NON-CONFIDENTIAL VERSION

OFCOM PAY TV INVESTIGATION

RESPONSE TO THIRD CONSULTATION BY THE FA PREMIER LEAGUE

28 SEPTEMBER 2009

Submitted for and on behalf of the FA Premier League

by DLA Piper UK LLP

1. EXECUTIVE SUMMARY

1.1 Despite lengthy submissions rebutting Ofcom's previous consultations Ofcom's third Consultation (the **"Consultation"**) is fatally flawed in a number of key areas. Most importantly the remedy will be highly detrimental to consumers by significantly devaluing content rights. However, this negative effect for consumers is entirely ignored by Ofcom.

1.2 The proposed remedy is ill-conceived, and unnecessary given that there are no findings of high retail prices; no actual lack of platform choice for Sky's sports and movie channels; and no findings that consumers are currently suffering from identifiable reduced quality or from a lack of actual or prospective innovation. Given the absence of any real identifiable consumer harm it is impossible to understand why Ofcom persists in trying to radically intervene.

1.3 The core of Ofcom's competition case is almost impossible to understand in the Consultation; particularly as the proposed intervention is, as explicitly stated by Ofcom, not designed to remedy excessive retail prices which do not exist. The Consultation clearly has a number of fundamental logical flaws, gaps in its analysis and conclusions, internal inconsistencies, irrational conclusions and a wholly unsatisfactory and flawed proportionality analysis. These problems are addressed in detail throughout the PL's response. However, the key faults in Ofcom's case can be summarised as follows:

1.3.1 Ofcom's market definition is flawed which leads to a fundamentally flawed basis for its entire case. Ofcom's starting point was wrong and it continues to underestimate the importance and competitive constraint of content (especially sports content) on free to air tv (**"FTA"**). This leads to an overreliance by Ofcom on certain sports content and the use of an erroneous and poorly applied test for defining the market. Furthermore, the market definition analysis continues to rely on the cellophane fallacy when there is no finding of high prices. Its use leads to a self-fulfilling prophecy that prevents Ofcom ever finding a relevant market wider than its erroneous starting point;

1.3.2 Ofcom is incorrect in its vague and unsubstantiated assessment of the competition concerns that apparently arise out of content aggregation;

1.3.3 Ofcom's assessment of market power at the wholesale and platform level and the competition law consequences of Sky's position is flawed and appears to suggest that Ofcom believes (wrongly) that any perceived market power requires remedy per se. Ofcom also fails properly to recognise the purpose and impact of the Commitments given by the PL to the Commission (especially in relation to barriers to entry). Ofcom's market share calculations are unclear and in a bidding market, where market shares are transient, they are not an indicator of market power. Furthermore, Ofcom's analysis of market shares fails properly to account for the competitive constraint posed by sport content on FTA and other channels. Ofcom also relies upon unsubstantiated assertions about Sky's historical and future position in bidding for PL rights that are irrelevant and do not amount to proof that Sky has market power now. For instance, Ofcom largely ignores the very important likely impact of "*regulatory gaming*" by some of Sky's competitors in the last PL auction and the fact that, to date, vertically integrated platform/retail competitors of Sky have simply not wanted to secure and exploit live PL rights;

1.3.4 Ofcom's competition concerns are flawed and fail to identify a coherent, credible and evidenced theory of harm that identifies how consumers are adversely affected. Ofcom relies on a weak, vague and speculative analysis of alleged unmet demand and makes no actual finding that there are high wholesale or high retail prices or what potential innovation is being stifled/prevented.

1.3.5 Ofcom continually conflates broadcasters and retailers with platform operators/retailers when considering what the effects are of Sky's alleged behaviour. This causes Ofcom to fail coherently to explain what its concerns actually amount to; and

1.3.6 Ofcom's proposed remedy will have serious negative consequences for Sky's revenues and the value Sky places on content rights including live PL rights and a wide range of other sports rights. The remedy will also reduce or remove the incentives on others to bid for content rights including live PL rights. This will devalue PL rights which will harm the PL's member clubs, football and most importantly consumers. The same is true for other UK sports and this can only lead to less investment in UK sports, to the detriment of consumers.

1.4 It is also clear that Ofcom's intervention is also based on a flawed and entirely unexplained concept of "*fair and effective competition*" in circumstances where Sky's alleged actions do not amount to any infringement of Article 82 EC/Chapter II CA98. Nowhere does Ofcom explain what "*fair and effective*" competition is and Ofcom cannot use an unknown and unexplained concept to remedy the fact that other platform operators have chosen not to bid for and utilise content on their own services. It is not sufficient for Ofcom to identify features of the market it does not like and describe these as an example of a lack of "*fair and effective competition*". When analysing the market Ofcom should still apply the normal competition rules even if it intends to use sectoral powers to remedy any concerns.

1.5 This is not a case about margin squeezing, excessive pricing, refusal to supply or excess profits. Ofcom itself recognises that Sky's actions do not amount to this[3]. Furthermore, Ofcom ignores the fact that the wholesale price Sky currently charges is in fact already regulated by the OFT's margin squeeze case in 2002. The rate card price does not produce a margin squeeze which results in Virgin Media being unable to compete. It clearly chooses not to.

1.6 Furthermore, "*core premium content*" is not an essential facility that Sky, as an allegedly dominant undertaking, would be forced to supply irrespective of any other concerns.

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[3] Paragraphs 8.16 - 8.21 Consultation

1.7 Absent a finding that the content is an essential facility (which Ofcom itself accepts it could not make in this case), there is no reason why Ofcom should have competition law concerns that Sky's actions have led to a lack of platform choice and that this is a bad thing for consumers per se. This is highly illogical given that Ofcom does not find that there are high retail prices or identify what innovation is being stifled. Furthermore, Sky's sports channels are available on the DSat platform, the cable platform, Tiscali's IPTV Platform and 3G mobile networks. There is no lack of platform choice.

1.8 Therefore, there is no cogent basis for imposing such a drastic remedy that will cause significant harm to consumers.

1.9 This is clear in Ofcom's inability to describe or (where possible) quantify the detriment consumers are suffering that it intends to remedy. Therefore, it can have no proper idea what its remedy will achieve. On this basis Ofcom cannot even begin to complete a proportionality assessment and impact assessment; let alone a satisfactory proportionality test. The regulated terms proposed by Ofcom also remain to a large extent unclear. This is unacceptable and, because Ofcom has not carried out a proper impact assessment, important stakeholders have not had a chance to comment on Ofcom's proposals.

1.10 Furthermore, given the lack of findings by Ofcom that there are high retail prices in the first place it is inconceivable that Ofcom could properly have concluded that its static welfare analysis demonstrates that (post-remedy) there will be a consumer surplus over five years of £370m[4]. In fact, it recognises that this figure is highly uncertain[5]. Moreover, the basis for its calculation is irrational. Ofcom cannot draw any meaningful conclusions from its consumer surplus calculation as there is nothing against which to compare it. This is not a meaningful economic test.

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[4] Furthermore, there is no explanation of this calculation so it is impossible to comment on its accuracy or otherwise.

[5] See paragraph, 1.69 Consultation

1.11 Moreover, in relation to the costs of the remedy (i.e. the economic costs and not just the implementation costs for Sky) Ofcom wrongly concludes (by assumption) that there will be no impact on the value of rights to rights holders. Therefore, it fails to take into account how damaging the remedy will be for content producers and therefore for consumers.

1.12 It is obvious that, if the remedy is imposed, Sky will lose significant wholesale and retail revenues. The mechanics of the proposed wholesale price (including the guaranteed retail margin and the ratchet) mean there will be significant scope for increased retail price competition by alternative retailers that take it up. In fact this appears to be what Ofcom envisages in Section 6 of the Consultation.

1.13 If Ofcom has not set the wholesale price at exactly the right level (which it clearly has not) price competition will instantly reduce Sky's retail revenues as customers either switch or Sky has to lower its retail prices (losing margin) to compete with retailers that have been handed a subsidy by Ofcom.

1.14 Any lowering of retail prices by Sky will automatically reduce the wholesale price but protect the retail margin for Sky's wholesale customers. Sky will not make up this loss in increased wholesale revenues. This price cutting is likely to continue until the wholesale price hits the cost - plus floor; causing the devaluation of rights that even Ofcom recognises would happen in that situation[6].

1.15 The consequence is that the value of sports rights will be significantly diminished to Sky; who will bid less for them as a result. The incentives on others to bid will also be removed or lowered by the remedy; thus lowering the value of sports rights. This will reduce the quality of the product which is created by sports rights owners and made available to spectators and fans as well as pay and FTA television viewers. This will be to the detriment of consumers. Ofcom fails to recognise this simple yet potentially catastrophic consequence of its proposed intervention in its proportionality assessment.

1.16 It is plain that Ofcom's proposed action is being driven by the views of platform operators/retailers who have, to date, been unwilling to invest in content themselves

6 Paragraph 8.81 Consultation

and who simply want to free ride on the back of investments in content and development/innovation made by Sky. Far from improving the situation for consumers the remedy will in fact be to the detriment of consumers as it will critically, reduce the quality of the content (due to reduced value of sports rights) which consumers want to watch (whether on television or at the stadium).

1.17 Finally, to the extent that Ofcom's concerns simply relate to platform choice for consumers this is easily capable of resolution by allowing Sky to continue with its Picnic proposals and to retail on DTT. The expansion of the DTT platform is being blocked, not by Sky's activities, but by Ofcom's refusal to allow Sky to continue with its Picnic proposal in light of the Consultation. Moreover, the fact that Ofcom has made no findings of high retail prices means there can be no concern that Sky would keep retail prices high or manage retail competition if it also retailed on DTT. The retail price would simply continue to be at competitive levels and Sky would have to compete with the retail offering, which includes ESPN, on DTT. Furthermore, allowing Sky to retail on DTT is the least onerous option available to remedy Ofcom's concern and as a result is the option that should be implemented in accordance with a adequate proportionately assessment. It would not, for instance, detrimentally affect the value of the PL's rights or the incentives on broadcasters to bid for the rights.

2. INTRODUCTION

2.1 This response to Ofcom's Pay TV Investigation Third Consultation (the "**Consultation**") is submitted for and on behalf of the FA Premier League (the **"PL"**) by DLA Piper UK LLP. The PL is a private limited company whose shareholders are its member football clubs which participate in the PL competition in each football season (which runs annually from August to May).

2.2 The PL has sought to address all issues raised in the Consultation which may affect its member clubs, the Commitments (the "**Commitments**") given by the PL to the European Commission (the "**Commission**") in 2006 and/or the sale and the use of PL live rights.

2.3 The PL is not to be taken as agreeing with or accepting any issues or conclusions in the Consultation which are not directly addressed in this response.

2.4 Where appropriate the PL refers Ofcom back to its responses to Ofcom's First and Second Consultation.

2.5 This response focuses on key issues of: Ofcom's market definition/market power analysis; Ofcom's theory of harm; the terms of the proposed remedy; Ofcom's proportionality and impact assessments; and the detrimental impact of the proposed remedy on rights holders and ultimately consumers. It also contains, where the PL is able to comment, the PL's responses to each section of the Consultation (under the same headings used by Ofcom).

2.6 Save in relation to Section Nine of the Consultation the PL does not directly answer the Consultation Questions.

3. OFCOM'S JURISDICTION

3.1 In the PL's Second Submission (dated 24 April 2009), following the Second Consultation, the PL questioned whether Ofcom had the power to intervene under S.316 CA03 in the way it proposed. Ofcom purports to deal with these concerns (and Sky's arguments on this issue) in Section 2 of the Consultation. However, it simply fails properly to consider the Communications Act and what it means. In particular Ofcom wholly fails to explain what it considers the key words in section 316(1) of "*ensuring fair and effective competition*" actually mean in this context.[9] Absent any such explanation, Ofcom is obviously not in a position properly to satisfy itself that

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9 So far as the PL has been able to ascertain, Ofcom has never previously published any statements or guidance as to the correct interpretation of s 316 CA 03. In paragraph 5.33 of its Statement dated 9 May 2006 relating to its Review of the Cross-Promotion Rules, Ofcom did express the view that "*a key issue in considering whether conduct might be prejudicial to fair and effective competition is whether the conduct is having, or might be expected to have, a material impact on the competitive process*." However, no reference to this approach is even made in the Third Consultation.

the licence conditions it proposes imposing upon Sky are licence conditions that can properly be regarded as falling within s 316 at all.

3.2 For the reasons developed below, the PL in any event submits that if s 316 is properly interpreted and applied it is clear that Ofcom does not have jurisdiction to impose a must offer obligation on Sky in this case.

3.3 In this respect, the starting point must of course be the language of s 316 itself. As Ofcom itself appears to recognise, the sectoral power that s 316 confers is not a wholly unlimited one to impose whatever licence conditions Ofcom may consider appropriate. Rather it is a power to impose conditions that are appropriate "*for ensuring fair and effective competition*". That phrase, which is not defined in CA 03, therefore, clearly provides an important constraint on Ofcom's ability to act under s 316 in any given case.

3.4 Before contemplating any action under s 316 in any case, it is therefore plainly necessary for Ofcom to have given consideration to the proper meaning of this phrase and hence the appropriate ambit of its statutory jurisdiction. Yet nowhere in the Consultation does Ofcom do so. Rather, it merely asserts (without any analysis or explanation) that it considers that the concept "*has a different purpose and scope*" to protecting against the occurrence of agreements and behaviour that would constitute breaches of CA 98.[10] On this basis, Ofcom also reaches the conclusion that it has jurisdiction to take action in this case, notwithstanding its own recognition that the conduct of Sky which it views with concern is conduct that does not constitute a breach of CA 98.[11]

3.5 The PL submits that Ofcom's approach in this respect is fundamentally flawed. In particular:

3.5.1 it fails to recognise that the very purpose of the provisions of Chapters I and II of CA 98 (and the provisions of the EC Treaty which they mirror),

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10 Paragraph 2.20 Consultation.

11 See paragraphs 8.16 to 8.20 of the Third Consultation.

prohibiting certain categories of anti competitive conduct, is to ensure that fair and effective competition is enabled and maintained;[12] and[13]

3.5.2 it nowhere attempts even to grapple with, let alone explain, why conduct that is recognised by the European Courts and the European Commission as not impairing fair or effective competition even when conducted by a dominant undertaking, is nonetheless to be regarded as impairing fair and effective competition for the purposes of s 316 CA 03.

3.6 Indeed, it cannot have been the intention of Parliament, when it granted Ofcom a sector specific competition regime, to allow Ofcom to use a wide ranging and vague standard to remedy concerns that have been recognised as a matter of European and UK competition law not to give rise to consumer detriment.

3.7 Specifically, as regards the conduct on the part of Sky of the type with which Ofcom is generally concerned in this case, namely a possible refusal to supply, it is to be noted that:

3.7.1 As a matter of European competition law, it has long been recognised that the interests of ensuring that effective competition is not restricted or distorted does not generally require the imposition of an obligation upon any undertaking, even one with market power, to contract with any particular

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12 Indeed Article 3(g) of the EC Treaty specifically provides that the activities of the European Community include a "system for ensuring that competition in the internal market is not distorted". Articles 81 and 82 EC (which are mirrored in the CA' 98) are amongst the specific Treaty provisions giving effect to this aim. In its recent Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertaking (published on 9 February 2009 (C(2009) 864 final)), the European Commission has thus repeatedly described its activities under Article 82 in terms of ensuring "effective competition between undertakings" and protecting an "effective competitive process." See, for example, paragraphs 5, 6 and 19 of the Guidance.

13 Indeed, in this context it is also noteworthy that when imposing a licence condition on British Telecommunications under s 7(5) of Part II of the Telecommunications Act 1984, which enabled it to impose conditions requisite or expedient having regard to the duties imposed on him by Section 3, including a duty "to maintain and promote effective competition between persons engaged in commercial activities connected with telecommunications in the United Kingdom" the Director General of Telecommunications imposed a condition that mirrored the wording of Article 81 and 82 EC. In *R v Director General of Telecommunications ex parte British telecommunications plc* [1997] C.L.Y. 4844, the Administrative Court (comprised of Phillips LJ and Hooper J) held that the DGT's powers to "maintain and promote effective competition" under Part II of the Act and its powers under part III of the Act to take action under the fair Trading Act 1973 and the Restrictive Trade Practices Act 1980 were both aimed at promoting the same objective, namely freedom of competition.

party. As the European Commission has itself recently emphasised,[14] this is because:[15]

> "*the existence of such an obligation – even if for fair remuneration – may undermine undertaking's incentives to invest and innovate and, thereby, possibly harm consumers. The knowledge that they may have a duty to supply against their will may lead dominant undertakings – or undertakings who anticipate that they may become dominant – not to invest, or to invest less in the activity in question. Also, competitors may be tempted to free ride on investments made by the dominant undertaking instead of investing themselves. Neither of these consequences would, in the long run, be in the interests of consumers*."

3.7.2 As Ofcom itself recognises at paragraph 8.18 of the Consultation, in a case where the party with market power on an upstream market competes on a downstream market with a buyer whom it refuses to supply, it has long been recognised as a matter of European competition law that the purpose of preventing distortion of competition only requires the imposition of an obligation to supply in exceptional circumstances where the good or service in question is objectively indispensible for operators to be able to compete effectively on the market, such that the refusal to supply is liable to eliminate, immediately or over time, effective competition in the downstream market.[16]

3.7.3 These principles are recognised equally to apply in the case of the exploitation of intellectual property rights, where it has been acknowledged that to impose an obligation upon the proprietor of a protected design to grant third parties, even in return for a reasonable royalty, a licence for the supply of products incorporating the design would lead to the proprietor thereof

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14 See paragraph 75 of the Commission's guidance on Article 82.

15 See also, for example, the comments of AG Jacobs in Case 7/97 *Oscar Bronner v Mediaprint* [1998] ECR I -7791, at paragraphs 57 to 58 ("the justification in terms of competition policy for interfering with a dominant undertaking's freedom to contract often requires a careful balancing of conflicting considerations. In the long term it is generally pro-competitive and in the interest of consumers to allow a company to retain for its own use facilities which its has developed for the purpose of its business. For example, if access to a production, purchasing or distributing facility were allowed too easily there would be no incentive for a competitor to develop competing facilities. Thus while competition was increased in the short term it would be reduced in the long term. Moreover, the incentive for a dominant undertaking to invest in efficient facilities would be reduced if its competitors were, upon request, able to share the benefits. Thus the mere fact that by retaining a facility for its own use a dominant undertaking retains an advantage over a competitor cannot justify requiring access to it.".

16 See also, for example, Case 7/97 *Oscar Bronner v Mediaprint* [1998] ECR I -7791, at paragraphs 57 to 58

being deprived of the substance of his exclusive right.[17] The same is of course true of any requirement imposed upon a party acquiring exclusive media rights to a sporting event to entitle third parties also to exploit the same events.[18] Ofcom appears expressly to acknowledge this at paragraph 1.32 of the Consultation, where it states 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.*"

3.8 Yet, notwithstanding these clear principles, Ofcom does not even attempt to explain in the Consultation, let alone do so in a satisfactory manner, the basis on which it contends that a statutory provision permitting to impose licence conditions for the purpose of "*ensuring fair and effective competition*", entitles a licence condition to prohibit conduct that would not be regarded as restricting or distorting competition as a matter of Community or UK competition law. This failure is even more critical given the serious negative impact on rights holders such as the PL (and consumers) that will arise from imposition of the proposed remedy.

3.9 In this respect, the PL acknowledges that there is an important distinction between Ofcom's powers under s 316 CA'03 and its powers under CA98. The former clearly permits Ofcom to take action in advance of any anti competitive conduct occurring, whereas the latter does not. Indeed, it was this potential need for advance action that was highlighted in the statement to Parliament when s 316 was introduced to which Ofcom itself refers at paragraph 2.21 of the Consultation[19]. However, that distinction between Ofcom's respective powers under s 316 and CA 98, clearly does not justify Ofcom's apparent view that the words "*ensuring fair and effective competition*" have some broader (but as yet totally undefined) aim than the provisions of CA98 (and the EC Treaty) regulating anti competitive conduct.

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17 See, for example, Case 238/87 *Volvo v Veng* [1988] ECR 6211,. .

18 Indeed, in its orientation document on the Broadcasting of Sports events and competition law, published in 1998 (Competition Policy Newsletter 1998, No 2) the European Commission expressly noted that for the broadcaster exclusivity represents "the only way to guarantee the value of a given sports programme…"

19 Although Ofcom also refers in paragraph 2.22 of the Third Consultation to the views of a joint DTI/Treasury Report, the terms of that report (which does not appear even to have been addressing the specific terms of the CA '03) are plainly outside the category of material that can legitimately be referred to as an aid to statutory construction.

3.10 Nor is it permissible for Ofcom to rely (as it purports to do in para 2.23 of the Consultation) on s 3(1)(b) of the CA '03 as supporting the view that s 316 is to be given some broad meaning, unencumbered by the extensive existing case law under CA 98 (and the EC Treaty) on the nature of conduct that impairs fair and effective competition. This is because s 3(1)(b) CA 03 is not a free standing source of power for Ofcom. Rather, it merely defines the duties to be pursued by Ofcom "*in carrying out their functions*" (words which are significantly omitted by Ofcom in paragraph 2.23 of the Consultation). The extent of those functions and powers are accordingly defined by the other provisions of CA 03, in the present case s 316 CA '03, and cannot legitimately be broadened by reliance on s 3(1)(b).

3.11 Further, the other terms of CA 03 only serve to underline that s 316(1) does not have the broader purpose for which its appears Ofcom contends. In particular:

3.11.1 Under s 317(2), before imposing any licence condition under s 316, Ofcom is expressly required to consider whether a more appropriate way of proceeding would be under the CA98, thereby underlining the obvious overlap between Ofcom's powers under the respective provisions (subject to the distinction recognised above);

3.11.2 However, despite the fact that s 370(2) of CA 03 expressly confers powers on Ofcom to make a market reference to the Competition Act under s 131 of the EA 02 (in cases relating to commercial activities connected with communications matters) s 317 does not contain any similar requirement upon Ofcom, before taking action under s 316, to consider whether a more appropriate way of proceedings would be under the EA 02. The absence of any such requirement strongly suggests that Parliament did not envisage that s 316 would enable Ofcom itself to undertake an exercise akin to the market investigations that the Competition Commission ("**CC**") is enabled under EA 02 to conduct. Yet Ofcom's approach under s 316 of the CA 03 in this case appears to be that s 316 confers precisely such powers upon it.

3.12 Indeed, it appears clear from its Consultations that Ofcom considers itself to be engaged on an exercise that is akin to a market study or market investigation by the CC. However, in those types of inquiry there is a well defined and clear test that must be met before remedies can be imposed, namely a finding that there is a feature or features of the relevant market that prevent, restrict or distort competition and that action should be taken to remedy, mitigate or prevent the adverse effect and any detrimental effects thereof on customers (a phrase which is itself defined in s 134(5) EA 02). The EA 02 also imposes express and important safeguards to the recommendation of any remedy, for example an express duty on the CC to have regard to the effect of any action on any relevant customer. Yet, in this case, the standard on the back of which Ofcom is proposing to impose a remedy is neither well defined, well tested or clear in its aim of identifying consumer harm and preventing it. This cannot have been Parliament's intent in enacting s 316 CA 03.

3.13 Furthermore, the PL sets out below in relation to Section Ten of the Consultation its view that Ofcom's use of Sections 316 to 318 CA03, to impose the wide reaching and highly intrusive remedy it proposes, is disproportionate and in breach of its regulatory obligations under Section 3(3)(b) CA03.

4. SECTION THREE CONSULTATION - THE UK PAY TV MARKET

4.1 In Section 3 of the Consultation Ofcom sets out various conclusions it has reached in relation to the UK pay tv market and explains that there are particular characteristics of the market which it considers affect its assessment of whether it is appropriate for it to take action to ensure "*fair and effective competition*". The characteristics Ofcom focuses on are[20]:-

4.1.1 consumers preferences for content, and the particular importance of premium content as a driver of pay tv subscriptions;

4.1.2 content aggregation and the potential creation of market power;

4.1.3 fixed content production costs and the importance of price discrimination; and

4.1.4 vertical integration of firms which are active in the market and the incentives this creates.

4.2 In relation to the first, second and fourth characteristics identified by Ofcom, the PL refers Ofcom to Section 4 of its response to the Second Consultation as Ofcom

20 Paragraph 3.2 Consultation

largely repeats its previous conclusions in this Consultation. The PL's further comments are set out below.

4.3 Essentially, Ofcom fails to accord sufficient weight to the importance of other content (sport and non-sport) when assessing consumers' content preferences. In particular, Ofcom fails to acknowledge the diverse and high quality sports content on FTA. Whilst it is accepted that sport, including live PL matches, can be **a** driver of pay tv subscriptions it is not **the** driver and Ofcom's definitions and views of what amounts to premium content (as driving pay tv subscriptions) are too narrow. It is inherently unlikely that consumers value a single sport or sporting competition above all other content when deciding whether to purchase a pay tv subscription. This is clearly recognised by Ofcom in its finding that "*.....consumers have very varied preferences for different types of content. This was illustrated by the consumer research"*[21].

4.4 In addition, Ofcom has failed to recognise the need for content aggregation and has misunderstood the effects of content aggregation. This has led it to make unsubstantiated and erroneous statements about the possibility of the PL obtaining monopoly rents.

4.5 Finally, Ofcom makes a simplistic assertion that vertically integrated firms have an incentive to withhold inputs from that downstream competitors. The conditions necessary for that assertion to be feasible (let alone probable) are quite stringent (it is for this reason that vertical mergers are not necessarily seen as problematic). Yet Ofcom fails to show that Sky does have that incentive and that its behaviour is consistent with withholding premium content. The fact that Sky offers its channels at a rate card and that Sky's premium channels are retailed on Virgin Media's cable platform, Tiscali's IPTV platform and on 3G mobile phone networks suggests that Sky is not withholding. Moreover, Ofcom recognises the benefits of vertical integration but appears largely to largely ignore these in the rest of the Consultation.

PL's comments on Ofcom's analysis

4.6 Despite Ofcom's numerous statements, throughout the Consultation, about its "*concerns about the inability of new platforms to develop without core premium content"* Ofcom recognises, in paragraph 3.12 of the Consultation, that new platforms

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21 Paragraph 3.18 Consultation

for delivering pay tv services **have** emerged (e.g. BT Vision, Top Up TV, Tiscali/Home Choice) and that others also have the potential to deliver pay TV services (e.g. Freesat and Canvas).

4.7 The pay tv market is dynamic and varied and it is overly simplistic simply to look at "*core premium content"* as being the only key to a successful pay tv offering. Platforms do not simply compete on a pay tv offering and if a platform can offer other services that are attractive to consumers (e.g. broadband) then it will attract subscribers with or without Sky[22].

4.8 Ofcom clearly recognises that it cannot simply look to the past and that "*the future development of the market cannot in these circumstances simply be extrapolated from the past. Our analysis .....must therefore take a forward looking view, focusing on those characteristics of the market which are most likely to influence the development over the next few years*[23]*"*.

4.9 However, Ofcom does entirely the opposite and examines the importance of content (such as live sports content) in the context of the past only[24]. This leads to a weak conclusion on future developments that "*our view was and remains that live top-flight sports programming is likely to have an enduring appeal"*[25]. This is the only forward looking conclusion Ofcom attempts to reach and it is unexplained and unsubstantiated.

Consumer preferences

4.10 Whilst it may well be true that live sport does have an enduring appeal this does not mean that live sport is **the** most significant or effective content in driving pay tv subscriptions.

4.11 Moreover, the evidence cited by Ofcom does not support such a conclusion[26]. Ofcom in fact finds that there are three genres of content most valued by consumers and that these are sports, soap operas and films (see Figure 4 in Paragraph 3.21). However, Ofcom wrongly disregards soap operas on the basis that "*soap operas are widely*

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22 A "platform" is just a distribution technology and is not necessarily defined by a platform operator.
23 Paragraph 3.13 Consultation
24 See paragraphs 3.18 to 3.29 Consultation
25 Paragraph 3.31 Consultation
26 Paragraphs 3.16 to 3.34 Consultation

available on free to air television and so unlikely to be a primary driver of pay tv subscriptions". This ignores the evidence in paragraph 3.21 that soap operas are almost equally important as sport to pay tv customers (27% of pay tv and 31% of FTA decision makers say soap operas are "must have" content as opposed to 33% of pay tv and 31% of FTA decision makers who say sport is "must have" content).

4.12 Therefore, it is clearly a significant over-statement by Ofcom that "*sport [and films] are the genres which **stand out** as being amongst the most valued genres by consumers"*[27]. Sport is clearly just one of the "*must have"* types of content for consumers; it does not on its own drive pay tv subscriptions. Sport is also very important for FTA consumers.

