

# **The Proposed Wholesale Must Offer Remedy**

Martin Cave

September 2009

## **Introduction**

1. I have been invited by Herbert Smith LLP, the external lawyers to BSkyB (Sky) to express my opinion on certain aspects of Ofcom's proposals in its pay-TV review to impose a wholesale must-offer requirement for premium content. I am asked to comment on the appropriateness of Ofcom's proposed wholesale must offer remedy set out in the Pay TV phase three document dated 26 June 2009 and in particular:
  - (a) whether it is sensible to develop a price control regime for premium pay TV on the basis of Ofcom's proposals for establishing a rate-card for regulated charges and proposals for changing the rate card; and
  - (b) whether it is sensible to apply compulsory licensing and price control to high definition versions of Sky's premium channels.
2. I have been asked to prepare this opinion on the assumption that Ofcom's findings set out in chapters 3 to 7 of the phase 3 document stand. I therefore do not comment upon these findings (although I understand that Sky does not accept them).

## **Background**

3. I am professor and director of the Centre for Management under Regulation at Warwick Business School at the University of Warwick. I was formerly professor of economics and vice-principal at Brunel University. I am a regulatory economist specializing in the communications sector. As well as academic writing and research I have advised several governments and regulators on communications: these include the Governments of Australia, Canada, France, New Zealand and the UK; regulators such as the European Commission, the New Zealand Commerce Commission, and telecommunications regulatory authorities in Armenia, France, Germany, Greece, Jordan, Singapore, Thailand, and the UK. From 1996 to 2002, I was a member of the Competition Commission. In 1998 I advised the Director General of Fair Trading on Sky's rate card for the supply of its TV channels to cable operators, and acted as an expert witness for the Director in the matter of collective selling of Premier League Rights before the Restrictive Trade Practices Court. A brief curriculum vitae is appended.

## **Summary and Overview**

4. *To summarise my conclusions, the Ofcom must-offer proposals are likely to have adverse effects on economic efficiency and consumer welfare which the*

*regulator does not adequately acknowledge. Ex ante price regulation is being proposed for a market place which is not characterised by structural barriers to entry (where such regulation is often unavoidable) but by strategic ones(as described by Ofcom). The proposals appear to be directed at achieving a pre-determined end- state in a market place where the future is highly unpredictable, by specifically setting mandatory prices at retail minus levels, based on a notional entrant less efficient than Sky in the same operations. This procedure is likely to create an unhealthy climate of co-dependency between entrant(s) and regulator which may chill genuine competition. Premium channels also exhibit a high degree of mutability, and this has led Ofcom to propose additional restrictions which are likely to reduce the flexibility with which programming can respond to changing tastes and availability of content. A particular concern is the effect of the proposals on innovation. By requiring Sky to share its HD products relating to premium content with competitors at retail minus prices, it risks creating a precedent which will weaken incentives to innovate in a market place which exhibits very high levels of innovation.*

5. The paper is organised as follows: Section I describes the must-offer proposal. Section II considers the conventional scope of *ex ante* price controls, and ways in which the present case differs from other cases. Section III assesses the proposed access pricing principle. Section IV examines the proposed arrangements for dealing with price changes, and Section V the probable effects of the proposals on innovation. Section VI contains a summary and conclusions.

## **I The proposals**

6. The aspects of the proposals I have been asked to consider are as follows.
7. As the only wholesale supplier of premium channels with market power (as alleged by Ofcom), Sky will be subject to wholesale ‘must-offer’ remedy with respect to Core Premium channels.
8. The wholesale price of the channels will be computed on a retail minus basis, the ‘minus’ element being constructed to enable a larger DTT-based retailer (for example, reaching three million subscribers within 10 years) to match Sky’s retail prices (and its products and services), incorporating allowance for DTT transmission costs and a reasonable return on investment. All retailers would have access to the same wholesale prices. (para 9.56)<sup>1</sup>
9. Ofcom proposes, because of concerns that Sky may raise the retail price of its wholesale channels, that wholesale prices of premium channels be adjusted according to a ratchet principle:

---

<sup>1</sup> All para references of this type are to *Ofcom, Pay TV phase three document: proposed remedies*, 26 June 2009.

