RESPONSE BY BRITISH SKY BROADCASTING GROUP PLC TO OFCOM'S CONSULTATION DOCUMENT 'PAY TV PHASE THREE DOCUMENT: PROPOSED REMEDIES' OF 26 JUNE 2009

INTRODUCTION

1. This document (the "**Response**") is the response of British Sky Broadcasting Group plc ("**Sky**") to Ofcom's Consultation Document *"Pay TV phase three document: Proposed remedies*" of 26 June 2009 (the "**Consultation Document**").[1]

2. This Response is structured as follows:

Section 1: Overview

Section 2: Ofcom's approach to its investigation

Section 3: Ofcom's recourse to sectoral powers is legally unsound

Section 4: Ofcom's historic analysis of Sky's aggregate profitability

Section 5: Analysis of competition at the retail level

Section 6: Ofcom's competition concerns: Sky has an incentive to distribute its channels widely

Section 7: Ofcom's competition concerns: Ofcom's allegations regarding high wholesale prices are unfounded

Section 8: Consumer effects do not justify Ofcom's intervention

Section 9: Ofcom's proposed interventionist and unprecedented new regulation is not necessary, proportionate or consistent and does not reflect best regulatory practice

Section 10: Ofcom's proposed extended retail-minus price control regime is neither necessary nor proportionate, and does not reflect best regulatory practice

Section 11: Ofcom has failed to carry out an impact assessment to the requisite standard

3. This Response incorporates six Annexes prepared by external consultants:

Annex 1: a report by Professor Martin Cave of the University of Warwick on the potential consequences of Ofcom's proposed wholesale must offer remedy;

1 All references to the "Consultation Document" in this Response are to Ofcom's Third Consultation Document unless otherwise stated.

Annex 2: a report by Professor Paul Grout of Bristol University on the use of profitability;

Annex 3: a response by Paul Seabright and Thierry Magnac of the Toulouse School of Economics to Ofcom's criticisms of their previous report (submitted in response to the Second Consultation Document), prefaced by further comments by Sky;

Annex 4: a report by PricewaterhouseCoopers ("PwC") on the dispersion of profitability; [2]

Annex 5: a report by Human Capital on the use of consumer research in hypothetical monopolist tests; and

Annex 7: a further report by PwC on the use of comparator analysis by Oxera to assess Sky's profitability; [3]

4. This Response also incorporates two Annexes prepared by Sky:

Annex 6: a critique of Ofcom's proposals in Section 12 of the Consultation Document to use targeted interventions to address specific concerns regarding content rights;

Annex 8: a critique of Ofcom's proposed draft licence condition in Section 11 of the Consultation Document;

2 In accordance with the terms of PwC's engagement, Ofcom is referred to the disclaimer at Page 1 of **Annex 4** to this Response.

3 In accordance with the terms of PwC's engagement, Ofcom is referred to the disclaimer at Page i of **Annex 7** to this Response.

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SECTION 1: OVERVIEW

A. Introduction

Ofcom's extreme agenda

1.1 Ofcom has set out a clear agenda in its latest Consultation Document[1]. It wants to promote the growth of Pay TV retailers operating on DTT, and to encourage Pay TV retailing on new IPTV platforms in the future. Ofcom seeks to achieve that aim by compelling Sky to license its premium channels to retailers on those platforms at sharply reduced rates. For more obscure reasons, Ofcom also wishes those sharply reduced rates to be extended to retailers on other platforms, such as Virgin Media. In effect, Sky's channels are to be treated as regulated assets, the development and use of which is to be controlled by Ofcom in order to further Ofcom's policy objectives, to the benefit of Sky's current and future competitors and, in Sky's view, to the detriment of Sky, the competitive process and consumers.

1.2 This is an extreme and unprecedented intervention (as confirmed by research commissioned by Ofcom[2]) and it is being proposed in circumstances in which:

- Ofcom has itself acknowledged that good outcomes are being delivered to consumers;[3]
- Ofcom has not found Sky to be in breach of any competition law;[4] and
- even on the basis of Ofcom's own calculations of Sky's aggregate profitability, Sky is earning returns above its cost of capital to a degree which is perfectly normal.[5]

1.3 It is an intervention whose objective is entirely at odds with the free and undistorted operation of the competitive process. It leads to outcomes which would not be seen in a free and competitive market. No rational channel provider would willingly alter its preferred business model or reduce its wholesale prices in order to promote the growth of particular Pay TV retailers in the manner proposed by Ofcom. Nor would it be considered desirable, in a free and competitive market, for entry or expansion by designated operators with higher cost bases to be promoted and sustained through subsidy. Yet that is precisely the effect of Ofcom's proposals, which are in essence a form of

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1 "*Pay TV phase three document, Proposed remedies*", dated 26 June 2009 (the "**Consultation Document**").

2 Report of Value Partners contained in Annex 11 to the Consultation Document.

3 See, for example (i) Ofcom's First Consultation Document of 18 December 2007, (ii) Ofcom's International Communications Market Report of November 2008, (iii) Ed Richards: Sky has brought "*very substantial consumer benefit*", *Financial Times*, 13 February 2009 and (iv) Ofcom's website summary (published on 6 August 2009) of its 2009 UK Communications Market Report.

4 Paragraphs 8.11 to 8.21 of the Consultation Document.

5 See **Section 4** of this Response.

industrial policy. Ofcom fails completely to recognise, let alone to assess, the detriments to competition and to consumers – such as reduced incentives to invest in content and to innovate - that would be likely to flow from its proposals. Ofcom makes no case that its ultimate policy objectives are, themselves, appropriate or proportionate, and appears to regard them as entirely costless. As the report of an independent expert, Professor Martin Cave,[6] succinctly puts it, Ofcom's proposals "*are likely to have unintended consequences for consumers which Ofcom has not recognised or taken adequately into account… Ofcom's analysis pays insufficient attention to the detrimental effects which its proposals would have on end users of the services in question*".[7]

Ofcom's recourse to its sectoral powers is unsound

1.4 Ofcom's proposed means of achieving its objectives is through the use of its sectoral competition powers in order to compel Sky to license intellectual property in its channels at prices set by Ofcom. Ofcom rightly acknowledges that, in doing so, it is proposing to take a step that goes far beyond any that would be required under competition law;[8] but it fails to recognise that, in the circumstances of the present case, such a departure from orthodox competition law principles renders its proposed intervention unlawful. This is notwithstanding that Ofcom's earlier internal thinking on the use of its regulatory powers by a senior policy team acknowledged the need to act consistently with competition law principles. Now, however, Ofcom appears to accept no meaningful constraint at all on the use of its sectoral competition powers, and has declined to adhere to, or even to acknowledge, its previously established and more limited approach to the use of those powers.[9]

1.5 Moreover, Ofcom has failed to demonstrate, as its statutory duties require it to do, that:

(i) there is a problem with the competitive process of such magnitude that its proposed remedy is necessary, proportionate and in accordance with regulatory best practice; and

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6 Professor Cave's report (the "**Cave Report**") is included at **Annex 1** of this Response. Professor Cave is an expert in the field of regulatory policy (among others), and has carried out independent reviews of regulation for the Government on numerous occasions. In order to ensure the Cave Report was prepared with the same degree of independence and integrity as an expert would prepare a report in connection with litigation proceedings, Sky's external legal advisers have engaged Professor Cave under the terms of the Civil Procedure Rules and the protocol for instruction of experts. Sky's external legal advisers have also engaged Professor Paul Grout (whose report is referred to in footnote 13 below) and Professors Paul Seabright and Thierry Magnac (whose report is referred to in footnote 19 below) on the same basis.

7 Paragraphs 55 and 60 of the Cave Report. See also paragraphs 1.50 and 1.64 to 1.69 of this **Section 1** below.

8 See, for example, paragraphs 8.16 to 8.19 and 9.60 to 9.63 of the Consultation Document.

9 Ofcom's statement on cross promotions. Available at: http://www.ofcom.org.uk/consult/condocs/promotion/statement/statement.pdf

(ii) (under an impact assessment capable of withstanding profound and rigorous scrutiny) the benefits flowing from the imposition of its proposed remedy outweigh the many serious detriments.

1.6 Ofcom is in danger of breaching its principal duty to further the interests of consumers.

1.7 At the very least, one would have expected Ofcom carefully to have analysed each separate element of its proposals, such as:

- the requirement for Sky to wholesale rather than self-retail its premium channels via other platforms;
- the requirement for Sky to have its wholesale prices set by Ofcom;
- the requirement for the wholesale prices set by Ofcom to be determined by reference to the costs of a hypothetical DTT retailer; and
- the requirement for innovative services such as Sky's HD premium channels to be included within Ofcom's compulsory licensing regime,

in order to determine whether the implementation of each element would be consistent with its statutory duties and with the proper use of its sectoral competition powers. But Ofcom has failed to do this.

Ofcom's assessment of the evidence is skewed and its analytical approach defective

1.8 Each step in Ofcom's analysis is deficient, the result of an approach in which Ofcom appears to have started with a view of the end point it wishes to reach and then considered the evidence by reference to the extent to which it is or is not consistent with that end point. As Ofcom itself admits, it has first reached conclusions and then tested those conclusions against the evidence;[10] whereas it should first have looked objectively at all the evidence and then drawn appropriate conclusions.

1.9 This approach has led to serious distortions in the way Ofcom has treated evidence. Ofcom has lost sight of the fact that the burden of proof is on Ofcom to demonstrate that its proposed intervention is justified. Instead, Ofcom appears to have acted on the assumption that its intervention is justified unless overwhelming evidence can be adduced to the contrary. Moreover, Ofcom has been highly selective in its treatment of evidence depending on whether it is consistent or inconsistent with the conclusions that Ofcom seeks to draw. Cogent and compelling evidence which is inconsistent with Ofcom's case, including evidence adduced by Ofcom itself in earlier consultations, has been irrationally dismissed or even ignored.

1.10 Critical elements of Ofcom's case – which have potentially profound consequences - rely on inference, the self-interested assertions of third parties, or on financial modelling on Ofcom's part which contains unsupportable and

[10] Paragraph 2.57 of the Consultation Document.

counterintuitive assumptions, compounded by obvious and rudimentary errors and inconsistencies.[11] Ofcom's financial modelling is, simply put, not fit for purpose as a basis on which Ofcom could seek to justify, or proceed with, its proposals. Indeed, it is a matter of some concern that Ofcom chose to consult on such extreme proposals, which would have potentially profound consequences for businesses and consumers alike, when the key financial modelling on which it relies is of such an inadequate standard.

1.11 Where Ofcom has sought to bolster its case by commissioning reports from external consultants, it has misrepresented what those reports actually say. For example, much of Ofcom's case relies heavily on Oxera's report on Sky's aggregate profitability. Even leaving aside any discussion of the appropriateness of Oxera's methodology (which, without explanation, adopts an approach to the measurement of profitability which Ofcom had itself dismissed as unreliable in its previous consultation in this investigation[12]), the conclusions which Ofcom draws from Oxera's report ignore completely Oxera's careful caveats and are inappropriate and certainly not supported by Oxera's actual findings. Most notably, Ofcom appears to consider that any return which is not "*close to*" a firm's cost of capital must be evidence of a problem which needs to be solved by regulation. That is not a proposition that finds any support in Oxera's report, or indeed in any economic literature of any substance.[13]

1.12 The result of these deficiencies is that, in each critical step in its analysis, Ofcom reaches views which, in light of the available evidence, are perverse or extreme. While such an approach may be one which has been forced upon Ofcom in seeking to justify its radical intervention, it is not one to be expected from a regulator professing a "*bias against intervention*".[14] Still less is it an approach which is consistent with Ofcom's statutory duties.

Ofcom has mischaracterised Sky's approach to channel distribution

1.13 The key "*problem*" which Ofcom alleges in its Consultation Document relies on a mischaracterisation of what Ofcom describes as Sky's "*approach*" to the distribution of its premium channels. But that approach is not, as Ofcom asserts, one designed to restrict distribution of Sky's channels. On the contrary, it is the normal approach of any rational investor in television channels – to maximise the revenue derived from the distribution of its channels, which creates an incentive to seek wide distribution. Consistent with this, and

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11 See, for example, paragraphs 1.37 and 1.56 below.

12 Oxera has carried out a profitability assessment based on a "*truncated IRR approach*". At paragraph 1.55 of Annex 9 to its Second Consultation Document, Ofcom stated that "*Ofcom considers that a profitability assessment based on a truncated IRR approach is unlikely to yield a robust conclusion about Sky's profitability.*"

13 Sky includes at **Annex 2** of this Response an independent expert's report from Professor Paul Grout entitled "A *Report on Profitability*" which, among other things, addresses Oxera's report and the conclusions that Ofcom has drawn from it. Professor Grout's analysis of stock market evidence, set out in his report at **Annex 2,** demonstrates that Sky has not experienced an abnormal return. There is no evidence, therefore, that Sky is earning excessive returns resulting in consumer detriment.

14 Third bullet point of Ofcom's Regulatory Principles. http://www.ofcom.org.uk/about/sdrp/.

contrary to the impression given by the Consultation Document, Sky's premium channels are available on a variety of platforms, including cable, IPTV, the internet and four out of the five 3G mobile phone networks, as well as satellite. Sky's premium channels are not currently available on DTT, but it was precisely the incentive to seek wide distribution that drove Sky in early 2007, following Ofcom's removal of its own restrictions on the provision of pay television channels on DTT Multiplexes B, C and D, to seek Ofcom's approval to make its premium channels available via DTT once again.[15] The issue at the heart of this long investigation is not, in truth, the lack of availability of Sky's channels, but Ofcom's concerns about the commercial basis upon which they are available. Sky wishes to earn returns from the distribution of its channels which reflect their value and the considerable ongoing risks and investments Sky continues to take and make in producing those channels.

1.14 Ofcom itself is well aware that this is the reality of Sky's "*approach*" to premium channel distribution. In December 2007, in an attempt to end the stasis arising from Ofcom's various reviews and investigations, which were causing Sky's plans to launch its 'Picnic' offering via DTT to be held up, Sky proposed to Ofcom that it would set aside its commercially rational preference for self-retailing its premium channels via secure third party platforms and agree instead to wholesale its premium channels based on a pricing scheme which would have offered substantial discounts to any retailer improving on the then level of Sky premium channel penetration on cable networks. This proposed scheme formed the foundation for the progression of weeks of subsequent detailed discussion between Sky and senior Ofcom officials of how Sky proposed to "*approach*" the wholesaling of its premium channels. Despite five months of constructive discussions, Ofcom decided to reject Sky's proposals on the basis that "*our respective views on the issue of the price of any wholesale offering remained, despite our respective best efforts, apart*".[16] This rejection (in April 2008) came before Ofcom had even fully reviewed Sky's Response to Ofcom's First Consultation Document. Since then, Ofcom has been implacably committed to finding a means through regulation of securing deeper wholesale price cuts than those which would have flowed from the wholesale pricing scheme which Sky offered to adopt – an offer which should have been more than enough to satisfy a regulator acting reasonably. As a result, Ofcom's investigation has (so far) continued for a further year and a half during which time Ofcom has continued to withhold its approval of Sky's application to broadcast its premium channels via DTT, with the effect that consumers continue to be denied any possibility of accessing those channels via DTT. Ofcom's purported use of its powers in this way is illegitimate and unjustified.

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15 Sky made its premium channels available to ITV Digital until ITV Digital's closure. The DTT capacity used by ITV Digital was reallocated by Ofcom for the provision of free TV channels (under the Freeview banner).

16 Letter from Ed Richards to Jeremy Darroch of 16 May 2008.

B. Ofcom's "competition issues"

Ofcom's analysis suffers from a distorted perspective

1.15 Ofcom's starting point in the Consultation Document is to seek to demonstrate that Sky enjoys market power at the wholesale level. It is evident that, contrary to the normal approach of competition policy, Ofcom views market power in and of itself as something that needs to be addressed. But Ofcom's undue focus on seeking to define narrow **wholesale** markets leads it to lose sight of the fact that it is the means by which competition operates at the **retail** level that is the critical issue in any analysis of whether Ofcom's proposed intervention is justified.

1.16 Ofcom's consideration of this critical issue remains remarkably thin; in essence a mere addendum to its analysis of market power at the wholesale level. Important evidence of how competition operates at the retail level has been ignored or irrationally dismissed. A good example is Ofcom's consideration of the key competitive dynamic between free and pay television services. Ofcom itself states that "*the key dynamics in recent years have been Sky, driving growth in pay TV, and Freeview, driving growth in free-to-air multi-channel TV*"[17] and that Freeview "*provided a credible free-to-air alternative for those consumers who wanted multi-channel TV but did not wish to pay for it*".[18] The Competition Commission, having received copious evidence from ITV and others, cited similar dynamics in finding an "*all TV*" market (in which Sky and Freeview compete for custom) in its consideration of Sky's acquisition of a stake in ITV. Important econometric evidence was provided to Ofcom from independent experts of the extent of the constraint Freeview exerts on Pay TV retailers. This key competitive dynamic has served to push both free to air operators and pay TV retailers alike to innovate relentlessly and to deliver better quality and better value services to consumers. Yet it has been almost completely ignored by Ofcom in its analysis – and powerful econometric evidence provided to Ofcom by Sky was irrationally dismissed on the basis of a misrepresentation of the views provided to Ofcom by its own external consultant.[19]

1.17 Similar criticisms can be levelled with regard to Ofcom's analysis of retail level competition in relation to Sky's premium movie channels. Ofcom's focus on seeking to define narrow retail markets for premium movie channels leads it to lose sight of the practical reality of the significant and increasing constraints imposed on retailers of Sky's premium movie channels by the explosive growth in the ways that consumers can choose to view movies and other programming in the home.

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17 Paragraph 3.10 of the Consultation Document.

18 Paragraph 3.9 of the Consultation Document.

19 This is discussed in an independent expert's report from Professors Paul Seabright and Thierry Magnac, (the "**Seabright and Magnac Report**") included at **Annex 3** of this Response.

Ofcom's alleged "problems"

1.18 Within the artificially narrow markets which Ofcom has defined, Ofcom identifies two "*problems*". Although Ofcom does not find Sky to be in breach of competition law, Ofcom alleges that:

(i) Sky has an incentive to restrict wholesale supply of its premium channels and is acting on that incentive; and

(ii) Sky is setting high wholesale prices for its channels.

1.19 Those "*problems*" are said to arise as a result of Sky's market power, and traverse the same ground as "*refusal to supply*" and "*excessive pricing*" and/or "*margin squeeze*", on each of which there is a well established competition law jurisprudence. In the circumstances, Ofcom should apply the same competition tests as would apply under general competition law, albeit allowing for the fact that its sectoral competition powers are *ex-ante* in nature. Ofcom's failure to do so of itself renders its proposed intervention unlawful. But in any event, Ofcom cannot even establish that the "*problems*" it identifies would have a material impact on the competitive process, that being the test that Ofcom itself previously adopted.

No restricted distribution – DTT and IPTV

<u>*Ofcom's shifting and erroneous views of Sky's incentives*</u>

1.20 Dealing with the first alleged "*problem*", Ofcom has moderated its previous allegation that Sky has "*the incentive to restrict the supply of its Core Premium Channels to other retailers and other platforms*"[20] and now makes the narrower allegation that "*Sky has a strategic incentive to restrict **wholesale** supply of its channels to other retailers.*"[21]

1.21 Ofcom also now appears to accept that, on a "*static*" (*i.e.* short-term) analysis, Sky has a strong incentive to wholesale. But, rather than that recognition causing it to reconsider its hypothesis regarding Sky's incentives, Ofcom now claims that this strong incentive is outweighed by ill-defined "*strategic incentives*" to withhold wholesale supply. The evidence upon which Ofcom relies to support this claim is weak and ambiguous; and Ofcom notably fails to address the paper submitted to Ofcom by CRA[22] which critically examined Ofcom's assessment of strategic effects in its Second Consultation Document and concluded that none of the theoretical strategic mechanisms that had been identified by Ofcom stood up to closer economic scrutiny. Moreover, Ofcom makes no attempt to quantify these supposed "*strategic incentives*", which is a fundamental gap in its analysis since it is therefore in no position to assess whether such incentives would *outweigh* the static incentives to wholesale operating in the other direction.

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20 Paragraph 1.29 of Ofcom's Second Consultation Document.

21 Paragraph 6.94 of the Consultation Document. (Emphasis added).

22 Annex 4 of Sky's Response to the Second Consultation Document.

1.22 The key argument that Ofcom now runs appears to be that Sky has an incentive to withhold its channels from other platforms unless the operators of those platforms agree to a commercial model under which Sky is the channel retailer. As Ofcom now accepts, Sky's overriding incentive is to maximise revenue. Sky's view (based on nearly 20 years' experience as a retailer, and a wholesaler to cable operators) is that this is more likely to occur if Sky is the retailer, and so responsible for marketing and customer service. Setanta (whose distribution strategy Ofcom compares favourably with Sky's) evidently took the same view. Where it had the opportunity to access other platforms and to self-retail its channels, it did (both on satellite and DTT). Ofcom makes no cogent case why Sky (uniquely) should be denied the ability to adopt a legitimate commercial model adopted by others in the UK, and commonplace in other countries such as France and Germany.

1.23 But Sky's preference for self-retailing does not mean that if, for whatever reason, that avenue is not open to Sky, it does not then have an incentive to wholesale. The key incentive in those circumstances is to maximise the wholesale revenue to be derived from distribution. Sky would not, as Ofcom appears to believe, simply walk away from the opportunity to increase wholesale revenues – which add to bottom-line profit – in the event that it could not negotiate a self-retail deal, out of fear of ill-defined "*strategic*" consequences.

No evidence that Sky is acting on an incentive to restrict supply

1.24 Nor does the evidence suggest that Sky is acting on an incentive to restrict supply of its channels. Ofcom merely infers from the absence of Sky's premium channels on DTT alone (among the many platforms on which those channels are available), and the fact that Sky's premium channels are available on a self-retailed rather than wholesale basis on Tiscali's IPTV platform, that Sky is acting on such an incentive (despite acknowledging that at no time has Sky explicitly refused to wholesale). It is simply not open to Ofcom to draw this inference.

1.25 To the extent that Ofcom is suggesting that Sky is seeking to retain a content exclusivity advantage for the satellite and cable platforms, this suggestion is unsustainable in the face of the evidence of Sky's innovative distribution of its channels via 3G mobile phone networks, the internet and games consoles (exceeding that which was achieved by Setanta) and IPTV, and its attempt to distribute its channels via DTT under its Picnic proposals. Moreover, the reasons for the absence of Sky's channels on a wholesale basis from DTT and IPTV are readily explicable.

The absence of Sky's premium channels from DTT is readily explicable

1.26 In the case of DTT, there are important practical and technical reasons why this is the case. Ofcom's DTT multiplex licensing regime precludes the provision by Sky of any channels on DTT multiplexes B, C and D other than the three free-to-air channels which it currently provides, and Ofcom has (for well over two years) continued to withhold its approval for Sky to replace those channels with (among others) its premium channels. To the extent that any other capacity were to become available on any other DTT multiplex, it is unclear whether Sky would be entitled to be the provider (with editorial control) of its premium channels via that capacity. In any event, until very recently neither of the current DTT pay TV retailers had approached Sky with an offer to obtain and bear the cost of DTT capacity for the provision of Sky's premium channels. Moreover, as Ofcom is well aware, there are legitimate security concerns in relation to both the TUTV and BT Vision platforms, which Sky discussed in detail with Ofcom in early 2008, and which neither operator appears to have done anything to address since Sky first raised them. Ofcom cannot simply overlook these practical realities and rely on inferences based on its shifting views of Sky's incentives and motivations.

1.27 A critical stumbling block has also been price. This is unsurprising given that, as with any supplier/distributor negotiation, each of the supplier and distributor wishes to maximise the returns it will derive from distribution. It is for this reason that Sky prefers a distribution model under which it self-retails, and this has indeed been an important dynamic in Sky's discussions with BT Vision and TUTV. But, as Ofcom has recognised, Sky has not ruled out the potentially less attractive (in revenue terms) alternative of a wholesale supply model. Where the negotiation is under a wholesale model, the opposing pressures are between the channel provider's natural desire to maximise revenue, and the distributor's natural desire to minimise input costs. Ofcom appears to suggest that a failure by Sky either immediately to concede its commercially rational preference for self-retailing, or to accede to the distributor's desire to minimise input costs, is evidence of Sky acting on an incentive to restrict wholesale supply. That is manifestly untenable.

1.28 A particular issue in the case of Sky's wholesale negotiations with BT Vision and TUTV has been the shadow cast by Ofcom's investigation. The realistic prospect of Ofcom setting lower prices for Sky's channels and removing Sky's freedom to negotiate those prices creates an incentive for prospective DTT retailers of Sky's channels not meaningfully to negotiate with Sky, and there is evidence that BT Vision has been acting on that incentive. TUTV has not engaged at all with Sky for over 2 years.

The absence of Sky's premium channels from IPTV on a wholesale basis is also explicable

1.29 In the case of IPTV, it is important to understand that BT Vision is still not capable of distributing linear channels by means of IPTV. However, Sky has reached an agreement with the only currently operational linear channel IPTV player - Tiscali. The fact that the outcome of Sky's negotiations with Tiscali was that Tiscali accepted that Sky could self-retail on Tiscali's platform cannot properly be treated as evidence of Sky acting on an incentive to restrict wholesale supply of its channels. So far as other potential pay TV retailers on IPTV are concerned, Ofcom accepts in the Consultation Document that there are numerous technical reasons why such retailers are yet to emerge. Accordingly, their failure to emerge so far cannot properly be treated as evidence of Sky acting on an incentive to restrict wholesale supply of its channels.

1.30 Overall, therefore, there is no cogent evidence to support Ofcom's case of alleged competition "*problems*" in relation to restricted distribution on DTT and IPTV. Moreover, and importantly, Ofcom fails completely to address the question of whether, even were such restrictions to exist, they are having a material impact on the competitive process – an assessment which would require Ofcom to take full account of the established competition law jurisprudence in relation to the limited circumstances in which compulsory licensing of intellectual property is justified, and the importance of distinguishing between the protection of competition and the protection of competitors.

No restricted distribution – Virgin Media

1.31 Ofcom's arguments in relation to Virgin Media are more nuanced. In that case, there is no absence of availability on Virgin Media's platform on a wholesale basis from which Ofcom can seek to draw any inference, and this therefore presents an obvious problem for Ofcom's hypothesis that Sky is acting on an incentive to restrict wholesale supply. Instead, Ofcom runs two alternative arguments in an attempt to support that hypothesis.

1.32 First, Ofcom argues that Sky's wholesale pricing policy has the intention and likely effect of inhibiting the effectiveness of Virgin Media as a competitor to Sky's satellite service. This argument explicitly rests upon the assumption that Sky's wholesale pricing policy is to charge the highest prices which meet the conditions of a margin squeeze test. This assumption is factually incorrect (Sky's prices are in fact significantly lower). But more importantly, as explained above, and as would be the case for a standalone channel provider, Sky's wholesale pricing policy is to set prices which it believes will maximise its distribution revenue. A failure by Sky to reduce its prices simply because a distributor wishes to reduce its input costs cannot rationally be treated as evidence of an intention to inhibit the effectiveness of that distributor as a downstream competitor - as Ofcom itself recognises,[23] there are well known issues in relation to wholesale supply arrangements which demand more complex solutions than simply cutting per-subscriber charges. Nor is it evidence of a material impact on the competitive process, as opposed to a particular competitor.

1.33 Second, Ofcom argues that "*Sky's reluctance to supply services such as HD*"[24] has the intention and likely effect of inhibiting the effectiveness of Virgin Media as a competitor to Sky's satellite service. Ofcom's evidence for its proposition that Sky is "*reluctant*" to supply services such as HD is particularly thin, and ignores completely the clear evidence that Sky provided to Ofcom on this subject in its submission of 27 May 2009. In particular, Ofcom fails to recognise that Virgin Media initially chose to prioritise VoD and high-speed broadband over HD. It was not until March 2009 that Virgin Media finalised its (then) HD strategy and was in a position to put out a request for proposal calling for proposals to supply linear HD channels for distribution on its platform, to which Sky

23 Paragraph 3.54 of the Consultation Document.

24 Paragraph 6.129 of the Consultation Document.

responded. Moreover, even if it were the case that Sky had refused to supply such services to Virgin Media, Ofcom has not made out a case that such a refusal would have a material impact on the competitive process.

Wholesale price levels are not "high"

1.34 Ofcom relies upon a report commissioned from Oxera (which is, notably, the sole evidence on which Ofcom relies after nearly three years of investigation) and its own calculations to support the proposition that Sky is charging "*high*" wholesale prices for its premium channels.

1.35 Ofcom has not, however, demonstrated that the margin Sky earns on its premium channel wholesale supply business is high or that Sky's wholesale prices are high. These propositions cannot properly be based on Oxera's report - Oxera did not say that Sky's premium wholesale margins are high.

1.36 Nor can they properly be based on the fact that Sky's current cable ratecard prices are above Ofcom's estimate of cost-plus prices. The cost-plus prices which Ofcom has calculated are wrong and would, even based on Ofcom's analysis (and before correcting Ofcom's numerous modelling errors), allow the notional premium wholesale business modelled by Ofcom to earn an average operating margin over the next 10 years of only 0.4%, an absurdly low figure.[25]

1.37 In any event, Ofcom's cost-plus price calculation model contains a number of basic but material errors which affect the results substantially. For example, Ofcom's model overstates the notional premium wholesale business' revenue by assuming UK Sky subscriber net growth in 2008/2009 of 736,000; but Sky's actual reported subscriber net growth in UK and the Republic of Ireland was 462,000 – the highest figure for five years.

1.38 Once those errors are corrected within Ofcom's model, the model indicates that, were Sky actually to charge Ofcom's cost-plus prices, the notional premium wholesale business would lose more than £700 million over 4 years and would incur an average loss as a percentage of sales of 15%. This is a clear illustration why regulators such as Ofcom should not seek to manage markets.

1.39 If those same errors are corrected, but it is assumed that Sky charges its current cable ratecard prices instead of Ofcom's cost-plus prices, Ofcom's model indicates that the notional premium wholesale business would earn an operating margin of around 24%, which is slightly lower than the estimate Ofcom set out in its Second Consultation Document and which Sky showed was at the low end of the estimates for a number of comparator companies. Hence all the available evidence suggests that Sky's current wholesale margins, at current cable ratecard prices, are entirely normal.

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25 This is the result of Ofcom's curious decision to derive cost-plus prices within an inappropriate discounted cash-flow framework and then to assign an opening capital value of £160 million, which is an absurd value for a channel supply business with estimated operating costs of £15 billion over 10 years.

1.40 It is also notable that, in a subsequent section of its Consultation Document, Ofcom states that it does not consider that the evidence is sufficient for an excessive pricing case under the Competition Act 1998.[26] It is unclear why Ofcom nevertheless considers the evidence to be sufficient to demonstrate that Sky's wholesale prices are so high that intrusive price regulation at sharply reduced rates is justified.

C. Ofcom's proposed wholesale must offer "remedy"

Ofcom must, in seeking to justify its proposals, comply with important statutory duties

1.41 Ofcom's case is that, even though Ofcom has not found that "*Sky's approach*" to the distribution of its channels breaches competition law, the imposition of a compulsory licensing requirement through the use of its sectoral competition powers is required in order to deal with competition problems "*stemming from Sky's approach to the wholesale supply of Core Premium Channels*".[27] However, as explained above, nothing in "*Sky's approach*" to the distribution of its channels causes an impact on the competitive process sufficient to justify Ofcom's use of its sectoral powers in this way.

1.42 But in any event, in exercising its powers to impose any remedy, Ofcom must at the very least comply with important statutory duties:

(i) to demonstrate that there is a problem with the competitive process in a properly defined market of such magnitude that its proposed remedy is necessary, proportionate and in accordance with regulatory best practice;[28] and

(ii) to demonstrate that (under an impact assessment capable of withstanding profound and rigorous scrutiny) the benefits flowing from the imposition of its proposed remedy outweigh the many serious detriments.[29]

1.43 Ofcom must also ensure that the imposition of its proposed remedy would not put it in breach of its principal duty to further the interests of consumers.[30] Ofcom's approach in its Consultation Document falls well short of the standards required by these statutory duties.

1.44 In assessing the extent to which Ofcom has complied with these duties, it is important to keep in mind three important factors.

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26 Paragraph 8.17 of the Consultation Document.

27 Paragraph 8.1 of the Consultation Document.

28 Section 3(3) of the Communications Act 2003.

29 Section 7 of the Communications Act 2003, as applied by the CAT in its judgement in Case 1094/3/3/08 *Vodafone Ltd v Office of Communications* [2008] CAT 22, 18 September 2008.

30 Section 3(1)(b) of the Communications Act 2003.

Consumers are well served

1.45 First, as Ofcom has previously acknowledged, both in this process and in its other publications, consumers are very well served. Ofcom continues to have ample evidence that the UK audiovisual market is delivering considerable innovation, unrivalled choice of content, high levels of penetration and satisfaction and competitive pricing.

1.46 But Ofcom is dismissive of, and somewhat perplexed by, the high levels of consumer satisfaction indicated by its own research:

> "*We have not conducted any further analysis of consumer satisfaction. However we share Virgin Media's concern as to the limited usefulness of survey evidence in this regard. Customers may well express high levels of satisfaction if a service is provided at a quality and price they have come to expect, but that does not rule out the possibility that a change in the market, through greater price competition or more innovation, would greatly increase consumer welfare.*"[31]

1.47 Ofcom's view appears to be that it is axiomatic that its policy objectives are in the interests of consumers, whether they know it or not. And its paternalistic faith in its ability to deliver better outcomes for consumers leads it to lose perspective and to fall into the trap of believing that, by seeking to control outcomes at the margins, it can deliver better outcomes than the market would overall, without risk or cost.

1.48 The very specific instances of alleged consumer detriment which Ofcom alleges are either entirely speculative and/or immaterial or are not properly referable to Ofcom's concerns about "*Sky's approach*" to the distribution of its channels. For example:

- Ofcom points to a lack of choice for consumers in relation to the platforms via which Sky's premium channels can be accessed. But the only distribution platform via which Sky's premium channels are unavailable is DTT. Had Ofcom approved Sky's Picnic proposals, Sky's premium channels would already be available to consumers via DTT, at least from Sky.

- Ofcom's concerns regarding innovation are now significantly narrower than those expressed in its Second Consultation Document. Ofcom appears to have dropped its concerns about retail packaging innovation and focuses in particular on the take-up of VoD. But Ofcom's concerns about VoD relate to the effect on VoD operators of the movie studios' licensing policies in relation to SVoD rights, and are not referable to "*Sky's approach*" to the distribution of its linear channels.

- Ofcom's concerns regarding high retail prices depend entirely on its flawed analysis of Sky's wholesale margins; and Ofcom continues to

[31] Paragraph 7.48 of the Consultation Document.

ignore the clear evidence provided by PwC that Sky's retail prices for pay TV packages in the UK are consistent with prices for comparable packages in other countries.[32]

Yet Ofcom is proposing highly interventionist and unprecedented regulation, carrying with it real risks of consumer detriment

1.49 Second, Ofcom's proposed compulsory licensing requirement is highly interventionist, to a degree which is both extreme and unprecedented. As Ofcom itself acknowledges, compulsory licensing is only regarded as justified in exceptional circumstances under competition law (circumstances which do not apply in this case), for good reasons. Despite Ofcom having previously, and incorrectly, described its proposals as consistent with long-standing regulation in the US, it is in fact unheard of for a regulator to step in to determine the price of pay TV channels in the way Ofcom proposes and in effect to turn pay TV channels into a form of common regulated asset under which even content changes must be agreed by all accessing those channels. Again, there are sound reasons why this is the case.

1.50 As Professor Cave explains in his report, Ofcom's proposals:

- do not adequately take into account the disadvantages of *ex ante* regulation in the particular circumstances of provision of pay TV services, particularly the "*high degree of mutability*"[33] of such products;

- seek to apply *ex ante* regulation in circumstances where more traditional arguments for such regulation, based on structural or legal/regulatory barriers to entry, do not apply;

- do not adequately take into account the inevitable adverse effects of access regulation on competition and innovation in the service where access is mandated;

- are likely to give rise to "*several dysfunctional consequences*"[34], such as the opportunity for competitors to pass on their increased retail costs to Sky, reducing Sky's incentives to incur expenditure which might be in consumers' interests and providing incentives to raise retail prices. Professor Cave argues that the proposals are "*biased towards higher retail prices – i.e in favour of producers and against consumers*";[35]

- would generate a need to revisit price controls frequently, due to "*the complex and changing nature of the services to which access is being mandated*";[36]

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32 Footnote 77 of the Consultation Document.

33 Paragraph 4 of the Cave Report.

34 Paragraph 37 of the Cave Report.

35 Paragraph 37 of the Cave Report.

36 Paragraph 47 of the Cave Report.

- comprise a policy "o*f entry assistance which it has calibrated on the basis of its judgment of what 'should' succeed, despite the fact that the international history of pro-active regulation and policy-making in this area points to the dangers of so doing*",[37] particularly in view of the fast pace of technical change in this sector; and

- risk giving rise to "*an unhealthy climate of co-dependency between entrant(s) and regulator which may chill genuine competition*".[38]

1.51 Having regard to these real risks of material consumer detriment, none of Ofcom's increasingly narrow concerns regarding alleged consumer detriment (even if made out – which is far from the case) call for Ofcom's extreme proposals to resolve them.

The effect of this regulation is to impose a hypothecated tax on Sky to be used as a subsidy to fund Ofcom's policy agenda

1.52 Third, on any analysis, the price reductions Ofcom is seeking to impose on Sky will result in it forgoing revenue that it would otherwise have earned absent Ofcom's intervention. And this forgone revenue is to be transferred to less efficient operators in order (expressly) to compensate for their lesser scale and their choice of less efficient distribution technology. In other words, Sky's revenue is being taxed, and that tax is being used as a subsidy to promote the growth of those distribution technologies that Ofcom has chosen to favour. This is inherently confiscatory, and fundamentally unfair.

1.53 Each of these factors speaks clearly to the question of whether Ofcom's proposals are consistent with best regulatory practice. But they also speak to the question of whether they are necessary and proportionate. To take two key examples:

(i) Ofcom's price control proposals; and

(ii) Ofcom's compulsory licensing proposals in relation to Sky's HD channels.

Ofcom's proposed price controls are unnecessary and disproportionate

Ofcom's rationale for imposing price control is inadequate

1.54 Ofcom's rationale for removing Sky's freedom to negotiate the price for carriage of its own channels is wholly inadequate. In essence Ofcom is saying that if Sky is left with this freedom, prices will be higher than Ofcom wants to see. But this in turn means that Ofcom must demonstrate that the price reductions it wishes to impose are necessary and proportionate. Ofcom has failed to do this. Not least, Ofcom has failed to demonstrate that reducing Sky's wholesale prices

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[37] Paragraph 29 of the Cave Report.

[38] Paragraph 4 of the Cave Report.

is necessary to achieve its policy objectives, even on the assumption that those objectives are appropriate in the first place.

1.55 And, fundamentally, Ofcom's financial modelling does not support the proposition that the range of prices on which Ofcom is consulting is appropriate or justified. Ofcom is, in fact, consulting on wholly erroneous figures which cannot be relied upon as a basis for Ofcom to move forward with its proposals.

1.56 The top end of Ofcom's proposed range of prices has been estimated by Ofcom to reflect a hypothetical retail business, similar to Sky's, incorporating a return on investment based on Ofcom's estimate for Sky's cost of capital of 10.3% ("Sky Retail-Minus Prices"). But the Sky Retail-Minus Prices have been calculated on an erroneous basis. For example:

- on the revenue side, Ofcom makes five adjustments to Sky's published retail prices in order to determine "*reference prices*" for its "*retail-minus*" calculations. Ofcom makes mistakes in calculating each and every one of these adjustments – with the result that Ofcom substantially underestimates the revenue earned by the hypothetical retail business;

- on the cost side, in calculating monthly transmission costs for basic channels (for which an allocation is made by Ofcom to the hypothetical retail business) from an annual figure, Ofcom fails to divide by 12 – with the result that Ofcom substantially overestimates the costs incurred by the hypothetical retail business.

1.57 Moreover, Ofcom repeats the same serious errors in its calculation of Sky Retail-Minus Prices as those made in its calculation of cost-plus prices (see paragraph 1.37 above).

1.58 Once these and a number of other significant errors are corrected, it is clear that (even within Ofcom's own framework of analysis) the hypothetical retail business could pay Sky's current cable ratecard prices and earn a return on investment significantly in excess of Ofcom's assumed cost of capital of 10.3%. The top end of the range of prices on which Ofcom is consulting should therefore be at least as high as Sky's current cable ratecard prices, even without raising any of the many questions which could reasonably be raised about the appropriateness of Ofcom's modelling methodology and cost allocations.

1.59 The bottom end of Ofcom's proposed range of prices has been estimated by Ofcom to reflect a hypothetical DTT retailer (as conceived by Ofcom) that builds up a subscriber base of 1 million subscribers after 10 years ("Small DTT Retail-Minus Prices"). Ofcom also calculates a set of prices to reflect a different hypothetical DTT retailer that builds up a subscriber base of 3 million subscribers after 10 years ("Large DTT Retail-Minus Prices"). It is these Large DTT Retail-Minus Prices which form the basis of Ofcom's proposed remedy prices, which Ofcom notes are roughly mid-way through the range for consultation.

1.60 However both Ofcom's Small DTT Retail-Minus Prices and Large DTT Retail-Minus Prices reflect a hypothetical business model that could not be implemented in the real world – a model under which, for example, the hypothetical DTT retailer uses expensive (and scarce) DTT capacity to distribute five premium channels, but uses satellite to distribute around 150 basic channels. It is instead more appropriate to use the Picnic business model which reflects what a real-world retailer actually planned to do and is a plan which was commercially tested and against which millions of pounds was invested. The Picnic operator could afford to pay Sky's current cable ratecard prices and earn a return on investment in excess of Ofcom's assumed cost of capital of 10.3% (even accepting the adjustments Ofcom has made to Picnic's actual business plan). The bottom end of the range of prices on which Ofcom is consulting should therefore be at least as high as Sky's current cable ratecard prices.

1.61 In other words, Sky's current cable ratecard prices are already below those which, properly calculated, and using realistic assumptions, would be generated by Ofcom's own wholesale pricing models.

1.62 Moreover, the prices which Ofcom is proposing would not allow Sky's wholesale business to earn an adequate return. On the basis of Ofcom's own cost-plus price calculation model (corrected for errors as set out in paragraph 1.38 above), if Sky were to charge Large DTT Retail-Minus Prices (*i.e.* those which Ofcom appears to prefer) the notional premium wholesale business used for the purpose of the model would expect to earn an average operating margin over the next 4 years of only 8% per annum. This is well below normal levels and insufficient to maintain Sky's current levels of investment in programming.

1.63 It is also noteworthy that Ofcom seeks to justify a reduction to Sky's wholesale prices because it wishes to derive prices which cater for retailers with "*smaller scale due to more recent entry*" and retailers using "*a DTT platform for distribution*".[39] But Virgin Media falls into neither category and Ofcom provides no cogent justification for Virgin Media gaining the windfall benefit of substantial price cuts. In fact, the financial modelling which Ofcom uses to derive the range of prices on which it is consulting assumes ongoing future decline in the number of Virgin Media subscribers to Sky's premium channels, representing an unambiguous loss for Sky. All that has happened in relation to those Virgin Media subscribers who remain is that a greater proportion of the retail margin earned has been transferred from Sky to Virgin Media without any commensurate increase in consumer welfare.

The imposition of price control would be wholly disproportionate

1.64 In any event, for the reasons explained in Professor Cave's report, Ofcom's proposals are clearly disproportionate. Sky would also highlight the following points.

[39] Paragraph 9.3 of the Consultation Document.

1.65 First, Ofcom has failed to acknowledge or to take seriously the very material adverse effects on incentives to invest in content that would flow from any implementation of its proposals. Contrary to the sentiments expressed by Ofcom in its Consultation Document, Sky's production of its channels requires it, on an ongoing basis, to continue to risk substantial investments in content – Sky's current forward rights commitments are close to £4 billion – with no guarantee that an adequate return will be made on these investments. Ofcom's intervention would severely blunt Sky's incentives to continue to invest at these levels, particularly if, as Sky expects, Ofcom's intervention resulted in Sky's wholesale business earning lower wholesale revenues. Moreover, it would not only be Sky's incentives to invest in content that would be blunted. Pay TV retailers benefiting from lower regulated prices for Sky's premium channels would have little incentive to bid for content themselves. This is not simply a matter of economic theory. It is a reality that has been confirmed by Neil Berkett, Virgin Media's Chief Executive, when discussing with investors the implications of Ofcom's Consultation Document:

> "*Given our recent success, our decision to focus our attention and resources on the regulatory debate rather than competing head on and acquiring premium content is proving to be the right one*".[40]

1.66 As its duties require it to, Ofcom has recognised in its regulation of communications infrastructure the need to have regard to the desirability of encouraging investment. The desirability of encouraging investment in content appears to be less obvious to Ofcom. The damaging consequences for investment in British sport, for example, as a result of the imposition of regulation which reduces the returns sporting bodies earn from the licensing of rights to televise their sports would be profound.

1.67 Second, Ofcom's proposed regulation forces an outcome that would not be seen in a competitive market. A channel provider's overriding incentive is to maximise the revenue derived from the distribution of its channel. A channel provider would not unilaterally adopt an alternative distribution model, or reduce its wholesale prices in order to promote the entry or expansion of a particular retailer, unless it had a reasonable degree of confidence that in doing so it would maximise its revenue. A spreadsheet from a regulator indicating that there are scenarios in which that might be the case cannot reasonably be relied upon to provide that level of confidence.

1.68 Third, Ofcom has failed to take into account, or to comprehend, the serious competitive distortions that would arise from its proposals. Ofcom's "*ratchet*"[41] proposal requires, among other things, Sky's wholesale prices going forward to be reduced in line with reductions in its retail prices. This blunts Sky's incentives to engage in price competition. If faced with a competitor offering a lower retail price, it would be irrational for Sky to meet that competition and

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40 Virgin Media Q2 2009 Earning Release Conference Call (August 2009). http://www.thomson-webcast.net/uk/dispatching/?event_id=9da72dba9d88aa5de41e7d8939481305&portal_id=ff0878c2f32d7333f51123455ef8759d.

41 Paragraph 9.47 of the Consultation Document.

reduce its retail prices because that would lead to further automatic reductions in its wholesale revenue. For the same reason, Sky's incentives to maximise efficiency in its retailing activities would also be blunted. This may be in the interests of certain of Sky's competitors, but it is not in the interests of competition or of consumers.

1.69 Another feature of the "*ratchet*" is that, in the event that Sky raised its retail prices, it would have to seek Ofcom's consent to increase its wholesale prices. There are profound implications arising from this for Sky's ability to run its business which Ofcom has failed to think through. For example, Sky's bidding strategy in relation to content rights would become dependent on second-guessing what levels of expenditure Ofcom might subsequently deem to be appropriate.

Ofcom's proposals to compel Sky to license its HD premium channels are unnecessary and disproportionate

1.70 Ofcom has failed to articulate a case that, even were Sky deliberately to withhold its HD premium channels from other retailers, there would be a material impact on the competitive process. Indeed, Ofcom now seems somewhat confused as to whether it is access to content or to "*platform features*" which is important to competition, but has appeared to conclude that anything which Sky regards as important must be an essential input for a competitor.

1.71 But even leaving aside Ofcom's failure to demonstrate that its proposals to compel Sky to license its HD premium channels on price regulated terms are necessary, they are clearly disproportionate.

1.72 First, they represent a form of discriminatory regulation which results in serious competitive distortions. Ofcom cites the growth in innovative platform features as one of the benefits it sees as flowing from its proposals. Innovation will, according to Ofcom's vision, be a central dynamic of competition between retailers of Sky's channels. But the effect of Ofcom's regulation is that Sky's ability to differentiate its retail offering from its competitors through such innovation will be significantly distorted. The moment that Ofcom considers (as it has in relation to HD) that any innovative feature in any way affecting its premium channels is important to Sky and has ceased to be "*brand new*",[42] Sky will be required to offer it to its competitors. Meanwhile, those competitors will be able to continue to compete on the basis that their platform has better features, by being able to offer new features without the risk that these features will need to be offered to their rivals.

1.73 Second, and as noted by Professor Cave in his report, the prospect of an innovative product becoming the subject of regulated price control if it proves successful seriously blunts the incentive to invest in that product in the first place. Given that Sky has, until now, been a driving force behind innovation in TV (as Ofcom accepts), that is a very serious problem.

42 Paragraph 9.139 of the Consultation Document.

Ofcom's Impact Assessment is wholly inadequate

1.74 Ofcom's assessment of the impact of its proposals is wholly inadequate. Ofcom has a duty to present its analysis in a way that consultees can comment on meaningfully. But Ofcom has failed clearly to set out its impact assessment in a way which enables consultees to do this. Ofcom claims that its impact assessment is spread throughout its Consultation Document,[43] but no indication is given where, over and above the limited assessment contained in Section 10 of the Consultation Document, or what the significance of any points claimed to be in the remainder of the document might be. Ofcom has also presented estimates of costs and benefits without any explanation of how they were calculated.

1.75 Such elements of Ofcom's impact assessment that are ascertainable appear to suffer from a number of fatal defects, including the following.

1.76 First, Ofcom has adopted the wrong counterfactual. It has assumed that, absent Ofcom's regulation, Sky's premium channels would never be available on DTT, and thus Ofcom seeks to claim as a benefit of its intervention the availability of those channels over DTT. That is wholly untenable. Ofcom accepts that, at minimum, Sky has an incentive to retail its premium channels on other platforms. Had it not been for Ofcom's withholding of approval of Sky's application to make its premium channels available via DTT, Sky's premium channels would already be available on DTT under Sky's Picnic proposals. Indeed, had Ofcom accepted the proposed wholesaling commitments Sky offered to Ofcom in December 2007, it is entirely plausible that (assuming the necessary security upgrades had been made) Sky's premium channels would also by now be available from other DTT based retailers. The correct counterfactual is therefore one in which Sky's premium channels are available in the future via DTT absent any intervention by Ofcom, and incremental costs and benefits must be assessed based on the incremental effects caused by Ofcom's proposed regulation compared to this scenario. It is readily apparent that, based on this counterfactual, the incremental benefit attributable to Ofcom's proposals would be at best minimal. Once this is stripped out of the benefits calculation, only the detriments flowing from Ofcom's proposals to Sky, to competition, and to consumers remain.

1.77 Second, and even leaving aside the implications of Ofcom's erroneous counterfactual, Ofcom's limited evaluation of the benefits and costs of its proposals is wholly inadequate. In relation to benefits, key assumptions underpinning Ofcom's assessment, such as the "*choke price*" and "*demand curve*" adopted by Ofcom, are (as Ofcom has indicated in correspondence with Sky) the product of pure conjecture on Ofcom's part, rather than evidence. Ofcom's estimates of premium channel subscriber levels following the implementation of its proposals are manifestly unrealistic, and certainly not evidence based. Inexplicably, Ofcom uses a different financial model in its assessment of benefits than those it uses in relation to its assessment of Sky's wholesale prices, and this materially increases Ofcom's estimates of consumer

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[43] Paragraph 10.6 of the Consultation Document.

benefits. In relation to costs, even leaving aside the fact that, once its unfounded assumptions are corrected, "*benefits*" identified by Ofcom would likely become "*costs*", Ofcom has entirely failed to recognise, let alone to assess, the significant risks of consumer detriment flowing from its proposals.

1.78 Third, contrary to all guidance on the proper conduct of impact assessments, Ofcom evaluates only the costs and benefits of its proposal against the option of doing nothing. It fails completely to assess other more proportionate policies available (such as options not requiring detailed ongoing price control). This, in itself, is a clear indication that Ofcom has been implacably committed to implementing wholesale price control regulation in relation to Sky's premium channels.

1.79 Ofcom cannot, consistent with its statutory duties, proceed with the implementation of its proposals without first undertaking a proper impact assessment of those proposals and giving consultees the opportunity to comment meaningfully on that assessment.

D. "Content" Remedies

1.80 Ofcom proposes remedies in relation to "*content*" which affect the way in which rights for both Premier League football and SVoD movies services are sold. Ofcom's aim is to remove market power, rather than its alleged adverse effects, which of itself is contrary to its statutory remit. Moreover, in both cases the remedies aim to eliminate exclusivity in relation to content – for Premier League football by removing "*cross-platform exclusivity*" for certain live rights, and for movies by removing exclusivity in the pay TV window by separating SVoD from linear rights. This approach amounts to an attack on the exclusivity of content which is the cornerstone of competition in audiovisual services, undermining the very basis on which the industry operates.

1.81 The alleged concerns that motivate Ofcom's proposals are baseless. But, in common with Ofcom's main proposal, these proposals raise serious risks of unintended consequences which Ofcom again fails to recognise – in particular, for the value of content rights. This is notwithstanding its recognition that, in principle, regulators should be very cautious about intervening to change how firms exploit content rights. However, without any evidence to support its position, Ofcom is substituting its own judgment for that of the rights holders, seemingly dismissing the fact that those rights holders are clearly better placed than Ofcom to judge how best to protect the value of their rights and maximise their revenues.

1.82 Contrary to Ofcom's suggestion, the way in which SVoD movies rights are sold is not a suitable candidate for a market investigation reference to the Competition Commission: it is a limited issue which does not give rise to any real consumer harm.

1.83 Any intervention by Ofcom under its general competition law powers into the Premier League's collective selling arrangements must be informed by a comprehensive analysis within a proper competition law framework. Ofcom has not, to date, undertaken such an analysis, yet it is apparent that it already holds well-developed views as to the form of intervention required. Ofcom's approach is, accordingly, procedurally unsound.

E. Conclusion

1.84 Ofcom's intervention is not justified on competition grounds. It is in essence a form of industrial policy under which Ofcom wishes to step in and seek to "*manage*" the market in an effort to deliver alternative outcomes, in order to promote the growth of particular high-cost technologies that it has chosen to favour. Ofcom has got carried away with this vision without stopping to think through the consequences that would flow from the implementation of its proposals, and has put the achievement of its objectives ahead of a proper evidence-based consideration of the issues.

1.85 The consequences of Ofcom's proposals are overwhelmingly detrimental:

- they blunt incentives to invest in content, both on the part of Sky and on the part of those firms benefiting from Ofcom's price controls, and send a clear message that investment in content is regarded by Ofcom as less important than investment in infrastructure;
- they blunt incentives to invest in innovation, particularly on the part of Sky, whose record of continuing and relentless innovation is exemplary;
- they have the potential to create serious distortions of competition both in relation to retail pricing and in innovation; and
- they create all the detriments to competition and efficiency that arise in any cases of subsidy and detailed central planning.

1.86 Ofcom's proposals are essentially confiscatory, and suggest that the moment a firm makes a return above its cost of capital, Ofcom will price regulate in order to ensure that its returns fall back into line with those implied by Ofcom's spreadsheet models of perfect competition. If implemented, Ofcom's proposals would send an extremely negative message about the UK as a place to invest, and Ofcom as a responsible licensing authority.

1.87 Ultimately and most of all, however, all of the above effects would result in serious detriment to consumers.

SECTION 2: OFCOM'S APPROACH TO ITS INVESTIGATION

A. Introduction

2.1 Ofcom's pay TV investigation is vitiated by failings of analysis and procedure. Ofcom's agenda, from the beginning of (and, indeed, prior to the commencement of) the investigation, appears to have been to intervene in Sky's distribution arrangements for its premium channels. Accordingly, Ofcom has ignored or attempted to deflect any evidence or arguments that indicate that its desired intervention is neither necessary nor proportionate.

2.2 Ofcom's proposed intervention takes the form of an extreme remedy requiring the compulsory licensing of Sky's premium channels, on a wholesale basis, at substantially reduced charges (when compared to the current cable ratecard) and upon terms determined by Ofcom. Such intervention could only be justified in the most clear-cut and extreme of cases. This is not such a case. Indeed, even if there were significant issues in the pay TV sector that might justify intervention (which there are not), the intervention proposed by Ofcom exceeds that which any objective regulator could contemplate: Ofcom's proposals amount to (i) subsidising less efficient platform operators by a transfer of resources from Sky to those operators, and (ii) giving an unwarranted price reduction to Virgin Media.

2.3 This Section of the Response outlines some of the particularly serious flaws in Ofcom's approach[1], which, in short, are:

- its refusal to define the legal framework within which it is operating, apparently preferring to believe it has complete freedom of action, unlimited by stated principles;

- its disregard for its statutory duties, including those which require it to have regard to appropriate regulatory principles and practices and to carry out an impact assessment in relation to new regulation; and

- its approach to evidence, which involves shifting the burden of proof on to Sky to rebut Ofcom's "*conclusions*", attributing greater weight to submissions that support its position and disregarding or downplaying evidence that contradicts its position, thus enabling it to reinforce its erroneous conclusion that the proposed extreme remedy is needed.

2.4 These failings are symptomatic of an approach (i) in which Ofcom commenced its investigation with a fixed conviction that problems exist in the pay TV

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1 In the interests of brevity, Sky does not repeat, in this Response, all the points we have made previously with regard to Ofcom's flawed approach to this investigation. Nor do we identify each and every instance in the Consultation Document where Ofcom has distorted, misrepresented or simply ignored points made by Sky and its independent experts in previous submissions (though we reserve the right to do so).

sector;[2] and (ii) in which Ofcom has been implacably committed to securing – through regulation – deeper wholesale price cuts than those which would have flowed from the wholesale pricing scheme Sky offered to adopt in its proposed commitments to Ofcom[3]; an offer which should have been more than enough to satisfy a regulator acting reasonably.

B. Unprincipled approach to use of sectoral powers

2.5 Throughout its investigation Ofcom has failed to articulate a proper test for the use of its powers under section 316 CA03.

2.6 In its response to the Second Consultation Document, Sky noted that Ofcom had not set out an explanation of what it understood by the concept of "*fair and effective competition*" or of conduct that would be "*prejudicial*" to such competition.[4] Such an explanation, Sky noted, might have been expected, given the relatively rare use of section 316 (or its predecessor provision).

2.7 Ofcom has still not explained what "*fair and effective competition*" is. Nor has it explained how it would apply a "*fair and effective competition*" test. The closest Ofcom comes to setting out the way in which it proposes to apply such a test in this context is to state:

> "[w]*hen analysing competition concerns within the context of s316, we therefore consider whether those concerns create a risk that fair and effective competition is not occurring, and will not occur*".[5]

2.8 As Sky notes in paragraph 3.8 of **Section 3** of this Response, such an approach is entirely inadequate: Ofcom gives no consideration to the materiality of either the degree of risk, or the degree of harm to competition, required in order to invoke section 316. Moreover, Ofcom's 'test' (as set out above) provides no explanation of what Ofcom means by "*fair and effective competition*"; it is simply a restatement of the language of section 316. This is all the more concerning in light of the fact that Ofcom formed a team of senior personnel to formulate an internal policy on the use and application of section 316 and is now acting in a way that is inconsistent with the recommendations of that team. This is also discussed in **Section 3** of this Response.

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2 For example, as long ago as 21 September 2006 Ofcom was considering the "*possible status of competition concerns*" in relation to the wholesale deals for the supply of "*premium sports content*" (see slide 28 of a slide pack entitled "*Premium sports content – way forward*").

3 See paragraphs 6.62 to 6.65 of **Section 6** of this Response.

4 Sky's Response to the Second Consultation Document, paragraphs 1.5 of Section 3 and 3.6 of Section 3 (quoting paragraph 5.32 of Ofcom's Statement on the review of the cross-promotion rule).

5 Paragraph 2.11 of the Consultation Document.

C. Ofcom's disregard for its statutory duties

2.9 As discussed in **Section 3** of this Response, Ofcom has certain statutory duties which it is obliged to consider when introducing new regulation. In its determination to plough ahead with its proposed intervention, Ofcom has sidestepped these statutory duties and, with them, any principled approach to the use of its section 316 powers.

2.10 Ofcom has failed to have regard to regulatory best practice, contrary to its obligation under section 3(3)(b) of the CA03, in relation to the appraisal of the need for, and proportionality of, new regulation. This issue is discussed in detail in **Section 9** of this Response.

2.11 Moreover, a principled approach would require proper consideration of a range of options and evaluation of the costs and benefits of intervention; something that Ofcom has singularly failed to do. This issue is discussed in detail in **Section 11** of this Response.

2.12 Ofcom's proposals would, if implemented, result in Ofcom breaching its principal duty "*to further the interests of consumers in relevant markets, where* appropriate *by promoting competition.*"[6] Ofcom does not acknowledge the adverse effects on efficiency and consumer welfare that its proposals are likely to have. Sky has commissioned Professor Martin Cave of Warwick University to comment on the appropriateness of Ofcom's proposed wholesale must offer remedy. His opinion, which is provided in a report (the "**Cave Report**") at **Annex 1** of this Response, concludes that "*Ofcom's analysis pays insufficient attention to the detrimental effects which its proposals would have on end users of the services in question*".[7]

D. Ofcom's flawed approach to the treatment of evidence

2.13 Ofcom appears to have assessed evidence against its fixed convictions, rather than drawing conclusions following a balanced and open-minded assessment of the full range of evidence available to it. A reasonable regulator conducting a scrupulously open-minded review would first evaluate the evidence before it and then draw conclusions from that evidence. That is not how this investigation has been run. In Ofcom's own words:

> "*We have ... tested each of our conclusions in an objective and transparent manner against all the evidence which is currently available*".[8]

2.14 This approach to decision-making leads to an illegitimate reversal of the appropriate burden of proof.

2.15 Rather than reaching evidence-based conclusions <u>after</u> proper consideration of the evidence, Ofcom has reached its conclusions first and then sought evidence

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6 Section 3(1)(b) CA03.

7 Paragraph 60 of the Cave Report at **Annex 1** of this Response.

8 Paragraph 2.57 of the Consultation Document.

to support such conclusions. This approach has led to serious distortions in the way Ofcom has treated evidence. Ofcom has lost sight of the fact that it has the burden of proof to demonstrate that its proposed intervention is justified. Instead, Ofcom appears to have acted on the assumption that its intervention is justified unless overwhelming evidence can be adduced to the contrary. Moreover, Ofcom has been highly selective in its treatment of evidence depending on whether such evidence supports or challenges its conclusions. Cogent and compelling evidence which is inconsistent with Ofcom's case, including evidence adduced by Ofcom itself in earlier consultations, has been irrationally dismissed or even ignored. The following examples, which are neither exhaustive nor limited to the current Consultation Document, illustrate Ofcom's flawed approach to the evidence:

- The use of truncated IRR analysis. In the Second Consultation Document, Ofcom questioned the usefulness of the use of truncated IRR analysis (such analysis was submitted by the Complainants to Ofcom). Subsequently and without explanation, Ofcom performed a *volte-face* and commissioned Oxera to conduct analysis of Sky's profitability on a truncated IRR basis. Sky provided Ofcom with independent expert evidence from Professor Grout[9] which questioned the pertinence of truncated IRR analysis. Ofcom has chosen to ignore this expert evidence in the Consultation Document;[10]

- Ofcom has misrepresented the evidence of its own experts. For example, much of Ofcom's case relies heavily on Oxera's report on Sky's aggregate profitability. The conclusions Ofcom draws from Oxera's report ignore Oxera's careful caveats are not supported by Oxera's actual findings and are inappropriate. Most notably, Ofcom appears to consider that any return which is not "*close to*" a firm's cost of capital must be evidence of a competition concern. That is not a proposition that finds any support in Oxera's report[11]

- Similarly, following the submission of the Seabright report, Ofcom commissioned Professor Andrew Chesher to review Professor Seabright's work. Ofcom states that Professor Chesher expressed "*concerns*"[12] about Professor Seabright's report when, in fact, the Chesher review does not use this term. Commenting upon both Professor Chesher's review and Ofcom's misrepresentation of it, Professor Seabright states "*Professor Chesher's Review…at no point cast any doubt on the rigor or professionalism of our methods….<u>Ofcom's</u>*

9 Professor Grout's preliminary report, entitled "*A brief note on the use of the truncated IRR methodology for assessing profitability*", submitted to Ofcom in May 2009.

10 See **Section 4** of this Response and **Annex 2** to this Response.

11 See the Grout Report at **Annex 2** of this Response which, among other things, addresses Oxera's report and the conclusions that Ofcom has drawn from it. Professor Grout's analysis of stock market evidence, set out in his report at **Annex 2,** demonstrates that Sky has not experienced an abnormal return. There is no evidence, therefore, that Sky is earning excessive returns resulting in consumer detriment.

12 See paragraph 4.179 of the Consultation Document.

document misrepresents the views of its own expert as well as our report."[13] (Emphasis added).

- Ofcom's inconsistent treatment of survey data. Sky has relied on Ofcom's published research relating to levels of consumer satisfaction[14]: as Ofcom quotes in the Third Consultation "*Sky referred to Ofcom's own research which it believes showed that consumers are satisfied with their pay TV services, and getting good value for money from them.*"[15] Rather than accept the conclusions of its own research, which in this instance was unhelpful to its case, Ofcom preferred instead to question "*the limited usefulness of survey evidence in this regard.*"[16] If Ofcom considers that its own consumer evidence is of such limited usefulness, Sky questions why Ofcom conducts such research;[17]

- In relation to its 'vertical arithmetic' exercise, Ofcom has now accepted that its previous analysis of static incentives was flawed and that (contrary to Ofcom's views in the Second Consultation Document) Sky does indeed have a static incentive to supply its content to other platforms. This significant reversal of its position should have materially affected Ofcom's conclusion as to Sky's overall incentives. But apparently it has not. Ofcom fails to amend in any way its conclusion as to Sky's overall incentives (or even re-assess its previous analysis);[18]

- Ofcom fails to refer to the second paper by CRA[19] (submitted by Sky in the Response to the Second Consultation Document), which critically examines Ofcom's approach to its assessment of Sky's strategic incentives and which concludes that none of the strategic mechanisms identified by Ofcom stands up to closer economic scrutiny;[20]

- Similarly, Sky showed convincingly, in the Response to the Second Consultation Document, that Ofcom's comparisons of Tiscali's prices and Sky's prices was wrong and that in fact Tiscali prices were generally lower than Sky's and, even more importantly, that Tiscali prices were significantly lower than prices of similar packages retailed by Virgin Media. Ofcom does not comment on Sky's analysis in the Consultation Document, merely mentioning that no conclusions can be drawn from

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13 **Annex 3** of Sky's Response to the Second Consultation Document.

14 For example, The Consumer Experience Research - http://www.ofcom.org.uk/research/tce/

15 Paragraph 7.44 of the Consultation Document.

16 Paragraph 7.48 of the Consultation Document.

17 See **Section 5** for further detail.

18 See paragraphs 6.10 to 6.16 of **Section 6**.

19 Annex 4 of Sky's Response to the Second Consultation Document.

20 See paragraph 6.14 of **Section 6** of this Response.

the results of its analysis into Tiscali's prices which is extraordinary given the strength of the evidence provided by Sky,;[21]

- Ofcom failed to attribute sufficient weight to significant evidence, for example, the economic evidence of Professor Paul Seabright and Thierry Magnac on the competitive constraint posed by DTT availability on the take up of pay TV services;[22]

- Ofcom readily dismisses the extensive research of PwC on international comparators across Europe with regard to price, consumer choice and innovation with respect to pay TV services, which was submitted as part of Sky's Response to the First Consultation Document. PwC provided an additional report directly addressing Ofcom's criticisms, which was submitted as part of Sky's Response to the Second Consultation Document. Ofcom simply dismisses PwC's report stating that "*differences between countries mean that comparing a price in one country with a price in another country is fraught with difficulties.*"[23] This despite stating in its First Consultation Document (based on later discredited submissions from LECG on behalf of the Complainants) that "*a headline comparison of revenues per head indicates that UK prices may be high compared to other countries*".[24]

2.16 Ofcom's analysis of evidence in relation to market definition is particularly flawed, not least because its examination of retail markets in Section 4 of the Consultation Document is, to all intents, an afterthought. In **Section 5** to this Response, we discuss some of the more particular failings in Ofcom's use of evidence in relation to analysis of competition at the retail level.

2.17 Where submissions by third parties support Ofcom's conclusion, it classes such submissions as evidence without subjecting them to adequate (or indeed any) scrutiny or common sense filter. Those supporting Ofcom's proposals essentially fall into two categories:

- the instigators of the investigation, namely those organisations with the most to gain from Ofcom's proposals; and

- third parties, such as the BBC, Freesat, Freeview and the ALMR (an association of pub owners and operators) which do not provide pay TV services.

2.18 The submissions of these respondents are often no more than opinion, unsupported by tangible factual evidence. Ofcom notes that certain respondents 'agree' with its analysis as if this, in itself, provides validation of its position. In such cases it is not clear what particular insight, knowledge or

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21 See paragraphs 6.134 to 6.139 of **Section 6**.

22 See **Annex 3** to this Response.

23 Footnote 77 of the Consultation Document.

24 Paragraph 1.20 of Ofcom's First Consultation Document.

experience such respondents draw upon to come to the opinion on which Ofcom relies for support. For example, the fact that the BBC acknowledges in the first sentence of its response to the Second Consultation Document that "*the BBC does not operate in the pay TV market*",[25] does not prevent Ofcom from citing the following excerpts from the BBC's submission, to the effect that the BBC:

- "*agreed with Ofcom's assessment of markets for premium sports* [and premium movies] *channels*";[26]

- "*expressly stated that retailers and platform operators could not get sufficient access to Sky's premium sports and movies channels*";[27]

- "*said that where Sky supplied Virgin Media with wholesale channels, it had an incentive to provide the lowest acceptable quality, and not to provide any additional features*";[28] and

- "*agreed with Ofcom's assessment that consumers' choice of pay TV service is primarily influenced by the content that is available, rather than by platform features*".[29]

2.19 The ALMR is also cited as having "*agreed with Ofcom's conclusion that Sky had an* incentive *to restrict content*".[30] It is not at all clear what expertise the ALMR has to opine on the incentives of a pay TV operator.

2.20 The opinion of all stakeholders should always be treated with a certain circumspection and a clear distinction should be drawn between evidence and opinion. In its guidance on the conduct of impact assessments, the European Commission warns that:

> "*it is important to distinguish evidence from opinions... an open consultation is unlikely to provide a fully representative picture of opinions... You should also be careful in drawing conclusions if there are only a small number of responses and they come from a narrow range of interests*".[31]

2.21 Opinions, no matter how professionally presented, need to be assessed to take into account any vested interests in the outcome of the investigation and subjected to rigorous scrutiny and verification.

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25 Page 1 of the BBC's response to the Second Consultation Document.

26 Paragraphs 4.225 and 4.385 of the Consultation Document.

27 Paragraph 6.15 of the Consultation Document.

28 Paragraph 6.22 of the Consultation Document.

29 Paragraph 7.36 of the Consultation Document.

30 Paragraph 6.23 of the Consultation Document.

31 Page 19 of the European Commission Impact Assessment Guidelines, SEC (2009) 92, 15 January 2009. http://ec.europa.eu/governance/impact/commission_guidelines/docs/iag_2009_en.pdf

E. Conclusion

2.22 Allowing stakeholders the opportunity to respond intelligently to a decision maker's proposals is a cornerstone of the proper consultation process. Failure, on Ofcom's part, to present evidence fairly and objectively fundamentally undermines the ability of stakeholders to respond intelligently to its case. Its improper process has undermined both its investigation and the conclusions it has drawn thus far. Such conclusions do not provide a sound basis for its proposed action.

2.23 Ofcom appears to be determined to push ahead with its preferred remedy in a manner which puts its objectives ahead of evidence. In doing so, Ofcom has lost sight of the fact that the burden of proof is on Ofcom to demonstrate that its proposed intervention is justified. Ofcom's approach is that of a litigant seeking to win its case at all costs, rather than that of an objective and evidenced-based regulator.

SECTION 3: OFCOM'S RECOURSE TO SECTORAL POWERS IS LEGALLY UNSOUND

A. Introduction

3.1 Sky's position in relation to Ofcom's proposed recourse to its section 316[1] powers to impose a compulsory licensing obligation on Sky remains as set out in its response to the Second Consultation Document:

- Ofcom has failed to articulate a proper test for the exercise of its section 316 powers (Part B);

- Ofcom's proposed use of its section 316 powers is unprecedented, strains them beyond their proper scope, and is inconsistent with the approach it has previously adopted when acting under section 316 (Part C);

- Ofcom has not established to a sufficient standard of proof that it has met the test for intervention under section 316 (whether in the extreme form proposed or otherwise) (Part D);

- in any event, the proposed compulsory licensing obligation is outside the scope of section 316 since it is both unfair and inconsistent with outcomes that would occur in an effectively competitive market (Part E); and

- in formulating the proposed remedy Ofcom has failed to have proper regard to its duties under the CA03 (Part F).

3.2 Despite attempts to give the appearance of engaging earnestly with Sky's arguments on the proper scope and application of its powers, Ofcom has not properly addressed Sky's submissions. Ofcom has mischaracterised a number of Sky's arguments, or in some cases has not even acknowledged them.

3.3 Since submitting its Response to the Second Consultation Document, Sky has discovered that Ofcom considered the very issue of the use of its section 316 powers to be of sufficient importance to put together a senior project team to analyse and consider it in detail, and that Ofcom's proposed use of its section 316 powers is inconsistent with that team's recommendations.[2] Ofcom's failure to engage on these points is, therefore, all the more surprising.

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1 Unless otherwise stated, all statutory references in this Section are to the Communications Act 2003 ("**CA03**").

2 The recommendations of the Ofcom senior project team, and the subsequent departure from those recommendations, are considered in subsections B and C below.

B. Ofcom's failure to articulate a test for section 316

3.4 Ofcom purports to be acting under section 316. Section 316(2) permits the imposition of conditions in connection with the provision of licensed services:

> *"… that OFCOM consider appropriate for securing that the provider of the service does not-*
>
> *(a) enter into or maintain any arrangements, or*
>
> *(b) engage in any practice,*
>
> *which OFCOM consider, or would consider, to be prejudicial to fair and effective competition in the provision of licensed services or of connected services."*

3.5 It is self-evident that Ofcom cannot exercise the power in section 316 without first clearly setting out the proper analytical framework for its use, applying it rigorously and demonstrating that the test has been met.

3.6 Extraordinarily, notwithstanding that it now purports to be consulting on remedies for the competition problems that it alleges exist, Ofcom has still not explained what it understands by the concepts of 'fair and effective competition' and conduct that would be 'prejudicial' to such competition. Whilst Ofcom notes that *"Sky argued that we had not set out a test for the use of s316"*,[3] its response is essentially merely to state what it believes the test under section 316 is **not** - for example: *"We do not consider that the concept of "ensuring fair and effective competition" is limited to protecting against the occurrence of agreements and behaviour that would constitute breaches of CA98, rather it has a different purpose and scope"*.[4]

3.7 The closest that Ofcom comes to setting out a test for the application of s316 is to state:

> *"When analysing competition concerns within the context of s316, we therefore consider whether those concerns create a risk that fair and effective competition is not occurring, and will not occur. If that is the case, then we consider what conditions (if any) it may be appropriate to insert into licences to make certain of providing for fair and effective competition."*[5]

3.8 Such an approach is entirely inadequate: in referring to *"a risk that fair and effective competition is not occurring"*, Ofcom gives no consideration to the materiality of either the degree of risk, or the degree of harm to competition, required in order to invoke section 316. Moreover, the 'test' provides no

3 Paragraph 2.14 of the Consultation Document.

4 Paragraph 2.20 of the Consultation Document.

5 Paragraph 2.11 of the Consultation Document.

explanation of what Ofcom means by *"fair and effective competition"*; it is simply a restatement of the language of section 316.

3.9 This failure to grapple properly with the legal provision that lies at the heart of its proposed intervention is profoundly concerning and puzzling. Indeed, it is particularly puzzling in the light of documents disclosed to Sky by Ofcom following a Freedom of Information Act request in August 2009. Those documents demonstrate that, in 2005, Ofcom formed a project team consisting of senior personnel (including Ofcom's now General Counsel, its Chief Economist and its then Director of Competition Policy)[6] (the "**Senior Ofcom Project Team**") precisely in order to *"formulate an internal policy on how Ofcom is to apply its s.316 powers in a proportionate and transparent manner"*.[7] The document notes that:

> *"the detailed application of these powers are* [sic] *not specified in the Act, and further Ofcom has not yet determined a policy as to how and under what circumstances it would apply these powers.*
>
> *An internal and consistent formulation of our policy with respect to these powers is important in its own right; given Ofcom's objectives of acting in accordance with sound regulatory principles."*[8]

3.10 Ofcom went on to conclude:

> *"The project appears indispensable. We require more direction on how to apply these powers ... Ofcom's commitment to being a light touch, sound, proportionate regulator means that it needs a policy on how to approach s316 which is grounded in sound competition economics/law and reflects our position as a converged regulator."*[9]

3.11 As explained below, the Senior Ofcom Project Team went on to develop an analysis of section 316, much of which Sky agrees with. Unfortunately, but revealingly, Ofcom has entirely failed to adhere to the approach that it developed internally. Instead, as explained in **Section 2** above, Ofcom appears in the present case to have approached its task, and thus section 316, from an inverted perspective: it has worked backwards to engineer a story of harm to justify its desired intervention, under the pretext of ensuring fair and effective competition. In so doing, Ofcom has lost sight of the purpose of section 316 and failed to appreciate the proper limits on the exercise of the powers contained in it.

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6 The members of the Senior Ofcom Project Team are detailed in the papers entitled (i) *"Project Requirements Document: Ex Ante Competition Powers in Broadcasting, Project Requirements Document"*, dated 13 December 2004 and (ii) *"Use of s.316 competition powers in broadcasting: Ensuring a consistent internal economic approach"*, dated 20 June 2005.

7 *"Project Requirements Document: Ex Ante Competition Powers in Broadcasting, C1-10-06, 13"*, dated 13 December 2004.

8 *Ibid*, page 1.

9 *Ibid*, page 3.

