OFCOM PAY TV MARKET INVESTIGATION

RESPONSE OF VIRGIN MEDIA INC. TO OFCOM'S PHASE THREE DOCUMENT OF 26 JUNE 2009

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NON-CONFIDENTIAL VERSION

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1. EXECUTIVE SUMMARY AND INTRODUCTION

Executive Summary

1.1 Virgin Media agrees with Ofcom's conclusion that Sky has a position of market power in the wholesale market for premium sports and movie channels and that:

(a) Sky is acting on an incentive to restrict the distribution of premium channels to other retailers;

(b) Sky is setting high wholesale prices in order to maximise wholesale profits; and

(c) some services, such as those relying on SVOD movie rights, are unavailable because Sky favours its own platform and retail business.

1.2 As Ofcom has correctly identified, these competition concerns have serious negative consequences for consumers, who suffer a lack of choice, high retail prices and reduced levels of innovation.

1.3 Virgin Media therefore supports Ofcom's proposal to address restricted distribution of Sky's Core Premium channels by imposing a WMO obligation under Ofcom's sectoral powers. If correctly implemented, a WMO obligation will lead to a range of very material consumer benefits, including more choice, lower prices and greater innovation. In particular, as a consequence of the WMO, Virgin Media:

(a) will be able to lower prices for Sky's Core Premium channels, and will be incentivised actively to market those channels, thereby increasing consumer awareness of their availability on Virgin Media's platform and leading to more intense head-to-head competition with Sky;

(b) will be able to offer interactive and HD content related to Sky's Core Premium channels on the Virgin Media platform;

(c) will be able to increase the choice of provider for consumers who are not in cable active areas and want Sky's Core Premium channels;

(d) will be able to offer more flexible bundling of Sky's Core Premium channels; and

(e) will have greater incentives to innovate in relation to the delivery of Core Premium channels, especially in relation to services which are particularly suited to platforms other that Sky's DSat platform (e.g. interactive services).

1.4 Nevertheless, the ability of Virgin Media to deliver these consumer benefits will be dependent on: (i) the scope of the WMO being extended to include Sky Sports 3 and Xtra; (ii) the relevant wholesale prices being set no higher than the bottom of the range proposed by Ofcom (rather than in the middle); and (iii) Ofcom addressing a number of specific issues relating to the detailed implementation of the WMO.

Scope of WMO

1.5 It is essential that, in addition to Sky Sports 1 and Sky Sports 2, the scope of the WMO should also extend to include Sky Sports 3 and Xtra. Ofcom's decision to limit the scope of the WMO to Sky Sports 1 and Sky Sports 2 reflects a narrow approach to market definition which fails to have regard to the way in which subscribers make purchasing choices. Specifically, consumers value a wide range of attractive sports and, in making purchasing decisions, choose between packages of channels (and not between individual channels). In consequence, rival retailers will not be able to compete effectively with Sky without being able to offer the full range of attractive sports content available across Sky's premium sports channel portfolio. This requires access to Sky Sports 3 and Xtra. Put simply, without access to those channels (or with access only on uneconomic terms), the consumer offering of rival retailers will inevitably compare very unfavourably with the packages offered by Sky and there will be a continued risk to fair and effective competition.

1.6 Further, if the WMO is restricted to Sky Sports 1 and Sky Sports 2 it will be easily "gamed" by Sky in such a way as to undermine the effectiveness of the remedy. In particular, Sky will be likely to move content away from WMO channels to Sky Sports 3 and Xtra. Even if this occurred to a limited extent, it could inflict considerable damage on rival retailers if the content comprised key events (for example, key matches such as Manchester United FAPL games, additional Champions League matches and important cricket or rugby matches). This risk is best addressed by extending the scope of the remedy to include Sky Sports 3 and Xtra.

Pricing

1.7 Virgin Media supports Ofcom's general methodology for setting prices under the WMO, i.e. a retail-minus calculation with a cost-plus cross-check. However, after carefully reviewing the information available to it, and the methodology set out in Ofcom's consultation document, Virgin Media is of the view that prices no higher than the bottom of Ofcom's proposed range are more consistent with the aim of ensuring fair and effective competition than prices mid-way through the range. In this regard, Virgin Media has a number of observations on the detail of Ofcom's price setting methodology, all of which support Virgin Media's view that the prices should be set no higher than the bottom of Ofcom's proposed range. Specifically:

(a) Ofcom has not used the most appropriate retail prices as its starting point in the retail-minus calculation. In this connection, the use of a weighted average price as the reference price has a number of important drawbacks. Most importantly it may not enable TV retailers to compete with Sky, especially as regards new customers, and it would afford Sky an opportunity to game the WMO. To address this, Ofcom should take each of the Core Premium wholesale products and undertake a retail-minus calculation for each combination of these products with different basic mixes. It should then use the lowest of the resulting wholesale prices as the regulated price. This will guarantee that rival retailers will be able to compete with any current retail package offered by Sky;