- if Sky's retail prices fall, then so should the corresponding wholesale prices;
  - if retail prices increase, while there is a presumption that wholesale price increase in a corresponding manner. Sky will be required to seek consent for any such increase. (para 9.47)
10. Arrangements would be in place for the re-examination of charges in response to material changes in:
- channel product costs
  - costs of pay TV retailers
  - the structure of retail prices.
11. Relatedly, according to the Draft Licence, Sky must set out arrangements under which changes to the content of channels would be notified and agreed. (para 11.10(3) d)
12. The above approach would also be applied to high definition (HD) versions of the Core Premium channels. (para 9.13)

## **II The conventional scope of *ex ante* price regulation of wholesale services**

13. Access by retail competitors to services provided by a rival has been mandated under both competition law and sector-specific legislation. The latter approach has become common over the past twenty years in application to network industries, primarily those which rely upon a physical distribution network.<sup>2</sup> This has been associated with the insertion of competition into what were previously vertically integrated monopolies. In summary, competitors have been encouraged to enter the contestable parts of such value chains. However, entry is not practicable into all activities, particularly distribution networks characterised by a persistent 'natural monopoly' property - meaning that the market is more cheaply served by a single firm rather than by more than one. To permit competition to go forward, access is mandated to certain services. Because the pure retailing activity is normally seen as contestable, the retail margin is normally not regulated. As a result, the mandated services are wholesale ones.
14. In network industries, the services to which access is mandated are typically fairly homogeneous and adequately definable in terms of a small number of descriptors. For example:
- the service of delivering letters from a sorting office to customers' premises in specified areas;
  - the transmission of electricity between two specified locations on a high voltage grid;

---

<sup>2</sup> Such methods are not generally applied in relation to 'virtual networks' comprising, for example, users of a particular type of software.

- leasing a copper loop connecting a customer's premises to a local telephone exchange.
15. The relative ease of specification of the service in these cases contrasts with the likely mutability of a wholesale premium channel. Its composition is likely to change; material will be added and subtracted as new rights are acquired or as tastes change. This problem is discussed further in Section 4 below.
  16. The prior issue, though, is whether wholesale premium channels satisfy the same sort of requirement for eligibility for *ex ante* regulation as other services subject to mandatory access. This question can be addressed by examining whether premium channels meet the same criteria for *ex ante* regulation as those employed in other sectors.
  17. One useful point of comparison is with the EU regulatory regime for electronic communications services. This was established in a series of Directives of the European Parliament and the Council of 7 March 2002 which laid down procedures for the application of *ex ante* regulation in certain markets.<sup>3</sup> These are identified in a Recommendation issued by the European Commission.<sup>4</sup> It should be noted that content markets are explicitly excluded from the set of markets under consideration covered in the Directive and Recommendation. The point made here is thus by analogy only.
  18. The Commission's Recommendation identified three cumulative criteria for the application of *ex ante* regulation. These are:
    - i) the presence of high and non-transitory entry barriers of a structural, or legal / regulatory nature;
    - ii) markets where there is no likely tendency towards effective competition within the relevant time horizon for the same structural or legal/regulatory reasons;
    - iii) markets where the application of competition law alone would not adequately address the market failure(s) concerned.
  19. It is noteworthy that only two types of entry barrier are admissible as grounds for *ex ante* regulation – structural and legal/regulatory. The first results from cost and demand conditions which create barriers to entry, the example cited being substantial economies of scale and high sunk costs. Legal and regulatory barriers are self explanatory.
  20. Neither structural nor legal/regulatory barriers to entry seem to be present in the case of retailing wholesale premium TV channels (they are not mentioned

---

<sup>3</sup> See Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications and services (Framework Directive). Amendments to the Directive are now undergoing a conciliation process within the European Institutions, but the proposed changes do not affect the matters discussed here.

<sup>4</sup> Commission Recommendation on relevant product and service markets within the electronic communications sector susceptible to *ex ante* regulation in accordance with Directive 2002/21/EC, first edition 2002; second edition 2007.

in the phase 3 document), nor are they invoked by Ofcom as justifying the proposed intervention in the wholesale market for premium content. Ofcom's case is that Sky's failure to supply at present is 'based on an incentive to restrict the distribution of premium channels, with effects on a variety of platforms' (para 1.3). In other words, the barrier to entry, according to Ofcom is not a structural but a 'strategic' one.