C. The substantive test for the use of section 316

3.12 At first glance, the somewhat non-specific language of section 316 might appear to give Ofcom a wide discretion in its use. However, it is clear, when section 316 is construed in its proper statutory and regulatory context - in the light of, amongst other factors, Ofcom's obligation in section 3(3)(b) to intervene only where necessary, its stated objective of being a 'light touch' regulator, and the close relationship between Ofcom's section 316 powers and those under the Competition Act 1998 (**"CA98"**) - that the permissible scope of intervention under section 316 is far more limited.

3.13 In this context, Sky makes the following points.

The need to assess outcomes in the round and identify material competition concerns

3.14 When addressing the possibility of intervention under section 316 or under general competition law, an assessment of whether competition is effective must have regard to outcomes in the round – not just those particular ones that a regulator might wish for in an ideal world. As we have emphasised in previous submissions,[10] no real-world market ever produces a textbook version of perfect competition. And as the OFT notes, in a paper which warns against excessive government interference with the competitive process, *"in almost all markets, some suppliers can exercise a degree of market power"*.[11] Indeed, in a recommendations paper on section 316 produced by the Senior Ofcom Project Team for Ofcom's Policy Executive[12] it is conceded that *"some level of competitive distortion occurs in most markets, so need to be clear when we would be concerned."*[13]

3.15 Whilst Ofcom is right to refer to its duty under section 3(1)(b) to further the interests of consumers in relevant markets (*where appropriate* by promoting competition), Ofcom cannot simply set all the good outcomes (described fully in Sky's previous submissions) to one side, as it has done, and decide that it must intervene because it wants to see some different market structure that it thinks might be better. This is, at the very least, because experience suggests that public bodies' attempts to manage outcomes in this way are very likely to lead to worse outcomes overall. No intervention is cost-free, and it is often the case that the specific benefits that the regulator seeks to achieve are outweighed by the wider adverse consequences of intervention, including the potential for jeopardy to positive outcomes that already exist in the market.

10 See, for example, paragraph 4.20 of Section 3 of Sky's Response to the Second Consultation Document.

11 *"Government in markets: Why competition matters – a guide for policy makers"*, OFT (September 2009).

12 Two of the members of the Senior Ofcom Project Team are current members of the Policy Executive, namely Ofcom's Chief Economist and Ofcom's General Counsel.

13 "*Use of s.316 competition powers in broadcasting: Ensuring a consistent internal economic approach, PE 20 June 2005"*, at page 6.

3.16 It cannot be the case that section 316 gives Ofcom an unbounded discretion to mould markets as it sees fit. Rather, where the proposed remedy involves such intrusive and confiscatory regulation as it does here, and where, as is the case here, there is strong evidence of positive consumer outcomes overall, the very real risk that intervention will result in distortions of competition and consumer detriments means that the hurdle for intervention must be very high. Ofcom has not acknowledged these points, still less addressed them.

3.17 It follows from the points made above that, as a necessary (but not sufficient) condition for intervention, Ofcom must satisfy the test that it has previously adopted in relation to the application of section 316 – namely, that there is, or might be expected to be, *"a material impact on the competitive process"*.[14] These notions of materiality and impact on the competitive **process** (rather than on particular competitors) are consistent with general competition law jurisprudence,[15] and are equally appropriate in the exercise of Ofcom's powers under section 316 in the present case. This is consistent with the recommendation of the Senior Ofcom Project Team with regard to the proposed "*test for action under s.316*" which is that it should be imposed only "*on firms which materially affect competition.*"[16]

Choice of section 316 or CA98

3.18 There is clearly an extremely close relationship between Ofcom's CA98 powers and its sectoral competition powers. One aspect of the relationship is reflected in the important constraints on the exercise of the powers under section 316 which require Ofcom to consider, amongst other matters, whether it would be more appropriate to proceed under the CA98,[17] and to review, and where appropriate roll back, regulation under section 316.[18]

3.19 Sky does not dispute that the sectoral competition powers were created because Parliament was not satisfied that the CA98 prohibitions would necessarily always be sufficient to enable Ofcom to protect the interests of consumers. However, as the extract from the Minister's speech quoted at paragraph 2.21 of the Consultation Document makes clear, the legislative scheme within which section 316 sits supplements Ofcom's CA98 powers by allowing it to act proactively (in particular, by allowing it to take *"advance action or action in a short time frame*") rather than having to wait until the conditions for intervening under CA98 are met (i.e. where there has been a breach). The records of the Parliamentary proceedings do not support the proposition that

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14 Ofcom's statement on cross-promotion rules, paragraph 5.33. See further paragraph 3.6 of Section 3 of Sky's Response to the Second Consultation Document.

15 See, for example, the Opinion of Advocate General Jacobs in Case C-7/97 *Bronner v Mediaprint* [1998] ECR I-7791 at [58].

16 Papers submitted by the Senior Ofcom Project Team to Ofcom's Policy Executive entitled *"Use of s.316 competition powers in broadcasting: Ensuring a consistent internal economic approach"*, dated 13 June 2005 and 20 June 2005.

17 See section 317(2) CA03.

18 See section 318 CA03.

Ofcom can use section 316 to restructure markets to support policy objectives that are not underpinned by broader competition law principles and policy.

3.20 The issue of when to use section 316 in preference to the CA98 was addressed by the Senior Ofcom Project Team in a presentation of its recommendations to the Ofcom Policy Executive, when it posed the question "*When might we want to use s.316 instead of the Competition Act?*".[19] In response, the Senior Ofcom Project Team stated that it is appropriate to take:

> "*ex ante action where certain conditions characterise the market:*
>
> - *High and sustainable barriers to entry*
> - *Timing is critical*
> - *Avoid predictable and frequent interventions*".[20]

None of these conditions is satisfied in the present case:

(a) Ofcom has not established that there are high and sustainable barriers to entry into the retail market. Nor has it done so in respect of the wholesale market. For example, the rights contracts between Sky and the movie studios, and between Sky and the various holders of sports rights from which Sky create its channels, are fully contestable on a regular basis (indeed, the Premier League rights are currently subject to commitments given by the Premier League to the European Commission governing the sale and use of those rights). It is clear that high and sustainable barriers to entry with regard to such rights, and thus with regard to the creation of wholesale channels based on the exploitation of such rights, do not exist;[21]

(b) Ofcom's formal investigation has thus far run for over two and a half years (its informal 'investigation' has clearly been running considerably longer[22]). It is clear that timing is not critical here. Moreover, if timing were critical, Ofcom could have secured wholesale supply to all secure TV platforms by accepting Sky's offer of a commitment to that effect in December 2007.[23] Ofcom could also have removed the main barrier to Sky's premium channels being available on DTT by amending relevant

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19 Papers submitted by the Senior Ofcom Project Team to Ofcom's Policy Executive entitled *"Use of s.316 competition powers in broadcasting: Ensuring a consistent internal economic approach"*, dated 13 June 2005 and 20 June 2005.

20 Papers submitted by the Senior Ofcom Project Team to Ofcom's Policy Executive entitled *"Use of s.316 competition powers in broadcasting: Ensuring a consistent internal economic approach"*, dated 13 June 2005 and 20 June 2005.

21 See Annex 3 to Sky's Response to the First Consultation Document.

22 See, for example, Ofcom's presentations entitled *"Premium Sports, way forward"*, dated 21 September 2006, and "*Use of ex ante competition powers for a competition purpose in broadcasting: Developing an internal economic approach"* dated 15 March 2005, which on page 15 refers to *"Sky in wholesale/retail Pay TV"* as a *"Potential area of concern"*.

23 See paragraphs 6.64 to 6.65 of **Section 6** below.

licences and thus enabling Sky to launch its proposed Picnic service;[24] and

(c) as explained below, in **Sections 6, 7 and 8** of this Response, no intervention is required in the present case because there is no material harm to the competitive process or consumers; but even if there were, it is clear that the regulatory regime contemplated by Ofcom would not avoid frequent interventions but rather precipitate them.[25]

3.21 It is also significant that the Senior Ofcom Project Team did not include, as a reason for Ofcom to use section 316 in preference to the CA98, not being able to achieve a desired policy outcome under CA98;[26] yet that is clearly the approach adopted by Ofcom in the Consultation Document.[27]

The application of competition law principles under section 316

3.22 One element of the test for intervention has been addressed above: the need, as in general competition law, for a **material** impact on the competitive **process** (rather than specific competitors). However, the relationship between competition law and section 316 goes far further than that. The Senior Ofcom Project Team posed itself the question *"Should we apply competition law principles to s.316?"*[28] It rightly responded:

> "***No reason to depart from competition framework for broadcasting markets*** *– broadcasting is not "special"*
>
> - *Broadcast and media content markets are amenable to standard economic analysis*
> - *Other policy objectives of broadcasting (e.g. cultural, content, standards, diversity) are separate issues which are addressed through other specific parts of the Act."* (Emphasis added.)

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24 See paragraphs 6.44 to 6.46 of **Section 6** below.

25 See, for the latter point, **Part I of Section 9** and **Part I(B) of Section 10** below.

26 This is consistent with the position set out in the Joint DTI/Treasury report entitled *"Concurrent Competition Powers in Sectoral Regulation"*:

"The argument that competition law sets a high hurdle for intervention is not a convincing argument for using sector-specific regulation as an alternative. If regulators believe that they cannot use their competition powers to remedy perceived problems within a competitive market, ***then it is questionable whether it is appropriate to use sector-specific regulatory instruments in that market instead"*** (at paragraph 4.20, emphasis added).

27 See, for example, paragraphs 8.16 to 8.20 of the Consultation Document.

28 Paper submitted by the Senior Ofcom Project Team to Ofcom's Policy Executive entitled *"Use of s.316 competition powers in broadcasting: Ensuring a consistent internal economic approach"*, dated 20 June 2005, at page 4.

3.23 This is consistent with earlier concerns made in a presentation to an internal steering group, when the Senior Ofcom Project Team noted that:

> *"Any attempt to 'invent' new competition approach unlikely to be acceptable to the CAT – greater likelihood of appeal, and loss of appeal".*[29]

3.24 It is also consistent with the views of the Senior Ofcom Project Team in its recommendation to the Ofcom Policy Executive that use of section 316 in cases of *"Potential and predictable abuse of single or joint SMP"*, which includes *"refusal to supply,* [and] *margin squeeze" "**mirrors the ex post (Article 82/Chapter 2) framework**"* [30] (emphasis added).

3.25 The Senior Project Team accordingly concluded in its recommendation to the Policy Executive:[31]

> "***What should the test for action under section 316 be*** *since none is specified in the Act?*
>
> - *Where market power is the problem conditions should be imposed only on firms with SMP (**ie an ex ante version of the Competition Act**)*" (emphasis added).

3.26 It follows that, in circumstances where the substantive competition concerns identified by Ofcom traverse the same ground as has already been considered in competition law jurisprudence, Ofcom must apply the same approach under section 316 as would be applied under competition law (albeit having regard to the differences in proof that follow from using powers under an *ex ante* regime as opposed to an *ex post* one – see paragraph 3.32 below). Such an approach would not necessarily preclude going beyond competition law where, for example, the competition concerns arise not from dominance or anti-competitive agreements but from particular features of the market which give rise to competition concerns such as oligopolistic behaviour. In the present case, however, the concerns identified by Ofcom all derive from Sky's alleged market power and fall squarely within categories of conduct in respect of which there is clear competition law jurisprudence.

3.27 A number of points follow from this.

3.28 First, in order to demonstrate that any of its concerns might be material, Ofcom would need to begin by demonstrating dominance. As Ofcom itself noted:

> *"Market power is a continuum, but concerning degrees of ability, probability and materiality of harm to competition only arise with*

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29 Presentation from the Senior Ofcom Project Team to the Competition in Broadcasting Markets steering group, dated 15 March 2005.

30 Papers submitted by the Senior Ofcom Project Team to Ofcom's Policy Executive entitled *"Use of s.316 competition powers in broadcasting: Ensuring a consistent internal economic approach"*, dated 15 June 2005 and 20 June 2005.

31 *"Use of s.316 competition powers in broadcasting: Ensuring a consistent internal economic approach"*, dated 15 June 2005, at page 2.

> *"significant" market power, which is equated to the legal concept of dominance."*[32]

3.29 This is directly contrary to Ofcom's stance at paragraph 5.13 of the Consultation Document, where Ofcom misrepresents Sky's earlier submissions in an attempt to support the erroneous proposition that Ofcom would not need to establish dominance in the present case. In contrast to Ofcom's evident confusion, Sky position is (and always has been) clear:

(a) dominance is not a requirement for all interventions under section 316;

(b) it is, however, required where (as here) the alleged source of the competition concern is market power;

(c) the types of downstream effects with which Ofcom is concerned are of such low significance that they could arise even without dominance; they cannot, of themselves, therefore legitimately be the basis for intervention.

3.30 Second, as regards each of the potential competition concerns raised in the Consultation Document:

(a) given that Ofcom contemplates mandating Sky's supply of its premium channels, it must apply the jurisprudence on compulsory supply of intellectual property. Well-established competition principles dictate that the use of a compulsory supply remedy must be limited to the most exceptional circumstances; this reflects the fact that this type of obligation (even before considering the price reductions to be imposed) is highly interventionist and onerous;[33]

(b) if Ofcom wishes to impose a remedy to constrain prices justified on the basis that they are excessive, it must demonstrate such excessive pricing in accordance with competition law principles, which make clear the extreme care that needs to be exercised before intervening in an undertaking's pricing decisions;[34] and

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32 Paper submitted by the Senior Ofcom Project Team to Ofcom's Policy Executive entitled *"Use of s.316 competition powers in broadcasting: Ensuring a consistent internal economic approach"*, dated 20 June 2005, at page 7.

33 In Case C418/01 *IMS Health v NDC Health* [2004] ECR I-5039, the European Court of Justice held (at [38] and [52]) that intervention under Article 82 to compel the supply of intellectual property may only be permitted in exceptional circumstances where four cumulative conditions are satisfied: (1) provision of the intellectual property is indispensable for carrying on a particular business; (2) refusal to supply is preventing the emergence of a new product for which there is a potential consumer demand; (3) the refusal is such as to exclude any competition on the secondary market; and (4) the refusal is not objectively justified.

34 A price is so excessive as to be contrary to competition law where it bears no reasonable relation to the economic value of the product supplied (see Case 27/76 *United Brands v Commission* [1978] ECR 207 at [250]). Establishing that a price is in excess of costs is merely the first element of the test; it is then necessary to demonstrate that the price is either unfair in itself or when compared to competing products (see *United Brands* at [252]). See further, *Attheraces v BHB* [2007] EWCA Civ 38, [114]-[119] and [208]-[213]; this case also makes clear (at

(c) if Ofcom wishes to intervene with regard to the relationship between Sky's wholesale and retail prices because of concerns about the ability of competitors to compete in the retail market, it must adhere to the jurisprudence on margin squeeze, which makes clear that it is contrary to basic principles of competition law (as well as wholly unfair) to require an undertaking to cut its prices to below the level that its own retail operation requires in order to compete, so as to subsidise its less efficient competitors.[35]

3.31 However, in the present case, Ofcom consistently fails properly to address such points, and plainly makes no attempt to establish that it has met the standard competition law tests for condemning behaviour as anti-competitive. Indeed, Ofcom acknowledges that it would have difficulties in meeting those tests.[36] Moreover, whilst it evidently does not accept Sky's case on the limits of section 316, Ofcom has not stated what **it** considers the limits to be. One can only conclude, therefore, that, in stark contrast to the position adopted internally, for the purposes of its case against Sky, Ofcom considers that there are **no** limits on the scope of section 316 and that it gives it unbounded discretion to intervene to manage outcomes and to implement policy objectives.

Standard of proof

3.32 The standard of proof for exercising Ofcom's section 316 powers is the civil standard of the balance of probabilities. A prospective analysis necessarily requires to be undertaken with great care, given that it involves a prediction as to future events. Indeed, the Senior Ofcom Project Team noted in its recommendation to the Ofcom Policy Executive, that "*when acting ex ante the balance of probabilities is different from acting ex post ie we need to establish a high probability of abuse / competition detriment…*" and that it is "[n]*ot sufficient to identify the feature* [which is materially restricting/preventing/distorting competition] *alone, need good evidence that feature will translate to material effect on competition.*"[37]

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[208]) that *"even a hypothetically competitive market may yield a rate of profit above … the reasonable margin represented by cost +"*.

35 An undertaking which is dominant in both an upstream and related downstream market commits a margin squeeze when the margin between the price which it charges downstream competitors for access to the upstream product and the price which it charges for the derived product is insufficient to reflect that dominant company's own costs of transformation on the downstream market: see Case T-271/03 *Deutsche Telekom v Commission* [2008] 5 CMLR 9 at [188]-[193].

36 See, for example, paragraphs 8.16 to 8.20 of the Consultation Document.

37 Papers submitted by the Senior Ofcom Project Team to Ofcom's Policy Executive entitled *"Use of s.316 competition powers in broadcasting: Ensuring a consistent internal economic approach"*, dated 13 June 2005 and 20 June 2005.

Conclusion

3.33 Ofcom's position in this case, albeit wholly contrary to its internal position, appears to be that it can invoke its section 316 powers on the very slightest pretext, with no regard to competition law policy and principles or the gravity of the problem. For the reasons set out above, that is untenable.

D. Ofcom has not met the tests required for its intervention under section 316

3.34 Ofcom has plainly not met the required competition law tests that permit intervention to mandate supply or adjust pricing. To the extent it has even addressed them, it has been to note its concern that it could not meet them, and to signal its departure from them.[38] Moreover, we set out below why Ofcom has not even satisfied the necessary condition of demonstrating a 'material effect on the competitive process'.

Ofcom has not conducted a competition analysis within a proper framework

3.35 Ofcom needs to assess the impact of identified conduct on competition within a proper framework which defines the relevant market(s), assesses the degree of market power (to the extent that it forms part of the analysis) and assesses the impact of the identified conduct on competition in affected market(s).

3.36 There has, at least, been a minor improvement since the Second Consultation Document, in that Ofcom has heeded Sky's argument that, to be in a position to assess the impact on competition on a retail market, Ofcom should define that retail market.

3.37 But Ofcom's market definition and market power analyses, at both the retail and wholesale levels, are significantly deficient in numerous respects and are quite insufficient for the purpose of a proper competition analysis.[39]

3.38 Moreover, even where dominance or market power is properly established (which is not the case here) one cannot simply assume that this is giving rise, or will give rise, to a material impact on the competitive process that is sufficient to trigger intervention under section 316.

Ofcom's concerns are not material or have not been established to a sufficient standard

3.39 As we demonstrate in **Sections 6 and 7** below, Ofcom's concerns are not material. But even if they were, Ofcom certainly has not come anywhere close to meeting the criteria that would need to be satisfied under general competition law to justify imposition of a compulsory licensing obligation, let alone one that is coupled with a requirement to reduce prices.

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[38] See paragraphs 8.16 to 8.21 of the Consultation Document.

[39] See **Section 5** of this Response.

E. Ofcom's remedy falls outside the legitimate scope of section 316

3.40 As explained above, the imposition of highly intrusive mandatory supply obligations at regulated prices demands compelling and cogent justification on the basis of orthodox competition law principles which is manifestly absent from Ofcom's analysis in the Consultation Document. However, even if there **were** compelling evidence in support of intervention, the particular remedy proposed by Ofcom in the present case cannot be justified as consistent with section 316.

3.41 The proposed remedy has elements which would not be found in a competitive market, since it would force Sky to act in a way which is illogical (for Sky or any other broadcaster, whether or not it has a retail business and whether or not it has market power). Sky is apparently to be required to supply its channels at reduced wholesale prices to all customers in order to subsidise entry that is less efficient than existing providers (including Sky). But, as discussed in more detail in **Section 6** below, a broadcaster, regardless of whether it has its own retail business, seeks to distribute its channels to platforms so as to maximise aggregate wholesale revenues and has no incentive to reduce its wholesale prices absent comfort that such a move would increase its total wholesale revenues (for example, through minimum guarantees or other forms of commitments).

3.42 Ofcom's own analysis suggests that there is a risk that its proposed intervention would result in a reduction in Sky's profits.[40] Furthermore, as we demonstrate in Sections 11 and 12 below, Ofcom's estimates of the benefits of its proposals are not soundly based, being both methodologically flawed, and not supported by adequate evidence; when the effect of Ofcom's proposed regulation on Sky is properly evaluated, it is entirely clear that Ofcom's proposed regulation would have a negative impact on Sky's revenues.

3.43 Further, not only is such an outcome incompatible with ensuring effective competition, it is manifestly unfair, since it requires Sky to subsidise its less efficient competitors in circumstances where Ofcom has failed to demonstrate that Sky's wholesale prices would of themselves justify regulatory intervention.

3.44 However wide Ofcom might argue section 316 is intended to be, mandating market outcomes which do not reflect those that would be seen in a competitive market, and require a subsidy by more efficient operators of less efficient ones, is plainly inimical to the concept of *"ensuring fair and effective competition"* that is the purpose of section 316. It follows that the nature of the price control proposed by Ofcom must fall outside the proper scope of section 316.

[40] Paragraph 10.73 of the Consultation Document.

F. Ofcom's legal obligations in relation to the introduction of new regulation

3.45 We have discussed above the need for Ofcom to establish to the required standard that Sky is actually engaging, or is more likely than not to engage in, the alleged conduct, and that such conduct is having or can be expected to have a material impact on the competitive process such as to justify Ofcom's intervention.

3.46 Where these requirements are met, and Ofcom is assessing its proposals for new regulation to ensure fair and effective competition, Ofcom must have proper regard to its general duties.[41]

3.47 Of particular note are:

- Ofcom's principal duty under section 3(1)(b) CA03 to further the interests of consumers (where appropriate by promoting competition). This requires Ofcom to establish to the appropriate standard that its intervention would benefit consumers;
- section 3(3) CA03, which requires Ofcom to have regard to the principles under which regulatory activities should be proportionate, consistent and targeted only at cases in which action is needed, and also to have regard to any other principles appearing to Ofcom to represent the best regulatory practice; and
- section 7 CA03, which places a duty on Ofcom to carry out an impact assessment in relation to new regulation. The CAT's judgment in the *Vodafone* case[42] makes clear that Ofcom's assessment of the costs and benefits of its regulatory proposals must be able to withstand *"profound and rigorous scrutiny"*.[43] This is clearly an exacting standard.

3.48 We set out in **Sections 9, 10 and 11** below our assessment of Ofcom's application of those duties to its proposals for new regulation.

G. Conclusion

3.49 Ofcom's approach and proposals stray well beyond the bounds of mainstream regulatory thinking. Ofcom's approach is also legally unsound. It is not open to Ofcom to invoke section 316 in the way it proposes to pursue its policy vision. In the circumstances, Ofcom's departure from orthodox competition law principles renders its intervention unlawful.

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41 Ofcom at least now makes reference to these duties in the Consultation Document (previously a conspicuous omission that Sky pointed out in its Response to the Second Consultation Document) and accepts that they apply to the present case.

42 *Vodafone v Ofcom* [2008] CAT 22.

43 *Ibid*, paragraphs 47 to 49.

SECTION 4: OFCOM'S HISTORIC ANALYSIS OF SKY'S AGGREGATE PROFITABILITY

A. Introduction

4.1 Before turning to Ofcom's competition concerns and its proposed new regulatory regime, it is necessary to consider Ofcom's analysis of Sky's aggregate profitability, as Ofcom's assertion that Sky's aggregate profits are too high is an important part of its case for imposing draconian new regulation on Sky. This **Section 4** focuses on Ofcom's analysis of Sky's historic aggregate profitability (i.e., the profitability of Sky as a whole), and the conclusions that Ofcom draws based on this analysis. This Section should be read in conjunction with the Expert Report of Professor Paul Grout which is included at **Annex 2** of this Response (the "**Grout Report**").[1] Ofcom's analysis of the profitability of Sky's notional premium channel business is addressed in **Section 7**.

4.2 In the face of a wide range of evidence that the market is producing good outcomes for consumers (which we summarise briefly in **Section 8** below), Ofcom's argument for intervention is apparently motivated by its belief that Sky is charging more than Ofcom thinks reasonable for its premium sports and movie channels. It is this assertion that consumers are harmed by "*unduly high*" prices which forms a key part of Ofcom's case against Sky.

4.3 An argument that Sky earns "*high*" profits underpins a number of significant elements of Ofcom's case, namely that:

- it is appropriate to require Sky to reduce its wholesale prices.[2]
- compulsory reductions in Sky's wholesale charges for its premium sports and movie channels would not have a significant impact on Sky[3]

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1 The Grout Report should be read in conjunction with the note that was prepared by Professor Paul Grout and submitted to Ofcom by Sky in May 2009 (the "**Grout Note**").

Professor Grout is the Professor of Political Economy and Head of the Department of Economics at the University of Bristol, and is a recognised expert in the field of regulation and competition policy. His work has been published widely and he has advised extensively in this field, including specifically on matters concerning the assessment and use of profitability data in regulatory policy. He has advised numerous government agencies (including the Competition Commission, the OFT, Ofgem and the EC Commission) and private companies.

2 For example, at paragraph 5.7, Ofcom states: "*The competition concerns we identify in section 6 relate to the unavailability of Sky's channels to third parties at an appropriate wholesale price (either because Sky does not supply those channels or because we consider that the wholesale price is unduly high)*". It is clear that Ofcom regards its profitability analysis as supporting its view that wholesale prices are "*unduly high*".

3 For example, at paragraph 10.74, Ofcom states: "*As we set out in section 6, we believe Sky to be making returns on its pay TV business that are well above its cost of capital. In light of this, and in light of the fact that we are not proposing to bring wholesale prices down as far as the cost-plus figures, we believe that the decrease in wholesale prices that we are proposing could at most decrease the high margins that Sky is making, rather than putting its wholesale business into loss-making territory.*"

or on Sky's incentive to invest (because they act simply to reduce Sky's alleged excessive levels of profitability); and

- it is appropriate to pursue the imposition on Sky of an intrusive regulatory regime in which one of the key objectives is to reduce Sky's wholesale charges, rather than accepting Sky's offer of commitments in relation to supplying its premium channels to other operators (see paragraph 1.14 of Section 1 and paragraphs 6.64 and 6.65 of Section 6).

4.4 Put simply the claim of excessive aggregate profitability is one of the grounds on which Ofcom concludes that retail prices "*are above the competitive level*"[4] (and from which it also infers that wholesale prices are "*unduly high*"[5]). In this Section we show that there is simply no basis for the claim that Sky's profitability is excessive and hence no basis for the claim that retail prices are above competitive levels. In **Section 7** we show that there is no basis for the claim that wholesale prices are high and in **Section 8** we show that retail prices compare well with prices across a range of countries.

4.5 This Section 4 is organised into six main parts.

- Part B shows Ofcom's shifting position throughout its consultation towards (a) the level of Sky's profitability, and (b) the reliability of methodologies for assessing Sky's profitability.

- In Part C we show that Oxera's estimates of Sky's IRR may not be reliable.

- In Part D we show that the conclusion that Sky's profitability is, and will continue to be, excessive, cannot be attributed to Oxera. This is Ofcom's conclusion, not Oxera's, notwithstanding Ofcom's attempt to argue that Oxera's Report supports its views.

- In Part E we show that, even if Oxera's estimate of Sky's IRR were reliable, Ofcom's conclusion that Sky is earning (and can be expected to continue to earn) excessive profits or that Sky is charging retail prices which are unduly high is not sustainable.

- In Part F we show that Oxera's comparator analysis is unreliable.

- Finally, in Part G, we summarise the conclusions of Professor Grout's analysis which, using a number of different approaches, indicates that Sky's historic profitability cannot be regarded as being excessive.

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4 Paragraph 7.6 of the Consultation Document.

5 Paragraphs 4.52 and 6.160 of the Consultation Document.

B. Ofcom's shifting position on Sky's profitability

4.6 In its First Consultation Document Ofcom carried out two types of aggregate profitability analysis: an analysis of historic returns to Sky's shareholders, and a historic analysis of Sky's enterprise to book value ratio. In relation to its analysis of returns to shareholders Ofcom concluded that its analysis "*does not highlight excessive returns being earned in comparison with other leading companies.*"[6] In relation to the ratio of Sky's enterprise value to book value Ofcom concluded that although (on an adjusted basis) Sky's market value exceeds the asset value by a significant amount "*this also appears to be true for a significant number of other companies*".[7] Each of these types of analysis might suggest that Sky's profits are normal, in the sense that they are consistent with the levels earned by other leading companies. Ofcom agreed, stating:

> "*our initial conclusion is that we do not see this analysis as providing sufficient evidence to support a claim that Sky is earning excessive profits.*"[8]

4.7 It would have been an entirely reasonable approach to rely on this initial conclusion, but instead Ofcom subsequently went on to seek more or different evidence that it could claim to be "*sufficient*" to support a claim of excessive profits.

4.8 Somewhat remarkably, and without explanation, Ofcom's Second Consultation Document sought to place a different interpretation on its previous analysis. In its Second Consultation Document Ofcom summarised its findings in relation to Sky's profitability in the First Consultation Document as follows:

> "*We found that it would be possible to conclude that Sky's profits were high for certain periods, although they did not appear to be high for other periods. Overall, it was difficult to be definitive as to whether Sky had made excessive profits*". [9]

4.9 This is not an accurate reflection of the findings of the First Consultation Document. Nowhere in that consultation document does Ofcom say that it would be possible to conclude that Sky's profits were "*high for certain periods*", still less excessive. Ofcom's revised interpretation of the analysis set out in its First Consultation Document also makes no reference to the fact that Sky's returns were in line with those of "*a significant number of other companies*"[10] on both of the profit measures considered.

4.10 Ofcom's Second Consultation Document adopted a new approach to profitability. Rather than seeking to examine Sky's *overall* profitability, Ofcom focused its search for excess profits on the returns of Sky's premium channel

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6 Paragraph 4.74 of the First Consultation Document.

7 Paragraph 4.70 of the First Consultation Document.

8 Paragraph 4.71 of the First Consultation Document.

9 Paragraph 7.73 of the Second Consultation Document.

10 Paragraph 4.70 of the First Consultation Document.

business. Based on the recommendations in Oxera's 2003 Report on profitability analysis for the OFT,[11] Ofcom undertook an analysis of the gross margin of Sky's premium channel business, which concluded only that:

> "*Gross margins on movies are significantly higher than those observed on sports... Operating margins for the part of Sky's business hypothetically contained within PremiumChannelCo are higher than those observed or expected for Sky as a whole*".[12]

4.11 It appears that the reason for Ofcom's shift of emphasis to disaggregated profitability was that Ofcom had concluded that the approach to measuring firms' aggregate profitability which the Complainants were pressing Ofcom to undertake,[13] and which Ofcom appears to have discussed with the Complainants[14] – a truncated IRR analysis - was unlikely to produce reliable results when applied to Sky. Ofcom stated:

> "*The analysis set out here shows that the results* [of a truncated IRR analysis] *are highly volatile to different assumptions regarding the appropriate asset values and scope and the time period selected for analysis. Different but plausible approaches to estimating product line profitability and capital intensity can also impact the IRR result. The plausible range of outcomes is considerably broader than those presented here, particularly when the cumulative impact of multiple changes in assumptions is taken into account. Given the uncertainties over MEA values for a business that has invested considerably in its brand over a long period, and the particular circumstances in this case,* ***Ofcom considers that a profitability assessment based on a truncated IRR approach is unlikely to yield a robust conclusion about Sky's profitability.***"[15] (Emphasis added)

4.12 Following receipt of responses to Ofcom's Second Consultation Document, Ofcom appears to have recognised that the absence of any evidence that Sky earned excessive profits was a fundamental weakness in its clear desire to impose intrusive new regulation on Sky. For example, Sky's Response had argued strongly that Ofcom's intrusive price control proposals were apparently targeted at a problem ("*high wholesale prices*") concerning which it had no evidence.[16]

4.13 It was, therefore, not particularly surprising that Ofcom's attention returned to the issue of profitability at that point. What was surprising, however, in light of Ofcom's statement in its Second Consultation Document that a profitability

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11 Assessing profitability in competition policy analysis, OFT 657, July 2003.

12 Paragraph 2.51 at Annex 9 to the Second Consultation Document.

13 Setanta Sports Holdings and Top Up TV Europe response to Ofcom's First Consultation, Section 11.

14 Footnote 14 to Annex 9 the Second Consultation Document refers to a "*Conference call between Top Up TV/Setants* [sic] *representatives and Ofcom, 3 September 2008*".

15 Paragraph 1.55 at Annex 9 of the Second Consultation Document.

16 See 3(b) of Section 7 of Sky's Response to the Second Consultation Document.

assessment based on a truncated IRR approach was unlikely to yield a robust conclusion, was that Ofcom then commissioned Oxera to undertake that very assessment. Given this evident *volte-face*, at a meeting on 30 April 2009 Sky asked Ofcom why it had changed its view on the reliability of this approach. Ofcom's response was that, if it chose to place weight on Oxera's analysis in its next consultation document, it would explain why its view had changed about the reliability of the truncated IRR approach.

4.14 Ofcom now places a great deal of weight on truncated IRR analysis as a measure of profitability. Indeed, Ofcom appears to have rejected all the other measures of profitability. In particular, in basing its conclusions entirely on Oxera's analysis (or rather, on Ofcom's flawed interpretation of it), Ofcom has ignored the measures of profitability set out in its First Consultation Document - as well as evidence set out in PwC's First Report which showed that Sky's retail prices are consistent with prices for comparable packages in other countries[17] – all of which strongly suggest that Sky's profits are normal.[18]

4.15 Yet no reasons are now given for Ofcom's change of heart about the reliability of a truncated IRR approach. Ofcom states:

> "*In our previous work, we highlighted the difficulties we had found with applying these principles. However, we believe that Oxera has managed to overcome the various difficulties, by virtue both of its expertise and of its access to considerably more detailed financial data.*"[19]

4.16 These two unreasoned claims do not in any way explain how the concerns set out by Ofcom in the Second Pay TV consultation document have been overcome. Ofcom's previous reason for considering that "*a profitability assessment based on a truncated IRR approach is unlikely to yield a robust conclusion about Sky's profitability*" was the sensitivity of the result of that analysis - Ofcom describes it as being "*highly volatile*" - to issues such as the numerous assumptions that need to be made in performing such analysis, and the time period over which the truncated IRR is measured. Such matters are not a function of the relative skill of those performing the calculations, nor of the detail of the financial data available. They are fundamental issues that remain with Oxera's analysis and Ofcom's interpretation of it.

4.17 Given the concerns expressed by Ofcom in the Second Consultation Document about the reliability of the truncated IRR approach, it is of considerable surprise that these concerns are not discussed in the Consultation Document. It is also surprising that Oxera's Report does not seek to address them – for example by

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17 Whilst this evidence does not directly relate to Sky's profitability it is nevertheless relevant given that Ofcom uses its profitability analysis to infer that retail prices are unduly high. See for example paragraph 7.6 of the Consultation Document.

18 Ofcom has also ignored evidence provided by Sky in Section 6 of its Response to the Second Consultation Document which showed that the operating margin for Sky's notional premium channels business was comparable (in fact at the lower end of the range) with that of a number of similar companies.

19 Paragraph 6.175 of the Consultation Document.

investigating the sensitivity of estimates of Sky's historic IRR, as recognised in the Second Consultation Document,[20] to *"different assumptions regarding the appropriate asset values and scope and the time period selected for analysis"* and *"different but plausible approaches to estimating product line profitability and capital intensity"*.[21]

4.18 In the Parts below we show that Ofcom's analysis is significantly flawed. Ofcom's evidence remains insufficient to demonstrate that Sky's profits are excessive or that its retail prices are unduly high. Ofcom is no better able to demonstrate these matters following the Consultation Document than it was before.

C. Concerns about the reliability of Oxera's estimate of Sky's IRR

4.19 Oxera's Report contains a range of different approaches to measuring Sky's historic profitability. Both Oxera's, and subsequently Ofcom's, focus, however, is on the results of a truncated IRR analysis of Sky's profitability over the period 2004-2008. Oxera describes the truncated IRR framework as "*a conceptually appropriate framework for profitability analysis in the context of competition investigations*",[22] and considers that other measures (notably ROCE estimates) play a "*supporting*"[23] role.

4.20 The central finding of Oxera's Report is that, over the period 2004-2008, Sky's truncated IRR (looking at Sky in aggregate) is estimated to have been "*around 20%*".[24]

4.21 Oxera's approach to estimating Sky's profitability for this period requires Sky's assets – including its notional 'intangible assets', the value of which in Oxera's analysis dwarfs the value of Sky's tangible assets – to be valued at the beginning and end of the time period for investigation and identification of Sky's cash flows that are associated with Sky's pay TV business.

4.22 There is significant uncertainty relating to the valuation of Sky's intangible assets. For example, different approaches and estimates of Sky's assets at the beginning and end of the time period selected would have a material impact on the estimate of Sky's truncated IRR. This is something which gave Ofcom particular concern in its Second Consultation[25] and the effect of this is clearly demonstrated in Figure 58 of the Consultation Document. The problems with

20 See Paragraph 4.11 above.

21 Paragraph 1.55 of Annex 9 of the Second Consultation Document.

22 Page 3 of Oxera's Report at Annex 9 of the Consultation Document.

23 Page 5 of Oxera's Report at Annex 9 of the Consultation Document.

24 Paragraph 4.29 and page ii of Oxera's Report at Annex 9 of the Consultation Document. To be more precise, Oxera finds Sky's pre-tax nominal IRR for this period to be either 19% or 20% (depending on the approach taken to replacement cost) - see Table 4.5 on page 29 of Oxera's Report.

25 See for example paragraphs 130 and 131 in which Ofcom draws attention to the uncertainties associated with trying to estimate the value of intangible assets and to the fact that an IRR calculation is therefore unlikely to provide robust evidence of excessive profitability or returns.

providing an appropriate value for Sky's assets and hence the difficulty in estimating an accurate rate of return are commented on further in the Grout Report.

4.23 Further, Sky's cash flows over time have been quite volatile[26] such that the estimates of profit will be sensitive to the period selected as well as the allocation of cash flows to particular lines of business. Indeed, in its Second Consultation Document Ofcom highlighted that the "*disaggregation of data could be particularly complex because of the presence of a number of different product lines with shared costs and revenues*"[27] which would "*present issues in trying to estimate an IRR which related directly to Sky's UK pay TV operations.*"[28]

4.24 Further, Oxera's approach is somewhat inconsistent – it includes in its analysis assets and cash flows relating to Sky's broadband business, for example, but excludes Sky's investments in joint ventures with other pay TV broadcasters, which are clearly related to Sky's pay TV activities.

4.25 An additional issue related to the range of Sky's business activities is that the way in which a firm chooses to structure its business can greatly affect the measured IRR. Even matters as simple as when payments are made for subscription installation and related costs or content can have significant effects on a truncated IRR, without affecting the underlying profitability of the company. This issue is discussed and illustrated in the Grout Report.[29]

4.26 As a consequence Sky has a number of concerns in relation to the reliability of Oxera's analysis of Sky's profitability. In particular, as discussed above, Sky is concerned that Oxera does not appear to have subjected its approach to the types of sensitivity testing that led Ofcom to its initial conclusion that this approach is unlikely to yield a robust conclusion about Sky's profitability. Such testing could include an examination of the sensitivity of the estimated IRR to different time periods, or sensitivity analysis which seeks to assess the cumulative impact of changing several of the inputs simultaneously (rather than examining the impact of varying one variable at a time, as Oxera has done).

4.27 In such circumstances it is highly unusual that Oxera does not provide a range for its estimate of Sky's aggregate IRR, reflecting the sensitivity to different but plausible assumptions for key input variables, relying instead on a statement that Sky's IRR "*appear*[s] *to be around*" this level.[30] The normal approach would be that some indication would be given of the potential range which lies "*around*" this point estimate of Sky's past profitability. It is probable that Oxera's estimate of this variable is subject to a very significant degree of uncertainty and the range in which this point estimate is located is likely to be wide.

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26 See Table 4.3 of Oxera's Report.

27 Paragraph 1.21 at Annex 9 of the Second Consultation Document.

28 *Ibid.*

29 Section 5 of the Grout Note.

30 Page ii of Oxera's Report.

D. Oxera's Report does not support Ofcom's conclusion that Sky is earning, and can be expected to continue to earn, excessive profits

4.28 Ofcom seeks to argue that Oxera's Report supports its view that (i) Sky is earning and is likely to continue to earn "*supernormal*" or "*excessive*" profits and (ii) that such excessive profits are "*likely to be reflected in high retail prices being paid by consumers*".[31] A careful review of Oxera's Report indicates, however, that it is misleading for Ofcom to associate these conclusions with Oxera.

4.29 Above all, it is clear that the conclusions as to whether Sky's historic profitability is 'high', or "*excessive*" do not derive from Oxera's Report. These conclusions are Ofcom's, not Oxera's. Oxera provides Ofcom with estimates of Sky's historic IRR.[32] Ofcom then compares those estimates against its own calculations of Sky's weighted average cost of capital ('WACC'), and it is Ofcom alone who concludes that this comparison demonstrates that Sky is earning (and may be expected to continue to earn) "*excessive profits*" and that such excessive profits are "*likely to be reflected in high retail prices being paid by consumers*".[33]

4.30 Oxera's finding in relation to Sky's historic IRR contains no assessment or judgment regarding the reasonableness of Sky's profitability. Oxera does not conclude that Sky's IRR is "*high*" or "*excessive*" or indeed that Sky's retail prices are above competitive levels. Where Oxera does suggest that its estimates of returns could appropriately be compared with an *ex ante* cost of capital, Oxera is clear that it has not done this as part of its investigation. Even more importantly Oxera does not opine that if a firm is earning returns above its cost of capital such returns should properly be considered excessive[34] or could properly be considered to indicate a weakness in competition. Nor does Oxera suggest that a comparison of a firm's returns with its cost of capital provides a robust estimate of the **extent** to which a firm is creating shareholder value. An IRR greater than the cost of capital means that the NPV will be greater than zero at the cost of capital (and therefore creates shareholder value). A comparison of an IRR and the cost of capital does not, however, indicate how high the NPV will be. Yet in interpreting Oxera's analysis Ofcom makes both of these assumptions, assumptions which, as set out in the Grout Report, lack any theoretical underpinning and which are certainly not justified by reference to Oxera's Report. Hence it is clear that Ofcom's conclusions regarding Sky's profitability are entirely its own and that it is not appropriate to associate them with Oxera.

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31 Paragraph 1.47 of the Consultation Document.

32 Oxera also undertake an exercise of comparing Sky's profitability against that of other companies. As discussed below, this analysis is wholly unreliable and no conclusions can be drawn from it.

33 Paragraph 1.47 of the Consultation Document.

34 The difference between excess returns and excessive returns is discussed in paragraphs 4.53 to 4.56 below.

4.31 That Ofcom's conclusions are its own, rather than Oxera's, is not made clear by Ofcom in its discussion of Sky's profitability. Whether or not this lack of clarity is intentional, it is highly inappropriate, and provides further support for Sky's view that Ofcom's approach to evidence is skewed.[35]

4.32 There are several other differences between Oxera's analysis and Ofcom's use of that analysis.

4.33 First, whereas Oxera is obviously aware of the many limitations of its analysis, and its report is careful to state its findings using caveated language (e.g. "*suggests that*", "*appear to be*", "*around*") these careful caveats are largely ignored by Ofcom. In particular, in drawing conclusions based on Oxera's estimate of Sky's IRR, Ofcom proceeds as if Oxera had concluded that Sky's IRR was definitively 20% over the past five years. Ofcom takes no account of the fact that the 'true IRR' may be higher or lower than Oxera's estimate due both to methodological issues and to measurement error (which we discuss further below). This is particularly surprising given Ofcom's previous concerns that the "*possible range of assets values in this case was wide*"[36] and the existence of "*potentially significant cost and revenue allocation issues*".[37]

4.34 Second, Ofcom suggests that Oxera's analysis supports a finding that Sky's profitability is likely to continue to be excessive in future. For example, Ofcom states:

> "*The analysis which has been carried out by Oxera suggests that Sky is earning and is likely to **continue earning aggregate** returns in excess of its cost of capital.*"[38]
>
> "*We believe that Oxera's analysis provides evidence that if the pay TV market is left unchanged, **Sky's future IRR** (based on ongoing profitability and the value of its asset base) would be likely to exceed its cost of capital.*"[39] (Emphasis added in each case.)

4.35 Oxera, however, did not undertake a forward-looking analysis of Sky's profitability – for example as might be undertaken using projections of Sky's future costs and revenues based on business plans, or analysts' projections. Oxera's profitability analysis is instead entirely backwards looking; indeed, it goes so far as to track Sky's returns back as far as 1995. Ofcom cannot therefore rely on Oxera's Report in support of its assertion that any alleged historic excessive profits are likely to persist into the future.

4.36 The only statements in Oxera's Report that are forward looking relate to the potential for entry by new pay TV operators in the future (although it does not

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35 See **Section 2** of this Response.

36 Paragraph 1.30 at Annex 9 of the Second Consultation Document.

37 Paragraph 1.31 at Annex 9 of the Second Consultation Document.

38 Paragraph 1.47 of the Consultation Document.

39 Paragraph 6.194 of the Consultation Document.

appear that this view was informed by detailed evidence or knowledge of pay TV).[40] Oxera's speculation that new entry may diminish Sky's profitability in the future is, however, based on an erroneous view that the only source of challenge to Sky's future profitability could come from new pay TV operators. This ignores entirely the competition faced by Sky from provision of audiovisual programmes for free (including free to air television services), competition from other ways of consuming movies, and an increase in the intensity of competition from existing market players both at the wholesale and retail level including Virgin Media, BT and ESPN. We note that Oxera's language is in any case highly caveated and amounts to no more than speculation by a consultant engaged for its expertise in matters of profitability, rather than being a participant in, or expert on, the audiovisual sector. Accordingly, no weight can be placed on Oxera's speculations.

4.37 Moreover, Ofcom's conclusion that Sky's future IRR is likely to continue to exceed its cost of capital is also inconsistent with Oxera's analysis which shows that Sky's IRR is in fact declining. For example, Table 4.5 of Oxera's Report shows that Oxera's estimate of the IRR is significantly lower (by between **[CONFIDENTIAL]** and **[CONFIDENTIAL]** percentage points) for the period 2004-2008 versus 1995-2008 across each of the different approaches to valuing assets. Indeed Oxera recognises this in concluding that "*the estimates of IRR under the replacement costs approach seem to have been decreasing over time*".[41]

4.38 In summary, it is misleading of Ofcom to claim that its conclusions relating to Sky's profitability are based on Oxera's analysis – other than in the limited sense that Oxera provides one of the inputs on which Ofcom bases its conclusions. Conclusions about the "*excessive*" level of Sky's historic profitability are Ofcom's conclusions alone and not those of an independent expert.

E. Ofcom's proposition that Sky's profitability is "*high*" or "*excessive*"

4.39 Ofcom regards Sky's aggregate profitability over the past five years as being "*high*" or "*excessive*" and suggests this is evidence of high retail prices. Ofcom states:

> "*We are now consulting on the view that: Sky appears to be making **high aggregate returns***".[42]
>
> "*Evidence that Sky is earning **excessive profits** supports a view that retail prices are above competitive levels*".[43]

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[40] For example, Oxera states: "*These results seem to suggest that, from the point of view of a potential new entrant, the costs of acquiring new customers have been increasing over time and currently seem higher relative to expected lifetime cash flows than in the past. This may highlight the challenges associated with profitable entry into this market in future. To the extent that there may be learning-by-doing effects, the costs of acquiring customers from the point of view of a hypothetical new entrant would be higher.*" (Page iii of Oxera's Report at Annex 9 of the Consultation Document.)

[41] Page 30 of Oxera's Report at Annex 9 of the Consultation Document.

[42] Paragraph 1.4 of the Consultation Document.

> "*As described in section 6 (paragraphs 6.170 to 6.207), our analysis indicates that Sky earns* ***high margins*** *in its pay TV business*".[44] (Emphasis added in each case.)

4.40 Such claims invariably depend on a comparison of observed profitability with an appropriate benchmark. Ofcom's approach to relevant benchmarks is, however, imprecise; Ofcom's Consultation Document contains no clear discussion of this issue.[45]

4.41 Ofcom's Consultation Document briefly mentioned returns earned by comparator companies[46] but places greatest weight on a particular benchmark[47] – Ofcom's estimate of Sky's weighted average cost of capital. Ofcom's principal argument is that Sky's past profitability should be regarded as being "*high*", or "*excessive*", because it is estimated to have been greater than Sky's cost of capital. For example, Ofcom states:

> "*As described in section 6 (paragraphs 6.170 to 6.207), our analysis indicates that Sky earns high margins in its pay TV business – reflected in the difference between its IRR and its cost of capital*".[48]
>
> "*This* [analysis] *suggests that in aggregate Sky has been making returns in excess of 20%.... This is in comparison with a likely cost of capital of 10.3%... Evidence that Sky is earning excessive profits supports a view that retail prices are above competitive levels.*"[49]

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43 Paragraph 4.53 of the Consultation Document.

44 Paragraph 7.104 of the Consultation Document.

45 The principal such discussion is at paragraph 6.176 of the Consultation Document, which states: "*In a competitive market with freedom of entry and exit we would not expect the IRR of a particular project substantially to exceed the cost of capital in the long run. An IRR substantially above the cost of capital could indicate the existence of barriers to entry and market power.*" This brief discussion is confusing in its statement that Ofcom's expectation is that in a competitive market the IRR of a particular project would not be expected substantially to exceed "*the cost of capital in the long run*". In the final sentence of this paragraph, Ofcom does not define what it means by "*substantially above*", and it is notable that Ofcom considers only that such an excess "***could*** *indicate the existence of barriers to entry and market power.*" (Emphasis added.)

46 See paragraph 6.200 and Oxera's Report at Annex 9 of the Consultation Document.

47 Ofcom also mentions, almost in passing, the benchmarks of profits being regarded as being high if they are above those which would be expected "*in a fully competitive market*" (see paragraph 6.202), or a "*perfectly competitive market*" (see paragraph 6.201 of the Consultation Document). In relation to the first of these, it is not clear what is meant by a "*fully competitive market*", let alone what levels of profits firms might be expected to earn in such a market and hence what actual number the measures of Sky's profitability calculated by Oxera might be compared against. In relation to the second we understand that Ofcom draws inference from the fact that in a perfectly competitive market firms would be expected to earn returns consistent with their cost of capital. We comment below in paragraph 4.48 why a perfectly competitive market is not a sensible benchmark to apply when considering the appropriateness of Sky's profitability.

48 Paragraph 7.104 of the Consultation Document.

49 Paragraphs 4.52 and 4.53 of the Consultation Document.

4.42 There are several significant problems with Ofcom's arguments, each of which is explored in more detail in the sections below:

- earning an IRR above the cost of capital is not sufficient to conclude that a firm is earning excessive profits or that prices are unduly high;
- there are many reasons why Sky might be expected to earn more than its cost of capital which are not indicative of competition problems; and
- Ofcom has ignored measurement error.

Comparing firms' profitability to their cost of capital

4.43 Ofcom's key proposition is that Sky's historic returns are "*high*" or "*excessive*" simply because they exceed Ofcom's estimate of Sky's cost of capital. This proposition, however, is a fallacy and cannot be relied upon.

4.44 It is of considerable surprise that Ofcom seeks to rely so categorically on this proposition because the attendant flaws were discussed in the note prepared by Professor Paul Grout, submitted to Ofcom by Sky in May 2009 (the "**Grout Note**"). That note clearly shows that a finding that a firm's truncated IRR exceeds its cost of capital cannot be regarded as a safe basis for a conclusion that a firm is earning excessive profits. Professor Grout explained that this is because of issues concerning (a) the reliability of a truncated IRR as a measure of a firm's profitability, and (b) because a simple excess of a firm's IRR over its cost of capital does not necessarily indicate that its profitability is "*excessive*".

4.45 Professor Grout notes that "*IRR analysis has to be treated with great caution to inform an answer of this type*".[50] He also warns that "*The IRR is likely to be highly prone to error if one tries to identify whether the return is persistently significantly above the cost of capital*".[51] There are a number of reasons for this, as discussed in the Grout Note. IRR is not 'designed for' or well-suited to assessing the question of whether returns *persistently and significantly* exceed the cost of capital. For example, as noted above, the way in which a firm chooses to structure its business or the timing of payments for rights can greatly affect the measured IRR without affecting the underlying profitability of the business.

4.46 Yet Ofcom does not even refer to the Grout Note in its Consultation Document. Nor did Ofcom seek to discuss such matters, either with Sky or Professor Grout, prior to the publication of its Consultation Document. Ofcom's disregard of an important submission from an independent expert in such matters falls well short of the standard of behaviour that is required from a competent, fair and open-minded regulator.

4.47 Textbook economic theory observes that firms operating in perfectly competitive markets in equilibrium (i.e. where there are no changes occurring in factors such as technology or consumer demands) should not earn profits that exceed

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50 Page 10 of the Grout Note.

51 Page 14 of the Grout Note.

their cost of capital, because such profits will quickly be 'competed away' via imitation – for example as a result of new entry, or expansion by existing competitors.

4.48 A "*perfectly competitive market*" is, however, widely recognised to be a largely irrelevant benchmark in the real world. It is self-evident that the paradigm of perfectly competitive markets in equilibrium cannot sensibly be used as the basis for a reasonable view as to levels of profits in the real world – both in general[52] and in relation to the provision of pay TV services in particular. The characteristics of the provision of pay TV services do not remotely conform with the assumptions that underpin the perfect competition paradigm, and the markets in which these services are provided are clearly not in equilibrium in any meaningful sense, in particular due to rapid, profound and ongoing underlying technological change, and changes in consumer demands.[53]

4.49 Returns in excess of a firm's cost of capital may be described as 'excess' returns. 'Excess' returns should, however, be anticipated to be the norm in the case of successful, innovative and durable firms, rather than an aberration or a sign of competition problems. They are an integral part of a well-functioning market economy, and will be observed in the most competitive of real world markets. Excess returns are the motivation that drives productive and dynamic efficiency – i.e. the reduction of costs over time, and the creation of, and investment in, innovative new products and technologies that are the key driver of welfare gains to both consumers and society more generally.[54] It would be extraordinary if every instance of firms earning returns above their cost of capital were held up as an indicator of a need for regulatory intervention to remedy this occurrence.

4.50 The reason that successful firms will be observed to earn excess returns is straightforward. Firms' profits are the result of a series of investments over time. Standard investment theory indicates that firms should invest where they identify 'NPV positive' projects – investment opportunities where returns exceed their cost of capital (and, where they have multiple such opportunities but finite resources, firms should invest in projects with the highest expected NPV). Furthermore, it is well-known that firms tend to set hurdle rates for investment well above their cost of capital (either explicitly, or implicitly when evaluating investment decisions) to provide a 'margin of error' – i.e. to reflect the risk of project failure, or uncertainty about potential returns.

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52 As noted in Bishop and Walker (2002): "*The model of perfect competition is the first economic model that most economists learn, but perversely it bears little relation to reality.*" Page 17 in Simon Bishop and Mike Walker, The economics of EC competition law; concepts, application and measurement. London, Sweet & Maxwell, 2002.

53 The rapidly changing nature of the UK audiovisual sector, of which pay TV is a part, is recognised in numerous Ofcom publications.

54 This is one of the key reasons why utility regulation has moved away from rate-of-return type approaches to price control (in which firms are permitted only to earn returns equal to their cost of capital), to 'incentive regulation' (such as RPI-X price control), that **encourages** regulated firms to seek to earn rates of return above their cost of capital. Accordingly, even regulated utilities will typically be observed, ex post, to have earned returns that exceed their cost of capital, because they have successfully responded to the incentives placed before them.

4.51 Accordingly, given that firms' profits are the result of such investments, firms that are faced with a series of NPV-positive projects over time, and execute them successfully (which tends to be the case for firms that remain in the market and so are available for analysis), will be observed to earn returns above their cost of capital.

4.52 Moreover, PwC's Report at **Annex 4** looks at the dispersion of returns amongst companies within each of a range of industries, and observes that it is common for profitability and valuation to differ amongst the players in a given industry. Not all firms will be successful; the expectation would be that there will be a distribution reflecting different firms' different rates of return, and it is normal for some companies to be substantially more profitable than others.

The difference between excess returns and excessive returns

4.53 A distinction should be drawn between 'excess returns' (i.e. returns in excess of the cost of capital) and 'excessive returns'. 'Excessive returns' may be considered to be returns that are attributable to a high degree of non-transitory market power. It is generally recognised, however, that regulators and competition authorities should set a high threshold for labelling returns as being "*excessive*" due to:

(a) the difficulty of distinguishing between excess returns (which are common) and excessive returns. We discuss this point further below;

(b) the measurement errors in profitability analysis; and

(c) the potential significant adverse consequences for diminishing incentives for investment and innovation that would arise if firms were disincentivised from seeking ways of increasing their profitability – for example via innovation or taking advantage of cost-reducing technology - for fear of regulators confusing excess returns with excessive returns and seeking to confiscate those returns.

4.54 It is evident from Ofcom's Consultation Document that it does not properly appreciate the distinction between excess returns and excessive returns; Ofcom appears erroneously to consider the labels of "*returns in excess of its cost of capital*" and "*excessive profits*" as interchangeable and to erroneously interpret any profits that are in excess of a firm's cost of capital as a sufficient indicator of weak competition or reflective of prices that are unduly high.

4.55 Contrary to Ofcom's simplistic analysis, returns in excess of cost of capital are normally regarded as a weak and imperfect indicator of whether competition is effective, due to the fact that such a gap can be caused by a range of factors other than the exercise of market power. It is only possible to conclude that such excess returns are attributable to weak competition if other potential causes of them can be safely ruled out, which is rarely the case – and is certainly not the case in relation to Sky's business.

4.56 This point was expressed cogently by the late Professor Paul Geroski during his tenure as Chairman of the Competition Commission in a paper entitled "*Profitability analysis in competition policy*". Professor Geroski stated:

> "*since profits are simply a residual that emerges after a firm's costs have been subtracted from its revenues, one can never be very clear why profits are high – it could be high prices swelling revenues or superior efficiency reducing costs, or perhaps both. There is, in fact, just so much that one can infer about the drivers of competition by looking at one number. To make the traditional inference from persistently high profits of a particular feature of the market that has adverse effects on competition, one needs to be sure that it is that feature, and not some other, which causes the high profits that one observes. Since many features of a market affect the revenues and costs of firms, it is rarely going to be the case that links between particular features of the market and profitability will be easy to establish. The Competition Commission's guidance on this is clear:*
>
> > *at points in time the profits of some firms may exceed what might be termed 'the normal level'. Reasons for this may include, for instance, cyclical factors, transitory price or other initiatives, the fact that some firms may be more efficient than others, the fact that some firms may be earning profits gained as a result of past innovation …*
>
> *All of this leads to the conclusion that any backward-looking analysis of profitability should have two components: a measurement exercise (answering the question: 'are profits persistently high?'), and an analysis of profitability (answering the question: 'why are they high?').*"[55]

Why Sky's past profitability might be expected to exceed its cost of capital

4.57 In essence, despite Sky's repeated submissions on the latter point, Ofcom has made little or no effort to answer the second question posed by Professor Geroski – why are profits in excess of Sky's cost of capital? Ofcom persists in a narrow view that Sky's success is essentially founded on taking big risks associated with developing pay TV services in the UK in the 1990s, and Sky should now be expected to earn little more than its cost of capital. All subsequent investments and innovations are ignored or downplayed. In the Consultation Document, Ofcom argues:

> "*When looking at Sky's historic returns, we need to be aware of the danger that returns may appear excessive, but that they in fact reflect an outcome in which actual (ex post) returns are above historical (ex ante) expected returns purely because a risky business has succeeded. Hence although we observe that Sky's historic returns for the period 1995-2008 appear relatively high, we need to accept that they may reflect this type of outcome.*

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55 Professor Paul Geroski, 'Profitability analysis and competition policy', February 2005. Published in Essays in Competition Policy, Competition Commission, August 2006. Available at: http://www.competition-Commission.org.uk/our role/analysis/essays in competition policy paul geroski.pdf.

> *In the early part of the period, Sky's business model was unproven, and there may well have been substantial downside risks for which investors needed to be compensated.*
>
> *However, when we consider Sky's more recent returns, concerns about potential failure are far less relevant. Sky has a proven business model, its risk of failure is low and we do not anticipate an outcome in which it is likely to face substantial stranded costs. Hence on this basis, we consider that it is appropriate to compare the IRR that Oxera has derived with a forward looking WACC.*"[56]

4.58 It should be noted that "*failure*" or a risk of "*stranded costs*" are not the only outcomes that should be considered. Sky continues to invest and take risks in order to maintain returns above the level of its cost of capital, as almost every company strives to do. The substantial risks that Sky faces are of failed and undermined investments on which it does not earn an appropriate return, reducing the profitability of the company as a whole.

4.59 Later in the Consultation Document Ofcom notes further that:

> "*We recognise that in some circumstances consumers' interests can best be served by allowing firms to take risks in order to establish a strong market position based on an innovative product, and subsequently to earn high returns as a reward for those risks. Sky took on substantial risk in establishing its pay TV business in the early 1990s, and in switching its service to digital in the late 1990s. Since then Sky has continued to invest in new services such as HD.*
>
> *However, given the time that has passed since Sky made its riskiest investments in the UK pay TV market…*"[57]

4.60 Sky has a strong and consistent track record of being an innovator, and in particular a first mover – identifying opportunities, undertaking large-scale, risky investments to take advantage of such opportunities, and executing well. It has typically been the case that, after some delay, Sky has been imitated in these innovations. For example, the advantages from which Sky initially benefited by virtue of being a leader in the provision of premium sports and movie services, offering consumers a broader range and choice of channels, being the first to launch digital TV services, and introducing of Sky+ and HD have all gradually been or will be eroded, as these products and services have been replicated by others. But it has been a hallmark of Sky's success that as each innovation has been imitated Sky has moved on to the next one and often remained one step ahead of its competitors. The latest example of this ability to continue to innovate is that just as Virgin Media, Freeview and Freesat have followed Sky in offering HD services, Sky has announced its intention to launch the world's first 3D TV channel.

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[56] Paragraphs 6.191 to 6.192 of the Consultation Document.

[57] Paragraphs 7.111 to 7.112 of the Consultation Document.

4.61 In such a context, a finding that Sky has, in the past, earned an aggregate rate of return that exceeds its estimated cost of capital should be entirely unsurprising.

4.62 Sky indicated in its previous submissions[58] that Ofcom's consideration of both the range of investments that Sky has made in the past, and the level of risk associated with the investments that Sky has made (and continues to make) in its business, was completely inadequate in view of the potential consequences that flow from a lack of proper appreciation of this matter. Ofcom's consideration of, and conclusions drawn from, these matters continues to be defective.

4.63 By arguing that Sky's riskiest investments were made a long time ago in the 1990s, Ofcom ignores the fact that since the time of its digital launch Sky has managed to grow its subscriber base from around 3.5 million to almost 10 million subscribers. Ofcom proceeds as if having made these "*riskiest investments*" Sky's current degree of success was a forgone conclusion. It clearly was not. For example, in 2001 Zenith Media forecast that Sky's subscriber base would reach 7.7 million by 2010.[59] Similarly, Informa forecast in early 2002 that Sky's subscriber base would reach 7.8 million homes by 2010.[60] Accordingly, Sky has added almost twice as many subscribers in the last 8 or 9 years than was anticipated.

4.64 Sky has managed to achieve its subscriber milestones, and very high levels of pay TV penetration, by being willing consistently to take risks. Whilst none of these risks may on their own equate to the risk Sky faced at the launch of its service, when combined they are very substantial indeed. In the following paragraphs we describe the risks that Sky has faced in connection with:

- expanding and changing its premium sports and movies services;
- launching and investing in its own and third party basic channels;
- launching its own, and assisting others to launch, HD channels;
- subsidising reception equipment, from the digibox in the late 1990s through to the Sky+ PVR and then HD boxes in 2009;
- expanding its business beyond TV through investment in its own broadband and telephony business; and
- investments in upgrading its infrastructure and technology platforms, and the software in its set top boxes.

Premium sports and movies services

4.65 Although Sky Sports was launched in 1991 and Sky began exclusive live coverage of the Premier League in 1992 it is wholly incorrect to suggest that

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58 See, for example, paragraph 4.15 and footnote 20 of Section 7 of Sky's Response to the Second Consultation Document.

59 "Television in Europe to 2010", Zenith Media 2001.

60 "European Television" 6th edition, Informa Media Group February 2002.

subsequent to those investments Sky took no further risks in relation to Sky Sports. Since 1992 Sky has substantially increased the portfolio of sports rights it offers its subscribers to include, for example, the America's Cup, World Darts, Rugby Super League, the Ryder Cup, The British Lions and the FA Cup. In addition Sky commenced exclusive coverage of England Test matches in 2006 (as part of a deal valued at £ [**CONFIDENTIAL**] million over 4 years) and launched its coverage of the UEFA Champions League in 2003 (as part of a deal valued at CHF [**CONFIDENTIAL**] million, or around £ [**CONFIDENTIAL**] million at today's exchange rates). There was no certainty that extending Sky's portfolio of sports events beyond Premier League would be a successful strategy, or that it would generate sufficient additional revenues to justify outbidding a range of broadcasters including the BBC and ITV for those rights. At the same time the risk which Sky has faced in bidding for Premier League rights has grown considerably, with the amount which Sky has had to guarantee in order to acquire live UK Premier League rights rising from £192 million in 1992 (for 5 years) to £1,623 million in 2010 (for 3 years).

4.66 In relation to its movie channels Sky has taken considerable risks in overhauling its movie portfolio by launching multiplex versions of its channels and more recently re-organising its movie channels in genre themes. At the same time Sky has given substantial guarantees to the movie studios, guaranteeing payment of licence fees against [**CONFIDENTIAL**] million subscribers on an on-going basis, despite considerable risk that changes in technology and other means by which movies might be viewed would substantially diminish the number of subscribers to its service.

Basic channels

4.67 In 1993 Sky launched its first package of basic subscription channels. This was, however, limited to only 14 channels. Since that time Sky has assembled a comprehensive package of basic content, which could not have happened had Sky not been willing to make substantial and long term commitments to third party channel providers to support the launch and expansion of their channel portfolios. Today Sky's annual commitments to third party channel partners is around £350 million.

4.68 In relation to its own basic channels, Sky has made significant investment in Sky News and Sky Sports News. In relation to Sky1, Sky has taken considerable risks investing in its own commissions such as *Hogfather*, *Skellig*, and *The Take* and has taken the substantial and unprecedented risk amongst similar pay TV channels of buying exclusive rights for US entertainment shows (including buying out the free to air window). In all of these cases there was no certainty at the time these investments were made that such programming would result in sufficient churn savings or new subscribers to justify such investments. Sky also took the considerable risk in 2005 of reorganising its basic content into genre packs to try to stimulate growth in its total number of subscribers. In so doing Sky had to incur the risk that its revenue from existing customers would decline as customers potentially traded down to take smaller and cheaper basic packages.

HD channels

4.69 Sky launched the UK's first nationwide HD television service in 2006. To make this launch possible Sky had to make significant commitments to third party channel providers to encourage them to launch HD channels, and incurred substantial costs in its own broadcasting operations to support the creation of a number of Sky branded HD channels. Sky also had to make a long term commitment to Astra to acquire new transponder capacity for its HD service. Sky has invested to try to create demand for HD services in the UK where no such demand previously existed. In so doing it has put at risk substantial marketing money and has made significant investments in set-top-box subsidy to try to reduce the barrier to take-up. There was no certainty when these investments were made that HD would gain sufficient traction with Sky's actual and potential subscribers for this investment to pay-off. Indeed the media industry as a whole was very sceptical of the value of HD to UK consumers, judging that HD would only succeed in the US due to the relatively poor SD technology in the US.

Digital service and reception equipment

4.70 Sky launched the UK's first digital TV service in 1998. In the year after launch, following very disappointing early sales Sky substantially changed its business model and introduced the concept of free set-top boxes as a way of driving take-up for its digital service, gambling that initially sceptical prospects would take the service, find that they enjoyed it, and end up staying. This switch in business model (unprecedented at the time but now widely imitated) involved substantial risk. At the time there was no certainty that this risk would pay off in terms of generating sufficient incremental additions or that those subscribers that took advantage of the free dish and box offer would subscribe for long enough to recover their subscriber acquisition costs. Indeed, this inherent risk in subsidising equipment is a theme that runs throughout Sky's growth story: that is, Sky's incurring significant costs to acquire subscribers and taking the risk that these subscribers will remain customers for long enough, and will take a sufficiently large package of services for this initial investment to pay back. The fact that pay TV is now an established business model does not diminish the risk which Sky faces on an ongoing basis in seeking to continue to drive subscriber growth.

4.71 Sky has subsequently invested additional subsidy in its subscriber base as it has invested to upgrade its customers to new higher specification boxes including Sky+. Sky invested considerable research and development to create an integrated set top box and digital video recorder which was launched in 2001. Sky then incurred substantial marketing costs to try to create significant demand for digital recorders. As part of this strategy Sky subsidised the cost of Sky+ equipment for its existing subscribers. Sky now does not earn any incremental revenue from Sky+ subscribers; rather the benefit to Sky arises through improved customer satisfaction and retention. There was no certainty at the time Sky made its initial investment in Sky+ that the product would be successful and gain traction with customers; indeed, it took some time before this occurred. Likewise, more recently, there was no certainty that Sky's investment in Sky+ equipment would generate sufficient churn savings or drive sufficient new subscriber additions to be justifiable.

Broadband and telephony

4.72 Sky has also taken considerable risk in extending its product offering beyond TV services to include broadband and telephony, where it has had to compete for customers against well established incumbents. Sky invested £209 million in its acquisition of Easynet and at the time announced that it expected to invest over £400 million in its broadband and telephony business. It is not credible for Ofcom to suggest that this investment did not involve substantial risk.

Infrastructure and technology platforms

4.73 Sky has also made significant investments in upgrading its infrastructure and technology platforms. For example, in 2005 Sky undertook to substantially overhaul its customer management system. The business justification for such investment was that the investment would improve Sky's ability to manage its customer relationships and that as a consequence Sky could expect to reduce its churn rate.

4.74 Sky is also in the process of completely rewriting the core software in its set-top-box, a project on which Sky has spent around £[**CONFIDENTIAL**] million to date. The business justification for this project was that it will reduce the cost of Sky's technology royalty payments and will provide a platform which it is hoped will increase the speed with which Sky can bring new innovations to market. There is, however, no certainty that this software project will achieve its original objectives, and considerable risk that in overcoming the substantial development hurdles, compromises will need to be made which could undermine the planned cost savings or benefits in terms of speed of innovations. In undertaking such an advanced software development project, Sky is also exposed to the very considerable risk that the project will be so delayed that by the time it is implemented the technology will have been superseded by something new and more advanced.

Failure to have due regard to uncertainty and measurement error

4.75 Ofcom places a great deal of weight in its Consultation Document on two values – Oxera's "*20%*" figure, and Ofcom's calculation of Sky's current cost of capital of "*10.3%*". Ofcom, however, fails to have any regard to the fact that these figures are likely to fall within ranges as a result both of uncertainty about the 'true' value of underlying variables, and measurement error.

4.76 For example, the Brattle Group's report for Ofcom includes a very significant discussion about the potential unreliability of its estimate of Sky's equity beta, which is a key input into Ofcom's estimate of Sky's cost of capital:

> "*In chapter 3 we demonstrate that none of the estimates are biased, and they pass several statistical tests.* ***However, chapter 3 does not rule out the possibility that our estimates may simply be mid-points within relatively wide ranges, because the standard errors may understate the total***

uncertainty of the estimates. Another possibility is that BSkyB's equity has changed over the past few years for other reasons than gearing.

If equity beta is in fact changing over time, the estimates we present here are much less certain than the standard errors of the regressions would suggest. *The "Kalman filter" is a standard technique for estimating parameters that are changing over time, and this has been applied to the estimation of equity betas.* ***Such techniques might be applied in this case, though we note that they typically produce estimates with rather wide confidence intervals.***

To know with confidence whether and why the equity beta of a share changes over time ***would require some additional investigation into possible reasons for the change. The research should screen for company-specific events such as changes in investment plans, or for market-related events such as the technology boom around 2000.***

The alternative possibilities prompt us to urge caution in interpreting our current beta estimates for BSkyB. The estimates might be less certain than implied by the standard errors of the regressions. Furthermore, the current estimates could reflect unusual and temporary market conditions.

The best current estimate for BSkyB's equity beta is 0.85, the average of the estimates shown in Table 1. ***We would normally recommend a range of +/- approximately two standard deviations around this mid-point figure—ie, a range of 0.75–0.95 in this case. However, in light of the discussion above, we would also recommend further analysis before discounting the possibility that BSkyB's equity beta might lie outside this range.***"[61] (Emphasis added in each case.)

4.77 Ofcom simply ignores these points, which the Brattle Group takes considerable care to set out in detail. Ofcom does not refer to them at all, and states:

"*We estimate Sky's equity beta to be 0.85, based on a report we commissioned from the Brattle Group*".[62]

4.78 Once proper regard is given to the fact that both the IRR (see paragraph 4.27 above) and Ofcom's estimate of Sky's WACC are likely to lie within ranges, there is the possibility that the gap between Sky's actual rate of return and its cost of capital over the past five years is either smaller or greater than that on which Ofcom relies.

F. Oxera's comparator analyses

4.79 Oxera includes a distinct benchmarking analysis which compares Sky's returns against those of a number of other companies. Oxera's principal approach is to attempt to identify firms that might be considered to be relevant comparators to

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61 Pages 5-6 of 'Estimate of BSB's Equity Beta', Annex 10 of the Consultation Document.

62 Paragraph 2.41 of Annex 10 to the Consultation Document.

Sky. Oxera then compares a number of performance metrics (return on capital employed and return on sales) and valuation metrics (EV/total assets and EV/(OPEX + CAPEX) for Sky and the identified sets of comparators.[63] It does not compare performance based on a truncated IRR approach.

4.80 The principal and most obvious problem with this exercise is that the group of firms identified by Oxera as 'relevant comparators' to Sky are not in fact relevant as comparators. Although the process used by Oxera to determine its comparators has the outward appearance of being scientific, the output derived from that process is not fit for the purpose for which it is intended. The majority of the companies identified by Oxera are sufficiently different to Sky in at least some respects (and many are different to Sky in numerous respects) such that it is meaningless to compare the metrics identified by Oxera for these companies against those of Sky. For example, Oxera appears to believe that it is sensible to compare Sky's performance with that of companies such as:

- France Telecom (principally a telecommunications network operator);
- Vue Cinemas (a cinema chain operator);
- Tesco Mobile (a virtual mobile telephony business);
- GCap (a commercial radio business);
- Reed Elsevier (a book publisher);
- ITV (a mature, advertising funded public service broadcaster); and
- five (a loss-making, advertising funded public service broadcaster).

4.81 Sky commissioned PwC to conduct research and analysis to evaluate the selection of comparators used in Oxera's benchmarking of Sky's profitability against other businesses. PwC has prepared a substantial report[64] which demonstrates that no reliable conclusions can be drawn from Oxera's comparator analysis. It is perhaps instructive in this respect that Ofcom appears to place no weight at all on Oxera's comparator analysis. PwC concludes that none of the non-TV companies used by Oxera can be considered reliable comparators to Sky for the purpose of profitability benchmarking using the accounting ratios considered by Oxera for the period between 2003 and 2007. Of the 29 TV companies used by Oxera, PwC concludes that 26 can be considered unreliable comparators to Sky for the purposes of profitability benchmarking using the accounting ratios considered by Oxera for the period between 2003 and 2007. PwC concludes that the remaining 3 companies (Direct TV, Dish, Canal+) are potentially reliable comparators, but notes Direct and Canal should only be considered if certain adjustments were made to

63 Oxera also undertakes another type of comparator analysis which adopts an approach that was used by the Competition Commission in its Classified Directory Advertising Services market investigation. Although Oxera does not provide a great deal of explanation of this approach, it concludes: "Overall, this suggests that [Sky's] IRRs based on bottom-up analysis of replacement costs are not out of line with returns based on the analysis of comparators." (See page 31 of Oxera's Report). Ofcom fails to mention this analysis in the Consultation Document. In Sky's view this is another example of Ofcom's approach to evidence being skewed.

64 At **Annex 4** of this Response.

reported results and that Dish and Direct have specific features that mean that its "*comparability is limited*"[65]. In any event, PwC concludes that because there are only 3 companies that they consider to be potentially reliable comparators, the sample is too small and would be sensitive to specific characteristics or events that differ from Sky. Hence they conclude that Oxera's profitability benchmarking of Sky has extremely limited value.

4.82 PwC also find that the pattern and degree of variation in returns within the set of Oxera's TV comparators does not appear to differ from other randomly chosen sectors.[66] This suggests that to the extent that (for the five year period considered by Oxera) one or more companies earned higher returns than the average of the sector this should be considered normal and is not indicative of any competition problems.

4.83 A proper comparator analysis has an important role to play in determining whether Sky's profitability should be considered to be "*excessive*" or not. It is, however, appropriate to examine the distribution of firms' profitabilities, taking into account a wide range of firms and industries, in order to establish the range of returns that are observed in the market in an attempt to understand what might be considered 'excessive'. There is also value in identifying specific firms that are sufficiently similar to Sky (either to Sky as a whole or to a relevant part of Sky for which the return can reliably be assessed). These firms, however, must be selected with care in order to ensure that they are relevant comparators. Little if any insight can be gained from looking at an arbitrary set of firms that bear some slight similarity to Sky but are not sufficiently similar for an individual comparison to be informative and do not collectively form a large enough group to encompass the range of returns that can be expected in any sector.

G. Professor Grout's analysis suggests Sky's profitability is normal

4.84 Professor Grout undertakes an assessment of Sky's profitability based on shareholder returns and concludes that "*approaching Sky's profitability through this stock market evidence does not support a case that Sky is abnormally profitable.*"[67]

4.85 Ofcom notes that Oxera's IRR analysis is supported by other measures of profitability, including ROCE estimates. Professor Grout has also sought to establish whether Sky's ROCE, as estimated by Oxera, might be considered to be reasonable based on the results of previous Competition Commission investigations. Oxera estimates that Sky's ROCE over the last 5 years is 6% where assets are calculated based on market value, between **[CONFIDENTIAL]** % and **[CONFIDENTIAL]** % based on replacement cost and 29% based on book value.[68] Professor Grout's analysis indicates that, at the firm level, the average

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65 See page 175 and 183 of PwC Report at Annex 7 to this Response. For example PwC notes that neither company has wholesale operations comparable with Sky's.

