Sky Movies Mix and Sky Sports and Movies Mix are taken by **[✂]**% of wholesale subscribers to Sky Movies channels.

[260] Our full analysis is contained in Annex 6, Appendix 6.

4.369 We said that falling wholesale prices for Sky Movies Mix channels could be evidence of an increasing competitive constraint from other substitutes, although it is not clear that this would be sufficient to reduce prices to competitive levels.

4.370 We also examined the wholesale mark-up over programming costs. Our analysis in Figure 36 suggested a widening wholesale margin over costs.

Figure 36 Variable programming costs as a proportion of the wholesale price

[✂]

Source: Sky annual accounts 2002 to 2007, Sky response to information request of 29th May 2008

Note: Note: the analysis covers only UK and ROI residential subscribers, not commercial subscribers. We assume that all Sky Sports channel programming costs are fixed and all Sky Movies channel costs are variable with wholesale subscribers

4.371 We therefore considered that the fall in wholesale prices of packages containing Movies Mix and Sports and Movies Mix does not necessarily imply an effective competitive wholesale constraint. In fact, the **[✂]** and prices could indicate increasing market power.

Respondents' views

4.372 Sky criticised our assessment of changes in wholesale prices[261]. It said that our conclusions were biased by the choice of start and end points of analysis It also said that our choice of inflation deflator was 'unusual'.

Our current view

4.373 Figure 37 shows our analysis of wholesale prices under a range of different deflator assumptions taking comparable start and end dates as Sky suggested.

Figure 37 Wholesale price changes Q2 2002 – Q2 2008

[✂]

Source: Sky response to Ofcom information request of 29 May 2008.

4.374 The alternative inflation deflators suggested by Sky do not materially affect our conclusions. Indeed, the GDP deflator generates results that lie near the middle of the plausible range. Similarly, we think that changing the start and end dates of our analysis only has a minimal effect on our results.

4.375 We therefore remain of the view that there has been an increase in the margin of wholesale prices over per subscriber costs. This appears to us consistent with the view that wholesale prices are not constrained to competitive levels.

Conclusion on relevant market for wholesale premium movie channels

4.376 We remain of the view that there is a relevant economic market for wholesale premium movies channels. As with sports, we have reviewed a wide range of evidence:

[261] Sky response to September 2008 consultation Annex 6 4.3.

- The number of subscribers to Sky Movies has declined over the past few years despite constant real prices.

- We can see a growing number of potential substitutes which some consumers find attractive: PPV VoD, DVD rental, online downloads, and a greater number of films on FTA TV. However consumption of movies on FTA TV is declining in line with reductions in the consumption of Sky Movies.

- Our consumer survey evidence and analysis of BARB data suggests that access to new films is an important feature of premium movie channels, and that channels containing older films or other film content are likely to be a weak substitute.

- Our evidence on pricing of DVDs, and our consideration of the different characteristics of DVDs and premium movies, indicates that these are likely to represent relatively weak substitutes for premium movies.

- Online DVD rentals may represent a small but growing constraint on Sky Movies. However, analysis of rentals volumes over time suggests the growth of this format may be largely driven by switching from over the counter rentals.

- Similarly, although downloading films may become a more important factor, relatively few consumers currently use such services.

- Our analysis of elasticity evidence suggests a weak response to price changes, which is insufficient to constrain a hypothetical monopolist, indicating that consumers' price sensitivity would not constrain a hypothetical wholesaler's prices to the competitive level. As with premium sports, retail and wholesale prices may well be above competitive levels, and we therefore need to interpret consumer switching behaviour with care: high switching rates at competitive prices could indicate a need to broaden the relevant market, but high switching rates at higher prices would be consistent with a narrow market.

- We have seen programming costs decline in real terms, but wholesale prices decline to a lesser extent. This appears inconsistent with a view that the constraint on wholesale prices has been increasing. In addition, in our view Oxera's analysis suggests that wholesale margins for Sky's movie channels are higher than for its sports channels (see section 6).

4.377 On balance, we believe it likely that the wholesale supply of channels which include the first TV subscription window of movies produced or licensed by any of Universal, Viacom, 20th Century Fox, Walt Disney, Sony or Time Warner or their wholly owned or controlled subsidiaries ("Core Premium Movie channels") form a relevant market. However, we observe that the constraint from other ways of watching films is growing and may grow further in the future. We consider online rental DVDs, PPV, films on FTA and basic tier TV and online downloads to be the closest substitutes, but their inclusion in the market would not affect our assessment of market power.

4.378 The market is likely therefore currently to include the following channels[262]: Sky Movies Action & Thriller, Sky Movies Comedy, Sky Movies Drama, Sky Movies Family, Sky Movies Premiere+1, Sky Movies SciFi & Horror, Sky Movies Screen 1,

[262] See also appendix 3 of Annex 6 for an assessment of which Sky Movies channels are defined as Core Premium Movie channels.

Sky Movies Screen 2, Sky Movies Modern Greats, Sky Movies Indie or Disney Cinemagic and the HD versions of these channels. In the remainder of the document, we will refer to these channels as ‘Core Premium Movies’ channels. We proceed in this document to consider whether there is a risk that there is not, and will not be, fair and effective competition in the provision of Core Premium Movie channels.

Retail markets for premium movie channels

4.379 We now assess retail markets for the provision of packages including Core Premium Movie channels. The key question for our analysis is whether films on FTA or basic tier or alternative formats are likely to constrain a monopolist retailer of premium movie channels. We recognise that premium movie channels are retailed in wider bundles containing basic tier channels or sports channels and take the basic plus premium bundle as our focal product. When assessing the constraints on premium movie channel retailers we consider the competitive constraints on the premium element of the bundle.

4.380 As with our assessment of wholesale markets we consider:

- Demand side substitution:
  - Consumer response to price rises.
  - Evidence of consumer preferences and product characteristics.
  - Evidence of the constraint from DVD rental and retail.
  - Evidence of the constraint from FTA.
- Supply side substitution.
- Summary of conclusions.

Our position in the First Pay TV Consultation

4.381 In our First Pay TV Consultation we considered markets for packages containing premium movies channels. We considered the key driver of demand for subscription pay TV premium movie packages appears to be the very wide choice of first run Hollywood films that are always available and accessible to consumers at a zero marginal cost. Whilst similar or even higher quality content is available on pay-per-view and DVD, these characteristics appear to be of secondary importance to consumers of subscription premium movie channels.

4.382 The consumer survey also suggested that there was no particularly close substitute to Sky Movies. If consumers stop their subscription to Sky Movies they spend their money on a wide variety of products. Perhaps surprisingly, there was very limited reported switching to DVD (retail or rental) or pay-per-view TV, suggesting that these are relatively weak substitutes. The absence of a particularly close substitute is consistent with a narrow subscription pay TV premium movies market.

4.383 We examined evidence of consumers’ response to price changes and considered evidence of consumers’ stated response to hypothetical price rises. We concluded that premium movie bundles are likely to be in a separate economic market which does not include FTA or basic-tier TV channels, PPV or DVD rentals.

Responses to our consultation

4.384 Sky considered that markets are broader, encompassing at least FTA channels, basic tier TV channels, audiovisual content from the internet and DVDs. In particular, it stated that there are now many more potential substitutes for Sky Movies than there were ten years ago[263]. Sky reported that the aggregate constraint from DVD rental and retail, VoD and an increasing number of films on basic and FTA TV was "having a major impact on TV retailers' ability to attract subscribers to packages that included premium movie channels"[264]. It stated that despite flat inflation-adjusted prices since 2001 the number of subscribers to the channels was declining. Furthermore, fewer new subscribers tended to take Sky Movies.

4.385 BT, Setanta, Top Up TV, Virgin Media, BBC, and **[✂]** all agreed with Ofcom's assessment of markets for premium movies channels.

Demand side substitution

<u>Evidence of consumers' response to price changes</u>

Our position in the First Pay TV Consultation

4.386 In the First Pay TV Consultation we considered consumers' responses to price changes since 2000. The number of subscribers has grown during the period – although subscriber numbers levelled off since 2004, and fell slightly in 2007. We considered that there did not appear to have been a significant change in the quality of the Movie package products over the period. In particular, the number of films broadcast on Sky Movie channels has remained relatively stable since 2001, although the addition of other services, such as "free" broadband on Sky or greater on-demand services on Virgin Media and Sky could be viewed as a quality change.

4.387 We found that consumers stated response to hypothetical price rises indicated that there was a strong price response to relatively small changes in prices. However, we stated that the magnitude of these results should be treated with caution as prices may be above competitive levels and there was a risk of stated preference bias.

Responses to our consultation

4.388 Sky believed that our survey evidence on consumers' stated response to hypothetical price rises was strong evidence that consumers were price elastic. It stated that, unless there was strong and compelling evidence that prices were above competitive levels, we should accept that the results indicate that consumers are very price-sensitive.

4.389 BT stated that the high level of switching indicated by the results could be as a result of cellophane fallacy pricing, and that therefore by relying on this data we might draw excessively broad markets.

[263] Sky response Annex 2 paragraph 3.73 – 3.81.

[264] Sky response paragraph 6.36.

Our current view

4.390 As with our analysis of consumer response to price rises in our consideration of wholesale markets above we have estimated the minimum consumer elasticity that would be required to constrain a monopolist retailer from increasing prices above current levels.

Figure 38 Estimates of Sky Movies subscribers' elasticities and retail critical loss

		Sky Sports and Movies Mix	Sky Movies Mix
1	Minimum elasticity to constrain a retail monopolist (critical loss)	[✂]	[✂]
2	Sky conjoint estimate	[✂]	[✂]

Source: Critical loss: see Appendix 2 of Annex 6; Sky conjoint: [✂] supplied to Ofcom by Sky in July 2007

4.391 The evidence from Sky's conjoint survey appears to suggest that insufficient subscribers would switch to an alternative product to constrain a monopolist retailer. However the conclusion is less firm than with premium sports as the experiment only tested the impact of a **[✂]**. For the reasons set out in paragraph 4.144 we do not rely on our estimates of elasticity from our willingness to pay survey.

4.392 At the same time, actual numbers of subscribers to Sky Movies have declined somewhat despite falling real prices. However, we remain of the view that the cellophane fallacy effect is present: if prices are above competitive levels we would expect switching to be higher than if they were at competitive levels. Hence our evidence on consumers' observed response to price changes could be consistent with an effective competitive constraint or switching in response to cellophane fallacy prices.

Evidence of consumer preferences and product characteristics

Our position in the First Pay TV Consultation

4.393 For our First Pay TV Consultation, we commissioned a consumer research survey which asked Sky Movies consumers about the characteristics of the product that they particularly value[265]. The key conclusions of that research were:

- Access to a wide range of films was the most important characteristic (cited by 83% of subscribers as 'must have' or 'nice to have').

- This was closely followed by having films available at all times, and access to new releases (cited by 70% and 72% of subscribers respectively).

[265] Ofcom pay TV research, phase 2, see Annex 14 to the First Pay TV Consultation.

- Consumers also value not having to pay each time they watch a film, and the convenience of not having to rent a DVD (respectively cited by 63% and 65% of consumers as either 'must have' or 'nice to have' features).

4.394 These findings, and in particular, the convenience aspect of having a wide range of films available, at home, and free at the point of consumption, suggests that for many consumers DVD rental, pay per view, and seeing films at the cinema may not provide particularly effective substitutes. Online subscription DVD rental services may appeal to those consumers who value the convenience of paying monthly or not having to go to a DVD shop.

Responses to our consultation

4.395 Sky argued that our analysis focused on the preferences of average subscribers, rather than those most likely to switch in response to a price rise ('marginal subscribers').

Our current view

4.396 As we set out in paragraphs 4.282 to 4.285 we analysed preferences of 'price sensitive' subscribers and gathered further evidence from firms within the market and analysis of audience data on Sky movies channels. As with our assessment of the wholesale supply of Core Premium Movie channels we consider subscription access to new movies from the pay TV window to be the key characteristics of premium movie channels.

Evidence of the constraint from DVDs

Our position in the First Pay TV Consultation

4.397 We assessed changes in prices and demand for Sky Movies and DVDs. We found that between 2001 and 2006 the retail price of DVDs has fallen in real terms by 43% while expenditure on retail DVDs has tripled over the period[266].

4.398 As stated above, it is difficult to draw firm conclusions from such data. However, we noted that the price of Sky Movies had grown at approximately the same rate as that of Sky Sports, despite what appeared to be a greater array of potential substitutes. In particular, the growth in popularity of renting and purchasing DVDs did not appear to have had a constraining impact on the price of Sky Movies.

Responses to our consultation

4.399 As we set out above[267] Sky believed that DVD retail and rentals were a strong constraint on the retailing of Sky Movies channels. In response to our second consultation it stated that the reduction in time between the cinema release and DVD rental release meant that the pay TV window was becoming less valuable.

[266] Source: Screen Digest, see annex 11 to our First Pay TV Consultation.

[267] See paragraph 4.278 and 4.286.

Our current view

4.400 Our evidence on pricing of DVDs and the growth of DVD rentals indicates that these are likely to represent relatively weak substitutes for premium movies[268]. Similarly, although downloading films may become a more important factor, relatively few consumers currently use it.

The constraint from films on FTA or basic tier TV

Our position in the First Pay TV Consultation

4.401 There is also a growing availability of movies on basic-tier pay TV and FTA TV channels which premium movie consumers might find attractive. However, for the reasons set out above[269], these channels are unable to provide the latest releases or to match the quality of movies that are available on subscription pay TV premium movie channels.

Responses to our consultation

4.402 In response to our first consultation Sky noted[270] that the number and variety of films on FTA TV had increased considerably since 2001. For example it noted that in 2001 there were about 8 films screened per day on terrestrial channels[271], but in 2007 there were 27 films screened per day. It stated that the constraint from FTA and basic tier TV (along with other constraints) had increased significantly. [272]

Our current view

4.403 The growth in movie channels on FTA and basic tier packages has increased the availability of older films to consumers. However, these films are likely to be less valuable to consumers and therefore represent a weak competitive constraint on retailers of premium movie channels.

Supply side substitution

Our position in the First Pay TV Consultation

4.404 We considered supply-side substitution; in particular we have considered whether an alternative supplier could switch to retailing a package of channels including premium movie channels within a relatively short period of time without incurring significant sunk costs.

4.405 We considered it unlikely that supply-side substitution is likely to provide a constraint. In particular, there are no alternative wholesalers of subscription premium movies as a result of Sky's exclusive contracts with the six major studios.

[268] See for example paragraphs 4.341 to 4.342.

[269] See paragraphs 4.346 to 4.355.

[270] Sky response to Ofcom's December 2007 consultation Annex 2 3.78.

[271] PSB channels and sister digital channels.

[272] Sky response to Ofcom's December 2007 consultation Annex 2 3.79.

Responses to our consultation

4.406 Sky claimed[273] that rapid entry is possible as rights become available at periodic intervals. It said that from late 2008, **[✂]**.

Our current view

4.407 We have considered whether an increase in the retail price of package containing premium sports channels would incentivise alternative suppliers to enter the market. We consider that in the relatively short term it would be unlikely that a new entrant could enter the market without incurring sunk costs in acquiring content and customers. For this reason we do not consider supply side substitution to be sufficient to widen markets. This view is strengthened by our subsequent review of barriers to entry in the context of market power.

Conclusion on markets for retail of premium movies channels

4.408 The evidence is indicative of a narrow market for the retail markets for packages containing premium movies channels which we define as being channels or packages of channels containing Core Premium Movie channels. Evidence on subscribers' price sensitivity can be difficult to interpret but suggests that insufficient numbers of subscribers would switch to constrain a monopolist retailer of premium movies channels, even at current prices. Our research indicates that content on Core Premium channels is sufficiently important to a large enough number of consumers that the constraint from FTA channels or basic tier channels is relatively weak.

4.409 We acknowledge that subscription DVD rentals or PPV might be a potential substitute for some subscribers, but consider these to be out of market constraints. New entrants would have to make significant investments in content and acquiring subscribers to supply a channel so we do not consider that supply side substitution would broaden the markets.

4.410 Our current view is that the relevant retail market is for retail supply of television bundles containing Core Premium Movie channels.

4.411 We therefore proceed in this document to consider whether there is a risk that there is not, and will not be, fair and effective competition in the provision of bundles containing Core Premium Movie channels. As is often the case with market definition, the precise boundaries of this relevant market are difficult to determine with certainty. In the following section we assess retail market shares including out of market constraints such as PPV films, subscription DVD rentals, on line downloads or other films on FTA or basic tier TV.

[273] Sky's response to Ofcom's First Pay TV Consultation Annex 3.

Section 5

Market power

Summary

5.1 We consulted in September 2008 on a view that Sky had market power in the wholesale of premium sports and movies channels. We continue to believe that Sky has market power in the markets for wholesale of Core Premium Sports channels and Core Premium Movie channels, based on evidence including Sky's high market shares, its control of key rights and the limited potential for market entry.

5.2 We are also now consulting on the view that Sky also holds a position of market power in the markets for the retail of packages including Core Premium Sports and Movies channels. Sky's market shares are very high in the retail markets as well in wholesale. Barriers to entry in acquiring the relevant wholesale inputs are high – a number of potential retailers have been unable to conclude agreements to retail Sky's Sports and Movies channels. Although various retailers have gained access to Setanta Sports 1, we do not believe that this is likely to act as a binding constraint on Sky.

5.3 Although we believe Sky holds a position of retail market power, our competition concerns focus not on this, but on the exercise of market power at the wholesale level, as set out in the following section.

Introduction

5.4 This section summarises Ofcom's assessment of market power within the four relevant markets defined in section 4 of this document. Our analysis is set out in full in Annex 8. This section is structured as follows:

- Introduction to the assessment of wholesale market power.
- Wholesale Core Premium Sports channels.
- Wholesale Core Premium Movie channels.
- Introduction to the assessment of retail market power.
- Retail television bundles containing Core Premium Sports channels.
- Retail television bundles containing Core Premium Movie channels.

Introduction to the assessment of wholesale market power

Approach to the assessment of wholesale market power

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

5.6 In this document we are considering the case for intervention under s316 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.

5.7 The competition concerns we identify in section 6 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.

5.8 In this section 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.

5.9 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 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.

5.10 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.

Overview of the further representations received on the approach to assessing wholesale market power

5.11 In its response to the Second Pay TV Consultation, Sky criticised Ofcom's analysis of market power at the wholesale level. According to Sky the more significant flaws in Ofcom's analysis were as follows:

- First, Sky considered that Ofcom's analysis was carried out as though Ofcom was engaged in an application of 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[274].

- Second, Sky considered that Ofcom's approach to assessing entry barriers was mechanistic and likely to be erroneous. Sky stated that Ofcom's concept of which

[274] In paragraph 3.13 of section 3 of its response to the Second Pay TV Consultation Sky comments 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.

factors constitute entry barriers performs poorly against the definition set out in the OFT's CA98 guidelines (the "OFT Market Power Guidelines")[275]. These 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). 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.

- Third, 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.

- Fourth, in a late submission on 1 June 2009, Sky asserted that our analysis gave "primacy" to market shares. Sky stated that, in this case, market shares should be treated with a high degree of scepticism, particularly since the products under consideration are differentiated. Sky suggested that our 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, particularly our choice of which 'out of market' products to include and which market shares measures to use.

Ofcom's view on the further representations on the approach to assessing wholesale market power

5.12 Ofcom has considered carefully Sky's further representations. Our responses to each of Sky's four arguments are summarised below.

5.13 First, in terms of Sky's arguments about the relevance of dominance as a measure of market power:

- We agree with Sky that dominance is not a necessary precondition for the competition concerns that we have identified (see above). Were Sky 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 as understood in a CA98 case.

- Sky is arguing that the appropriate standard is lower than dominance[276]. 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)

[275] *Assessment of market power*, OFT, December 2004, available at http://oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft415.pdf

[276] Sky stated that, for the types of downstream effects that Ofcom was concerned about in the Second Pay TV Consultation to arise, "it is likely to be necessary only that [broadcasters] have a degree of market power associated with the exclusive control of rights to content that is widely valued by consumers" (section 7, paragraph 11.3).

standard adopted. Accordingly, we do not accept that our use of the dominance standard impugns the analysis in later sections of this document.

5.14 Second, we do not accept Sky's criticisms of our concept of entry barriers. We consider that it is legitimate to rely on a broad range of factors, including factors that can be characterised as Sky being more efficient that its competitors. Our response to this point is set out fully in Annex 8. In summary:

- Sky referred to 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 can be legitimate to regard them as barriers to entry.

- 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.

5.15 Third, 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 set out our response to Sky's earlier arguments in paragraphs 1.10-1.16 of Annex 7 to the Second Pay TV Consultation. That response referred to our views in that consultation concerning Sky's profitability and a number of sub-optimal outcomes for consumers.

- On profitability, in the Second Pay TV Consultation we considered that the evidence on profitability was insufficient to overturn our view that Sky has market power. We have subsequently conducted further analysis that provides firmer evidence that Sky is currently earning a return that is higher than its cost of capital (see section 6). Contrary to Sky's position, the profitability evidence thus supplements and reinforces the evidence summarised below that Sky enjoys a dominant position.

- We continue to rely on the outcome for consumers and our analysis of this issue is set out in section 7. Moreover , we consider that Sky's current conduct is in fact leading to detrimental outcomes. As explained in this section, we do not agree with Sky's view of consumer outcomes – rather we consider that there is an adverse effect on the interests of consumers.

- In any event, 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)[277]. In other words, it is characterised by the *ability* to behave independently rather than the exercise of that ability. 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. Further, as discussed above, we agree with Sky that dominance is not a necessary precondition for the competition concerns identified.

[277] Case 27/76 *United Brands v Commission* [1978] ECR 207, paragraph 38.

5.16 Fourth, as highlighted by Sky, we recognise that where there is a great deal of product differentiation this brings to the fore several limitations of relying on market shares. Suppliers that lie outside of the market may exert a moderate constraint upon suppliers within the relevant market. Similarly, suppliers within the relevant market may not exert a particularly strong constraint because their products are differentiated. However we have addressed these limitations in a number of ways:

- 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.

- To reflect the potential constraint imposed by products outside of the relevant market, we have also calculated market shares that include 'out of market' products that are likely to exert a moderate constraint. 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 more remote substitutes. While it is not the case that the more 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.

Wholesale Core Premium Sports channels

5.17 Below we set out a summary of our assessment of market power in the wholesale supply of Core Premium Sports channels. First, a background section explains which channels lie within the relevant market, summarises our position in the Second Pay TV Consultation, summarises the further representations we have received and provides a brief overview of further developments. We then consider the strength of any competitive constraints on suppliers in this market, namely:

- Competition from existing competitors.

- Competition from potential competitors.

- Countervailing buyer power ("CBP").

Background

<u>The channels within the relevant market</u>

5.18 As set out in section 4, we consider that the relevant market is the wholesale supply of channels regularly featuring live sporting events which a significant number of consumers find highly valuable[278]. For the reasons given in paragraphs 4.94 to 4.134,

[278] 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

the channels that lie within that relevant market (at least until recently) are Sky Sports 1, Sky Sports 2 and Setanta Sports 1[279].

Our position in the Second Pay TV Consultation

5.19 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 had market power and was likely to hold that position 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 2006 when the European Commission's intervention ensured that one company could no longer win all the rights. In the Second Pay TV Consultation, we estimated that Sky's market share (when estimated on the basis of wholesale revenues) in May 2008 was **[✂]**% [over 70%].

- Sky's market share remained high even when we expanded our market definition to include other popular 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 could afford to bid a larger amount than any other bidder.

- 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 the 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.

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

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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.

[279] Setanta went into administration on 23 June 2009, shortly after the live FAPL rights which had been held by Setanta were awarded to ESPN. ESPN has announced that it has agreed a wholesale deal with Sky for distribution on Sky's DSat platform. It has also announced an intention to make its channel including FAPL coverage 'widely available across multiple pay-TV platforms', although at the time of writing no other details of availability across platforms other than Sky's have been announced. Our subsequent conclusions are likely to be independent of whether Setanta Sports 1, or some other channel provided by ESPN, exists as part of the Core Premium Sports market.

Overview of the further representations received on the approach to assessing wholesale market power

5.21 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 albeit for a different reason, namely that there is a range of substitutable content. These arguments are set out and considered in section 4 and section 8.

5.22 Sky considered that the Live FAPL Rights are "contestable".

5.23 The FAPL disagreed that there are barriers to acquiring the Live FAPL Rights. The FAPL referred to the European Commission's intervention 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.

5.24 **[✂]** 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 "toe-hold 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.

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

5.26 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

5.27 As explained in paragraph 2.54, 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. As we set out in paragraph 2.54, Setanta has now lost its rights to broadcast live FAPL matches from the 2009/10 season onwards and gone into administration, and those rights have now been acquired by ESPN.

Existing competitors

Existing competitors within the relevant market

5.28 As explained above, there are two firms currently active in the relevant market: Sky and Setanta (although Setanta is set to be replaced by ESPN). As explained in Annex 8 we consider that Setanta Sports 1 is a substitute for Sky Sports 1 and 2.

5.29 As discussed above, we are assessing Sky's market power against the dominance threshold. In the context of that threshold, while market shares are not conclusive evidence, 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%[280]. The OFT Market Power Guidelines state that it is generally unlikely that an undertaking will be individually dominant if its share of the relevant market is below 40%, although there may be exceptions (paragraph 2.12).

5.30 We have calculated market shares as a proportion of the revenues earned by Sky and Setanta from the wholesale supply of Core Premium Sports channels. This updates the calculations in the Second Pay TV Consultation, in particular to reflect more recent data. Setanta attracted a significant number of additional subscribers once it began broadcasting live FAPL matches in August 2007. That initial rise meant that Setanta's share of revenues was around **[✂]** [0-10%] in the second half of 2007. Setanta's share of revenues continued to grow and had increased to around **[✂]** [10-20%] in the second half of 2008. As a result, Sky's share of revenues has thus fallen somewhat in recent years. However Sky's market share in the second half of 2008 was still very high (around **[✂]** [80-90%]) and remained well above the 50% threshold at which dominance can be presumed, in the absence of evidence to the contrary. These figures include self-supply of channels to Sky's and Setanta's retail businesses[281].

5.31 Moreover, looking forward, Setanta Sports will no longer be broadcasting live FAPL matches. and has gone into administration.. 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, since Sky won the rights to 23 of the games previously broadcast by Setanta. As a result, Sky's market share will probably rise[282]. This evidence suggests that constraints on Sky may be weaker from mid-2010 onwards.

Out of market constraints

5.32 As explained in paragraph 4.72 in section 4, similar sports events to those broadcast on Sky Sports 1 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

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[280] Case C62/86 *AKZO Chemie BV v Commission* [1991] ECR I-3359.

[281] Sky Sports and Setanta Sports 1 are not only sold on a stand-alone basis e.g. Sky Sports is also bundled with Sky's movie channels and Setanta Sports 1 is bundled with other Setanta Sports channels. Sky's market share depends on how much of the wholesale price of bundles containing Sky's movie channels is attributed to Sky Sports 1 and 2. If Sky's wholesale revenues are calculated using the incremental wholesale price of Sky Sports then Sky's market share remains high (around **[✂]** [70-80%] in the second half of 2008). See Annex 8 for further details.

[282] First, it is plausible that the wholesale price charged by Setanta will fall, given the loss of FAPL content from its channels. Second, it is plausible that Setanta will attract fewer subscribers than it does at present. For example, 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 (Source: Annex 1 of Setanta's response dated 15 April 2009 to Ofcom's information request response dated 20 March 2009). A material share of these subscribers may leave once Setanta screens 50% fewer live FAPL matches.

recognised that channels outside of the relevant market nonetheless exerted a competitive constraint to a degree.

5.33 We have thus considered the extent of the constraint imposed by 'out of market' products. In particular, we have calculated market shares as if moderate substitutes for Sky Sports 1 and 2 were within the relevant market. We have taken into account 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 not included other well-known sports such as the Olympics or Formula One motorsports since we believe that they are poor substitutes for the events broadcast on Sky Sports 1 and 2. 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[283].

5.34 We have calculated market shares that include moderate 'out of market' substitutes based on the price of the rights of leading events in the six sports listed in the previous paragraph[284]. While there are a number of gaps in the underlying data, we do have data on the most valuable sporting events (including FAPL matches) and we believe that the broad results are informative. These alternative market share figures are set out in Figure 39 below. This shows that in 2008 Sky accounted for approximately **[✂]**% [60-70%] of the expenditure on rights on leading football, cricket, tennis, golf, rugby union and rugby league events.

Figure 39 Wholesale market shares in 2008 including 'out of market' constraints (calculated using expenditure on relevant sporting events)

Sky	Setanta	BBC	ITV	Other
[60-70]%	[10-20]%	[0-10]%	[10-20]%	[0-10]%

Source: Ofcom calculations

5.35 We recognise that, in the case of listed events, calculating market shares using rights prices is likely to understate the strength of free to air channels' competitive position (the restrictions on broadcasting these events exclusively on pay TV are likely to lower the price of the rights to listed events). However, the effect on the market shares presented above is unlikely to be large given the relatively small number of listed events that are relevant to this calculation[285]. We thus consider that Sky enjoys a very high market share, even if moderate 'out of market' substitutes are taken into

[283] We previously 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. That analysis has been updated to reflect the changes in this document to the market definition.

[284] Direct assessment of revenues is complicated by the challenge of disaggregating advertising revenues for the relevant matches, so we have not used this measure. Unlike the Second Pay TV Consultation, we have not used audience figures to calculated 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.

[285] 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.

account[286]. Moreover, as explained in paragraph 4.73 the coverage of these sports on free to air channels is a relatively poor substitute for the coverage on Sky Sports 1 and 2 and thus these market shares overstate the strength of the constraint exercised by free to air channels.

Conclusion on existing competitors

5.36 In summary:

- We calculate that Sky currently has a market share well in excess of 70% (see paragraph 5.30 above). Our view is that Sky's market shares are a strong indication of it possessing market power in the wholesale supply of Core Premium Sports channels, and are in fact consistent with it being dominant.

- Indeed Sky's market share has persistently been well above the 50% threshold at which dominance would be presumed in the context of Article 82, in the absence of evidence to the contrary.

- Even when 'out of market' constraints are taken into account, existing competitors do not exert a strong constraint upon Sky. Sky's market share remains high (over 50%) even if moderate substitutes are taken into account. These alternative market share figures will overstate the strength of the competitive constraint exercised by these products and thus understate the extent of Sky's market power. Moreover, as shown by the magnitude of these market share figures, 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.

5.37 In the analysis of entry and expansion barriers and CBP that follows, we therefore focus on the position of Sky.

Potential competitors: barriers to entry and expansion

5.38 Where entry barriers are low, it may not be profitable to sustain prices above competitive levels because this would attract new entry which would then drive the price down, at least in the long term[287]. Below we summarise why we believe that there are, and, in the absence of further regulatory intervention will remain, important barriers to entry in this market.

5.39 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[288]. Thus

[286] We have recalculated the figures presented in Figure 39 assuming that the BBC and ITV's payments for *all* these sports (not just the listed events) should be uplifted (see Annex 8). If the BBC and ITV's payments are uplifted by 50% (which is likely to considerably overstate the value of the live sport broadcast by the BBC and ITV) Sky's market share falls to **[✂]** [50-60%] and Setanta's market share falls to **[✂]** [10-20%]. The BBC and ITV's market shares rise to **[✂]** [10-20%] and **[✂]** [10-20%] respectively. 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%].

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

[288] As was the case when Setanta began broadcasting live FAPL matches in 2007, following its acquisition of the Live FAPL Rights (see footnote 277 above).

barriers to acquiring rights also act as barriers to expansion. Our analysis thus focuses on whether there are obstacles to acquiring the rights to certain key sporting events.

5.40 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; and
- Why Sky is likely to win the majority of the Live FAPL Rights[289].

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

5.42 By way of background, Figure 40 lists leading football, rugby league, rugby union, cricket, golf and tennis events. It shows the annual value of the rights and the broadcaster(s) that currently hold those rights. Where known, it also shows which broadcaster(s) held those rights in the last contractual period and which broadcaster(s) will hold those rights in the next contractual period.

Figure 40 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)	

289 The FAPL and Sky have argued that entry barriers are not high. Other submissions have identified various other factors which purportedly act as barriers to entry. These are addressed in Annex 8.

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	Total annual value of live rights	Previous rights holder(s)	Current rights holder(s)	Future rights holder(s)
RUGBY UNION				
Six Nations	[✂]		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): 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.

Sale process for the Live FAPL Rights

5.43 The Live FAPL Rights are sold by the FAPL. 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.

5.44 The Commitments set transparency and non-discrimination conditions for the bidding process. The Commitments apply for the six seasons from 2007/08 onwards, or two rounds of bidding. The Commitments require six packages of live rights, each for 23 matches, to be made available. 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 41 below). A first pick match is likely to be more attractive to final consumers than a fourth pick match. No one bidder is allowed to acquire all six packages and packages must be bid for on a stand-alone basis i.e. the amount bid cannot be conditional on the number of packages a bidder wins.

Figure 41 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

5.45 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).

5.46 In 2009, the FAPL sold the rights to the 2010/11 to 2013/14 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>

5.47 As explained above in paragraphs 5.6 to 5.9, we are assessing the extent of market power held by Sky by reference to the dominance threshold. Under this framework we therefore consider whether potential competition is sufficiently strong to undermine the dominant position suggested by Sky's market shares. In other words, the relevant issue is not whether small scale entry is possible/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.

5.48 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).

5.49 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[290].

5.50 The evidence supporting our position is set out in full in Annex 8. Below we summarise evidence: (i) demonstrating the particular importance of the Live FAPL Rights; (ii) showing that Sky's strong wholesale position will persist unless Sky loses multiple packages of Live FAPL Rights; and (iii) showing that package A is particularly important.

5.51 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 subscribers[291]. This is shown by survey evidence. For example, 75% of premium sports channel subscribers who watch sport at least once a week considered that live FAPL matches were "very important" (Second Pay TV Consultation, Annex 6, Figure 17). 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.

- Of the most popular football contests, the FAPL has particular characteristics (regularity and number of games) which make it particularly attractive when creating a mass market wholesale sports channel (see paragraph 4.80). This is reflected in 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 to 2009/10 seasons was £1,707m which is an average of £569m per annum[292]. In contrast, the average annual amount paid for live Champions League rights is £85m and for the right to live FA Cup plus England home international football matches is £106m (i.e. less than 20% of the FAPL figure in both cases). The average annual amount paid for the live rights to the Six Nations rugby union tournament was £40m (i.e. less than 10% of the FAPL figure)[293]. Given the sheer scale of the difference in the amounts that

[290] 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 wholesale 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.

[291] Clearly there are other sports rights that are highly valued by 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 materially erode Sky's wholesale position.

[292] See Annex 10 to First Pay TV Consultation.

[293] The annual cost of the rights to live Champions League matches relates to the 2006/07 to 2008/09 tournaments. The annual cost of the rights to live FA Cup and England home internationals matches

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 also reflected in contemporaneous documents. For example, **[✂]**[294]. It is also reflected in **[✂]**.

5.52 Turning to the second issue, the available evidence suggests that Sky's strong wholesale position will persist unless Sky loses multiple packages of Live FAPL Rights. Setanta only acquired two packages of live FAPL Rights in 2006 and, as shown by the market share figures presented above, Sky has retained a very high market share. This is notwithstanding Setanta's success in winning various other sporting rights (including other popular football matches, such as FA Cup and England international matches). It is also supported by **[✂]**[295]. Similarly, **[✂]**[296].

5.53 The particular importance of package A reflects the characteristics of that package (it contains 23 first pick matches i.e. 61% of the 38 first pick matches available). Its importance is confirmed by **[✂]**[297].The importance of first pick matches and package A in particular is also highlighted by documents provided to Ofcom. **[✂]**[298].

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

5.54 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.

5.55 Moreover even when the rights to later FAPL seasons become available, we consider that Sky is likely to win the majority of those rights.

5.56 Our view is strongly supported by the historical evidence. Prior to the European Commission's intervention, Sky has always won all of the Live FAPL Rights. While the Commitments 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 "contestable", in practice there are significant barriers to other parties winning sufficient rights away from Sky.

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

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relates to 2008/09 to 2011/12. The annual Six Nations rights cost of £40m relates to the period 2010 to 2013 (previously the annual cost was £30m per annum). First Pay TV Consultation, Annex 10, pages 3 and 69.

[294] **[✂]**.

[295] **[✂]**.

[296] **[✂]**.

[297] **[✂]**.

[298] **[✂]**. This document was produced prior to Ofcom's current investigation and we consider that it reliably reflects **[✂]** views at the time.

- In 2006, **[✂]**. However packages C and D are less attractive and, as explained in paragraph 5.28 to 5.31 above, Sky was able to maintain a very high wholesale market share even though it lost both of these packages.
- In 2009, **[✂]**.
- Moreover in 2009 **[✂]** is consistent with our view that Sky is likely to retain the majority of the Live FAPL Rights.

5.58 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 retail subscriber base and the impact of the staggered expiry dates of rights agreements for different sporting contests.

5.59 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 in Annex 8 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 (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.
- A range of bidder specific factors. For example the funding models of free to air broadcasters may make it harder for them to outbid pay TV broadcasters.

5.60 We do not have a settled view on the relative importance of each of these different factors, although as explained in Annex 8 the **[✂]** suggest that the third of these factors may be relatively less important than the others[299]. However we consider that in aggregate these factors contribute to Sky being likely to win the majority of the Live FAPL Rights.

5.61 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.

Live rights to other sports

5.62 As explained in section 4, the relevant market is the wholesale supply of channels regularly 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.

[299] Specifically, if this factor were very important then we would expect Virgin Media to be the second strongest bidder for key rights, since it is vertically integrated with the only retailer on the second largest pay TV platform. **[✂]**.

5.63 However, as explained 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. Moreover, if a third party were to acquire sufficient rights to live FAPL matches, it might not need to acquire the rights to many other sporting contests in order to impose a strong competitive constraint upon Sky's Core Premium Sports channels[300].

5.64 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. In particular, the attractiveness of UEFA Champions League rights is supported by the survey evidence set out in the Second Pay TV Consultation.

5.65 Sky Sports 1 and 2 feature live football, rugby union, rugby league, cricket, tennis and golf. Figure 40 above sets out which broadcaster(s) currently hold the rights to leading live events in these sports, as well as summarising the position in the previous rights agreement and (where known) in any agreements to license these rights in the future.

5.66 The pattern of broadcasters that have won these other live rights is less clear cut than for the Live FAPL Rights and differs between sports. Sky has been fairly successful when bidding for live football rights. Indeed in March 2008, Sky won the rights to an increased number of Champions League matches[301]. However, both FTA and other pay TV broadcasters have also successfully acquired the rights to a number of attractive sporting events (e.g. Setanta and ITV jointly acquired the rights to England international football matches and FA Cup matches)[302]. Sky has a strong track record in winning all the available cricket rights. In contrast, for live golf, rugby union and rugby league the pattern is mixed, with rights being won by the BBC, Setanta and Sky. Compared to the other sports, Sky tends to win relatively fewer rights to tennis tournaments.

5.67 Thus, based on the parties that have won sports rights recently, it is not clear that there are particular obstacles to third parties such as the BBC, ITV or Setanta acquiring the rights to live golf, rugby union, rugby league and (especially) tennis matches. However, crucially in our view, the historical picture suggests that Sky is more likely to be successful in retaining or acquiring live football and (especially) cricket rights.

Countervailing buyer power

5.68 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 in recent years. 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.

[300] Specifically, **[✂]**.

[301] 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 has added to the number of live matches it will broadcast by winning the second pick Tuesday match from ITV.

[302] As explained in paragraph 5.35 above, very few listed events are relevant to this analysis.

5.69 We retain the view set out in the Second Pay TV Consultation that Virgin Media has a degree of CBP in relation to the licensing of Sky Sports and Sky Movies channels. 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.

5.70 However, we also retain our view that Virgin Media's buyer power in relation to Sky's Core Premium Sports channels is limited. In coming to this view, we have taken into account the following evidence:

- First, the importance of Sky's Core Premium Sports channels to Virgin Media's 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 to 3.34, 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 1 (or an equivalent channel provided by ESPN) 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 and since access to Setanta Sports alone 1 is insufficient. As we set out in paragraphs 5.38 to 5.67 above, we believe that there are substantial barriers to entry upstream, such that Virgin Media cannot achieve or sponsor entry quickly. This vulnerability leaves Virgin Media in a comparatively weak position with respect to Sky.

- Second, **[✂]**. Sky has stated **[✂]**[303]. While we accept that the regulatory environment may affect Sky's wholesale pricing structure, and the upper limit of its rates, **[✂]**[304].

- Third, evidence from Virgin Media **[✂]**. This evidence is set out in detail in Annex 8. We would expect the creation of Virgin Media from the merger of NTL and Telewest to have 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, particularly as it has not directly addressed Virgin Media's 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 6.112, 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 some bundles that include Sky Sports and/or Sky Movies (although this is not the case

[303] Sky response dated 29 July 2008 to Ofcom information request dated 2 July 2008.

[304] **[✂]** the bargaining process between Setanta and Virgin Media for cable carriage of Setanta's channels. Documents relating to this process have been provided to Ofcom. These 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.

for all bundles). Virgin Media has not been able to negotiate a wholesale price that enables it to earn a higher margin on 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 6.106, 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[305]. 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.

5.71 In relation to retailers other than those on 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 very quickly agreed wholesale deals with Virgin Media, BT Vision, Tiscali and Top Up TV[306]. We set out the evidence we have reviewed on these negotiations in section 6. 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

5.72 In summary, our view is that Virgin Media is the most likely retailer to exercise CBP over Sky. However, we believe that, while Virgin Media is a significant outlet for Sky, the commercial balance of the relationship appears to be strongly in favour of Sky. We therefore believe that no party exercises sufficient CBP to counter Sky's seller power in the context of Core Premium Sports channels.

Conclusion on the wholesale supply of Core Premium Sports channels

5.73 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. Even under the high threshold established under the Chapter II prohibition of CA98, we consider that Sky holds a dominant position, and that it is likely to be dominant for the next three to four years.

Wholesale Core Premium Movie channels

5.74 A summary of our assessment of market power in the wholesale supply of Core Premium Movie channels is set out below. First, a background section explains which channels lie within the relevant market, summarises our position in the Second Pay

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[305] Our Vertical Arithmetic analysis indicates that failing to reach a wholesale supply agreement with Virgin Media would be costly to Sky, relative to 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.

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

TV Consultation, summarises the further representations that we have received and provides a brief overview of further developments. We then consider the strength of any competitive constraints on suppliers in this market, namely:

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

Background

The channels within the relevant market

5.75 As set out in section 4, we consider that the relevant market is 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[307]. The following channels that are wholesaled by Sky lie within that relevant market: Premiere, Premiere +1, Comedy, Family, Action/Thriller, Sci-Fi/Horror, Drama, Screen 1, Screen 2, Modern Greats and Indie[308], and HD versions of these channels. We consider that Disney Cinemagic also lies within the relevant market since it broadcasts animated films in the first pay TV window that were produced by Disney.

Our position in the Second Pay TV Consultation

5.76 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 held market power and was likely to hold that position in the 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 somewhat, to include for example pay-per-view ("PPV") movies or DVD rental subscription 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.

[307] 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.

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

- 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.

5.77 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.

<u>Overview of the further representations received on the approach to assessing wholesale market power</u>

5.78 Sky considered that the rights to movies were "contestable". As discussed in section 4, Sky highlighted a number of changes such as to the windowing of films and increasing penetration of new ways of viewing 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 these changes have reduced the number of subscribers to Sky Movies as well as Sky Movies' share of viewing amongst subscribers to that channel since 2006. Sky also stated that the real price of Sky Movies has fallen since late 2006.

5.79 The Four Parties broadly agreed with the approach in the Second Pay TV Consultation to market definition and the assessment of market power.

5.80 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 was a barrier to entry. Virgin Media 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.

5.81 **[✂]** 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.

5.82 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>

5.83 Since the publication of the Second Pay TV Consultation, **[✂]**.

Existing competitors

<u>Existing competitors within the relevant market</u>

5.84 We have updated our market share calculations to take into account the inclusion of Disney Cinemagic within the relevant market. These market shares were calculated based on wholesale revenues and include an estimate of the revenues that Sky earns from the self supply of Sky Movies to its own retail arm. We estimate that in the second half of 2007 and in 2008, Sky had a wholesale market share of approximately

[✂]% [90-100%][309]. This is well above the 50% threshold at which dominance under a CA98 analysis can be presumed, in the absence of evidence to the contrary. Disney accounted for the remaining **[✂]**% [0-10%] share. 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 paragraphs 4.256, 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 channels.

Out of market constraints

5.85 As explained in paragraph 4.377, we recognise that there is 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 they do not lie within the relevant market, but they nonetheless are moderately close substitutes for Sky Movies channels.

5.86 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. 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.

5.87 First, we have calculated market shares taking into account three other ways in which consumers can pay to watch movies: (i) PPV movies; (ii) online DVD rental services (such as Lovefilm); and (iii) legal movie downloads (to rent or own). These market shares were calculated based on revenues earned by these various services[310].

Figure 42 Wholesale market shares in 2008 including moderate 'out of market' constraints (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

5.88 Second, we have calculated market shares taking into account movies screened on other channels. These market shares were calculated based on broadcasters'

[309] If Sky's wholesale revenues are calculated using the incremental wholesale price of Sky Movies then Sky's market share remains extremely high (around **[✂]** [90-100%]). See Annex 8 for further details.

[310] In particular, we calculated these figures using the retail revenue generated from PPV movies, online DVD rental packages and legal movie downloads, rather than the wholesale revenues associated with these services. This is likely to overstate their wholesale market share.

expenditure on rights to movies, including less recent films such as library films[311]. These figures do not include Disney Cinemagic.

Figure 43 Wholesale market shares including moderate 'out of market' constraints (calculated using expenditure on rights to movies)

	Sky	BBC	ITV	Channel 4	Channel 5	Basic channels
2007	[50-60]%	[✂]%	[✂]%	[✂]%	[✂]%	[✂]%
2008	[50-60]%	[✂]%	[✂]%	[✂]%	[✂]%	[✂]%

Source: Ofcom calculations

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

5.90 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 there is no difference in the strength of our reasoning on the extent to which these products are substitutes. 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%])[312]. However we do not place significant weight on this figure. This is because DVD sales are a more 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 to 4.335).

5.91 Sky argued that focusing on putative market shares understates the extent of the competitive constraints on its channels. As discussed in section 4, 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.

[311] Use of this proxy for the attractiveness of films avoids the difficulties in identifying the revenue attributable to movies for free to air broadcasters or broadcasters for whom movies is only a small proportion of their output.

[312] DVD retail sales in 2008 were £2.27bn. Source: BVA Yearbook 2009, British Video Association, page 28.

5.92 We recognise that Sky's market share is declining. However, 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.

5.93 We also accept that looking at market shares alone might not be a reliable guide to market power[313]. 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. First, the moderate substitutes set out above lie outside of the relevant market (for the reasons set out in section 4, 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 understate it. Second, 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.

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

<u>Conclusion on existing competitors</u>

5.95 Sky's very high market share indicates that it holds a position of market power. Under a CA98 analysis it would create a (rebuttable) presumption that it enjoys a dominant position. If this share is retained over the next three to four years, we would expect any dominance to be retained over that period. Our conclusions take into account the constraint imposed by 'out of market' products. Under alternative market definitions that include moderate substitutes Sky's market share remains above the 50% threshold that the ECJ has stated is associated with a presumption of dominance (in the absence of evidence to the contrary). Moreover we recognise that these alternative market share figures will overstate the strength of the competitive constraint exercised by these 'out of market' products and thus understate the extent of Sky's market power.

Potential competitors: barriers to entry and expansion

5.96 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")[314].

5.97 Our analysis thus focuses on whether there are obstacles to acquiring the Movie Rights. Below we explain:

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[313] OFT Market Power Guidelines, paragraph 4.3.

[314] As explained in paragraphs 4.323 to 4.324, 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.

- The sale process for the Movie Rights.
- Why, in order to materially undermine its 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

5.98 The Movie Rights are sold following negotiations between interested parties and each individual rights holder. 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 broadcast a particular film in the first TV subscription window.

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

5.99 Under this framework we therefore consider 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 Movie channels. As explained in paragraph 5.47 above, under this framework we therefore consider whether potential competition is sufficiently strong to undermine the dominant position suggested by Sky's market shares. Given Sky's high current market share, this requires that Sky loses a large proportion of the rights it currently holds as a result of entry. For example, even if a new entrant acquired the Movie Rights from one or perhaps two of the smaller Major Hollywood Studios, then this might only reduce Sky's market share by some 10-25% (see Annex 8). Thus, even if entry on this scale were viable it is unlikely to be sufficient to materially undermine Sky's wholesale position.

5.100 Accordingly we consider that Sky's wholesale position would not be materially undermined unless Sky lost the majority of the Movie Rights. It is difficult to be precise about what is meant by "majority" in this context, particularly as the importance of a Major 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 over 50% of the rights, measured by the Major Film Production Groups' box office receipts[315]. 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.

Sky is likely to win the majority of the Movie Rights

5.101 In principle, as Sky's current contracts 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.

5.102 Our view is strongly supported by the historical evidence. Sky has always won the overwhelming majority of the Movie Rights. The only other broadcaster that has won

[315] 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 5.85 to 5.94 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.

these rights (Disney Cinemagic) is vertically integrated with the rights holder. We regard this as clear evidence that, contrary to Sky's claims that these rights are "contestable", in practice there are significant barriers to other parties winning sufficient rights away from Sky.

5.103 Further evidence that new entrants are not in a position to outbid Sky is provided in internal documents. **[✂]**[316].

5.104 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 in Annex 8 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 being vertically integrated with retailers with a significant subscriber base; and
- Bidder specific factors.

5.105 We do not have a settled view on the relative importance of each of these different factors, although as explained in paragraph 5.60 above and Annex 8 the **[✂]** suggest that the third of these factors may be relatively less important than the others. However we consider that in aggregate these factors contribute to Sky being likely to win the majority of the Movie Rights. These factors also suggest that there are significant barriers to a Major Film Production Group exploiting its rights directly, for example by developing its own movie channel.

Conclusion on barriers to entry and expansion

5.106 In conclusion, our current view is that it is likely that Sky will continue to win the majority of the Movie Rights as and when they become available. As a result, Sky's position in the wholesale supply of Core Premium Movie channels is unlikely to be undermined by potential entrants.

5.107 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

5.108 The only major independent purchaser of the 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

[316] **[✂]**.

and potential) are likely to exert sufficient CBP to offset Sky's seller power over the next three to four years.

5.109 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)[317]. We therefore believe that no party exercises sufficient buyer power to counter Sky's seller power in the wholesale supply of Core Premium Movie channels.

Conclusion on the wholesale supply of Core Premium Movie channels

5.110 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. Even under the higher threshold established under the Chapter II prohibition of CA98 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.

Introduction to the assessment of retail market power

5.111 Sky considered that the scope and the extent of competition within the relevant downstream market(s) were important. Similarly, the Four Parties considered that the Second Pay TV Consultation made a material omission in failing to assess market definition and market power in relation to the supply of premium channels at the retail level. These representations are summarised and addressed in section 4.

5.112 We have considered the extent to which any party holds market power in the relevant retail markets defined in section 4 above, namely:

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

5.113 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.

[317] As well as the material on CBP presented in relation to Core Premium Sports channels, we have also taken some additional documentary evidence into account in reaching our conclusion on CBP in relation to Core Premium Movie channels. That material is set out in Annex 8.

The ability to sustain retail prices appreciably above the competitive level

5.114 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). We have thus considered whether Sky possesses market power at the retail level, applying this standard approach.

The ability to sustain retail margins appreciably above the competitive level

5.115 In its response to the First Pay TV Consultation, Sky referred to the "double counting" of market power by Ofcom. For example, Sky considered that, in the First Pay TV Consultation, Ofcom 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.

5.116 We agree with Sky that, given the structure of the pay TV industry, such "double counting" risks giving a misleading impression about the source of market power. Where a firm is vertically integrated and in a position of market power at the wholesale level it may well choose to earn any excessive returns at the wholesale level, rather than at the retail level[318]. It would do this by setting a high 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[319].

5.117 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.

5.118 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 can be thought of as asking whether Sky

[318] 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 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.

[319] 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 those 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.

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.

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

5.119 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. We identify factors that are relevant to this question. We refer to these factors in section 10 as part of our assessment of remedies. 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[320].

Retail television bundles containing Core Premium Sports channels

5.120 At least until very recently Sky, Virgin Media, Setanta, Top Up TV and BT Vision retailed Core Premium Sports channels[321] [322]. Sky retails Sky Sports 1 and 2 on its DSat platform[323]. 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).

5.121 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);

[320] For the avoidance of doubt, we do not consider that this 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.

[321] 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.

[322] 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.

[323] Sky also directly retails its channels over Tiscali's IPTV platform.

- Second, consider whether Sky has the ability to charge a retail margin that is appreciably above the competitive level; and
- 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

5.122 In the First Pay TV Consultation we considered whether Sky had the ability to sustain retail prices appreciably above the competitive level and concluded that it was likely that Sky was dominant in the "retailing of premium sports packages" (Annex 13, paragraph 5.38).

Current retail market shares

5.123 We have calculated market shares as a proportion of the retail 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. These are summarised in Figure 44 below (in this figure, we have aggregated the negligible retail market shares of Setanta, Top Up TV and BT Vision). These market shares were calculated based on the revenue earned from retail television bundles containing Core Premium Sports channels. We have included the entire revenue earned from a retail television bundle, including any mandatory non-television components[324]. 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 44 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

5.124 Sky accounts for a very high proportion of the revenue earned from the supply of retail television bundles containing Core Premium Sports channels, with Virgin Media being the only other retailer with a material market share.

[324] 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 sports mix package and one basic mix (for a price of £35.50/month) we have used the entire retail price of that bundle. We have not included revenue from certain add-ons to this package such as multiroom. 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.

Retail market shares including 'out of market constraints'

5.125 As explained in section 4, on balance we took the view that only retail television bundles including Sky Sports 1 and 2 and Setanta Sports 1 lay within the relevant market. However we recognised that there was nonetheless a degree of substitutability with channels outside 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.

5.126 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 (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 45 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 44 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 45 Market shares in the retail supply of sports channels, including moderate 'out of market' constraints (calculated using expenditure on relevant sports rights)

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

Source: Ofcom calculations

5.127 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 depressed the market share of retailers that supply much smaller bundles, such as Setanta).

Barriers to entry and expansion

5.128 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/ESPN. 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.
- IPTV.

5.129 However, currently Sky only supplies its Core Premium Sports channels to itself and retailers using cable as a distribution technology. As discussed in section 6, retailers using IPTV and DTT as a distribution technology have been unable to reach an agreement with Sky to retail 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.

5.130 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. Moreover establishing a new cable network would be time consuming and extremely costly.

5.131 In contrast, Setanta reached agreements with a number of retailers using a variety of distribution technologies, and ESPN has announced its intention to do the same. There thus seemed to be few barriers to acquiring access to Setanta Sports 1 (or an ESPN equivalent in future) 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).

5.132 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 5.30 to 5.31 above and as demonstrated by the relative wholesale market shares of Sky and Setanta, 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) 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 retailing Setanta Sports 1) have been able to secure, as shown in Figure 44 and Figure 45 above[325].

Countervailing buyer power

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

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

5.134 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

[325] Moreover, as discussed in paragraphs 5.151 to 5.153 below, entry by retailers using DSat, IPTV or DTT as a distribution technology is costly and it is not clear whether further event is actually likely.

which dominance can be presumed under a CA98 analysis, in the absence of evidence to the contrary. 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[326]. 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.

5.135 However, it is important to recognise the limitations of this conclusion. As explained in paragraphs 5.115 to 5.118 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 wholesale supply of Core Premium Sports channels is characterised by Sky's dominance which gives Sky the ability to exercise its market power at the wholesale level rather than the retail level (for example by using high wholesale prices to raise retail prices, rather than by the exercise of retail market power). 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. Rather those competition concerns centre on Sky's conduct at the wholesale level.

The ability to sustain retail margins appreciably above the competitive level

5.136 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.

5.137 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, **[✂]**[327]. 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 from consumers it supplies indirectly via Virgin Media as well as the consumers it directly supplies.

5.138 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.

[326] See also the discussion of switching costs in paragraphs 5.142 to 5.146 below.

[327] Sky response dated 28 July 2008 to Ofcom's information request dated 2 July 2008, paragraph 9.

Extent of retail competition absent the exercise of wholesale market power

5.139 Amongst other things, the discussion above highlights:

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

- That 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.

5.140 This raises the question of what would be the extent of retail competition if these factors were not present i.e. if Sky did not exercise its wholesale market power. 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 mute retail competition)? Similarly, are there other material barriers to entry, apart from wholesale access to Sky's Core Premium Channels (which is relevant to whether additional entry would occur, if potential entrants could obtain wholesale access to Sky's channels)?

5.141 Below we discuss the following factors:

- Switching costs between retailers;

- The extent of product differentiation between retailers; and

- Additional barriers to entry.

<u>Switching costs</u>

5.142 In terms of the first of these factors, namely switching costs between retailers, we stated in the First Pay TV Consultation and Second Pay TV Consultation that these costs will vary depending on which retailer a customer is switching from and which retailer a customer is switching to.

- We stated that 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 the Second Pay TV Consultation we noted the delay that Setanta has experienced in building up its subscriber base and concluded that it might reflect two factors: first, consumer inertia and the tendency of some consumers to hesitate before taking up a new service; and second, 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 still when the process of 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:

    - o We considered that retail customer switching costs to Sky's DSat service or Virgin Media's cable service were high. In particular, the First Pay TV Consultation referred to set-top box costs, installation costs and the possible inconvenience associated with the installation process (such requiring a visit by an engineer).

- o In contrast, we stated that the switching to some of the newer platforms might be somewhat less costly. IPTV or DTT-based platforms involve fewer additional changes in hardware than cable and satellite. IPTV-based platforms use the existing telephone line and DTT-based platforms use the existing aerial.

5.143 Finally, 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, so consumers 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. The finding that bundling creates additional barriers to switching is supported by more recent Ofcom research[328].

5.144 Research for Ofcom also found some evidence that customers' perceptions were a barrier to switching, although not exclusively and in varying degrees. Survey evidence indicates that, in the case of multichannel TV, consumers that have actually switched regard 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.

5.145 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[329].

5.146 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. 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[330].