21. Since one of the objectives of the regulatory framework described above is precisely to prevent or limit restrictions on competition<sup>5</sup>, it is natural to ask why the above limitation on *ex ante* regulation is adopted. It is based on a recognition that *ex ante* regulation should only be imposed where it is necessary to so.<sup>6</sup> In my opinion this conclusion directly follows from the adverse effects which such regulation inevitably has on competition and innovation in the service where access is mandated, and by extension throughout the value chain. In relation to competition, mandating access to a service relieves competitors of the need to acquire it for themselves. They can instead get it from someone else, and if the price is set deliberately low (as in this case), they will do so. If it comes from that source in a standardised form, this automatically reduces the degree of competition and choice available to end users. It also discourages innovation by the access provider, since such innovation brings it diminished benefits, as it has to share all the gains with access seekers. Furthermore, it often turns out to be the case - and this aspect is particularly prominent in this case as a result of the fluid nature of the service- that side conditions brought in to deal with potential issues to which the primary intervention might give rise have themselves adverse effects on consumers.
22. I believe that recognition of the disadvantages of *ex ante* regulation is widely shared, and I describe the nature of those problems below in more detail. But there is one further consequence of *ex ante* regulation which I mention here. When access to one firm's assets is mandated to a competitor, the parties – access seeker, access provider and regulator - become locked in a continuing relationship. For the access seeker, regulatory interventions become a key strategic resource upon which it relies heavily; the access price decision can literally make or break the entrant's business. The embrace is particularly close in cases where the number of access-seeking entrants may effectively be limited to one. In this case the relationship between entrant and regulator becomes almost one of co-dependency, in the sense that both the entrant and the regulator want the entry to succeed, the latter to avoid the reputational effects of a failed regulatory intervention. This creates pressure for frequent discretionary intervention directed at a particular end state in terms of industry structure. This problem is recognised as being particularly acute when there is a duopoly comprising an incumbent and a single licensed entrant.<sup>7</sup> In my view, for reasons I explain below, Ofcom's proposal, which relies on the creation of

---

<sup>5</sup> Framework Directive, Article 8.2.

<sup>6</sup> See Framework Directive, recital 27.

<sup>7</sup> Licensed duopolies were established in countries like Australia and the UK in the telecommunications sector, until it was recognised that fuller forms of liberalization were preferable. The present case is, of course, not one of duopoly, as other firms, notably Virgin Media, are already in the market.

what I call below a ‘designated entrant’, comes perilously close to a commitment to which the regulator’s reputation will be unhealthily tied.

### III Setting the wholesale price

23. As Ofcom notes, there are two principal approaches to setting wholesale prices mandated by the regulator – cost-plus and retail minus. In networks industries use of cost-plus prices is the normal (but not invariable) rule for pricing access to assets characterised by persistent natural monopoly or ‘structural barrier’ properties. Retail minus is largely (but not wholly) confined to new services or cases where a complete wholesale product is passed to a retailer for resale.
24. If the principal purpose of regulation were to be to control the wholesale price of premium content, a cost-plus approach would be natural. However, Ofcom’s case for intervention in these proceedings, it says, is not based on evidence of high wholesale prices, although Ofcom claims it is strengthened by that evidence (para 1.6). Instead it is based on a view that Sky is acting with a strategic motive which yields an incentive to restrict supply of premium channels to other retailers, as a result of its vertical integration between retail and wholesale activities (para 1.24). In these circumstances I can understand why, having decided to mandate a wholesale product, Ofcom chooses the retail minus approach, in which the wholesale price generates a margin on the basis of which the competitor can substitute its own activities in place of those of the incumbent.
25. This naturally leads on to the question of how the minus component is set. Before addressing this question in relation to *ex ante* regulation, I first observe that retail minus pricing has affinities with the application of the margin squeeze tests under European competition law. When such tests are applied, they require the difference between a wholesale and retail price (i.e. the minus in the retail minus formula) to be large enough to cover the cost of an efficient operator. A recent judgment of the CFI has clarified that this means the costs of the vertically integrated supplier<sup>8</sup>.
26. In sector-specific regulation, it is a common but not universal procedure to set the minus on the basis of the fully distributed costs of the vertically integrated incumbent, in performing the tasks to be taken on by competitors.<sup>9</sup> This has the advantage of permitting observations of costs actually incurred by an existing operator, and it ensures (loosely speaking) that a successful entrant must be as good as the incumbent.
27. In the present circumstances, however, Ofcom proposes to base the ‘minus’ on the costs of a specific hypothetical entrant. This is defined as an efficient entrant using digital terrestrial transmission (DTT) in the form of ‘a larger competitor (for example, reaching three million subscribers after 10 years)’