4.13 The fact that Ofcom's own evidence shows that other content (and not just other sport content) is highly valued by subscribers across pay tv and FTA should not be disregarded by Ofcom.

4.14 This must have been recognised by Ofcom in its weak conclusion, that "***some** content can drive take up of pay tv services"*[28] (emphasis added).

Content aggregation

4.15 In paragraph 3.35 of the Consultation Ofcom describes the process of content aggregation in order to set up its conclusions that "*content aggregation has enabled Sky to gain a position of market power in the wholesale markets of premium sports and movie channels"*[29].

4.16 Specifically, Ofcom considers that "*Sky's market power is enabled by content aggregation ... specifically the aggregation of the rights to specific sporting competitions by sporting bodies such as the FAPL and the further aggregation by Sky to the rights to different competitions*"[30]. Ofcom explains this conclusion in paragraph 3.38 of the Consultation by stating that aggregation can result in the creation of market power in particular when it "*involves the aggregation within a narrow economic market of a number of pieces of content which otherwise might be full or partial substitutes for each other*".

27 Paragraph 3.22 Consultation
28 Paragraph 3.34 Consultation
29 Paragraph 1.2 Consultation
30 Paragraph 1.16 Consultation

4.17 However, Ofcom clearly misunderstands the need for and consequences of aggregation by the PL. This is dealt with further below in relation to Section 5 of the Consultation.

4.18 Content aggregation at the upstream level is necessary in order to ensure that a meaningful product is created for exploitation by broadcasters which showcases and/or tells the story of an entire competition.

4.19 Content aggregation by broadcasters is also essential in order for broadcasters to be able to provide distinct channels, programmes and bundles rather than a random collection of content. Ultimately content aggregation occurs because consumers demand it.

4.20 This can be seen in the noted benefits to content aggregation, which include:-

4.20.1 aggregation is often necessary in order to establish a pay tv proposition which consumers are willing to buy;

4.20.2 aggregation can benefit consumers by increasing the quality of content. For example, the collective selling of sports rights and the ability for broadcasters to aggregate content is recognised as: generating greater revenues that contribute to attracting a higher quality of playing talent; and to distributing the income from rights more evenly among teams, making contests more competitive and therefore more interesting for sports fans and supporters (including pay TV and FTA viewers).

4.21 Furthermore, content aggregation is not just relevant to pay tv. It is of equal importance to FTA and, for instance, without content aggregation the BBC would not be able to offer to millions of FTA viewers programmes such as Match of the Day or Football Focus; and ITV would not be able to offer its UEFA Champions League coverage.

4.22 Whilst the benefits of content aggregation are recognised (in a limited way) by Ofcom in paragraphs 3.36 and 3.37 of its Consultation they are given insufficient weight.

4.23 Moreover, Ofcom also attempts to use content aggregation to make irrelevant, vague and unsupported assertions about the possibility that there are monopoly rents flowing upstream[31]. However, it is unclear what Ofcom is seeking to assert by making these statements; particularly in light of its recognition that it is difficult to distinguish monopoly rents from scarcity rents associated with the talent that underpins the content. The PL's member clubs are faced with enormous wage bills to attract and retain playing talent and this benefits consumers directly. There can be no suggestion of there being any monopoly rents at the PL level.

4.24 Ofcom recognises that "*high salaries paid to some footballers…..may be an indication of market power, but could equally well reflect the scarcity value of football skills….this makes the precise identification of monopoly profits in content markets particularly difficult*"[32].

4.25 For these reasons there is also no basis for any suggestion that Sky is charging an excessive wholesale price for its channels because of monopoly rents at the PL level.

4.26 Therefore, Ofcom cannot implicitly assume that it is justified in imposing regulation in one market because it considers that **there might be** monopoly power in that market or an upstream market, even though it cannot be certain which.

4.27 Such an approach to regulation and in particular, drastic and intrusive regulation, is adhoc and punitive. Furthermore, the market for the sale of PL rights has already been examined by the Commission and there was no finding or even suggestion by the Commission that the PL is extracting monopoly rents.

Vertical integration

4.28 In paragraphs 3.52 to 3.56 of the Consultation Ofcom makes a number of high level and theoretical statements about the incentives on vertically integrated firms to refuse to supply wholesale services or to supply on less favourable terms than it supplies itself. As a result, Ofcom states that "***absent regulation****, there is a incentive for a firm that is vertically integrated between wholesale and retail market to refuse to*

31 Paragraph 3.40 Consulation
32 Paragraph 3.41 Consultation

supply wholesale services to other retailers, or to supply them on less favourable terms than the suppliers themselves"[33].

4.29 However, this statement is simply wrong. Vertical integration does not in and of itself require regulation.

4.30 Regulation (by competition law) would typically only be necessary if the vertically integrated firm was, say, dominant and operating a margin squeeze on its competitors. Ofcom recognises that there is no evidence that this is what Sky is doing[34].

4.31 Furthermore, the evidence considered by Ofcom in Section 6 of the Consultation does not support any finding that Sky is using its vertical integration in an abusive way. Ofcom must, therefore, dismiss any of its conclusions based on this flawed and theoretical approach to vertical integration.

5. SECTION FOUR CONSULTATION - MARKET DEFINITION

5.1 In the PL's response to the Second Consultation, the PL set out its comments on Ofcom's market definition analysis. The PL refers Ofcom to those submissions which in the large part remain extant.

5.2 However, it is noted that Ofcom has undertaken some supplementary work in the Consultation, in particular, with regard to:

5.2.1 the extent to which sport content on FTA imposes a competitive constraint on Sky; and

5.2.2 the relevant retail market.

5.3 The PL's detailed comments on market definition are set out below and Ofcom's conclusions on market definition can be summarised as follows:-

5.3.1 There is a separate narrow economic market for the wholesale of core premium sport;

33 Paragraph 3.55 Consultation

34 In the only other instance where regulation in the UK has intervened to break up vertical integration (The Beer Orders) the MMC irretrievably damaged the market and destroyed the businesses of many brewers.

5.3.2 Core premium sports channels comprise Sky Sports 1 and 2 and Setanta Sports 1 (now ESPN);

5.3.3 These channels are "*core premium sports channels"* because they contain "*highly popular live sporting events shown regularly throughout the year and this content distinguishes them from other channels which feature less popular events";* and

5.3.4 There is a narrow market for the retail of packages including core premium sports to residential customers because demand-side substitution is unlikely and entry by new suppliers in the short term is also unlikely because of lack of wholesale availability of relevant channels.

5.4 Therefore, Ofcom's conclusions are predicated on a conclusion that at the wholesale and retail level sport content (and certain types of sport content) is in a market on its own and is not constrained by any other content. Furthermore, the sport content that Ofcom is concerned with apparently has certain qualities that mean it is only available on pay tv.

5.5 Firstly, as set out in its response to Section 3 of the Consultation the PL disputes Ofcom's view that sport content is not constrained by other television content, and that it is the key driver of pay tv subscriptions. Whilst sport content is clearly important television content for some viewers it is not the only important content for viewers. For instance, consumers across FTA and pay tv are equally as interested in watching soap operas[35] as they are in watching sport.

5.6 Therefore, it is plain that Ofcom does not understand that content **in all its different forms** is what makes up a television offering. Retailers or broadcasters will seek a wide variety of content to offer consumers. Broadcasters will want to acquire, and will select content from, a variety of sport, soap operas, dramas, documentaries and other programming genres in order to produce either thematic channels or to produce a wide variety of programmes on a channel, or across channels, in order to offer a wide variety of content at the wholesale level. Ofcom ought to have analysed this properly and considered, by reference to content generally, what content is substitutable at a wholesale level.

[35] Figure 4 page 41 Consultation

5.7 Ofcom purports to have done this[36] by considering what retail customers' preferences are to determine how to define the wholesale markets. However, Ofcom should have considered how platforms/broadcasters would react to consumer preferences e.g. if the wholesale price of sports content was too high platforms/broadcasters would switch to other wholesale content inputs to offer consumers. Although sports and movies (at least) are both, according to Ofcom, drivers of pay tv take up, Ofcom only looked at consumer preferences in the context of sports content (by reference to what is on Sky Sports). It also ignores (for no plausible reason) the findings of the Seabright study and the CC's conclusions in the ITV/BSkyB merger inquiry which support a finding that the relevant retail market is an "*All-TV*" market[37]. If the retail market is an "*All-TV*" market then the wholesale market is also likely to be "*All-TV*".

5.8 In summary, the PL's position on Ofcom's market definition analysis is that:

5.8.1 Ofcom got the starting point of its analysis of market definition wrong by not looking at how platforms/broadcasters use content as wholesale input.

5.8.2 There are not separate markets for the supply of particular content for the production of channels for pay tv or FTA. Retailers of pay tv and broadcasters can choose from a wide variety of content and their purchasing decisions in relation to content are not necessarily driven by individual consumer preferences that may occur at a consumer level ;

5.8.3 Ofcom's approach to the evidence on substitutability of content to identify and define markets is flawed, highly selective, inconsistent and incorrectly disregards evidence which does not support Ofcom's pre-existing view of the markets;

5.8.4 Ofcom' fails to take into account the importance of a wide range of high value sports content available on FTA and wrongly attempts to argue that all such sports content is one-off events and not regular;

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36 Figure 6 (5th row, 2nd column) page 63 Consultation

37 Paragraph 4.169 and 4.179 Consultation and 4.179 Consultation (but note that Ofcom again is only focussing on sport and ignoring the more fundamental question of what content competes for viewers)

5.8.5 Ofcom's treatment of the cellophane fallacy and approach to the hypothetical monopolist test ("HMT") is illogical given its own inconclusive findings on wholesale pricing and no finding that retail prices are high.

The Cellophane Fallacy

5.9 Ofcom states that any HMT and critical loss analysis it undertakes in this case will be subject to the cellophane fallacy; *"the scope to apply the HMT empirically in the present case is compromised by the cellophane effect"*[38]. However, as the cellophane fallacy will only take effect when prices are above competitive levels, it would appear that Ofcom has assumed that prices are above competitive levels.

5.10 Yet, on the contrary Ofcom's conclusions on the level of wholesale pricing are inconclusive[39] and it does not find that there are high retail prices. The PL is not in a position to comment in detail on the analysis, but notes that high margins in the broadcasting industry do not suggest that wholesale or retail prices are high or that there is not a competitive market. As Ofcom has acknowledged, it is hard to identify the competitive price in this market because fixed costs are very high and marginal costs are very low[40]. It is to be expected, therefore, that prices will be above the marginal cost and difficult to determine how much higher they will be[41].

5.11 Accordingly, Ofcom is not justified in concluding that pricing is above competitive levels on this basis.

5.12 Ofcom also seeks to argue that absent any evidence of Sky's excessive profitability, it should be concerned that prices are above competitive levels for two reasons:

5.12.1 "*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*"[42]; and

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38 Paragraphs 4.43 and 4.44 Consultation.
39 Paragraph 4.28, 4.30 and 4.48 Consultation
40 Second Consultation, paragraph 4.47
41 Paragraph 4.26 Consultation
42 Paragraph 4.53 Consultation

5.12.2 "*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, lending to prices above the competitive levels, 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*."[43]

5.13 The first of these points provides no evidence in relation to the level of competitive pricing and is not a reason to be concerned that prices are above competitive levels: it is merely a statement as to what the implications are of prices being only moderately above competitive levels, were that to be established.

5.14 The second point relating to the potential for rights owners to extract monopoly rents is baseless speculation. Ofcom has no evidence to support its theory and the theory is in fact flawed by virtue of the existence of scarcity rents (which Ofcom recognises exist). In any event, there is no force in the reference to joint selling. The most saleable and attractive product (to broadcasters and consumers) arises at the level of the league. The product that might be sold individually by football clubs is quite different and inferior (if it could be sold at all). The fact that the PL content is attractive to certain broadcasters and viewers does not provide any evidence that the PL is extracting any monopoly rents.

5.15 Ofcom repeatedly relies on the assumed existence of the cellophane fallacy to reject evidence which is inconsistent with its findings in respect of market definition and market power. However, Ofcom fails to provide any direct evidence that pricing is above competitive levels and it is, therefore, not entitled to assume that the cellophane fallacy applies. Since its use of the cellophane fallacy is not supported by any finding that pricing is above competitive levels, Ofcom's conclusions on market definition and market power are not reliable.

Ofcom's approach to defining wholesale markets: Sky Sports 1

5.16 In its analysis of what is to be included in the relevant wholesale markets Ofcom states that it has started with Sky Sports 1. This is the wrong approach to market definition and produces a self-fulfilling result. At the wholesale level Ofcom should be concerned with assessing what content retailers of pay tv services and broadcasters

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[43] Ibid, second bullet point

need and want to purchase to create a customer offering. This does not start with an analysis of only Sky Sports 1's characteristics to define what is to be included in the relevant wholesale markets.

5.17 In any event, the characteristics that Ofcom notes apply to sports content on Sky Sports 1 [44] are equally applicable to sports content which is available on FTA and other pay tv services.

5.18 The characteristics considered for Sky Sports 1 are:

5.18.1 It contains a very significant volume of live sport;

5.18.2 That sport content is highly valued by consumers - reflected in preferences and amounts paid for rights; and

5.18.3 It shows live events that are frequently and regularly available: which is important for driving pay tv subscriptions.

5.19 As set out above, Ofcom ignores the fact that there is sport content on FTA that equally fits these characteristics (high volume, highly valued by consumers; and frequently and regularly available).

5.20 On the basis of Ofcom's own data in Figure 7 the following very important, high volume and/or frequent/regular sport is on FTA either exclusively or equivalent volume to that on Sky Sports 1:

5.20.1 FA cup matches;

5.20.2 UEFA champions league matches;

5.20.3 UEFA Europa League matches;

5.20.4 Rugby Six Nations;

5.20.5 Rugby Union Magners League;

5.20.6 Rugby League Challenge Cup; and

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[44] Paragraph 4.69 Consultation

5.20.7 Wimbledon tennis.

5.21 In addition, Figure 7 for some inexplicable reason chooses to ignore other very important and/or frequent/regular sport available on FTA such as Formula One motor racing which takes place annually and on a regular basis between March and October.

5.22 In addition, other very high quality annual and important sporting events are also available on FTA and would constrain the pricing of Sky Sports 1, including:

5.22.1 England football internationals;

5.22.2 Golf - The Open;

5.22.3 Golf US Masters;

5.22.4 Golf Scottish Open;

5.22.5 Stella Artois tennis.

5.22.6 Rugby Union England internationals.

5.23 Whilst Ofcom attempts to recognise that there is a wide range of sporting content available on FTA digital channels and FTA (and that they do hold highly valued live rights[45]) it reaches the wrong conclusions when considering the extent to which the price of Sky Sports 1 is constrained by content on other channels, by reference to:

5.23.1 Indirect constraints - e.g. product characteristics, consumer preferences, consumers response to a SSNIP and potential FTA constraint;

5.23.2 Supply side substitution potential;

5.23.3 Direct demand side substitution; and

5.23.4 Changes to wholesale prices.

Indirect constraints: Product characteristics/consumer preferences

5.24 At paragraph 4.99 - 4.101 of the Consultation Ofcom sets out its approach to considering what live sports content is a substitute for the content on Sky Sports 1.

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45 Paragraph 4.74 Consultation

This is a progression from its previous views in the Second Consultation where it had limited its definition of core premium sport to essentially just live PL matches.

5.25 Whilst the PL welcomes Ofcom's acknowledgement that consumer preferences demonstrate a desire for sport other than live PL matches[46] it continues to dispute Ofcom's conclusions that there are no close substitutes on FTA for the sports shown on Sky Sports 1 sufficient to constrain Sky Sports 1.

5.26 Following an analysis of the sport available on Sky's sports channels, and the possible substitutes for that content and consumer preferences, Ofcom states that *"[w]e 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. We therefore think it is unlikely that FTA would be a sufficient indirect constraint. However, we acknowledge that some sport set out in Figure 7* [i.e. sport available on free to air TV] *might act as a strong out of market constraint on a monopolist wholesale of premium sports channels"*[47].

5.27 The PL disagrees with this conclusion for two main reasons.

5.28 Firstly, whilst Ofcom is correct to recognise[48] the high quality sporting content on FTA, and that this acts as a constraint on pay TV, the approach to and selective nature of its analysis results in the extent of the constraint imposed being understated and so the market being defined too narrowly.

5.29 Ofcom repeatedly refers to the importance of "*regularity and quantity*" of sports content[49] and asserts that one-off, high quality, sporting events such as Wimbledon or the Rugby Union Six Nations cannot be substitutes for sporting content on Sky. However, this claim is not supported by any evidence. There is no explanation of why regularity is deemed so important and in any event this claim is flawed for the reasons explained below.

5.30 Ofcom errs in its analysis that certain events, which are not '*available on a regular basis*' are not substitutable with regular events such as PL matches. This reliance on "regularity" is without foundation or explanation. Ofcom has also not provided any

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46 See paragraph 4.95, 4.97, and 4.99 Consultation
47 Paragraph 4.134 Consultation
48 Paragraph 4.127 Consultation
49 Paragraph 4.128 Consultation

evidence to support its assertion but it is repeatedly relied on. Furthermore, Ofcom's own evidence contradicts its reliance on "regularity" in order to exclude other sports content. As set out in Figure 10 of the Consultation, most of the non-football key sports events cited as important by subscribers are not regular events over a period of several months yet they are considered more important than more regular events in the relevant sport. For example, Wimbledon is more important than the ATP or LTA tours; and the Rugby Union Six Nations is more important than either the Heineken Cup or the Guinness Premiership (which Ofcom describes as 'valuable sports content' for Sky)[50]. Moreover, an event such as Wimbledon (although not regular over a period of months) provides 13 consecutive days of the highest quality sport and during the summer months when other sports such as football and rugby are not available to broadcasters. As such, an event such as Wimbledon would be extremely attractive to a pay TV broadcaster. Ofcom's assumption, therefore, that events that are not regular are of no value is unfounded.

5.31 Moreover, Ofcom ignores the fact that there is also a high quantity of regular sporting events on FTA throughout the year (e.g. Formula One).

5.32 In addition, Ofcom's reference to the sports on Sky Sports 1 actually include sport that is neither regular nor broadcast in high quantity. For example, the Golf Ryder Cup and the US Open (both golf and tennis) are one-off sporting events yet Ofcom includes these in its descriptions of sport on Sky Sports 1 that is regular, valuable and broadcast in high quantity i.e. sport that is not substitutable with sport on FTA. Alternatively, if Ofcom regards these events as regular, valuable and broadcast in high quantity then Ofcom should have included equivalent events on FTA (for example Wimbledon, the British Open and the US Masters) in its definition of the market e.g. those listed above.

5.33 Secondly, the PL disputes the approach taken by Ofcom in only considering exact sporting substitutes for the particular sports shown on Sky Sports 1. Accordingly, Ofcom's analysis only considers the coverage of: football; cricket; golf; rugby union; rugby league; and tennis.

5.34 This approach means that Ofcom wrongly disregards the importance of other high quality sports shown on FTA TV but which are not covered at all on Sky including:

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[50] Paragraph 4.95 Consultation

Formula One Motor Racing, Moto GP, the Winter and Summer Olympics, the World Athletics Championships, the Grand National, the Cheltenham Festival, the Derby (and numerous other horse racing events), the Snooker Grand Prix, World Championship Snooker, the darts Grand Slam, the Tour de France, and events such as the London Marathon, the London Triathlon, the Great North Run and the Oxford and Cambridge boat race.

5.35 Furthermore, considering only the sports which are currently covered by Sky creates a skewed picture: there are a limited number of events in each sport's calendar so if Sky owns the rights in respect of some of those events, then necessarily there will be less substitutable content available on other channels in respect of that particular event. Ofcom should have taken into consideration *all* sport broadcast on both pay TV and FTA in order to assess the extent to which sport content on FTA constrains sport content in pay TV.

5.36 This is particularly important given Ofcom's acknowledgement that *"FTA broadcasters also hold a number of other highly valued live rights (either exclusively or with pay TV operators)"* and its citation (in footnote 91) of some of the events listed above.

5.37 The PL attaches at **Annex 1** a complete list of all the key sports content on FTA throughout the year. However, it is not properly explained why Ofcom does not give these events sufficient weight in its analysis or why it does not consider them relevant to its assessment of what available substitutes there are to the content on Sky, save that they are allegedly not capable of matching the "*quantity of regularly available content"* on FTA[51].

5.38 The quantity of key sports content (set out in **Annex 1**) available on FTA throughout the year completely undermines any conclusion by Ofcom that the sport on FTA is not of sufficient quantity, or regularly available. Ofcom also could not possibly conclude that this wealth of sport content is not of the highest quality and attractiveness to consumers.

51 Paragraph 4.134 Consultation

5.39 Therefore, Ofcom's approach to regularity and quantity of programming is flawed in that it results in Ofcom wrongly concluding that content on FTA does not fall within the same market as pay TV sports content.

5.40 In conclusion, the errors in Ofcom's analysis, set out above, lead it to draw the market definition too narrowly and incorrectly conclude that certain pay tv sports content falls within a different market to FTA sports content.

Indirect Constraints: Consumer's response to a SSNIP and observed response to price changes

5.41 In paragraph's 4.135 to 4.162 of the Consultation Ofcom seeks to assess whether consumers' responses to a SSNIP and observed price changes support its narrow market definitions.

5.42 However, on its own admission the evidence does not actually support it and we are not taken any further by this analysis. On the contrary it points to a wider market definition.

Indirect Constraints: Assessment of the constraint from FTA

5.43 As set out above the PL disagrees with Ofcom's conclusion[52] that FTA places a limited constraint on Sky Sports because (even though it is of high value and high quality) it is infrequent. **Annex 1** contains a list of the high quality and attractive sporting events available on a regular basis on FTA throughout the year. Annex 1 demonstrates conclusively that this is just a false conclusion on Ofcom's part; and one that ignores the regular, high quantity of high quality content available on FTA throughout the year.

5.44 In any event, Ofcom's rejection of the impact of FTA (specifically Freeview) on Sky Sports is weak and based on conclusions that are unsupported - even in Ofcom's own work.

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[52] Paragraph 4163 Consultation

5.45 Ofcom acknowledges that the Seabright Study demonstrates that there is interaction between the demand for FTA and pay tv[53]; and that sport on FTA may now be a closer substitute for sport on pay tv.[54] Its rejection of Seabright has no validity and appears to be based on Ofcom's reluctance to use any evidence that does not support its case.

5.46 Therefore, Ofcom's conclusions on indirect retail constraints are wrong and as such Ofcom cannot rely on this to sweep aside the need to do a proper analysis of wholesale demand side substitution.

Conclusions on wholesale markets

5.47 Ofcom is wrong to conclude that sport on FTA lies outside its relevant wholesale market. It fails to start its analysis from the correct point and it fails to take into account sport that meets its own characteristics for being "*core and premium*".

5.48 Furthermore, it incorrectly relies on the cellophane fallacy (when there are no findings of high retail prices and the conclusions on wholesale prices are inclusive) to avoid properly conducting a SSNIP test in relation to subscribers' price sensitivity. In any event, it is self evident that consumers want a wide variety of content and will be price sensitive in relation to all content if retail prices were to increase. This cannot support a narrow wholesale market.

Retail markets

5.49 In relation to retail market definition Ofcom repeats its analytical error of referring to the cellophane effect in order to discount its own findings that consumer demand is highly elastic e.g. customers would switch in the event of a 5% price increase.

5.50 As set out above, the cellophane fallacy has no relevance in this case as Ofcom has not found there to be high retail prices. Therefore, it should not discount evidence of switching on this basis.

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53 Paragraph 4.181
54 Paragraph 4.172 Consultation
56 Paragraphs 5.1 and 5.10 Consultation

5.51 Finally, Ofcom concludes that sport content (and other content) on FTA is not a demand side substitute for Sky Sports 1 and 2. It is plainly wrong for the reasons set out above. Therefore, Ofcom's conclusions on retail markets are insufficiently evidenced and manifestly incorrect.

6. SECTION FIVE CONSULTATION - MARKET POWER

6.1 In Section 5 of the Consultation, Ofcom sets out its conclusions on market power and the basis of its conclusion that Sky has market power at both the wholesale and retail level. Sky's market power at the wholesale level apparently comes from its control of key rights and Ofcom makes its assessment by reference to the current position and what is likely to happen in the next three to four years[56]. Ofcom focuses its analysis almost exclusively on the PL's rights and their relationship with Sky's alleged market power.

6.2 However, in bidding markets historical bidding patterns and market shares are largely irrelevant. Furthermore, it is typically very difficult to predict the future with any degree of accuracy or certainty. At the next auction of the PL's rights (or any other sports rights) everything could change (this is the nature of sealed bid auctions where the highest price wins) and Ofcom cannot rely on previous auctions to predict the outcome in three to four years time. Furthermore, when making predictions about the future, cogent, clear and strong evidence is required; all of which is lacking in the Consultation.

General Comments

6.3 Ofcom's analysis in relation to Sky's alleged market power is confused and, save in relation to market shares, limited to an analysis of Sky's historical acquisition and likely future acquisition of live PL rights. This focus on live PL rights is also inconsistent with Ofcom's widening of its market definition (in Section 4 of the Consultation) to include channels which show sports content other than live PL matches[57]. Ofcom has no basis for simply focusing its market share and market power analysis on live PL football and disregarding other sports.

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[57] Paragraph 4.209 and 4.210 Consultation

6.4 In any event, for the reasons set out below, the PL does not accept that Sky can have market power at a wholesale level as a result of acquisition of its live rights. The Commitments and auction process were specifically designed to deal with the Commission's concerns about the collective sale of the PL's rights causing market power and foreclosure problems in the downstream broadcast market. Therefore, it is intuitively wrong for Ofcom to now base almost its entire case on an argument that Sky has market power arising out of its acquisition of the PL's live rights. This is inconsistent with the Commitments and Ofcom, as a National Competition Authority, is not entitled to depart from the views of the Commission.

6.5 Furthermore, Sky's current incumbency in holding the rights and subscriber base, does not give it an inherent advantage over other bidders in relation to the PL's rights. The Commitments given to the Commission by the PL were designed to ensure that the auctions were fair, transparent and open to any bidder (to win on price alone). Anyone can win. Therefore, the operation of the auction process specifically does not give Sky any advantage over other bidders.

6.6 In addition, Ofcom's conclusions on the need for a large subscriber base in order to be successful in bidding for rights are internally inconsistent.

6.7 Finally, it is unhelpful that Ofcom's analysis on market power is spread out across Section 5 of the Consultation and Annex 8 of the Consultation; with additional work and evidence that is relevant to the conclusions contained only in Annex 8. Furthermore a large proportion of its analysis, particularly in relation to market shares and the PL's bidding history, is redacted and it is impossible to comment on the calculations and conclusions that Ofcom has not revealed to the PL.

Wholesale market power

6.8 Ofcom's analysis of Sky's alleged market power is based on its view of the following[58]:

6.8.1 The competition from existing competitors;

6.8.2 The competition from potential competitors; and

[58] Paragraph 5.17 Consultation

6.8.3 Countervailing buyer power.

Existing competitors within the relevant market/out of market constraints

6.9 At paragraphs 5.28 to 5.31 of the Consultation Ofcom purports to calculate Sky's market share as a proportion of the revenues earned by it from the wholesale supply of core premium sports channels. In paragraph 5.32 to 5.35 Ofcom then goes on to assess Sky's market share on an alternative basis, taking into account channels outside the relevant market that *"nonetheless exerted a competitive constraint to a degree"*[59].

6.10 Ofcom reaches the following conclusions:-

6.10.1 *"Sky currently has a market share well in access of 70%.... 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.*"

6.10.2 "*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 over-state 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*"[60].

6.11 Unfortunately, however, Ofcom does not set out how it actually arrived at its market share calculation and details of its calculations are set out in a separate "confidential spreadsheet"[61]. Therefore, it is impossible for the PL to comment on Ofcom's calculations. Nevertheless, what is clear is that on the basis of a flawed market definition Ofcom's market share calculations are meaningless and all of the PL's other comments on market power must be read subject to that overriding fact.

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59 Paragraph 5.32 Consultation
60 Paragraph 5.36 Consultation
61 Paragraph 2.78 Annex 8 Consultation

6.12 In any event, the analysis of "*out of market constraints"* placed on Sky, when considering its market share, is also flawed by virtue of Ofcom's approach to what constitutes an "*out of market constraint*" described in Paragraph 5.33 of the Consultation. It has wrongly taken into account only those sporting events broadcast on Sky Sports 1 and 2 and has not included relevant sports on FTA such as Formula One and UEFA Champions League, FA Cup, Rugby Union Six Nations etc. The reason given for failing to include, for instance, Formula One is that Ofcom *believes* that it is a poor substitute for the events broadcast on Sky Sports 1 and 2. There is, however, no evidence for this belief whatsoever in the Consultation or Annex 8 and it is simply untenable; Formula One is a high volume, regular and highly valued sporting event.

