

BBC's response to Ofcom Pay TV phase three document

Executive Summary

The BBC welcomes the opportunity to respond to Ofcom's consultation on the pay TV review, initiated in 2007.

Whilst the BBC is not directly involved in the pay television sector, and whilst the free- to-air and the pay TV markets continue to be distinct, there are strong links between them which gives it a clear interest in the investigation. In addition, it believes that promoting open and competitive markets will benefit licence fee payers and the wider industry.

Pay TV is an important part of the television landscape, and Sky has been a leading player in bringing innovative services to pay TV consumers for many years. It has taken significant risks in the past and has earned the right to earn a reasonable rate of return as a reward. The BBC welcomes its involvement in broadcasting.

The question Ofcom is struggling with now is whether the market is competitive and whether the returns being earned by Sky are reasonable or excessive; the rewards of innovation or generated from the exploitation of market power. We note that during the investigation, Ofcom has undertaken extensive analysis and concluded that there are key areas in which there is not fair and effective competition and proposed appropriate remedies.

The BBC has already set out its position in the previous consultations on the matter and rather than repeating the same points, will summarise its views and refer to its previous responses for further details.

The BBC broadly agrees with Ofcom's conclusions and proposed actions, which should ensure fair and effective competition, increase consumer choice and foster innovation.

In particular we agree that

- Access to premium sports and movies content is key to the development of a competitive pay TV offer
- Sky has market power in the wholesale markets for premium sports and movies channels
- The wholesale market for premium sports contains Sky Sports 1 and Sky Sports 2¹. We agree with Ofcom's view that Sky Sports 2 is part of this market, and believe that the need for inclusion of Sky Sports 3 and Xtra in the future should be kept under review.

¹ We agree with Ofcom that competition concerns are likely to be independent of whether Setanta Sports 1, or equivalent sports channels provided by ESPN, form part of the Core Premium Sports market.

- The wholesale market for movies channels contains all Sky movies channels apart from Classics.
- In the current circumstances, it seems difficult for new entrants to compete and thrive in the pay TV sector.
- A wholesale must-offer condition implemented effectively by Ofcom would help address those concerns
- Some targeted intervention in the way premium content rights are bought might also be necessary, in particular to ensure that the outcome of the FAPL 2012 auction does not hinder competition, and that VOD rights for movies can be fully exploited in a fair and competitive environment.

In addition, we consider that Sky's market power in the wholesale and retail provision of (in particular) premium sport content is augmented by its role in distributing premium sport content for other wholesalers and retailers, such as Setanta/ESPN. This additional source of power allows Sky to limit the availability of premium sport content to competing platforms.

The BBC believes that the conclusions reached by Ofcom at the end of this extensive consultation process and exhaustive analysis are sound and that the actions it proposes to undertake are able to increase competition and innovation for the benefits of UK viewers. It hopes that there will be no further delay to action, since this would make it more difficult for potential competitors to survive or develop.

- 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?*

Sky is a successful company with a track record of innovation and risk taking which has delivered significant benefits to consumers of Pay TV. Sky has earned the right to generate a reasonable rate of return from its pay TV business as a reward for its past risk taking. It is only when it can be demonstrated that the rewards being earned are excessive and result from exploitation of market power that intervention is justified. We therefore welcome Ofcom's analysis of Sky's profitability as an important indicator of the competitive situation in the pay-TV market.

The BBC is not in a situation where it can usefully comment on the assessment of Sky's profitability. However, it would appear that the methodology followed by Ofcom and Oxera is sound and follows an approach used previously by the OFT and the Competition Commission.

Consumer effects

The BBC agrees with Ofcom's analysis and conclusions on this point, and in particular with the finding that consumers are worse off because Sky does not wholesale its services to other retailers on the various platforms. It agrees that whilst there are definitely concerns that

consumers currently do not benefit from a competitive market, there is also a significant risk that the situation could worsen.

The BBC therefore supports Ofcom's view that it should take a forward looking view to ensure the interests of citizens and consumers are adequately protected. Where appropriate, this could include taking actions to ensure that the market remains competitive and that the opportunities for innovation can be fully seized by market players.

6. Do you agree with our characterisation of the relationship between high wholesale prices and retail pricing?

The BBC agrees with Ofcom's analysis of the relationship between wholesale and retail prices. There is clear evidence of the relationship between wholesale and retail pricing in the pay-TV sector going back to the OFT's margin squeeze analysis in 2002.

We fully agree that there is a risk that the competition concerns identified by Ofcom could reduce significantly the scale and depth of innovation in the sector. In particular, restricted distribution of Core Premium channels will force consumers to choose the Sky platform rather than other platforms, whether or not it offers them the best price or the most innovative service. This risks hindering the development of innovative platforms, offering for instance a range of on demand or, in the future, of 3D content. It is also possible, as noted by Ofcom that the restricted availability of Sky's Core Premium channels will slow the growth of IPTV in the UK 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.