---

<sup>8</sup> See *Deutsche Telekom v Commission*, Case T-271/03, para 193.

<sup>9</sup> An exception is provided by the England & Wales water industry, where the retail margin is set on the basis of avoidable costs.

(para 9.8). Below I refer to this hypothetical operator as the ‘designated entrant’.<sup>10</sup>

28. It is possible to make several observations about this approach. First, because the costs of the designated entrant are higher than those of Sky, its immediate effect is to increase total industry costs. In other words, it is designed to generate productive inefficiency, in the interest of what is hoped will be greater competition. Second, it implicitly involves specifying a desired end state, by calibrating the minus to be consistent with a competitor of a particular size. Third, that process of calibration is based on specification of a particular transmission technology, DTT. Finally, given the overall size of the market as projected by Ofcom, as a result of economies of scale in retail and distribution activities, it is unlikely that more than one entrant will gain three million customers in 10 years. As a result, the number of ‘designated entrants’ is likely to settle at one – leading to the above-noted problems of co-dependency between entrant and regulator.
29. Of these objections, it is probably unnecessary to belabour the feature of the proposal that it is explicitly designed to shape the structure of the market place. It is often said that the goal of the regulator or competition authority should not be to protect a competitor, or type of competitor, but to protect the competitive process (and thus the interests of end users). In my opinion, this proposition is generally correct, but it is particularly apposite in the case of a market place subject to a fast pace of technical change. It is hard to think of an activity which has gone through more turbulence in the past twenty years than the delivery of digital signals, including video. New wireless and wireline platforms have emerged. Within the wireline/fibre category, the UK Government is promoting the construction of different varieties of next generation access networks (NGAs), including upgraded cable systems, notably those of Virgin Media.<sup>11</sup> Within wireless technologies, traditional analogue terrestrial transmission is giving way to a plethora of options for delivery of video including DTT, mobile broadcasting, satellite from stationary or non-stationary satellites, 3G mobile technology and its long term evolution (LTE), Wi-Max etc. In my opinion, it is extremely hazardous to predict which platform or platforms will and should triumph in the medium term. Yet Ofcom is proposing to undertake a programme of entry assistance which it has calibrated on the basis of its judgment of what ‘should’ succeed, despite the fact that the international history of pro-active regulation and policy-making in this area points to the dangers of so doing; one conspicuous examples is provided by the early attempts by the European Commission and the Japanese Government to promote High Definition broadcasting.
30. Ofcom’s calibration of a price control which designates a DTT entrant has spillover effects on neglected platforms. Thus, in several countries, IPTV has proved to be successful in gaining adherents. Conceivably, a successful IPTV entrant in the UK might be a better long term prospect than an entrant using the DTT platform, of which capacity, including capacity to offer HDTV

---

<sup>10</sup> It should be stressed that Ofcom does not use this terminology.

<sup>11</sup> See *Digital Britain, Final report*, BIS and DCMS, June 2009.

channels, is very limited. Another regulator, coming at the issue with Ofcom's market-shaping intent, might rationally prefer an IPTV-based approach.<sup>12</sup> Yet to some degree Ofcom has also affected IPTV's prospects by designing a regulatory regime which designates an entrant of another type.

31. Equally, cable is rejected as the vehicle for introducing competition as it is a platform closed to other retailers and, accordingly, offers no potential for entry. It is not clear why this aspect rules out the possibility of designating it as the principal competitor and constructing wholesale prices to accomplish this outcome.
32. This section has argued that the pricing principle which Ofcom has adopted designates a particular form of entrant and calibrates the regulatory regime on this basis. This is a risky procedure in a dynamic market such as video platforms and content. In the next section, I discuss the problems which arise from the proposed method of changing prices.