6.13 Therefore, even on its own approach Ofcom should have included, at the very least, Formula One as a sport that exerts an out of market constraint on Sky. It should also have included all other high quality, regular and high quantity sports on FTA (that are not also on Sky Sports 1) such as UEFA Champions League[62], FA Cup, athletics, horse racing, motor racing of all forms, snooker etc.

6.14 Nevertheless, it is important to note that, as Ofcom recognised, market shares are of limited use in complex markets such as the broadcast market and markets where there is a great deal of product differentiation[63]. In addition, market shares are particularly inconclusive if based only on revenues. This is not the most appropriate way of calculating market shares in an all-TV broadcasting market and Ofcom should also have, for instance, considered market shares by reference to commercial impacts[64].

6.15 Market shares are also inconclusive in relation to the constraint exercised by existing competitors when the markets analysed are bidding markets. This is recognised by Ofcom at paragraph 2.23 of Annex 8 and its reference to Paragraph 4.5 of the OFT's Market Power Guidelines. In bidding markets (e.g. markets for the acquisition of sporting content rights) market shares are temporary and fluctuate in accordance with the outcome of bids. A high market share does not necessarily reflect market power

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62 Although UEFA Champions League matches are shown on Sky Sports, other, different matches (invariably featuring domestic clubs) are exclusively live on FTA and are not available on any Sky Sports Channel.

63 Paragraph 2.48 Annex 8 and Paragraph 5.29 and 5.35 Section 5 Consultation

64 See, CC Provisional Decision as to Change of Circumstances "Review of ITV contract Rights Renewal Undertakings" 15 September 2009 at paragraphs 6.23 to 6.35 where the CC looks at share of commercial impacts and net advertising revenue ("NAR").

and can at best only be indicative. Firms with a small market share can impose a competitive constraint on those with larger market shares as what matters is simply that a credible bid can be submitted rather than whether one or other bidder currently has a large market share, or will achieve a large market share. Setanta's entry in 2006 is a perfect example of this.

6.16 Typically, the factors driving competitive bidding are the number of bidders and how closely they compete with each other. The fact that only one bidder may win does not necessarily indicate market power in the bidding market or give it market power in the downstream market.

6.17 Furthermore, the fact that Sky has consistently placed competitive (and high) bids for the acquisition of PL rights demonstrates that it is subject to competitive constraints in the acquisition of rights. The *ex ante* competition of rights was all that the Commission was concerned with when it sought the Commitments from the PL. According to the Commission, the creation of *ex ante* competition would prevent any winner obtaining market power in a (properly defined) downstream broadcast market. This approach is consistent with the approach adopted by the Commission when considering exclusive sports rights e.g. UEFA and Bundesliga -

6.18 Ofcom's failure to recognise this, and its failure to define properly the downstream broadcast market, and as a result the out of market constraints on Sky, render its conclusions on market share irrelevant. As a result, market shares should be disregarded when Ofcom is considering whether Sky has obtained or is exercising any market power.

Potential competitor: barriers to entry and expansion

6.19 As Ofcom rightly recognises, where barriers to entry/expansion are low, it is unlikely that a firm has market power that enables it profitably to sustain prices above competitive levels[65]. However, Ofcom does not accept that barriers to entry into its wrongly defined wholesale core premium sports market are low.

6.20 It finds that "*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*". It goes

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65 Paragraph 5.38 Consultation

on to state that "*our analysis thus focuses on whether there are obstacles to acquiring the rights to certain key sporting events*"[66].

6.21 Despite this apparent general approach, Ofcom's analysis then (inexplicably) focuses only on the acquisition of live PL rights and does not consider the acquisition of any other key sporting events. It appears to do this in order to ignore, conveniently, the picture displayed in Figure 40 in the Consultation which shows that Sky is considerably less successful in acquiring the rights to other football and sporting events. It also ignores its own conclusions in Paragraphs 5.66 and 5.67 where it finds that Sky has only *"been fairly successful when bidding for live football rights"*; *"for live golf, rugby union and rugby league the pattern is mixed, with rights being won by the BBC, Setanta and Sky"*; *"Sky wins relatively fewer rights to tennis tournaments"*; and *"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"*.

6.22 The apparent rationale for entirely ignoring these other sports is that *"Sky is likely to maintain its wholesale position if it wins the majority of the live FAPL rights"*[67]. Ofcom seeks to support this statement by reference to evidence that apparently:

6.22.1 demonstrates the particular importance of live PL rights and shows that Sky's strong wholesale position will persist unless Sky loses multiple packages of live PL rights; and

6.22.2 demonstrates that Sky is likely to win the majority of live PL inputs.

6.23 To the extent that the PL is able (notwithstanding extensive redactions by Ofcom) we deal with each of the issues further below.

6.24 In summary, the PL does not accept that there are significant barriers to entry and expansion in relation to the acquisition of its rights. Furthermore, there are, in fact, no findings by Ofcom that Sky is sustaining prices above competitive levels that would be consistent with a finding of market power. Ofcom's conclusions on barriers to entry are flawed and cannot be relied upon.

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66 Paragraph 5.39 Consultation
67 Paragraphs 5.47 and 5.48 Consultation

The Importance of live PL rights

6.25 As set out above, Ofcom considers that Sky's position of market power would be changed if it lost the majority of live PL rights. Therefore, in order to make good this assertion, it needs to demonstrate that live PL rights are so important and attractive to pay tv broadcasters, over and above all other sporting events and competitions, that obtaining live PL rights even for a limited period (as envisaged by the Commitments) is enough to give Sky market power. Its reasoning is set out both in Paragraph 5.51 of the Consultation and Paragraph 2.116 of Annex 8. The content of these paragraphs is broadly similar save that Annex 8 expands on Ofcom's points and, therefore, we address the issues raised in paragraph 2.116 of Annex 8 as this is the more comprehensive summary of the evidence Ofcom is relying upon.

6.26 The basis of Ofcom's conclusions is set out in four bullet points. However, the substance of the third and fourth bullet points are entirely redacted and it is impossible to comment on these at all[68]. Save in relation to Footnote 61. This refers to press speculation about Setanta's viability following the loss of a single package of live PL rights and concludes that this highlights the importance of these rights. Clearly, press speculation is entirely lacking in any credibility and should be given no weight whatsoever in Ofcom's analysis or conclusions. There is no evidential value at all in press speculation and all this demonstrates is that Ofcom's case on the importance of live PL rights is so weak as to need to be propped up by press speculation.

6.27 In relation to the first bullet point Ofcom refers to evidence that *"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 Sport subscribers."* In support it cites the fact that 75% of premium sports channel subscribers considers that live PL matches were *"very important … 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*"

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68 Ofcom has also refused to provide the PL with the text underlying these redactions.

6.28 However, Ofcom completely ignores the fact that its own survey evidence also records that other football events (available on FTA) were equally as popular as PL matches. UEFA Champions League, International football matches and FA Cup matches were also "very important" to 72%, 71% and 71% of subscribers respectively. Therefore, Ofcom's own survey evidence runs contrary to its assertion that PL rights are the single most important content for Sky and that it would only lose market power if it lost these rights.

6.29 Ofcom clearly recognises the limitations of this apparent "evidence" by also referring back to Paragraph 4.80 of the Consultation and its conclusions that the PL has specific characteristics, in terms of regularity and number of highly attractive matches, that make it particularly attractive when creating a mass market wholesale sports channel. The PL's view on these apparent "specific characteristics" is addressed in relation to section 4 of the Consultation above (i.e. many other sporting competitions on pay tv and FTA also share these characteristics of high quality, value to customers and regular transmission).

6.30 Ofcom's simple conclusion that live PL football is attractive is facile and is not capable of supporting a conclusion that live PL rights provide Sky with its alleged market power. Ofcom has failed to demonstrate (by reference to proper evidence) that live PL football is significantly more important than any other football or sport content.

6.31 This approach and conclusion is also entirely inconsistent with Ofcom's widening of the market in section 4 to include other sports.

6.32 In relation to the second bullet point Ofcom also attempts to compare the total amount paid for live PL rights (on an average per annum basis) with the average annual amount paid for live UEFA Champions League rights, FA Cup rights and England home international matches in order to attempt to demonstrate that live PL rights command much higher values and are, therefore, more attractive. However, Ofcom's use of average per annum values as a way of considering the respective values of different sports' rights is entirely self-serving. If Ofcom had, for example, compared average revenue per PL match against average revenue per UEFA Champions League match including a domestic team there would be little difference in value. In any event, Ofcom's comparison does not demonstrate anything in relation to market power. The simple fact is that rights to UEFA Champions League, (involving domestic clubs), the FA Cup and England home internationals involve fewer games per season than the PL competition and as a result will attract lower bids on an average per annum basis. Furthermore, the rights are also typically purchased (to some extent) by FTA broadcasters which pay less for them due to scheduling constraints on FTA. Ofcom's analysis demonstrates nothing more than the fact that the PL's rights are attractive.

6.33 Ofcom's next argument, in support of its conclusion that Sky's market power will be maintained by holding live PL rights, is set out in paragraph 5.52 of the Consultation and 2.117 of Annex 8. Ofcom concludes that *"the available evidence suggests that Sky's wholesale position will be maintained unless Sky loses multiple packages of live FAPL rights"*.

6.34 Again, the substantive elements of Ofcom's conclusions are redacted and it is impossible for the PL to comment on Ofcom's analysis in this respect.

6.35 In any event, Ofcom's conclusion appears to be based on an argument that despite Setanta's success in winning various other sporting rights Sky still maintains a high market share. However, the PL cannot comment as the substance of Ofcom's work is redacted. Nevertheless, as set out above the fact that these markets are bidding markets means that market shares are largely irrelevant in assessing the true market power of a party and the competitive constraint posed by undertakings with smaller market shares.

6.36 The fact remains that the Commission carefully considered and accepted six packages of rights could be sold (with a prohibition on one single buyer). Moreover, Setanta *was* able to win a large number of other sporting rights, which it bid for against Sky, and was able to use these rights to establish a competitor to Sky Sports. This *ex ante* competition for rights is what matters and provided that competition remains (which it does following the emergence of ESPN) there is nothing to suggest that Sky will maintain its wholesale position unless it loses multiple packages of live PL rights.

Sky is likely to win the majority of the live FAPL rights

6.37 Ofcom also sets out, in paragraphs 5.54 to 5.58 and paragraphs 2.119 to 2.126 of Annex 8 to the Consultation, its analysis and conclusions on why it believes Sky is likely to win the majority of live FAPL rights; giving it market power now and for the foreseeable future.

6.38 The core of Ofcom's conclusions are its analysis of bids for live PL rights submitted in 2006 and 2009.

6.39 Firstly, this reliance on historical data flies in the face of Ofcom's recognition earlier in the Consultation that the future development of the market cannot simply be extrapolated from the past[69]. It is intuitively wrong for Ofcom to seek to base a finding of current market power on the basis of speculation about future events.

6.40 ***[Confidential]***

6.41 ***[Confidential]***

6.42 Ofcom cannot conclude that the 2009 auction demonstrates anything about Sky's likelihood of winning PL rights in any future auction; nor (absent Ofcom's proposed intervention) the view of other bidders about their likelihood of successfully bidding.

6.43 There can be no guarantee who will win any future rights and no evidence to suggest that Sky is likely to win the majority of live PL rights.

6.44 In any event, when looking at future events and predicting what will occur Ofcom must exercise considerable caution when it does not have any hard evidence to support its conclusions. The European Court of Justice made this clear, in *European Commission v Tetra Laval,* where it found that when considering future events the evidence relied upon, the approach must be to "*factually accurate, reliable and consistent but also whether that evidence contains all the information which must be taken into account in order to assess a complex situation and whether it is capable of substantiating the conclusions drawn from it.* ***Such a review is all the more necessary in the case of a prospective analysis"***[70](emphasis added).

6.45 In this case Ofcom has clearly failed to satisfy the test set out by the European Court of Justice in *Tetra Laval* .

Factors that explain why Sky is likely to win the majority of live FAPL rights

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69 Paragraph 3.13 Consultation

70 Case C-12/03 P *Commission v Tetra Laval* 15 February 2005 at para 39 and 42-44

6.46 In paragraphs 2.127 to 2.147 of Annex 8 Ofcom sets out its reasons why it believes entry barriers are high and that Sky has a material advantage over rival bidders that means it is likely to win the majority of live PL rights. The four factors that Ofcom considers are:

6.46.1 branding advantages enjoyed by Sky;

6.46.2 the delay that a new entrant would face in building a subscriber base;

6.46.3 the efficiency advantages that may flow from bidders such as Sky being vertically integrated with pay TV retailers with a significant subscriber base[71]; and

6.46.4 a range of bidder specific factors.

6.47 The first factor considered by Ofcom is seriously lacking in credibility for two reasons. Firstly, most of the other potential bidders have well known and highly successful brand names. For example, it is hardly credible to suggest that Sky enjoys significant branding advantages over Virgin Media or BT or that it has access to a significantly bigger customer base than both these operators. Secondly, even if Sky did enjoy branding advantages (which the PL does not accept), any such advantages make no difference to an undertaking's ability to bid competitively for rights.

6.48 Furthermore, Ofcom's arguments about the need for a subscriber base are inconsistent with its view in paragraph 6.64 of the Consultation where it finds that a large subscriber base is not the most important factor when bidding for rights. This factor is, therefore, not a credible consideration for Ofcom when analysing whether any barriers to entry exist.

6.49 The PL also agrees with Sky that live PL rights are contestable and there is a wide range of potential bidders as evidenced by the entry of Setanta and now ESPN ***[Confidential]***.

6.50 As set out above the Commitments were specifically designed to ensure that there are no barriers to entry in the acquisition of live PL rights. Furthermore, the Commission has at no time during the operation of the Commitments, and following the auctions in 2006 and 2009, sought to reopen its investigation on the basis of concerns about competition in the acquisition of the PL's rights.

Retail market power

6.51 Ofcom's conclusions on retail market power also demonstrate why there is a logical gap in its analysis of its competition concerns and consumer effects.

6.52 Firstly, Ofcom expressly disavows any suggestion that there are concerns about Sky's behaviour or position at the retail level. Whilst Ofcom finds that Sky has a dominant position it notes that "*it is important to recognise the limitations of this conclusion*"[72].

6.53 Furthermore, Ofcom finds that "*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*" i.e. retail prices are not high[73]. Ofcom also does not find that switching costs (for consumers) would be high[74].

6.54 Its conclusions on retail market power are vague and inconclusive. Accordingly, they cannot be relied upon.

7. SECTION SIX CONSULTATION - COMPETITION ISSUES

7.1 Ofcom sets out a summary of its alleged "competition issues" in paragraphs 6.2 - 6.4 of the Consultation. These are essentially that:

7.1.1 Sky is vertically integrated and has market power at a wholesale level;

7.1.2 As a result, Sky either refuses to supply its channels to other retailers and/or platforms or makes the channels available on unfavourable terms;

7.1.3 This creates reduced consumer choice and inhibits the growth of innovative pay tv services and means there is not (or is not likely to be) fair and effective competition;

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71 Ofcom suggests that this factor may be less important than the others in Paragraph 5.60 of the Consultation

72 Paragraph 5.135 Consultation

73 Paragraph 5.138 Consultation

74 Paragraph 5.146 Consultation

76 See, for example, paragraph 6.155, 6.198 Consultation

7.1.4 Sky is setting high wholesale prices for its channels to maximise wholesale margins; and

7.1.5 This can have the effect of keeping retail prices high.

7.2 The PL is not in a position to comment on the factual and evidential findings in Section 6 underpinning these concerns.

7.3 However, it is plain that Ofcom's "competition" concerns in relation to sports content do not amount to anything that could remotely be considered competition concerns if measured against the understood principles of competition law. Any putative lack of choice of live sports content on any platform does not result from Sky's behaviour but from the failure of other vertically integrated retailers/platform operators to successfully bid for and broadcast live sports content. Furthermore, any such failures to bid for rights are not as a result of Sky managing or controlling competition for rights. Sky has to bid on the same basis as any other party will bid and the bidding process maximises competition between bidders.

7.4 Moreover, Ofcom clearly conflates standalone retailers and integrated retailers/platform operators when describing its concerns throughout Section 6. This results in an almost incoherent and logically flawed case. Ofcom's case is also internally inconsistent.

7.5 However, what is apparent is that underpinning Ofcom's "competition" concerns is clearly an assumption that Sky **must** supply (at an appropriate price) its channels. However, this is despite the fact that Ofcom recognises that:

7.5.1 This is not a margin squeeze case under CA98;

7.5.2 This is not an excessive pricing case under CA98;

7.5.3 This is not a refusal to supply case under CA98; and

7.5.4 This is not an excess profits case requiring remedy under a market investigation approach.

7.6 As set out above in relation to jurisdiction, even where dominance has been established (which is not the case here), that does not preclude an undertaking from choosing its own trading partners and choosing the terms on which to supply (so long as these are not abusive). Sky is under no obligation to supply per se.

7.7 Most importantly, however, Ofcom does not find that consumers are paying high retail prices. Any suggestion that there might be high prices is based on Ofcom's inconclusive (by its own admission[76]) view of wholesale prices and margins.

7.8 Furthermore, Ofcom's suggestion that innovation has or might be dampened by any lack of wholesale supply by Sky is entirely unsupported by any evidence on what innovation, or possible innovation, Ofcom is concerned about. Speculative or theoretical possibilities of future innovation are insufficient to form the basis of any competition concerns.

7.9 Therefore, all Ofcom's concerns are based on is its undefined and vague notion of ensuring "fair and effective competition". It is entirely unclear how (and counter - intuitive to suggest that) behaviour that is perfectly legitimate and does not amount to abusive behaviour under Article 82EC/Chapter II CA98 could be characterised as being prejudicial to "*fair and effective"* competition.

Supply and Incentives to Supply

7.10 In paragraphs 6.60 to 6.67 of the Consultation Ofcom sets out why it believes Sky does not have a strategic incentive to supply other "retailers". In particular, Ofcom is apparently concerned 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"*[77].

7.11 However, this concern is unclear and appears to be wholly dependent on an assumption that a large subscriber base is essential to gaining an advantage over other bidders. As set out below, this is inconsistent with Ofcom's own findings later in Section 6 relating to the factors that influence bidding for rights e.g. paragraph 6.64 of the Consultation.

7.12 In any event, in relation to the PL's live rights, it is plainly not true that a large subscriber base is essential for successful bidding. Setanta and ESPN are clear

77 Paragraph 6.60 Consultation

examples of how new entrants have been able to bid for and win rights, without a pre-existing subscriber base. Indeed, ***[Confidential]*** and in 2006 Setanta outbid Sky for live PL rights (despite Sky's installed subscriber base of 8 million).

7.13 Furthermore, Ofcom appears to conflate concerns about standalone retailers and integrated retailers/platform operators and does not appear to understand what Sky's strategic incentives actually mean in practice.

7.14 This can be seen in paragraph 6.65 of the Consultation where Ofcom finds that Sky's preference for retailing rather than wholesaling demonstrates what its strategic incentives are.

7.15 Firstly, Ofcom explains that if Sky retails *"it can benefit not only from its own satellite subscribers, but also from subscribers on other platforms whose customers are less likely to subscriber 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"*[78].

7.16 However, the first two sentences of this conclusion are inconsistent and counter-intuitive. On the one hand Ofcom finds that retailing on another platform enables Sky to increase its retail subscriber base by accessing customers over that new platform. Yet, on the other hand, Ofcom finds that retailing on another platform will allow Sky to lock consumers into its own platform. This must be by keeping the retail price up and/or manipulating the retail packaging and price on platforms other than its own platform and thus pulling subscribers over to its satellite platform. These two positions are inconsistent.

7.17 It is also counter-intuitive for Sky to put retail prices up on non-DSat platforms. This would cause it to lose retail revenues over these platforms, especially if these are the subscribers that Ofcom finds *"are less likely to subscribe via satellite"*. It would also be likely to damage Sky's brand and market position to retail on different platforms at higher prices than on its own DSat platform.

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78 Paragraph 6.65 (first bullet point) Consultation

7.18 Secondly, Ofcom finds that *"if it [Sky] wholesales to others, it still gets the wholesale revenue associated with subscribers on other platforms, but loses control over cross-platform retail packaging and pricing, which means that it faces a greater risk of losing customers form its satellite platform, and it also runs the risk that others may grow to present more of a challenge in competing for rights upstream"*[79].

7.19 However, this can only be a legitimate concern if Ofcom had found that retail prices were too high. It did not, and cannot, do so.

7.20 In addition, Ofcom's concern about Sky seeking to prevent others from bidding against it for rights is contradicted by the available evidence (see above) and is also internally inconsistent with Ofcom's own finding that a large existing subscriber base *"is one of a number of factors that influence the ability and incentive for a firm to compete aggressively for rights"* but is *"perhaps not the most important of these factors"* [80].

7.21 Any concern about Sky seeking to prevent others being able to bid against it is also only relevant to the extent that it relates to other integrated retailers/platform operators. Ofcom accepts 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"* [81].

7.22 However, the reality is that Virgin Media and BT (the other integrated retailers/platform operators) have to-date displayed no interest in seriously bidding for live sports rights - despite having large subscriber or customer bases. Ofcom cannot, therefore, have a legitimate concern that Sky is seeking to or is inhibiting their ability to bid for live sports rights.

7.23 In any event, Sky could, in theory, still exercise some control over the retail price (if this is what Ofcom's concern is) on other non satellite platforms, by wholesaling at a price that produced a margin squeeze on its retail competitors. However, Ofcom itself recognises that Sky is not doing this.

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79 Paragraph 6.65 (second bullet point) Consultation

80 Paragraph 6.64 Consultation. It is also noted that the other "factors" Ofcom refers to are not explained or considered at all. What these other "factors" are is totally unknown.

81 Paragraph 6.63 (third bullet point) Consultation

7.24 Essentially, Ofcom concludes that that Sky derives two strategic benefits from keeping *"its retail competitors weak*"[82] e.g.:

7.24.1 "*to manage competition between retailers on different platforms, in order to protect the position of Sky's own satellite platform*"; and

7.24.2 "*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*"[83].

7.25 Yet, Ofcom has not adequately or coherently explained how Sky is managing competition between retailers on different platforms or what benefit it is deriving from doing so. Any "management of competition" would suggest that retail prices are high and being kept high; or that innovation is being prevented. There is no finding that retail prices are high and no explanation by Ofcom of what, if any, innovation is being prevented.

7.26 Ofcom's conclusion in paragraph 6.94 is only really relevant if there are high retail prices: which it does not find.

7.27 Furthermore, as set out above in relation to bidding for sports rights and Sky's incentives to prevent rivals establishing a subscriber base Ofcom's conclusions are internally inconsistent.

7.28 In any event, as previously explained, there can be no suggestion that companies like BT, Virgin Media, Orange etc do not have a large and varied customer base to market to and use to bid for rights. The simple truth is that they have so far not wanted to invest in content and produce their own broadcast product.

7.29 Therefore, Ofcom's descriptions of Sky's "strategic incentives" are flawed irrational and simply meaningless in the current market and economic context. As a consequence Ofcom has no basis for concluding that Sky's acknowledged static

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82 Paragraph 6.66 Consultation
83 Paragraph 6.66 Consultation
85 Paragraph 6.91 Consultation

incentive to wholesale to other platforms is outweighed by these alleged strategic incentives[85].

Supply to Virgin Media

7.30 In paragraphs 6.97 to 6.129 of the consultation Ofcom sets out its alternative concern e.g. that Sky's supply to Virgin Media is at a wholesale price that does not allow Virgin Media to compete effectively at a retail level[86].

7.31 However, Ofcom's view is clearly based on an illogical analysis of the wholesale price to Virgin Media, and an erroneous view that, instead of using the rate-card as a reference price Sky should negotiate with Virgin Media to "*establish a mutually beneficial price*"[87].

7.32 There is no such thing, in economic terms, as a *"mutually beneficial"* price. Sky is in principle perfectly entitled to set the wholesale price at whatever level it chooses as long as this price is not capable of margin squeezing Virgin Media (nor is it an excessive price or one that is tantamount to a refusal to supply).

7.33 Given that the wholesale rate-card price is effectively regulated following the OFT's margin squeeze case against Sky in 2002 any wholesale price below this *de facto* price is not capable of producing a margin squeeze. Therefore, as a matter of logic Virgin Media must be able to compete at the retail level. If it is not able to so then this must be for reasons other than the wholesale price Sky is charging.

7.34 For instance, Ofcom notes that cable penetration is low due to technical access difficulties for consumers so there may be technical reasons which explain why Virgin Media may choose not to compete at the retail level as aggressively as it might[89].

7.35 In any event, Ofcom's concerns actually appear to be related to movies rather than sports[90]. There is no real separation of Ofcom's analysis between movies and sport when considering consumer penetration on cable and the difference in retail price for

86 Paragraph 6.129 Consultation
87 Paragraph 6.110 Consultation
89 Paragraph 5.145 and 5.155 Consultation
90 See, for example, Paragraph 6.114 Consultation

basic channels plus sports on Sky and Virgin Media is negligible[91]. It is, therefore, clear that there is no basis at all to suggest that Virgin Media cannot compete with Sky at the retail level.

Wholesale pricing of Core Premium channels

7.36 The PL notes the further work that Oxera has carried out for Ofcom in relation to Sky's profitability, as set out in paragraphs 6.170 to 6.207. However, it is clearly unable to comment on the detail of this analysis or ultimately its conclusions.

7.37 Nevertheless, it is clear from the Consultation that Ofcom is not able to conclude that there is any distortion in retail competition or that retail prices are too high[92].

7.38 Furthermore, in relation to wholesale prices/margins it is also clear that Oxera's conclusions are inconclusive and highly sensitive to the assumptions made and the fact that the analysis is based on historical data that reflects the risky nature of Sky's business and previous investments. Ofcom's finding that recent returns do not include such an element of risk is erroneous given the continued substantial investment that Sky makes in innovative services and products. Therefore, it is clearly inappropriate to conclude that Sky now has *"a proven business model [and] its risks of failure [are] low"* [93] .

7.39 More generally, Ofcom states that the findings of **possible** high wholesale prices/margins are more likely to be in movies than sports.

7.40 As a result, there is no coherent basis at all in Section 6 of the Consultation for intervention in the way in which Sky wholesales its content.

8. SECTION SEVEN CONSULTATION - CONSUMER EFFECTS

8.1 Section 7 of Ofcom's Consultation sets out the apparent consumer detriment arising out of its findings in relation to Sky's market power and the competition issues that it alleges arise from Sky's market power.

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91 This is not the case for Movies

92 See, for example, 6.170, 6.195, 6.204 Consultation which do not contain any definite or actual findings of high retail prices

93 Paragraph 6.191 and 6.192 Consultation

8.2 However, it is unclear, throughout the Consultation, what evidence Ofcom relies on and what the full basis of its case is as it has redacted large parts of the Consultation and its Annexes making it largely impossible to respond to key aspects of Ofcom's workings and conclusions[94].

8.3 In any event, Section 7 fails to articulate properly a coherent theory of harm, i.e. how exactly consumers are being harmed and the detriment they are suffering from the alleged lack of platform choice and Ofcom's expectations of reduced innovation. Without a credible and evidenced theory of harm demonstrating how consumers are adversely affected it is difficult to see that any remedy is required let alone such a drastic remedy.

8.4 Furthermore, the nature of Ofcom's conclusions and its theory of harm vary throughout the document and appear to come down essentially to the following speculative propositions:-

8.4.1 Sky's vertical integration and alleged market power in the acquisition of content, means that it "***may*** *distribute its premium content in a manner that favours its own platform and its own retail business*[95]*". It* ***might*** *do so either by denying this content to other retailers and/or other platforms, or by making it available on unfavourable terms* [96]*" (emphasis added).*

8.4.2 "*Sky* ***may*** *exploit content rights in order to favour its own retail business and platform*[97]"; (emphasis added) and

8.4.3 "*Sky* ***may*** *set high wholesale prices for its content in order to maximise wholesale profits. This can be reflected in high retail prices*[98]" (emphasis added).

8.4.4 Ofcom finds that Sky only *"****appears*** *to be acting on an incentive to restrict supply of core premium channels to other retailers*[99]*"* (emphasis added).