66 See **Annex 4** to this Response.

67 Pages 4 and 28 of the Grout Report at **Annex 2** of this Response.

68 Page 29 of Oxera's Report at Annex 9 of the Consultation Document

ROCE based on book value looking across all inquiries was 37.3%[69] and was 43.6%[70] for inquiries where there was a finding against the public interest. Professor Grout concludes that:

> "*Certainly, whether correct or not, Oxera's estimate of Sky's ROCE based on book value of 26% for the period 1995 to 2008 and 29% for the shorter period 2004 to 2008 appear comparatively small when compared to the figures in any of the tables provided above.*"[71]

H. Conclusion

4.86 Ofcom regards Sky's aggregate profitability over the past five years as being "*high*" or "*excessive*" and suggests this is evidence of high retail prices. When looked at properly it is clear that there is no compelling evidence of high aggregate profitability and hence Ofcom's claims of high retail prices are unsustainable. Oxera's IRR estimate may not be reliable for a company such as Sky. Ofcom's estimate of Sky's WACC is likely to be subject to error. Even if these estimates were reliable, the conclusions which Ofcom draws are not appropriate. In particular, Ofcom entirely fails to assess whether the gap that it observes between Sky's IRR and WACC is the product of other factors such as successful innovation. Professor Grout has shown that shareholder returns are not excessive compared to other businesses. The clear weight of the evidence indicates that Sky's profitability is not high and certainly not at a level which is indicative of competition concerns.

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69 Table 4 at page 31 of the Grout Report at **Annex 2** of this Response.

70 Table 5 at page 32 of the Grout Report at **Annex 2** of this Response.

71 Page 33 of the Grout Report at **Annex 2** of this Response.

SECTION 5: ANALYSIS OF COMPETITION AT THE RETAIL LEVEL

A. Introduction

5.1 A major element of Ofcom's case is its belief that Sky has, and is acting, on an incentive not to supply its premium channels via platforms other than those on which they are currently available. Even if this proposition were established to an appropriate standard (which it is not), on its own such a withholding would not be sufficient to establish a case for intrusive and onerous new regulation. Ofcom would also need to establish that the withholding of Sky's channels satisfies the established competition law test for the circumstances in which a refusal to supply can cause competition concerns justifying intervention – namely that the refusal to supply: relates to a product or service indispensable for carrying on a particular business; excludes any effective competition on that market; prevents the appearance of a new product for which there is potential consumer demand; and is not objectively justifiable.[1] This would require a proper analysis of competition within the market in which the competition concerns are said to arise – namely the retail market.

5.2 Ofcom evidently does not accept such an approach since it fails to properly engage with established competition principles. But even if Ofcom were correct, that would still not relieve it of the need to carry out a robust and comprehensive analysis of competition at the retail level. Without such an analysis it is unable even to establish that the alleged conduct is having, or might be expected to have, "*a material impact on the competitive process*" (the test that Ofcom has previously used in relation to section 316 CA03[2]). Ofcom now belatedly formally accepts[3] the need to analyse competition at the retail level. But Ofcom has in reality lost sight of the purpose of such analysis. Its retail market definition is, in substance, no more than an addendum to an extensive (although deeply flawed) analysis of relevant markets and market power at the wholesale level. The result is that Ofcom's analysis of the retail level is both cursory and inchoate, and quite insufficient for the purpose of a proper competition analysis.

5.3 Sky has already commented extensively on Ofcom's analysis of market definition and market power at the wholesale level, and continues to rely on those submissions.[4] In light of this, and given that Ofcom's Consultation

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1 See **Section 3** of this Response.

2 Ofcom's statement on cross-promotion rules, paragraph 5.33. See further paragraph 3.7 of Section 3 of Sky's Response to the Second Consultation Document.

3 Having considered the issue of retail markets in its First Consultation Document, Ofcom argued in its Second Consultation Document that analysis at this level was unnecessary. Having realised this error (after numerous consultees pointed it out in their responses to the Second Consultation), rather than begin afresh and conduct a full analysis that addressed the evidence and arguments put forward in response to the First Consultation Document, Ofcom has merely added some brief analysis and conclusions about the scope of retail markets to its wholesale market analysis.

4 Sky does not consider that Ofcom has had proper regard to the arguments and evidence that it has presented, and Ofcom's analysis continues to be significantly deficient in numerous

Document raises a large number of other more significant issues, Sky has elected to prioritise dealing with those issues.

5.4 Similarly, given the time available for responding to Ofcom's Consultation Document, Sky has elected to focus only on the key points of Ofcom's analysis of competition at the retail level.[5] This is principally because, as Sky shows in **Section 6** of this Response, Ofcom's conclusion that Sky has an incentive and is acting on an incentive to withhold its premium channels from other platforms and/or retailers is without merit. As a result, the issue of the market in which the alleged action is said adversely to affect competition is of secondary importance from the point of view of Sky's Response.

5.5 For the reasons set out briefly below, Ofcom's analysis at the retail level is manifestly insufficient. It is cursory and directed at the wrong questions, and the evidence and analysis cited to support its counterintuitive conclusions are extremely weak. By contrast, there is a significant amount of compelling evidence available that supports propositions that (a) markets at the retail level are wider than those that Ofcom defines, and (b) competition at the retail level is robust. In these circumstances, even if Sky were to withhold its premium channels from other platforms and/or retailers, such a withholding would be unlikely to have a serious adverse effect on competition at the retail level.

B. Ofcom's analysis of competition at the retail level

5.6 Analysis of the current and prospective state of competition at the retail level is an indispensable element of Ofcom's case for intrusive new regulation because, if Ofcom's allegation about Sky's behaviour were correct (which it is not), that is the level at which the effect of such behaviour on competition would be felt. A standard market definition analysis, if undertaken properly and with due regard to its limitations, can be a valuable input into an investigation of the type that Ofcom needs to conduct because it encourages the examination of evidence relevant to this issue in a systematic way.

5.7 It is critical to bear in mind, however, that (a) market definition is a means to an end, and not an end in itself;[6] if sight is lost of this purpose, market definition

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respects. In particular, Ofcom's evidence and analysis are insufficient to support the conclusions that it draws. Sky reserves the right to make further submissions on these matters at a future point in time, should it prove appropriate to do so.

5 Again, Sky reserves the right to provide further submissions on this matter at a later date should it prove appropriate to do so (in addition to the further submission discussed below).

6 This is, for example indicated clearly in the European Commission's Notice on market definition, which states:

"*Market definition is a tool to identify and define the boundaries of competition between firms. It serves to establish the framework within which competition policy is applied by the Commission. The main purpose of market definition is to identify in a systematic way the competitive constraints that the undertakings involved face. The objective of defining a market in both its product and geographic dimension is to identify those actual competitors of the undertakings involved that are capable of constraining those undertakings' behaviour and of preventing them from behaving independently of effective competitive pressure.*"

can become a barrier to effective analysis of competition between firms, rather than a helpful input to that analysis, and (b) the standard framework of market definition analysis is difficult to apply in some circumstances, notably in cases in which, as in the provision of television services, competition through product differentiation plays an important role, and, as in this case, where the products and services being examined are complex.[7] Such issues do not call for the abandonment of standard market definition analysis. They do, however, generate a need for a careful analysis that considers a broad range of relevant evidence.

5.8 Ofcom's analysis fails in the first instance because it fails to recognise these points.

5.9 First, Ofcom's retail-level analysis is, as with its wholesale-level analysis, aimed at assessing whether any firms have market power. At the retail level, that is the wrong focus. At the retail level, the focus should instead be on seeking to identify in a systematic way the competitive constraints faced by retailers of a number of different types of pay TV services, namely (in this case) pay TV services that include premium sports and/or premium movie channels.

5.10 Second, Ofcom fails to have due regard to the difficulties in applying the standard market definition framework in this case. Ofcom's analysis is mechanical and maladroit.

5.11 Third, Ofcom's analysis also suffers from a large number of other flaws, which are discussed briefly below.

Ofcom's use of evidence in relation to its market definition analysis is deficient in numerous respects

5.12 Above all, Ofcom's use of evidence all it is not fair and balanced. It generally follows the inverted approach described elsewhere in the Consultation Document of testing Ofcom's conclusions against evidence.[8] Moreover, it is inept, and either ignores substantial amounts of robust evidence (including much evidence in past submissions by Sky) that points to the conclusions reached by Ofcom being erroneous,[9] or attempts to reject such evidence on the most spurious of grounds.[10]

(Paragraph 2 of the European Commission "*Notice on the definition of relevant market for the purposes of Community competition law*", OJ C372/97/5. Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y1209(01):EN:HTML)

7 On this point, see further paragraphs 1.50 to 1.51 of Annex 2 of Sky's Response to Ofcom's First Consultation Document.

8 See Paragraph 2.57 of the Consultation Document.

9 For example, the large quantity of Sky's internal documents which have been submitted to Ofcom and clearly demonstrate the range of competitive constraints on Sky's business. A selection of relevant quotes from these documents are included with this Response at **Appendix 1** to this Response.

10 A prime example of this is Ofcom's rejection of robust evidence on the viewing behaviour of consumers after they cancel subscriptions to movie channels on the basis that it is

5.13 Ofcom's use of evidence is unsystematic. By this Sky means that Ofcom does not follow a rational process of (a) determine the types of evidence that it should examine, (b) consider the best way of evaluating such evidence, and (c) then apply that framework in a consistent and rigorous manner. Instead, (a) the selection of evidence for consideration, (b) the framework for assessment of each piece of evidence and (c) the application of the approach chosen to assess each type of evidence in each instance, are all largely *ad hoc*.

5.14 Furthermore, a key issue with Ofcom's analysis of evidence is that it is unscientific in the sense that it does not establish proper benchmarks against which its hypotheses are to be tested. This means that consultees are left in the position that it is unclear what evidence, or types of evidence would ever be sufficient to overturn Ofcom's hypotheses. For example, Sky has presented evidence – which Ofcom appears to accept – that retail prices for pay TV services have been falling in real, value-adjusted terms.[11] Normally, such a finding would be taken to indicate the presence of a significant competitive constraint on firms' behaviour. Yet Ofcom rejects this observation on the basis that prices could be falling and yet markets still be narrow.

5.15 Ofcom claims that it has taken into account a wide range of evidence. This is exaggerated,[12] but in any case, the key problem is that this evidence is not selected or assessed systematically.

Ofcom's application of the standard market definition framework is deficient in numerous respects

5.16 Ofcom's analysis fails to have due regard to many standard matters dealt with in a market definition exercise. Among other things:

- it fails adequately to focus on the preferences of marginal consumers;

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counterintuitive that their total level of viewing increased after they cancelled their movies subscriptions. In the first instance, it is difficult to see (and Ofcom does not explain) what motivates its view that this is counterintuitive. Second, Ofcom cannot dismiss robust evidence simply because it believes that what the data shows is counterintuitive. The result emerges from reliable data, and is therefore itself reliable.

11 Sky has presented Ofcom with compelling evidence that retail prices have been flat or falling in real terms, while the quality of serviced delivered to consumers has increased significantly. This evidence was discussed at some length in Ofcom's Second Consultation Document. See Appendix 3 of Annex 6 to Ofcom's Second Consultation Document. The fact that this analysis is not even referred to in Ofcom's analysis of relevant markets at the retail level in the Consultation Document is yet another example of Ofcom's skewed approach to the use of evidence.

12 For example, in its table setting out the range of evidence it has considered (Figure 6 of the Consultation Document), Ofcom claims to have considered "*evidence on market outcomes for consumers*". As an example of such consideration – which, as discussed below, comprises valuable evidence in this case – Ofcom states only that its "*Assessment of market power relies on our broader assessment of consumer outcomes*". This wholly unspecific assertion provides no evidence that Ofcom has systematically considered the consistency of its conclusions in relation to market definition with "*evidence on market outcomes for consumers*".

- it fails to begin from an adequate description of the products supplied to consumers, and potential substitutes;[13] and

- it fails properly to consider competitive constraints on the focal products used in its analysis.[14]

5.17 Of its many failings, Ofcom's failure properly to address the issue of product differentiation is the most significant (and contributes to other errors). Recognition that application of standard market definition procedures in a mechanical way will produce false inferences in relation to competition among firms when product differentiation plays a central role, as in this case, is commonplace. In particular, it is commonly recognised that in such circumstances:

(a) it is especially important to focus on the aggregate constraint provided by all potential substitutes;[15]

(b) it is inappropriate to focus on differences in products' characteristics as delineating market boundaries;[16]

(c) it is likely to be simplistic to regard particular products as being "*in*" or "*out*" of the market;[17]

(d) it is important to focus on the underlying intended use served by differentiated products;[18] and

(e) while it is likely to be able to be determined that a particular product does not comprise a relevant market, it may be significantly more difficult to determine the scope of the market that is relevant to a particular product.[19]

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13 The importance of this first step in a market definition analysis is discussed in paragraphs 147 and 148 of the judgment of the Competition Commission Appeal Tribunal in Case No. 1005/1/1/01*Aberdeen Journals Limited v. Director General of Fair Trading* (*Aberdeen Journals*), 19 March 2002.

14 Ofcom tends to look for constraints on the "*premium element*" of pay TV services supplied to consumers. For example, Ofcom states: "*When assessing the constraints on premium sports channel retailers we consider the constraint on the premium element of the bundle* (paragraph 4.228 of the Consultation Document). Such an approach is erroneous. Analysis of competitive constraints should be based on the products that are actually supplied to consumers, not components of those products.

15 See, for example, paragraph 2.12 of Sky's submission "*Additional comments on Ofcom's analysis of market definition and market power in the pay TV review*", of 1 June 2009 ("**Sky's June Submission**").

16 Paragraph 2.13 of Sky's June Submission.

17 Paragraphs 4.8 to 4.11 of Sky's June Submission.

18 Paragraphs 6.12 to 6.14 of Sky's June Submission.

19 Paragraph 2.11 of Sky's June Submission.

5.18 Ofcom's analysis fails to recognise all these points. For example, Ofcom places a great deal of weight in its analysis on issues relating to differences among product characteristics that are largely subjective, in particular labelling of different products as "*close*" substitutes, "*moderate*" substitutes, "*out of market*" constraints and so on.[20] Similarly, Ofcom persists in undertaking analysis of the constraints faced by suppliers of particular products by the availability of other products on a pair-wise basis, particularly in relation to services that include premium movie channels,[21] despite Sky having pointed out the error in this approach on a number of previous occasions.[22]

5.19 In fact, Ofcom erroneously regards product differentiation as leading to weaker competition among firms in the provision of audiovisual services. Ofcom states:

> "*The existence of product differentiation will tend to dampen the strength of direct competition between retailers*".[23]

5.20 Such a proposition is simplistic in the extreme and out of line with mainstream thinking. Together with Ofcom's unsophisticated rejection of the relevance of models of monopolistic competition to analysis of competition in the audiovisual industry,[24] it indicates that Ofcom does not have a sound grasp of the underlying economics of competition in such markets, or how economic theory should be applied to real-world situations.[25]

5.21 A further significant failure is the failure properly to take into account the complexity of choices faced by consumers at the retail level – with regard to, for example, supplier, platform, hardware bundles and so on.[26] Ofcom argues that its analysis 'abstracts from' such complexities "*in order to provide a meaningful analysis of specific points*"[27]. It is clear, however, that an analysis that 'abstracts from' a wide range of factors relevant to the issue at hand may be tractable but it is unlikely to produce meaningful analysis. That is the case with regard to Ofcom's simplified framework of analysis.

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20 See, for example, paragraph 5.34 of the Consultation Document.

21 For example, Ofcom seeks to examine separately the constraint that the supply of products such as DVD sales, and DVD rentals place separately on the supply of services that include premium movie channels. The correct approach is to assess the *aggregate* constraint posed by all substitutes.

22 See, for example, paragraph 4.45 of Sky's June Submission.

23 Paragraph 3.52 of Annex 8 of the Consultation Document.

24 Paragraph 4.49 of the Consultation Document.

25 For example, one of the reasons given by Ofcom for dismissing the relevance of the model of monopolistic competition is that profits have not been driven to zero as required in textbook models. (See paragraph 4.49 of the Consultation Document.) Such an approach to the application of the insights of economic theory to real-world situations is unsophisticated.

26 This issue is discussed in part 6 of Sky's June Submission.

27 Paragraph 4.50 of the Consultation Document

C. Ofcom's conclusions

5.22 Ofcom concludes that there are two relevant retail markets for the purposes of its inquiry: "*retail supply of Sky Sports 1, Sky Sports 2 or Setanta Sports 1 as well as HD versions of these channels or TV packages that contain these channels*",[28] and "*retail supply of television bundles containing Core Premium Movie channels*".[29] Ofcom defines Core Premium Movie channels to be "*channels including movies in the first TV subscription window produced or licensed by the six major Hollywood studios*".[30]

5.23 Perhaps the most notable aspect of Ofcom's market definitions is their narrow focus on particular products – being defined around specific products supplied by particular broadcasters (Sky and Setanta), or including particular inputs (movies in a particular window produced by the six major Hollywood movie studios). It is very unusual for markets to be defined in such narrow terms; normally markets are defined in more generic terms.

5.24 In Ofcom's conception, the only competition faced by retailers of premium pay TV services is from other retailers of premium pay TV services. Ofcom takes the view that in their efforts to attract subscribers to their services, and retain them as subscribers, retailers of premium pay TV services face "*moderate*" "*out of market*"[31] competition from the BBC, ITV, Channel 4, five and a myriad of other smaller broadcasters. But such competition is, in Ofcom's conception, insufficient to act as an effective constraint on their behaviour.

5.25 Sky considers that this analysis is both counterintuitive and erroneous. In Sky's view, retailers of premium pay TV services, such as Sky and Virgin Media, face strong competition not only from each other, but also from the combined strength of the free to air broadcasters set out above[32].[33] They must seek to persuade consumers to take out a pay TV subscription in order to expand the choice of programmes available to them, over and above the vast range of high quality programming that is available for free, and provide consumers with sufficient reasons to continue to subscribe each month.

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28 Paragraph 4.252 of the Consultation Document.

29 Paragraph 4.410 of the Consultation Document.

30 *Ibid.* Ofcom considers Sky Movies Action & Thriller, Sky Movies Comedy, Sky Movies Drama, Sky Movies Family, Sky Movies Premiere, Sky Movies Premiere+1, Sky Movies SciFi & Horror, Sky Movies Screen 1, Sky Movies Screen 2, Sky Movies Modern Classics, Sky Movies Indie and Disney Cinemagic and the HD versions of these channels to meet this definition.

31 Paragraphs 5.33, 5.54 and 5.86 of the Consultation Document.

32 As Sky noted in its Response to Ofcom's First Consultation Document, because the services provided to consumers are free, the constraint that they impose on the suppliers of pay TV services arises from *the aggregate* of the programming they make available to consumers.

33 The quotations from Sky's internal documents set out at **Appendix 1** indicate clearly that Sky regards such services as significant competitive constraints on its ability to attract and retain subscribers.

5.26 Indeed, this would appear to accord with some views expressed by Ofcom in the Consultation Document. For example, Ofcom argues that:

> "*the key dynamics in recent years have been Sky, driving growth in pay TV, and Freeview, driving growth in free-to-air multi-channel TV*"[34]

and that Freeview:

> "*provided a credible free-to-air alternative for those consumers who wanted multi-channel TV but did not wish to pay for it*".[35]

5.27 Sky's Response to Ofcom's First Consultation Document described the high quality and growth over time of the programming available to UK households on a free to air basis.[36] The large majority of such programming is provided by a small number of broadcasters – the public service broadcasters – with the BBC dominating the free to air sector. The BBC is an extremely large and powerful broadcaster, with guaranteed funding of over £3.5 billion per annum. It spends over £2 billion a year on programming for its channels, the majority of which is acknowledged to be of an extremely high standard. Between them, the public service broadcasters spend over £3 billion per annum on creating and acquiring programmes for broadcast directly to consumers. It is wholly implausible to believe that the availability of these broadcasters' services comprises only a "*moderate*" constraint on the behaviour of firms whose businesses involve persuading consumers to subscribe to pay TV services.

5.28 In addition to this pervasive and increasing[37] competitive constraint, suppliers of pay TV services that include premium movie channels face strong and growing competition from a wide variety of alternative ways of watching movies.

5.29 By the time a movie is shown on Sky's movie channels, as well as having been shown in the cinema, it will have been available for sale on DVD in Tesco or via Amazon for close to a year – often at very low prices, frequently £5 or less by the time it is shown on Sky's movie channels – available for rental via a wide range of services for a few pounds per night,[38] and available via pay per view

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34 Paragraph 3.10 of the Consultation Document.

35 Paragraph 3.9 of the Consultation Document.

36 See paragraphs 3.17 to 3.24 of Annex 2 to Sky's Response to the First Consultation Document.

37 The constraint is increasing because (a) there has been a massive increase in the number of free to air television channels available to consumers over time (see Figure 1 of Annex 2 of Sky's Response to the First Consultation Document), (b) there is an increasing number of ways of accessing free to air broadcasters' programming (for example, Ofcom's Consultation Document refers, for example, to the "*remarkable success*" of the BBC's iPlayer (paragraph 10.45)), and (c) consumers are able easily to store programming on PVRs in order to build libraries of programming.

38 Ofcom's view is that Sky's channels provide access to a wide range of movies for a fixed monthly fee, without the inconvenience associated with movie rental. For marginal subscribers, however – for example, those subscribers who watch only one or two movies in the pay TV window a month – they may be only part of those subscribers' total movie viewing, and the benefits over and above other ways of viewing may be small.

and video on demand services. The movie will continue to be available for rental and purchase (often at a declining price) on DVD during and after the period it is able to be shown on Sky's movie channels – a 15 month period.

5.30 Moreover, only a relatively small proportion of movies shown on Sky's movie channels are 'Hollywood blockbusters' – Ofcom's analysis frequently gives the impression that this is all they ever show. Analysis provided to Ofcom by Sky in 2008[39] showed that in 2006/7 (the last year's data available at the time that the information was provided to Ofcom) only around [**CONFIDENTIAL**]% of films shown on Sky's premium channels fell into what might be regarded as the 'blockbuster' category. Around [**CONFIDENTIAL**]% of films were 'library' movies – *i.e.* movies from the window after the pay TV window. An enormous number of such movies are also broadcast on free to air and basic pay TV channels – during 2007 an average of 27 movies per day on the terrestrial channels and their digital sister channels alone.[40]

5.31 The situation in relation to services that include premium sports channels is less clear-cut. Premium sports channels are differentiated from other television channels on the basis that they broadcast live coverage of a range of sports events that cannot be viewed other than on those particular sports channels, and it is less likely to be the case that other types of programming (for example, drama) are good substitutes for watching live sports events, at least for infra-marginal customers.

5.32 Nevertheless it is necessary to bear in mind the facts that (a) in considering the demand-side constraints faced by suppliers, emphasis should be placed on the preferences of marginal consumers, and (b) there is in fact, in aggregate a very compelling and high quality portfolio of live sports available on free to air television and basic pay TV channels.[41] This can be combined with the possibility of watching live sporting events broadcast on pay TV channels, in pubs or with friends, to listen on the radio, to watch delayed 'as live' coverage from BT or football clubs' own channels and websites, or to watch highlights programmes.

5.33 This aggregate offering may not meet the demand of consumers who want to watch substantial amounts of live Premier League football on a weekly basis during the football season. But such consumers are unlikely to be 'marginal consumers'. It seems probable that marginal consumers are those who have a moderate interest in sport, and can be attracted to subscribe to a service that includes premium sports channels if it offers good value for money; otherwise

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39 Sky' Submission "*Analysis of the quality of films broadcast on Sky's movie channels: 2001/02 – 2006/07*", 19 August 2008.

40 See paragraph 3.78 of Annex 2 of Sky's Response to the First Consultation Document.

41 Sports events and competitions broadcast on free to air television include the Olympic Games, football's World Cup and European Championships, Champions League football, FA Cup matches, Wimbledon, the Grand National, the Derby, the Rugby World Cup, Six Nations rugby matches, UEFA Cup football, US Masters Golf, and Formula One motor racing. A wide range of sport is also available on basic pay TV channels such as Eurosport.

they are content to rely on the rich array of sports programming available to them for free to fulfil their demand for such programming.

5.34 It is also necessary to bear in mind that the supply of premium pay TV packages is likely to be constrained by basic pay TV packages.

5.35 Accordingly, in Sky's view the relevant market in which premium pay TV services are provided is at least the "*all-TV market*" (including VoD services) defined by the Competition Commission in its inquiry into the purchase by Sky of a 17.9% stake in ITV, with stronger constraints applying to the suppliers of services that include premium movie channels.

5.36 In essence, given that there are two competing hypotheses about the nature of competition at this level, the key question is straightforward, and is as follows: is the evidence available, considered objectively and in the round, more consistent with a view that (a) retailers of premium pay TV services in the UK compete principally with each other, or with a view that (b) they also face strong competition from the UK's powerful free to air television sector, as well as (in the case of the supply of premium pay TV movie services), a myriad of alternative ways of watching movies? In Sky's view, it is incontrovertible that the weight of available evidence supports the latter proposition.

Ofcom's reliance on past decisions as the starting point for its analysis

5.37 Throughout its inquiry Ofcom's analysis has been coloured strongly by a view that the appropriate starting point for analysis is the decisions of competition authorities in past cases that conclude that pay TV services are supplied in narrow markets – but disregarding, for example, the recent decision of the Competition Commission in relation to Sky's purchase of a stake in ITV, which takes a broader view.[42] In essence, and despite Ofcom's claims to the contrary, it has approached evidence and its analysis via this presumption – that markets should be considered to be narrow unless there is extremely compelling evidence to the contrary.

5.38 Such a starting point is both inappropriate[43] and counterintuitive, particularly in relation to pay TV services that include premium movie channels, and it is notable that those past decisions by competition authorities on this matter taking a narrow view tend to (a) come from countries in which the market circumstances are rather different from that of the UK, and/or (b) predate widespread take up of digital television services, the rapid rise in the number of free to air television channels that occurred in the UK after 2002, the ubiquity of DVDs, and the introduction of non-exclusive PPV and VoD services.[44]

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42 This is discussed further below.

43 The reasons for this were set out in Appendix 4 of Annex 2 to Sky's Response to Ofcom's First Consultation Document. In the context of market definition at the retail level, it is important to note that the OFTs 2002 Decision did not deal in any detail with this issue – its focus was on Sky's position at the wholesale level.

44 These points were discussed in detail in Appendix 4 to Annex 2 of Sky's Response to the First Consultation Document.

The evidence relied on by Ofcom does not support its conclusions in relation to the relevant markets that it has defined

5.39 A review of the bases for the conclusions that Ofcom has reached in relation to the scope of the other relevant markets at the retail level indicates that the evidence cited, and analysis conducted, by Ofcom is wholly unreliable and does not support those conclusions. Sky intends to submit a critique of that evidence and analysis shortly.

D. There is compelling evidence available that indicates that suppliers of premium pay TV services face significant competition from other firms at the retail level

5.40 There is a wide range of compelling evidence available, including much evidence provided by Sky in the past and effectively ignored by Ofcom, that indicates that suppliers of premium pay TV services face significant competition from other firms at the retail level.

5.41 In principle, such a proposition can be put in terms of relevant markets being wider than those that Ofcom has defined, but such an approach risks becoming weighed down by a sterile debate over somewhat esoteric analytical issues, which serve to distract from, rather than contribute to, addressing the relevant question in this case – namely the competitive constraints on suppliers of premium pay TV packages at the retail level, which a market definition exercise is normally intended to inform.

5.42 In the following sections, therefore, Sky cites briefly a range of evidence that indicates that suppliers of premium pay TV services face significant competition from suppliers of other services at the retail level. This is not intended to be comprehensive; it is intended simply to demonstrate the range of evidence available that indicates that Ofcom's conclusions are not sustainable.

Market outcomes

5.43 In a situation in which the question to be addressed is whether competition among firms operating at the retail level is strong it is both appropriate and informative to examine market outcomes. Markets in which competition is weak will tend to deliver very different outcomes from those in which competition is strong. Some of these differences are set out in **Table 5.1** below. Observation of outcomes that tend to be delivered by competitive markets therefore provides strong evidence that competition is strong.

Table 5.1

Typical market outcomes under strong and weak competition

	Weak competition	Strong competition
Pricing	High, restraining demand	Provides a reasonable return on investment and innovation, encourages high take-up of services
Product variety	Narrow	Wide
Consumer satisfaction	Low	Good
Innovation	Weak	Strong
Profitability	If costs are constrained, profitability will be high	Reasonable return on investment and innovation
Costs	Risk of X-inefficiency	Costs minimised

5.44 It is clear that, when judged against these types of criteria, the outcomes delivered by suppliers in the UK's audiovisual sector are far more consistent with a view that markets are competitive, than one in which there is a series of narrow markets in which a small number of suppliers have powerful positions.[45] Indeed, the types of market outcomes found by Ofcom in its First Consultation Document are significantly more in keeping with outcomes in the "*strong competition*" column than the "*weak competition*" column.

SSNIP research undertaken by Human Capital

5.45 In its market definition analysis, Ofcom has sought to apply the hypothetical monopolist test, either directly, or in the form of Critical Loss Analysis.

5.46 Ofcom dismissed the results of its first analysis, which was based on a consumer survey for two reasons, the first of which was that Ofcom considered that its consumer research was likely to suffer from what it called "*stated preference bias*", by which Ofcom meant a bias that arises when consumers are presented with questions about hypothetical situations. Rather than attempt to overcome such a bias in new research, Ofcom has been content subsequently to rely on citation of this bias as a reason for rejecting the reliability of that research.[46]

45 This point is discussed in more detail in **Section 8** of this Response and has been discussed at length in Sky's responses to the previous Consultation Documents.

46 Sky notes that Ofcom has not referred to any possible bias in the other research on which it relies (for example, Ofcom's research relating to the sports that consumers value or the results of Freeview's survey on consumers' willingness to pay for television channels delivered via DTT). Again, this indicates Ofcom's skewed approach to the use of evidence.

5.47 In order to undertake its Critical Loss Analysis Ofcom has used data from a survey undertaken for Sky by KAE in 2007. Ofcom fails to recognise, however, that this data also is not fit for the purpose which Ofcom attempts to use it.[47]

5.48 Accordingly, Sky commissioned Human Capital to undertake consumer research that might reliably be used to undertake analysis of the type intended by Ofcom – in particular, consumer research that is as free as possible from survey biases. Their report is attached at **Annex 5** to this Response.

5.49 The Human Capital report indicates that what is more conventionally known as "*hypothetical bias*" is a well-known potential consumer survey bias, and that there are several techniques that can be used that are effective in addressing it. Human Capital designed and implemented a sophisticated consumer survey, the results of which must be considered to be as free as possible from hypothetical bias (and other potential biases that potentially arise in consumer surveys). Their consumer survey was also designed to ensure that it meets the requirements of both industry standards for such analysis and criteria set out for the use of consumer survey evidence in analysis in court cases involving competition matters.

5.50 The results of their analysis are summarised in **Table 5.1** and **Table 5.2**. They find that both 5% and 10% increases in prices (which are the price increases conventionally tested in such analysis) for all products would generate significant consumer switching.

Table 5.2

Results of a 5% price increase

Focal product	(1) Continue current subscription	(2) Cancel pay TV subscription or move to platform where focal product is not available*	(3) Downgrade and move out of focal product group	(4) Change subscription but stay within focal product group	(5) Upgrade to top tier
Dual Sports	82.2%	8.6%	5.5%	3.4%	0.4%
Dual Movies	74.0%	8.4%	14.2%	3.4%	0.0%
Top Tier	78.1%	8.6%	10.8%	2.5%	
Dual Sports and Top Tier	77.7%	8.8%	6.7%	6.7%	
Dual Movies and Top Tier	76.4%	8.7%	10.6%	4.2%	

* In the case of dual sports, this includes BT Vision and Top Up TV; in the case of Dual Movies and Top Tier, it includes both those retailers and also Tiscali, since Dual Movies is not available on Tiscali's platform.

[47] Sky will set out the reasons for this in its forthcoming submission on the reasons that Ofcom's evidence and analysis do not support its conclusions on the scope of relevant retail markets.

Table 5.3

Results of a 10% price increase

Focal product	(1) Continue current subscription	(2) Cancel pay TV subscription or move to platform where focal product is not available	(3) Downgrade and move out of focal product group	(4) Change subscription but stay within focal product group	(5) Upgrade to top tier
Dual Sports	55.0%	22.4%	16.6%	4.7%	1.3%
Dual Movies	40.1%	23.7%	29.5%	6.7%	0.0%
Top Tier	54.5%	19.4%	20.5%	5.6%	
Dual Sports and Top Tier	54.1%	20.6%	13.4%	12.0%	
Dual Movies and Top Tier	50.9%	20.7%	19.7%	8.7%	

5.51 Sky does not have sufficient data on the variables required in order to use this data to replicate the Critical Loss Analysis which Ofcom undertook. Nevertheless, taken at face value the levels of switching that are observed in relation to the SSNIPs tested by Human Capital appear inconsistent with a view that markets are narrow.

5.52 Ofcom also considered that its earlier research was not reliable because it potentially suffered from issues concerning the Cellophane fallacy – the risk that consumers' reactions to price rises will be found to be too great (and therefore markets defined too widely) if prices are already above competitive levels.

5.53 Ofcom should not assume that the Cellophane fallacy is an issue in the absence of sound evidence that that is likely to be the case. This is consistent with, for example, the European Commission's guidelines on market analysis for electronic communications networks and services:

> "*…the working assumption will be that current prevailing prices are set at competitive levels… NRAs should proceed on the basis that the prevailing price levels form a reasonable basis from which to start the relevant analysis unless there is evidence that this is not in fact the case.*"[48]

More generally, where there is a concern about the Cellophane fallacy, as Sky explained in its earlier submission it made to Ofcom, it is important to develop "*an internally consistent analysis*",[49] based on examination of a range of

[48] 'Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services', 2002/C 165/03, paragraph 42.

[49] Paragraph 4.24 of Sky's June submission. The quotation is from Philip Nelson, "*Monopoly Power, Market Definition, and the Cellophane Fallacy*", presentation at US DOJ Antitrust Division

appropriate evidence. In other words, the Cellophane fallacy should be considered to be a problem where there are strong grounds for believing – based on consideration of other relevant evidence – that prices are likely to be above competitive levels. All the relevant available evidence points to this not being the case. In particular, as explained in **Section 4** of this Response, there is no evidence that Sky is earning excessive profits, which is a good indicator that prices are not above competitive levels.

Econometric research carried out by Professor Seabright

5.54 The econometric research carried out by Professor Seabright and his colleagues[50] provides strong and compelling evidence of the competitive constraint that the availability of free to air television places on the supply of pay TV services at the retail level. It is a sophisticated, thorough and high quality piece of analysis and Ofcom's own econometric expert, Professor Chesher, raised only minor issues with it.

5.55 Ofcom's rejection of that evidence, including, as indicated in the memorandum submitted by Professors Seabright and Magnac,[51] by misrepresenting the views of its own econometric expert, is particularly objectionable. Ofcom provides no good reason for not taking this study into account properly in its analysis. The principal reason why the study is dismissed so readily, and on such spurious grounds, by Ofcom appears to be that it does not accord with Ofcom's prior beliefs about the scope of relevant markets in this case. Sky discusses Ofcom's reasons for dismissing Professor Seabright's research further at **Annex 3**. It is demonstrated that Ofcom's reasons are without foundation.

The Competition Commission's Report into the purchase by Sky of a stake in ITV

5.56 The Competition Commission concluded that the relevant market for the purpose of its analysis of this transaction was a market for "*all-TV*", which includes VoD services. This is the relevant market in which the Competition Commission considered that pay TV services (including basic pay TV services and premium pay TV services) are provided at the retail level. The Competition Commission was so concerned about the prospects of competition in this market being diminished by Sky holding 17.9% of the ITV's shares that it concluded that Sky should be required to divest a significant part of that stake.

5.57 Ofcom has sought constantly during its inquiry to play down this finding – at first by arguing that the Competition Commission found that free to air and basic pay TV services – but not premium pay TV services – are in the same relevant market, which was not the case, and latterly citing a variety of

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public hearings on single firm conduct and antitrust law, March 2007. Available at: http://www.usdoj.gov/atr/public/hearings/single_firm/docs/222008.pdf.

[50] In order to ensure the Seabright and Magnac Report was prepared with the same degree of independence and integrity as an expert would prepare a report in connection with litigation proceedings, Sky's external legal advisers have engaged Professors Seabright and Magnac under the terms of the Civil Procedure Rules and the protocol for instruction of experts.

[51] **Annex 3** of this Response.

different, equally erroneous, reasons – for example that it is irrelevant to the current analysis because the Competition Commission was engaged in a merger inquiry.

5.58 Ofcom's reasons for rejecting this finding, however, are spurious. It was reached on the basis of a thorough analysis, free of preconceptions, in which considerable emphasis was placed on submissions from ITV and internal documents from Sky and other market participants examined by the CC.

5.59 For example, ITV's submission to the CC set out its view of competition at the retail level as follows:

> *"ITV considers that it is important to ensure that the precise dynamic of competition between ITV and BSkyB is captured within the "all TV" market. Specifically it is crucial to capture BSkyB's ability and incentive to affect ITV's conduct so as to alter the extent of competition between free-to-air platforms and the pay TV DTH platform. The effects of this conduct would be magnified by the nature of competition in this sector, which is characterised by both price competition and dynamic, innovation-based competition, as UK television markets move towards digital switchover."*[52]
>
> *"ITV's assessment is that BSkyB's response to increased competition from free-to-air channels and platforms (such as the analogue terrestrial and increasingly DTT) has been to expand the services that it offers its subscribers, via innovations such as: (a) Sky+; (b) Sky Multiroom; (c) Enhanced Electronic Programme Guide (EPG) functionality; (d) Sky Talk; (e) Sky Broadband; (f) Sky Anytime; and (g) Sky HD".*[53]
>
> *"BSkyB's competitive response to rivals 'catching up' has been to innovate further."*[54]
>
> *"ITV has interpreted these and other such changes to BSkyB's pricing policy as a competitive response to Freeview and the increasing attractiveness of the free-to-air digital television alternative to pay TV."*[55]

5.60 ITV's position in the inquiry was one of considerable hostility to Sky. While Sky disagreed with many of ITV's views and with the Competition Commission's conclusions in relation to the ability of Sky to affect competition through its stake in ITV, ITV's views on competition at the retail level are cogent and very much in accord with Sky's own experience and understanding of the market. They are not reflected at all in Ofcom's analysis or its conclusions.

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52 Paragraph 7.11 of "*ITV plc: Statement of case on competition issues*", 18 June 2007, submitted to the Competition Commission. Available at: http://www.competition-commission.org.uk/inquiries/ref2007/itv/pdf/main_party_submission_itv_competition.pdf.

53 *Ibid*, paragraph 7.20.

54 *Ibid*, paragraph 7.22.

55 *Ibid*, paragraph 7.39.

International comparisons

5.61 Sky has submitted two substantial reports prepared by PwC that compare pay TV services available to consumers in the UK to those available to consumers in other countries in Europe. These show clearly that the UK consumers are among the best served – in terms of quality, choice, value for money and delivery of new innovative services – in Europe. Such findings are wholly inconsistent with Ofcom's perspective on competition at the retail level. Yet Ofcom has constantly sought to dismiss or downplay PwC's findings – again, on grounds that Sky considers to be implausible.

Internal documents and public statements

5.62 Ofcom makes little use in its analysis of either internal documents or public statements by industry players about matters of direct relevance to their business, which are normally favoured as a source of evidence in analyses of competition among firms. Public statements that are required to be accompanied by declarations as to their truthfulness – such as firms' US securities filings – are particularly useful in this respect. In its Response to the First Consultation Document, Sky pointed out to Ofcom that in its SEC filings, Virgin Media states that:

> "*The level of competition is intense in each of the markets in which we compete, and we expect competition to increase....In the digital television market we compete primarily with BSkyB in providing digital pay television services. Competition increased as a result of the launch of Freeview in October 2002....*"[56]

Ofcom appears to have no regard to this submission.

5.63 Ofcom's almost total lack of reference to Sky's internal documents is a particularly glaring omission from its analysis. In May 2008 Ofcom requested that Sky provide it with internal documents which discuss "*the competitive challenge faced by Sky from: (a) multichannel free to air TV, (b) other pay TV providers and (c) other means by which consumers are able to watch films.*" Meeting this request was a considerable task, requiring a substantial document trawl to be undertaken. The internal Sky documents that were provided to Ofcom are replete with clear indications of the fact that Sky gives substantial and regular consideration to the competition posed by these services for Sky's business. Yet Ofcom does not even mention any of this evidence in its analysis.

5.64 Sky has provided in **[CONFIDENTIAL] Appendix 1** to this Response a representative sample of quotations from those internal documents. It is not only these particular quotations, but the tenor of the internal documents (which cover an extended period) taken as a whole, that provide good evidence that Sky acts on a belief that it faces strong competition from retailers of services that are outside the markets that Ofcom has defined.

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[56] Cited at paragraph 3.90 of Annex 2 to Sky's Response to Ofcom's First Consultation Document.

Evidence about the viewing behaviour of consumers who stop subscribing to packages containing premium movies channels

5.65 Services that include premium movie channels face strong competitive constraints both from the availability of movies from a wide variety of other sources, but also because a wide range of other programming fulfils the same intended use as movies – *i.e.* to provide 'in home' audiovisual entertainment.

5.66 Strong and compelling evidence of the substitutability of movies and other types of programming was provided in Sky's submission to Ofcom of June 2009. That submission presented an analysis of viewing of a group of households who removed Sky Movies from their subscription packages between April 2007 and March 2008, using Skyview data. Sky looked at their viewing in the year before downgrading, and the year after, and found that after downgrading:

- they watched more movies on other channels; and
- their total viewing remained in line with that of all Sky households.

5.67 This evidence clearly demonstrates that these households have transferred their viewing of premium movie channels to a mixture of movies and other programming.

5.68 Ofcom dismisses this evidence on the basis of a series of wholly spurious reasons.[57] For example, Ofcom argues that the finding that these households total viewing increased after cancelling their movies subscription is "*counter-intuitive*", which leads Ofcom "*to doubt the reliability of Sky's analysis*".[58] That is a surprising argument for a regulator which professes a desire to make evidence-based decisions to put forward. Without any attempt to examine the "*reliability of Sky's analysis*" – which is a straightforward presentation of reliable data – Ofcom chose to base its view on its own 'intuition' about what would be expected in such a situation.

E. Analysis of competition at the retail level: summary and conclusion

5.69 The purpose of assessing the nature and extent of retail-level competition in this case is to determine whether a refusal by Sky to supply its premium channels to other pay TV retailers and/or platforms would be capable of have a significant adverse effect on the competitive process in a relevant market. Ofcom considers that the markets that are relevant for the purposes of its inquiry are narrow ones – markets for the supply to consumers of pay TV services that include either premium sports channels, or premium movie channels. These conclusions, however, are both counterintuitive and are contradicted by a wide range of reliable and readily available evidence that should properly have been taken into account if Ofcom had approached the question of market definition and market power in an appropriate and competent fashion.

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57 Paragraph 4.319 of the Consultation Document.

58 *Ibid.*

SECTION 6: OFCOM'S COMPETITION CONCERNS: SKY HAS AN INCENTIVE TO DISTRIBUTE ITS CHANNELS WIDELY

A. Introduction

6.1 In **Section 6** of the Consultation Document, Ofcom identifies two "*competition issues*"[1] which it considers arise from Sky's alleged market power:

(a) Sky's "*strategic incentive to restrict wholesale supply of its [Core Premium] channels";*[2] and

(b) the "*high wholesale prices*"[3] Sky charges for those channels.

6.2 This **Section 6** focuses on the first of these concerns and shows that Sky is not, in fact, restricting the supply of its premium channels and that there is no evidence to suggest that it has an incentive to do so. Ofcom's second concern, relating to high wholesale prices, is addressed in **Section 7** below.

6.3 This **Section 6** therefore examines Sky's alleged incentive to restrict supply of its premium channels to other retailers.

(a) In Part B of this **Section 6** we show that Sky does have an incentive to supply its channels. Moreover, (i) Ofcom has failed to show that Sky has strong incentives (strategic or otherwise) to restrict the wholesale supply of its channels; and (ii) Ofcom has failed to conduct a balancing exercise to weigh Sky's purported strategic incentives against its recognised static incentives to supply. These failures fundamentally undermine Ofcom's analysis and the basis of its concerns.

(b) In Part C of this **Section 6** we show that Sky has not restricted supply of its channels and is not therefore acting on the alleged incentives to restrict supply.

6.4 As explained in **Section 3** above, given the nature of the concerns identified by Ofcom in the present case (Sky's alleged market power giving rise to concerns of withholding of supply and excessive wholesale pricing and/or margin squeeze), Ofcom should demonstrate that the established competition law tests for such abuses have been met, or that it is highly likely that they would be met, allowing for the *ex-ante* nature of its powers. As we explain in **Section 3**[4], notwithstanding its own internal thinking which confirms that it should adopt such an approach, Ofcom has not even attempted to meet the legal test in *IMS*

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1 Ofcom states that it has three "*concerns*", however, its third concern, namely lack of SVoD rights, is not dealt with by Ofcom in any detail in Section 6 of the Consultation Document. Rather, Ofcom deals with this "*concern*" in Section 12 of the Consultation Document. Sky addresses this "*concern*" in **Annex 6** of this Response.

2 Paragraph 6.94 of the Consultation Document.

3 Paragraph 6.3 of the Consultation Document.

4 Paragraphs 3.22 to 3.44 of **Section 3** of this Response.

Health vs. NDC Health that underpins whether the withholding of access to intellectual property gives rise to competition concerns warranting intervention.

6.5 Accordingly, Ofcom's case on alleged restriction of supply fails before even embarking upon a detailed examination of the underlying economic issues. Moreover, Ofcom cannot *even* satisfy to a sufficient standard of proof the test it previously formulated and applied in relation to section 316, namely, that it should demonstrate conduct having a 'material effect on the competitive process' has occurred or is more likely than not to occur.[5]

B. Sky has an incentive to distribute its channels widely

6.6 Sky has already made the point that it has a strong incentive to make its premium channels available across a variety of platforms.[6] Whilst Ofcom disputes this, its reasoning, and the specific nature of its erroneous claim, that Sky has an incentive to restrict the supply of its channels, have changed over the course of this investigation.

6.7 In its Second Consultation, Ofcom stated that Sky has "*the incentive to restrict the supply of its Core Premium channels to other retailers and other platforms.*"[7] Ofcom was incorrect and it appears that it has now accepted that Sky has "*short term*" or static incentives to supply its channels ("static incentives").

6.8 Ofcom has significantly moderated its previous allegation. Ofcom's current position is that "*Sky has a* ***strategic*** *incentive to restrict* ***wholesale*** *supply of its channels to other retailers*".[8]

6.9 As we explain below:

(a) From an economic perspective, Ofcom's views as to Sky's purported strategic incentives have no credible basis;

(b) Ofcom fails to quantify the effect of any alleged strategic incentive in order to assess whether it outweighs static incentives to supply;

(c) there is no evidentiary basis for such a claim in respect of either Virgin Media or new entrants; and

(d) to the extent that Sky has a preference to retail its channels via other platforms; that preference is legitimate and derives from Sky's motivation to maximise revenue from its premium channels and does not support Ofcom's alleged strategic incentive: if Sky could not retail then it would certainly consider wholesale supply.

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5 See paragraphs 3.1 to 3.16 of Section 3 of Sky's Response to the Second Consultation Document.

6 Section 5 of Sky's Response to the Second Consultation Document and in particular Parts 2(a) and 2(b).

7 Paragraphs 1.29 and 6.2 of the Second Consultation Document.

8 Paragraph 6.94 of the Consultation Document.

Ofcom's focus on strategic incentives

6.10 Ofcom's inclusion of the word "*strategic*" is significant. In the Second Consultation Document, Ofcom distinguished between (i) Sky's static incentives[9] and (ii) its purported long-term or strategic incentives ("strategic incentives")[10]. With regard to static incentives, Ofcom concluded that it would be profitable for Sky to withdraw supply of its premium channels from Virgin Media after seven or eight years[11] and that a decision by Sky not to supply its premium channels to new retailers would be likely to be profitable within a "*significantly shorter time period than is the case for Virgin Media*".[12] Ofcom also claimed that static analysis (namely, the vertical arithmetic exercise) does not capture all of the longer-term strategic incentives and accordingly the vertical arithmetic is likely to "*overstate* [Sky's]...*incentive to supply*".[13]

6.11 In summary, Ofcom's Second Consultation concluded, erroneously, that Sky has both the static and the strategic incentive to restrict the supply of its premium channels to third parties.

6.12 Ofcom has now departed from its previous conclusions. It now accepts that its previous analysis of static incentives (as reflected in the vertical arithmetic exercise) was flawed and that Sky does, in fact, have a static incentive to supply both Virgin Media and DTT retailers.[14] Ofcom states that it:

> "*agree*[s] *with Sky's reading of our Second Pay TV Consultation which showed that Sky would have a static incentive to wholesale to DTT retailers*...[and] *a positive commercial incentive to supply Virgin Media"*.[15]

6.13 This is a significant *volte-face* on Ofcom's part, which should materially affect Ofcom's conclusion as to Sky's overall incentives. But apparently it does not. Despite this crucial acceptance of Sky's static incentives, Ofcom nevertheless, and rather bizarrely, fails to amend in any way its conclusion as to Sky's overall incentives (or even re-assess its previous analysis).

6.14 Moreover, Ofcom's arguments in relation to Sky's purported strategic incentives do not involve appropriate dynamic mechanisms, in an economic sense. Whilst, in the Second Consultation, Ofcom appeared to acknowledge (as set out in the CRA paper submitted by Sky in response to the First Consultation Document[16]) the need to identify mechanisms which link short-run conduct with a long-term

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9 Paragraphs 6.55 and 6.69 of the Second Consultation Document.

10 Paragraph 6.95 of the Second Consultation Document.

11 Paragraphs 6.100 to 6.106 of the Second Consultation Document.

12 Paragraph 6.97 of the Second Consultation Document.

13 Paragraph 6.95 of the Second Consultation Document.

14 Paragraphs 6.58, 6.91, 6.98, 6.99 of the Consultation Document.

15 Paragraphs 6.58 and 6.97 of the Consultation Document.

16 CRA Paper entitled "*Ofcom's Consultation on the UK Pay TV Industry: Vertical Integration and Short-run/Long-run issues*", dated 4 April 2008.

ability to compete,[17] it fails, once again, to conduct any such analysis. It is illuminating and surprising that Ofcom does not in the Consultation Document make any reference to the further paper by CRA (submitted by Sky in its response to the Second Consultation Document),[18] which examines critically Ofcom's assessment of strategic effects and concludes that none of the strategic mechanisms identified by Ofcom stands up to closer economic scrutiny. Ofcom has not sought to rebut any of the points made by CRA and Sky considers that these points continue to stand. This is a further example of Ofcom's skewed approach to the treatment of evidence.

6.15 In any event, it is not sufficient for Ofcom to support its assertions by merely claiming that Sky has some strategic incentives not to supply. Rather, Ofcom would need to show that such strategic incentives are so strong as to outweigh Sky's static incentives to supply. But Ofcom fails to do this. Ofcom has presented no proper arguments or evidence that this is the case and it makes no attempt to assess the strength of the alleged strategic incentives.[19] Given that failure, Ofcom cannot conduct, and indeed does not conduct, the crucial balancing exercise between the acknowledged static incentives to supply and the purported strategic incentive to restrict supply. As such, Ofcom is not entitled to reach its overall conclusion as to Sky's incentives.

6.16 We now examine Ofcom's specific arguments regarding the alleged strategic incentives to restrict supply of Sky's premium channels to (i) Virgin Media; and (ii) new entrants.

Strategic incentives to supply Virgin Media

6.17 Ofcom accepts that the vertical arithmetic indicates that Sky does have a positive commercial incentive to supply its channels to Virgin Media.[20] However, it considers that two of the many thousands of Sky internal documents that have been provided to Ofcom during the course of this investigation suggest that Sky weighs static revenue considerations against a purported strategic incentive to weaken or eliminate Virgin Media as a competitor.[21] Neither of these documents provide evidence of such a proposition.

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17 "*We also agree with CRA that it is important to explain carefully the relevant dynamic effects and consider whether those effects are plausible, in light of the available evidence.*" Paragraph 2.30 of Annex 8 of the Second Consultation Document.

18 Annex 4 of Sky's Response to the Second Consultation Document.

19 Instead, Ofcom merely abstracts from the economic arguments and infers, because it believes that Sky is in fact restricting supply, that the strategic incentive must therefore be sufficient to outweigh the acknowledged static incentive for wide distribution. See paragraph 6.91 of the Consultation Document.

20 Paragraph 6.97 of the Consultation Document.

21 Neither document could, in any way, be said to constitute, demonstrate or even refer to Sky's strategic incentives to supply its channels on a wholesale basis.

6.18 One of these documents[22] relates to Sky 1 (which is a basic channel) and therefore is not relevant to Ofcom's analysis of premium channels. Moreover, that document does not refer to "*strategic incentives*". Rather, it relates to an exercise of balancing whatever is determined to be the static value of Sky 1's exclusive availability on Sky's DTH platform versus the revenue that Sky could achieve from making Sky 1 available to Virgin Media. In other words, Sky was undertaking precisely the vertical arithmetic exercise to determine the optimal approach to distribution of Sky 1.

6.19 The other is a draft document from 2003.[23] From the overall poor quality of the document, its lack of structure, repeated pages, spelling errors and repeated inclusion of terms such as "*blah*", it is clear that the document is very much in early draft form. In fact, the document was never circulated and was not shared with any of Sky's senior management. Moreover, two of the three quotes to which Ofcom refers relate to the static incentives that would be reflected in the vertical arithmetic (*i.e.* they consider the static trade-off between higher wholesale revenues and lower retail revenues). In relation to the third quote, Ofcom appears to have automatically assumed that the reference to cable being weak and "*the opportunity to finish them off*" relates to Sky's wholesale strategy, when no such link is made in the document.

6.20 The document is not limited to a discussion of Sky's wholesale strategy, but is much broader and considers all the means by which cable and Sky interact, including in intensity of competition in the retail market. Reading the third quote in context, it is clear that the correct interpretation of the document is that it draws a link between cable's weakness and Sky's retail strategy, thus suggesting that Sky should compete very aggressively **at the retail level** to capitalise on cable weakness, and not that Sky should somehow modify its wholesale strategy, which has been (and continues to be) to supply its premium channels to cable.

6.21 Moreover, the principal point is that it is wholly illegitimate for Ofcom to infer that the document somehow captures Sky's wholesale strategy. This is a clear example of a skewed approach to evidence. Ofcom seeks material to support its own hypotheses and seems prepared to allow a single statement in a flimsy draft document to outweigh much more important and incontrovertible evidence. As Ofcom is aware, Sky's actual behaviour at the time this document was drafted (and its subsequent behaviour) is quite inconsistent with such inference. Sky devoted significant resources to, and was in extensive negotiations with, the then major cable operators (ntl and Telewest), to try to conclude agreements for discount schemes in order to increase the number of premium cable subscribers.

6.22 Over the course of the second half of 2003, Sky and Telewest negotiated the terms of a wholesale supply agreement in respect of Sky's sports and movies

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[22] A memo to Dawn Airey (the then Managing Director of Sky Networks), of a meeting with James Murdoch (the then Chief Executive of BSkyB) in August 2006.

[23] Described by Ofcom as a "*draft slide pack from Sky – which dates back to 2003.*" Paragraph 6.104 of the Consultation Document.

channels.[24] The agreement was intended further to incentivise Telewest actively to market Sky's premium channels to Telewest's residential subscribers, *inter alia,* by introducing a modified wholesale pricing structure which rewarded any uplift in the sales of Sky's channels with reductions in Sky's ratecard prices (*i.e.* which attempted to overcome the principal-agent problem which Ofcom itself recognises). By the end of 2003, Sky declared itself to have no further comments on the wording of the draft agreement. At around the same time, Telewest led Sky to believe that it too had reached the stage where final sign-off was imminent. Ultimately, Telewest declined to enter into the agreement due to an unspecified concern. Sky believes that Telewest's change of heart was connected with the restructuring process in which Telewest was involved at the time. Irrespective of the lack of agreement, Sky had reached the point at which it was prepared to agree in principle a discount structure for Telewest (subject to regulatory comfort being given). This is hardly the response of a company adopting a wholesale strategy designed to "*finish off*" cable through withholding wholesale supply.

6.23 Similarly, with regard to ntl, in July 2004, Sky and ntl agreed a non-binding term sheet for a proposed new agreement governing ntl's distribution of Sky's premium channels via its cable network.[25] The proposed agreement would have offered ntl deductions from the wholesale fees payable in respect of residential subscribers to Sky's main premium channels at the time (Sky Movies 1, Sky Movies 2, Sky Sports 1 and Sky Sports 2) in return for uplifts in ntl's sales of those channels over a specified threshold and a commitment from ntl to carry Sky's premium channels throughout the term of the agreement. Having agreed the non-binding term sheet, and in light of the lack of clarity in the OFT's 2002 Decision with respect to Sky's ability confidently to enter into longer-term wholesale agreements, Sky sought guidance from Ofcom as to whether the proposed agreement with ntl would be consistent with the Competition Act 1998. Ultimately, Ofcom did not provide Sky with the legal comfort it needed and Sky concluded that it would not be prudent to enter into the proposed agreement with ntl and risk subsequent censure. Again, the fact that agreement with ntl was reached indicates clearly that the objective of Sky's wholesale strategy was not to "*finish off*" cable through withholding wholesale supply.[26]

6.24 Moreover, on 30 September 2003 and 1 October 2003 (i.e. around the time the "*blah*" document was drafted), Sky offered its linear TV channel Sky Sports Xtra to ntl and Telewest respectively on a wholesale basis. In October 2003, Sky

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24 A copy of the final version of the proposed Sky and Telewest agreement is included at **Appendix 2**.

25 A copy of the non-binding term sheet between Sky and ntl is included at **Appendix 2**.

26 Sky also entered into an agreement with ntl on 6 September 2000 which included provisions to further incentivise ntl to market Sky's premium channel to ntl's residential customers, by offering a discount scheme where there was an uplift in sales. A copy of this agreement is included at **Appendix 2.**

reached agreement with both ntl and Telewest and the channel was launched on both cable platforms that month.[27]

6.25 Sky's actual actions, both in trying to agree a discount structure with ntl and Telewest, and also in providing an additional Sky Sports branded channel to both cable companies, are clearly inconsistent with Ofcom's suggestion that Sky was seeking to restrict supply of its premium channels in order to finish cable off.

6.26 Moreover, it is not even clear how Sky could finish cable off by altering its wholesale strategy. The suggestion being made is that, as a result of Sky's wholesale pricing, a significant number of Virgin Media customers take Virgin Media's basic-only service because Virgin Media does not encourage them also to take Sky's premium channels. It is not clear how this would materially weaken Virgin Media.[28] In particular, as we indicated in our Response to the Second Consultation Document, it is not plausible to suggest that Virgin Media is weakened or harmed because its basic-only subscribers, who could have elected to take premium channels from Virgin Media, are somehow more likely to switch to Sky's DTH platform. We note that Ofcom has not responded to this point.[29]

6.27 In summary, Ofcom has presented no credible theory or evidence that Sky has a strategic incentive not to supply Virgin Media and it turns a blind eye to the clear evidence of Sky's preparedness to supply its corporate predecessors. Further to this, Ofcom has not provided any evidence to outweigh the very strong and positive results of the vertical arithmetic which show a strong static incentive to supply. Accordingly, Ofcom has no basis on which to suggest that (absent the constraints imposed by competition law) Sky's incentives would lead it to withdraw supply from Virgin Media.

Strategic incentives to supply new entrants

6.28 We note that Ofcom's discussion of strategic incentives with regard to the supply to new entrants appears implicitly to accept that several of its previous arguments on strategic incentives were flawed. Previously, in respect of supply to new competitors, Ofcom's position in summary was that there were three dynamic mechanisms. In the Consultation Document, Ofcom refers only to one of the three dynamic mechanisms, namely the alleged incentives to restrict

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27 Telewest's press release for the launch of Sky Sports Xtra may be found at the following link: http://investors.virginmedia.com/phoenix.zhtml?c=205406&p=irol-newsArticle_print&ID=934284&highlight=. ntl's press release for the launch of Sky Sports Xtra may be found at the following link: http://investors.virginmedia.com/phoenix.zhtml?c=205406&p=irol-newsArticle&ID=934616&highlight=

28 In fact, as we indicated in our previous submission, the declining penetration of Sky's premium channels on Virgin Media's network would instead result in an unambiguous loss for Sky. The fact that there are many customers of Virgin Media who have chosen not to take Sky's premium channels does Sky no good at all. See, for example, paragraphs 2.6(b), 2.11 and 2.20 to 2.28 of Section 5 of the Second Response to the Consultation Document.

29 See paragraph 2.28 of Section 5 of Sky's Response to the Second Consultation Document.

supply in order to prevent rival retailers from bidding against Sky for content rights.[30]

6.29 Sky has already explained to Ofcom that restricted supply would in fact be likely to have the opposite impact, namely to increase incentives to bid for content, and conversely that rival retailers with guaranteed access to Sky's premium channels, particularly at the very low prices suggested by Ofcom, would have a lower incentive to bid for content rights.[31] The same point has been made by a significant rights owner.[32] Indeed, the internal Sky document to which Ofcom refers[33] (namely, the "*blah*" document) as providing evidence that Sky weighs up static revenue considerations against strategic considerations provides no support for Ofcom's view that Sky might restrict supply in order to reduce competition for rights. Rather, the document actually, and clearly, supports the reverse line of reasoning. Namely, that conferring long-term security of supply on other platforms would reduce the likelihood that rival platform owners would feel the need to bid for rights upstream. In a recent conference call with investors, Neil Berkett (CEO of Virgin Media) made this very point:

> "*Given our recent success* [in terms of the Pay TV investigation] *our decision to focus our attention and resources on the regulatory debate rather than competing head-on and acquiring premium content is proving to be the right one.*"[34]

6.30 Whilst Ofcom accepts that this line of reasoning (that giving rival retailers such as Virgin Media long-term security of supply would reduce the likelihood of Virgin Media acquiring upstream rights[35]) may have some merit, it nevertheless continues to assert that it would not be enough to give Sky an incentive to supply its channels to new entrants.[36] Ofcom suggests that by withholding supply from a new entrant, Sky would prevent such a new entrant from becoming established and "*it is unlikely that a completely new entrant would be in a position to challenge Sky in bidding for content.*"[37] This is clearly utter nonsense. Sky has faced considerable competition for sports rights in the last several years from, for example, Setanta and ESPN, both of which were (on the basis of Ofcom's market definition) new entrants and both of which, when they entered, had no established subscriber base of any kind (and neither are platform operators). Indeed, Ofcom itself acknowledges that some of the

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30 Paragraph 6.60 of Section 6 of the Consultation Document.

31 See paragraph 4.15 of Annex 7 to Sky's Response to the Second Consultation Document.

32 See the response of the Football Association Premier League to the Second Consultation Document, paragraphs 1.10 to 1.12, 3.13 and 9.14 to 9.22.

33 Paragraph 6.63 of the Consultation Document.

34 Virgin Media Q2 2009 Earning Release Conference Call (August 2009). http://www.thomson-webcast.net/uk/dispatching/?event_id=9da72dba9d88aa5de41e7d8939481305&portal_id=ff0878c2f32d7333f51123455ef8759d

35 Paragraph 6.63 of the Consultation Document.

36 Paragraph 6.63 of the Consultation Document.

37 Paragraph 6.63 of the Consultation Document.

strongest competitors are non-integrated, *i.e.* are bidders that have no retail or platform subscriber base.[38]

6.31 In its conclusion on strategic incentives, although Ofcom still maintains its view that a large existing subscriber base may provide some advantage in bidding for rights, it acknowledges that it is only "*one of a number of factors that influence the ability and incentive for a firm to compete aggressively for rights, and perhaps not the most important of these factors.*"[39] Given this conclusion, and in light of the strong static incentives to supply, it would appear that, on a proper reading, even Ofcom's own analysis shows that Sky does indeed have an incentive to supply its channels to new platforms. Accordingly, it would seem that Ofcom's allegation about Sky's disincentive to supply is now much narrower and is instead merely that Sky has an incentive to withhold its channels from third party platforms, unless they agree to a retail deal. We discuss this much narrower allegation in the following paragraphs.

Sky's preference for retailing its premium channels

6.32 As Sky has informed Ofcom on numerous occasions,[40] whilst Sky has an incentive to distribute its channels widely, it has a strong preference to retail its channels itself. Sky's preference stems from its almost 20 years of experience with cable, where its premium channels achieve a considerably lower penetration rate than where Sky is the retailer. We reiterate below, briefly, the factors that contribute to Sky's relative success in retailing its premium packages (and cable's poor performance in that activity):

(a) Sky has proven marketing expertise in communicating the value of its premium channels and, more generally, know-how and expertise in marketing television services is one of its core strengths. Cable and the IPTV providers' core strengths, on the other hand, tend to lie in different areas, in particular in the sale of telephony and broadband;

(b) third party retailers do not have the same incentives as Sky to market Sky's channels, as Ofcom itself acknowledged in its Second Consultation Document, where it stated that "*a vertically separate retailer has a diminished incentive to attract additional subscribers by engaging in marketing/advertising or by dropping retail prices (this latter effect is known as a 'double marginalisation'). In contrast, the incentives of a vertically integrated firm's retail and wholesale arms are likely to be better aligned.*"[41];

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38 Paragraph 6.63 of the Consultation Document.

39 Paragraph 6.64 of the Consultation Document.

40 See for example, paragraphs 4.16 to 4.22 of Part D of Sky's Response to the Complaint, Section 10 of Sky's Response to the First Consultation Document and Section 5 of Sky's Response to the Second Consultation Document.

41 Paragraph 5.61 of the Second Consultation Document. Ofcom also refers to "*double marginalisation*" at paragraph 3.54 of the Consultation Document.

(c) Sky believes the reasons for cable's poor performance in selling Sky's premium channels to date are exacerbated by the fact that it generates very high margins in other products, *e.g.* telephony and broadband, and is therefore incentivised to focus on these products. Because cable and IPTV operators have largely fixed costs for broadband and telephony, marginal costs are low and so margins on sales are high, so they will always prefer to sell these products rather than a pay TV service, for which they will face a variable cost. This is the exact reverse of the position for Sky in respect of pay TV;

(d) with respect to movie channels in particular, Sky observes that another retailer will prefer to market its own pay-per-view services or VoD services in preference to Sky's movie channels. As regards sports channels, Sky would be vulnerable to a contract between the retailer and a competing sports channel supplier conferring on the retailer a preference to market the competing channel; and

(e) Sky also believes that, if a customer who is taking Sky's channels calls to cancel their subscription, a third party retailer's incentive is to focus on making sure that customer is retained as a connected customer of some kind, perhaps just for basic TV and/or telecommunications services, and that the subscription to Sky's channels would be sacrificed if necessary to secure that objective (this is a function of the fixed versus variable costs issue set out in (c) above). Sky has greater incentives than third party retailers to persuade the customer to retain their subscription to a Sky channel, and greater experience of doing so successfully.

6.33 As is clear from the above, there is an obvious and justified commercial rationale for Sky's preference to retail its premium channels itself, wherever possible, and this rationale is motivated by maximising revenue from Sky's premium channels and is not based on any strategic incentive regarding the relative strength of rival retailers. We also note that, in respect of the largest platform, and the only platform where it had the regulated right to do so (namely, Sky's DTH satellite platform), Setanta also opted to retail its channels directly to customers. In addition, Setanta chose to retail its channels on TUTV's platform and thus made itself available on a retail basis over DTT technology. Therefore, Sky's preference to retail its channels is not unique in the UK.[42]

6.34 Ofcom has not commented on Sky's reasons for wanting to retail its channels, nor has it taken the time to argue that they are not valid.[43] Instead, Ofcom suggests that Sky has a strategic incentive to supply rival platforms only on retail terms.[44] Although this now appears to be an important part of Ofcom's case, it devotes only two paragraphs out of over 350 pages to this point, each of

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42 Further examples of companies self-retailing their channels outside of the UK are set in paragraph 6.130 of this **Section 6**.

43 Ofcom's limited objections in paragraph 6.85 of the Consultation Document do not engage with the question of the validity of Sky's rationale for preferring to self-retail.

44 Paragraph 6.65 of the Consultation Document.

which is highly confused and very difficult to follow.[45] We believe that what Ofcom is now trying to say is that Sky's incentives are to supply third parties only on a retail basis and not to supply on a wholesale basis.[46] It suggests that by supplying on a retail basis, Sky secures the benefits of broad distribution of its channels but is able also to secure the purported strategic benefits of not supplying rival retailers that Ofcom identifies. It also suggests that Sky's preference for retailing is an absolute preference and that Sky's motivation for retailing is an alleged strategic incentive not to supply rival retailers and not, as Sky has explained, simply to maximise revenue from premium channels.

6.35 Sky would clearly agree that by retailing its channels over multiple platforms (or indeed wholesaling them) Sky earns incremental revenues and profits. Ofcom also suggests, however, that Sky has certain longer term or strategic incentives which are so strong that they mean that, if the option of retailing directly on a new platform were not available, then Sky would have an incentive not to make its channels available to that platform at all.[47] This is a leap of logic which cannot be sustained. If retailing were not possible, why would Sky not consider a wholesale arrangement? Ofcom provides no convincing answer to this question.

6.36 Ofcom refers to two alleged strategic benefits (1) "*the ability to manage competition between retailers on different platforms, in order to protect the position of Sky's own satellite platform.*"[48] and, (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.*"[49] No significant further detail is offered by Ofcom.

6.37 With respect to the first of these alleged strategic incentives, it is difficult to understand what point Ofcom is making, and in any event it makes no reference to dynamic mechanisms in an economic sense. Whilst Ofcom refers to managing competition in order to "*protect the position of Sky's own satellite platform*" no explanation is given as to why this would be of strategic benefit to Sky or how this would increase Sky's profits in the long term. Sky's reading of the first of the alleged strategic incentives is that it is not strategic, and instead refers to the vertical arithmetic exercise.

6.38 The purpose of the vertical arithmetic analysis is to help to determine the effect upon Sky's incentives to supply its channels by measuring the difference between the margin that Sky would generate from supplying its channels to only its DTH satellite customers versus the margin that may be earned from a wholesale relationship (or even a retail deal). Ofcom agrees that, notwithstanding the fact that Sky earns a lower return on wholesale (or other retail customers) than from its DTH satellite customers, it nevertheless has an

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45 Paragraphs 6.65 and 6.66 of the Consultation Document.

46 Paragraphs 6.65 to 6.67 of the Consultation Document.

47 Paragraph 6.90 of the Consultation Document.

48 Paragraph 6.66 of the Consultation Document.

49 Paragraph 6.66 of the Consultation Document.

incentive to supply.[50] To the extent that Ofcom is trying to make a point that relates to strategic rather than static incentives, it is not clear and it is certainly not properly made out.

6.39 The second of the alleged strategic incentives, namely that Ofcom considers that it is in Sky's interest to keep its retail competitors weak, in part to strengthen Sky's position in bidding for content rights, is the same point as we discussed above in relation to the alleged strategic incentive to withhold supply from new entrants (see paragraphs 6.28 to 6.31 of this **Section 6)**. As set out above, all the evidence suggests that wholesaling Sky's premium channels, particularly at the wholesale prices proposed by Ofcom, is likely to have the opposite effect and make all rival retailers – established or new - less likely to compete with Sky for rights. In particular, the benefit in terms of bidding for rights of having a retail subscriber base is downplayed by Ofcom in an immediately preceding paragraph. At paragraph 6.64, Ofcom states that the relative size of a bidder's existing subscriber base is unlikely to be the "*most important*" factor in determining the ability and incentive for a firm to compete aggressively for rights (and thereby, by implication to determine the outcome of a bid for rights). Having stated this, Ofcom cannot then rely upon this factor as being important to support its critical assertion that Sky has an incentive to retail and not to wholesale.

6.40 In summary, neither of these alleged strategic incentives **to retail and not wholesale** has any basis. Moreover, even if they had some merit (which they do not) Ofcom has not shown that these alleged strategic benefits are so material that it would make sense for Sky to supply rival platforms on a retail basis only and not to supply on a wholesale basis even where retail supply was not possible.

C. Sky is not acting on the alleged incentives nor has it restricted supply

6.41 Having demonstrated in Part B of this **Section 6** that Sky does not have a theoretical incentive to restrict the supply of its channels, this Part C examines Sky's efforts to make its channels available via different distribution technologies. This Part C shows that Sky has not restricted supply of its channels and is not therefore acting on the alleged incentives to restrict supply.

6.42 This Part C examines the following factors with regard to new entrants, (a) Sky's channels are widely available; (b) Sky made considerable efforts to make its premium channels available on DTT; (c) Sky has offered to retail its channels on all other platforms that have approached it; (d) Ofcom is inappropriately partial in its view that Sky should concede its preference to retail in favour of a third party's preference for wholesale supply; (e) Ofcom's focus on premium channels fails to acknowledge the inter-related regulatory issues of platform

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[50] See, for example, paragraph 6.58 of the Consultation Document. Indeed, this result should not be surprising to Ofcom. Ofcom's hypothesis is that Sky's retail margin is so low that new entrant retailers cannot compete based on Sky's retail margins. If Sky's retail margin is low then the margin it would generate from supplying its channels to its DTH satellite customers versus the margin it would earn from a wholesale relationship should not be significantly different.

access; and (f) Sky has offered wholesale deals. This Part C then examines the following factors with regard to Virgin Media, (a) the wholesale price charged to Virgin Media is not evidence of an incentive to withhold; and (b) the fact that Sky's HD channels are not yet available on Virgin Media's platform is not evidence of a broad incentive to withhold.

(i) New entrants – Sky is not acting on alleged incentives to restrict supply

(a) <u>Sky's channels are widely available</u>

6.43 As Ofcom is aware, Sky's premium channels are available over a number of different platforms other than DTH. As **Table 6.1** below shows, Sky's premium channels are available on all material UK cable networks,[51] the only IPTV platform in the UK capable of delivering linear TV channels, the internet, four out of five of the 3G mobile phone networks[52] and Sky's DTH platform.[53] The table also shows the availability of Setanta's channels prior to its going into administration. What is clear from the table is that Sky's channels are available on a number of platforms that Setanta's were not.[54] In the case of the one distribution technology via which Sky's channels are not available – DTT – Sky has made considerable efforts and invested significant amounts of time and money in order to try to make its channels available on DTT (such efforts are discussed below). Sky also considers that the table below is a better representation of the comparative availability of Sky's and Setanta's channels than Figures 49 and 50 of the Consultation Document, which Sky considers to be misleading:

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51 Material cable operators include Virgin Media, Smallworld and Wight Cable.

52 Vodafone, Orange, T-Mobile and 3.

53 Sky's premium channels will also be available on [**CONFIDENTIAL**] the Xbox 360 [**CONFIDENTIAL**] in the near-future. [**CONFIDENTIAL**].

54 Sky is not implying that Setanta had an ulterior motive in not making its channels available on the same platforms on which Sky's channels are available. Rather, the then unavailability of Setanta's channels on a number of platforms is an example of where commercial terms could not be agreed between a broadcaster (Setanta) and a particular platform operator. ITV's channel "ITV HD" is another example of this. ITV HD is available on the BBC/ITV Freesat platform but is not available from within the EPG on Sky's DTH platform. Ofcom jumps to the wrong conclusion in assuming that the unavailability of Sky's channels on a platform is due to the application of strategic incentives.

Table 6.1

Availability of Sky and Setanta channels over different platforms

(prior to Setanta going into administration in June 2009)

Platform operator	Virgin media	WIGHT CABLE	SMALLWORLD	sky		topup tv		BT	tiscali.		e		T-Mobile	orange		vodafone	3
Platform technology	**Cable**	**Cable**	**Cable**	**DTH Satellite**		**DTT**		**DTT/IPTV**[1]	**IPTV**		**Internet (to PC / Mac)**		**3G mobile**	**3G mobile**		**3G mobile**	**3G mobile**
Retailer	Virgin media	WIGHT CABLE	SMALLWORLD	sky	SETANTA SPORTS	topup tv	SETANTA SPORTS	BT	sky	tiscali.	sky	SETANTA SPORTS	sky[3]	sky	[2]	sky[3]	sky[3]
SETANTA SPORTS	●	●	●		●	●	●	●		●		●			●		
SKY SPORTS	●	●	●	●					●		●		●	●		●	●
SKY movies	●	●	●	●					●		●						

1. DTT is used to deliver linear channels, not the IPTV network. BT's IPTV network is not currently capable of delivering linear channels.
2. Setanta's arrangements with Orange are unknown to Sky.
3. Associated bundled data pack retailed by network operator.

(b) *Sky made considerable efforts to make its premium channels available on DTT*

6.44 Sky exerted very considerable effort, and put very considerable resources into, trying to make its premium channels available via DTT.[55]

6.45 In April 2007, Sky and NGW applied to Ofcom to vary their respective DPS and Multiplex licences to reflect a proposed change in the line up on DTT Multiplex C – from three free to air channels to five pay TV channels, including Sky Sports 1 and Sky Movies 1, under the brand name Picnic. Ofcom has still not approved the application. Had the application been approved, this would have not only allowed Picnic to launch, but, subject to satisfactory resolution of security issues (which are discussed in paragraphs 6.95 to 6.101), it would have introduced the potential to wholesale to other DTT retailers, perhaps by means of simulcrypt.

6.46 Sky has invested considerable effort and man-hours in trying to bring its Picnic service, and thus to bring some of Sky's premium channels, to DTT. Sky also made a very substantial financial investment in Picnic. Over the past three years, Sky has spent [**CONFIDENTIAL**] on capital assets and [**CONFIDENTIAL**] on operational costs in connection with Picnic. Despite such efforts, Sky has not been able to launch Picnic due to Ofcom's refusal to amend Sky's (and NGW's) licences. It should be clear that the main barrier to Sky's premium channels being available on DTT was Ofcom.