#### **IV Responding to cost and price changes**

33. The particular retail minus pricing regime described above constitutes only part of the 'rules' for setting prices to implement the must-offer proposal. An important complement are rules for changing prices.

##### *A. Retailing costs*

34. In the case of mandatory access to physical infrastructure in network industries, the cost of the service and its characteristics are stable enough for a price control to be established for 3-5 years, often in the form of a price cap of the RPI-X type. This process involves making a forecast of costs, which is then translated into a (notionally immutable) trajectory for prices for a given service. One benefit of this is that it limits discretionary regulatory intervention within the period.
35. The Ofcom proposal, by contrast, envisages several 're-openers' – or changes in circumstances which allow the wholesale prices of premium channels to be revisited. One example is a change in retail costs. Thus Ofcom writes: '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 higher retailing costs' (para 9.38). This process of review is supported by Sky's competitors. Thus Ofcom reports that 'Virgin media considered that there should be a mechanism to assess the retail margin "on a regular basis"'. The Four Parties went further and suggested that there should be a monthly adjustment mechanism for wholesale prices' (para 9.41, footnotes omitted).

---

<sup>12</sup> Ofcom discusses the prospects for IPTV in a cursory fashion at para 9.132.



36. Ofcom accepts in principle that changes on retail costs may justify a revision of the wholesale price. This appears to reflect a concern that countermeasures must be in place in case Sky seeks to raise rivals' costs by raising its own. For example, Sky might increase its marketing costs, requiring a similar increase by competitors: 'if 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' (para 9.40). It also appears that an increase in competitors' costs alone would also apparently be capable of triggering a reduction in wholesale prices.
37. I foresee several dysfunctional consequences from this aspect of the proposals. The last feature opens up an opportunity for competitors to pass on their increased retail costs to Sky. However determined Ofcom may be to resist recognition of cost increases which are not 'efficient', its ability to discriminate in this respect will inevitably be limited. To put it in another way, Ofcom will be drawn into continuous debate about retail costs, in circumstances where there is no observation of the costs, let alone the efficient costs, of an operator of a kind which, for a significant period, will not exist or exist at a sub-optimal scale. Secondly, if Sky knows that any expenditure on retail it makes may be matched by a decline in the wholesale price it can charge its competitors, its incentive to incur expenditure which might be in consumers' interests will be compromised. Thirdly, Sky can avoid any reduction in its wholesale price as a result of retail cost changes by raising the retail price paid by end users. Subject to the points made in (B) below, the system is thus biased towards higher retail prices- ie in favour of producers and against consumers.

*B. Changes in retail prices*

38. Ofcom notes that under a retail minus price regime, Sky could increase its wholesale prices by the simple expedient of increasing its retail prices. I would have expected Ofcom to have investigated more fully the circumstances in which it might be rational for Sky to adopt this course of conduct, especially in the context of the particular retail minus rule which Ofcom proposes to apply. Notwithstanding the absence of such an analysis, a regime is proposed (para 9.47) in which
- '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.'
39. The reason for the asymmetry is the fear that while retail price rises might be due to innocent factors, such as inflation, they might also be 'prompted by a desire to increase the wholesale prices of Sky's competitors' (para 9.50).
40. However, the inability to change retail prices 'without permission' has further consequences. As noted in (C) below, it complicates potentially beneficial switches of content across channels. More significantly, it may check incentives to acquire new content. Sky may be reluctant to pay significant

amounts for additional content or larger amounts to renew licences for existing content if there is a residual doubt about whether they can recover the outlays in higher retail prices without having to increase competitors' retail margins as they do so.