(b) it is inappropriate to use the current forward-looking estimate of the WACC for Sky as a proxy for the reasonable return on investment a likely entrant would need to make. This is because the WACC for a new entrant would almost certainly be higher than Sky's current WACC. In addition, it is not clear whether Ofcom has appropriately reflected the greater risks facing new entrants in its estimates of cash flows;

(c) Ofcom should set regulated wholesale prices which allow competition by both large and small entrants. In particular, prices should not be set by reference to the costs of larger entrants, as currently proposed by Ofcom, when entry on a smaller scale in the DTT platform is significantly more plausible;

(d) Ofcom has significantly underestimated the fixed costs that a pay TV retail business would incur; and

(e) DTT transmission costs are likely to be higher than the £8 million per video stream per annum assumed by Ofcom.

Other concerns

1.8 Whilst the scope of the WMO and the approach to calculating wholesale prices are the key areas in which Virgin Media believes Ofcom should revisit the approach set out in the consultation document, Virgin Media also has concerns about a number of the more technical features of the WMO. These include the application of the WMO to commercial premises; the application of the WMO to enhanced features (including HD channels and interactive features); the approach to minimum qualifying criteria; complaint handling; technical delivery issues; changes in Sky's retail prices; and cross-promotion. Each of these concerns is considered in detail in the main body of this Submission.

1.9 Virgin Media is supportive of Ofcom's proposals for addressing concerns arising in relation to SVOD movie rights and FAPL content rights. Specifically, Virgin Media supports Ofcom's proposal to resolve these issues by liaising directly with the Hollywood Movie Studios and FAPL. However, Virgin Media supports this approach only on the basis that Ofcom should commence its discussions with the Hollywood Movie Studios and FAPL immediately. Further, should Ofcom be unable to resolve the concerns it has identified adequately and promptly, it should refer those matters to the Competition Commission for detailed review under the market investigation provisions of the Enterprise Act.

1.10 Lastly, it is now two and a half years since Ofcom opened its investigation into the pay TV market. Given the protracted nature of this investigation, and the fact that consumers continue to suffer detriment as a consequence of the competition concerns identified by Ofcom, it is essential that the Ofcom reaches a final decision as soon as possible and promptly implements WMO.

Introduction

1.11 This submission (the **"Submission"**) sets out Virgin Media's[1] response to *Ofcom's Pay TV phase three document* of 26 June 2009 (**"Third Consultation Document"**). The Submission reflects the structure of the Third Consultation Document.[2] In this regard:

(a) Section 2 comments on Ofcom's findings in relation to the UK pay TV market;

(b) Section 3 addresses Ofcom's findings in relation to market definition, focussing on Ofcom's approach to defining retail markets and Core Premium Sports;

(c) Sections 4, 5 and 6 comment on Ofcom's findings as regards market power, competition issues and consumer effects;

(d) Section 7 sets out in detail Virgin Media's observations on the pricing terms and principles of the proposed wholesale must-offer obligation (**"WMO"**);

(e) Section 8 sets out in detail Virgin Media's observations on the non-pricing terms and principles of the proposed WMO, including observations on the scope of the remedy, commercial premises, interactive services, minimum quality criteria, complaint handling, technical delivery, cross-promotion issues and the use of a reference offer;

(f) Section 9 comments on Ofcom's findings as regards the proportionality of a WMO;

(g) Section 10 comments on Ofcom's consultation on licence conditions; and

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1 [**CONFIDENTIAL**].

2 For completeness Virgin Media confirms it has not commented on Section 2 of the Third Consultation Document on the legal framework. This is because Ofcom's position has not changed significantly from previous consultation documents.

(h) Section 11 considers Ofcom's proposed approach to content rights remedies, specifically in relation to subscription video-on-demand (**"SVOD"**) movie rights and Football Association Premier League (**"FAPL"**) rights.