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94 This is a failure in itself that would render Ofcom's work invalid - see *Vodafone and Others v Ofcom* and H3G [2008] CAT 22 at paragraph 97

95 Although it should be noted that there is in fact no actual finding of high retail prices.

96 Paragraph 1.23 Consultation.

97 *ibid*

98 *ibid*

99 Paragraph 1.24 Consultation

8.5 The most Ofcom is able to say when summarising its theory of harm in Section 7 is that:

8.5.1 "*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***"[100] (emphasis added);

8.5.2 "*those customers who most value premium content are more likely to have chosen Sky's own satellite platform. This means that* ***some*** *customers are* ***likely to be*** *on a platform which would not have been their first choice had premium content been equally available on all platforms*"[101] (emphasis added);

8.5.3 "*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 ... 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*"; (emphasis added) and

8.5.4 "*these concerns are exacerbated as we look forward to the future; we are at a point where the potential choice of platform is increasing ... 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*". (emphasis added)

8.6 The majority of Ofcom's findings are all based on theoretical possibilities or apparent *"likely effects"*. The whole of section 7 is littered with weak assumptions, conjecture and unsubstantiated predictions which do not explain how consumers are suffering as a result of any actual harm that requires remedying; let alone in such a drastic way[102].

8.7 Ofcom's analysis of unmet demand, giving rise to apparent lack of choice, is unsupported by adequate evidence. Therefore, it is by no means clear that consumers

100 Paragraph 7.2 Consultation
101 Paragraph 7.3 Consultation
102 See for example paragraphs 7.3 to 7.5, 7.58, 7.67, 7.74, and figure 60 on page 232 Consultation.

do in fact believe they are suffering as a result of a lack of choice. If they are happy with their current provider, or would not purchase pay TV anyway (or would be unlikely to even at current competitive retail prices) then there is not in fact any unmet demand.

8.8 In addition to these flaws in Ofcom's findings of unmet demand and an apparent lack of choice for consumers, Ofcom fails to articulate how the alleged lack of choice results in consumer detriment.

8.9 Typically, consumer detriment from a lack of choice would arise through higher retail prices or a lack of actual innovation or identifiable likely innovation. However, the Consultation contains no evidence to support either such concern or explain how the alleged lack of choice or alleged lack of innovation causes welfare loss to consumers. Furthermore, this is not a case of an essential facility that would require supply for the sake of supply.

8.10 Moreover, as Ofcom recognises elsewhere in its Consultation, Sky has invested large sums of money and talent in acquiring, producing and exploiting content and providing innovative services for the benefit of consumers[103]. As Sky has set out in its responses to Ofcom's Consultations (see for example paragraph 7.26 to 7.28 of the Consultation) the UK audio visual market is competitive and characterised by constant innovation and development. On this basis it is hard to see what consumers are missing in terms of innovation in relation to, for example, the broadcast of live sports.

8.11 That is hard fact in contrast with Ofcom's admission that *"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 counterfactual for the development of the market, depending on whether or not we intervene"*[104].

8.12 In any event, all the possible future scenarios set out by Ofcom in paragraphs 7.15 to 7.19 of the Consultation are more suitable for non-live content that can be watched on demand and Ofcom has failed to identify <u>any</u> future innovation in content delivery that would be relevant to live sports broadcasting. This is significant in relation to its

[103] Paragraphs 1.45, 7.83 and figure 61 Consultation
[104] Paragraph 7.14 Consultation

failure to identify properly a theory of harm (and detriment to consumers) in relation to core premium sports content.

8.13 Given the fact that retail prices are not high, and Ofcom's recognition that it has in fact no idea what actual innovation will occur and what the benefits will be, it is clear that Ofcom cannot possibly meet the proportionality test it must overcome in order to impose the proposed remedy.

8.14 The PL deals with proportionality issues further in relation to Section 10 of the Consultation, as set out below.

Choice

8.15 In paragraphs 7.50 to 7.82 of the Consultation Ofcom sets out its case that consumers have a limited choice of retailers from whom they can purchase core premium channels and that distribution of important pay TV content is limited to certain platforms giving rise to unmet demand. Ofcom's conclusion on choice is set out in paragraph 7.81 and it concludes that platform choice is distorted because *"consumers who in principal would prefer to view core premium channels over platforms on non-satellite platforms do not have this as a free choice"*. [sic]

8.16 Furthermore, Ofcom concludes that its concerns are exacerbated by reference to the future and that *"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"*. This statement is unsupported by any evidence or explanation of how (and what) other platforms are being restricted.

8.17 Furthermore, there is no adequate evidence in Ofcom's analysis to show that consumers subscribe to DSat in order to access core premium sport when in fact they really want to or would prefer to subscribe to, say, DTT or IPTV; or that consumers do not subscribe to DTT or IPTV because of a lack of core premium sport (even at current competitive retail prices).

8.18 Ofcom also ignores the fact that Premium sports content is actually available on cable, at the same total price as it is available on Sky (both platforms currently enforce a buy-through so the basic price differential is irrelevant)[105]. It is also

105 Paragraph 6.114 Consultation

available on IPTV via Tiscali and on DTT previously via Setanta and now ESPN. Given the fact that there are no high retail prices this suggests that customers choose the satellite platform because that is the platform they want. Therefore, there is no evidence of a real concern about platform choice in relation to sports content and no need for Ofcom to intervene on this basis.

Unmet Demand

8.19 Ofcom's basis for its conclusions about lack of platform choice being a concern are its vague and unsubstantiated assertions that there is unmet demand amongst basic cable customers and other households; and that customers of Sky's core premium channels on its own platform *may* have a preference for other platforms but have subscribed to Sky in order to access premium content.

8.20 However, not only are all of these concerns unsubstantiated but they are also irrelevant unless they are accompanied by a finding of high retail prices. This finding is absent.

8.21 In relation to Sky's premium customers on the satellite platform Ofcom has a concern that a proportion of these customers are not on their preferred platform. However, it recognises that consumers have a choice between DSat and Cable[106].

8.22 Ofcom is also concerned that Sky's premium customers "could also potentially have a preference for accessing these channels via other distribution technologies than cable[107]".

8.23 Yet, this conclusion is so speculative that it is meaningless. In addition, the evidence Ofcom cites in relation to Sky's customers being driven to Sky by availability of content[109] actually just demonstrates that Sky's customers are unlikely to be suffering in terms of unmet platform demand given the fact that it is content rather than platform features that consumers value[110].

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106 Paragraph 7.57 Consultation
107 Paragraph 7.60 Consultation
109 Paragraph 7.56 Consultation
110 See Ofcom's acknowledgement of this paragraph 1.12 Consultation

8.24 In relation to basic cable customers Ofcom suggests that there is unmet demand amongst these customers for Sky's core premium channels and that this is demonstrated by a decline in the customer penetration of Sky's core premium channels on Virgin Media. However, Ofcom rightly notes that there has also been a decline in customer penetration on the satellite platform and that there is no difference in price for Sky Sports channels on Sky's DSat and Virgin Media's cable platform. Ofcom itself finds that the prices are broadly similar (paragraph 6.114) which suggests that there is not unmet demand amongst basic cable customers. To the extent that Ofcom makes any other relevant findings these are redacted and the PL cannot comment.

8.25 It is clear, therefore, from the points set out above, that there is no meaningful evidence to suggest that there is unmet demand amongst satellite or cable customers (of either basic or premium channels).

8.26 Ofcom, therefore, focuses its assertions about unmet demand on households that do not subscribe to either the Sky platform or cable and asserts that *"there is evidence ... of substantial unmet demand among other households for core premium channels"*. Ofcom cites a number of reasons for this apparent unmet demand, including, the inability to access satellite or cable platforms because of the area in which people live; a preference for content to be delivered by DTT or IPTV based platforms because, for example, of a preference for video on demand services; and preference for entry level premium content bundles which are not currently available. None of these concerns can be derived from Sky's actions or Ofcom's alleged competition concerns. In addition, the alleged lack of entry level premium content bundles is misleading since ESPN is available as an entry level (or non-premium) channel on DTT via TUTV and BT and on cable via Virgin Media. In any event, it does not follow that Ofcom's proposed remedy would lead to Sky's premium channels being offered on multiple platforms as part of entry level packages.

8.27 Therefore, there is no basis for finding that Sky's actions cause *"a specific concern that a proportion of the 13.7 million households that are not currently on either D-sat 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"*[111].

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[111] Paragraph 7.66 Consultation

8.28 Furthermore, despite this apparently strong concern there is no attempt by Ofcom to analyse what proportion of these 13.7 million households Ofcom is concerned about. In fact there is no relevant evidence in the Consultation to support this concern at all.

8.29 Ofcom's attempts at citing relevant evidence to support its concerns about unmet demand are based on irrelevant research carried out by Freeview in November 2007 that apparently found that, **only**, *"around 22 per cent of Freeview users would definitely or probably consider paying either a monthly or one-off fee to access more channels in addition to Freeview's channels"*[112]. As Ofcom itself recognises this research does not specify which channels consumers would like to take up or at what price and in any event the research shows no more than the possibility that less than a quarter of the sample would at most "consider" subscribing to unidentified pay services. Furthermore, it does not separate out what percentage of that 22 per cent of customers would "*definitely"* consider paying a monthly or one-off fee as opposed to what percentage of customers would "*probably*" consider paying a monthly or one-off fee. In short this research is so weak as to be utterly meaningless.

8.30 Therefore, Ofcom attempts to resolve the clear difficulties with this evidence by referring to its own consumer research which apparently indicated that sports channels are one of the most popular genres where there is a high degree of exclusivity to pay TV. However, this has nothing to do with Ofcom's conclusion that there is unmet demand for Sky Sports on platforms other than satellite or cable.

8.31 Furthermore, in relation to IPTV Ofcom is only able to conclude that *"it is possible 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. Both of these effects could occur to some extent, although there is a degree of trade-off between them"*[113]. In relation to IPTV Ofcom acknowledges that the position of unmet demand is complex given the fact that IPTV platforms *"are still in their infancy"*[114]. All that Ofcom can conclude is *"that the demand for pay IPTV services based on premium content **may** be significant and that IPTV is likely to become an increasingly important distribution technology"*

112 Paragraph 7.67 Consultation
113 Paragraph 7.72 Consultation
114 Paragraph 1.40 - fourth bullet point Consultation

(emphasis added). This is insufficient. Consumer demand and choice should only be analysed in the context of what is actually available or highly likely (more likely than not) to be available. It should not be considered on the basis of theoretical future possibilities.

8.32 It is also far from clear that speculation about the future development of IPTV provides any evidence of unmet demand for Sky's core premium channels. Again, Ofcom is unable to provide any evidence to support its vague and theoretical assertions and they do not support any clear or credible theory of consumer harm arising out of Sky's alleged market power.

8.33 Finally, Ofcom's analysis also entirely ignores the availability of Setanta and now ESPN. The PL understands that EPSN is available not only on DSat but also on Virgin Media via an entry level package and on DTT via BT and Top Up Tv.

Innovation

8.34 In paragraph 7.101 of the Consultation Ofcom concludes that "*Access to the Core Premium Channels which Sky currently controls is highly important to new entrants or other firms planning to expand… Without access to this content, the overall prospects for such a firm are likely to be greatly diminished, and so is the likelihood that it will be willing to take on substantial innovation*".

8.35 However, Ofcom provides no evidence to support this conclusion and does not provide any explanation of what this future "substantial innovation" will or might be. On this basis, it has made no case at all that consumers are suffering as a result of lack of innovation caused by Sky's actions.

8.36 Therefore, lack of actual or potential innovation is not a consumer detriment that Ofcom can use as part of any credible or coherent theory of harm it tries to advance to support its implementation of the proposed remedy.

Consumer effects relating to high wholesale prices

8.37 Paragraphs 7.104 to 7.112 of the Consultation set out Ofcom's conclusions on the apparent consumer effects of current wholesale prices.

8.38 However, these paragraphs are notable in that they do not contain any evidence to support a finding of high wholesale prices or high retail prices. Ofcom skirts around the issue and is only able to raise theoretical concerns that are unsupported in reality.

8.39 Nowhere else in the Consultation does Ofcom find that there are high retail prices. Furthermore, Ofcom recognises 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 1990's, and in switching its service to digital in the late 1990's. Since then Sky has continued to invest in new services such as HD"*[115].

8.40 This ongoing investment and risk-taking should not be dampened by Ofcom's actions when there is no real or coherent theory of harm or identification of any consumer detriment.

8.41 In conclusion, it is clear from Section 7 of the Consultation that Ofcom has not reached any finding of actual consumer harm and that all its theoretical possibilities for consumer harm are unsupported by any evidence. There is no consumer detriment to be remedied and, therefore, no clear view on what the proposed remedy will achieve.

8.42 It is clear that, as a result, there is absolutely no basis on which Ofcom can even consider imposing its proposed remedy.

9. SECTION EIGHT CONSULTATION - REMEDIES/CHANNEL DISTRIBUTION

9.1 Section 8 of the Consultation reiterates Ofcom's view that a wholesale must offer remedy is the appropriate way of dealing with its concerns about the alleged lack of *"fair and effective competition"*. It sets out in Section 8 various issues about the scope of the remedy, including the fact that Ofcom continues to believe that it should set the prices at which the relevant channels should be wholesaled.

9.2 Ofcom also deals with the question of whether it would be more appropriate to proceed under CA98 rather than under CA03. This is addressed by the PL in the section above in relation to Ofcom's jurisdiction.

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[115] Paragraph 7.111 Consultation

9.3 The PL's views on the various issues that it is able to comment on are set out below.

Is the remedy necessary?

9.4 In paragraph 8.5 Ofcom sets out the context in which it proposes to impose the wholesale must offer remedy. It explains that *"we…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"* (emphasis added).

9.5 However, it is to be noted that all Ofcom is able to conclude is that it has a *concern* that there may be high wholesale prices. Furthermore, there is no finding of high retail prices anywhere in the Consultation. Ofcom cannot rely on a concern about high wholesale prices or a spurious and theoretical concern about a lack of choice or innovation in relation to existing platforms and damage to the development of possible new platforms (that are unidentified) to support this radical intervention.

9.6 The remedy is in fact likely to stifle innovation by dampening Sky's incentives to invest in the acquisition of content and innovate in its use of the content it does acquire. This would lead to a lower quality broadcast product which will reduce the attractiveness of the core premium channels to consumers and therefore their willingness to pay for the content. This would devalue content even more to the broadcasters; making them less inclined to bid for it and thus lowering the value to the PL and other rights holders.

9.7 Furthermore, regulation at the wholesale level can only ever be justified if it is to the benefit of end consumers through either higher quality services or lower retail prices. The simple aim of facilitating entry of theoretical new or alternative retailers is not in of itself beneficial to consumers. Consumers do not benefit from more retailers, only from either lower prices or a higher quality of service.

9.8 Therefore, this is an insufficient basis upon which to conclude that such a drastic and highly interventionist remedy is necessary.

9.9 In general, regulatory intervention is justifiable only if a competition concern can be identified that gives rise to consumer detriment and the remedy is able to address that concern in the least onerous way possible. The proposed remedy is clearly not necessary as there is no identifiable consumer detriment. Therefore, the remedy could never be the least onerous option available.

9.10 Ofcom's proposed remedy will also have significant ramifications in terms of restricting and distorting competition in the retail market thus significantly affecting the upstream content rights market and devaluing the rights of the PL and other sports rights holders.

9.11 Furthermore, if Ofcom's only actual concern is an alleged lack of choice for consumers (even though there is no evidence of unmet demand) then this concern could be alleviated simply by allowing Sky to retail on DTT. Ofcom cannot get round this simply by saying that Sky may then be able to control retail competition. As set out above in response to Section Six of the Consultation, it is not in its interests to do so.

Eligible retailers

9.12 The PL acknowledges Ofcom's recognition, at paragraph 8.52 of the Consultation, that the remedy should not apply to other retailers on Sky's DTH platform. However, the PL notes that Ofcom has failed to deal with the arguments it made in paragraph 9.37 of its response to the Second Consultation.

Inclusion of regulated pricing

9.13 Ofcom continues to take the view that as part of the imposition of a must offer remedy it has to set the wholesale price Sky can charge. It also concludes that the price it sets ought to be on a retail-minus basis as it recognises the significant issues that arise in relation to the value of rights, and for rights-holders such as the PL, from adopting a cost-plus pricing approach.

9.14 The PL notes Ofcom's statement in paragraph 8.85 that a retail-minus approach does not tackle any concerns about high wholesale margins and that, to the extent those concerns exist, they are related to the way in which rights are sold. However, it does not agree that the way in which rights are sold is necessarily or even capable of increasing wholesale margins.

9.15 Sky's wholesale margins will be dependent on a wide variety of factors, including its cost base and how its common costs are apportioned to the wholesale of its channels; the cost of the PL's rights are only one element of this.

9.16 Therefore, there is no basis for intervention in the way in which the PL sells its rights in order to address any possible concerns about Sky's high wholesale margins; and there is no basis for any suggestion that the PL is extracting monopoly rents[117]. The PL sets out its position in relation to the sale of its rights further below.

9.17 In relation to the wholesale price proposed the PL agrees with Ofcom that it should not impose a cost-plus price approach as this would drive the value of content down below the cost of production and thus seriously damage the value of the PL's rights which would have a drastic effect on its member clubs and consumers.

9.18 However, the inclusion of retail-minus price regulation in the proposed remedy is also fraught with practical difficulties and the way the remedy will operate is likely in fact to drive the retail price down to the cost-plus floor with the same damaging consequences as identified by Ofcom in relation to a cost-plus approach. Either way it will devalue the rights to Sky. These arguments are dealt with fully below in relation to Sections 9 and 10 of the Consultation.

9.19 Finally, the PL is unable to comment on the other terms of the must offer remedy set out in Section 8.

10. SECTION NINE CONSULTATION - TERMS OF THE WHOLESALE MUST OFFER REMEDY

10.1 The PL recognises, and welcomes, Ofcom's acknowledgment that a cost plus pricing approach to setting the price in the wholesale must offer remedy would risk artificially depressing rights value and competition for content rights; to the detriment of consumers.

117 Paragraph 8.84 Consultation

10.2 However, price regulation of any form in competition cases is almost never appropriate as competition authorities are usually badly placed to assess what the competitive, correct market price should be[118]. All Ofcom is achieving in this case is setting a price that is significantly below Sky's current wholesale price to Virgin and one which will reduce its wholesale and retail margins whilst increasing its actual or potential competitors' retail margins. This is highly distortive of competition in the retail market and will negatively affect consumers.

10.3 There are substantial issues with a retail minus pricing approach and the calculations set out by Ofcom in Section 9 of the Consultation as a result of the impact that it has on the retail market, the value of content rights to Sky, the incentives on broadcasters to bid for the rights of the PL and other rights holders and the consequential reduction in value of rights generally.

10.4 **Annex 2** contains an analysis and critique by RBB of the details of Ofcom's proposed remedy which also responds to the specific questions asked by Ofcom in relation to Section 9 of the Consultation. These issues are also picked up further in relation to Section 10 of the Consultation.

11. SECTION TEN CONSULTATION - PROPORTIONALITY

11.1 In Section 10 of the Consultation Ofcom states that it has *"compared the impact of a wholesale must-offer remedy against the counterfactual from several different perspectives"*[119] e.g. consumers; retailers other than Sky; Sky; and rights-holders.

11.2 Ofcom also purports to have carried out an impact assessment (as defined in Section 7 CA03), the purpose of which was apparently to assess whether the proposed remedy is proportionate by reference to the purpose of S.316 CA03 and Ofcom's other duties under CA03[121]. It has plainly not done a proper Impact Assessment and has largely ignored its own Guidelines on "*Better Policy Making: Ofcom's approach to Impact Assessments*" (July 2005). ("Ofcom's Guidelines").

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118 A fact that Ofcom accepts and, after three rounds of consultation, Ofcom is yet to identify a "competitive market price".

119 Paragraph 10.1 Consultation

121 Paragraph 10.6 and 10.8 Consultation

11.3 Furthermore, the reference to S.316 CA03 and Ofcom's duties under CA03 is meaningless in the context of assessing whether its actions are proportionate unless there is a clear and settled test that is being considered by Ofcom, and whether Ofcom has identified and quantified consumer detriment that requires remedying.

11.4 As set out above, Ofcom's use of the concept of *"fair and effective competition"* is entirely undefined, in contrast to clear and settled competition law tests that competition regulators typically are required to consider when assessing if there are competition law concerns leading to consumers suffering adverse effects.

11.5 Furthermore, Ofcom has neither identified any actual effects on competition nor has it identified any real and clearly quantifiable consumer detriment. For instance, in relation to market investigations the CC can only impose a remedy if there is an identifiable adverse effect on competition and a detrimental effect on consumers. In relation to CA98 investigations there can only be directions as to future conduct if an infringement has been proven.

11.6 This clear failure to identify the consumer harm being suffered, and quantify the extent of this harm, clearly fails any proportionality assessment at the first hurdle.

11.7 In any event, even if there were in fact quantifiable (and quantified) consumer detriment requiring remedy, it is plain that Ofcom has in fact no idea how its remedy will actually work or what it will achieve. Nor does it have any evidence to support its assertions and/or it has relied on irrational assumptions.

Ofcom's Impact Assessments and the general principles of proportionality

11.8 Ofcom's Guidelines make it clear that as a general principle it must take the imposition of regulation very seriously and it must properly assess the different options available (including not regulating) and the costs (in detail) and benefits in favour of regulating[122].

11.9 In particular, Ofcom states that "*one of our key regulatory principles is that we have a bias against intervention. This means that a high hurdle must be overcome before we regulate*"[123]. It also makes it clear that when carrying out an Impact Assessment it

122 See Paragraph 1.7

123 Paragraphs 1.1 to 1.18 Ofcom's Guidelines

will "*be guided by the principle of proportionality*"[124]. The principles of proportionality to be applied are well settled:

"...the measure (1) must be effective to achieve the legitimate aim in question (appropriate); (2) must be no more onerous than is required to achieve that aim (necessary); (3) must be the least onerous, if there is a choice of equally effective measures; and (4) in any event must not produce adverse effects which are disproportionate to the aim pursued".[125]

11.10 Firstly, therefore, when undertaking the proportionality assessment Ofcom should have clearly analysed and explained (supported by evidence) why the remedy was necessary in the first place and what exactly the remedy would be likely to achieve.

11.11 Secondly, Ofcom should have then assessed whether the remedy would be effective in achieving this aim and if it was the least onerous way of achieving its aim. This is inextricably linked to the first question i.e. what is the aim of the remedy, what is it trying to achieve.

11.12 Finally, Ofcom should then have assessed whether the costs of implementing the remedy were greater or lesser than the benefits the remedy would actually achieve for consumers. Again, this is clearly linked to what the aim of the remedy is, what exactly Ofcom is intending to correct. Furthermore, "costs" do not just involve the actual administrative or compliance cost of implementing a remedy. They also involve an assessment of the full "economic cost" of the remedy to all relevant stakeholders such as harm by loss of business or revenues and detriment to consumers.

11.13 These principles of proportionality (essentially defining the costs and benefits of proposed action) are recognised in Ofcom's Guidelines where in paragraph 5.30 Ofcom recognises that "*in analysing costs and benefits it is necessary to apply the principle of proportionality*"; "*as far as possible, it should be made clear who bears the costs and who receives the benefits.....assumptions should be clearly spelt out";*

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124 Ibid Paragraph 1.1

125 *Tesco v Competition Commission* [2009] CAT6 at paragraph 137 Case C-331/88 *R v Ministry of Agriculture, Fisheries and Food Secretary of State for Health ex parte FEDESA* [1990] ECR I-4023

127 Paragraph 5.9 Consultation

and ... "the cost of complying with regulation… should be identified as well as the possible negative impacts of regulation".

11.14 Ofcom spells out further, in paragraph 5, how exactly it should define costs and benefits. However, it will be seen from the analysis below that Ofcom has demonstrably not met its own standards for identifying costs and benefits.

First Question: What is the aim of the remedy, what will it achieve?

11.15 At the outset of any proper proportionality assessment Ofcom ought to have properly identified what the consumer detriment was that it was proposing to remedy. Ofcom's Guidelines recognise this when it states that as a first stage Ofcom must "*assess… the scale of the problem*"[127]. As set out above, in relation to Section 6 and 7 of the Consultation, it is abundantly clear that Ofcom has in fact no coherent or rational case in relation to the competition concerns and the detrimental effects on consumers. It has nowhere identified the problem to address or the scale of that problem.

11.16 It is plain that consumers are not suffering in terms of high retail prices and nor are they suffering, in any identifiable and evidenced way, in terms of a lack of or reduced innovation or any lack of availability of high quality content.

11.17 In relation to platform choice consumers can currently view live sports content on DSat, DTT, Cable and IPTV. In terms of retail choice consumers can currently purchase live sports content from Sky, Virgin Media and Top up TV; which is of course in addition to the wide range of high quality sport available on FTA channels on all platforms.

11.18 Therefore, it is wholly unclear what consumer detriment Ofcom is concerned about that it apparently needs to remedy in such a drastic way. As a result there is no quantification, anywhere in the Consultation, of any welfare loss to consumers that Ofcom can use in its proportionality assessment. This is a fundamental flaw in the first stage of Ofcom's proportionality assessment.

11.19 Moreover, Ofcom has not identified or quantified in any clear or definitive way what its remedy will actually achieve in terms of static and dynamic benefits to consumers, Sky, retailers other than Sky and rights holders. Ofcom has simply made assertions that are not supported by any proper evidence or analysis but based on assumptions. Its assertions and assumptions are also, in important respects, wholly irrational.

11.20 Nor has Ofcom made any attempt to identify a credible or consistent time period over which the remedy will take effect. It states that it will either be five years or ten years depending on what suits Ofcom's case. In any event, either is arbitrary and 10 years is certainly too long a period over which to consider the remedy and its likely impact.

11.21 In fact, Ofcom recognises that it cannot actually quantify the benefits that will flow from its intervention and is only able to summarise the *"**likely** effects of intervention"*[128] as follows:

11.21.1 Consumer choice: *"We see **prospects** for consumers to exercise greater and freer platform choice…customers would be able to purchase core premium channels from a variety of platforms across distribution technologies"*[129] *(emphasis added)*;

11.21.2 Innovation: *"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 operator"*[130] *(emphasis added);*

11.21.3 New entry: *"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"*[131] *(emphasis added)*;

11.22 However, these summaries of possible outcomes of the remedy are wholly insufficient.

11.23 This is Ofcom's first fundamental failure and fails the test set out by the Competition Appeal Tribunal ("CAT") in the *Tesco* case where it was clearly held, in relation to applying the proportionality principles, that "*it is necessary to know what the measure is expected to achieve in terms of an aim, before one can sensibly assess whether that*

128 Paragraph 10.16 Consultation
129 Paragraph 10.19 Consultation
130 *ibid*
131 *ibid*

aim is proportionate to any adverse effects of the measure. The proportionality of a measure cannot be assessed by reference to an aim which measure is not able to achieve"[132].

11.24 It is also not acceptable for Ofcom to avoid identifying what the remedy will achieve by finding that some of the benefits are not quantifiable[133]. As the CAT held in *Tesco* if the benefits cannot be quantified then "*this is a factor of which account would need to be taken in the balancing exercise which it carried out"*[134]. Ofcom has plainly not accounted for the fact that almost all the possible, alleged, "*benefits"* it has identified are unquantifiable and this clearly affects its ability to conclude that the remedy will be proportionate.

11.25 Set out below are the reasons why, on Ofcom's own analysis, it is plain that it either:

11.25.1 does not know what the remedy will achieve, either in static or dynamic terms;

11.25.2 is unable to provide any evidence to support its aims; and

11.25.3 its aims are in fact wholly unlikely to be effective and/or to harm rights holders and consumers.

Effects of its remedy on consumers

11.26 In relation to consumers, Ofcom attempts to identify the static and dynamic benefits that will arise in paragraphs 10.26 to 10.55 of the Consultation. The three areas that Ofcom considers are choice, innovation and retail pricing.

11.27 Its only attempt at quantifying what its remedy will achieve is set out in paragraphs 10.23 and 10.40 where Ofcom finds that there will be a consumer surplus of around £370 million. However, it is clear that this "*estimate is subject to a degree of uncertainty*"[135] which renders the prediction irrelevant.

11.28 In any event, Ofcom's approach to calculating consumer surplus is fundamentally flawed as it is not based on a proper economic comparison. It is inappropriate to

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132 Paragraph 143 [2009] CAT 6
133 Paragraph 10.10 Consultation
134 Paragraph 162 [2009] CAT 6
135 Paragraph 10.2 Consultation.

measure consumer surplus without there being anything against which to compare it. The calculation is entirely meaningless and tells one nothing about what the net effect of the remedy will be.