*C. Wholesale channel costs*

41. The retail minus methodology does not in principle control the general level of wholesale prices- which 'fall out' as a remainder after Ofcom's definition of retail and transmission costs has been subtracted from retail prices. However, Ofcom is concerned that Sky may find it expedient, either solely in its own interests or with the goal of injuring retail competitors, to shift content from channel to channel.<sup>13</sup> This might leave competitors being offered wholesale channels at prices which fail to reflect their value. In Ofcom's view, if such changes were sufficiently material, this might require a re-assessment of the pricing calculations.
42. The problem is that, in trying to prevent such conduct, Ofcom places obstacles in the way of changes in channel costs which have a beneficial effect on consumers. Of course, it can argue that it will be able to identify such cases and wave them through. But it will also be in receipt of representations from competitors which may resist such proposals for their own private reasons. As soon as departures from a 'no permission required' regime are allowed, inertia is injected into the process.
43. There is, however, the apparently greater threat to beneficial reorganization of channel content in the interests of consumers. Draft licence condition 3(d) refers to an obligation in Sky's licence to publish terms and conditions which include as least the following:  
    'the arrangements under which changes to the content of the Licensed Service shall be notified and agreed ...' (para 11.10 (3)d)
44. While the meaning of this is not spelt out, it may reflect a desire on Ofcom's part to ensure that changes in channel content are agreed with competing retailers, and as with other provisions considered in this section, the motive may be to prevent Sky from acting solely in its own commercial interests. But the effect of requiring agreement by retail competitors to changes in channel content may effectively congeal the status quo forever, especially when accompanied by the controls on price described above.

*D. A final comment*

45. The matters discussed in this section seem to follow a common course. Ofcom proposes a must-offer regime for premium channels based on a particular pricing principle. It then turns out that the products to be subject to *ex ante* regulation are complex and subject to rapidly changing tastes. Difficulties also arise because the minus element in the price formula is not based on any observable operator's costs but upon the costs of a hypothetical operator.

---

<sup>13</sup> para 9.40.

46. Ofcom asserts that the above circumstances create gaming opportunities for Sky. Its response is to add further powers of adjustment to thwart such conduct. But in adding such powers, it fails to recognise that their existence may have adverse consequences for consumers, either because they may be exercised in ways which prevent the emergence of consumer benefits, or because the very existence of the powers will diminish Sky's incentives to propose such beneficial changes.
47. Such problems arise in other cases of *ex ante* regulation. But the special problem here is the complex and changing nature of the services to which access is being mandated. In my opinion, wholesale premium channels are unusually inhospitable territory in which to impose such controls.

## **V The treatment of High Definition channels and impact on innovation.**

48. Ofcom proposes that the regime described above should broadly be applied in a wholesale must-offer regime for HD premium channels. As above, the channels must be offered at retail minus prices, presumably subject to the same additional regulation relating to price and cost changes.
49. The treatment of HD channels illustrates the problems which *ex ante* regulation has in dealing with innovation. In particular, if any new service has to be made available to competitors on the basis of a cost plus or retail minus access price, then the returns to innovation are diminished and in the limit a socially beneficial innovation may never materialise or materialise later than it should have.
50. In the case of HD, Ofcom recognises this problem: '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' (para 9.139).
51. However the concessions made in this case are relatively small. Recall that retail minus pricing provides the mandated service to competitors at a price designed to allow them to incur retailing and other costs and still match the access provider's retail prices. The regime above augmented the usual margin by estimating the costs of a specially designated entrant. In the case of HD, that regime is amended slightly in two ways:
  - the subtracted retailing costs are based on a compromise between those of the 'designated entrant' and those of Sky itself (para 9.142);
  - the subtracted transmission costs are based not on the higher costs of a DTT operator, as in the case described above, but on those of on those of a satellite (DSat) operator (para 9.143).
52. The latter is explained on the basis that the prospects for HD delivery on DTT are limited in the short to medium term. Given DTT capacity limitations, this is not surprising, but where other costs are based on the designated DTT

operator, it seems inconsistent to suppose that HD is delivered using an entirely different platform.

53. In my opinion, the key question concerning innovation is: what impact will the proposed arrangements for HD have on the incentive for Sky (or any subsequently regulated operator) to make further substantial investments in innovation. In my opinion, the effects are likely to be adverse. The basic retail minus methodology requires new services to be made available immediately. It gives the competitor a cost-based margin within which it can provide its own retailing and transmission services. And it means that any market-expanding subsidies to the consumers engrossed in the retail price are automatically passed on by the access provider to its competitors.
54. In another context (that of access to next generation access networks), Ofcom has adopted an approach in which, in the case of certain new wholesale services capable of supporting super-fast broadband, the access price is subject to commercial agreement between the parties.<sup>14</sup> While I accept that there are significant differences between the cases, this seems to me to grant a proper recognition to the importance of not stifling investment and innovation. The HD precedent in the current proposals seems to risk exactly such stifling.