(c) *Sky has offered to retail its channels on all other platforms that have approached it*

6.47 Sky has also committed considerable resources and effort into distributing its channels over a number of different platforms. Sky has offered retail deals to all TV platforms that have approached it.[56] Ofcom does not dispute this fact. Instead, Ofcom tries to dismiss these offers by suggesting, at paragraph 6.40, that they are nonetheless tantamount to non-supply: [57]

> "*In our view, this response to requests for wholesale supply has had the same effect as an outright refusal…*".[58]

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55 Sky notes that certain of its premium channels were available via DTT on the ONdigital/ITV Digital platform prior the closure of that platform in 2002.

56 For example, Sky has offered retail deals to BT (as referred to in this **Section 6**), TUTV and also Orange. For example, Orange was offered a Sky-By-Wire deal (a retail deal) on a number of occasions in 2007 and 2008 and was sent a Sky-By-Wire contract for comment. In response to these offers, Orange indicated to Sky "*Regrettably, at this time, we are not proceeding with a digital TV product [which was]…disappointing given the level of mutual effort that has been invested…*" Correspondence from Angie Mee of Orange to Sky, dated 19 March 2009.

57 It is significant that Ofcom's reasoning on retail deals has changed significantly since the Second Consultation. In its Second Consultation Document, Ofcom accepted that it would in fact be entirely justified if Sky were to have a preference for retailing because it considered that it was more efficient: "*the absence of a wholesale deal could in part reflect a world in which Sky is more efficient than its retail rivals*" (Paragraph 6.54 of the Second Consultation Document). Ofcom has now entirely reversed its position without any apparent justification or new evidence.

58 Paragraph 6.40 of the Consultation Document.

6.48 Ofcom supports this extreme claim by saying that "*most competing retailers are understandably reluctant to allow Sky to retail directly to their customer bases*".[59] This is extremely partial. Competing retailers may well have a preference to reach a wholesale deal with Sky. Conversely, one of Sky's preferences is to provide its premium channels on a retail basis (for the reasons set out above). Ofcom sees only one side of the equation.

6.49 Ofcom should acknowledge that each side of the commercial negotiation has legitimate reasons for preferring its own model. It is not open to Ofcom to decree that one is legitimate and to suggest that the other is effectively a refusal to supply. On that logic, a platform's preference to secure a wholesale deal from Sky over allowing Sky to retail its channels itself can equally be characterised as a refusal to allow Sky's premium channels access to the platform. The simple fact is that, in real-world negotiations, each party begins with its own legitimate preferences and objectives, and the purpose of negotiation is to reach a mutually beneficial solution.

6.50 Moreover, the negative way in which Ofcom expresses the fact that third parties are "*understandably reluctant to allow Sky to retail directly to their customer base*"[60] is surprising to Sky, as this is exactly what Sky is required to permit in relation to its own customer base (pursuant to obligations placed on Sky by, amongst others, Ofcom).

6.51 Finally, when a broadcaster launches a pay TV channel, it may choose whether to retail or wholesale that channel. Whereas Setanta chose to enter into a direct retail relationship with customers on both DTH satellite and DTT platforms, other broadcasters, for example ESPN, have decided to wholesale channels. In each case, the broadcaster was able to determine how to sell its property, namely, its channels. It should be for Sky to determine whether to offer wholesale or retail terms to other platforms. Sky's discretion and choice as to how commercially to exploit its property should not be abrogated without proper justification, which has not been provided.

(d) Ofcom is inappropriately partial in its view that Sky should concede its preference to retail in favour of a third party's preference to wholesale[61]

6.52 Despite what Ofcom thinks – that Sky's offer to retail its channels is tantamount to an outright refusal to supply – it nevertheless goes on to suggest that, where it has not been possible for Sky to agree a retail deal with a third party, Sky should concede (immediately and without further negotiation) its preference to obtain access to other operators' platforms in favour of a third party's preference for wholesale access to Sky's channels:

59 Paragraph 6.40 of the Consultation Document.

60 Paragraph 6.40 of the Consultation Document.

61 As set out above, in paragraphs 6.32 to 6.40 of this **Section 6**, Sky has legitimate reasons for seeking to offer its channels directly on new platforms. In particular, the margin Sky makes from selling premium channels will always exceed the margin earned by a third party retailer and hence Sky believes that penetration of its channels is likely to be higher where it retails its channels itself. The evidence from wholesale supply to Virgin Media strongly supports this.

> *"Nor has Sky attempted to negotiate wholesale supply arrangements after it became clear these providers* [to whom Sky had offered a retail deal] *were not going to accept a retail agreement with Sky*".[62]

6.53 Ofcom's conclusions here appear to reflect a high degree of commercial naïvety. When conflicting preferences collide (as is the case where one party wants a retail deal and the other wants a wholesale deal), there will often be a degree of stand-off. Ofcom is, in effect, suggesting that when faced with the prospect of such a stand-off, Sky should immediately capitulate and the wishes of competing retailers should always prevail. Of course, an alternative view is that the platform should capitulate. Indeed, when it comes to Sky's own DTH satellite platform, it is the preferences of the channel supplier that do prevail; because that platform is open.[63]

6.54 In any event, it is not for Ofcom to determine that the failure between Sky and a third party to agree a retail deal should, of itself, necessitate Sky giving up its preference to retail. Ofcom appears to fail to recognise that in negotiations parties will often not want to concede particular points of principle unless there are good reasons to do so. This is part of normal commercial negotiations.

6.55 Sky considers that in normal circumstances, against the backdrop of a truly light touch regulator, and where both parties have something to gain from reaching a deal, commercial disputes of this type would be resolved by the parties through normal negotiation, as each side would be willing to give ground in exchange for the right minimum revenue guarantee, or other commitments.

6.56 Ofcom's regulatory process, including its long-running Pay TV investigation has, however, had a 'chilling' effect on negotiations, with BT and others seeking to gauge whether a commercial deal is better or worse than they might achieve through the regulator. The 'chilling' effect has been greatly exacerbated by the prospect of Ofcom proposing to set a lower price for Sky's channels in conjunction with compulsory licensing. This has incentivised retailers not to negotiate with Sky for the supply of Sky's channels. For example, Sky has had no contact with TUTV since Ofcom raised the prospect that it will deliver regulated access to Sky's channels. Moreover, discussions with BT have also been sporadic and disjointed due to the Ofcom investigation and it is significant that BT only re-engaged in earnest in discussions with Sky following the publication of Ofcom's Consultation Document.

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62 Paragraph 6.41 of the Consultation Document. We note in this context that, Ofcom concedes in paragraph 6.36, albeit with evident reluctance, that at no stage has Sky actually ruled out the possibility of a wholesale supply alternative in any of its negotiations for the distribution of its premium channels.

63 As Ofcom is aware, BT and TUTV have not capitulated to Sky's preference to retail its premium channels on BT and TUTV's platforms. This could suggest that access to Sky's channels is not quite so essential as they and Ofcom allege.

(e) *Ofcom's focus on premium channels fails to acknowledge the inter-related regulatory issue of platform access*

6.57 Given Sky's legitimate preference to retail its premium channels, it is entirely rational for Sky to seek to gain access to a third party's platform in order to distribute its channels. Where a third party has refused access to its platform or offered unreasonable terms, Sky has, in certain circumstances, taken steps to seek to gain regulated access to that party's platform, pursuant to the CA 2003.[64]

6.58 One such instance where Sky has sought regulated access is in the case of TUTV's DTT platform. As Ofcom is aware, Sky made a formal request to TUTV, as an operator of conditional access services, to provide Sky with regulated access to its platform.[65] Following this, Sky asked Ofcom to confirm whether TUTV was subject to the open access regulation set out in section 75 of the CA 2003. Ofcom confirmed to Sky that such a question of legal interpretation would take it some considerable time to determine:

> *"In terms of a timeframe under which Ofcom can consider the issue as to whether section 75(2) applies to Top Up TV, this is a complex matter and it is the first time that this issue has been raised with Ofcom. Therefore, we believe that it could take up to 6 months to fully analyse this matter."*[66]

6.59 Almost a year after Sky's request, in early 2007, Ofcom proposed to set access-related conditions on TUTV, requiring TUTV to give access to its conditional access services on fair, reasonable and non-discriminatory terms.[67] Despite its proposal to open up TUTV's platform to third parties on a regulated basis, over two years later Ofcom still has not imposed access-related conditions on TUTV. It appears that Ofcom has preferred not to pursue this issue.

6.60 Had Ofcom imposed access-related conditions on TUTV (as is required by CA03), it is possible that certain of Sky's premium sports and movies channels could have been made available to TUTV's customers (subject to satisfactory resolution of security issues). Moreover, in the event that Sky's premium channels were available on the TUTV platform, Ofcom's concerns - about Sky's channels not being available on DTT - would not exist and Ofcom could not accuse Sky of acting on the alleged incentive to restrict supply of its premium channels in relation to the only technology over which Sky's channels are not currently provided.

6.61 It is evident that it is not Sky acting on any theoretical strategic incentive, but rather Ofcom itself that has caused Sky's channels to be unavailable on DTT, through its decisions not to act in relation to a number of regulatory issues

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64 Section 75 CA03.

65 Letter from Richard Freudenstein (the then Chief Operating Officer of Sky) to David Chance (Chairman of TUTV), dated 10 February 2006.

66 Letter from Nicola Floyd (the then Director of Competition Policy at Ofcom) to James Conyers (General Counsel at Sky), dated 11 April 2006.

67 http://www.ofcom.org.uk/consult/condocs/tutv/

(amongst others, its failure to amend Sky and NGW's licences to enable it to launch Picnic, its failure to impose access-related conditions on TUTV, and its decision to put on hold its platform market review, which would determine "*which TV platforms have market power*"[68] and therefore which TV platforms are required to provide regulated access to Sky and other third parties). It is also the case that Ofcom's investigations have encouraged BT, TUTV and Virgin Media to await the conclusion of Ofcom's market investigation, rather than entering into meaningful discussions with Sky about the supply of Sky's premium channels. This should be of considerable embarrassment to Ofcom – a major regulatory failing – but Ofcom declines to acknowledge this and instead prefers to blame Sky.[69]

(f) *<u>Sky has offered wholesale deals</u>*

6.62 Furthermore, despite its entirely reasonable preference to retail its premium channels:

- Sky has offered Ofcom commitments to make its channels available on a wholesale basis; and
- Sky has offered BT its channels on a wholesale basis.

6.63 The following paragraphs provide some detail on these offers.

Sky's offer to Ofcom to wholesale its channels to third parties

6.64 Between December 2007 and April 2008 (in an attempt to end the stasis arising from Ofcom's investigations), Sky had discussions with Ofcom and ultimately offered commitments to Ofcom which included:

- a commitment to wholesale to all secure platforms;
- significant discounts against prices charged to cable if certain levels of penetration were achieved;
- a discount in relation to all packages that include a reduced movie offering from Sky (i.e. only a single Sky premium movie channel) for retailers with limited capacity (consistent with Sky's charge to narrowband cable operators, see paragraph 6.84 below for further detail on narrowband cable operators); and

68 Ofcom Annual Plan 2008/09. http://www.ofcom.org.uk/about/accoun/reports_plans/annual_plan0809/statement/annplan0809.pdf

69 Ofcom is referred to **Section 2** of this Response, which sets out Ofcom's disregard for its statutory duties and, amongst other things, it breach of its section 3(1)(b) CA03 principal duty "*to further the interests of consumers in relevant markets, where appropriate by promoting competition.*"

- agreement to share with BT Vision and TUTV the benefit of Sky's low DTT transmission costs.[70]

6.65 These negotiations ultimately proved fruitless because it became apparent that Ofcom was determined to secure more significant wholesale price cuts than Sky had already offered (notwithstanding the fact that at that point Ofcom did not have – and indeed still does not have - evidence of high wholesale prices or excessive profitability). Indeed, in April 2008, Ofcom ultimately rejected Sky's proposals on the basis that "*our respective views on the issue of the price of any wholesale offering remained, despite our respective best efforts, apart.*"[71] So, despite Sky's offer to wholesale its channels, Ofcom has chosen a further 18 months (so far) of non-supply to DTT in pursuit of additional price cuts.

Sky's offer to wholesale its channels to BT

6.66 With regard to the wholesale offer by Sky to BT, there has been considerable negotiation between the two organisations.

6.67 Sky's legitimate preference was for a retail deal and this was pointed out on a number of occasions. Despite Sky's preference, on 15 October 2007, Sky set out an outline of the wholesale financial terms that would apply were it to supply BT on wholesale terms. Sky's willingness to negotiate a wholesale deal was also made clear to BT in subsequent discussions.

6.68 Although Sky never abandoned its preference for a retail deal, the provision of wholesale financial terms and the subsequent engagement with BT on those terms clearly shows that Sky was prepared to enter into a wholesale agreement with BT, subject to agreeing appropriate commercial terms. That BT clearly understood this is demonstrated by BT's presentation of a counter-proposal to Sky which focussed exclusively on the key terms for a wholesale supply deal.[72] Had BT not understood that Sky was willing to agree wholesale terms, it is not clear on what basis they would subsequently have come back with key terms for a wholesale arrangement.

6.69 There are numerous reasons why agreement was not reached with Ofcom and BT. Sky considers the following were significant contributory factors to the lack of agreement: (i) failure to agree reductions in wholesale prices; (ii) BT did not in fact have adequate security; (iii) BT did not have transmission capacity needed to carry Sky's channels; and (iv) BT had a strong incentive not to carry the channels whilst Ofcom's investigation was ongoing. We discuss each of these below.

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70 A brief summary of the outline of the commitments is set out in the letter from Jeremy Darroch, Sky's Chief Executive Officer, to Ed Richards, Ofcom's Chief Executive Officer, dated 30 April 2008.

71 Letter of 16 May 2008 from Ed Richards to Jeremy Darroch.

72 Letter from Marc Watson of BT to Stephen Nuttall of Sky, dated 21 December 2007.

(i) Failure to agree reductions in wholesale prices

6.70 Given Sky's offer to Ofcom and its wholesale offer to BT, it is apparent that Sky was willing to wholesale its channels irrespective of its legitimate stated preference to retail. The principal point at issue, however, both with regard to the offer to Ofcom and the offer to BT, was price. Rather than reach an agreement and thus guarantee early supply, both Ofcom and BT have preferred to hold out for lower prices.

6.71 Given the weight that Ofcom puts on non-availability of channels on DTT (BT would have been well aware of Ofcom's views, as these are set out in Ofcom's Picnic consultation document, which was published between the date on which Sky outlined the basis of a wholesale offer to BT[73] and the date on which BT provided Sky with the key terms of a wholesale arrangement[74]), it is clear that BT had a clear incentive not to agree to carry Sky's channels on cable ratecard terms. Ofcom fails to give appropriate weight to the fact that BT's failure to agree to these terms might at least in part be explained by BT's desire to secure more favourable terms via a regulatory route, a path for which Ofcom must take some considerable responsibility, having seemingly encouraged BT that this could be delivered.

6.72 In its response to the Second Consultation Document[75], Sky argued that a reluctance by Sky to reduce its wholesale price is entirely consistent with the behaviour that would be expected of a stand-alone broadcaster which did not have its own retail business and cannot therefore be taken as evidence that Sky, motivated by strategic incentives linked to its vertical integration, has an incentive to restrict distribution or was in fact seeking to restrict supply.

6.73 In its Consultation Document, Ofcom makes some attempt to rebut this point, though we note that in doing so Ofcom puts particular emphasis on whether a non-vertically integrated broadcaster would be willing to supply **less efficient** platforms rather than whether it would be willing to reduce its price. Ofcom states that there "*are a number of arguments against Sky's claim that supply is restricted because other firms are less efficient than established retailers:*"

(a) "*Sky's argument…is inconsistent*" regarding "*inter-platform switching*";

(b) "*Sky has not sought to… establish whether or not these suppliers are efficient*";

(c) "*even if other firms were less efficient… there is an opportunity cost to Sky in being absent from a platform*"; and

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73 On 15 October 2007.

74 On 21 December 2007.

75 Paragraph 2.35 of Section 5 of Sky's Response to the Second Consultation Document.

(d) "*Our analysis of Sky's business model for Picnic indicates that the proposed service would not be profitable if Sky charged Picnic the wholesale rate-card price*".[76]

In the following paragraphs we examine each of the points made by Ofcom.

(a) Switching – Sky's views are not inconsistent

6.74 Ofcom's first point - that Sky's view is inconsistent with its views on platform switching - is wrong. Ofcom does not provide any citation for its assertion that Sky previously argued that inter-platform switching is likely to be limited. Sky has reviewed its previous submissions and the only reference it can find to inter-platform switching is at paragraph 2.11 of Section 5 of Sky's response to the Second Consultation. In this paragraph, Sky did not say that inter-platform switching was low. What Sky actually said was that if Sky's premium channels were no longer available on a particular platform, it would expect existing subscribers that intended to switch to a platform that still carried Sky's channels to do so quickly. Sky did not expect significant switching to occur on an ongoing basis, *i.e.* the change in premium channel availability would cause most people to switch straight away or not at all.

6.75 To be clear, whilst Sky indicated at paragraph 2.11 that it expected on-going switching amongst existing subscribers to a particular platform that no longer carried Sky's channels to be low, Sky did not say that the removal of Sky's channels from a particular platform would have no long-term effects. There would still be a long-term effect in terms of the choice of platform by people coming to pay TV for the first time.

6.76 Therefore, Sky's previous evidence on switching is not inconsistent with its view that a stand-alone broadcaster would be reluctant to reduce its wholesale price to cater to a new retailer. A stand-alone broadcaster would face a trade-off: for each new retailer it supplies at a lower price, it would gain for each completely new subscriber to that retailer, but would lose for every subscriber that switches to that retailer from a retailer that pays a higher wholesale price.

6.77 Sky - or any other broadcaster – would therefore be right to be concerned about supplying new retailers at lower wholesale prices, because there is likely to be some cannibalisation, both in terms of up-front switching or immediate switching and an ongoing effect where the new retailer takes subscribers who would otherwise have gone to a retailer paying a higher wholesale price (as opposed to the long-term effect amongst existing subscribers, which Sky indicated at paragraph 2.11 of Section 5 of Sky's Response to the Second Consultation Document it expected to be low). As Sky previously indicated, given this risk, a stand-alone broadcaster would be expected to offer lower wholesale prices to a new retailer only if it could secure a minimum guarantee or other form of commitment so as to give it a reasonable degree of comfort that overall it would earn higher wholesale revenues.[77] Alternatively, a stand-

76 Paragraph 6.69 of the Consultation Document.

77 Moreover, if Sky were to offer new retailers significantly more favourable wholesale terms than those upon which it wholesales to Virgin Media, the commercial pressure that Virgin Media

alone broadcaster might accept that such a new retailer would set higher subscription prices and that the number of sales it achieved by supplying this higher priced retailer might be lower than it achieved by supplying other more efficient retailers.

(b) Sky was not required to establish whether particular suppliers are efficient

6.78 Ofcom's second point is that Sky has not sought to establish whether or not particular suppliers are efficient. In placing particular emphasis on whether a retailer was efficient, Ofcom appears to have missed the point. Whether a retailer needed such a price cut because they were less efficient or simply because they wanted to secure a higher margin is not relevant. The issue is, whether, faced with a retailer that would not agree to its offer, a non-integrated broadcaster might decide not to reduce its wholesale price to that retailer. It is clear that BT was offered Sky's channels on ratecard terms and did not agree to those prices. Sky did not need to determine whether BT was likely to be efficient as it was apparent at the time that in order to reach an agreement Sky would need to reduce its prices below the cable ratecard (indeed, as we noted in response to the Second Consultation Document, BT's counter-offer to Sky of 21 December 2007 proposed a [**CONFIDENTIAL**]% discount against the wholesale price for Sky Sports 1 and a wholesale price for Sky Movies 1 that was [**CONFIDENTIAL**]).

(c) Wholesale supply to less efficient retailers

6.79 Ofcom's third point is that, even if other firms were less efficient, a broadcaster incurs an opportunity cost if its channel(s) are not available on a platform. Ofcom goes on to state that, in light of this opportunity cost, wholesale supply, to arguably less efficient retailers, is likely to be better for Sky than absence from a platform. This point seems to have nothing to do with whether it would make sense for a non-vertically integrated broadcaster to reduce its price. It relates instead to whether, even where Sky felt that it would be a more successful retailer than the platform operator, it should nevertheless agree to supply at wholesale terms whilst it tries to secure retail access. As Ofcom's third point is not relevant, we have dealt with it elsewhere (see paragraphs 6.52 to 6.56 of this **Section 6**).

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would then bring to bear upon Sky for a rate cut would be considerable. Even absent a regulatory requirement to do so, it simply would not be a commercially sustainable position for Sky to take.

One counterintuitive aspect of two separate wholesale charging structures in this instance is that Virgin Media would be paying a higher price under the cable ratecard than an operator that had fewer premium subscribers.

Moreover, setting aside the potential issue of commercial pressure, were Sky to offer significantly more favourable terms to firms other than Virgin Media, it is readily conceivable that Virgin Media would allege some form of anti-competitive conduct on the part of Sky (and that it would seek some form of legal redress).

(d) Picnic would be profitable based on Sky's ratecard prices

6.80 Ofcom's last point relates to Picnic. Ofcom claims that Picnic would not be profitable if Sky charged Picnic its wholesale ratecard prices for its premium channels. Sky disputes this statement as it disagrees with Ofcom's underlying profitability assessment of the Picnic model.

6.81 Sky provided Ofcom with its business plan for Picnic (which was produced in the normal course of business) which showed that Sky expected to make profits of [**CONFIDENTIAL**] over the first [**CONFIDENTIAL**] years[78] of the service when paying cable ratecard prices for Sky's premium channels. Ofcom, seeking to replace Sky's real-world commercial assessment with its own, has made a number of adjustments to Sky's business plan (further details of which are set out below), the effect of which is that Ofcom concludes that Picnic would be unprofitable and could not notionally afford to pay Sky's cable ratecard prices.

6.82 There are several problems with Ofcom's analysis. First, and most obviously, having made several adjustments to Sky's original business plan for Picnic, Ofcom calculates a five year net present value ("NPV") (with no terminal value) of minus [**CONFIDENTIAL**] (based on a discount rate of 10.3% consistent with Ofcom's estimate of Sky's weighted average cost of capital) and concludes on the basis of this NPV that Picnic would be unprofitable. Assessing Picnic's profitability (or otherwise) and its ability to pay ratecard prices on the basis of a five year NPV with no terminal value is inconsistent with the approach Ofcom uses in the retail-minus and cost-plus evaluations, where a 10 year NPV including terminal value is used to estimate profitability.

6.83 **Table 6.2** below illustrates how, by using the original Picnic model (which extends to 2017/18), adjusted in accordance with Ofcom's approach, the 10 year NPV including terminal value returns [**CONFIDENTIAL**] profit. Thus, even applying Ofcom's adjustments, Picnic would be profitable paying cable ratecard prices, if a period that is consistent with Ofcom's other financial analysis is used:

Table 6.2

Ofcom's original model

	5 Year NPV	**5 Year NPV + Terminal Value**	**10 Year NPV + Terminal Value**
Ofcom's original model	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]

6.84 Second, although Ofcom asserts that the adjustments it has made to Sky's Picnic business plan were reasonable, this is not, in fact, the case. Several of the adjustments have no basis and are inappropriate. These include:

78 Note, this is profit not a discounted NPV.

- Ofcom has used the full wholesale ratecard price for 'single movies and single sports' (£17.59) and not the discounted rate ([**CONFIDENTIAL**]) currently offered to operators with a reduced movie service due to limited capacity. This discount on the single movie sports package is not something which Sky devised simply for Picnic but is a price currently charged to a number of narrowband cable operators that also offer a similar limited movie service.[79] Hence, Ofcom's upwards adjustment for the price of 'single movies and single sports' is wrong and the adjustment should not be made;

- Ofcom has applied inflation to the notional Sky basic channel wholesale price, resulting in prices increasing from [**CONFIDENTIAL**] per subscriber per month in 2008/2009 (even though Sky actually included a figure of [**CONFIDENTIAL**]per subscriber per month for 2008/2009 in the Picnic business plan) to [**CONFIDENTIAL**] per subscriber per month in 2012/2013. It is not appropriate to make this change. The prices for Sky's basic channels, which were included in the Picnic business plan, were based on Sky's carriage agreement with Virgin Media (its biggest third party wholesale customer). On reflection, Sky considers that the estimate of [**CONFIDENTIAL**] per subscriber per month for 2008/2009 is probably too high.[80] In addition, Sky's carriage agreement with Virgin Media is for three years and does not include any annual RPI adjustments. Accordingly, it is inappropriate for Ofcom to apply inflation adjustments in its model;

- There are good reasons why transmission costs should be excluded entirely. As indicated in **Section 7** of this Response, Sky's prices to the cable operators include the cost of delivery to the cable head-end.[81] Nevertheless, Ofcom has included the full transmission costs for Sky's channels. Such an approach is inconsistent with Ofcom's own fictional DTT retailer. With regard to its fictional DTT retailer, Ofcom included a third of the cost of DTT transmission on the assumption that such transmission costs would be equally divided between three DTT retailers. This division of transmission costs is consistent with the commitments Sky offered Ofcom in early 2008. The consistent

79 For example, narrowband cable companies include, Martin Dawes Ltd, SCC International and Star Systems.

80 Under Sky's carriage deal with Virgin Media, Sky receives a maximum of approximately [**CONFIDENTIAL**] per subscriber per month (assuming it qualifies for the maximum performance ratchet) in respect of re-distribution over Virgin Media's cable network of Sky 1, Sky 2, Sky 3, Sky News, Sky Sports News, Sky Arts 1, Sky Arts 2, Sky Real Lives and Sky Real Lives 2. Sky's previous estimate of [**CONFIDENTIAL**] per subscriber per month for a 11-hour version of Sky 1 and an hour of Sky News seems relatively high as compared to the [**CONFIDENTIAL**] per subscriber per month which Virgin Media pays for a much broader channel offering (including cost of delivery via satellite to the cable head-end). It is clear from recent discussions with Virgin Media, which included discussion on the value it places on individual channels within the overall carriage deal, that the assumption of [**CONFIDENTIAL**] per subscriber per month used in the Picnic plan is on the high side.

81 Sky anticipates that the same may apply to the supply by ESPN of its channels to DTT retailers. Ofcom should ask who bears or bore the transmission costs for ESPN or Setanta.

approach would therefore be to include only one-third of the DTT transmission costs;[82]

- Ofcom has attempted to remove all standalone Broadband and Talk revenue and costs. Sky considers this to be incorrect, as the Picnic business plan reflects a cost base that was predicated on the basis of being a single new business *i.e.* the costs are premised on being able to offer a standalone Broadband and Talk product. A model for a venture where every subscriber had to take TV would have an entirely different (lower) cost structure. For example, had Sky considered offering services to only TV subscribers it may not have decided to launch a new brand (the costs of which are included in the business plan) and may instead have used the Sky brand;

- Further to the above point, in any event, Ofcom's approach to excluding stand-alone broadband and telephony subscribers is flawed, as it does not strip out all the costs that might be allocated to such subscribers. Ofcom has tried to allocate common costs relating to retention, marketing and the 'welcome pack'. However, it has ignored the other common costs such as 'above the line' marketing, IT, R&D, online development, and call centre costs. We note that although Ofcom's spreadsheet attempts to allocate these costs based on subscribers, the costs are not, in fact, deducted in their calculations.

6.85 The above adjustments have been corrected[83] in the model under two alternative methodologies. The **Table 6.3** methodology includes the entirety of Broadband and Talk standalone subscribers' revenues and costs. As illustrated below, under this methodology, Picnic is profitable even on a 5 Year NPV basis with no terminal value:

[82] As indicated above, at paragraph 6.64 of this **Section 6**, the commitments included an agreement to share with BT Vision and TUTV the benefit of Sky's low DTT transmission costs.

[83] In Ofcom's calculations there is also a small error on the summary tab cell G41, which incorrectly sums across quarters and therefore reports incorrect costs for 2011/12 which we have not corrected.

Table 6.3

Ofcom's original model – corrected (1)

	5 Year NPV (£m)	**5 Year NPV + Terminal Value** (£m)	**10 Year NPV + Terminal Value** (£m)
Ofcom's original model	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
Impact of:			
Correct wholesale price of premiums to £16.34	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
Remove inflation applied to prices for Sky basic channels	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
Remove two-thirds of transmission costs	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
Add back BB and Telephony standalone revenue and costs	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
Total	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]

6.86 The **Table 6.4** methodology removes common costs for Broadband and Talk standalone subscribers which have been allocated on a subscriber basis. As illustrated below, Picnic is only marginally loss making[84] looking at a 5 Year NPV with no terminal value and is clearly profitable when looked at on a basis consistent with Ofcom's retail minus and cost-plus evaluations:

84 Sky's Picnic model shows that it would generate revenues of [**CONFIDENTIAL**] over the first five years of operation. Therefore, a loss of [**CONFIDENTIAL**], when compared with the revenue generated, is not material.

Table 6.4

Ofcom's original model – corrected (2)

	5 Year NPV (£m)	**5 Year NPV + Terminal Value** (£m)	**10 Year NPV + Terminal Value** (£m)
Ofcom's original model	**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
Impact of:			
Correct wholesale price of premiums to £16.34	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
Remove inflation applied to prices for Sky basic channels	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
Remove two-thirds of transmission costs	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
Allocate common costs for BB and Telephony standalone based on subscribers	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
Total	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]

6.87 Moreover, even if Ofcom had shown that Picnic could not 'afford to pay' Sky's cable ratecard prices, the answer is not that Sky's wholesale prices must be reduced. If Picnic's retail mark-up is not sufficient to cover its costs, then Picnic should simply increase its retail prices. Ofcom ignores this possibility and jumps to the incorrect conclusion that if the Picnic business plan cannot afford to pay Sky's wholesale prices then those wholesale prices must be reduced.

6.88 Indeed, there would seem to be scope for Picnic to increase its retail prices, if this were to prove necessary. The premium channels' retail price reflected in Picnic's business plan was [**CONFIDENTIAL**] cheaper than the nearest equivalent package on DTH satellite[85] and therefore [**CONFIDENTIAL**] cheaper than the prices which Ofcom assumes for its hypothetical DTT retailer (Ofcom assumes the hypothetical DTT retailer would charge the same retail price as the nearest DTH satellite equivalent).[86]

6.89 In any event, more generally, given Ofcom's belief that there is substantial unmet demand for Sky's premium channels via DTT, there should be no requirement for DTT to charge the same retail prices as Sky does on its DTH

85 The proposed price for basic channels, single sports and single movies was [**CONFIDENTIAL**]. As at September 2008, the Sky DTH satellite price for one mix with single movies and single sports (the nearest comparable package on DTH satellite) was £35.

86 Sky notes that it would not be correct for Ofcom to infer that any price increase would reduce Picnic's profitability, as set out above, and hence make it less able to afford Sky's premium channels, based on cable ratecard prices. The retail prices contained in the Picnic business plan reflect what Sky considered, at the time, to be profit maximising for Picnic, taking into account the impact of Picnic pricing on the profits earned on the sale of premium channels for Sky as a whole. Small increases in the retail price for Picnic could therefore be expected to increase the profitability of Picnic, as a stand alone retailer. This is well established in the economics literature on double marginalisation.

satellite platform. A DTT operator should be able to charge a higher price to reflect the higher costs of distribution. Such an operator could expect to be able to charge a higher price and remain competitive because customers with a strong preference for DTT technology should be willing to pay a premium to receive channels in that way. If DTT consumers, whose demand for Sky's channels is alleged to be unmet, are not willing to pay a modest premium for Sky's channels delivered by DTT (such prevailing rate would include the increased costs associated with DTT distribution) then this would suggest that they do not really have a strong preference for DTT delivery and that the reasons that they do not currently take Sky's channels cannot be because they are unavailable via DTT. The fact that their demand for Sky's channels is currently unmet would instead more likely relate to the fact they would like Sky's premium channels but are not willing to pay the prevailing price for them. This is no different from suggesting that there is unmet demand for 5-series BMWs because some people quite like the idea of having a BMW but, finding the £35,000 price point a little steep, would be willing to pay £25,000.

(ii) No capacity

6.90 Irrespective of the fact that a wholesale agreement was never reached either with a platform using DTT technology[87] or with Ofcom, Sky could not have supplied its channels on a wholesale basis to any DTT retailer because Sky had, and indeed still has, no way of broadcasting its premium channels via DTT. As Ofcom is aware, its DTT Multiplex licensing regime precludes the provision by Sky of any channels on DTT Multiplexes B, C and D other than the three free to air channels which it currently provides.

6.91 Ofcom rejects Sky's claim that it could not offer its channels via DTT because its application to Ofcom to change its channel line-up was pending and notes that a third party retailer such as TUTV would have scope to use one of its own video streams for premium channels. This displays a fundamental lack of understanding of the commercial reality, as it is Sky and not the DTT retailer who is expected to pay for such capacity.

6.92 In discussions with TUTV, TUTV did offer to procure the necessary capacity from a third party (Five) on Multiplex A provided Sky paid [**CONFIDENTIAL**] per annum for that capacity, and not, as Ofcom claims[88], that this capacity would be provided by the retailer at the retailer's expense. It is entirely reasonable for Sky to want to use the capacity it has already committed to on DTT to supply its premium channels, as envisaged in the Picnic business plan, rather than paying TUTV [**CONFIDENTIAL**] for such additional capacity.

6.93 In any event, the additional capacity TUTV offered Sky was sub-let from Five. It was, and indeed it still is, unclear whether Sky would be entitled to be the provider (with editorial control) of its premium channels via Five's capacity. This added to the unattractiveness of TUTV's offer to Sky.

87 Sky notes that certain of its premium channels were available via DTT on the ONdigital/ITV Digital platform prior the closure of that platform in 2002.

88 Paragraph 6.77 of the Consultation Document.

6.94 With regard to BT, it has only recently (in July 2009) offered to procure DTT capacity for Sky's premium channels itself. Prior to July 2009, this option, of BT procuring capacity, was not available to Sky. Previously all of Sky's discussions with BT were premised on Sky securing approval from Ofcom to change its DTT channel line-up.

(iii) No Proper Security

6.95 Sky has made clear to [**CONFIDENTIAL**], on a number of occasions, that it has concerns about the security of their platforms. For example, and as Sky previously set out to Ofcom,[89] [**CONFIDENTIAL**] piracy has been a core issue for Sky over many years and it is an issue which [**CONFIDENTIAL**] has shown little interest in resolving.

6.96 In addition to the security concerns that Sky has in relation to its channels, Sky also needs to comply with the additional, varying, and very onerous security obligations and copy protection obligations that are contained in the agreements between Sky and the movie studios. [**CONFIDENTIAL**]. In addition, Sky must ensure that its movie channels are similarly protected on non-Sky platforms used to deliver Sky's movie channels.

6.97 As Ofcom will be aware, Sky's concerns regarding the adequacy of the conditional access systems used by [**CONFIDENTIAL**] was extensively discussed with both parties and also, in early 2008, with Ofcom (in the context of discussions concerning Sky's Picnic proposals and otherwise).[90]

6.98 With regard to its discussions with [**CONFIDENTIAL**], Sky informed [**CONFIDENTIAL**] on a number of occasions about its concerns with [**CONFIDENTIAL**] CA technology. For example, in June 2007, Sky informed [**CONFIDENTIAL**] that its security concerns "*would need to be resolved satisfactorily before any deal – wholesale or retail – could be done to make available Sky premium channels via the* [**CONFIDENTIAL**] *decoder base.*"[91] Sky notes that Ofcom, in paragraph 6.80 of its Consultation Document, refers directly to this concern.

6.99 With regard to [**CONFIDENTIAL**], Sky informed [**CONFIDENTIAL**] in October 2007 that it would need to convince Sky of "*the security counter measures that* [**CONFIDENTIAL**] *would adopt in the event that the* [**CONFIDENTIAL**] *were to be compromised were appropriate.*"[92]

6.100 Sky notes that Ofcom has acknowledged, both publicly and privately, the legitimacy of Sky's security concerns. During discussions with Ofcom between December 2007 and April 2008 regarding the possibility of Sky giving wholesaling commitments to Ofcom, Ofcom accepted Sky's legitimate security concerns [**CONFIDENTIAL**]. Moreover, despite the fact that those discussions did

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not result in Ofcom accepting the commitments from Sky, in the Second Consultation Document, Ofcom explicitly and publicly recognised that Sky's security concerns were legitimate when it stated that any platform used to distribute Sky's channels (pursuant to the proposed wholesale must offer obligation) would need to be "*secure...to protect against content piracy*".[93]

6.101 Sky understands that [**CONFIDENTIAL**] still has not updated its conditional access system (despite claiming that the necessary upgrades would be undertaken in 2008) and still uses a version of [**CONFIDENTIAL**] which Sky does not consider sufficiently secure to protect Sky's premium channel from piracy. We also understand that [**CONFIDENTIAL**] also uses the same unsecure version of [**CONFIDENTIAL**]. Regardless of whether or not a commercial deal had progressed further, it is clear that Sky would not actually supply its channels to [**CONFIDENTIAL**] unless and until the relevant platform introduces a version of [**CONFIDENTIAL**] (or any other conditional access system) which met Sky's legitimate concerns. Put simply, Sky was not prepared to supply its channels to any [**CONFIDENTIAL**] retailer which could not adequately address Sky's legitimate concerns with regard to platform security.

(iv) Regulatory Uncertainty

6.102 As Sky has already set out above, and as Sky indicated in its previous response to the Second Consultation Document,[94] the shadow cast by Ofcom's *de facto* presence at the negotiating table has been a major obstacle to commercial agreements.

6.103 Sky has been unable to use its existing capacity to broadcast its premium channels on DTT due to the fact that Ofcom is, after more than two years, still considering Sky and NGW's applications to allow Sky to replace its current three free to air channels with five pay channels.

6.104 BT has, in fact, at the very highest level been entirely clear with Sky that it was not inclined to negotiate commercial wholesale terms with Sky and instead was awaiting the outcome of Ofcom's market investigation. Moreover, it is no coincidence that, predicated on an expectation raised by the Consultation Document, BT has now, for the first time, indicated a willingness to take Sky's premium channels on ratecard terms.

6.105 TUTV has ceased completely to engage with Sky during the currency of Ofcom's investigation.

6.106 It is not open to Ofcom to overlook the above evidence and rely on inferences as to why agreements have not been reached with DTT platform operators based on its shifting views of Sky's incentives and motivations.

[93] Paragraph 1.67 of the Consultation Document.

[94] Sky's Response to the Second Consultation, Section 5 paragraphs 2.25 and 2.37 to 2.38.

(ii) Virgin Media – Sky is not acting on alleged incentives nor has it restricted supply

(a) *The wholesale price charged to Virgin Media is not evidence of an incentive to withhold*

6.107 Ofcom relies on its consideration of Sky's relationship with Virgin Media to attempt to argue that Sky is acting on the alleged incentive to restrict distribution of its channels. Ofcom suggests that Sky has set its wholesale price so as to ensure that Virgin Media does not have an incentive to market Sky's channels, and, as a result, over time customers with an interest in Sky's channels are more likely to choose DTH satellite.

6.108 For this to have any validity, Ofcom would first have to show (i) that Sky's wholesale prices are too high, and (ii) that Sky sets such "*high*" wholesale prices to restrict supply and not to maximise profits from wholesaling its premium channels. As we set out below in **Section 7**, Ofcom's analysis of Sky's wholesale prices is wholly inadequate. Even if Sky does set prices that Ofcom considers to be "*high*", the reason for this pricing is to maximise revenues. That has nothing to do with "*restricting*" supply.

6.109 Ofcom's inference that Sky's prices are set so that Virgin Media does not have an incentive to market Sky's channels appears to be based on: (i) its belief that Sky sets prices that just meet the conditions of a margin squeeze test; and (ii) its claim that Sky itself has acknowledged that Virgin Media does not have an incentive to market Sky's channels. In the paragraphs below we show that neither of these statements has any basis in fact.

6.110 At paragraphs 6.109-6.110 of the Consultation Document, Ofcom misrepresents Sky's submissions. Ofcom states "*our understanding is that Sky has, for the past seven years, been setting its price level by calculating the price just below an abusive price, as determined by the OFT in 2002. Sky appears to present the margin squeeze price as a floor beneath which it will not negotiate, either with cable retailers or others.*"[95] Sky stated that it continued to supply Virgin Media on cable ratecard terms and that, in its view, those ratecard terms complied with the OFT's test. Sky did not suggest, as Ofcom now **objectionably** claims, that its prices were **just** sufficient to pass a ratecard test. Sky's wholesale prices comfortably pass the range of prices in the OFT's test. Sky estimates, based upon its interpretation of the OFT's test, that its retailing business has in the last 8 years earned at least [**CONFIDENTIAL**] over and above the threshold reflected in the OFT's test.

6.111 Ofcom then quotes Sky as saying that "*a third party platform operator does not have the incentives to invest in marketing Sky channels*"[96]. In fact, on proper review, it is clear that the paragraph from which Ofcom quotes (namely, the above quotation), was **not** a direct quotation from what Sky said but instead was Ofcom's attempt to paraphrase (incorrectly) Sky's submission. Sky in fact

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95 Paragraph 6.110 of the Consultation Document. This allegation is repeated throughout the consultation, see for example paragraphs 1.25, 6.129, 6.156, 7.106, 7.107 and 10.50.

96 Paragraph 6.111 of the Consultation Document.

said that "*third party retailers do not have the **same** incentives as Sky to market Sky's channels*"[97].

6.112 Regardless of the wholesale price for Sky's channels, Sky's incentive to sell those channels to consumers will always be greater than that of Virgin Media. This is because – in the case of Sky's sports channels - Virgin Media incurs an incremental cost per subscriber where Sky's sports channels are sold to a consumer. Sky incurs no such incremental cost. In the case of Sky's movie channels, Virgin Media incurs an incremental cost per subscriber which exceeds the per subscriber costs that Sky pays the movie studios in respect of those channels (in addition, Virgin Media has its own movies services that it will prefer to sell to its customers). This is one of the reasons why Sky prefers to enter into retail deals on third party platforms.[98]

6.113 That said, Sky is acutely aware of the cable network's poor performance in selling Sky's premium channels. The decline in premium subscribers on the cable network over the last 5 years has resulted in an annual decline in wholesale revenue of [**CONFIDENTIAL**], at current prices.[99] It is likely that Virgin Media's performance in selling Sky's channels has been particularly poor in recent years in part because Virgin Media has focused on other priorities. These priorities have including restructuring its debt, rebranding its services as Virgin Media, upgrading its network to offer next generation broadband, launching its 50 Mb broadband, improving its customer service, consolidating its billing systems and integrating Virgin Mobile.

6.114 Although Virgin Media undertakes significant marketing of Sky's premium channels in order to attract new customers to its platform[100], Virgin Media has not made similar efforts to market Sky's premium channels to its basic subscribers. Virgin Media claims that its efforts to sell premium channels to its basic customers are limited because it alleges that it does not make any profit from basic customers upgrading to take Sky's premium channels. The profit which Virgin Media makes by upgrading its basic customers, however, is a function of how Virgin Media sets its basic TV pricing. Sky notes that the incremental price which Virgin Media charges for Sky's premium channels varies considerably based on the basic tier through which Sky's premium channels are purchased. The price of Dual Sports for example ranges from £26

97 Paragraph 4.17(b) of Part D of Sky's Response to the Complaint of October 2007.

98 Contrary to Ofcom's suggestion Sky has supported actions which increase Virgin Media's "*incentives to invest in marketing Sky channels*". Therefore when approached by Virgin Media in early 2009 with a proposal whereby Virgin Media Limited was to cease its premium television channel business and a wholly-owned Luxembourg subsidiary, Future Entertainment SARL ("FES"), of Virgin Media Limited's parent company would commence operations to provide the premium television channels in the UK to residential customers by means of Virgin Media's cable networks, Sky acquiesced to that proposal in respect of the continuing supply of its premium channels. Given the advantageous VAT rates available to FES in respect of a supply of services from Luxembourg the effect of this change was to allow Virgin Media to earn an increased margin on the sale of Sky's premium channels (assuming unchanged retail prices) and thereby to increase its incentive to market those channels.

99 See also, paragraph 2.23 of Section 5 of Sky's Response to the Second Consultation.

100 See **Appendix 3** for examples of Virgin Media's recent acquisition marketing materials.

per month when purchased though M tier to £19 per month when purchased through the XL tier. Indeed, the incremental price of Sky's premium channels when purchased through the M and L packs is sufficient to make such upgrade activity profitable to Virgin Media.

6.115 Whilst the level of Virgin Media's incentive to sell Sky's premium channels to its basic customers is in large part a function of Virgin Media's own pricing structure, Sky has nevertheless sought to increase Virgin Media's incentive to sell Sky's premium channels by offering lower wholesale prices in return for improved performance (see Paragraph 5.12 of Annex 5.1 of Sky's Response to the Complaint). Such an approach is also entirely consistent with normal commercial behaviour and exactly what a broadcaster would do irrespective of whether or not it was vertically integrated. Incentivising Virgin Media by offering lower rates in return for higher levels of performance is more likely to lead to improved sales than simply cutting wholesale prices regardless of performance. A simple reduction in wholesale prices would provide no guarantee of improved effort to sell Sky's channels and would run the strong risk that Sky would be made worse off through lower wholesale revenue.

6.116 Indeed, that is precisely the result that Ofcom's own wholesale model appears to suggest: that if Sky had sought to incentivise Virgin Media by simply cutting its wholesale price. Sky would have been made worse off. Far from assuming that the proposed reduction in wholesale prices results in an increase in premium subscribers on Virgin Media (or indeed that any increase is sufficient to offset the reduction in wholesale price), Ofcom's wholesale model assumes that the number of premium subscribers on Virgin Media continues to decline. In particular, it is clear that the principal effect of lowering the wholesale price to Virgin Media is to make Sky worse off and to transfer a value from Sky to Virgin Media of [**CONFIDENTIAL**] over four years.[101]

(b) *<u>The fact that Sky's HD channels are not yet available on Virgin Media's platform is not evidence of a broad incentive to withhold</u>*

6.117 Ofcom also alleges that Sky is "*reluctant*" to supply its HD channels to Virgin Media and that this "*is further evidence that its supply of content to cable is primarily based on what Sky perceives as a 'must-supply' obligation*"[102]. This allegation is entirely unsustainable in light of the clear evidence on this subject which Sky provided to Ofcom on 27 May 2009 (to which Ofcom makes no reference and has apparently no regard), the key elements of which Sky repeats below.

6.118 In March 2009 Virgin Media sent Sky a "*High Definition Request For Proposal*" (the "RFP"). The RFP stated that Virgin Media was "*now keen*" to receive proposals from HD content providers wishing to distribute their content via the Virgin Media platform. On 24 March 2009, Sky replied to the Virgin Media request and offered to make available to Virgin Media a number of its HD

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[101] Based on Ofcom's proposal of ratecard prices for a larger competitor on DTT (scenario 4) in Figure 64 of the Consultation Document.

[102] Paragraph 6.122 of the Consultation Document.

channels on a wholesale basis, including Sky Sports 1 HD, Sky Sports 2 HD and Sky Sports 3 HD.[103] Although that reply did not include any proposal from Sky in respect of the Sky Movies HD channels, as the cover letter makes clear the absence of such a proposal was a consequence of Virgin Media's stated plans for HD channels in the RFP rather than any reluctance on the part of Sky to supply the Sky Movies HD channels. Indeed, the cover letter specifically included an offer to develop "*an attractive Sky Movies HD proposal for Virgin Media*"[104] if such a proposal was of interest to Virgin Media. In subsequent discussions between Sky and Virgin Media, regarding the potential supply of Sky HD services, Virgin Media has not indicated any interest in the supply of a Sky Movies HD service in the near future.

6.119 Sky has, therefore, offered to make its HD sports channels available to Virgin Media at the first genuine opportunity. Therefore, the fact that Sky's HD sports channels are not currently available on the Virgin Media cable platform is not evidence of an incentive to withhold such channels. Sky also notes that Virgin Media did not select Sky's sports HD channels from the RFP process. This suggests that either (a) Virgin Media is not especially interested in Sky's sports HD channels, or (b) Virgin Media prefers to rely on the regulator to deliver Sky's HD channels to it on regulated terms.

6.120 Sky is still in discussions with Virgin Media regarding the supply of certain of its HD channels. Whilst an agreement has not yet been reached, it is clear that Sky has offered to make its HD channels available to Virgin Media. Therefore, the fact that Sky's HD channels are not currently available on the Virgin Media cable platform is not evidence of Sky acting on an incentive to withhold such channels.

6.121 Moreover, Sky understands that Virgin Media's cable platform was previously subject to capacity limitations which limited its ability to expand the number of linear HD channels on its platform.[105] It is clear from the RFP that the distribution of HD channels had in early 2009 only just become a realistic consideration (and therefore proposition) for Virgin Media. Sky understands that such capacity has recently become available because Virgin Media has reduced the portion of its network dedicated to the delivery of an analogue TV service.

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103 BSkyB response to Virgin Media's HD Request for Proposal, dated 24 March 2009.

104 Cover letter from David Rey to Peter Chapman , dated 24 March 2009 which states:

"*As you will be aware we currently broadcast 9 Sky Movies HD channels and we would be keen to offer them to Virgin Media subscribers. However, taking into account the initial limit of 5/6 HD channels and Virgin Media's current emphasis on its Filmflex VOD proposition, and without having any information about Virgin Media's preferences as between different HD channels, we have focused in this Proposal on the Sky Basic HD and Sky Sports HD channels. We are happy to discuss this approach and to see whether we can develop an attractive Sky Movies HD proposal for Virgin Media, if we have misgauged your likely level of interest in such a proposal at this time.*"

105 In October 2007, Malcolm Wall (the then Chief Executive of Virgin Media's content division) stated that "*We are bandwidth constrained*".

D. No material impact on competition

6.122 In the Parts above it is clear that Ofcom has not established that Sky has an incentive to restrict supply of its premium channels. We have also demonstrated that Sky has not in fact restricted distribution of its channels.

6.123 As noted at the start of this **Section 6**, Ofcom has not even embarked on an attempt to show that the normal competition law test for a refusal to licence intellectual property has been met. In the following paragraphs we show that, in addition, Ofcom has failed to demonstrate that Sky's alleged conduct is more likely than not to result in a material impact on the competitive process.

6.124 Before doing this, we first note that a crucial first step in assessing whether, absent Sky offering to wholesale its channels to new retailers, effective competition would be likely to be eliminated, is to determine the scope of the downstream market. Sky considers that the relevant retail market (as set out in **Section 5**) includes pay (including VoD) and free to air television services. It is clear that within this market, effective competition would not be eliminated if Sky did not offer to wholesale its channels to new retailers. Moreover, even if the relevant market were limited to retailing of pay TV, it is clear that if Sky failed to agree wholesale terms with any new retailer, effective competition would not be eliminated. For example, within this more narrowly defined market there would nevertheless be competition between Sky, Virgin Media, BT Vision and Tiscali TV.

6.125 Setting market definition to one side, Ofcom does not allege that Sky has refused to make its channels available on rival platforms but more narrowly that Sky has not offered its channels to rival retailers on wholesale terms. In fact, Ofcom acknowledges[106] that Sky has offered to retail its channels on rival platforms. Therefore Ofcom would need instead to show that such retail supply could be expected to materially harm the competitive process.[107] It does not do this. Instead Ofcom has misdirected itself and inappropriately sought to demonstrate that if Sky's channels were **not available on a third party platform** the competitive process is harmed.

6.126 Only one paragraph of Ofcom's 350 pages appears relevant to an assessment of whether Ofcom has proved that retail supply of Sky's channels on third party platforms is more likely than not to result in a material impact on the competitive process. At paragraph 6.85 Ofcom briefly identifies three concerns flowing from a scenario in which Sky retails its premium channels itself.

6.127 First, Ofcom considers that if Sky were to retail its channels itself this would prevent vigorous competition between retailers on different platforms. Competition is a function of many different factors including the set-up costs of joining a platform, set-top box functionality, reliability of picture, customer

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106 Paragraph 6.33 of the Consultation Document.

107 Sky notes that had Ofcom either amended Sky's licence to enable it to launch Picnic, imposed access-related conditions on TUTV, or completed its platform market review, certain of Sky's premium channels might already be available on DTT.

service, range of basic packages offered and their price, range and price of other add on services *etc*. None of these would be under Sky's control.

6.128 Ofcom's only possible concern regarding the intensity of competition – in so far as Sky understands Ofcom's concern - could be that where Sky retails its premium channels itself, the price of packages, including Sky's premium channels, would be unreasonably high relative to what they might be under a wholesale approach. But as we demonstrated in response to the Second Consultation Document, the price of packages including Sky's premium channels via Tiscali TV are substantially cheaper than equivalent packages via Virgin Media (*i.e.* where they are offered by the platform operator)[108]. We note that Ofcom has not sought to rebut this observation. See paragraphs 6.136 and following below for further detail.

6.129 Similarly, Sky's plans for Picnic indicated that Sky intended to charge prices which were [**CONFIDENTIAL**] per month lower than the closest equivalent package on DTH satellite and therefore [**CONFIDENTIAL**] cheaper than the prices which Ofcom assumes for its hypothetical DTT retailer (as Ofcom has assumed they would be the same price as on the DTH platform).[109] Given this retail price difference (between Picnic and DTH satellite), it is clear that there would be competition between different platforms using different technologies if Sky self-retailed its premium channels on Picnic.[110]

6.130 Evidence from France is also relevant where IPTV has been very successful in competing for new customers against the incumbent satellite platform despite the fact that premium channels delivered over IPTV are retailed directly by Canal Plus,[111] which is also the incumbent satellite operator, and not by the IPTV platform operators. In addition, in Germany, Sky Deutschland retails its channels itself over multiple platforms including over the cable networks.[112] Another example of channels being retailed by a broadcaster over a third party's platform is in Italy, where Sky Italia's Mondo packages[113] are made available on the IPTV platforms of Fastweb and Alice Home TV.[114]

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108 See paragraphs 2.47 to 2.50 of Section Five of Sky's Response to the Second Consultation.

109 Sky also notes that its premium channels are cheaper on a stand-alone basis via Sky Player than they are via Sky's DTH platform.

110 Moreover, this retail competition would occur on the basis of Picnic paying the cable ratecard prices (and being profitable doing so - see paragraphs 6.80 to 6.89 of this **Section 6** for further discussion of the wholesale price Picnic could afford to pay for Sky's premium channels).

111 Canal+ provides a variant of the Canal+ Le Bouquet package on all platforms including IPTV and cable, see page 26 of the Appendix to Annex 1 of Sky's Response to the First Consultation Document.

112 See references to "Premiere", which was rebranded Sky Deutschland over the summer of 2009, on page 51 of the Appendix to Annex 1 of Sky's Response to the First Consultation Document.

113 The Mondo package includes most of the channels available within the Sky Italia packages.

114 See page 83 of the Appendix to Annex 1 of Sky's Response to the First Consultation Document. It is clear that Sky's preference to self-retail is not unique.

6.131 Second, Ofcom suggests that Sky retailing on one platform versus Sky retailing on another does not represent a real choice. Ofcom's primary stated concern is that the availability of Sky's channels should not be a factor in determining which platform a consumer selects and that consumers should instead be able to choose the platform which they prefer. It is not clear how this choice would be impaired if, on their preferred platform, Sky's premium channels were retailed by Sky rather than the platform operator. Consumers would nevertheless be able to choose to subscribe to Sky's channels via DTT or IPTV based platforms if for example they had a preference for VoD services or because they were unwilling or unable to have a satellite dish.

6.132 Third, Ofcom suggests that Sky would have a weaker incentive than alternative providers to compete aggressively with its core DTH satellite platform. This third point seems to be the same as the first point - that self-retail by Sky, rather than wholesale supply, would result in less vigorous competition.

6.133 Ofcom claims that its concerns are borne out by the experience of Sky by Wire and Sky Player. Ofcom reports Tiscali's view that Sky prices its Sky by Wire service too high to achieve significant take-up but notes that from its own analysis "*it was not clear whether Sky by Wire offered poorer value to viewers.*"[115]

6.134 In its Second Consultation Document, however, Ofcom concluded that, where Sky retails via other operators' platforms, it has an incentive to weaken its retail offering; in reaching this conclusion it relied on the premise that Tiscali prices[116] are higher than DTH satellite prices for similar packages. Ofcom asserted that a "*comparison of the pricing of Sky's product on DTH with its product on Tiscali is illuminating" and that "it is very apparent that the DTH offer is more attractive.*"[117]

6.135 As noted above, Sky showed that Ofcom's comparison was wrong and that in fact Tiscali prices were generally lower than Sky's and, even more importantly, that Tiscali prices were significantly lower than prices of similar packages retailed by Virgin Media, which is supplied on wholesale terms. Whilst Ofcom does not comment on Sky's analysis it notes that the packages are not directly comparable because of differences in basic channels between the packages. Whilst the basic channels included in packages offered by Tiscali are different from those offered by Sky and Virgin Media it is disingenuous to say that this means no conclusions can be drawn. This is tantamount to saying that no conclusions can be drawn from any data since it is clear that no situation will ever be perfectly comparable as other factors will always be different.

6.136 Comparing Tiscali's Variety Pack and Sky's Variety Pack there are five pay TV channels that Tiscali includes that Sky does not and 30 pay TV channels which Sky includes and Tiscali does not. Sky estimates that it pays (notionally or otherwise) approximately [**CONFIDENTIAL**] per-subscriber per month for the 30

115 Paragraph 6.86 of the Consultation Document.

116 For the purposes of this discussion, we use the term "Tiscali prices" to refer to the total retail price a subscriber would pay to access Sky's premium channels via the Tiscali TV platform.

117 Paragraph 6.86 of the Consultation Document.

additional pay TV channels which it includes. Sky offers the five channels included in Tiscali's variety pack in its other packs and estimates that it pays (notionally or otherwise) approximately [**CONFIDENTIAL**] per-subscriber per month for these five channels. Accordingly, the differences in the content provided by the two packs equates to a cost of approximately [**CONFIDENTIAL**] per-subscriber per month. Given that Sky's previous analysis[118] showed that aside from single movies Tiscali prices were between £1.01 and £5.01 cheaper per month than the equivalent Sky digital package it is unlikely that the differences in the basic content are sufficient to undermine the conclusion that the price for premium tiers other than single movies would if anything be more expensive via DTH satellite than via Tiscali TV.

6.137 Even more significantly, comparing Tiscali's Variety Pack and Virgin Media's M pack there are five pay TV channels that Tiscali includes that Virgin Media does not and five pay TV channels which Virgin Media includes and Tiscali does not. Sky estimates that it pays (notionally or otherwise) [**CONFIDENTIAL**] pence-per-subscriber per month for the five additional pay TV channels which Virgin Media includes. Sky also estimates that it pays (notionally or otherwise) approximately [**CONFIDENTIAL**] per-subscriber per month for the five channels which Tiscali includes. Accordingly, the content provided by Tiscali relative to the content provided by Virgin Media equates to an additional cost of approximately [**CONFIDENTIAL**] per-subscriber per month. Sky's previous analysis[119] showed Tiscali prices were between £5.46 and £21.46 cheaper per month than the equivalent Virgin Media package. Accordingly, Tiscali prices are cheaper than those offered by Virgin Media and also include higher quality content (in the sense that the channels in the Tiscali TV basic pack are more expensive to acquire from third party channel providers than the content included in the Virgin Media basic pack). The differences in the basic content therefore strengthen the conclusion that the price for premium tiers would be more expensive via Virgin Media than via Tiscali TV. Accordingly, it is absolutely clear that prices on Tiscali TV (under a retail deal with Sky) are substantially more attractive prices than the prices on Virgin Media under a wholesale deal.

6.138 Even if Ofcom's view that the evidence is "*not clear*" is accepted, this would be yet another example of a key piece of evidence upon which Ofcom previously relied falling away without Ofcom amending its conclusions.

6.139 Ofcom's evidence in relation to Tiscali now relies entirely on the lower penetration rates for Sky's premium channels via Tiscali TV relative to DTH satellite. It is clear that that this will reflect very many different factors[120] (such as the maturity of the platform) and moreover that any such comparison will likely vary over time. As Sky has disclosed to Ofcom, penetration of Sky's premium channels on Tiscali's platform has been as high as [**CONFIDENTIAL**].

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118 See paragraphs 2.45 to 2.53 of Section 5 of Sky's Response to the Second Consultation Document for further information on Tiscali's pricing.

119 See paragraphs 2.45 to 2.53 of Section 5 of Sky's Response to the Second Consultation Document for further information on Tiscali pricing.

120 Paragraph 2.51 of Section Five of Sky's Response to the Second Consultation Document.

Conclusion – Supply of Sky's channels: There is no material impact on competition

6.140 As is clear from the above, Ofcom has not established that Sky has an incentive to restrict supply of its premium channels. Nor has Ofcom demonstrated that Sky has, in fact, restricted the supply of its premium channels.

6.141 Ofcom acknowledges that Sky has offered to retail its channels on rival platforms. Accordingly, in order to establish an expected material harm to the competitive process, Ofcom needs to show that such retail supply could be expected to materially harm the competitive process relative to an outcome in which Sky wholesaled its channels. It does not do this. Rather, as the discussion about Picnic in this **Section 6** shows, Sky intended to set charges for Picnic that were substantially lower than the charges of the closest equivalent on DTH satellite. In addition, it is absolutely clear that the prices available to consumers of Tiscali TV under a retail deal are substantially more attractive than those offered by Virgin Media under a wholesale deal.

6.142 As this **Section 6** shows, Sky's approach to distributing its premium channels does not, and could not, lead to a distortion of competition or material harm to the competitive process. Ofcom therefore fails to demonstrate that Sky's alleged conduct with regard to the supply of its premium channels is more likely than not to result in a material impact on the competitive process.

SECTION 7: OFCOM'S COMPETITION CONCERNS: OFCOM'S ALLEGATIONS REGARDING HIGH WHOLESALE PRICES ARE UNFOUNDED

A. Introduction

7.1 Having dealt with Ofcom's first competition concern (Sky's incentives to distribute its channels) in **Section 6**, Sky now turns in this **Section 7** to the second potential competition concern. That is, Ofcom's thesis that Sky is setting high wholesale prices for its premium channels in order to maximise wholesale profits, and that this can have the effect of keeping retail prices high.[1]

7.2 Ofcom proposes to use its sectoral powers to curtail Sky's economic freedom by regulating Sky's wholesale prices. Before exercising its powers under section 316, however, Ofcom must demonstrate that the substantive test for the exercise of those powers is met. As explained in **Section 3** above, given the nature of the concerns identified by Ofcom in the present case (Sky's alleged market power giving rise to concerns of refusal to supply and excessive wholesale pricing and/or margin squeeze), Ofcom should demonstrate that the established competition law tests for such abuses have been met, or that it is highly likely that they would be met, allowing for the *ex-ante* nature of its powers. However, notwithstanding its own internal thinking which confirms that it should adopt such an approach, Ofcom has not even attempted to meet those tests. Accordingly, its case fails before even embarking upon a detailed examination of its competition analysis.

7.3 But it does not stop with Ofcom casting standard competition law principles aside. As demonstrated in this section, it cannot *even* satisfy (and does not purport to satisfy) the test it previously formulated and applied in relation to section 316 that it should demonstrate that conduct having a 'material effect on the competitive process' has occurred or is more likely than not to occur.[2]

7.4 In Part B of this Section, we show that Ofcom has not established that the operating margin for Sky's notional Premium Wholesale business as a whole (which, for convenience, we denote as '**Premium Wholesale**' hereafter) is high or that Sky's wholesale charges for its premium channels are high. Specifically:

- This claim cannot properly be based on the Oxera Report at Annex 9 to the Consultation Document. Oxera's Report does not say that Premium Wholesale operating margin is high in any absolute sense.

- Nor can the claim properly be based on the fact that Sky's current ratecard prices are above Ofcom's estimate of cost-plus prices. The cost-plus prices that Ofcom has calculated are significantly too low and would, even based on Ofcom's analysis, allow the sub-set of activities within Premium Wholesale modelled by Ofcom (which, for convenience,

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1 Paragraph 6.3 of the Consultation Document.

2 See paragraphs 3.1 to 3.16 of Section 3 of Sky's Response to the Second Consultation Document.

we denote as "**Narrow Premium Wholesale**") to earn an average operating margin over the next 10 years of only 0.4%.

- Furthermore, Ofcom's model of Narrow Premium Wholesale contains a multitude of material errors which affect the result substantially. Once these errors are corrected Narrow Premium Wholesale would, if it were to charge Ofcom's cost-plus prices, expect to make a loss of over £700 million over the next four years.

7.5 In Part C of this Section, we show that, once corrected for some of these errors, Ofcom's model of Narrow Premium Wholesale indicates that if Sky were to charge its current cable rate-card prices, Narrow Premium Wholesale would expect to earn a normal operating margin over the next 4 years. Ofcom's model after these corrections and at current ratecard prices produces an estimated operating margin for Narrow Premium Wholesale which is slightly lower than the estimate for Premium Wholesale that Ofcom set out in its Second Consultation Document, and which Sky showed was at the low end of the estimates for a number of comparator companies. Hence, all the available evidence suggests that Premium Wholesale operating margins at current ratecard prices are entirely normal.

7.6 In Part D of this Section we establish that, in any event, Ofcom has failed to show that setting high wholesale prices for premium channels is likely to have a material impact on the competitive process and that, in fact, Ofcom appears to agree that high wholesale prices would be unlikely to distort retail competition.

B. Ofcom has not shown that Sky's wholesale prices are high

7.7 In its Second Consultation Document Ofcom sought to examine the profitability of Premium Wholesale by calculating its gross margin. Ofcom calculated a gross margin on the wholesaling of premium sports channels of between [**CONFIDENTIAL**]% and [**CONFIDENTIAL**]% and between [**CONFIDENTIAL**]% and [**CONFIDENTIAL**]% for premium movie channels. In response to that Consultation Document, Sky showed that because these lines of business have substantial common revenues (and to a lesser extent common costs), the only meaningful way of approaching the evaluation of profitability of Premium Wholesale is to examine its profitability as a whole. Sky also showed that Ofcom's estimate of an overall operating margin of 25% included a number of material errors and was likely to be overstated, but that in any event an operating margin of 25% is at the lower end of the range of operating margins earned by a number of similar companies.

7.8 In its Consultation Document Ofcom makes virtually no comment on Sky's response and fails to make any reference to the fact that Sky compared Ofcom's estimate of operating margins with that earned by a number of similar companies and found it to be at the low end of the operating margins earned by those companies. In particular, Ofcom makes no attempt to argue that the companies were not appropriate benchmarks.[3]

7.9 Ofcom now no longer seeks to use its analysis of operating margins to support its conclusion that Sky's wholesale prices are high. Instead it states that:

> "*we acknowledge that the evidence and analysis which we presented in our previous consultations does not allow us to conclude on whether Sky is earning monopoly profits either in aggregate or in its wholesale business*".[4]

7.10 Ofcom fails to accept that a proper assessment of operating margin - an approach to assessing the profitability of Premium Wholesale which Ofcom itself put forward and which is widely adopted in the real world - shows that Premium Wholesale is not earning excessive operating margins. Instead it concludes that the analysis of operating margins is inconclusive and moves away from an approach seemingly based on operating margins to search for a different approach in the hope that this will be more helpful to its case. This is not the behaviour of a regulator acting reasonably or objectively.

7.11 Accordingly, in its Consultation Document Ofcom switches tack and returns to an approach of evaluating profits based on a truncated internal rate of return ("**IRR**"). This is despite previously concluding that such an approach would not "*yield a robust conclusion about Sky's profitability*".[5,6] In particular, Ofcom commissioned Oxera to assess Sky's profitability based on a truncated IRR approach both on an aggregate and disaggregated basis. Based on its interpretation of Oxera's analysis and on its own pricing analysis Ofcom concludes that:

- Sky is setting high wholesale prices which are reflected in it earning high wholesale margins;[7] and
- these are likely to be particularly concentrated in high wholesale margins on its premium movie channels.[8]

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3 We note that Ofcom attempts to distance itself from its previous estimate of operating margins for Premium Wholesale by stating that the estimate relied on Sky's estimate of operating costs which were not endorsed by Ofcom. It is not open to Ofcom simply to dismiss this evidence, which clearly demonstrates that Premium Wholesale operating margins are reasonable, on the basis that one of the inputs into the calculation did not come from Ofcom. Ofcom has requested substantial financial information from Sky and so should have been in a position to establish whether it considered these estimates to be reasonable. We note that Ofcom is not saying that Sky's estimates of operating costs were too high or that a more appropriate estimate would have substantially altered the conclusion.

4 Paragraph 6.170 of the Consultation Document.

5 Paragraph 1.55 of Annex 9 of the Second Consultation Document.

6 The inconsistency between Ofcom's reliance on a truncated IRR and its previous views on such an approach as set out in the Second Consultation Document is explored more fully in paragraphs 4.11 to 4.18 of **Section 4** of this Response.

7 See paragraphs 1.4, 1.64, 8.5, 12.1, 7.104, 10.74, 12.22 of the Consultation Document.

7.12 More specifically, Ofcom states at paragraph 12.22 of the Consultation Document:

> *"Additionally, we have already set out a concern relating to high margins within Sky's wholesale business. This is based both on the profitability analysis carried out by Oxera (see Section 6) and our own pricing analysis, which shows a significant gap between retail-minus and cost-plus prices (see section 9). Our view, particularly in light of our pricing analysis, is that the evidence of high margins is stronger for Sky's movie channels than its sports channels."*

B(a) Ofcom misrepresents Oxera's conclusions

7.13 A careful review of the Oxera Report reveals that Ofcom has misrepresented its findings and inappropriately sought to suggest that Ofcom's conclusions are supported by Oxera when they clearly are not. Oxera did not say that Sky was earning high wholesale margins. What Oxera actually said was that the analysis of wholesale profitability relies on assumptions about allocation of cost, revenues and assets and is therefore "*inherently more uncertain*".[9] In particular it notes that the results should be "*interpreted in terms of the **relative** relationship between returns for different activities, **as opposed to the absolute levels** of returns*" (emphasis added).[10]

7.14 Consistent with these statements, Oxera merely goes so far as to conclude that the returns from wholesale activities appear to be higher than for retail activities.[11] Oxera did not draw any conclusion as to whether the level of return on Sky's wholesale activities might be considered high in any absolute sense; indeed, it specifically cautioned against any such inferences being drawn. Oxera certainly did not suggest that it was appropriate to draw conclusions on the appropriateness of the profitability of wholesale activities by comparing their estimate of the truncated IRR on wholesale activities with an estimate of Sky's cost of capital, even though this is precisely what Ofcom has sought to do.

7.15 Nor did Oxera say that Sky's margins on its movie channel business were especially high. What Oxera actually said was that the "*results of the analysis at*

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8 See paragraphs 1.78, 12.28, 7.104, 12.22 of the Consultation Document. Sky notes that paragraph 7.104 of the Consultation Document is confidential.

9 Page iii of the Oxera Report at Annex 9 of the Consultation Document.

10 See second paragraph on page 33 of the Oxera Report. See also Section 5.1 of the Oxera Report which states: "*the objective of the analysis is to assess **relative** returns between different activities, as opposed to estimating the **absolute** level of returns*" (emphasis added).

11 We note that it is not clear what conclusions can be drawn from this. In particular as Sky noted in para 3.4 of Section 6 of Sky's Response to the Second Consultation Document, the different parts of Sky's businesses will be exposed to different levels of risk, sunk costs and reflect different levels of capital investments and would therefore be expected to earn different margins and have different costs of capital. Indeed, it is hardly surprising that returns for wholesale activities appear to be higher than for retail activities, as wholesale has all the large fixed long term commitments and therefore higher risk, whereas retail is largely a variable cost business so the risk is lower.

this level of disaggregation are not sufficiently robust to conclude on the profitability of movies and sports channels".[12]

7.16 Accordingly, Oxera's analysis cannot be used to support the conclusion Ofcom seems to draw, that is, that Sky's wholesale prices and particularly the price of its premium movie channels are unduly high[13] and reflect a high margin.

7.17 Indeed we note that elsewhere in its report Ofcom itself acknowledges the limits of the Oxera Report. At paragraph 8.17 of the Consultation Document, Ofcom states that it:

> "*do[es] not however consider that the evidence provided by the Oxera report in relation to the wholesale margins for Core premium Sports channels or Core Premium Movie channels is likely to provide a sufficient basis for an excessive pricing case under CA98 against Sky.*"

7.18 It is unclear why Ofcom considers that Oxera's analysis can, on the one hand, be sufficient to demonstrate that Sky's wholesale prices are high (and hence can be reduced without preventing Sky from earning a reasonable margin) but would, on the other, not provide sufficient evidence to support an excessive pricing case.

B(b) Ofcom's pricing analysis is so flawed it cannot be relied on

7.19 The second basis for Ofcom's belief that Sky's wholesale prices are high is that its pricing analysis shows that Sky's current ratecard prices are above Ofcom's estimate of cost-plus prices.

7.20 Before considering the detail of Ofcom's pricing analysis it is important to understand that Ofcom's pricing analysis is not based on Sky's notional wholesale business ("**Wholesale**") or indeed the premium part of Sky's notional wholesale business, Premium Wholesale. Instead Ofcom's pricing analysis attempts to isolate the costs and revenues related to the supply of standard definition versions of Sky's premium channels to residential subscribers in the UK on a package by package basis.[14] We refer to this notional part of Premium Wholesale as Narrow Premium Wholesale.

7.21 Ofcom calculates cost-plus prices as reflected in column 6 of Figure 64 of the Consultation Document which it considers "*are appropriate to allow a reasonable return*".[15] Ofcom infers that Narrow Premium Wholesale's operating margin is high due to the fact that its estimate of the cost plus price is below the existing cable ratecard offered to Virgin Media. Ofcom's estimates of cost-plus prices are, however, so seriously flawed that they cannot be relied on. Accordingly, the fact that Sky's current ratecard prices exceed Ofcom's estimate of cost-plus

12 Page 33 of the Oxera Report at Annex 9 of the Consultation Document.

13 See for example paragraphs 1.4, 4.53, 8.5 and 12.28 of the Consultation Document.

14 Therefore it attempts to exclude costs and revenues associated with Sky providing HD, Ireland, commercial, PPV and, inexplicably, Multiroom services.

15 Paragraph 9.191 of the Consultation Document.

prices provides no evidence that Narrow Premium Wholesale earns high operating margins or that Sky's wholesale prices are high.

Ofcom's approach is flawed

7.22 Ofcom has sought to calculate cost-plus wholesale prices within the context of a discounted cash-flow framework including a terminal value. Ofcom uses its estimate of the opening asset value of Narrow Premium Wholesale as a cost incurred in the first year and employs the same discount rate of 10.3% used for Sky as a whole.[16]

7.23 Ofcom's analysis of cost-plus prices cannot be relied on due to the fact that the methodology it adopted is not fit for purpose. As set out by Oxera in its 2003 Paper for the OFT,[17] estimating profitability based on an IRR is not appropriate "*In industries with high intangibles and low fixed assets (e.g. trading companies and knowledge-based sectors); or where it is not possible to allocate capital between lines of business*".[18] Both of these problems arise in relation to Premium Wholesale (and Narrow Premium Wholesale).

7.24 In relation to the first problem, Ofcom itself acknowledges that Premium Wholesale is asset-light (see paragraph 1.13 of Annex 6 to the Second Consultation Document). In relation to the second problem it is clear that Oxera had considerable difficulty in estimating the capital base for Premium Wholesale (and Narrow Premium Wholesale) which is exactly why it made no such estimate. By indicating that the opening asset base it uses to derive its cost plus pricing is "*consistent with the Oxera work*",[19] Ofcom leaves the reader with the misleading impression that the asset base was calculated by Oxera. In fact it was not. Given its stated concerns about the quality of data and the inherent uncertainty associated with disaggregated profitability analysis, Oxera did not calculate an asset base for Premium Wholesale (or Narrow Premium Wholesale) and only went so far as to calculate an asset base for Wholesale. So, despite claiming that "*Oxera is a recognised expert in the field of economic profitability*",[20] and that Oxera was commissioned "*to address the specific*

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16 Ofcom's use of a cost of capital that was derived for Sky as a whole is not appropriate. Although Ofcom acknowledges that in some circumstances it may be appropriate to use a disaggregated cost of capital, it concludes that there are no reasonable grounds for believing that there are sufficient differences between the various parts of Sky's business for this to be necessary in this case. However, Sky notes that Ofcom previously recognised (at paragraph 5.92 of its Determination to resolve a dispute between Rapture Television plc and British Sky Broadcasting Ltd about EPG listing charges), that a cost of capital in relation to one part of Sky's business, Sky's platform business, could differ from the WACC for Sky as a whole. Moreover, there are, in fact, quite good reasons for expecting the cost of capital to be higher for Premium Wholesale than for Sky as whole due to the high level of fixed costs. It is therefore obvious that Ofcom must, as it did with BT (paragraph 9.118 of the Consultation Document) consider the appropriate cost of capital on a disaggregated basis.

17 Oxera (2003), "*Assessing profitability in competition policy analysis*", Economic Discussion Paper 6, Office of Fair Trading (the "**2003 Oxera Report**").

18 Figure 1.2 of the 2003 Oxera Report.

19 Paragraph 9.155 of the Consultation Document.

20 Paragraph 6.172 of the Consultation Document.

difficulties…with analysing Sky's … disaggregated profitability",[21] Ofcom in the end relies on its own estimate of the opening asset base, a calculation that Oxera was unable to perform.

7.25 In any event it would not be possible to infer that Narrow Premium Wholesale is earning excessive profits or that its wholesale prices are high simply on the basis that its prices exceed price levels consistent with Narrow Premium Wholesale earning a return on investment equal to its cost of capital.[22] Earning a return that exceeds a firm's cost of capital should be anticipated to be the norm and is an integral part of a well functioning market economy and will be observed in the most competitive of markets (for a more detailed discussion of reasons why successful firms could be expected to earn a return that exceeds the cost of capital, see paragraphs 4.43 to 4.52 of **Section 4** of this Response.