11.29 Ofcom also does not include any explanation or set out the calculations used to derive its consumer surplus estimate. This is also a fundamental error in its proportionality assessment. It has been explicitly recognised by the CAT that where Ofcom relies on technical calculations or analysis, and where it also requires meaningful consultation, that it must disclose the necessary information to allow intelligent response[137]:

"94 The Tribunal notes that the Decision followed a lengthy process, including two consultation documents and two notices issued under section 135 (as described further in section III above). It can hardly be suggested therefore that, at least in form, the consultation process was inadequate. However, mere consultation and transparency alone are not sufficient grounds to save a decision which is in itself flawed as a substantive matter to the extent we find in this case. The purpose of consultation is to seek the informed views of, and best available information from, industry and, with the benefit of the expertise inherent in a specialised regulatory body, apply those views and information to the perceived industry failings. The Tribunal notes the comments of Lord Woof M.R., giving the judgment of the Court of Appeal in ex p Coughlan (albeit in a judicial review context), at paragraph 108 as follows:

> *"It is common ground that, whether or not consultation of interested parties and the public is a legal requirement, if it is embarked upon it must be carried out properly.*
>
> *To be proper, consultation must be undertaken at a time when proposals are still at a formative stage; it must include sufficient reasons for particular proposals and allow those consulted to give intelligent consideration and an intelligent response; adequate time must be given for this purpose; and the product of consultation must*

137 *Vodafone Ltd & Ors v Ofcom and H3G* [2008] CAT 22 paragraphs 94 and 95.

be conscientiously taken into account when the ultimate decision is taken ..."

95 *This Tribunal finds that, in the circumstances, the process undertaken by OFCOM did not allow stakeholders fully to provide intelligent and realistic responses to the questions asked of them. For example, as noted above, in the absence of a provisional technical specification on which consultees could provide useful data, OFCOM deprived themselves of the opportunity properly to inform their analysis of the potential costs of the proposals."*

11.30 Ofcom itself acknowledges that there is a "*range of possible outcomes*" depending on the assumptions it has made, and variations on these, but has not analysed or presented any of these possible outcomes to the Consultation[138].

11.31 Instead, Ofcom makes a number of assertions about what **might** happen in terms of consumer choice, innovation and retail pricing. All of these assertions are either irrational, unsupported by any evidence or wholly unquantified when they ought to have been.

11.32 Firstly, in relation to consumer choice Ofcom starts by concluding that under its wholesale must offer remedy *"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"*[139]. However, Ofcom does not explain or even attempt to explain where this increased consumer choice will actually come from, when it will arrive and how it will arrive.

11.33 Furthermore, the evidence that Ofcom cites to support this argument in fact suggests that this increased choice may not in fact be easily achievable and/or that consumers do not necessarily value increased platform choice. For example, in paragraphs 10.33-10.35 of the Consultation Ofcom records that:

11.33.1 DTT is not suited to carrying large packages of pay TV channels, given its capacity constraints (note it certainly could not carry all of the HD and SD versions of Sky's Core Premium Channels);

[138] Paragraph 10.25 Consultation.

[139] Paragraph 10.30 Consultation

11.33.2 only around 22% of Freeview users would definitely or *probably* consider paying a monthly or one off fee to access more channels (note there is no explanation of what channels or fee and in any event this relatively small proportion of Freeview users would only consider making such a purchase which is hardly compelling evidence of unmet demand); and

11.33.3 there only **may be** scope for expansion on IPTV (over and above Tiscali's IPTV platform on which Sky retails its channels) as this technology becomes more practical for pay tv (the PL notes that IPTV is currently more suited to on demand content than linear channels and that BT Vision is currently not technically capable of carrying linear channels on IPTV[140]).

11.34 On this basis Ofcom cannot be sure at all what the benefits of its remedy will be in terms of increasing take-up of Sky's core premium channels on DTT and IPTV platforms.

11.35 Secondly, in relation to increased platform innovation Ofcom starts by concluding that *"it is likely that consumers would also enjoy benefits of greater technical innovation of pay TV platforms under our proposed remedy compared with the counterfactual"*[141]. The rationale for this being that Core Premium channels are important for pay tv retailers and access to them under the wholesale must offer remedy is likely to promote their development in general, meaning that potentially a wider range of viable platforms are likely to emerge[142].

11.36 However, Ofcom then goes on to qualify this by finding that *"...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 *"the dynamic, forward-looking benefits of platform innovation that would be likely to resulted from a wholesale must offer remedy are impossible to forecast with any degree of certainty, and we have therefore not sought to do so"*[143].

140 See paragraph 1.29 of The Overview of Sky's response to Ofcom's Third Consultation published on Sky's website on 21 September 2009.
141 Paragraph 10.41 Consultation
142 Paragraph 10.42 Consultation
143 Paragraphs 10.44 and 10.45 Consultation

11.37 These findings make it clear that Ofcom has no understanding or sense of what the remedy might bring in terms of innovation. Its arguments are reliant on speculation that new platforms may somehow develop as a result of wholesale access to content. There is no evidence to support this. Therefore, Ofcom has not identified any benefit from innovation post remedy.

11.38 In relation to increased retail innovation Ofcom's conclusions are also dependent on retailers being able to utilise non DSat platforms given the fact that Ofcom's remedy will not apply to other retailers on Sky's DTH platform. However, as recognised by Ofcom the DTT platform is capacity constrained and will currently not be able to support all HD and SD linear channels Ofcom includes in its remedy. Therefore, it is not obvious how the DTT platform will provide a basis for innovation. Nor does Ofcom explain how the IPTV platform will provide a basis for innovation.

11.39 At best innovation may help DTT and IPTV platforms to pick up some new subscribers. However, Ofcom has no evidence that this will be the case, or how many will be picked up on DTT/IPTV, or when these platforms will be providing a viable offering of linear pay channels.

11.40 Essentially, therefore, the remedy will only be capable of producing benefits to consumers if it results in increased price competition and reduced retail prices which do not have the effect of depressing the quality and attractiveness of the content valued by consumers. Reduced retail pricing is in fact most likely to be the result of the remedy and the obvious and easy way for retailers to try and force switching away from Sky, or gain take up from new subscribers. However, this effect of the remedy would distort the retail market through false competition subsidised by Sky; and would damage and distort the upstream market for content rights by devaluing the rights to Sky thereby reducing the quality of the sporting spectacle and programming content available to consumers.

11.41 Ofcom must know this and, therefore, its findings that retail prices will not change are irrational. They also do not accord with its earlier findings in Section 6 that it wants to see rigorous retail competition and its finding that the remedy may incentivise

Virgin Media to invest in marketing Sky's channels and lower its retail price thus increasing penetration on the cable platform[144].

11.42 Furthermore, the way in which the wholesale price is set (including the ratchet) will encourage and assist increased retail price competition and allow retailers to significantly undercut Sky whilst still maintaining a set retail margin. Sky will not be able to react without losing retail margin (but not gaining increased wholesale revenues) and subsidising this increased price competition.

Effects of its remedy on retailers other than Sky

11.43 In relation to the effect of its remedy on producers Ofcom's assessment of producer surplus does not contain any of its underlying workings or calculations and similarly fails to identify in any meaningful way what the static and dynamic benefits of the remedy will actually be.

11.44 In fact, it is plain that its remedy may have a significant negative static effect for new entrants[145].

11.45 For example, in relation to new entrants it is, firstly, unclear who Ofcom is referring to as a "new entrant" in paragraphs 10.57 to 10.66 of the Consultation. It is assumed that Ofcom is referring to the existing retailers and integrated retailers/platform operators but this is wholly unclear as is what the different effects might be for different operators.

11.46 Instead of identifying these key issues Ofcom has simply undertaken one producer surplus calculation and concluded that, over a five year reference period, there would be a negative producer surplus of -£230m.

11.47 This is apparently, however, offset and reduced to zero over a longer time period and an "expectation" that operators will be able to innovate and achieve dynamic benefits.

11.48 Nevertheless, Ofcom does not explain or even attempt to explain what form this innovation will take or how it will offset this negative producer surplus; or over what time period. It is insufficient, and fails a proper proportionality assessment, simply to find (as Ofcom does) that *"The dynamic benefits of this potential innovation are*

144 Paragraph 10.39 Consultation

difficult to quantify, but we would expect them to be substantial and significantly greater than under the counterfactual".[146]

11.49 If a regulator is unable to quantify dynamic benefits, or even attempt to explain what they are, then this must be taken into account when weighing the expected effects of its remedy against the costs of its remedy[147]. Ofcom has plainly not done this.

Effects of its remedy on Sky

11.50 In relation to the effect of its remedy on Sky Ofcom reaches a wide range of varying conclusions on the producer surplus. In its worst case Sky will suffer a negative producer surplus, over five years, of -£250m. However, in Ofcom's highest case it will gain a surplus of £610m.

11.51 None of these calculations are set out or explained in the Consultation and Ofcom recognises that there is uncertainty around the numbers[148]. Plainly, they cannot be relied upon to quantify the producer surplus for Sky.

11.52 Furthermore, in Ofcom's explanation of the likely static effects of its remedy on Sky it ignores one important effect: the reduction in retail revenues to Sky as a result of increased retail price competition which Ofcom itself recognises will exist in paragraph 6.58 of the Consultation. Ofcom is plainly wrong, for the reasons set out above (and further below), to conclude that the remedy will not provoke increased retail price competition and a lowering of retail prices by Sky in response to undercutting it will face from operators taking advantage of the fixed wholesale price, retail margin and the ratchet.

11.53 Again, Ofcom's analysis of the effects of the remedy on Sky is wholly insufficient and fails to quantify properly the effects of the remedy.

11.54 Whilst Ofcom asserts that it has now carried out a more detailed quantitative assessment in this Consultation than its previous qualitative assessment this is demonstrably incorrect when the actual findings and analysis are considered.

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145 Paragraphs 10.65 and 10.73 Consultation
146 Paragraph 10.66 Consultation
147 See *Tesco* at paragraph 162
148 Paragraph 10.74 Consultation

11.55 Ofcom's assessment could neither be considered quantitative nor qualitative. It simply amounts to a number of unsubstantiated, and speculative assertions about what Ofcom believes will be the impact of its remedy.

11.56 This is insufficient given the drastic nature of the remedy. As the CAT found in *Tesco* "*the more intrusive, uncertain in its effect, or wide-reaching a proposed remedy is likely to prove, the more detailed or deeper the investigation of the factor in question may need to be*"[149].

11.57 As a consequence of its superficial assessment, Ofcom has not addressed or reached adequate and evidenced conclusions on what the actual aim of its remedy is (i.e. is it appropriate) or whether it will achieve this aim (i.e. be effective). This makes Ofcom's ability to carry out a proper proportionality assessment impossible as it fails the first two proportionality principles set out above.

11.58 However, for completeness the PL sets out below its view on whether the remedy is more onerous than is required to achieve the aim necessary/there is a less onerous remedy available and whether the remedy produces adverse effects which are disproportionate to its aim.

Is the remedy more onerous than required/least onerous option and does it produce adverse effects that are disproportionate to what it pursues

11.59 In relation to these issues Ofcom must consider what it is that it exactly seeks to remedy and consider whether its remedy will produce costs and adverse effects that outweigh any benefit that might arise.

11.60 Therefore, Ofcom must identify and analyse what the economic costs of its remedy are (including the costs to Sky and the costs to rights holders in terms of reduced value) and provide evidence to support any conclusion that the costs are less than the benefit to the consumers and new entrants of the remedy. For instance, Ofcom should assess "*the debit side of a proposed measure so that this can be balanced against the benefits or "credit" side*"[150].

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[149] Paragraph 129, *Tesco*

[150] Paragraph 130 *Tesco*

11.61 The reason for doing this is that it is clear that a *" measure will be considered not to be proportionate if it is ineffective with respect to its aim, or if its "costs" are disproportionately large in comparison with the mischief at which it is aimed"*[151].

11.62 However, in identifying the costs that it must weigh against the alleged benefits of its intervention[152] Ofcom only identified incremental administrative and compliance costs for Sky. Its refusal to acknowledge the likely economic costs of its remedy on rights holders, such as the PL, was flawed and simply wrong. As set out below the remedy will have a significant effect on Sky and on rights holders (and as a consequence consumers) and Ofcom has erred in not recognising this.

11.63 Therefore, the proportionality assessment fails again.

11.64 In addition, as set out above, Ofcom's concerns could easily have been remedied by allowing Sky to retail on the DTT platform. This would have been a less onerous obligation and ought to be capable of alleviating its concerns. By not allowing this Ofcom is in fact distorting the retail market itself and potentially causing harm to consumers.

Adverse effects of the remedy on the PL (and other sports rightsholders)

11.65 The final nail in the coffin of Ofcom's alleged proportionality assessment is its failure to identify and take into account the adverse effects of the remedy on the relevant stakeholders; and in particular the impact on rights holders such as the PL. Ofcom's conclusions on the effect of the remedy on the PL are wholly irrational and do not recognise the severe adverse effects on the PL and other relevant sports rights holders.

11.66 As set out repeatedly in this response the proposed remedy will have a significant detrimental impact on the value of sports rights and the PL's rights as a result of its impact on the value of rights to bidders and the incentives on bidders to bid for the rights. This detrimental impact (cost) does not outweigh any alleged benefits of the remedy.

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151 Paragraph 131 *Tesco*

152 Paragraph 10.20 Consultation

11.67 The PL sets out, in more detail below, the clear economic costs of Ofcom's remedy on rights holders such as the PL arising out of the effects of the remedy on Sky and other retailers/platform operators and broadcasters.

11.68 In paragraphs 10.75 to 10.86 of the Consultation Ofcom simply performs a cursory and unsatisfactory assessment of the impact its proposed remedy will have on the value of rights. Its assessment amounts to little more than assertion, with no quantitative or independent qualitative evidence to justify its position. It, therefore, clearly fails any proportionality test

11.69 Ofcom argues that the value of rights content is determined by two factors:

11.69.1 The value of the rights to Sky, which in Ofcom's view is affected by the wholesale revenues earned from Sky Sports 1 and Sky Sports 2. In Ofcom's (incorrect) opinion, provided the proposed wholesale remedy will permit Sky sufficient revenues to cover its full rights expenditure, it will have no adverse effect on the amount that Sky will bid.

11.69.2 The incentive of other potential bidders to compete for the rights. Ofcom argues that competition for sports rights will not be adversely affected and may actually lead to an increase in the vigour of that bidding competition.

11.70 In essence Ofcom assesses the willingness to pay for content by:

11.70.1 assuming that Sky will be willing to pay as much as it currently does for rights on the grounds that the cost-plus floor will ensure Sky recovers sufficient wholesale revenues to recover its (current) spending on rights. This is despite the fact that wholesale prices will actually decline significantly under the proposed remedy. Specifically Ofcom consider that *"based on Oxera's analysis [of Sky's profitability] …[the remedy] would not affect Sky's ability at least to match its current levels of rights expenditure"*[153];

11.70.2 arguing that Sky may even be willing to pay more under the remedy because the expanded market may mean that Sky's wholesale revenue would increase. Specifically, Ofcom states that *"expansion is likely to counter-balance the reduction in wholesale prices, potentially to a large extent, meaning that*

153 Paragraph 10.81 Consultation

Sky's wholesale revenues may not substantially decrease, and indeed may increase"[154];

11.70.3 ignoring the impact of the proposed remedy on Sky's retail revenues; and

11.70.4 ignoring the willingness to pay of potential competitors and the role that plays in auctions for content rights.

11.71 Ofcom also assumes that bidders other than Sky will continue to have strong incentives to bid for content rights, specifically:

11.71.1.1 *"it is unlikely that the introduction of such a remedy will affect the incentives of free-to-air broadcasters in general"*[155];

11.71.1.2 *"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"*[156]*; and*

11.71.1.3 vertically integrated competitors to Sky (eg Virgin) and BT may decide to rely on the wholesale remedy while others will want to gain editorial control. Ofcom conclude with the paradox that *"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"*[157];

11.72 Such analysis is both overly simplistic and misrepresents the likely outcome of its proposed retail minus price regulation and why this will lower the value of rights to Sky and others; and thus reduce the value of sports rights generally, including the

[154] Paragraph 10.82 Consultation
[155] Paragraph 10.84 Consultation
[156] Paragraph 10.84 Consultation
[157] Ibid

PL's rights. This will cause a significant decline in the quality of content which will only be detrimental to consumers.

11.73 The following explains the flaws in Ofcom's reasoning. It is noted that auctions theory makes it clear that the outcome of an auction is affected by (a) the valuation placed on the rights by bidders and (b) the degree of competition amongst bidders for rights, including the number of bidders. A decline in either (a) or (b) will lead to a reduction in the value of content rights.

11.74 In the remainder of this section, we consider how the proposed wholesale remedy will likely affect competition for, and the value of, the audiovisual rights of content that is packaged in Sky Sports 1 and Sky Sports 2. Those rights include not only the PL but also other football rights, such as UEFA Champions League, Scottish Premier League, the FA Cup, and the rights to other sports, including *inter alia* rights to English cricket, European Tour golf, rugby union, rugby league and tennis.

11.75 Contrary to the assertion in Ofcom's Consultation the proposed wholesale remedy will almost certainly lead to (a) a reduction in the valuation placed on these rights by Sky and by other potential bidders; and (b) a reduction in the number of bidders, which will likely result in a reduction on the vigour of competition for these rights. Both of these outcomes will inevitably lead to a lowering of the value to be paid for these sports content rights. It is stressed again that such adverse effects apply not only to the PL but also to all other sporting events that are either currently or potentially shown on Sky Sports 1 and 2.

11.76 Moreover, Ofcom's assertion that the reduction in Sky's current revenues from Virgin Media will be offset by an increase in the total number of subscribers to Sky Sports 1 and 2 is entirely unfounded. The notion that any market expansion in the total number of subscribers to Sky Sports 1 and 2 on non-Sky platforms will be sufficient to offset the immediate reduction in the current wholesale price and the likely reduction in Sky's retail revenues is shown to be wrong in **Annex 3** which models the effect of the proposed remedy on Sky's combined wholesale and retail revenues.

11.77 Ofcom's assertion that the value of rights will be unaffected because Sky's revenues will increase is wrong for the following reasons:

11.77.1 First, the required market expansion effect (considered in more detail below in relation to the effect of the remedy on Sky) would need to be substantial in order for Sky's wholesale revenues to remain at current levels. But even if the working assumption that retail prices are unlikely to be affected by the proposed wholesale remedy were correct (which the PL considers highly implausible), it is extremely unlikely that the market expansion effect would be anything but modest. Without increased price competition alternative retailers can only compete on the quality of the service they provide. As Ofcom accepts, the quality of television channels is predominantly dependent on their programming. Under the wholesale remedy Sky's core premium channels may be available on all platforms. It stands to reason that under Ofcom's presumed scenario, market expansion based only on small differences in the basic channels offered by other platforms, is never likely to be sufficient to offset Sky's reduced wholesale revenues.

11.77.2 Second, in the alternative scenario where the proposed wholesale remedy does lead to a reduction in retail prices, which we expect it will given the overly generous margin Ofcom permits to the likes of Virgin and BT (see **Annex 2**), that can only serve to cut drastically Sky's revenues further. As the modelling in **Annex 3** shows, the initial effect of price competition that causes Sky to reduce its retail price would be a reduction in Sky's revenues that would not be offset by market expansion.

11.77.3 Furthermore, increased retail price competition will begin a chain reaction that would logically see the wholesale price drop to, and potentially below, the cost plus floor. The retail-minus calculation of the wholesale price protects the margin of Sky's competitors until wholesale prices reach the cost-plus floor. Any increased price competition that leads to Sky cutting its retail price will continue to drive down retail prices until the wholesale price reaches the cost-plus floor since, while the wholesale price remains above the cost-plus floor, alternative retailers will continue to be able to undercut Sky's retail prices without themselves having to make a loss. As accepted by Ofcom, setting wholesale prices based on the cost-plus methodology would adversely affect incentives to bid for content rights. Therefore, once the wholesale price reaches the cost plus floor, rights holders must realise lower returns for their content. That in turn will artificially reduce Sky's costs (as well as the quality of its content) which will result in a reduction in the cost-plus wholesale price below that based on current costs derived in competitive markets for content rights. This further reduction in the wholesale price will drive down retail prices further thus continuing the cycle in which retail prices and the value of content rights continually fall even once the wholesale price reaches the cost-plus floor. Therefore, contrary to Ofcom's assertion the cost-plus floor will fail to provide any protection to the value of rights (see **Annex 3**).

11.77.4 Third, any market expansion effect would need to take place within the time period covered by the next sale of content rights (i.e. for the PL a three year period but for other rights holders the period may be longer or shorter); any market expansion after that period is simply irrelevant for bidders determining the value of content rights. Ofcom simply fails to take this market fact into account when it assesses the validity of its proposed remedy over a ten year period. The modelling of Sky's revenues in Annex 3 suggests that the market expansion necessary to offset Sky's reduced revenues from lower wholesale charges is unlikely to materialise before PL rights are next awarded.

11.78 The reduction in the valuation of PL rights and other sports rights will necessarily reduce the revenues which are made available for investment in football and other sports in England and Wales, the development of grass roots sport across the country and the large number of charitable and social causes supported by rights holders such as the PL both domestically and around the world: most importantly, the consequent damage to investment in sport would damage the sporting spectacle and the programming content which consumers value so highly.

11.79 This response primarily addresses the impact of the proposed remedy upon the PL. However, as noted above it is important to recognise that the proposed remedy would have a similarly detrimental impact upon each and every sport and sporting competition which is featured on either of the Core Premium sports channels targeted by Ofcom. The continued health of a large number of these sports depends upon an open and competitive market for rights and the value that such a market creates. Ofcom's proposed remedy will damage not only the PL and English football but also British sport as a whole. Ofcom's proposed remedy should, therefore, be assessed with that fact in mind.

11.80 Bidders for the PL's live rights in the United Kingdom can be separated into the following different categories of bidder:

11.80.1 Sky (as the direct target of Ofcom's proposed remedy);

11.80.2 pay television broadcasters who are not also platform operators (for example, ESPN or, previously, Setanta);

11.80.3 FTA broadcasters (primarily, the BBC, ITV, Channel 4 and Channel 5); and

11.80.4 vertically integrated content providers and platform operators (other than Sky) such as Virgin Media and BT.

11.81 Set out below is the effect that the proposed wholesale remedy would have upon each category of bidder in terms of the impact of the proposed remedy on the valuation placed on PL rights and in terms of the likelihood that each category would continue to bid. We explain why the overall effect of the proposed remedy would be to reduce the value of the rights to Sky and other potential bidders and reduce competition for live PL rights leading to a deflationary effect upon the value of those rights and the damaging consequences of any such deflation set out in above.

Effect on Sky's incentives to bid/value of rights to Sky

11.82 Sky has in the past been the most bold and, therefore, the most successful bidder for the PL's live rights. The damaging impact of any wholesale remedy will, therefore, be most keenly felt by the PL if its effect is to reduce the value of these inputs to Sky and Sky's appetite for PL rights. In this regard, Sky's commitment to investing in the PL and its coverage of the competition have had nothing but a beneficial effect for all stakeholders in English football.

11.83 This investment has enabled the PL member clubs to create one of the world's leading and most-watched sporting competitions. The flow of audiovisual revenues to its member Clubs means that those Clubs can attract top playing talent from across the world and can invest in state-of-the-art stadia and facilities where supporters can watch that playing talent compete on the pitch. Ofcom should be under no illusion that its misguided intervention threatens this success story (and the continued health of British sport as a whole) and will damage consumers.

11.84 Ofcom seeks to claim that Sky's valuation of the PL's rights will not be adversely affected provided Sky can make a profit on wholesaling its channels (see paragraph 10.79). Ofcom states that this will be the case since the regulated wholesale price will be set above the cost-plus level and so Sky's wholesale revenues will be sufficient to cover the cost of securing the rights to the content that it has currently secured in the market. Moreover, Ofcom seeks to argue that Sky's overall wholesale revenues may in fact increase as a result of Ofcom's proposed remedy because of the increase in the total number of subscribers to Sky Sports 1 and 2 on all platforms (the so called "market expansion" effect).

11.85 However, this is an extremely simplistic and misleading claim which ignores the following factors.

11.86 The valuation that Sky places on the acquisition of PL rights depends on the total expected revenues to be earned from employing those rights and not just on the wholesale revenues that it will earn. The proposed wholesale remedy is likely to result in a reduction in the total revenues earned.

11.86.1 First, the proposed wholesale remedy will result in a loss of retail revenues arising from consumers switching from Sky (Ofcom must be expecting this) to a competing platform as a result of increased price competition (which will also push the wholesale price to, and likely beyond, the current cost plus floor).

11.86.2 Second, wholesale revenues earned on sales to Virgin Media will decline since the proposed wholesale remedy envisages a significant reduction of around 20% in those wholesale terms.

11.86.3 Third, any market expansion in the total number of subscribers on platforms other than Sky's during the relevant period (i.e. the period covered by the sale of the rights) will be too low to offset Sky's revenue losses.

11.87 Each of these is considered in turn.

11.88 Ofcom clearly envisages that the proposed wholesale remedy will lead to consumers that are currently purchasing Sky Sports 1 and 2 from Sky's DSat platform switching to purchasing those channels from a competing platform; if that were not the case, there would be no rationale at all for imposing the proposed wholesale remedy.

Ofcom's proposed wholesale remedy and the protected (excessive) retail margin will allow other retailers to significantly undercut Sky's retail prices by setting their prices below the current competitive levels.

11.89 Each consumer that switches away from Sky would result in a loss of the "retail margin" associated with that customer. According to figure 65 of the Consultation the proposed wholesale remedy will provide for a retail margin on premium channels of between £13.39 and £17.82 (i.e. the difference between the Sky's current retail price and the respective regulated wholesale price). Assuming that following the introduction of the proposed wholesale remedy Sky were to lose 10% of its premium retail subscriber base, this would result in a reduction in revenues from premium channels of 8.7% (not including revenues those customers contribute when purchasing other services Sky offers). That revenue directly contributes to Sky's considerable fixed and common costs.

11.90 Ofcom's failure to take account of the loss in Sky's retail revenues will have a substantial detrimental effect on Sky's ability to recover its costs from acquiring rights and also its ability to earn a return on its investment. This will clearly affect the value Sky places on content rights .

11.91 Contrary to Ofcom's claim that its proposed remedy would lead to an increase in Sky's wholesale revenues, it is inevitable that in the short to medium term (i.e. the period covered by the next bidding round for sports rights) the remedy would lead to a decrease in Sky's wholesale revenues. This is because the regulated wholesale price proposed by Ofcom will result in a reduction of approximately 20% (based on the midpoint of Ofcom's weight average range of wholesale prices from consultation) in the per subscriber wholesale price currently charged by Sky to Virgin Media.

11.92 Furthermore, the analysis of Sky's hypothetical revenues in **Annex 3** demonstrates that the proposed wholesale remedy could lead to a reduction in Sky's combined revenues of between 4% and 19%. The extent of lost revenue will be dependent on how the market develops, particularly the proportion of consumers that switch from Sky's platform, the level of the wholesale price Ofcom imposes, the degree of any reductions in retail prices that come about from increased retail price competition and the extent of any expansion of the market for Sky's premium channels. Given the substantial fixed costs associated with operating its DSat platform, and other fixed costs, such a loss in revenue would translate into a seriously adverse impact on profitability. It is inconceivable that such a considerable loss of revenue would have no impact on Sky's ability to bid for rights.

11.93 Ofcom recognises the loss of wholesale revenues but argues that the fall in Sky's current wholesale revenues would be offset by an increase in wholesale revenues obtained from wholesaling to other platforms. But in order for this to be the case, the number of new subscribers to Sky's channels on other platforms would have to be so great as to make it extremely unlikely to occur and certainly would not occur within the timeframe of the current contract round for PL and other sports rights which are generally three years in duration[158]. The proposed wholesale remedy will therefore inevitably depress Sky's wholesale revenues with consequential adverse effects on Sky's valuation of those content rights.

11.94 In short, Sky's valuation of PL content rights would be seriously adversely affected by the proposed wholesale remedy.

11.95 In addition to the above revenue effects, the proposed wholesale remedy restricts Sky's commercial freedom and in so doing increases the risks associated with bidding for sports content rights. Currently, Sky bears the entire financial risk associated with its investment in sports content rights but is not constrained (other than by market forces) in its setting of retail prices (which are not found to be too high). Under the proposed wholesale remedy, that would no longer be the case.

11.96 Sky would be disincentivised from decreasing its retail prices because it knows this will automatically reduce the regulated wholesale price and is effectively prevented from increasing its retail prices since this would not necessarily lead to any increase in the regulated wholesale price. Clearly, without the commercial flexibility to determine its retail prices freely, the risks associated with bidding large sums for sports content rights that Sky faces will increase as a result of the proposed wholesale remedy and this will necessarily reduce Sky's willingness to bid at the same levels absent the proposed market intervention.