## VI Conclusions

55. This paper has considered the probable consequences of certain features of the form of *ex ante* regulation which Ofcom proposes to impose on Sky, in the form of a must offer requirement for premium channels. I consider that the proposals are likely to have unintended consequences for consumers which Ofcom has not recognised or taken adequately into account.
56. Premium channels differ from many services subject to price control because the problem of barriers to entry which Ofcom believes exist and which such price control is attempting to resolve are not structural ones associated with the nature of costs or demand but strategic ones to which *ex ante* regulation is not best suited. Secondly, premium channels differ from traditional physical structures to which access is commonly mandated *ex ante* because of the high level of mutability of the service, which opens up opportunities for frequent regulatory intervention.
57. The price control regime which Ofcom proposes to impose is a retail minus one, with the ‘minus’ element calibrated to permit a particular firm – described above as the designated entrant – exactly to match Sky’s offerings and prices. The regulator is thus explicitly designing its intervention with a view to a particular market structure, rather than creating an environment in which a

---

<sup>14</sup> Ofcom, *Delivering super-fast broadband in the UK*, March 2009. This document explains the need for pricing flexibility in the following terms: ‘Where demand is uncertain, forecasting costs and revenues is likely to be difficult. [Price regulation] also carries the risk of stifling investment .... Such [pricing] flexibility also allows operators to manage the risks of their investments and make pricing judgements in the face of various markets uncertainties and their requirement to earn a sufficient rate of return.’ (At para 8.15.)

competitive process can better operate. This is particularly hazardous in a marketplace characterised by fast and unpredictable technical progress and a variety of existing and emerging means of meeting such demands for video. Moreover, the designation of what may well turn out to be a single new competitor risks creating a co-dependency between the regulator and that competitor, with the regulator focusing its efforts on influencing the regulator and the regulator 'protecting' its reputational investment in the competitor.

58. In addition to these issues with the underlying intervention, Ofcom's perceived need to build in re-openers in the price controls has adverse consequences for consumers, in the form of preventing adjustments to mandated services which would benefit consumers. These include a bias against retail price cuts.
59. Finally, the proposals as they relate to HD premium services, which are broadly as described above, diminish incentives to make investments in innovations, which Sky will expect to have to share with competitors. Arguably, in the circumstances of the sector, this is the greatest source of detriment to consumers.
60. I thus conclude that Ofcom's analysis pays insufficient attention to the detrimental effects which its proposals would have on end users of the services in question.

**Appendix: curriculum vitae of  
Professor Martin Cave, B.A., BPhil, DPhil**

**Office Address**

Centre for Management under Regulation  
Warwick Business School  
University of Warwick  
Coventry, CV4 7AL

Telephone: 44(0)7958483709  
Email [martin.cave@wbs.ac.uk](mailto:martin.cave@wbs.ac.uk)

Date of birth : 13 December 1948

***Education***

BA, First Class, Philosophy, Politics and Economics, Balliol College, University of Oxford, 1969

BPhil in Economics, Nuffield College, University of Oxford, 1971

DPhil, Nuffield College, University of Oxford, 1977

***Principal Academic Employment to Date***

1974 to 1987   Lecturer, Senior Lecturer and Professor of Economics, Brunel University.

1989 to 1994   Dean, Faculty of Social Sciences, Brunel University.

1994 to 1996   Pro-Vice-Chancellor, Brunel University.

1996 to 2001   Vice-Principal(Deputy Vice Chancellor), Brunel University

2001 to date   Professor and Director, Centre for Management under Regulation,  
Warwick Business School, University of Warwick.