The result would be that Sky's position will be very difficult to challenge, resulting ultimately in higher prices for consumers.

In its previous responses, the BBC also argued that Ofcom should (a) take a two-sided market approach to its profitability analysis, particularly for channel operators and (b) include Sky's platform operations in its analysis given that excess profits at one level can be transferred to (or extracted by) another upstream (or downstream) level. Our view on vertical integration is set out in our answer to question 8.

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?

As expressed in our previous responses, we agree with this view. The BBC is convinced by Ofcom's arguments that using its sector-specific powers under section 316 of the CA03 is the most appropriate and the most effective means to fulfil its duties to consumers as expressed in section 3 of the Act. In particular, the BBC supports the view that the situation is such that Ofcom needs to take a broad ranging view, looking across the sector, considering future as well as current developments, rather than trying to amend specific situations. The BBC considers that relying on ex-post powers available under CA98 is likely to result in significant costs to competition and consumers given the reactive nature of those powers.

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?

As developed in its previous submissions, the BBC believes that vertical integration remains the key issue of concern and without it Sky's incentive would be to provide its channels to as many platforms as possible. The BBC has argued that as pay TV platforms are a significant potential source of market power, it is vital for Ofcom to undertake its analysis from the perspective of intermediate customers (including channel providers and other platform operators) as well as final customers. Ofcom might want to refer for instance to Enders analysis² which suggests that Sky has sufficient power to restrict the competitive threat represented by operators such as ESPN; since they rely on Sky for the major share of their retail revenues, they might not be in a situation where they can compete aggressively for rights.

However, the BBC understands Ofcom's preference for a wholesale must-offer remedy.

The BBC is convinced by the evidence produced by Ofcom to show that in the absence of vertical separation, such a remedy if properly implemented is likely to promote wider availability of Core Premium channels and remove the current distortion of inter-platform competition.

9. Do you agree with our proposal not to apply a remedy to wholesalers without market power?

We note that Ofcom's conclusions on market power rely on market share analysis, access to certain premium sports rights and high entry barriers. We also note that Ofcom has not found Setanta/ESPN to have market power. Competition analysis is clear that without market power there is unlikely to be a competition concern and on that basis we are happy for Ofcom not to apply the remedy to wholesalers without market power.

There is a risk that Sky's role as a distributor of premium sport content augments its market power at both the wholesale and retail levels such that Sky is able to restrict the availability of non-Sky premium sport content to competing platforms such as Freesat. This is supported by Ofcom's statement in paragraph 8.31 of the Phase Three document that "...the guiding principle behind our application of a wholesale must-offer to Sky is that it should apply to those channels which re 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". We look to Ofcom to address this issue in its final conclusions, especially if Ofcom confirms its view that Sky has retail market power.

10. Do you agree with our proposal not to extend a remedy to retailers on Sky's own platforms?

² Endersanalysis. ESPN and Sky- the new complementary premium sports duo, 20th August 2009.

Ofcom has rightly emphasized the need to support competition between platforms. However, the BBC is surprised that it has not also addressed intra-platform competition issues given the importance of switching costs for consumers.

In particular, Ofcom proposes not to extend the benefits of the wholesale must-offer remedy to Sky's own platform. Ofcom summarises its reasoning in paragraph 1.54, specifically that 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 and both these concerns can be addressed by applying the remedy only to non-Sky platforms. We find this reasoning confusing, especially in the light of Ofcom's move to find Sky has retail market power also.

The BBC has in past responses argued that there are significant switching costs for consumers wishing to move between platforms and that these costs are increasing as pay-TV platform operators bundle telephony (both fixed line and mobile) and broadband with pay TV. In the face of such consumer switching costs, the BBC would expect Ofcom to wish to promote intra-platform competition on the largest pay-TV platform as well as inter-platform competition. Although subscribers to Sky's platform have access to the core channels at issue, consumers on Sky's platform still face constraints, particularly if Sky has retail market power. Without competition between retailers on the platform, Sky's subscribers cannot benefit from innovation in the pricing of retail channels such as the size and make up of channel bundles and whether or not there is buy through from basic to premium channels. We do not believe that lack of evidence of excess returns in Sky's retail business is evidence that there is fair and effective competition (it could just as easily be evidence of high pricing at the wholesale level).

Should Ofcom remain of the view that the benefits of the wholesale must-offer remedy should not be extended to retailers on Sky's own platform, we would caution Ofcom to ensure that its conclusions are worded sufficiently carefully so as to ensure that the benefits of the wholesale must-offer remedy are available to other satellite platforms, such as Freesat, not operated by Sky.