11.97 Sky will also know that competition for rights from, and the value of the rights to, other pay television broadcasters and retailers will be either non-existent or

158 See Annex 3

diminished for the reasons explained below and that therefore it will have to bid less for the rights in order to outbid those other broadcasters and retailers. This will further depress competition for, and the value of, the rights.

11.98 Ofcom argues that its use of the cost–plus floor will protect Sky's valuation of rights and thereby the value of rights. Such speculation is flawed. In the short term the value of premium channels may be protected by Ofcom's use of the cost plus floor. However, over time, retail price competition (made propitious by the overly generous margin Ofcom permits in its retail-minus calculation) will lead to Sky being forced to reduce its retail prices in order to retain subscribers.

11.99 Those reductions in retail prices will drive down wholesale prices (under the retail-minus calculation) to the cost-plus floor. Once wholesale prices reach the cost-plus floor, other bidders for content rights have reduced incentives to bid for content (as Ofcom recognises). In turn that will depress the value of rights and reduce Sky's costs and ultimately reduce premium content to parity with ordinary content. Dispossessed of the ability to realise the value in their premium content, premium content producers will not be able to invest in developing their content. In the case of the PL this would mean a reduction in investment in, inter alia, playing talent, stadium facilities, lower levels of English football and good causes.

11.100 It is also worth noting that, by removing Sky's ability to differentiate its retail offering, Ofcom's proposed remedy would also disincentivise Sky from investing in its coverage of sporting events and competitions such as the PL. In the past, Sky has invested in producing innovative coverage of PL matches including, by way of example, HD coverage, player-cam facilities, alternative "fan" commentaries, multi-camera coverage, super slow-motion camera coverage and software enabling detailed match analysis. If Sky knows that competitors can free-ride on its investment, its incentive to invest in producing innovative coverage will be significantly diminished.

Effect on Pay Television Broadcasters' (not platform operators) incentives to bid/valuation of rights

11.101 Just as is the case with Sky, the valuation of sports content rights by pay tv broadcasters is determined by (a) the retail revenues that those rights can be expected to generate (b) the wholesale revenues that those rights can be expected to generate and (c) the risks incurred when securing those rights. The proposed wholesale remedy will adversely affect the valuation for pay tv broadcasters.

11.102 As envisaged by Ofcom, the proposed wholesale remedy will entail switching of subscribers away from the DSat platform to competing platforms. Just as such switching adversely affects Sky's retail revenues, it will also affect pay tv broadcasters (such as ESPN) that choose to retail their channels on the Sky platform. As Sky's subscriber base and/or retail prices decrease this will inevitably reduce the retail revenues that other pay tv broadcasters can earn on the DSat platform.

11.103 Furthermore, the proposed wholesale remedy will reduce the bargaining position of alternative pay TV broadcasters (such as ESPN) whose business model (and ability to bid competitively for rights) depends on their ability to secure a fair wholesale price via their distribution deals for their channels with as many platforms as possible.

11.104 If Sky's Core Premium sports channels will be universally available at a discounted wholesale price to all other platform operators, that will make it more difficult for other broadcasters to obtain a fair wholesale price for their Channels and this will reduce incentives to invest in the acquisition of sports rights.

11.105 In addition, other retailers (such as Top Up Tv) will have less incentive to purchase wholesale channels from broadcasters such as ESPN when they can obtain Sky's Channels at a subsidised price.

11.106 Equally, if the proposed remedy results in switching from the DSat platform (as Ofcom clearly expects), Sky will also have less incentive to invest in acquiring such sports channels for retailing on its platform. This will depress the wholesale prices paid by platform operators for other sports channels on all platforms.

11.107 The reduction in expected retail and wholesale revenues these other pay TV broadcasters expect will inevitably reduce their incentives to bid for content rights and invest in the creation of sports channels to compete with Sky Sports.

11.108 Furthermore, if other pay tv broadcasters know that content rights are less valuable to Sky, they will also bid less for them since they know they will face less competition in the market for rights. In other words, Ofcom's proposed remedy will serve only to depress the value of content rights to broadcaster and rights holders.

Effect on Vertically Integrated Pay Television Retailers/Platform Operators Incentives to bid/valuation of rights.

11.109 Ofcom accepts that a likely consequence of the proposed wholesale remedy is that vertically integrated platform operators, such as Virgin Media, will decide to rely entirely on the wholesale must-offer remedy.

11.110 Ofcom will be aware that no other platform operator has bid successfully and contracted for live PL rights. By way of example, Virgin Media has been in business for at least as long as Sky (previously in the form of NTL and Telewest) and has not once submitted a successful bid for exclusive live rights or set up a channel upon which the rights might be exploited. The same applies to BT. However, these are not insignificant or failing companies.

11.111 Nevertheless, Ofcom still appears to feel the need to intervene in order to allow these organisations to free-ride on the back of Sky's investment and earn a guaranteed fifty per cent (50%) margin (see figure 65 of the Consultation).

11.112 This is clearly disastrous for all sellers of any audiovisual content which features on any Sky sports channel. Pay television retailers/platform operators are effectively removed from the rights market because there is no reason whatsoever for any such undertaking to compete and risk its own money in the rights market when it can be certain of obtaining access to premium content via Sky and at an artificially depressed price.

11.113 Indeed, the idea that the existence of the wholesale remedy will somehow create a competitive utopia in which undertakings such as Virgin Media and BT Vision suddenly consider that they should reverse their historic strategy and start to bid for rights is self-evidently misguided. Indeed, Virgin Media's CEO has recently stated that the developments on the regulatory front have vindicated the company's strategy of not bidding for premium content rights[159]. With the rights to retail Sky's Core Premium channels handed to them on a plate by the regulator, any incentive they once might have had to bid competitively for rights is effectively gone forever. This will further reduce competition for, and depress the value of, sports rights.

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159 Virgin Media Q2 2009 Earning Release Conference Call August 2009.

Effect on Free-to-Air Broadcasters' incentives to bid/valuation of rights

11.114 The regulated wholesale remedy will have little or no effect upon the willingness of FTA broadcasters to bid for PL rights. FTA broadcasters are more limited in their ability to monetise any investment in sports rights because they do not have access to subscription revenues. Further, capacity constraints mean that FTA broadcasters do not have the airtime available to broadcast the same quantity of sports programming as a broadcaster of a dedicated sports channel.

11.115 FTA broadcasters are also restricted to an extent by their public service remit - for example, it seems unlikely that the BBC would be supported in a bid for a substantial quantity of live PL rights.

11.116 This means that, once the value of PL live rights to pay television broadcasters and platform operators has been depressed as a result of the wholesale remedy, no FTA broadcaster will be in a position to make up that reduction in the value of PL rights.

Summary

11.117 The proposed wholesale remedy will have the following impact on the valuation placed on rights and the likelihood of bidding for those rights:

Market participant	**Impact of Proposed Wholesale Remedy**
Sky	Reduced valuation of rights
Pay TV broadcasters	Reduced valuation of rights
Vertically integrated platforms	No incentive to bid for rights
Free-to-air broadcasters	No direct change

11.118 Combined, these consequences of the proposed wholesale remedy necessarily imply that the valuation of sports content rights will decline and most likely that decline will be significant. Not only, therefore, is there nothing to support Ofcom's assertion that the proposed wholesale remedy will have no impact on the valuation of content rights, but there is every reason to expect that the reduction in content values that the remedy would produce will depress the quality of content which is currently available to, and highly valued by, consumers.

11.119 Consequentially, the adverse effects and costs of the remedy for broadcasters, rights holders and consumers will dramatically outweigh any benefits (if they exist) that might arise from the remedy.

11.120 Therefore, if Ofcom had undertaken a proper proportionality assessment it would have realised that its proposed remedy is wholly disproportionate and must not be imposed.

12. SECTION 12 CONSULTATION - REMEDIES: CONTENT RIGHTS

12.1 In Section 12 of the Consultation Ofcom describes a concern that its proposed remedy will not address Sky's market power[160]; and raises two alleged concerns that arise out of Sky's market power; namely, high wholesale margins and the restricted exploitation of content rights. Ofcom does not intend to address these concerns by intervention at source. However, Ofcom states that these concerns may give rise to a case for more targeted intervention in relation to the next PL auction. Therefore, Ofcom intends to review with the PL how any auction of its rights in 2012 will comply with competition law; including exploring with the PL whether it is willing to provide further commitments.

12.2 However, Ofcom has failed to identify any actual competition law concerns arising out of the sale of the PL's rights; and certainly there is nothing that justifies any such intervention. Ofcom, therefore, cannot legitimately seek to intervene in the way in which the PL sells its rights in the future on the basis of unsupported allegations about the current market position.

12.3 Competition law does not prevent the acquisition of or maintenance of market power per se (save possibly in relation to merger control: which we are obviously not concerned with) and Ofcom has no grounds for significantly disrupting the legitimate exploitation of the PL's rights in the future on the basis of unsupported allegations.

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160 Paragraph 12.4 Consultation.

12.4 Moreover, there is no need at this stage for "targeted interventions"[161] into the way in which the PL sells its rights in the future. The PL has not taken any action in relation to the sale of its rights from the 2013/14 season onwards that could constitute a basis for Ofcom initiating an investigation under CA98. Any action by Ofcom would clearly fail the Section 25 CA98 test as there are no reasonable grounds whatsoever for suspecting that the PL (and/or its members clubs) have entered into any agreement in relation to the sale of the PL's rights after the 2012/13 season. Any decision to open an investigation at this stage would be strongly resisted by the PL.

12.5 In any event, it goes without saying that the PL takes its obligation to comply with competition law seriously and does not intend to take any action in the future that would infringe either Article 81 EC or Chapter 1 CA98.

12.6 Ofcom's proposals (see paragraph 12.42 Consultation) are wholly inappropriate and without foundation. They amount to nothing more than an erroneous view that collective selling per se ought to now be investigated as a potential infringement of competition law. This is an entirely unsupportable approach; especially in light of UK case law, existing Commission decisions and Ofcom's recognition that content aggregation by rights holders such as the PL produces significant consumer benefits; making it necessary and, therefore, not an infringement of competition law.

Sale of the PL's rights and market power

12.7 In paragraphs 12.35 to paragraph 12.42 of the Consultation Ofcom raises concerns about *"the role of collective selling in creating market power"*; and specifically 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"*.

12.8 However, it also recognises the multiple benefits of collective selling by sporting organisations and that the Commission has either accepted commitments or attached conditions to Article 81(3) EC exemptions for the collective sale of sports content by a number of different rights owners.

12.9 Nevertheless, despite these acknowledgments Ofcom does not analyse the Commitments given by the PL and it ignores the purpose of those Commitments e.g.

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161 Paragraph 12.14 Consultation

to meet the Commission's concerns that there could be downstream foreclosure effects in the broadcast market through collective selling.

12.10 As set out below, there is absolutely no basis for any competition law concerns arising out of content aggregation which has always been found (in the sporting context) to give rise to significant benefits for rights holders, broadcasters and consumers.

12.11 Content aggregation clearly creates the "virtuous circle" which is objectively necessary to protect the solidarity principle and bring a variety of benefits to ultimate consumers not least in terms of the quality of content which is available for spectators, fans and television viewers to enjoy at all levels of sport.

12.12 Under the Commitments the PL's live rights are sold in evenly balanced packages so that broadcasters can acquire sufficient rights to compete in the downstream markets. The additional rule against a single buyer of all packages also protects competition in the downstream market. The auction allows any broadcaster to contest the rights and provides equal access to any broadcaster wishing to acquire the rights.

12.13 The Commitments were sufficient to address the competition law concerns identified, which largely related to the effect on the downstream market, because they *"considerably improved the scope for ex ante competition for the rights"*. The Commitments allow for the rights to be offered frequently to the market and anyone can bid to win the rights. There is nothing in the process that favours the current incumbent broadcaster for any package.

12.14 The Commitments that the PL provided to the Commission have done exactly what the Commission intended in providing ex ante competition for the PL's rights. There has been no restriction of output or foreclosure of competitors in the downstream broadcast market. As Ofcom recognises, the Commitments facilitated the entry of Setanta (and now ESPN) into the market and the development of entry level packages on non-Sky platforms.

12.15 Furthermore, the Commission has examined the operation of the PL Commitments (along with the *UEFA* and *Bundesliga* commitments), in a Working Paper accompanying its recent White Paper on Sport.

12.16 Paragraph 3.1.3.2 of Annex 1 to its Working Paper clearly demonstrates the Commission's view that the maintenance of sufficient *ex ante* competition addresses any competition concerns that might otherwise arise. The Commission explained that:

12.16.1 in order to reduce the risk of foreclosure effects in the downstream market the Commission required the collective sellers from the upstream market to organise a competitive bidding process under non-discriminatory and transparent terms because "*this approach gives all potential buyers an opportunity to compete for the rights"*.

12.16.2 although the Commission acknowledged the need for a certain degree of exclusivity the risk of long term market foreclosure was addressed by requiring the duration of the exclusive rights that were offered to be limited. Longer contract duration would have risked creating a situation "*where a successful buyer would be able to establish a dominant position on the downstream market reducing the scope for effective ex ante competition in the context of future bidding rounds"*.

12.16.3 in order to limit the risk of market foreclosure resulting from a single buyer acquiring all rights it would oblige the collective selling entity to unbundle the media rights into separate packages which reduced the scope of the exclusivity; and

12.16.4 the no single buyer obligation in the PL Commitments was deemed necessary *"to prevent downstream foreclosure and to ensure access also of other market players"*.

12.17 It is also important to note that the Commission accepted that Sky should be entitled to win 5 of the 6 packages and carefully considered the balance of the packages to ensure that a win of 5 of the 6 packages would not adversely affect competition in the downstream market.

12.18 The Commitments were deliberately designed to ensure that no single buyer of its rights could develop or obtain market power in the downstream broadcast market. There is no suggestion and has never been any suggestion by the Commission that the Commitments are not operating properly. This clearly seriously calls into question

Ofcom's downstream competition concerns, especially any suggestion that Sky is charging high wholesale prices as a result of its acquisition of live PL rights.

12.19 The fact that Sky won 4 of the 6 packages for 2007 - 2010 and 5 of the 6 packages for 2010 - 2013 is irrelevant and does not mean that it has long term dominance that would foreclose access to or expansion in the downstream market.

12.20 The simple fact is that prior to the emergence of Setanta (and now ESPN) other pay TV broadcasters/platform operators/retailers have consistently demonstrated (over a period of nearly 20 years) an unwillingness to bid competitively for sports rights and have simply not wanted to invest in the development of sports channels. As a result, they have chosen to focus their businesses elsewhere. This is not due to a lack of competition at any level of the chain.

Competition law implications of collective selling

12.21 When considering the application of Article 81 EC Chapter I CA98 to the collective sale of exclusive media rights licences, one of the key competition law concerns for the enforcement authorities/national courts has been on ensuring that no foreclosure issues arise at a downstream, broadcast level. The clear focus in the Commitments given to the Commission by the PL, and in the analysis in other cases such as *UEFA*[162] and *Bundesliga*[163], was on ensuring that there are sufficient and proper opportunities for *ex ante* competition in the acquisition of sports media rights.

12.22 Provided sufficient *ex ante* competition exists, and the duration and substance of the relevant licences is not excessive, it is well recognised that no foreclosure issues can arise in the downstream market. Therefore, collective selling cannot give rise to a cause for concern. On the contrary, it is well recognised that "*promoting efficient competition for sports TV rights is likely to improve competition on TV broadcasting markets and give viewers access to quality TV services, which are reasonably priced, innovative and varied*"[164].

12.23 The collective selling of sporting rights has been considered extensively by the Commission and the national courts in recent years. The most relevant case law is

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162 COMP/C.2-37.398 *Joint Selling of the commercial rights of the UEFA Champions League* 23 July 2003

163 COMP/C.2-37.214 *Joint Selling of the media rights to the German Bundesliga, 19 January 2005*

164 See, Bellamy & Child "*European Community Law of Competition"* Sixth Ed at page 372.

analysed further below as both the Commission and the UK High Court have taken a somewhat different view of the competition law implications of collective selling. It is far from clear that collective selling, per se, could give rise to any competition law concerns under Article 81/Chapter 1 Competition Act 1998.

12.24 However, it is important to note that none of the case law has found collective selling to be an infringement of Article 81/Chapter by "*object*" and all consideration of collective selling has been in relation to either its "*effect*" on competition, or whether collective selling is necessary and, therefore, not an infringement of competition law in the first place.

12.25 In the case of sport it is not necessarily the case that collective selling is an infringement of competition law. Such agreements, can either be necessary or have no effect on competition by virtue of how the arrangements operate.

No "effect" on competition

12.26 In the *UEFA* and *FAPL* cases the European Commission found that collective selling did have an **effect** on competition. However, in *UEFA* the arrangements were exempted under Article 81(3) and in the *FAPL* case the selling arrangements were modified so as to satisfy the Commission that the collective selling no longer had an effect on competition.

12.27 The main competition law concerns about the effect of collective selling in the *UEFA* and *FAPL* cases arose in circumstances where there was one aggregator of all rights to a particular sporting competition selling rights on behalf of all undertakings which could possibly lead to the creation of foreclosure effects in downstream markets. There were no concerns about the collective selling leading to detrimentally higher prices at the wholesale or retail level. In fact funds obtained through the collective selling of rights are redistributed throughout the sport to the benefit of consumers.

12.28 It is clear from these cases that the Commission was concerned to ensure that collective selling, of all the rights to a particular sporting competition by the aggregator, did not result in only one purchaser acquiring all the rights which would lead to foreclosure in the broadcasting market. Therefore, in both *UEFA* and *FAPL* the rights were sold in packages so that multiple broadcasters could acquire sufficient rights to compete in the downstream broadcast market. These rights were sold by auction to ensure that there was equal access for broadcasters and effective competition for the acquisition of the rights.

Collective selling is objectively necessary

12.29 A different approach to collective selling by sporting organisations has been taken by the UK courts. The Competition CAT in the *Attheraces* case[165] found that collective selling was objectively necessary and therefore did not fall within the prohibition in Article 81(1) at all.

12.30 In relation to the general approach to analysing whether agreements infringe Article 81(1) the CAT held as follows in *Attheraces*:

> *"ostensibly restrictive arrangements which are necessary to achieve a proper commercial objective will not, or may not, constitute an anti-competitive infringement at all. Whether or not they will do so requires an objective analysis of the particular arrangement entered into by the parties, assessed by reference to their subjective "wants" and against the evidence of the particular market in which they made their arrangement. The task then is to consider whether the restrictive arrangement of which complaint is made is "necessary" to achieve the objective…competition law is not an area of law in which there is much scope for absolute concepts or sharp edges".*

12.31 In applying this to the facts of the case the CAT accepted that there was a necessary critical mass of rights that needed to be acquired in order for the new venture to be viable. It then went on to consider whether the critical mass could have been acquired by individual negotiation with racecourse owners rather than by a process of collective negotiation. It dismissed the idea of assembling a critical mass by individual negotiation as *"a triumph of theory over commercial reality"*[167]. The CAT concluded that central negotiation was the only realistic way forward, for both the seller and the bidders, and that *"the central negotiation in which the Courses engaged was necessary for the achievement both by them and by ATR of the legitimate*

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165 Paragraph 167 CAT Judgment
167 Paragraph 170 CAT Judgment

commercial objective of creating the new product that ATR proposed to exploit for the benefit of itself, the punters, the racecourses and racing generally…We conclude that the MRA involved no infringement of the Chapter I prohibition"[168].

12.32 In the *BAGS* litigation the High Court and Court of Appeal analysed necessity by considering whether the agreements had as either their *object* or *effect* a restriction of competition[169]. The Court of Appeal upheld the conclusions of the High Court that the agreements did not have as their object or effect a restriction because the way in which the agreements were operated (i.e. through a closed, exclusive collective sale) was necessary to allow new entry into the market.

12.33 It is clear, therefore, from these cases that there can be no basis for Ofcom suggesting that collective selling per se is an actionable infringement of competition law. To the extent that it is either necessary or does not have as its "*object*" or "*effect*" a restriction, prevention or distortion of competition then it will not be an infringement.

Ofcom's proposals

12.34 In paragraph 12.39 of the Consultation Ofcom states that it intends *"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"*.

12.35 As set out above, there is absolutely no basis upon which Ofcom can institute any competition law investigation, or request commitments from the FAPL, in relation to any possible action it might take in respect of the sale of its rights from the 2013/4 season onwards.

12.36 The PL has not taken any decisions (or action) at this stage about any sale of its rights post the 2012 /13 season .

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168 Paragraph 175 CAT Judgment

169 Bookmakers Afternoon Greyhound Services Ltd & Others v Amalgamated Racing Ltd & Others [2008] EWHC 1978 Ch and [2009] EWCA Civ 750

12.37 Ofcom has no basis for opening an investigation now in relation to any unknown action that the PL might take in respect of the sale of its rights from the 2013/14 season onwards. As a result there can be no basis for Ofcom's suggestion in paragraph 12.42 of the Consultation that it intends to consider a new set of commitments from the PL and whether the continued operation of the collective selling arrangement is an infringement of Article 81/Chapter I CA98 "*based on evidence of developments in the market"*.

12.38 Ofcom has absolutely no basis to suggest that Setanta's exit provides it with any evidence at all that is relevant to the way in which the PL sells its rights after the 2012/13 season or to the effects of the PL's sale of its rights. Any reference to Setanta, as a basis for an attempt to take (premature and speculative) action against the PL, is entirely erroneous.

12.39 Setanta's exit from the market cannot be attributed to any action by the PL or the way in which it sold its rights. The PL is not in a position to comment on exactly why Setanta exited the market but it is clear that it exited due to a combination of factors including: the economic downturn; its business model; the financing of its business; management and corporate governance failures; and its distribution strategy on non-DTH platforms. None of these factors are in any way related to the way in which the PL sold its rights.

12.40 In any event, ESPN has entered the market and taken over Setanta's market position and its PL rights packages for the 4 seasons starting with the 2009/10 season. Therefore, Setanta's exit has had no bearing at all on competition in the downstream broadcast market.

12.41 Despite the fact that there is no basis for any action by Ofcom at this stage it goes on to set out that, when it examines any need for *ex post* intervention it is likely to consider, *inter alia*, the matters set out in paragraph 12.42 of the Consultation. Given the fact that there is no basis for intervention at all, Ofcom has no right to propose for consultation any of the measures set out in paragraph 12.42 in relation to the PL's future packaging. It is for the PL to determine its future packaging in compliance with competition law. The PL will not countenance any attempt by Ofcom, or any of the potential bidders for the rights, to try and determine its future rights packaging.

13. CONCLUSIONS

13.1 Ofcom proposes the following regulatory intervention:

13.1.1 To mandate that Sky makes its premium channels available to competing pay tv platforms; and

13.1.2 To regulate the wholesale price at which those premium channels are made available.

13.2 The proposed regulatory intervention is, as explicitly stated by Ofcom, not designed to remedy excessive retail prices. Ofcom states at several places in its Consultation Paper that retail prices are not above competitive levels. There is also no suggestion that the quality of Sky's Premium Channel offerings have been adversely affected in the current market environment. Rather, the proposed regulatory intervention is designed to subsidise the activities of Virgin Media, BT and any others who take up the remedy offer.

13.3 However, the proposed regulatory intervention goes against the fundamental principles of property law which dictates that firms should have the right to choose their trading partners and to dispose freely of their property. As the EC Commission's Article 82 Guidance states (paragraph 74), this principle applies even to firms that might be held to be dominant. Deviations from this fundamental principle of property rights will generally serve to undermine firms' incentives to invest and to innovate, with consequent adverse effects for competition and therefore consumers. The failure of Ofcom to articulate the consumer detriment that is alleged by Ofcom to exist is a fundamental flaw in its assessment.

13.4 Furthermore, as Ofcom acknowledges, the proposed regulatory intervention raises the danger that it will worsen outcomes for consumers if either the regulatory intervention is unwarranted or the regulated wholesale price is set an inappropriate level.

13.5 For these reasons, PL has the following concerns.

13.5.1 Ofcom's assessment of the relevant market and market power is flawed and since this is the central plank of Ofcom's argument, the entire analysis is flawed.

13.5.2 Calculating the regulated wholesale price is fraught with difficulties.

13.5.3 The proposed regulatory intervention will inevitably serve to depress the value of rights to sporting events which will be of significant detriment to consumers. These sporting events include not only those of the PL but all other sporting events that are or might potentially be shown on Sky Sports 1 and/or Sky Sports 2.

13.6 As the Consultation makes clear, determining the regulated wholesale price is beset by a number of complexities and difficulties.

13.6.1 First, current wholesale prices do not foreclose competitors; there is no price squeeze.

13.6.2 In determining the level of regulated wholesale prices, there is a mismatch between the time horizon over which rights are typically acquired i.e. 3 years and the time horizon used to calculate the wholesale prices i.e. 10 years. This results in a very large subsidy to platforms that are currently active in the market.

13.6.3 Even disregarding the above, calculating the wholesale price is beset by problems of cost allocation and uncertainties over future market trends.

13.7 Finally, and most importantly the proposed regulated wholesale remedy will inevitably have adverse effects on rights holders.

13.8 It is facile to pretend that the proposed regulatory intervention will not have an adverse impact on rights holders. The proposed regulation will reduce the revenues that Sky earns from utilising the sports rights that it has acquired; this will reduce its incentives to bid aggressively for rights. Moreover, other platforms will have less incentives to bid and some, such as Virgin Media, will have no incentive to bid; they will simply free-ride on the risks taken by others and reap the rewards of the Ofcom subsidy.

13.9 The likely impact of the subsidy granted by Ofcom to existing platform operators would be to distort retail prices below competitive levels; with further consequent adverse effects on the valuation of rights.

13.10 These adverse effects will be felt not only by the PL but all sports that are or might potentially be shown on Sky Sports 1 and/or Sky Sports 2.

13.11 Ofcom should bear in mind that the UK pay-TV industry is a success story built on the foundation of high quality and attractive programming content for which consumers are willing to pay. Ofcom's intervention will undermine the ability and incentives of rights holders to invest in the production of that content, and depress the incentives of broadcasters to invest in the acquisition of that content and the production of innovative programming based on that content and will therefore jeopardise that success story.

13.12 Consumers will, therefore, suffer significantly because the quality of the content which they value will be reduced. This is entirely contrary to Ofcom's statutory duty to further the interests of consumers.

DLA PIPER UK LLP
FOR AND ON BEHALF OF THE FA PREMIER LEAGUE
28 SEPTEMBER 2009

ANNEX 1

MAJOR SPORTS EVENTS BROADCAST LIVE ON FREE-TO-AIR TELEVISION

Listed below are the major sports events that are broadcast live on free-to-air television in the United Kingdom in a calendar year based on current rights cycles. The broadcast rights holders are indicated in brackets following each event and the events are, in the overwhelming majority, broadcast on the main free-to-air channels (e.g. ITV1 as opposed to ITV4). Those events not held annually are indicated with an asterisk (*). Please note that dates are approximate as the precise timetabling of an event is subject to change depending on variations in the calendar and/or the venue.