***Principal Advisory Activities***

- Appointed by the **Secretary of State for Transport** to chair an expert panel on airport regulation, 2008
- Appointed by the **Chancellor of the Exchequer** and **Secretary of State for the Environment, Farming and Rural Affairs** to review competition and innovation in the water sector, 2008
- Member, **UK Payments Council**, 2007-2010.
- Appointed by **Secretary of State for Communities and Local Government** to undertake an independent review of the regulation of social housing, 2006-7.
- Appointed special adviser to **European Commissioner Reding** on the reform of European telecommunications regulation 2006.

- Appointed by **Chancellor of Exchequer** to conduct an independent audit of major spectrum holdings, December 2004- November 2005.
- Adviser to **Lord Chancellor's Department** on reforms in legal regulation 2004-5.
- Economic Advisor to **OFCOM**, from 2003 to 2006.
- Non-Executive Advisory Director at **OFWAT**, 2001 -2005.
- Appointed by **Chancellor of the Exchequer and the Secretary of State for Trade and Industry** to undertake an independent review of spectrum management, 2001 / 2002.
- Member, **UK Competition Commission**, 1996-2002.
- Economic Adviser, part-time, **at HM Treasury**, 1986-90.

### *Selected Recent Publications*

#### *Books, Major Reports & Monographs*

(edited with R Baldwin and M Lodge) *Oxford Handbook on Regulation*, Oxford University Press, in press

*Independent review of competition and innovation in the England & Wales water industry*, 2009

(with C. Doyle and W. Webb), *Essentials of Modern Spectrum Management*, Cambridge University Press, 2007.

*Every Tenant Matters*, Department of Communities and Local Government, 2007

(edited with K. Nakamura) *Digital Broadcasting*, Edward Elgar, 2006.

*Independent Audit of Spectrum Holdings: Report to the Chancellor*, HMSO, 2005

(edited with S. Majumdar and I. Vogelsang) *Handbook of Telecommunications Economics. Vol 1 and 2*. Elsevier; 2002, 2005.

*Review of Radio Spectrum Management*, HM Treasury and DTI, 2002.

(With R. Crandall) *Telecommunications Liberalization on Two Sides of the Atlantic*, Brookings Institution, 2001.

(With R. Baldwin), *Understanding Regulation*, 1999, Oxford University Press.

### Selected Articles

(with Jos Huigen) 'Regulation and the promotion of investment in next generation networks-a European dilemma', *Telecommunications Policy*, 2008, vol 28, No 11, pp713-721.

(with K Hatta) 'Universal service obligations and spectrum policy' *INFO*, 2008, vol 10. Nos 5/6, pp59-69.

'Broadband regulation in Europe- present and future' *Competition and regulation in network industries*, 2007, pp405-423

(with P. Crocioni) ' Does Europe need network neutrality rules?' *International Journal of Communications*, 2007, pp669-679

'Six degrees of separation: operational separation as a remedy in European telecommunications regulation', *Communications and Strategies*, No. 3, 2006

(with L. Prosperetti and C. Doyle) 'Where are we going? Technologies, markets and long range public policy issues in European Communications', *Information Economics and Policy*, 18 (3) 2006, pp. 242-255.

'Encouraging infrastructure competition via the ladder of investment', *Telecommunications Policy*, April 2006, pp 223-237.

'Competition and the exercise of market power in broadcasting: a review of recent UK experience', *INFO* 5, 2005, pp. 20-8.

(with P. Crowther) 'Pre-emptive competition policy meets regulatory anti-trust' *European Competition Law Review*, Vol. 26, 9, 2005, pp. 481-490.

'Separation and access prices in postal services' *Journal of Network Industries*, 2005, pp.115-33.

(With R. Baldwin and K. Malleson) 'Regulating Legal Services: Time for the Big Bang?' *The Modern Law Review*, Vol 67,5, 2004, pp 787-815.

(with R. Collins and P. Crowther) 'Regulating the BBC', *Telecommunications Policy*, April/May 2004, pp. 249-272.

(with R. Mason) 'The Economics of the Internet: Infrastructure and Regulation', *Oxford Review of Economic Policy*, No.2, 2001, pp188-201.

'Voucher Programmes and their Role in Distributing Public Services', *OECD Journal on Budgeting*, volume 1 no. 1. OECD, 2001, pp 59-88.

(with R. Crandall) 'Sports Rights and the Broadcasting Industry' *Economic Journal*, Feb 2001, pp f4 – f26.