7.26 In circumstances where either of the problems referred to in paragraph 7.23 above arise, the 2003 Oxera Report indicates that the preferred approach is to "*estimate ROS, gross margins or market valuations*" and "*benchmark against corresponding measures of comparator companies*".[23] Accordingly, when asked to consider a disaggregated profitability analysis of Sky, Oxera cautioned against the use of an IRR and indicated that "*it seems more appropriate to place more weight on alternative profitability measures*".[24] Consistent with this Oxera did not attempt to assess the profitability of Premium Wholesale (or Narrow Premium Wholesale) on the basis of an IRR or return on capital employed. Instead Oxera sought to assess the profitability of Premium Wholesale by estimating the operating margin (or return on sales) and the margin earned over direct costs.

7.27 In summary, based on the advice of its own expert, Ofcom should not have sought to derive cost-plus prices within a DCF framework. The only reliable basis for exploring the issue of interest to Ofcom is to assess the profitability of Premium Wholesale based on its operating margin and then compare this to comparator companies.[25] In so doing Ofcom must properly respond to the analysis presented by Sky in its Response to the Second Consultation Document

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21 Paragraph 6.173 of the Consultation Document.

22 Nor is it appropriate to infer that wholesale prices for Sky's premium channels must be high on the basis of Ofcom's aggregate profitability analysis. As we show in **Section 4** there are material problems with Ofcom's aggregate profitability analysis. Even if it were sound, which it is not, it would not be appropriate to make such a leap in logic. There are numerous possible reasons why Sky's IRR over the past five years may have exceeded its cost of capital other than as a result of unduly high wholesale charges for Sky's premium sports and movie channels. For example, Sky's returns may have been boosted during this period by the success of Sky+, Sky's introduction of a wide range of new basic packages, increased penetration of Sky's Multiroom service and so on. Without proper investigation, which Ofcom has not undertaken, it is inappropriate for Ofcom to claim a direct relationship between Sky's aggregate profitability and wholesale charges for Sky's premium sports and movie channels.

23 Figure 1.2 of the 2003 Oxera Report.

24 Page 34 of the Oxera Report at Annex 9 of the Consultation Document.

25 Operating margin is also one of the key measures used by financial analysts when assessing and comparing businesses in the TV sector.

which showed that the operating margin was at the low end of the range for a number of comparable companies.

The fact that the approach is flawed is self-evident from the outputs

7.28 Indeed the fact that Ofcom's approach is not appropriate should be evident to Ofcom from the results it produced:

- Based on Ofcom's analysis, in theory, Narrow Premium Wholesale would be permitted to earn a profit of only £16 million per annum. This would be a function of Ofcom's own estimate of an opening asset value for Narrow Premium Wholesale of £160 million,[26] and Ofcom's assumption that the return on Narrow Premium Wholesale is reasonable provided it equals Ofcom's estimate of Sky's WACC of 10.3%. Revenues and costs, however, fluctuate, and so in fact Ofcom's model shows that if Sky were to charge Ofcom's estimate of cost-plus prices, Narrow Premium Wholesale would earn an aggregate return of £65 million over the next 10 years, on a business with £15 billion in aggregate operating costs (over the same period), which equates to an operating margin of only 0.4%[27] (see **Table 7.1** below).

[26] Ofcom initially calculate this number as £162 million, however the movies element has been incorrectly allocated between packages and therefore the actual number used by Ofcom to calculate the cost-plus prices is £160 million.

[27] Throughout this section, in order to derive an operating margin we have assumed that depreciation will be equal to capital expenditure. Although we accept that this may not be the case in a given year, it is likely to be correct over the long term.

Table 7.1

Ofcom's estimates of Narrow Premium Wholesale revenues and costs

£m	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	Total
Revenue	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Capital employed	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Operating costs	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Operating cashflow	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Operating margin	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]

- Even Channel 4 (a non-commercial public service channel, with no shareholders, whose remit is to fulfil a number of public service objectives) earned an operating margin in excess of 10% in 2005, prior to the start of the current advertising down-turn. It is a complete nonsense to suggest that it should be considered reasonable for Narrow Premium Wholesale to earn an operating margin which is less than one-twenty-fifth of that previously earned by Channel 4.[1] Similarly, the Chief Executive of BBC Worldwide has indicated that if the potential merger of BBC Worldwide and Channel 4 happened, then the UK only venture "*would turn over a figure in excess of £800 million and produce a profit in the order of £200 million*"[2], which implies an operating margin of 25%.

- Even more absurdly, if Sky were to charge the cost-plus prices which Ofcom has estimated then Narrow Premium Wholesale would make a loss of £24 million over the next two years.

- Allowing Narrow Premium Wholesale an average return of only £6.5 million per annum, or 0.4% operating margin, makes no intuitive sense given the very significant risks involved in content creation and content acquisition. Sky continually makes future commitments to rights owners which are currently close to £4 billion, many of which are fixed.[3] Whether Sky can generate sufficient revenue to meet these commitments will depend on the number of subscribers to its channels (across DTH satellite and wholesale) it can attract and maintain which exposes it to considerable risk. It is a complete nonsense to suggest that a broadcaster would be willing to incur substantial fixed costs in the creation or acquisition of content if all they were permitted to make was an operating margin of 0.4%. We challenge Ofcom to find any broadcasting business willing to invest on this basis.

- Ofcom's estimate of an opening asset base of £160 million for Narrow Premium Wholesale is also entirely inconsistent with Oxera's estimate of [**CONFIDENTIAL**] for the value of the assets associated with Wholesale for the previous year. The Consultation Document does not provide any explanation for this glaring inconsistency. It was only after asking Ofcom to explain this discrepancy on two separate occasions that Ofcom eventually acknowledged that it had in fact overruled "*the recognised expert in the field of economic profitability*"[4] and unilaterally decided that it should ignore the subscriber base intangible assets and the contractual obligations intangible asset which Oxera had allocated to

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1 In the same period ITV Group made an operating margin of 15%.

2 Chief Executive of BBC Worldwide Mr John Smith, from page 39 of minutes of evidence taken before the House of Lords Select Committee on Communications on Wednesday 13 May 2009.

3 Per Sky's annual reports, future minimum expenditure contracted for television programme rights was £3,911 million, £2,356 million and £2,638 million at June 2009, June 2008 and June 2007 respectively.

4 Paragraph 6.172 Consultation Document.

Wholesale.[5] We find it disturbing that Ofcom chose not to make this clear in its Consultation Document and it required some detective work from Sky to expose what Ofcom had done.

The fact that Ofcom's cost-plus prices are significantly too low is even clearer once the errors in their analysis are corrected

7.29 As well as relying on a flawed methodology which is inconsistent with the advice of its own expert and produced results that are not plausible, Ofcom also makes a number of material errors in its calculations. Once these errors are corrected it shows that if Sky were to set wholesale charges consistent with Ofcom's cost-plus prices then, far from earning a reasonable return, it would in fact suffer very material losses. In the following Part of this Section we detail some of the most material errors to ongoing revenues and costs (ignoring opening asset values referred to above) we have identified. These errors highlight the lack of understanding of Sky's business and lack of general modelling competence, combined with an apparent lack of cross-checking, which is disappointing considering Ofcom's conclusions had the potential substantially to affect Sky's share price. We note, however, that we have had significant difficulty in working through Ofcom's analysis due to the lack of any proper supporting documentation and the poor attention to modelling best practice. There may, therefore, be other material errors which we have not yet identified.

7.30 In seeking to correct Ofcom's errors we have focused on those which are unambiguous and arise due to:

- a misunderstanding of the business area(s) to which certain cost categories relate;
- manifest errors in Ofcom's estimates of subscribers, revenues or costs; and
- analytical defects in establishing the costs and revenues of Narrow Premium Wholesale.

7.31 We could undermine Ofcom's conclusions still further by challenging the various other assumptions Ofcom has made regarding the allocation of common costs. We have chosen not to do this at this stage because it is not necessary (Ofcom's conclusions can be shown to be seriously flawed without resorting to a discussion of alternative allocations of common costs). In addition, whereas in some cases there may be an approach to allocating common costs, for example, which is meaningful and properly relates to the underlying drivers of those costs, in many circumstances electing to use one allocation method versus another can be fairly arbitrary. In these circumstances, the estimates of

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5 In addition, i) the basis of allocation of opening assets between Basic Wholesale and Premium Wholesale is inconsistent with other allocations and highly questionable and ii) Ofcom uses a broker report, which is over a year and a half old, as the forecast of **opening** assets for 2009/10 but incorrectly uses the **closing** asset values from the broker report for 2009/10 in its calculations.

profitability of each line of business will then simply reflect whatever approach to allocation is selected. That said it is clear that Ofcom's results could be materially different if Ofcom were to use a different (but nevertheless equally reasonable) allocation of costs.[6]

7.32 Sky would, however, note that given the inherent uncertainty involved in allocating costs it is best practice to opt for an approach that limits the extent to which such arbitrary allocations need to be made. Ofcom's approach, on the other hand, of trying to estimate the profitability of Narrow Premium Wholesale (instead of Premium Wholesale) and on a package by package basis requires many assumptions regarding the allocation of costs (and revenue or margin) which are unnecessary. For example, sports rights are shared by the different activities in which a broadcaster can exploit those rights. Based on its inappropriate approach, however, Ofcom has needed to allocate sports rights costs across UK standard definition residential, commercial and Ireland and then across packages containing different Sky Sports channels. Sky considers that such detailed sub-allocation of common costs (and revenue or margin) creates the potential to draw conclusions which are not robust and rely on a particular assumption about how to allocate costs (and revenue or margin). Ofcom should have tried to avoid this risk by looking at the profitability of Premium Wholesale as a whole and not Narrow Premium Wholesale.[7,8]

7.33 Given the inherent uncertainty in forecasting revenues, costs and subscribers over the long term we have focused our corrections below over a four year period.

(a) Subscribers

<u>Opening UK DTH satellite subscribers</u>

7.34 To obtain an opening subscriber position for the first year of detailed modelling (2009/10), Ofcom uses a "*Broker's report*" estimate of [**CONFIDENTIAL**] closing

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6 Sky would like to have been able to quantify the sensitivity of Ofcom's results to its assumptions regarding cost allocations by running sensitivity analysis within Ofcom's own models. However, due to the lack of flexibility within Ofcom's models and the inconsistent linking across spreadsheets Sky could not in the time period allowed undertake this exercise without first rebuilding all of Ofcom's models from scratch. This is one of many examples of Ofcom not complying with modelling best practice.

7 See also discussion in **Section 10** paragraphs 10.93 to 10.95, which are also relevant to this analysis.

8 If, however, Ofcom nevertheless attempts to sub-allocate costs to different lines of business within Premium Wholesale then, at the very least, it must correct for an error in relation to Multiroom. The proportion of costs Ofcom has allocated to Narrow Premium Wholesale is reduced due to the fact that Ofcom has taken a proportion of the total wholesale costs allocated to sports and movies to Multiroom. However, the wholesale price of Sky's premium channels allows each retailer to provide Multiroom services to their customers in respect of those channels without incurring any additional wholesale cost. Hence there is no Multiroom wholesale revenue stream to cover these costs.

UK DTH satellite subscribers for June 2009[9] and applies the tier mix as at September 2008.

7.35 This estimate of closing UK DTH satellite subscribers implies UK net additions of 736k in 2008/09, which has no basis in reality. As Sky reported in its year end results, net additions across both UK and Ireland were 462k in 2008/09, the highest figure for five years. It is worrying that Ofcom's knowledge of Sky's business is so poor that it did not notice that this was an absurd assumption or that it was not picked up in a simple cross-check of the model.

7.36 Sky has therefore corrected Ofcom's analysis to include actual closing UK DTH satellite subscribers as at June 2009 and their tier mix at that point.

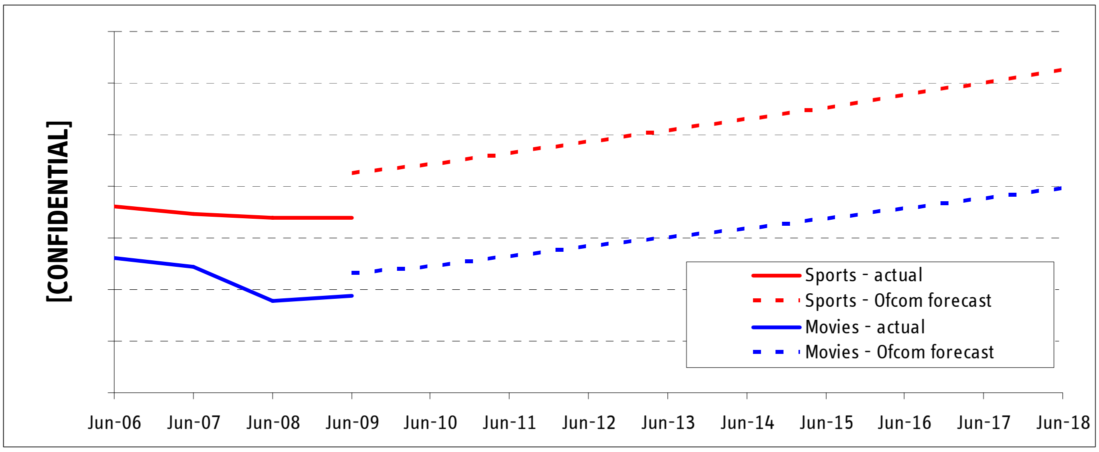
Forecast UK DTH satellite subscribers

7.37 Ofcom's forecasts of Sky's UK DTH satellite subscribers are sourced from *"Broker reports adjusted to reflect impact of WMO"*[10] with Ofcom's key assumption that Sky's tier mix remains unchanged from September 2008.

7.38 The assumption of a static tier mix combined with increasing total subscribers leads to significant increases in Sky Sports and Sky Movie subscribers over the period modelled. This would imply a reversal of the current trends which has seen the absolute volume of these subscribers on UK DTH satellite fall over the last 3 years. Comparing Sky's actual subscriber levels with Ofcom's forecasts (all figures from Ofcom's model) highlights this assumed improved performance which Ofcom should have recognised:

Figure 7.2

Sky UK DTH satellite subscribers



7.39 Sky has therefore used an assumption consistent with current trends that UK DTH satellite Sports and Movie subscribers remain flat for the period modelled

9 Figure in cell E267 with source in cell P267 on "*Sky subscribers*" sheet of Ofcom's Wholesale Pricing Model. For clarity Sky notes that all spreadsheet references in this Section refer to Ofcom's Wholesale Pricing Model provided to Sky on 6 July 2009, unless otherwise stated.

10 Row 29 of the "*Control sheet*" sheet.

and kept Ofcom's assumptions for the overall growth from 2009/10 onwards of the DTH base unchanged. This is an extremely conservative assumption given that, separately, Ofcom believes that Sky will lose approximately one million premium DTH satellite subscribers to a new DTT operator over the next 10 years.[11]

(b) Advertising

Costs

7.40 Ofcom has attributed the direct costs of operating Sky's advertising sales department as a "*Non TV*" cost.[12]

7.41 This cost is clearly a cost of Wholesale and so presumably a simple error by Ofcom, so Sky has therefore re-attributed it to Wholesale.

Revenue forecasts

7.42 Following a convoluted calculation to determine notional advertising and sponsorship revenues for 2007/08 (they are notional as they assume Sky's basic channels were available on Virgin Media for the period), Ofcom then assumes these figures increase with inflation[13] to provide figures for the modelled period.

7.43 In light of the current advertising downturn, to assume that Sky's retained advertising revenues effectively remain the same between 2007/08 and 2009/10 is clearly incorrect. Ofcom, as the sector regulator, must be well aware of the advertising downturn.

7.44 Sky's recent results reported a 6% annual decrease in total advertising revenue in 2008/09 despite Sky's basic channels becoming available again in Virgin Media homes. The like-for-like annual revenue decrease for Sky owned channels in the UK was[**CONFIDENTIAL**]%, significantly worse than the 0.95% increase forecast by Ofcom.

7.45 The outlook for 09/10 is also challenging:

- ITV has said "*the rate of market decline has eased slightly in the second half* [of 2009]... *ITV NAR is currently forecast to be down 12% for the third quarter*".[14]

- The latest Zenith forecast[15] predicts TV advertising revenues to be 14% lower in 2009 compared to 2008 and a further 2% lower in 2010.

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11 Paragraph 1.40 of the Consultation Document.

12 Cell H835 of the "*Consolidation*" sheet.

13 0.95% for 08/09, -1.5% for 09/10 and 2.5% thereafter cells E73, E74 and E75 of the *"Control sheet"* respectively.

14 ITV 2009 Interim Results press release, 6 August 2009. Available at: http://www.itvplc.com/media/newsrelease/?id=22780

- A later GroupM forecast[16] predicts TV advertising revenues to be 14% lower in 2009 compared to 2008 and a further 3% lower in 2010.

7.46 Whilst it is currently unclear how the advertising market will develop over the remainder of the current financial year, Ofcom's forecast for a 1.5% reduction in 2009/10 is outside the range of all current forecasts and, based on the above, a reduction of 5% would appear to be at the more optimistic end of the current range of forecasts.

7.47 Sky has therefore substituted Ofcom's inflation adjustments such that advertising and sponsorship revenue forecasts for 2009/10 will fall by 15%[17] from the notional 2007/08 figures calculated by Ofcom.

Inconsistent return on advertising revenue vs Narrow Premium Wholesale

7.48 Ofcom has treated the advertising and sponsorship revenue earned by Narrow Premium Wholesale as a reduction of costs and not directly as revenue. The amount deducted is "*such that the advertising of premium channels has the same operating margin as Sky's total group operating margin (about 15% for 2007/08)*".[18]

7.49 This is an arbitrary adjustment and another example of an approach adopted by Ofcom which requires an additional unnecessary assumption. Where the operating margin of Sky group is lower than for Narrow Premium Wholesale, this approach also has the effect of artificially increasing the operating margin of the Narrow Premium Wholesale and increasing this gap.

7.50 It is to be expected that a wholesale business would sell advertising on its channels and would regard this as a revenue stream. Therefore, rather than reduce the cost of Narrow Premium Wholesale by making this arbitrary adjustment, the costs should remain and this revenue simply recognised as revenue rather than negative cost. Ofcom also uses this cost reduction treatment to exclude other normal streams of Narrow Premium Wholesale revenue (i.e. sports sublicence revenue), which should also be treated as revenue. Such an approach would also be consistent with Ofcom's treatment of advertising and other revenues in its retail minus calculations.

7.51 Sky has, therefore, treated all of Narrow Premium Wholesale revenue streams as revenue and has reversed out the two cost reductions made by Ofcom.

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15 Page 171 of ZenithOptimedia, "*Advertising expenditure forecasts – July 2009*".

16 *"This Year Next Year UK summer 2009"* press release issued on 3 June 2009. Available at: https://publications.groupm.com/images/Press%20release%20for%20TYNY%20UK%20Summer%202009.pdf

17 Reflecting a like-for-like 10% decline for Sky's channels in 2008/09 and an optimistic estimated decline of only 5% in 2009/10.

18 Paragraph 9.152 of the Consultation Document.

(c) Wholesale costs

Sports rights costs

7.52 Ofcom has performed a detailed calculation to forecast sports rights costs by looking at the top 10 sports rights by value in detail and performing a simple extrapolation for remaining rights spend.

7.53 This calculation has many flaws including:

- Ofcom's assumption that within a particular rights contract the payments increase by inflation each year;
- incorrect values used for certain contracted rights; and
- failure to take account of the non-annual rights detailed in Section 6 of Sky's Response to the Second Consultation Document.

7.54 Rather than correct these many individual errors Sky has considered the overall forecast of rights cost.

7.55 **Table 7.3** below shows a comparison of Ofcom's estimate of Sky's total sports rights costs (following the subscriber adjustments above) and Sky's latest forecast.[19] It shows that Ofcom's forecasts underestimate Sky's total sports rights costs by a total of £162m over 4 years.

Table 7.3

Sky's annual total sports rights costs

Financial Year	Ofcom's forecast	Sky's forecast
09/10	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
10/11	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
11/12	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
12/13	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]

Note: There will be a slight difference between the forecasts as Ofcom's are cash payments (i.e. inclusive of any upfront payments) and Sky's figures are the P&L charge

7.56 Sky has therefore substituted Ofcom's forecasts for Sky's latest forecasts of total sports rights costs which it regards as considerably better informed (this estimate of total sports rights costs has then been allocated across different

[19] These forecasts are sourced from Sky's latest forecast and 5-year plan. As Sky has previously explained to Ofcom the 5-year plan does not provide a reliable prognostication of what Sky believes will happen in the future. The nature of the assumptions varies depending on the data and reflects a mixture of public targets, aspirations for particular parts of the business or may in some cases be simple projections based on past years' data. In relation to sports rights, sports production, fixed movies rights and the variable cost per movie subscriber, Sky considers the assumptions in the 5-year plan to be reasonable, as a large proportion of the costs are committed or readily forecastable.

parts of Premium Wholesale consistent with Ofcom's own allocation percentages).[20]

Sports production costs

7.57 Ofcom has incorrectly calculated a sports production figure for 2007/08 and then exacerbated this error by only increasing it by inflation.[21]

7.58 This assumption takes no account of the extra rights Sky has purchased and the additional production costs required. It also ignores the production costs associated with non-annual rights.

7.59 **Table 7.4** below compares Ofcom's forecast of Sky's total sports production costs with Sky's latest forecast. It shows that Ofcom's forecasts underestimate Sky's total production costs by a total of £126m over 4 years.

Table 7.4

Sky's annual total sports production costs

Financial Year	Ofcom's forecast	Sky's forecast
2009/10	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
2010/11	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
2011/12	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
2012/13	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]

7.60 Sky has therefore substituted Ofcom's forecasts for Sky's latest forecasts of total sports production cost which it regards as considerably better informed (this estimate of total sports production costs has then been allocated across different parts of Premium Wholesale consistent with Ofcom's own allocation percentages).[22]

20 Sky notes that, although Ofcom allocates a portion of total sports rights costs to HD, in some of its calculations it somewhat inexplicably did not do so when looking at individual sports rights. Sky has assumed that this was in error and in allocating corrected total sports rights attributed a portion of the costs to HD, consistent with Ofcom's allocation percentages where such percentages were applied.

21 The figure calculated by Ofcom (which includes direct production costs, overhead costs, promos and channel management) is £10 million lower than the actual cost for 2007/2008 in the management accounts provided to Ofcom.

22 Sky notes that in its allocation of sports production costs Ofcom has also incorrectly allocated a share of those costs to PPV services. This is incorrect as all PPV production costs are identified separately in Sky's management accounts. In allocating corrected total sports production costs, Sky has corrected this error and not attributed a portion of production costs to PPV.

Sports production costs allocation

7.61 Ofcom has allocated UK sports production costs equally between Sky Sports 1, Sky Sports 2, Sky Sports 3 and Sky Sports Xtra.[23]

7.62 As Ofcom recognises in its allocation of sports rights costs between the Sky Sports channels, rights costs should not be split evenly between channels. Therefore it is surprising that Ofcom has nevertheless chosen to allocate the associated production costs equally across the Sky Sports channels.

7.63 Sky has calculated a more sensible alternative which allocates production cost for each sports contract based on the number of live hours on each channel in 2007/08. Whilst no method is perfect, this is a considerably more sensible method for allocating production costs across channels because it is in line with the key driver of production costs, which is live hours.

7.64 **Table 7.4** below summarises the percentage split between channels based on Ofcom's allocation and Sky's proposed method of live hours:

Table 7.4

Allocation of Sky's 2007/08 total sports production costs

	Ofcom's allocation	Based on live hours
Sky Sports 1	25%	55%
Sky Sports 2	25%	28%
Sky Sports 3	25%	10%
Sky Sports Xtra	25%	8%

7.65 Sky has corrected Ofcom's allocation and used the more accurate allocation based on live hours.

Movies costs

7.66 Ofcom has performed a detailed calculation to forecast movies costs.

7.67 This calculation has many flaws including:

- incorrectly splitting costs between rights and production;
- failure to take into account that some costs are fixed and some are variable; and
- failure to take into account that most of the costs are paid in US Dollars and therefore affected by movements in the exchange rate.

[23] Rows 69 to 72 of the "*Cost of premium rights*" sheet.

7.68 Rather than correct these many individual errors Sky has considered the overall forecast of movies costs.

7.69 **Table 7.5** below shows a comparison of Ofcom's estimate of Sky's movies costs for Narrow Premium Wholesale (following the subscriber adjustments above) and Sky's latest forecast[24]. It shows that Ofcom's forecasts overestimate Sky's movies costs for Narrow Premium Wholesale by a total of £59 million over 4 years.

Table 7.5

Narrow Premium Wholesale's movies costs

Financial Year	Ofcom's forecast	Sky's forecast
09/10	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
10/11	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
11/12	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
12/13	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]

7.70 Sky has therefore substituted Ofcom's forecasts for Sky's latest forecasts of movies costs which it regards as considerably better informed.

Sky Networks' marketing

7.71 Ofcom has allocated the marketing spend that is solely deployed to promote Sky's channels across Wholesale, Sky's notional retail business ('**Retail**') and Sky's notional platform business ('**Platform**').[25]

7.72 This cost is clearly a cost of Wholesale and should be treated as such.

7.73 Over the last couple of years Sky has increased its expenditure in this area and the latest forecast for direct marketing of premium channels is [**CONFIDENTIAL**] for 2009/2010.

7.74 Sky has therefore correctly allocated the 2007/2008 Sky Networks' marketing spend solely to Wholesale (to ensure it is not incorrectly allocated to Retail or Platform) and used [**CONFIDENTIAL**] as the forecast cost for Premium Wholesale for 2009/2010 (which is then increased by inflation and subscriber growth and allocated across the different parts of Premium Wholesale consistent with Ofcom's assumptions and approach).

24 Sky's latest forecast has been calculated from the sum of i) the forecast of fixed costs (allocated across different parts of Premium Wholesale consistent with Ofcom's approach) and ii) the forecast of variable cost per subscriber per month multiplied by the total number of UK residential standard definition movie subscribers in the pricing model (following the subscriber adjustment above).

25 Line 698 of the "*Consolidation*" sheet.

Technical operations

7.75 Ofcom has attributed [**CONFIDENTIAL**] of technical operations costs directly to Wholesale in 2007/2008 and then allocated this cost between Sky's notional basic wholesale business (**'Basic Wholesale'**) and Premium Wholesale based on the number of UK DTH satellite subscribers.

7.76 As we set out above in paragraph 7.31 there is often no 'correct' way of allocating common costs and in many circumstances electing which approach to use will be fairly arbitrary. In the case of technical operations (*e.g.* studio facilities), however, costs can meaningfully be divided amongst different lines of business based on usage. An allocation based on usage reflects the underlying drivers of these costs as compared to Ofcom's approach which was arbitrarily based on DTH satellite subscriber numbers. In **Table 7.6** below Sky has calculated an alternative allocation which as far as possible reflects underlying usage in 2008/2009:

Table 7.6

Allocation of Sky's 2008/2009 technical operations costs

	Ofcom's allocation	Cost driver allocation
Basic	48%	29%
Sports	28%	68%
Movies	24%	3%

7.77 Sky has therefore used the more sensible cost driver allocation for technical operations cost.

(d) Transmission

7.78 Ofcom has attributed the estimated transponder costs for premium channels to Retail. This is consistent with the approach taken by the OFT in its 2002 CA98 decision.

7.79 The OFT included transmission in Retail because "*the principal cable operators took delivery of BSkyB channels by means of land-line links, and BSkyB did not pay for carriage of its channels on such third party platforms*".[26] The OFT stated that "*Only the minor third party distributors are now reliant upon satellite transmission for reception of BSkyB channels and the revenue received from such companies would not justify BroadCo's investment in satellite transmission*".[27]

7.80 Since the 2002 OFT Decision, however, the basis on which cable operators receive Sky's channels has changed. Virgin Media no longer receives Sky's channels by means of a landline and instead relies on satellite transmission to

[26] Paragraph 478 of the 2002 OFT Decision.

[27] Paragraph 479 of the 2002 OFT Decision.

receive Sky's premium channels. In fact all cable operators who retail Sky's premium channels do so after picking up the signal at their head-end via a professional decoder and a satellite dish and incur no additional ongoing costs to get the signals from Sky's premises to their head ends.

7.81 Therefore the reasons why the OFT allocated DTH satellite transmission cost to Retail no longer apply. Sky's premium wholesale prices now include the cost of delivering the signal to the head-end and are not 'factory gate' products as Ofcom has assumed.[28] The cost of DTH transmission is therefore part of the costs incurred by Premium Wholesale and is not borne by retailers.

7.82 Sky has therefore correctly attributed premium channel transmission costs to Premium Wholesale (which is then increased by inflation and allocated across the different parts of Premium Wholesale consistent with Ofcom's assumptions and approach).[29,30]

(e) Capital expenditure

7.83 Ofcom performs a very complex, hard to follow and seriously flawed calculation for ongoing capital expenditure requirements which appears to be based on inappropriate information and ignores data which Sky provided or which was in the public domain. As a result, Ofcom's forecast, that Narrow Premium Wholesale will spend only £14 million on capital expenditure in 2009/2010, is substantially too low.

7.84 Ofcom's estimate appears to have entirely ignored Sky's investment in a new production facility, despite the fact that Sky's investment has been publicly announced. As detailed in Sky's press release on 9 January 2009, Sky expects to spend £233 million in total over four years on the construction of a new on-site production facility. This facility will open in 2011 and be the new home of Sky Sports and Sky's entertainment channels. Sky spent £34 million and £92 million on this project in 2007/2008 and 2008/2009 respectively, bringing total spend to date to £126 million. A simple extrapolation suggests at least £50 million being spent per annum over the next two years which should be attributed to Wholesale.

7.85 Ofcom appears to use as its source for capital expenditure old broker reports. Sky, however, provided Ofcom with a detailed breakdown of its actual capital expenditure for 2007/08[31]. It is not clear why Ofcom has not used this data.

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28 Paragraph 9.57 of the Consultation Document.

29 In addition to changing the allocation in cells E547 and E548 of the "*Sky operating costs*" sheet, Sky has also had to correct the links in Ofcom's Wholesale Pricing Model from cell E546 as these are incorrect.

30 Sky notes that if Ofcom nevertheless continues to prefer to classify satellite transmission as a retail cost, such costs of delivery will in effect no longer be included in Sky's premium wholesale charges and Sky will instead need to set a separate charge for cable operators for use of its satellite capacity.

31 Supplied to Ofcom as part of the information request dated 15 December 2008.

7.86 In the paragraphs below, Sky has taken, for all costs other than those relating to the new production facility which is referred to above, the 2008/09 actuals (in the same format as the 2007/08 actuals provided to Ofcom) and allocated a proportion to Premium Wholesale consistent with Ofcom's approach to common costs, save in respect of technical operations which have been allocated based on studio usage.

7.87 From the breakdown of actual capital expenditure in 2008/09:

- "*Broadcast and content*" is a cost of Wholesale;
- "*Customer management*" less [**CONFIDENTIAL**] spent on non-TV projects could be attributed to Platform consistent with Ofcom's treatment of subscriber management operating costs; and
- a number of other categories[32] could be considered to be shared across pay TV in general, which could be allocated across Wholesale, Platform and Retail based on subscribers consistent with Ofcom's allocation of common operating costs.

7.88 In terms of allocating these items to Premium Wholesale the following allocations could be used:

- the new production facility and "*broadcast and content*" could be allocated based on usage and use the same allocation percentages as technical operations costs set out in paragraph 7.76 above; and
- the remaining general Pay TV items could be allocated based on subscribers consistent with Ofcom's allocations.

7.89 **Table 7.7** below summarises the forecast for capital expenditure for Premium Wholesale, consistent with Ofcom's methodology for growing operating costs with inflation and subscribers.

Table 7.7

Capital expenditure forecast for Premium Wholesale

	2009/10	2010/11	2011/12	2012/13
New production facility	£36m	£36m		
Broadcast and content	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
Customer management	-	-	-	-
Pay TV	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]	[**CONFIDENTIAL**]
Total	**CONFIDENTIAL**]	**CONFIDENTIAL**]	**CONFIDENTIAL**]	[**CONFIDENTIAL**]

[32] These are "*technology*", "*commercial and online*" and "*corporate, property and M&E*" excluding the £92 million spent on the new on-site production facility.

7.90 Sky has therefore substituted Ofcom's forecast for the figures above which it regards as considerably better informed (which are then allocated across the different parts of Premium Wholesale consistent with Ofcom's own allocation percentages).

(f) Cross-promotion

7.91 In splitting Wholesale between Premium Wholesale and Basic Wholesale, Ofcom has failed to recognise the value of cross-promotional airtime between channels (i.e. the value of airtime on Sky's basic channels used to promote either Sky's premium sports channels or movie channels and vice versa).

7.92 If Sky's premium channels and its basic channels traded with each other on an arm's length basis then Sky's premium channels would expect to pay for promotion on Sky's basic channels and similarly Sky's premium channels would expect to be paid for promoting Sky's basic channels. These payments and revenues would reside with the wholesale business running the channel.

7.93 Sky estimates that in 2008/09 the cost of airtime used to promote Sky's premium channels on Sky's basic channels was [**CONFIDENTIAL**]. Similarly, Sky estimates that the revenues earned by Sky's premium channels from cross promoting Sky's basic channels and other Sky products and services were [**CONFIDENTIAL**].

7.94 Sky has correctly included these revenue and cost items, assuming 2009/10 figures are 5% lower than 2008/09[33] (which is then increased by inflation and allocated across different parts of Premium Wholesale consistent with Ofcom's assumptions and own allocation percentages).

Summary

7.95 For each of the errors identified above we have sought to give some indication of the magnitude and the impact of correcting it on the profitability or otherwise of Narrow Premium Wholesale assuming Sky was to charge Ofcom's cost-plus prices. In **Table 7.8** below we have provided an estimate of the cumulative cash impact of each correction over a four year period.[34]

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33 As per advertising forecasts in footnote 44 of this **Section 7**.

34 The estimates provided in the table have been derived on the basis that the errors in the rows above have also been corrected (*i.e.* the effect of correcting for wholesale costs errors after correcting subscribers and advertising errors). This is necessary in order to be able to sum the errors down the table to produce a cumulative total.

Table 7.8

Profitability of Narrow Premium Wholesale

	Operating cashflow over 4 years[35]	*Operating margin over 4 years*
Per Ofcom model	£75m	1.5%
Adjusting for errors:		
Subscribers	(£265m)	(5.8%)
Advertising	(£21m)	0.0%
Wholesale costs	(£357m)	(7.3%)
Transmission	(£20m)	(0.4%)
Capex	(£93m)	(1.9%)
Cross-promotion	(£55m)	(1.1%)
Corrected Ofcom model	**(£735m)**	**(15.0%)**

7.96 **Table 7.8** above shows that if Sky were to price its premium channels at the rates consistent with Ofcom's cost-plus prices then, far from making a "*reasonable return*" as claimed by Ofcom, Narrow Premium Wholesale would incur very significant losses. Narrow Premium Wholesale would expect to make a loss of over £700 million over the next 4 years and would expect to incur a loss as a percentage of sales of 15%.

35 Excludes initial capital employed.

C. Once corrected Ofcom's analysis shows that Narrow Premium Wholesale operating margins are normal using current ratecard prices

7.97 Sky has corrected the errors set out above in Ofcom's analysis and within Ofcom's framework calculated the operating margin which Narrow Premium Wholesale could be expected to earn over the next four years if it were to charge the current cable ratecard prices.[36] This estimate is based entirely on Ofcom's own analysis save for the errors listed above and is summarised in **Table 7.9** below.

Table 7.9

Narrow Premium Wholesale operating margin

Results over four years based on current ratecard		
	Per Ofcom model	Corrected Ofcom model
Revenue	£7,630m	£7,439m
Operating costs	(£4,799m)	(£5,631m)
Operating cashflow	£2,831m	£1,808m
Operating margin	**37.1%**	**24.3%**

7.98 **Table 7.9** above demonstrates that Narrow Premium Wholesale operating margin would be in the order of 24%, which is, in fact, lower than the estimate Ofcom presented in its Second Consultation Document. Accordingly, the analysis presented in Sky's Response to the Second Consultation Document is robust and cannot be ignored. In particular, the operating margin expected to be earned by Narrow Premium Wholesale is at the low end of the operating margin earned by a number of comparable companies.

7.99 We note further that Oxera undertook its own benchmarking analysis, to which Ofcom briefly refers in the main body of the Consultation Document.[37] The main focus of Oxera's comparator analysis was to benchmark Sky's aggregate profitability though there is also a small discussion in relation to disaggregated profits. Oxera indicates that it has sought to assess Sky's disaggregated profitability relative to its comparators by carrying out clustering analysis for Wholesale using the revenue, cost and asset allocations underlying their profitability analysis. The ROCE and ROS that Oxera estimates for Wholesale[38] has then "*been benchmarked against the two broad samples of comparators (TV and non-TV)*".[39]

36 The prices used for 2009/10 are the weighted average of the previous ratecard to 31 August 2009 and the current ratecard from 01 September 2009, which are then inflated by 2.5% thereafter consistent with Ofcom's assumptions.

37 Paragraph 6.200 of the Consultation Document.

38 Ofcom's disaggregated profitability analysis therefore compares the profitability of Wholesale and not Narrow Premium Wholesale.

39 Page 52 of the Oxera Report at Annex 9 of the Consultation Document.

7.100 Far from including a "broad sample", however, Oxera compares Wholesale with a sample of only two TV companies (Canal Plus and Premiere) and only two non-TV companies (EMI and Sony BMG).[40] Neither of these TV companies limits its activities to wholesaling channels as they are both vertically integrated and therefore derive a large proportion of revenue from retail activities. In addition, Premiere has faced considerable financial difficultly over the last several years and, based on table A3.3 of the Oxera Report, suffered an operating margin of -4.8%[41] so cannot therefore reasonably form one of the benchmarks for long running sustainable profitability. EMI and Sony BMG are materially different to Wholesale and are not active in the creation and wholesale of premium pay TV channels, or any TV channels for that matter, and thus cannot reasonably form benchmarks.

7.101 This is supported by a report by PwC (at **Annex 7**) on the selection of comparators used by Oxera which concludes that, looking at Wholesale, all four companies are "*unreliable comparators*".[42]

7.102 As noted in **Section 4**, a proper comparator analysis has an important role to play in determining whether profitability should be considered to be "*excessive*" or not, but comparisons to individual companies are only informative if those companies are carefully selected. The primary problem with Oxera's analysis is that although it purports to use scientific methods to identify comparators, a more thorough analysis reveals that very few of those it selected are, in fact, appropriate comparators. Even for some firms which may appear appropriate, Oxera has not selected the divisions of businesses which are the most appropriate comparators for Wholesale. For example:

- Oxera appears to have looked at the returns of Discovery Holding Company, which owns companies that are not comparable to Wholesale, rather than Discovery Communications Holding, which produces Discovery's pay TV channels;

- Oxera appears to have looked at the returns of Viacom as a whole, which encompasses many business arms (including movie production) that are not comparable to Wholesale, rather than Viacom Media Networks, which produces pay TV channels; and

- Oxera has looked at Time Warner Cable, a division of Time Warner whose business primary involves the operation of cable TV and broadband services, but Time Warner Networks would have been a more appropriate division since it produces pay TV channels.

7.103 By contrast, a carefully considered selection of companies – and, where possible, a focus on companies primarily engaged in broadcasting or for whom results specific to their broadcasting businesses are available – is likely to

40 Page 47 of the Oxera Report at Annex 9 of the Consultation Document.

41 Page 88 of the Oxera Report at Annex 9 of the Consultation Document.

42 See pages 245 and 246 of the PwC Report at Annex 7.

provide a far more reliable comparison for Wholesale (which is consistent with Sky's previous analysis in Section 6 of its Response to the Second Consultation Document as referred to above in paragraph 7.98).

7.104 All the evidence therefore suggests that Narrow Premium Wholesale's operating margins are entirely normal at the current cable ratecard prices. There is no evidence that Sky's wholesale prices are unduly high and therefore no basis for Ofcom to seek to reduce these prices.

D. No impact on the competitive process or justification for intervention

7.105 In the preceding Parts of this Section we have demonstrated that Sky is not setting high wholesale prices. In this Part D we show that, even if Sky had been setting high wholesale prices, Ofcom has not established that this would more likely than not have a material impact on the competitive process or that its proposed intervention under section 316 would be justified.

7.106 In its Response to the Second Consultation Document, Sky noted that Ofcom had not even attempted to show that setting high wholesale prices for premium channels might damage the competitive process.[43]

7.107 In the Consultation Document Ofcom states: *"We do not however accept Sky's argument that we have failed to show that high wholesale prices for premium channels might damage the competitive process*".[44] But Ofcom's explanation as to why it takes this view in fact appears entirely to acknowledge Sky's argument, since Ofcom goes on to state: *"<u>we agree that high wholesale prices do not necessarily distort retail competition</u>, but they are a potential outcome of weak wholesale competition, and are likely to have a direct impact on consumers in the form of high retail prices*" (emphasis added).[45]

7.108 It is unclear how alleged high wholesale prices charged to Virgin Media could have materially distorted the competitive process. Ofcom attempts to argue that, as a result of Sky's alleged high wholesale prices, Virgin Media has a limited incentive to promote Sky's premium channels and that "*as a result, people with a strong demand for these services are more likely (and increasingly likely over time) to choose DSat*".[46]

7.109 In considering this allegation it is useful to consider separately Virgin Media's incentives to upgrade basic customers to Sky's premium channels and Virgin Media's incentive to market Sky's channels to new acquisitions.

7.110 Sky understands that Virgin Media has alleged that it has limited incentive to upgrade its basic customers, but Sky is not aware of any claim on the part of Virgin Media that it also has a limited incentive to market Sky's channels to new

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43 Paragraph 1.5 of Section 6 of Sky's Response to the Second Consultation Document.

44 Paragraph 6.170 of the Consultation Document.

45 *Ibid.*

46 Paragraph 6.129 of the Consultation Document.

acquisitions. Indeed Sky's channels are prominently featured in Virgin Media's acquisition marketing materials (see **Appendix 6**).[47]

7.111 Whilst Virgin Media does not have the same incentive as Sky to market Sky's premium channels to its existing basic customers, it is simply wrong to suggest that Virgin Media basic-only customers are unaware of the availability of Sky's channels. Those customers are exposed to Virgin Media's acquisition marketing, which as indicated above prominently features Sky's premium channels. In addition Sky's premium channels are listed in Virgin Media's electronic programming guide and their availability on Virgin Media's platform is clear in cross-promotions for Sky's premium channels which Sky includes on its basic channels on all platforms.

7.112 Moreover, basic customers that Virgin Media must actively persuade to upgrade to premium channels are not customers with a "*strong demand*" for Sky's premium channels. Customers with a strong demand for premium channels would be expected to subscribe to premium channels when they first subscribe to Virgin Media. It is not credible to suggest that Virgin Media's basic-only subscribers, who could have elected to take premium channels from Virgin Media, are somehow more likely to switch to Sky. This provides no basis upon which to argue that, as a result of Sky's wholesale prices, customers are more likely to choose DTH satellite.

7.113 The fact that alleged high wholesale prices would be unlikely to have an impact upon the competitive process can also be seen by considering the way that Virgin Media might react to the imposition of Ofcom's proposed remedy.

7.114 One possibility is that Virgin Media would pass the price cuts on to its customers. If Virgin Media were to do this then by virtue of Ofcom's proposed "ratchet"[48] it would probably not be sensible for Sky to respond to Virgin Media's lower prices, since if it were to do so, Ofcom would then require Sky to reduce its wholesale prices still further (potentially resulting in further reduction in Virgin Media's retail prices).[49] Accordingly, if Virgin Media were to respond to Ofcom's proposed remedy by reducing its retail prices the remedy would be likely to distort competition by handing to Virgin Media a unique ability to pass on its existing lower retail cost or any future savings in retail costs on to consumers.

7.115 An alternative outcome might be that the price cuts flow through to higher profit margins for Virgin Media and that these higher margins do not incentivise Virgin Media to devote more effort to marketing Sky's premium channels. We note that Ofcom's own analysis seems to suggest that it believes that this is the more likely outcome. Ofcom's model of Narrow Premium Wholesale, far from

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47 See for example at **Appendix 6** Virgin Media's marketing material "*Virgin TV. A brilliant line up*." and "*3 steps to entertainment heaven*" both of which prominently mention the ability to add Sky Sports and Sky Movies for an additional fee.

48 Paragraph 9.47 of the Consultation Document.

49 In addition, looked at from Ofcom's perspective, DTT entrants may not be able to compete with Virgin Media either.

assuming that there is an increase in premium subscribers on Virgin Media, assumes that the number of premium subscribers on Virgin Media continues to decline. In particular it is clear that Ofcom seems to be of the view that the principal effect of lowering the wholesale price to Virgin Media is a transfer of value from Sky to Virgin Media of [**CONFIDENTIAL**] over four years.[50] Thus Ofcom's proposed remedy would not provide any benefits in terms of increasing competition at the retail level.

50 Based on Ofcom's proposal of ratecard prices for a larger competitor on DTT (scenario 4) in figure 64 of the Consultation Document.

SECTION 8: CONSUMER EFFECTS DO NOT JUSTIFY OFCOM'S INTERVENTION

A. Introduction

8.1 This Section of our Response comments on Section 7 of the Consultation Document, entitled *"Consumer effects"*. Ofcom does not set out clearly the purpose of this Section of the Consultation Document, nor is it clear to Sky what that purpose is; we have therefore found it difficult to comment on its content. We do not address all aspects of Section 7 here and, accordingly, the comments below should not be treated as exhaustive.

8.2 Ofcom uses the criteria of choice (of platform and content), innovation and pricing purportedly to consider the effects on consumers of Sky's *"approach"* to wholesaling its premium channels.[1]

8.3 Ofcom also links the exercise that it claims to undertake in Section 7 to its principal duty to protect the interests of consumers, where appropriate by promoting competition, noting that it takes that duty into account when considering action under section 316.[2]

8.4 It appears, therefore, that Ofcom is seeking to use the effects on consumers that it claims to identify in Section 7 to justify its proposed intervention under section 316. As we show below, however, each of the alleged consumer harms that Ofcom purports to have identified is either entirely speculative and/or immaterial or could not stem from Ofcom's concerns about "*Sky's approach*" to the distribution of its channels.

B. The market is working well for consumers

8.5 Ofcom's assessment of the operation of the market from a consumer perspective should be the product of a holistic approach to the UK TV sector and the wider UK audiovisual market. Instead, Ofcom continues to focus on one or two narrow elements and to have inappropriately little regard to the wealth of clear and observable factors which overwhelmingly demonstrate that the market is delivering impressive benefits to UK consumers.

8.6 Both Ofcom's Consultation Documents and Sky's submissions[3] have provided extensive evidence that, **based on Ofcom's own criteria** (as set out in its Consultation Documents) - and indeed on any reasonable criteria – pay TV

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1 Paragraph 7.1 of the Consultation Document.

2 Paragraph 7.10 of the Consultation Document.

3 See, for example:

(a) Part B and Annex 3 of Sky's Response to the Complaint;

(b) Sections 4, 5, 11 and 12 of Part 2, Paragraphs 2.1 to 2.5 of Part 3, the introduction to Section 4 of Part 3, Paragraphs 5.1 to 7.7 of Part 3 and Annex 1 of Sky's Response to the First Consultation Document; and

(c) Section 2 and Annexes 1 and 2 of Sky's Response to the Second Consultation Document.

delivers good outcomes for consumers in the UK. In summary, these positive outcomes include:

(a) high consumer satisfaction with pay TV services;[4]

(b) penetration of digital pay TV in the UK which is amongst the highest in Europe;[5]

(c) consumers being very well served in terms of content choice (both range of channels and range and quality of content) - in particular, consumers having a choice of over 500 unique linear channels (including over 30 HD channels);[6]

(d) innovation to date offering strong benefits for consumers[7] and the UK being one of the leading European countries in terms of the development and penetration of innovative products and services, including VoD services, HD and PVRs;[8]

(e) retail prices from Sky which, on a like-for-like basis, are not out of line with prices of pay TV providers in other European countries;[9]

(f) Sky continuing to be a leader in terms of innovation on pricing and packaging in comparison to the pay TV providers in comparable European countries.[10]

8.7 Faced with this positive evidence,[11] Ofcom would need to have clear evidence that there is (or will be) serious harm to consumers in order to justify

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4 Paragraphs 4.3 to 4.7 of the First Consultation Document; Section 4 of Sky's Response to the First Consultation Document.

5 Paragraph 4.4 of Part 2 of Sky's Response to the Second Consultation Document; Section 2.5 of the Second PwC Report.

6 Figure 24 of the First Consultation Document; Part 3 of Section 2 of Sky's Response to the Second Consultation Document.

7 Paragraphs 4.26 to 4.28 of the First Consultation Document.

8 Section 4 of the First PwC Report; Section 6 of Part 3 of Sky's Response to the First Consultation Document; Section 5 of the Second PwC Report.

9 Section 8 of Part 3 of Sky's Response to the First Consultation Document; Section 3 of the First PwC Report.

10 Section 4 of the Second PwC Report.

11 Particularly striking in this most recent Consultation Document is Ofcom's failure to engage with the new evidence provided by Sky in the form of the Second PwC Report on the outcomes for consumers in relation to pay TV in Europe (Annex 1 to Sky's Response to the Second Consultation Document). This despite the fact that:

(a) the report contains 86 pages of detailed findings by a respected firm of consultants, based on a comparator analysis of information collected on 15 countries, and

(b) Sky has referred to its findings extensively in support of its positive view of consumer outcomes.

In Ofcom's view this report and its predecessor (the first PwC report) apparently merit only a couple of cursory references, in the vein of *"[Sky] further believed that a PwC report it had commissioned supported that view"* (paragraph 7.33 of the Consultation Document) and *"Sky* intervening. Ofcom does not have such evidence. Indeed, Ofcom's theories of consumer harm are largely speculative. However, Ofcom itself acknowledges that future developments in the sector are unpredictable:

> *"the markets of interest to us are part of a sector where there is considerable scope for innovation and profound changes in the consumer experience. But the scale and depth of innovation, and the technologies that will play the greatest role in the future of the sector, are at present uncertain."*[12]

8.8 Sky agrees, and, for this reason, Ofcom's speculative theories of future harm cannot support intervention.

C. Choice

8.9 Ofcom claims that *"consumers on **a number of platforms** are currently either unable to access the most valuable sport and movie content, or face restricted access"* (emphasis added).[13] Ofcom considers that, therefore, *"some consumers will have to choose between either doing without Core Premium channels, or accessing pay TV via a platform that would not otherwise be their preferred choice"*.[14]

8.10 Despite the reference to *"a number of platforms"* highlighted in the paragraph above, and similar references elsewhere (for example, *"the restricted availability of Sky's premium content on other platforms"*[15]), a proper examination of the facts (detailed in **Section 6** above) shows that the only distribution technology via which Sky's channels are not available is DTT. In the UK, in addition to DTH satellite, Sky's premium channels can be accessed on all material cable

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cited a second report it had commissioned from PwC, which, Sky claimed, supported the fact that the UK is one of the "leaders in terms of innovation services"" (paragraph 7.38 of the Consultation Document; see also paragraph 7.40 of the Consultation Document). Ofcom does not express any view on the validity or otherwise of PwC's findings or the conclusions that Sky draws from them, other than to take issue with a description of the Second PwC report which it ascribes to Sky but which in fact misrepresents the point that Sky made (paragraph 7.89 of the Consultation Document). The closest that Ofcom comes to any kind of judgment of the relevance of the latest PwC findings is its observation that PwC's innovation ranking does not take account of the penetration rates of VoD and NVoD services (paragraph 7.90 of the Consultation Document). (As Ofcom acknowledges at paragraph 7.90 of the Consultation Document, PwC had itself considered whether robust indicators could be developed but did not do so due to lack of data.) Ofcom's failure to engage in any meaningful way with this evidence is not consistent with a regulator seeking to take appropriate account of all available evidence in order to form a comprehensive view of consumer outcomes.

12 Paragraph 7.20 of the Consultation Document. See also, for example, paragraph 7.14 of the Consultation Document:

"It is of course impossible to predict with any precision the future benefits for consumers of innovation, and come up with a precise factual and counter-factual for the development of the market, depending on whether or not we intervene."

13 Paragraph 7.2 of the Consultation Document.

14 Paragraph 7.52 of the Consultation Document.

15 Paragraph 7.2 of the Consultation Document.

networks, all but one of the 3G mobile phone networks, the only IPTV platform capable of delivering linear TV channels and via a PC or TV linked to the internet.[16] The channels will also soon be available via [**CONFIDENTIAL**] the Xbox360 [**CONFIDENTIAL**] via the internet.

8.11 In relation to **DTT** (as noted, the only distribution technology via which Sky's premium channels are not currently available), Ofcom relies on evidence in the form of Freeview research and Sky's estimates for its own proposed Picnic service to support the proposition that a significant number of consumers *"are worse off* ***because Sky does not wholesale to retailers on DTT****"* (emphasis added).[17] There is much in the reasoning and methodology underlying Ofcom's quantification of unmet demand for Sky's premium channels on DTT with which Sky would take issue,[18] but the primary issue for these purposes is not the level of unmet demand for the channels on DTT but rather the reasons for their non-availability on DTT. Ofcom has side-stepped the points made by Sky in its response to the Second Consultation Document regarding the reasons why its premium channels are not available on DTT. In particular, Ofcom fails to acknowledge that it has declined to remove barriers to the retailing of Sky's channels on DTT (by Sky itself or by a third party pursuant to a wholesale arrangement) and that, had Ofcom approved Sky's application to change its channel line-up, DTT consumers would now be able to access Sky premium channels at least from Sky.[19]

8.12 Contrary to Ofcom's assertion, therefore, consumers are not worse off *"because Sky does not wholesale to retailers on DTT"* – they are worse off because Ofcom's current regulation prevents those channels from being broadcast via DTT. Accordingly, any alleged unmet demand on DTT that Ofcom purports to identify cannot be used as evidence that Sky's approach to wholesaling has caused (or will cause) consumer harm; an assertion that there is unmet demand cannot, therefore, be used to justify imposition of the proposed wholesale must-offer remedy.

8.13 Ofcom does not in fact find any other platforms on which Sky's channels are not available. Instead, the remainder of Ofcom's concerns regarding lack of choice relate to **platforms on which Sky's channels are already available** but where Ofcom is not satisfied with the manner in which they are made available[20] – namely the cable platform and Tiscali's IPTV platform. When using the term

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16 Several major manufacturers, including Panasonic, Samsung, Sony and LG, have announced the launch this year of internet-enabled TV sets which will give consumers direct access to the internet and the ability to view streamed content.

17 Paragraph 7.68 of the Consultation Document.

18 See paragraphs 11.93 to 11.116 of **Section 11** of this Response.

19 Paragraphs 6.90 to 6.93 of **Section 6**.

20 Ofcom claims that there is a risk that the distortion of consumer choice that it claims to have identified in relation to TV services would extend to the other services which are included in 'triple-play' bundles (paragraphs 7.75 to 7.79 of the Consultation Document). Since Ofcom's claim that Sky's approach to wholesaling restricts consumer choice in TV services is unfounded, so is any suggestion of a connected restriction of choice of bundles.

"restricted availability" [21] in relation to Sky's channels, therefore, Ofcom is equating these circumstances with non-availability, which is clearly untenable.

8.14 A large part of Ofcom's analysis focuses on existing **cable basic subscribers**. Ofcom points to the low penetration of Sky's premium channels in comparison with that achieved on DTH and raises the concern that there is unmet demand amongst basic cable subscribers. Sky agrees with Ofcom's view that there is unmet demand for Sky's premium channels on cable; we disagree on its cause, and possibly its extent.

8.15 Ofcom categorises unmet demand amongst basic cable subscribers as a *"*[p]*otential distortion of choice"*.[22] But Sky's premium channels are manifestly available on cable at broadly similar prices to those on DTH, as Ofcom itself observes. Nor can it credibly be said that consumers are unaware of this availability; while Virgin Media may not engage in bespoke activity to encourage its customers on basic packages to take Sky's premium channels, those customers are exposed to considerable marketing by Virgin Media which gives prominence to Sky's premium channels.[23] Furthermore, Virgin Media's EPG clearly shows the availability of the channels.

8.16 It is untenable, therefore, to suggest that cable customers with a strong demand for the channels would not subscribe to them on the cable platform.

8.17 To the extent that there are basic subscribers on the cable platform that do not subscribe to Sky's premium channels because Virgin Media does not market them strongly, their demand must be relatively weak and any lost consumer surplus in respect of those consumers is likely to be low.

8.18 It seems, however, that Ofcom believes that a substantial proportion of Virgin Media customers who do not currently subscribe to Sky's premium channels have an interest in subscribing to those channels *"although evidently not at current prices"*.[24,25] Ofcom's point therefore appears to be that a significant number of basic cable customers might add premium channels to their subscription package if wholesale prices were lower. If this were correct, it would not be a function of lack of choice or unmet demand – it would be demand for the same product at a lower price. We therefore address this aspect of Ofcom's theory of consumer harm in our discussion of Ofcom's analysis of *"Consumer effects relating to high wholesale prices"* in Part E of this Section below.

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21 See, for example, paragraph 7.2 of the Consultation Document.

22 Figure 60 of the Consultation Document.

23 Sky has provided just a few of the many examples of this type of marketing at **Appendix 3**.

24 Paragraph 7.63 of the Consultation Document.

25 Note that whatever evidence Ofcom cites in support of this view has been excised from the public version of the Consultation Document on the grounds of confidentiality (paragraph 7.63 and footnote 490 of the Consultation Document). Therefore, whilst this may appear 'evident' to Ofcom, Sky is not in a position to assess whether it agrees.

8.19 The reasons why, in Sky's view, its premium channels achieve a considerably lower penetration rate on platforms where they are retailed by third parties than where Sky is the retailer are set out in **Section 6** above.[26] Sky also notes that one of the reasons for low penetration of Sky's premium channels on cable networks specifically is piracy, which has been a core issue for Sky over many years.

8.20 Ofcom also purports to identify unmet demand in relation to Sky's premium channels delivered via **IPTV**. Contrary to the impression generated by its drafting,[27] Ofcom is not in fact suggesting that there are currently IPTV subscribers who do not have access to Sky's premium channels but who could have such access (indeed, no such subscribers exist, since the only IPTV network capable of distributing Sky's premium channels (Tiscali's IPTV platform) does carry those channels). Rather, Ofcom seems to have an obtusely articulated concern[28] that a perceived inability of IPTV to fulfil its potential as a further choice for consumers is somehow connected with the distribution of Sky's premium channels. Ofcom presents no evidence in support of this concern; it simply refers to statements by Tiscali attributing the lack of success of IPTV to *"a lack of access to premium channels"*.[29] Elsewhere in the document Ofcom clearly states its view that IPTV is not currently an effective alternative to existing technologies and is unlikely to become an important distribution technology until its cost base is reduced.[30] This is inconsistent with Tiscali's view that the lack of success of IPTV is related in some way to Sky's channels.[31]

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26 Paragraph 6.32 of **Section 6** of this Response.

27 Paragraph 7.66 of the Consultation Document.

28 Paragraphs 7.71 and 7.72 of the Consultation Document.

29 Paragraph 7.71 of the Consultation Document.

Although Ofcom does not make the point in this context, Sky can only assume that Ofcom's position must be, in part, a function of its view, set out in Section 6 of the Consultation Document, that *"[f]rom a consumer perspective, a choice of Sky retailing on one platform vs. Sky retailing on another platform does not represent a real choice"* (paragraph 6.85 of the Consultation Document). Yet Ofcom does not explain why consumer demand could not be satisfied, and consumer choice delivered, by Sky gaining access to other platforms and selling its channels directly to consumers. As demonstrated in **Section 6** of this Response (paragraph 6.137) prices on Tiscali TV (under a retail deal with Sky) are substantially more attractive than Virgin Media's prices. Hence, the comparison does not suggest that Tiscali TV would be more successful were it supplied on a wholesale basis. Furthermore, as noted in paragraph 6.131 of **Section 6** of this Response, it is not clear how consumers' choice of platform would be impaired if, on their preferred platform, Sky's premium channels were retailed by Sky rather than the platform operator.

30 Paragraph 9.132 of the Consultation Document.

31 To the extent that Ofcom may be suggesting that IPTV's growth and development may be hampered by non-availability of Sky's channels on IPTV platforms that are yet to emerge, we note that it is clear from Sky's arrangement with Tiscali that Sky has been willing to retail its channels on IPTV platforms.

D. Innovation

8.21 Ofcom's arguments in relation to innovation have been something of a moving feast.[32] Ofcom now appears to identify three sources of consumer harm which it claims result from Sky's approach to the wholesale supply of its premium channels:

(i) Sky tends to innovate in ways that favour the DTH satellite platform;

(ii) VoD services have not developed as they might have been expected to and, in particular, consumers do not have access to first-run premium movies on a 'full SVoD service' on any TV platform during the pay TV window; and

(iii) lack of access to Sky's premium channels will make it much less likely that there will be substantial innovation on new platforms.

(i) Sky's innovations favour DTH

8.22 According to Ofcom, although Sky has a record as an innovator, the fact that it is in a much stronger position than any other firm to be a large-scale innovator and that it has, in Ofcom's view, a natural incentive to protect its own platform, means that it will tend to favour only those innovations which tend to support its incumbent advantages over potential entrants. Ofcom believes that this will inhibit the development of IPTV and mobile services which could otherwise use premium content to drive demand.[33]

8.23 We note that Ofcom continues to recognise that *"innovation in platform enhancements has been strong in the UK*".[34] Ofcom then goes on to state, as if it were a negative, *"… it has been stronger in developments that favour satellite platforms, and less strong in those that favour non-satellite platforms"*.[35] We note, however, that Ofcom is not saying that innovations that favour non-satellite platforms have been poor in any absolute sense - simply that they have been less strong than those that favour satellite platforms. There is a simple reason for this fact, which is that no other market participant has been willing to invest in its platform (including content) to the extent that Sky has.[36] It would be inappropriate, therefore, to use Sky as a benchmark in such a way that other

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32 Ofcom's focus when discussing innovation has shifted significantly. For example, in the Second Consultation Document, Ofcom seemed to place significant weight on its assertion that *"the record of the UK pay TV industry has been less strong in relation to retail packaging innovation"* (paragraph 7.48 of the Second Consultation Document). Sky strongly rebuffed this statement in its response (paragraphs 3.37 to 3.49 of Section 5 of the Response to the Second Consultation Document) and we note that this no longer appears to form part of Ofcom's reasoning. Similarly, Ofcom's discussion of VoD is materially different to the position that it took in its previous consultation, as we discuss below.

33 Paragraph 1.46 of the Consultation Document.

34 Paragraph 7.84 of the Consultation Document.

35 *Ibid.*

36 See **Section 4** of this Response (paragraphs 4.62 *et seq.*) for a summary of Sky's key investments and the risks that it has faced over the last two decades.

platforms/players falling short of its record on innovation is taken as evidence of a problem. For example, whilst VoD has not developed as quickly as some innovations introduced by Sky, the pace and scope of the introduction of VoD services in the UK has nonetheless been good.

8.24 Nor is there any evidence that Sky's approach to innovation has in any way harmed, or is likely to harm, the process of innovation more generally: on the contrary, many of Sky's innovations (for example, HD and PVRs) have been copied on other platforms; and, as described below, other platform innovations have been developed by third parties quite independently of access to Sky's premium channels.

(ii) VoD services

8.25 Ofcom's discussion of VoD is materially different to the position that it took in its previous consultation. We note that Ofcom no longer claims, as it did in the Second Consultation Document, that *"some other markets appear to be leading the UK in the development of VoD services"*[37] or suggests that rivals are unable to develop VoD services because of a lack of access to the content on Sky's premium channels.[38]

8.26 Ofcom's concern in relation to VoD appears now to be much narrower. Its concern now appears to be only that the movies that Sky shows on its linear movie channels are not contemporaneously available on a SVoD basis on TV platforms[39] (although Sky's SVoD movies services is provided on to the PC via Sky Player and, in a more limited form, as part of Sky Anytime). This concern, however, is misplaced and is based on an untenable reading of evidence which Sky provided to Ofcom, which set out a list of services which provide movies on an on-demand basis.[40] Ofcom dismisses Sky's evidence on the basis that the services listed do not show movies in the first TV subscription window or do not provide movies on a SVoD basis. But this view does not take into account the fact that these services do, nonetheless, show the very same movies that Sky broadcasts but before (and after) they are available on Sky's movie channels (whether via VoD, SVoD, PPV or otherwise). Ofcom's narrow focus on the availability of movies specifically on a SVoD basis within the pay TV window ignores the reality that consumers are well served with a multitude of realistic options for viewing movies. The fact that some movies may not be available as part of a SVoD service on Sky's channels (on TV platforms) during the pay TV window evidences no material consumer detriment.

8.27 Additionally, while Sky maintains that Ofcom's narrow focus on 'true' SVoD services is misplaced in this context, we also note that Ofcom incorrectly asserts that none of the services Sky referred to offers movies on a SVoD basis.[41] In

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37 Paragraph 7.47 of the Second Consultation Document.

38 *Ibid.*

39 Paragraph 7.97 of the Consultation Document.

40 Paragraphs 7.91 to 7.92 of the Consultation Document.

41 Paragraph 7.92 of the Consultation Document.

fact, as Sky clearly set out in Annex 2 to its Response to the Second Consultation Document, PictureBox offers a SVoD service which is available on BT Vision, TUTV, and Tiscali TV.[42] This factual error could have been avoided, had Ofcom not overlooked the evidence presented by Sky. The PictureBox service has since also launched on Virgin Media's platform (for the first time offering movies in HD).[43]

8.28 Ofcom does not explain why the alleged consumer detriment that it claims results from the non-availability of a TV SVoD service offering the titles on Sky's linear channels in the same window should be sufficiently material to merit action on its part. It does not adequately explain why it is important to consumer welfare for such VoD services to be able to show movies several months later than they already do[44] or why it should be important from a consumer perspective for such movies to be available on an SVoD basis.[45] The closest Ofcom gets to explaining why there might be consumer detriment associated with the non-availability of SVoD movies in the pay TV window is: (a) to cite Virgin Media's assertion, without any apparent evidence, that demand for SVoD movies was strong and growing and (b) to assert in passing that SVoD rights *"offer a payment mechanism which is likely to be particularly attractive to consumers"*[46] (even if this is true, the same holds for linear movies channels, so that this demand is already met). But these unsupported assertions provide no evidential basis for a finding of consumer detriment. They also ignore Sky's earlier observations in response to the Second Consultation Document that Ofcom had not provided any evidence in support of the proposition that consumer demand for PPV services is lower than the potential demand for subscription services.[47]

8.29 In any case, this narrow concern regarding the non-availability of a movies SVoD service in the pay TV window (even if it were well founded, which it is not) cannot be used to justify Ofcom's proposed remedy of mandating wholesale supply of Sky's premium channels, let alone a reduction in Sky's wholesale prices. The consumer detriment supposedly identified does not (and could not) stem from Sky's approach to the wholesale supply of its linear premium channels. Rather, it relates to the manner in which movies studios sell their rights and, in particular, the exclusive nature of those rights in the pay

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42 Paragraph 2.7 and 3.14 of Annex 2 of Sky's Response to the Second Consultation Document.

43 Joint press release by Virgin Media and Universal Pictures, *Virgin Media And Universal Pictures Launch "PictureBox" Movies-On-Demand Service*, dated 29 June 2009. PictureBox on Virgin Media *"provide*[s] *a broad selection of recent and library feature films"* for £5 per month with subscribers able to view titles from a selection of 28 films at any given time, with seven new titles being added to the line-up each Friday.

44 The movies pay TV exhibition window begins 5 or 6 months (depending on the studio) after the start of the PPV window.

45 In particular Ofcom makes no attempt to respond to the points raised by Sky in its Response to the Second Consultation Document, at footnote 72, where we pointed out that the most popular reasons for subscribing to Sky's movie channels cited in an Ofcom survey could equally be satisfied by a VOD service.

46 Paragraph 12.17 of the Consultation Document.

47 Footnote 72 of Sky's Response to the Second Consultation Document.

TV window and the fact that studios have positioned SVoD as a service connected with the linear service. Ofcom has recognised this distinction elsewhere in the Consultation Document, by proposing the manner in which SVoD rights are sold as a candidate for a reference to the Competition Commission under the Enterprise Act.[48] We comment on Ofcom's analysis of this issue, and its proposals on intervention, in **Annex 6** of this Response.

8.30 Finally, Ofcom makes a number of inaccurate statements in relation to VoD that Sky wishes to correct:

- We note that Ofcom continues to assert that Sky is technically unable to make movies available on a true SVoD service.[49] [**CONFIDENTIAL**] [50]

- Ofcom asserts that the PwC report does not establish that its conclusions on VoD are flawed because the PwC report does not include data on the take-up of VoD services (notwithstanding that neither Sky nor PwC ever suggested that it did provide such data). Ofcom might be justified in taking this view in circumstances where it had other data which showed that take-up of VoD services in the UK was relatively low. However, Ofcom has no such data. Instead Ofcom merely repeats its references to Screen Digest data from the Second Consultation Document and asserts that VoD services accounted for a smaller proportion of pay TV revenues in the UK than in other countries.[51] Ofcom's continued reliance on this statement as being sufficient to dismiss the findings of the PwC report is untenable given the strength of the PwC evidence as against a mere assertion concerning revenue data for countries which are not comparable to the UK. Ofcom has yet again entirely ignored Sky's demonstration that Ofcom has misrepresented Screen Digest data. As we explained in paragraph 3.55 of Section 5 of our Response to the Second Consultation Document, the Screen Digest does not report revenues from VoD services. It also includes a range of other services including subscription revenues from PVRs. Accordingly, countries in which operators have dropped such subscriptions – such as in the UK – will be shown to perform worse on the Screen Digest metric even though having no PVR subscription charge means that consumers are better off.

- The Screen Digest data cannot, therefore, be used to dismiss the findings of the PwC report. The PwC report is the only reliable evidence of the speed of innovation in relation to the introduction of VoD services. It clearly shows that the UK has been as quick to launch as other European media markets and that there is no evidence that development of VoD services has been generally less effective than

48 Section 12 of the Consultation Document.

49 Paragraph 7.97 of the Consultation Document.

50 Sky already provides a more limited SVoD service via satellite in the form of Sky Anytime.

51 Paragraph 7.87 of the Consultation Document.

other types of innovation which are alleged to be more suitable to DTH satellite.

(iii) Innovation on new platforms

8.31 Ofcom posits that, without access to the content on Sky's premium channels, the *"overall prospects"* for a new entrant or another firm planning to expand are likely to be greatly diminished, and so is the likelihood that they would be willing to take a risk on substantial innovation, and secure finance for the necessary investment.[52]

8.32 Following the shift in focus noted in footnote 29 above, Ofcom's conclusions on consumer detriment relating to lack of innovation now appear, therefore, to rely almost solely on speculating that without access to Sky's premium channels the development of new innovative platforms may be held back. Accordingly, Ofcom is not claiming that the alleged restricted distribution of Sky's premium channels has led to reduced innovation; rather, Ofcom is now claiming that because of alleged restricted distribution there may be a **risk** to innovation of an unspecified nature in the future. Ofcom's concerns are entirely speculative in nature. Without evidence that innovation has been held back to date, Ofcom has no basis for predicting such an effect in the future.

8.33 But Ofcom has no such evidence that investment in new platforms has been held back. Indeed services such as iPlayer, Kangaroo and Canvas, developments in games consoles, and Virgin Media's VoD offering are all examples of substantial innovations that have been proposed or developed without the relevant services including provision of Sky's premium channels.

8.34 Ofcom mentions IPTV and mobile services. As set out in Sky's Response to the Second Consultation Document, a review of the facts shows that Ofcom's concerns in relation to mobile TV are not well founded. Sky was the first to launch a mobile TV service in the UK and has been working closely with a number of industry players to try to encourage the development of broadcast mobile platforms (for further details see 3.58 of Sky's Response to the Second Consultation Document). Ofcom has not sought to respond to any of Sky's comments rebutting the risk to the development of mobile TV other than simply to assert its continued unspecified concern.

8.35 In relation to IPTV, Ofcom itself acknowledges that IPTV is not currently a viable distribution technology and will not be until its costs are reduced.[53] For example, as noted in Sky's Response to the Second Consultation Document,[54] when Orange stepped back from IPTV its comments at the time made it clear that its reasons for withdrawing from IPTV in the UK were not related to access to Sky's channels.

52 Paragraph 7.101 of the Consultation Document.

53 Paragraph 9.132 of the Consultation Document.

54 Paragraph 2.40 of Section 5 of Sky's Response to the Second Consultation Document.

8.36 In any case, even if Ofcom had made the case that consumers would be harmed because Sky's premium channels would not be made available on IPTV platforms, there would be no need for a wholesaling obligation; it would be sufficient for there to be certainty that the channels would be available to consumers on the relevant platforms, as they would be if Sky were free to negotiate access to the platforms in order to retail.

E. Pricing

8.37 When examining consumer issues in relation to pricing, Ofcom focuses on the effects on consumers of the high margins that it considers that Sky earns in its pay TV business – particularly at the wholesale level. Ofcom concludes that these high wholesale margins translate into high retail prices for subscribers.[55]

8.38 In reaching this conclusion, Ofcom has effectively rejected the evidence submitted by Sky in support of the position that its retail prices are consistent with prices for comparable packages in other countries, in the form of the First PwC Report. That report indicated that, when compared to packages of similar quality, Sky's prices were lower than those of 10 of the 19 equivalent packages offered by retailers in other countries.[56] Ofcom claims to have *"considered this evidence in* [the] *Second Pay TV Consultation (see paragraphs 7.63 and 7.71)"*;[57] but Ofcom's consideration simply amounted to expressing a view that *"differences between countries mean that comparing a price in one country with a price in another country is fraught with difficulties"*[58] – this despite the fact that Ofcom included numerous comparisons of pay TV services in different countries in the First Consultation Document. Sky's prices have, in fact, been compared with those of retailers in other countries, and Ofcom has not provided any analysis to contradict PwC's conclusions. It is therefore surprising, given the weight that Ofcom has given to such comparisons in its other consultations and market reports,[59] that Ofcom appears largely to ignore this evidence in this case, stating that it considers the evidence that it sets out in Section 6 *"to be more helpful in assessing Sky's profitability"*.[60]

8.39 Instead, Ofcom relies solely on its analysis of the Oxera's profitability analysis (in the Oxera Report) to support its view that retail prices are high: *"The analysis which has been carried out by Oxera* suggests *that Sky is earning aggregate returns in excess of its costs of capital, implying retail prices that are above the competitive*

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55 Paragraphs 7.107 and 7.112 of the Consultation Document. Paragraph 7.107 suggests that this conclusion arises as a result of Ofcom's belief that Sky charges the highest non-margin squeezing price.

56 The high level of pay TV penetration in the UK, accepted by Ofcom, provides further support that UK price levels are reasonable.

57 Footnote 77 of the Consultation Document.

58 *Ibid.*

59 See, by way of illustration, Ofcom's International Communications Market Reports (the most recent of which was published in November 2008) which include significant levels of international price benchmarking.

60 Footnote 77 of the Consultation Document.

level."[61] But it is misleading of Ofcom to claim that its conclusions relating to Sky's profitability are based on Oxera's analysis: those conclusions are Ofcom's not Oxera's. In fact, for reasons discussed in detail in **Section 4** above, it is inappropriate for Ofcom to interpret the Oxera Report as indicating that Sky is earning 'excessive profits', and can be expected to continue to do so. Moreover, Professor Grout's analysis of stock market evidence, set out in his report at **Annex 2,** demonstrates that Sky has not experienced an abnormal return. There is no evidence, therefore, that Sky is earning excessive returns resulting in consumer detriment.

8.40 As noted above, Ofcom attempts to identify the implications for consumers of high wholesale prices, positing (a) a weak incentive for cable to market these channels, leading to low take-up;[62] and (b) that substantial numbers have an interest in subscribing to Sky's premium channels *"although evidently not at current prices"*.[63]

8.41 Sky is only too aware that cable has weaker incentives than Sky to market Sky's premium channels to its basic subscribers,[64] a point that Ofcom acknowledges is inherent in a wholesale supply arrangement.[65] But we dispute the reasons that Ofcom suggests give rise to this situation. Ofcom apparently believes that a reduction in Sky's wholesale prices would 'fix' cable's incentives. Sky does not agree that simply cutting wholesale prices is the best way to address cable's weaker incentives. In Sky's view, the approach which comes closest to solving what is, fundamentally, a problem inherent in the principal/agent relationship involves agreeing appropriate discount structures in wholesale agreements to better incentivise cable to promote Sky's premium channels. In fact, this has driven Sky's past attempts to agree appropriate discount structures with cable operators.[66]

8.42 In conclusion Ofcom has no evidence to support its proposition that consumers' interests are harmed by the level of wholesale prices and cannot rely on this to support its case for intervention.

F. Consumer satisfaction

8.43 In the First Consultation Document, Ofcom cited customer satisfaction data in support of its assessment that the market appears to be serving its customers

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61 Paragraph 7.6 of the Consultation Document.

62 Figure 60 of the Consultation Document.

63 Paragraph 7.63 of the Consultation Document.

64 Although we do not accept that those incentives are weak in any absolute sense.

65 Paragraph 3.54 of the Consultation Document.

66 The effect of Ofcom's proposed intervention to secure lower wholesale prices on cable retail prices is, however, uncertain. We note that Ofcom appears to assume that there would be no reduction in cable retail prices (and the effect of the remedy would thus be a revenue transfer from Sky to Virgin Media). Thus, to the extent that Ofcom is suggesting that consumer harm results from the current level of retail prices, its proposed remedy would not necessarily address this harm.