[328] For example, qualititative research for Ofcom found that respondents largely looked to switch their services as a bundle rather than to unbundle and revert to using individual suppliers for each service. This research implied that that the more services that were bundled, the less interest in switching. *The consumer experience, 2008 research report*, Ofcom ("Consumer Experience 2008"), page 96 available at: http://www.ofcom.org.uk/research/tce/ce08/research.pdf

[329] Consumer Experience 2008, Figure 10 on page 14.

[330] Of multichannel TV consumers that had switched supplier, in 2008 66% reported that it was "very easy" and a further 23% reported that it was "fairly easy". Only a total of 6% reported that it was "fairly difficult" or "very difficult". In contrast, of consumers who had not switched supplier the respective figures are 24%, 37% and 20% (with 19% responding "don't know"). Consumer Experience 2008, figure 132 on page 99 and figure 133 on page 100.

Production differentiation

5.147 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 a 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[331].

Barriers to entry

5.148 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:

- Cable.
- Sky's DSat platform.
- A DSat platform other than Sky's.
- DTT.
- IPTV.

5.149 As discussed in paragraph 5.130 above, in practice we do not consider that further entry using a cable as a distribution technology is likely.

5.150 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.

5.151 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

[331] Product differentiation is relevant to the consequences 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.

5.152 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 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 [332].

5.153 The ITV-Sky CC Report found that entry by IPTV retailers using local loop unbundling involved substantial investment costs (paragraph 4.96). Orange previously announced that it intended to launch an IPTV service (originally in 2007), **[✂]**[333]. **[✂]**.

5.154 As discussed in paragraph 9.34, 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 over new entrants that only retail Core Premium Sports channels. Accordingly, new entrants may seek to also supply a range of services.

Conclusion

5.155 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). 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 no longer exercised 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

5.156 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[334].

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

[332] 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.

[333] **[✂]**.

[334] Sky also directly retails some of its movie channels over Tiscali's IPTV platform.

- 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

5.158 In the First Pay TV Consultation we considered whether Sky had the ability to sustain retail prices appreciably above the competitive level and concluded that it was likely that Sky was dominant in the retail supply of "packages containing premium movie channels" (Annex 13, paragraph 5.63).

Current retail market shares

5.159 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 46 below. These market shares were calculated based on the revenue earned from retail television bundles containing Core Premium Movie channels. We have included the entire revenue earned from a retail television bundle, including any mandatory non-television components.

Figure 46 Market shares in the supply of retail television bundles containing Core Premium Sports channels (calculated on a revenue basis)

	Sky	Virgin Media
2H 2007	[90-100]%	[0-10]%
1H 2008	[90-100]%	[0-10]%
1H 2008	[90-100]%	[0-10]%

Source: Ofcom calculations

5.160 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'

5.161 As explained in paragraph 4.377, certain other ways of viewing movies may constrain Sky to a degree. In particular PPV movies, DVD rental subscription packages and library films may be moderate substitutes for retail bundles containing Sky Movies. In order to understand the extent of the constraint imposed by these 'out of market' products, we have calculated market shares as if this 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 somewhat outside of the relevant market but that may nonetheless act as (imperfect) substitutes.

5.162 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 Core Premium Movie channels as well as the revenues generated from the various 'out of market' products. Note that Sky's market shares will tend to be higher than in the corresponding wholesale calculations set out in Figure 42 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 Sports channels.

Figure 47 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	Virgin Media	Others
Including PPV	[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

5.163 Second, in Figure 43 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 proportion set out in Figure 46 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 48 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

5.164 Taking moderate 'out of market' substitutes 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 5.89 above, 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.

5.165 As noted in paragraph 5.91 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 5.93 above.

Barriers to entry and expansion

5.166 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 5.128 to 5.132 above also applies here.

5.167 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, 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.

5.168 Moreover, as explained 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, 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 of Sky Movies, and thus on retailers of Sky Movies, is demonstrated by the relative wholesale market shares of Sky and Disney (see paragraph 5.84 above).

Countervailing buyer power

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

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

5.170 Sky enjoys a high retail market share in the retail supply of bundles containing Core Premium Movie 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. The exception is one of the measures that includes moderate 'out of market' constraints, where Sky's market share is **[✂]**% [40-50%]. 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[335]. 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.

5.171 The caveats set out in paragraph 5.135 above, as part of the assessment of retail television bundles containing Core Premium Sports channels, also apply here.

[335] See also the discussion of switching costs in paragraphs 5.142 to 5.146 above.

The ability to sustain retail margins appreciably above the competitive level

5.172 In paragraphs 5.136 to 5.138 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.

5.173 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.

Extent of retail competition absent the exercise of wholesale market power

5.174 In paragraphs 5.142 to 5.155 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.

5.175 The analysis of Core Premium Movie channels does however differ in one important respect to the equivalent analysis of Core Premium Sports, 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 of 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 6

Competition issues

Summary

6.1 We have three concerns arising from Sky's market power.

6.2 Firstly, we are concerned that Sky, as a vertically integrated firm, with market power in a key upstream market, distributes its Core Premium channels in a manner that favours its own platform and its own retail business. It does so either by denying these channels to other retailers and / or other platforms, or by making it available on unfavourable terms. The effect can be to reduce consumer choice, and to inhibit the growth of innovative pay TV services. The increased importance of 'triple-play' bundles creates a further risk that this distortion will extend to the other services which are included in such bundles, notably broadband and telephony services. Sky's approach to the supply of Core Premium channels creates a position under which there is not, and there is not likely to be, fair and effective competition.

6.3 Secondly, we are concerned that Sky is setting high wholesale prices for its channels in order to maximise wholesale profits. This can have the effect of keeping retail prices high.

6.4 We are also concerned about the unavailability of services based on particular types of subscription VoD rights, as a particular case of Sky favouring its own platform and retail business.

Introduction

6.5 In our Second Pay TV Consultation, we consulted on our conclusion that Sky had market power in the wholesale of Core Premium Sports channels and Core Premium Movie channels. Our view was that Sky was dominant and was likely to be dominant in those relevant markets for at least the next three to four years. Our analysis suggested that entry barriers were such that market power was likely to persist for the foreseeable future. We acknowledged that if the rights ownership situation were to change significantly in the future, our assessment of market power would be subject to revision.

6.6 As described in Section 5 above (paragraph 5.110), our current view remains that Sky has market power in the wholesale supply of Core Premium channels, and that market power is likely to continue for the foreseeable future. We therefore consider that Sky holds a degree of market power such that it has the ability to act in a manner which is inconsistent with the conditions for ensuring fair and effective competition.

6.7 We explained in our Second Pay TV Consultation how we thought Sky could exploit its market power. We then consulted on the evidence associated with our two primary concerns:

- A risk that Sky, as a vertically integrated firm, with market power in a key upstream market, would distribute its premium channels in a manner that favours its own platform and its own retail business. It might do so either by denying these channels to other retailers and / or other platforms, or by making it available on unfavourable terms.

- A risk that Sky would set high wholesale prices for its channels in order to maximise wholesale profits.

6.8 We deal with each of these points in turn below. We consider whether Sky has the ability and the incentive to act in a manner that is not consistent with fair and effective competition in the wholesale of Core Premium channels and the retail supply of bundles which include Core Premium channels.

6.9 We also consider as a third possible concern the unavailability of services based on particular types of subscription VoD rights, as a particular case of Sky favouring its own platform and retail business.

Distribution of Core Premium channels

Introduction

Our views in September

6.10 In relation to the first of our concerns – the restricted distribution of Core Premium channels – we believed that the decisions Sky faced with respect to wholesaling were: whether to engage in wholesale supply of its Core Premium channels to companies who were seeking such supply; if so, what terms to offer; whether to continue to wholesale its Core Premium channels to companies (particularly Virgin Media) with which it had a wholesale arrangement, and, again, the terms (price and non-price) of supply to those companies.

6.11 Although Sky's Core Premium channels are provided on a wholesale basis to Virgin Media, we noted that the combination of wholesale charges and incremental retail price made it incrementally unprofitable for Virgin Media to encourage existing basic subscribers to upgrade to Core Premium channels. Virgin Media therefore had no incentive to market Sky's Core Premium Channels actively to those customers. However, if Virgin Media were to stop selling premium channels it would risk losing a proportion of its subscriber base for whom those channels are particularly important.

6.12 We also believed that Sky had the incentive to restrict the supply of its Core Premium channels to other retailers and other platforms, and we further believed there was evidence which suggested that Sky was acting on that incentive:

- A number of new entrants, seeking to establish new retail businesses and / or new platforms, had sought to purchase access to Sky's premium channels on wholesale terms, but none of these had been successful. Having reviewed the available correspondence between those new entrants and Sky, we concluded that no commercially agreed wholesale deals appeared imminent, despite evidence of negotiations going on for several years.

- We analysed the incentives we believed Sky faced to wholesale its channels to competing retailers and / or on competing platforms. Our conclusion was that there were a number of incentives which might motivate Sky against supplying other retailers at a wholesale price which those other retailers were prepared to pay.

- We recognised that Sky retailing its channels directly to other platforms was likely to improve the availability of Sky's channels. We also recognised that Sky might have the ability to retail its channels as effectively on other platforms as it did over its own platform. However, while we believed that Sky would prefer to retail rather than wholesale its channels on other platforms, we did not believe that it had the incentive to retail on those platforms as effectively as on its own platform. That view was supported by the available evidence, which suggested that where Sky did retail on other platforms, using its 'Sky by Wire' service, the resulting retail offering was of lower quality, was sold at a higher price than similar offerings on its own platform, and had been taken up by only a small proportion of potential subscribers.

Consultation responses

Negotiations over possible supply/current distribution of Sky's channels

6.13 Sky did not accept that there was any evidence that it had restricted supply of its premium channels, and argued that it had not refused to supply its premium channels to retailers on new platforms. Sky also argued that there was no evidence to suggest that it had an incentive to restrict supply. Sky therefore saw no grounds upon which Ofcom could properly find that Sky was more likely than not to restrict the supply of its premium channels in the future[336].

6.14 Sky also criticised Ofcom's analysis of the possible explanations for a failure to reach agreement, on the grounds that it was far too narrow and ignored other much more plausible explanations[337]. Sky argued that it was restricted from offering new retailers terms which were below the price at which it wholesales to Virgin Media, as such discrimination might constitute anti-competitive behaviour[338]. Sky pointed out the possibility that new entrants were engaged in regulatory gaming[339]. Referring to its negotiations with BT on wholesale access, Sky said that Ofcom could not ignore the fact that BT's failure to agree to the terms might be explained by BT's desire to seek to secure more favourable terms via a regulatory route[340]. Sky claimed that none of the new entrants currently had any means by which to distribute Sky's channels, and as it has not been able to broadcast its channels on DTT it had no means by which it could offer its channels to any of the DTT retailers for distribution[341].

6.15 The majority of respondents agreed with our analysis. A number, including Virgin Media, the BBC and **[✂]**, expressly stated that retailers and platform operators could not get sufficient access to Sky's premium sports and movies channels. **[✂]** noted that Sky's premium channels were currently provided on a wholesale basis to Virgin Media, but said that the rate-card charged by Sky, combined with the incremental retail price, generated higher like-for-like retail prices for cable subscribers than those for Sky.**[342]** **[✂]** pointed out the difficulties Sky's competitors,

[336] Sky response, Section 3, paragraphs 4.2 to 4.4.

[337] Sky response, Section 5, paragraph 2.36.

[338] Sky response, Section 5. paragraph 2.34.

[339] Sky response, Section 5, paragraph 2.37.

[340] Sky response, Section 1, page 10.

[341] Sky response, Section 5, paragraph 2.39, 2.41.

[342] However, it is not clear from our analysis that the retail prices of Sky premium channels differ between DSat and cable.

notably BT Vision, Top Up TV and Tiscali, had faced in trying to reach wholesale agreements with Sky for its pay TV channels. **[✂]**"[343].

6.16 In its response, Virgin Media said that Sky has limited the distribution of those channels to other retailers (either by refusing to supply the relevant channels or by supplying them only on uneconomic terms)[344].

6.17 Virgin Media agreed with Ofcom's pictorial representation of the distribution of Sky's premium sports and movies channels, and noted that Sky also distributed individual movies via its PC VoD service, SkyPlayer, as part of its Sky Movies package (supplied to DSat subscribers only)[345]. Virgin Media also pointed out that we had not explicitly recognised that Sky had also refused to supply to Virgin Media:

- Sky Sports and Sky Movies on a wholesale basis for Virgin Media's off-net IPTV service.
- HD and interactive enhanced features related to Sky's premium sports and movies channels[346].

Incentives to supply

6.18 Sky asserted that Ofcom's conclusion appeared to rely almost entirely on its analysis of Sky's incentives to (continue to) supply its premium channels to Virgin Media[347]. It also argued that Ofcom's focus on Sky's incentives to supply its premium channels to Virgin Media, via the construction of hypothetical spreadsheet models, was perverse, and the conclusion it drew from those models was misguided[348]. Sky suggested that the prospect of Sky withdrawing its premium channels from Virgin Media was remote[349] and that Ofcom's analysis failed to consider real-world facts[350]. Sky pointed out that it supplied cable operators prior to a regulatory obligation to do so, that it would be subject to significant regulatory risk if it were to withdraw its premium channels from Virgin Media without objective justification, and that such withdrawal would result in immediate commercial loss and adverse publicity[351].

6.19 Sky also argued that Ofcom should have focussed on Sky's incentives to supply retailers on new platforms[352] and that there was no reason to presume that Sky had a

[343] **[✂]** confidential response, paragraph 6.1 (no non-confidential response supplied).

[344] Virgin Media response, paragraph 1.1

[345] Virgin Media response, Annex 1, paragraph 15.2.

[346] Virgin Media response, Annex 1, section 15.4.

[347] Sky response, Section 5, paragraph 2.4.

[348] Sky response, Section 5, paragraph 2.5.

[349] Sky response, Section 5, paragraph 2.7.

[350] Sky response, Section 5, paragraph 2.6.

[351] Sky response Section 5, paragraph 2.6.

[352] Sky response Section 5, paragraph 2.8.

greater incentive to refuse to supply new or smaller pay TV retailers than it did to withdraw its premium channels from Virgin Media[353]. Sky argued that the outcome of Ofcom's own vertical arithmetic analysis of supply on DTT supports its position that it has an incentive to supply[354].

6.20 Sky also criticised Ofcom[355] for setting out in Second Pay TV Consultation two possible explanations for a failure to supply – i.e. Sky intentionally withholding supply, and Sky not being willing to lower the price to a level that any retailer would be prepared to pay – and not properly analysing how the reasons for a failure to supply might affect possible remedies. Sky argued that if the reason why supply is not occurring is attributable to the inefficiency of other retailers then it would clearly be disproportionate to remedy this by imposing a burden on Sky.

6.21 Sky criticised the part of Ofcom's "vertical arithmetic" model which analysed the effects on Sky's revenues on supplying or withdrawing supply from Virgin Media[356]. Among other points, Sky argued that:

- **[✂]**.
- **[✂]**.
- Even if long-term switching were to occur, withdrawal of supply would be initially loss-making, and would only be profitable over a long time, which would not be attractive to Sky given market uncertainty.
- The figures in the model indicated a net increase in premium channel subscribers if it withdrew supply, which was unlikely in practice.

6.22 Other respondents broadly agreed with our assessment of Sky's incentives to wholesale its channels to other retailers.

- The BBC said that there were a number of incentives which might motivate Sky against supplying its channels to competing retailers and/or competing platforms, in particular the desire to prevent the emergence or growth of potential retail or platform competitors. The BBC also said that where Sky supplied Virgin Media with wholesale channels, it had an incentive to provide the lowest acceptable quality, and not to provide any additional features. This was because Sky had a strong incentive to ensure that consumers wishing to access Sky's premium channels got a better deal, both in quality and price terms if they did so through Sky satellite platform rather than through any other pay TV platform. [357]
- BT supported our position that due to its vertical integration Sky has limited incentives to wholesale those channels to third parties on any basis that allows

[353] Sky response Section 5, paragraph 2.9.

[354] Sky response, Section 5, paragraph 2.8.

[355] Section 5, paragraph 2.31, page 69.

[356] Section 5, paragraph 2.11, pages 64 to 66.

[357] BBC response, page 4.

for those third parties genuinely to compete and thus deliver benefits in terms of lower prices and innovation[358].

- BT recognised the complexity of trying to capture many potential impacts in terms of incentives of supply. It said the prevention of downstream competition had long-term impacts upstream that were very difficult to quantify. BT said that Ofcom might understate the incentives for Sky not to provide wholesale services[359].

- In its submission, Tiscali agreed that Sky had incentives to favour its own retail operation and noted that there had been no extension to Sky wholesaling beyond the existing arrangement with Virgin Media despite negotiations with other parties going on for some time[360].

- Virgin Media said that Sky had no incentive to engage in constructive and timely commercial negotiations, and could be expected to adopt every strategy at its disposal to delay and limit the development of retail competition[361].

6.23 A large number of respondents shared Ofcom's view that it was important for multiple operators to have wholesale access to premium channels, rather than Sky retailing on others' platforms.

- Tiscali, which carries Sky by Wire, noted that the Sky by Wire retail arrangement did not work for alternative suppliers and was not a satisfactory way to address Sky's position in premium content broadcasting. Sky exercised too much restriction over the packaging of Sky by Wire services and priced them too highly for them to achieve any significant take-up in the market[362].

- **[✂]** also believed that a retail agreement with Sky would undermine its ability to compete effectively against Sky, in particular because of the inability to package and price channels in a differentiated way which might challenge Sky's retail supply[363].

- The ALMR agreed with Ofcom's conclusion that Sky had an incentive to restrict content[364].

Our current view

6.24 We begin by setting out the background and current situation regarding supply of Core Premium channels by Sky. Sky currently only wholesales these channels to cable firms, primarily Virgin Media. We analyse:

[358] BT response, Q18.

[359] BT response, Q19.

[360] Tiscali response, page 1 (non confidential version).

[361] Virgin response, paragraph 6.1 (a) (non confidential version).

[362] Tiscali response, page 1 (non confidential version).

[363] **[✂]** confidential response page 12 (no non-confidential response supplied).

[364] ALMR non-confidential response, page 2.

- Wholesale supply of Core Premium channels to new entrants:
  - We review negotiations between Sky and new entrants for the supply of Sky's Core Premium channels. Compared to the case of Setanta, Sky's negotiations with other retailers have markedly failed to lead to agreement.
  - We therefore consider possible reasons for this, particularly Sky's commercial and strategic incentives to withhold supply.
  - Next we consider the important distinction between wholesale and retail supply to other platforms by Sky, and consider whether our concerns would be met by Sky retailing its Core Premium channels on other platforms.
- Wholesale supply of Core Premium channels to Virgin Media:
  - We discuss our revisions of our Vertical Arithmetic model following responses to the Second Pay TV Consultation.
  - We consider Sky's reasons for supplying Virgin Media and review relevant internal documents.
  - Next, we consider the terms of Sky's supply to Virgin Media – how these are set, and their effect on Sky's incentives.
  - We consider Sky's non-supply to Virgin Media of additional services such as HD.
  - Then we consider the outcomes of Sky's policy towards Virgin Media, in terms of the relative lack of success of Core Premium channels on Virgin Media compared to on DSat.
- The supply of Core Premium channels to commercial premises.

Background

6.25 Sky first entered into commercial deals with cable operators for the supply of its sports and movies channels in the early 1990s.

6.26 In 1996, the Director General of Fair Trading (the "Director") conducted a review under the Fair Trading Act 1973 of the wholesale pay TV market following complaints raised by some cable operators. The Director concluded that premium programming rights gave Sky a powerful position in the wholesale pay TV market and that Sky's acquisition of premium programming had created a barrier to entry into the market. The Director also concluded that Sky was dominant in the supply of sports channels in the UK pay TV market. To meet the Director's concerns, Sky gave the Director non-statutory undertakings (the "1996 Undertakings") in July 1996 regarding the terms it offered to cable operators for supplying its channels. Sky undertook to supply certain channels separately, and to publish a rate-card showing its wholesale prices for cable companies, with a discount structure approved in advance by the Director.

6.27 Following a 2002 investigation under the Competition Act 1998, the Office of Fair Trading (the "OFT") decided[365] that there were insufficient grounds to find that Sky

[365] CA98/20/2002, 17 December 2002.

had abused a dominant position by exercising a margin squeeze on distributors of its premium channels. Since 2002, Sky has continued to supply cable operators at a price which it believes is compliant with the test laid down by the OFT (see paragraph 6.109).

Current situation

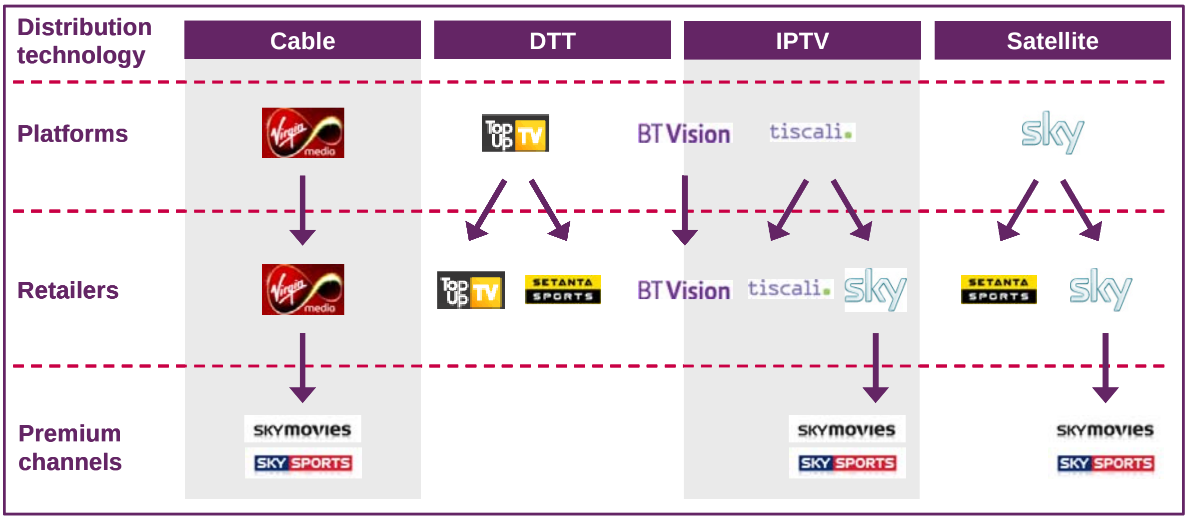
6.28 Our Second Pay TV Consultation [366] noted that Sky's premium channels were available through three routes:

- Directly from Sky as a retailer on DSat.
- On cable via retailers Virgin Media, Wight Cable and Smallworld.
- On Tiscali's IPTV network, but retailed by Sky.

6.29 They are now additionally available from Sky as a retailer via Sky Player over the internet. Sky has conducted negotiations with various other parties for the provision of its Core Premium channels in recent years, but none of these negotiations has led to an agreement for either wholesale or retail supply.

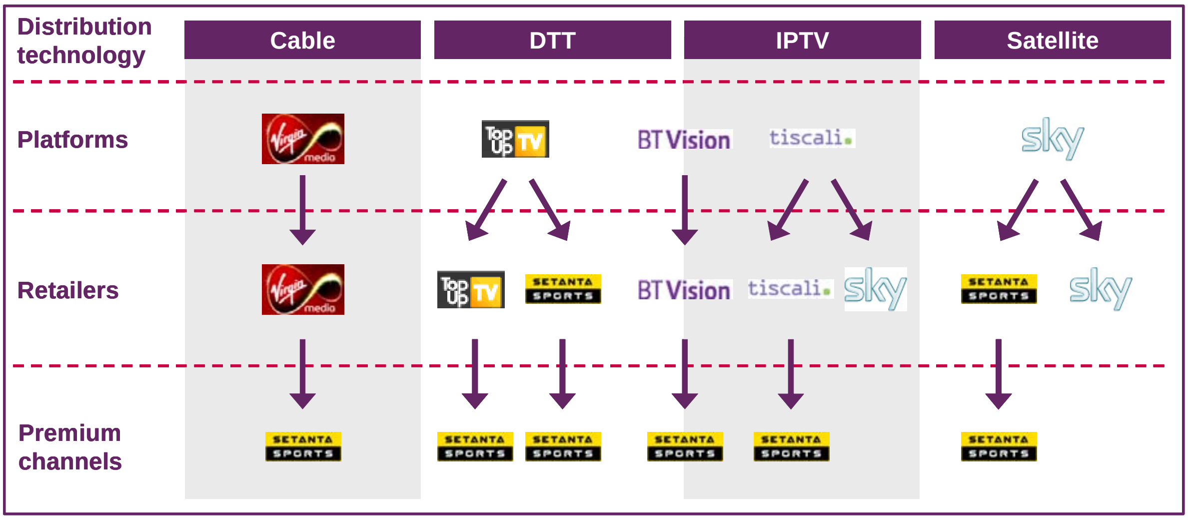
6.30 Figure 49 below shows the various major platforms and retailers, where Sky premium channels are available and through which retailers. Figure 50 below that shows the same information for Setanta's premium channels. As the figures show, Sky's premium channels are available through two major retailers, whereas Setanta's channels were made available through five different major retailers. ESPN has announced a similar intention to make its channel including live FAPL widely available.

Figure 49 Distribution of Sky premium channels



366 Paragraph 6.22.

Figure 50 Distribution of Setanta premium channels



6.31 In addition to residential supply, pay TV services including Sky's Core Premium channels are also supplied to commercial premises – mostly pubs and clubs, but also hotels, offices and holiday parks, among others. These channels are not available to commercial premises on other platforms – i.e. availability of Sky's Core Premium channels on cable is limited to residential customers.

Wholesale supply of Core Premium channels to new entrants

6.32 We begin by setting out the recent history of negotiations between Sky and other parties for the wholesale supply of Sky's Core Premium channels. Next we compare this to the supply of Setanta's Core Premium channels. We then consider possible commercial and strategic incentives that Sky could have for not supplying these channels to other retailers. We also consider several arguments from Sky as to the lack of supply to other retailers.

Negotiations for supply of Core Premium channels

6.33 We begin by setting out our view of the history of negotiations between Sky and others for the wholesale supply of Core Premium channels. Our Second Pay TV Consultation included a review of correspondence and meeting notes relating to discussions between Sky and other parties for the distribution of Sky's basic and premium channels. Several pay TV retailers have sought agreements for the wholesale supply of Sky's pay TV channels in recent years. Figure 51 illustrates the negotiations that have taken place between Sky and BT Vision, Orange, TUTV and Virgin Media. The figure provides examples of:

- Retailers asking Sky for wholesale access to its Core Premium channels [✂][367].

[367] BT Vision response dated 26 Feb 2008 to Ofcom information request dated 20 Dec 2007, question 4(i); [✂]; Sky responses dated 9 and 17 Apr 2009 to Ofcom information request dated 20 Mar 2009, questions 4 and 5; TUTV response dated 30 Mar 2009 to Ofcom information request dated 20 Mar 2009, question 4;

- Sky responding to such requests with counter-offers to retail its channels on the provider's platform, or rejecting specific proposals on the grounds that it would prefer a retail deal **[✂]**[368].
- **[✂]**[369].
- **[✂]**[370].

6.34 None of these negotiations led to:

- Sky making a firm offer of a wholesale deal for its Core Premium channels.
- **[✂]**.
- Sky reaching an agreement with the other provider for the wholesale of its Core Premium channels.

6.35 **[✂]**.[371] **[✂]**, we have seen no evidence of any further negotiations between Sky and BT Vision since May 2008, or between Sky and TUTV since June 2007, for the supply of Sky's Core Premium channels.

6.36 We are aware of no case in which Sky has formally refused to enter into some form of dialogue with parties requesting wholesale supply of its Core Premium channels. Nor has it refused outright to agree wholesale terms. Indeed, Sky has taken care to avoid explicit refusals of wholesale supply and to refute claims that it has made such refusals. For one example, **[✂]** Figure 51[372]. **[✂]**:

> **[✂]**[373]

6.37 However, Sky has consistently responded to requests for wholesale supply with counter-offers to retail its channels on behalf of other retailers. Sky's position has been that it would be unwilling to enter into a wholesale deal unless it could be shown that it would not be better off under a retail arrangement.

6.38 **[✂]**:

> **[✂]**[374]

6.39 **[✂]**[375]:

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[368] **[✂]**

[369] **[✂]**

[370] **[✂]**

[371] Sky response dated 17 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 4.

[372] **[✂]**

[373] Sky response dated 8 May 2009 to Ofcom information request dated 20 Mar 2009, question 7

[374] Sky response dated 8 May 2009 to Ofcom information request dated 20 Mar 2009, question 7

[375] **[✂]**.

[✂][376]

[✂][377]

6.40 In our view, this response to requests for wholesale supply has had the same effect as an outright refusal because (a) most competing retailers are understandably reluctant to allow Sky to retail directly to their customer bases and (b) retailers are unlikely to be in a position to be able to demonstrate conclusively to Sky that Sky would be better off under a wholesale arrangement than a retail arrangement.

6.41 In every case, the outcome has been a collapse of negotiations. Nor has Sky attempted to negotiate wholesale supply arrangements after it became clear that these providers were not going to accept a retail agreement with Sky.

[376] Sky response dated 8 May 2009 to Ofcom information request dated 20 Mar 2009, question 7.

[377] Ibid.

Figure 51 Abstract of Sky negotiations with BT Vision, Orange, TUTV and Virgin Media 2006 - 2009

[✂]

Abstract of Sky negotiations with BT Vision, Orange, TUTV and Virgin Media 2006 – 2009 (Continued)

[✂]

6.42 Furthermore, there is no evidence from Sky's negotiations with third parties or its internal correspondence that it has considered offering a lower price in order to encourage take-up. **[✂]**.

6.43 **[✂]** in Figure 52. **[✂]**[378], **[✂]**[379]. **[✂]**.

Figure 52 References to pricing in Sky negotiations with BT Vision and Orange

[✂]

6.44 **[✂]**.

6.45 **[✂]**.

- **[✂]**.
- **[✂]**.

6.46 **[✂]**.

- **[✂]**.
- **[✂]**.

Setanta as a supplier of wholesale channels.

6.47 Our Second Pay TV Consultation compared the availability of Sky's Core Premium channels via other retailers with that of Setanta.

6.48 Following the auction in 2006 for rights to FAPL coverage for three seasons from 2007 / 2008, Setanta owned the rights to one third of the available live FAPL matches. It was the second player in the market for the wholesale of Core Premium Sports channels.

6.49 There are several reasons why we might expect Setanta to wholesale in a more platform-neutral manner than Sky:

- Setanta was vertically integrated to some extent, in that it operated both as a wholesale supplier of premium channels and as a retailer of those channels. However, unlike Sky, Setanta was not vertically integrated with a platform business.

[378] **[✂]**; Sky response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 5.

[379] **[✂]**.

- Setanta did not have market power at the wholesale channel level, and was therefore less likely to be able to exploit any market power by favouring its own retail business.

- Moreover, Setanta did not retail the same range of additional services as Sky. This suggested that the additional retail margin Setanta earned by diverting subscribers to its retail business may be lower than that earned by Sky.

6.50 This expectation was supported by the evidence. Unlike Sky's channels, Setanta's were available very widely. Not only did Setanta itself retail over a number of platforms (Sky's DSat platform and Top Up TV's DTT platform), but it also concluded a number of wholesale deals, with Virgin, Tiscali, BT Vision and Top Up TV, and did so within a relatively short period of time. ESPN has announced a similar intention to make its channel including live FAPL widely available.

6.51 Sky argued that its channels were distributed over several mobile phone networks, whereas Setanta's channels were only available over one such network. However, in our view there is no basis for considering this as evidence that Setanta has tried to restrict supply of its channels, since we are not aware that Setanta has refused to make its channels available over any mobile phone network. The limited availability of Setanta's channels may simply reflect the fact that linear TV over mobile phones is currently a small market.

6.52 In summary, Sky has not shown itself willing to negotiate wholesale supply of its channels to third parties, and the outcome is that it has no such wholesale supply arrangements in place other than with Virgin Media. In contrast, Setanta has agreed supply arrangements with third parties relatively quickly. ESPN, the new purchaser of the FAPL rights previously owned by Setanta, appears to be in a similar position to Setanta, in that it is not vertically integrated, and has stated a desire to agree wholesale deals across a range of platforms; although at the time of writing only a deal with Sky has been announced.

6.53 Sky argued that it was not in a position to offer its premium channels to any DTT retailer because of the practical considerations described in paragraphs 6.74 to 6.81 below, and that this invalidated any inferences being drawn from comparison with Setanta. However, as we shall discuss, we do not accept the arguments Sky put forward as to why it could not supply to any DTT retailers.

Sky's incentives to supply third parties, and reasons for non-supply

6.54 We have considered the following possible reasons for the lack of wholesale supply of Core Premium channels to providers other than cable:

- That Sky did not have a commercial incentive to supply its channels on other platforms.

- That Sky was acting out of a strategic incentive to withhold supply.

- That retailers on other platforms were less efficient than Sky.

- That the other parties to negotiations were engaged in regulatory gaming.

- That practical considerations prevented Sky from wholesaling to other providers.

Commercial incentives

6.55 In this section we consider the short term commercial incentives which Sky might have to restrict wholesale supply of its Core Premium channels – i.e. the trade-off Sky would face between increased wholesale revenues as new-to-Sky subscribers accessed Sky's channels on other platforms, and the loss of retail margins from existing Sky DSat subscribers switching to other platforms (including lost revenues on other services which Sky bundles with its pay TV channels). In doing so we abstract from strategic incentives such as any concern Sky might have that wholesaling its channels to other platforms would weaken its position in relation to competitors – whether in terms of downstream retail presence, or bidding for content rights.

6.56 In our Second Pay TV Consultation we noted[380] that our 'vertical arithmetic' analysis indicated that Sky would have an incentive to supply its Core Premium channels to DTT retailers at the cable rate-card price. We emphasised that this result was purely indicative, and that Sky's incentives were highly sensitive to its wholesale price.

6.57 Sky said that Ofcom's own analysis shows that Sky would have a strong static incentive to supply its premium channels to other retailers. Sky agreed that the precise results were indicative rather than definitive, but said they provided no evidence or basis on which to conclude that Sky has an incentive to withhold supply of its premium channels[381].

6.58 We agree with Sky's reading of our Second Pay TV Consultation which showed that Sky would have a static incentive to wholesale to DTT retailers, at prices as low as **[✂]**% below the cable rate-card. This estimate should, however, be treated with caution as it does not take account of the effect on Sky of:

- The risk to Sky's wider retail business of any lost revenue from bundling – i.e. if Sky wholesales its Core Premium channels through a third party rather than retailing, it loses the opportunity to bundle these channels with its other channels, with additional TV services and with broadband and telephony services.

- The risk to Sky's DSat business that, if it offered a discount on the rate-card to DTT retailers it would have to offer the same discount to cable.

- The possible effect on Sky's DSat business if DTT retailers passed on a discount on the rate-card in lower retail prices. This could have a positive effect of growing the market and increasing Sky's wholesale revenues but also a negative (to Sky) effect of causing Sky DSat customers to switch to DTT.

6.59 Sky argued[382] that failing to lower rates for less-efficient entrants could not be seen as evidence that it is favouring its own platform and retail business. It argued that the 2002 OFT Decision established that Sky's own retail business could afford to pay the wholesale rates charged to cable operators and remain profitable. It said that the fact that other retailers might not be prepared to pay them could not be used as evidence that Sky was favouring its own platform. It added that if it were to offer new retailers

[380] Paragraph 6.112.

[381] Sky response, Annex 7, paragraph 3.10 (non-confidential).

[382] Sky response, Section 5, paragraph 2.34-5 (page 70).

terms which were below the price at which it wholesales to Virgin Media (or notionally to itself on its own platform) then it would disadvantage Virgin Media (or its own downstream retail operation) and would discriminate in favour of other retailers.

Strategic incentives

6.60 In the Second Pay TV Consultation (Annex 8) we considered various reasons – other than the static commercial incentives described above – why Sky might have a strategic incentive to restrict supply. In particular we considered that, in a contest for rights to TV content, a firm which was the leading retailer on a pay TV platform would have an advantage over other bidders, and that this advantage would be greater the larger the firm's subscriber base. In view of this, we considered that Sky would have a strategic incentive to restrict supply in order to prevent rival retailers from bidding against it for content rights, forcing Sky either to pay higher prices for those rights or to lose the rights – and hence, potentially, its wholesale market power in respect of premium content.

6.61 Our review of internal Sky documents relating to Sky's supply of channels to Virgin (described in paragraphs 6.103 to 6.105 below) provides evidence that Sky weighs short-term revenue considerations against its strategic incentive to weaken or eliminate Virgin Media as a competitor. We would expect Sky to take a similar approach in deciding whether to supply its Core Premium channels to other retailers.

6.62 Sky advanced a number of criticisms of our view that it had a strategic incentive to withhold supply from new entrants[383]:

- It was inconsistent with Ofcom's view that Sky was able easily to win all available content rights in which it was interested.
- Sky would be incurring a significant loss in wholesale revenue in the hope that, at best, it can secure a small saving in the amount it pays for rights.
- According to Ofcom's view, Sky only gains an advantage against retailers who are integrated with platforms, so withholding would lead to no benefit when bidding against the likes of Setanta, ESPN / Disney or the terrestrial broadcasters, amongst others.
- Any platform operator wanting to retail premium channels would be more likely to bid for content rights itself if it did not have wholesale access to Sky's channels.

6.63 We consider each of these points in turn:

- We do not consider it inconsistent to argue that Sky's advantage in bidding for content rights is a significant entry barrier, but also that it has an incentive to prevent an entrant from building up a subscriber base which would eventually enable it to challenge Sky in bidding for content.
- We have seen no evidence that the "saving" Sky secures in the amount it pays for rights – i.e. the difference between what it pays and what it would have to pay if it were bidding against a strong competitor – is small.

[383] Sky response, Section 5, paragraph 2.15.

- We recognise that restricting supply will not give Sky an advantage in bidding against retailers who are not integrated with platforms, and that this includes some of its strongest current competitors in bidding for rights.

- We recognise that this point has merit. **[✂]**. However, this may not necessarily give Sky an incentive to supply channels to new entrants. Wholesale access could well be a stepping stone to building a sufficient subscriber base in order to be in a position to bid for rights. If wholesale access were withheld from the first, a competitor would find it difficult to become established, and it is unlikely that a completely new entrant would be in a position to challenge Sky in bidding for content.

6.64 Our present view is that while a large existing subscriber base may provide some advantage in bidding for rights, it is one of a number of factors that influence the ability and incentive for a firm to compete aggressively for rights, and perhaps not the most important of these factors.

6.65 Sky's strategic incentives are clear in its strong demonstrated preference for retailing rather than wholesaling to others.

- If it retails, it can benefit not only from its own satellite subscribers, but also from subscribers on other platforms whose customers are less likely to subscribe via satellite. Sky can influence the movement of subscribers between platforms through its retail packaging and pricing, thereby ensuring that it as far as possible locks consumers into its core satellite platform. At the same time it minimises the likelihood that others can strengthen their position in bidding for rights through a large subscriber base.

- On the other hand, if it wholesales to others, it still gets the wholesale revenue associated with subscribers on other platforms, but loses the control over cross-platform retail packaging and pricing, which means that it faces a greater risk of losing customers from its satellite platform, and it also runs the risk that others may grow to present more of a challenge in competing for rights upstream.

6.66 Our view is therefore that Sky derives two strategic benefits from keeping its retail competitors weak:

- The ability to manage competition between retailers on different platforms, in order to protect the position of Sky's own satellite platform.

- The ability to prevent rival retailers from establishing a strong retail presence, which, as well as being a threat in the retail market, could strengthen their position in bidding for content rights.

6.67 This ties very clearly in with what we see from the evidence – despite the apparently available wholesale revenue, Sky shows no willingness to enter into a wholesale agreement, instead consistently holding out for a retail deal, even if this leads to a breakdown of negotiations.

Efficiency

6.68 Sky further argued that a stand-alone broadcaster with no retail business would distribute its channels to third party platforms so as to maximise aggregate wholesale revenues. As such it would have no incentive to reduce its wholesale prices to cater for a new retailer that was less efficient than established retailers, and would be concerned about the less-efficient entrant taking sales away from its more established (wholesale) customers.

6.69 There are a number of arguments against Sky's claim that supply is restricted because other firms are less efficient than established retailers:

- Sky's argument, that if it were a non-integrated wholesaler it would be concerned about taking sales away from more efficient providers, is inconsistent with its argument that inter-platform switching is likely to be limited.

- Sky has not sought to reach agreements for the wholesale supply of its premium channels to third parties who have requested such supply. As such, it has not had the opportunity to establish whether or not these suppliers are efficient. We would expect a non-integrated wholesaler to engage in detailed price negotiations, in order to establish whether entrant retailers were more efficient than its more established wholesale customers.

- Even if other firms were less efficient than Sky at retailing its Core Premium channels, there is an opportunity cost to Sky in being absent from a platform while it tries (largely unsuccessfully to date) to negotiate access as a retailer. Wholesale supply to an arguably less-efficient retailer is likely to be better for Sky, from a short-term revenue perspective, than being absent from the platform. Using our Vertical Arithmetic model, we estimate that, if Sky agreed to supply the Core Premium channels currently planned for its Picnic proposal to a third party DTT retailer then it would earn revenues of around £**[✂]** per annum on DTT. This illustrative figure is based on: (a) a wholesale price of £**[✂]** (i.e. £**[✂]** below the rate-card price), (b) take-up rates similar to those which Sky expects for Picnic, and (c) no reduction in Sky's DSat subscribers.

- Our analysis of Sky's business model for Picnic indicates that the proposed service would not be profitable if Sky charged Picnic the wholesale rate-card price for its premium channels. Again, this goes against Sky's claim that an efficient retailer could supply on DTT at the rate-card price, as Sky itself appears unable to do so. In its profitability model, Sky modelled cashflows over **[✂]** years, **[✂]** channels. However, after taking transmission costs into account[384], stripping out a cross-subsidy from customers who do not take a TV product[385], and making other small but in our view reasonable adjustments[386], Picnic would only be profitable **[✂]** if it paid a wholesale charge **[✂]**% below that on the current cable rate-card for premium channels. This finding indicates that Sky would not pass its own "efficient retailer" test on DTT.

[384] Which Sky had excluded but which we consider a retail costs which Picnic would have to bear.

[385] I.e. a contribution to common costs from stand-alone phone and broadband customers who would not take the Picnic TV product.

[386] Notably discounting future cashflows using an estimate of Sky's weighted average cost of capital.

Regulatory gaming

6.70 Sky told us that we had ignored the possibility that new entrants were engaged in regulatory gaming. **[✂]**[387]**.** Sky said its view that BT was trying to game the regulator was evidenced by **[✂]**[388].

6.71 We recognise that the prospect of regulatory intervention by Ofcom could have the potential to influence commercial negotiations between parties such as Sky and BT. We have carried out an extensive examination of correspondence between Sky and others, and of internal documents, in order to assess incentives of both sides of these negotiations. However we note that:

- **[✂]**[389].
- **[✂]**.
- **[✂]**[390].
- **[✂]**.
- **[✂]**.

6.72 We consider that, while it is possible that BT had regard to a possible regulatory outcome in negotiating with Sky (see, for example, paragraph 6.36 above), we have no basis for believing that this was the reason for the failure of these negotiations.

6.73 Sky's claim of regulatory gaming mentions only BT. It does not mention the negotiations with others which also failed to reach an agreement for wholesale supply. We have also reviewed documents relating to negotiations between these other parties and Sky. Our view is that these documents do not support the notion that the failure to reach agreement was ultimately due to regulatory gaming on the part of any of these firms.

Practical considerations

6.74 Sky also argued that there were a number of practical reasons for its non-supply of premium channels to third parties.

6.75 It said that other than Tiscali, which carries Core Premium Sky channels, no IPTV platform currently in existence was capable of delivering linear channels. In particular, neither BT nor Orange had launched an IPTV network with this capability. As such, there was "no commercial urgency to reach agreement as none of the new entrants currently have any means by which to distribute Sky's channels".[391]

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[387] Sky response, section 5, paragraph 2.37

[388] Sky response, section 5, paragraph 2.38

[389] BT response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009

[390] Evidenced by a note from BT of a meeting on 8th January 2008.

[391] Sky response, Section 5, paragraph 2.39.

6.76 We recognise that there are challenges to developing an IPTV service. However, we consider that the view that there is no commercial urgency is somewhat at odds with the repeated requests by other retailers for a wholesale deal. The investment in developing an IPTV network is substantial, and BT and Orange would reasonably wish to secure rights to retail Core Premium channels on their networks before making this investment. The fact that Tiscali is already distributing a number of Sky's linear channels, including live sport, is evidence that IPTV distribution is possible over BT's copper access network. We are not aware of any technical reason why other operators could not develop an equivalent IPTV capability in a relatively short time frame which would allow linear channels to be distributed to the majority of their broadband customers.

6.77 Sky also argued that it could not broadcast its premium channels via DTT without first securing DTT capacity. It said it had no means by which it could offer its channels to any of the DTT retailers for distribution[392]. It argued that, as its Picnic application was pending, it had no means by which to facilitate the provision of its channels either to itself or to any other retailer over the DTT platform. However, we note that a third party retailer such as TUTV would have scope to use one of its own videostreams for premium channels, or purchase capacity from another broadcaster and use it to carry Sky's premium channels.

6.78 Next, Sky argued that **[✂]**. It said that ensuring that Sky's channels were distributed in a secure manner was fundamental to Sky's business model, and that it would be irresponsible for Sky to distribute its channels on any platforms that were not secure. [393]

6.79 We recognise that Sky's concerns about security are genuine, **[✂]**[394]. **[✂]**[395].

6.80 However we note that Sky has been willing to discuss retail supply on DTT while failing to engage in discussion about wholesale supply, despite security issues arising in respect of both arrangements (i.e. the same Conditional Access system would be used regardless of whether supply was wholesale or retail). **[✂]**[396].

6.81 As such, we do not consider that Sky's past reluctance to engage in negotiations for wholesale supply can be explained solely by its concerns about security. Looking forward, we take account of Sky's security concerns in Section 9 on the scope of a wholesale must-offer remedy.

Effect of retail by Sky

6.82 Our Second Pay TV Consultation expressed the view that Sky had the incentive to restrict the supply of its Core Premium channels to other retailers and other

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[392] Sky response, Section 5, paragraph 2.41.

[393] Sky response, Section 5, paragraph 2.42.

[394] **[✂]**; Sky response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 3

[395] **[✂]**.

[396] Sky response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 3; **[✂]**. However it is not clear why Sky would have less control over security as a retailer than as a wholesaler, and this has not been the basis of Sky's arguments to us.

platforms. It was clear that our concern related specifically to the lack of wholesale supply by Sky to retailers on those platforms. Indeed, we explained that it was unlikely that a satisfactory answer to our competition concerns would be for Sky to become the only actual or potential retailer of premium channels across all platforms.[397]

6.83 In light of this, we consider it revealing that, in its response to our Second Pay TV Consultation, Sky repeatedly argues that it does not have an incentive to restrict supply to its Core Premium content, but that it makes this argument without distinguishing between wholesale supply and retail supply. In addition, when Sky seeks to counter our concerns about the lack of wholesale supply by citing examples of supply by Sky on other platforms, the examples given are all of Sky acting as the retailer. Sky fails to have regard to our focus on wholesale supply in the Second Pay TV Consultation.

6.84 Sky said its preferred strategy was to maximise revenue from its premium channels by distributing them across all secure platforms[398]. However our review of negotiations with third parties (paragraphs 6.33 to 6.43) shows that Sky has generally been unwilling to engage with a discussion with third party providers about the possibility of wholesale supply and consistently links the potential for wholesale supply with the potential for retailing by Sky. Moreover, as described above, its response to our Second Pay TV Consultation supports the view that it is unwilling to engage in a discussion about wholesale supply with third party retailers. We conclude from this that Sky does not, and will not, assess requests for wholesale supply without linking this to the development of its own retail business.

6.85 We considered whether retail by Sky on other platforms would have an equivalent effect to retail by other providers. We would have several concerns with a situation where Sky was the retailer of premium channels across multiple platforms, rather than Sky wholesaling to other retailers.

- Put most simply, we would like to see vigorous competition between retailers on different platforms. This desire would not be satisfied by there being one retailer of these important channels across platforms.

- From a consumer perspective, a choice of Sky retailing on one platform vs. Sky retailing on another platform does not represent a real choice.

- Sky would have a weaker incentive to compete aggressively than alternative providers. The reason for this is that Sky would be likely to have more capacity and functionality on its own DSat platform than on other platforms, giving it more scope to sell bundled services on DSat.

6.86 Sky by Wire and Sky Player appear to offer evidence of such an effect. Tiscali has complained that Sky prices its Sky by Wire service too high to achieve any significant take-up[399]. Sky's DSat offer and Sky by Wire on Tiscali are not directly comparable, in part because the basic channels differ between the packages. From our analysis of the offers, it was not clear whether Sky by Wire offered poorer value to viewers

[397] Second pay TV consultation, paragraph 6.2.

[398] Sky response, Section 5, paragraph 2.2.

[399] Tiscali response, page 1 (non confidential)

than Sky on DSat. However, we noted in our Second Pay TV Consultation[400] that a disparity between the attractiveness of Sky by Wire and Sky's products on satellite was borne out in subscriber numbers to Tiscali's platform. Of a total **[✂]** Tiscali TV subscribers in June 2008, only **[✂]**% took the Sky by Wire product, while **[✂]**% of Sky DSat customers, and around **[✂]**% of Virgin customers, took Sky Sports or Movies.

6.87 Sky Player, previously only made available to DSat subscribers, is now also available on a standalone subscription basis, without a dish. Therefore it is now, in theory, a competitor to Sky's DSat service, albeit one that is transmitted over the internet and offers a significantly lower picture quality, and one that is available for viewing on PCs rather than TV screens. As discussed in paragraph 6.119 in the context of HD services, we consider that, while content is a key driver of demand for pay TV services, where the same content is available on two platforms, other features, including picture quality and the means of viewing content, are likely to be important in driving the platform choice.

6.88 As illustrated in Figure 53, Sky Player packages closely mirror Sky's DSat packages, both in structure (buy-through from basic) and in pricing (£1 to £1.50 cheaper than similar DSat packages).

Figure 53 Retail prices for Sky Player and Sky's DSat service

Sky Player offer	Sky Player price	Sky DSat offer	Sky DSat price
Entertainment Pack	£15	1 Mix	£16.50
Entertainment Pack + Movies Pack	£32	1 Mix + Movies Pack	£33.50
Entertainment Pack + Sports Pack	£34	1 Mix + Sports Pack	£35.50
Entertainment Pack + Sports Pack + Movies Pack	£41	1 Mix + Sports Pack + Movies Pack	£42

6.89 As such, the evidence from Sky Player tends to support a view that if Sky retailed on other platforms, it would take care not to offer a more attractive package (in either quality or price) than was available on its DSat platform. An independent retailer would not face such a constraint.

Summary

6.90 Wholesale supply of Sky's Core Premium channels is currently limited to cable. Our view, based on analysis of documents of Sky's negotiations with pay TV retailers is that Sky has strongly and successfully resisted attempts by other retailers to secure wholesale deals. Sky has not **[✂]** pursued wholesale supply on other platforms even when there has clearly been no prospect of the retailer agreeing to let Sky retail on its platform.

6.91 Our analysis suggests that in static commercial terms Sky may have an incentive to wholesale to other platforms. However, the fact that it is not doing so suggests either that this incentive is not present, or is outweighed by other factors.

[400] Paragraph 6.127.

6.92 Sky's argument that new entrants would be less efficient in retailing its channels is not supported by evidence. It has not sought to determine whether such retailers would be more efficient, and in its Picnic business model Sky fails its own efficiency test.

6.93 We do not consider that negotiations for wholesale supply have failed simply because of regulatory gaming by parties other than Sky, or that practical considerations explain the lack of wholesale supply.

6.94 We consider that Sky has a strategic incentive to restrict wholesale supply of its channels to other retailers, in order to prevent them from becoming sufficiently established in the market to pose a challenge to Sky's market power as a wholesaler and retailer of Core Premium channels, and in order to prevent them pulling subscribers away from its satellite platform. We also consider that it is likely to be acting on that incentive.

6.95 The Core Premium channels are "licensed services" for the purposes of s316 CA03. We therefore consider that Sky's approach to the wholesale supply of Core Premium channels creates a position under which there is not, and there is not likely to be, fair and effective competition.

6.96 Finally, we note that the example of Setanta, which entered the market as a wholesaler and agreed terms across a range of platforms offers a stark contrast to that of Sky[401]. ESPN has stated its intention to act in a similar manner.

Supply of Sky's Core Premium channels to Virgin Media

6.97 We begin this section by revising our Vertical Arithmetic analysis of Sky's commercial incentives to supply Virgin Media. Next we consider Sky's strategic incentives, particularly in the light of internal Sky documents. While Sky appears to have a positive commercial incentive to supply Virgin Media, it is also concerned to limit Virgin Media's effectiveness as a retail competitor. We consider the terms under which Sky supplies to Virgin Media, particularly its wholesale prices which are designed to satisfy the conditions of a margin squeeze test, and its restriction of additional services such as HD TV. We look at the outcome of these restrictions on Virgin Media's incentives, and the rate of subscriptions to Sky Core Premium channels on Virgin Media.

Vertical Arithmetic

6.98 As noted above, Sky has questioned the assumptions and outcomes of our Vertical Arithmetic model, which indicated that withdrawal of supply from Virgin would be profitable. We have revised our Vertical Arithmetic model in the light of criticisms from Sky.

- We corrected a misinterpretation of Sky's cost data that mistakenly spread UK residential costs across Sky's entire DSat customer base (i.e. including ROI and commercial customers).

- We revised our calculations from consumer survey data to more formally account for 'don't know' and 'none of these' responses.

[401] See paragraph 2.53 for our summary of the current position with relation to Setanta.

- We revised some of our switching assumptions to move downwards the proportion of customers we would expect to choose Sky over Virgin Media if premium channels were withdrawn from cable.

6.99 On the basis of our revisions, it appears that the revenue effect of withdrawing wholesale supply to Virgin would be negative over a longer initial period than we previously estimated – up to 11 to 12 years. This suggests that, at current prices, Sky is likely to have a stronger incentive to supply to Virgin than we estimated. However, we note that:

- The prices at which Sky supplies to Virgin Media, discussed below, are an important factor in this calculation: Virgin Media has argued that at current prices it does not have an incentive to compete aggressively in the retail of Core Premium channels[402]. If Sky were required to supply to Virgin Media at a lower price, its wholesale revenues could increase or decrease (depending on whether the lower price attracted a sufficiently greater volume of new cable subscribers to counter the lower per-subscriber price), but its revenues as a retailer would tend to decrease if this led to switching from Sky to Virgin Media.

- Our Vertical Arithmetic analysis merely compares revenue streams from wholesaling and retailing. It does not take account of Sky's strategic incentives.

Sky's reasons for supplying Virgin Media

6.100 Sky argued that the effect of past competition enquiries into Sky's business was that Sky "already operated under a de facto 'must supply' requirement in relation to cable".[403]

6.101 We note that in light of this de facto must supply arrangement, we cannot interpret the fact of Sky's current supply to Virgin Media as evidence of an ongoing commercial incentive to supply, whatever may have been its original incentive in the 1990s. In particular, we cannot regard it as evidence that Sky currently has a commercial incentive to supply Virgin Media which outweighs any strategic incentive to withdraw supply.

6.102 Sky also argued that it had begun to supply premium channels to cable operators without being required to do so. Again we note that if Sky believes that it is obliged to supply premium channels to Virgin, it cannot also argue that its currently supplying Virgin is evidence that it has a commercial incentive to do so. In addition, we note that the terms on which cable operators were initially offered Sky's channels prompted intervention by the OFT (see paragraph 6.26).

Internal documents

6.103 Documents which Sky disclosed during High Court proceedings, **[✂]**.

6.104 **[✂]**:

> **[✂]**.

[402] Virgin Media response paragraph 6.12, 6.13.

[403] Sky response, section 5, paragraph 2.6(b).

6.105 **[✂]**:

> **[✂]**[404].

6.106 We asked Sky to provide us with any relevant strategy documents relating to the supply or potential supply of its Core Premium channels to Virgin or other cable retailers since January 2006. **[✂]**[405]. We take this as indicating that Sky has not reconsidered its strategy towards supplying its Core Premium channels to cable retailers in more than three years. This is consistent with Sky's view that it is under a *de facto* must supply arrangement (see paragraph 6.109 below).

6.107 In summary, Sky currently considers itself under a must-supply obligation as regards Virgin Media. [406] Whether Sky would supply Virgin Media in the absence of this obligation is unclear, and depends on the terms of supply. Our Vertical Arithmetic indicates that withdrawing supply from 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.

Terms of supply to Virgin

6.108 We now consider the terms under which Sky wholesales its Core Premium channels to Virgin Media. In particular, we consider:

- How Sky sets its terms to Virgin Media.
- The effect of these terms on Virgin Media's incentives.
- The outcome in take-up of Core Premium channels by Virgin Media customers.
- Whether take-up rates reflect a difference in the make up of Sky and Virgin Media customer bases.
- Non-supply by Sky of additional services to Virgin Media.

How Sky sets its terms

6.109 Sky told us that since 2002 it had continued to supply cable operators at a price which believed was compliant with the test laid down by the OFT[407]:

> **[✂]**.

6.110 The threshold at which a margin squeeze abuse occurs is necessarily high. In other words, rather than entering into negotiations to establish a mutually beneficial price, our understanding is that Sky has, for the past seven years, been setting its price level by calculating the price just below an abusive price, as determined by the OFT in 2002. Sky appears to present the margin squeeze price as a floor beneath which it

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[404] **[✂]**.

[405] Sky response (14th April 2009) to final Ofcom information request, question 6.

[406] Sky response, section 5, para 2.6(b)

[407] Information request response, 28 July 2008.

will not negotiate, either with cable retailers or others. However under CA98 Sky would clearly be free to agree a lower price. The outcome of this conduct is that the margin available to cable retailers is very low and that there is no incentive for cable retailers to expand sales of premium channels beyond those customers that would leave cable if the channels were not available.

Effect on Virgin's incentives

6.111 Sky argued that "a third party platform operator does not have the incentives to invest in marketing Sky's channels and this could be exacerbated where the third party has higher margin products such as telephony and broadband"[408].

6.112 However, Virgin Media argued that the reason it did not have an incentive to invest in marketing Sky's channels was that the wholesale price was too high.

6.113 [✂][409].