January

- African Cup of Nations* (BBC)
- Coca Cola Championship Football (BBC)
- FA Cup Football (ITV)
- Australian Open Tennis (BBC)

February

- Winter Olympic Games* (BBC)
- UEFA Champions League Football (ITV)
- Coca Cola Championship Football (BBC)
- FA Cup Football (ITV)
- Six Nations Rugby (BBC)
- UEFA Europa League Football (ITV/Five)
- NFL Superbowl (BBC)

March

- FIA Formula 1 Grand Prix (BBC)
- UEFA Champions League Football (ITV)
- Coca Cola Championship Football (BBC)
- FA Cup Football (ITV)
- Six Nations Rugby (BBC)
- FIFA World Cup/UEFA European Football Championship Qualifiers* (ITV)
- Cheltenham Festival (Channel 4)
- UEFA Europa League Football (ITV/Five)

April

- The Boat Race (BBC)
- US Masters Golf (BBC)
- FIA Formula 1 Grand Prix (BBC)
- World Snooker Championships (BBC)
- Grand National (BBC)
- London Marathon (BBC)
- UEFA Champions League Football (ITV)
- Coca Cola Championship Football (BBC)
- FA Cup Football (ITV)
- FIFA World Cup/UEFA European Football Championship Qualifiers* (ITV)
- UEFA Europa League Football (ITV/Five)

May

- FA Cup Football (including Final) (ITV)
- UEFA Champions League Football (including Final) (ITV)
- UEFA Europa League Football (including Final) (ITV/Five)
- FIA Formula 1 Grand Prix (BBC)
- Coca Cola Championship Football (BBC)
- French Open Tennis (BBC)
- FIFA World Cup/UEFA European Football Championship Qualifiers* (ITV)

June

- FIA Formula 1 Grand Prix (BBC)
- Wimbledon (BBC)
- FIFA World Cup* (BBC/ITV)
- UEFA European Football Championships* (BBC/ITV)
- FIFA World Cup/UEFA European Football Championship Qualifiers* (ITV)
- French Open Tennis (BBC)
- Royal Ascot (BBC)
- The Derby (BBC)

July

- FIA Formula 1 Grand Prix (BBC)
- Wimbledon (BBC)
- FIFA World Cup* (BBC/ITV)
- UEFA European Football Championships* (BBC/ITV)
- Summer Olympic Games* (BBC)
- The Open Championships Golf (BBC)

August

- FIA Formula 1 Grand Prix (BBC)

- IAAF World Athletics Championships* (BBC)
- Summer Olympic Games (BBC)
- Coca Cola Championship Football (BBC)
- UEFA Champions League Football (ITV)
- Challenge Cup Final (BBC)

<u>September</u>

- FIA Formula 1 Grand Prix (BBC)
- UEFA Champions League Football (ITV)
- Coca Cola Championship Football (BBC)
- FIFA World Cup/UEFA European Football Championship Qualifiers* (ITV)
- IRB Rugby World Cup* (ITV)
- UEFA Europa League Football (ITV/Five)

<u>October</u>

- FIA Formula 1 Grand Prix (BBC)
- UEFA Champions League Football (ITV)
- Coca Cola Championship Football (BBC)
- FIFA World Cup/UEFA European Football Championship Qualifiers* (ITV)
- IRB Rugby World Cup* (ITV)
- Commonwealth Games* (BBC)
- UEFA Europa League Football (ITV/Five)
- Prix de l'Arc de Triomphe (BBC)

<u>November</u>

- UEFA Champions League Football (ITV)
- Coca Cola Championship Football (BBC)
- FIFA World Cup/UEFA European Football Championship Qualifiers* (ITV)
- Barclays ATP Tour World Finals Tennis (BBC)
- FA Cup Football (ITV)
- UEFA Europa League Football (ITV/Five)

<u>December</u>

- UEFA Champions League Football (ITV)
- Coca Cola Championship Football (BBC)
- FA Cup Football (ITV)
- UEFA Europa League Football (ITV/Five)
- UK Championships Snooker (BBC)

Annex 2 - Responses to Consultation Questions, Section 9

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?

The use of retail-minus price regulation, although appropriate in regulating the telecommunications industry, is inappropriate in regulating the price of Core Premium channels for a number of reasons:

- In its Second and Third Consultations into pay TV, Ofcom concluded that the use of a cost-plus based wholesale-must offer remedy would be detrimental since it would adversely distort incentives to bid for content. The basis for selecting a retail-minus approach to determining the regulated wholesale price can therefore be seen as a default option.

- Although the retail-minus approach is applied to regulating the telecommunications industry, it is has a serious flaw when applied to pay TV. In the telecommunications sector, there is no ongoing link between the cost of an investment and the quality of service an infrastructure provider offers: once a network has been built, the investment is sunk and the network operator does not have to make considerable further investment in order to continue to provide services (further investment is only required to develop new services, which typically are initially not regulated). As such, retail-minus price regulation does not hamper the investment in infrastructure, and therefore the quality of the service offered to customers.

  In marked contrast, pay TV operators must continually invest in acquiring new content: access to the content rights that are used as inputs in the creation of channels, including Core Premium channels, is obtained for a limited period, typically three years in the case of sport. At the end of that period, the pay TV operator must re-invest in bidding for the rights anew. Moreover, the quality of that content is itself dependent on the amount that pay TV operators are prepared to bid; in other words, the quality of the content rights is not fixed. The ability of different content providers to invest in new content is reliant to differing degrees on the ability to raise revenue from selling content rights to UK Pay TV operators. For example, US movie producers are likely less reliant on revenues from UK Pay TV operators than is the FAPL given the broader range of revenue streams open to them such as worldwide cinema and DVD distribution.

- The requirement for pay TV operators to reinvest periodically also highlights the inappropriateness of setting regulated wholesale prices on a ten year horizon. By calculating regulated wholesale prices over a ten year time horizon to permit a new entrant to break-even, Ofcom's regulated wholesale price will result in a retail margin that is far too generous. In brief, in calculating the margin for a retailer Ofcom makes allowance for costs that many beneficiaries of the regulated wholesale price will simply not need to incur. Notably, Virgin, currently the only independent retailer of Sky's premium channels, will inappropriately benefit from the allowance for those cost elements that it has already sunk, which it need not incur (or need not incur to the full extent permitted for in Ofcom's calculation of the retail margin). For example, Virgin will not incur the additional costs of broadcasting on DTT and nor does it need to develop a subscriber base. As such the wholesale price determined by Ofcom effectively hands established retailers, such as Virgin and BT, a subsidy. As described below (in response to question 18), sub-optimal wholesale prices will lead to considerable distortions in the retail market for Sky's Premium channels and ultimately damage incentives to invest in those channels. That, in turn, can only lead to a reduction in investment in content and lower realised value from content providers with all the damaging consequences that will follow.

16. Do you agree with our proposal to set simple linear prices per subscriber, allowing flexibility for other pricing structures?

A discussion over whether there are alternative pricing mechanisms to the proposed linear pricing would seem pointless when there are so many flaws in Ofcom's determination of the regulated wholesale price. As Ofcom acknowledges, failure to set the regulated wholesale price at appropriate levels will lead to adverse consequences in the market for consumers. As such, FAPL has no comments at this time on the wholesale pricing structure proposed by Ofcom, but rather considers that Ofcom should first reconsider the appropriateness of and/or address the deficiencies in its proposed wholesale remedy.

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?

The FAPL believes that the 'ratchet' will give rise to serious distortions. First, it should be noted that Ofcom fails to provide a rationale that explains the need for the 'ratchet' that is based on economic logic rather than an unfounded hypothetical concern that Sky *might* be able to exploit customers if Ofcom does not prevent it from increasing prices. Ofcom considers that, *"a clear consequence of allowing wholesale prices to track retail prices directly is the <u>potential</u> for Sky to raise its wholesale prices significantly by raising its retail prices significantly. ... 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 <u>believe</u> it is appropriate to consider practical mechanisms which would help ameliorate these concerns."*[170] On the one hand this statement merely speculates that Sky might choose to increase its retail prices so as to increase the wholesale price. On the other hand Ofcom recognises that there is a real and binding constraint on Sky's ability to profit from increasing its retail price since any increase in the retail price above competitive levels causes subscribers to switch to alternative platforms. Indeed, it can be assumed that the magnitude of customer switching would be such that any increase in Sky's retail prices would not be profitable; if that were not the case, Sky would not be profit-maximising.

Second, competition is recognised to bring benefits to consumers in terms of lower prices and higher quality. The ratchet limits Sky's ability to compete effectively on either price or quality. By preventing the wholesale price from increasing, Ofcom has limited Sky's ability both to adjust its retail prices in response to price competition, and to invest in new content. Specifically:

- Sky would have significantly reduced incentives to reduce its retail prices in response to more efficient competitors. First, if Sky was to lower its retail price that would be passed onto competitors in the form of a lower wholesale price, therefore Sky would gain no competitive advantage. Second, the ratchet would restrict Sky's ability to return prices to current levels. Even if Sky could obtain a competitive advantage by reducing its retail prices, it would be reluctant to do so under the proposed regulatory intervention since it would be unable to return prices to current levels later on.

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[170] Third Consultation, 9.228

- Sky has little incentive to increase the quality of its offerings of the regulated channels. Normally, if a producer increases the quality of its product it can command a higher premium and that is its reward for innovation. The ratchet however prevents Sky from increasing its wholesale price and the wholesale price prevents Sky from increasing its retail price. Therefore it would largely be the third party retailers that would benefit from such quality improvements because they would attract more subscribers but not incur any greater costs.

Finally, as noted in response to question 19, the use of average revenue per subscriber (ARPU) to determine Sky's retail prices for its premium channels, combined with the ratchet will prevent Sky from being able to compete in other markets. The ARPU used by Ofcom included revenues more correctly attributable to other services. Therefore if Sky lowers the prices of those other services, the ARPU for its premium subscribers will go down and so the wholesale price will follow. When/if Sky restores the prices of those other services, the ratchet would prevent corresponding changes in the wholesale price.

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?

No, for the following reasons:

In determining the regulated wholesale price for its proposed wholesale remedy Ofcom makes allowances for competitors which are less efficient than Sky (for example, *inter alia*, the allowance for DTT transmission costs). Ofcom's rationale is that the allowances it makes for a less efficient retailer are necessary to induce entry of a provider on DTT. What Ofcom fails to recognise is that the margin it permits <u>all</u> prospective retailers of Sky's premium channels, including firms that are already active in the pay tv industry or who do not provide services on DTT at all (such as Virgin Media), is overly generous to alternative providers with lower costs and/or larger customer bases than Ofcom's hypothetical new entrant on DTT. Alternative retailers with lower costs than a DTT provider (but which may potentially be less efficient than Sky) will effectively be granted a subsidy greater than that required to induce efficient new entry into the market. It is unclear what those retailers will do with their windfall, specifically whether they will simply retain it as profit, use it to distort competition in the retail market for Sky's premium channels (and possibly prevent the entry of the new DTT provider that the wholesale remedy is intended to induce by undermining the price that entrant can achieve), or use it to distort competition in other markets in which it participates (for example by reducing the price of triple play bundles). The consequences of Ofcom's method for determining the wholesale price are discussed in more detail in response to question 21.

19. Do you agree with our approach for deriving starting retail prices given the complexity of retail bundling?

Using the average revenue per customer as the starting point for retail prices, while practical, has two fundamental problems:

- First, it will incentivise alternative retailers to 'cherry pick' Sky's most valuable customers. To see how this may come about it is insightful to consider a simple example in which Sky currently retails a 'premium' channel in two packages. Package A is a large package with many channels, customers who purchase it pay more overall, but effectively receive a discount on each channel for purchasing more. The 'effective' charge for the premium channel in package A is £10. Conversely, package B is a light user package containing fewer channels, it costs less in total than Package A, but consumers receive no effective discount. The 'effective' charge for the premium channel in package B is £12 per subscriber. With an equal number of subscribers to each package the average revenue per subscriber would be £11.

Basing the wholesale price on £11 would allow third party retailers to target Sky's 'light' users without being equally efficient. Sky could respond by reducing the price of package B, but that would prevent Sky's retail arm from recovering its costs. Sky would therefore need to raise the price of package A. However, that would lead to fewer package A subscribers, and it is unlikely that the lost revenue would be offset by the increased revenue from additional package B subscribers, because if that were the case Sky would be in a better position to charge more similar prices for the different packages it offers currently, yet it does not.

- Second, the combination of average revenue per user (ARPU - which includes revenues from services other than premium channels) in combination with the ratchet will restrict Sky's ability to compete in other markets. Under the proposed remedy any reduction in the ARPU will lead to a reduction in the wholesale price from premium channels. For example, if Sky reduces the retail prices for its telephone services, that would reduce the ARPU from premium channel subscribers (as well as all other subscribers) which would (inappropriately) be passed onto alternative retailers in the form of lower wholesale prices. Moreover, the ratchet would restrict the ability to increase wholesale prices if Sky were to revert to its original charges for telecoms services. It is therefore entirely inappropriate to impose a remedy which will act to restrict competition in those markets.

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?

The description of Ofcom's methodology for determining the wholesale price and its treatment of costs is insufficiently detailed. Without access to the underlying model and the underlying data, it is impossible to assess exactly what Ofcom has actually calculated and how it has treated specific costs. Nevertheless, based solely on the description provided in the Third Consultation FAPL considers that there are a number of fundamental flaws in Ofcom's approach which suggest that the resulting proposed regulated wholesale prices are imprecisely determined and possibly dependent on unsubstantiated assumptions.

- It is unclear how Ofcom has applied its discounted cash flow analysis (i.e. its multi-year analysis). Specifically Ofcom fails to set out how it expects subscriptions to the new entrant to develop over the ten year horizon that it considers. The speed at which the alternative retailer is able to attract new subscribers (or those customers currently subscribing to Sky's platform) will have a considerable effect on the business case of that retailer and in turn on the margin permitted in the retail-minus calculation. In addition, Ofcom provides no rationale for examining a ten year horizon and given that large retail competitors are already active in the market a ten year horizon is clearly inappropriate. Indeed, as noted above, there is a mismatch between a ten year horizon and the time horizon over which bids are made for rights content, which is typically 3 years.

- Ofcom's approach to cost allocation is insufficiently set out. Ofcom only discusses rather vague cost categories and it is unclear how costs that may be considered to be in more than one category are being treated by Ofcom. For example marketing costs is one category and the split in costs between the UK and Ireland is another, yet Ofcom does not set out how it allocates Sky's entire marketing costs between the UK and Ireland. Furthermore, from the explanation provided, Ofcom's application appears to be *ad hoc*: Ofcom adopts a mix-and-match approach to its choice of cost allocation methods, with little or no reasoning provided for these different approaches.

- Using Sky's costs as a proxy for a new entrant is likely to be erroneous and lead to the wholesale price being further poorly defined. For example, alternative retailers are unlikely to market Sky's channels as actively as Sky does. Therefore, most of those marketing costs will continue to lie with Sky and the proxy will overestimate the costs which the alternative retailer will incur. In turn that will lead to too low a wholesale price.

- The use of Sky's cost of capital, which includes both its wholesale (i.e. channel and platform provision) and retail activities may not be relevant for a pure retailer which is likely to face different risks to a vertically integrated provider.

We discuss each of these points in turn below.

Multi-year analysis

Ofcom argues that the regulated wholesale price should be set at a level that would allow a new entrant to become viable within 10 years. On this basis, Ofcom determines the level of regulated wholesale prices that would enable an entrant to make a return discounted over 10 years equal to its estimated cost of capital (see below).

It is unclear how Ofcom estimates regulated wholesale prices of individual bundles. Given there are several channel bundles there is the possibility of multiple combinations of regulated wholesale prices that would predict a breakeven point for a new entrant. Without identifying how Ofcom reaches its regulated wholesale prices, it is not possible to assess whether it has identified the most economically efficient prices (i.e. those that would maximise total welfare).

Nor does Ofcom set out how it considers subscriber numbers will develop for its hypothetical incumbent. Such an assumption is likely to have a considerable impact on the estimated retail-minus regulated wholesale price. For example, if the new entrant is not expected to attract a large number of subscribers until the last three years it will need a considerable 'subsidy' to keep it active in the first seven years.

Ofcom does not provide a rationale for its period of 10 years other than that is the period over which it would "expect the [hypothetical] entrant to have established a brand and subscriber base".[171] Clearly, a 10 year horizon is inappropriate for existing established competitors of the size of Virgin Media and BT.

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171 Paragraph 9.111.

Problems with allocating fixed and common costs

Most of the costs Sky incurs are independent of the number of subscribers and often are relevant to the supply of more than one channel; in other words, Sky incurs common costs in the course of its business operations. How such common costs are dealt with can have a considerable effect on the proposed regulated wholesale price. Specifically, the more that common costs are attributed to retail of the premium sports and movies channels, the lower will be the wholesale price under Ofcom's retail-minus (or cost-plus) methodology. Conversely the more those common costs are attributed to wholesale (i.e. content provision) or the retail of non-premium channels the higher will be the wholesale price.

There are numerous ways that common costs can potentially be allocated. Indeed, there is no accepted method for doing so. However, the choice of allocation mechanism can have a significant effect on the regulated price.

There are two important points to consider when allocating costs, first that allocating too much cost to Ofcom's calculation of the margin will lead to sub-optimal wholesale (and therefore retail) prices and second that the choice of allocation mechanism will have a considerable impact on the allocation of costs and it is therefore important to identify and use the appropriate mechanism to ensure that the correct proportion of costs are allocated appropriately.

Table 1 demonstrates the effect that the choice of cost allocation mechanism can have using a simple example with a common cost of £10m for providing 10 channels, 2 of which are 'premium'. The basic channels alone attract 6m subscribers and £60m in revenue and, the premium channels attract a further 2m subscribers and an additional £40m in revenue. The resulting discounts to the retail price change considerably depending on which cost allocation mechanism is applied. Notably, allocating costs according to revenue would result in the lowest wholesale price by virtue of (in this example) the premium channels accounting for proportionally more revenue (40%|) than the proportion of channels they use (20%) or the proportion of subscribers they attract (25%).

Table 1: Effect of different cost allocation mechanisms

	By channels	By subscribers	By revenue
Cost allocated to core channels	£8m	£7.5m	£6m
Cost allocated to premium channels	£2m	£2.5m	£4m
Premium channel retail price	£20	£20	£20
Premium channel wholesale price	£19	£18.75	£18

Ofcom identifies a number of cost categories which it deducts from the retail price, some of which are treated as common costs. However, it does not specify which, nor does it provide specific details of how it treats individual cost categories. Moreover, its approach to apportioning common costs is unclear and inconsistent. Specifically, Ofcom purports to:

- Allocate costs between UK and Ireland based on the number of customers served (it is unclear whether this is premium or core customers), which would be inappropriate for allocating the cost of FAPL and other UK sports rights which have greater appeal to a UK audience.

- Allocate costs between business and residential customers according to revenue, which is inappropriate for costs that are related to the number of connections and which is likely to deduct more costs than appropriate.

- Allocate costs common to basic and premium packages according to a rule described as 'subscriber product units'. Our understanding is that a subscriber taking only a basic package would count as one unit and a subscriber taking a basic plus a premium package would count as two units (it is unclear whether sports and movies constitute separate packages). Therefore, Ofcom is *de facto* allocating twice the amount of common costs to premium package subscribers as to basic package subscribers and is not factoring in a discount for bulk purchasing. This rule is entirely arbitrary.

- Costs common to premium sports and premium movies have been allocated according to subscriber numbers.

- Costs common to SD and HD have been allocated according to revenue.

Ofcom does not set out how it treats costs which would be captured by more than one of the above rules, for example marketing of basic and premium channels to business and residential customers in both the UK and Ireland.

Moreover Ofcom's approach is *ad hoc*; some costs are allocated according to revenue whereas others are allocated according to subscriber number. Ofcom provides no rationale for selecting the different allocation methodologies for different cost categories. If there is an economic rationale underlying Ofcom's choices it is not transparent. If there is no economic rationale for Ofcom's choices that suggests that the wholesale price Ofcom calculates will be imprecise and so likely lead to inefficient entry.

Erroneous to use of Sky's costs as a proxy for the costs alternative providers will incur

There is no good reason to expect that the costs that an independent retailer can expect to incur will bear resemblance to the costs of a vertically integrated provider that undertakes both wholesale and retail activities. By way of example, Ofcom at paragraph 9.100 seems to suggest that a pay TV retailer will incur programming costs which include the cost of "producing channels". As a pure retailer of Sky's premium channels it is unclear why an allowance should be made for the costs that Sky incurs in producing its channels. Similarly, the marketing costs of a retailer will be entirely divorced from those of a wholesale provider. Using the marketing costs of a wholesaler provider of a product (for example Marmite) to proxy the marketing costs of a retailer (for example Tesco) is illogical.

Appropriate discount rate

Ofcom uses its estimate of Sky's cost of capital (10.3%) as the relevant cost of capital for a new entrant. As sensitivity Ofcom repeats its analysis using a cost of capital of 15%, i.e. it allows a higher margin for the new entrant, and thereby calculates a lower wholesale price. No similar sensitivity is performed for a 5% cost of capital.

Ofcom argues that there will be no difference in the cost of capital between wholesalers and retailers because that would require "returns that were differently correlated with the rest of the market". Put differently, Ofcom considers that wholesaling and retailing returns are highly correlated. That however is unlikely. The returns of wholesalers and retailers depend on their respective revenue and cost streams over the 10 years Ofcom considers is relevant.

Under the proposed remedy, retailers' revenues and costs are perfectly correlated (they receive an amount from each subscriber; they attract and pay a fee per subscriber). On the other hand, the wholesaler (Sky) receives a per subscriber price, but its costs are unrelated to the number of subscribers. Indeed, the wholesaler faces many risks that the retailer does not: it may win or fail to win the rights to a particular sporting event (the 'ratchet' divorces success in winning rights from subscriber revenues); the price it must pay for content may change considerably. Given these additional risk factors the wholesale arm of Sky must carry it is wrong to consider only a higher and not lower cost of capital for the new entrant.

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?

Ofcom focuses on the business case for an entrant on DTT to develop a subscriber base to a level that it becomes competitive vis-a-vis Sky. This results in a margin that is far too generous for many of the potential retailers. Sub-optimal wholesale prices will distort retail competition, lead to sub-optimal retail prices and hinder investment in developing channels for consumers. If Sky were forced to subsidise a new entrant *and* provide the same level of subsidy to Virgin and other large communications providers, that would be highly inequitable. Providing large competitors that currently have a considerable customer base and less costly means of transmission than DTT, with a margin intended to induce a new entrant to develop a customer base on the relatively costly DTT platform, will distort competition in the retail market and curtail Sky's incentive to invest in content.

Ofcom asserts that smaller scale entrants would be less likely to achieve the economies of scale that Sky enjoys. In order to 'correct' this, Ofcom considers different scales of new entrants, from one of equivalent scale to Sky, to a relatively small new entrant. The wholesale price is adjusted downward to allow these smaller new entrants to break even. The resulting single wholesale price wholly ignores the range of economic positions of the undertakings that may be in a position to benefit from the proposed regulated outcome.

As Sky noted, many of the firms who are likely to take up the wholesale offer cannot be considered small. The 3rd Consultation responds as follows:

> "*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*".[172]

That response ignores the fact that at least two existing retail competitors, Virgin and BT, are substantial companies with substantial customer bases, so it is unclear why Sky should be required to subsidise either of these undertakings to 'enter the market'. These undertakings could achieve considerable economies of scale relatively quickly if they were to invest in their own channels and content. Nor is it adequately established that other platforms could not develop absent the proposed remedy.

The prices that arise from Ofcom's methodology result in retail margins in excess of 50%. The ability of Sky to respond to an increase in retail competition (that might arise from retail competitors choosing to earn lower retail margins) is severely limited by the proposed pricing approach: any decrease in Sky's retail price necessarily results in a decline in the regulated wholesale price. This will reduce Sky's ability to compete in retail markets by reducing its incentives to cut retail prices. Put simply, any third party that retails Sky's premium channels could choose to under-cut Sky's own retail prices without needing to incur a loss because of the generous retail margin provided to it under the proposed approach. Sky, however, would be unable to respond because any cut in its own retail price would be passed on to third parties through a corresponding reduction in the wholesale price, thus enabling them to continue undercutting Sky.

Furthermore, Ofcom's regulated pricing approach assumes, incorrectly, that competition between platforms is confined to the respective pay TV offerings of those platforms i.e. Ofcom ignores the scope for retail competition where pay TV services are bundled together with broadband and/or telephony offerings. Typically providers offer a bundle of services including television, telephony and broadband. The growing importance of bundles to both retailers and consumers is recognised in Ofcom assessment of Fixed Narrowband Retail Services Markets. In that review Ofcom note that since 2003 it has "*seen a trend towards narrowband services being only one component of a bundle of communications services - including telephony, broadband and pay TV services - with both benefits in terms of convenience and often price to consumers*"[173] and that *"[c]onsumers and businesses are now able to jointly purchase ... service ... at reduced rate [and] consumers have seen innovation in packaging*"[174]

The different business plans of different platforms means the optimal mark-up on 'premium' channels will differ across platforms. In some instances a retailer may wish to offer premium channels at lower gross retail margins than those implied by the proposed pricing approach in order to benefit from the

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172 Paragraph 9.129.

173 Ofcom, Fixed Narrowband Retail Service Markets, September 2009, 3.11

174 Ofcom, Fixed Narrowband Retail Service Markets, September 2009, 3.13

increased take-up of other bundled services. This explains why Ofcom observes that Virgin makes a return below its WACC on Sky's Premium channels[175] and why Sky has made a loss on its broadband offerings in 2009[176]. Put simply, each retailer plays to its strength: because Virgin is the fibre optic network in the UK which can offer the fastest broadband speed, those are the products from which it recovers most of its common costs; Sky does not have that advantage so it is from TV services that Sky recovers the majority of its common costs. If competing platforms reduce retail prices so as to benefit from increased revenues arising from the increase in take-up of their other services, Sky is again deterred from responding by cutting its own retail prices. The scope for such "bundled" competition could severely undermine Sky's ability to compete in the retail market.

It follows that without adjusting the margin to account for the considerable strengths of the established retailers rather than some hypothetical new entrant on DTT, the remedy will distort competition in the retail market.

Furthermore, we note that without adjusting the wholesale price to reflect the relative positions of different retailers, Ofcom proposed remedy is unlikely to have the effect, intended by Ofcom, of introducing a new entrant on DTT. If a uniform wholesale price prevails, the alternative retailers of Sky's premium channels which have lower costs and larger subscriber bases than a new entrant on DTT, will be able to undercut the retail prices of a new entrant and prevent it from ever entering the market. Even if the likes of Virgin and BT do not undercut Sky's retail prices, the very threat that they might do if a new entrant appears might be sufficient to prevent that new entrant from ever materialising.

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?

Ofcom's description of the methodology applied to determining the wholesale price for HD channels is far from clear. Commenting on the methodology or the prices is therefore difficult. What Ofcom seems to imply is that it uses the same methodology as for SD with two differences: the use of DSAT transmission costs in place of DTT transmission costs (because Ofcom considers that platform to be more suitable to HD transmission); and, a sensitivity that allocates more costs to SD on the basis that Sky 'seems' to subsidise its HD boxes to a greater extent than SD boxes.

Given that Sky's premium channels are already available on DSAT it is unclear why Ofcom proxies the costs of a new entrant based on costs it would never achieve. We also recognise that using the costs of a DTT broadcaster would be inappropriate since HD is not as yet available on DTT. However, this suggests that until the costs of a feasible new entrant on a different platform can accurately be determined Ofcom should not attempt to set wholesale prices for HD.

[175] [reference third con]

[176] See [reference Sky's quarterly report]

That Sky chooses effectively to subsidise the HD boxes it provides to its subscribers who purchase many HD services; not just premium channels, and who also have the potential to purchase additional HD channels as they become available in the future, does not suggest that Sky should also be required effectively to subsidise the HD equipment of alternative platform providers. Put simply, Sky expects to recoup its subsidy of Sky HD boxes by selling both premium HD services and non-premium services today, and an increasing number of HD services in the future. If, as seems to be the implication of Ofcom's analysis, Sky were to be forced to offer the same subsidy to HD customers on alternative platforms it would be unlikely ever to recover that from its premium channels alone.

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

Given the lack of any basis for the remedy and the fundamental flaws in the wholesale pricing proposed by Ofcom, FAPL does not propose to comment on this.

Other issues

The consultation does not set out any questions regarding to Ofcom's calculation of the cost-plus floor for prices. FAPL considers the cost-plus floor to be of considerable importance because as Ofcom itself states, regulated wholesale prices below the cost-plus floor must inevitably have a detrimental impact on the value of content rights.

A cost-plus calculation of a wholesale price includes two elements: a calculation of the appropriate costs and a calculation of a reasonable margin for the wholesaler. Ofcom's description of its method for calculating the cost-plus wholesale price fails to mention how it will determine the margin to be added to Sky's costs. It is therefore not clear that Ofcom has added a margin and impossible to determine whether any margin that has been added is reasonable.

ANNEX 3 - Effect of the proposed remedy on Sky's revenues

1. Introduction and Summary

Sky values content rights because good content attracts subscribers to the channels on which those rights are broadcast. The value that Sky places on any particular content rights is related to the revenue it expects to obtain from them. Sky's primary sources of revenues are from selling packaged channels to its own subscribers (i.e. retail revenues); and selling those channels to other platforms, specifically (at the present time) Virgin (i.e. wholesale revenues). Following the introduction of the proposed wholesale remedy, Sky's wholesale revenues will decline immediately by some 20% and retail revenues will likely decline as a consequence of consumers switching to alternative resellers.

However, Ofcom argues that these reductions in revenue will be more than offset by the effects of "market expansion" i.e. an increase in the total number of subscribers to Sky Sports 1 and 2.

That assertion is wrong for two reasons:

- first, Ofcom incorrectly considers the effects of its remedy over a ten (or sometimes five) year period. This timeframe is irrelevant for assessing the impact of the remedy on content rights which are typically sold for considerably shorter windows (e.g. FAPL rights are awarded for three year periods); and,
- second, the market expansion necessary to offset the negative impact on Sky's wholesale and retail revenues arising from Ofcom's proposed wholesale remedy would need to be so great as to make it highly unlikely to materialise before Sky must next bid for content rights.