11. Is it necessary for us to set the prices of a wholesale must-offer?

In a situation where market power and incentives to exploit that power have been identified, and where wholesale must-offer has been proposed as the most effective remedy it is absolutely necessary for the wholesale price to be regulated. If wholesale prices were not regulated the remedy would be ineffective as Sky could use both price and non-price conditions to prevent third part retailers from purchasing its wholesale channels.

Joint response to questions 12 and 15- to 20

12. Do you agree with our overall price-setting approach of using retail-minus, with a cost-plus cross-check?

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?*

The BBC is not well placed to comment in detail on these issues and will make only a few points. The BBC supports Ofcom's proposal and broadly accepts its calculation methodology, which seems able to maximise the chances of a fair outcome.

Setting prices on a retail minus basis using a cost plus analysis as a cross check seems an effective way to combine the benefit of both approaches.

The BBC agrees that Ofcom's retail-minus calculation should start from Sky's retail prices and deduct the retail costs of an efficient entrant. However, Ofcom should consider that a new entrant might face entry costs or might need to understand how the market works before becoming really efficient. When calculating the retail costs of an efficient entrant, Ofcom might wish to recognise the need to allow for a "learning period": it will not always be possible for a new entrant to be immediately as efficient as Sky, and therefore there might be legitimate reasons why its retail costs could be higher.

In addition, it might be useful to consider whether the methodology should allow for different entry costs on different platforms and the scale of the entrant. For instance, transmission costs on satellite vary depending on the number of transponders acquired simultaneously by an operator.

13. Do you agree with our proposal to include HD and primary interactive sports content in a remedy?

Yes. The BBC believes that HD is becoming the new television standard, and therefore argues that the must-offer remedy should include HD versions of existing services as well as any stand alone HD services. To exclude them would significantly weaken the inter-platform competition benefits that wholesale must-offer should otherwise deliver.

In addition, we agree that interactive applications should also be included. As rightly stated by Ofcom, the "red button" services are often used not only as a nice "add-on" but as part of the main offer, in particular for major sports events where there can be no real difference between the content offered on linear services and that offered through the red button. Should interactive services not be included within the remedy, there would be a risk that some key content be shown on the red button services, thus making the remedy ineffective.

14. Do you agree with our views as the concerns relating to commercial premises?

It has been suggested to us that the sale of premium sports channels to commercial premises generates significant income – running into hundreds of millions of pounds . Excluding this part of the market automatically places new retailers at a commercial disadvantage and makes it more difficult for them to successfully enter the pay TV sector. The BBC therefore supports Ofcom’s stated intention to monitor closely the situation, and take further action if necessary.

23. Do you agree with our proposals for non-price terms – in particular on Minimum Qualifying Retailer, Minimum Security Requirements and a Reference offer?

In its previous responses, the BBC had argued that there were a number of non price-related points to consider. The BBC is satisfied that Ofcom has considered the right list of such issues, and proposed broadly adequate responses. However, it would insist on two points:

- Ofcom should monitor the determination by Sky of Minimum Security Requirements, and remain ready to intervene if it appears that they are unrealistic and cannot be met by a sufficient number of parties.
- Ofcom should also monitor the development by Sky of new services, ensuring that they do not “game” the remedy, in particular as premium sports content is concerned.

Joint response to questions

24. Do you agree that a wholesale must-offer remedy is unlikely to contribute significantly to the administrative costs currently incurred by Sky?
and

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?

Generally speaking, the BBC agrees with Ofcom’s impact assessment and its arguments that the wholesale must-offer remedy it proposes is proportionate.

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?

The BBC is not well placed to comment on this question, which is one for retailers who will have to implement the condition.

27. Do you agree with our proposed approach to addressing concerns about the restricted exploitation of SVoD movies rights?

Yes. The BBC agrees with Ofcom that the development of on demand movies offers would be a very positive step. Ensuring a better circulation of SVOD movies rights would increase choice for viewers and help the establishment and development of potential competitors.

The BBC believes Ofcom’s proposed path of action – first talking to the Major Hollywood Studios- is the most appropriate.

28. Do you agree with our proposed way forward on FAPL?

The BBC agrees with Ofcom's proposed way forward. Since the existing commitments given by the FAPL will no longer apply to the 2012 auction, it is important that Ofcom enters into discussions with the FAPL now on how the League proposes to ensure this auction complies with competition law. The BBC believes that, when doing so, Ofcom should consider the limited effect of the previous measures and the reasons which they have been unsuccessful in securing a lasting increase in competition. Approaching the FAPL now also allows Ofcom sufficient time to contact the European Commission if necessary.

29. In particular, what remedies do you believe we should consider on FAPL, if any?

The BBC agrees with the objectives set by Ofcom in their consultation document (12.42), and in particular supports the view that it should explore mechanisms aimed at both the residential and commercial sectors.

It may be that simple roll-out of the existing remedy would not be effective in future. Indeed, Ofcom's own analysis suggests that it is important to have access to one of the two primary packages for there to be effective channels competition in sports.