Figure 54 Rate-card price and incremental retail price of Sky's Core Premium channels on Virgin Media

Bundle	Price increment* (£)	Wholesale rate-card charge (£)	Margin over wholesale rate-card (£)
Sky Sports Mix	17.24	18.39	-1.15
Sky Movies Mix	16.02	16.59	-0.57
Sky Sports Mix & Sky Movies Mix	22.70	23.40	-0.70

**Weighted average across Virgin Media's packages*

Note: Prices and subscriber numbers are for Virgin Media's M, L and XL digital products. Prices and subscriber numbers for analogue, legacy and other packages are not included in this calculation. Subscriber numbers are as of October 2008; prices are as of April 2009.

6.114 Prices charged by Sky and Virgin Media for premium channels are not directly comparable, because they are bundled with different packages of basic content and other services. In our Second Pay TV consultation (Figure 6, page 40) we set out package prices. Sky charged £17 for its basic only TV package, while Virgin Media charged £11. The two charged a similar price for basic content with sports (Sky £36 and Virgin Media £37), although this meant that a current or potential Virgin Media customer had to pay more to upgrade to premium sports than a Sky customer. Virgin Media's prices were higher for basic and premium movies (£41, Sky £34) and for basic with premium sports and movies (£48, Sky £43). Current prices (May 2009) are shown in Figure 55. Virgin Media's prices are currently lower than Sky's for basic and premium packages.

[408] Second Pay TV Consultation, paragraph 6.39.

[409] Source: Virgin Media, Market Investigation Workshop, 16th May 2008, page 15.

Figure 55 Package prices for Sky and Virgin Media

	Sky	Virgin Media
Basic	£16.50	£11*
Basic + Sky Sports	£35.50 (+ £19)**	£37 (+ £26)
Basic + Sky Movies	£33.50 (+ £17)	£41 (+ £30)
Basic + Sky Sports and Movies	£42 (+ £25.50)	£48 (+ £37)

**For Virgin Media's M package, which is "free" with an £11 phone line*

***Figures in parenthesis show additional cost above basic package prices*

Additional services

6.115 A further potential concern arises from the non-supply of Sky HD services to Virgin. **[✂]**[410].

6.116 **[✂]**[411].

6.117 **[✂]**[412], **[✂]**.

6.118 As Sky pointed out[413], in the Second Pay TV Consultation[414] we noted that the quality of content was of primary importance in attracting viewers. We said that content was more important than platform features (such as EPGs, DVRs, VoD and HD), which added to convenience or, in the case of HD, to technical quality. We noted that if customers did not want to watch a programme, then the ability to watch it in HD would not change their minds.

6.119 However, this view was set out in the context of discussing the importance of premium content, and we continue to see Core Premium content as a key driver of platform choice. However, where the same content is available on two platforms, as Sky's Core Premium content is on DSat and cable, then the customer's choice between those platforms cannot be influenced by the content. In this case, the choice will be determined by other factors, such as price, consumer preference for one type of platform over another, or the availability of enhanced platform features.

6.120 In this context, the availability of services such as HD could well make the difference between a customer choosing one platform or another. As such they could be of

[410] Virgin Media response to Second Pay TV Consultation, paragraph 7.38.

[411] Sky response dated 17 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 4.

[412] Sky response, Section 7, paragraph 8.6.

[413] Sky Response, Section 7, paragraph 8.6.

[414] Paragraph 3.36.

crucial importance to the competing platform providers. Sky has commented that "Such has been the consumer demand for HD that Sky+ HD is the fastest selling additional TV product ever offered by Sky"[415]. Sky has recently promoted this service with the slogan "High Definition. Now it's for everyone".

6.121 **[✂]**[416].

6.122 As such, we consider that Sky's characterisation of our argument as being that "it is content that matters" is oversimplified, and there is no merit in the conclusion that Sky draws from this mischaracterisation. We consider that Sky's reluctance to supply HD content to Virgin Media is further evidence that its supply of content to cable is primarily based on what Sky perceives as a "must-supply" obligation (see paragraph 6.100), and is limited to the scope of that obligation.

6.123 **[✂]**[417]. Few FAPL matches (as Sky set out, only one in recent seasons), although rather more Champions League matches are only available through the red button on Sky – eight Champions League group matches take place on the same evening, to which Sky has the rights to all but one, meaning that it is not possible to show all the matches via the linear channels. Our consumer research indicates that Player Cam is not seen as important by subscribers. In our view, although there are sufficient Champions League matches available via the red button to be material, red button and Player Cam services are likely to be of less importance to subscribers than HD services.

6.124 While our primary concern is with the effect of Sky's wholesale pricing policy on Virgin Media's incentives, we consider that Sky's reluctance to allow access to other channel enhancements has the same intention and likely effect – namely to inhibit the effectiveness of Virgin Media as a competitor to Sky's DSat service.

Outcome among Virgin Media subscribers

6.125 We consider that the level of pricing on the cable rate-card, and the availability of additional services, contribute to the fact that subscription to Sky's Core Premium channels is much lower among Virgin Media subscribers than among Sky customers. In 2008, only **[✂]**% of Virgin Media customers subscribed to Sky premium channels, down from **[✂]**% in 2000. Penetration of Sky premium channels **[✂]** among Sky subscribers, but remains much higher than among Virgin Media subscribers (**[✂]**% in 2008, **[✂]**% in 2002) – and Sky's total absolute number of premium subscribers **[✂]**.

6.126 **[✂]**[418] **[✂]**.

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[415] Section 2, para 2.22.

[416] **[✂]**.

[417] Virgin Response paragraph 7.49.

[418] Telewest merged with NTL in 2006, and the merged firm was rebranded as Virgin Media in 2007.

Figure 56 Number and penetration of subscribers to Sky's premium channels on satellite and cable

[✂]

6.127 As shown in Figure 6 of our Second Pay TV Consultation, the result is that while Sky and Virgin have **[✂]** of basic customers, Sky accounts for **[✂]** of premium customers.

6.128 We see various different drivers of the difference in penetration between cable and satellite.

- Some consumers might choose cable in order to take telephony or broadband services; this is likely to have been particularly true in the early period shown in the chart above, when Sky did not offer triple-play bundles. It may be the case that for these people content is of lesser importance than for those people who choose satellite. This is likely to explain some of the difference. However, it does not explain why penetration would have decreased over time.

- Some of this difference in penetration may be due to more people with a strong demand for premium channels choosing DSat in the first place – i.e. content driving the choice of platform – rather than Sky being intrinsically more efficient than Virgin Media in promoting premium channels to customers who have already signed up to the platform.

- We can see from retail prices that bundles including Core Premium channels are higher via Virgin Media than via Sky, suggesting that Sky's offer is more likely to be attractive to new customers.

- For existing basic customers, the incremental price of Core Premium channels is higher, making it less immediately attractive for a customer to add Core Premium channels. As we have set out, Virgin Media appears not to have a strong incentive to try to sell Core Premium channels to existing basic subscribers.

Summary

6.129 Sky's practice of charging Virgin Media the highest prices which Sky believes meet the conditions of a margin squeeze test leaves Virgin Media with limited incentive to promote Sky's Core Premium channels to its customers. As a result, people with a strong demand for these services are more likely (and increasingly likely over time) to choose DSat. Sky's reluctance to supply services such as HD tends to exacerbate this effect. The Core Premium channels are "licensed services" for the purposes of s316 CA03. We therefore consider that Sky's approach to the wholesale supply of Core Premium channels creates a position in which there is not, and there is not likely to be, fair and effective competition in the wholesale of Core Premium channels and the retail supply of bundles which include Core Premium channels.

Commercial premises

6.130 While the discussion to this point has focused on supply to residential subscribers, pay TV services including Sky's Core Premium channels are also supplied to commercial premises – mostly pubs and clubs, but also hotels, offices and holiday parks, among others.

6.131 The Association of Licensed Multiple Retailers (ALMR), a trade body which represents licensed retailers (who comprise the majority of commercial pay TV subscribers) told us that competition was limited in the supply of pay TV services to commercial subscribers, and that this was leading to poor outcomes for consumers. It noted that even Setanta's channels, which include the only Core Premium content other than Sky's, were only available to commercial subscribers through Sky's retail service.[419]

6.132 Virgin Media told us that it has not actively marketed Sky premium channels to commercial premises since 2006[420]. **[✂]**[421]. Given these issues, and its experience in negotiating with Sky over the residential rate-card, Virgin Media is pessimistic about successfully negotiating with Sky over its wholesale commercial rates[422].

6.133 Setanta[423] and Top Up TV[424] told us that they would be interested in supplying pay TV services to commercial premises. **[✂]**[425].

6.134 Setanta told us that it had agreed to allow Sky to retail its channels to commercial premises because **[✂]**[426].

6.135 **[✂]**[427]. **[✂]**[428].

6.136 **[✂]**[429] **[✂]**[430] **[✂]**[431] **[✂]**.

6.137 TUTV told us that it had made several efforts to negotiate access to premium channels for commercial (and residential) subscribers, but that Sky had failed to offer

[419] Response to Second Pay TV Consultation Document, page 2. (non confidential)

[420] **[✂]**.

[421] Virgin Media response dated 8 April 2009 to Ofcom information request dated 24 March 2009, question 16.

[422] Virgin Media response dated 8 April 2009 to Ofcom information request dated 24 March 2009, question 17.

[423] Setanta response dated15 April 2009 to Ofcom information request dated 20 March 2009, question 5.

[424] Top Up TV response dated 8 May 2009 to Ofcom information request dated 20 March 2009, question 7.

[425] Sky Business subscription revenues were **[✂]** in 2007/08.

[426] Setanta response dated 15 April 2009 to Ofcom information request dated 20 March 2009, question 7.

[427] Setanta response dated 15 April 2009 to Ofcom information request dated 20 March 2009, question 7.

[428] Setanta response dated 15 April 2009 to Ofcom information request dated 20 March 2009, question 5.

[429] **[✂]** response dated 2 April 2009 to Ofcom information request dated 20 March 2009, page 1.

[430] Response to Ofcom information request dated 20 March 2009.

[431] Response to Ofcom information request dated 20 March 2009.

TUTV a deal[432]. In its offer of a retail deal to TUTV in January 2006, Sky stipulated that the arrangement would exclude commercial subscribers[433].

6.138 In our view, the supply of Core Premium channels to commercial premises is somewhat less attractive to potential third party retailers than supply to residential customers. One reason for this is that the scope to bundle Core Premium channels with other services is likely to be far more limited. For example, customers to a public house will care about whether it has Sky Sports or Setanta, but are likely to be far less interested in other features such as the range of basic channels carried, interactive services, and inclusion of other services such as broadband in the package. Therefore it only makes commercial sense to supply the commercial sector if there is a sufficient margin on Core Premium channels for the retailing of these channels to be viable on a standalone basis.

6.139 The gradual exit of Virgin Media from supply to commercial premises appears consistent with this effect – in contrast with the residential sector, where Virgin Media faces broadly similar terms of supply from Sky. The difference between the two is that in the residential sector when Virgin Media supplies a customer with Core Premium channels this is as part of a broader package, and it is profitable for Virgin Media to supply these channels as part of this package rather than lose the customer, even if it would prefer to retain the customer without providing Core Premium channels.

6.140 From our review of documents from Sky and third party retailers, commercial premises do not appear to have been an important part of negotiations for wholesale supply. While it is understandable that the focus of discussion would be on residential supply, if other retailers had a genuine interest in supplying commercial premises we would have expected to see this more strongly reflected in the documentation. On balance, we do not consider that the arguments of a competition concern arising from lack of wholesale access to be strong on the commercial side – and they are certainly less strong than on the residential side.

Restricted exploitation of content rights

6.141 The discussion above deals with the restricted distribution of Sky's linear channels. The same incentives which determine how Sky distributes its channels are also likely to determine how it exploits its content rights, in the sense that Sky has an incentive to exploit its content rights in such a manner as to favour its own retail business and its own platform. The resulting selective exploitation of content rights might be a concern if it allowed Sky to protect its market power, and distort competition.

6.142 One specific concern relates to the exploitation of the rights to distribute movies via Video on Demand (VoD). These have a high strategic importance, due to the potential which we have already noted for disruptive change in the way movies are distributed.

6.143 Current pay TV services, based on the broadcast of linear channels, deliver a small number of movies to a large number of viewers simultaneously. As discussed in section 4, this is an attractive service to many consumers:

[432] **[✂]** response dated 30 Mar 2009 to Ofcom information request dated 20 Mar 2009; question 6.

[433] Sky response dated 9 Apr 2009 to Ofcom information request dated 20 Mar 2009, question 3; Top Up TV response dated 30 Mar 2009 to Ofcom information request dated 20 Mar 2009 question 4.

- It allows consumers to choose from a reasonably wide range of high quality movie content. The level of choice depends on the number of channels which can be broadcast simultaneously, and is therefore higher on platforms which are not severely capacity constrained, such as satellite and cable. The level of choice can be enhanced by the use of DVRs, and by various forms of push-VoD service.

- It allows consumers to do so in a convenient manner, from their own living room, and with a simple payment mechanism.

6.144 The degree of choice that can be provided is however fundamentally limited by the broadcast medium being used. It is not difficult to imagine a world in which libraries of movies are accessed more directly, via various forms of IPTV or internet download. The enhanced level of choice this would offer is likely to be highly attractive to consumers.

6.145 We noted in our 2008 Communications Market Report[434] that one of the most significant recent developments has been the emergence of the internet as an important content distribution platform, both for the television industry, with access to online content now offered by all of the major broadcasters, and for consumers, with, for example, 700,000 video streams served daily in May 2008 by the BBC iPlayer. We referred in section 7 to a number of new developments in TV delivery, including movie downloads.

6.146 However, a number of elements need to be in place for the internet and / or IPTV[435] to become an effective means of delivering premium content to large numbers of consumers:

- Sufficient bandwidth for video content to be delivered over residential broadband networks, without any degradation in quality.

- A secure means of delivering premium content, which protects against piracy.

- The ability to view such content on a TV screen, via suitable set-top boxes, as well as on a PC.

- The ability to pay for such content in a convenient manner.

6.147 The first three of these are essentially technical issues, which are being actively explored elsewhere. For example, the provision of sufficient bandwidth to deliver video content to residential consumers is a core goal of the Digital Britain report[436], whilst the delivery of such content to TVs as well as PCs is the core goal of projects such as the BBC's Canvas initiative. These are areas where there is a great deal of scope for technical innovation, to the benefit of consumers.

[434] http://www.ofcom.org.uk/research/cm/cmr08/.

[435] Premium content might in principle be delivered either over closed IPTV platforms, such as that operated by Tiscali, or the open internet. Both require issues associated with network bandwidth and encryption to be addressed, but the mechanisms for doing so are likely to be different.

[436] http://www.culture.gov.uk/images/publications/digitalbritain-finalreport-jun09.pdf.

6.148 However, this innovation will only take place if the right content is available, with a payment mechanism that is convenient for consumers. There are two sets of rights that are relevant in this context:

- VoD services sold on a Pay-Per-View (PPV) or Pay-Per-Download (PPD) basis. These rights are widely available, on a non-exclusive basis. They have the attraction that they are available in an earlier window than existing pay TV services. However, despite this fact, services based on these rights have thus far had a limited impact on the market, a point which is illustrated by the relatively low value which retailers continue to put on these rights.

- VoD services sold on a subscription service (SVoD). At present the movie studios bundle these rights with the rights to show movies on subscription linear channels, and these bundled rights are acquired on an exclusive basis by Sky. As discussed in more detail below, Sky does not currently however have the capability to exploit these SVoD rights on its satellite platform, and it does not have the incentive to develop a product based on these rights to be supplied to competing TV platforms. Sky therefore only exploits the rights via its PC-based Sky Player application, which has thus far had limited impact on the market.

6.149 In order to confirm the current position regarding the current licensing of subscription and SVoD rights, the process by which these were awarded, and the possibility of future change, we have sent formal information requests to all six major Hollywood Studios. We have also obtained copies of the current contracts between the studios and Sky. The current position is summarised in Figure 57 below.

Figure 57 Sky's SVoD rights with major Hollywood studios

Studio	Exclusive SVoD rights	Restrictions
Sony	[✂]	[✂]
Paramount	[✂]	
20th Century Fox *(Note: Fox is owned by News International, which also has a 39% stake in Sky)*	[✂]	[✂]
Disney	[✂]	[✂]
Universal	[✂]	[✂]
Warner	[✂]	[✂]

6.150 We conclude that:

- Sky does currently hold the SVoD rights for all six studios.

- **[✂]**.

- **[✂]**.

- **[✂]**[437]. It seems that, on balance, there is unlikely to be a substantial change in the way these rights are awarded in the UK in the short to medium-term.

6.151 Not only does Sky not provide onward supply of services based on these rights, it also does not exploit them fully itself. Sky's premium movies channels are currently available on SVoD only through Sky Player to the PC. This presumably reflects the fact that its satellite platform is not well suited to the exploitation of these rights.

6.152 Sky's strategy in relation to these rights is illustrated by evidence from information request responses, in particular, **[✂]**[438].

6.153 **[✂]**[439] **[✂]**[440]. **[✂]**.

6.154 We believe that Sky has an incentive to restrict exploitation of these subscription VoD rights, in order to protect its own linear movie channels, which are the only means by which it can deliver movie content on its satellite platform. Furthermore, it appears to be acting on this incentive.

Wholesale pricing of Core Premium channels

Our views in September

6.155 We noted in our Second Pay TV Consultation that the wholesale market power which we had identified might be exploited not only by restricting distribution of premium content, but also by setting high wholesale prices for that content. However, the evidence of high wholesale prices was not clear-cut. This is due to a variety of practical difficulties associated with an analysis of wholesale prices for content. We considered a range of evidence on both retail pricing and Sky's profitability to address this question.

6.156 We noted that when a seller of a product is in a position of market power, it can potentially set prices above competitive levels. Sky retails directly to around **[✂]**% of subscribers to its Core Premium channels, and supplies the remaining **[✂]**% at a wholesale price determined by a rate-card which we understand to be designed to give cable firms just enough margin – if they retail at the same price as Sky – for Sky to pass its interpretation of the OFT's margin squeeze test (see paragraph 6.109).

6.157 As such, Sky effectively controls the retail prices of its Core Premium channels. It can set its own retail prices at an optimal (profit maximising) level, and set its wholesale price to cable operators which will require them to charge the same or a similar price. The returns that cable firms can earn from retailing Sky's Core Premium channels are constrained by the rate-card. If we were to consider Sky's retail business as a purchaser of wholesale content at rate-card prices from its wholesale business, then this retail business would face the same constrained returns as a retailer. Under this interpretation, if Sky were to earn monopoly profits we would expect these to be extracted at the wholesale level.

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[437] **[✂]**.

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

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

[440] **[✂]**. Ibid.

6.158 High wholesale prices would reflect the market power derived from content aggregation. However, we also explained that it is not always entirely clear who is likely to be the main beneficiary of the aggregation process. It is likely that many of the rents flow upstream to where the aggregation took place. In the case of Core Premium channels, the situations of sport and movies are subtly different.

- In sports there are different levels of aggregation taking place. Sporting bodies such as the FAPL or UEFA aggregate content through the use of collective selling, and this is then further aggregated by Sky through its purchase of the rights to various different sporting events. If there were a fully competitive market for the purchase of rights such as FAPL then we would expect the aggregation benefits associated with those rights to flow entirely upstream to sporting bodies themselves. To the extent that there was insufficient competition between purchasers for the rights, then the purchasers might extract some of the rents.

- In movies, in contrast, Sky carries out the aggregation of content by purchasing rights from all six Major Hollywood Studios. We considered that Sky was likely to benefit from its role as aggregator and noted that there appeared to be less intense competition for the movie rights, but it was also likely that the Major Hollywood Studios could extract some of the benefit from aggregation in their individual negotiations with Sky. We did not directly assess the balance of negotiating power between Sky and the Major Hollywood Studios.

6.159 As well as a lack of clarity over where the benefits of the aggregation process accrue, it can also be difficult to distinguish monopoly rents from scarcity rents, such as the value placed on footballing or movie-making talent.

6.160 These considerations suggest that evidence of high profitability for Sky as a whole would suggest that wholesale prices were above competitive levels – although it would not be a necessary condition – since the monopoly rents associated with the high wholesale prices could flow upstream. Similarly, evidence of high retail prices would also suggest that wholesale prices were above competitive levels, with the associated rents being extracted further up the value chain.

6.161 In our First Pay TV Consultation we attempted to carry out some analysis of the profitability of the whole of Sky, for want of useful information on the industry as a whole, as a way of attempting to establish whether consumers were suffering from high prices. That analysis was inconclusive. We revisited it in our Second Pay TV Consultation in light of consultation responses, but again found it to be inconclusive, for similar reasons as the First Pay TV Consultation. These reasons focused particularly on difficulties around establishing an appropriate asset base for a company as light on tangible assets as Sky, on the difficulty of selecting an appropriate time period, and on the cumulative impact of changes to the assumptions we were making.

6.162 We also considered whether Sky earned monopoly profits in wholesaling its Core Premium content. We treated Sky's wholesale function – i.e. the purchase of content, packaging into channels, and wholesale supply to Sky (as a retailer) and Virgin Media – as a distinct business. We estimated the gross margin earned by this business from sports as being between **[✂]**% and **[✂]**%, and that from movies as being between **[✂]**% and **[✂]**%.

6.163 Sky provided an estimate of operating costs for this business which we used to estimate operating margins[441]. We did not endorse Sky's estimate, but we noted that it suggested an operating margin at wholesale level of around **[✂]**%. However, we noted that there were many uncertainties with establishing the level of capital (particularly intangible assets) attributable to this part of Sky's business, so estimating an economic return was extremely difficult.

6.164 In both previous consultations we discussed analysis carried out by LECG, which was submitted to Ofcom as part of the Four Parties' July 2007 Submission. This analysis purported to indicate that retail prices were high in the UK compared to other major pay TV markets. We assessed this work in detail and subjected it to external review. Our view was that the analysis did not robustly support or rebut the assertion of high retail prices.

6.165 In light of the various uncertainties, and with the limited amount of financial information available to us at the time, we found that the direct evidence that Sky was earning monopoly rents was inconclusive. We also said that we would consider this further. We could not conclude on whether Sky was earning monopoly profits either in aggregate or in its wholesale business.

Consultation responses

6.166 Sky argued that Ofcom's failure to conclude on the existence of excessive wholesale pricing meant that it could not base any intervention on such allegations. It went on to criticise Ofcom's profitability analysis.

6.167 Sky believed Ofcom committed a number of errors which meant that the limited conclusions that Ofcom drew were unreliable. It argued that the normal framework for such an evaluation was to consider the profitability of comparator companies. It further argued that Ofcom did not even attempt to show that setting high wholesale prices for premium channels might damage the competitive process.

6.168 In particular, Sky noted that it was not possible to evaluate separately the profitability of Sky's supply of premium sports and premium movie channels and that Ofcom's approach is likely to overstate the profitability of Sky's notional premium channel business over the medium term.

6.169 A number of respondents encouraged us to look further at aggregate and disaggregated profitability for Sky.

Our current view

6.170 We acknowledge that the evidence and analysis which we presented in our previous consultations does not allow us to conclude on whether Sky is earning monopoly profits either in aggregate or in its wholesale business. We do not however accept Sky's argument that we have failed to show that high wholesale prices for premium channels might damage the competitive process. We agree that high wholesale prices do not necessarily distort retail competition, but they are a potential outcome of weak wholesale competition, and are likely to have a direct impact on consumers in the form of high retail prices.

[441] **[✂]**.

6.171 We have therefore carried out a considerable amount of further analysis of both the aggregate and disaggregated profitability of Sky. In particular, we commissioned Oxera, a consultancy, to carry out an independent assessment of the profitability of Sky's Core Premium content. Oxera's report is included in Annex 9.

6.172 Oxera is a recognised expert in the field of economic profitability, and has direct experience of carrying out this type of analysis in the context of market investigations for both the OFT and the CC. In addition to advice on particular cases, Oxera provided guidance to the OFT in its report "Assessing profitability in competition policy analysis" [442]. This provided the basis of the approach that we sought to apply in our Second Pay TV Consultation.

6.173 Oxera's work for this consultation document has attempted to address the specific difficulties we identified with analysing Sky's aggregate and disaggregated profitability that we set out in our previous consultations. The particular focus has been on establishing an appropriate asset base by looking at intangible assets and on addressing the challenges involved in selecting an appropriate time period. Oxera's analysis has looked at a number of time periods, and has found similar results regardless of time period, which gives us greater confidence in the results.

6.174 In order to inform the analysis we requested – under Oxera's guidance – a large amount of detailed historical financial data from Sky, which were made available to Oxera for the purposes of its analysis. Oxera has examined Sky's aggregate profitability by estimating the value of Sky's asset base, including intangible assets not listed on the balance sheet, such as subscribers. In addition, it has looked at profitability for Sky's wholesale and retail businesses.

Oxera's methodology

6.175 Oxera used the same conceptual framework in this piece of analysis to that which it has used in its work for the OFT and the CC. This centres on the use of NPV and IRR profitability metrics and the 'value-to-the-owner' principle for valuing assets. In our previous work, we highlighted the difficulties we had found with applying these principles. However, we believe that Oxera has managed to overcome the various difficulties, by virtue both of its expertise and of its access to considerably more detailed financial data.

6.176 In a competitive market with freedom of entry and exit we would not expect the IRR of a particular project substantially to exceed the cost of capital in the long run. An IRR substantially above the cost of capital could indicate the existence of barriers to entry and market power.

6.177 When looking at a specific period over the lifespan of an economic activity Oxera has used a truncated IRR approach, in which the initial asset value is treated as a cash outflow and the residual value at the end of the period in question is treated as a cash inflow.

6.178 This approach tends to result in greater emphasis being placed on obtaining the correct valuation of the asset base at the beginning and end of the period. If the opening balance is understated or the closing value is overstated, then the resultant IRR will be overstated, while the reverse is true if the opening balance is too high or

[442] Available at http://www.oft.gov.uk/shared_oft/reports/comp_policy/oft657.pdf

the closing balance is too low. In addition, the shorter the period being looked at, the greater the reliance tends to be on opening and closing asset values.

6.179 Oxera's IRR analysis is supported by other measures of profitability, including ROCE estimates, which also rely on estimates of the appropriate capital base. Hence assessment of the appropriate capital base is a central part of Oxera's work.

6.180 To determine Sky's asset base at the beginning and end of the period (as required by the IRR methodology), Oxera has measured off-balance sheet intangible assets by looking at the minimum loss that a firm would suffer were it deprived of the use of that asset. This loss is determined by looking at the options available to a business at any point in time:

- Replace the assets – the replacement cost or cost of a modern equivalent asset (MEA) becomes the appropriate cost.
- Sell the assets – the net realisable value (NRV) becomes the appropriate valuation.
- Continue to use the assets – the value would be the NPV of cash flows from continuing to use the assets.

6.181 The largest component of intangible assets not listed on the balance sheet is Sky's subscriber base, which can be valued in a number of different ways. Oxera's approach treats the subscriber base as being similar to capital expenditure, in which Sky 'invests' each year in order to obtain new customers.

6.182 The subscriber base is valued on the basis of capitalised subscriber acquisition costs (SACs), which are depreciated each year. The depreciated customer capex figure from prior years can be valued at the end of each period based on the current replacement cost of the remaining subscribers, which can be estimated from the most recent SAC figures.

6.183 Other intangible items that may not be fully captured on Sky's balance sheet include contractual obligations related to future programming obligations, e.g. FAPL rights. Oxera looked at the underlying terms of the rights in order to assess what value of future contractual obligations should be capitalised.

The results of Oxera's analysis

Sky's asset base

6.184 As explained above, Oxera considers a number of different approaches to assess the appropriate value of Sky's asset base making specific allowance for intangible assets on a replacement cost basis. Figure 58 compares these valuations with Sky's book value and market value for the period 1995 to 2008[443].

Figure 58 Value of Sky's asset base under different valuation approaches (£m)

[✂]

6.185 The figure shows that the inclusion of intangible assets substantially raises the value of Sky's asset base relative to book value. However, as Oxera notes, it also

[443] See Annex 9, Figure 4.1.

"suggests that, from flotation up to 2008, the estimated market value of Sky's assets was significantly higher than the estimated replacement cost value". As such it appears that the market perceives that the value of Sky's future cash flows substantially exceeds the underlying replacement cost of the assets.

Aggregate profitability

6.186 Oxera states that its "aggregate profitability analysis suggests that over the last five years under the base case scenario the returns appear around **[✂]**%. Over the longer term the returns appear higher, up to **[✂]**% on the IRR basis . . . under the base case scenario, the IRR ranges from 20% to 28%".

6.187 Oxera also considered ROCE and found that "[o]n a replacement cost basis, the ROCE ranges from 16% to 22% under the base case scenario . . . These estimates should be regarded as conservative because they do not account for holding gains associated with growth of the asset value...in the numerator of the ROCE. If holding gains were accounted for, the ROCE would be closer to the IRR". Put differently, in periods where there is substantial investment – as was the case, for example, during Sky's transition to digital – ROCE results tend to be biased downwards.

6.188 Theoretically, in steady state, we would expect IRR and ROCE to produce broadly the same answers – as is the case over the period from 2004-2008, where Oxera's base case assumptions show an IRR of **[✂]**% and a ROCE of **[✂]**%. This provides us with a strong degree of comfort around the IRR estimates. In the longer period 1995 – 2008, there is more disparity between the two sets of estimates, which may be due to a very low opening asset value in 1995. Overall, this suggests that Oxera's IRR analysis over the 2004 – 2008 period may be more robust than the longer period.

6.189 Oxera has also provided results under a more conservative set of assumptions in which all subscriber management costs and retention marketing costs are capitalised. These assumptions almost certainly overstate the costs that should reasonably be capitalised, since they include costs that are more reasonably considered marketing expenditure. In practice, the conservative case makes relatively little difference to the IRR results, but they further depress the ROCE results. Oxera's view is that the ROCE results under this assumption are unlikely to provide as reliable a guide to profitability as the IRR results.

Comparison of Sky's aggregate returns to its cost of capital

6.190 The key concept when assessing the reasonableness of a firm's returns is whether the firm can earn a positive NPV on its expected (i.e. probability-weighted) future cash flows at its weighted average cost of capital (WACC). The use of *expected* future cash flows is important since it addresses cases where a firm must incur sunk costs and faces a risk of failure. In the event that the firm fails, the sunk costs will be lost. An investor will therefore invest in a project only if the future cash flows if the project succeeds are sufficient to cover the probability-weighted losses if the project fails[444]. This issue is particularly relevant for firms in a start-up phase where there

[444] Consider a hypothetical example in which a firm drills two oil wells each with sunk costs, but where only one of the oil wells is successful. In this situation, the firm would invest only if it expected to earn a sufficient return from the successful well to cover not only the sunk costs of that well, but also the sunk costs of the unsuccessful well.

may be considerable uncertainty about a new business model[445]. It is much less of a concern when looking at an established firm with relatively little risk of failure.

6.191 When looking at Sky's historic returns, we need to be aware of the danger that returns may appear excessive, but that they in fact reflect an outcome in which actual (ex post) returns are above historical (ex ante) expected returns purely because a risky business has succeeded. Hence although we observe that Sky's historic returns for the period 1995-2008 appear relatively high, we need to accept that they may reflect this type of outcome. In the early part of the period, Sky's business model was unproven, and there may well have been substantial downside risks for which investors needed to be compensated.

6.192 However, when we consider Sky's more recent returns, concerns about potential failure are far less relevant. Sky has a proven business model, its risk of failure is low and we do not anticipate an outcome in which it is likely to face substantial stranded costs. Hence on this basis, we consider that it is appropriate to compare the IRR that Oxera has derived with a forward looking WACC.

6.193 Our forward-looking estimate of Sky's cost of capital, set out in Annex 10, is 10.3%. We would suggest that this is the relevant benchmark for looking at Sky's IRR for future years, but is also a reasonable estimate of Sky's cost of capital in the last few years, including the 2004 – 08 period that Oxera have considered.

6.194 We believe that Oxera's analysis provides evidence that if the pay TV market is left unchanged, Sky's future IRR (based on ongoing profitability and the value of its asset base) would be likely to exceed its cost of capital.

Disaggregated profitability

6.195 We also asked Oxera to consider the profitability of Sky's wholesale and retail businesses separately, and to look separately at the profitability of Sky's wholesale movies and sports activities. On the former, Oxera concludes that "[r]eturns for Sky wholesale activities appear higher than for Sky retail activities. These results seem robust to a number of cost allocation approaches and sensitivity checks." Specifically, Oxera found that Sky's wholesale operation has an estimated IRR of **[✂]**%, higher than its retail operation (**[✂]**%), both based on replacement cost of assets[446].

[445] While this is formally the correct way to address the risk of failure, it can be extremely difficult to determine the probabilities that should be attached to particular cashflow projections. As a result companies frequently address failure risks in a more simplistic way, by using a hurdle rate of return that is somewhat above their WACC.

[446] These figures are based on Oxera's own "high level" cost allocation between wholesale and retail activities. They are supported by calculations based on Analysys Mason's bottom-up cost allocation which also show that wholesale returns are higher than retail returns. However, the Analysys Mason allocation results in higher returns for both retail and wholesale businesses. This is because although revenues are the same as in the "high level" approach, the alternative calculation excludes some non-TV costs that cannot be identified at a higher level of disaggregation. In other words, the calculation of returns under the Analysys Mason cost allocation includes some non-TV revenues, but not the associated costs. This overstates the overall returns, but is nonetheless informative with respect to relative wholesale and retail returns. We would expect all of the non-TV revenues to apply to Sky's retail business. Exclusion of these revenues would reduce Sky's retail returns, but leave wholesale returns unchanged. Hence the conclusion that wholesale returns are higher than retail returns appears robust.

6.196 On the relative profitability of Sky's wholesale sports and movies activities, as we have highlighted previously, a critical challenge relates to revenue allocation for products sold in bundles. However, because most costs are direct, it is possible to reach a clearer view on the most appropriate cost allocation. Under Oxera's central "preference based" assumption for revenue allocation, and based on Sky's wholesale rate-card prices, it estimates margins of **[✂]**% and **[✂]**% for sports and movies respectively.

6.197 Oxera then considers an alternative approach to disaggregating sports and movies revenues when these products are sold in bundles. At one extreme, all subscribers to bundles of sports and movies are treated as "sports lovers", purchasing movies as an add-on. Hence Oxera considers the stand-alone price of sports as the relevant price of sports in the bundle, and the incremental price of movies to be the relevant price of movies[447]. At the other extreme, all subscribers to the bundles are treated as "movie lovers", so the relevant price of movies is the standalone movies price, and the relevant price of sports is the incremental price. These extreme assumptions do not change the overall result that margins for movies are greater than those for sports, although the maximum allocation of revenues to sports narrows the gap substantially (margins for movies are **[✂]**% and margins for sport are **[✂]**%).

6.198 Nonetheless, Oxera concludes that "estimates of returns for sports / movies channels do not seem sufficiently robust to draw conclusions on the relative returns at the retail and wholesale levels".

6.199 We agree that it is difficult to be definitive on returns on investment. However, in our own view, because of the relatively low level of common costs in this area and the possibility of identifying the reasonable limits for revenue allocation, we can be more definitive with respect to margins. We consider that the evidence points towards margins for movies being higher than those for sports.

Comparison of Sky's returns to other comparators

6.200 We also asked Oxera to benchmark Sky's results against appropriate comparators (firms with similar business characteristics to Sky, both TV and non-TV). The results of this comparison are described in detail in Oxera's report (Annex 9), but in summary Oxera found that Sky in aggregate, and Sky's wholesale operations in particular, had a higher ROCE than comparator businesses over the period 2003-07. While the range of results was wide, the mean and median ROCE across 30 comparators were both around 7%, compared to Sky's ROCE of **[✂]**% (book asset values) and **[✂]**% (based on replacement cost). Sky's retail operations had a similar ROCE to comparators, although Sky's retail margins appeared lower than comparators.

Conclusions

6.201 Oxera's results suggest that Sky is earning returns considerably above its WACC. As Oxera states in its report, its analysis suggests that Sky is making returns higher than would be expected in a competitive market where new entrants were able to compete

[447] Any greater allocation of revenues to sports would assume that purchasers of the bundle were paying more than their willingness to pay for movies. To take a simple and entirely illustrative example, if the combined price of sports and movies is £50 and the standalone price of sports is £40, then this extreme allocation would assume that the sports product was priced at £40 in the bundle, and the movies product was priced at £10. Any subscribers with a lower willingness to pay for movies would only purchase the standalone sports product.

effectively for all subscribers. The analysis shows that the cost of acquiring new subscribers has increased over time, but by less than would have been expected in a perfectly competitive market.

6.202 More specifically, Oxera's analysis suggests that the value of Sky's subscriber base, and its IRR are higher than would be expected in a fully competitive market. Our view based on Oxera's analysis is that in a competitive market new entrants would have reduced the profitability of the subscriber base and effectively competed for Sky's most valuable subscribers. This would have had the effect of pushing Sky's aggregate returns down considerably closer to its cost of capital. This does not appear to have happened.

6.203 Indeed, recent comments by Jeremy Darroch suggest that Sky believes there is scope for it to increase its profitability in the near future. At a recent conference, he stated that the business "feels like it's on the cusp of a turnaround in profits and earnings" having "invested a lot over the last few years"[448]. This would suggest that Sky's view is that more recent returns have been depressed by investment – perhaps in triple play, which is included in Oxera's analysis – but that they are likely to increase in the future.

6.204 Oxera's results also suggest that profitability is higher for Sky's wholesale business than for its retail business. This is consistent with what we would expect from our economic analysis of the incentives that Sky faces, and Sky's own statements about the way in which it determines its wholesale rate-card.

6.205 This result depends in part on the allocation of costs between Sky's wholesale and retail activities - an allocation that is also relevant to our discussion of pricing in section 9 below. Oxera's results are robust to using the same detailed cost allocation that we have used as part of our pricing analysis. In conjunction with our understanding of the way in which Sky sets its wholesale prices, the finding that profits are higher at the wholesale level helps provide assurance of the appropriateness of that cost allocation.

6.206 We recognise that further disaggregation of profitability beyond wholesale and retail activities needs to be treated with caution, because of the difficulties of attributing revenues to products that are sold in bundles, further challenges around cost allocation and the difficulty of allocating assets to particular lines of business. However, we believe that there is merit in looking at wholesale returns on sales for premium sports and premium movie channels. These products account for relatively few common costs and it is possible to identify the likely range of appropriate revenue allocations. Furthermore, a margin calculation does not rely on a view on asset allocation. It therefore provides an indication of the likely relativity between the two categories of product.

6.207 Oxera's results suggest that wholesale margins for movies channels are higher than those for wholesale sports channels. This result holds even under the most extreme revenue allocation assumptions that we would consider reasonable. As with our view on wholesale returns versus retail returns, this result accords with our understanding of the way in which the market works – namely that, other things being equal, the rents associated with content aggregation are likely to accrue in large part to the content aggregator.

[448] www.broadcastnow.co.uk/5002087.article

Consultation questions

1. Do you agree with Oxera's approach to the valuation of Sky's intangible asset base?

2. Do you agree with Oxera's approach to assessing Sky's profitability?

3. Do you agree with our assessment of Sky's weighted average cost of capital?

4. Do you agree with the conclusions we draw about Sky's aggregate profitability?

5. Do you agree with the conclusions we draw about Sky's profitability at a disaggregated level?

Section 7

Consumer effects

Summary

7.1 We noted in our Second Pay TV Consultation that markets where competition is weak, and consumers are unable to exercise a real choice between suppliers, are unlikely to deliver the best outcomes for consumers. We set out several criteria against which we proposed to assess the operation of the market from a consumer perspective, focussing on choice, innovation and pricing. We use those criteria to consider the effect on consumers of the position that, as a result of Sky's approach to the wholesale supply of Core Premium channels, there is not, and there is not likely to be, fair and effective competition.

7.2 The most obvious manifestation of reduced consumer choice is the restricted availability of Sky's premium content on other platforms. The fact that consumers on a number of platforms are currently either unable to access the most valuable sport and movie content, or face restricted access, is a source of concern.

7.3 Those customers who most value premium content are more likely to have chosen Sky's own satellite platform. This means that some consumers are likely to be on a platform which would not have been their first choice had premium content been equally available on all platforms.

7.4 This creates a risk that existing platforms may not create new capabilities, and that new platforms may not emerge at all, because of a dependence on access to premium content. This dependence might either be direct (e.g. the dependence of IPTV services on certain VoD rights) or indirect (e.g. because new platforms cannot build sufficient scale without access to premium content). Either way, there is a risk that platform innovation will be reduced.

7.5 These concerns are exacerbated as we look forward to the future; we are at a point where the potential choice of platforms is increasing, and is set to increase further. The chances of these options developing fully to the benefit of consumers are likely to be limited by the restricted availability of Core Premium channels. We consider on the basis of these effects that there is an adverse effect on the interests of consumers.

7.6 The analysis which has been carried out by Oxera suggests that Sky is earning aggregate returns in excess of its cost of capital, implying retail prices that are above the competitive level.

Introduction

7.7 In this section we assess the likely effects on consumers of the competition concerns we identified in the previous section. This takes into consideration the historical development of pay TV, and the evidence that this provides to us, but also takes a forward looking view of the potential benefits to consumers associated with future developments.

7.8 Our previous consultations set out criteria by which we would judge the performance of the market. We set out our views on consumer effects in light of these, which are as follows:

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

7.9 In section 6 we reached the view that Sky's approach to the wholesale supply of Core Premium channels creates a position in which there is not, and there is not likely to be, fair and effective competition in the wholesale of Core Premium channels and the retail supply of bundles which include Core Premium channels. In this section we consider the effects on consumers of that position. We also identify concerns which relate to high wholesale margins. We take these in turn, but start by reviewing our position in our Second Pay TV Consultation and consultation responses.

The need for a forward-looking view

7.10 As discussed in section 2, under s316 we are required to ensure fair and effective competition in the provision of licensed services. When considering action under s316 we take into account our sectoral duties, including our principal duty to protect the interests of consumers, where appropriate by promoting competition. Under this framework we should therefore, as the sectoral regulator, take a forward-looking view of the market in order to assess the likely future effects of the competition issues identified in section 6 for markets and the consumers they serve.

7.11 We noted in Section 3 that it is possible to distinguish three fairly distinct periods of historic growth in pay TV:

- Steady growth in analogue pay TV services during the 1990s, on both satellite and cable, driven by access to premium content, and in particular the acquisition by Sky in 1992 of exclusive rights to live Premier League football.
- The migration from analogue to digital at the end of the 1990s, greatly increasing the range of content and value-added services that could be delivered to subscribers.

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

7.12 However, our forward looking assessment needs to take account of a number of important developments recently, including:

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

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

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

- The intervention by the European Commission to change the way in which Premier League football rights are sold. The 2007/ 8 football season was the first since 1992 for which Sky has not owned these rights exclusively.

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

7.13 We set out in our 2008 Communications Market Report[449] a number of ways in which some recent innovations are already benefiting consumers:

- We found that penetration of digital television rose by around 7.5 percentage points in the year, reaching 87.1% by the end of Q1 2008, making DTV as prevalent as fixed telephony connections. We noted that this has in turn triggered a surge of interest in new services to enhance digital television viewing. These include digital video recorders (DVRs) which are now available for all TV platforms and are in 23% of homes, and high-definition (HD) transmissions, received in around 5% of satellite households, and in 11% of cable TV homes.

- The internet emerged as a popular platform for broadcasters for the distribution of audio-visual content in 2007/08. Itv.com re-launched in summer 2007 with free access to live channels, catch-up and archive content. The BBC's iPlayer went live in the same period, first offering downloads and then at Christmas streamed content. By April 2008 it had a unique monthly audience of 1.4m and was dealing with over 700,000 daily viewing requests; Sky re-launched its internet service as Sky Player and Channel 4 began offering free access to its programmes from the last seven days on its website.

- Consumers appear to be responding to this increased supply of internet-based content. Seventeen per cent of those with broadband watched TV over the internet, up by eight percentage points on 2006. This is particularly apparent among younger people; twenty-six per cent of those aged 15-24 watched TV over the internet, up by 16 percentage points in twelve months. A report by O+O – "TV Enters The On Demand Age" (January 2009) – noted that iPlayer is almost as popular as YouTube, with Sky Player some way behind.

[449] http://www.ofcom.org.uk/research/cm/cmr08/

- Mobile broadband emerged in 2008 as an increasingly popular means of accessing the internet. The five mobile network operators have all begun to target their mobile broadband offers at residential consumers, and while the subscriber base is relatively low, it is growing fast. There were over 500k new connections in the five months from February 2008, with 133k connections in June 2008. However, there is still not much evidence of demand for mobile TV[450].

- Four in ten households took a bundled communications service in 2007 (the same proportion as in 2006), but Ofcom's research suggests that more complex bundles are becoming increasingly popular, with a shift during 2007 in favour of the triple-play of fixed / broadband / TV. The proportion taking this option rose by 78%, to account for 32% of all bundles taken in Q1 2008, mainly from fixed line and broadband double-play bundles[451].

7.14 It is of course impossible to predict with any precision the future benefits for consumers of innovation, and come up with a precise factual and counter-factual for the development of the market, depending on whether or not we intervene. Nevertheless, it is clear that the interaction between networks, content and devices is at the heart of how consumers will consume content services in the future.

7.15 Some possible future scenarios were set out in a piece of research carried out by Deloitte as part of our preparation for Ofcom's new strategic framework, as summarised in the table below.

[450] O+O report: TV Enters The On Demand Age, January 2009 - http://www.oando.co.uk/publications.php.

[451] http://www.ofcom.org.uk/research/cm/cmr08/converge/converge.pdf, figure 2.90.

Figure 59 Summary of forward-looking scenarios set out by Deloitte

Scenario	Description	Impact on consumers
'Groundhog Day'	Very similar to today's world, where no capacity constraints exist and most consumers prefer a 'lean back' experience	Mass market continues to consume 'lean back' passive content
'Jamie and the Magic Torch'	A device led environment, where consumers are free to use any content on any device	Primary relationship with devices, which offer increased quality and choice
'Absolute Power'	A world of choice and personalisation where consumers are served instantly via the cloud	Primary relationships with online CSPs offering the broadest range of content and services
'Pushing Tin'	The service remains prominent but content and service delivery are enabled by the network operators	Content and services are prioritised by the network and delivered by the device
'The Matrix'	A walled garden of content and services delivered from the cloud in partnership with the network operators	Primary relationship with the network operator who offer a walled garden of controlled services
'Upstairs Downstairs'	Major network capacity constraints in some areas create a world of digital 'haves' and 'have-nots'	A digital divide exists between those in areas with significant access speeds and those in areas without
'Pirates of the Caribbean'	Lack of incentive to invest in content of the network as consumers are happy to access illegal content and services	A drop in content choice and quality due to a lack of incentive for CSPs to invest

7.16 More specific examples of new means of accessing content include:

- Video on demand. The BBC in particular believes VoD services have great potential. Project Canvas aims to combine multiple on-demand services and make them accessible directly through the television set. The recent public consultation document on Canvas highlighted the success of iPlayer on Virgin Media's platform. The BBC reported that in the week commencing 30 June 2008, an average of 235,000 Virgin Media 'unique users' accessed TV iPlayer content each day, compared to 359,000 'unique users' accessing the PC iPlayer[452]. It is estimated[453] that 5.5 million UK households had access to VoD services in 2008, and that this will rise to 8.5 million (30% penetration) when Digital Switchover takes place in 2012, rising to about 11 million homes by 2017.

[452] Canvas:Proposition and public value case" http://www.bbc.co.uk/bbctrust/assets/files/pdf/consult/canvas/canvas_application.pdf.

[453] Source: Enders Analysis.

- TV through internet-connected games consoles. Some forecasts have predicted consoles forming up to half of the market for downloaded movies. Consoles have the potential to combine television viewing (bringing Internet-delivered VoD to the television set) and gaming[454].

- Video downloaded onto portable devices such as an iPod or portable games consoles.

7.17 The Deloitte report also noted the possibility of 'wild cards', which might have potentially disruptive effects (positively or negatively) such as mobile TV taking off or next-generation DVRs pulling content direct from the internet. These particularly make the point that innovation is inherently unpredictable.

7.18 We have also looked at recent consumer research carried out by Essential and presented to Ofcom. Their report suggests that the overwhelming consumer demand is for long-form (i.e. full programmes rather than clips) on demand content on TV. According to the research, VoD consumption will start to "take off only once it is widely and easily available through the TV screen"[455]. The report also identifies other qualities for successful long form VoD services, for example:

- Offering a wide range of content under one roof.

- Integration with other viewing options e.g. linear channels and the hard drive – regardless of delivery technology.

- Content portable across platform/devices once purchased[456].

7.19 The Cisco Visual Network Index (VNI) is an effort to forecast the growth and use of IP networking worldwide, and provides a useful perspective on the forward looking potential of TV and other video services delivered over IP. The most recent forecast[457] suggests that:

- The sum of all forms of video (TV, VoD, Internet, and P2P) will account for over 91 percent of global consumer traffic by 2013. Internet video alone will account for over 60 percent of all consumer Internet traffic in 2013.

- Real-time video is growing in importance. By 2013, internet TV will be over 4 percent of consumer internet traffic, and other video will be 8 percent of consumer internet traffic. TV has gained substantial ground in the past few years: globally, P2P TV is now slightly over 7 percent of overall P2P traffic at over 200 petabytes per month.

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[454] New Media Markets, Julia Glotz "Consoles 'could take biggest share of VOD market'", 15 May 2009.

[455] Essential, "VOD: State of Play", a consumer research report, September 2008, slide 7.

[456] Ibid, slide 12.

[457] http://www.cisco.com/en/US/solutions/collateral/ns341/ns525/ns537/ns705/ns827/white_paper_c11-481360_ns827_Networking_Solutions_White_Paper.html

- VoD traffic will double every two years through 2013. Consumer IPTV and CATV traffic will grow at a 53 percent CAGR between 2008 and 2013, compared to a CAGR of 40 percent for consumer Internet traffic[458].

7.20 In summary, the markets of interest to us are part of a sector where there is considerable scope for innovation and profound changes in the consumer experience. But the scale and depth of innovation, and the technologies that will play the greatest role in the future of the sector, are at present uncertain. We must have regard to this broader picture in assessing the effects on consumers of the competition problems we have identified.

Our position in September

7.21 In our Second Pay TV Consultation, we set out our view that competition in pay TV was likely to be weakened by restricted distribution of Core Premium channels. We argued that markets where competition is weak, and consumers are unable to exercise a real choice between suppliers, are unlikely to deliver the best outcomes for consumers. This might manifest itself in several ways.

7.22 Firstly, we identified a risk that consumer choice and retail innovation will be reduced. The most obvious manifestation of reduced consumer choice is the restricted availability of Sky’s premium content on other platforms. Even where content was available on a platform, we argued that consumer choice might be restricted if that content were only made available via a limited range of content bundles. We noted that although Sky did offer a wide range of content bundles, the pricing of these encouraged consumers to trade up to a small number of ‘big mixes’. We believed that consumers would benefit from a wider variety of entry-level packages being more widely available for premium content.

7.23 Secondly, we identified a risk that platform innovation would be reduced. We argued that innovation in areas less well suited to the strengths of Sky’s DSat platform might well have proceeded faster if wholesale premium content had been more widely available on other platforms.

7.24 We stressed that the development of the pay TV sector was at a point when new platforms using new distribution technologies, such as IPTV and mobile TV, could offer significant benefits to consumers. Our general expectation was that such platforms would offer consumers greater convenience and enhanced service flexibility, by allowing them to access content on demand, or when on the move. We recognized a real risk that the development of these new platforms could be held back by limited access to premium content, thereby denying consumers the associated benefits.

7.25 Finally, we said that there was a risk that prices to consumers would be high, either because of Sky’s ability to set high wholesale prices, or because of Sky’s ability to leverage upstream market power into downstream retail markets and set high retail prices.

[458] These are global forecasts; bearing in mind the current situation with regard to Sky’s approach to the wholesale supply of Core Premium channels, the UK could fall behind this.

Respondents' views

Overall approach

7.26 Sky argued that the UK audiovisual market was competitive and functioning well: "It is delivering strong benefits to consumers who can choose from over 500 unique linear channels, thousands of different packages of channels, numerous suppliers of PVRs, thousands of hours of VoD content from a wide range of sources, the largest number of HD channels available in Europe, and genuine value pay TV services from a number of providers over multiple platforms"[459].

7.27 Sky highlighted the recent developments in the market (e.g. iPlayer, Blinkbox) that contribute to the competitive nature of a market in which there are high levels of penetration for pay TV and within that, for premium channels and PVRs[460].

7.28 Sky argued that the current healthy state of the market must be taken into account in considering the proportionality of any intervention and that Ofcom did not properly consider what is at risk through its proposed intervention[461]. It argued Ofcom's proposals had the potential to introduce long-term distortions in the sector, resulting, among other things, in a worse outcome for consumers[462].

7.29 One of the individual respondents, Pablo Ibáñez Colomo, a researcher at the European University Institute, strongly criticized Ofcom for the presented theories of harm. In particular he believed that those theories were outdated and based on the protection of competitors, and not on the protection of competition. He also argued that in order to establish that Sky's refusal to supply harmed consumers, Ofcom should have provided evidence that such a strategy would foreclose downstream markets.

7.30 The UK Film Council was concerned that the current lack of competitive offerings in the premium content market had had an adverse effect on consumers, inhibiting new entrants, limiting choice and discouraging innovation to the detriment of many, including the independent film industry in the UK[463].

7.31 The ALMR noted that in the commercial market content was only available via one platform and one retailer[464], and said that customers were being priced out of the platform[465].

7.32 **[✂]** considered that the consumer harm was greater than that identified by Ofcom. **[✂]** argued that it included adverse effects in markets such as residential retail

[459] Sky response, Section 1, page 4.

[460] Sky response, Section 2, paragraphs 1.4 to 1.5.

[461] Sky response, Section 2, paragraph 1.6.

[462] Sky response, Section 1, page 4.

[463] UK Film Council response, Section A, paragraph 4.

[464] ALMR response page 2.

[465] ALMR response page 3.

broadband, where Sky was using bundled services to leverage its position[466]. It also warned that in the absence of regulation, Sky's strategy would "inhibit innovation and erode the nascent inter-platform competition that currently exists between the DSat, cable, DTT and IPTV platforms"[467]. **[✂]** was also concerned that Ofcom did not discuss the obvious detriment that "polarisation" between premium and basic pay TV propositions had on market competition and consumer choice[468].

Choice

7.33 Sky argued that developments in choice of content and platform provision had benefited consumers and that the retail market was competitive. It further believed that a PwC report it had commissioned[469] supported that view, as well as statements made by some of the stakeholders.

7.34 Sky said that consumers had access to a wide range of free to air television channels, and a huge variety of quality content on pay TV channels. Sky said that consumers now had platform choice that did not exist when Ofcom started its investigation. For example (and as discussed above), in December 2008, Sky launched an online linear pay TV service via the Sky Player, which enables customers to subscribe to watch a package of channels from Sky on either a PC or Mac without the need to install a TV-based service[470].

7.35 Freesat felt that under the current situation consumers did not have a wide choice of points of access to premium content. Even where choice of provider was available, consumers had to pay a higher price for access to premium content than they would on Sky. Freesat predicted that without intervention, this was unlikely to change, particularly in the domain of live premium sports content. It noted that the situation with movies might be different as consumers could benefit from increasingly wide distribution of premium movie content via other distribution technologies such as the internet[471].

7.36 The BBC agreed with Ofcom's assessment that consumers' choice of pay TV service is primarily influenced by the content that is available, rather than by platform features[472]. Those wishing to receive premium content were restricted to one option. They could not make choices based on prices, or access some other features they might like and which are provided by other operators[473].

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[466] **[✂]** response, paragraph 2.1.

[467] **[✂]** response, section 6.2.

[468] **[✂]** response, section 8.1.

[469] 'The outcome for consumers in relation to pay TV in Europe', submitted as Annex 1 to Sky's Response to the First Consultation Document.

[470] Sky response, section 2, paragraph 3.9.

[471] Freesat response, question 22.

[472] BBC response, page 1.

[473] BBC response, question 21.

7.37 **[✂]** said that Sky distributed its content in a way that makes it cheaper / more attractive for the customer to choose Sky than select another distribution method. Without intervention customer choice would be effectively reduced to one operator[474].

Innovation

7.38 Sky believed that the UK's pay TV market was delivering positive outcomes for consumers and that there has been substantial innovation in the market due to competitive pressures at the retail level. Further to that Sky cited a second report it had commissioned from PwC, which, Sky claimed, supported the fact that the UK is one of the "leaders in terms of innovation services"[475].

7.39 Sky highlighted that it provided consumers with a number of VoD services either via the TV or the PC. It stated that the number of VoD services that are available to consumers has increased substantially in the past few years and pointed out other platforms providing such services. Sky again cited iPlayer, which it considered a huge success, as being available through a number of different platforms and being used by a large number and a wide variety of consumers[476].

7.40 Sky also argued that it has made substantial innovations in its pricing and packaging over time. The introduction of genre packages provided Sky's subscribers with greater choice and flexibility. The PwC report recognised this and found that Sky has been a leader in the introduction of genre-themed basic packages.

7.41 Freesat acknowledged that at present some consumers benefit from innovative platform enhancements made on the Sky platform. It asked whether further innovations would have been generated, particularly on non-satellite platforms, if there had been more vigorous competition in that sector[477].

7.42 Virgin Media agreed with Ofcom's analysis in relation to innovation. Additionally, it believed that consumers were being denied the ability "to choose… the retail product that best serves their needs" due to the lack of packaging innovation[478].

7.43 **[✂]** argued that there were adverse effects in markets such as residential retail broadband, where Sky was using bundled services to leverage its position[479].

Satisfaction

7.44 Sky referred to Ofcom's own research which it believes showed that consumers are satisfied with their pay TV services, and getting good value for money from them. Sky said it was not surprised to see the high levels of consumer satisfaction, given the

[474] **[✂]** response, question 22.

[475] Sky response, section 2, paragraph 2.34.

[476] Sky response, section 2, paragraph 2.36.

[477] Freesat response, question 22.

[478] Virgin Media response, Annex 1, paragraph 23.1(b)

[479] **[✂]** response, paragraph 2.1.

increase in content, the flexibility over how it can be consumed and a lower real price[480].

7.45 Virgin Media reiterated its concerns that Ofcom's analysis failed to provide any information on customer satisfaction levels which might otherwise prevail under more competitive market conditions. It believed that the current results in that respect are biased[481].

Our current view

7.46 We distinguish between effects which arise from restricted distribution of Core Premium channels and restricted exploitation of particular content rights, and those which arise from high wholesale prices.