"reasonably *well*".[67] Ofcom no longer appears to be prepared to place any weight on its own consumer satisfaction data, instead stating at paragraph 7.48 of the Consultation Document that it shares Virgin Media's concern as to the limited usefulness of its own survey evidence.[68] Ofcom has not, however, conducted any further analysis of consumer satisfaction. This would appear to be an omission, given that Ofcom's justification for intervention is that *"Sky's approach to the wholesale supply of Core Premium channels results, and is likely to result in future, in an adverse effect on the interests of consumers"*.[69] Ofcom also states at paragraph 7.48 of the Consultation Document:

> *"Customers may well express high levels of satisfaction if a service is provided at a quality and price they have come to expect, but does not rule out the possibility that a change in the market, through greater price competition or more innovation, would greatly increase consumer welfare."*

8.44 This is another instance of Ofcom reversing its position without properly setting out the reasons for such a reversal. Ofcom is apparently now of the paternalistic view that consumers are not able to hold properly informed opinions on the quality and price of pay TV services, and that greater weight should instead be placed on its own unsubstantiated speculations. Yet Ofcom itself previously undertook and published the results of consumer research which illustrates that pay TV consumers have reference points in the form of other communications services (fixed line, mobile and broadband services) which allow them to put pay TV services into context;[70] pay TV services can also be compared against free-to-air TV, provided for the price of the TV licence fee. Consumers are clearly capable of drawing comparisons and Ofcom's research indicates that satisfaction levels with pay TV services are in line with those for other communications services. Furthermore, given that, as we have pointed out previously,[71] pay TV penetration is relatively high (as Ofcom accepts),[72] it cannot be credibly argued that any legitimate concern could exist as to consumer exclusion on a large scale due to, for example, lack of platform choice or high prices.

G. Conclusion

8.45 Ofcom continues to have ample evidence that the UK audiovisual market is functioning well, delivering considerable innovation, an impressive choice of

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67 Paragraph 4.76 of the First Consultation Document.

68 Yet we note that Ofcom's latest Communications Report, published on 6 August 2009 (*i.e.* after publication of the Consultation Document), includes consumer satisfaction data (see, for example, 1.2.7 and 2.3.8 of that Report).

69 Paragraph 7.113 of the Consultation Document.

70 Figure 19 of the First Consultation Document.

71 See, for example, paragraph 3.63 of Section 5 of Sky's Response to the Second Consultation Document.

72 Paragraph 7.29 of the Second Consultation Document.

content, high levels of penetration and consumer satisfaction, and competitive and effective pricing.

8.46 Ofcom has chosen to set this evidence to one side, however. Rather than take an appropriately holistic approach, Ofcom instead focuses in on only one or two narrow points. Yet, even in relation to these points, Ofcom's analysis does not support its conclusions.

8.47 In the face of strong evidence that the market is serving consumers well, Ofcom would need clear evidence of serious consumer detriment in order to justify intervention, given the very real risk that such intervention could have detrimental effects that would undermine existing and future benefits to consumers. Ofcom has no such evidence and its theories of harm are entirely speculative.

8.48 It is clear, therefore, that Sky's approach to the wholesale supply of its premium channels neither results, nor is likely to result, in any material adverse effect on the interests of consumers. Ofcom's principal duty does not, therefore, require it to take action under section 316 in the manner proposed. Ofcom's intervention would, in fact, risk undermining consumer benefits (now and in the future) and thus harm the very consumer interests that it is tasked with furthering, in breach of its principal duty.

SECTION 9: OFCOM'S PROPOSED INTERVENTIONIST AND UNPRECEDENTED NEW REGULATION IS NOT NECESSARY, PROPORTIONATE OR CONSISTENT AND DOES NOT REFLECT BEST REGULATORY PRACTICE

A. Introduction

9.1 This **Section 9** of Sky's Response addresses Ofcom's proposed new regulatory regime. Following a summary of the key elements of Ofcom's proposed new regulatory regime, and Ofcom's legal obligations in relation to the introduction of new regulation, we assess a number of the key elements of Ofcom's proposals against the criteria of necessity, proportionality, consistency, and whether they reflect best regulatory practice.

9.2 In each case, we demonstrate that Ofcom fails entirely to make out an adequate case that its proposed new regulation is targeted at a case in which action is needed and (to the extent that any such case is made out), that such regulation would be a disproportionate response to any concerns that Ofcom has raised.

9.3 We do not comment in this section on Ofcom's proposals to discuss rights to Premier League football and Hollywood movies with their owners.[1]

B. Summary of Ofcom's proposals

9.4 The regulatory proposals set out in Ofcom's Consultation Document are, with minor variations, those which Sky addressed in its Response to Ofcom's Second Consultation Document.[2] The principal difference is that Ofcom has now developed proposals for the wholesale charges that it considers that it should set for Sky's premium sports and movie channels.

9.5 The key elements of Ofcom's proposals are:

(a) licence conditions that would require Sky to supply to third parties on request (other than in respect of platforms operated by Sky):

(i) standard definition versions of its premium sports and movie channels;

(ii) high definition versions of its premium sports and movie channels; and

(iii) "*Interactive Content*";

(b) prescriptive *ex ante* price control of charges for these services, involving:

(i) a requirement that Sky charges all third parties the same monthly charge for supply of its channels; and

[1] See **Annex 6** to this Response.

[2] See Part 2 of Section 7 of Sky's Response to the Second Consultation Document.

(ii) charges for Sky's channels being set on an 'extended retail-minus' basis;

(c) detailed intervention in the terms and conditions of carriage agreements in relation to Sky's television channels; and

(d) intervention in Sky's operational freedom as a television broadcaster – for example proposals that changes to the content of Sky's channels must be agreed with other distributors of Sky's channels.

9.6 As in Sky's Response to Ofcom's Second Consultation Document, we use the term 'extended retail-minus' price control to distinguish Ofcom's proposed price control regime from the well-established, competition law-based, approach to retail-minus price control in which the 'minus' is determined according to a vertically integrated operator's actual ***own retail costs***.[3] In Ofcom's proposals, the 'minus' is, instead, to be determined using a novel methodology based on Ofcom's forecasts of the costs and revenues of developing and operating hypothetical new DTT-based pay TV retail businesses.

C. Ofcom's legal obligations in relation to the introduction of new regulation

9.7 As Ofcom recognises,[4] it is under a number of legal obligations in relation to proposals to introduce new regulation:

- under section 3(3)(a) CA03 Ofcom must have regard to the principles under which its regulatory activities should be, among other things, proportionate, consistent and targeted only at cases in which action is needed;
- under section 3(3)(b) CA03 Ofcom must have regard to best regulatory practice.

9.8 Ofcom must also ensure that its proposals give effect to its principal duty under section 3(1)(b) CA03 to further the interests of consumers in relevant markets.

9.9 Furthermore, a number of the matters to which Ofcom should also have regard in performing its duties set out at section 3(4) CA03 are also of direct relevance to its proposals, namely:

- section 3(4)(b) – the desirability of promoting competition in relevant markets; and
- section 3(4)(d) – the desirability of encouraging investment and innovation in relevant markets.

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3 Ofcom appears to have misunderstood this distinction. See paragraphs 8.70 and 8.77 of the Consultation Document.

4 See, in particular, paragraphs 2.44 to 2.48 of the Consultation Document.

9.10 The concept of "*proportionality*" has been discussed recently in the CAT's judgment in *Tesco v. Competition Commission*.[5] The CAT summarised the main principles underlying the concept of proportionality as follows:

> *"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*".[6]

9.11 For the reasons set out below, and in **Section 10** of this Response, Ofcom's proposals fail to meet the legal standards set by sections 3(3) and 3(4) CA03, and, moreover, if implemented, Ofcom's proposals would lead it to be in breach of its principal duty under section 3(1)(b) CA03, to further the interests of consumers in relevant markets.

9.12 Ofcom also has a duty under section 7 CA03 to undertake an impact assessment of its proposals to the standard set out by the CAT in its judgment in *Vodafone v Ofcom*[7]. As we discuss in **Section 11**, Ofcom has failed entirely to fulfil this duty.

Burden of proof

9.13 The burden of proof in relation to demonstrating that Ofcom's proposals meet its CA03 duties and obligations rests with Ofcom. Ofcom must demonstrate clearly that its proposals are targeted only at cases in which action is necessary, proportionate, consistent and reflect best regulatory practice.

Ofcom's view of its responsibilities (including its regulatory principles)

9.14 Ofcom discusses its legal responsibilities in relation to the introduction of new regulation at paragraphs 2.44 – 2.48 of the Consultation Document. At paragraph 2.45 of the Consultation Document, Ofcom states:

> "*Under s3(3)(b) we must also have regard to our own regulatory principles, which include the requirements that:*
>
> - *Ofcom will operate with a bias against intervention, but with a willingness to intervene firmly, promptly and effectively where required.*
> - *Ofcom will strive to ensure its interventions will be evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome.*

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5 Judgment of the Competition Appeal Tribunal in *Tesco v. Competition Commission* [2009] CAT 6, 4 March 2009 ("**Tesco v. Competition Commission**").

6 Paragraph 137, *op cit.*

7 Paragraph 47 of the judgment of the Competition Appeal Tribunal, *Vodafone Limited v. Office of Communications*, [2008] CAT 22, 18 September 2008 ("**Vodafone v. Ofcom**")

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

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

9.15 In developing its proposals for new intrusive regulation in this case, Ofcom has manifestly not had adequate regard to those principles. In particular:

- as Sky demonstrates below, Ofcom has not acted with a bias against intervention – in fact, quite the opposite. Above all, however, as we demonstrate below, Ofcom's proposed interventions are not "*required*";

- significant parts of its analysis in relation to these proposals are not evidence-based. For example:

  - o as Ofcom has admitted,[8] important elements of Ofcom's impact assessment depend on assumptions for which Ofcom has no evidence;

  - o Ofcom's approach to the programming delivered via Sky's interactive services continues to be impressionistic and it appears to have made no effort at all to understand the cost associated with delivering such services on platforms other than Sky's;

- as we demonstrate in this **Section 9** and **Section 10** of this Response, Ofcom's proposals for intrusive new regulation are not proportionate; and

- Ofcom has reached readily for some of the most intrusive regulatory options available (compulsory licensing and prescriptive price control) without properly considering less intrusive approaches.

D. Ofcom fails to recognise that its regulatory proposals have a number of distinct elements, which must be assessed separately

9.16 Ofcom's regulatory proposals comprise a number of distinct elements which (a) are sufficiently distinguishable, and (b) have different costs and benefits associated with them, such that each should separately be assessed in terms of being necessary, proportionate, consistent and reflecting best regulatory practice.

9.17 For example, Ofcom proposes that Sky must make interactive sports services available (in some form, which is unclear from Ofcom's proposals[9]) to third parties in such a way that they are able to operate on third party platforms. The necessity of this proposal, and its costs and benefits, are capable of being assessed, and should be assessed, on a standalone basis.

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8 Steve Unger's letter to James Conyers of 1 September 2009.

9 See below, Part H of this **Section 9**.

9.18 Ofcom is obliged to apply such a separate assessment to the following elements of its proposals as a minimum:

(a) compulsory licensing of standard definition versions of Sky's premium sports channels;

(b) compulsory licensing of standard definition versions of Sky's premium movie channels;

(c) compulsory licensing of high definition versions of Sky's premium channels;

(d) compulsory licensing of Sky's interactive services;

(e) prescriptive, extended retail-minus price control; and

(f) price cuts for Virgin Media.

9.19 In this **Section 9** of Sky's Response we assess Ofcom's proposals in relation to (a) to (d), above against the criteria of whether they:

(i) are targeted only at cases in which action is needed;

(ii) are proportionate;

(iii) are consistent; and

(iv) reflect best regulatory practice.

9.20 We assess a number of other elements of Ofcom's regulatory proposals against these criteria in Part I, below, and we assess Ofcom's price control proposals (including the proposal that Sky would be required to cut wholesale charges paid by Virgin Media), in **Section 10** of this Response.

E. The conditions that must be met in order to apply compulsory licensing

9.21 The proposals reviewed in parts F-H, below, involve the imposition on Sky of compulsory licensing obligations in relation to its intellectual property. Perhaps the most obvious element of any argument that such obligations are targeted at a case in which action is needed is that there should be a clear and compelling case that, absent intervention, Sky would refuse to license its intellectual property to third parties. That, however, is a necessary but not sufficient condition for intervention. The well-recognised potential for abrogation of a firm's right freely to choose its trading partners to damage incentives for investment and innovation means that such intervention should be reserved only for exceptional circumstances.

9.22 In *IMS Health v NDC Health*[10], the European Court of Justice held that intervention under Article 82 to compel the supply of intellectual property may only be permitted in exceptional circumstances where four cumulative

10 Case C418/01 *IMS Health v NDC* Health [2004] ECR I-5039 at 38 and 52.

conditions are satisfied: (1) provision of the intellectual property is indispensable for carrying on a particular business; (2) refusal to supply is preventing the emergence of a new product for which there is a potential consumer demand; (3) the refusal is such as to exclude any competition on the secondary market; and (4) the refusal is not objectively justified.

9.23 For the reasons explained in **Section 3** of this Response, Ofcom's arguments in relation to the need to impose compulsory licensing on Sky in relation to a number of its services should be assessed against the above principles.

F. Compulsory licensing of Sky's standard definition premium sports and movie channels

(i) Targeted at a case in which action is needed

9.24 Ofcom's rationale for its proposal to impose compulsory licensing obligations on Sky in relation to its standard definition premium channels is based on a proposition that, absent Ofcom's proposed regulation, Sky would not make its premium pay TV channels available via new platforms. This proposition is reflected in Ofcom's impact assessment in which in the counterfactual (i.e. the situation absent intervention by Ofcom) Sky's premium channels are assumed by Ofcom only to be available on the platforms via which they are currently distributed, in perpetuity.

9.25 Ofcom's rationale, however, is without merit. As discussed in **Section 6** of this Response, Ofcom's arguments about Sky's incentives to make its channels available on new platforms are (a) ill-founded, and (b) contradicted by a substantial amount of readily available evidence. In particular, Sky has a clear track record in seeking to make its premium channels available via as wide a range of platforms as possible – they are available via DTH satellite, all material cable networks in the UK,[11] Tiscali's IPTV network, four out of five UK 3G mobile phone networks, and the internet. They are also likely shortly to become available via the **[CONFIDENTIAL]** Xbox 360 platform **[CONFIDENTIAL]**.

9.26 The focus of Ofcom's concern is the fact that Sky's premium channels are not yet available via DTT-based platforms. Yet, as is also discussed in **Section 6**, above, the reasons for this have more to do with Ofcom's actions than Sky's. For example, absent the delays caused by Ofcom in relation to Sky's Picnic service, and the chilling effect on commercial negotiation with firms such as BT and TUTV that Ofcom's pay TV review has created, the significant likelihood is that Sky's premium pay TV channels would already be available via one or more DTT-based platforms. In this respect Ofcom cannot ignore the fact that in December 2007 Sky offered commitments to Ofcom to wholesale its premium pay TV channels to all operators of secure platforms.

9.27 In such circumstances Ofcom cannot claim that the imposition of compulsory licensing obligations on Sky in relation to Sky's standard definition premium

[11] Material cable operators include Virgin Media, Smallworld and Wight Cable.

channels is targeted at a case in which action is needed. On the contrary, there is no problem that would warrant regulatory intervention.

9.28 It is evident, however, that an issue that concerns Ofcom is not the lack of availability of Sky's channels on new platforms *per se*, but instead a perceived lack of their provision to the operators of new platforms on a *wholesale basis*, rather than a retail basis. Ofcom's consideration of this issue is insufficient to demonstrate that its regulatory proposal is targeted at a case in which action is necessary. Ofcom devotes only seven paragraphs – which are completely unclear – out of the 350 pages in its Consultation Document to this issue, and none provides a basis for regulation. As discussed in **Section 6**, Ofcom's apparent view that wholesale supply of Sky's premium channels is inherently more desirable than a situation in which Sky retails its channels on other platforms is unfounded.[12]

The 'importance' of Sky's premium channels

9.29 Ofcom's arguments in relation to the need to impose compulsory licensing also rest to a considerable extent on the issue of the 'importance' of Sky's premium channels. In essence, this issue depends on a combination of the attractiveness of programming broadcast on Sky's channels, and the extent to which there are adequate substitutes for that programming – from the points of view of both consumers and pay TV retailers. This issue of 'importance' is relevant to the indispensability of Sky's premium channels, and the possibility of a refusal by Sky to license its premium channels to exclude any effective competition on the downstream market. Sky considers that neither its premium sports channels[13], nor its premium movie channels fall into such a category. Ofcom's proposal to apply such regulation to Sky's premium movie channels in particular is manifestly unjustified.[14]

9.30 This is for two reasons. First, Sky's movie channels compete against both other ways of viewing movies ***and*** non-movies programming. Accordingly, it is not necessary to retail Sky's movie channels in order to provide services that compete with those channels.

9.31 Second, consumers have available to them a wide range of alternative ways of viewing movies, and other firms are able to provide movies services (including paid-for movies services). Many of the alternatives available to consumers offer

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12 See paragraphs 6.126 to 6.139 of this Response.

13 Ofcom significantly underestimates the range of substitutes available to consumers for the specific programming broadcast on Sky's premium sports channels. For example, consumers are able to view programming carried on Sky's sports channel in pubs, and listen to coverage of the events broadcast on Sky's sports channels on the radio. Extensive highlights of such programming are also often available on free to air television channels (as is the case, for example, with Premier League football, and domestic Test match cricket). More generally, there is a wide range of high quality sport – including, much live football, the 'Crown Jewels of sports broadcasting (events such as Wimbledon, The Olympic Games, football's World Cup and European Championships), and Formula One motor racing – on free to air television.

14 This proposition cannot be taken to mean that Sky considers that compulsory licensing of its premium sports channels is warranted.

the ability to watch movies in 'windows' prior to the pay TV window, during which movies are shown on Sky's movie channels – a period that runs from roughly 12 months to 27 months after cinematic release. In particular, movies are available in cinemas, to rent or purchase on DVD, and via PPV and VoD services, before they become available for broadcast on Sky's movie channels, and continue to be available for rental or purchase on DVD during and after the pay TV window. Other operators, such as BT, heavily promote their movie services on the basis that they offer movies before they are available on Sky's pay TV channels.

9.32 There is also a vast and increasing number of films broadcast on free to air and basic pay TV channels from the 'library' window (*i.e.* the window after the pay TV window). While these are older films, the vast number of films available to broadcasters means that they are able to select and broadcast those that are of greatest enduring popularity with viewers. With movies it is clearly not the case that 'quality' is determined solely by temporal proximity to cinematic release.

9.33 It is important to note in this regard that Sky has no exclusivity over movies prior to, or after, the pay TV window. Other pay TV operators can and do provide movies to consumers on a pay per view and VoD basis via their own services, such as Virgin Media's FilmFlex service, and movies are clearly available on DVD from a wide and growing number of outlets. NBC Universal offers a SVoD service (PictureBox), which offers movies after the pay window but prior to the free to air window as well as movies from the library window.[15]

9.34 Finally, in addition to these types of alternatives to Sky's premium movie channels, there is a growing variety of internet-based movies download services which offer movies on either a purchase or rental basis, and which are provided by a wide variety of firms. Consumers' use of such services is currently relatively small. As Ofcom notes, however, they are likely to increase in importance in the future.[16]

9.35 Accordingly, even if the relevant downstream market were considered only to include different ways of watching movies,[17] it is evident that a refusal by Sky to license its movie channels to third parties would not be capable of preventing effective competition on that market.

9.36 The discussion in the following part is without prejudice to the fundamental point that Ofcom has put forward no adequate justification for imposing on Sky compulsory licensing of standard definition premium sports and movie channels.

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15 On Virgin Media's platform, the majority of movies available from PictureBox are available in HD.

16 See paragraph 3.33 of the Consultation Document.

17 As discussed in **Section 5**, above, Sky considers that the relevant downstream market is wider than this.

(ii) Proportionality / reflecting best regulatory practice

9.37 Contrary to both best regulatory practice and its own guidance, Ofcom has considered only a single way of remedying the problem that it considers exists – an intervention that is highly intrusive in nature and extremely broad in scope. As a result, it is impossible for Ofcom to determine whether that option meets the criteria for a regulatory intervention to be proportionate as set out by the CAT in *Tesco v. Competition Commission*.

9.38 If Ofcom establishes a clear and compelling case that there is a problem to which a remedy may be required, it should consider alternative, less intrusive regulatory options and carefully evaluate their costs and benefits in order to determine that the option selected: (a) is no more onerous than is required to remedy the problem that Ofcom has identified, (b) is the least onerous, if there is a choice of equally effective measures, and (c) does not produce adverse effects which are disproportionate to the aim of the remedy. Ofcom should also ensure that it reflects best regulatory practice in selecting its preferred option.

9.39 Having commissioned research on approaches to such matters in other countries (the Value Partners study), it is somewhat surprising that Ofcom does not consider any of the alternative approaches that have been adopted elsewhere as potential alternatives to its own proposed approach. Where there is regulation of this type at all, a number of the approaches used in other countries would appear to be more proportionate approaches to it, and Ofcom should have considered them carefully. In particular, Ofcom should have considered properly the costs and benefits of adopting a regulatory regime such as that which operates in the US in which compulsory licensing:

(a) is accompanied by a 'light touch' regulatory regime that does not involve prescriptive price controls;[18] and

(b) is applied on a non-discriminatory basis to all television channels offered by broadcasters that meet transparent criteria.

9.40 Ofcom should have also carefully considered the costs and benefits of imposing compulsory licensing on fewer of Sky's premium sports and movie channels, and, in particular, evaluated the costs and benefits of not applying compulsory licensing to Sky's movie channels.

9.41 In undertaking a comparison of the costs and benefits of such options, Ofcom should have taken into account the negative consequences associated with an intervention that significantly diminishes Sky's ability to act on its legitimate desire to retail its channels on other platforms.

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18 As discussed in **Section 10** of this Response, Ofcom's radical and onerous price control proposals are a key source of the disproportionate nature of Ofcom's proposals for new regulation in this case.

G. Compulsory licensing of Sky's high definition premium sports and movie channels

Ofcom should not be contemplating imposing compulsory licensing on the supply of high definition versions of Sky's premium channels

9.42 Ofcom's proposal to impose compulsory licensing on high definition versions of Sky's premium channels is extremely puzzling. These are new and innovative products, and Sky has invested substantial effort and resources in driving their take-up, with the result that the UK is a leader in high definition television services in Europe.

9.43 In these circumstances, it would be expected that a regulator acting in accordance with a principle of having a bias against intervention, and having regard to:

(a) the conventional view that compulsory licensing is highly intrusive, and has potentially significant adverse consequences for incentives to invest in innovation; and

(b) a range of Ofcom's legal obligations – such as its obligation to secure the provision of high quality television services, the desirability of encouraging investment and innovation in relevant markets;

would demonstrate a high degree of reluctance even to propose such an intervention. Indeed, in these circumstances it would be expected that there would be a strong presumption that Ofcom should not interfere with the provision of services of this type unless there were very compelling arguments and evidence that it should do so.

9.44 On the contrary, however, Ofcom appears to base its proposal to apply compulsory licensing to Sky's high definition channels on the flimsiest of grounds – such as the citation of statements from Sky's corporate promotional literature as to its success in creating demand for this new service, and its own impressionistic (and largely meaningless) statements such as that "*HD capability sits at the heart of next generation TV platforms*".

9.45 Ofcom's entire rationale for imposing compulsory licensing on Sky's high definition channels is as follows:

> *"The guiding principle behind our application of a wholesale must-offer* (sic) *to Sky is that it should apply to those channels and services which are the source of Sky's market power, and where Sky's approach to wholesale supply does and will lead to a situation in which there is not, and will not be, fair and effective competition.*
>
> *The scope of any obligation should therefore cover all Core Premium channels supplied by Sky. We note in this context that the markets for Core Premium channels are defined by reference to the content contained within these channels, not the resolution at which this content is viewed, or whether the content is delivered via the main channel or the red button.*

> *We would see it as potentially discriminatory for Sky to supply others with inferior products to the ones it supplies its own retail arm – this could prevent other retailers from being able to compete effectively in the retail market. Our level of concern would depend on whether there is a risk to fair and effective competition. As the paragraphs below indicate, we believe that the restricted supply of HD versions of the channels... does create a risk to fair and effective competition. On this basis our view is that these should be included within the scope of the obligation.*"[19]

9.46 Ofcom goes on to state (in the "*paragraphs below*") that:

> "*Our view is that, on the available evidence, the difference between SD and HD is significant, both as a driver of platform innovation*[20] *and for the consumer experience.*
>
> *HD capability sits at the heart of next generation TV platforms.*[21] *Sky has recently reduced the retail price of its HD set top box to £49. HD services from the PSBs are planned to launch on DTT by the end of 2009. Sky, BT Vision and Virgin Media already offer on-demand HD content.*
>
> *HD is becoming increasingly important to consumers, and consumer adoption is accelerating. Sky's own research shows that 74% of consumers want HD quality and demand for HD is accelerating - this is mirrored in take-up of HD: 7% of Sky customers took up HD as at September 2008. In its review of 2008 Sky states:*
>
> > *"As high definition becomes increasingly established as the new benchmark for video services, we expect the superior range and quality of content offered by Sky+ HD to be a key driver of demand from new and existing customers."*
>
> *Sky has also said on a number of occasions that HD has been the most rapidly adopted service it has ever introduced. For example, it said in The Sky Story in 2007 that:*
>
> > *"We are now transforming the TV viewing experience yet again through the launch of High Definition. We did so in the face of predictions that HD was a needless luxury. It has since seen the fastest take-up of any of our additional TV services to date".*
>
> *We accept in principle that we should be cautious about deterring future investment in innovation; innovative services in future which relate to the premium channels covered by the wholesale must-offer would not automatically be included in the obligation. However, based on the*

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19 Paragraphs 8.89 to 8.91 of the Consultation Document.

20 Ofcom provides no indication as to why it believes that HD channels are "*a driver of platform innovation*" – or even what it means by this vague proposition, or what evidence Ofcom believes supports this proposition.

21 It is wholly unclear what Ofcom means by this statement, or how it is related to the statements that follow it.

> *evidence set out above on availability of services, and Sky's own pronouncements, HD appears no longer to be a brand new innovation, and more an integral part of the pay TV landscape. We therefore consider we need to include HD versions of the channels* [within the scope of Ofcom's proposed compulsory licensing regulation]*."*[22]

9.47 The explanation of why Ofcom considers it necessary and proportionate to impose compulsory licensing on high definition versions of Sky's premium sports and movie channels is inadequate. Ofcom's analysis examines none of the issues that would normally be expected to comprise the basis for a proposal to impose such intrusive regulation - for example, matters such as: an assessment of whether there was a strong possibility that the firm would indeed withhold supply; an assessment of the downstream market relevant to the conduct in question; an assessment of the potential impact on competition in that market of a refusal to supply, including whether *ex-post* action would be sufficient to address any problems; and whether there could be objective justifications for a refusal to supply. Quite simply, it does not come close to clearing the high threshold that must be met in order to warrant the use of such intrusive regulation, particularly in light of the new and innovative nature of the services to which Ofcom proposes that it is applied.

9.48 Of course, given that Sky offered a commitment to Ofcom to provide wholesale supply, the most obvious proportionate remedy in the present case to any perceived problem of lack of supply would simply have been to accept Sky's offer. The fact that Ofcom did not do so, and its reasons for not doing so (see **Section 6**), demonstrate that a perceived risk of an absence of wholesale supply could not of itself possibly be a justification for Ofcom's proposed intervention. We address Ofcom's other justifications below.

(i) Targeted at a case in which action is needed

9.49 As indicated above, the standard test for imposing compulsory licensing on the supply of intellectual property rights requires, at a minimum, that it is intended to address a refusal to supply.

9.50 The closest Ofcom comes to attempting to make out such a case is the expression of a view that Sky has been 'reluctant' to supply its high definition channels to Virgin Media.[23] Even if Ofcom had demonstrated that such 'reluctance' existed, however, which it has not, it is clear that there is a substantial difference between Sky being 'reluctant' to supply its HD channels and being likely to refuse to do so.

9.51 In fact, a proper review of relevant evidence indicates that far from refusing to supply high definition versions of its premium channels to third parties, Sky has taken the first genuine opportunity available to it to attempt to do so.

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22 Paragraphs 8.94 to 8.99 of the Consultation Document.

23 Paragraphs 6.122 to 6.129 of the Consultation Document.

9.52 By way of background, until the relatively recent past, DTH satellite has been the only UK audiovisual platform **capable** of being used to deliver high definition television channels to viewers, due to the lack of availability of sufficient spectrum bandwidth on other platforms. Virgin Media has, however, recently generated sufficient spare capacity on its cable network to carry high definition television channels, and, as discussed in **Section 6**, above, in March 2009 sent Sky a "*High Definition Request for Proposal*" (the "**RFP**"). Sky responded to that RFP, in March 2009, with a proposal to supply a number of its HD channels on a wholesale basis, including Sky Sports 1 HD, Sky Sports 2 HD and Sky Sports 3 HD. Virgin Media has not accepted this offer and chose six other channels for its launch of linear HD services on its platform.

9.53 Since Sky has offered to make its HD sports channels available to Virgin Media, a proposition that compulsory licensing of these channels is needed in order to remedy a refusal to supply is without merit.

9.54 It is also important to note that Virgin Media is likely to be the only other operator capable of carrying Sky's HD channels for the foreseeable future.[24]

9.55 Moreover, even if Ofcom were to prove to an adequate standard that Sky had refused to supply high definition versions of its premium channels to Virgin Media, a proposition that regulation is required in order to address such a refusal would fail another of the conditions that must be met in order for such intervention to be warranted – namely, that those channels are indispensable to operation in the relevant downstream market.

9.56 Ofcom argues elsewhere in its Consultation Document that services that include high definition versions of Sky's channels are part of broader markets which also includes standard definition versions of the relevant channels.[25] Accordingly, it is evident that firms are able to operate on the relevant markets defined by Ofcom without retailing Sky's high definition channels – and indeed, Virgin Media has chosen not to carry Sky's HD sports channels at the launch of its linear HD service.

9.57 Ofcom attempts to lower this threshold by arguing that, in effect, compulsory licensing is justifiable where a refusal to supply would mean that a firm's rivals were unable to replicate its services.

9.58 It is particularly inappropriate in the current case because service differentiation is an extremely important element of competition among firms in the UK audiovisual sector,[26] and a policy that blunted firms' incentives to differentiate their services could have very adverse effects for consumers.

[24] Ofcom acknowledges that the "*prospect for offering HD versions of the Core Premium channels on DTT or IPTV seems more limited in the short to medium term.*" (Paragraph 9.143 of the Consultation Document.)

[25] Paragraphs 4.13, 4.252 and 4.378 of the Consultation Document.

[26] This type of competition is particularly important in this sector because, subject to capacity constraints, firms have tended not to compete via offering television channels that are not available via other pay TV retailers. ITV attempted this strategy with a sports channel that was exclusive to its DTT pay TV service, but the strategy was an unequivocal failure.

Indeed, such an effect would be wholly contrary to one of the stated purposes of Ofcom's proposed new regulation – to promote the development of innovative new services.

9.59 Ofcom's argument that competition can be effective only if firms have the same attributes, including being able to offer the same product set, is wrong. For example, Virgin Media differentiates its services by being able to offer (among other things) 'superfast' broadband, 'true VoD', and 'quad play' packages (of TV, fixed line telephony, mobile telephony and broadband services). The fact that other firms do not offer the same product set as Virgin Media does not mean that they cannot compete with it.

9.60 This point would also appear to be entirely consistent with Ofcom's views in relation to BT. In its statement removing regulation of BT's activities in the retail market for residential phone services, Ofcom argued that this was possible because the market is "*effectively competitive*".[27] Ofcom reached this conclusion despite recognising that BT continues to have a market share of over 50% and "*has a significant first-mover advantage because of its installed base and brand recognition*",[28] attributes that are either impossible, or extremely difficult, for other firms to replicate.

9.61 Accordingly, Ofcom cannot claim that the imposition of compulsory licensing obligations on Sky in relation to Sky's high definition premium channels is targeted at a problem for which action is necessary. On the contrary, there appears to be no problem at all that would warrant regulatory intervention.

9.62 The arguments set out below are without prejudice to Ofcom's failure to demonstrate that compulsory licensing of Sky's channels is targeted at a case in which action is needed.

(ii) Proportionate

9.63 The most important issue to be examined when considering the proportionality of the imposition of compulsory licensing in relation to Sky's high definition channels is its potential adverse impact on incentives for investment and innovation, in light of the fact that they are new and innovative products in which Sky has invested very substantial amounts.

9.64 It is reasonably evident that the application of compulsory licensing to Sky's high definition channels is likely to have an adverse impact on Sky's incentives (and potentially those of other firms) to invest in innovation in the future, and to invest in driving the take-up of innovative new products. Professor Cave takes the same view in his Expert Report. He states:

> "*A particular concern* [with Ofcom's proposals for new regulation] *is the effect of the proposals on innovation. For example, by requiring Sky to*

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27 Paragraph 1.2 of Ofcom's final regulatory statement: "*fixed narrowband retail services markets, identification of markets and determination of market power*", 15 September 2009.

28 Paragraph 6.42 of Ofcom's consultation document "*fixed narrowband retail services market*", 19 March 2009.

> *share its HD products relating to premium content with competitors at retail minus prices, it risks creating a precedent which will weaken incentives to innovate in a market place which exhibits very high levels of innovation.*"[29]

9.65 This is particularly the case where a significant reason that demand for Sky's high definition television services is growing is that Sky has devoted substantial efforts, and invested substantial amounts, in marketing these services to consumers. A policy that punishes such efforts by imposing compulsory licensing on a firm if it is successful in creating demand for a new product or service is likely significantly to damage incentives to engage in such activity, which would harm consumers.

9.66 Ofcom recognises the argument that compelling the supply of new services may diminish incentives for investment in innovation. Nevertheless, it is evident that Ofcom does not place much weight on this potential detriment from its proposal. Ofcom states:

> *"We accept in principle that we should be cautious about deterring future investment in innovation; innovative services in future which relate to the premium channels covered by the wholesale must-offer* [sic] *would not automatically be included in the obligation. However, based on the evidence set out above on availability of services, and Sky's own pronouncements, HD appears no longer to be a brand new innovation, and more an integral part of the pay TV landscape. We therefore consider we need to include HD versions of the channels* [within the scope of Ofcom's proposed compulsory licensing regulation]*."*[30]

9.67 These assertions do not, in any sense, comprise the careful analysis of an issue of considerable importance that should be expected in relation to this proposed new regulation. Ofcom's statement that it accepts "*in principle that we should be cautious about deterring future investment in innovation*" appears to be lip service – the prefacing of this statement with the words "*in principle*" is telling in this respect.

9.68 The core of Ofcom's argument is that Sky should be permitted exclusivity over innovations in relation to its premium channels in which it invests only so long as they are regarded by Ofcom as being "*brand new*" – a concept that Ofcom fails to even attempt to define. Once that period runs out, in order to ensure that other operators are able to offer at least the same set of products and services as Sky, Ofcom would then step in and require Sky to deliver those products and services to its rivals. This is an argument that is staggering in its neglect of the possible detrimental consequences of such a policy.

9.69 Ofcom's proposition would substantially damage Sky's incentive to compete in this way. Any firm, including Sky, would be reluctant to take on the risk associated with the development of, and investment in, innovative new products and services if the pay-back on those efforts and investments depended on a

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29 Page 2 of the Cave Report.

30 Paragraph 8.99 of the Consultation Document.

regulator's future judgment about when they might be considered no longer to be "*brand new*", and therefore be handed over to rivals on terms set by Ofcom. That is particularly the case where Ofcom has shown itself readily to be persuaded by the lobbying activities of Sky's rivals, who would clearly demand 'access' to anything that gave Sky a source of competitive advantage.

9.70 It is this impact on incentives to invest and innovate, and to market new services effectively - which is in turn likely to have a significant adverse impact on effective retail and platform competition (in direct contradiction of the aim of Ofcom's policies) and on consumers - that is the key reason for considering that such a policy is disproportionate to the achievement of any legitimate objective at which Ofcom considers its proposals are directed. It is inconsistent with Ofcom's principal duty under CA03, to further the interests of consumers in relevant markets.

(iii) Consistency

ITV's HD channel

9.71 In its Response to Ofcom's Second Consultation Document Sky argued that Ofcom's proposal to apply compulsory licensing to Sky's high definition channels was inconsistent with the treatment of high definition channels offered by the public service broadcasters. Ofcom rejects any inconsistency in approach based on an argument that it does "*not see evidence of this*"[31] (*i.e.* restricting distribution). It would appear to be the case that Ofcom has 'not seen' such evidence because it has not sought such evidence.[32]

9.72 The evidence in relation to ITV's HD channel is readily available, and could be sought from either ITV or Sky. Were Ofcom to seek that evidence, it would show clearly that ITV has chosen not to make its HD channel available to households on Sky's DTH satellite platform – even though the channel is broadcast via satellite – because it considers that the amount offered by Sky for making it available to households on Sky's platform was insufficient.

9.73 It is inconsistent for Ofcom to regard failure to reach agreement on price and other terms as evidence of Sky acting on an incentive to withhold its channels from other platforms, and to take a different view in relation to ITV's behaviour in relation to supply of its HD channel.

Ofcom policy on next generation access networks

9.74 Ofcom has, for some time, been considering the approach it should take in relation to the regulation of 'next generation access' networks – networks that enable 'superfast' broadband services to be provided to consumers. One of Ofcom's key concerns in examining this issue has been the desire not to discourage investment in such networks. Ofcom has concluded that it is not currently appropriate to impose intrusive price regulation on the wholesale

31 Paragraph 8.100 of the Consultation Document.

32 This is yet another example of Ofcom's skewed approach to evidence.

supply of such services. The fact that the pricing of such services would be constrained by the continued availability of 'standard' broadband services has been a key factor in Ofcom's conclusion.

9.75 It is evident that there are some similarities in the types of issues involved in Ofcom's consideration of super-fast broadband and the approach to regulation of Sky's high definition television services. Ofcom's conclusions as between the two issues are, however, inconsistent.

(iv) Reflecting best regulatory practice

9.76 Ofcom's proposals to impose compulsory licensing obligations on Sky in relation to Sky's high definition premium channels do not accord with best regulatory practice in numerous respects. In particular, rather than setting a high threshold for the introduction of regulation of this type, in recognition of its potential adverse impact on incentives to invest and innovate, Ofcom's threshold is inappropriately low.

H. Compulsory supply of "*interactive content*"

9.77 One of the key problems with Ofcom's proposals in the Consultation Document in relation to Sky's interactive sports services is that they are inchoate. Ofcom does not clearly set out in any single part of its Consultation Document what it is that Sky would be compelled to provide to third parties, or the terms on which Ofcom would compel such supply. Ofcom refers variously to regulation being applied to:

- "*additional video-streams supplied via interactive 'red button' services in the remedy, in circumstances where these contain actual coverage of sporting events which might normally be shown on the main channel*" [33];
- "*primary interactive content*"[34]; and
- "*primary interactive services*"[35].

9.78 Elsewhere, Ofcom states:

> *"we propose to consult on including within the scope of the remedy any sports matches shown live via the red button which are part of events that appear on Sky Sports 1 and Sky Sports 2."*[36]

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[33] Paragraph 1.61 of the Consultation Document.

[34] Paragraph 8.91 of the Consultation Document.

[35] Paragraphs 8.101 to 8.111 of the Consultation Document.

[36] Paragraph 8.109 of the Consultation Document. Unusually, Ofcom indicates that it 'proposes' to consult on such matters – appearing to indicate that such a consultation would occur in the future. Yet Ofcom's draft licence condition refers to "*Interactive Content*" (without providing a definition of what appears to be a defined term) on which it is *currently* consulting.

9.79 This variety of formulations results in a situation in which consultees are not able to give intelligent consideration or provide intelligent responses to Ofcom's proposals.

9.80 Moreover, in keeping with Ofcom's approach to these services in its Second Consultation Document, its proposals in relation to interactive services do not appear to be informed by evidence-based analysis of issues related to these services. These issues include, for example:

- the channels with which they are associated;
- the programming carried on the services;
- consumers' views in relation to these services, and
- technical issues related to their supply on different platforms.

9.81 This unthorough approach again leads Ofcom to put forward proposals for intrusive new regulation that fail to meet its legal obligations to ensure that such proposals are targeted at a case in which action is necessary and proportionate.

Whether Ofcom can compel the supply of such services

9.82 Ofcom appears to be contemplating imposing compulsory licensing on Sky's interactive services on the basis that they are behind Sky's licensed television channels on which it intends to impose compulsory licensing under Section 316 CA03 (namely Sky Sports 1 and Sky Sports 2).

9.83 As discussed further below, a key part of Ofcom's most recent rationale for compelling Sky to provide its interactive services to third parties is that they carry live UEFA Champions League football.[37] UEFA Champions League football, however, has always been made available via an interactive service that is part of Sky's 'Sky Sports Xtra' service. The interactive service on which live UEFA Champions League football is accessed is therefore not part of either of the premium sports channels – Sky Sports 1 and 2 – on which Ofcom proposes to impose compulsory licensing using Section 316 CA03. Ofcom cannot compel the supply of interactive services that are part of channels that are not within the scope of its proposed compulsory licensing obligations.

9.84 The discussion in the following parts is without prejudice to this fundamental point.

(i) Targeted at a case in which action is needed

37 In its Second Consultation Document Ofcom argued that Sky should be compelled to supply its interactive services to third parties on the basis of a belief that Sky often showed Premier League matches via those services. Ofcom now accepts that its previous view was erroneous, stating "*live FAPL matches may seldom appear via the red button*" (paragraph 8.107 of the Consultation Document). Ofcom, however, simply changes tack and argues that the availability of UEFA Champions' League football via these services warrants the imposition of compulsory supply obligations on them.

9.85 The fundamental flaw in Ofcom's argument that compulsory provision of Sky's interactive sports services to third parties is targeted at a case in which action is necessary is that it is impossible to argue either that they are indispensable for operating in the relevant downstream market, or that a refusal to license such services to other operators would exclude any effective competition on the downstream market.

9.86 This is simply and clearly demonstrated by the fact that they have been available only on Sky's DTH satellite platform for many years, without any demonstrable impact on competition in any relevant downstream market. If the lack of availability of such services on other platforms was likely to have a significant impact on their ability to compete with Sky, it would be expected that there would be clear and compelling evidence of such an effect – in fact, such an effect would have been expected to have manifested itself a long time ago. It is telling that Ofcom does not even attempt to demonstrate such an effect.

9.87 One of the key reasons for this is that all available evidence – including Ofcom's own evidence - points strongly to a view that consumers place relatively little value on such services. Sky provided evidence on this matter in its Response to Ofcom's First Consultation Document.[38] Ofcom appears to have had no regard at all to that evidence in formulating its regulatory proposals.

9.88 Ofcom again attempts to set an absurdly low threshold for the imposition of compulsory supply obligations – in this case arguing that:

> "*The possibility that content could be shown via the red button suggests that there could be a risk to fair and effective competition if video and audio streams containing content of types otherwise shown on the main linear stream were not offered as part of the remedy*".[39]

9.89 In other words, in this case Ofcom is proposing the use of a highly intrusive regulatory remedy on the basis of a series of 'possibilities' that a particular course of conduct 'could' create "*a risk to fair and effective competition*" (a concept that Ofcom has entirely failed to define). It is, therefore, wholly evident that Ofcom's rationale for this proposal does not come close to clearing the high threshold that must be met in order to warrant the use of such intrusive regulation.

UEFA Champions League football

9.90 As with its Second Consultation Document, Ofcom also seeks to justify its proposal on a basis that appears to derive from Ofcom's impressions of the programming delivered via these services, rather than a proper examination of relevant evidence on this matter. In particular, Ofcom now focuses on the availability of UEFA Champions League football via Sky's interactive services. Ofcom states:

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38 See paragraphs 10.34 to 10.36 of Part 2 of Sky's Response to the First Consultation Document.

39 Paragraph 8.106 of the Consultation Document.

> *"Sky can show 15 live Champions League matches per week from the start of the 2009-10 season, of which many will be shown via the red button*[40].

9.91 This statement is erroneous, and appears intended to overstate the amount of live UEFA Champions League football provided via Sky's interactive services. UEFA Champions League rounds take place on an irregular basis, not a weekly basis. For the 2009/10 season, there will be 6 weeks during the football season in which Sky would be able to broadcast 15 live matches across Tuesday and Wednesday evenings.

9.92 Sky's interactive service is used to broadcast a number of UEFA Champions League matches that take place at the same time as those that are likely to be of greatest interest to UK viewers, which are broadcast on linear television channels (both free to air and pay). **Table 9.1** sets out the matches made available via Sky's interactive service only (i.e. are not also broadcast on a linear television channel[41]) on a typical UEFA Champions League match day during the 2008/09 season, while **Table 9.2** sets out the matches broadcast on linear channels on those days.

Table 9.1

UEFA Champions League 2008/09 – Match day 4
Matches available via Sky's interactive service

Day	Date	Match
Tue	04-Nov	Cluj v Bordeaux
		Werder Bremen v Panathinaikos
		Sporting Lisbon v Shakhtar
		Marseille v PSV
Wed	05-Nov	Aalborg v Villareal
		Fiorentina v Bayern Munich
		Lyon v Steaua
		Dynamo Kiev v Porto
		Real Madrid v Juventus
		BATE v Zenit St. Petersburg

Table 9.2

UEFA Champions League 2008/09 – Match day 4
Matches available via linear television channels

40 Paragraph 8.107 of the Consultation Document. Ofcom's statement also gives a misleading impression that this would be a new service beginning in 2009/10. In fact, Sky has broadcast 14 matches each week that Champions League matches are played (prior to the knock-out stages of the tournament) for the last 6 years. The only difference being that Sky will now have 1 additional match per week with 8 on a Tuesday evening and 7 on a Wednesday evening.

41 Matches are sometimes both (a) included in a linear television channel, and (b) accessible via an interactive service. On the match day cited in the table above this applied to the following matches: Barcelona v. Basle, Anorthosis v Inter Milan, Celtic v Manchester United, and Arsenal v Fenerbahce.

Day	Date	Match	Channel
Tue	04-Nov	Liverpool v Athletico Madrid	ITV1
		Roma v Chelsea	ITV4
		Barcelona v Basle	Sky Sports 2/ Active
		Anorthosis v Inter Milan	Sky Sports Xtra/ Active
Wed	05-Nov	Celtic v Manchester United	Sky Sports 2/ Active
		Arsenal v Fenerbahce	Sky Sports Xtra/ Active

9.93 It is difficult to believe that Ofcom considers that being able to offer live coverage of the types of matches in Table 9.1 to UK consumers, at the same time as the matches set out in Table 9.2 are available on linear channels, is of such significance to "*fair and effective competition*" (whatever Ofcom means by that phrase) at the retail level that it is necessary to impose compulsory licensing on Sky in relation to its interactive sports services. Certainly, Ofcom offers no evidence to support such a proposition.

Ofcom's proposed 'listing' approach to regulation

9.94 One proposition that Ofcom appears to have in mind is that it would designate a list of events that, if Sky made live coverage of such sports events available via an interactive application that comprised part of Sky Sports 1 or Sky Sports 2, Sky would also be required to make its interactive service available to third parties. Ofcom states:

> *"we propose to consult on including within the scope of the remedy any sports matches shown live via the red button which are part of events that appear on Sky Sports 1 and Sky Sports 2, e.g. those shown in Figure 7 such as FAPL, Champions League, Carling Cup, English Test cricket, World Golf Championship, Heineken Cup, Super League*".[42]

9.95 Ofcom sets out no criteria for the selection of these events, nor any details of how its proposed regulatory regime would be intended to operate. For example, it is wholly unclear why Ofcom considers that making coverage of the World Golf Championship – an event that is of appeal to a very small minority of viewers – or Heineken Cup rugby available via an interactive service might warrant the imposition of compulsory licensing obligations on Sky. Ofcom's proposal is wholly inappropriate and should not be pursued further.

The possibility of gaming

9.96 A final reason adduced by Ofcom for compelling the provision of Sky's interactive sports services to third parties is a concern on Ofcom's part that, absent compulsory licensing, Sky might use such services as a means of 'gaming' the principal intervention, namely compulsory licensing of its

[42] Paragraph 8.109 of the Consultation Document.

premium sports channels, by moving programming from its linear channels to interactive services associated with those channels.

9.97 Best regulatory practice indicates that regulation should be proportionate to the risk of undesirable events occurring. In this case, that principle calls for an evaluation of the risk that Sky would seek to behave in the way that Ofcom fears in the future.

9.98 This risk is small. There are sound reasons why it does not make commercial sense to make highly attractive programming available via interactive services; it would substantially reduce audiences to such content, certainly reducing advertising revenue, and potentially cause significant levels of customer dissatisfaction. It is wholly improbable that any benefits derived from 'gaming' Ofcom's regulation, would outweigh such detriments.

9.99 Accordingly, Ofcom cannot justify its proposal to impose intrusive compulsory licensing obligations on Sky in relation to such services on the basis of a small risk of such services being used to game Ofcom's proposed intervention.

9.100 More generally, Ofcom's propositions that: (a) without being able to replicate the full portfolio of services offered by Sky, Sky's competitors would not be able to "*compete effectively in the retail market*", and (b) lack of wholesale access to these services means that there is a "*risk to fair and effective competition*" at the retail level are both hollow and ill-founded. Such hand-waving cannot comprise a sound basis for the application of intrusive compulsory licensing obligations.

(ii) Proportionality

9.101 It would be extremely difficult, and therefore costly, for Sky to supply its interactive services to all-comers. This difficulty derives from the facts that (a) no other platforms use the technology on which Sky's interactive services are based and (b) Sky's interactive services are technically complex. As Sky noted in its Response to Ofcom's Second Consultation Document, Ofcom's statement in that consultation that "*The authoring, distribution and operation of interactive services by multiple retailers across multiple digital TV platforms is a technically complex subject*"[43] was correct, but comprises a very considerable understatement.

9.102 The operational complexity is particularly acute in relation to interactive sports services because these are not services that comprise playout of a linear schedule of pre-recorded programming. Instead, the interactive service is an integral part of the live programme being broadcast and decisions about what content to include behind the red button sometimes can be changed at a moment's notice to reflect the way that events are unfolding. In order to provide such a service Sky, as the channel broadcaster, needs to be able to manipulate and control the interactive application. Accordingly, Ofcom's

43 Paragraph 9.92 of the Second Consultation Document.

distinction between the 'editorial' features of interactive sports applications, and their programming, is a false one. The two matters are integrally related.

9.103 In such circumstances, it is clear that a decision to impose compulsory licensing obligations on Sky in relation to such services would need to be based on a very careful assessment of the costs and benefits of doing so. Ofcom, however, has made no effort at all to assess such costs and benefits: its proposals to compel supply of Sky's interactive services to third parties are not considered in Ofcom's impact assessment. It is, therefore, wholly unclear how Ofcom considers that it can reach a view that the proportionality of imposing such regulation is "*finely balanced*".[44]

9.104 The arguments are in fact not "*finely balanced*". It is clear that the benefits of regulation would be minimal and the costs, which derive from both the technical incompatibility of different platforms and the requirement that Sky would need to control applications running on other operators' platforms, would be very substantial.

9.105 Ofcom appears to propose that the solution to problems raised by the technical incompatibility of different platforms would be for Sky to specify the technical details regarding the operation of interactive applications on other platforms, which would then be developed and operated by other platform operators. Ofcom states that:

> "*Sky would need to provide sufficient information on the design and minimum functionality of the interactive service which retailers would need to produce*".[45]

9.106 As discussed above, this proposition is based on a view of the nature of interactive services that is misconceived; interactive services are, on a technical level, an integral part of the editorial proposition of the channels from which they are accessed. Sky cannot allow a third party to take responsibility for producing a service which is part of Sky's editorial offering and indeed part of a service for which Sky is the licensee. Sky would need to take responsibility for interactive services on rival platforms itself. In this way it could ensure that such interactive channel enhancement would be a functionally and editorially identical experience to its digital satellite counterpart.

I. Other aspects of Ofcom's proposed regulation

9.107 Ofcom also proposes to regulate a range of other matters, including:

(a) "[n]*on-price issues*"[46] relating to carriage agreements, such as conditions relating to security requirements and subscriber audits;

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[44] Paragraph 8.109 of the Consultation Document.

[45] Paragraph 8.111 of the Consultation Document.

[46] Paragraph 9.15 of the Consultation Document.

(b) issues related to Sky's bundling of non-pay TV services with packages that include Sky's premium pay TV channels; and

(c) Ofcom proposes to introduce a requirement that Sky obtains the agreement of third party distributors of its channels to changes in the content included on its channels.

9.108 We comment briefly below on each of these proposals. Their common features are that the rationale put forward by Ofcom in relation to each of them is either nugatory or non-existent, and they appear wholly disproportionate responses to any issues identified by Ofcom.

Regulation of "non-price issues" relating to carriage agreements, such as conditions relating to security requirements and subscriber audits

9.109 Ofcom's rationale for proposing that such matters should be regulated is that it considers that, if they were left to commercial negotiation, there is a risk that Sky might drag out negotiation of such issues in order to undermine the effectiveness of the requirement to supply its channels to third parties.[47]

9.110 It is not consistent with Ofcom's principle of operating with a bias against regulating to propose regulation on the basis of a wholly un-quantified risk. An approach that would be more in keeping with such a principle would be not to regulate such matters at the outset, and regulate at a later stage if it became apparent that Sky was in fact using negotiation to undermine the effectiveness of Ofcom's policy.

9.111 One of the significant downsides from attempting to regulate such matters is that such regulation would substantially eliminate flexibility in relation to carriage agreements – for example, the ability to tailor terms and conditions to the requirements of a particular retailer, or to amend agreements as circumstances change. Ofcom does not appear to have had due regard to such a potential detriment from its proposal.

9.112 As discussed in **Section 10**, below, the proposition that the only way of preventing firms from delaying negotiations unduly is via prescriptive regulation is, quite obviously, without merit. A range of more proportionate solutions is available, if such solutions are required, that do not have the significant downside of eliminating a significant degree of flexibility that is caused by the use of prescriptive regulation. As but one example, providing firms a right to complain to Ofcom if they considered that the other party was unduly delaying negotiation might comprise a more proportionate alternative.[48]

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[47] Paragraph 9.209 of the Consultation Document.

[48] See footnote 12 of **Section 10** of this Response.

<u>Issues related to Sky's bundling of non-pay TV services with packages that include Sky's premium pay TV channels</u>

9.113 One entirely new proposal in Ofcom's Third Consultation Document is that, if Sky provides retail packages that include "*non-TV products*", and the 'incremental price' of the non-TV products is below the product's (or products') 'long run incremental cost', then Ofcom would require Sky to reduce wholesale charges for its premium channels by the difference between these two measures. Ofcom includes a draft condition to this effect in its proposed new licence conditions (although the drafting of this condition is erroneous).[49]

9.114 Two features of this proposal are notable.

9.115 First, Ofcom's proposal is discriminatory. Ofcom appears to be concerned about Sky adopting a strategy that, were Ofcom to compel Sky to supply its premium channels to third party pay TV retailers, would be available to all such firms – *i.e.* the bundling of services that include Sky's premium channels with other products. Such a concern would be wholly inappropriate.

9.116 Second, Ofcom has made no attempt to examine the potential consequences of its proposal, or, in particular, its practicability. Taken at face value, significant elements of Ofcom's proposal – for example the need to assess the 'long run incremental cost' of "*non-TV products*" and determining what is in fact a "*non-TV product*" – would be enormously complex issues in their own right.

9.117 Furthermore, Ofcom should not require each "*non-TV product*" to be priced above its incremental cost; it should be sufficient that incremental revenues from non-TV products included in a bundle with premium pay TV services in aggregate cover the incremental costs of such non-TV products.[50] For example, in relation to the provision of broadband and telephony services, the bundling of these services is a normal form of competition between firms.

9.118 In summary, Ofcom's proposal in relation to "*wider bundles*"[51] appears ill-considered. It is discriminatory, does not appear to be targeted at any issue in which action is necessary, and Ofcom has made no attempt to determine whether or not it is a proportionate response to any such issue. Ofcom has no basis on which to pursue this proposal any further.

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49 See **Annex 8** to this Response.

50 This approach is the natural extension of the approach taken to bundling in the European Commission's publication entitled 'Guidance on the Commission's enforcement priorities in applying Article 82 EC Treaty to abusive exclusionary conduct by dominant undertakings', and is set out clearly in the European Commission's publication entitled 'Notice on the application of competition rules to the Postal Sector', which at paragraph 3.2 states: "*cross-subsidisation between non-reserved activities is not in itself abusive*".

51 Paragraphs 9.203 to 9.208 of the Consultation Document.

<u>A requirement that Sky obtains the agreement of third party distributors of its channels to changes to the content of its channels</u>

9.119 Ofcom's draft licence conditions contain a proposal that Sky should be required to seek and obtain the approval of third party distributors of its channels before making changes to their scheduling. The draft conditions would require that Sky publishes:

> "*standard terms and conditions…which shall include… the arrangements under which changes to the content of the Licensed Service shall be notified and agreed*".[52]

9.120 Again, this appears to comprise an extreme proposal, the ramifications of which Ofcom has not stopped to consider before drafting a licence condition. There is no discussion of this proposal in the body of the Consultation Document, so it is impossible for consultees to determine Ofcom's rationale for it, or why Ofcom considers that it might be a proportionate response to a clearly defined problem.

9.121 It would be entirely inappropriate for anyone other than the licensee of particular channels to have editorial control over them. Notwithstanding this point, the proposition that Sky's commercial rivals should be given the power to veto changes to the content of Sky's channels is clearly also inappropriate under any circumstances. It is particularly inappropriate in relation to Sky's sports channels, where changes to the scheduling of programming across Sky's portfolio of sports channels take place frequently, and can need to occur in very short timeframes. A requirement to have to obtain the permission of potentially a number of different distributors of Sky's channels in order to undertake such changes would simply be unworkable.

9.122 It is therefore difficult to conceive of any valid reason that might have motivated Ofcom to put forward such a proposal, and it should not be pursued any further.

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52 Paragraph 11.10 of the Consultation Document.

SECTION 10: OFCOM'S PROPOSED EXTENDED RETAIL-MINUS PRICE CONTROL REGIME IS NEITHER NECESSARY NOR PROPORTIONATE, AND DOES NOT REFLECT BEST REGULATORY PRACTICE

Introduction

10.1 Ofcom proposes to impose on Sky a new price control regime in which Sky's wholesale charges are set according to calculations undertaken by Ofcom. This would replace the current situation in which, subject to any requirements flowing from the Competition Act, such charges are determined on a normal commercial basis.

10.2 The particular form of the price control regime proposed by Ofcom is unprecedented in relation to the provision of pay TV services, as research commissioned by Ofcom has now demonstrated. Ofcom proposes to set charges on an 'extended retail-minus' basis[1], where Sky's charges are determined as a residual between Sky's retail charges for services that include its premium channels, and the costs of a hypothetical new DTT retailer of Sky's channels, whose costs are higher than Sky's.

10.3 Sky explains below why price control in general, and the particular form of price control proposed by Ofcom, are both unnecessary in relation to Sky's premium pay TV channels, and out of all proportion to any of the issues identified by Ofcom in its pay TV review.

10.4 This section contains three parts. **Part I** assesses Ofcom's price control proposals against Ofcom's obligations (described in **Section 9** above) to ensure that proposals for new regulation are targeted only at cases in which action is needed, proportionate, consistent and reflective of best regulatory practice. Sky therefore explains that:

(a) price control is not targeted at a case in which action is needed; and

(b) Ofcom has failed to appreciate the extent and scale of the potential adverse consequences that would arise from the introduction of its proposed price control regulation, fatally undermining Ofcom's assessment of its proportionality.

10.5 **Part II** provides an assessment of Ofcom's calculations of appropriate levels for regulated charges for Sky's premium channels. It explains that Ofcom's calculations are very seriously flawed, both in methodology and execution. Correction of the errors in Ofcom's analysis shows that development of sustainable DTT-based pay TV services would be feasible at Sky's current ratecard charges, a proposition that is confirmed both by proper examination of Sky's business plan for its Picnic service, and by public statements made by BT and TUTV.

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1 As set out in **Section 9** above, we use this term to distinguish Ofcom's proposed approach from the well-established, competition law-based, approach to retail-minus price control in which the 'minus' is determined according to a vertically integrated operator's actual ***own retail costs***.

10.6 **Part III** assesses Ofcom's proposal that Sky must cut the charges for its premium channels paid by the current principal third party distributor of those channels, Virgin Media, against the criteria set out above (i.e., necessity, proportionality, consistency and being reflective of best regulatory practice). We explain there that Ofcom has adduced no adequate reason in support of the proposition that such a price cut is needed, and, in particular, that the proposal is a disproportionate response to any issue that Ofcom considers that it has identified.

Part I

Assessment of Ofcom's price control proposals against the criteria of necessity, proportionality and best regulatory practice

A. Targeted at a case in which action is needed

10.7 In its Second Consultation Document, Ofcom argued that, if it imposed compulsory licensing requirements on Sky it would be necessary also to impose a prescriptive price control regime, because it was not possible to have one without the other. That proposition was erroneous, as is indicated, for example by the US programme access rules, which impose the type of compulsory licensing obligations considered necessary by Ofcom, without being accompanied by a prescriptive price control regime.

(i) Ofcom's argument that extended retail-minus price control is needed to support the development of pay TV retailers of a type that it judges to be appropriate

10.8 The purpose of Ofcom's proposed new price control regime is to reduce wholesale charges for Sky's premium channels in order to facilitate the development of new DTT-based pay TV services. Ofcom's argument in this respect appears to be based on two different propositions.

10.9 First, Ofcom argues that new DTT-based pay TV services would not emerge at all if they were required to pay cable ratecard wholesale charges for Sky's premium channels. Ofcom states:

> "*if we did not set prices, it is likely that prices would ultimately default to the cable rate-card.*[2] *[✂].... As our subsequent analysis on pricing shows, the current rate-card prices are higher than those needed for a rival retailer to be able to compete. Indeed, as we set out in chapter 6, our analysis of Sky's modelling of Picnic's profitability suggests that even Picnic would not be possible using the cable rate-card prices as an input.*"[3]

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2 As Sky explained in its Response to Ofcom's Second Consultation Document, Sky has effectively been required to wholesale its channels to cable operators on a ratecard basis for regulatory reasons, see paragrapgh 3.14 of Section 7 of that response, and the associated relevance to Sky's response to questions from Ofcom of 2 July 2008.

3 Paragraph 8.74 of the Consultation Document. Ofcom's linking of the ability to compete of "*a rival retailer*" and Sky's proposed Picnic service indicates that Ofcom has in mind a DTT-based operator when referring to "*a rival retailer*".

10.10 The assertion that a new pay TV retailer that retailed Sky's premium channels would not be able to pay standard charges for those channels and operate profitably is wrong; as we discuss in detail below it is wholly an artefact of Ofcom's fundamentally flawed analysis. Contrary to Ofcom's belief, new DTT-based pay TV businesses that retailed some of[4] Sky's premium pay TV channels could be developed based on the cable ratecard.

10.11 As discussed in **Section 6**, the analysis on which Ofcom's conclusion that "*even Picnic would not be profitable using the cable rate-card prices as an input*" is wrong. Picnic could have been developed profitably at cable ratecard prices. The Picnic business plan reflects what an experienced real-world operator actually planned to do, in which Sky invested over £40 million before it had to be mothballed due to Ofcom, in effect, preventing its further development.

10.12 Furthermore, as discussed below, public statements by TUTV and BT indicate that they do not require reductions in wholesale charges for Sky's premium channels in order to retail them.

10.13 Second, Ofcom takes the view that it is appropriate for Ofcom to determine the scale (in terms of number of subscribers) and nature of new DTT-based services. Ofcom has set prices so that (a) a single provider should establish a subscriber base, in aggregate, of 1.7 million subscribers after 5 years, and 3 million subscribers after 10 years, and (b) as far as possible replicate existing pay TV businesses (particularly Sky's DTH satellite business) including matching their prices.

10.14 Ofcom's argument is that, based on its modelling, the only way of meeting the objectives of promoting entry at the retail level is to reduce the cost base of DTT-based pay TV services, and it views reductions in wholesale charges for Sky's premium channels as an appropriate way of doing so. In Ofcom's policy, wholesale charges for Sky's premium channels are a residual, to be driven down (provided that they do not fall below Ofcom's erroneous estimates of cost-based floors for such charges) in order to make Ofcom's model of hypothetical DTT-based pay TV businesses profitable at the subscriber targets and retail prices desired by Ofcom.

10.15 These propositions are reflected in the following statement in the Consultation Document:

> "*we propose that retail-minus prices should be set to allow a larger competitor (for example, reaching three million subscribers after 10 years) to compete with Sky's retail prices, incorporating an allowance for DTT transmission costs and a reasonable return on investment.*"[5]

10.16 Normally, it would be expected that matters such as business strategies (including the services offered to consumers, pricing and subscriber targets)

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4 There would not be sufficient DTT capacity for such a service to carry all Sky's premium pay TV channels.

5 Paragraph 9.8 of the Consultation Document.

would be something that would be determined by the market, rather than by a regulator. For this reason, and bearing in mind the intrusive and confiscatory nature of Ofcom's proposals, it would be expected that Ofcom's rationale for supplanting market determination of such matters with its own vision for the development of DTT-based services would be set out clearly, and supported by compelling evidence and analysis. Yet that is not the case.

10.17 Ofcom's evident belief is that new services can "*compete with*" existing services only if they are as similar as possible to existing services in all respects, including their prices. Ofcom provides no justification at all for this belief. It is misconceived. Competition among firms offering different products and services is common, particularly where firms use different technologies to deliver similar products to consumers. In such circumstances, the normal expectation would be that the types of services offered by DTT-based operators would be tailored to the particular strengths (e.g. the ability to offer 'plug and play' propositions) and weaknesses (expensive and limited channel capacity) of their chosen delivery technology, potentially at different charges to those of other pay TV retailers. This is, for example, the type of competition that exists among Sky and Virgin Media, whose prices and product offerings are differentiated from each other and reflect the strengths of their respective underlying technologies.

10.18 Ofcom's other apparent basis for considering that it should effectively determine the appropriate business strategy for new DTT-based pay TV retailers is that achieving the subscriber targets planned by Ofcom is necessary in order to deliver increased innovation in the provision of audiovisual services to consumers. For example, Ofcom's judgment about what constitutes an 'efficient entrant' (which is the term erroneously used by Ofcom to describe its desired business model for new DTT-based operators) is justified by reference to the benefits that would be created from "*platform choice, **platform innovation** and market expansion*"[6]. The proposition is also indicated, somewhat obliquely, in the following statement:

> "[Premium content not being available on all platforms] ***creates a risk that existing platforms may not create new capabilities, …*** *because of a dependence on access to premium content. This dependence might either be direct (e.g. the dependence of IPTV services on certain VoD rights) or indirect (e.g.* ***because new platforms cannot build sufficient scale without access to premium content)****. Either way, there is a risk that platform innovation will be reduced.*"[7] (Emphasis added)

10.19 Given the brief and passing reference to this argument, it is unclear whether Ofcom is in fact seeking to rely on it in support of an argument that it is necessary to reduce wholesale charges for Sky's premium channels. If Ofcom is seeking to rely on this argument, then it is not made out – Ofcom provides no evidence or analysis in support of it.

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6 Paragraph 9.126 of the Consultation Document.

7 Paragraph 1.44 of the Consultation Document.

10.20 It is clear that Ofcom places considerable weight on the benefits that arise from innovation in support of its proposals – for example as indicated in **Section 10** of the Consultation Document. The key point, however, is that there is no demonstrable link between realisation of those benefits and Ofcom's possible view that it must reduce Sky's wholesale charges in order to enable new DTT-based pay TV retailers to achieve subscriber bases of "*sufficient scale*", for two reasons.

10.21 First, an ability and incentive to innovate is unlikely to depend on having a large subscriber base. Smaller firms are just as likely to be innovative as larger firms, and if availability of resources is an important determinant of firms ability to innovate, Ofcom has indicated that the types of firms that it expects to avail themselves of cheap access to Sky's premium channels include very large firms – such as BT and France Telecom.[8]

10.22 Second, Ofcom's proposition that the level and nature of innovation in the provision of audiovisual services to consumers in the UK would increase significantly as a result of the introduction of its proposed regulatory regime is both speculative[9] and erroneous. As discussed further in **Section 11** below, it is the product of both a fundamentally flawed counterfactual, and a failure to recognise that competition among pay TV services and free to air television services is a key driver of innovation in such services.

10.23 Moreover, if this is in fact the rationale on which Ofcom bases the view that it should effectively determine a subscriber target for new DTT-based pay TV services, then Ofcom's policy may well be ineffective in its aim and thus it is not proportionate. Ofcom's Consultation Document recognises the possibility that there may be multiple DTT-based pay TV retailers, none of which individually has a 'large' subscriber base.[10]

(ii) Ofcom's other justifications for introducing a price control regime

10.24 Ofcom also puts forward a number of other arguments as to why it considers that price control is needed (other than in order to reduce Sky's wholesale charges).

<u>To prevent delays arising from negotiation</u>

10.25 Ofcom argues that, if setting charges were left to negotiation, Sky would use such negotiations as a pretext to delay, potentially for very long periods of time, supply of its channels to third parties. Ofcom states:

> "*a substantial length of time has already been spent by Sky and others in commercial negotiation over the principle of supply, without any significant progress, as we set out in section 6.... A remedy which still left scope for*

8 See paragraph 9.129 of the Consultation Document.

9 See **Section 11** of this Response.

10 For example, the 'base case' in Ofcom's wholesale pricing model and impact assessment is that there would be 3 DTT-based pay TV retailers.

months or even years of negotiation on the precise level of prices (and other terms) would not be effective."[11]

10.26 As we discuss in **Section 6** of this Response, Ofcom's characterisation of discussions between Sky and other operators for supply of its premium channels is one-sided. In fact, commercial negotiation in relation to supply of Sky's channels on new platforms has, over the past few years, been substantially hampered by Ofcom's inquiry, which has provided other operators with an incentive not to enter into meaningful negotiations with Sky. It is therefore wholly inappropriate for Ofcom to argue that lack of progress in commercial negotiations for supply of Sky's channels requires the imposition of onerous new regulation when Ofcom itself has contributed significantly to the lack of such progress.

10.27 In any event, a time-frame of "*months*" for the completion of negotiations would not be unusual in the case of complex agreements – particularly where agreements are negotiated for the first time.

10.28 Moreover, if Ofcom demonstrates, to an adequate standard, that Sky is more likely than not to use such negotiations in order substantially to delay supply of its premium channels, it is plain that a proposal to introduce prescriptive price control, with significant reductions in Sky's charges, could not be regarded as a proportionate response to such an issue. It would be possible to devise more proportionate responses to prevent unreasonable delays in negotiation of carriage agreements.[12]

<u>*International experience*</u>

10.29 Ofcom argues that international experience indicates that compulsory licensing needs to be accompanied by prescriptive price control. Ofcom states:

> "*we can also draw on the study of international examples of wholesale must-offer remedies that we commissioned from Value Partners, which is attached at Annex 11. This shows that the effectiveness of such remedies has been hampered by the lack of definition of precise terms of supply. For example, the remedy in place* [sic] *on Sky Italia did not initially include a price. Establishing a price had to wait until the dispute resolution process was able to determine it. Agcom (the Italian regulator) reflected on this to the effect that:*

11 Paragraph 8.74 of the Consultation Document.

12 For example, parties might be given the right to complain to Ofcom if they considered that Sky was delaying negotiations unduly, or regulation might make provision for Alternative Dispute Resolution ("ADR") procedures to be required if the parties are unable to reach agreement within a specified period of time. Sky notes that these are not put forward as the only possible solutions to the issue identified by Ofcom – they are intended only to illustrate the point that there are likely to be numerous, substantially more proportionate ways of preventing negotiations being used as a pretext for avoiding compliance with a compulsory licensing obligation than the use of prescriptive price control.

> *"If we were to design it [the wholesale must-offer remedy on the* [sic] *merged Sky Italia] again, we would be more explicit about the pricing rule and not give as much autonomy to Sky".*"[13]

10.30 This is a poor justification for introducing a prescriptive price control regime in the UK.

10.31 First, Ofcom's argument is based on a highly selective reading of the Value Partners study. Overall, the Value Partners study does not 'show' "*that the effectiveness of* [compulsory licensing regulation] *has been hampered by the lack of definition of precise terms of supply*". For example, Ofcom's selective representation of the study ignores statements such as:

> "*Overall, the FCC considers the* [program access rules] *to have been very successful in fulfilling their original intention, i.e. to enable new entrants to emerge in the pay TV market over the long-term.*"[14]

10.32 The US programme access rules do not include prescriptive price controls.

10.33 In relation to the views of the Italian regulator, it cannot be ruled out that this represents the desire on the part of one particular regulator to have more power and to expand its remit. The citation of such an inclination on the part of the Italian regulator does not in any way support a proposition that it is necessary for Ofcom to impose onerous prescriptive price control regulation on Sky, particularly in view of the unusual regulatory, political and market circumstances that exist in the media market in Italy. Indeed, in this respect, Ofcom ignores entirely the statement in the Value Partners study that:

> "*While the study of international cases provides valuable information about the experience in other countries, there are necessarily limits on the extent of inferences that can be drawn due to contextual differences between the markets studied.*"[15]

10.34 Third, even if there were merit in the conclusion that Ofcom draws – that international experience indicates that price control is warranted – (which there is not), it cannot justify the imposition of an extended retail-minus price control. No such price control of premium television channels, in which the aim is to support the entry of less efficient operators than existing distributors, is found in any other country in the world.

<u>High prices</u>

10.35 Although Ofcom does not anywhere clearly state that this is the case, it is evident that Ofcom also takes the view that its proposed price control regulation is justified on the basis of its belief that charges for Sky's premium channels are

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13 Paragraph 8.74 of the Consultation Document.

14 Page 32 of the Value Partners study.

15 Page 4 of the Value Partners study.

"*unduly high*".[16] In other words, Ofcom in part views its price control proposals in standard terms of reducing firms' excessive profitability. As discussed extensively in **Section 4** and **Section 7** of this Response, and Professor Grout's Independent Expert Report, Ofcom's view that Sky earns excessive profits, either as a whole, or in its premium channel business, is wholly unreliable. This view cannot, therefore, comprise an adequate basis for a conclusion that Ofcom's proposed price control is targeted at a case in which action is needed.

Targeted at a case in which action is needed: conclusion

10.36 Ofcom has failed entirely to make out an adequate case that its proposed prescriptive price control regime, with charges for Sky's premium channels being determined on an extended retail-minus basis, is targeted at a case in which action is needed. On the contrary, Ofcom's case appears to be based on no more than a desire to shape market outcomes in ways that are wholly unsupported, and unsupportable.

10.37 The arguments in relation to proportionality and consistency of Ofcom's proposals with best regulatory practice set out below are without prejudice to the fundamental point that Ofcom has failed to make out a case that this proposed regulation is needed.

B. Proportionality

(i) The views of Professor Cave

10.38 At **Annex 1** of this Response we provide an Independent Expert Report on Ofcom's regulatory proposals prepared by Professor Martin Cave. As discussed in **Section 1**, above, Professor Cave is an expert in the fied of regulatory policy (among others) and his views should be afforded significant weight by Ofcom when considering responses to its consultation. Professor Cave's Report indicates clearly the disproportionate nature of Ofcom's proposals and their lack of conformity with best regulatory practice. He summarises his views as follows:

> "*the Ofcom must-offer proposals are likely to have adverse effects on economic efficiency and consumer welfare which the regulator does not adequately acknowledge.*"[17]

10.39 Professor Cave explains that (among other things) Ofcom's proposals:

- do not adequately take into account the disadvantages of *ex ante* regulation in the particular circumstances of provision of pay TV services, particularly the "*high degree of mutability*" of such products;[18]

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16 Paragraph 5.7 of the Consultation Document.

17 Paragraph 4 of Professor Cave's Independent Expert Report at **Annex 1** of this Response ("the **Cave Report**").

18 *Ibid.*

- seek to apply ex ante regulation in circumstances where more traditional arguments for such regulation, based on structural or legal/regulatory barriers to entry, do not apply;

- do not adequately take into account the inevitable adverse effects of access regulation on competition and innovation in the service where access is mandated;

- are likely to give rise to "*several dysfunctional consequences*" [19], such as the opportunity for competitors to pass on their increased retail costs to Sky, reducing Sky's incentives to incur expenditure which might be in consumers' interests and providing incentives to raise retail prices. Professor Cave explains that the proposals are *biased towards higher retail prices – i.e in favour of producers and against consumers*" [20];

- would generate a need to revisit price controls frequently, due to "*the complex and changing nature of the services to which access is being mandated*";[21]

- comprise a policy "*of entry assistance which it has calibrated on the basis of its judgment of what 'should' succeed, despite the fact that the international history of pro-active regulation and policy-making in this area points to the dangers of so doing*"[22], particularly in view of the fast pace of technical change in this sector; and

- risk giving rise to "*an unhealthy climate of co-dependency between entrant(s) and regulator which may chill genuine competition*" [23].

10.40 In particular, Professor Cave explains the way in which the complex and changing nature of the products to be regulated, combined with Ofcom's concern about the potential for its intervention to be 'gamed' via changes in product characteristics (including charges), leads to Ofcom proposing layer upon layer of interventions to address such potential changes. Professor Cave states:

> "*Ofcom asserts that the above circumstances* [i.e. the fact that price control applies to complex and changing products, and is based on a hypothetical operator's costs] *create gaming opportunities for Sky. Its response is to add further powers of adjustment to thwart such conduct. But in adding such powers,* [Ofcom] *fails to recognise that their existence may have adverse consequences for consumers, either because they may be exercised in ways which prevent the emergence of consumer benefits, or*

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19 Paragraph 37 of the Cave Report.

20 *Ibid.*

21 Paragraph 47 of the Cave Report.

22 Paragraph 29 of the Cave Report.

23 Paragraph 4 of the Cave Report.

> *because the very existence of the powers will diminish Sky's incentives to propose such beneficial changes.*"[24]

10.41 In the sections below we raise a number of further potential consequences of Ofcom's proposals that were unlikely to have been apparent to Professor Cave when he prepared his Report – for example, because they depend on financial analysis that Sky has itself undertaken.