This annex presents some simple modelling to illustrate these two points.

Without detailed information on Sky and Virgin's subscriber numbers and the preferences of those customers and the costs of both businesses, it is not possible to model the most likely effect on Sky's combined revenues taking into account both firms' and customers' responses. We therefore consider the impact on Sky's combined revenues for different hypothetical scenarios that capture the different possible wholesale prices proposed by Ofcom, the impact of price competition that may drive down retail prices and the growth in subscribers on non-Sky platforms. Our modelling takes into account the important dynamic changes in the market following the introduction of the proposed remedy. Specifically the dynamic nature of our modelling allows the market to develop over time and compares the net present value of Sky's combined revenues with the combined revenues it would expect absent the remedy.

Due to the lack of information available to us, our calculations can only be viewed as illustrative. Nevertheless they do indicate clearly that market expansion effects would have to be implausibly high in order for Ofcom's assertion that they will offset the certain reduction in Sky's combined revenues to hold true.

Our analysis is based on a number of assumptions: the ratio of Sky's premium channel subscriber base to Virgin's; the wholesale price pre- and post-remedy and the retail price pre-and post remedy. Our base case makes the following assumptions.

- Sky has four times as many premium subscribers as Virgin;
- the pre-remedy wholesale price is the weighted average of Sky's rate card (£20.72);
- the post-remedy wholesale price will be set as the midpoint of Ofcom's proposed range (£16.45); and
- the pre- and post-remedy retail prices will be £32.90 (as implied by a 50% retail margin, see below).

Finally, we use Ofcom's estimate of Sky's weighted average cost of capital (10.3%) for discounting future combined revenues.

Assessing the impact of the proposed wholesale remedy over a three year horizon is appropriate for assessing the impact of the proposed regulatory intervention on the value of rights because, when bidding for rights, Sky and other bidders will be concerned with their expected combined revenue for the period for which those rights are granted (in the case of FAPL three years).

To capture the dynamics of the Pay TV market and Ofcom's proposed remedy we set out the following:

- first, a simple model determines the level of market expansion required to offset the reduction in wholesale prices proposed in Ofcom's remedy;
- second, a more developed multi-factor analysis demonstrates the combined effect of various factors focusing, in particular, on: market expansion; subscriber switching; how retail price competition drives prices to sub-optimal levels; and reductions in the retail price lead to reductions in the wholesale price.

These models forecast the net present value (NPV) of Sky's combined revenues for the first three years following the introduction of the wholesale remedy and contrast them with Sky's expected combined revenues absent the wholesale remedy.

Necessary market expansion to offset losses

The results of our simple dynamic model (see Table 3) demonstrate that the wholesale market for Sky's premium channels would need to expand by some 42% in three years in order for Ofcom's proposed remedy to have no effect of the NPV of Sky's combined revenues. That, we consider, is a highly unlikely level of expansion.

Multifactor analysis

The multi-factor analysis calculates the NPV of Sky's combined revenues absent the remedy and compares it against a base case that assumes that:

- post remedy the market will expand and ultimately the wholesale market will double in size;

- subscribers will switch from Sky to other retailers at the rate of 5% per year; and

- Sky's retail prices fall at the same rate.

Our base case also assumes that the wholesale price can never go below the current cost-plus floor set out in Ofcom's Third Consultation.

In addition, five alternative scenarios are examined.

The first examines market expansion by modelling new subscribers to platforms other than Sky (in addition to those that switch) as an S-shaped curve (i.e. there is an initial period with few new subscribers and the rate of growth is slow, followed by a period of high growth in which the bulk of new subscribers are added and finally a period when new subscriptions reach their assumed saturation level in which growth slows).

The second examines the influence of customer switching on Sky's combined revenues by examining the effect on revenues if 10% (rather than 5%) of Sky's premium subscriber base switches to alternative retailers each year.

The third explores the effect of retail price erosion that will inevitably occur following the introduction of the proposed wholesale remedy, including the secondary impact from the reduction in the wholesale price under the retail-minus wholesale price calculation. This is modelled by allowing the retail price to decline by 10% each year and assuming that wholesale prices follow retail prices with a one month lag.

The fourth scenario considers the impact on Sky's combined revenues of wholesale prices falling below the current level of the cost-plus floor, which is captured by removing the modelling assumption that wholesale prices can never go below the current cost-plus floor.

The final scenario examines the effect on Sky's combined revenues of the level at which the wholesale price is set by repeating our base case but applying highest and lowest prices from Ofcom's proposed range.

The results of our modelling demonstrate that:

- our base case predicts that Sky would lose 11.3% of its combined revenues in the first three years following the introduction of the remedy;

- even if the wholesale market can be expected ultimately to expand to twice its current size, that would be insufficient to offset the losses arising from the wholesale remedy and Sky would continue to lose some 9.3% of its combined revenues as a result of the wholesale remedy (see Table 4);

- the greater the rate at which Sky's current subscribers switch, the greater the damage to Sky's combined revenues and, if switching occurs at the rate of 10% per year (as opposed to 5% in our base case), that would increase the loss in Sky's combined revenues to 14.1% (see Table 5) ;
- of all the effects we consider, retail price erosion is likely to have the most damaging effect on Sky's combined revenues and if price competition leads to a reduction in retail prices of 10% each year, that would cut Sky's combined revenues by 17% (see Table 6);
- if the cost-plus floor fails to preserve the wholesale price, that will have a detrimental effect, particularly if retail prices fall rapidly (10% per year) in which case Sky's combined revenues would decline by 19.3% (see Table 7);
- the level at which the wholesale price is set will affect the degree to which Sky suffers a loss in combined revenue as a result of the remedy, however, (as Table 8 demonstrates) even if Ofcom adopted the highest wholesale prices from the range it is consulting on, that would be insufficient to preserves Sky's combined revenues which would decline by 9.4% in three years;
- crucially, **there is no plausible scenario which would lead to Sky's combined revenues increasing following the introduction of the wholesale remedy** and our modelling suggest that Sky stands to lose a considerable proportion of its combined revenues if the remedy is introduced.

2. Assumptions and methodology

When bidding for content rights Sky will be concerned with its future combined revenues over the period for which it will hold those rights, should it be successful in acquiring them. Over that period, consumer switching and the erosion of retail prices (and thereby wholesale prices under the retail-minus calculation) is likely to vary, for example, one would expect market expansion to be slow at first, then speed up if there are new market players who are able to develop their platforms and ultimately slow as subscriber numbers reach saturation levels.

Ofcom considers the business case for a new entrant over a ten year horizon. But assessing the impact on Sky's combined revenues over such a long period would be grossly out of kilter with Sky's business model (and those of content producers). Sky has to acquire rights to sport (and movie) content in order to produce its premium channels. Those rights are typically granted for windows considerably shorter than ten years. In the case of FAPL rights are sold for three consecutive seasons. It follows that when bidding for rights Sky will consider the combined revenues it will earn over the period the rights cover, rather than those going far into the future. We, therefore, develop scenarios that examine the effect of the proposed wholesale remedy on Sky's combined revenues over a three year window.

To capture the dynamic effects of Ofcom's proposed wholesale remedy on Sky's combined revenues, and hence on Sky's willingness to pay for content, we compare the net present value of Sky's combined revenues absent the remedy with the NPV of Sky's combined revenues under the remedy over a three year window. We do this using two modelling approaches.

- In the first, we model Sky's combined revenues for three years and compound the growth in new subscribers each year. That is, in each year Sky's wholesale subscriber base (effectively Virgin's premium channel subscriber base) is assumed to grow by a fixed percent (5%, 10% and 12.5%). In this model Sky's subscriber base and retail price remain unchanged.
- In the second we take a different approach to the development of the market. Specifically we allow many factors to effect Sky's combined revenues including: permitting customers to switch from Sky to other retailers; adopting an S-shaped curve of take up in new wholesale subscriptions that follows what one would expect in a new market; modelling price competition as a sequence of reductions in Sky's retail price; and permitting the wholesale price to track reductions in Sky's retail price.

Both modelling approaches begin by setting a base case that hypothetically captures Sky's combined revenues pre-remedy. This calculates the total combined revenues Sky obtains directly from its premium channels as (1) the wholesale revenue from selling to Virgin, and (2) separately the wholesale and retail revenues for a hypothetically separated Sky. Revenues are calculated as the relevant price multiplied by the number of subscribers.

We begin with a description of the common assumption we use and then describe each modelling approach.

2.1. Common assumptions

Our base case assumptions on prices and subscribers are set out in Table 2.

Table 2: Assumptions used to calculate the effect of the remedy on Sky's combined revenues

Assumption	Base Case
Ratio of subscribers (Sky:Virgin)	4:1
Wholesale Price	
Pre-remedy	£20.72
Post-remedy	£16.45
Retail Price	
Pre-remedy	£32.90
Post-remedy	£32.90

Our base case assumes that Sky currently has four times as many subscribers to premium channels as Virgin (i.e. a ratio of 4:1). The third consultation provides no indication of current subscriber numbers. Therefore in our multi-factor analysis we have included two scenarios to examine the sensitivity of our modelling to this assumption. In one scenario, we assume that Sky has six premium channel subscribers for each Virgin subscriber to premium channels and in the other that Sky has twice as many subscribers to premium channels as Virgin.

In addition, in our base case, for simplicity, we take as the pre-remedy monthly per subscriber wholesale price for Sky's channels the weighted average of Sky's rate card from Figure 70 of the Third Consultation (£20.72).[177] The wholesale price post remedy for the base case is taken as the midpoint of the weighted average range of proposed wholesale prices (£16.45).[178] The average retail price of Sky's premium channels pre-remedy is based on a 50% retail mark-up on the midpoint of the proposed wholesale price weighted average range. This approach follows from Figure 65 of the Third Consultation which suggests that the Wholesale remedy will afford third party retailers a retail mark-up of around 50% (excluding the costs of basic channels) across the different bundles of channels.

[177] See Figure 70, Third Consultation

[178] See Figure 70, Third Consultation

2.1.1. Calculate the stand-alone market expansion necessary to offset lost combined revenue

Using this modelling approach, we calculate Sky's combined revenues from retailing and wholesaling of its premium channels for three years absent the remedy and then discount those cash flows into current prices using Sky's cost of capital. Against that background, we compare those discounted combined revenues with the revenues Sky would achieve if the remedy were to be imposed. This calculation includes an initial reduction in wholesale revenues arising from the reduction in the wholesale price resulting from the proposed remedy. Offset against that loss is an increase in wholesale revenues arising from the assumed growth in wholesale subscription. This growth is captured as a compounded increase in Virgin's premium subscriber base. For example, if Virgin has 1000 subscribers to premium channels and we assume that growth will occur at 10% per year following implementation of the proposed remedy, we would model 1100 subscribers to premium channels on non-Sky platforms in the first year, 1210 (i.e. an addition 110) in the second year and 1331 in the third year.

In addition to the common assumptions outlined above, this analysis requires an assumption as to how the market for premium channels will develop over the timeframe considered and, specifically, what proportion of Sky's current retail subscribers would switch to alternative providers and the overall expansion in the demand for wholesale premium channels. First, we assume that Sky retains all of its premium subscribers (i.e. none of Sky's subscribers switch), and that, in addition, Virgin's subscriber base expands by 5% per year compounded (10% and 12.5% variants are also tested). Finally, we discount Sky's combined revenues by the weighted average cost of capital (WACC) assumed by Ofcom in the Third Consultation (10.3%).

2.1.2. Multi-factor assessment

In this modelling approach, we again consider Sky's combined revenues over a period of three years absent the remedy and compare the NPV of those combined revenues with the predicted combined revenues under the proposed wholesale remedy. Whereas in the previous simple analysis we calculated combined revenues for each year separately, in this analysis we calculate combined revenues on a monthly basis. This allows for more flexible changes in the market than an assessment on an annual basis.

This analysis also considers a number of separate effects altering the market simultaneously. Those effects include:

- new subscribers being attracted to new platforms (i.e. in addition to subscribers that switch platform);
- subscribers switching from Sky to other retailers;
- price competition driving down Sky's retail price; and,
- cuts in the wholesale price following Sky's reductions to its retail price.

Below we discuss how we model each of these effects in turn.

New subscribers to non-Sky platforms (market expansion)

New products and services do not generally generate growth that follows a compound curve (i.e. growth is ever increasing) as assumed in the first basic modelling approach discussed above. The growth in most new (successful) products can be characterised as an initial period when there are few customers and growth is relatively slow, usually because many potential customers are either unaware of, or unsure about the quality of, the new product. Then as the marketing activities of the firm begin to take effect, and as the effect of initial customers' positive experiences becomes known to other potential customers, the speed of take-up increases. Finally, as the market becomes saturated and there are fewer potential new customers, the pace at which new customers materialise slows.

To capture this property of market development we model take-up of new wholesale premium channels (not including customers switching from Sky) using a Gompetz curve.[179] We model three scenarios:

- a mid-demand case in which the number of new subscriptions to Sky's premium channels on non-Sky platforms will ultimately be equal to the current number of subscribers to Sky's premium channels on Virgin;
- a low demand case in which the number of new subscriptions to Sky's premium channels on non-Sky platforms will ultimately be equal to half the current number of subscribers to Sky's premium channels on Virgin; and
- a high demand case in which the number of new subscriptions to Sky's premium channels on non-Sky platforms will ultimately be equal to double the current number of subscribers to Sky's premium channels on Virgin.

Across all three scenarios, demand for new wholesale subscriptions reaches half of its long run level after three years.

Subscriber switching

It is not clear how many of, or how quickly, Sky's current premium subscribers might switch to alternative retailers. If, as Ofcom argues (incorrectly in our view), there are currently many subscribers to Sky's platform who would value access to premium channels on other platforms but are prevented from choosing an alternative platform because of Sky's (alleged) high wholesale price, one would expect to observe an initial flurry of switching. Conversely, if those subscribers are locked into contracts and unable to switch (or if such subscribers simply do not exist) one would expect to see a delay to any switching or possibly no switching at all.

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179 The Gompetz curve predicts the number of subscribers according to the formula: a represents the maximum number of subscribers and b and c are parameters that control the rate of take-up. We have modelled subscriptions using b equal to four and c equal to 0.05. In our mid demand case a is equal to 1 (i.e. the number of Virgin subscribers), in our high demand case a is set equal to two, and in our low demand case a is set equal to a half.

Given that the profile of switching is not predictable we assume that Sky loses a fixed proportion of its premium subscriber base each month. This will take a path somewhere between an initial flurry of switching and one in which switching is delayed. Our base case assumes that Sky loses 0.43% of its subscriber base each month (this corresponds to a compounded rate of 5% per annum) - as sensitivities we model two alternative switching rates (2.5% pa and 10% pa).

Erosion of retail prices

Price competition will inevitably intensify following the introduction of Ofcom's proposed wholesale remedy. Ofcom proposes to set the wholesale price below that currently offered to Virgin. That clearly gives Virgin scope to cut its retail prices.

Without detailed knowledge of Sky's business and its customers, it is not clear to the FAPL what Sky's response to price competition will be. Nevertheless, price competition must lead to an erosion of Sky's retail price over time. To capture this, we cut Sky's retail price for premium channels each month by a fixed percent. For our base case, we set the rate of price reduction to 5% per annum (0.43% per month). In addition, we test two scenarios. First, a scenario which corresponds to less fierce price competition resulting in a reduction of Sky's retail prices by 2.5% per annum. The other scenario reflects more intense price competition meaning retail prices fall more quickly (at a rate of 10% per annum).

Cuts in wholesale price

Ofcom's retail minus calculation of the wholesale price would see cuts in Sky's retail prices passed on to other retailers in the form of lower wholesale charges. We model this by allowing the wholesale price to track the retail price with a one month lag. Thus, the wholesale price in a month is equal to Sky's retail price in the previous month less the retail-minus margin. Ofcom does not specify how it intends to set the margin. Therefore, we model the wholesale price using a margin that is fixed in absolute value (at £13.57).[180]

In addition, in our base case we set the cost-plus floor as the minimum wholesale price. That, however, is likely to be a conservative approach. This is because once the wholesale price reaches the cost-plus floor, other vertically integrated suppliers will have reduced incentives to bid for content rights. In turn, that will lead to a reduction in bids for content rights and so a reduction in the value of those rights. That will lead to a reduction in Sky's costs which will cause the wholesale price to continue to fall even once the cost-plus floor has been reached. We capture this in our modelling by allowing retail price reductions to continue to lead to reductions in the wholesale price in one scenario.

The level of the wholesale price

In addition to the sensitivities set out above we also model the effect of the level at which Ofcom sets the regulated wholesale price. We repeat our base case calculations using the top and bottom of the weighted average range of prices proposed by Ofcom (£18.35 and £14.55 respectively).

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180 A scenario was also developed in which the margin was set as a proportion of Sky's retail price. For brevity we do not present the results herein. Nevertheless it did not materially affect the conclusions we draw from our analysis.

3. Modelling results

This section presents the results of our modelling. First we present the results of our calculation of the market expansion necessary to offset Sky's lost combined revenues. This modelling demonstrates that the wholesale market would need to expand by 12.5% each year for three years (or 42% overall) for Sky's combined revenue (and, therefore, its valuation of rights) to be unaffected, a scenario that we consider unlikely.

Second, we present the results of our second, dynamic modelling approach which demonstrates that there is no plausible set of assumptions that will lead to Sky's combined revenues increasing following the introduction of the proposed wholesale remedy. Instead, the likely effect on Sky's combined revenue will be a considerable reduction. In turn, that must damage Sky's willingness and/or ability to bid for content rights and, therefore, damage the value of those content rights.

3.1.1. Stand-alone market expansion necessary to offset lost combined revenue

The results from the dynamic modelling, in which we consider only growth in subscribers to non-Sky platforms, demonstrates that the extent of market expansion necessary to offset Sky's losses from the proposed regulatory intervention would be so large as to be implausible over a 3 year time horizon. Table 3 shows the effect of the wholesale remedy on Sky's combined revenues. The scenarios assume that Virgin's subscriber base will grow by 5%, 10% and 12.5% per year (assuming no loss to Sky of its own retail customers).

A year-on-year growth of Virgin's premium subscriber base of 5% would result in an expansion of subscribers to non-Sky platforms of 16% by year three. That, however, would be insufficient to offset the losses to Sky's combined revenues resulting from the proposed remedy as Sky would continue to lose revenue in year three relative to the counterfactual in which no wholesale remedy was imposed. For the wholesale remedy to be NPV neutral Virgin would have to grow its premium subscriber base by 12.5% each year. That would require an expansion of its customer base of some 42% over three years. An expansion of such magnitude is highly unlikely given that Virgin has been retailing Sky's premium channels for some 15 years or more.

Table 3: Simple dynamic assessment of the degree of market expansion necessary to preserve Sky's combined revenues

	Compounded growth in wholesale subscriptions		
	5%	**10%**	**12.5%**
Revenue impact			
Year 1	-2.3%	-1.7%	-1.5%
Year 2	-1.7%	-0.5%	0.1%
Year 3	-1.1%	0.8%	1.8%
Combined effect over 3 years (NPV revenue)	-1.7%	-0.6%	0%
Overall growth in wholesale subscriptions at end of year 3	16%	33%	42%

Source: RBB calculation

3.1.2. Multi-factor analysis results

This sub-section presents the results from our multi-factor dynamic analysis of Sky's combined revenues. Specifically, it presents the impact of the proposed wholesale remedy on Sky's combined revenues in five different scenarios.[181]

- The first considers the impact of market expansion and reaffirms the results from the simple dynamic analysis that market expansion is highly unlikely to be sufficient to offset the negative effects on Sky's combined revenues arising from the wholesale remedy.
- The second examines the influence of customer switching on Ofcom's wholesale remedy and shows that our analysis is not dependent on any assumption of the degree of customer switching.
- The third explores the effect of retail price erosion that will inevitably occur following the introduction of the proposed wholesale remedy (because the margin Ofcom permits retailers is overly generous to undertakings such as Virgin), including the secondary impact from the reduction in the wholesale

[181] In additional we modelled scenarios in which the ratio of Sky's subscribers to premium channels relative to Virgin's subscribers to premium channels was altered. In one variant, the ratio was set to six to one (i.e. Sky has six subscribers to premium channels for each Virgin subscriber to premium channels), in the other two to one. Our base case indicates that Sky would lose 11.3% of its combined revenues and these scenarios predict 11.1% and 11.7% respectively. Therefore our analysis does not seem to be dependent on this assumption.

price under the retail price minus calculation and highlights the considerable adverse effect any price reduction will have on Sky's combined revenues.

- The fourth scenario studies the impact on Sky's combined revenues of wholesale prices falling below the level of the cost-plus floor set out by Ofcom in the Third Consultation and demonstrates that failure to preserve the wholesale price at or above the current cost-plus floor will result in a considerable reduction in Sky's combined revenues.
- The final scenario examines the effect that the level at which the wholesale price is set will have on Sky's combined revenues and shows that, as one would expect, a higher wholesale price would protect Sky's revenues to some degree, but even the top prices in Ofcom's consultation range would be insufficient to offset Sky's lost combined revenue.

We present our findings in each of these scenarios in turn.

Effect of market expansion

The more additional subscribers to non-Sky platforms that are attracted by new retailers (assuming any such expansion occurs), the greater will be the offsetting effect against the loss in Sky's combined revenues arising from the reduction in wholesale prices under the remedy. Table 4 shows the NPV of the lost combined revenue in the first three years following the introduction of Ofcom's proposed wholesale remedy.

Table 4: Lost combined revenue (NPV 3 years) – sensitivity to market expansion

	Base case (market expansion equal to Virgin)	No market expansion	Low market expansion (market expands by half the size of Virgin)	High market expansion (market expands by twice the size of Virgin)
Loss in NPV of 3 year revenue	11.3%	13.2%	12.2%	9.3%

Source:RBB calculation

The base case, which takes the midpoint in all assumptions (including level of market expansion, the level of consumer switching away from Sky and level of retail price erosion), predicts that Sky would lose the equivalent of 11.3% of its combined revenues in the first three years following the imposition of Ofcom's proposed remedy. The extent of market expansion will be an important factor in determining the effect of the remedy on Sky's combined revenues. If there is no market expansion, the combined effects of the reduction in both the wholesale price and the retail price will lead to a loss of Sky's combined revenues in the first three years equivalent to 13.2% of NPV. If expansion does occur but is limited (modelled as additional wholesale customers equal to half of Virgin's current premium channel subscriber base ultimately taking up Sky's premium channels on alternative platforms) Sky would be set to lose 12.2% of its combined revenues.

However, crucially, even if the market can be expected to add twice as many subscribers as currently subscribe to Virgin (an unlikely scenario), there would be insufficient new demand in the first three years to offset losses in Sky's combined revenues and Sky would lose over 9% of its combined revenues. This analysis further supports the findings from the simple dynamic analysis presented above in demonstrating that market expansion is unlikely to be sufficient to offset the negative effects on Sky's combined revenues that will arise from the proposed wholesale remedy.

Effect of customer switching

The rate at which Sky's retail subscribers can be expected to switch to alternative retailers (including, but not limited to, Virgin) will also influence the loss in Sky's combined revenues that result from the proposed wholesale remedy. Table 5 presents the results of our sensitivity analysis with respect to the extent of customer switching away from Sky.

Table 5: Lost combined revenue (NPV 3 years) – sensitivity to customer switching away from Sky

	Base case (5% Sky's customer switch per year)	No switching	Low switching (2.5% Sky's customer switch per year)	High switching (10% Sky's customer switch per year)
Loss in NPV of 3 year revenue	11.3%	8.3%	9.8%	14.1%

Source:RBB calculation

It is not unsurprising that the greater the number of Sky's retail customers who switch to alternative retailers, the greater the adverse effect of the wholesale remedy on Sky's combined revenues. Nevertheless, our modelling demonstrates that even if Sky retained its current retail subscriber base, the wholesale remedy would still lead to a reduction in Sky's combined revenues of 8.3%. We, therefore, do not consider that our analysis is dependent upon the assumption of consumer switching following the introduction of the proposed remedy.

Effect of retail price erosion

The price competition that will inevitably follow the introduction of the proposed wholesale remedy will force Sky to reduce its retail prices in order to preserve subscriber numbers. In turn, that will lead to a reduction in the wholesale price that Sky's competitors have to pay and so put further downward pressure on Sky's own retail price. The table below captures the results of retail price erosion and the compounding impact through the knock-on effect from a reduction in wholesale prices. In this scenario the wholesale price never falls below the cost-plus floor.

Absent any decline in retail prices, Sky would still be expected to lose 3.6% of its combined revenues. Even with moderate reductions in retail prices of 2.5% per year, the loss to Sky would be considerably increased as it would expect to lose almost 8% of its combined revenues. If (as could reasonably be expected) there is intense retail price competition and Sky is forced to cut its retail prices by 10% each year, Sky would lose 17% of its combined revenues.

This clearly demonstrates that the overly generous margin set by Ofcom will lead to sub-optimal prices and will considerably damage Sky's revenues and, therefore, its ability and/or willingness to bid for content rights.

Table 6: Lost combined revenue (NPV 3 years) – effect of retail price erosion

	Base case (Prices decline by 5% per year)	No price erosion	Slow price erosion (Prices decline by 2.5% per year)	Fast price erosion (Prices decline by 10% per year)
Loss in NPV of 3 year revenue	11.3%	3.6%	7.7%	17.0%

Source:RBB calculation

Effect of cost-plus floor failing to prevent reduction in value of rights

Ofcom claims that the value of content rights will be unaffected by the proposed wholesale remedy because its use of the cost-plus floor to set a lower limit on the wholesale price will protect Sky's wholesale revenue and thereby Sky's ability to bid for rights. Such a presumption is flawed because Sky's ability and willingness to bid for rights depends on, inter alia, its combined revenues and not the wholesale price alone.

Moreover, we contest the presumption that the cost plus floor will preserve Sky's revenue. As Ofcom accepts, setting wholesale prices using the cost-plus method would lead to the undesirable and perverse consequence that other vertically integrated channel providers would have reduced incentives to bid for content, which, in turn, would depress the value of content rights. It is clear that, once wholesale prices reach the cost plus floor, this effect will take over and Sky's costs will be cut as it bids less for content rights. Therefore wholesale prices will continue to fall even after the wholesale price reaches the current cost-plus floor.

This effect is captured in our modelling of Sky's combined revenues by allowing the wholesale price to continue to fall once the current cost-plus floor is reached. Table 7 presents the results of this modelling. It demonstrates that, if the cost-plus floor is breached, Sky would expect to lose 11.6% of its combined revenue in the first three years (compared to 11.4% in our base case). However, in this case the wholesale price only dips below the cost-plus floor towards the end of the second year. The potentially damaging effect of the wholesale price breaking the cost-plus floor can be more easily seen by examining what would happen under two different scenarios. First, extending our analysis to look at the NPV of Sky's combined revenues over a 5 year window indicates that if the cost plus floor is exceeded, then Sky would be expected to lose 16.6% of its combined revenues compared to the counterfactual of no wholesale remedy. Similarly, if retail price competition is more vigorous and retail prices, therefore, fall by 10% each year (rather than the 5% in our base case) then Sky would lose almost one fifth of its combined revenues in the first three years following the introduction of the proposed wholesale remedy.

Table 7: Lost combined revenue (NPV 3/5 years) – effect if wholesale price is pushed below current cost plus floor

	Base case (wholesale price never falls below cost plus floor)	Wholesale price is pushed below current cost-plus floor	Wholesale price is pushed below current cost-plus floor and high price competition	NPV over 5 years when wholesale price is pushed below current cost-plus floor
Loss in NPV of 3 (or 5) year revenue	11.3%	11.6%	19.3%	16.6%

Source:RBB calculation

Effect of the level of the wholesale price

The level at which the wholesale price is set will influence the degree to which Sky loses revenue as a result of the remedy. However, as Table 8 demonstrates even if Ofcom adopts the highest wholesale prices from the range it is consulting on, that would be insufficient to preserves Sky's combined revenues which would decline by some 9.8% in three years.

Table 8: Lost combined revenue (NPV 3 years) – effect of the level of the wholesale price

	Base case (Wholesale price £16.45)	High wholesale price (£18.35)	Low wholesale price (£14.55)
Loss in NPV of 3 year revenue	11.3%	9.8%	11.9%

Source:RBB calculation

The scenarios above all demonstrate the potentially disastrous impact of the wholesale remedy on Sky's combined revenues and, therefore, its ability to continue to bid for content valued by subscribers. The combined effects of retail price erosion, consumer switching and the potential reduction of the wholesale price below the current cost-plus floor will all fail to be offset by any plausible expansion of the market for subscribers to Sky's premium channels on non-Sky platforms.