7.47 Restricted distribution of Core Premium channels and restricted exploitation of content rights affect both the choice which is available to consumers, and the scope for innovation (including the large scale adoption of innovative products) in the market. High wholesale prices are likely to be directly reflected in the retail prices consumers pay for pay TV services which include Core Premium channels. We consider each of these effects in turn.

7.48 We have not conducted any further analysis of consumer satisfaction. However we share Virgin Media’s concern as to the limited usefulness of survey evidence in this regard. Customers may well express high levels of satisfaction if a service is provided at a quality and price they have come to expect, but that does not rule out the possibility that a change in the market, through greater price competition or more innovation, would greatly increase consumer welfare.

7.49 We consider in this section both those effects from our competition concerns that we can observe already having an impact on consumers now, and also those effects that are likely to have more of an impact as the pay TV landscape develops into the future.

Choice

7.50 Consumers have a limited choice of retailers from whom they can purchase Core Premium channels. As we have set out in section 6, distribution of the most important pay TV content is limited to certain platforms. Given that only around half of all homes are in areas where cable is available[482], this means that around half of UK households only have a single option[483] for subscribing to a pay TV service which includes these channels.

7.51 Many consumers have strong preferences for particular TV channels or content, as we set out in section 3 and in our market definition analysis in section 4. Consumers are also likely to have preferences for a particular delivery platform, since different

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480 Sky response, section 2, paragraph 4.6.

481 Virgin Media response, Annex 1, paragraph 23.4.

482 Virgin Media reaches 12.6 million homes in the UK out of a total of around 25.7 million (Source: Virgin Media, Annual Report 2008, page 7; National Statistics, Social Trends 2008).

483 Some of these households may not be able to access Sky DSat either, because of technical or other restrictions.

platforms have different technical characteristics, and pay TV services are sold in varying bundles with other services which vary depending on the platform[484].

7.52 The combination of these factors means that some consumers will have to choose between either doing without Core Premium channels, or accessing pay TV via a platform that would not otherwise be their preferred choice.

7.53 The potential effects are summarised in Figure 60. We consider in turn the different groups for whom we see a potential concern.

Figure 60 Consumer effects relating to choice

Type of household / subscriber	Number of households / subscribers (million, 2008)	Potential distortion of choice
DSat: Basic	[✂]	None
DSat: Sky Core Premium	[✂]	Distortion of platform choice – some consumers with a preference for other platforms may have subscribed to Sky to access premium content
Cable: Basic	[✂]	Unmet demand – weak incentives on cable firms to market Sky Core Premium channels, leading to low take-up
Cable: Sky Core Premium	[✂]	None
Other households	13.7	Unmet demand – some consumers would subscribe to Sky Core Premium channels if available on other platforms

Basic customers on DSAT

7.54 We do not have a concern that there is any distortion of consumer choice in relation to the **[✂]** million consumers currently on DSat and purchasing basic channels. These consumers have chosen the DSat platform for some reason other than Core Premium channels, so we assume that this platform choice is undistorted, and these consumers have the option of purchasing Core Premium channels.

484 Sky noted in its response to our Second Pay TV Consultation that: "Sky believes that making its content available across a variety of platforms increases demand because there is a significant number of consumers who have strong preferences as to which platform they use, or are restricted as to which platforms are available to them". Section 5, paragraph 2.2.

Sky Core Premium customers on DSat

7.55 The restricted availability of premium content on other platforms is likely to distort platform choice for those consumers who have a strong interest in premium content, even if they also have a preference for a non-DSat platform. This creates a specific concern that a proportion of the **[✂]** million Core Premium consumers who are currently on DSat are not on their preferred platform.

7.56 Premium content is clearly an important driver of platform choice: in a survey for Ofcom[485], 64 per cent of Sky premium customers, when asked about reasons for choosing their current TV provider, mentioned being able to watch particular programmes or channels as among their top three reasons (compared to 43 per cent of Sky basic customers and 20 per cent of Virgin Media customers[486]). In contrast, Virgin Media customers were much more likely to mention price and availability of bundled services as reasons for choosing their provider – few Sky customers mentioned these factors.

7.57 In areas where both DSat and cable are available, consumers with a strong preference for pay TV content have at least two choices of provider, although the lack of incentive on Virgin Media to market Sky's Core Premium channels may mean that some are unaware it is carried by Virgin Media. Another possible reason for some Sky customers choosing to watch Core Premium channels on DSat rather than cable may be access to Sky's HD and Sky's interactive services[487].

7.58 We are concerned that some subscribers may have chosen DSat because of the restricted availability of these services, rather than out of a preference for the DSat platform.

7.59 Although the platform differences between Sky and cable operators have arguably shrunk in recent years, as Sky has increasingly offered bundled products, there remain substantial differences between the two types of platforms, which are likely to influence consumer choice. For example, quite apart from differences in the extent of bundled services, Virgin Media's platform has been able to provide true VoD for several years, unlike satellite; in addition, it avoids the need for a satellite dish.

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[485] Pay TV research Phase 3, TNS Media Division, September 2007.

[486] We note that this research took place in late 2007, and results are likely to have been influenced to some extent by the dispute – ongoing at the time – between Sky and Virgin Media which led to Sky basic channels being removed from Virgin Media's platform.

[487] Survey evidence from 2007 (Pay TV research Phase 3, TNS Media Division, September 2007) indicated that Sky customers were more likely than Virgin Media customers to mention recording features (Such as Sky+, Telewest TV Drive or V Box) and on-screen programming guides as reasons for choosing their TV providers. These features were mentioned by, respectively, 10 and 8 per cent of Sky customers, but only 2 and 3 per cent of Virgin Media customers. While this is clearly of less importance than other aspects of the service, the difference suggests a perception that Sky has better recording and programme guides than Virgin Media, and this may explain some of the preference for Sky's platform among those with a strong preference for Core Premium channels. Sky premium customers were twice as likely to mention recording features as a reason for choosing Sky (12%) as Sky basic customers (5%) or Virgin Media premium customers (6%). Other features were seen as less important by both Sky and Virgin Media customers – for example HDTV, interactive services and pay-per-view or VoD services. However, this is likely to reflect that HDTV and VoD were just being introduced into the market at the time of the survey.

7.60 Sky's Core Premium customers on DSat could also potentially have a preference for accessing these channels via other distribution technologies than cable. The extent of such preference has not yet been tested in practice, due to the very limited availability of Core Premium content on other platforms. It does however seem to have been a consideration for Sky when considering its strategy in relation to other platforms, for example:

- Early research for Sky relating to its planned Picnic service suggested that a proportion of customers for the proposed service would come from Sky's DSat customers.[488]

- Our assessment of Sky's pricing for Core Premium channels on Sky Player (see Section 6) suggests that Sky may have some concern about the propensity of its DSat Core Premium customers to switch to viewing these channels via PC.

- A survey by O&O[489] found that 20 to 25 per cent of existing cable and Sky homes might be interested, and 8 per cent to 12 per cent seriously interested in swapping to Picnic.

- On the basis of our impact assessment, we estimate that by the fifth year of our proposed remedy DTT / IPTV retailers would serve two million Core Premium customers. Of those, we estimated that just over half would, in the absence of a remedy, take a pay TV package from Sky.

<u>Basic cable customers</u>

7.61 As noted in paragraph 6.125 above, penetration of Sky's Core Premium channels on Virgin Media is only **[✂]** of that on DSat, and has fallen substantially in recent years. Penetration of this content on DSat has also fallen, but the gap in penetration between the two platforms has widened. This creates a specific concern that there is unmet demand amongst the **[✂]** million basic consumers who are currently on cable for Core Premium channels.

7.62 The difference in penetration of Sky's Core Premium channels between DSat and cable is surprising given that it is available on both platforms at a broadly similar price. The fact that penetration on cable has declined **[✂]** in recent years suggests that this is not all down to consumers having an innate preference for watching Core Premium channels via satellite.

7.63 **[✂]**[490]. This suggests that a substantial proportion of Virgin Media customers who do not currently subscribe to Sky's Core Premium channels may have an interest in doing so, although evidently not at current prices.

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[488] Spot Market Sizing Debrief, Incite Marketing Planning, May 2007; Quantitative Omnibus Research Findings, Sky, January 2007.

[489] O+O report: TV Enters The On Demand Age, January 2009 - http://www.oando.co.uk/publications.php .

[490] **[✂]**.

Premium customers on cable

7.64 We do not have a significant concern that there is a distortion of consumer choice in relation to the **[✂]** consumers currently on cable and purchasing Core Premium channels. It is possible that these consumers would have purchased Core Premium channels on DTT or IPTV had they been available on these platforms, but the fact that they have chosen the cable platform over DSat, despite their interest in Core Premium content, suggests that they do value certain features of the cable platform.

Other households

7.65 While households with a very strong demand for Sky's Core Premium channels are likely to subscribe to DSat or cable, there is evidence, described below, of substantial unmet demand among other households for Core Premium channels, This unmet demand might arise for a variety of reasons including:

- Inability to access existing satellite or cable platforms. Such consumers may live outside cable areas and be unable or unwilling to have a satellite dish
- A preference for content to be delivered via DTT or IPTV-based platforms, on which Core Premium channels are not currently available, for example because of a preference for 'Video on Demand' services.
- A preference for entry-level premium content bundles, of a type which are not currently available. Such consumers may be unwilling to pay for a full package of premium content at current prices, but would be interested in the types of entry-level packages introduced by Setanta[491].

7.66 This raises a specific concern that a proportion of the 13.7m households that are not currently on either DSat or cable would subscribe to Core Premium channels if these were widely available on DTT or IPTV platforms, but that they are currently unable to do so.

7.67 Research carried out by Freeview in November 2007 found that around 22% of Freeview users would definitely or probably consider paying either a monthly or one-off fee to access more channels / programmes in addition to Freeview's channels[492]. While this research did not specify which channels consumers would particularly like to take up via DTT, our own consumer research indicates that sports and movies are the two most popular genres where there is a high degree of exclusivity to pay TV (see section 3).

7.68 Further evidence comes from Sky's proposed Picnic service. Sky estimated (in April 2008) that around **[✂]** current DTT households would subscribe to premium content on its proposed Picnic service within three years of launch, and equivalent to around **[✂]** per cent of DTT households, and **[✂]** within five years. This suggests that a significant number of households who do not subscribe to DSat or cable would

[491] Although following Setanta's exit from the market, it remains to be seen to what extent ESPN's packaging and pricing will follow Setanta's.

[492] 462 face-to-face interviews were conducted between 14 and 25 November 2007 by Taylor Nelson Sofres on behalf of Freeview. 70% of respondents were Freeview viewers and 30% were non-digital viewers.

like to have access to Sky's Core Premium channels on another platform. As such, these consumers are worse off because Sky does not wholesale to retailers on DTT.

7.69 Of course, demand for this content on DTT will depend on the retail price. Sky planned to charge £**[✂]** for five channels[493] in its proposed Picnic service. But on Sky's DSat service, to take an example, Sky charges £33.50 for a bundle which includes its Variety entertainment pack (23 channels, only two of which are on Freeview) and its Movies pack (12 channels), £35.50 for Variety with Sports (four channels, including Sky Sports 2), or £42 for Variety with Movies and Sports.

7.70 **[✂]**[494], **[✂]**.

7.71 If Sky continues to favour its DSat platform, the growth of innovative services such as IPTV may increase the distortion of platform choice. As reported in our previous consultation[495], Tiscali (which carries Sky's Core Premium channels on its IPTV platform, but effectively as Sky's agent[496]) has attributed the lack of success of IPTV to a lack of access to premium channels.

7.72 This distortion could have an increasingly important impact on UK consumers. As mentioned in paragraph 7.19, global consumer IPTV and VoD traffic has recently been forecast to grow at 53 per cent per annum from 2008 to 2013[497]. It is possible that the restricted availability of Sky's Core Premium channels will slow the growth of IPTV in the UK – as Tiscali argues has already happened, and that, to the extent that IPTV *does* become a more widely adopted platform, some consumers will suffer a detriment of not being able to watch Core Premium channels on this platform. Both of these effects could occur to some extent, although clearly there is a degree of trade-off between them.

7.73 Our concern here is only amplified as time goes on, and more ways of consuming TV emerge as viable alternatives for consumers. As more distribution technologies and platforms emerge, so the preferences for those are likely to become more fragmented. In the 1990s, consumers would have had a choice of just satellite or cable for pay TV; now and looking into the future they might in principle be able to add IPTV, DTT, mobile TV, alternative satellite platforms, other devices such as games consoles or various hybrids to those options. That choice will however not be open to them if their preferences for Core Premium channels are strong enough to force them to remain with the current options.

7.74 In addition, in the long term the restricted supply of Core Premium channels may prevent the emergence of other platforms, or limit their development, leading to less choice and competition and therefore to the detriment of consumers. This point is considered further in our discussion of innovation.

[493] Five channels on three streams.

[494] Sky's business model for Picnic assumes that it will not draw customers away from DSat, suggesting Sky may have set the price of Picnic to achieve this.

[495] Second Pay TV consultation, paragraph 6.13.

[496] Second Pay TV consultation, paragraph 6.85.

[497] Cisco Visual Networking Index: Forecast and Methodology, 2008–2013

Distorted choice of bundles

7.75 In our Second Pay TV Consultation (paragraph 6.1), we noted that the increased importance of 'triple-play' bundles creates a further risk that the distortion of consumer choice would extend to the other services which are included in such bundles, such as broadband and telephony services. We remain of this view.

7.76 Where Sky bundles additional products with Core Premium channels, there is a risk that it can leverage its upstream market power to distort downstream competition. Our potential concern is that efficient providers of the additional products may be unable to compete with Sky because they do not have access to the relevant upstream input.

7.77 The nature of this concern depends on the way in which the additional products are priced. Where the incremental price of an additional product is at or above its long run incremental cost, we would not have a concern. Efficient rival providers of the additional product would be able to compete, and consumers would have an undistorted choice between taking the additional product from Sky or from an alternative provider.

7.78 However, if the incremental price of an additional bundled product were less than its (long run) incremental cost, then potential competitors for the bundled product would not be able to compete on equivalent terms. To match Sky's incremental price, they would be obliged to price a standalone product below cost. Furthermore, they would not be able to compete for the bundle because they would not have access to the relevant wholesale channels. In other words, the bundle would not be replicable.

7.79 In this context, we note that setting incremental prices below incremental cost may nonetheless be profitable for Sky (even absent any wider strategic considerations). A low price for an additional product may attract more subscribers to Sky's Core Premium pay TV offering, and these additional revenues may offset any losses associated with the additional product. However, our concern in this area is not so much about Sky deliberately pricing below cost in the hope of future recoupment, but the exclusion of efficient competitors in downstream markets.

7.80 We have not undertaken a detailed analysis of Sky's incremental costs and incremental prices to confirm whether or not any of Sky's current bundles would give rise to concerns of this sort. In principle, if we were able to ensure that Sky's bundles were properly replicable, then such concerns would not arise. We discuss this issue in more detail in section 9.

Conclusions on choice

7.81 Our concerns on choice relate not only to the current situation for consumers, but also in particular how the pay TV sector is likely to develop in future.

- In terms of current concerns, choice of platforms is already limited by the restricted availability of Core Premium channels. We believe platform choice is already likely to have been distorted, since consumers who in principle would prefer to view Core Premium channels over platforms on non-satellite platforms do not have this as a free choice.

- Similarly, while we should be cautious about being too precise about the reasons for the much lower penetration of premium channels on Virgin Media's platform than on Sky's, it appears that the platform choice of people subscribing to premium channels has been distorted in favour of satellite and away from cable over time.

- These concerns are exacerbated as we look forward to the future; we are at a point where the potential choice of platforms is increasing, and is set to increase further. The chances of these options developing fully to the benefit of consumers are likely to be limited by the restricted availability of Core Premium channels.

- We also have a current and forward-looking concern related to the possibility of market power in Core Premium channels distorting choice of wider bundles, which again is a concern that increases over time, as bundling becomes more widespread.

7.82 We consider on the basis of the above that Sky's approach to the wholesale supply of Core Premium channels results, and is likely to result in future, in an adverse effect on the interests of consumers.

Innovation

7.83 In our Second Pay TV Consultation (paragraphs 7.44 – 7.47) we noted that the record of innovation in platform enhancements was strong in the UK, particularly on Sky's satellite platform. However, we noted that the PwC report commissioned by Sky focused on types of innovation that were well suited to satellite, and on which Sky had performed strongly, including HD, DVRs, and digital TV itself.

7.84 We remain of the view that innovation in platform enhancement has been strong in the UK, but that it has been stronger in developments that favour satellite platforms, and less strong in those that favour non-satellite platforms.

7.85 Looking forward, we see scope for platforms using technologies such as IPTV to develop much more substantially. We would expect to see the fastest progress in these areas if companies other than Sky were able to push them forward. Sky might also make some progress in IPTV, as an example – some of its set-top boxes already have the technical capability. However, as we set out in section 6, we believe that Sky has an incentive to manage the relative success of different retail businesses in favour of its core satellite platform. A much more dynamic environment would be likely if other companies were to gain access to the critically important Core Premium channels, to enable them to push forward with new ways of delivering TV.

7.86 Figure 61 illustrates major innovations that have taken place in the pay TV sector in recent years.

Figure 61 Innovations by Sky and other pay TV providers, 1997 to 2008

Year	Sky	Other providers
1997	**Sky Box Office** - shows movies and occasionally sporting events on PPV (nVoD). The movies are available for £3.91. Sky reported half a million unique users per month for the year ending in August 2008.	
1998	**Sky Digital** - the improvement in picture and sound quality, increased number of channels and an interactive service.	
1999		**Tiscali TV (formerly known as Homechoice)** - television and VoD service (pull VoD). It offers services on PPV and SVoD. Non-premium movies are available from £1.99. Customers can also sign up to PictureBox for £5. Customers must take Tiscali Broadband to receive TV service. In March 2009 Tiscali had just over [✂] subscribers.
2001	**PVR – Sky+** - results for the first quarter 2009 show that Sky+ has over 5 million users. From 1 July 2008, the standard cost to DTH subscribers of a Sky+ box is a one-off fee of either £75 or £150 depending on the services to which customers subscribe.	
2004	**Sky By Wire** - TV services retailed directly by Sky over the fixed line networks. It was made available on the Tiscali platform. In March 2009 there were only [✂] subscribers to Sky channels.	**Top Up TV** – pay TV service via DTT. It offered Freeview viewers a number of extra channels on a subscription-basis. At the end of October 2008, the total number of pay TV packages supplied by TUTV to subscribers was approximately [✂]
2005	**Sky Mobile TV** - over 25 channels contained in four packages are streamed to the subscriber's mobile phone. Depending on the customer's mobile network subscription to up to four packages which cost from £3 to £5 per month. 3G phone required. In November 2008 one of the mobile phone websites reported that the service (across all networks) had more than 200,000 monthly subscribers, at a cost of £5 per month or £1 per day.	**Virgin Media** - TV-VoD services (pull VoD) on PPV (including premium movies) and SVoD (shows and series). Films cost between £2.00 and £3.50 (HD movies up to £4.50). Customers must sign up to Virgin Phone to get TV services. In the last quarter of 2008 VoD usage increased to 52.9 million average monthly views.
2006	**HD** –requires a Sky+ HD Digibox. All HD channels available to those who subscribe to the Sky Movies and Sky Sports packages. Monthly subscription fee for HD is £10. Over 1 million Sky households took HD as at March 2009. Sky by broadband (a.k.a. - Sky Anytime on PC, Sky Player) - enables premium customers to download sports and movies to their PCs at no extra cost. Sky reported 49000 unique users each month between January and June 2008.	BT Vision – pay TV and VoD service. The BT Vision set-top-box incorporates PVR functionality, provides pull VoD and supports HD (only pre-recorded content). It also provides access to the Freeview DTT service. Content available on SVoD and PPV. Value Packs start from £13.70 a month. Premium movies are for £3.45 and the classics for £1.99. Customers must sign up to BT Phoneline and BT Broadband. By the end of March 2009, BT had over 400k customers. Top Up TV - Top Up TV Anytime. The company changed its business model into a VoD (push VoD). It offers services on SVoD basis. Viewing packs are available from £7 a month (movies content includes films from PictureBox). Boxes are from £49.99 to £99.99. The customer can use the box as a PVR. Over [✂] customers subscribed to the packages in February 2009. Virgin Media – HD service – requires a HD set-top box. Mainly available for VoD content. The V+ Box is from £49 to £99.
2007	**Sky Anytime** – VoD service available to some Sky+ and Sky+ HD customers (push-VoD). The service is intended to provide a catch-up of a selection of the last week's programming. Over 1.6 million homes used the service in 2008.	**Setanta Sports (with FAPL)** - is available on several platforms in the UK, including Sky and Virgin Media. Monthly subscriptions are available, and Virgin includes most of Setanta's channels at no separate charge in its more expensive packages. BT's Value Packs include optional Setanta Sports 1. Individual Viewing Pack on Setanta Sports 1 is for £10.75 per month. Customers on Freeview can subscribe for £10.99 per month.
2008	**Sky Player** - online subscription TV service offering live TV and VoD on SVoD and PPV basis. Non Sky TV consumers can access online content without the need to subscribe to an existing TV-based service from £15 a month. Individual episodes are available from £1. Minimum contract is one month. For Sky digital satellite customers the service is at no extra cost.	

Note that the table shows the launch year for particular services. The description of the services, however, aims to reflect the current situation.

VoD

7.87 VoD is a particular example of a delivery mechanism that does not favour satellite. As noted in our Second Pay TV Consultation, VoD services accounted for a smaller proportion of pay TV revenues in the UK than in other countries including Spain, the US and France.

7.88 As noted above, Sky told us that[498] that there had been strong innovation in VoD, among other services, in the UK (although much of this was for basic FTA content). Sky argued that Ofcom's analysis of VoD services in the UK was seriously flawed. It argued that there were multiple sources of VoD services carrying a wide range of content.

7.89 VoD services were excluded from PwC's innovation index. Sky provided a second report from PwC, to supplement the first. It said that the revised report incorporated VoD and near-VoD services into its innovation indicator and found that this did not significantly alter the ranking in its first report, with the UK remaining among the four leading countries. Sky said that this was hardly a surprise, as the number of VoD services available to UK consumers had increased substantially in the past few years.

7.90 Sky presented this as evidence that Ofcom's analysis of innovation in VoD provision was flawed. We do not consider this to be an accurate description of the PwC report. PwC's innovation indicators combine two sets of indicators – one based on the introduction of a service, the other based on its penetration in the country concerned[499]. PwC considered whether robust VoD and nVoD indicators could be developed. However owing to the lack of data, it did not develop such penetration indicators[500]. As a result, its final ranking takes account only of the date of introduction of VoD and nVoD services in each country, not the penetration rate[501].

7.91 Sky also told us that VoD movies were available from Virgin Media, BT Vision, Tiscali TV, Top Up TV, Sky, 4oD, Apple TV, iTunes, Microsoft Xbox Live Marketplace and Lovefilm[502].

7.92 Of the nine platforms which Sky mentions (other than Sky itself), we note that Lovefilm does not appear to supply VoD movies, while iTunes is not a TV platform but rather a means of downloading movies to Apple TV. Among the remaining platforms, none provides Core Premium movies on VoD, and none is an SVoD service.

7.93 Virgin Media argued that consumer demand for SVoD movies was strong and growing, but that it had been unable to negotiate SVoD rights to premium first-run

[498] Sky response to Second Pay TV Consultation, Section 2, paragraph 2.2.

[499] Second PwC report, page 76.

[500] Ibid, page 68.

[501] Ibid, page 77.

[502] Sky response, Annex 2, paragraph 2.7.

movies, because of Sky's exclusive rights to this content[503]. The exclusivity of Sky's rights is summarised in Figure 57. Sky's agreements with the six major Hollywood movie studios give it exclusive rights to first-run movies over all platforms including SVoD, **[✂]**.

7.94 Sky faces a technological restriction in the supply of SVoD services: because DSat is a one-to-many technology, it is unable to offer true SVoD. In contrast, Sky+ and Sky Anytime perform a similar role to SVoD from a consumer perspective, but in a manner that better plays to the strengths of Sky's satellite platform.

7.95 Virgin Media told us that it had negotiated with **[✂]** for a share of linear rights as well as non-exclusive SVoD rights, but this negotiation was unsuccessful **[✂]**. Virgin Media said that **[✂]**[504].

7.96 Virgin Media also told us that it had **[✂]** explored the potential to secure a deal for a non-exclusive SVoD movie package with **[✂]**. Discussion between Virgin Media's senior management and **[✂]** revealed, however, that such a move could have repercussions as regards the price that **[✂]** receives from Sky for the package of linear rights. **[✂]**[505].

7.97 In summary Sky's exclusive right to first-run premium movies, its technical inability to make those movies available on a true SVoD service on DSat, and its non-supply of those movies for SVoD on other platforms, mean that UK consumers do not have access to this content on a full SVoD service on any TV platform.

HD and DVRs

7.98 As Figure 61 shows, both HD and DVRs are examples of innovations that have been spearheaded by Sky. Sky now has over 30 HD channels on its satellite platform. Sky pushed the introduction of DVRs with its Sky+ boxes, and has now been followed in this by all other major platforms.

7.99 HD is an example of a platform enhancement that is very well suited to satellite. Broadcast capacity on a satellite platform is much cheaper than some other distribution technologies, particularly DTT and IPTV.

7.100 DVRs, in contrast, could equally have been led by another platform. However, they are very well suited to satellite, because they enable a satellite platform to compensate for its limited ability to offer VoD, by delivering a service which has many of the features of VoD. Low-cost transponder capacity can be used in conjunction with high-capacity DVRs to deliver a form of nVoD, or 'push' VoD.

Conclusions on innovation

7.101 Access to the Core Premium channels which Sky currently controls is highly important to new entrants or to other firms planning to expand (as, indeed, was the case when Sky entered the market). Without access to this content, the overall prospects for such a firm are likely to be greatly diminished, and so is the likelihood

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[503] Virgin Media response, paragraphs 4.20, 4.21.

[504] Virgin Media response, paragraph 4.20.

[505] Virgin Media response, page 27, footnote 79.

that it will be willing to take a risk on substantial innovation, and secure finance for the necessary investment. As an example, **[✂]**.

7.102 We recognise Sky's record as an innovator. However, our central concern is that, despite the size and importance of pay TV in the UK, one firm is in a much stronger position than any other to be a large-scale innovator, and that firm is a mature business with a natural incentive to protect its existing business model and distribution platform. As such it will tend to favour only those innovations – in platform enhancement, and in pricing and packaging – which do not cannibalise its existing customer base, and which tend to support its incumbent advantages over potential entrants. This will tend to inhibit the development of other services and platforms which could otherwise use Core Premium content to drive demand, such as next generation networks, and mobile TV services.

7.103 We consider on the basis of the above that Sky's approach to the wholesale supply of Core Premium channels results, and is likely to result in the future, in an adverse effect on the interests of consumers.

Consumer effects relating to high wholesale prices

7.104 As described in section 6 (paragraphs 6.170 to 6.207), our analysis indicates that Sky earns high margins in its pay TV business – reflected in the difference between its IRR and its cost of capital – and these high margins are particularly concentrated at the wholesale level of the business, and in the supply of Core Premium movies. In particular we found that Sky's aggregate returns were almost double its cost of capital.

7.105 In assessing the implications of this analysis for consumers, the distinctions between wholesale and retail supply, and between the supply of sports and movies content, must be considered carefully.

7.106 To begin with the distinction between **wholesale and retail**, the context is that Sky supplies its Core Premium channels in two circumstances – directly via its own retail service, primarily on DSat, and as a wholesaler to other retailers, primarily Virgin Media.

- As the DSat retailer, Sky sets a retail price, and the allocation of its revenues (from DSat retail sales) between the wholesale and retail sides of its business is essentially a matter of internal accounting.

- As a wholesaler to Virgin Media and others, Sky sets prices according to the rate-card. As Sky has told us (see paragraph 6.109), these rate-card prices are set subject to satisfying the conditions of a margin squeeze test – our view is that this implies at the highest level Sky can charge within the constraints of this test. The highest rate-card prices which passes this test will depend on Sky's own DSat retail prices.

- **[✂]**.

- Our view is that in practice the margin squeeze test leads Sky to set its internal wholesale prices at the highest possible level – i.e. to earn only the minimum margin at the retail level, because this is a comparator for the margin it can allow to Virgin Media.

7.107 In view of this, if Sky earns high wholesale margins, this will tend to translate into high prices for both its DSat retail subscribers and for Virgin Media (and other cable) subscribers. But the fact that these margins are earned at the wholesale level rather than the retail level is only important insofar as it reflects Sky's margin-squeeze-test-based approach to setting rate-card prices.

7.108 Turning to the question of whether Sky earns different margins for its movies and sports content as set out at paragraphs 6.196 to 6.199, Oxera's analysis indicates that Sky may earn higher margins for movies.

7.109 However, this does not necessarily mean that retail prices paid by subscribers to Core Premium Movies are less good value than those paid by subscribers to Core Premium Sports. Rather, it may be that upstream content providers of sports content, such as the FAPL have been more effective in capturing monopoly rents from Sky than movie content providers, such as Hollywood studios.

7.110 In view of Sky's control over the Core Premium channels which would be essential for an entrant or other player to challenge its current position, we see no prospect that competition will intensify in the foreseeable future, such as to drive down prices.

7.111 We recognise that in some circumstances consumers' interests can best be served by allowing firms to take risks in order to establish a strong market position based on an innovative product, and subsequently to earn high returns as a reward for those risks. Sky took on substantial risk in establishing its pay TV business in the early 1990s, and in switching its service to digital in the late 1990s. Since then Sky has continued to invest in new services such as HD.

7.112 However, given the time that has passed since Sky made its riskiest investments in the UK pay TV market, we do not consider that ongoing high prices can be justified by Sky's history of investment. We do not believe that in seeking to address the conditions which currently allow Sky to sustain high prices to pay TV subscribers, we would be acting against the interests of consumers.

Conclusion

7.113 We consider on the basis of the above that Sky's approach to the wholesale supply of Core Premium channels results, and is likely to result in future, in an adverse effect on the interests of consumers.

Consultation questions

6. Do you agree with our characterisation of the relationship between high wholesale prices and retail pricing?

Section 8

Remedies – channel distribution

Summary

8.1 We continue to believe that a wholesale must-offer remedy is an appropriate way of dealing with our concerns about the lack of fair and effective competition, stemming from Sky's approach to the wholesale supply of Core Premium channels. There are various questions as to the right scope of this kind of remedy, which we address in this section. In particular, we believe we should set prices and other key terms for a wholesale must-offer. We propose to set prices on a retail-minus basis, although using cost-plus as a cross-check.

8.2 Our current view is that it would not be more appropriate to proceed in relation to some or all of the matters in question under CA98. We welcome comments on that view.

Introduction

8.3 In section 6 we reached the view that as a result of Sky's approach to the wholesale supply of Core Premium channels, there is not, and is not likely to be, fair and effective competition in the wholesale supply of Core Premium channels and the retail supply of bundles which include Core Premium channels.

8.4 We identified a further concern that Sky might restrict the exploitation of content rights that it owns. Our specific concern related to SVoD rights. We return to this issue in section 12.

8.5 We also identified a concern that market power at the wholesale level could result in high wholesale prices; the margin made as a result of those high prices might either go to Sky or upstream to rights holders. Our view based on Oxera's analysis is that Sky is indeed making high wholesale margins.

8.6 In section 7 we explained the adverse effect on consumers that we consider has resulted, and is likely to result, from Sky's approach to the wholesale supply of Core Premium channels.

8.7 In this section we consider, as required under s317(2), whether it would be more appropriate to proceed under CA98 than under s316. We then continue to consider what form of remedy (if any) might be imposed under s316 in order to ensure fair and effective competition so that we can address the adverse effects on consumers identified in section 7.

8.8 In section 9 we set out various issues relating to the terms of a wholesale must-offer; this is focused on price, but also considers non-price-related issues such as security.

8.9 In section 10 we consider whether a licence condition in the proposed form is proportionate by reference to the purpose of s316, and in light of our duties under CA03. That includes the carrying out of a full impact assessment. In section 11 we consult on the drafting of a proposed licence condition.

8.10 Throughout these sections, we take into account consultation respondents' views on our positions as set out in our Second Pay TV Consultation. We also take into account the study of international examples of wholesale must-offer remedies that we commissioned from Value Partners, which is attached at Annex 11. It is important to understand, however, that there are limits on the extent of inferences that can be drawn from this due to contextual differences from the UK.

Whether it is more appropriate to proceed under CA098 – s317(2)

8.11 We consider in this section whether a more appropriate way to proceed in order to address some or all of the concerns identified in this document would be under CA98. The approach to this assessment is discussed above at Section 2.

8.12 In our Second Pay TV Consultation we considered that it might not be more appropriate to proceed under CA98 because:

- We would still see a competition problem even absent a finding of anti-competitive behaviour under CA98.
- Some types of remedy would not be available under CA98.
- Even if anti-competitive behaviour were taking place, under a CA98 process it might take a considerable amount of time for this to become apparent.

8.13 Our current view is that it would not be more appropriate to proceed in relation to some or all of the matters in question under CA98. We welcome comments on this view.

8.14 In sections 6 and 7 we explain how specific competition concerns affect competition and consumers. These are concerns which we think affect all of the actual and potential retailers of pay TV, operators of pay TV platforms, and consumers of pay TV. We discuss below how a wholesale must-offer remedy might tackle the effects on choice and innovation. The issue of how to tackle these effects is essentially one of how and whether an intervention in the market would best achieve a situation in which competition across all the relevant markets protects the interests of pay TV consumers over the coming years. We think it is more appropriate to do that by considering how we might act to ensure fair and effective competition across those markets in the context of s316. Under s316 we look across the sector, taking into account the duties that have been put in place for us to consider as a sectoral regulator, rather than by looking only at any specific cases of past conduct that might be taken forward under CA98, where those duties may not apply.

8.15 Any decisions under CA98 would target particular instances of anti-competitive behaviour by Sky in respect of the wholesale supply (or non-supply) of Core Premium Channels to particular companies. If we are correct that Sky is acting on an underlying incentive to restrict wholesale supply, this could be manifested in any number of different behaviours towards any number of companies. It might be possible to tackle that situation by bringing multiple CA98 cases. However, we consider it is unlikely that this approach would be as successful in tackling Sky's underlying incentives as a wholesale must-offer remedy.

8.16 One type of case that it might be appropriate to bring against Sky under CA98, given the competition concerns identified, would be to consider whether Sky was engaged in a margin squeeze abuse. That would involve revisiting many of the same issues addressed by the OFT in its 2002 decision. Under CA98 the test for a margin squeeze abuse would focus on whether a purchaser that was as efficient as Sky would be able to retail Core Premium channels on a profitable basis at the current rate-card price. That might not enable us to consider, in determining what form of remedy might be appropriate, issues created by differences in (a) scale between Sky and other retailers (b) distribution technologies used by other retailers. We identified in section 6 competition concerns around the lack of supply to potential entrants and in section 7 discussed the consumer detriment that might result from that, including restricted availability of channels and restricted innovation. We need to be able to consider the how and whether a pricing remedy that takes into account differences in scale and in distribution technology could address the risk to fair and effective competition we have identified. We proceed to do this below at section 9, where we also consider the impact of a pricing remedy based on approaches used under a CA98 margin squeeze test.

8.17 The price at which Sky offers to wholesale content might also be examined in the context of an excessive pricing case. We do not however consider that the evidence provided by the Oxera report in relation to the wholesale margins for Core Premium Sports channels or Core Premium Movie channels is likely to provide a sufficient basis for an excessive pricing case under CA98 against Sky. In any event, the principal risk to fair and effective competition that we have identified relates to the restricted supply of channels, rather than high prices in themselves.

8.18 We have also considered the possibility of relying on CA98 by considering whether Sky has committed a refusal to supply abuse. The legal test for refusal to supply was discussed by the European Court of First Instance in the context of the Microsoft case[506]. The Court found that a refusal to supply abuse might be found to exist where:

- The refusal relates to a product or service indispensable to the exercise of a particular activity on a neighbouring market. For these purposes it is necessary to identify two markets: the one in which the undertaking refusing to supply holds a dominant position (upstream) and one in which the product in question is to be used (downstream). It is sufficient that the second market is potential or hypothetical.

- The refusal is of such a kind as to exclude any effective competition on that neighbouring market.

- The refusal prevents the appearance of a new product for which there is potential consumer demand.

8.19 We note in this context that the test under CA98 for a refusal to supply may involve a requirement to demonstrate that a failure to supply would eliminate competition from the market. The European Commission in setting its “enforcement priorities” for Article 82 also provides support for this view[507]. Sky has also argued this in the context of a suggestion from a rival retailer that failing to wholesale certain Core Premium channels could constitute an abuse under CA98[508]. In circumstances where Sky continues to wholesale Core Premium channels to Virgin Media it may not be the case that such an “elimination of competition” threshold would be met. We have

[506] Case T-201/04, Microsoft Corporation v Commission, judgment of 17 September 2007.

[507] Guidance on its enforcement priorities in applying Article 82 to abusive exclusionary conduct by dominant undertakings, 3 December 2008.

[508] **[✂]**.

however identified a competition concern that Sky has an incentive not to supply potential new entrants. The consumer harm we have identified which flows from that will exist irrespective of whether Sky continues to supply on cable. In these circumstances there is a risk that the test for a refusal to supply under CA98 might not be met, but that there would still exist a competition concern leading to consumer harm which it is appropriate to address through the use of Ofcom's sectoral powers.

8.20 Even if it were the case that the conditions of a refusal to supply case under CA98 were met, we would face the limitations discussed above that might arise from trying to bring action against individual instances of a refusal to supply. The competition concern is Sky's incentive to restrict supply – i.e. not to reach agreement on the terms for the wholesale of the Core Premium channels. We recognise however that there are various genuine and complex issues to resolve in settling the non-price terms of any wholesale agreement – e.g. on encryption standards. A CA98 case on refusal to supply which concerned non-price terms is likely to focus on whether Sky was objectively justified in failing to reach an agreement in respect of that issue. If a case was brought in relation to a position taken by Sky on a particular issue, in a particular negotiation, this may not resolve the problem because (a) Sky might shift the focus of its concerns in that particular negotiation to another non-price term; and (b) Sky is still under an incentive to delay over the same issue in other, or future, negotiations with other purchasers.

8.21 Our current view is that it would not be more appropriate to proceed in relation to some or all of the matters in question under CA98. We welcome comments on that view. In the following paragraphs of this section we therefore proceed to consider the principles of a potential wholesale must-offer remedy.

Principles of a wholesale must-offer remedy

8.22 We said in our Second Pay TV Consultation that we could eliminate Sky's ability to act on its incentives to restrict distribution of Core Premium channels by requiring it to provide wholesale access to particular channels on regulated terms. We proposed to do this using our sectoral competition powers under s316 CA03. We believed that this would strengthen competition between competition between retailers and platforms, while maximising choice for consumers.

8.23 Sky argued in response to our proposals that there is no justification for new regulation. Sky emphasised that Ofcom has a legal obligation to ensure that its regulation is, among other things, targeted only at cases in which action is needed. It believed that the proposed regulation fails this test. The requirement that regulation should be targeted only at cases in which action is necessary means that Ofcom must establish that its proposals are aimed at remedying significant and persistent consumer detriment and capable of remedying the identified consumer detriment cost-effectively.

8.24 Others agreed with the general approach of a wholesale must-offer. For instance, BT believed that a wholesale must-offer represented the first step towards enabling it to compete with Sky in the retail market, although it stated that this would not be a complete solution to all the competition issues it had identified in pay TV. **[✂]** agreed with this position, supporting a wholesale must-offer, but saying that on its own it would not be an adequate solution. The Four Parties also took this approach, saying that Ofcom's proposed remedy would facilitate greater competition in pay TV. However they also believed that this would only be a partial solution, pointing to what they felt were problems at all tiers of the value chain – for example, the barriers to entry upstream.

8.25 We set out in section 2 our framework for proceeding under s316. For the reasons set out in this sub-section, we still believe that a wholesale must-offer form of obligation is capable of addressing the concerns we have identified. A wholesale must-offer would require Sky to supply particular channels to other retailers. Such a remedy would be a very direct approach to addressing the concerns we have identified. We have identified a lack of wholesale supply to retailers that have sought it. We also find that Sky's wholesale prices to Virgin Media provide it with no incentive to supply premium channels to existing customers. Requiring Sky to wholesale its channels to others would be a way of ensuring that it does not exercise its market power by restricting supply. Pursuant to section 316(1) the regime for every licensed service shall include the conditions that Ofcom considers appropriate for ensuring fair and effective competition in the provision of licensed services and connected services. Under s316(2) those conditions must include the conditions (if any) that Ofcom considers are appropriate for securing that the provider of a service does not engage is a practice which Ofcom considers, or would consider, to be prejudicial to fair and effective competition. We consider that a wholesale must-offer obligation in the proposed form falls within the scope of s316(1) and also satisfies the requirement in s316(2).

8.26 Beyond this overall principle, there are a number of important aspects of a wholesale must-offer that we need to consider. Setting out our view on these questions enables us to propose a specific form of wholesale must-offer remedy for consultation. However, it would be open to us to take different approaches on any of these questions, taking into account views from consultation respondents.

- To which wholesalers should it apply?
- Which channels should it cover?
- Should a must-offer apply to retailers on all platforms?
- Should a must-offer apply for the purposes of onward retail to commercial premises?
- Should we set specific terms, particularly prices?
- If we were to set prices, what approach should we adopt?
- Should a must-offer include enhanced versions of relevant channels – HD and interactive?
- Should a must-offer include on-demand services that accompany the linear channels?

8.27 We discuss each of these issues below and explain our current position. This results in a specific proposal for the content of a wholesale must-offer obligation for consultation. We remain open to submissions on each element of the resulting proposal.

To which wholesalers should it apply?

8.28 We proposed in our Second Pay TV Consultation to apply a wholesale must-offer remedy to Sky. We considered whether a similar obligation should apply to other firms, and suggested that any such proposal be considered against the following criteria.

- Whether the firm has market power.
- Whether the firm has an incentive to act on this market power, for example due to its vertical integration.
- Whether there is evidence that the firm is acting on these incentives.

8.29 We considered the specific question of whether the remedy should be applied to Setanta and concluded that it should not be. This was on the basis that we had not found Setanta to have market power, that it does not have the same degree of vertical integration as Sky, and that it does not appear to be restricting the supply of its content to the same extent as Sky. We noted that although Setanta has been a wholesaler of premium content for a much shorter period than Sky, its content is already available widely on a wholesale basis, as well as being available via retail on Sky's DSat platform. We acknowledged that Sky does not currently retail Setanta's content, but that there are a variety of possible interpretations of this, and we did not see it as evidence of Setanta restricting supply of its content[509].

8.30 Sky pushed back on this, stating that this represented an inconsistency in our approach. We do not accept that our approach is inconsistent. We remain of the view is that it would not be appropriate to apply our proposed remedy to any firm which happens to be active in the provision of Core Premium channels. We have set out the principles which should determine whether a firm is subject to our proposed remedy, and we have applied those principles in a consistent manner.

Which channels should it cover?

8.31 The guiding principle behind our application of a wholesale must-offer to Sky is that it should apply to those channels which are the source of Sky's market power, and where Sky's approach to wholesale supply does and will lead to a situation in which there is not, and will not be, fair and effective competition.

8.32 We proposed in our Second Pay TV Consultation that the scope of the wholesale must-offer obligation should cover all Core Premium Sports and Core Premium Movie channels supplied by Sky. Based on the analysis of market definitions and market power which we set out in section 4 and 5 of this document, this means that the obligation would cover:

- Sky Sports 1, Sky Sports HD, Sky Sports 2, and Sky Sports 2 HD.
- All of Sky's premium movies channels apart from Sky Movies Classics.These are Sky Movies Action & Thriller, Sky Movies Action & Thriller HD, Sky Movies Comedy, Sky Movies Comedy HD, Sky Movies Drama, Sky Movies Drama HD, Sky Movies Family, Sky Movies Family HD, Sky Movies Premiere, Sky Movies Premiere HD, Sky Movies Premiere+1, Sky Movies SciFi & Horror, Sky Movies SciFi & Horror, Sky Movies Screen 1, Sky Movies Screen 1 HD, Sky Movies Screen 2, Sky Movies Screen 2 HD, Sky Movies Modern Greats, Sky Movies

[509] As we set out in paragraph 2.54, ESPN is in the process of replacing Setanta; we would expect to apply the same criteria to ESPN as to Setanta. We therefore await developments in terms of wholesale deals that ESPN may agree.

Modern Greats HD, Sky Movies Indie or and Disney Cinemagic and the HD versions of these channels, (see below for our discussion of HD)[510].

8.33 Various respondents to our Second Pay TV Consultation argued that all of the Sky Sports channels should be included within the scope of the wholesale must-offer obligation, on the basis that Sky's market power stemmed from its aggregation of a wide variety of content. Sky responded to these views in an additional submission to Ofcom on 5 June 2009. In that document, which we have published alongside this consultation, Sky criticised the Four Parties' proposal that we should include non-Core Premium channels in our remedy.

8.34 We have considered the arguments by the Four Parties and others in our analysis of market definitions and market power, and whilst we accept that Sky's market power does in part derive from its aggregation of content, we do not accept that any content which Sky aggregates automatically results in the creation of market power. We remain of the view that the obligation should apply to those channels which we have identified as the source of Sky's market power, as set out above.

8.35 This conclusion is of course based on our current market definitions. The evidence on which these market definitions are based can only relate to existing channels, and the existing distribution of content rights across those channels. We noted in our Second Pay TV Consultation the possibility that Sky might change the way in which it distributes its content rights across its channels, and we are also mindful of the international study by Value Partners, which shows that wholesale must-offer remedies in other countries have been limited in their effectiveness where there has been a lack of clarity over what constitutes a "premium channel", allowing the remedy to be gamed. If Sky were to create new channels, containing a significant amount of content currently broadcast on channels within the scope of the proposed remedy, then we would clearly need to consider extending the scope of the remedy to those channels.

8.36 As we set out in sections 4 and 5, we see the Core Premium Sports and Movies channels as including a sufficient quantity of the most important content to be a source of market power. Based on the same evidence as we used to come to that conclusion, we believe that including both Sky Sports 1 and 2 in the remedy, but not 3 and Xtra, is appropriate in order to ensure fair and effective competition. Similarly, we believe it is appropriate to include all the Core Premium Movie channels in the remedy. Our views on market definition and market power indicate that only including some of the channels would be likely to result in a continued risk to fair and effective competition.

Should a must-offer apply to retailers on all platforms?

8.37 There is a question as to whether it would be appropriate for a wholesale must-offer remedy to apply to all retailers, regardless of the platform on which they retail. In our Second Pay TV Consultation, we set out a view that it might not be appropriate to extend the requirement to retailers on Sky's own platform(s).

8.38 The FAPL expressed its view that any obligation on Sky to wholesale its channels to third party retailers on the DTH platform would be excessive and disproportionate and would be likely to eliminate competition for the FAPL's rights.

[510] We refer in this paragraph to the names of the channels as used in the relevant broadcasting licences.

8.39 In their separate response, Setanta and Top Up TV argued strongly that the wholesale must-offer obligation is only the first step on a “ladder of investment”. They believed that it is crucial to include Sky’s satellite platform within the scope of the wholesale must-offer obligation. It would enable third parties to build up a critical mass of premium pay TV subscribers and to make necessary investments at all levels of the pay TV supply chain in order to compete more effectively with Sky.

8.40 **[✂]** was of the opinion that content should be made available to other retailers on all other platforms, particularly DSat, DTT, cable and IPTV. Furthermore the ‘must-offer’ obligation should extend to mobile platforms as they evolve over time.

8.41 The BBC acknowledged the complexity of the issue of extending the eligibility to retailers operating on the satellite platform. It was broadly in favour of such an extension but believed a decision on this point might be premature. The BBC felt that by excluding the satellite platform we risked ignoring a potential source of market power in the pay TV value chain that might affect downstream markets, restrict competition and, ultimately, reduce choice for final consumers.

8.42 Tiscali thought that excluding retailers on the Sky platform may lack rational justification and could be disputed by such retailers on the grounds of discrimination.

8.43 **[✂]**.

8.44 The primary purpose of the remedy is to address the restricted availability of Sky’s premium channels on non-Sky platforms, and the effects on innovation and choice we believe arise as a result. These concerns can be addressed by requiring Sky to supply its premium channels only to retailers on non-Sky platform(s). We remain of the view that these objectives do not require us to extend the obligation to retailers on Sky’s platform(s).

8.45 Extending the proposed remedy to include Sky’s own platform(s) would be a significant additional intervention. Competitors to Sky would then be able to purchase wholesale access to Sky’s platform services and Sky’s content, both on regulated terms. A likely outcome is the emergence of a large number of resellers, reselling Sky’s existing services to Sky’s existing subscriber base. This would certainly result in an increased intensity of retail competition, but it would also be disruptive to Sky’s existing business, and may result in a reduced incentive on all firms to invest in new content and new platforms.

8.46 An additional intervention of this type would only be likely to be appropriate if it addressed a risk to fair and effective competition. We have considered two types of effects which might be relevant to that assessment:

- Additional downstream effects of Sky’s wholesale market power, over and above the restricted availability of Sky’s content on non-Sky platforms.

- Reducing or eliminating Sky’s wholesale market power at source.

8.47 It might be appropriate to consider extending a wholesale must-offer obligation to retailers on Sky’s own platform(s), if there was some other competition concern that related specifically to fair and effective competition concerning retailers on these platform(s), and if those concerns would not be adequately addressed by requiring Sky to supply its premium channels to non-Sky platforms. In particular:

- It might be appropriate to extend the supply obligation to Sky's own platform(s) if there was evidence that Sky was earning high retail margins, which might be reduced by stronger intra-platform competition. However, we do not have evidence that this is the case.

- It might be appropriate to extend the supply obligation to Sky's own platform(s) if there was evidence of a lack of retail innovation. Some such evidence does exist, in particular in relation to a lack of entry-level premium packages. However, it is likely that this specific concern can be remedied by a supply obligation on other platforms. DTT in particular is likely to be well-suited to the provision of new entry level premium packages.

8.48 In addition to remedying the downstream effects of Sky's market power, the wholesale supply obligation that we propose may provide a mechanism to make upstream rights markets more contestable, thereby reducing Sky's market power at source. The reason for this is that access to a large subscriber base is likely to play a role in companies' ability to bid successfully for content rights. This is essentially a 'ladder of investment' argument. In order to maximise this effect, it might be appropriate to enable alternative retailers to retail Sky's premium channels via Sky's satellite platform(s), thereby gaining direct access to the **[✂]** million subscribers on that platform. It might also be appropriate to enable alternative retailers to sell Sky's premium channels to 'pubs and clubs' (see below).

8.49 However, while we believe there is likely to be a relationship between subscriber base size and ability to bid for rights, this is only one factor influencing companies' ability to bid. Additionally, we believe it should be possible for alternative retailers to address Sky's existing subscribers via other platforms, particularly those based on DTT (given the low switching costs associated with DTT).

8.50 On balance we do not believe that an additional intervention associated with extending the obligation to Sky's platform(s) would be appropriate for ensuring fair and effective competition.

8.51 Note that in reaching this conclusion we do make a distinction between a 'platform' and a 'distribution technology'. Our proposed remedy applies to a variety of distribution technologies: cable, satellite, IPTV, DTT, mobile TV. There may then be several different 'platforms' on each distribution technology, each platform being defined by the set of conditional access technology and reception equipment that is particular to it.

8.52 We do not propose to extend our proposed remedy to Sky's platform(s), but we do propose that it should extend to other platforms using the same distribution technologies as Sky. For example, both Sky and Freesat operate satellite platforms, and our proposed remedy would apply to an alternative retailer on Freesat (obviously subject to that being part of Freesat's strategy, and a suitable conditional access system being put in place).

Should a must-offer apply for the purposes of onward retail to commercial premises?

8.53 We proposed in our Second Pay TV Consultation not to apply a wholesale must-offer for onward retail to commercial premises, instead restricting the obligation to offer to retailers to residential customers.

8.54 Many respondents questioned the level of attention given to commercial premises in other parts of our analysis. Virgin Media specifically stated that the remedy should apply equally in favour of retailers to residential and commercial customers.

8.55 The ALMR was disappointed that Ofcom did not apply the remedy to the commercial market, "where the effects on competition are already clearly felt and readily identified". It further explained the importance of extending the obligation in favour of retailers to commercial subscribers. It said first that a must-offer could also be applied to commercial customers, and that if it did not, an alternative route must be taken – either a reference to the CC under EA02, or a retail price cap.

8.56 The Four Parties disagreed with our provisional conclusion to apply the remedy in relation to the residential sector only. They saw no reason why an ex ante pricing rule based on a retail-minus methodology could not function by reference to a retail rate-card based on rateable values. The Four Parties argued that given that Sky's revenues from the commercial market represent nearly one third of its total expenditure on sports rights/programming, a failure on Ofcom's part to address competition concerns in the commercial market would perpetuate one of the most significant barriers to entry upstream. Furthermore, in the absence of a remedy applying to the commercial market, Sky would have access to a very large stream of revenue and profit that would be denied to rival pay TV retailers. The Four Parties warned that there is a high likelihood that the application of a wholesale must-offer remedy just for retailers to the residential market will be undermined by Sky's exclusive access to the commercial market.

8.57 Additionally, **[✂]** noted that Ofcom did not address the issue of Sky's commercial revenue from its supply of content to commercial premises. It believed Ofcom should consider extending its review to incorporate consideration of the dynamics of the commercial market.

8.58 The BBC considered that the commercial market is a key one for premium sports content: "increasing competition in the commercial sector could not only have a positive effect on prices, but also allow Sky's competitors to benefit from a stronger income base, therefore increase their ability to challenge Sky in auctions for Premium Sports content".

8.59 Freesat felt it was inconsistent to apply a remedy to channels addressing residential customers but not commercial customers.

8.60 **[✂]** felt comfortable with Ofcom's focus on the residential market given the importance of the market.

8.61 The FAPL agreed with Ofcom's conclusions that any wholesale remedy should only apply in relation to residential customers. It recognised that there are different considerations for commercial subscribers.

8.62 Our view is that extending the proposed remedy to include persons retailing to commercial premises would be a significant additional intervention. It could only be justified if it was appropriate in order to ensure fair and effective competition. The effects relevant to that assessment are similar to those which we considered above in the context of our discussion of retail on Sky's own platform(s), namely:

- Effects which arise from remedying the downstream effects of Sky's wholesale market power.

- Effects which arise from reducing or eliminating Sky's wholesale market power at source.

8.63 As we set out in section 6, the downstream effects of Sky's market power that we have identified in relation to residential customers do not apply in the same way to commercial customers. In particular, while concerns have been put to us regarding the level of prices for commercial customers, we do not see evidence of restricted supply, either at the retail level or the wholesale level:

- The main concern that the ALMR and some individual commercial customers have put to us, in response to our September 2008 consultation, is the level of retail pricing.

- We do not see the same evidence of restriction of wholesale supply as in the case of residential subscribers. **[✂]**.

- The one company that does take a wholesale product – Virgin Media – actually stopped supplying commercial customers. Beyond that, the one other company that had direct access to the key FAPL rights – Setanta – elected not to retail to commercial customers itself, instead selling through Sky. This means that even if our proposed remedy was extended to retailers to commercial customers, there is currently no other distribution network than that controlled by Sky.

8.64 With these points in mind, the Four Parties' suggestion that a wholesale must-offer obligation could simply be extended to commercial premises, with an expanded retail margin, does not seem appropriate. We see limited evidence of any restriction of supply, whilst a wholesale must-offer obligation with prices set on a retail-minus basis would only address the apparent concerns about high retail prices if we were to artificially depress the wholesale price. The wholesale price which we determine can provide for an increased retail margin, if there is a need to compensate for specific and unavoidable retail costs associated with market entry (see section 9), but it is not an appropriate mechanism for achieving a specific reduction in retail prices, the magnitude of which would essentially be arbitrary.

8.65 The Four Parties also made reference to the same 'ladder' of investment argument that we set out above in the context of our discussion of retail on Sky's own platform(s) (see paragraph 8.48). They noted that there is a substantial revenue stream associated with the supply of Sky's premium channels to commercial customers, and that without access to this revenue stream other pay TV retailers are likely to be unable to bid successfully for rights.

8.66 However, the same arguments that we set out in the context of our discussion of retail on Sky's own platform(s) also apply here. While we believe there is likely to be a relationship between subscriber base size and ability to bid for rights, this is only one factor influencing companies' ability to bid. It should be possible for alternative bidders for rights to address commercial customers either by agreeing a wholesale deal with Sky's existing retail business, as Setanta has done for its channels, or by developing their own distribution networks.

8.67 On this basis, we still do not consider it would be appropriate apply a wholesale must-offer obligation to commercial customers. However, we recognise the strong views taken by individual commercial customers, and by the ALMR, with regard to retail pricing to commercial customers, and will continue to keep this under review. In particular, it might be appropriate to consider a specific remedy in relation to commercial customers, potentially as part of any further action we may pursue relating to the sale of FAPL sports rights (see section 12 below).

Should we set specific terms, particularly prices?

8.68 In our September 2008 Consultation, we stated that it would be necessary to specify an ex ante pricing rule for the channels contained within any wholesale must-offer. If a wholesale must-offer remedy is appropriate, we note that in order to ensure that this can be an effective means of ensuring fair and effective competition, we may need to set a specific price. If we did not set a price, then in order for the remedy to be effective, we would certainly need to establish a mechanism for the rapid resolution of pricing disputes.

8.69 In Sky's view, a major flaw was that Ofcom considered some significant issues such as the range of services and the commercial matters to which regulation would apply as simply a matter of "*getting the detail right*". Sky thought this was a fundamental misconception. It insisted that Ofcom instead properly considers the necessity and proportionality of extending the scope of compulsory licensing beyond linear standard definition versions of Sky's premium channels, and micro-regulating a wide range of wholly standard commercial issues.

8.70 Sky argued that retail-minus price controls are not compatible with best practice approaches to sectoral regulation. Sky urged that if Ofcom continued to believe that a 'must-offer' obligation is a necessary solution, it should reject the option of accompanying that regulation with an *ex ante* extended retail-minus price control. In Sky's view, imposing an "extended retail-minus price control":

> "falls into the same category as structural break-up because it is similarly disproportionate and it should therefore also be ruled out at this stage".

8.71 The view that we ought to set detailed terms, and prices in particular, was strongly supported by some consultation respondents. The Four Parties put this view particularly forcefully. BT for example expressed the belief that: "[Ofcom not setting prices] would simply lead to delay and inevitable disputes to Ofcom, ultimately requiring Ofcom to set the price in any case". Tiscali also took a similar view.