(ii) Other potential detriments

<u>*Reducing returns to Sky's premium channel business below a reasonable level*</u>

10.42 One of the key benchmarks set by Ofcom for the proportionality of its proposals is that Sky should be able to earn a reasonable return on the provision of its premium channels. Ofcom states:

> *"The basis of our cost-plus price is that this is the figure that should allow Sky sufficient wholesale revenue to recover its full rights expenditure, plus an allocation of other direct and common costs, and make a return which reflects its cost of capital.... the prices we are consulting on are in aggregate above the cost-plus figures, implying that Sky should not have difficulty maintaining its current levels of rights expenditure."*[25]

10.43 Elsewhere, Ofcom states that it is "*expressly not our intention*" to *"set prices in such a way that would push Sky into making a loss on wholesaling its channels based on the current rights fees*".[26]

10.44 As we set out in detail in **Section 7**, Ofcom's own advisors indicated that the methodology used by Ofcom (NPV) to assess the profitability of Sky's premium channel business is not fit for purpose and that in industries which are asset light it is more appropriate to use alternative measures of profitability such as operating margin. Ofcom's Cost-Plus prices are in any case materially flawed. Correcting for the errors in Ofcom's cost-plus model indicates that were Sky to charge the wholesale prices which Ofcom proposes then its notional premium wholesale business (as defined by Ofcom and referred to in **Section 7** as Narrow Premium Wholesale) would expect to earn an average operating margin over the next 4 years of only 8% per annum. This would be considerably lower than the returns which similar businesses would expect to earn and would not provide Sky with sufficient return to sustain its current levels of investment in programming and would seriously deter Sky from making further such investments. The wholesale prices which Ofcom proposes are therefore too low.

10.45 Accordingly, it is clear that Ofcom's proposed price control would not allow Sky to earn a reasonable return and is therefore not proportionate.

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24 Paragraph 46 of the Cave Report.

25 Paragraph 10.80 of the Consultation Document.

26 Paragraph 10.79 of the Consultation Document.

Distorting signals for efficient investment

10.46 Ofcom's approach involves a policy-driven alteration in investment incentives – reducing incentives for investment in content, and increasing incentives for investment in pay TV retailing. Adopting a policy of interfering in this way in firms' investment incentives is likely generally to be undesirable[27]. If, however, there are clear, well-justified reasons to support particular economic activities – for example, if they have significant positive externalities associated with them – it is generally considered that it is better to support such activities via transparent mechanisms, such as time-limited government subsidies.

10.47 Moreover, it seems unlikely that such a policy would, if examined properly, be desirable in this case. There are no obvious externalities associated with the development of new pay TV retail businesses, and the policy would give rise to a considerable risk of reducing investment in services that are widely recognised for their high quality and which are valued highly by millions of consumers.

Encouraging sub-optimal consumer choices

10.48 Ofcom's policy is intended to result in substantial numbers of households switching from their current choice of pay TV service, to one of the new services supported by Ofcom. Were such choices the result of competition on the merits among services facing a level playing field there could of course be no objection to such switching; firms aiming to encourage other firms' customers to switch, and to persuade their existing subscribers to remain as customers of their own services, are central to competition in the pay TV sector. Ofcom's proposed regulatory regime, however, would reduce the scope for competition on the merits[28], and favour operators using a particular technology (by compensating for the cost disadvantages of DTT). As a result, it raises the possibility of significant numbers of consumers being encouraged to adopt particular services when, absent Ofcom's proposed artificial support for particular services, they would have preferred an alternative.

Consequences for the operation of Sky's business

10.49 Ofcom's proposed price control would have a substantial impact on Sky's ability to effectively operate its premium pay TV channel business.

10.50 Professor Cave's Independent Expert Report discusses the problems that would arise from the introduction of Ofcom's proposed price control regime as a result of the unsuitability of the type of regulation proposed when the products to which it is applied have a "*high degree of mutability*".[29]

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27 Artificially altering investment incentives is likely to lead to allocative inefficiency – either too much, or too little, investment compared to that which is optimal.

28 For example, Ofcom's proposed 'ratchet' would restrict Sky's ability and incentive to compete with other operators by lowering retail prices.

29 Paragraph 4 of the Cave Report.

10.51 A further difficulty, however, arises in relation to the fact that Sky must regularly participate in auctions for programming rights. Auctions of this type have the potential to increase the cost base of Sky's premium channels – for example, if Sky acquires new rights, or the cost of rights that it currently holds increases - and the best way of recouping such cost increases may be through higher wholesale charges (which might in turn be reflected in higher retail prices on DTH satellite). Yet such charges would be controlled by Ofcom. Accordingly, in order to determine whether and how much to bid for particular programming rights, Sky would need to consider whether or not Ofcom might permit Sky to recover its increased costs via increased wholesale charges. The only statement in Ofcom's Consultation Document on this matter is as follows:

> "*If these types of changes were sufficiently material, it may well be appropriate for wholesale prices to change, requiring a reassessment of the pricing calculations.*"[30]

10.52 Such an approach would, therefore, give rise to significant risk to Sky in participating in contests for programming rights, given that Sky's ability to monetise the acquisition of programming rights via price increases would depend on Ofcom's subsequent decisions about whether (a) Ofcom regards the changes in Sky's costs as "*sufficiently material*" and (b) whether and when Ofcom permitted Sky to increase wholesale charges at the conclusion of its price control review. This could have a profound effect on Sky's ability to take part effectively in contests for programming rights.

Administrative burdens

10.53 Price controls are inherently resource-intensive to administer and comply with on the part of Sky, Ofcom and all other interested parties. Ofcom's claim that the burdens associated with administering and complying with price control regimes would be "*fairly limited*"[31] is surprising in light of its familiarity with the burdens associated with the administration of price controls in the telecommunications sector. It is also unconvincing. The number and volume of consultation documents on Ofcom's web site related to such matters, and the huge amounts of effort that have been devoted to price controls in the mobile telephony sector, provide an illustration of the scale of the burden imposed by price control regulation.

10.54 Moreover, it is evident that the administrative costs of such a regime are likely to be considerably greater than those associated with the administration of telecoms regulation for two reasons.

10.55 First, the radical nature of Ofcom's proposals would mean that there is likely to be a substantial element of 'learning-by-doing' in the administration of such a regulatory regime; unlike in telecoms, there is no body of accumulated regulatory experience that can be drawn on.

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30 Paragraph 9.39 of the Consultation Document.

31 Paragraph 10.70 of the Consultation Document.

10.56 Second, it is evident that there is likely to be a need for far more frequent reviews of regulation than in relation to telecoms services. Indeed, Professor Cave's Expert Report explains that there is a risk that the approach will result in almost continuous review of a range of issues, such as appropriate levels of retail costs and whether changes to Sky's channels should be permitted. The administrative burdens associated with having to engage with micromanagement of this type are likely to be substantial.

Reduction in payments for rights

10.57 As discussed in **Section 11**, below, Ofcom's consideration of the potential for its proposed regulatory regime to reduce payments for programming rights is inadequate. After an extremely cursory analysis, Ofcom simply concludes that "[o]*ur view is that the likelihood of a wholesale must-offer remedy (set on a retail-minus basis) leading to a significant decrease in rights values is low*".[32]

10.58 It is difficult to believe, however, that the combination of (a) the reduction in incentives to invest in content caused by the reduction in returns to the provision of premium pay TV channels, and (b) the reduction in competition for programming rights caused by the compulsory supply of those channels, risk-free at low prices, would not diminish the amounts paid for programming rights, or lead to coverage of a range of less popular programming being reduced in order to make cost savings.[33]

Costs associated with regulatory errors

10.59 Ofcom's proposed approach to setting charges for Sky's premium channels involves a considerable element of subjectivity, and the need for complex commercial and financial analysis. Ofcom indicates that it acknowledges that errors in the exercise of its judgment could lead to adverse consequences in relation to the promotion of inefficient entry[34], but fails to recognise that such errors, together with errors in its commercial and financial analysis could also have substantial adverse impacts on Sky. The fact that the risk of such errors is high is demonstrated by the significant flaws that Sky identifies in the analysis that underpins Ofcom's proposals in the Consultation Document as to the levels at which it proposes to set charges for Sky's premium channels[35].

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32 Paragraph 10.77 of the Consultation Document.

33 The same point as been made by a significant rights owner, see paragraphs 1.10 to 1.12, 3.13 and 9.14 to 9.22 of the response of the Football Association Premier League to Ofcom's Second Consultation Document.

34 Ofcom states: "*we acknowledge that there is a degree of judgement to be exercised, for example, in what constitutes an 'efficient' entrant – setting the threshold high risks low levels of market entry, and limited competition, whereas setting the threshold low risks high levels of market entry by inefficient sub-scale firms, the costs of which could ultimately fall onto consumers.*" (Paragraph 9.5 of the Consultation Document.)

35 See part II of this **Section 10**, below.

<u>*Unintended adverse consequences*</u>

10.60 One of the key reasons that policy-makers are normally wary of adopting radical and unprecedented approaches to regulation is that they have a high risk of producing adverse unintended consequences. Such consequences are those which, even after very thorough analysis and consideration of the potential consequences of a particular policy, cannot be anticipated (by contrast with detriments that can be foreseen and taken into account with a sufficiently robust analysis). The scope for such consequences to arise suggests that, even after a thorough examination of potential adverse consequences has been undertaken, a significant degree of caution should yet be exercised in adopting radical approaches to regulation. For example, it can be argued that radical policy approaches might be considered only where there is very clear evidence of serious, long-term consumer detriment which it is impossible to address using more standard regulatory approaches. The current case does not fall into that category.

(iii) Ofcom's view of the consequences of introducing an extended retail-minus price control

10.61 One of the most astonishing of Ofcom's views in its Consultation Document is its evident view that there would be little or no downside from the introduction of its proposed new price control regime. As discussed in **Section 11** of this Response, Section 10 of Ofcom's Consultation Document, which is entitled "*proportionality of a wholesale must-offer remedy*", is almost entirely silent on this issue.

10.62 Ofcom's sanguineness on this matter has three sources:

(i) a naïve view that, provided that Sky's wholesale charges are not reduced below "*cost-plus*" levels, there would not be any consequences for Sky's business;

(ii) a claim that Sky will earn higher revenues as a result of Ofcom's proposed price control; and

(iii) a failure on Ofcom's part properly to consider the potential detriments of its proposals, which stems from a belief that development of regulation is simply a matter of "*getting the detail right*".

10.63 We discuss each of these below.

<u>*Ofcom's argument that provided that Sky's wholesale charges are not reduced below "cost-plus" levels, there would not be any consequences for Sky's business*</u>

10.64 A key reason for Ofcom's belief that its proposals are proportionate is that Ofcom considers that, as long as it sets charges above its estimate of "*cost-plus*" levels, there would not be any consequences for Sky's business. Ofcom states:

> "*The basis of our cost-plus price is that this is the figure that should allow Sky sufficient wholesale revenue to recover its full rights expenditure, plus*

an allocation of other direct and common costs, and make a return which reflects its cost of capital. By definition, therefore, even if we went as far as to reduce wholesale prices down to that level, Sky should still have a sustainable business based on its current level of rights expenditure. However, we are not proposing to do that; the prices we are consulting on are in aggregate above the cost-plus figures, implying that Sky should not have difficulty maintaining its current levels of rights expenditure.

To draw on another aspect of our analysis to make a similar point: our views of Sky's profitability, based on Oxera's analysis, are that Sky is currently making returns above its likely cost of capital, particularly in the wholesale movie part of its business. With that in mind, even if our remedy substantially reduced the level of wholesale prices for movies (although not to the level of cost-plus prices) and potentially reduced those returns, it would not affect Sky's ability at least to match its current levels of rights expenditure."[36]

10.65 In essence, Ofcom perceives its policy to be akin to a hypothecated windfall profits tax, with the proceeds of the tax going to support the higher costs of Ofcom's proposed new DTT-based pay TV businesses. Ofcom considers that the tax will have no effect on Sky because, in Ofcom's conception, it would at worst reduce excessive profits earned in Sky's premium channel business. These propositions are misconceived.

10.66 One of the key reasons that windfall profits taxes have relatively limited impacts on firms' incentives and future actions is that they are normally one-off in nature. Ofcom's tax, however, would be ongoing, in perpetuity, and would therefore be likely to cause changes in Sky's future behaviour. Furthermore, there are no 'windfalls' in Sky's premium channel business to be taxed. The profits arising from this business (a) are the result of Sky's investment, risk-taking and enterprise, rather than windfalls, and (b) provide a reasonable return on the costs of running that business; as set out in **Section 7**, above, Ofcom's calculations that underpin its cost-plus floors (and its views in relation to Sky's profitability more generally) are wrong.

10.67 Moreover, Ofcom's proposition is plainly wrong. A reduction in firms' revenues, and therefore returns, must reduce its ability and incentive to continue to invest at the same level as prior to the reductions in its revenues. The fact that returns remain above its cost of capital is irrelevant.

Ofcom's claim that Sky will earn higher revenues as a result of Ofcom's proposed price control

10.68 A second key reason for Ofcom's view that its proposals are proportionate is its belief that Sky would be made better off as a result of having new regulation imposed upon it, including compulsory reductions in its wholesale charges.

[36] Paragraphs 10.80 and 10.81 of the Consultation Document.

10.69 Ofcom has asserted in both the Second Consultation Document, and the current Consultation Document[37], that its proposed new regulation will make Sky better off, by expanding the market for Sky's channels. Ofcom notes in the current consultation document that this proposition "*may seem surprising*"[38]. In fact, this proposition is not merely surprising, it is perverse and wrong. It is the result of Ofcom's fundamentally flawed counterfactual, in which Sky is implausibly assumed by Ofcom to ignore a profitable opportunity for additional sales of its channels, for some vague and unspecified "*strategic incentive*", and therefore never supplies its channels via DTT. Evaluating the effect of Ofcom's proposed regulation on Sky using a realistic counterfactual – where Sky launches Picnic and/or supplies it channels to other DTT-based operators at ratecard prices – would make it clear that Ofcom's proposed regulation would have an unambiguous negative impact on Sky's revenues.

10.70 As discussed in its Response to Ofcom's Second Consultation Document, Sky is an experienced and successful commercial business. It is perverse for Ofcom to claim that it would be able to increase Sky's profitability – by the very substantial amounts claimed in Ofcom's impact assessment – by imposing on Sky reductions in wholesale charges for its premium channels. If such price cuts would increase Sky's profitability, Sky is likely to have made them a long time ago.

10.71 Ofcom's arguments on this matter also appear inconsistent. On the one hand, Ofcom argues that there is an enormous commercial opportunity, based on substantial unmet demand for Sky's premium channels among households who have an overwhelming desire to receive those channels via DTT. Ofcom believes that exploitation of that opportunity would substantially increase Sky's profitability. Yet, on the other hand, it believes that Sky is actively seeking to prevent its channels being made available to these consumers. In reality, neither of these arguments is correct. There is a demand for reception of Sky's premium channels via DTT that could profitably be exploited (at current ratecard charges), but it is unlikely to be as substantial as Ofcom believes – Ofcom's views on this matter are not evidence-based. Moreover, all available evidence indicates that, absent Ofcom's intervention, that demand would already be being met by Sky and/or other operators.

Failure properly to consider the potential detriments arising from this proposal

10.72 Ofcom fails to recognise that its proposals have potentially very serious adverse consequences associated with them because it simply fails to consider that possibility. As discussed in **Section 11**, below, Ofcom fails to undertake any meaningful analysis of the potential detriments arising from its proposed regulatory regime, including its proposal to apply extended retail-minus price control to the supply of Sky's premium channels. This failure appears to stem from a belief on Ofcom's part that any potential adverse consequences can be avoided simply by 'getting the detail [of regulation] right'. Such a proposition is without merit.

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37 Paragraph 10.4 of the Consultation Document.

38 *Ibid.*

C. Best regulatory practice

Ofcom's price control proposals are radical and unprecedented

10.73 One of Ofcom's justifications for its regulatory proposals in the Second Consultation Document was that they are a normal form of regulation in other countries, both in form and motivation. Ed Richards stated publicly that the type of regulation being proposed by Ofcom had existed in the United States "*for years*". Sky submitted, in response to Ofcom's Second Consultation Document, that those arguments were clearly both impressionistic and erroneous.

10.74 Apparently in response to this submission, and confirming Sky's view that Ofcom's arguments were impressionistic, Ofcom commissioned Value Partners to examine the motivation for, and operation of, compulsory licensing regulation in relation to pay TV channels in other countries. It is of little satisfaction to Sky that Value Partners' research confirms our proposition that Ofcom proposed new regulation is radical and unprecedented. The approach proposed by Ofcom does not exist anywhere else in the world, and, where 'must offer' regulation has been introduced, it:

(a) has tended to be a counterbalance to significant reductions in competition among pay TV operators resulting from mergers; and

(b) has not been accompanied by prescriptive price controls.

10.75 Above all, Value Partners' study confirms that nowhere in the world has any regulator conceived of a notion that a pay TV operators' television channels should be used as an instrument of an industrial policy intended to result in the creation by a regulator of new pay TV retail businesses.

10.76 It is clear, therefore, that Ofcom's price control proposals do not reflect current best regulatory practice.

Industrial planning

10.77 Ofcom claims:

> "*It is our objective that the market should determine which platforms are successful, not the regulator*".[39]

10.78 That statement is impossible to reconcile with Ofcom's proposals to introduce a profoundly interventionist new regulatory regime with the explicit aim of supporting the development of services deemed desirable by Ofcom. It is, moreover, contradicted directly by Ofcom's discussion of its proposed new regulation, in which selection of the level at which Ofcom proposes to set

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[39] Paragraph 9.56 of the Consultation Document. We acknowledge that this quotation goes on to say "*and not Sky*". That, however, is beside the point. The key point, as we state above, is that Ofcom's statement that it is not proposing to determine market outcomes is false.

wholesale charges for Sky's channels is a matter of which type(s) of service Ofcom decides are desirable. As noted above, Ofcom states:

> "*we propose that retail-minus prices should be set to allow a larger competitor (for example, reaching three million subscribers after 10 years) to compete with Sky's retail prices, incorporating an allowance for DTT transmission costs and a reasonable return on investment.*"[40]

10.79 That is self-evidently not determination of the success of platforms by the market; it is industrial planning.

10.80 Similarly, Ofcom argues in relation to the appropriate allowance for transmission costs:

> "*Our assessment is that competitors are particularly likely to adopt DTT as a distribution technology in the short to medium term and therefore it is necessary for us to consider what wholesale prices would enable a DTT-based retailer to operate a viable business.*"[41]

10.81 Focusing on ensuring the viability of DTT-based services in this manner is plainly industrial planning.

10.82 As discussed in Professor Cave's Expert Report, industrial planning of this type is "*a risky procedure in a dynamic market such as video platforms and content*".[42]

10.83 Sky discussed the potential detriments associated with industrial planning in some detail in its Response to Ofcom's Second Consultation Document. In particular we discussed the fact that, contrary to Ofcom's desire to support 'efficient' operators, industrial planning usually leads to supported firms being inefficient operators, dependent on ongoing support for their existence and encouraged to devote substantial amounts of time and effort to ensuring the continuance and expansion of such support, rather than serving their consumers well.[43] Ofcom has not had regard to these arguments.

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[40] Paragraph 9.8 of the Consultation Document.

[41] Paragraph 9.135 of the Consultation Document.

[42] Paragraph 32 of the Cave Report.

[43] See paragraphs 6.31 to 6.44 of Sky's Response to Ofcom's Second Consultation Document.

Part II

Ofcom's calculations of appropriate levels for regulated charges for Sky's premium channels

A. Introduction

10.84 In this **Part II**, we discuss Ofcom's calculations that underpin the regulated wholesale charges for packages of standard definition versions of Sky's premium channels on which Ofcom is consulting. This discussion is without prejudice to Sky's fundamental argument that the imposition of price control on Sky, in any form, is neither necessary nor proportionate.

10.85 The financial analysis that forms the basis for the level of charges for Sky's premium channels that Ofcom proposes to set is riddled with errors. It also involves estimating the costs and revenues of a wholly unrealistic model of a hypothetical DTT operator. Correction of the errors in Ofcom's analysis, and use of a more appropriate model of a hypothetical DTT operator's business, demonstrates that there is no justification for setting regulated charges for Sky's premium channels below current ratecard levels.

B. Ofcom's proposed range of regulated wholesale charges

10.86 Ofcom sets out a range of wholesale charges for packages of Sky premium sports and movie channels for consultation. These are set out in Figures 64 and 70 in Ofcom's Consultation Document and summarised in **Table 10.1** below. This table makes it clear that the top of Ofcom's range for consultation is significantly below Sky's current ratecard charges.

Table 10.1

Sky's premium wholesale ratecard and Ofcom's range of charges for consultation

	Previous ratecard[44]	**Top of the range for consultation (DTH Premium Retail)**	**Ofcom's preferred charges (Large competitor on DTT)**	**Bottom of the range for consultation (Small competitor on DTT)**
Single Sports	£13.48	£11.24	£10.63	£9.41
Single Movies	£12.48	£9.61	£8.95	£7.58
Sky Sports 1 & 2	£18.39	£16.48	£15.69	£14.10
Movies Mix	£16.59	£15.73	£14.67	£12.38
Sky Sports 1 & 2 & Movies Mix	£23.40	£20.43	£18.90	£16.98
Sky Sports 1 & Single Movies	£17.59	£15.59	£14.71	£14.71
Sky Sports 2 & Single Movies	£17.59	£15.59	£14.64	£12.69
Single Sports & Movies Mix	£19.80	£19.57	£18.21	£15.34
Sky Sports 1 & 2 & Single Movies	£20.60	£18.58	£17.45	£16.98
Weighted average[45]	**£20.72**	**£18.35**	**£17.13**	**£14.55**

The method used by Ofcom to calculate these charges

10.87 Ofcom attempts to create a series of models of the costs and revenues associated with retailing pay TV packages that include basic channels and the premium channel packages set out in **Table 10.1**, on a package-by-package basis. For example, Ofcom seeks to estimate the costs and revenues associated with retailing a package that includes basic pay TV channels, Sky Sports 1 and Sky Sports 2. The costs in this model are fully allocated costs – i.e. they include any directly attributable costs associated with retailing such a package as well as allocations of common costs.

44 Ratecard prices applicable up to 31 August 2009.

45 The weighted average in the table for bottom of the range for consultation and large competitor on DTT is consistent with Ofcom Figures 64 and 70 and therefore does not take into account instances where prices are set equivalent to the cost-plus price.

10.88 The costs and revenues assessed by Ofcom are intended to be those associated with providing standard definition services to UK residential consumers. Ofcom examines such costs and revenues for a number of different types of notional retail pay TV businesses, as described further below.

10.89 Ofcom then treats wholesale charges for packages of Sky's premium pay TV channels as a variable in these models. For each type of notional retail business, and each type of pay TV package, it determines what wholesale charges provide a zero net present value ('NPV') of cash flows, using a discount rate of 10.3% (i.e. using Ofcom's estimate of Sky's cost of capital[46]) – i.e. what premium wholesale charges allow these notional businesses to earn a return exactly equal to their assumed cost of capital on a product-by-product basis. Cash flows are assessed over a ten year period, and a terminal value included.

10.90 This is a very unusual approach and it is almost bound to provide erroneous results. In the real world, retailers of pay TV services plan their businesses on the basis of providing a wide range of services (both pay TV and non-pay TV) to consumers. Other than in relation to charges for content, the vast majority of their costs are likely to be common across the range of services they offer.[47]

10.91 The key reasons that Ofcom's approach is unlikely to provide meaningful results are that (a) it is a wholly abstract exercise that bears no relationship to how businesses operate or are planned in the real world, (b) it requires an extensive amount of allocation of common cost, which we discuss further below, and (c) it embodies an implicit assumption that the return on every type of service offered by a multi-product retailer should be the same (in this case, 10.3%). There is no basis for such an assumption.

10.92 In such circumstances, the most appropriate way of attempting to establish whether charges are 'affordable' to pay TV retailers is to seek to determine whether, based on realistic models of their total costs and revenues, across the lines of business that are typically carried out together, they are able to operate profitably at prevailing wholesale charges. This was, for example, broadly the method followed by the OFT in its examination of the profitability of Sky's retail

[46] Ofcom's use of a cost of capital that was derived for Sky as a whole is not appropriate, given that it is examining the profitability of retailing operations. Although Ofcom acknowledges that in some circumstances it may be appropriate to use a disaggregated cost of capital it concludes that there are no reasonable grounds for believing that there are sufficient differences between the various parts of Sky's business for this to be necessary in this case. However, Sky notes that Ofcom previously recognised (at paragraph 5.92 of its Determination to resolve a dispute between Rapture Television plc and British Sky Broadcasting Ltd about EPG listing charges), that a cost of capital in relation to one part of Sky's business, Sky's platform business, could be different than the WACC for Sky as a whole. It is therefore clear that Ofcom should, as it does in the case of BT (paragraph 9.118 of the Consultation Document), consider the appropriate cost of capital on a disaggregated basis.

[47] By way of illustration of this issue, Sky's call centres deal with queries about subscriptions from subscribers in the ROI and UK, from residential and commercial subscribers, and from basic-only and basic plus premium subscribers. They also deal with technical queries related to Sky's TV services, and a range of other services retailed by Sky, such as broadband and telephony services. Attempting to develop a model of the profitability of retailing particular types of services requires call centre costs to be allocated to each different line of business.

business in its inquiry that ended in 2002. In what follows we have, however worked with Ofcom's framework.

Common cost allocation

10.93 Adopting a fully allocated cost approach on a product-by-product basis requires Ofcom to make an extremely large number of assumptions about common cost allocations. This is problematic because, while in some cases there may be an approach to allocating common costs that properly relate to the underlying drivers of those costs, more usually there will be a number of plausible allocation methods, and electing to use one allocation method versus another can be largely arbitrary. In these circumstances the estimates of profitability of each line of business will then largely reflect whatever approach to common cost allocation is selected. This creates the potential for conclusions to be drawn that are wholly the product of assumed cost allocations, in circumstances where different, but equally justified allocations produce different conclusions and very different policy prescriptions.

10.94 Given this issue it is best practice to opt for an approach to addressing questions relating to profitability that minimises the need for such allocations. Ofcom have, however, taken the contrary approach - given the narrowness of Ofcom's notional businesses, in order to estimate their costs on a fully allocated cost basis an extremely large number of allocations of common costs needs to be undertaken. This significantly increases the risk that Ofcom's conclusions are dependent on the myriad of arbitrary decisions it has made about allocating costs, when alternative but equally plausible decisions would have produced different conclusions.[48]

10.95 Accordingly, in principle, Ofcom's conclusions about the 'affordability' of its ratecard charges are likely to be open to considerable challenge on the basis that they depend on particular allocations of common costs. Sky has elected not to do this at this stage because it is not necessary - Ofcom's conclusions are shown to be seriously flawed without the need to discuss alternative methods of common cost allocation. Nevertheless, Ofcom should not underestimate the importance of this issue; it should recognise that Sky would be able to contest large numbers of the cost allocations that Ofcom has undertaken were it to persist in its erroneous view that its flawed calculations of 'affordable' wholesale charges for Sky's premium channels are in any way meaningful. Sky accordingly reserves its position on common cost allocation.

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48 Sky has been unable to quantify the sensitivity of Ofcom's results to its assumptions regarding cost allocations by running sensitivity analysis using Ofcom's own models as it would have preferred, due to the lack of flexibility within Ofcom's models and the inconsistent linking across spreadsheets. Running such sensitivity analysis would have required rebuilding all Ofcom's models, which would not have been a productive use of resources in the time available to respond to the consultation.

Other lines of business

10.96 While Ofcom's methodology is generally unsound, it is particularly flawed in relation to two specific issues.

10.97 Ofcom's models of the costs and revenues of its notional pay TV retailers include the following:

(a) an allocation of costs and revenues associated with Sky's DTH satellite ***platform*** business (e.g. revenues earned from third parties, such as the BBC and ITV, from the provision of conditional access services and listings in its EPG); and

(b) an allocation of costs and revenue associated with Sky's ***wholesale*** **basic channel business** (e.g. the costs and revenues associated with channels such as Sky One and Sky Sports News).

10.98 While such allocations are unusual in relation to consideration of the costs and revenues of a notional DTH satellite-based retail business, it is simply nonsensical to include them in models of notional DTT-based retail businesses, which, as discussed below, is what Ofcom does.

Ofcom's notional businesses

10.99 The notional business that provides the charges at the top of Ofcom's range (column 2 in **Table 10.1** above) is a notional DTH satellite-based retailer with a large subscriber base that supplies premium plus basic pay TV packages (but not basic only packages) to UK residential subscribers. For convenience, in what follows we refer to this "business" (as defined by Ofcom) as the "**DTH Premium Retail**" business and wholesale charges determined in relation to this business as "**DTH Retail-Minus**" charges. Ofcom finds these charges to be below Sky's current ratecard charges.

10.100 The business that provides the bottom of Ofcom's range (column 4) is an entirely hypothetical retail business that uses DTT technology and builds up a total subscriber base (including basic-only subscribers) of 1 million subscribers after 10 years. We refer to charges calculated by Ofcom in relation to such a retailer's premium "business" as "**Small DTT Retail-Minus**" charges.[49]

10.101 Ofcom's preferred set of charges (column 3) is based on Ofcom's estimates of an entirely hypothetical retail business that uses DTT technology and builds up a total subscriber base (including basic-only subscribers) of 3 million subscribers after 10 years. Ofcom describes these charges as lying "*roughly mid-way through* [sic] *our range for consultation*".[50] They are said by Ofcom:

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49 Where charges calculated on this basis are less than those determined on a cost-plus basis, as is the case in relation to a number of Ofcom's estimates, Ofcom replaces the calculated charges with its estimates of cost-plus based charges.

50 Paragraph 9.8 of the Consultation Document.

"*to allow a larger competitor (for example, reaching three million subscribers after 10 years) to compete with Sky's retail prices, incorporating an allowance for DTT transmission costs and a reasonable return on investment*".[51]

10.102 We refer to charges calculated by Ofcom in relation to such a retailer's this premium "business" as "**Large DTT Retail-Minus**" charges.

10.103 In the discussion in the sections below we demonstrate that:

(a) Ofcom's calculation of DTH Retail-Minus charges is riddled with significant errors. Once these errors are corrected Ofcom's notional DTH Premium Retail business could, in fact, afford to pay Sky's current ratecard charges and earn a return that is greater than 10.3%. **The top of the range is therefore at least as high as Sky's current ratecard charges**.

(b) Ofcom's Small DTT Retail-Minus and Large DTT Retail-Minus models are also riddled with errors. More importantly, however, they are based on hypothetical business models that could not in reality be implemented, and, accordingly, the wholesale charges produced by these models are meaningless

A more meaningful approach is to estimate the wholesale charges that Sky's proposed Picnic service would have been able to 'afford', based on its business plan. This business plan reflects what an experienced real-world operator **actually planned to do** and was approved by Sky's Board. Sky invested around [**CONFIDENTIAL**] in the project before it had to be mothballed. Sky's Picnic business plan shows that the Picnic business could afford to pay Sky's current ratecard prices and earn a return that is greater than 10.3%. **The bottom of the range is therefore also at least as high as Sky's current ratecard prices.**

10.104 The clear result of this analysis is that Ofcom's "*range*" is spurious – an artefact of its deeply flawed analysis. Both Sky's own business, and other businesses, can 'afford' to pay Sky's ratecard charges for its premium channels, and there is no reason to introduce a new price control regime in order to compel Sky to set charges below these levels.

C. Ofcom's calculation of DTH Retail-Minus charges is riddled with significant errors.

10.105 Ofcom attempts to estimate the charges for Sky's premium channels that a notional retailer using DTH satellite distribution could 'afford' to pay. Ofcom uses Sky's own cost and revenue data for this exercise. Ofcom's model of this notional entity, however, is extremely unusual. Ofcom envisages a DTH satellite-based retailer that retails only packages that include premium and basic pay TV channels – i.e. the notional retailer does not seek to retail basic-only packages, or any other services.

[51] *Ibid.*

10.106 Even more unusually, however, as discussed above, Ofcom attributes as costs and revenues of the notional DTH retailer an allocation of costs and revenues associated with Sky's **platform** business, and an allocation of costs and revenues associated with Sky's **basic wholesale channel** business.

10.107 Ofcom's calculation of DTH Retail-Minus charges is riddled with significant errors. In the discussion below we set out some of the most material errors we have been able to identify. We note, however, that we have been significantly impeded in that task by the lack of proper supporting documentation in Ofcom's spreadsheet models, and the lack of attention to modelling best practice in their construction. The likelihood is, therefore, that there are other material errors which we have not been able to identify for these reasons in the time available.

10.108 In seeking to correct Ofcom's errors we have focused on those which are unambiguous and arise due to:

(i) a misunderstanding of the business areas to which certain cost categories relate;

(ii) manifest errors in estimates of subscribers, revenues or costs; and

(iii) analytical defects in establishing the costs and revenues of the DTH Premium Retail business.

(a) Cost-plus error adjustments

10.109 In **Section 7** above Sky identified a numbers of errors in Ofcom's estimates of cost-plus wholesale prices for Sky's premium channels. Several of the errors identified in **Section 7** feed through into Ofcom's calculations of the DTH Retail-Minus charges. Where relevant Sky has made changes to Ofcom's estimate of the costs and revenues associated with DTH Premium Retail to be consistent with the changes Sky made to Ofcom's cost-plus model.[52]

(b) Retail revenue

10.110 Ofcom estimates retail revenue for the DTH Premium Retail business by multiplying (a) the number of subscribers to each of the various types of basic plus premium packages available and (b) a "**Reference Retail Price**".

10.111 The Reference Retail Price is calculated in two steps. First, Ofcom makes a series of adjustments to published 2009 retail prices. Second, Ofcom calculates a weighted average price for each type of premium package given that such

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52 These errors arise in relation to the following issues: "*Opening UK DTH satellite subscribers*", "*Forecast UK DTH satellite subscribers*", advertising "*Costs*", advertising "*Revenue forecasts*", "*Sports rights costs*", "*Sports production costs*", "*Sports production costs allocation*", "*Sky Networks' marketing*", "*Technical operations*", "*Transmission*", "*Capital Expenditure*" and "*Cross promotion*".

packages are offered at a variety of different price points (reflecting the fact that they are provided with different combinations of basic channels[53]).

10.112 The adjustments made in the first step in this process are intended by Ofcom to account for the following factors:

- VAT;
- 2009/10 changes in retail prices;
- Sky Sports 3 and Sky Sports Xtra;
- a la carte channels; and
- software discounts

10.113 Regrettably, all five of the adjustments which Ofcom makes are erroneous. These errors are highly material and mean that Ofcom substantially underestimates the revenue of the DTH Premium Retail business. For example, the adjusted retail price calculated by Ofcom for Dual Sports purchased with six basic mixes in 2009/10 is £31.26. The correct figure should be £33.68. The errors in each of these adjustments are discussed in more detail below.

VAT and 2009/10 price changes

10.114 In calculating Reference Retail Prices Ofcom uses the following assumptions for VAT and 2009/10 changes in retail prices:

(i) an assumption that the VAT rate is 17.5% for the full year; and

(ii) an assumption that retail prices for Sky's packages **decline by 1.5%** in 2009/10.

10.115 Both these assumptions are incorrect. In January 2009 VAT was temporarily reduced to 15%. The VAT rate is expected to revert to 17.5% in January 2010. Sky has also announced new retail prices for residential DTH subscribers which apply from September 2009. The changes in prices are different to those assumed by Ofcom in its model.

10.116 In addition, in conjunction with the VAT reduction in January 2009, Sky reduced its retail prices to pass on this reduction to consumers and maintain the level of ex-VAT retail revenue. [**CONFIDENTIAL**]

10.117 Sky has therefore amended Ofcom's incorrect approach to calculating Reference Retail Prices for 2009/10 by using instead the average of the following:

- 2 months of prices to August 2009 with VAT at 15%;
- 4 months of prices from September 2009 with VAT at 15%; and

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[53] Each set of premium channels (e.g. Sky Sports 1 & 2) can be purchased in conjunction with a range of different combinations of basic channels, so there is a variety of different retail prices for each set of premium channels. The "*Reference Retail Price*" is a weighted average price across the various basic package combinations for each set of premium channels, with the weights provided by the number of subscribers to each combination fixed at current levels.

- 6 months of prices from September 2009 [**CONFIDENTIAL**] with VAT at 17.5%.

Sky Sports 3/Sky Sports Xtra

10.118 Ofcom deducts an amount from the retail price of packages including Sky Sports 1 and Sky Sports 2 (which include Sky Sports 3 and Sky Sports Xtra as bonus channels) to reflect the costs associated with Sky Sports 3 and Sky Sports Xtra.

10.119 As described in **Section 7**, Ofcom's forecast of sports rights and production costs is flawed and its allocation of sports production costs across Sky's portfolio of sports channels inappropriate. These errors in Ofcom's estimates of cost-plus prices flow through to Ofcom's estimate of the amount to deduct for Sky Sports 3 and Sky Sports Xtra. Accordingly, Sky has corrected Ofcom's estimate of the appropriate amount to deduct for Sky Sports 3 and Sky Sports Xtra consistent which the errors it corrected in Ofcom's estimates of cost-plus prices.[54]

A la carte subscriptions

10.120 Ofcom has made a deduction from observed retail prices to reflect the average revenue received from UK residential DTH satellite subscribers paying for a la carte channels. However, as Ofcom started with retail prices which do not include any additional amounts paid for a la carte channels, such a deduction is erroneous. Sky has therefore correctly ignored this deduction.

Software discounts

10.121 The final deduction Ofcom has made from Sky's retail prices is an amount intended to reflect the average monthly value of software discounts. The term 'software discounts' refers to discounted subscription charges (for example '3 months half price' offers).

10.122 Ofcom has performed a detailed but wholly erroneous calculation of the average value of software discounts in 2007/08. In fact, Sky accounts for the value of such discounts in its management accounts.[55] Sky has therefore used this correct figure for software discounts in 2007/08 and followed Ofcom's methodology to calculate the average percentage discount and applied this to all packages in 2009/10.

(c) Transmission costs for basic channels

10.123 Ofcom has calculated an annual figure for transmission costs for basic channels and then sought to turn this into a monthly cost per subscriber figure – which would normally be done by dividing the total cost by the average number of subscribers, and then dividing by 12 (months). Ofcom has, however, failed to

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54 Sky has therefore used this revised amount of **[CONFIDENTIAL]** for 2009/10 rather than the £1.06 used by Ofcom for 2007/08, which was then increased by inflation.

55 Line 110 of the "*consolidation*" sheet of the model.

divide by 12.[56] This is clearly a basic calculation error, which we have corrected.[57]

(d) Wholesale revenue in relation to basic channels

10.124 As indicated above, Ofcom's DTH Premium Retail model includes costs and revenues associated with Sky's basic wholesale channel business. Ofcom's calculation of the revenue associated with Sky's basic pay TV channels relies on actual data for 2007/08 which is then used as the basis for future revenue forecasts. During 2007/08 Sky's basic channels were not carried by Virgin Media due to a dispute over carriage fees for these channels. As a result, Ofcom's base year figures – and therefore forecasts for future years, do not include any wholesale revenue in relation to these channels – a fact which is acknowledged in Ofcom's spreadsheets.[58]

10.125 Carriage revenue in respect of Virgin Media's cable network for 2009/10 and beyond has apparently been omitted in error. Indeed, in deriving the advertising component of revenues of this business, Ofcom recognises this issue and makes specific provision to account for Sky's basic channels returning to Virgin Media.

10.126 Sky's latest forecast assumes that Sky will receive **[CONFIDENTIAL]** in basic wholesale revenues from Virgin Media in 2009/10 under the current carriage agreement (which does not include any annual RPI adjustments). Sky has therefore added **[CONFIDENTIAL]** to Ofcom's calculation of total basic wholesale revenue in each year to correct for this omission.

(e) Multiroom revenues

10.127 Ofcom has excluded Multiroom services from its calculation on the basis that Ofcom:

> "*consider*[s] *these services to be outside Sky's core business of retailing subscription packages*".[59]

10.128 This proposition is irrational. Sky's Multiroom service is a subscription service that enables Sky's customers to view the channels to which they subscribe via additional set-top boxes in their homes. It is manifestly a service provided by the part of Sky's business that relates to "*retailing subscription packages*".

10.129 More specifically, the wholesale prices for Sky's premium channels set out on the cable ratecard also permit Virgin Media to distribute Sky's premium

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[56] Lines 357, 358 and 359 of the "*New entrant costs*" sheet of the model

[57] The DTH Premium Retail business includes an allocation of costs and revenues associated with Sky's basic wholesale channel business. Accordingly, transmission costs are included regardless of whether they should properly be classified as a cost of Sky's basic wholesale business or Sky's retail business.

[58] Line 25 of the "*Sky other revenue*" sheet in the model clearly states "*Total basic wholesale revenues excluding Virgin Media*".

[59] Paragraph 9.77 of the Consultation Document.

channels to several boxes within subscribers' homes and to derive subscription revenue from this if it chooses. Virgin Media does not incur any additional premium channel wholesale costs in supplying premium channels to a second set-top box. Accordingly, the wholesale costs which Ofcom has estimated for the DTH Premium Retail business reflect the cost of buying the right to distribute Sky's channels to multiple set-top boxes (primary and multi-room). Ofcom cannot calculate wholesale costs based on the cable ratecard yet exclude Multiroom revenue which is one of the ways in which a retailer can recover such wholesale costs.

10.130 Sky has therefore correctly included Multiroom revenues and costs as follows:

- for 2007/08, we calculated a UK share of total Multiroom revenue[60] and costs[61] consistent with Ofcom's own allocation percentages;
- we increased these figures each year by Ofcom's inflation assumptions; and
- **[CONFIDENTIAL]** % of these figures were allocated to the DTH Premium Retail business on the basis that **[CONFIDENTIAL]** % of current Sky DTH satellite UK Multiroom subscribers are premium subscribers.

(f) The effect of correcting the errors in Ofcom's analysis

10.131 For each of the errors identified above we have indicated the magnitude of correcting the error on the profitability or otherwise of the DTH Premium Retail business as a whole by providing an estimate of the NPV (over 10 years plus terminal value) of the cash impact of such corrections discounted at 10.3%.

10.132 We have not sought to estimate the impact on price of each particular product combination. Given the poor quality of Ofcom's documentation and lack of transparency in its modelling it would be extremely onerous to estimate the impact of each error on the price of each wholesale product. Such an approach is also unnecessary. This is because Ofcom's product-by-product analysis is based on a particular allocation of common costs and the key implicit assumption that Sky is required to earn the same return on every product combination. There is no reason why that should be the case. Accordingly, the conclusions that are drawn below for the aggregate profitability of the DTH Premium Retail business or the impact on average wholesale prices are robust to such corrections being implemented on a product-by-product basis. Any apparent inconsistency between the results of an aggregate versus product-by-product approach will simply be a function of a particular assumption regarding common costs and that returns should be the same on all services offered by a retailer.

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60 Sky has used the actual revenue from Multiroom subscribers from D107 of the "*Consolidation*" sheet in the model rather than Ofcom's incorrectly calculated figure.

61 Sky has used Ofcom's calculation of total Multiroom costs from cell E145 of the "*Cost allocation*" sheet.

10.133 The impact of the errors is set out in **Table 10.2** below.[62] In total these errors are so significant that they add up to over £3.6 billion.

Table 10.2

NPV (10 years with terminal value) of the DTH Premium Retail business

	DTH Retail-Minus charges	***Current ratecard***[63]
Per Ofcom model	£0m	(£3,048m)
Adjusting for errors:		
Cost-plus error adjustments[64]	£0m	£585m
Retail revenue	£2,261m	£2,261m
Transmission costs	£475m	£475m
Basic wholesale revenue	£233m	£233m
Multiroom	£713m	£713m
Corrected Ofcom model	**£3,682m**	**£1,219m**

10.134 The table shows that, if the DTH Premium Retail business were to be charged the DTH Retail-Minus prices (i.e. prices consistent with the top of the range) calculated by Ofcom, the NPV of the DTH Premium Retail business' cash flows, once all the above errors are corrected, would be around £3.7 billion - not zero as estimated by Ofcom. It is therefore clear that, even within Ofcom's framework, the DTH Premium Retail business can pay prices significantly higher than the top of the range (set out in column 2 of Table 10.1) and be profitable. Indeed the errors are so material that the operator could pay wholesale prices consistent with the current cable ratecard and earn a return on investment significantly in excess of Ofcom's assumed cost of capital of 10.3%. In fact, even at current ratecard prices, DTH Premium Retail would earn a return above its cost of capital of £1.2 billion. The top end of the range is therefore at least as high as Sky's current ratecard charges.

62 The estimates provided in the table have been derived on the basis that the errors in the rows above have also been corrected (i.e. the effect of correcting for transmission costs errors after correcting cost plus error adjustments and retail revenue errors). This is necessary in order to be able to sum the errors down the table to produce a cumulative total.

63 The prices used for 2009/10 are the weighted average of the previous ratecard to 31 August 2009 and the current ratecard from 1 September 2009, which are then inflated by 2.5% thereafter consistent with Ofcom's assumptions.

64 This includes the effect of the lower deduction in respect of Sky Sports 3 and Sky Sports Xtra.

D. Ofcom's DTT business model is nonsensical

10.135 The basis on which 'affordable' charges for Ofcom's notional DTT-based businesses have been calculated is briefly described in paragraph 9.167 of Ofcom's Consultation Document. In essence the cost base for each of the hypothesised DTT retailers has been estimated as follows:

(i) by taking Ofcom's estimate of Sky's retail costs and adjusting the cost base to reflect the DTT-based operator's smaller subscriber base; and

(ii) removing the transponder costs associated with DTH satellite delivery of premium channels and replacing these with transmission costs based on DTT delivery.[65]

10.136 Ofcom assumes the hypothetical DTT retailers have the same Reference Retail Price as the DTH Premium Retail business and so, to all intents and purposes, are assumed to set the same retail price.[66]

10.137 Accordingly, as modelled by Ofcom, both the small and large DTT operators adopt a business model which is identical to that adopted by Sky in almost all respects apart from the fact that premium channels are broadcast via DTT instead of via satellite and that they operate at a smaller scale. Therefore, the errors identified above in relation to Ofcom's estimate of DTH Retail-Minus prices flow through into Ofcom's calculations of the costs and revenues of Ofcom's hypothetical DTT operators. Accordingly, Ofcom's Small DTT Retail-Minus charges and Large DTT Retail-Minus charges are substantially too low.

10.138 A further consequence of this approach is that Ofcom includes in its models of such businesses an allocation of costs and revenues associated with Sky's platform business and Sky's basic wholesale channel business. That is clearly nonsensical.

10.139 Moreover, even from a cursory analysis it is clear that the business model that Ofcom assumes for its notional DTT-based retailers makes no sense more generally. There are many reasons for this but some of the key ones are as follows.

10.140 First, although Ofcom has replaced DTH satellite transmission costs for premium channels, it has retained DTH satellite transmission for all other channels. Accordingly, Ofcom's hypothetical DTT-based businesses (small and large) use expensive DTT capacity to distribute 5 premium channels to their subscribers, yet somehow use cheap satellite capacity to distribute around 150 basic pay TV channels to those households.[67] Accordingly, in order to receive

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65 Ofcom have used an estimate of £8m per annum per videostream on DTT which is probably above the current market rate and **[CONFIDENTIAL]**, see **Section 6**.

66 Implied by paragraph 9.167 of the Consultation Document and confirmed in the "*Retail minus calculations*" sheet.

67 Ofcom cannot subsequently assume that these basic channels are also offered via DTT since there is insufficient capacity to do so and in any case the cost of offering a large number of channels via DTT would be prohibitive.

services from these hypothetical retailers subscribers would need to have an aerial capable of receiving DTT signals as well as a satellite dish. Such subscribers would also need a box that includes a DTT tuner and a satellite tuner or potentially two boxes. Such a proposition is not credible.

10.141 Second, each of the hypothesised DTT retailers is assumed to broadcast five of Sky's premium channels via DTT. It is not clear that there is adequate spare DTT capacity to broadcast these five channels particularly given the restrictions on Sky channels in respect of multiplexes B, C and D.[68] Ofcom provides no indication as to the origins of this capacity or which channels currently being broadcast via DTT they would replace.

10.142 Third, each of the hypothesised DTT retailers is assumed to incur subscriber acquisition costs equal to those incurred by Sky. Sky's subscriber acquisition cost includes the cost of installing satellite reception equipment in people's homes. A DTT-based operator would not need to incur installation costs in relation to its subscribers as one of the benefits of DTT is that it is a 'plug and play' proposition. Moreover, we note that Ofcom has alleged that there is substantial unmet demand for Sky's premium channels in DTT homes and that a pay DTT service on DTT will benefit from low switching costs because it has alleged customers already have the necessary equipment.[69] If this is correct then, trying to persuade DTT homes which are alleged to have a strong demand for Sky's premium channels to subscribe to a pay TV service should be substantially easier and less expensive than trying to grow an allegedly mature pay TV business on satellite which already has over **[CONFIDENTIAL]** UK subscribers.

10.143 Fourth, Sky's cost base (and hence the cost base of Ofcom's hypothetical DTT retailers) includes subscriber upgrade costs which reflect the fact that Sky has a very large subscriber base, many of whom were acquired historically and hence have a set-top box which is less advanced than the boxes which Sky is offering to new subscribers e.g. Sky+ and high definition set-top boxes. A new entrant does not face this issue as it does not have to manage the upgrade of an existing subscriber base to new, more advanced equipment (all new subscribers would start with the up-to-date equipment) and hence a new entrant would not incur the costs associated with upgrading the set-top boxes of an installed base of customers.

10.144 Fifth, Ofcom's hypothetical DTT retailer's strategy is unrealistic as it fails to take proper account of the fact that, more likely than not, the scarcity of DTT capacity will prohibit it from offering a HD service. Instead Ofcom appears to assume that a DTT retailer would be able to offer premium HD channels to their subscribers. For example, Ofcom has assumed that 2 out of the 3 million large DTT Retailer's subscribers take an HD service.[70] There is currently insufficient capacity for a DTT retailer to be able to offer Sky's premium channels in HD. It

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68 See Conditions 11(8) and (11) of the Multiplex B, Multiplex C and Multiplex D licences, as at 19 February 2007.

69 Paragraphs 5.142, 5.152, 7.65 and 8.49 of the Consultation Document.

70 Footnote 552 of the Consultation Document.

is not clear on what basis Ofcom has assumed that such capacity would become available.

10.145 As these examples demonstrate, Ofcom's notional business models for its DTT-based operators have no basis in reality; they are entirely fictional and could not in fact be implemented.

10.146 The fact that Ofcom's approach is divorced from commercial reality should also have been self evident based on the results that such an approach provides. For example, Ofcom's analysis indicated that the small DTT retailer would be unlikely to enter based on Ofcom's proposed prices. Ofcom's analysis suggests that the hypothetical small DTT retailer would need wholesale prices for premium channels to fall by 30%[71] for entry to be profitable, whereas Ofcom is in fact recommending a reduction in wholesale prices of 17%.

10.147 Even a large DTT retailer of the type envisaged by Ofcom might be unlikely to enter. A retailer that adopted Ofcom's strategy (as reflected in Ofcom's hypothesised costs and revenues) would need to expect to gain 3 million subscribers over 10 years (1.65 million after 5 years), of which almost 2 million would need to be premium subscribers (over 1 million after 5 years). This seems large relative to the current aggregate number of premium customers (an increase of over 30%). Sky's Picnic business plan included **[CONFIDENTIAL]** premium subscribers on DTT after 5 years.[72] Sky's figure of **[CONFIDENTIAL]** seems more in line with Setanta's subscriber numbers **[CONFIDENTIAL]**.

10.148 Even if a total of 3 million subscribers was considered achievable for the DTT opportunity after 10 years as a whole it is not obvious that any single operator would expect to achieve subscribers at this level on its own. There are currently two DTT platforms, one operated by BT and one by TUTV. Indeed, we note that in calculating the DTT transmission costs Ofcom has assumed that they are split across 3 operators. It seems unlikely that any operator would expect to achieve 3 million subscribers if there were at least two other DTT platforms offering similar channels.

10.149 Accordingly, it would seem that the prospects of a DTT operator with the business model (including the high costs) which Ofcom hypothesises actually entering the market are slim. That does not mean that Sky's wholesale prices need to be reduced further. Instead, it demonstrates that the business model which Ofcom has hypothesised is ill-conceived and cannot be thought of as reflecting a reasonably efficient operator. The reality is that actual DTT players such as BT and TUTV believe that they can profitably sell Sky's premium channels and indeed that they do not need significant price cuts in order to be able to do so. For example, TUTV's Executive Chairman said in a recent

71 The weighted average of Small DTT Retail-Minus prices as calculated by Ofcom is 30% below the weighted average of current rate-card prices.

72 In its discussion of take-up of new services on DTT, Ofcom cites research undertaken for Freeview in 2007. As we explain in **Section 11**, a proper examination of that research shows that is has little relevance to a service that charges a monthly subscription fee for access to premium sport and movie channels, and cannot be used in support of Ofcom's assumptions on take-up.

interview with Television Magazine that *"he could retail the Sky [Sports] channel for less than **£20 per month**"*.[73] Similarly, BT Vision's Chief Executive in an interview with the Independent appears to have suggested that BT's charge for Sky Sports might be as little as **£15 per month**[74] (emphasis added). Whilst these statements are prefaced on Ofcom's proposed wholesale price cut of £2.85[75] for Single Sports coming into effect, the prices which BT and TUTV have indicated they expect to charge undercut the lowest price currently offered by Sky for a package that contains Sky Sports 1 by more than this amount.[76] It is therefore clear that BT and TUTV could offer prices which were below the lowest price currently offered by Sky for a package containing Sky Sports 1 without the price cuts proposed by Ofcom.

10.150 And even if all these problems were ignored, Ofcom's approach lacks any economic or commercial logic and is inconsistent with the outcomes in a competitive market.

10.151 Ofcom acknowledges that each of the hypothesised DTT operators is less efficient than Sky due to (a) the more expensive costs of DTT transmission and (b) their smaller scale. Ofcom similarly confirms that these disadvantages are not temporary but would be expected to persist. In such circumstances it is not economically or commercially literate for an entrant to expect that it could incur exactly the same costs as the existing operators in all respects save for higher transmission costs and at the same time also expect to be able to match existing more efficient operator's retail prices. Indeed in a competitive market entry of this type would not be expected to occur as it would not be sustainable. We note that while Sky would, under Ofcom's proposed regulatory regime, be prevented from competing on the merits with such an entrant and could not pass its lower existing retail cost or any future savings in its retail costs on to consumers, Virgin Media would face no such restriction.

10.152 Instead, in a normal market free from distortionary intervention an entrant could be expected to base its strategy on either (i) charging a higher premium relative to the price of an equivalent service on an incumbent platform to reflect the higher costs of distribution; and/or, (ii) adopting a lower cost business model. Such an operator could expect to charge a higher price because customers with a strong preference for DTT technology would be expected to be willing to pay a premium to receive channels in that way. In addition, an operator would expect to be able to reduce costs in other areas and design a product which reflected the target market for its service and the particular disadvantages and advantages of the DTT technology.

10.153 Indeed this second option is exactly what statements made by the potential retailers of Sky's premium channels via DTT say they will do.

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73 Page 27, *Television Magazine*, September 2009.

74 Page 35 and 42, *The Independent*, 27 July 2009.

75 Or the £3.25 reduction from current ratecard prices.

76 Prices BT and TUTV have indicated they would charge are between £5.50 and £10.50 per month lower than the lowest price currently offered by Sky for a package containing Sky Sports 1 which is £25.50 per month.

10.154 For example, TUTV's Executive Chairman in an interview for Television Magazine indicated that TUTV has designed its product specifically to target its market and has adapted its business model to reduce costs. He stated:

> *"…as the cost of DTT spectrum rocketed,* [TUTV] *was forced to change its business model. It switched from linear channels to push VoD (video on demand), with programmes being downloaded overnight to Freeview boxes equipped with a PVR"; and*
>
> He calls TUTV *""pay-TV lite", a friendly voice in the ear of customers who want most of their viewing to remain free. Customers can pay just £9.99 per month for 25 different "channels" of programming that are downloaded overnight".* [77]

10.155 Accordingly, Sky considers that the approach Ofcom has used to model the DTT retailer cannot be relied on because it is not based in reality and, in any event, goes way beyond the types of entry that would be expected in a competitive market.

The profitability of Picnic's business plan

10.156 As discussed above, to the extent it is relevant to assess the 'affordability' of charges for Sky's premium channels it is more appropriate to consider whether, at prevailing charges for those channels, there is a profitable opportunity to retail them via new platforms, including DTT-based platforms.

10.157 In relation to DTT-based services, the most appropriate way of examining this question is to consider Sky's Picnic business plan. The business plan which Sky provided to Ofcom in relation to Picnic is not some hypothetical, artificial business model drawn up by a regulator but reflects a real world commercial plan, tailored to the realities of DTT, which was scrutinised by Sky's Executive and endorsed by Sky's Board. Moreover, it was a plan against which Sky committed significant resources and expenditure of **[CONFIDENTIAL]**. The Picnic strategy reflected the fact that DTT capacity is scarce and relatively expensive. It also recognised that Picnic would have been a late entrant and would hence need to differentiate its offering relative to those offered by incumbents. In addition, it recognised that for many existing Freeview homes one of the key reasons why they have not subscribed to pay TV thus far is that they are deterred from subscribing by a perception that they would be paying for channels that they do not want, and are put off by subscription contracts with an initial minimum duration (e.g. a 12 month initial term).[78] Accordingly, Picnic planned to offer customers a more limited selection of the very best pay TV channels and [**CONFIDENTIAL**].

10.158 As Sky has shown in **Section 6**, even allowing for Ofcom's amendments, Picnic's business plan is profitable over [**CONFIDENTIAL**] years including a terminal

77 Page 26, *Television Magazine*, September 2009.

78 See, for example, Sky's internal presentation "Freeview and Prime: governance team update", 19 December 2007, provided in response to Ofcom's information request of 29 May 2008.

value, and more so once the spurious amendments Ofcom has made to Picnic's actual business plan are removed.

10.159 Accordingly, it is entirely clear that, if the bottom threshold were based on the profitability of a plausible new DTT retailer, rather than Ofcom's wholly nonsensical constructs, such a retailer could pay Sky's current ratecard prices even using Ofcom's discount rate of 10.3%. The bottom end of the range is therefore at least as high as Sky's current ratecard prices.

Part III

Ofcom's proposal that Sky must reduce wholesale charges to Virgin Media

10.160 Ofcom proposes that Sky must have a single set of regulated wholesale charges for its premium pay TV channels. Given that Ofcom proposes to set regulated wholesale charges below the current ratecard charges, this means that Virgin Media, the principal major third party retailer of Sky's premium channels, would benefit immediately from reduced wholesale charges. The result would be an immediate and ongoing transfer of revenue from Sky to Virgin Media of around **[CONFIDENTIAL]** in the next four years.[79]

A. Targeted at a case in which action is needed

10.161 The rationale put forward by Ofcom for this proposal is that it is justified by the principle of "*technology neutrality*". Ofcom states:

> "*we believe that technology neutrality is a key principle to take into account in determining our approach to pricing. It is our objective that the market should determine which platforms are successful, not the regulator, and not Sky. For the same wholesale product, it follows that there should be one price for retailers across all distribution technologies.*"[80]

10.162 This argument appears somewhat disingenuous – particularly in view of Ofcom's approach to the determination of regulated wholesale charges for Sky's premium channels, which is not 'technology neutral', being based on the costs and revenues of an operator using DTT technology.

10.163 Moreover, simply citing a "*principle*" of "*technology neutrality*" does not comprise an adequate justification for Ofcom's proposal. Ofcom's rationale for forcing Sky to set lower wholesale charges for its premium channels to DTT-based operators is that such operators would not be able to 'afford' the wholesale charges paid by Virgin Media and set the same retail prices as Sky (and implicitly Virgin Media). It is entirely unreasonable then simply to assert that Virgin Media must also be able to benefit from lower charges, and justify such a proposal on the basis of a vague reference to "*technological neutrality*".

10.164 The suspicion is, therefore, that Ofcom's proposal is motivated not, as stated, by some vague principle of technology neutrality, but by Ofcom's view, expressed elsewhere in its Consultation Document, that:

> *"we see a likely link between the current prices and the low penetration of premium customers on cable*".[81]

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79 Based on Ofcom's proposal of ratecard prices for a larger competitor on DTT (scenario 4) in figure 64 of the Consultation Document.

80 Paragraph 9.56 of the Consultation Document. As we note above, Ofcom's statement that the market should determine which platforms are successful is contradicted by Ofcom's policy proposals in this case.

81 Paragraph 8.74 of the Consultation Document.

10.165 In other words, it may be suspected that the 'problem' at which the proposed cuts in wholesale charges for Virgin Media is targeted is, in Ofcom's mind, "*the low penetration of premium customers on cable*".

10.166 Ofcom, however, fails to provide any reason at all why the lack of sales by a particular operator should be regarded as a problem which requires any regulatory intervention. For example, Ofcom's attempt to articulate any consumer detriment arising from Virgin Media's failure to market Sky's channels effectively to its existing customer base is inadequate.[82]

10.167 Accordingly, Ofcom has failed entirely to demonstrate that its proposal to compel Sky to reduce wholesale charges paid by Virgin Media is targeted at a case in which action is needed. The following discussion is without prejudice to this fundamental point.

B. Proportionate

10.168 Even if Ofcom had demonstrated to an adequate standard that this issue warranted regulatory intervention, the intervention proposed by Ofcom would plainly not be proportionate.

10.169 First, the issue that is of concern to Ofcom is as much a function of Virgin Media's behaviour, including the way in which it sets its retail prices, as it is a function of the pricing of Sky's premium channels. It is wholly unclear why any intervention should be targeted at wholesale charges for Sky's premium channels, rather than seeking to address Virgin Media's behaviour.

10.170 Second, the proposed intervention would not be proportionate in the sense of being "*effective to achieve the legitimate aim in question*".[83] This is for the straightforward reason that there is no way of ensuring that the windfall delivered by Ofcom's proposal would be used to increase the penetration of Sky's channels among existing Virgin Media subscribers. Virgin Media would be free to spend the windfall on whatever it wished.

10.171 Third, Ofcom's proposal is not "*no more onerous than is required to achieve that aim*".[84] The source of the issue that concerns Ofcom is a standard principal-agent problem between an upstream supplier and a distributor when it is not possible to engage in contracts with non-linear tariffs. As Sky indicated in its Response to the Second Consultation Document, Sky has effectively been prevented from negotiating such contracts with distributors of its channels in the past by regulators. A more proportionate regulatory response to the issue, therefore, would be for Ofcom not to impose its proposed price control but instead to signal a willingness to permit such agreements to be negotiated and implemented. Such an approach would have the virtues of being a market driven response to the issue identified by Ofcom as a concern, relying, as it

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82 See **Section 8** of this Response for further discussion of this issue.

83 Paragraph 137 of the Judgment of the Competition Appeals Tribunal, *Tesco v. Competition Commission*, Case 1104/6/8/08, 4 March 2009.

84 *Ibid.*

does, on firms' commercial incentives, avoiding the expropriation of Sky's revenues for no benefit, and requiring only a minimal role for Ofcom.

C. Reflective of best regulatory practice

10.172 Government policies which simply act to transfer revenues from one firm to another, without adequate justification or compensating benefits, are, in mainstream thinking, regarded as unmeritorious. This is because they violate basic principles that underpin private property, which is integral to the success of market-based economies.

Part IV

Summary and conclusions

10.173 Ofcom's proposal to impose an unprecedented and intrusive new price control regime on Sky is both unsupported and unsupportable. Despite the range of reasons put forward by Ofcom intended to justify it, it is evident that its aim is to implement reductions in wholesale charges for Sky's premium channels, which are part of an industrial planning policy in which Ofcom is seeking to support the development of new DTT-based pay TV retail businesses, with the scale and nature of those businesses determined by Ofcom.

10.174 Such a policy is unnecessary: there is a profitable opportunity for such businesses to develop while paying wholesale charges for Sky's premium channels in line with current levels, as Picnic's business plan, considered properly, demonstrates, so these matters should be left to the market.

10.175 Even more importantly, however, as indicated clearly in Professor Cave's Expert Report, industrial planning of this type carries with it serious risks of significant adverse consequences that Ofcom has failed to consider, and the panoply of regulation required in order to implement Ofcom's proposed price control would have very substantial adverse economic consequences. Furthermore, were Ofcom to require Sky to set wholesale charges at the levels proposed, the return on its premium channel business would not enable Sky to sustain its current levels of investment in programming, and would seriously deter Sky from making further such investments. Accordingly, Ofcom's proposals are wholly disproportionate.

10.176 In these circumstances, it is unnecessary to consider further the flaws in Ofcom's proposals for the reductions it proposes to compel Sky to make in its wholesale charges for its premium channels, and its wholly unsupportable assertion that such price cuts must be granted to Virgin Media. For completeness, however, Ofcom's financial analysis of what charges it should determine for Sky's premium channels is constructed using a methodology that is without merit, aimed at calculating charges for hypothetical businesses that could not ever be implemented in reality. And on top of these flaws, Ofcom's analysis is riddled with numerous, often straightforward, calculation errors. Accordingly, no weight at all can be placed on its results. Ofcom has no basis for compelling Sky to reduce its wholesale charges below their current levels.

SECTION 11: OFCOM HAS FAILED TO CARRY OUT AN IMPACT ASSESSMENT TO THE REQUISITE STANDARD

Introduction

11.1 As discussed in **Section 3** above, Ofcom has an obligation to undertake an impact assessment in relation to its proposed regulation that conforms both to best regulatory practice, and to the criteria set out by the CAT in *Vodafone v. Ofcom*.[1] Furthermore, Ofcom's presentation of its impact assessment must be sufficiently clear and detailed as to enable consultees to give intelligent consideration and intelligent responses to it.

11.2 A robust impact assessment should be a key means by which Ofcom demonstrates that its regulatory proposals meet the requirements of section 3(3) CA03. In other words, it should be how Ofcom demonstrates that each element of its regulatory proposals is necessary and proportionate.

11.3 For the reasons set out in this Section, Ofcom's impact assessment in this case manifestly fails to meet its legal duties in this respect. Currently, due to the flaws in its impact assessment, Ofcom has no way of evaluating whether its regulatory proposals in this case are necessary and proportionate (a prerequisite for action on its part). The only way for Ofcom to remedy this failure is to undertake a proper impact assessment of its proposals and to undertake a new consultation.

11.4 In **Part I** of this Section, we discuss general issues related to Ofcom's impact assessment. In **Part II**, we assess Ofcom's estimates of the costs and benefits of its proposed new regulatory regime. This Section is without prejudice to Sky's case that Ofcom has entirely failed to demonstrate a competition problem sufficient to justify consideration of whether it should be remedied, and if so, how that might be achieved.

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1 Paragraph 346 of the judgment of the Competition Appeals Tribunal in Case 1094/3/3/08 *Vodafone Ltd v Office of Communications* [2008] CAT 22, 18 September 2008 ("**Vodafone v. Ofcom**").

Part I

A. Impact assessment

11.5 The term *'impact assessment'* applies to two different (though related) matters:

(a) the *process* of assessing proposals for government intervention; and

(b) a standalone *document* (or section of a document) that comprehensively demonstrates the necessity and proportionality of proposals for government intervention.[2] Such a document should, among other things, demonstrate in a clear manner that:

(i) there is a problem that potentially justifies government intervention;

(ii) the regulator has considered properly a range of alternative solutions to that problem, including not intervening;

(iii) the proposed intervention would be effective in remedying that problem;

(iv) the benefits of the proposed course of action outweigh its costs;

(v) the proposed course of action has the highest expected net benefit (taking into account the likelihood of forecast costs and benefits) among the range of options that has been considered; and

(vi) the net benefit is sufficiently large to justify the risks of intervention.

11.6 A requirement to undertake an impact assessment (in both senses) is intended to improve the quality of government regulation, in particular by avoiding unnecessary or disproportionate regulation. It is intended to act as a counterweight to the risk of excessive regulation, by requiring that regulators set out both (a) the reasoning that underpins their proposals for new regulation, and (b) the anticipated costs and benefits of those proposals, and expose this analysis to scrutiny. For example, the European Commission's guidance on impact assessment states:

> "[Impact assessment] *consists of a set of logical steps to help structure the preparation of Commission proposals. By testing the need for intervention at the EU level and by examining the potential impacts of a range of policy options, it should lead to improvements and simplification of the regulatory environment.*"[3]

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2 Such a document is sometimes referred to as a 'formal', or 'final' impact assessment.

3 European Commission, "*Better Regulation: Impact Assessment*". Available at: http://ec.europa.eu/governance/better_regulation/impact_en.htm.

11.7 The National Audit Office describes impact assessment as follows:

> *"Impact assessment is a tool for assessing the need for and the impact of a proposed regulation. Used well, impact assessment can lead to a better understanding of the consequences of a regulation and thus encourage evidence-based decision making. Impact assessment also increases the transparency and accountability of policy-making because reasoning is exposed to challenge both internally and from interested stakeholders."*[4]

B. Ofcom's legal duty in relation to impact assessment

11.8 Section 7 CA03 imposes on Ofcom a duty to carry out an impact assessment in relation to important new regulation. Section 7 CA03 requires Ofcom to provide in relation to important proposals an impact assessment of the latter type described above[5] - *i.e.* a standalone document that demonstrates the necessity and proportionality of its proposals for new regulation. Ofcom's own guidance on impact assessment also states:

> "*Although the analysis set out in an Impact Assessment should inform and underpin the main body of any consultation on a policy proposal, it is important that an Impact Assessment should be clearly identified. It will generally be set out in a separate section or annex, although in many cases the Impact Assessment is likely to be a summary of the analysis which forms the main substance of the consultation document or statement.*"[6]

11.9 The CAT's judgment in *Vodafone v. Ofcom* makes clear two criteria that must be met by Ofcom in discharging its duty in relation to impact assessment. First, the CAT's judgment states that:

> *"it is still incumbent on Ofcom... to conduct their assessment with appropriate care, attention and accuracy so that their results are soundly based and can withstand the profound and rigorous scrutiny that the Tribunal will apply on an appeal*".[7]

11.10 Second, the judgment notes that consultation by Ofcom on its impact assessment must satisfy general public law standards on consultation, including providing consultees with sufficient information as to enable them to make "*intelligent and realistic*"[8] responses to Ofcom's analysis. The CAT reflects and

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4 Page 4 of the National Audit Office "*Review of Economic Regulator: Impact Assessments*" for the House of Lords Select Committee on Regulators', October 2007. Available at: http://www.nao.org.uk/idoc.ashx?docId=dac62137-6553-4e79-83d1-e63eb66830b5&version=-1.

5 As we note above, Ofcom's failure properly to engage in impact assessment of the former type is a key reason why Ofcom has arrived at unnecessary and disproportionate regulatory proposals.

6 Ofcom: '*Better Policy Making – Ofcom's approach to Impact Assessment*', paragraph 6.1. Available at: http://www.ofcom.org.uk/consult/policy_making/ ("**Better Policy Making**").

7 Paragraph 46 of *Vodafone v. Ofcom.*

8 *Ibid*, paragraph 95.

relies upon the comments of Lord Woolf MR giving the judgment of the Court of Appeal in *R v North and East Devon Health Authority, Ex p Coughlan* that:

> *"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 be conscientiously taken into account when the ultimate decision is taken."*[9]

C. Ofcom's approach does not accord with its own guidance on impact assessment

11.11 Ofcom has set out the approach that it intends to follow when undertaking impact assessments in its publication entitled "*Better Policy Making, Ofcom's approach to impact assessments*".[10] At a minimum, it is clear that any impact assessments undertaken by Ofcom should accord with its own guidance.[11]

11.12 The approach taken by Ofcom to the development of new regulation in this case, however, does not accord with that guidance. This can be seen clearly by comparing Ofcom's description of why it considers impact assessment to be important that is set out in its guidance with Ofcom's approach to impact assessment in this case.[12] Ofcom's guidance states:

> *"Why is Impact Assessment important?*
>
> *The decisions which Ofcom makes can impose significant costs on our stakeholders and it is important for us to think very carefully before adding to the burden of regulation. 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. If intervention is justified, we aim to choose the least intrusive means of achieving our objectives, recognising the potential for regulation to reduce competition. These guidelines explain how Impact Assessments will be used to help us apply these principles in a transparent and justifiable way.*
>
> *Impact Assessments form a key part of best practice policy making, which is reflected in our statutory duty to carry them out. They provide a way of*

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9 Paragraph 108 of the Court of Appeal's judgment in *R v North and East Devon Health Authority, Ex p Coughlan* [2001] QB 213.

10 *Ibid.*

11 Ofcom also has a legal obligation to ensure that its approach to new regulation is in accord with best regulatory practice. Accordingly, to the extent that Ofcom's own guidance does not conform with best regulatory practice, it is arguable that undertaking an impact assessment that is in conformity with Ofcom's own guidance would not be sufficient to satisfy Ofcom's legal duties. There is a strong case that Ofcom's guidance falls considerably short of best practice in relation to impact assessment – for example, as set out in a wide range of publications by other bodies. (See **Appendix 4** to this **Section 11**.)

12 Ofcom's impact assessment in this case also does not conform with numerous other statements in Ofcom's own guidance. Sky reserves the right to comment more fully on Ofcom's analysis in the event that Ofcom chooses not to undertake a proper impact assessment and re-consult on that impact assessment.

considering different options for regulation and then selecting the best option. In selecting and analysing options, the need to further the interests of citizens and consumers is of paramount importance….

In identifying options, we will aim to consider a wide range of options, including not regulating. Where appropriate, we will explore more risk-based, targeted approaches to regulation and will consider whether there are alternatives to formal regulation, such as co-regulation.

In developing policy proposals, our aim will be to think widely about the possible impacts, taking account of the whole value chain and knock-on effects across the communications sector. By doing so, we will seek to minimise any unintended consequences.

To be effective, the process of doing an Impact Assessment should begin right at the start of a project, with the Impact Assessment being developed from then onwards. An Impact Assessment should therefore be a core part of the policy-making process, not a bureaucratic add-on."[13]

11.13 These statements are reflected in Ofcom's discussion of its approach to regulation and legislative obligations in relation to introducing new regulation at paragraph 2.44 in the Consultation Document.

11.14 Ofcom's development of proposals for an onerous and intrusive new regulatory regime in this case is wholly inconsistent with the statements quoted above. In particular, contrary to the statements set out above:

- Ofcom has not acted with a bias against intervention in this case, and has set an extremely low threshold for proposing radical and onerous new regulation. As shown in **Section 9** of this Response, it has been prepared to argue that intrusive new regulation is 'needed' on the flimsiest of grounds, with virtually no assessment of the costs and benefits associated with its proposals;

- Ofcom has not had any regard to the statement that it will "*aim to choose the least intrusive means of achieving* [its] *objectives*". Ofcom has reached readily for some of the most intrusive regulatory options available (compulsory licensing and prescriptive price control) without considering less intrusive approaches.

- Ofcom's impact assessment barely considers the possibility that regulation will reduce competition;

- Ofcom has identified only a single regulatory option – that which it proposes to implement. It has given no attention at all to alternatives to formal regulation, or different formulations of regulatory intervention;

[13] Paragraphs 1.1 to 1.6 of Better Policy Making.

- Ofcom has taken a narrow and cursory approach to considering the possible impacts of its proposals, which is particularly important in this case as there is substantial scope for unintended consequences in light of the radical nature of those proposals; and

- by its own admission[14], Ofcom's impact assessment has been an "*add-on*" undertaken at the end of its policy development process. It did not "*begin right at the start of [the current] project*", and it has not been "*a core part of the policymaking process*".

11.15 In the centre of the passage in its *Better Policy Making* document quoted above, Ofcom also quotes from a document issued by the Better Regulation Task Force, as follows:

> *"The option of not intervening...should always be seriously considered. Sometimes the fact that a market is working imperfectly is used to justify taking action. But no market ever works perfectly, while the effects of...regulation and its unintended consequences, may be worse than the effects of the imperfect market".*[15]

11.16 Ofcom's approach in this case completely ignores this advice. Despite a claimed "*bias against intervention*" Ofcom has not seriously considered the option of not intervening in this case, and is relying on a perception that the market might not be working perfectly to support its proposition that a burdensome new regulatory regime is required.

11.17 A regulator operating with a bias against intervention, and having proper regard to the advice of the Better Regulation Task Force cited by Ofcom, could not properly have reached the conclusion reached by Ofcom in this case that it is necessary and proportionate to impose radical and far-reaching new regulation on Sky.

D. Ofcom provides insufficient detail for consultees to be placed in a position whereby they are able to give "*intelligent consideration and an intelligent response*" to the impact assessment that Ofcom purports to have undertaken

11.18 As noted above, Ofcom's presentation of its impact assessment must be sufficiently clear and detailed as to enable consultees to give intelligent

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14 At paragraph 10.15 of the Consultation Document Ofcom argues that it was not in a position to carry out an impact assessment previously because: "*we had not reached a view on whether it may be appropriate to set wholesale prices, still less carried out the necessary work to understand what an appropriate range of prices might be.*" In other words, in this case Ofcom considers that it is only after it has decided that it "*may be appropriate to set wholesale prices*" and carried out detailed work on the prices that it would charge that it feels able to begin to assess the costs and benefits of its proposals.

15 The quotation is taken from '*Imaginative thinking for better regulation*', Better Regulation Task Force, September 2003. Available at: http://archive.cabinetoffice.gov.uk/brc/upload/assets/www.brc.gov.uk/brtf_0402_annex_1.pdf. Cited on page 3 of Better Policy Making.

consideration and intelligent responses to it. Ofcom's presentation of its impact assessment in this case, however, manifestly fails that test.

Ofcom does not set out its impact assessment in a single place

11.19 Ofcom's impact assessment should comprise a clear and comprehensive statement of all the arguments on which Ofcom is relying in support of its case that the new regulatory regime proposed by Ofcom is necessary and proportionate. In its Consultation Document, however, Ofcom states:

> "*the analysis in [*Section 10*] and other parts of this document, in particular sections 8 and 9, represents an impact assessment as defined in s7 CA03*".[16]

11.20 This is wholly unsatisfactory. Ofcom does not identify those "*other parts of this document*" which it believes to form part of its impact assessment, and the sections to which it refers "*in particular*" cover a large number of issues which may, or may not, be considered to be part of Ofcom's impact assessment. In essence, Ofcom requires that consultees must work out for themselves which "*other parts of this document*" – which constitute more than 600 pages – Ofcom believes comprise part of its impact assessment. It is clear that such an approach does not enable consultees to give intelligent consideration and intelligent responses to Ofcom's impact assessment.