8.72 Similarly, **[✂]** believed that any licence condition or direction issued by Ofcom in the form of a wholesale must-offer remedy should include ex ante pricing rule. It suggested that in designing the remedy, Ofcom should give due consideration to Harbord and Ottaviani[511].

8.73 **[✂]** noted that given the inherent difficulties in calculating the appropriate wholesale price it is better to avoid ex post action wherever possible by setting a pro-competitive ex ante pricing rule.

8.74 We have considered this further, and now propose that we should indeed consult on an option including a range of prices, rather than assuming at this stage that, if it is appropriate to impose a wholesale must-offer remedy, prices should be left to commercial negotiation based on a set of pricing principles. We consider that this is

[511] Harbord and Ottaviani, Contracts and Competition in the Pay-TV Market, Economies Discussion Paper No.45, Regulation Limitation Working Paper Series, London Business School (July 2001)

likely to be appropriate as it would enable the obligation to provide an effective means of ensuring fair and effective competition, for a number of reasons.

- Firstly, a substantial length of time has already been spent by Sky and others in commercial negotiation over the principle of supply, without any significant progress, as we set out in section 6. We could in theory attempt to set pricing principles in such a way that the level of the price is somewhat constrained. However, regardless of what principles we might seek to set out, there would still remain room for further negotiation on actual prices. A remedy which still left scope for months or even years of negotiation on the precise level of prices (and other terms) would not be effective.

- Secondly, if we did not set prices, it is likely that prices would ultimately default to the cable rate-card. **[✂]**. We do not believe this would enable us to ensure fair and effective competition. As our subsequent analysis on pricing shows, the current rate-card prices are higher than those needed for a rival retailer to be able to compete. Indeed, as we set out in chapter 6, our analysis of Sky's modelling of Picnic's profitability suggests that even Picnic would **[✂]**[512]. In the case of the one major existing competitor, Virgin Media, we see a likely link between the current prices and the low penetration of premium customers on cable.

- Thirdly, we can also draw on the study of international examples of wholesale must-offer remedies that we commissioned from Value Partners, which is attached at Annex 11. This shows that the effectiveness of such remedies has been hampered by the lack of definition of precise terms of supply. For example, the remedy in place on Sky Italia did not initially include a price. Establishing a price had to wait until the dispute resolution process was able to determine it. Agcom (the Italian regulator) reflected on this to the effect that:

  > "If we were to design it [the wholesale must-offer remedy on the merged Sky Italia] again, we would be more explicit about the pricing rule and not give as much autonomy to Sky"[513].

8.75 Prices are not the only terms that we might want to set. There are a number of other important considerations involved in establishing wholesale agreements, such as conditional access security in particular. The same principles apply to these as we have outlined in respect to prices. In order to ensure the effectiveness of the remedy, we believe it would be appropriate to restrict the scope for protracted future negotiating around these terms, which might otherwise delay the successful implementation of the remedy. We also address these further terms in section 9.

If we were to set prices, what approach should adopt?

8.76 Our Second Pay TV Consultation suggested that we might set prices using retail-minus, with cost-plus as a cross-check. Our reason for not using cost-plus as the primary method was that we could see a risk of artificially depressing rights values. We remain of the view that this is an important consideration, and therefore that retail-minus pricing is the most appropriate approach in this instance.

[512] Once we have made reasonable adjustments to Sky's calculations – in particular **[✂]**.

[513] See Value Partners' report (Annex 11), page 16.

8.77 As noted above, Sky argued strongly against imposition of an “extended retail-minus price control”. Sky did not however set out an alternative form of price control, and we interpret these comments as a general objection to any form of ex ante price control, rather than an argument in favour of some form of alternative, such as cost-plus pricing.

8.78 The Four Parties stated that both the retail-minus methodology and the cost-based approach should be used, and therefore supported Ofcom’s suggestion to adopt a retail-minus approach but use a cost-based analysis as a cross-check. This view was based on concerns relating to Sky setting wholesale prices for its premium channels in a manner that discriminates between different retailers and Sky setting high wholesale prices now and/or in the future. Freesat also supported this approach, as did BT and Virgin Media in their individual responses.

8.79 **[✂]**’s submission argued against the use of retail-minus pricing, proposed by Ofcom, as this would not promote the interests of consumers. Referring to Harbord and Ottaviani’s paper on Anticompetitive Contracts in the UK pay TV market, **[✂]** pointed out the disadvantages of such a solution. It further believed that retail-minus pricing is unsuitable because it will require considerable regulatory supervision. **[✂]** admitted that although a cost-plus model is more attractive, it still has certain weaknesses. **[✂]** noted that, should Ofcom favour a per-subscriber fee remedy, the only suitable methodology for its application is long-run average incremental cost (LRAIC). It argued that a per user / subscriber fee approach is not the only approach and, indeed, may not be the optimal approach as the market matures. **[✂]** submitted that, on the basis of the Harbord and Ottaviani analysis, an *ex ante* pricing rule giving resellers the ability to purchase wholesale content on a lump sum basis should be available, potentially in addition to a per-user fee, as this is more likely to enhance consumer welfare.

8.80 We continue to believe that the appropriate approach is to set prices on a retail-minus basis, using a cost-plus analysis as a cross-check. We acknowledge that cost-plus pricing has a number of advantages:

- It allows us to set prices in a competitively neutral manner, without having to consider how different models of downstream competition might be affected. In particular it does not require us to make any assumptions about the platform or distribution technology that a potential retailer might want to use.
- It can in principle address concerns relating to high wholesale margins as well as availability of channels.
- It avoids some of the practical difficulties associated with setting prices on a retail-minus basis. In particular it would not require us to tackle any of the issues raised by retail bundling in the context of a retail-minus analysis.

8.81 However, there is a major issue with cost-plus pricing in the context of pay TV, which is that it risks artificially depressing rights values. Firms are unlikely to bid vigorously for content rights if the result of doing so is to push up the future wholesale price of the channels they purchase from Sky. Indeed, if the outcome of a rights auction has a direct effect on the level of wholesale prices, then some individual firms will have a strong incentive not to bid, and there may even be an incentive for various forms of coordinated behaviour.

8.82 Using a retail-minus approach does not give rise to the same concerns. Under retail-minus, changes in wholesale prices over time are not driven by the results of rights auctions, but are set in relation to retail prices. A bidder in an auction does not see the same increase in its own wholesale channel costs if it competes vigorously for rights.

8.83 As set out in both of our previous documents, one of our key concerns is to ensure that consumers have continued access to a wide range of high-quality content. That position is likely to be undermined if the ability to generate a return on the production of content is artificially reduced. On this basis we do not believe it is appropriate to adopt cost-plus pricing.

8.84 As noted in section 4, owners of the rights to highly valued content could in principle be able to extract some or all of the monopoly rents from these rights. We thus accept the logic of **[✂]**'s argument that the current price of rights may be inflated. However we do not accept that this undermines our concern that the use of a cost-plus approach would unduly depress rights prices. While the use of a cost-plus approach would reduce the extent to which rights holders are able to earn unduly high revenues, there is no reason to believe that it would result in rights prices at or close to the true economic cost of the resources used to create those rights. Rather there is a risk of overshooting, with the price of rights being driven below the economically efficient level. This would undermine incentives for content generation.

8.85 We acknowledge that one important consequence of adopting a retail-minus approach is that we cannot use our proposed remedy to tackle fully any concerns that relate to high wholesale margins. To the extent that such concerns exist, they would have to be addressed by some other form of intervention, probably related to the way in which content rights are sold. Were we to intervene to tackle any high wholesale margins this would also potentially address the unduly high rights prices that **[✂]** suggested exist. We return to this point in section 12.

8.86 As **[✂]** observed, when setting price controls in other sectors that we regulate we have used cost-plus approaches. However this does not imply that a cost-plus approach is appropriate in this case. Our concern about the impact of a cost-plus approach on rights prices reflects the specific characteristics of the pay TV industry in particular:

- Rights costs are a significant proportion of wholesalers' costs (so that, by altering their behaviour when bidding for rights, firms can materially affect the regulated wholesale price under a cost-plus approach).

- The firms that are likely to be eligible for supply under any wholesale must-offer are also important determinants of rights prices (implying that important bidders have the incentive and ability to affect rights prices).

- The downside of bidding less aggressively for content rights is likely to be small.

- Payments from UK pay TV operators make up a material proportion of rights holders' revenues, particularly in the case of sports, which implies that there is a material effect on incentives for content generation.

8.87 We do not accept **[✂]**'s argument that a retail-minus approach, unlike a cost-plus approach, would impose significant ongoing regulatory burdens. **[✂]** did not elaborate on this argument and in particular did not explain why we would be required to investigate complaints whenever Sky changes its retail prices. We recognise that the relationship between wholesale prices (assuming that they are regulated) and retail prices is an important aspect of the design of a wholesale must-offer and we address this issue in paragraphs 9.37 to 9.52 below.

Should a must-offer include enhanced versions of relevant channels – HD or interactive?

8.88 Our Second Pay TV Consultation set out various enhancements to the standard SD channels that Sky offers its own retail customers and that we proposed to include within the scope of any wholesale must-offer obligation. These were:

- High definition versions of the channels.
- Interactive services providing access to primary content, typically via a 'red button' on the TV screen. By primary content we mean footage which is directly dependent on the licensing of rights from content owners. We distinguished this from editorial content, or other additional services, which could be generated by any retailer, and which we did not propose to include in the scope of the obligation.

8.89 We apply the same principles here that we applied to our consideration of which channels should be included within the scope of the obligation. The guiding principle behind our application of a wholesale must-offer to Sky is that it should apply to those channels and services which are the source of Sky's market power, and where Sky's approach to wholesale supply does and will lead to a situation in which there is not, and will not be, fair and effective competition.

8.90 The scope of any obligation should therefore cover all Core Premium channels supplied by Sky. We note in this context that the markets for Core Premium channels are defined by reference to the content contained within these channels, not the resolution at which this content is viewed, or whether the content is delivered via the main channel or the red button.

8.91 We would see it as potentially discriminatory for Sky to supply others with inferior products to the ones it supplies its own retail arm – this could prevent other retailers from being able to compete effectively in the retail market. Our level of concern would depend on whether there is a risk to fair and effective competition. As the paragraphs below indicate, we believe that the restricted supply of HD versions of the channels and primary interactive content does create a risk to fair and effective competition. On this basis our view is that these should be included within the scope of the obligation.

<u>HD</u>

8.92 Sky objected to the idea of requiring it to license HD versions of its premium channels to other platforms, especially since there is no 'must-offer' obligation on PSBs in relation to HD versions of their main channels or any of their interactive services.

8.93 Virgin Media agreed with Ofcom's observation that the obligation should extend to HD versions of the content. In its response, Virgin Media further explained why it considered HD content as important and why there are no technical or other issues which prohibit the inclusion of HD services.

8.94 Our view is that, on the available evidence, the difference between SD and HD is significant, both as a driver of platform innovation and for the consumer experience.

8.95 HD capability sits at the heart of next generation TV platforms. Sky has recently reduced the retail price of its HD set top box to £49. HD services from the PSBs are planned to launch on DTT by the end of 2009. Sky, BT Vision and Virgin Media already offer on-demand HD content.

8.96 HD is becoming increasingly important to consumers, and consumer adoption is accelerating. Sky's own research shows that 74% of consumers want HD quality and demand for HD is accelerating[514] - this is mirrored in take-up of HD: 7% of Sky customers took up HD as at September 2008. In its review of 2008[515] Sky states:

> "As high definition becomes increasingly established as the new benchmark for video services, we expect the superior range and quality of content offered by Sky+ HD to be a key driver of demand from new and existing customers."

8.97 Sky has also said on a number of occasions that HD has been the most rapidly adopted service it has ever introduced. For example, it said in The Sky Story in 2007 that:

> "We are now transforming the TV viewing experience yet again through the launch of High Definition. We did so in the face of predictions that HD was a needless luxury. It has since seen the fastest take-up of any of our additional TV services to date"[516].

8.98 **[✂]**.

8.99 We accept in principle that we should be cautious about deterring future investment in innovation; innovative services in future which relate to the premium channels covered by the wholesale must-offer would not automatically be included in the obligation. However, based on the evidence set out above on availability of services, and Sky's own pronouncements, HD appears no longer to be a brand new innovation, and more an integral part of the pay TV landscape. We therefore consider we need to include HD versions of the channels within the scope of the remedy in order to ensure fair and effective competition.

8.100 We acknowledge Sky's argument that we should treat its HD channels and the HD channels operated by the PSBs in a consistent manner. In particular we acknowledge the importance of the UK originated content shown on PSB channels (see paragraph 3.19 above), and we might well have competition concerns if the PSBs were individually or collectively exploiting any market power associated with this content by restricting its distribution. We do not however see evidence of this:

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514 http://corporate.sky.com/documents/pdf/latest_results/a0822cb8409e4e25a959e61b2620730c page 20

515 http://corporate.sky.com/documents/pdf/1ffb247d89b6490c9cd3dc7a4f24f4eb/annual_review_2008.pdf page 21

516 http://corporate.sky.com/documents/pdf/1ffb247d89b6490c9cd3dc7a4f24f4eb/the_sky_story_2007.pdf

- Substantial effort has been devoted to ensuring that all of the main PSB channels can be made available on DTT[517].
- The BBC currently makes available HD versions of its channels on all other platforms which have sufficient capacity to carry them.
- There are some restrictions associated with the distribution of HD versions of the commercial PSBs channels. However, we do not have evidence to consider that these restrictions create a risk to fair and effective competition.

Primary interactive services

8.101 Sky strongly criticised Ofcom's interventionist approach to interactive services. It described this as being "wholly disproportionate". Sky claimed that there appeared to be a misconception as the existence of a problem that needed to be remedied, when in fact there was no such problem. It argued that between the 1994/95 football season and the end of the 2007/08 football season, only one live FAPL football match was shown via the red button. It further explained that there is a good commercial reason for such a solution.

8.102 While **[✂]** agreed with our approach relating to the content and channels covered by the obligation, it stated that this should not exclude future innovation, whether of channels, content or delivery methods. Otherwise it feared that the wholesale offer to could be undermined.

8.103 In its separate response, Virgin Media noted that it is common for certain Champions League games to be available only via the red button. This type of service is also used by Sky to offer its multi-start movie service. Virgin Media therefore considered that the obligation, at the very least, should be extended to include all services or features which enable viewers to access primary interactive content.

8.104 Freesat suggested that due to the complex and often proprietary nature of interactive service development and transmission, Ofcom should also require Sky to make such services available to other retailers in the appropriate technical format for a given platform, even at the cost of the retailer.

8.105 Our view is that technological developments are increasingly blurring the distinction between interactive services and platform functionality. For example, the multi-start interactive service provided on Sky Movie channels provides consumers' similar benefits to the staggered movie start times offered by Sky Box Office via the Sky Electronic Programme Guide and some of the benefits of the Sky Anytime service available on Sky+ set top boxes.

8.106 The possibility that content could be shown via the red button suggests that there could be a risk to fair and effective competition if video and audio streams containing content of types otherwise shown on the main linear stream were not offered as part of the remedy. We acknowledge that the volume of such content is small compared to the volume of premium content shown on the main channel. However, Sky clearly places some value on the programming shown via the red button: in its "Sky Story", Sky says that:

[517] See for example http://www.ofcom.org.uk/media/news/2008/10/nr_20081017

> "Fans of the UEFA Champions League on Sky Sports now have the opportunity to choose up to eight simultaneous matches via our interactive multi-screen service. The red button has become a familiar and useful feature for viewers in millions of homes"[518].

8.107 In 2008 Sky obtained rights to an additional set of Champions League matches. This means that although live FAPL matches may seldom appear via the red button, Sky can show 15 live Champions League matches per week from the start of the 2009-10 season, of which many will be shown via the red button. Our view is that this amount of content shown via the red button is likely to be material.

8.108 We are in any case concerned that if premium content could be excluded from the scope of the remedy, by making it available via the red button rather than on the main channel, this would provide a mechanism for the remedy to be gamed.

8.109 The position here is finely balanced; we propose to consult on including within the scope of the remedy any sports matches shown live via the red button which are part of events that appear on Sky Sports 1 and Sky Sports 2, e.g. those shown in Figure 7 such as FAPL, Champions League, Carling Cup, English Test cricket, World Golf Championship, Heineken Cup, Super League.

8.110 In principle, if Sky were to show movies of the type we identified in section 4 as forming part of Core Premium Movie channels via the red button, we would propose also to include these in the obligation. In reality, we do not believe this to be a major way of distributing movies. We therefore do not propose to require this under the proposed remedy.

8.111 Sky would need to provide sufficient information on the design and minimum functionality of the interactive service which retailers would need to produce (at their own expense) to allow this content to be accessed from the main linear channels.

Should a must-offer include on-demand services that accompany the linear channels?

8.112 In our Second Pay TV Consultation we set out for consultation the view that we should extend the wholesale must-offer to video-on-demand services that were linked to the channels which fell under the obligation.

8.113 Sky argued that proposal to extend remarked the wholesale must-offer obligation to SVoD was radical in nature and said: "Such a proposal goes beyond compulsory access to existing property or facilities – which is in itself controversial - and is an extreme form of intervention in normal market processes". Sky called for Ofcom to have regards to, among other things, the potential negative impact on Sky's incentives to invest in and develop SVoD services.

8.114 The Four Parties supported the proposal to apply the wholesale must-offer obligation to SVoD rights. The Four Parties emphasised the need for Ofcom's remedy not to be limited to the application of the wholesale must-offer obligation in respect of such SVoD rights as Sky possesses. They considered that it is important to prevent Sky enforcing its holdbacks (and negotiating new holdbacks) over such. The Four Parties believed that ex ante measures to prevent the warehousing of SVoD rights by a licensed broadcaster are within the scope of Ofcom's powers under s316 CA03.

[518] http://www.skymedia.co.uk/_downloads/11/The20Sky20Story.pdf , page 12.

8.115 We acknowledge the argument of the Four Parties that ex ante measures to prevent the warehousing of SVoD rights by a licensed broadcaster are within the scope of Ofcom's powers under s316 CA03. However, these powers relate to the provision of licensed services, and not to the manner in which such upstream content rights are sold and subsequently exploited. We set out our intention at the end of this document to address issues relating to SVoD rights on movies through an intervention at the rights level. This is the most direct way of addressing the concerns we have in this area.

8.116 Sky does however supply an SVoD service – Sky Player on PC – to existing subscribers to Sky's linear channels, as well as on a standalone basis. Section 316 CA03 does permit us to consider services which are 'connected services' to a licensed service within the scope of a license condition, and we believe that when Sky Player is provided to an existing subscriber to Sky's linear channels it is indeed a 'connected service' in the sense of s316.

8.117 As this is an existing service, and one which is clearly connected to the main retail offering, we might therefore expect this also to be offered by Sky to customers of other retailers alongside the linear product. Not doing so would imply a degree of discrimination between Sky's internal supply and the approach to third parties. We are not however clear that this if this service is not part of the wholesale must-offer obligation there would be a continued risk to fair and effective competition. We also question whether it would be appropriate to include this as part of the remedy given that in order to allow customers of third party retailers with access to Sky Player, Sky would require commercially sensitive information on the identity of these customers, and the content which they are entitled to access.

8.118 In light of this, and our primary intention to address VoD issues through action at the rights level as we set out in section 12, we do not consider it would be appropriate to include this element within the scope of the wholesale must-offer obligation. We would be prepared to review that position if, following any implementation of a wholesale must-offer, it became apparent that restricted access to this service created a risk to fair and effective competition.

Consultation questions

7. Do you agree with our view that it would not be more appropriate to proceed in relation to some or all of the matters in question under CA98?

8. Do you agree that a wholesale must-offer is in principle the best way of answering our concerns around restricted distribution of Core Premium channels?

9. Do you agree with our proposal not to apply a remedy to wholesalers without market power?

10. Do you agree with our proposal not to extend a remedy to retailers on Sky's own platforms?

11. Is it necessary for us to set the prices of a wholesale must-offer?

12. Do you agree with our overall price-setting approach of using retail-minus, with a cost-plus cross-check?

13. Do you agree with our proposal to include HD and primary interactive sports content in a remedy?

14. Do you agree with our views as the concerns relating to commercial premises?

Section 9

Terms of a wholesale must-offer remedy

Summary

9.1 We have put forward the view that we should not only proceed to consider a wholesale must-offer remedy, but we should include detailed terms in the scope of the remedy – price being the primary condition.

9.2 We have carried out a substantial piece of analysis to establish the appropriate level for wholesale prices:

- We derive retail-minus prices by considering a discounted cashflow analysis. We determine the wholesale price that an efficient retailer could afford to pay given its own retail costs and the need to earn a return, while at the same time matching Sky's current retail prices.

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

9.3 There are a number of issues of principle and methodology to consider in deriving wholesale prices on a retail-minus basis. In summary, we propose to:

- Calculate prices for each combination of Core Premium channels that Sky makes available to its retail customers;

- Start from the prices of the closest retail package to the wholesale product in question, accepting that this includes different mixes of basic channels given Sky's current 'buy-through' retail pricing structure;

- Deduct direct variable costs as well as a pro-rated allocation of fixed and common costs for basic content and retailing, to derive a retail-minus wholesale price;

- Use a multiple year discounted cashflow analysis and terminal value calculation, with a discount rate set equal to an estimate of Sky's cost of capital, thereby incorporating a return on investment;

- Derive prices for an entrant that would be as efficient as Sky at equivalent scale, but has smaller scale due to more recent entry, while avoiding the costs of market entry by inefficient sub-scale firms;

- Derive prices which allow efficient entry using not only a DSat platform but also a DTT platform for distribution, given it is the most likely technology for potential competitors to use in the short to medium term, and the technology which is most likely to yield the greatest number of additional subscribers.

9.4 There are also a number of issues of principle and methodology to consider in deriving our cost-plus cross-check. In summary, we propose to:

- Allocate Sky's total costs to Sky's wholesale channel business, consistent with our retail-minus calculations, using independent data where available;

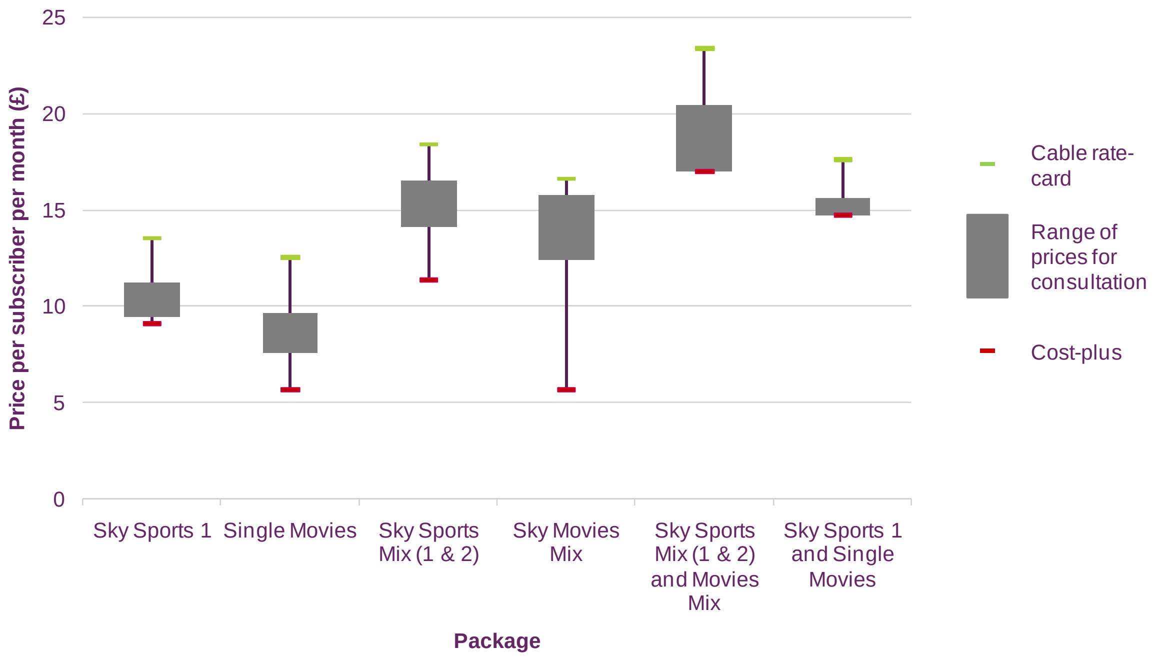
- Derive wholesale prices for each Core Premium channel on the basis of an allocation of premium rights and programming costs, as well as fixed and common costs associated with channel production;

- Use a multiple year discounted cashflow analysis and terminal value calculation, consistent with our retail-minus calculations.

9.5 In addition to these principles, we acknowledge that there is a degree of judgement to be exercised, for example, in what constitutes an ‘efficient’ entrant – setting the threshold high risks low levels of market entry, and limited competition, whereas setting the threshold low risks high levels of market entry by inefficient sub-scale firms, the costs of which could ultimately fall onto consumers. We have therefore modelled a number of different approaches to explore the sensitivity of the wholesale prices to some of these issues.

9.6 The figure below shows our proposed range of prices for consultation for each of the key wholesale products. This range of prices is below the existing cable rate-card offered to Virgin Media, and is consistent with our view that there are high wholesale margins at present. The range of prices is also above our cost-plus figures, which is designed to ensure that Sky continues to earn a reasonable return on its investment at the wholesale channel level. Indeed, our expectation is that Sky’s wholesale revenues net of additional costs are likely to increase due to any reduction in wholesale charges to cable being more than offset by additional wholesale revenues associated with market expansion.

Figure 62 Chart showing range of prices for consultation for key products (£ per subscriber per month)



9.7 The top and bottom of the range of prices for consultation are calculated as follows:

- Top of the range: these prices reflect a retail business similar to Sky’s and are estimated on the basis of competing with Sky’s retail prices, incurring Sky’s costs (including Sky’s costs of DSat transmission), and operating at Sky’s scale. However, in contrast to the existing rate-card prices, which are based on Sky’s application of the OFT margin squeeze test, we have incorporated a return on investment based on our estimate of 10.3% for Sky's cost of capital.

- Bottom of the range: these prices reflect a competitor which is as efficient as Sky at equivalent scale, but has higher average costs at lower scale due to the presence of fixed costs. We have modelled a smaller competitor on the same cost curve as Sky, but which builds up its subscriber base to reach one million subscribers after 10 years, using a DTT transmission platform rather than DSat. Where prices derived according to this approach are below the cost-plus prices we have taken our cost-plus figures as the bottom of the range for consultation.

9.8 On the basis of the principles highlighted above, we propose that retail-minus prices should be set to allow a larger competitor (for example, reaching three million subscribers after 10 years) to compete with Sky's retail prices, incorporating an allowance for DTT transmission costs and a reasonable return on investment. This would suggest prices roughly mid-way through our range for consultation.

9.9 Our calculations have not explicitly taken account of the costs and revenues of additional services that Sky bundles with its Core Premium pay TV packages. We recognise a risk that rivals might not be able to replicate Sky's broader bundles as a result. To safeguard the effectiveness of the remedy, we propose that wholesale prices should be subject to a further adjustment in the event that Sky bundles additional retail products where the incremental price for the additional product is below its long run incremental cost.

9.10 We also propose to set an incremental wholesale price for HD, to reflect Sky's own retail pricing structure. The range on which we are consulting is: £4.00-6.39 per subscriber per month.

9.11 There are a number of important terms not related to price that we propose to include in a wholesale must-offer:

- We propose that Sky should produce a reference offer which would set out fair, reasonable and non-discriminatory terms to form the basis of its commercial arrangements with third party retailers;

- We also propose to require Sky to provide a set of Minimum Security Requirements that are both platform and CA technology-agnostic, to protect against content piracy;

- We would expect Sky to issue a set of reasonable "Minimum Qualifying Criteria" for prospective retailers of its channels.

Introduction

9.12 In this section we focus on the proposal for a wholesale must-offer remedy to address the distribution of Sky's Core Premium channels and thereby ensure fair and effective competition. Within this option there are a number of forms a wholesale must-offer could take:

- A must-offer obligation without dictating any price or non-price terms.

- A must-offer obligation including pricing terms.

- A must-offer obligation including some non-price terms.

- A must-offer obligation including both price and non-price terms.

9.13 Our view is that a proposed wholesale must-offer remedy should include some level of detail of the terms of a wholesale offer – both with regard to price and non-price terms. This section addresses a number of issues relating to how the price of wholesale channels should be calculated, and consults on the appropriateness of a range of prices, should we decide a wholesale must-offer remedy including pricing terms is appropriate. The section also considers a number of non-price terms, such as qualifying criteria for retailers, security, the potential for a reference offer, and cross-promotion, should it be appropriate to impose such terms.

9.14 It is worth noting that even under our preferred approach of a wholesale must-offer remedy including pricing and non-price terms, it would still be open to Sky to make other offers and therefore to agree terms on other bases, in addition to those specified by the wholesale must-offer remedy.

9.15 The section is structured as follows:

- Principles in setting wholesale prices: given the objectives we are seeking to achieve through a wholesale must-offer remedy, what are the key principles we should adopt in setting wholesale prices?

- Calculation methodology: at the stage of calculating specific prices, what methodology should we apply?

- Implementation and analysis: what are the specific figures that result from implementing different pricing approaches and what is an appropriate range of prices and conditions for consultation?

- Non-price issues related to the implementation of a wholesale must-offer: what are the appropriate terms around issues such as qualifying criteria for retailers, security, and cross-promotion?

Principles in setting wholesale prices

9.16 In section 8 we highlighted a number of important aspects of a wholesale must-offer that we need to consider. While our focus in this section is on the pricing of channels, some of the broader principles around how we approach a wholesale must-offer remedy will be relevant to the question of setting prices. These include:

- The channels that are covered by a wholesale must-offer: this is the first step in determining the set of relevant wholesale products for which we should derive prices;

- The overall approach to setting prices: in particular (i) the appropriate calculation methodology to derive specific price levels, (ii) the appropriate structure for wholesale prices and (iii) the evolution of prices over time;

- The application of a wholesale must-offer to retailers on different platforms: this will inform how prices should be set across different platforms.

9.17 We consider the principles involved in addressing each of these issues below.

Set of relevant wholesale products

9.18 We noted in section 8 that our preferred remedy is for a wholesale must-offer to apply to channels which are the source of Sky's market power – without access to these channels other retailers would not be able to compete effectively with Sky.

9.19 Our competition concern relates to the supply of all Sky's Core Premium Sports and Movie channels and we therefore propose that a wholesale must-offer should apply to:

- Sky Sports 1, Sky Sports HD, Sky Sports 2, and Sky Sports 2 HD.
- All of Sky's premium movie channels apart from Sky Movies Classics.These are Sky Movies Action & Thriller, Sky Movies Action & Thriller HD, Sky Movies Comedy, Sky Movies Comedy HD, Sky Movies Drama, Sky Movies Drama HD, Sky Movies Family, Sky Movies Family HD, Sky Movies Premiere, Sky Movies Premiere HD, Sky Movies Premiere+1, Sky Movies SciFi & Horror, Sky Movies SciFi & Horror, Sky Movies Screen 1, Sky Movies Screen 1 HD, Sky Movies Screen 2, Sky Movies Screen 2 HD, Sky Movies Modern Greats, Sky Movies Modern Greats HD, Sky Movies Indie and Disney Cinemagic and the HD versions of these channels (see below for our discussion of HD)[519].

9.20 Our aim in including these Core Premium channels within a wholesale must-offer obligation is to address the adverse effects on consumers identified in section 7.

9.21 This means that we need to derive prices for each combination of Core Premium channels that Sky makes available to its retail customers. If we only derived prices for single wholesale Core Premium channels individually, while a competing retailer would be able to assemble an offering with the Core Premium channels included within Sky's larger retail bundles, it would be unlikely to be able to do so at a competitive price. Conversely, if we did not derive prices for standalone Core Premium channels, this would be likely to impede other retailers' ability to improve consumers' choice by offering differentiated retail products – for example, by offering Sky Sports 1 as a standalone channel, or by offering Sky Sports 1 bundled with Setanta Sports 1[520].

9.22 The standard definition Core Premium wholesale products for which we derive prices are as follows:

- Sky Sports 1;
- Sky Sports 2;
- Sky Sports 1&2;
- Single Movies[521];

[519] We refer in this paragraph to the names of the channels as used in the relevant broadcasting licences.

[520] Or potentially an alternative Core Premium Sports channel.

[521] While Sky retails two sets of movie channels – Sky Movies 1 and Sky Movies 2 – our approaches to calculating wholesale prices for Sky Movies 1 and Sky Movies 2 result in identical prices for the two

- Sky Movies Mix;
- Sky Sports 1 and Single Movies;
- Sky Sports 1 and Sky Movies Mix;
- Sky Sports 2 and Single Movies;
- Sky Sports 2 and Sky Movies Mix;
- Sky Sports 1&2 and Sky Movies Mix; and
- Sky Sports 1&2 and Single Movies.

9.23 This set of wholesale products broadly corresponds to the products which are currently made available to Virgin Media under the existing rate-card. The exceptions are Sky Sports 3 and Sky Sports Xtra which do not fall within our definition of Core Premium channels.

9.24 We also noted in section 8 that high definition (HD) is becoming increasingly important to consumers, and access to HD versions of the Core Premium channels is appropriate to address our competition concerns. We propose to set a price for access to these HD channels and address the appropriate approach to setting wholesale prices for these channels separately.

Overall approach to deriving prices

Calculation methodology for deriving price levels

9.25 Given our concern around Sky's approach to the wholesale supply of Core Premium channels, we continue to believe that it is appropriate to derive prices on a retail-minus basis, using cost-plus as a cross-check.

9.26 As we noted in the previous section we acknowledge that cost-plus pricing has a number of advantages:

- It allows us to set prices in a competitively neutral manner, without having to consider how different models of downstream competition might be affected. In particular it does not require us to make any assumptions about the platform or distribution technology that a potential retailer might want to use.
- It can in principle address concerns relating to high wholesale margins as well as availability of channels.
- It avoids some of the practical difficulties associated with setting prices on a retail-minus basis. In particular it would not require us to tackle any of the issues raised by retail bundling in the context of a retail-minus analysis.

9.27 However, there is a major issue with cost-plus pricing in the context of pay TV, which is that it risks artificially depressing rights values. Firms are unlikely to bid vigorously

products. This is also the price that is derived for a single movie channel and hence we refer to this wholesale product as 'Single Movies'. Sky Movies 1 and Sky Movies 2 can also be purchased together as Sky Movies Mix which then includes Sky Movies Premiere as a bonus channel. **[✂]**.

for content rights if the result of doing so is to push up the future wholesale price of the channels they purchase from Sky. Indeed, if the outcome of a rights auction has a direct effect on the level of wholesale prices, then some individual firms will have a strong incentive not to bid, and there may even be an incentive for various forms of coordinated behaviour.

9.28 As set out in both of our previous documents, one of our key objectives is to ensure that consumers have continued access to a wide range of high-quality content. This objective is likely to be undermined if the ability to generate a return on the production of content is artificially reduced. On this basis we do not believe it is appropriate to adopt cost-plus pricing.

9.29 Our focus is therefore on determining an appropriate calculation methodology to derive wholesale prices on a retail-minus basis. We also discuss our approach to calculating cost-plus prices in paragraphs 9.144 to 9.158 as a cross-check on our retail-minus calculations.

Appropriate structure for wholesale prices

9.30 In principle, it would be possible to structure wholesale prices in a number of different ways. We propose to put in place linear per subscriber wholesale prices, i.e. wholesale prices in pounds per month per subscriber, without any form of two-part tariff or discounts. We understand that the vast majority of channels (and not just Core Premium channels) that are wholesaled to multiple competing retailers are done so on a per subscriber basis. This suggests that we might expect a per subscriber structure in competitive wholesale markets.

9.31 In its response to the Second Pay TV Consultation, **[✂]** favoured setting regulated wholesale prices on a lump-sum basis (page 16)[522]. In other words a retailer would pay a lump-sum in order to receive a particular channel, regardless of the number of subscribers it ultimately retailed that channel to. **[✂]** considered that setting prices on a lump-sum basis is likely to lead to lower retail prices since the marginal cost that a retailer faces if it attracts an additional subscriber is much lower. In contrast, per subscriber wholesale prices increase the cost to a retailer of supplying an additional subscriber which discourages retailers from cutting retail prices to win additional business (indeed the per subscriber wholesale price sets a floor below which it is unprofitable to drop retail prices). **[✂]** thus considered that a lump-sum fee is more likely to enhance consumer welfare and cited an academic paper in support of its position (page 16)[523].

9.32 We see advantages in adopting a pricing structure which mimics more closely the structure of wholesale costs, i.e. principally the content costs that Sky faces (particularly for sport) with high fixed costs and low marginal costs. We could allow for an upfront lump-sum fee, and a lower per subscriber channel fee. Such an approach might have attractive efficiency properties. It would result in pricing signals which more accurately reflect underlying cost structures and therefore help to deliver the same benefits to other retailers as vertical integration provides for Sky (e.g. the avoidance of double marginalisation). However, it would be likely to raise barriers for

[522] **[✂]** stated that the option to acquire these channels on a per subscriber basis could be available as well. This would give retailers a choice between a lump-sum wholesale price and a per subscriber wholesale price.

[523] **[✂]** cited the Harbord-Ottaviani Paper in support of this argument.

new entrants, which runs counter to our overall objective of promoting competition to remedy the effects we identified in section 7.

9.33 Conversely, given the concerns we have expressed about the availability of Core Premium channels, and our proposal to ensure fair and effective competition by providing access to this content to competing retailers, it might be possible to argue for a structure which gave an advantage to smaller operators until they achieved greater scale. This might be the case particularly if fixed retail costs were very substantial, and cost barriers to entry into retail pay TV markets were therefore very high. However, the information we have analysed in relation to established pay TV companies suggests that fixed costs are not a substantial part of their retailing cost bases once they achieve scale. To the extent that fixed costs may present an issue for efficient entrants, we have considered this within our methodology for deriving retail-minus prices (see paragraphs 9.124 to 9.129) rather than proposing a non-linear pricing structure, in part for the efficiency reasons raised in the paragraph above.

9.34 Although the principle we intend to follow is that of a simple linear per subscriber price, this is not intended to prohibit alternative structures being negotiated as part of commercial discussions between Sky and its wholesale customers. We see advantages in there being flexibility in pricing structures, which may have more desirable efficiency properties, to allow greater innovation in retail packaging.

9.35 We recognise that there would be flexibility for bespoke prices to be negotiated between Sky and its wholesale customers. This would be in addition to wholesale customers having the fallback option of access to Core Premium channels at simple linear prices per subscriber, as set by the remedy. We are keen to receive comments on whether our approach would be likely to raise any concerns, and to understand the nature of any such concerns.

Evolution of prices over time

9.36 We are proposing to derive prices on a forward-looking basis. Having established initial price levels and a pricing structure for the set of wholesale products, we also need to consider how these prices should evolve over time.

9.37 There are a number of principles we should keep in mind when considering how best to allow wholesale prices to evolve over time.

- Resolving our competition concerns: we would want prices to change in a way which did the most possible to answer the concerns we have expressed about restricted distribution of content, also bearing in mind our concern about high wholesale margins.

- Responsiveness: we would want wholesale prices to be able to respond appropriately to changes in the market, whether in terms of prices or costs.

- Predictability and transparency: we would want competing retailers to have sufficient visibility of future wholesale prices to enable them to plan their businesses effectively.

- Practicality: related to the above point on predictability, we would want to avoid reopening pricing calculations frequently. Each time there is a requirement to do this, it is likely to introduce a degree of uncertainty, as well as imposing an additional burden on stakeholders whose input is required in the process.

- Incentives: we would want prices to evolve in a way that neither causes artificial reduction of rights values, nor creates an incentive to engage in inefficient behaviour.

- Gaming: given our view on Sky's incentives to restrict distribution of its channels, we are conscious of the possibility that Sky could seek to manipulate pricing rules to its own advantage. For example, it might seek to apply pressure to competitors' retail margins. We would want our approach to the evolution of prices to minimise the scope for manipulation as far as possible.

9.38 Given our focus on a retail-minus pricing calculation, our starting point in principle is to expect wholesale prices to evolve over time in a way that maintains the margin between retail and wholesale prices. This approach helps to addresses obvious concerns of margin squeeze which would arise from a reduction in Sky's retail prices where wholesale prices remained static. However, it is worth considering more generally how we might expect wholesale prices to evolve in response to change.

9.39 There are a number of different types of changes to consider. Four broad categories are:

i) Significant changes in wholesale channel costs: for example, Sky might move a part of its content from one channel to another for commercial reasons, thereby significantly changing the costs, quality and value of the channels subject to the remedy. In a more extreme case, it may choose to launch a new channel on which it shows much of the most important content. The same situation would arise if Sky were to lose a substantial portion of the rights it currently licenses. If these types of changes were sufficiently material, it may well be appropriate for wholesale prices to change, requiring a reassessment of the pricing calculations. It may even require a reassessment of which channels should be subject to the wholesale must-offer remedy.

ii) Significant changes in retailing costs: for example, if the efficient costs of retailing increased unexpectedly and this level of expenditure was not reflected in the initial retail-minus calculation, then it would be appropriate for wholesale prices to be adjusted downwards in response to the higher retailing costs. Conversely, an upwards adjustment to wholesale prices would be appropriate in response to a significant decrease in the retailing costs of an efficient retailer. If these types of changes were sufficiently material, as above, the only plausible option is likely to be to reassess the full set of pricing calculations.

iii) Significant changes in retail pricing structure: A significant change in wholesale channel costs (e.g. for the reasons raised in point i) above), might be expected to change the relative cost and value of channels and therefore the relative prices for the wholesale channels. As in i) above, this would be likely to require a reassessment of the pricing calculations. However, given our expectation that Sky will have sought to optimise its current retail prices, we would not expect a significant change in relative retail prices absent a change in content costs or in demand.

iv) Minor changes to retail prices: for example, Sky routinely revises its retail prices once a year in September, taking account of consumer demand and preferences. In this case, we would want, as far as possible, for wholesale prices to respond appropriately, without the need to reopen the full set of pricing calculations.

9.40 In a situation where a wholesale must-offer remedy applies, we recognise that Sky would have the incentive to implement changes to wholesale costs, retail costs or retail prices because of the possible adverse impact these changes might have on its competitors. Specific examples corresponding to the first three categories are:

i) Shifting valuable content away from a wholesale must-offer channel: this would reduce the quality and value of the regulated channel, as well as its underlying costs, which would disadvantage competing retailers if wholesale prices were not adjusted to fall in response.

ii) Increases in marketing expenditure: a significant increase in Sky's marketing expenditure would be expected to require a similar increase in marketing expenditure for other retailers in order to remain competitive. However, if this level of expenditure was not reflected in the initial allowance of retailing costs used to derive retail-minus wholesale prices, and wholesale prices remained unchanged as a result of no change in retail prices, this would reduce competitors' retail margins which might cause them to be unprofitable.

iii) Increases in selected retail prices but not others: for example, if retail competitors were primarily interested in gaining access to a single Core Premium channel, such as Sky Sports 1, Sky might have an incentive to change the relativity of its retail prices, increasing the price of retail packages which contain Sky Sports 1 (but no other Core Premium channels) while leaving the retail prices of its larger bundles of Core Premium channels (e.g. Sky Sports 1&2) unchanged. The effect of this retail price increase might not be that significant in terms of Sky's retail revenue (e.g. if Sky has few retail subscribers taking these packages relative to the larger bundles of Sky Sports 1&2) but would potentially have the effect of increasing the regulated wholesale price for Sky Sports 1. As a consequence, competing retailers who are attempting to differentiate themselves by focussing on smaller retail packages may now struggle. Their potential subscribers would be more likely to switch to offerings from competitors (including Sky) who offer larger bundles for what would now be a smaller price increment.

9.41 In its response to our Second Pay TV Consultation, Virgin Media considered that there should be a mechanism to assess the retail margin "*on a regular basis*"[524]. The Four Parties went further and suggested that there should be a monthly adjustment mechanism for wholesale prices[525].

9.42 As noted above, we acknowledge that significant changes which fall into categories (i) to (iii) above would require us to reassess the full set of pricing calculations. The calculations are complex and we believe it would be impracticable to do this on a regular basis. Our expectation is therefore that the threshold for this type of intervention will be high – in other words, we propose only to reassess the full set of pricing calculations if there are very major changes to wholesale costs, retail costs or retail prices. We therefore do not propose to impose accounting separation obligations, which we believe would be disproportionate in these circumstances. We also anticipate reviewing the effectiveness of this approach after a reasonable period (see paragraphs 9.241 to 9.245). The outstanding question is how best to address more minor changes in retail pricing as described in category (iv).

[524] section 6 paragraphs 6.38-6.39 of Virgin Media's response to our Second Pay TV Consultation

[525] section 6 paragraphs 6.16 of the Four Parties' response to our Second Pay TV Consultation

9.43 We believe that in principle, consistent with our retail-minus approach to setting initial prices, it is appropriate for wholesale prices to maintain the margin between retail and wholesale prices over time. A further question under this approach is whether wholesale prices should:

- track retail prices preserving an absolute margin in pounds per subscriber; or
- track retail prices preserving the margin as a fixed percentage of the retail price.

9.44 The appropriate mechanism depends on how retailing costs arise. If they are predominately driven as an absolute cost per subscriber (e.g. costs for certain bundled basic channels) then this would suggest preserving an absolute margin. Conversely, if retailing costs are predominately driven as a percentage of the retail price (e.g. it may be that a proportion of marketing expenditure is budgeted in this way), this would suggest tracking retail prices as a percentage.

9.45 In practice, we also note that each of these approaches has different effects on incentives to engage in regulatory gaming. If there is a greater concern of margin squeeze through reducing retail prices, preserving an absolute margin may be preferable. If, however, there is a concern of increasing retail prices in order to raise competitors' costs, tracking a percentage of the retail price is likely to dampen this incentive, and might help to address this concern.

9.46 We have also raised concerns of high wholesale margins arising from the potential to exercise market power. While we do not propose to address these concerns through our approach to setting wholesale prices, but rather to take forward these issues at the rights level (see section 12), a clear consequence of allowing wholesale prices to track retail prices directly is the potential for Sky to raise its wholesale prices significantly by raising its retail prices significantly. This would clearly intensify our concerns about high wholesale margins, ahead of exploring content rights issues. While we recognise that there are other constraints on Sky raising its retail prices substantially (e.g. loss of retail subscribers and retail revenue, and negative publicity), we believe it is appropriate to consider practical mechanisms which would help ameliorate these concerns.

9.47 We are therefore consulting on the proposal to use a 'ratchet' approach, which would have the following properties:

- If retail prices decrease then wholesale prices should also decrease;
- If retail prices increase then, while there is a presumption that wholesale prices should increase in a corresponding manner, we would first require Sky to seek consent for any increase in wholesale prices.

9.48 We also believe that purchasers of the wholesale must-offer products should be given a reasonable period of notice prior to any changes in wholesale prices. The notice period is one example of the non-price terms that could be set out in a reference offer (see paragraphs 9.228 to 9.230).

9.49 There are a number of examples where we would expect increases in retail prices to be reflected in increases in wholesale prices. For example, we would expect both retail prices and costs to increase with inflation – and this is the assumption we have incorporated into our calculations[526].

9.50 However, we can anticipate situations where an increase in retail prices is not primarily a response to consumer demand and preferences, but is prompted by an incentive to increase the wholesale prices that Sky's competitors face. For example, for the reasons described above, we would be more cautious if the relativities in the prices of Core Premium retail packages were revised significantly. To improve transparency, a pragmatic addition would be to identify generic types of reasons for legitimate increases in wholesale prices in response to increases in retail prices (in addition to inflation).

9.51 We welcome suggestions from stakeholders in response to this proposal and the two options on how wholesale prices should track retail prices.

Applicable prices for different platforms: technology neutrality

9.52 As discussed in section 8, our preferred approach is to require Sky to supply its Core Premium channels at regulated prices to non-Sky platforms. In principle, the obligation would apply to any non-Sky platforms (subject to security and quality considerations, see paragraphs 9.209 to 9.245 below), regardless of the underlying distribution technology, whether for example, DSat, cable, DTT, or IPTV.

9.53 This raises the question of whether all retailers should pay the same price, or whether their use of different distribution technologies should be taken into account.

9.54 In its response to our Second Pay TV Consultation, Sky stated that Ofcom's proposals were "distinctly non-technology neutral . . . in that they place a great deal of emphasis on seeking to support new operators who use DTT or IPTV technology"[527].

9.55 Virgin Media considered that there should not be different prices for different retailers, but rather "a single wholesale rate-card should be set which would apply to all existing retailers (across different platforms), as well as to new entrants seeking access to Sky's premium content"[528]. In contrast, BT argued that the optimal approach would be to determine a separate wholesale price for each rival pay TV platform[529].

9.56 In response to Sky's characterisation of our position, we believe that technology-neutrality is a key principle to take into account in determining our approach to pricing. It is our objective that the market should determine which platforms are successful, not the regulator, and not Sky. For the same wholesale product, it follows that there should be one price for retailers across all distribution technologies.

[526] In general, we assume future inflation of 2.5%. However, we also needed to adjust 2007/08 costs and 2008/09 prices to 2009/10 levels. For 2007/08 to 2008/09, we have assumed inflation of 0.9%, based on actual RPI inflation for the calendar year 2008. For 2008/09 to 2009/10, we have assumed inflation of -1.5%, based on forecasts of RPI inflation for the calendar year 2009, published in the Treasury's comparison of independent forecasts from June 2009.

[527] section 7 paragraph 6.16 of Sky's response to our Second Pay TV Consultation

[528] section 6 paragraph 6.1 of Virgin Media's response to our Second Pay TV Consultation

[529] BT's response to our Second Pay TV Consultation

9.57 We therefore focus on deriving prices for a set of 'factory gate' products which exclude any form of onward transmission. This is a set of products where the signal is picked up via a leased line at Sky's premises, so no payment is made to Sky for the transmission of the channels to end users[530]. As a result, competing retailers would have access to the Core Premium channels on the same basis, at the same price, regardless of the cost of their chosen distribution technology. A competing retailer would take this wholesale factory gate product, and in addition to the wholesale price, would incur the costs of transmission as well as retailing, in order to deliver a retail offering to its subscribers. The retail-minus price for the factory gate product must therefore reflect an allowance for competing retailers for the costs of transmission.

9.58 Under a cost-plus approach to setting prices, the same price would apply to all retailers for the same factory gate product regardless of distribution technology. However, in the context of a retail-minus approach, deriving a set of prices which is consistent with this technology-neutral principle raises a number of challenges, given that different distribution technologies entail different costs of transmission. The question of whether our retail-minus methodology should consider a retailer incurring the costs of DSat transmission, or the costs of transmission associated with a different distribution technology is addressed directly in paragraphs 9.130 to 9.137.

Calculation methodology: retail-minus approach

9.59 As noted above, we believe that the right overall approach is to derive prices on a retail-minus basis, using cost-plus as a cross-check. It is therefore necessary for us to consider the methodology that should underpin our retail-minus calculation.

9.60 The OFT considered a number of similar questions in its 2002 investigation into whether Sky had engaged in a margin squeeze abuse under CA98. Under such an ex post test for margin squeeze, the focus would be on whether a purchaser that was as efficient as Sky would be able to retail Core Premium channels on a profitable basis at the current rate-card price. The OFT examined this question by looking at Sky's costs.

9.61 However, as discussed in section 2, the purpose and scope of our sectoral powers under s316 are different to our powers as a competition authority under CA98. We identified in section 7 adverse effects on consumers which result, and are likely to result in future, from Sky's approach to the wholesale supply of Core Premium channels. Under s316 we have the power to impose licence conditions to ensure fair and effective competition, and under s3(1)(b) we have a principal duty to further the interests of consumers, where appropriate by promoting competition.

9.62 In determining what form of remedy might be appropriate, an ex-post margin squeeze test may not enable us to take account of entrants' costs, in particular issues created by differences in (a) scale between Sky and other retailers (b) distribution technologies used by other retailers. Having identified competition concerns around the lack of supply to potential entrants (section 6) and the resulting consumer detriment (section 7), it is appropriate for us to consider the possible benefit of a pricing remedy that takes into account differences in scale and in distribution technology. The key issue becomes the judgement as to what constitutes

[530] We would envisage that retailers could still negotiate alternative arrangements with Sky which could entail an incremental charge to the factory gate price.

an 'efficient' entrant, acknowledging the trade-off between the dynamic benefits of entry and competition, and the static costs of inefficient entry.

9.63 The approach we have adopted is to derive prices on a retail-minus basis for an efficient entrant looking to retail Core Premium channels. The efficient entrant is hypothetical – we do not focus on a particular potential or existing retail competitor to Sky. Our concept of 'entrant' is a potential or existing retailer who does not currently offer Core Premium channels, but might well be offering other retail services, including other pay TV services.

9.64 The general principle of a retail-minus approach is to derive wholesale prices by asking: 'how much could an efficient entrant afford to pay for the wholesale channels after taking into account all of its other costs and the need to earn a return on its investment?' The resulting wholesale prices should be at a level which allows the efficient entrant to compete with Sky in retail markets, providing similar products at similar prices. That is not to say we would expect or desire competitors to adopt identical business models to Sky, but rather that there should be a comparable retail cost 'allowance' for others to compete in retail markets. For example, the cost allowance might be used to subsidise set-top boxes or license basic channels (following a similar business model to Sky), to package Core Premium channels alongside new services, or to retail unbundled packages at a lower price point. Our intention would be to facilitate diversity in business models and product offerings in order to provide greater choice to consumers.

9.65 In addition to this retail-minus calculation, adopting a cost-plus cross-check ensures that our proposed approach would enable Sky to recover the costs it efficiently incurs in the provision of its Core Premium wholesale channels.

9.66 For the retail-minus calculation, at this most fundamental level there are therefore two key questions:

- What retail prices should we start from?
- What costs should we deduct from the reference retail price?

9.67 Both these questions raise further methodological issues in calculating retail-minus wholesale prices. In particular:

- Should we adopt a single year or a multiple year analysis?
- How should we allow for an appropriate return?
- What is a reasonable scale to consider for the efficient entrant?
- How should we deal with differences in the costs of alternative distribution technologies?

9.68 We have also considered separately how to derive wholesale prices for HD versions of the Core Premium channels on a retail-minus basis, given Sky's current retail pricing structure (see paragraphs 9.138 to 9.143).

Retail prices as the starting point of the calculation

9.69 The first step of the retail-minus calculation is to derive a retail price for each of the 11 Core Premium wholesale products identified in the list in paragraph 9.22. This retail price is the starting point of the retail-minus calculation, from which retail costs are subsequently deducted.

9.70 Given the presence of discounts, which means that consumers may not pay the headline published price for a package, we have derived reference retail prices by assessing the average revenue per user (ARPU) for different retail packages. We have calculated Sky's average customer discount by deriving Sky's expected pay TV revenues (given headline retail prices) and comparing this with actual pay TV revenues. We have then applied this discount factor to all Sky's retail prices as a first step in our calculation.

9.71 An immediate challenge is the lack of a unique retail price corresponding to a given Core Premium wholesale product. Rather, given Sky's broad portfolio of retail offerings, there are a multitude of retail prices for each of the 11 relevant wholesale products, depending on, for example: the number of basic mixes included, whether the subscriber also purchases additional services such as Multiroom, Sky Box Office (a pay-per-view service), broadband and telephony, and whether the subscriber receives a discount.

9.72 We approach this by considering each of the 11 Core Premium wholesale products in turn. We refer to the wholesale product that we are deriving a price for as the 'focal' Core Premium wholesale product. We then need to determine which retail packages to take into account for this focal wholesale product, and where we take into account multiple retail packages, how we derive a single retail price as a starting reference point for the retail-minus calculation. We consider this question for four different types of additional products which can be bundled with the focal Core Premium wholesale product:

- Additional non-TV services (such as broadband and telephony);
- Additional TV services (such as Multiroom);
- Different packages of basic channels; and
- Other Core Premium channels (which are not the focal wholesale product).

Retail packages including additional non-TV services

9.73 The first challenge to address in calculating an appropriate wholesale price on a retail-minus basis is presented by the combination of pay TV services in retail bundles with non-television services, such as broadband and telephony.

9.74 We set out in our previous consultation documents that we are conducting a pay TV market investigation, identifying competition concerns around the lack of supply to potential entrants and the detriment to consumers of pay TV services that might result, including restricted availability of channels and restricted innovation. The primary focus of our wholesale prices is therefore on enabling potential entrants to compete in the provision of pay TV bundles that include Core Premium channels.

9.75 We have therefore taken as our starting point the price of a pure TV product. We have not taken into consideration either the revenues or costs associated with other non-TV services, and particularly Sky's broadband and telephony products.

9.76 However, as explained in section 7 above, there may also be effects on adjacent markets if Sky is able to leverage its upstream market power into those markets by setting the incremental price of additional products below their incremental cost. In such circumstances, the wholesale prices that we set out below would enable competition in the provision of pay TV bundles, but may not ensure fair and effective competition in the provision of bundles of wider retail services. Efficient retailers would not be able to replicate Sky's wider bundles. That position could therefore undermine the efficacy of the wholesale must-offer obligation. We explain below in paragraphs 9.203 to 9.208 how we propose to address this concern.

Retail packages including additional TV services

9.77 Secondly, Sky makes certain TV-related services available to customers for an additional charge. These services include Multiroom, Sky Box Office and standalone premium channels such as MUTV and Chelsea TV. For Sky, these services generate extra revenues as well as additional costs. We consider these services to be outside Sky's core business of retailing subscription packages. Our approach has therefore been to exclude both the relevant revenues and costs (including a consistent allocation of common costs – see paragraphs 9.99 to 9.102) from our calculation. In other words, we assume that the efficient entrant is not required to offer these services. Therefore it would not bear these additional costs, nor would it earn the associated revenues. We acknowledge that, in principle, the concern highlighted in the previous paragraph could equally apply to additional TV services bundled with Core Premium channels, as well as additional non-TV services. Our proposal in paragraphs 9.203 to 9.208, therefore addresses wider retail bundles in general.

9.78 HD versions of Sky's Core Premium channels are made available to Sky's retail customers, bundled with other HD channels, for a fixed additional monthly fee. While our view is that HD versions of the Core Premium channels should be subject to the wholesale must-offer obligations, given Sky's retail pricing structure, we propose setting a separate wholesale charge based on the incremental HD retail price. We discuss the derivation of a HD wholesale price in paragraphs 9.138 to 9.143. It is therefore appropriate to exclude both the additional revenue and the relevant costs of HD packages when deriving ARPU for standard definition retail packages.

Treatment of packages which include different basic channels

9.79 As a result of the above, we propose focussing on Sky's 'pure' TV retail packages, excluding additional services, for our reference retail prices.

9.80 There are no standalone premium retail packages – all of Sky's Core Premium channels are currently subject to a compulsory buy-through[531], meaning that consumers have to buy a basic package before they can buy a premium package. As a result, all 11 of the Core Premium wholesale products are only available at the retail level bundled with basic channels. The relevant starting retail price therefore includes both the focal Core Premium wholesale product and basic channels, from which we need to deduct the costs associated with the basic channels.

9.81 However, Sky offers different mixes of bundled basic channels and therefore there is no single retail package for a given Core Premium wholesale product. For example, a Sky customer wishing to purchase Sky Sports 1 must subscribe to Sky Sports 1 bundled with between one and six basic channel mixes. There are six different retail prices for Sky Sports 1 retail packages depending on the number of basic channel

531 [✂].

mixes taken. This raises the question: how should we derive a single retail reference price for Sky Sports 1 from these six different retail prices?

9.82 There are a number of different approaches we could take. For example, we could simply take the smallest retail package (with the lowest retail price) – i.e. the retail bundle with only one basic channel mix. This approach would minimise the retail costs to be deducted from this retail price, arguably leading to the simplest calculation. However, in reality most consumers purchase significantly more than one basic channel mix, and so this approach may not be very representative of the retail price actually paid by Sky's customers.

9.83 Another, rather more complicated, approach would be to calculate the six wholesale prices derived from a retail-minus calculation applied to all six different retail prices, and then to take the lowest of the resulting wholesale prices. This approach would ensure that other retailers are able to compete with all six retail price points. However, our aim is to derive a set of wholesale prices which allow other retailers a comparable retail cost 'allowance' to compete in retail markets with a differentiated set of bundles, rather than to ensure they can compete by offering precisely the same bundles as Sky, at exactly the same price points.

9.84 A third approach – and the one we have adopted – takes a weighted average of Sky's retail prices for different bundles, weighted by the number of Sky's retail customers who take that number of basic channels. We consider that this figure provides the most accurate representation of the retail price paid by Sky's customers, and is therefore the best starting point for the retail-minus calculation.

Treatment of packages which include other Core Premium channels

9.85 For each of the Core Premium wholesale products, the methodology described above identifies a single retail price to act as a reference point for the retail-minus calculation. This approach takes the focal Core Premium wholesale product and identifies the retail packages which include this Core Premium wholesale product, and no other Core Premium channels – in other words, our approach is to take the 'closest retail product'. For example, if the focal wholesale product is Sky Sports 1, then our methodology derives the appropriate reference retail price for Sky Sports 1 based on the weighted average of the six retail prices for Sky Sports 1 bundled with different basic mixes.

9.86 However, it would also be possible to derive a retail-minus price for the focal wholesale product starting from larger bundles which include other Core Premium channels. For example, there are a number of other retail packages which include Sky Sports 1 which could be used as the starting point for the retail-minus calculation. These retail packages include other Core Premium channels – notably retail packages which include Sky Sports 2 as well as Sky Sports 1, and retail packages which include Sky's movie channels as well as Sky Sports 1.

9.87 Our objective is to address the effects on consumers identified in section 7 by providing other retailers access to Sky's Core Premium channels at prices which enable them to compete with Sky's retail offerings. In this context, we believe that the approach of taking the closest retail product is the appropriate starting point. For example, by construction, our retail-minus calculation should allow a competing retailer to offer Sky Sports 1 at retail prices which are competitive with Sky's retail packages which include Sky Sports 1 and no other Core Premium channels. Similarly, a competing retailer should be able to offer Sky Sports 1&2 at prices which are competitive with Sky's retail packages which include Sky Sports 1&2 and no other Core Premium channels.

9.88 This principle is worth contrasting with our position on basic channels included in the retail bundle. We expect other products, notably basic channels, to be more readily available. We therefore do not believe it is appropriate for regulation to facilitate other retailers replicating Sky's basic bundles precisely, at exactly the same price points, as opposed to bundling alternative basic channels or other services in order to create differentiated retail products. In contrast, there is no credible competitive alternative to Sky's Core Premium channels, and hence we believe that competitors should be enabled to replicate each of Sky's Core Premium bundles. By setting a price for the Core Premium wholesale product corresponding to each of Sky's Core Premium retail bundles, with a sufficient margin, an efficient entrant should be able to compete with these retail products. We therefore believe that our approach of taking the closest retail product for each Core Premium wholesale product is appropriate.

9.89 A concern could arise in practice if Sky's retail prices were set not with consumer demand and consumer preferences in mind, but with a view to manipulating the resulting regulated wholesale prices. For example, in paragraph 9.40 above, we describe an example where there may be an incentive to increase the price of retail packages which contain Sky Sports 1 (but no other Core Premium channels) relative to larger retail bundles containing Sky Sports 1&2 to the potential detriment of competing retailers who are attempting to differentiate themselves by focussing on smaller retail packages.

9.90 We believe that our approach to how regulated wholesale prices should change over time (see paragraphs 9.36 to 9.51) will help to address this type of concern in the future. However, we note there is an incentive for Sky to change its current retail prices ahead of any wholesale must-offer obligations coming into force. One way to address this concern would be to determine wholesale prices on the basis of retail prices effective at the time of this consultation. In addition, we have considered the likely prices that would result for wholesale products (e.g. Sky Sports 1) starting with retail packages containing larger bundles of Core Premium channels (e.g. Sky Sports 1&2) and the appropriate adjustments to deduct the cost of the additional Core Premium channels (e.g. Sky Sports 2). In cases where this leads to a significant discrepancy in the wholesale price from the more direct approach described above, we consider whether further adjustments should be made (see paragraph 9.171).

Relevant costs to be deducted

9.91 Having identified an appropriate reference retail price for each Core Premium wholesale product we need to identify the corresponding costs that should be deducted in order to derive the retail-minus wholesale price.

9.92 Since the retail bundles that form the basis of our retail-minus calculation include both the Core Premium channels for which we wish to set a wholesale price, as well as basic channels, there are two broad steps:

- Deduct the costs associated with the bundled basic channels;
- Deduct the costs associated with retailing the Core Premium channel product.

9.93 However, we first need to consider:

i) Which type of costs should be deducted?

ii) What is a reasonable cost benchmark for an efficient retail entrant?

9.94 The first question concerns the treatment of incremental and common costs. One approach would be to deduct only the incremental costs associated with retailing (and basic content). This is effectively the approach suggested by the "Efficient Component Pricing Rule" (ECPR[532]) which broadly aims to ensure (under some relatively strict assumptions) that a vertically integrated wholesaler/retailer is indifferent between supplying its own retail arm and a competing retailer. Under this approach, if a large proportion of retailing costs were common (for example common across retail and wholesale businesses) then we would only make a relatively small deduction for retailing costs. A competing retailer paying the resulting wholesale price would therefore only be able to recover a small proportion of its retailing costs if it were to match Sky's retail prices, making it unviable unless it recovered all its common costs from other lines of business. We do not believe that this approach would meet our objective of promoting fair and effective competition in order to address the detriment identified in section 7.

9.95 At the other extreme, we might deduct not only the incremental costs associated with retailing but also all of the common costs. This approach would enable retail competitors selling only Core Premium channels to match Sky's retail prices whilst recovering their full standalone costs of retailing. However, we do not believe this approach would lead to an efficient outcome. Existing and prospective competitors are likely to provide other products and services in addition to Core Premium channels (rather than acting as pure resellers) and we would expect them to be able to recover a proportion of their common costs from the sale of those other products and services.

9.96 There is inevitably a degree of judgement in this choice, but we believe that it is appropriate to deduct both the incremental costs associated with retailing and basic content from our reference retail prices, as well as a proportion of common costs. This requires us to consider the question of cost allocations.

9.97 The second question in paragraph 9.93 above concerns the source of our cost information. Our focus is on deriving a set of wholesale prices for an efficient retail entrant. We have used Sky's own costs as the basis for our calculations. Our aim is to promote competition on different platforms in order to address our identified competition concerns. However, of the various relevant cost categories, most are unlikely to be fundamentally different depending on the sorts of platform two different operators use. For example, the cost of marketing is unlikely to differ purely as a result of one operator choosing to set up a platform on DTT as opposed to IPTV. For that reason, in these areas we start with Sky's costs, as the best available proxy for an efficient scale retailer. We address the notable exception of scale issues and transmission costs in paragraphs 9.124 to 9.129 and 9.130 to 9.137 below.

9.98 We therefore consider cost allocation issues, and in particular the allocation of common costs, in the context of Sky's costs.

Cost allocation issues

9.99 As noted above, we start from Sky's costs as the best available proxy for an efficient pay TV retailer. In reviewing Sky's management accounts, we need to identify which costs should be allocated to the retailing of the different Core Premium packages.

[532] See William J. Baumol, "Some Subtle Issues in Railroad Deregulation" (1979)

While the allocation to Sky's retail business is relevant to our retail-minus calculation, the allocation to Sky's wholesale channel business is relevant to our cost-plus calculation. We consider these issues as follows:

- The categories of cost that we need to allocate;
- The parts of the business between which we need to allocate the costs; and
- The way we have allocated costs to the relevant parts of the business (e.g. according to subscriber numbers, revenue or 'product units').

9.100 A pay TV retailer incurs a number of different costs. The main categories of cost that we have considered, based on Sky's management accounts, are:

- Programming costs: this category relates to costs incurred in licensing and producing channels, which is relatively straightforward to allocate to basic, premium sports and premium movie channels. We have generally regarded these costs to be common across residential and commercial customers, and between SD and HD services, except in the case of channels only available in SD.
- Marketing costs: a retailer of pay TV services will be expected to incur marketing costs in the promotion of its premium packages. However, Sky incurs marketing costs not only in this respect, but also in respect of its wholesale business (e.g. the promotion of specific channels) and in respect of its platform business (e.g. subsidies of DSat set-top boxes) which should be allocated accordingly. However, some marketing costs should also be considered to be common across Sky's businesses.
- Subscriber management costs: a retailer incurs these costs, which include operating call centres and subscriber management IT systems, in servicing its customer base. A retailer also incurs costs for technical platform services (for example, conditional-access and electronic programme guide charges). We have established these platform costs on the basis of an analysis of Sky's current platform-related costs in its management accounts which are allocated to Sky's platform business. While an alternative approach would be to base our calculations on Sky's platform access charges, this approach raises further complications due to the likely inclusion of historic set-top box subsidies.
- Subscriber acquisition costs: a retailer would be expected to incur costs in acquiring and connecting new subscribers. While Sky does not have a clearly delineated cost category which corresponds to this in its management accounts, we have sought to identify these costs from various different subcategories.
- Transmission costs: within this broad category of costs, a retailer incurs costs in delivery of its services to end users. In the case of Sky, a significant proportion of these costs relates to satellite transponders[533]. Sky also incurs costs (such as studio production and editing costs) in its production of channels, which should be allocated to its wholesale business, and in developing its platform which should be allocated to its platform business. It is relatively straightforward to

[533] We consider that the costs of transmitting channels to the consumer are ultimately incurred by retailers rather than wholesale channel providers. Channels subject to the wholesale must-offer are to be made available at Sky's premises for onward transmission by retailers, so we expect Sky to incur minimal transmission costs.

identify the parts of Sky's businesses that these costs should be allocated to in contrast with other categories such as marketing.

- Administration costs: a retailer will also incur costs in the general administration of its retail business. These costs include corporate finance, communications and human resources functions. Sky's administration costs are largely common across its entire business.

9.101 Sky's management accounts relate to its wholesale, retail, and platform functions, and therefore it is necessary to allocate the above cost categories across these businesses, as well as to further sub-divisions. The key parts of the business that we have allocated costs to and the methodology we have used to allocate common costs, are:

- Wholesale, retail and platform: we have allocated common costs based on the number of customers served by each function where: for wholesale this is the number of premium customers served by Sky and Virgin Media; for retail this is the total number of subscribers to Sky's retail packages on DSat and 'Sky by Wire'; and for platform, this is the total number of customers on Sky's DSat platform. Marketing expenditure is a substantial category which in some cases may be a common cost across different parts of Sky's functions. If an individual expense primarily benefits Sky's retail business, it is appropriate that this cost is allocated entirely to the retail business. However, if the expense promotes Sky's brand more generally, including the Sky Sports and Sky Movies brands, this can in part be expected to benefit all retailers of Sky's premium channels. In this case we would allocate a portion of costs to Sky's wholesale business, on the basis of the number of customers served, for recovery through wholesale charges for premium channels.

- UK and Ireland subscribers: Sky's management accounts relate to both countries and we have allocated common costs based on the number of customers served by Sky in each of the two countries.

- Residential and commercial subscribers: we have allocated common costs for premium sports on the basis of revenue, acknowledging that one individual commercial subscriber has a much higher value than a residential subscriber.

- Basic and premium packages: we have taken a pragmatic approach and allocated common costs on the basis of 'subscriber product units' as a measure of value – where a subscriber taking only 'basic' is measured as one unit and a subscriber taking 'basic + premium' is measured as two product units. Other alternative methods would be to allocate costs purely on the basis of subscriber numbers, or purely on the basis of revenue. Allocating on the basis of subscriber numbers would tend to over-allocate costs to basic; for example, marketing costs are likely to be disproportionately targeted at premium customers, given the higher likely return on marketing expenditure. Other costs may at least at first glance seem better suited to allocations by subscriber numbers – subscriber management, for example. However, even in this example we might expect some greater effort to be spent on higher-value subscribers, making the correlation less clear. It might also be argued that we should allocate costs differently for each individual cost category or cost item. However, the lack of clear correlation between particular cost categories and appropriate methods of allocation suggests that overall, although we would not claim that using subscriber units is perfect, it is an appropriate way of allocating common costs.

- Premium sports and premium movies: we have allocated common costs between these two categories on the basis of the total number of subscribers taking each product.

- SD and HD services: we have allocated common costs primarily on the basis of Sky's revenue from SD and HD services respectively. In addition, we note that set-top box subsidies are likely to be higher for HD which may argue for a higher allocation of common costs to HD in this particular sub-category.

9.102 To provide some more specific examples:

- A Sky-wide cost such as Sky's central finance team is allocated to all parts of Sky's business in each market in proportion to the number of subscribers served by each function.

- Certain marketing expenses for the Sky One channel are assumed to be common between Sky's basic wholesale business and its retail business, and these are also allocated in proportion to number of subscribers served by each function.

- Third party programming costs are assumed to relate only to retail, but are allocated between the UK and Ireland (by number of subscribers), between residential and commercial subscribers (by revenue) and between SD and HD subscriptions (primarily by revenue).

<u>Specific costs deducted from retail prices</u>

9.103 As noted above, at the broadest level the costs to be deducted from the reference retail prices are basic content costs and retailing costs. There are specific points to address in the treatment of basic content costs.

9.104 We have first deducted the costs associated with basic channels – both the direct costs (the per subscriber charges for third-party channels), and the implied charges for Sky's owned channels. We have also deducted an allocation of common costs to basic, with allocations carried out as set out earlier in this section. Our approach to calculating the costs of basic channels associated with different retail packages is consistent with our approach to calculating *revenues* from basic channels, used to establish the starting reference retail prices.

9.105 We recognise that retail competitors may face higher carriage fees than Sky for third party basic channels, on account of weaker buyer power. This weaker buyer power may also extend to acquiring other inputs such as customer equipment. While such weaker buyer power may arise as a result of smaller scale, our aim is to enable other retailers to have a similar retail cost 'allowance' to compete with Sky's retail packages by including their own proposition (whether basic channels or other services) rather than to replicate Sky's retail bundles with precisely the same basic channels and services. Alternative retailers have the opportunity to include other basic channels or services in their competing retail packages, and for some products they may have cost advantages in comparison to Sky. There is a separate issue where lower scale may result in unavoidable higher costs for an efficient entrant, for example if the average cost of retailing the Core Premium channels is higher due to the presence of fixed costs. We address this issue in paragraphs 9.124 to 9.129.

9.106 A similar issue to the deduction of basic content costs arises in the case of deriving prices for wholesale products which include Sky Sports 1&2, which requires the costs of Sky Sports 3 and Sky Sports Xtra to be deducted. This is because we do not include Sky Sports 3 and Sky Sports Xtra as part of any of our proposed wholesale products although they are included as bonus channels in the retail packages containing Sky Sports 1&2. We have approached this adjustment based on the costs of sports rights and channel production allocated to Sky Sports 3 and Sky Sports Xtra (see paragraphs 9.146 to 9.152).

9.107 In principle a deduction should also be made for the costs of Sky Movies Classics from the relevant reference retail prices given that this channel is not included in any of the wholesale products. However, we have not made an adjustment for this single movie channel as any effect on wholesale charges is likely to be immaterial. This is because Classics predominately exploits library rights, which are relatively inexpensive, and has comparatively low viewing figures, so would only be allocated a small share of relevant costs.

Single year vs. multiple year analysis

9.108 Having established the starting retail prices and the costs to be deducted, there are still a number of key methodological issues to be considered before implementing a retail-minus calculation. Firstly, should the calculation be on the basis of a single year or a multiple year analysis?

9.109 Our objective is to derive wholesale prices which can address the concerns identified in sections 6 and 7. We have therefore considered what prices might be appropriate for an efficient entrant in order for it to be able to compete with Sky's retail prices. In this context it is appropriate to consider an analysis over a period of time, to determine whether there is a credible business case for entry, rather than for a single year. This is particularly the case given the likely growth profile of an efficient entrant – a single year analysis is unlikely to be representative.

9.110 A discounted cashflow (DCF) analysis is a standard approach to examining a business case over a period of time. We therefore propose to use a DCF analysis as a way of reflecting the likely business model of a retailer taking Sky's wholesale channels. For our retail-minus calculations we have modelled cashflows over a period of ten years at the end of which we include a terminal value reflecting the ongoing value of the business. This reflects assumed growth in subscriber numbers over the first nine years of the analysis after which we assume a steady state for the purposes of the terminal value calculation.

9.111 The inclusion of a terminal value implies that the retail business of the efficient entrant retains value into the future. After ten years, we would expect the entrant to have established a brand and subscriber base, through which it can expect to earn positive cashflows in future periods. We have calculated a terminal value on the basis of forecasted future cashflows. We considered calculating the terminal value on the basis of the residual value of tangible and intangible assets; correctly derived, this would be the same as the value of future cashflows. However, we considered that forecasting future cashflows directly was likely to produce a more accurate estimate of future value.

9.112 In calculating wholesale charges, the entrant's expected per-subscriber cashflows, including a terminal value, are discounted using a rate set equal to an estimate of the cost of capital. The wholesale charge for each Core Premium wholesale product is then set such that the additional costs from wholesale charges take the net present value (NPV) of the entrant's cashflows to zero. That is, the NPV of retail revenues, retail costs and wholesale charges is sufficient for the entrant to break even. Our calculations consider a period of ten years because our aim is to derive prices which enable effective competition from efficient operators that are prepared to make a substantial investment in pay TV rather than to enable weak entrants to earn short term profits at Sky's expense. We would also expect entrants to innovate, providing additional sources of value not captured in these calculations. Furthermore, our cost-plus cross-check is designed to ensure that Sky would continue to earn a reasonable return on its investment in providing Core Premium channels.

9.113 Adopting a DCF analysis differs from the approach taken by the OFT in its 2002 margin squeeze case. There are several reasons why we propose not taking a similar approach to the OFT.

- We believe our approach of looking at a potential competitor's business over time, taking into account likely subscriber growth, fixed / variable costs and subscriber acquisition costs is a more accurate way of working out whether a competitor would be able to build a business based on particular wholesale prices. Given the competition concerns we are seeking to address, this approach is likely to be more appropriate.

- The OFT's analysis was carried out in a very different context from the context in which we are carrying out our modelling. The OFT was examining Sky's past behaviour, in order to establish whether Sky had contravened competition law. Our analysis is intended to ensure fair and effective competition by establishing the price that a likely competitor could afford, and therefore looks into the future. We have mirrored the type of assessment such a competitor would be likely to make, taking a view on the likely future cashflows of a competitor's business and the need for competitors to be able to earn a reasonable return[534].

9.114 This approach requires taking a view on how retail prices and retail costs evolve over the period. We assume that these remain constant in real terms. Note that the retail-minus calculation does not involve assumptions about how rights costs evolve over time – rather, this issue is relevant to our cost-plus calculation (see paragraphs 9.153 to 9.158). However, our retail-minus approach also requires us taking a view on the path of wholesale prices over time. There are numerous possibilities for how wholesale charges change over time, each of which can be consistent with the principle that the NPV of cashflows is equal to zero over the business' lifetime. We have assumed that the per subscriber retail margin remains constant in real terms, and as a result that wholesale charges remain constant in real terms. We considered other possible profiles of charges, including charges that are fixed in nominal terms and charges that retain a fixed absolute difference from retail prices. However, we have adopted the assumption that wholesale charges are constant in real terms in the interests of simplicity and practicality. It is not clear that an alternative approach would be more appropriate: for example, rising prices over time might encourage inefficient early entry.

Appropriate discount rate and treatment of returns

9.115 Within the context of a DCF analysis, discounting future per-subscriber cashflows effectively incorporates a return for the entrant as compensation for incurring risks in

[534] This of course does not mean that it is inappropriate to adopt a DCF analysis in an ex post competition context – for example, there may well be circumstances where a similar DCF analysis to the one we have adopted is appropriate in ex post investigations of margin squeeze abuse.

entering a new market. This raises the question of what the appropriate discount rate should be and whether it incorporates an appropriate return.

9.116 In our analysis of an efficient entrant's cashflows, the discount rate should be set to the appropriate cost of capital. We have derived a forward-looking cost of capital figure of 10.3%. This figure is based on our view of Sky's cost of capital, derived from the capital asset pricing model (CAPM) approach. While we recognise that there may be changes to Sky's risk profile in the future, we have based our calculations on the market information available now, which should reflect these future considerations to the extent possible. Further, as convergence and bundling become more important, we expect most firms competing in retail communications markets to be fairly diversified, facing a broadly similar risk profile. For the details on how we have arrived at this figure, see Annex 10.

9.117 Our general approach to setting wholesale prices has been to base our analysis on Sky's costs as an efficient retailer of pay TV services, except where there is a particularly compelling reason to do otherwise. With respect to the appropriate cost of capital we recognise that Sky is an established operator. However, we note the potential for entrant retailers of Core Premium pay TV services to also be significant retail operators, providing a range of services to existing customers. Furthermore, it is unclear whether competitors face systematically different risks from Sky, assuming access to Sky's content. We therefore do not propose to make an adjustment for the different risk profiles of entrants. However, we have carried out a sensitivity on our retail-minus calculations to examine the effect of assuming a discount rate of 15% rather than 10.3% (see paragraphs 9.172 to 9.176).

9.118 In our recent analysis of BT[535], we reached the view that there were sufficient differences between the various parts of BT's business that we should use a disaggregated cost of capital. We have considered whether it would be appropriate to adopt a similar approach here – i.e. to use different cost of capital figures for wholesale and retail activities – and concluded that in this instance it would not be appropriate. The key question is whether the wholesale and retail businesses would have materially different betas (a key parameter in the CAPM). For them to do so they would need returns that were differently correlated with the rest of the market, and by implication not correlated with one another. In the case of BT we had reasonable grounds for supposing that such differences were likely. We do not see similar arguments with respect to pay TV. Put differently, we think retail performance and wholesale performance are likely to be strongly correlated. We note the potential for a wholesale must-offer remedy to reduce this correlation over time, and we would expect to review this at a suitable review point (see paragraphs 9.241 to 9.245).

9.119 When mirroring Sky's business at Sky's scale, in our retail-minus modelling, our approach requires us to incorporate a view on the opening intangible asset value. The analysis carried out for us by Oxera has taken a view on several categories of intangibles, primarily Sky's customer base, where it has valued the current base by reference to subscriber acquisition costs. Our analysis has included an approach where we incorporate Sky's opening asset base in a way which is consistent with Oxera's analysis, valuing Sky's subscriber base using current replacement cost.

[535] See the Cost of Capital annex in "A new pricing framework for Openreach", May 2009, http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/annexes.pdf and Section 7 of "Ofcom's approach to risk in the assessment of the cost of capital", August 2005, http://www.ofcom.org.uk/consult/condocs/cost_capital2/statement/final.pdf

9.120 While the theoretically correct approach is to consider return on investment, by setting the NPV to zero at the relevant discount rate, if we were unable accurately to reflect a return on investment, a fallback might be to use a return on turnover (ROT) approach. In the OFT's margin squeeze test based on Sky's costs and Sky's scale, the OFT decided that it was very difficult to estimate and allocate the asset base with any precision, so adopted a ROT approach as a proxy. The figure it used for ROT in Sky's retail business was 1.5% on the basis that 1.5% was a "conservative assumption of the minimum that [Sky retail] might be expected to earn". Note, however, that the OFT's test was a very different test to the one that may be appropriate here, but one which the OFT judged suitable in the context of assessing whether Sky's behaviour had been illegal.

9.121 More generally, it is very difficult to know what the correct ROT figure should be, given that a ROT approach effectively reflects a judgement about whether other businesses have a similar capital structure to the one under consideration[536]. We therefore believe it is more appropriate to adopt a DCF approach and to estimate the opening intangible asset value, in order to consider return on investment.

9.122 Given the difficulties in incorporating a view on intangible assets, it may be appropriate to fall back on a ROT approach, though not necessarily using a ROT figure of 1.5%. Sky has told us that it sets its prices in line with the OFT's methodology in 2002, which assumed a return on turnover in Sky's retail business of 1.5%. Within our analysis, we have calculated the prices that would result from discounting future cashflows at the rate required to replicate such returns. These prices are therefore an approximation to the OFT's approach, and hence also an approximation of the way Sky sets its prices to the best of our understanding given the information available to us[537].

9.123 There is also the question of how we should treat subscriber acquisition costs, for an efficient entrant. We have done this in a manner consistent with Oxera's approach with respect to the allocation of subscriber acquisition costs to retail activities, noting that as we are modelling cashflows rather than building up an asset base, it is not necessary to identify intangibles in the model for scenarios based on an entrant's scale.

Appropriate scale of retailer

9.124 As already noted, in determining the magnitude of costs to be deducted from the reference retail prices, a key question is the appropriate scale of the efficient entrant as this affects the entrant's average costs.

9.125 Our starting point is to consider Sky's average costs and hence Sky's scale. This would imply basing our modelling on Sky's current UK subscriber base. Given economies of scale, a competitor that is as efficient as Sky at equivalent scale may nevertheless, at lower scale, have average total costs which exceed Sky's due to the presence of fixed costs. Adopting Sky's scale may not therefore result in a price

[536] With this in mind, Oxera has carried out an analysis of suitable benchmark companies' retail returns. We should not automatically assume that these figures represent a good proxy for retail returns in this case. However, Oxera's results are substantially above 1.5%: within a range of results, a group of TV comparators has a median return on turnover of 12% - see Annex 9 for more details. The wholesale prices under our base case assumptions imply a return on turnover of around 3.9%.

[537] We asked Sky to provide us with details of how it calculated its prices, however it declined to provide us with any detailed information. **[✂]**.

which enables new firms to enter given these higher average total costs at their likely lower scale. Setting prices purely based on Sky's own costs would decrease the likelihood of viable competitors emerging, jeopardising the benefits of wider distribution and enhanced innovation that the proposed remedy is intended to produce.

9.126 We need to consider what wholesale price would enable an efficient entrant to put together a viable business plan. In the interests of competitive neutrality we believe it is appropriate that we set a single price for a given wholesale product, regardless of the scale of the prospective retailer. However, there is a degree of judgement as to what constitutes an 'efficient' entrant – setting the threshold high risks low levels of market entry, and limited competition, whereas setting the threshold low risks high levels of market entry by inefficient sub-scale firms, the costs of which would ultimately fall onto consumers. We acknowledge that our approach results in some duplication of fixed costs – we consider the trade-off between these costs (and the costs of compliance), with the benefits of greater and freer platform choice, platform innovation and market expansion, in section 10.

9.127 We assume that the efficient entrant will incur a set level of fixed costs, which is incurred at each and every level of output. Over and above these fixed costs, the entrant incurs variable costs, primarily driven by its number of subscribers.

- Assuming a smaller number of subscribers for the efficient entrant results in a lower wholesale price than for a retail business of Sky's scale. Average total retailing costs per subscriber decline as the number of subscribers increases because of the presence of fixed costs. A small retailer therefore needs a lower wholesale price in order to compete effectively. The fixed cost assumption is no different from that applied when we assume Sky's scale. We have assumed a single cost curve and only vary *where* the retailer is on the curve in our analysis[538].

- We have generated this fixed cost number by reviewing a range of data relating to certain cost categories in Sky's business. These are third party programming, news and entertainment channels, marketing, subscriber management, administration and transmission not directly related to channels. We have also considered data from existing smaller competitors as a reasonable indicator of the minimum level of fixed cost achievable by an efficient entrant. The majority of fixed costs arise from marketing expenditure where we have estimated the minimum required expenditure to allow a competitor to run marketing campaigns each year.

9.128 Sky described a wholesale must-offer taking into account competitors' costs as regulation of a "radical and unprecedented nature"[539], and also highlighted the fact that some of the companies that we envisaged would take the wholesale must-offer were not new entrants, but large companies in their own right.

9.129 The prices that we are setting out for consultation in this document follow a number of principles which mean that we do not accept Sky's criticisms.

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[538] The exception to this approach is in respect of the transmission of premium channels, where under some pricing scenarios we take DTT rather than DSat transmission costs. We explain this approach in paragraphs 9.130 to 9.137.

[539] section 7 paragraph 6.2 of Sky's response to our Second Pay TV Consultation

- Our use of competitors' scale for our modelling attempts to reflect what Sky's costs would be at a smaller scale than it has now. It is indeed the case that some of the companies that might take up the wholesale must-offer are large in their own right – BT, Virgin Media and Orange for example. However, such companies, large or not, are in no position to take a product at a price which is uneconomic at the sort of scale they are likely to achieve in their pay TV businesses over a plausible planning horizon. We therefore consider this approach is appropriate for ensuring fair and effective competition.

- We have adopted similar principles in fulfilling our duties to promote competition within the telecoms framework. Most key prices within that framework are set on a cost-plus basis, so the question does not arise, but in those cases where we have set retail-minus prices (in particular, in setting prices for wholesale bitstream broadband access products[540]) we have used the costs of an efficient new entrant.

- In any event, our approach of incorporating a cost-plus cross-check is designed to ensure that Sky is able to earn a reasonable return, at least equal to its cost of capital, on its wholesale Core Premium channels[541]. We explicitly avoid setting any prices that do not satisfy this condition.

Allowance for transmission costs

9.130 As previously noted, we have taken account of responses regarding the principle of technology-neutrality and propose to adopt an approach which sets a single price, applicable to all competing retailers, for a given factory gate product which excludes onward transmission to retail customers. The retail-minus price for the factory gate product must therefore incorporate an allowance for the costs of transmission (in addition to the costs of retailing). In practice, deriving a set of retail-minus prices which is consistent with such a technology-neutral principle presents challenges given that different distribution technologies entail different transmission costs.

9.131 Our starting point for establishing the likely costs of an efficient entrant has been to look at Sky's own costs on its satellite platform. However, as in the case of the entrant retailer's scale (discussed above), there are good reasons to consider deviating from Sky's own costs when it comes to transmission costs.

9.132 There are four different distribution technologies which can be used to deliver standard definition pay TV services to the home, all with quite different cost structures:

- DSat (digital satellite): which reflects Sky's own costs and is therefore an important proxy for efficient entry. There is also the possibility of offering pay TV services on new satellite platforms (e.g. Freesat).

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[540] Direction Setting the Margin between IPStream and ATM interconnection Prices, 26 August 2004, http://www.ofcom.org.uk/consult/condocs/adsl_price/statement/statement.pdf.

[541] If it were not for the significant risk of a detrimental impact on the value of rights, it may have been more appropriate to derive wholesale prices directly on a cost-plus basis which would avoid the issues that Sky raises about taking account of competitors' costs. In other words, the issue of competitors' costs only arises because we have had to adopt a retail-minus approach to work 'backwards', deriving wholesale prices from Sky's retail prices, in the absence of a cost-plus methodology being workable.

- DTT (digital terrestrial television): which we believe is likely to provide the main potential for entry in the near term.

- Cable: which currently offers no potential for entry, since Virgin Media already markets Core Premium channels, and the platform is currently closed to other retailers. The key pricing issue in relation to cable is not market entry, but the level of the ongoing incentive to market Core Premium channels at the existing rate-card price (see paragraph 6.125 in section 6).

- IPTV (TV over broadband): we believe that this could become an important distribution technology in the medium to long term. However, for this technology to become an effective alternative to the existing technologies above, its cost base would need to reduce. There are two possible ways that this could happen. Firstly, the cost of fixed network conveyance could fall. There has been a general trend of falling network conveyance costs however increased demand for capacity and a greater use of Ethernet is acting to accelerate this trend. Secondly, the network architecture could evolve to make more efficient use of the available capacity, for instance, by deploying content caches deeper in the network. Whilst it is clear that developments are making TV over broadband a more attractive proposition we do not at this time believe that it is appropriate to use current network conveyance costs as a proxy for the distribution costs of an efficient IPTV network.

9.133 In the first instance, we have derived retail-minus wholesale prices on the basis of the satellite transponder costs that Sky incurs. Taking account of these DSat costs enables us to derive wholesale prices for an entrant who is as efficient as Sky in terms of transmission costs.

9.134 In addition to considering wholesale prices for a retailer using DSat transmission, we have also derived retail-minus wholesale prices for a retailer using a DTT platform, recognising that the costs of DTT transmission are higher than those associated with DSat.

9.135 In section 7 we set out the adverse effects on consumers resulting from Sky's approach to wholesale supply of Core Premium channels. Our preferred remedy is that these channels should be made available on a suitable wholesale basis to competing retailers. Our assessment is that competitors are particularly likely to adopt DTT as a distribution technology in the short to medium term[542] and therefore it is necessary for us to consider what wholesale prices would enable a DTT-based retailer to operate a viable business. We therefore propose to base our retail-minus prices on an efficient entrant using DTT transmission. We have used recent observations of market rates for DTT capacity, and have assumed that the efficient entrant bears the costs of transmitting premium channels, but shares the costs with other retailers through the use of simulcrypt[543] arrangements on DTT, given that DTT transmission capacity is relatively scarce.

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[542] Sky's application to launch Picnic – a pay TV service on DTT – is relevant in this context.

[543] Simulcrypt enables the same channel to be broadcast with more than one conditional access system, which would allow different set-top boxes (with different conditional access systems) to receive the channel without having to use more than one videostream.

9.136 We have not attempted to derive retail-minus wholesale prices on the basis of transmission costs incurred by a cable operator or an IPTV-based retailer, for the reasons discussed above.

9.137 In addition, the transmission costs of DSat and DTT platforms are relatively clear. In contrast, for IPTV and cable platforms, the costs of TV transmission are shared across multi-service bundles including broadband and telephony, raising further challenges of cost allocation.

Approach to deriving prices for HD channels

9.138 As discussed in the previous section, we are proposing that HD versions of the Core Premium channels should also be subject to the wholesale must-offer provisions.

9.139 While HD is no longer a brand new innovation, we are cautious about deterring future investment in innovation and hence being overly intrusive in setting prices for the provision of HD versions of the Core Premium channels. Consistent with our approach to wholesale pricing for standard definition channels, we believe it is appropriate to adopt a retail-minus pricing approach, which mirrors Sky's retail pricing structure. Sky's current retail pricing practice is to charge a fixed fee per subscriber as an 'add-on' for access to HD versions of the same channels in the subscriber's standard definition package. It is therefore necessary to determine the costs that should be deducted from this retail 'add-on' charge which are essentially:

- The costs of retailing HD versions of the Core Premium channels (including the costs of transmission).
- Costs of HD versions of basic channels.

9.140 As in our retail-minus calculation for standard definition channels, our starting point is to consider Sky's costs. In determining the magnitude of the costs to be deducted, the key issues concern:

- The treatment of common costs.
- Scale and fixed cost assumptions.

9.141 There are few direct HD costs that we have been able to identify; most of the costs in Sky's management accounts appear to be common between SD and HD. Therefore, most of the costs to be deducted from the retail HD charge are an allocation of common costs between SD and HD. As already noted, we have allocated common costs between SD and HD services according to Sky's revenues for these two services, as a measure of value. In addition, we have considered a refinement with respect to net set-top box subsidies, where we have observed that Sky's subsidies are greater for HD boxes than for SD set-top boxes. We have therefore considered sensitivities where a larger proportion of these common costs are allocated to HD than would be implied by an allocation based on revenue.

9.142 Having established the retail HD costs to be deducted in year 1 of our analysis, we need to consider how these costs should be forecast to change in the future. In terms of scale and the number of HD subscribers, we have started from Sky's expected HD volumes, based on an analyst's forecast of HD subscriber numbers for future years. Given that we recognise HD to be a relatively new, innovative product, we believe it is appropriate to take these volumes, rather than those of market entrants, as our central assumption. However, we have also considered a sensitivity with volumes for

HD subscribers consistent with those that might be achieved by a 'large' entrant (see paragraph 9.201 below). In determining how average costs grow in the future with this growth in HD subscribers, it is important to establish the proportion of costs which vary with subscribers, and the proportion which are fixed costs. There is limited information with which to judge the proportion of fixed costs. We have assumed that about 50% of Sky's year 1 HD retail costs are fixed and around 50% will grow with subscriber numbers, recognising that a large proportion of current HD retail expenditure is effectively a fixed cost reflecting the current investment phase in promoting the HD product. We have, however, considered sensitivities around these proportions.

9.143 The resulting wholesale price is for a factory gate product which includes HD versions of Sky's Core Premium channels but excludes HD versions of basic channels from Sky or third party providers. Given this is a factory gate product, a retailer would also incur transmission costs for the HD channels as well as retailing costs in order to offer the HD retail service. We have assumed DSat transmission costs in deriving the retail-minus wholesale price, on the basis that these would be the costs incurred by a retailer as efficient as Sky, and the prospect for offering HD versions of the Core Premium channels on DTT or IPTV seems more limited in the short to medium term.

Approach to cost-plus as a cross-check

9.144 As noted at the beginning of this section, we do not propose to adopt a cost-plus approach as the primary mechanism for deriving wholesale prices given that the critical asset – content rights – is sold on a regular basis by auction or complex negotiation, meaning that a cost-plus approach to setting regulated prices could undermine content values. Nevertheless, we have calculated cost-plus prices as a cross-check to help ensure that the starting prices that we derive afford a reasonable return to Sky's wholesale business given the underlying input costs.

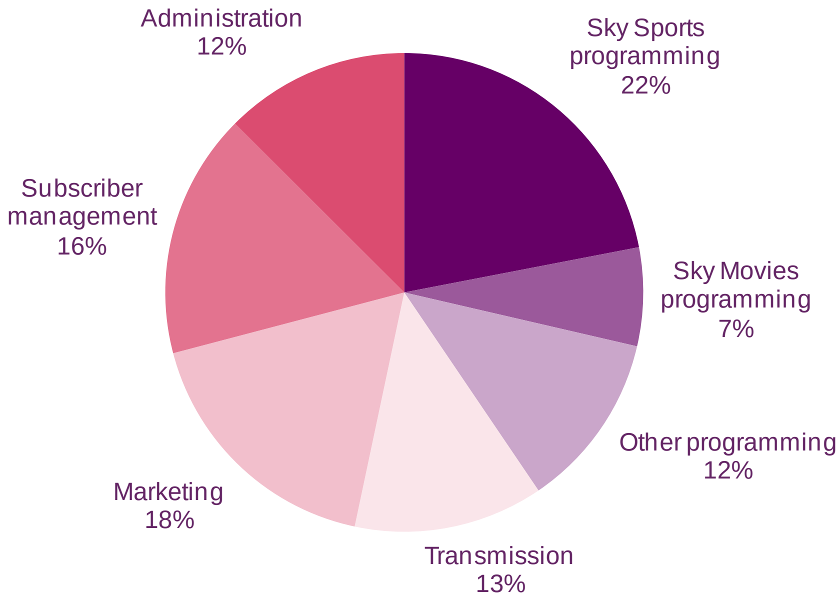
9.145 While in some respects a cost-plus approach avoids many of the practical difficulties associated with deriving retail-minus prices, for example, the need to tackle issues of retail bundling, there are nevertheless outstanding questions to address – some of which we have considered in the context of a retail-minus analysis. In particular:

- How should costs be allocated to wholesale channels?
- Is a multiple year analysis appropriate; over what period and at what discount rate, and how are costs expected to evolve?
- What is the appropriate size of the total wholesale market to consider?

Allocation of costs to Core Premium wholesale channels

9.146 The majority of costs incurred in supplying Core Premium wholesale channels are direct costs (e.g. the cost of the rights involved). These costs can vary significantly between Core Premium products – largely reflecting the different cost of rights for content within these channels. The significance of the costs of rights acquisition as a proportion of Sky's total costs is shown in Figure 63 below. In addition to the direct costs of rights, there are also common costs which must be allocated to these wholesale channels in order to derive a cost-plus price.

Figure 63 Sky's costs by major cost category (2007/08)



Source: Sky's 2008 Annual Report

9.147 The categories of cost that contribute to wholesale channel costs are primarily:

- Programming costs: rights fees payable to sports bodies and movie studios for content that is included in Sky's sports and movie channels respectively.
- Marketing costs: expenses that would be expected in part to benefit Sky's Core Premium wholesale customers, which are therefore legitimately recovered through cost-plus charges for Core Premium channels.
- Transmission costs: broadly defined, including certain technology development costs which we regard as a common cost across Sky's operations, and the operation of portals which would be expected to benefit all retailers of Sky's Core Premium channels.
- Administration costs: the costs of channel production and the operations of Sky Sports and Sky Movies channels which are relevant in their entirety to the wholesale of these channels, and the costs of overheads which are relevant to Sky's entire operations, which in part should be allocated to Sky's Core Premium wholesale activities.

9.148 We have drawn on a number of different data sources for our cost-plus calculations. In particular for the costs of sports rights acquisition, which make up the majority of the wholesale sports channel costs, we have used data from an independent expert publication, cross-checked against data from Sky where available[544]. In the case of movie channels, we have derived Sky's costs of rights directly from Sky's movie contracts.

[544] European TV and Sports Rights, published by SportBusiness Group (2008). This publication sets out expected rights fees over time. We cross-checked these forecasts against actual data for 2007/08 provided by Sky, and identified no significant discrepancies.

9.149 In the context of a cost-plus cross-check, Virgin Media argued that accounting separation between Sky's different businesses would be required to allow verification of the information submitted by Sky[545]. We are confident that the data we have analysed is sufficiently robust for our purposes and we describe our approach to cost allocation below. Furthermore, we have considered the impact of key parameters through sensitivity analysis (see paragraphs 9.178 to 9.183). We do not believe that imposing accounting separation obligations would be a significant benefit to our process.

9.150 As for our retail-minus approach, in analysing Sky's costs, it is necessary to allocate costs between different aspects of Sky's businesses. The key categories which determine wholesale channel costs are:

- Wholesale, retail and platform businesses: we have allocated common costs based on the number of customers served by each function.
- UK and Ireland subscribers: we have allocated common costs based on the number of customers served by Sky in each of the two countries.
- Residential and commercial subscribers: we have allocated common costs for premium sports between residential and commercial subscribers on the basis of revenue.
- Basic and premium packages: we have allocated common costs on the basis of 'subscriber product units' as a measure of value – as described in paragraph 9.101.
- Premium sports and premium movies: we have allocated common costs between these two categories on the basis of the total number of subscribers taking each product.

9.151 Having established the costs which are relevant to the Core Premium channels as a whole, we then need to determine how these costs should be allocated to individual Core Premium channels. The majority of these costs are the programming costs of sports and movie rights. Our approach differs for sports and movie channels reflecting the different way in which these rights costs are incurred. In general, we consider the correct approach is to allocate rights costs to channels according to their value to customers. However, for movie rights costs, because of the structure of Sky's agreements with the movie studios, we take a different approach. In more detail:

- For sports channels, the principle we have adopted is that fees allocated to channels should reflect consumers' perceived value of the content on each channel. We have examined Sky's current sports contracts with rights-holders and related sources and have allocated these rights costs between Sky's sports channels on the basis of a detailed analysis of channel listings and programme audiences, using viewer share data from the Broadcasters' Audience Research Board (BARB) for 2008. For example, FAPL content is predominantly allocated to Sky Sports 1, much less to Sky Sports 2 and none to Sky Sports 3 and Sky Sports Xtra, reflecting Sky's programming choices and viewers' behaviour. Across a full portfolio of different sports, we would not see viewing share as a good proxy for value, since the duration and frequency of different events and

[545] Section 6, paragraph 6.32 of Virgin Media's response to our Second Pay TV Consultation

sports is so different; for example, a cricket match may attract more viewing minutes over its duration than a much shorter football match, but the football match might still be the bigger attraction. However, we have looked on an event by event basis, and while we acknowledge that viewer hours are not a perfect proxy for perceived value of content, it is the best information available and we believe a reasonable proxy for this purpose.

- For movie channels, we examined Sky's contracts with movie studios to establish how payments relate to Sky's subscriber numbers. **[✂]**. This may lead to a slight over-recovery of costs from subscribers to only the least popular of Sky's channels. However, given that our objective in calculating cost-plus prices is to serve as a cross-check against our retail-minus prices being too low, we think it is appropriate to adopt a pragmatic approach.

9.152 As a final adjustment, Sky earns advertising and sponsorship revenues through its premium sports and movie channels. Therefore the costs incurred in producing wholesale premium channels support not only subscription revenues but also this advertising revenue. We have taken account of this by allocating a percentage of the wholesale channel costs to the advertising function, such that the advertising of premium channels has the same operating margin as Sky's total group operating margin (about 15% for 2007/8). This adjustment results in a reduction in the cost stack for calculating cost-plus wholesale charges.

Multiple year analysis

9.153 As for our retail-minus approach, we believe it is appropriate to consider costs over a period of time, rather than looking at a snapshot in any one single year. We have considered an explicitly modelled period of ten years followed by a terminal value (as in our retail-minus calculation).

9.154 We have also adopted the same discount rate of 10.3% used in our retail-minus calculations, as an estimate of Sky's wholesale cost of capital, given our view that wholesale and retail performance are likely to be strongly correlated.

9.155 Our approach is to calculate Sky's wholesale costs from year to year within the context of our discounted cashflow framework, including operating costs and capital expenditure. We have treated the opening premium wholesale asset value (consistent with the Oxera work) as a cost incurred in the first year, and calculated a perpetuity-based terminal value, consistent with the approach we have adopted in our retail-minus calculation.

9.156 A critical aspect of the modelling is our assumption about the costs of rights in future years. We have assumed that sports and movie rights fees will increase over time with both inflation and subscriber numbers. In other words, we have assumed that these fees remain constant per subscriber in real terms. This treatment reflects the purpose of the cost-plus calculation which is to ensure that our proposed wholesale prices, derived on the basis of a retail-minus methodology, allow Sky to recover its wholesale channel costs (including a reasonable return) in a range of possible circumstances. There is uncertainty in how Sky's content rights fees are likely to evolve in the future: they may increase at a slower rate, or even fall. However, we consider that our current treatment is appropriate given inherent uncertainties and the role of cost-plus in our overall approach.

9.157 Note that we assume subscriber numbers are flat in the terminal value, so there is no growth in costs accounted for by subscriber numbers after the ten-year period.

9.158 Finally, as for our retail-minus calculation, we assume cost-plus wholesale prices remain constant in real terms, and derive wholesale charges over the modelled period through a NPV approach.

Implementation and analysis

9.159 We have discussed above the issues of principle and the methodology we have adopted to derive retail-minus wholesale prices. In summary, we have:

- Started from the prices of the closest retail package to the Core Premium wholesale product in question, accepting that this includes different mixes of basic channels given Sky's current buy-through retail pricing structure.
- Identified a single retail price for a given wholesale product by taking the weighted average revenue of the different corresponding retail packages (which have different numbers of basic mixes).
- Deducted variable costs as well as a pro-rated allocation of fixed and common costs for basic content and retailing, to derive a retail-minus wholesale price.
- Used a multiple year discounted cashflow analysis and terminal value calculation with a discount rate set equal to an estimate of Sky's cost of capital, thereby incorporating a return on investment.
- Considered it appropriate to derive prices for an entrant that would be as efficient as Sky at equivalent scale, but has smaller scale due to more recent entry, while avoiding the costs of market entry by inefficient sub-scale firms.
- Considered it appropriate to derive prices which allow efficient entry using not only a DSat platform but also a DTT platform for distribution.

9.160 We have also derived cost-plus wholesale prices to act as a cross-check on whether the prices we propose afford a reasonable return to Sky's wholesale business.

Different pricing approaches considered

9.161 While we believe we have identified a reasonable set of principles to adopt in the context of determining appropriate prices, we have also calculated the wholesale prices corresponding to a number of alternative approaches in order to understand how sensitive the resulting prices are to these issues. In particular, we have explored the impact of the final three points listed above:

i) As an alternative to allowing a return on investment consistent with our estimate of Sky's cost of capital, we have also calculated the effect of adopting a return on turnover approach.

ii) In addition to taking account of entrants with smaller scale, we have also calculated the effect of deriving prices on the basis of the scale of Sky's current subscriber base.

iii) As an alternative to using DTT transmission costs, we have also calculated the effect of using DSat transmission costs.

9.162 Firstly, with respect to returns, we note that the OFT considered a return on turnover (ROT) of 1.5% in its ex post margin squeeze case of 2002. In order to understand how much difference our return on investment approach makes, we have modified the discount rate to apply to future cashflows in our analysis so as to obtain a ROT of 1.5%. Similarly, it is straightforward to modify the discount rate to derive wholesale prices which correspond to achieving an alternative specified ROT.

9.163 Secondly, we have considered two types of entrant in addition to a business operating at Sky's scale:

- A 'large' entrant: total fixed cost of retailing of about £12m[546] per year, subscriber numbers of one million at three years and three million after 10 years. In addition, there are fixed costs associated with the transmission of premium channels.
- A 'small' entrant: total fixed cost of retailing of about £12m per year, subscriber numbers of 330,000 at three years and one million after 10 years. As above, there are fixed costs associated with the transmission of premium channels.

9.164 We believe that these subscriber bases are plausible based on evidence we have reviewed from Sky's Picnic forecasts, and from the scale that existing competitors have achieved to date. These scale assumptions need to be placed in the context of the overall market. Our base case assumes a total addressable market of premium subscribers of 10 million subscribers in year 10, from 7 million at the present day. This figure has little impact on the retail-minus calculation, but is important for the cost-plus calculation, determining the average cost of sports rights per customer. We have also modelled a lower and a higher market size, of 9 million and 11 million subscribers respectively, the results of which are presented in paragraphs 9.177 to 9.183.

9.165 Overall, the scale effects are relatively small given that the retailing of pay TV services is not an asset-intensive business with significant fixed costs unlike, for example, network infrastructure businesses in telecoms markets. In this case fixed costs are a relatively small proportion (less than 10%) of a scale retailer's costs. The fixed cost figure we have used is based on benchmarks from existing operators; as noted above, two thirds of it consists of marketing costs, where we have assessed the minimum expenditure necessary to mount a marketing campaign.

9.166 Thirdly, we have derived retail-minus wholesale prices on the basis of an entrant using a DTT distribution platform as well as an entrant using DSat (for example, the Freesat platform).

9.167 To examine the impact on wholesale prices of these different approaches we have considered a number of different pricing scenarios. These pricing scenarios reflect different approaches to how we derive prices, including the use of different assumptions. The majority of these derive prices on a retail-minus basis. The final scenario shows prices obtained from a cost-plus calculation.

- Scenario 0: Current cable rate-card price. This is the set of prices currently charged by Sky to Virgin Media, which we understand Sky cross-checks to

[546] This is consistent with our single cost curve and an assumption that £15m of Sky's costs are fixed across the whole of Sky's business. Given the allocation of these fixed costs to different functions, around £3m are allocated to Sky's premium wholesale function, leaving approximately £12m of fixed costs to be incurred by a retail business – whether Sky's retail business or that of an entrant.

ensure compliance with its interpretation of the margin squeeze test applied by the OFT[547].

- Scenario 1: applies a discount rate to future cashflows so as to obtain a ROT of 1.5%, the figure adopted by the OFT in its ex post margin squeeze test. Scenario 1 is therefore essentially our approximation of the OFT methodology, using Sky's current costs.

- Scenario 2: applies a discount rate of 10.3% to the retailer's future cashflows, which is our estimate of Sky's cost of capital. We base this scenario on a retail business approximating to Sky's business – with Sky's costs (including DSat transmission costs), Sky's retail prices and Sky's opening asset base at the start of the period. We include a figure for intangible assets for Sky, based on the cost of acquiring subscribers at the start of the period. We also include a terminal value based on an estimate of future cashflows.

- Scenario 3: still applies a discount rate of 10.3%, but reflects the scale of a likely 'large' entrant, assuming a subscriber base of three million after 10 years. We assume that each competitor incurs fixed retailing costs of about £**[✂]** million per year (including transmission of premium content over DSat)[548].

- Scenario 4: is the same as Scenario 3, but makes an allowance for DTT transmission costs, as DTT is the most likely technology for potential competitors to use in the short to medium term, and the technology which is most likely to yield the greatest number of additional subscribers. Here we assume that each competitor incurs fixed retailing costs of about £**[✂]** million per year (including transmission of premium content over DTT)[549].

- Scenario 5: is the same as Scenario 4, but reflects the scale of a likely 'small' entrant and assumes a smaller subscriber base of one million after 10 years. Again we assume that each competitor incurs fixed retailing costs of about £**[✂]** million per year (including transmission of premium content over DTT).

- Scenario 6: is calculated on a cost-plus basis, using a NPV approach assuming a cost of capital of 10.3%.

9.168 The table below shows a range of prices that have emerged from our analysis, based on these different pricing scenarios. The final row of the table presents a weighted average of these prices, weighted by the number of Sky's retail subscribers purchasing each of these packages, which gives a broad aggregate measure with which to compare the different pricing approaches.

[547] This is to the best of our understanding given that Sky declined to provide us with its calculations as noted in paragraph 9.122.

[548] Assuming fixed premium transmission costs for DSat of £**[✂]**m.

[549] For the purposes of deriving an estimate of premium transmission costs we take an estimated cost of £**[✂]**m per videostream. However, we assume that this is spread amongst retailers using videostream sharing and simulcrypt arrangements, resulting in a per-retailer fixed cost of £**[✂]**m.

Figure 64 Table showing range of prices emerging from our calculations (£ per subscriber per month)

Scenario		0	1	2	3	4	5	6
		Rate-card	Ofcom rate-card approximation	NPV=0 at 10.4% WACC, Sky's scale, DSat	Large competitor on DSat	Larger competitor on DTT	Smaller competitor on DTT	Cost-plus
	Sky Sports 1	13.48	11.73	11.24	10.78	10.63	9.41	9.07
	Sky Sports 2	13.48	11.73	11.24	10.78	10.63	9.41	3.21
Single channels	Single Movies	12.48	10.10	9.61	8.95	8.95	7.58	5.64
Sport- or movies-only bundles	Sky Sports 1&2	18.39	16.98	16.48	16.00	15.69	14.10	11.34
	Sky Movies Mix	16.59	16.23	15.73	14.83	14.67	12.38	5.64
All channels bundle	Sky Sports 1&2 & Sky Movies Mix	23.40	20.94	20.43	19.40	18.90	15.66	16.98
	Sky Sports 1 & Single Movies	17.59	16.10	15.59	14.82	14.64	12.69	14.71
	Sky Sports 2 & Single Movies	17.59	16.10	15.59	14.82	14.64	12.69	8.85
	Sky Sports 1 & Sky Movies Mix	19.80	20.08	19.57	18.56	18.21	15.34	14.72
	Sky Sports 2 & Sky Movies Mix	19.80	20.08	19.57	18.56	18.21	15.34	8.85
Other combinations	Sky Sports 1&2 & Single Movies	20.60	19.09	18.58	17.78	17.45	15.13	16.98
Weighted average (by Sky's volumes)		**20.72**	**18.85**	**18.35**	**17.51**	**17.13**	**14.55**	**13.57**

Notes

1. The scenarios read from left to right, with one assumption changing in each one

2. Scenario 0 is the current cable rate-card

3. Scenarios 1 to 5 are calculated on a retail-minus basis, whereas 6 is calculated on a cost-plus basis

4. 1 uses the OFT's 1.5% return on turnover approach; 2 to 5 set prices at the level necessary to allow a retailer to achieve NPV of zero over 10 years

5. 1 and 2 assume Sky's scale, costs and starting asset base; 3 and 4 assume a retailer that achieves 3 million subscribers after 10 years; 5 assumes a retailer that achieves 1 million subscribers after 10 years

6. 1 to 3 assume that the retailer has transmission costs equivalent to Sky on satellite; 4 and 5 assume the retailer has the transmission costs of a DTT platform

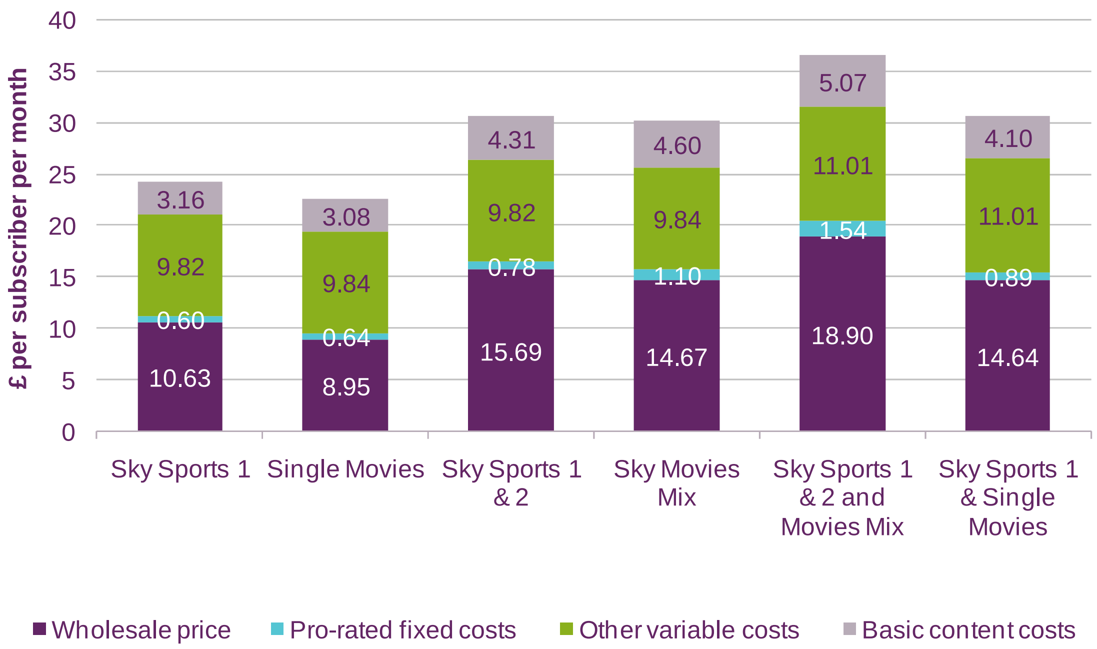
Analysis of differences in pricing approaches

9.169 Before analysing the differences resulting from these different pricing approaches we set out how the principles and methodology discussed above lead to these wholesale prices.