Lack of clear presentation of results

11.21 Ofcom puts forward a number of estimates of the value of costs and benefits arising from its proposed new regulation. For example, at paragraph 10.40, Ofcom states:

> "*We have sought to quantify these effects in broad terms. Taken together, we estimate that over five years, our proposed remedy is likely to deliver an increase in consumer surplus of around £370 million over the counterfactual.* Our sensitivity analysis suggests that this figure could lie in a very broad *range from around £100 million to £630 million.*"[17]

11.22 There is, however, no overall summary of Ofcom's estimates of the costs and benefits associated with its proposed new regulation – estimates are scattered through Section 10 of the Consultation Document in such a way that it is impossible to determine Ofcom's overall view. In view of Ofcom's proposition that it should proceed to implement the regulatory regime that it has designed it is evident that Ofcom considers that its benefits would outweigh its costs. Nevertheless, it is clearly unsatisfactory that the cost and benefit estimates that Ofcom consider supports such a proposition are not set out clearly in a single place so that it is possible to determine that this is in fact the case. Ofcom's failure in this respect significantly impedes consultees' ability to give intelligent consideration and intelligent responses to Ofcom's impact assessment.

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16 Paragraph 10.6 of the Consultation Document.

17 Paragraph 10.40 of the Consultation Document.

Insufficient description of Ofcom's methodology for calculations of costs and benefits

11.23 One of the more surprising elements of Section 10 of Ofcom's Consultation Document is that it includes only the most cursory of explanations of the methodology by which Ofcom has calculated estimates of costs and benefits, and the 'scenarios' that appear to inform Ofcom's sensitivity analysis.[18] The entirety of Ofcom's description of its methodology in the Consultation Document is as follows:

> "*In the assessment that follows, we set out the results of some quantitative analysis of those effects we can meaningfully attempt to quantify. To quantify the likely static impact of the remedy, we have sought to calculate the likely benefits to consumers and producers (i.e. consumer surplus and producer surplus) over a five year reference period. We have assumed that consumer surplus can be measured in terms of the difference between consumers' willingness to pay and what they actually pay for a pay TV service. We calculate producer surplus separately for Sky and its competitors. Our overall approach is to subtract additional costs (relative to the counterfactual) from additional revenues over the five year reference period.*
>
> *Our central case calculations assume that:*
>
> - *Wholesale prices are those set out in Section 9 for a 'larger entrant' retailer distributing on DTT.*
> - *The total number of premium subscribers on platforms other than DSat and cable rises to 2 million after 5 years*
> - *Total additional fixed costs for new entrants to the retail market for core premium channels amount to £43 million per year, including fixed transmission costs – this estimate is based on our estimates of fixed costs as set out in Section 9.*"[19]
>
> *We summarise the results of our quantitative analysis as broad ranges reflecting the sensitivities to key assumptions. Many of the assumptions used in our analysis are subject to substantial uncertainty. We have therefore considered a range of sensitivities to some of the key parameters. These include variations in the extent of the market expansion effect, different levels of aggregate fixed costs, alternative assumptions about demand conditions, and alternative assumptions about relative retail prices. Taken together, these sensitivities give rise to a wide set of potential outcomes."*[20]

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18 For example, Ofcom states: "*In our worst case for Sky, its producer surplus over five years decreases by around £250 million, and in our high case increases by £610 million.*" Paragraph 10.73 of the Consultation Document.

19 Paragraphs 10.23 to 10.24 of the Consultation Document.

20 Paragraph 10.25 of the Consultation Document.

11.24 This description is wholly inadequate to enable consultees to give intelligent consideration and intelligent responses to Ofcom's approach.

11.25 Accordingly, in order to attempt to be in a position to provide a meaningful response to Ofcom's estimates of the value of costs and benefits Ofcom expects to arise from its proposed new regulatory regime, Sky requested from Ofcom the spreadsheet model on which its calculations are based. On its own, however, this was largely impenetrable, and Sky had to request that Ofcom provide it with an explanation of the methodology and scenarios that underpinned its analysis.

11.26 While Ofcom has been helpful in meeting these additional requests for explanation of its estimates of the costs and benefits of its proposals, it is clearly highly unsatisfactory that Ofcom has not seen fit to include the type of material eventually provided to Sky at Sky's request in its published impact assessment. In particular, while Sky is, broadly speaking, now able to make informed submissions on Ofcom's cost and benefit estimates (which are wholly inadequate for the reasons given in Part II of this Section below), it is evident that, unless other parties have made similar requests, Sky is alone in that position.

E. Ofcom's counterfactual is without merit

11.27 The fundamental flaw in Ofcom's impact assessment is that it is based on an erroneous counterfactual.

11.28 The counterfactual plays a critical role in impact assessment. It describes what would be expected to occur under alternative approaches to regulation, including not intervening at all. In an impact assessment it is the *incremental* costs and benefits that matter – *i.e.* the costs and benefits that are attributable to a particular intervention in the sense that they would *not arise* in the counterfactual scenario.[21]

11.29 Ofcom's counterfactual is that, absent Ofcom's intervention, Sky's premium channels would *never* be made available via new platforms.[22] In Ofcom's

21 The counterfactual need not be the 'do nothing' option in all cases. For example, it is often appropriate to compare the incremental net benefits of two different regulatory options. In such a situation the outcomes associated with one of the regulatory options then become the counterfactual scenario. For example, Sky has argued that, in considering whether compulsory licensing should be applied to HD versions of Sky's premium channels one of the relevant counterfactuals should be a scenario in which compulsory licensing of SD versions of Sky's premium channels was imposed on Sky by Ofcom. Similarly, in considering the incremental net benefits associated with the introduction of price control, a relevant counterfactual is one in which compulsory licensing of Sky's channels was introduced by Ofcom with a non-prescriptive pricing obligation (such as a requirement that charges are fair, reasonable and non-discriminatory). Ofcom, however, considers only a single counterfactual – the 'do nothing' scenario.

22 Ofcom's impact assessment uses the term "*DTT and IPTV platforms*" as a shorthand for platforms capable of delivering linear television channels other than existing platforms of this type (cable, satellite, Tiscali's IPTV platform, 3G mobile platforms, the internet) (see footnote 559 and paragraphs 10.30 and 10.32.

modelling, absent its intervention *there are assumed to be no subscribers at all to Sky's premium channels via such services, in perpetuity.*

11.30 That is simply untenable. As set out in **Section 6**, above, Ofcom's analysis of Sky's incentives to supply its premium channels via new platforms is without merit. Ofcom accepts that Sky has an incentive at least to retail those channels on other platforms, and a proper examination of Ofcom's arguments shows that Sky also has an incentive to wholesale those channels on other platforms on appropriate commercial terms. It is wholly clear that, absent Ofcom's intervention, Sky's premium channels could **already** be available via DTT platforms, and would be made available via such platforms in the future.[23]

11.31 Accordingly, in practice most of the costs and benefits that Ofcom has measured (subject to the errors in Ofcom's approach which are discussed further below) arise from the exploitation of a clearly recognised business opportunity – the distribution of pay TV channels via DTT. Sky's willingness to exploit this opportunity was demonstrated by the substantial level of resources that Sky devoted to developing its proposed Picnic service before Sky had to mothball its plans. It does not require new regulation from Ofcom to ensure that this business opportunity is exploited, and therefore these costs and benefits cannot be attributed to the introduction of Ofcom's proposed new regulation.

11.32 This flaw is fatal to the entirety of Ofcom's impact assessment. Use of the wrong counterfactual means that all of Ofcom's estimates of the costs and benefits attributable to its proposed new regulatory regime are erroneous.

11.33 The relevant counterfactual is one in which Sky's channels are made available at some point in the future via new platforms (including new DTT-based platforms) absent any intervention by Ofcom, and the incremental costs and benefits must be assessed based on the incremental effects caused by Ofcom's proposed regulation compared to this scenario.

11.34 It is readily apparent that, based on this counterfactual, the incremental benefit attributable to Ofcom's proposed regulation would be nugatory.[24] Ofcom should avoid the introduction of new regulatory regimes which achieve only small incremental benefits, regardless of their measurable costs. This is for the well-recognised reasons that (a) regulation tends to carry with it considerable hidden costs, and a constant risk of unintended adverse consequences, and (b) once introduced, regulation tends both to put down firm roots, and expand over time. This means that the costs of regulation increase over time, and are extremely difficult to reverse. As Sky pointed out in its Response to the Second

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23 Even if Ofcom does not accept that the relevant counterfactual is negotiated access to Sky's channels, it cannot ignore the fact that 18 months ago Sky was prepared to supply its premium channels to BT and Top Up TV provided they met Sky's minimum security requirements at charges that included discounts for meeting penetration targets, but Ofcom declined to accept this offer, preferring instead to push ahead with proposals to introduce an onerous and radical new regulatory regime. In such circumstances it is wholly inappropriate for Ofcom to adopt a counterfactual in which Sky's channels are not available on these platforms.

24 The great majority of the quantifiable benefits claimed by Ofcom are derived simply from Sky's channels becoming available via DTT.

Consultation Document, such arguments should be familiar to Ofcom as they were set out very clearly in an academic paper entitled "*Regulatory creep and regulatory withdrawal*" by Ofcom's former Chairman, Lord Currie.[25]

11.35 Moreover, it is clear that a regulator which has a commitment to act with a bias against intervention, as Ofcom professes to have, would clearly not wish to introduce regulation which does not deliver significant benefits.

11.36 In this case, however, the fact that the costs of Ofcom's proposals are likely to be significant adds further weight to the proposition that Ofcom should not proceed to introduce its proposed new regulatory regime.

F. Ofcom considers only a single option, and fails to consider alternatives that are potentially more proportionate solutions to the alleged problems that it has identified

11.37 Ofcom's impact assessment (and its policy development process more generally) fails to conform with best regulatory practice (and Ofcom's own guidance) by considering only a single regulatory option. Ofcom's guidance stresses the need to consider a range of options. It states:

> "*In identifying options, we will aim to consider a wide range of options, including not regulating.*"[26]

11.38 Sky's Response to the Second Consultation Document pointed out that European Commission guidance on impact assessment warns against an irrational approach of comparing only three regulatory options – the do nothing option, the preferred option and "*the Ridiculous Option that nobody wants*".[27] Ofcom has avoided this pitfall simply by leaving out "*the Ridiculous Option that nobody wants*", and assessing only a single option – that which it proposes to implement – against the do nothing option.

11.39 The result is that Ofcom fails entirely to ascertain whether there are better options than the single regulatory option that it has developed, with 'better' in this context meaning delivering a greater net benefit than Ofcom's proposed regulation.

11.40 Such a failure is particularly glaring in view of the fact that the argument that there are clear, less intrusive alternatives to Ofcom's proposals available, which Ofcom should consider properly before choosing its preferred approach, was a significant argument in Sky's Response to Ofcom's Second Consultation document.[28] Ofcom has not had due regard to this argument.

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[25] Paragraph 4.20 of Section 3 of Sky's Response to the Second Consultation Document.

[26] Paragraph 1.4 of Better Policy Making.

[27] See paragraph 4.15 of Section 3 of Sky's Response to the Second Consultation Document.

[28] See Part 5 of Section 7 of Sky's Response to the Second Consultation Document.

11.41 In undertaking a new impact assessment Ofcom must consider properly the costs and benefits of a number of alternative, less intrusive and realistic alternatives to the single regulatory option that it has evaluated.

G. Ofcom fails to recognise that its regulatory proposals contain numerous, separable elements, which have their own costs and benefits attached to them, which should be assessed separately

11.42 Ofcom's approach to the development of its regulatory proposals in this case comprises two steps. First, Ofcom seeks to determine the scope and nature of its proposed regulation – what it described in its Second Consultation Document, as a task of "*getting the detail right*".[29] Second, Ofcom then considers that it should assess the 'proportionality' of the package of measures that it has developed by comparing the costs and benefits of that package of measures – in its entirety - against the costs and benefits that Ofcom considers would arise absent intervention. Such an approach means that Ofcom fails to consider narrower interventions which might have greater net benefits associated with them than the entirety of its proposed set of interventions.

11.43 Ofcom's proposed regulation of Sky's high definition services provides a key example. Including new and innovative services, such as HD channels, within the scope of compulsory licensing regulation creates a considerable risk of giving rise to significant economic costs due its impact on incentives for investment and innovation. Yet the incremental benefits of such a proposal are likely, *prima facie*, to be small, particularly relative to a counterfactual in which compulsory licensing of Sky's standard definition premium channels at regulated charges was introduced. This means that, *prima facie*, it is likely that the costs of this element of Ofcom's proposals would significantly outweigh its benefits.

11.44 Accordingly, a proper evaluation of the costs and benefits of extending the scope of regulation to Sky's high definition channels would be likely to result in them not being included within the scope of regulation. Ofcom's approach to impact assessment means that it fails to compare the costs and benefits of an option that includes regulation of Sky's high definition channels, with that of an option that does not include such regulation.

[29] Paragraph 9.8 of the Second Consultation Document.

H. Ofcom provides no adequate description of the nature and extent of problems, or how the regulatory regime that it has proposed would remedy them

11.45 A description of the nature and scale of the problems at which proposals for new regulation are targeted is an important element of an impact assessment.[30] For example, "*identifying the problem*" is described as the first of the "*key analytical steps*" in the European Commission's guidance on impact assessment, and involves the following:[31]

- Describe the nature and extent of the problem.
- Identify the key players/affected populations.
- Establish the drivers and underlying causes.
- Develop a clear baseline scenario, including, where necessary, sensitivity analysis and risk assessment.

11.46 Such a description is, in particular, important in helping to ensure that any proposed intervention is the minimum necessary to remedy identified problems, which, as noted in the CAT's judgment in *Tesco v. Competition Commission*,[32] is a key element of the concept of proportionality.

11.47 Ofcom's impact assessment, however, contains no such description, leaving consultees to determine for themselves the specific nature of the problems at which Ofcom believes that its proposals are targeted, which is both extremely difficult and inappropriate.

I. Inconsistencies between Ofcom's impact assessment and other parts of its analysis

11.48 It is self-evident that an impact assessment should accord with the analysis which underpins proposals to introduce new regulation. Ofcom's impact assessment in this case, however, appears to have been produced somewhat independently of the remainder of the analysis in Ofcom's consultation document, as there are numerous important inconsistencies between them.

11.49 The clearest indication of this is that there is considerable divergence between the forecast number of subscribers to pay TV services between Ofcom's impact assessment and the model that is used by Ofcom to determine the wholesale charges that it proposes to compel Sky to set.[33] Subscriber numbers in the

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30 This is a good example of where Ofcom's own guidance falls short of best regulatory practice, as it does not commit Ofcom to the standard approach of setting out such matters clearly in an impact assessment, such as that described in the European Commission's guidance above.

31 Page 5 of the European Commission "*Impact Assessment Guidelines*", 15 January 2009. Available at: http://ec.europa.eu/governance/impact/commission_guidelines/docs/iag_2009_en.pdf (the "**EC Impact Assessment Guidelines**")

32 Judgement of the Competition Appeals Tribunal in Case 1104/6/8/08 Tesco *v. Competition Commission* [2009] CAT 6, 4 March 2009.

33 Other discrepancies include differences in the wholesale charges for Sky's premium channels used in the different models (the impact assessment uses different charges for DTT operators and Virgin Media, contrary to Ofcom's conclusion that charges should be the same for both

'factual' situation in the impact assessment (i.e. what Ofcom expects to happen if it introduced its proposed new regulatory regime) should be the same as those in the model used to develop regulated charges for Sky's premium pay TV channels. Yet, as shown in **Figure 11.1** below, the total number of premium subscribers in the impact assessment is substantially higher than that in the price control model – which will tend significantly to overstate the benefits Ofcom considers would arise from the introduction of its proposed new regulatory regime.

Figure 11.1

Closing UK premium subscribers (total)

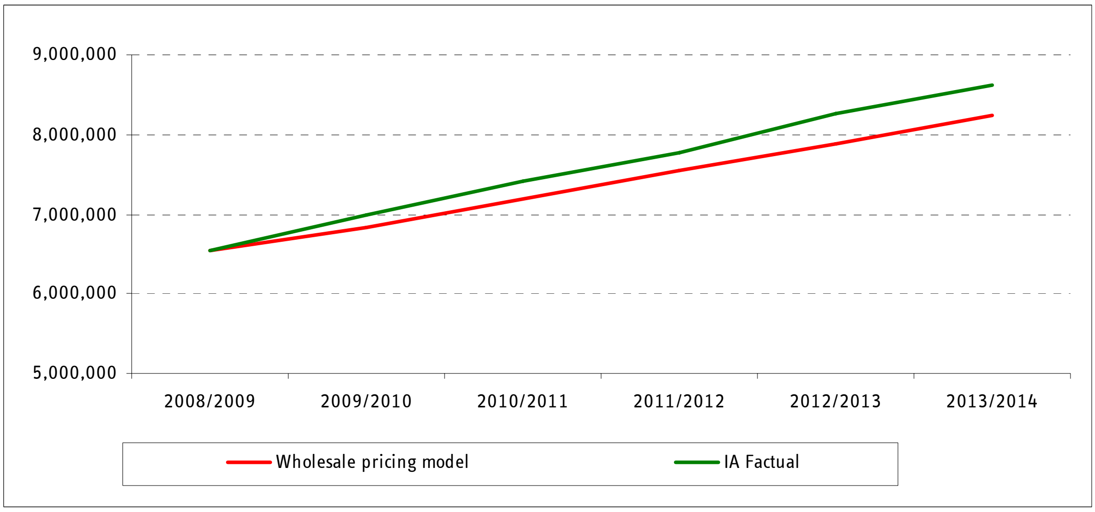
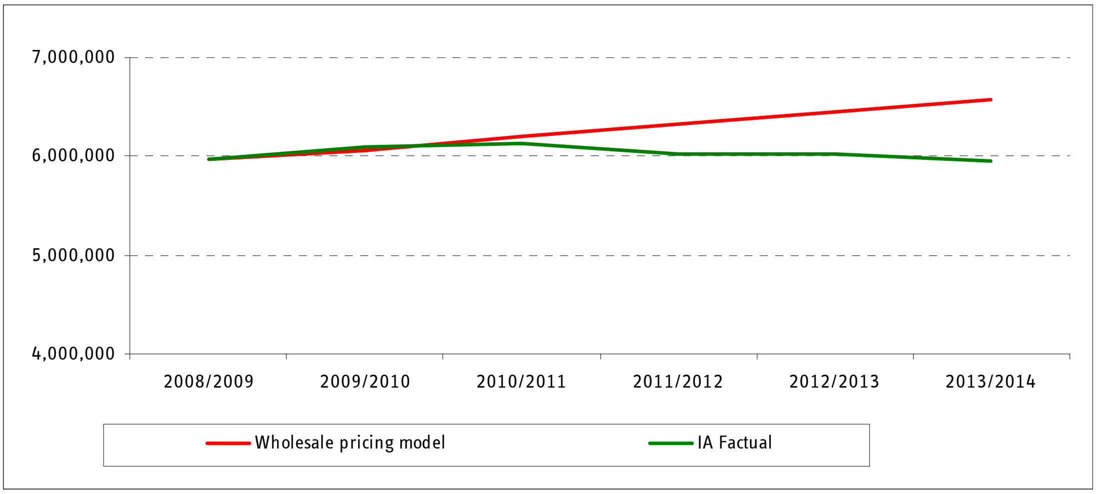


Figure 11.2

Closing UK premium subscribers (DTH)



operators, and neither matches the charges derived in the price control model), the number of DTT videostreams that are assumed, the costs of basic channels carried by new DTT services, and the level of fixed costs associated with new pay TV services.

Figure 11.3

Closing UK premium subscribers (DTT/IPTV)

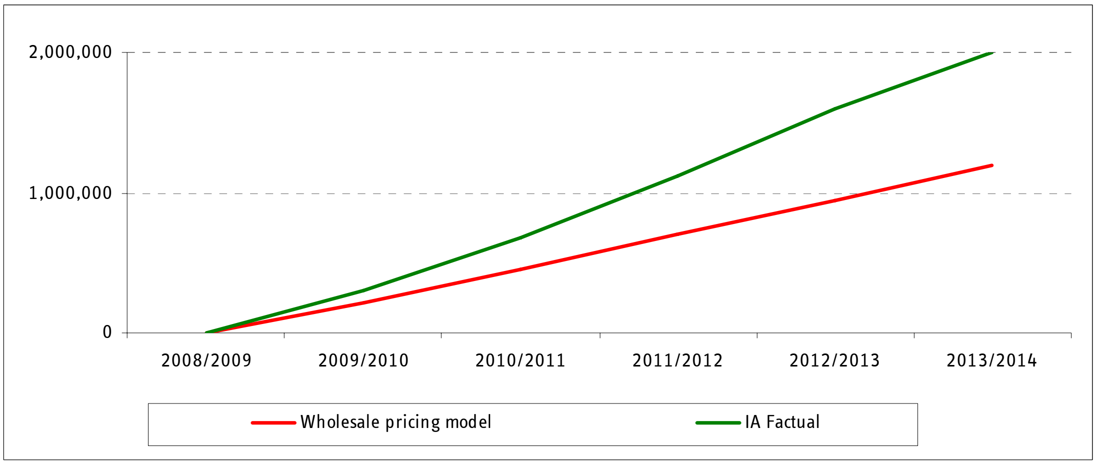
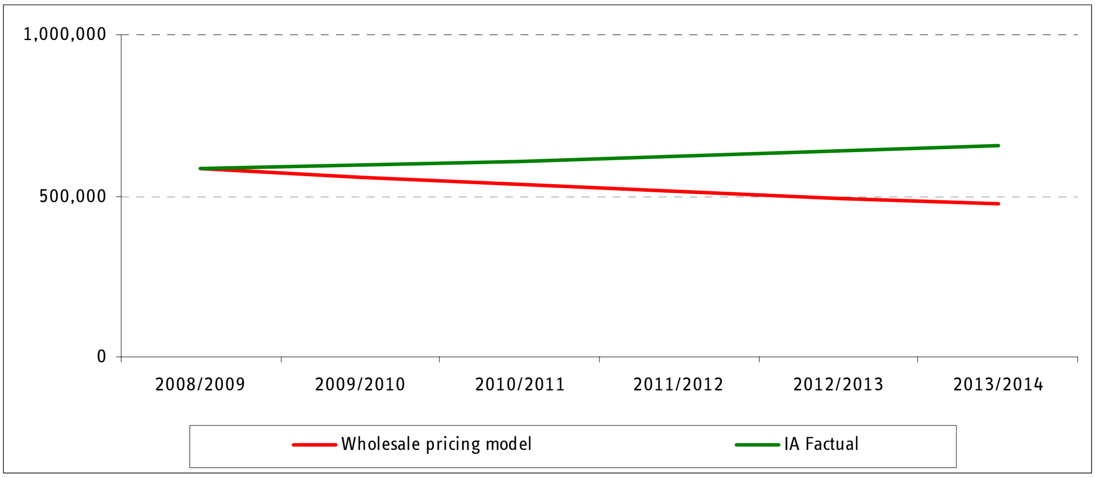


Figure 11.4

Closing UK premium subscribers (Virgin Media)



11.50 Such discrepancies point strongly to a lack of reliability in Ofcom's analysis. In these circumstances, it would be difficult to conclude that it is soundly based or that it has formed a core part of Ofcom's process.[34]

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[34] Sky also notes that the impact assessment model itself generates counterintuitive results in some of the scenarios that Ofcom has tested. For example:

- in the 'Sky - high case' scenario, the number of premium subscribers on DTH satellite is *higher* in the factual case (in which Sky's premium channels are available only via DTH satellite and cable) than in the counterfactual (in which Sky's premium channels are also available via DTT); and
- in the 'Sky low case' scenario, there are *fewer* premium subscribers in total in the factual than in the counterfactual.

These illogical results appear to arise from the interaction of various assumptions which are not supported by evidence and, clearly, not mutually compatible. Ofcom should not rely on such a model.

J. Ofcom's impact assessment does not fulfil its legal obligation to undertake an impact assessment of an adequate standard

11.51 It is commonly recognised that the level of detail at which an impact assessment should be undertaken should depend, to a certain extent, on the significance of the proposals that are being assessed.[35] In other words, a principle of proportionality governs the amount of attention given to impact assessment: the more significant is the proposed intervention, the more attention should be devoted to the assessment of its costs and benefits.

11.52 For example, guidance on impact assessment published by the Department for Business, Innovation and Skills (which is the Government department responsible for advising on impact assessment) states:

> "*the content of the Assessment should be proportionate to the problem involved and the size of the proposal.*"[36]

11.53 Ofcom's proposal to introduce a radical and onerous new regulatory regime comprises a very significant change to the regulatory landscape facing firms operating in the pay television business in the UK, particularly Sky. In such circumstances, and bearing in mind the legal requirement that Ofcom's impact assessment must be able to withstand profound and rigorous scrutiny, it is to be expected that Ofcom's impact assessment in this case would comprise a very substantial analysis.

11.54 Its meagre nature, therefore, is of considerable surprise. Excluding the summary and introduction, Ofcom's assessment of the costs and benefits of its proposed new regulatory regime consists of 14 pages, in a process in which Ofcom has, to date, published over 1,850 pages of material. The disproportionately small amount of attention given to this matter stands in stark contrast, for example, to:

(a) Ofcom's analysis of market definition and Sky's market power, which appears to have been something of an obsession of Ofcom's from the outset of its inquiry, on which it has published over 450 pages of material to date; and

(b) the amount of effort that Ofcom has devoted to calculating the wholesale charges that Ofcom considers it should set for Sky's premium channels.

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35 See, for example, Chapter 3 of the EC Impact Assessment Guidelines. Ofcom's own guidance makes passing reference to this matter, stating: "*Subject to the principle of proportionality, an Impact Assessment will generally….*" Ofcom then proceeds to explain its view of what an impact assessment will contain. See paragraph 2.1 of Better Policy Making.

36 See the Department for Business Innovation & Skills guidelines "*Impact Assessment Toolkit*". Available at: http://www.berr.gov.uk/whatwedo/bre/policy/scrutinising-new-regulations/preparing-impact-assessments/toolkit/page44228.html

11.55 Ofcom has devoted a wholly inadequate amount of attention to fulfilling its legal duty in relation to undertaking an impact assessment in this case. In light of the CAT's judgment in *Vodafone v. Ofcom*, which sets out clear standards for Ofcom in undertaking impact assessment, this represents a clear breach by Ofcom of its legal duty.

11.56 It is, also notable that Ofcom's response to the CAT's judgment in *Vodafone v. Ofcom* has been to undertake a fresh assessment of its policy proposals in that case, which has led to the publication of two new consultation documents, with a combined length of 182 pages, the majority of which are dedicated to impact assessments.[37] Each of these documents:

(a) assesses a broader set of options than that which was considered in the assessment that was criticised heavily by the CAT;

(b) sets out clearly, in one place, its assessment of the costs and benefits of those options;

(c) has involved the commissioning of significant amounts of additional research, including new consumer research, in order to ensure that its analysis is evidence-based; and

(d) involves matters which are arguably, in relative terms, of considerably less overall importance than those raised in the current case.

11.57 Sky does not suggest that there is any necessary similarity between the impact assessment appropriate for the Vodafone case and that which is called for by Ofcom's Pay TV review, but these factual observations give credence to Sky's characterisation of the impact assessment carried out by Ofcom in this case to date as completely inadequate.

K. Ofcom fails properly to consider the probabilities attached to potential outcomes

11.58 Ofcom fails to recognise that the expected value of future costs and benefits is the product of two variables: (a) the predicted magnitude of a particular cost or benefit, and (b) the likelihood of that cost or benefit being realised. This is particularly important when comparing costs and benefits that have different probabilities attached to them. For example an intervention that has a certain cost of £100 million, and a small chance of realising a benefit worth £150 million is unlikely to be proportionate. Disregarding the relative probabilities of the two estimates would result in the policy being adopted when it should not be.

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37 "*Mobile number portability - Review of the porting process*", Ofcom, 3 August 2009, available at: http://www.ofcom.org.uk/consult/condocs/gc18_mnp/ and "*Routing calls to ported telephone numbers, Consultation on proposals*", Ofcom, 3 August 2009, available at: http://www.ofcom.org.uk/consult/condocs/gc18_routing/.

11.59 Sky pointed out this issue in its Response to Ofcom's Second Consultation Document.[38] Ofcom has not had due regard to this argument in preparing its impact assessment.

11.60 It is readily apparent that there is a high degree of uncertainty associated with, in particular, the benefits which Ofcom argues will arise from its proposed new regulatory regime. For example, Ofcom states:

> "*The dynamic, forward-looking benefits of platform innovation that would be likely to result from a wholesale must-offer remedy are impossible to forecast with any degree of certainty".*[39]

11.61 If benefits are "*impossible to forecast with any degree of certainty*", little weight can be placed on them in a cost benefit analysis.

11.62 Indeed, where, as here (see **Part II** of this Section below) there are significant costs from regulation arising from harm to dynamic competition which are also difficult to quantify, a regulator with a bias against regulation must sensibly refrain from intervention, given the risk that any benefits of intervention may be outweighed (potentially very substantially) by its costs.

L. Inadequate consideration of the impact on competition

11.63 Ofcom's guidance on impact assessment states:

> "*Given Ofcom's commitment to promoting open and competitive markets, it will normally be appropriate to identify any impacts which each of the options would have on competition*".[40]

11.64 Ofcom's guidance also states that "*identifying any impacts on competition*"[41] will be one of the main stages in its production of an impact assessment.

11.65 Yet, despite the clear potential for a number of aspects of its proposed new regulatory regime to result in substantial distortions to competition, including lessening of competition,[42] Ofcom's impact assessment in this case devotes only brief attention to this matter.

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[38] See footnote 10 on page 109 of Sky's Response to Ofcom's Second Consultation Document. This stated: "*Ofcom should compare the costs of intervention against its benefits. Where Ofcom considers that there is uncertainty about whether a potential cost that has been identified will arise, Ofcom should **further** evaluate the probability (i.e. the **risk**) of that cost arising.*" (Emphasis in the original.)

[39] Paragraph 10.45 of the Consultation Document.

[40] Paragraph 5.22 of Better Policy Making.

[41] Paragraph 5.4. of Better Policy Making.

[42] For example, Ofcom's proposals may have a significant impact on Sky's incentive and ability to compete with other operators.

11.66 Ofcom's principal concern in relation to potential negative impacts on competition is in terms of a potential reduction in competition for programming rights. Ofcom states:

> "*if the remedy led to a reduction in competition for rights, then we might also expect a reduction in the value of bids* [for rights]".[43]

11.67 After a relatively short discussion of this matter, Ofcom simply concludes:

> "*Our view overall is that the risk of a wholesale must-offer remedy (set on a retail-minus basis) leading to significantly lower rights values than under the counterfactual is low*". [44]

11.68 Not only is such a cursory analysis insufficient, it is also likely to be erroneous. For example, it has already been contradicted by the Chief Executive of Virgin Media who has confirmed publicly that obtaining regulated access to Sky's premium channels at discounted charges means that Virgin Media was correct in choosing not to compete directly for rights to the content carried on those channels.[45]

11.69 More generally, however, it is evident that the potential effects of Ofcom's proposals affect competition in a number of areas other than in relation to programming rights, which Ofcom has not assessed at all.

M. Net benefit estimates must be placed in context

11.70 As discussed above, the non-transparent nature of Ofcom's impact assessment means that it is not actually possible to determine what Ofcom considers the total value of the net benefit of its proposals to be. Notwithstanding this problem, it is clear that Ofcom does not seek to place its net benefit estimates in any meaningful context. In order to determine whether any net benefit estimates are material, they need to be evaluated against some relevant comparator - for example, by comparing net benefit estimates against the turnover of the pay TV sector, or some other such measure.

N. It is unclear what Ofcom's conclusion Ofcom draws from its impact assessment

11.71 The fact that Ofcom appears to view its impact assessment as something of an 'add-on' to the process of developing its proposed new regulatory regime is further indicated by the observation that Ofcom does not draw any firm conclusion from its analysis. For example, Ofcom does not indicate clearly at any point – either in Section 10, or elsewhere in its Consultation Document – that, on the basis of its impact assessment, it is able to conclude that the benefits of its proposals outweigh their costs.

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43 Paragraph 10.78 of the Consultation Document.

44 Paragraph 10.86 of the Consultation Document.

45 See further the discussion of this matter at **Section 6** above.

O. The consequences of Ofcom's failure to undertake a valid impact assessment of an adequate standard

11.72 Ofcom's failure to undertake a valid impact assessment of an adequate standard means that it cannot reach a conclusion that it should proceed to implement its proposed regulatory regime. Currently, Ofcom does not have sufficient information and evidence available to it to reach a conclusion that each component of its proposals is necessary and proportionate, and, as set out in **Section 10** of this Response, there are strong grounds for considering that they are not necessary and proportionate.

11.73 Given the clear case law on this matter, Ofcom must now undertake an impact assessment of an adequate standard on each of the elements of its proposals and re-consult on that analysis. Failure to do so would comprise a clear and serious breach of Ofcom's duty under section 7 CA03.

11.74 Without prejudice to that conclusion, Sky sets out in Part II of this Section below its reasons for saying that such estimates as Ofcom has attempted to make of the costs and benefits of its proposed new regulatory regime are wholly inadequate and unfit for purpose.

Part II

Ofcom's estimates of the value of the costs and benefits of its proposed new regulatory regime

11.75 In this **Part II** of this Section of Sky's Response, we examine Ofcom's evaluation of the costs and benefits of its proposals.

A. Benefits

11.76 Ofcom divides the benefits from its proposals into two types: static benefits, and dynamic benefits. We discuss Ofcom's approach to (i) static benefits; and (ii) dynamic benefits below.

(i) Static benefits

11.77 Ofcom seeks to estimate the value of the "*static benefits*" that it expects to arise from its proposed new regulatory regime by estimating the additional consumer and producer surplus that would, in Ofcom's view, arise by comparison with a situation in which that new regulation was not introduced.

11.78 In light of the fundamental flaw that arises from Ofcom's use of an inappropriate counterfactual, we do not propose to comment in detail on Ofcom's calculation of the value of additional consumer and producer surplus that it considers would be generated as a result of the imposition of a new regulatory regime on Sky. In the following discussion, we have instead set out a number of observations to which Ofcom should have regard in preparing its revised impact assessment.[46]

11.79 Ofcom's approach to evaluation of consumer and producer benefits that would arise from the introduction of new regulation adopts an approach that is highly unlikely to be able to withstand profound and rigorous scrutiny. In essence, Ofcom attempts to estimate the consumer and producer surplus generated by the provision of all pay TV services in two states of the world – with its proposed new regulation, and without it. The impact of the new regulation on total welfare (*i.e.* the sum of consumer and producer surplus) is therefore the difference between the two estimates.

11.80 Such an approach requires sophisticated analysis, based on substantial evidence, in order to produce results that are soundly based. It is likely to require input from economic experts – in the same way, for example, that Ofcom sought the assistance of Oxera in relation to the assessment of profitability – and a considerable amount of consumer research.

11.81 To see this, it is necessary only to observe that Ofcom's approach requires it to establish the total amount of consumer surplus generated by the provision of

46 Sky reserves the right to comment more fully on Ofcom's analysis in the event that Ofcom chooses not to undertake a proper impact assessment and re-consult on that impact assessment.

pay TV services in the UK in each of the next five years, absent intervention. That is a challenging task. For example it requires:

- soundly based understanding of the willingness to pay of UK households for a range of different types of pay TV services (*e.g.* (i) basic-only packages, (ii) packages of basic plus premium sports channels, (iii) packages of basic plus premium movie channels, and (iv) packages that include basic, premium sports and premium movie channels) on a range of different platforms (including those that do not yet exist) and how these values might change in the future; and

- consideration of how consumer demand for bundles of TV and non-TV services (e.g. broadband, fixed line telephony, mobile telephony) should be dealt with in such an analysis; and

- consideration of how consumers value other aspects of the services available to them via different platforms – such as Sky+, high definition television services, free to air television services, VoD services and so on.

11.82 Yet dealing properly with such issues comprises only a single element of the analysis in which Ofcom is engaged.

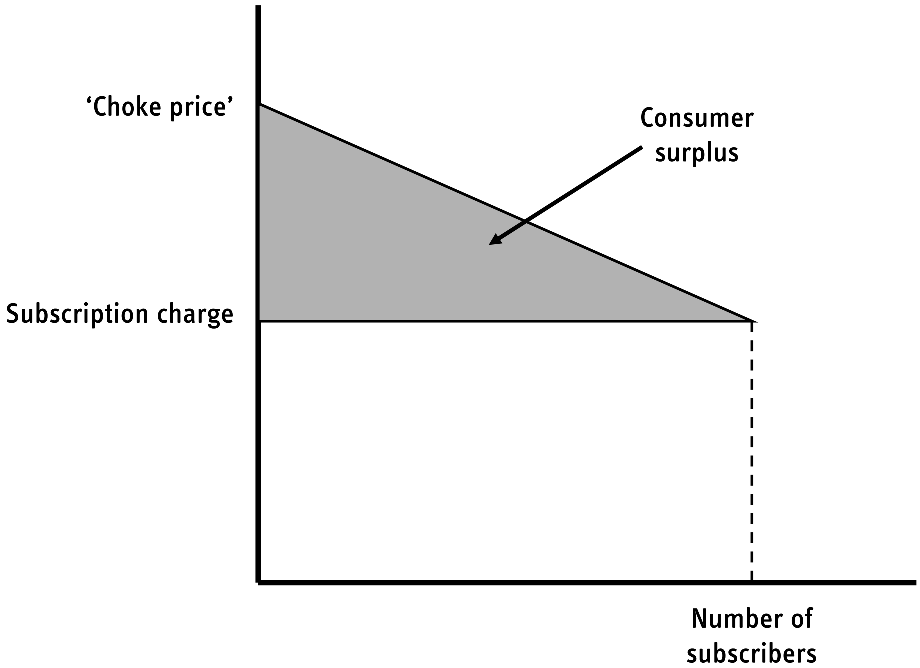
11.83 Ofcom's current approach, however, (a) is only slightly more sophisticated than what is known colloquially as 'back of the envelope' calculations, (b) by Ofcom's own admission,[47] is not supported by any relevant evidence base, and (c) does not appear to have input from external experts in demand analysis.

11.84 The unsophisticated and non-evidence-based nature of the analysis is well illustrated by looking at two of the key drivers of Ofcom's results: 'choke prices' and the shape of demand curves.

11.85 Ofcom's approach to the measurement of consumer surplus is based on a simple approach of estimating the area of a triangle in which the base is the number of subscribers to a pay TV service, and the height of the triangle is given by the difference between a notional 'choke price' and the price charged to consumers, as indicated in the diagram below. The 'choke price' is the price which, if charged, would result in demand for the service falling to zero. The 'choke price' will be essentially around the value which the household with the highest willingness to pay would be prepared to pay to receive the service. The approach assumes that demand is linear between the choke price and the market price.

[47] Letter from Steve Unger to James Conyers of 1 September 2009.

Figure 11.4



11.86 Accordingly, this approach places enormous weight on:

- the assumption that demand is linear over the relevant range;
- the value assumed for the choke price. If demand is linear, then the estimate of consumer surplus is highly sensitive to the assumed choke price. For example, if a particular service currently has 1 million subscribers at a subscription charge of £30 per month, consumer surplus generated by that service will be estimated to be £60 million per annum at a choke price of £40 per month (1/2 x 1m x (£40 – £30) x 12), and £120 million per annum at a choke price of £50 per month (1/2 x 1m x (£50 – £30) x 12); and
- subscriber numbers. Given that Ofcom's exercise is a forward looking one, this involves forecasting subscriber numbers for a large number of different pay TV services.

11.87 Given the central role of choke prices in Ofcom's analysis, it might be anticipated that they would be based on robust evidence and analysis. In fact, however, they appear simply to be 'assumptions'. When Sky requested the evidence and analysis that underpinned Ofcom's views on the choke prices included in its modelling, Ofcom replied:

> "*Choke prices are based on best estimates given our understanding of the market. Given the inevitably inexact nature of these estimates, they were subject to sensitivity analysis.*"[48]

[48] Letter from Steve Unger to James Conyers of 1 September 2009.

11.88 This would appear to be a statement that the choke prices used in the modelling are not based on any relevant evidence, but are instead based on introspection on Ofcom's part. That is clearly an inadequate basis for these critical inputs into Ofcom's analysis.

11.89 Similarly, estimates of consumer surplus will depend on the shape of demand curves for particular services. As discussed above, Ofcom's approach assumes that the demand curve for pay TV services is linear over the range in which consumer surplus is measured. Accordingly, it would be expected that Ofcom would provide some evidence or analysis in support of such an assumption. Again, however, no such evidence or analysis appears to exist. When questioned on the support for its assumption that demand is linear over the relevant range, Ofcom stated:

> "*we had insufficient information available to determine the exact shape of the demand curve. In the absence of such information, we have worked on the basis of a linear curve in order to make the modelling exercise more tractable.*"[49]

11.90 Again, this appears to be a somewhat veiled admission that the assumption of a linear demand curve is not evidence-based.[50]

11.91 There is no good reason to believe that demand for pay TV services is linear in nature. It is perhaps instructive that the demand curves estimated by Ofcom in its revised impact assessment in relation to mobile number portability, which are derived from consumer research, are not linear. The same choke price and a non-linear (convex) demand curve would produce a significantly smaller consumer surplus than if a linear demand curve is assumed, as illustrated below.

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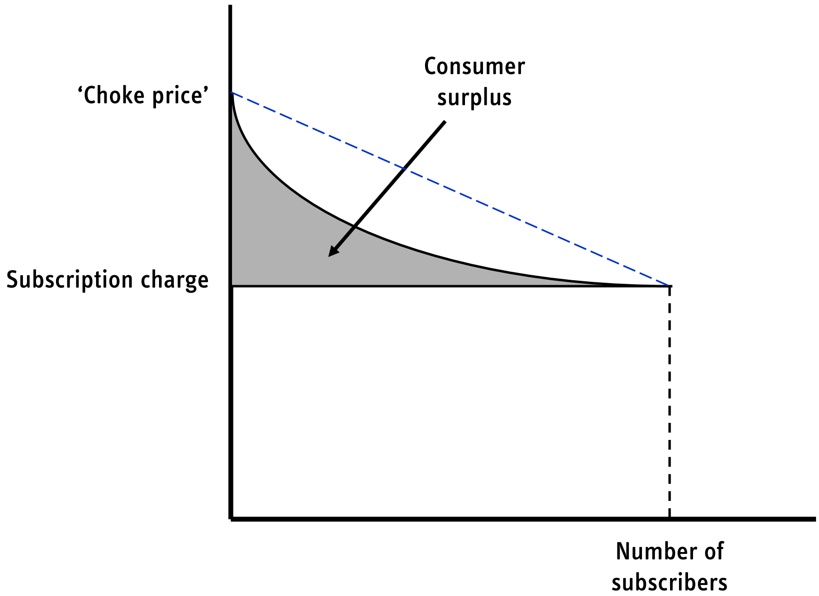
49 *Ibid.*

50 In Sky's view, it is likely that the statement that Ofcom had "***insufficient** evidence available to determine the **exact** shape of the demand curve*" (emphasis added) is wholly misleading. We suspect strongly that Ofcom has **no evidence** available to it that would indicate the shape of the demand curve over the relevant range (whether exactly or otherwise).

Figure 11.5



11.92 The analysis of changes in consumer and producer surplus arising from the introduction of Ofcom's proposed new regulatory regime becomes an order of magnitude more complex again if prices for services are assumed to change as a result of Ofcom's policy – as Ofcom appears to consider may be the case.[51] Deriving soundly-based estimates of changes in consumer surplus with changing prices would require, for example, robust estimates of cross-price elasticities of demand – which in turn would need to be derived from soundly-based econometric research. As far as Sky is aware, Ofcom has undertaken no such research itself, nor commissioned any such research. Accordingly, it is impossible to see how Ofcom considers that it could examine changes in consumer and producer surplus in scenarios in which prices are assumed to change.

Ofcom's forecasts of the number of subscribers to Sky's premium channels on new pay TV services

11.93 Changes in the number of subscribers to Sky's premium channels over time are a significant determinant of Ofcom's benefit estimates. Since the publication of its Second Consultation Document, Ofcom has asserted that the introduction of its new regulation would increase the total number of subscribers to Sky's premium channels, and this is a key driver of its belief that its proposed new regulation would increase both total welfare and Sky's profitability. (Again, the discussion in this Section sets to one side the fact that some degree of expansion would be expected absent Ofcom's intervention and therefore such an expansion cannot wholly be attributed to that regulation.)

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51 As indicated at paragraph 10.25 of the Consultation Document, where Ofcom states that it has examined changes in its estimates of costs and benefits with "*alternative assumptions about relative retail prices*".

11.94 In Ofcom's base case, Ofcom assumes that, after five years there would be 2 million households subscribing to Sky's premium channels via new pay TV services. Of these, around **[CONFIDENTIAL]** are additional (or 'incremental') subscribers – households who would not have subscribed to services that include Sky's premium channels in the absence of the new pay TV services – and around **[CONFIDENTIAL]** are households who are assumed to switch from an existing service to one of the new pay TV services. We discuss Ofcom's evidence and analysis related to each of these in the sub-sections below.

Incremental subscribers

11.95 Ofcom forecasts that there would be an additional **[CONFIDENTIAL]** households subscribing to Sky's premium channels as a result of its proposed new regulation. This is a very substantial increase above the current number of subscribers to those channels – a **[CONFIDENTIAL]** % increase - particularly having regard to the fact that the number of subscribers to such channels has been fairly flat over the past few years (in the case of Sky's sports channels) or declining (in the case of Sky's movie channels) despite falling charges for those services in real, value adjusted terms.

11.96 In these circumstances, it would be expected that Ofcom's forecasts of the number of subscribers to Sky's premium channels would be based on careful analysis of relevant evidence. Instead, however, Ofcom cites only two bases for its forecasts: research undertaken for Sky in relation to its proposed Picnic service, and research carried out by Freeview in 2007. Ofcom states:

> "*Our central estimate of 2 million subscribers after five years has been informed by research into consumers' interest in pay TV services on DTT undertaken by Sky and Freeview*".[52]

11.97 Ofcom also states:

> "*Sky estimated (in April 2008) that around **[CONFIDENTIAL]** households would subscribe to premium content on its proposed Picnic service within five years of launch, equivalent to around **[CONFIDENTIAL]** per cent of DTT-only households. More generally, research carried out by Freeview in November 2007 found that around 22 per cent of Freeview users would definitely or probably consider paying either a monthly or one-off fee to access more channels/programmes in addition to Freeview's channels.*"[53]

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[52] Footnote 559 of the Consultation Document. The figure of 2 million subscribers includes around **[CONFIDENTIAL]** subscribers who are forecast to switch from other providers.

[53] Paragraph 10.34 of the Consultation Document.

Picnic projections

11.98 The best source of Sky's projections of the level of potential demand for Sky's Picnic service is its business plan, rather than the consumer research carried out for Sky cited by Ofcom. Consumer research provides a very useful input into business planning, but it is only one input amongst many and companies in the real world, including Sky, are always cautious about relying on it to too great an extent. A business plan combines the insights delivered by consumer research and the deep experience of teams of people whose task it is to develop and market services to consumers. Moreover, that business plan was submitted to, and approved by, Sky's Board. Accordingly, it is surprising that Ofcom places no weight at all on Picnic's business plan as a source of soundly based estimates of the number of incremental subscribers that might be expected to be generated by the introduction of new pay TV services.

11.99 Picnic's business plan forecast that it would achieve around **[CONFIDENTIAL]** incremental premium subscribers after five years – less than **[CONFIDENTIAL]** the level assumed by Ofcom. Ofcom's forecasts include services other than Sky's own – there are assumed to be three new pay TV services - but even taking this into account, the difference between Picnic's business plan and Ofcom's subscriber forecasts is substantial. The development of new services would be likely to generate some level of incremental subscribers, particularly if each was differentiated in some way. It seems entirely improbable, however, that this would be sufficient to **[CONFIDENTIAL]** the total number of incremental subscribers to Sky's premium channels.

11.100 Similarly, Ofcom clearly hopes that Virgin Media might spend some of the windfall that Ofcom plans to deliver to it via Ofcom's mandated reductions in Sky's charges on increasing its premium channel subscriber base. Even if such a speculative hope could form a sound basis for an expectation of an expansion in demand for Sky's premium channels (which it does not) it is evident that it would be difficult for such an effect to account for the significant gap between Ofcom's forecasts and the Picnic business plan.

11.101 The substantial gap between the projections in Picnic's business plan, and Ofcom's forecasts of the number of incremental subscribers is likely to remain even if these two effects are combined.

11.102 This view is reinforced by the facts that:

(a) as discussed in **Part II** of **Section 10** above, Sky now regards its Picnic business plan as potentially ambitious, in light of our understanding of the number of subscribers Setanta premium sports channel attracted via DTT;

(b) the Picnic business plan was for the launch of a new service in 2008, whereas any new service launched as a result of the introduction of Ofcom's new regulatory regime would begin in 2010 at the earliest. In the interim, to the extent that there are potential new premium subscribers, Sky will have attracted many of them: digital switchover has commenced leading some former analogue households who would otherwise have considered Picnic to choose other options, and Sky has found other ways to reach consumers (such as Sky Player and a focus on Sky Homes to help consumers in MDUs access satellite pay TV services); and

(c) Sky develops long-term business plans, such as the Picnic business plan, on a 'stretch' basis – i.e. that Sky's Board expects that targets in such plans are demanding as opposed to being easily achievable.

11.103 Accordingly, it must be concluded that Sky's own analysis provides no support for Ofcom's forecast of an incremental **[CONFIDENTIAL]** subscribers to Sky's premium channels on new pay TV services after five years.

Freeview research

11.104 It is simply astonishing that Ofcom regards it as appropriate to cite repeatedly the Freeview research as a basis for its subscriber forecasts. Even the most cursory of examinations indicates that it cannot provide any support at all for Ofcom's views.

11.105 Ofcom relies on a single finding from that research, namely that:

> "*around 22% of Freeview users would definitely or probably consider paying either a monthly or one-off fee to access more channels/ programmes in addition to Freeview's channels*".[54]

11.106 The problems with relying on this as a basis for a conclusion about demand for Sky's premium channels among DTT households are readily apparent:

- the question put to consumers in the Freeview research covered two potential services – one where consumers pay a "*one-off fee*" to receive more "*channels/ programmes*", as well as a standard subscription service in which consumers pay a monthly fee for more "*channels/ programmes*". Although it is difficult to see what type of service those who created the survey had in mind when they asked about a "*one-off fee*" for more "*channels/programmes*", the fact that the question also covered consumers' interest in such a service means that no conclusions can be drawn from its results about propensity to take a standard subscription service with a monthly fee;

- the question asks only whether consumers would "*consider*" adopting such services. Accordingly, those who answered in the affirmative were indicating only that they would consider adopting those services, not whether they *would* adopt one of these types of service. It is likely to be the case that those who would actually proceed to adoption comprise a sub-set of those who would consider doing so.

  This is particularly important because no details of prospective services – in particular, prices – were put to interviewees. It is entirely clear

[54] Paragraph 7.67 of the Consultation Document.

that, without a clear indication of the prices that would be charged for the services in question and the details of them, little or no weight can be placed on consumers' expressions of interest in a hypothetical service;

- it is well-known that surveys that ask consumers about hypothetical situations are likely to suffer from "*hypothetical bias*" – a likelihood that stated intentions significantly overstate actual intentions when faced with a real situation.[55] Indeed, it is somewhat surprising that Ofcom does not recognise this possibility in this instance, in view of the fact that it has placed a great deal of weight on such a survey bias (which calls "*stated preference bias*") in dismissing the relevance of consumer survey evidence it obtained in a consumer survey it undertook in relation to market definition.[56] Ofcom appears to be using evidence in a wholly illegitimate way: ignoring a well-known survey bias when it wishes to rely on survey evidence that purportedly assists the case it wishes to advance, and citing that survey bias in relation to consumer survey evidence that undermines the proposition that it is seeking to advance.

  One of the findings of the literature on hypothetical bias is that it can be overcome by careful framing of questions and asking consumers follow-up questions about their certainty about their answers.[57] It has been found that such a bias can be substantially eliminated by focusing on the responses of consumers who state that they are 'definitely sure' that they would undertake a proposed course of action. The summary of the Freeview research provided to Sky indicates that only 5% of respondents – less than a quarter of the 22% that Ofcom cites – would "*definitely*" consider the two types of services put to them.[58] Accordingly, this would appear to be the more appropriate figure for the purposes of Ofcom's analysis (to the limited extent that the Freeview research is at all relevant to Ofcom's analysis);

- consumers were asked only about their preference in relation to "***more channels/ programmes** in addition to Freeview's channels.*" It is blindingly evident that this question cannot be relied on in support of a proposition that there is significant unmet demand for *Sky's premium sports and film channels.* There is simply no way of knowing what "*channels/ programmes*" that the 22% of survey respondents who answered that they would definitely or probably consider such services had in mind when they answered in the affirmative.

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55 See, for example, Patricia A. Champ, Richard C. Bishop and Rebecca Moore, "Approaches *to Mitigating Hypothetical Bias*". Available at: http://www.cof.orst.edu/cof/fr/facultypages/rosenberger/W1133%20Proceedings/Interim Report 18%20(2005)/IR18 8.pdf

56 See paragraph 4.144 of the Consultation Document.

57 *ibid.*

58 Page 5 of TNS Media research report "*Pay Services on DTT and proposed Picnic launch*", provided to Sky on 13 July 2009.

Ofcom appears to recognise this difficulty and argue that:

> "*While this research did not specify which channels consumers would particularly like to take up via DTT, our own consumer research indicates that sports and movies are the two most popular genres where there is a high degree of exclusivity to pay TV*".[59]

Not only is the inference that Ofcom is seeking to make – that it can be inferred that consumers who answered in the affirmative did so because they were interested in "*sports and movies*" – unreasonable, the reason given by Ofcom's for that inference is without merit: there is not "*a high degree of exclusivity to pay TV*" in relation to the sports and movie "*genres*". There is a vast array of sports programming available on free to air television, and movies are clearly available via a wide range of services other than premium pay TV channels. Furthermore, Ofcom's mono-causal view of the reasons that people subscribe to pay TV services once again leads it to erroneous conclusions or false arguments. There are more than **[CONFIDENTIAL]** UK households who subscribe to pay TV services that do not include any premium sports or movie channels, and basic-only subscribers currently comprise **[CONFIDENTIAL]** of Sky's net additions to its subscriber base.[60]

11.107 Accordingly, it is entirely evident that no weight at all could be placed on Freeview's research as a basis for Ofcom's incremental subscriber forecasts, and it is of considerable surprise that Ofcom seeks to do so. Indeed, if the research could be taken at face value then we would expect Top Up TV to have been considerably more successful than it actually has been.

<u>Ofcom's lack of consumer research</u>

11.108 The issue of the level of demand for a DTT-based service that included Sky's premium channels lies at the heart of Ofcom's case for its proposal to impose an intrusive and burdensome new regulatory regime on Sky. In such circumstances, it would be expected that Ofcom would have carried out its own research on this matter. Ofcom does not suffer any evident constraint on its resources in relation to undertaking research – it has commissioned copious amounts of research during its pay TV inquiry, including research on the most esoteric of subjects.

11.109 It is, therefore, simply astonishing that Ofcom has not seen fit to seek to base its view that its proposed new regulatory regime would result in a significant expansion in demand for Sky's premium channels on robust consumer survey evidence and instead chooses to cite others' research which is manifestly unsuitable for that purpose. This is especially surprising in view of the fact that Ofcom's forecasts are [**CONFIDENTIAL**] of those in Sky's Picnic business plan.

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59 Paragraph 7.67 of the Consultation Document.

60 Sky made this point to Ofcom in its Response to Ofcom's Second Consultation Document. (See paragraph 3.22 of Section 5 of Sky's Response to the Second Consultation Document.)

11.110 Ofcom's failure to undertake any research of its own on this issue is inappropriate for an evidence-based regulator, as well as rendering its estimates of the benefits that could arise from the introduction of its new regulatory regime wholly unreliable. It demonstrates a blatant disregard for the judgment of the CAT in *Vodafone v. Ofcom*, that requires that estimates of costs and benefits included in Ofcom's impact assessments must be "*soundly based*".[61]

Switchers

11.111 Ofcom also forecasts that there would be a very substantial number of existing pay TV subscribers who would switch to its proposed new pay TV services – around **[CONFIDENTIAL]** in Ofcom's base case. In this case, however, Ofcom cites no evidence at all for its belief. The estimate appears to be entirely assumption-based.

11.112 There are two reasons to believe that Ofcom's assumed number of switchers is very significantly in excess of a reasonable forecast.

11.113 First, loss of subscribers to rival pay TV businesses would be extremely costly to Sky and Virgin Media.[62] As a result, it might be expected that both firms would compete fiercely to prevent such switching. This would be particularly the case for Sky, given that under Ofcom's proposed regulatory regime it would earn substantial retail margins.

11.114 Ofcom fails entirely to appreciate such an incentive to prevent switching because it significantly underestimates the cost to Sky of losing subscribers to alternative services. For example, it fails to factor in the contribution that Sky would earn from lost subscribers on products such as multiroom, HD, PPV, telephony and broadband.

11.115 Second, it is evident that in the real world (as opposed to Ofcom's models) the variety of pay TV services available via DTT would be considerably more limited than that available via cable and satellite, due to the inherent capacity constraints faced by operators using DTT technology. In such circumstances, given Ofcom's assumption that its proposed 'DTT/IPTV' services are priced at the same level as those on satellite and cable, it is extremely difficult to see what might be expected to motivate around **[CONFIDENTIAL]** households who currently subscribe to premium pay TV services via satellite and cable to switch to the new services. This is particularly the case in a world in which increasing numbers of subscribers take a range of non-TV services from Sky and Virgin Media, and in which those suppliers offer popular TV services such as HD, PPV, PVRs, VoD and a wide range of channels, many of which may not be available from a DTT operator.

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61 Paragraph 46 of *Vodafone v. Ofcom.*

62 Sky and Virgin Media incur significant costs in acquiring subscribers ("SAC"), which provides a strong incentive to retain a customer for a sufficient period of time to recover such costs.

Subscriber numbers: summary and conclusion

11.116 Ofcom's forecast of 2 million households subscribing to Sky's premium channels after 5 years via services other than Sky's DTH satellite service and Virgin Media's cable service plays a key role in its estimates of the benefits of Ofcom's proposed new regulation. Accordingly, it would be expected that this forecast would be based on thorough, soundly-based research – particularly research which Ofcom had undertaken itself. Instead, however, Ofcom has no sound basis for this forecast; it is completely unreliable. As a result, on this basis alone, Ofcom's estimates of the benefits that it considers would arise from its proposed new regulation are unreliable.

Producer surplus

11.117 Ofcom's estimates of additional producer surplus are also unreliable. In the first instance, as with consumer benefits they are positive primarily because they are evaluated against an erroneous counterfactual.

11.118 Ofcom's view that there would be substantial gains in Sky's profits as a result of introducing its proposed new regulation (as indicated by Ofcom's impact assessment), is wholly inconsistent with a proposition that Sky has an incentive to withhold its channels from new platforms. Ofcom describes its view as "*surprising*".[63] As discussed in **Section 10**, above, it is perverse and wrong.

Consumer and producer surplus: summary and conclusions

11.119 Even setting to one side the key flaw in Ofcom's analysis of "*static benefits*" – that it is based on an erroneous counterfactual – it is clear that Ofcom's estimates of the value of such benefits that, in Ofcom's view, would be generated as a result of the introduction of its proposed new regulation, are wholly unreliable. Ofcom has adopted a demanding approach to the determination of such benefits, yet its analysis is unsophisticated. Above all, however, the values that Ofcom has used for a range of the key inputs into that analysis are either not evidence based, or not based on reliable evidence. As a result, no weight can be placed on Ofcom's estimates of the additional consumer and producer surplus that might be generated as a result of the introduction of Ofcom's proposed new regulation.

11.120 Sky notes that the criticisms set out above in relation to Ofcom's estimates of consumer and producer surplus are illustrative rather than exhaustive – they are intended to illustrate the key point that Ofcom's approach is unlikely to produce meaningful estimates of changes in welfare arising from the introduction of Ofcom's proposed new regulation. We have adopted this approach in light of the numerous and obvious flaws in Ofcom's impact assessment, and the limited time available to Sky to respond to the range of important issues raised by Ofcom's Consultation Document. Accordingly, Sky reserves the right to adduce a fuller critique of Ofcom's analysis if Ofcom chooses to continue to rely on that analysis as it stands.

63 Paragraph 10.4 of the Consultation Document.

(ii) Dynamic benefits

11.121 Ofcom argues that the dynamic benefits arising from its proposed new regulation are of "*particular importance*".[64]

11.122 Again, in evaluating Ofcom's claims it is again necessary to bear in mind that the relevant test is the extent to which Ofcom's proposed new regulation gives rise to greater innovation by firms than would be the case absent that regulation. In other words, as with static benefits, it is necessary for Ofcom to demonstrate that there would be significant dynamic benefits *over and above those that would be anticipated in the absence of its proposed regulation.*

11.123 Compared to a realistic counterfactual in which Sky's channels would become available via DTT-based platforms, the incremental benefit from Ofcom's proposed new regulation in terms of generating additional platform and retail innovation is likely to be negligible. Again, the remainder of this discussion is without prejudice to this point.

11.124 One of the most glaring features of Ofcom's consideration of dynamic benefits is the juxtaposition of statements that such benefits are a particularly important basis for Ofcom's proposed new regulatory system, and statements that such benefits are 'impossible to predict' (and therefore impossible to measure). For example, Ofcom states:

> "*We **would expect** additional dynamic benefits, due to retail and platform innovation. The effects of these are **difficult to quantify**, but we attach **particular importance** to the dynamic benefits to consumers associated with the effective exploitation of new distribution technologies, notably IPTV.*"[65]
>
> "*the dynamic benefits which **we expect to arise** from* [retail] *innovation are **difficult to quantify**, but **should be significant**.*"[66] (Emphasis added)
>
> "*The dynamic, forward-looking benefits of platform innovation that **would be likely to result** from a wholesale must-offer remedy are **impossible to forecast with any degree of certainty**, and we have therefore not sought to do so.*"[67]
>
> "*The forward-looking benefits of retail innovation that **would be likely** to result from a wholesale must-offer obligation are as **difficult to quantify** as the benefits of platform innovation. By definition, **we cannot predict** the sorts of retail innovation that might emerge.*"[68]

11.125 It cannot be appropriate for Ofcom to argue that benefits that are impossible to predict are a key basis for the imposition of significant new regulation on Sky.

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64 Paragraph 10.2 of the Consultation Document.

65 Paragraph 1.69, repeated at paragraph 10.2 of the Consultation Document.

66 Paragraph 1.70 , repeated at paragraph 10.3 of the Consultation Document.

67 Paragraph 10.45 of the Consultation Document.

68 Paragraph 10.48 of the Consultation Document.

Otherwise, any regulatory proposal could be justified simply by its proponent pointing to "*significant*" but completely unpredictable incremental dynamic benefits that are claimed to arise from it (or "*should*" arise from it).

11.126 Sky does not suggest that Ofcom should be required to engage in futurology, and we do not seek to argue that it is necessary for dynamic benefits to be quantified if it is unrealistic to do so.[69] But if Ofcom is to place a significant amount of weight on dynamic benefits, as it does, it is necessary for Ofcom to demonstrate to a reasonable standard that significant incremental dynamic benefits are more likely than not to emerge as a result of its proposed regulation – for example by clearly setting out the types of innovations that might be expected, why they might be expected to arrive as a result of the regulation but not otherwise, and how consumers would benefit from them. It cannot be sufficient simply to assert that they will be, or "*should be*", significant, or that benefits 'would be expected'. Such claims must instead be backed up by relevant evidence and analysis.

11.127 In particular, if restricted distribution of Sky's premium channels was in fact holding back retail or platform innovations as claimed by Ofcom it might be anticipated that there would be good examples of innovations that had already occurred elsewhere which were being inhibited in the UK. The extensive and comprehensive research undertaken by PwC,[70] which has been submitted to Ofcom, demonstrates that this is not the case.[71]

11.128 It is notable in this respect that where Ofcom attempts to set out the types of platform and retail innovations that might potentially be anticipated to arise as a result of its proposed new regulation they are either highly confused or erroneous.

11.129 For example, Ofcom states:

- "*the platform innovations that have emerged in recent years, e.g. VoD movie services on Virgin Media's cable network and Tiscali's and BT's IP* (sic) *networks, illustrate the kinds of benefits that consumers might enjoy. Moreover, the remarkable success of innovations such as the BBC's iPlayer suggests that on-demand services are likely to be increasingly popular with consumers in the future.*"[72]

11.130 There is perhaps no better illustration of the confusion in Ofcom's arguments than these statements. First, the fact that BT has been able to develop VoD movie services without retailing Sky's channels demonstrates that wholesale supply of those linear channels is not necessary for this type of innovation, and so would seem to undermine Ofcom's case for its proposed new regulation

69 Guidance on impact assessment generally indicates that, if costs and benefits cannot be quantified, they should at least be properly evaluated. See, for example, paragraph 5.30 of *Better Policy Making*.

70 Annex 1 of Sky's Response to the Second Consultation Document.

71 Sky's discussion in Part D of **Section 8** demonstrates that there is no lack of innovation in the UK.

72 Paragraph 10.45 of the Consultation Document.

rather than support it. Second, Ofcom's argument in relation to Tiscali appears to support Sky's view that it is not necessary for third party platform operators to retail Sky's premium channels in order for them to be able to develop their platforms, including the development of their VoD capabilities. This point is supported by the experience in France where IPTV platforms have developed successfully even though the platform operators do not themselves retail premium sports and movie channels – Canal+ self-retails its premium channels over those platforms.

11.131 Third, it is wholly unclear what relevance Ofcom considers the development of the BBC's iPlayer service has to its arguments. As far as we can see, it simply and clearly demonstrates both the powerful position held by the BBC as a driver of technological innovation in relation to audiovisual services in the UK, which is a factor that is entirely ignored in Ofcom's analysis more generally, and the fact that consumers have an appetite for content delivered free of charge, which is a consideration that is not properly reflected in Ofcom's market definition analysis.

11.132 As another example, Ofcom states:

> *"retail innovation that has emerged in recent years built around access to Setanta's Core Premium channel illustrates the kinds of benefits that consumers might see following the implementation of a wholesale must-offer remedy. Those examples include the availability of Setanta Sports 1 as part of smaller retail packages from BT Vision and Top Up TV and Top Up TV's "season ticket", which gave new customers a free season ticket to Setanta Sports 1 for the 2008/09 FAPL season."*[73]

11.133 Sky addressed these erroneous propositions in its response to Ofcom's previous consultation document. For example, as we have indicated previously "*the availability of Setanta Sports 1 as part of smaller retail packages from BT Vision and Top Up TV*" is entirely normal in relation to DTT-based television services (as considerable amounts of international evidence make clear[74]), and is a function of the capacity constraints of that platform. Sky's proposed Picnic service would also have comprised "*smaller retail packages*" for this reason. Where Setanta did not face such capacity constraints (on the DTH satellite platform) it offered its channels only as part of a broader bundle of channels with no opportunity for consumers to buy a subset of those channels at a lower price.

11.134 Similarly, as Sky has noted previously, the practice of offering consumers discounted or free services (in order to seek to earn revenue streams from them elsewhere, or at a later date) is not innovative. It is a tried and tested approach to marketing in relation to pay TV services.

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73 Paragraph 10.48 of the Consultation Document.

74 See the Second PwC Report, submitted as Annex 1 of Sky's Response to the Second Consultation Document.

11.135 Accordingly, the examples cited by Ofcom do not in any sense 'illustrate' "*the kinds of benefits that consumers might see following the implementation of a wholesale must-offer remedy.*"

11.136 Ofcom's failure to recognise that the introduction of a new DTT-based pay TV service is unlikely significantly to affect the pace of innovation in relation to the provision of audiovisual services in the UK stems from its flawed framework of analysis. Because Ofcom fails to recognise the strength of competition between providers of pay TV services and providers of free to air television services, it overlooks entirely the impact of such competition on the development of innovative new products and services.

11.137 The simple fact is that Sky faces intense competition from a strong free to air television sector – at the heart of which sits the BBC with guaranteed annual funding of £3.5 billion per annum – in addition to competition from other paid-for products and services, which, together, mean that Sky needs continually to innovate in order to attract and retain subscribers to its services. Indeed, as we note above, it is somewhat ironic that Ofcom cites "*the remarkable success*" of the BBC's iPlayer – a service developed by the licence fee funded BBC, devoted solely to delivery of content for free – as an example of the types of innovations that Ofcom considers would be the result of its proposed intervention.

11.138 The second major reason why Ofcom's perspective on this matter is flawed is that it fails to appreciate that technological development in relation to audiovisual services is independent of whether firms provide content to consumers on a paid-for or 'free' basis. For example, one of the key drivers of the development of video-over-the-internet services has been YouTube – a service that is entirely free to users.

11.139 The reality is that the sponsoring by Ofcom of the development of a new retail pay TV business on a platform that is severely constrained in its ability to provide consumers with attractive audiovisual services in the long term, is unlikely to make any difference at all to the pace of innovation in relation to the provision of audiovisual services to consumers.

B. Costs

11.140 The judgment of the CAT in *Vodafone v. Ofcom* makes it clear that it is expected that Ofcom should carry out assessment of the costs and benefits of its regulatory proposals with 'appropriate care and attention'. Ofcom's analysis of the costs that would be likely to arise from the introduction of its proposed new regulation fails entirely to meet that standard.

11.141 Ofcom's regulatory proposals in this case would introduce far-reaching economic regulation into a sphere of activity for the first time. They involve types of regulation which are normally avoided due to a well-recognised potential:

(a) to reduce incentives for investment and innovation (compulsory licensing);

(b) to cause long-term economic distortions and significant deadweight losses (prescriptive price control, industrial planning); and

(c) to impose significant administrative burdens (prescriptive price control).

11.142 Furthermore, the specific nature of Ofcom's price control proposals is that (as noted above) they would require Sky to make substantial immediate reductions in wholesale charges for its premium sports and movie channels – reductions that on average are 17% – including to Virgin Media, which would have an immediate impact on Sky's profitability.

11.143 Ofcom's proposals would also require Sky to make available to other operators interactive services, which – even by Ofcom's own admission – is a technically demanding task, and would impose on Sky compulsory licensing in relation to a service (high definition versions of its channels) which is relatively new and innovative. Ofcom indicates that it would be expected that Sky would be required to supply to third parties any future innovations associated with its premium channels when they were no longer regarded as being "*brand new*".[75]

11.144 Moreover, as Sky has argued previously, the radical nature of Ofcom's proposals – no regulation of this type exists anywhere else in the world – means that there would be a high risk of unintended adverse consequences, and regulatory creep associated with that regulation, were it to be implemented.

11.145 Yet the only costs which Ofcom considers in any detail are (a) the additional fixed costs associated with the introduction of new pay TV services (of which there would be three in Ofcom's base case), and (b) potential reductions in payments for content rights. Ofcom's discussion of both these matters is relatively brief – the first comprises five brief paragraphs, while the second comprises nine paragraphs.

11.146 In relation to these two issues:

(a) the level of attention given to the issue of additional fixed costs seems wholly disproportionate in light of the range of very important issues that are either not considered at all, or considered in a cursory way; and

(b) Ofcom's discussion of the potential for its proposed new regulation to result in lower payments for content rights is too cursory to provide a sound basis for its conclusion that "[o]*ur view is that the likelihood of a wholesale must-offer remedy (set on a retail-minus basis) leading to a significant decrease in rights values is low*"[76]. It rests largely on:

(i) an erroneous view[77] that Ofcom's proposed reductions in wholesale charges will have no impact on Sky's incentives to bid for content rights because they "*could at most decrease the high*

[75] Paragraph 8.99 of the Consultation Document.

[76] Paragraph 10.77 of the Consultation Document.

[77] Paragraphs 10.80 to 10.81 of the Consultation Document.

margins that Sky is making, rather than putting its wholesale business into loss-making territory";[78] and

(ii) an argument that its proposed new regulation "*would be likely to increase the amount paid for rights relative to their underlying value*"[79] (it is wholly unclear what the latter part of that statement is intended to mean) by increasing competition for such rights. In view of the fact that Ofcom proposes to grant all-comers risk-free access to Sky's channels at discounted charges, Ofcom's argument is improbable *a priori*, and has already been contradicted by public statements by the Chief Executive of Virgin Media.

11.147 The only other potential costs discussed by Ofcom are:

(a) "*Sky would be likely to incur additional administrative costs*";[80]

(b) a risk that "*Sky will earn lower wholesale revenues from its existing wholesale customers*";[81] and

(c) "*To the extent that Sky's retail subscribers switch to other retailers, Sky will sacrifice retail margin*" .[82]

11.148 Ofcom's discussion of (a) comprises four paragraphs. Ofcom states:

> "***It seems*** *these would comprise the costs of dealing with additional wholesale customers and the costs of ensuring compliance with new regulation*"[83] (emphasis added).

11.149 In other words, Ofcom has not investigated this matter sufficiently to ascertain what the nature of these costs would be.

11.150 Ofcom then argues that "*a wholesale must-offer remedy would not contribute significantly to* [the costs of dealing with additional wholesale customers]" on the wholly spurious basis that "*Sky has been involved in wholesale negotiations with prospective third party retailers in recent years, absent any wholesaling remedy*".[84]

11.151 Such costs would be dwarfed by the costs of dealing with Ofcom in relation to its proposed new regulation. Ofcom's consideration of such costs, with which it should be very familiar given that it administers a range of different price control regimes, however, amounts to two short sentences – the first a

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[78] Paragraph 10.74 of the Consultation Document.

[79] Paragraph 10.86 of the Consultation Document.

[80] Paragraph 10.68 of the Consultation Document.

[81] Paragraph 10.72 of the Consultation Document.

[82] *Ibid.*

[83] Paragraph 10.68 of the Consultation Document.

[84] Paragraph 10.69 of the Consultation Document.

statement that such costs "*appear to be fairly limited*",[85] and the second a wholly inadequate justification for that statement.

11.152 In relation to (b) and (c) (the risk of Sky earning lower wholesale and retail revenues) Ofcom discusses these together in a single paragraph (paragraph 10.73). Ofcom simply states that they have been considered as part of its quantitative analysis, and argues that:

(a) Ofcom's proposed new regulation may increase Sky's wholesale revenues, in which case there is no cost to Sky in this regard; and

(b) if Sky's wholesale revenues were reduced, there would be no consequence as long as Sky's wholesale business is not 'put' "*into loss-making territory*".[86] (Ofcom repeats and expands on this argument in the context of the discussion of the impact of its proposed new regulation on payments for content rights at paragraphs 10.79 to 10.81.)

11.153 Ofcom therefore undertakes no assessment at all of the consequences that might arise from switching away from Sky to DTT retailers that is caused by Ofcom's proposed new regulation, which Ofcom assumes is significant,[87] or how prices might evolve under this scenario (including Virgin Media's reaction to a reduction in its costs).

11.154 Ofcom's argument is that, as long as Ofcom's regulation has the effect of reducing "*high wholesale margins*"[88] there would be no cost associated with reducing Sky's wholesale revenues. As discussed in **Section 10**, above, that proposition is without merit. Above all, it is predicated on an erroneous view that Sky's premium channel business earns excessive profits which derives from Ofcom's erroneous analysis of Sky's profitability and its calculation of cost-plus floors for Sky's wholesale charges which Sky has shown is substantially flawed.

11.155 Accordingly, Ofcom has made no meaningful effort to assess the costs that would arise from the implementation of its proposed new regulatory regime.[89] Despite the fact that the costs and risks associated with Ofcom's proposals are relatively clear, and have been pointed out to Ofcom in Sky's previous submissions, Ofcom now considers that it is appropriate to devote only a few pages of the 1,850 pages of material that it has generated in its pay TV review to their assessment.

11.156 Ofcom's approach appears entirely to confirm the argument put by Sky in its Response to the Second Consultation Document that, in direct contradiction of both conventional thinking and common sense, Ofcom believes that its

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85 Paragraph 10.70 of the Consultation Document.

86 Paragraph 10.74 of the Consultation Document.

87 This is clear from the quantity of consumers switching in the impact assessment model.

88 Paragraph 1.4 of the Consultation Document.

89 These costs are discussed in **Section 10** of this Response.

proposals would, very largely, be cost-free.[90] Given the circumstances set out above, it is wholly improbable that that would be the case and Ofcom's failure properly to examine the costs of its proposals comprises a fundamental flaw in its impact assessment in this case. This can only be remedied by Ofcom undertaking a substantially more detailed and considered analysis, and re-consulting on that analysis.

11.157 Taking a decision to proceed to implement such regulatory proposals without a rigorous assessment of their potential costs would be like a bather jumping off a cliff at night hoping there is water below.[91] Yet that is precisely what Ofcom proposes to do.

C. Ofcom's assessment of the costs and benefits arising from its proposed new regulation: summary and conclusion

11.158 Ofcom's assessment of the potential costs and benefits of its proposals to introduce new regulation in this case fails entirely to meet the criteria set out for such analysis in the CAT's judgment in *Vodafone v. Ofcom*. Ofcom cannot be said to have conducted its assessment of these matters in this case "*with appropriate care, attention and accuracy so that their results are soundly based and can withstand the profound and rigorous scrutiny that the Tribunal will apply on appeal*".[92] Ofcom's estimates of the benefits of its proposals are not soundly based, being both methodologically flawed, and not supported by adequate evidence in relation to key input values and assumptions, while Ofcom's analysis of the potential costs of its proposals is too cursory in nature to enable Ofcom to draw any safe conclusions about the costs that would result from the introduction of its proposed new regulatory regime.

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90 If this were the case then we would expect to see widespread confiscation of profits above the cost of capital for deployment to subsidise other inefficient technologies and entrants. But we do not see this, for very good reasons.

91 This simile is taken from a paper by Steven S. Wildman on proposals to mandate a la carte supply of pay TV channels in the US. See: A Case for A La Carte and "*Increased Choice"? An Economic Assessment of the FCC's Further Report, March 2006*." Available at: http://www.ncta.com/PublicationType/ExpertStudy/2821.aspx.

92 See footnote 7 above.