Retail-minus calculations

9.170 The figure below is an example of the retail cost stack for the 'larger competitor on DTT' (Scenario 4) for some of the key wholesale products. This shows the reference retail price decomposed into the costs which are deducted (basic content costs, other variable costs and pro-rated fixed costs) and the resulting retail-minus wholesale price.

Figure 65 Retail cost stack



9.171 We noted in paragraph 9.90 that we would assess whether starting from larger bundles of Core Premium channels would lead to significant discrepancies compared to our approach of deriving wholesale prices from the closest retail package. Our analysis suggests that there may be a specific issue in the case of Sky Sports 2. The retail price for this Core Premium channel appears particularly high relative to costs, with limited take-up, suggesting that the retail price reflects pricing simplicity (it is set equal to the price for Sky Sports 1 retail packages) rather than purely a full reflection of cost or value. It may therefore not represent an effective benchmark for our purposes. However, our competition concerns are focussed much more on Sky Sports 1 and Sky Sports 1&2, and we therefore do not propose making any further adjustments to our methodology based on the closest retail package.

9.172 We have also undertaken sensitivities on our retail-minus calculations in Scenario 4 for some of the input parameters. In particular, we have considered sensitivities based on:

- allocations of common costs between wholesale, retail and platform functions of Sky's overall business;
- the discount rate applied to future cashflows; and
- the assumed cost of DTT transmission for premium channels.

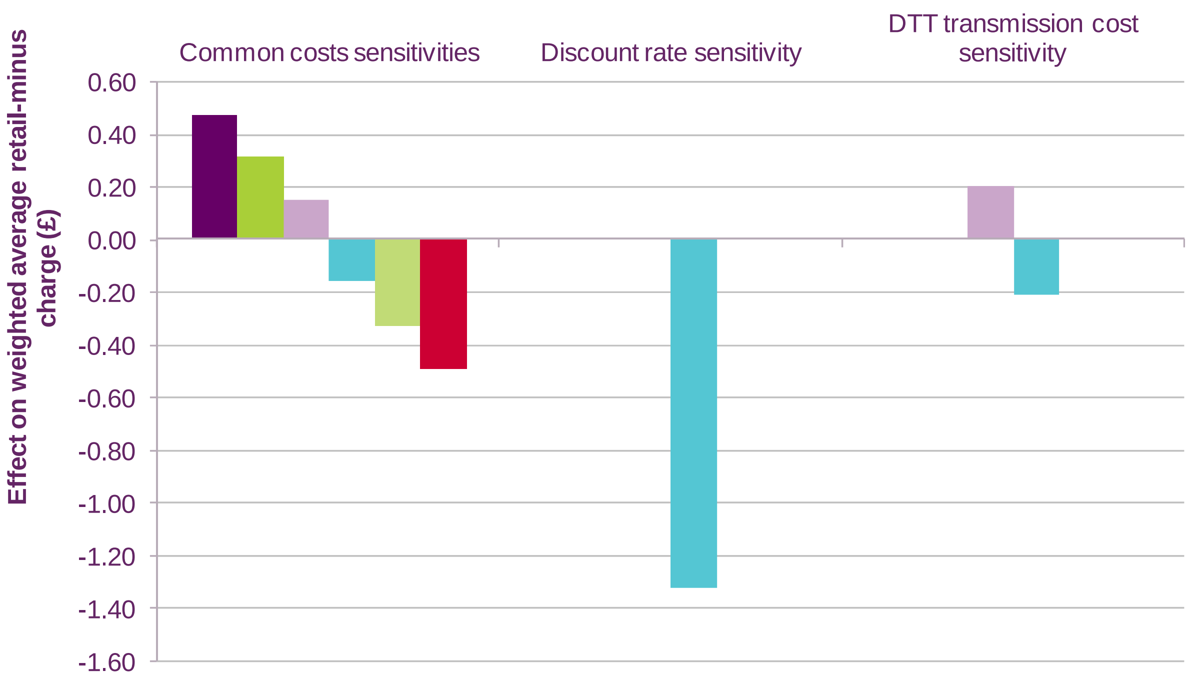
9.173 For the common cost allocation between wholesale, retail and platform functions, we have considered percentage variations which both increase and decrease the amount of common costs to be recovered from Sky's wholesale business rather than its retail function. This has an impact on the costs to be recovered in the retail cost stack. Increasing the allocation of common costs to Sky's wholesale function by 5, 10 and 15 percentage points increases weighted average retail-minus charges by £0.15 (1%), £0.29 (2%) and £0.43 (3%) respectively in the first year. Reducing the allocation of common costs to Sky's wholesale function by these percentages has a roughly similar effect on weighted average retail-minus charges in the opposite direction. These figures illustrate the sensitivity of retail-minus wholesale charges to cost allocation decisions.

9.174 As noted in paragraph 9.117, we have considered the sensitivity of retail-minus charges to the discount rate applied to future cashflows. If we were to assume a higher discount rate of 15%, to reflect a different risk profile to that of Sky, the weighted average retail-minus charge would decrease from £17.13 to £15.81 (an 8% fall).

9.175 We have also considered the sensitivity of wholesale prices to our assumption on the cost of a DTT videostream. We considered the sensitivity of wholesale prices to a £2 million annual increase or decrease to this cost. Under the higher cost, the weighted average wholesale price would be £16.92, as compared to a base case of £17.13, whereas under the lower cost, the average price would be £17.33. These are relatively modest changes of about +/- 1%.

9.176 The figure below summarises the effect of these sensitivities on our retail-minus calculations, for the particular case of the weighted average charge.

Figure 66 Sensitivity analysis for retail-minus calculations

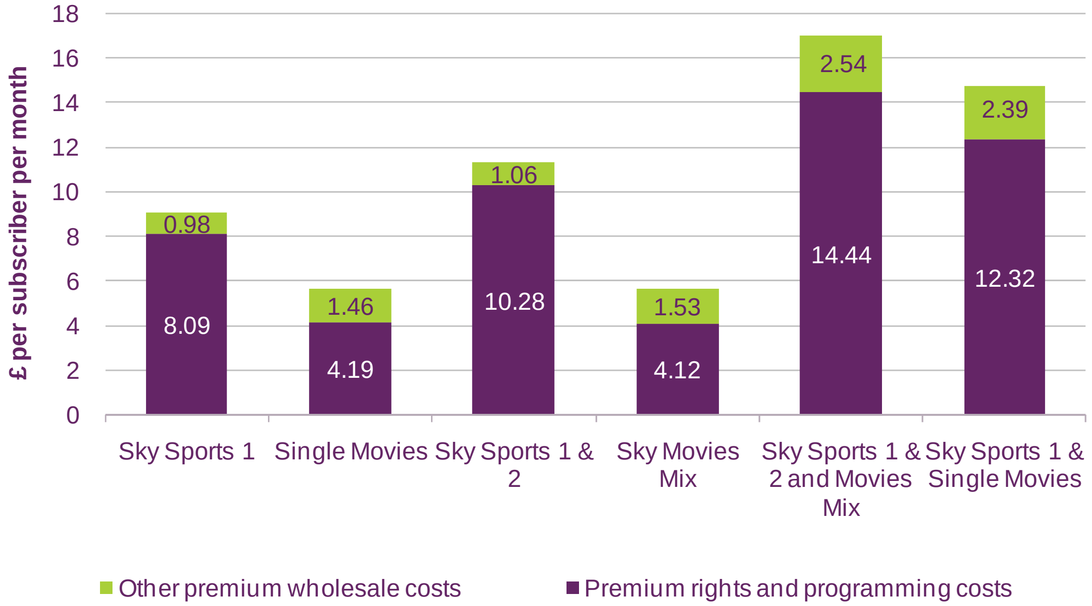


Note – each of the bars represent the different sensitivities in the order described in the paragraphs above.

Cost-plus calculations

9.177 Likewise, the figure below shows the cost-stack for our cost-plus wholesale prices for some of the key wholesale products. This figure demonstrates that the costs of the wholesale product are dominated by the programming costs – i.e. the costs of acquiring the premium sports and movies content.

Figure 67 Cost-plus cost stack



9.178 We have also undertaken sensitivities on our cost-plus calculations for some of the key parameters. In particular, we have considered sensitivities based on:

- Allocations of common costs between wholesale, retail and platform functions of Sky's overall business;
- Allocations of common costs between residential and commercial subscribers;
- Forecasts of the total addressable market for premium subscribers; and
- Forecasts of future rights fees.

9.179 With respect to common cost allocation between wholesale, retail and platform functions, we have considered percentage variations which both increase and decrease the amount of common costs to be recovered from Sky's wholesale business; this has a corresponding impact on the cost-plus charges. Increasing the allocation of common costs to Sky's wholesale function by 5, 10 and 15 percentage points increases weighted average cost-plus charges by £0.17 (1%), £0.33 (2%) and £0.49 (4%) respectively in the first year. The effect is symmetrical. Reducing the allocation of common costs to Sky's wholesale function by these percentages has a similar effect on weighted average cost-plus charges in the opposite direction. These figures illustrate the sensitivity of cost-plus wholesale charges to cost allocation decisions.

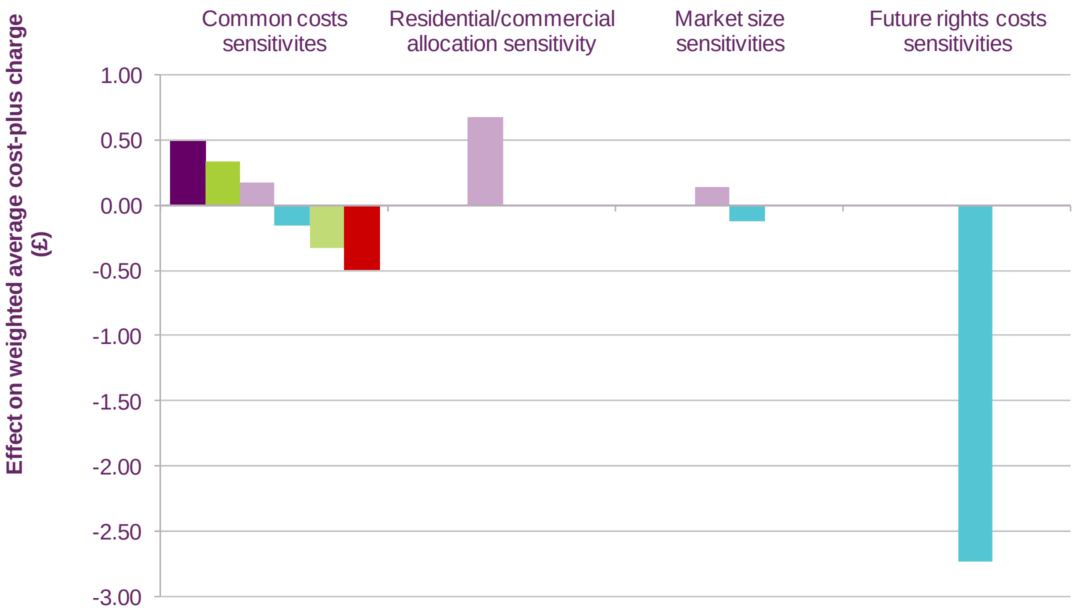
9.180 Similarly, we have considered the impact on the amount of common cost recovery from Sky's wholesale business of allocating common costs between residential and commercial subscribers on the basis of subscriber numbers rather than revenue. This has the effect of increasing the amount of common costs to be recovered from residential subscribers, and hence increases the cost-plus charges. Changing the allocation method to be on the basis of subscriber numbers increases the weighted average cost-plus charge from £13.57 to £14.24 (an increase of about 5%) in the first year.

9.181 Forecasts of the total addressable market for premium subscribers have an effect on Sky's forecasted wholesale costs – a larger total premium market means that per subscriber cost-plus prices can, to the extent that some wholesale costs do not vary with subscriber numbers, be lower and still generate the same overall revenue. Our base case assumes a total addressable market of premium subscribers of 10 million subscribers in year 10, from around 7 million at the present day. However, we have also modelled a lower and a higher market size, of 9 million and 11 million respectively. The effects are relatively modest. Whereas under our base case the weighted average cost-plus charge is £13.57, under the lower market size this charge is £13.71 (an increase of about 1%), and under the higher market size this charge is £13.45 (a decrease of about 1%).

9.182 Finally, forecasts of future rights fees have a material influence on the total costs to be recovered over the modelled period. Our base case is to assume that Sky's rights fees for sports and movies will increase with both subscriber numbers and inflation over time. We have examined the extent to which cost-plus charges would change if we were to assume that Sky's total premium rights costs were constant over time in real terms. Of the sensitivities considered, our analysis shows that this factor has the most significant impact. With rights costs constant in real terms, the weighted average wholesale charge would be £10.84 (a decrease of about 20%), compared to a base case of £13.57.

9.183 The figure below summarises the effect of these sensitivities on our cost-plus calculations, for the particular case of the weighted average charge.

Figure 68 Sensitivity analysis for cost-plus calculations



Note – each of the bars represent the different sensitivities in the order described in the paragraphs above.

<u>Analysis of different prices emerging from pricing scenarios</u>

9.184 Analysis of Figure 64 showing the prices emerging from our calculations raises a number of observations.

9.185 Firstly, we compare, at an aggregate level, the figures in Scenario 1 to the current cable rate-card (Scenario 0): as a weighted average, the figures we have derived are within 10% of the rate-card. However, there are some larger differences on a product by product basis – for example, Sky Sports 1 is almost 13% lower under Scenario 1 while Sky Sports 1 & Movies Mix is about 2% higher under Scenario 1. The OFT's test was carried out on an aggregate basis, not based on individual packages, whereas we have worked out the prices on a package by package basis. Sky could remain consistent with this aggregate test and still price particular wholesale products higher or lower.

9.186 We have faced uncertainties in establishing precisely how Sky sets its wholesale prices, particularly in the absence of the modelling that Sky uses to cross-check its prices against the OFT's test[550]. The discrepancies observed between the figures we have derived under Scenario 1 and the existing rate-card (Scenario 0) may be explained by the following:

- We present wholesale prices for 2009/10, whereas Sky's rate-card applies in 2008/09. We have adjusted charges for forecasted RPI inflation of -1.5%, so we would expect our charges to be commensurately lower. This has a small but significant effect;

- We have adjusted wholesale charges for packages including both Sky Sports 1 & 2 to reflect the absence of Sky Sports 3 from the wholesale product. Therefore, an implied price for Sky Sports 3 is included within the wholesale rate-card, but not our wholesale charges. This again has a small but significant effect;

- Sky's business has changed substantially since the OFT's margin squeeze investigation concluded in 2002, including the launch of new products such as Multiroom and HD. Our treatment of related revenues and costs may differ from that of Sky;

- While we have adopted different approaches to allocating common costs in certain cases, we believe the net effect of these differences is unlikely to lead to large differences in wholesale prices.

9.187 Scenario 2, which reflects the incorporation of a return on investment at our estimate of 10.3% for Sky's cost of capital, as opposed to a return on turnover of 1.5% in Scenario 1, results in lower retail-minus figures than Scenario 1, on average by about 50p, or 3%.

9.188 Similarly, Scenario 3, which reflects the scale of a 'large' entrant, as opposed to Sky's scale in Scenario 2, also results in consistently lower retail-minus figures than Scenario 2 by about 3-7%.

9.189 Scenario 4 shows the impact of making an allowance for DTT distribution costs compared to DSat transmission costs, as incurred by Sky (Scenario 3). As the figures show, the use of DTT distribution costs does not make a significant difference when compared with DSat costs – a difference of between about 0% and 3%. Hence any benefit afforded to a competitor using a more efficient distribution technology is likely to be very small in practice.

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[550] We requested Sky's modelling in question 6 of our formal information request of 12 November 2008. **[✂]**.

9.190 In contrast, Scenario 5, which reflects the scale of a 'small' entrant on DTT, as opposed to a 'large' entrant in Scenario 4, is a more significant difference with retail-minus prices about 10-17% lower using this assumption.

9.191 Finally, Scenario 6 sets out the cost-plus wholesale prices that we believe are appropriate to allow a reasonable return. In general (as reflected by the weighted average wholesale charge across wholesale products) the retail-minus approaches generate prices above the cost-plus figures. However, this is not true for all wholesale products – for example the retail-minus wholesale prices for a 'small' entrant are below the cost-plus figures for a number of wholesale products. This implies that the wholesale prices necessary to afford 'small' entrants on DTT the opportunity to compete with Sky's retail prices, would not necessarily permit a reasonable return on the investment in rights.

Range of wholesale prices for SD for consultation

9.192 Under our preferred option to set prices for a wholesale must-offer, we have selected a range of prices based on Scenarios 2 to 5 in Figure 64.

9.193 We have excluded Scenario 1 (setting prices on the basis of 1.5% return on turnover) from our range of prices for consultation. As we have previously discussed, the approach we have taken is based on allowing an appropriate economic return. We believe that this is best determined by identifying discounted future cashflows at a suitable cost of capital. It is much harder to identify the appropriate benchmark for a return on turnover approach. Furthermore, on the basis of comparators that we have identified, there is reason to believe that a ROT of 1.5% would be too low a benchmark in the context of ensuring fair and effective competition[551].

9.194 We recognise that there are arguments for excluding Scenario 2 given our aim to address restricted availability of Core Premium channels, and our view that it is unlikely to be reasonable to expect an efficient entrant to achieve Sky's scale. Nevertheless, while the principle we have adopted is that it is reasonable to consider an efficient entrant with smaller scale than Sky, the degree of adjustment made for scale is an important question for consultation. We have therefore included Scenario 2 at the upper end of our range of prices for consultation.

9.195 Likewise, we recognise that Scenario 3, which is based on DSat transmission, may not facilitate entry by competitors using alternative platforms with higher costs such as DTT, at least not without recourse to other efficiencies, such as those gained through retail bundling with other products. However, in the context of presenting a range of prices for consultation, we believe there is value in including prices which are based on DSat transmission costs, since this benchmark would reflect a competing retailer who is as efficient as Sky in this respect.

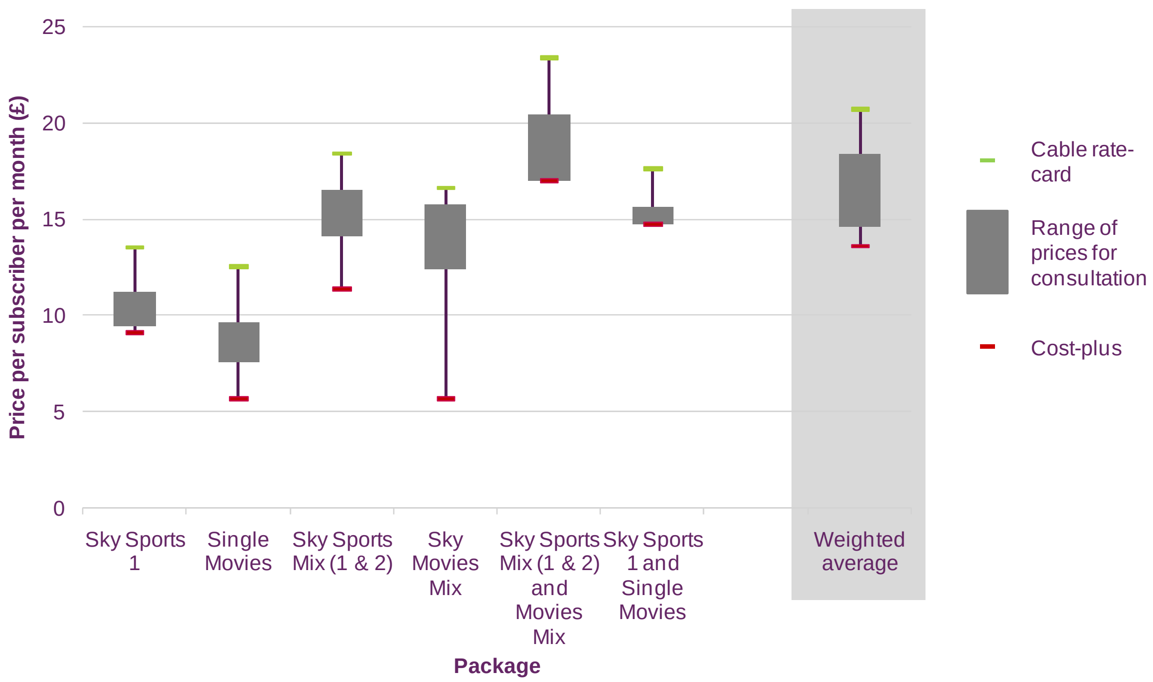
9.196 In principle, we have also excluded the cost-plus figures from our range for consultation. As we set out in the previous section, while the cost-plus figures are a helpful check, there is one major issue with a cost-plus wholesale must-offer: cost-plus prices would be likely to have a detrimental effect on rights auctions and negotiations. However, in practice, we believe it is appropriate for these figures to serve as a floor on prices, in order to ensure that Sky recovers its efficiently incurred costs (including a reasonable return).

[551] **[✂]**.

9.197 The relevant figures are set out as a chart below. This chart illustrates a number of points.

- In aggregate (as a weighted average), the outcomes of Scenarios 2 and 5 come out above the cost-plus figures, although not on all individual packages. On those packages where the outcome of Scenario 5 is below the cost-plus figure, we propose to use the cost-plus figure as the bottom of our range of prices for consultation.
- The bottom end of the range on Sky Sports 1 comes close to the cost-plus price, but this is not the case on Sky Sports 1&2 together. This suggests that, to the extent there are high wholesale margins within Sky Sports channels, they may not be associated with FAPL content (which is primarily shown on Sky Sports 1).
- The range of prices from Scenarios 2 and 5 is significantly above the cost-plus figure for packages just containing movies. This is consistent with our view that the returns on wholesale movie channels are greater than on sports channels.

Figure 69 Illustration of pricing scenarios



9.198 In summary, the range of prices for consultation is set out in the table below.

Figure 70 Table showing range of prices for consultation (£ per subscriber per month)

Product type	Product	0 Rate-card	2 Top of range for consultation	5 Bottom of range for consultation	6 Cost-plus
Single channels	Sky Sports 1	13.48	11.24	9.41	9.07
	Sky Sports 2	13.48	11.24	9.41	3.21
	Single Movies	12.48	9.61	7.58	5.64
Sport- or movies-only bundles	Sky Sports 1 & 2	18.39	16.48	14.10	11.34
	Sky Movies Mix	16.59	15.73	12.38	5.64
All channels bundle	Sky Sports 1 & 2 & Movies Mix	23.40	20.43	16.98	16.98
Other combinations	Sky Sports 1 & Single Movies	17.59	15.59	14.71	14.71
	Sky Sports 2 & Single Movies	17.59	15.59	12.69	8.85
	Sky Sports 1 & Movies Mix	19.80	19.57	15.34	14.72
	Sky Sports 2 & Movies Mix	19.80	19.57	15.34	8.85
	Sky Sports Mix & Single Movies	20.60	18.58	16.98	16.98
Weighted average (by competitor volumes)		**20.72**	**18.35**	**14.55**	**13.57**

Note – the bottom end of the range of prices for consultation is mainly prices from the 'smaller entrant on DTT' pricing scenario, except where these prices are lower than those calculated under a cost-plus method. The weighted average price for the bottom end of the range for consultation is calculated only using prices from the 'smaller entrant on DTT' scenario.

Range of wholesale prices for HD for consultation

9.199 Our preferred remedy also proposes to set an incremental wholesale price for the HD versions of Core Premium channels, to mirror the way Sky sets its retail prices for HD.

9.200 As set-out above, we have adopted a retail-minus calculation, similar to that used to derive wholesale prices for standard definition channels. This involves deducting the costs associated with basic HD channels and the costs of retailing HD from Sky's fixed retail fee per subscriber which is charged as a 'add-on' for access to HD versions of the SD channels already available to the subscriber.

9.201 In discussing the methodology we have used we noted a number of sensitivities that we have included in our analysis:

- Allocation of common costs between SD and HD: while we have allocated common costs according to revenue, which results in about 1.4% of common costs being allocated to HD services, we have considered an alternative approach for net set-top box subsidies. Higher set-top box subsidies for HD customers may warrant a higher allocation of these costs for recovery through HD charges. Therefore we have considered a sensitivity on the allocation to HD of this sub-category of common costs of a 2.8% allocation.

- Scale and number of HD subscribers: we have based our retail-minus calculation on Sky's scale and expected number of HD subscribers, but as a sensitivity also considered the number of HD subscribers consistent with a 'large' entrant (which reaches a total of three million pay TV subscribers after 10 years)[552].

- Proportion of fixed costs: we have assumed that about 50% of Sky's year 1 HD retail costs are fixed, but as a sensitivity derived prices assuming that different proportions of Sky's HD costs are fixed[553].

9.202 Under our central assumptions, the calculated wholesale charge for premium HD channels is £5.89. On the basis of this sensitivity analysis, we propose a range of £4.00-6.39 per subscriber per month for the wholesale price of a factory gate HD product.

Adjustment to wholesale prices for wider bundles

9.203 As explained above in paragraphs 9.69 to 9.90, we have derived wholesale prices for Core Premium channels by starting from bundles comprising basic channels and Core Premium channels. Our key principle is that by allowing other retailers access to Sky's Core Premium channels, they are able to replicate Sky's bundles. Hence by construction, we believe the prices on which we are consulting should achieve this objective with respect to pay TV bundles.

9.204 However, we have explicitly not made any allowance for the costs and revenues of other services that Sky bundles with Core Premium channels. There is therefore a risk that rivals might not be able to replicate Sky's broader bundles even if the other products in those bundles can be sourced competitively at the wholesale level. As we set out in section 7, this risk depends on the incremental price and cost of the additional product:

- If Sky's incremental price for an additional product is above the long run incremental cost of the product then we would not be concerned about replicability: access to content at the prices set out above should be sufficient to enable efficient competitors to match Sky's offering.

- On the other hand, if the incremental price of the additional product is below the long run incremental cost, then an efficient competitor would not be able to match Sky's offering. There is therefore a risk to fair and effective competition that Sky could encourage more and more subscribers to take wider bundles that include Core Premium channels at prices that other retailers cannot match. As we explained in section 7, this strategy could be exclusionary in effect. Put differently, Sky could increase its short term profits by attracting more customers to its bundles even without taking into account any longer-term strategic gains from the exclusion of competitors.

9.205 The concern about the exclusion of equally efficient rivals is particularly important, and we believe it is necessary to protect against it. If we fail to do so, there is a very real risk that Sky would be able to undermine the effectiveness of our remedy. We therefore propose to provide for an additional adjustment to wholesale prices to ensure replicability. This adjustment would apply in the event that Sky bundles

[552] We assume that two-thirds of this entrant retailer's subscribers will take a premium HD service over and above the standard SD service, so that there are two million HD subscribers.

[553] In our central case we assumed that 50% of basic channel and administration costs are fixed. We examined sensitivities by varying this proportion to 25% and 75% for these cost categories.

additional retail products with its Core Premium channels such that the incremental price for the additional retail product is below its long run incremental cost.

9.206 Conceptually, the adjustment would require us to add back the incremental price of the additional product and subtract the long run incremental cost. Since we would only make this adjustment where the incremental price was below the incremental cost, this would lead to a lower wholesale price for the relevant Core Premium channels.

9.207 There are a number of important choices to be made in implementing this adjustment:

- First, there is a question of whether we should calculate a set of parameters at this stage, or stop at setting out the relevant principles. We consider that it is more appropriate at this stage only to set out principles. Our concerns in this area are forward looking and intended to ensure that Sky cannot bundle additional services with its Core Premium channels in a manner that undermines the effectiveness of the remedy. Hence we do not and cannot know at this stage the precise level of any adjustment that would be necessary. In addition, since the primary focus of our work is on pay TV services we have not carried out a detailed analysis of the costs of Sky's additional bundled products.

- Second, it might, in principle, be appropriate to restrict the adjustment to apply only where an alternative retailer wished to replicate one of Sky's wider retail bundles by packaging an equivalent retail product with Sky's Core Premium channels. However, in practice such a condition would be extremely difficult to define. For simplicity, we therefore propose that the adjustment would apply to all relevant wholesale prices and retailers. That is, all wholesale prices would be adjusted by adding the incremental retail price of the additional retail product and deducting the long run incremental cost for the product, in the event that the incremental price was less than the long run incremental cost. It would of course also be open to Sky to adjust its retail prices to satisfy this condition and thereby avoid making any adjustment to its wholesale prices.

- Third, there is a question of materiality and the potential impact on Sky's incentives to innovate. We recognise that in some circumstances it may be appropriate as a market entry strategy to offer substantial discounts. We would not want to deter this sort of strategy (subject to wider competition law principles). However, there is a distinction between legitimate discounting to achieve market entry and subsequent exclusion of as-efficient rivals. We therefore intend that the adjustment only arises in the event that a bundled product is sold to a material number of subscribers. Our current thinking is that an appropriate threshold would be around 5% of Sky's retail subscriber base for Core Premium channels, but we are consulting on this figure.

9.208 There is clearly a close relationship between this proposed adjustment to wholesale prices and potential action under CA98. However, our current view is that it would not be more appropriate to proceed under CA98, and it is therefore appropriate to include it within the scope of our proposed remedy. The reason for this is that our rationale for proposing an adjustment is to ensure that Sky cannot undermine the remedy which we propose to apply to Core Premium channels by bundling other products with them in a manner that reduces the margin we believe alternative retailers need to be able to compete. As explained above, we have determined that margin on the basis of an ex ante margin squeeze rule which takes account of scale effects, DTT transmission costs and a 10.3% return on investment. It is therefore likely to be somewhat higher than the margin that might be derived under a competition law test, but it is nonetheless entirely consistent with our objective of ensuring fair and effective competition. There is a risk that this objective would be undermined if Sky could bundle additional products with Core Premium channels, in a manner that is consistent with the application of competition law to the entire bundle, but reduces the margin alternative retailers need to earn on Core Premium channels.

Non-price issues related to a wholesale must-offer

9.209 There are a number of non-price-related issues related to the implementation of a wholesale must-offer remedy on which we believe we should consult. The rationale for specifying terms as part of the remedy is similar to the rationale for specifying prices: on many of these there is scope for substantial delay in implementation of a wholesale must-offer while negotiations over the precise terms of supply take place. We propose to minimise this delay by setting out some requirements about particular terms. This will increase the effectiveness of the remedy.

9.210 Included in the list of issues are some which do not relate to the specific terms of the obligation, but rather to the way we propose to approach the enforcement and review of the obligation.

9.211 The areas that we address here are as follows:

- Minimum Qualifying Criteria
- Security issues and subscriber audit
- Reference offer
- New service development
- Cross promotion and 'clean feed'
- Complaint handling
- Review provisions

Minimum Qualifying Criteria

9.212 Sky stated its belief that in considering the issue of the retailers to whom Sky would be required to supply its services, Ofcom failed to have due regard to the necessity of allowing Sky to refuse to supply its channels in circumstances where there is a clear objective justification for doing so. It suggested that Ofcom should adopt the US program access rules[554].

9.213 As we identified in our Second Pay TV Consultation, there are two key issues when considering which third parties could exercise the wholesale must-offer remedy. The

[554] See section 76.1000 of the FCC cable rules. http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=0a81f2473b22a91f12189f8b74e8bbba&rgn=div6&view=text&node=47:4.0.1.1.4.15&idno=47 which set out a detailed ex-post complaints handling procedure in relation to wholesale supply of channels between competing pay-TV retailers.

first is to determine whether retailers must meet certain qualifying criteria and the second is to determine which platforms they should be able to retail the channels on.

9.214 Whilst we can envisage cases where Sky may have legitimate concerns that wholesaling its channels to certain retailers may have a damaging effect on its business and/or brand, it is important that prospective retailers are provided clarity on the qualifying criteria Sky would apply.

9.215 We are of the view that Sky could identify a number of objectively justifiable reasons why it would not wish to wholesale its channels to a prospective retailer ahead of individual negotiations. For example, Sky would legitimately want to ensure that a prospective retailer's platform was sufficiently secure to avoid compromising the value of Sky's own retail proposition, and that the prospective retailer could deliver the wholesale channels to a reasonable quality to avoid deteriorating Sky's wholesale channel brand. Documenting these criteria and making them available to prospective retailers would provide increased clarity of the criteria that retailers are expected to meet and could reduce concerns over discrimination by providing increased transparency. These "Minimum Qualifying Criteria" would be similar in concept to (and a superset of) the Minimum Security Requirements document that we proposed in our Second Pay TV Consultation (see below).

9.216 We envisage that the Minimum Qualifying Criteria would set out Sky's reasonable requirements for qualifying retailers as well as the requirements for a qualifying distribution platform e.g. picture quality, support for access services and parental control etc. **[✂]**.

9.217 While documented Minimum Qualifying Criteria will help to provide clarity and transparency to prospective retailers, it is unlikely to be exhaustive and Sky could have additional, objectively justifiable concerns in relation to individual retailers. In these circumstances we would expect Sky to enter into commercial negotiations to resolve these concerns. Where similar issues arise with a number of individual retailers we would expect Sky to update and re-issue the Minimum Qualifying Criteria accordingly.

Security issues and subscriber audit

9.218 We said in our Second Pay TV Consultation that we would expect Sky to be able to impose conditions on other retailers to ensure that the platforms being used to retail that content are secure, and that adequate processes are in place to protect against content piracy. We noted the risk of using security as a pretext to withhold content from specific retailers, and mentioned the possible need to establish some form of dispute resolution process. We set out three options for minimum security requirements (MSRs):

i) Sky, as the wholesale channel provider, defines the MSR by specifying which Conditional Access ("CA") technology must be used by each retailer. In this scenario Sky would be fully responsible for the integrity of the CA system and as such would also be liable for any breaches of that security system.

ii) Sky negotiates with each prospective retailer to agree the CA technology used and how liability for any breaches of security would be shared.

iii) Sky defines a set of technology and platform agnostic MSRs and retailers select a CA technology which they consider best fulfils these requirements.

9.219 Sky stated its belief that in relation to security requirements and liability for security breaches, Ofcom failed to have any regard to the central issue of how Sky is to be protected from or compensated for losses resulting from piracy. Sky argued that security issues were best addressed through commercial negotiation and should not be the subject of specific, detailed regulation[555]. Sky also raised this point in a subsequent confidential submission.

9.220 On the issue of security/conditional access, the Four Parties supported Ofcom's option (iii) of Sky defining a set of technology and platform agnostic MSRs. However, the Four Parties suggested that Sky cannot simply specify the MSRs that it considers necessary – it must specify a proportionate set of MSRs that are (i) objectively justified, (ii) reasonably required to protect the channels which are the subject of the wholesale must-offer obligation and (iii) consistent with the goal of promoting competition.

9.221 In determining minimum security requirements **[✂]** favoured option (ii) namely, a negotiation with each platform as to what the requirements would be. It thought that option (iii), allowing Sky to define a set of technology and platform agnostic MSRs, would risk the imposition of requirements that were unreasonable or unnecessary.

9.222 The BBC argued that Sky should not be allowed to decide on its own what it considers as sufficient protection. Virgin Media also proposed that retailers should have a role in defining MSRs.

9.223 Freesat believed that those conditions should be rather set by the upstream rights holders (e.g. FAPL or major movie studios) to protect their content. Otherwise Sky may unnecessarily restrict wholesale access on the basis that another platform does not conform to its "proprietary encryption standards".

9.224 We are fully aware that technical, operational and commercial aspects of security systems for pay TV are complex and fundamental to revenue protection. It is therefore important that we allow parties the flexibility to agree commercial terms which are optimised to their own requirements.

9.225 However, we re-iterate our position from our Second Pay TV Consultation that perceived concerns over the quality of security arrangements on a particular platform should not be used by Sky as a reason for withholding wholesale must-offer channels from that platform unless those reasons can be objectively justified.

9.226 We continue to hold the view that it is possible for Sky to set out a set of Minimum Security Requirements which are both platform and CA technology agnostic. Whilst we do not think it is necessary for prospective retailers to participate in the development of the MSRs, we do expect the MSRs set out by Sky to be objectively justifiable. These generic requirements would be made available to prospective wholesale customers to form the basis of more detailed technical, operational and commercial arrangements between specific retailers and Sky, which seek to minimise security breaches and assign liabilities. **[✂]**.

9.227 We are aware that no CA system is 100% secure, and that the MSRs may include requirements associated with subscriber audits and operational processes to establish the levels of any service theft and remedial action to be taken in response to a security breach. Where audits are conducted then we would expect that

[555] section 7 paragraph 10.7 of Sky's response to our Second Pay TV Consultation

independent, third parties would be employed if the parties could not agree on how audits should be performed.

Reference offer

9.228 Stakeholder responses to our Second Pay TV Consultation have identified a number of commercial terms which are likely to be common to all contracts between Sky and third party retailers. For example, Minimum Qualifying Criteria for retailers and Minimum Security Requirements as discussed above, and the duration of notice period prior to any changes in wholesale prices.

9.229 We would expect that the terms offered by Sky to prospective retailers to be fair, reasonable and non-discriminatory. In our Second Pay TV Consultation we suggested that a requirement on Sky to publish a reference offer may be an effective method of achieving this as it would increase transparency of the terms offered to each retailer (and hence facilitate non-discrimination) and reduce the time taken to negotiate terms.

9.230 We continue to believe it would be appropriate for Sky to produce a reference offer which would form the basis of its commercial arrangements with third party retailers. Whilst it may not be necessary to publish this offer in the public domain, we would expect it to be available to all prospective retailers (potentially subject to a suitable Non Disclosure Agreement).

New service development

9.231 In our Second Pay TV Consultation we proposed that Sky should be required to make available, at the wholesale level, products which are required to replicate new retail services Sky might launch based on the Core Premium content. Sky argued that such a requirement would reduce its incentives to invest in innovative new services.

9.232 Innovation is important and we acknowledge that there are benefits in providing Sky with a window of exclusivity on new retail services in order to experiment with new ideas and recoup investment. However, we do not consider that these benefits should necessarily be enjoyed in perpetuity.

9.233 We therefore propose that the remedy will not automatically apply to any new service developed by Sky based on the Core Premium channels. However, we will monitor the development of the market and will review the situation if there is a material change in the level of competition (see "Review Provisions" below).

Cross promotion and "clean feed"

9.234 In our Second Pay TV Consultation we proposed that Sky could be required to offer a "clean feed" of the wholesale must-offer channels which did not contain cross promotion of Sky channels and which were not included in the wholesale must-offer obligation or promotion of specific retail pay TV offerings. We also suggested all advertising minutes on the channels should be sold on a non-discriminatory basis, thereby providing all retailers the option of advertising their services on the channels.

9.235 We note that Ofcom's existing Broadcasting code and Cross Promotions code, amongst others, set out rules on promotion of channels and services with which Sky must comply.

9.236 We consider that compliance with the existing codes will address many of the concerns we might have on how Sky may cross promote its channels and services. We therefore do not intend to introduce specific conditions relating to these activities.

9.237 However, we would expect Sky to ensure that the feeds provided to third party retailers did not include excessive promotions of services and features which were not available to consumers on non-Sky platforms which could lead to consumer confusion or that might degrade the consumers' perception of the quality of the service provided by their pay TV retailer.

9.238 Individual retailers would be free to reach commercial agreement with Sky if they wished to distribute a different version of the Sky channels to those distributed by Sky on its retail services or advertise on these channels. For example, they may negotiate running different promotions during promotional air time or inserting different advertisements.

<u>Complaint handling</u>

9.239 Ofcom has published guidelines on how we will handle complaints that are referred to us for investigation including complaints regarding conditions set under section 316 of the Communications Act 2003 (http://www.ofcom.org.uk/bulletins/eu_directives/guidelines.pdf)[556].

9.240 Whilst our preference is for prospective retailers and Sky to reach commercial agreement in relation to supply of the relevant channels and content, in the event that a complaint is brought to us, we would normally follow these guidelines (or any subsequently published guidelines) in handling the complaint unless there is a good reason not to do so.

<u>Review provisions</u>

9.241 In our Second Pay TV Consultation, we stressed that such an intervention should not have an indefinite life. We suspected that reviewing the regulation after it had been in force for a period of time – say, three years – might be appropriate.

9.242 **[✂]** considered three years as an appropriate time to review. **[✂]** also believed that it should correspond with the duration of the exclusivity of the key content rights and therefore suggested to review the provision at the time of the next auction.

9.243 The BBC thought that three years seemed "broadly right", as a shorter period could not give enough time for wholesale or simulcrypt arrangements to be negotiated and implemented and for Ofcom and the industry to evaluate their effectiveness. It pointed out that the review should coincide with the outcome of the next FAPL rights auction.

9.244 The FAPL said that any wholesale must-offer obligation should be subject to regular review by Ofcom and should be reviewed in line with changes of ownership of the programming rights to which any such wholesale remedy applies.

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[556] These were adopted in 2004 and remain in force, however stakeholders may also consider Ofcom's 2006 consultation on revised guidelines which are available at http://www.ofcom.org.uk/consult/condocs/enforcement/

9.245 Given the broad agreement of our proposals in our Second Pay TV Consultation we propose to commence a review of this regulation three years after it comes into force. However, it may become appropriate to review the provisions before this time if we were to consider that there had been a material change in the operation of the market.

Consultation questions

15. Do you agree in principle that our retail-minus calculation should start from Sky's retail prices and deduct the retail costs of an efficient entrant?

16. Do you agree with our proposal to set simple linear prices per subscriber, allowing flexibility for other pricing structures?

17. Do you agree with our proposal for wholesale prices to evolve over time according to a 'ratchet' approach and how should these prices track retail prices over time?

18. Do you agree with the principle that the same price for a 'factory gate' product should apply to all retailers regardless of their scale and choice of distribution technology?

19. Do you agree with our approach for deriving starting retail prices given the complexity of retail bundling?

20. Do you agree with our calculation methodology to deduct retailing costs – in particular the use of a discounted cashflow analysis, deduction of incremental and pro-rated fixed and common costs, and the use of Sky's costs as an efficient retailer?

21. Do you agree with our proposal to focus on deriving prices for a 'large' entrant scale retailer using DTT transmission and what are your views on our range of prices?

22. Do you agree with our approach to deriving a wholesale price for HD services and what are your views on the resulting range of prices?

23. Do you agree with our proposals for non-price terms – in particular on Minimum Qualifying Retailer, Minimum Security Requirements and a Reference offer?

Section 10

Proportionality of a wholesale must-offer remedy

Summary

10.1 We have compared the impact of a wholesale must-offer remedy against the counterfactual from several different perspectives:

10.2 **Consumers** would benefit from greater and freer platform choice, increased platform innovation, plus market expansion effects. A static analysis suggests an increase in consumer surplus over five years of around £370 million according to our central estimate, though this estimate is subject to a degree of uncertainty[557]. We would expect additional dynamic benefits, due to retail and platform innovation. The effects of these are difficult to quantify, but we attach particular importance to the dynamic benefits to consumers associated with the effective exploitation of new distribution technologies, notably IPTV.

10.3 **Retailers other than Sky** would benefit from access to Core Premium channels, and be able to develop new and innovative products based on this access. Again, the dynamic benefits which we expect to arise from this innovation are difficult to quantify, but should be significant. They would however be partially offset by the duplication of fixed costs incurred during market entry. According to our static analysis, this duplication of fixed costs, together with subscriber acquisition costs as rival retailers build their subscriber bases, may result in a negative producer surplus over a five year period. This is unsurprising, reflecting the fact that our pricing analysis assumes a longer pay-back period, and that this assessment does not take account of other services and propositions we would expect these providers to offer. Our objective is to enable effective competition from efficient operators that are prepared to make a substantial long-term investment in pay TV, not to enable weak entrants to earn short-term profits at Sky's expense.

10.4 **Sky** would be subject to new regulation, and the associated administrative and compliance costs. It could also be subject to a reduction in its wholesale charges to cable and an extension of those wholesale charges to other operators. However, we expect these effects to be more than offset by additional wholesale revenues associated with market expansion. Sky's five-year producer surplus increases by around £240 million under our central estimate. In our low case, its producer surplus decreases by around £250 million, and in our high case it increases by £610 million. The proposition that our proposed intervention is beneficial for Sky, at least on a static analysis, may appear surprising, but it is consistent with our conclusion in section 6 that Sky has a static incentive to supply others even at wholesale prices well below current rate-card prices.

10.5 **Rights-holders** might be affected if there were a reduction in the level of wholesale revenue available to pay for rights, or if there was a major change in the incentives faced by bidders. We have considered the likely effect of a wholesale must-offer on the willingness to pay for upstream sports and movies rights of Sky and of other

[557] This figure – and all consumer and producer surplus figures presented in this section – is a 5 year NPV result derived using a social discount rate of 3.5%.

bidders. Our view is that the risk of a wholesale must-offer remedy (set on a retail-minus basis) leading to a significant decrease in rights values is low.

Introduction

10.6 The analysis in this section and other parts of this document, in particular sections 8 and 9, represents an impact assessment as defined in s7 CA03.

10.7 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in s7 CA03, and means that generally we have to carry out impact assessments where our proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in our activities. However, as a matter of policy we are committed to carrying out and publishing impact assessments in relation to the great majority of our policy decisions. For further information about our approach to impact assessments, please refer to our guidelines[558].

10.8 The purpose of this impact assessment is to determine whether it would be proportionate, by reference to the purpose of s316 and in light of our other duties under CA03, to impose a wholesale must-offer remedy in the form described in sections 8 and 9.

10.9 In carrying out this impact assessment, we have drawn on the impact assessment which we set out in our Second Pay TV Consultation. That impact assessment was however largely qualitative, since our thinking had not progressed sufficiently to make quantitative analysis meaningful. We are now able to set out the likely impact of a wholesale must-offer remedy at the prices which we set out for consultation in section 9, and taking into account various assumptions related to the pricing analysis, including the costs associated with market entry by new providers, and the associated market expansion effects.

10.10 The analysis presented here sets out our qualitative assessment of the full effects of a wholesale must-offer remedy, together with an estimate of those static effects which we consider can be quantified with at least a degree of accuracy. We stress that the quantitative analysis is only a part of our assessment: many of the effects that we have identified are not quantifiable even indicatively with any certainty. In those circumstances, quantification can be misleading and unhelpful.

Responses to our Second Pay TV Consultation

10.11 In our Second Pay TV Consultation, our view was that facilitating wholesale access to Core Premium content would have a positive impact for consumers, because it should allow additional innovative retailers and platforms to emerge, making use of Core Premium content. We said such intervention should also increase the level of choice for consumers, because Core Premium content would be available via a number of different retailers and platforms.

[558] http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf.

10.12 Our assessment in section 8 of our Second Pay TV Consultation set out our view that there could be substantial benefits to consumers from a wholesale must-offer obligation.

10.13 Sky commented that our analysis of the benefits of the proposed regulation did not analyse at all the costs of such regulation.

10.14 Sky considered that one of the major flaws was our not having undertaken any substantive assessment of the costs and benefits associated with the remedy. In particular, Sky felt that there was no consideration of the numerous and significant costs that it considers are likely to be associated with the introduction of new regulation of the type we proposed. It suggested that we had failed in our duty to conduct a proper impact assessment as required by s7 CA03.

Our approach to impact assessment

10.15 In our Second Pay TV Consultation, we were consulting on the appropriate overall form of a remedy. We were not in a position to carry out a detailed quantification of all the costs and benefits of a possible intervention. In particular, at that stage we had not reached a view on whether it may be appropriate to set wholesale prices, still less carried out the necessary work to understand what an appropriate range of prices might be. It was therefore impractical for us to carry out a more detailed impact assessment at that stage.

10.16 We have now taken our thinking further, and specifically have established a range of wholesale prices on which we are consulting as part of our preferred form of remedy. We are therefore able to go much further in evaluating the costs and benefits of intervention. At the same time, we recognise that the nature of the benefits we believe will flow from a wholesale must-offer remedy is such that complete quantification remains impractical. In the pages that follow, we therefore set out qualitatively the full range of likely effects of intervention, most importantly including the dynamic benefits that we consider will arise from greater competition. We also describe in quantitative terms some of the static costs and benefits.

10.17 In section 8, we explained why a wholesale must-offer remedy which does not specify a range of wholesale charges would provide scope for substantial delay in implementation. We therefore do not assess in this section the benefits and costs of that variant of the remedy.

10.18 We also explained in section 8, why the proposed remedy should cover all SD and HD versions of Sky's Core Premium channels. Accordingly, we do not assess in this section the costs and benefits of variations on the channels that are covered.

10.19 On the benefits side, there are a number of likely positive effects from a wholesale must-offer. These reflect the analysis we set out in section 7 on consumer effects.

- We see prospects for consumers to exercise **greater and freer platform choice**. Rather than having to choose from the limited number of platforms where Core Premium channels are currently available, consumers would be able to purchase Core Premium channels from a variety of platforms across distribution technologies.

- We anticipate additional **platform innovation** because access to Core Premium channels would enable rival retailers on alternative platforms to build scale and deliver innovation in ways which do not necessarily play to the strengths of a satellite platform.

- We see scope for **market expansion**: a wholesale must-offer has the potential to expand the total number of people that currently take Core Premium channels, and enable consumers to purchase channels in a wider variety of retail bundles.

10.20 The benefits of greater competition must however be weighed against the costs associated with allowing other competitors into the market. New entry typically results in some duplication of fixed costs across the market. We recognise that there would also be some incremental administrative and compliance costs for Sky, although we believe these to be low relative to the expected benefits from the remedy.

10.21 In the following pages, we consider the impact of the remedy on:

- Consumers (residential pay TV subscribers).
- Producers (Sky and its existing and potential competitors).
- Holders of sports and movies rights and bidders for those rights.

10.22 In each case we compare a scenario in which the remedy is in place with the counterfactual scenario in which there is no such obligation and the current restricted distribution of Sky's channels continues. In the counterfactual we assume that the growth in the overall number of pay TV subscribers on cable, DSat, DTT and IPTV follows current trends, that there are no fundamental changes in the competitive landscape at the retail level or the way in which sports and movies rights and bought and sold.

Quantification of market expansion effects and associated costs

10.23 In the assessment that follows, we set out the results of some quantitative analysis of those effects we can meaningfully attempt to quantify. To quantify the likely static impact of the remedy, we have sought to calculate the likely benefits to consumers and producers (i.e. consumer surplus and producer surplus) over a five year reference period. We have assumed that consumer surplus can be measured in terms of the difference between consumers' willingness to pay and what they actually pay for a pay TV service. We calculate producer surplus separately for Sky and its competitors. Our overall approach is to subtract additional costs (relative to the counterfactual) from additional revenues over the five year reference period.

10.24 Our central case calculations assume that:

- Wholesale prices are those set out in Section 9 for a 'larger entrant' retailer distributing on DTT.
- The total number of premium subscribers on platforms other than DSat and cable rises to 2 million after 5 years[559].

[559] There is uncertainty around the likely take-up of premium pay TV services on DTT and IPTV platforms. Our central estimate of 2 million subscribers after five years has been informed by research into consumers' interest in pay TV services on DTT undertaken by Sky and Freeview (see paragraph 10.34).

- Total additional fixed costs for new entrants to the retail market for core premium channels amount to £43 million per year, including fixed transmission costs – this estimate is based on our estimates of fixed costs as set out in Section 9.

10.25 We summarise the results of our quantitative analysis as broad ranges reflecting the sensitivities to key assumptions. Many of the assumptions used in our analysis are subject to substantial uncertainty. We have therefore considered a range of sensitivities to some of the key parameters. These include variations in the extent of the market expansion effect, different levels of aggregate fixed costs, alternative assumptions about demand conditions[560], and alternative assumptions about relative retail prices. Taken together, these sensitivities give rise to a wide set of potential outcomes.

Effects on consumers

10.26 We have assessed effects on consumers from the three points of view that we set out in our criteria for assessing the market. These were choice, innovation and pricing. We identified in section 7 the adverse effects on consumers that we consider result, and will result in future, from Sky's approach to the wholesale supply of Core Premium channels. In this section we therefore explain how a wholesale must-offer obligation in the form proposed could address those effects.

10.27 If Sky's retail competitors were able to gain access to Sky's Core Premium channels at appropriate wholesale prices under a wholesale must-offer remedy, they would be better placed to compete effectively with Sky at the retail level of the value chain. Accordingly, we would expect the remedy to deliver benefits to consumers in terms of greater platform choice and the dynamic benefits of greater platform and retail innovation.

Effects on choice

10.28 Making Sky's Core Premium channels available to more retailers would have the effect of increasing the number of consumers that can take the channels. It would also be likely to increase the availability of entry-level packages, packages that are not bundled with basic content, or packages that combine premium content with other products and services, giving consumers greater choice of the way they consume premium channels.

10.29 At present, consumers who have a preference for Sky's Core Premium channels, but who also have a preference for a platform which does not offer Sky's Core Premium channels, must either sacrifice the content or subscribe to a platform which is not their preferred choice. As such, the availability of Sky's Core Premium channels on some platforms but not on others has the potential to distort consumer choice of platform, relative to the scenario in which this content is available on all platforms.

10.30 Under a wholesale must-offer obligation, there is likely to be greater platform choice, as consumers would be able to purchase Sky's Core Premium channels from a greater number of different pay TV operators across different DTT and IPTV platforms. This is based on our view that Sky's competitors would probably take advantage of the proposed remedy. We consider this likely given the repeated – but unsuccessful – requests by BT Vision and Top Up TV for the wholesale supply of

[560] We have assumed linear demand functions in all cases, but have considered sensitivities to the 'choke price' (the key determinant of willingness to pay) for these functions.

Sky's Core Premium channels and that there is no evidence to suggest other operators are any less interested in obtaining Sky's channels.

10.31 Most importantly, consumers would be able to make choices based both on their content preferences and their platform preferences.

10.32 As explained in section 7, the most obvious manifestation of reduced consumer choice is the restricted availability of Sky's premium content on other platforms. The fact that consumers on a number of DTT and IPTV platforms are currently either unable to access the most valuable sport and movie content, or face restricted access, is a source of concern.

10.33 On DTT, we consider there to be significant opportunity for market expansion, given that there are about ten million DTT-only households[561] who cannot at present gain access to Sky's Core Premium channels (although they can currently access Setanta Sports 1, which is a Core Premium channel). While DTT is not suited to carrying large packages of pay TV channels (unlike cable and satellite), given its capacity constraints, the evidence we have seen indicates that there is significant unmet demand for Sky's Core Premium channels on platforms using this distribution technology (see paragraphs 7.65 to 7.74).

10.34 For example, Sky estimated (in April 2008) that around **[✂]** households would subscribe to premium content on its proposed Picnic service within five years of launch, equivalent to around **[✂]** per cent of DTT-only households[562]. More generally, research carried out by Freeview in November 2007 found that around 22 per cent of Freeview users would definitely or probably consider paying either a monthly or one-off fee to access more channels/programmes in addition to Freeview's channels[563].

10.35 There may also be scope for market expansion on IPTV, as this distribution technology becomes more practical for pay TV, where at present Sky's Core Premium channels can only be accessed via Sky by Wire and Sky Player.

10.36 We may also see some market expansion on cable under a wholesale must-offer remedy, where take-up of Sky's Core Premium channels is currently much lower than on satellite[564]. We have been provided with evidence to suggest that this may be attributable, at least in part, to Virgin Media's lack of an incentive to invest in marketing Sky's Core Premium channels as a consequence of wholesale charges being too high, and some additional services not being available (see paragraphs 6.115 to 6.124).

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561 See Ofcom's Digital Television Update – 2008 Q4: http://www.ofcom.org.uk/research/tv/reports/dtv/dtu_2008_04/.

562 **[✂]**.

563 462 face-to-face interviews were conducted between 14 and 25 November 2007 by Taylor Nelson Sofres on behalf of Freeview. 70% of respondents were Freeview viewers and 30% were non-digital viewers.

564 On cable, Virgin Media currently has about 3.5 million subscribers, of which **[✂]**% (about **[✂]**) subscribe to one or more of Sky's Core Premium channels. This is a reduction of **[✂]**% from the penetration rate in 2000.

10.37 In light of the current unmet demand for pay TV services, particularly on DTT, as noted above, we would expect there to be a significant increase in the take-up of pay TV services following the implementation of a wholesale must-offer remedy, for the following reasons.

10.38 First, consumers would be able to purchase Core Premium channels from a greater number of different retailers, across different DTT and (in time) IPTV platforms. Given the scale of potential demand for Sky's Core Premium channels on platforms where those channels are currently not available, it seems highly likely that this would lead to a significant increase in the consumer take-up of pay TV services.

10.39 Second, under a wholesale must-offer remedy, we would expect wholesale charges to be lower than the current cable rate-card, meaning that Virgin Media should have a greater incentive to invest in marketing Sky's Core Premium channels. It might also choose to offer lower retail prices to drive take-up of its pay TV services. We would therefore also expect the penetration rate of Sky's Core Premium channels among Virgin Media subscribers to increase over our five year reference period. Our central assumption is that Virgin Media gains an additional 180,000 Core Premium subscribers over five years relative to the counterfactual, including customers who switch from Sky.

10.40 We have sought to quantify these effects in broad terms. Taken together, we estimate that over five years, our proposed remedy is likely to deliver an increase in consumer surplus of around £370 million over the counterfactual[565]. Our sensitivity analysis suggests that this figure could lie in a very broad range from around £100 million to £630 million.

Effects on platform and retail innovation

Platform innovation

10.41 In addition to more platform choice, it is likely that consumers would also enjoy the benefits of greater technical innovation of pay TV platforms under our proposed remedy compared with the counterfactual. This should not be taken to suggest that we believe there would be no innovation if we decided not to intervene; Sky has been the source of a number of innovations, such as Sky+ and Sky+HD, which are beneficial to consumers. However, it clearly has an incentive to innovate in ways that play to the strengths of its own satellite platform.

10.42 Given the importance of Core Premium channels to pay TV retailers, access by operators other than those on DSat and cable to Sky's Core Premium channels under a wholesale must-offer remedy is likely to promote their development in general, meaning potentially a wider range of viable platforms that are quicker to emerge. For example, the investment in developing an IPTV network is substantial, and pay TV operators would reasonably wish to secure rights to retail Core Premium channels on their networks before making this investment.

10.43 Sky made an argument in the overview to its consultation response that "BT and TUTV were both willing to launch pay TV platforms and invest heavily in marketing them, even though they did not include Sky's premium sports and movie channels as part of their offering. Both retailers have been able to build successful businesses".

[565] This figure – and all consumer and producer surplus figures presented in this section – is a five year NPV result derived using a social discount rate of 3.5%.

However, both remain relatively small businesses, particularly taking into account the scale of BT's wider business[566].

10.44 As noted in section 7, we are at a point in the development of the pay TV sector when new platforms using new distribution technologies, such as IPTV, could start to offer significant benefits to consumers. The types of innovation which these new platforms might deliver to consumers are of course difficult to predict. Our general expectation, however, is that they will offer consumers greater convenience and enhanced service flexibility, e.g. by allowing them to access content on demand.

10.45 The dynamic, forward-looking benefits of platform innovation that would be likely to result from a wholesale must-offer remedy are impossible to forecast with any degree of certainty, and we have therefore not sought to do so. However, the platform innovations that have emerged in recent years, e.g. VoD movie services on Virgin Media's cable network and Tiscali's and BT's IP networks, illustrate the kinds of benefits that consumers might enjoy. Moreover, the remarkable success of innovations such as the BBC's iPlayer suggests that on-demand services are likely to be increasingly popular with consumers in the future. Access to a wider range of content, in particular Sky's Core Premium channels, would potentially enable these and other operators to innovate on the basis of that content, but also to build sufficient scale to innovate more generally.

10.46 We consider that an increase in platform innovation by Sky's retail competitors would be likely to provide Sky with an even greater incentive to innovate itself.

Retail innovation

10.47 Wholesale access to Sky's Core Premium channels on regulated terms would enable Sky's retail competitors to develop innovative ways of retailing those channels on DTT, IPTV and possibly on cable. For example, pay TV operators might choose to retail the channels on a stand-alone basis, as part of smaller, cheaper packages, or in conjunction with other innovative products[567].

10.48 The forward-looking benefits of retail innovation that would be likely to result from a wholesale must-offer obligation are as difficult to quantify as the benefits of platform innovation. By definition, we cannot predict the sorts of retail innovation that might emerge. However, retail innovation that has emerged in recent years built around access to Setanta's Core Premium channel illustrates the kinds of benefits that consumers might see following the implementation of a wholesale must-offer remedy. Those examples include the availability of Setanta Sports 1 as part of smaller retail packages from BT Vision and Top Up TV and Top Up TV's "season ticket", which gave new customers a free season ticket to Setanta Sports 1 for the 2008/09 FAPL season.

[566] BT announced in May 2009 that it had an installed base of around 430,000 BT Vision customers, not all of whom took a subscription package. Top Up TV had around **[✂]** subscribers in October 2008.

[567] At present, consumers are required by buy-through to take a basic package if they wish to subscribe to Sky's Core Premium channels on cable or satellite.

Effects on retail prices

10.49 We have proposed in our pricing analysis to put in place a set of wholesale charges that are lower than the current cable rate-card. In many markets, this would be expected directly to lead to a reduction in retail prices, but in the case of pay TV, the dynamics are more complex. Our overall view is that there is likely to be only a small effect on retail prices compared with the counterfactual.

<u>Sky's retail prices</u>

10.50 Sky currently sets its retail and wholesale prices in tandem. It sets retail prices based on what retail prices consumers will bear. Our understanding, as we described in section 6, is that Sky then sets wholesale prices so as to ensure the minimum possible gap between retail and wholesale prices – i.e. it sets wholesale prices as high as possible within the constraints of its interpretation of the OFT's margin squeeze test in 2002.

10.51 We are proposing in this document to increase the margin from its current level by setting wholesale prices that are lower than the current cable rate-card. In theory this might cause Sky to want to adjust its retail prices in some way. A large part of the effect on retail prices depends however on which option we follow for how wholesale prices change over time. If we were to allow wholesale prices to follow retail prices with a fixed absolute margin, this would be likely to encourage Sky to increase retail prices somewhat in order to increase wholesale prices. A fixed percentage margin is likely to create the opposite incentive: Sky might seek to reduce retail prices if wholesale prices reduced by a smaller amount, since that would constrain the ability of its rivals to compete.

10.52 In practice, these kinds of effects are likely to be limited in any case by the commercial realities of Sky's business. Currently only a small proportion of Sky's business comes from wholesale relative to retail. It is therefore unlikely to make sense for Sky to want to increase its retail prices in order to manipulate its wholesale prices, because this would risk damaging its substantial retail subscriber base. A wholesale must-offer remedy would change this balance somewhat, as it would add to the number of wholesale customers, but the change in the short term would be unlikely to be significant, given that Sky had **[✂]** million residential UK retail subscribers at the end of September 2008. Longer term, we might expect greater competitive intensity to put downward pressure on retail prices – or at least enable consumers to access cheaper entry level packages containing premium channels.

10.53 For the purposes of our quantitative analysis, we have assumed that there would be no change to Sky's retail prices compared with the counterfactual.

<u>Virgin Media's retail prices</u>

10.54 The situation for Virgin Media is likely to be rather different since it faces a more straightforward optimisation question in response to a change in wholesale prices. A fall in wholesale prices constitutes a fall in its marginal cost. We might therefore expect this to lead to a modest reduction in retail prices and an expansion in output. However, we have assumed that Virgin Media's retail prices are unchanged compared with the counterfactual, which may understate the consumer surplus figure of around £370 million.

Prices for other retailers

10.55 The entry of new retailers to the market for Core Premium channels is likely, over time, to increase the competitive intensity of that market. However, in the short term, we would not necessarily expect these retailers to offer lower retail prices than those currently available. Indeed our quantitative analysis assumes that retail prices will be closely linked to Sky's current prices. Nonetheless, if alternative retailers are able to innovate on the basis of access to premium content, then in time we would see the prospect for a wider range of other offerings, potentially including lower priced packages.

Effect on retailers of pay TV services

10.56 We would expect a wholesale must-offer remedy to affect both those firms that would take advantage of such a remedy and Sky. We address these in turn.

Effect on firms that would take advantage of a wholesale must-offer remedy

10.57 As we set out in section 3, the Core Premium channels are of major importance in driving pay TV subscriptions. As we further set out in section 8, ensuring access to these channels would allow firms other than Sky to compete more effectively in the retail market than in the counterfactual.

10.58 This would benefit new competitors in premium pay TV in terms of allowing them to achieve scale more quickly and being more able to attract subscribers, making them more able to progress other aspects of their business, such as the products they might seek to package with premium channels.

Duplication of fixed costs

10.59 We would expect new entry in the market for the supply of retail television bundles containing Core Premium Sports and Movies channels to be possible based on the charges in the range specified under a wholesale must-offer remedy. This is what drives the market expansion we discuss above. However, this expansion does not come without costs. We proposed in our discussion of pricing to set prices in such a way as to allow operators with smaller subscriber bases than Sky to put together viable businesses in pay TV using Core Premium channels. One consequence of this is we are likely to facilitate a modest duplication of fixed costs across the sector. Under the counterfactual, these duplicated costs would not exist.

10.60 While adding to the fixed costs of an industry is an undesirable consequence of any regulatory intervention, it is the level of those costs in relation to the benefits of intervention that is relevant. For the purposes of our impact assessment, we therefore need to determine the magnitude of the fixed costs that are likely to be incurred by new entrants over and above the fixed costs that would be incurred by Sky and Virgin Media if they remained the only retailers of Sky's Core Premium channels.

10.61 Having assessed benchmarks from existing operators, we consider that each new entrant in the markets for the supply of retail packages containing Core Premium channels would be likely to incur additional fixed costs of about £9 million. These fixed costs are over and above those incurred in retailing basic-only packages, which we estimate to be around £3 million, resulting in a total fixed cost of about £12 million. Two thirds of these costs are likely to consist of marketing costs, where we have assessed the minimum expenditure necessary to mount an effective campaign.

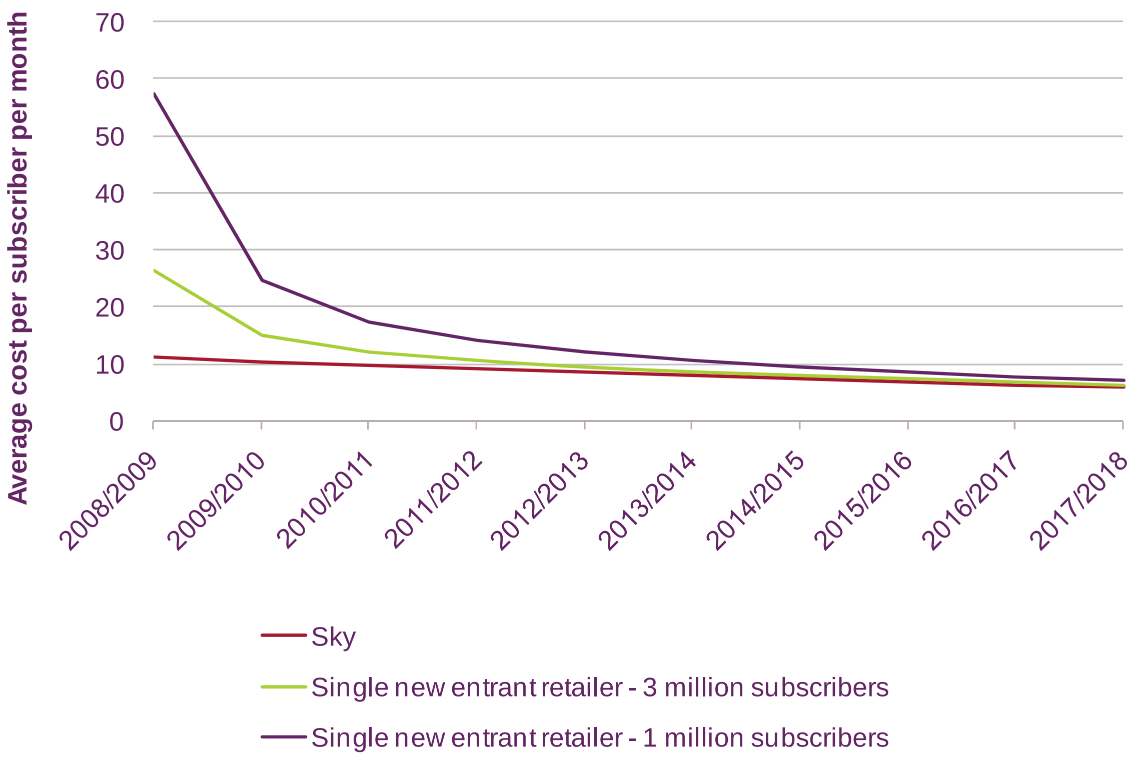
Entrants on DTT would also incur fixed transmission costs relating to Core Premium content, which we have estimated at £[✂]m per videostream per annum[568].

10.62 The number of new entrants which emerge following the implementation of the remedy and, consequently, the total additional fixed costs to the industry, will depend largely on the range of wholesale charges that we specify. As explained in section 9, we have set out a range of prices based on either large or small competitors. Our central case is one focused on a large competitor, achieving three million subscribers over 10 years. However, there may well be more than one competitor in practice.

10.63 In light of the above, it seems credible that over the five year reference period, the total additional fixed costs incurred by new entrants might fall within the range of £34 million to £52 million per annum. Note that these fixed costs are incurred over and above those incurred in retailing basic packages.

10.64 As shown in Figure 71, the average cost per subscriber is greater for the new entrants we envisage in our pricing modelling than for Sky. The area between the two new entrant curves[569] and the Sky curve represents in each case the relative importance of fixed costs implied in the proposed wholesale prices.

Figure 71 Graph showing average costs (£ per subscriber per month) excluding subscriber acquisition costs and capital expenditure, incurred by each new entrant under a wholesale must-offer remedy



10.65 In our quantitative analysis, we have derived the difference in producer surplus for Sky's retail competitors compared with the counterfactual. In our central case, the

568 [✂].

569 The two curves refer to the 'large' and 'small' competitors we referred to in section 9, which achieve three million and one million subscribers respectively over 10 years.

result is -£230 million. This negative result is not surprising: it reflects the fact that we are only considering a relatively short time (five year) frame in that analysis. More specifically, it reflects the fixed costs of entry that new entrants would incur, and the subscriber acquisition costs that they will face as they build scale. These are effectively investments with an expected pay-back of more than five years. Our pricing calculations explicitly assume a longer time period (effectively, the entrant's lifetime) over which we expect producer surplus to be zero. The objective of our remedy is to enable effective competition from efficient operators that are prepared to make a substantial investment in pay TV rather than to enable weak entrants to earn short-term profits at Sky's expense.

10.66 We also expect those operators to be able to innovate around the wholesale must-offer channels and therefore deliver additional value that is not captured in our static calculation of producer surplus. The dynamic benefits of this potential innovation are difficult to quantify, but we would expect them to be substantial and significantly greater than under the counterfactual.

Effect on Sky

10.67 In its response to our Second Pay TV Consultation, Sky argued that "the core of Ofcom's proposals for new regulation is the proposal to require Sky to license its premium sports and film channels to third parties, a proposal that is inherently confiscatory"[570]. We recognise the risks inherent in intervening in this market, and the danger that we are seen simply to "confiscate" profits from Sky's shareholders. However, we see the effects of our proposed remedy on Sky rather differently. In particular, we do not think that our proposed remedy is likely to have a substantial negative impact on Sky's business. There are two main sets of effects on Sky from our proposed wholesale must-offer, which we address in turn below:

- First, because we are introducing additional regulation, there are likely to be administrative and compliance costs associated with Sky implementing a wholesale must-offer.
- Second, and more substantively, there are the effects on Sky of a reduction in its wholesale charges and an extension of those wholesale charges to other operators.

Administrative and compliance costs

10.68 Sky would be likely to incur additional administrative costs following the implementation of a wholesale must-offer remedy, which would not be incurred under the counterfactual. It seems these would comprise the costs of dealing with additional wholesale customers and the costs of ensuring compliance with new regulation.

10.69 The costs of dealing with additional wholesale customers are in essence the costs to Sky of carrying out negotiations with prospective third party retailers for the wholesale supply of its Core Premium channels. In our view, a wholesale must-offer remedy would not contribute significantly to these costs, as Sky has been involved in wholesale negotiations with prospective third party retailers in recent years, absent any wholesaling remedy.

570 Sky response section 7, para 3.2.

10.70 The costs to Sky of ensuring compliance with a wholesale must-offer remedy appear to be fairly limited, given that in terms of delivery, Sky would not be required to provide a new wholesale product. Its only obligation would be to ensure that the Core Premium channels were made available to retail competitors at its premises (although Sky and competitors may agree to alternative delivery methods).

10.71 Whilst it is envisaged that administrative processes to audit subscriber numbers and compliance with security requirements will be required for each retailer, these are expected to be similar to those already in place in relation to wholesale supply to Virgin Media and the retail relationship with Tiscali.

<u>Reduced wholesale prices and wider availability of Sky's content</u>

10.72 The more substantive issue is the direct effect of our proposed remedy on Sky's wholesale and retail businesses. There are likely to be several static effects of our proposed wholesale prices on Sky:

- Sky will earn lower wholesale revenues from its existing wholesale subscribers.
- Sky will earn new wholesale revenues on additional wholesale subscribers.
- To the extent that Sky's retail subscribers switch to other retailers, Sky will sacrifice retail margin.

10.73 We have considered these effects in our quantitative analysis. Under our central case, the overall effect on Sky over five years is positive: compared with the counterfactual, Sky's producer surplus increases by around £240 million (including the effect on advertising revenues). In our worst case for Sky, its producer surplus over five years decreases by around £250 million, and in our high case increases by £610 million. This static analysis is consistent with our vertical arithmetic calculations in section 6, which suggests that Sky has a static incentive to supply others even at wholesale prices well below current rate-card prices.

10.74 There is, of course, uncertainty around these numbers. However, even though our worst case results in a negative producer surplus for Sky, we do not consider our proposed intervention to be disproportionate. As we set out in section 6, we believe Sky to be making returns on its pay TV business that are well above its cost of capital. In light of this, and in light of the fact that we are not proposing to bring wholesale prices down as far as the cost-plus figures, we believe that the decrease in wholesale prices that we are proposing could at most decrease the high margins that Sky is making, rather than putting its wholesale business into loss-making territory.

Effect on rights holders

10.75 We also need to consider the potential for the wholesale must-offer remedy to impact on rights holders, and any further indirect impact on consumers.

10.76 Respondents to our Second Pay TV Consultation highlighted this as a risk. In particular, the FAPL warned that the imposition of wholesale pricing obligations could risk distorting the upstream content rights market. It would in turn give rise to a diminution in value of the FAPL's rights which would also damage football as a whole. The BBC, despite agreeing in general with the approach of a wholesale must-offer remedy, highlighted the risk that it might reduce the incentive of companies to compete for rights upstream.

10.77 We have considered the likely effect of a wholesale must-offer on the willingness to pay for upstream sports and movies rights of Sky and of other bidders compared with the counterfactual. Our view is that the likelihood of a wholesale must-offer remedy (set on a retail-minus basis) leading to a significant decrease in rights values is low, for the reasons below.

10.78 The amount which is paid for sports and movie rights depends on two factors. The first is the value of the rights to Sky – if the wholesale must-offer remedy reduced the underlying value, we would expect a reduction in the amount paid for them. The second factor is the incentive on other potential bidders to compete for the rights – if the remedy led to a reduction in competition for rights, then we might also expect a reduction in the value of bids, even if the value of the rights to Sky was unaffected by the remedy.

Value of sports and movies rights to Sky

10.79 If in putting in place a wholesale must-offer, we were to set prices in a way that would push Sky into making a loss on wholesaling its channels based on the current rights fees, a likely reaction from Sky would be to reduce the amount it paid for the rights. However, that is expressly not our intention.

10.80 The basis of our cost-plus price is that this is the figure that should allow Sky sufficient wholesale revenue to recover its full rights expenditure, plus an allocation of other direct and common costs, and make a return which reflects its cost of capital. By definition, therefore, even if we went as far as to reduce wholesale prices down to that level, Sky should still have a sustainable business based on its current level of rights expenditure. However, we are not proposing to do that; the prices we are consulting on are in aggregate above the cost-plus figures, implying that Sky should not have difficulty maintaining its current levels of rights expenditure.

10.81 To draw on another aspect of our analysis to make a similar point: our views of Sky's profitability, based on Oxera's analysis, are that Sky is currently making returns above its likely cost of capital, particularly in the wholesale movie part of its business. With that in mind, even if our remedy substantially reduced the level of wholesale prices for movies (although not to the level of cost-plus prices) and potentially reduced those returns, it would not affect Sky's ability at least to match its current levels of rights expenditure.

10.82 Furthermore, as shown by our quantitative analysis, the direct effect of a reduction in wholesale prices is likely to be offset by the countervailing effect from market expansion. This expansion is likely to counter-balance the reduction in wholesale prices, potentially to a large extent, meaning that Sky's wholesale revenues may not substantially decrease, and indeed may increase.

Incentives to bid for sports and movie rights

10.83 The introduction of a wholesale must-offer remedy would mean that there are two means by which it is possible to obtain access to premium content: firms can retail Sky's premium channels on regulated terms, or they can go upstream and bid for the rights themselves. Each of these strategies has advantages and disadvantages.

- Firms which take advantage of the wholesale must-offer remedy are able to enter the retail market without incurring a high level of fixed costs, and develop retail propositions which build on access to Sky's premium channels. However, they have no editorial control over the content of those channels, nor do they have any control over the branding of those channels and more generally the ability to create and realise value from channel production.

- Firms which go upstream are able to determine what content is contained within their channels, and have editorial and branding control over their channels. They also benefit from any advertising revenue generated from those channels.

10.84 These incentives will play out in different ways for different types of firm. Therefore the introduction of a wholesale must-offer remedy may also play out differently:

- It is unlikely that the introduction of such a remedy will affect the incentives of free-to-air broadcasters in general, or public service broadcasters in particular. These broadcasters are likely to wish to retain editorial control over their channels, and (with the exception of the BBC) are in any case dependent on the advertising revenues from those channels.

- It also seems unlikely that a wholesale must-offer obligation would materially affect the incentives of those pay TV operators focused primarily on wholesale channel production. A company such as ESPN, for example, whose core expertise is in developing its own channels and wholesaling them to others, rather than purchasing channels and retailing them, is unlikely to be deterred from bidding vigorously by the wholesale availability of other channels.

- The situation is somewhat more complex for vertically integrated wholesaler/retailers such as Virgin Media. Some of these may decide to rely entirely on the wholesale must-offer remedy to drive retail take-up of their pay TV services to desired levels, resulting in a reduced incentive to bid for rights. Others may place more value on editorial control and branding of channels, so still be prepared to bid for rights; as an analogy, it would be hard to see Sky being satisfied with a flagship sports channel which was Virgin Media-branded. And if the existence of a wholesale must-offer remedy enables such firms to establish a subscriber base, which enables them to monetise sports and movie rights more quickly and more effectively, then they might have a greater interest in bidding for rights as a result of the remedy.

10.85 We have attempted to assess the likely impact of our proposed remedy on rights values by obtaining details of the various bids made in the last two FAPL auctions, considering how the actual bidders in these auctions might have responded had our proposed remedy been in place. **[✂]**.

10.86 While there is greater uncertainty on the impact of the remedy on competition for rights than on the value of those rights, our objective is to foster an environment in which there is greater competition at all levels of the value chain. This would be likely to increase the amount paid for rights relative to their underlying value. Our view overall is that the risk of a wholesale must-offer remedy (set on a retail-minus basis) leading to significantly lower rights values than under the counterfactual is low.

Equality impact assessment

10.87 We have considered whether it is required to undertake a full Equality Impact Assessment for our proposed remedy. On the basis of our Initial Equality Impact Assessment Screening we have determined that this is not required. We did not identify any significant impacts on equality likely to result from the proposed remedy.

Conclusion

10.88 Our analysis of the effects of a wholesale must-offer remedy on consumers suggest that compared with the counterfactual, there is potential for substantial (static) gains in consumer welfare resulting from a greater ability to exercise a choice of platform. We expect these gains to be augmented significantly by a range of dynamic benefits from the participation in the retail market for core premium channels of a wider range of firms. These dynamic benefits, though difficult to predict precisely, are likely to relate to considerably more retail and platform innovation than under the counterfactual.

10.89 The way we propose to set prices for Sky's Core Premium channels creates opportunities for rival firms to enter the market profitably. While our quantitative analysis shows a negative impact on producer surplus for these firms, this reflects the shorter time frame of that analysis. Our intention is to encourage efficient entry by firms committed to significant investment in pay TV. By its nature that type of investment requires a longer term commitment to the industry. We are not looking to enable short term entry and exit by firms that are simply seeking to profit at Sky's expense.

10.90 We also consider – contrary to Sky's claims – that our remedy is unlikely to have a detrimental impact on Sky. Our quantitative analysis, while not definitive, suggests that compared with the counterfactual, Sky would actually gain from the expansion in the distribution of its content.

10.91 In light of the above, we consider that our impact assessment supports our view that it would be appropriate to impose a wholesale must-offer obligation in the form proposed in order to ensure fair and effective competition.

Consultation questions

24. Do you agree that a wholesale must-offer remedy is unlikely to contribute significantly to the administrative costs currently incurred by Sky?

25. Do you consider that our impact assessment above supports our view that it would be appropriate to impose a wholesale must-offer obligation in the form proposed in order to ensure fair and effective competition?

Section 11

Consultation on licence conditions

Summary

11.1 The previous two sections set out our proposed policy in relation to various pricing and other aspects of a wholesale must-offer remedy. Implementation of these proposals would mean amending the conditions attached to certain licences.

11.2 Below are draft licence conditions which we propose to insert into the licences described. We welcome views from consultation respondents on the specifics of these drafts.

Introduction

11.3 Section 2 explains the legal framework for the insertion of licence conditions under s316 CA03. This enables Ofcom to set conditions in broadcast licences to ensure fair and effective competition. As set out in previous sections, our proposal is to put in place licence conditions to require Sky to wholesale some of its premium sports and premium movies channels on regulated terms.

11.4 This section sets out the practicalities for how we intend to put these proposals into practice, including a new draft condition. If we continue with these proposals, we will put in place amended licence conditions, taking into account comments from consultation respondents on the draft condition.

Affected channel licences

11.5 The affected licences are for the following channels:

- Sky Sports 1, Sky Sports HD, Sky Sports 2, and Sky Sports 2 HD.
- Sky Movies Action & Thriller, Sky Movies Action & Thriller HD, Sky Movies Comedy, Sky Movies Comedy HD, Sky Movies Drama, Sky Movies Drama HD, Sky Movies Family, Sky Movies Family HD, Sky Movies Premiere, Sky Movies Premiere HD, Sky Movies Premiere+1, Sky Movies SciFi & Horror, Sky Movies SciFi & Horror, Sky Movies Screen 1, Sky Movies Screen 1 HD, Sky Movies Screen 2, Sky Movies Screen 2 HD, Sky Movies Modern Greats, Sky Movies Modern Greats HD, Sky Movies Indie and Disney Cinemagic and the HD versions of these channels.

Taking into account future changes

11.6 At this point, we can only put in place amended licence conditions on channel licences that currently exist. As we have described in previous sections, television channels are not fixed products; it could well be that in future, Sky might seek to replace a channel named Sky Sports 1 with one named differently, licensed under a new channel licence, containing a somewhat different set of content, but still corresponding with the channels over which we have concerns.

11.7 There is no mechanism by which channel licences automatically adapt to this type of change. However, any proposed new licence, or change to an existing licence, would need to form the basis of an application to Ofcom, at which point we would review it in the context of this proposed remedy.

Draft conditions

11.8 Under section 316(1) the regime for every licensed service shall include the conditions that Ofcom consider appropriate for ensuring fair and effective competition in the provision of licensed services or of connected services. Under s316(2) those conditions must include the conditions (if any) that Ofcom consider are appropriate for securing that the provider of a service does not engage is a practice which Ofcom consider, or would consider, to be prejudicial to fair and effective competition. We consider that a wholesale must-offer obligation in the proposed form falls within the scope of s316(1) and also satisfies the requirement in s316(2).

11.9 As discussed above Ofcom proposes that it would be appropriate to include a wholesale must-offer condition into the licences of certain channels held by Sky. The proposed content of the condition is discussed in sections 8 to 10 above.

11.10 Pursuant to section 3(4)(b) of the Broadcasting Act 1990, Ofcom must give notice to the licensee before varying a Television Licensable Content Service licence and allow it a reasonable opportunity to make representations. Pursuant to that requirement we set out below for consultation the proposed text of a condition to be inserted into the licences held by Sky listed at paragraph 11.5 above.

14A Wholesale must-offer

(1) The Licensee shall offer the programme content of the Licensed Service, including Interactive Content, to any person for retail by that person to residential consumers in the United Kingdom on Qualifying Platforms:

(a) upon reasonable request in writing;

(b) within a reasonable time;

(c) on a non-exclusive basis;

(d) on fair and reasonable terms;

(e) without any undue discrimination; and

(f) in accordance with the requirements of this Condition 14A and any direction issued by Ofcom under this Licence.

(2) The charges offered for supply under Condition 14A(1) shall not exceed the Maximum Prices.

(3) The Licensee shall publish by [DATE] standard terms and conditions under which offers shall be made further to Condition 14A(1), which shall include at least the following:

(a) charges which do not exceed the Maximum Prices;

(b) the Minimum Qualifying Criteria for potential purchasers

(c) terms of payment and billing procedures, including the arrangements under which the number of subscribers shall be agreed for the purposes of calculating payments due;

(d) the arrangements under which changes to the content of the Licensed Service shall be notified and agreed;

(e) a dispute resolution procedure to be used between the parties; and

(f) the duration of agreements and notice periods.

(4) If the Licensee includes a Non-TV Product as part of a package it retails to consumers with the Licensed Service; and the incremental price of that Non-TV Product exceeds the long-run average incremental cost of that Non-TV Product (the "Amount"); then each of the Maximum Prices shall be reduced by the Amount.

(5) The Licensee shall comply with any direction or request for information issued by Ofcom for the purpose of ensuring, monitoring or investigating compliance with this Condition 14A.

(6) In the event that a person accepts an offer made pursuant to Condition 14(A)(1) the Licensee shall use its best endeavours to enable that person to commence retailing of the content of the Licensed Service, including Interactive Content.

(7) For the purposes of this Condition 14A:

"Maximum Prices" means [a set of prices would be established pursuant to the consultation, as discussed in Section 9 above]

"Minimum Qualifying Criteria" means the minimum requirements that must be satisfied by a potential purchaser requesting supply under Condition 14(A)(1), which may include requirements relating to: (a) financial standing; (b) technical standards for retail provision of content; (c) technical standards for securing wholesale supply of content; and (d) encryption and security (including allocation of liability);

"Non-TV Product" means a service which does not consist primarily in the provision of programmes.

"Qualifying Platform" means any platform used for the distribution of programmes to residential consumers in the United Kingdom, other than a platform operated by the Licensee.

Consultation questions

26. Do you have any comments on the draft wording of this condition, in light of the positions we have set out in the previous two sections?

Section 12

Remedies – content rights

Summary

12.1 Our proposed wholesale must-offer remedy would leave two concerns unresolved – our concern about high wholesale margins and our concern about restricted exploitation of certain content rights.

12.2 We do not believe there is a case for intervening to require major changes in the way content rights are bought and sold. We do however believe that there may be a case for more targeted interventions in relation to subscription video on demand movie rights, and in relation to the next FAPL auction, whether or not we continue with our proposed wholesale must-offer:

- Separating the sale of subscription video on demand movies rights from standard subscription rights could promote innovation, especially in relation to IPTV, and might also increase pressure on wholesale margins. We are considering a market reference to the Competition Commission on this subject, but propose first to explore with the Hollywood studios what their current commercial plans are, and whether these would reduce the need for regulatory intervention.

- In sports, the existing FAPL commitments will not apply to the 2012 auction. We therefore intend to review with the FAPL how it intends to ensure that this auction complies with competition law. That might involve exploring with the FAPL whether it is willing to provide further commitments.

Introduction

12.3 The wholesale must-offer obligation which we propose earlier in this document should promote the effective distribution of Core Premium Sports and Movie channels across different platforms. This would therefore address our concern that Sky is exploiting its market power by restricting distribution of these channels.

12.4 The proposed remedy would not however address the existence of this market power. Nor would it necessarily address some other effects which may arise from this market power, which we set out in section 6, specifically:

- High wholesale prices.

- The restricted exploitation of certain content rights.

12.5 We do not believe there is a case for intervening to require general changes in the way premium content rights are bought and sold. We do however believe that there may be a case for more targeted interventions to address certain specific concerns in relation to SVoD movie rights, and in relation to the next FAPL auction.

Our previous consultation

12.6 Our Second Pay TV Consultation set out a number of possible types of intervention in the way rights are bought and sold, the purpose of which would be to address Sky's market power at source. We suggested that there were broadly two types of intervention which might achieve this.

12.7 Firstly, it might be possible to ensure that no one provider has market power by placing specific restrictions on the aggregation of content. The current intervention into the sale of live FAPL rights permits one wholesale channel provider to obtain five of the six available packs. In order to eliminate market power, a more extreme form of intervention would be required, for example:

- A behavioural rule which prevents FAPL selling more than two of its six packages of rights to any one wholesale channel provider, and potentially similar rules with respect to other rights; and / or

- A behavioural rule which prevents any one wholesale channel provider from purchasing the rights to the output of more than two of the six Major Hollywood Studios.

12.8 However, we also noted that content aggregation has positive effects. Any remedy which prevents or restricts aggregation to the extent that would be necessary to eliminate market power is also likely to risk sacrificing some of these benefits. This might result in some consumers paying higher prices, due to a reduction in the efficiencies associated with content bundling. It might also result in reduced convenience for some consumers, who would potentially have to take multiple subscriptions or purchase multiple set-top boxes to get the content they want.

12.9 The BBC believed that intervening to restrict aggregation could have negative effects for rights holders and ultimately for consumers, and that it should be kept as a last resort, as perhaps not the best option at this stage. BT, although it supported a wholesale must-offer remedy, believed that Ofcom should take action to address the structural features of the market that give rise to Sky's market position, in order to achieve fair and effective competition, by way of specific interventions including wholesale mandated access to certain services.

12.10 Secondly, we suggested that it might be possible to reduce barriers to entry, and thereby reduce market power, by placing specific restrictions on the way content rights are sold to make them more contestable. This is one effect of the current intervention into the sale of live FAPL rights, which seeks to make these rights more contestable by limiting their duration, and ensuring that there is an open bidding process for their renewal. We noted however that while there is merit in reducing barriers to entry, the practical effect of such remedies may be limited.

12.11 Finally, we noted that in addition to these substantive arguments, there are also specific practical reasons why a rights level intervention was not appropriate at that point in time:

- In relation to live FAPL rights, there is already a remedy in place, imposed by the European Commission. We suggested it would be most appropriate to review this remedy towards the end of the current six-year period, at which point sufficient evidence should be available to allow a proper assessment. We noted however that an earlier review might be appropriate if there was a material change in circumstances, such as a major shift in the competitive landscape following the recent auction.

- In relation to the sale of other live sports rights, to the extent there is merit in reviewing these, we said that such a review should take place at the same time as any review of the existing FAPL remedy.

- In relation to the sale of movie rights, we noted that there was the possibility in the medium term of disruptive changes in the way movie content is distributed, and suggested that now might not be the right time for a regulator to attempt to set detailed behavioural rules governing the sale of movie content rights.

12.12 In response to this, the FAPL in particular pushed back strongly on the idea of intervening in the way rights are bought and sold, on the basis that there was existing regulation in place with respect to the sale of FAPL rights, effective until the end of the 2012/13 football season.

Our current view

12.13 We remain of the view that a remedy which placed major restrictions on the ability of firms to aggregate content, designed to eliminate market power at source, is likely to risk sacrificing the benefits to consumers of content aggregation. Furthermore, to the extent that we can find other means of addressing the effects of this market power, such measures may not be necessary. As a general rule, we therefore believe that they should only be explored as a last resort.

12.14 We do however believe that there may be a case for more targeted interventions to address certain specific concerns in relation to SVoD movie rights, and in relation to the next auction of live FAPL rights. We set these out in turn below.

Movies

12.15 We noted in our Second Pay TV Consultation that although premium movie content is likely to remain important to consumers, the manner in which it is distributed is likely to change. We consider in this section whether restricted access to certain movie rights may be holding back this change, to the detriment of consumers.

12.16 As discussed in Section 6, the same incentives which determine how Sky distributes its channels are also likely to determine how it exploits its content rights, in the sense that Sky has an incentive to exploit its content rights in such a manner as to favour its own retail business and its own platform. The resulting selective exploitation of content rights might be a concern if it allowed Sky to protect its market power, and distort competition

12.17 Our concern here relates to the exploitation of the rights to distribute movies via VoD. These have a high strategic importance, due to the potential which we have already noted for disruptive change in the way movies are distributed. We consider that the rights to sell VoD movie services on a subscription basis (SVoD rights) are of particular importance in this context, since they offer a payment mechanism which is likely to be particularly attractive to consumers.

12.18 We have established that Sky currently holds the SVoD rights for all six Major Hollywood Studios, and believe that there is unlikely to be a substantial change in the way these rights are awarded in the UK in the short to medium term.

12.19 We further believe that Sky has an incentive to restrict exploitation of these subscription VoD rights, in order to protect its own linear movie channels, which are the only means by which it can deliver movie content on its satellite platform. Furthermore, it appears to be acting on this incentive.

12.20 We acknowledge that competition authorities and regulators should be very cautious about intervening to change how firms exploit content rights, due to the risk that such interventions could stifle innovation. This risk to innovation is likely to be significantly higher for interventions in content markets, where the intervention may determine which products are developed for consumers, than for downstream interventions such as our proposed wholesale must-offer obligation, which are intended only to guard against the restricted distribution of these products.

12.21 However, in this particular instance there appears to be a risk that innovation in the development of VoD services may be stifled by the manner in which the VoD rights to premium movies are currently being exploited. This suggests that there may be a case, in this specific instance, for targeted intervention.

12.22 Additionally, we have already set out a concern relating to high margins within Sky's wholesale business. This is based both on the profitability analysis carried out by Oxera (see Section 6) and our own pricing analysis, which shows a significant gap between retail-minus and cost-plus prices (see section 9). Our view, particularly in light of our pricing analysis, is that the evidence of high margins is stronger for Sky's movie channels than its sports channels.

12.23 Both of these concerns could in principle be addressed by making the SVoD rights available separately to the linear subscription rights.

12.24 As we set out in section 4 on market definition, an SVoD service would be likely to be a closer substitute for the linear service than the current closest substitute, which is pay per view. Depending on the identity of the company that licensed the rights, it could therefore provide an increased constraint on wholesale margins, thereby offering the possibility of addressing remaining concerns about high wholesale margins on movies. Making the SVoD rights available transparently and separately from the linear rights could allow other companies, perhaps with greater abilities or willingness to exploit them than Sky, to get hold of the rights and establish services which could potentially appeal to consumers.

12.25 This is a form of remedy that could be investigated by the CC following a market investigation reference under EA02. In order to make such a reference we would need to have a reasonable suspicion that there are features of the market which prevent, restrict or distort competition. We identified a number of characteristics of the market in our discussion of the structure of the market in section 3. These characteristics, which we set out again here, not only underpin the competition concerns that bring us to our proposed wholesale must-offer, but are relevant as features of the market that we reasonably suspect of preventing, restricting or distorting competition:

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

12.26 In particular, content aggregation is important. We can see aggregation taking place through Sky purchasing the rights to the output from all six Major Hollywood Studios, thereby acting as a critical step in the creation of market power, which is the enabler for high wholesale margins. Aggregation also takes place in the form of different types of rights being sold together by the Major Hollywood Studios to Sky – in particular SVoD and linear rights. Rights are also sold across different distribution technologies.

12.27 However, passing this threshold does not automatically mean we should proceed to make such a reference; instead, we need to go on to consider whether this would be the right course of action, based on:

- The level of harm we see as resulting from the features we have identified, and whether a reference would be an appropriate response to that harm.
- Whether the problem could be addressed through undertakings.
- The existence of plausible remedies to address any harm we identify.
- The suitability or otherwise of our other competition powers under s316 CA03 and CA98.

12.28 In relation to the level of harm, we believe that the way in which SVoD rights are currently being sold may be holding back innovation on those platforms (such as IPTV) which are best suited to exploit them (see paragraphs 12.17 to 12.21 above). We also see evidence for high wholesale margins in the sale of movie channels, which are likely to be mirrored in high retail prices (see paragraphs 7.104 to 7.112 above).

12.29 We believe that a plausible remedy is available to address these concerns, namely a requirement to make SVoD rights available separately from the linear channel rights. This could be accompanied by a further rule that the same firm cannot buy both sets of rights, which would guarantee that they were exploited independently. Even without such a rule the separation of the different rights would at least provide transparency as to any rights 'warehousing'.

12.30 This remedy brings with it a relatively low risk of unintended consequences:

- The pricing constraint on linear channels is provided without any need to split up the existing packages of linear channels, so the risk of consumer inconvenience is low.
- There is a relatively low risk of undermining rights values. In the case of sports rights, which are sold for a fixed price, and on the basis of cross-platform exclusivity, removing that exclusivity risks undermining that fixed fee. Potential bidders would be less willing to pay the substantial fixed fees they currently pay if the benefits afforded by wholesale exclusivity had to be shared with others. However, movie rights are sold for a per subscriber fee, and a reduction in exclusivity should not have the same effect on that fee – it could in fact add to the number of consumers taking the service, and thereby to the number of per subscriber fees accruing to the rights owner.

12.31 To the extent that the current distribution of rights arises from unilateral decision-making by the individual studios this may not be an issue that is well-suited to being addressed under either s316 powers (which apply to the holders of broadcast licences) or under our general competition powers.

12.32 Our principal concern at this stage is whether a reference is an appropriate response at this time. In our last document, we explained our view that the medium-term plans of the studios might mean that this was the wrong time to make a reference to the CC. Since then, as noted above, **[✂]**. Our view is that there is unlikely to be a substantial change in the way these rights are awarded in the UK in the short to medium term.

12.33 We believe that before consulting formally on a reference, it would be constructive to engage further with the Major Hollywood Studios, to establish whether it is possible to avoid the need for further intervention as a result of their existing commercial strategies. We would prefer if possible to avoid the burden that a reference would entail and the potential additional regulation that could result, if the need for it would otherwise be obviated by the studios' strategies. We would expect that to take place over the next few months, with a possible consultation on a reference to follow depending on the outcome of that engagement.

12.34 If there was a reference to the CC there would be some inevitable interaction between the CC's consideration and our proposed wholesale must-offer. They would be targeted at different concerns, but there would be some analytical overlap. In the longer term, an intervention by the CC on SVoD rights might require us to revisit the analysis behind a wholesale must-offer, but we would in any case expect to review the wholesale must-offer in the event of a material change in the way rights are sold. A wholesale must-offer would be likely to have a more immediate effect on competition at the retail level by improving distribution of linear channels. It would ensure that content was more widely available within a short period from coming into force. An intervention at the rights level would by its nature take longer. Rights come up for renewal on a staggered basis – for example, as we have seen above, some of the movies contracts do not now come up for renewal until **[✂]**.

Sport

12.35 We noted in Section 5 that Sky's market power in the wholesale of Core Premium Sports channels depends to a significant extent on its control of the majority of the most important FAPL content. We noted in Section 3 that the mechanism by which this content is aggregated is collective selling by the football clubs. There is a substantial body of case law which has considered whether such collective selling is acceptable under competition law, including the investigation carried out the by European Commission which led to the commitments which governed the last two auctions[571].

12.36 This is a complex area, because while we do have concerns about the role of collective selling in creating market power, there are also some acknowledged benefits associated with collective selling. These were recognised in the White Paper on Sport published by the European Commission in 2007[572], which stated that collective selling has "the potential of improving the media product and its distribution to the advantage of football clubs, broadcasters and viewers"[573]. The Commission identified three types of benefits:

[571] See the documents under the European Commission's reference: COMP/38.173 - The Football Association Premier League Limited.

[572] http://ec.europa.eu/sport/white-paper/index_en.htm.

[573] Annex I: Sport and EU competition rules, paragraph 3.1.3.1.1.

- The creation of a single point of sale provides efficiencies by reducing transaction costs for football clubs and media operators.

- Branding of the output creates efficiencies as it helps the media products to get wider recognition and hence wider distribution.

- The creation of a league product: this is a product that is focused on the competition as a whole rather than the individual football clubs participating in the competition. This is attractive to many viewers.

12.37 However, in order to ensure that the positive effects of joint selling outweigh the negative effects on competition, the Commission has sought in past decisions to remedy the competition concerns resulting from the collective sale of exclusive sports media rights by attaching conditions to a declaration of exemption or accepting commitments binding on undertakings. The accepted solution in each case depended on the facts of the individual case, including the degree of market power and the restrictive practices found.

12.38 In the case of FAPL, commitments were given by FAPL covering the last two auctions, which were made legally binding under Article 9(1) of Regulation 1/2003. These commitments can be summarised as follows:

- The offer for sale by FAPL of packages of: (i) live TV rights; (ii) near-live TV rights; (iii) mobile rights; and (iv) national radio rights.

- All packages of rights are to be offered by means of a transparent and non-discriminatory tendering procedure. Packages are offered on a technology neutral basis and are neutral as to whether broadcasts are free or pay.

- Rights are offered for a period of three seasons.

- In relation to live TV rights, the FAPL makes available six packages of 23 matches each (a total of 138 matches per season). No one bidder is allowed to own all six packages (but it is therefore possible for one bidder to obtain five packages). Each package is structured on the basis of “picks” applicable to each round of FAPL matches (e.g. Package A contains 23 first picks, Package D contains eight second picks and 15 fourth picks).

- For near-live TV rights the FAPL makes available two packages of 121 matches each, comprising the 242 matches per season which are not broadcast live.

- At least one package of mobile rights (clips from matches) is to be offered by FAPL. The commitments reduced the embargoes for mobile broadcasts.

- Rights which are unsold or not exploited revert to the individual clubs. Individual clubs also have rights to delayed broadcasts of their matches on individual club channels and websites.

12.39 These commitments do not however apply to the next auction, which is expected to take place in 2011-12. We would therefore intend to review with the FAPL how it intends to ensure that the 2012 auction complies with competition law. That might involve exploring with the FAPL whether it is willing to provide further commitments.

12.40 In our Second Pay TV Consultation, we stated a view that we were not at the right time to intervene in the way sports rights were bought and sold. This was because of the existence of the existing commitments, and the importance of understanding how these play out in practice before considering our approach to future commitments. However, we are now in a better position to assess what the effect has been of the current commitments: they have facilitated the entry of Setanta into the market, and the development of new retail packages, in particular entry-level packages on non-Sky platforms. Partially offsetting this, some existing consumers on Sky's satellite have had to purchase an additional subscription at a price of at least £9.99 per month in order to continue being able to view all the FAPL matches. Moreover, the consumer benefits which have resulted from Setanta's entry into the market have not proved to be sustainable, at least in the form described above

12.41 The commitments offered by the FAPL to meet the concerns expressed to it by the Commission sought to improve the scope for ex ante competition for the rights to permit greater competition in the acquisition of those rights and to improve the accessibility of content for TV, radio and new media operators. The Commission's objective in accepting the commitments was to ensure that the arrangements did not restrict output or result in competitors being foreclosed from the relevant markets, to the detriment of consumers. However the greater competition which resulted from the commitments and the consumer benefits which have resulted from the Commission's action ensuring Setanta's entry into the market do not at the time of writing appear to be sustainable, at least in their current form: as we set out in section 3, Setanta has been unable to establish a lasting position in the market.

12.42 We would expect to take this evidence into consideration when considering any new set of commitments. We emphasise however that this does not mean that our objective in considering any new commitments would be to intervene more aggressively in order to ensure the success of a successor to Setanta. Rather we would consider as a national competition authority whether the continued operation of the collective selling arrangement by the FAPL appreciably prevents, restricts or distorts competition contrary to Article 81(1) EU (and Chapter 1 CA98) based on evidence of developments in the market. In examining the need for ex post intervention we are likely to include consideration of the following:

- We would wish to minimise any disruptive effect for existing consumers, by ensuring that they continue to have access to the full range of content. We would particularly wish to ensure that consumers on existing platforms continue to have access to the full range of FAPL content.

- We would want to facilitate competition. The current commitments achieve this by setting aside one package of rights, providing cross-platform exclusivity in relation to a subset of matches, for new entrants. We would wish to review the effectiveness of this approach. An alternative might be a reduction in cross-platform exclusivity for some matches, most likely achieved by making a subset of matches available on both DTT and existing platforms.

- We would wish to ensure that any reduction in the exclusivity premium associated with these rights does not artificially depress their value.

- We would wish to explore mechanisms by which commercial as well as residential consumers were protected from the detrimental effects of collective selling. For example, we might want to establish separate sets of rights for residential and commercial subscribers. This would not risk damaging rights values because the two sets of rights would not be substitutes, but could potentially offer a viable entry strategy for retailers targeting commercial consumers, as well as providing greater transparency as to profitability levels.

Consultation questions

27. Do you agree with our proposed approach to addressing concerns about the restricted exploitation of SVoD movies rights?

28. Do you agree with our proposed way forward on FAPL?

29. In particular, what remedies do you believe we should consider on FAPL, if any?

Annex 1

Responding to this consultation

How to respond

A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on 18 September 2009**.

A1.2 Ofcom strongly prefers to receive responses using the online web form at http://www.ofcom.org.uk/consult/condocs/third_paytv/howtorespond/form, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.

A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email william.hayter@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.

A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.

Will Hayter
Competition Group
Riverside House
2A Southwark Bridge Road
London SE1 9HA

Fax: 020 7783 4109

A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.

A1.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Will Hayter on 020 7783 4197.

Confidentiality

A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.

A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at http://www.ofcom.org.uk/about/accoun/disclaimer/.

Next steps

A1.11 We expect to issue a statement following receipt and analysis of consultation responses.

A1.12 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm.

Ofcom's consultation processes

A1.13 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.

A1.14 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk. We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.

A1.15 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Vicki Nash, Director Scotland, who is Ofcom's consultation champion:

Vicki Nash
Ofcom
Sutherland House
149 St. Vincent Street
Glasgow G2 5NW

Tel: 0141 229 7401
Fax: 0141 229 7433

Email vicki.nash@ofcom.org.uk

Annex 2

Ofcom's consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.

A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.

A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.

A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at www.ofcom.org.uk/consult/.

A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing ☐ Name/contact details/job title ☐

Whole response ☐ Organisation ☐

Part of the response ☐ If there is no separate annex, which parts?

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here. ☐

Name Signed (if hard copy)

Annex 4

Consultation questions

Sub heading

1. Do you agree with Oxera's approach to the valuation of Sky's intangible asset base?

2. Do you agree with Oxera's approach to assessing Sky's profitability?

3. Do you agree with our assessment of Sky's weighted average cost of capital?

4. Do you agree with the conclusions we draw about Sky's aggregate profitability?

5. Do you agree with the conclusions we draw about Sky's profitability at a disaggregated level?

6. Do you agree with our characterisation of the relationship between high wholesale prices and retail pricing?

7. Do you agree with our view that it would not be more appropriate to proceed in relation to some or all of the matters in question under CA98?

8. Do you agree that a wholesale must-offer is in principle the best way of answering our concerns around restricted distribution of Core Premium channels?

9. Do you agree with our proposal not to apply a remedy to wholesalers without market power?

10. Do you agree with our proposal not to extend a remedy to retailers on Sky's own platforms?

11. Is it necessary for us to set the prices of a wholesale must-offer?

12. Do you agree with our overall price-setting approach of using retail-minus, with a cost-plus cross-check?

13. Do you agree with our proposal to include HD and primary interactive sports content in a remedy?

14. Do you agree with our views as the concerns relating to commercial premises?

15. Do you agree in principle that our retail-minus calculation should start from Sky's retail prices and deduct the retail costs of an efficient entrant?

16. Do you agree with our proposal to set simple linear prices per subscriber, allowing flexibility for other pricing structures?

17. Do you agree with our proposal for wholesale prices to evolve over time according to a 'ratchet' approach and how should these prices track retail prices over time?

18. Do you agree with the principle that the same price for a 'factory gate' product should apply to all retailers regardless of their scale and choice of distribution technology?

19. Do you agree with our approach for deriving starting retail prices given the complexity of retail bundling?

20. Do you agree with our calculation methodology to deduct retailing costs – in particular the use of a discounted cashflow analysis, deduction of incremental and pro-rated fixed and common costs, and the use of Sky's costs as an efficient retailer?

21. Do you agree with our proposal to focus on deriving prices for a 'large' entrant scale retailer using DTT transmission and what are your views on our range of prices?

22. Do you agree with our approach to deriving a wholesale price for HD services and what are your views on the resulting range of prices?

23. Do you agree with our proposals for non-price terms – in particular on Minimum Qualifying Retailer, Minimum Security Requirements and a Reference offer?

24. Do you agree that a wholesale must-offer remedy is unlikely to contribute significantly to the administrative costs currently incurred by Sky?

25. Do you consider that our impact assessment above supports our view that it would be appropriate to impose a wholesale must-offer obligation in the form proposed in order to ensure fair and effective competition?

26. Do you have any comments on the draft wording of this condition, in light of the positions we have set out in the previous two sections?

27. Do you agree with our proposed approach to addressing concerns about the restricted exploitation of SVoD movies rights?

28. Do you agree with our proposed way forward on FAPL?

29. In particular, what remedies do you believe we should consider on FAPL, if any?

Annex 5

Glossary

API: Application Program Interface. A technology that facilitates exchanging of messages or data between two or more different software applications.

BARB: Broadcasters Audience Research Board. The pan-industry body which measures television viewing.

Broadband. A service or connection generally defined as being 'always on' and providing a bandwidth greater than narrowband.

CA: Conditional Access. A technology enabling a broadcaster to restrict access to content that it has made available on a digital platform only to those customers that have been authorised to access it.

CA03: Communications Act 2003.

CA98: Competition Act 1998.

CC: Competition Commission.

CAGR: Compound Annual Growth Rate. The average annual growth rate over a specified period of time. It is used to indicate the investment yield at the end of a specified period of time. The mathematical formula used to calculate CAGR = (present value/base value) (1/#of years) – 1.

Churn. The loss of customers subscribing to a particular pay TV package or retailer.

Core Premium channels. Includes both Core Premium Sports channels and Core Premium movie channels (see individual definitions below).

Core Premium Movie channels. Sky Movies channels apart from Sky Movies Classics. Specifically those premium channels or packages of premium channels which include movies from the major six Hollywood studios, shown in the first pay TV window.

Core Premium Sports channels. Sky Sports 1 and 2 and Setanta Sports 1. Specifically those premium channels which fit the description set out in section 4 of this document.

Digital switchover. The process of switching over the current analogue television broadcasting system to digital, as well as ensuring that people have adapted or upgraded their televisions and recording equipment to receive digital TV.

DSat: Digital satellite. A term used in the UK to refer to the digital satellite platform.

DTH: Direct to home. Another term for satellite distribution technology.

DTT: Digital Terrestrial Television. Currently most commonly delivered through Freeview.

DVB: Digital Video Broadcasting. A set of internationally accepted open standards for digital broadcasting, including standards for distribution by satellite, cable, radio and handheld devices (the latter known as DVB-H).

DVB-PCF: Digital Video Broadcasting-Portable Content Format. A technical specification that is specifically designed to provide an abstraction layer between the on screen presentation and functionality of an interactive application and the underlying operating system and hardware.

DVD: Digital Versatile Disc. A high capacity CD-size disc for carrying audio-visual content. Initially available read-only, but recordable formats are now available.

DVR: Digital Video Recorder (also known as Personal Video Recorder and Digital Television Recorder). A digital TV set-top box including a hard disc drive which allows the user to record, pause and rewind live TV.

EA02: Enterprise Act 2002.

EPG: Electronic Programme Guide. A programme schedule, typically broadcast alongside digital television or radio services, to provide information on the content and scheduling of current and future programmes.

FAPL: Football Association Premier League.

First Pay TV Consultation. The first Ofcom pay TV consultation published on 18 December 2007.

FTA: Free-to-air. Broadcast content that people can watch or listen to without having to pay a subscription.

HD: High Definition. A technology that provides viewers with better quality, high-resolution pictures.

HMT: Hypothetical Monopolist Test. An economic test used to assess whether demand- and supply-side substitutes provide a sufficiently strong competitive constraint to be included in a relevant market.

iDTV: Integrated Digital Television. A television set which has a built in digital tuner and receiver (typically for reception of digital terrestrial TV). iDTVs remove the need for an external set-top box.

Internet. A global network of networks, using a common set of standards (e.g. the Internet Protocol), accessed by users with a computer via a service provider.

IP: Internet Protocol. The packet data protocol used for routing and carriage of messages across the Internet and similar networks.

IPTV: Internet Protocol Television. The term used for television and/or video signals that are delivered to subscribers or viewers using Internet Protocol (IP), the technology that is also used to access the Internet. Typically used in the context of streamed linear and on demand content, but also sometimes for downloaded video clips.

ITC: Independent Television Commission. One of the regulators replaced by Ofcom in 2003.

Major Hollywood Studios. The six biggest Hollywood studios, namely Disney, Fox, Paramount, Sony, Universal and Warner.

MHEG5: Multimedia and Hypermedia Experts Group 5. Technology used for authoring applications for the digital terrestrial television platform.

Multi-channel. In the UK, this refers to the provision or receipt of television services other than the main five channels (BBC ONE & TWO, ITV1, Channel 4/S4C, Five) plus local analogue services. 'Multi-channel homes' comprise all those with digital terrestrial TV, satellite TV, digital cable or analogue cable, or TV over broadband. Also used as a noun to refer to a channel only available on digital platforms (or analogue cable).

Multiplex. A device that sends multiple signals or streams of information on a carrier at the same time in the form of a single, complex signal. The separate signals are then recovered at the receiving end.

MSR: Minimum Security Requirements.

OFT: Office of Fair Trading.

PPV: Pay-per-view. A service offering single viewings of a specific film, programme or event, provided to consumers for a one-off fee.

Platform. A pay TV platform can be defined as the specific combination of distribution and reception technology and conditional access that enables consumers to receive broadcasts. For example, Sky on DSat, Virgin Media on its cable network, Top Up TV on DTT or BT Vision and Tiscali TV on IPTV.

PSB Public Service Broadcasting, or Public Service Broadcaster. The Communications Act in the UK defines the PSBs to include the BBC, ITV1, Channel 4, Five and S4C.

PVR. See DVR.

SD: Standard Definition. As opposed to high definition.

Simulcrypt. A technology that allows a single broadcast channel to be used with tow or more conditional access systems.

STB: Set-top Box.

Second Pay TV Consultation. Ofcom's second consultation document on pay TV, published on 30 September 2008.

Service bundling. A marketing term describing the packaging together of different communications services by organisations that traditionally only offered one or two of those services.

SSNIP: Small, but significant, non-transitory increase in price. Used in the hypothetical monopolist test.

SVoD: Subscription Video on Demand. A type of VoD service that allows subscribers unlimited access to watch programmes or films whenever they choose to, not restricted by a linear schedule, for a regularly charged fee.

Time-shift. The broadcasting of a television service on more than one channel with a specified delay (typically an hour), to provide more than one opportunity for viewers to watch the service. Alternatively, the recording of programmes by viewers (using PVRs, recordable DVDs or VCRs) to watch at another time.

Top-flight sport. Sports matches from the higher competitive levels of the most popular sports in the UK. For example FAPL matches, FA Cup matches, English Test cricket matches, the Ryder Cup, Six Nations rugby union.

TPS: Technical Platform Services. A group of services comprising Conditional Access, Geographic Masking, Regionalisation, Electronic Programming Guides and Access Control.

UEFA: Union of European Football Associations. The governing body of football in Europe.

VoD: Video on Demand. A service or technology that enables TV viewers to watch programmes or films whenever they choose to, not restricted by a linear schedule. Also Near Video on Demand (NVoD), a service based on a linear schedule that is regularly repeated on multiple channels, usually at 15-minute intervals, so that viewers are never more than 15 minutes away from the start of the next transmission.

WCP: Wholesale channel provider.