2. THE UK PAY TV MARKET

2.1 In Section 3 of the Third Consultation Document Ofcom sets out some key features of the UK pay TV market which are relevant to Ofcom's assessment of whether it is appropriate to take action to ensure fair and effective competition. Specifically Ofcom observes that:

(a) sports and film are key drivers of pay TV subscriptions as they are the genres that are most valued by consumers and also have a high degree of exclusivity to pay TV.[3] This is supported by a number of other factors including the large sums paid by channel providers such as Sky and Setanta for such content and statements by Sky on the importance of such content;

(b) although content aggregation can in principle offer benefits to consumers,[4] there is a risk that the aggregation of content can result in the creation of market power, particularly when it involves the aggregation within a narrow economic market of a number of pieces of content which might otherwise be substitutes for each other;[5]

(c) given the high fixed costs of content, there is a strong incentive to distribute content to as wide a range of consumers as possible, especially in relation to advertising-funded free-to-air (**"FTA"**) broadcasting. However these incentives are different in relation to subscription-funded broadcasting where revenues are only likely to increase with reach if some form of price discrimination is adopted; and

(d) it is very common for companies in the pay TV industry to be vertically integrated. Although this vertical integration may enable firms to operate more efficiently, it may also change the incentives of firms.[6]

2.2 Virgin Media agrees, in general, with Ofcom's observations as regards features of the pay TV market. Indeed, the above observations are consistent with those made by Virgin Media and the Joint Parties in the July 2007 Joint Submission.[7]

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[3] Third Consultation Document, paragraph 3.22.

[4] Third Consultation Document, paragraph 3.36.

[5] Third Consultation Document, paragraph 3.38.

[6] Third Consultation Document, paragraph 3.55.

[7] *Submission to Ofcom on the need for a market investigation into the pay TV industry*, by British Telecommunications plc, Setanta Sports Holdings Limited, Top-Up TV Europe and Virgin Media Limited (the **"Joint Parties"**), 3 July 2007 (the **"July 2007 Joint Submission"**).

3. MARKET DEFINITION

Introduction

3.1 In Section 4 of the Third Consultation Document Ofcom defined four key relevant markets, namely:

(a) a wholesale market for Core Premium Sports channels comprising Sky Sports 1, Sky Sports 2 and Setanta Sports 1 and the high definition (**"HD"**) versions of these channels (**"wholesale Core Premium Sports market"**);

(b) a wholesale market for Core Premium Movie channels comprising all Sky Movies channels (except for Sky Classics) and Disney Cinemagic and the HD versions of these channels (**"wholesale Core Premium Movies market"**);

(c) a retail market for packages containing Core Premium Sports channels (**"retail Core Premium Sports market"**); and

(d) a retail market for packages containing Core Premium Movie channels (**"retail Core Premium Movies market"**).

3.2 The approach of Ofcom to defining the wholesale Core Premium Movies market is consistent with Ofcom's approach in the Second Consultation Document.[8] Virgin Media agrees with Ofcom's approach and makes no further submissions on this issue.

3.3 Accordingly, this section focuses on two market definition issues arising from the Third Consultation Document, namely:

(a) Ofcom's decision to consider, and its approach to defining, retail markets in relation to both Core Premium Sports and Core Premium Movies; and

(b) Ofcom's approach to defining Core Premium Sports.

3.4 Each of these issues are discussed in turn below.

Retail markets definitions

3.5 In the Second Consultation Document Ofcom chose not to consider and define relevant downstream retail markets. In response, Virgin Media and the Joint Parties argued that defining retail markets and identifying Sky's market power in these downstream markets is fundamental to the pay TV market investigation.[9] In this connection, Virgin Media submitted that the failure to define the retail market was problematic for a number of reasons including:

(a) the analysis of the wholesale market in isolation from the retail market fails to have regard to the degree to which the two are inter-related. Virgin Media considers that Sky's market power at the wholesale level is reinforced by its retail market power and vice versa;

(b) Ofcom is seeking through its proposed remedy to bring about effective competition in retail markets, and a failure to have proper regard to market power at the retail

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8 Ofcom *Pay TV second consultation – access to premium content* 30 September 2008 (**"Second Consultation Document"**), paragraphs 4.147 to 4.236.

9 In this regard Virgin Media refers to section 3 of the *Joint Response to Ofcom's Second Pay TV Consultation* of 12 December 2008 (**"Joint Response to Second Consultation"**) and section 5 of *Response of Virgin Media to Ofcom's Second Consultation of 30 September 2008* submitted on 18 December 2008 **("Virgin Media Response to Second Consultation"**).

level may lead to remedies being proposed that, whilst facilitating access to certain premium content, may not engender effective retail competition; and

(c) the rationale for the WMO remedy is based in large part on there not being effective competition in the retailing of premium channels with a range of resulting consumer detriments. It is not appropriate in this context to disregard the evidence assembled by Ofcom for the purpose of defining the relevant wholesale market which points irrefutably towards there being a separate market for the retailing of premium content, with Sky enjoying a dominant position in that market.

3.6 Against this background, Virgin Media supports Ofcom's decision to define retail markets in relation to the supply of Core Premium Movies and Core Premium Sports as it addresses a gap in the logical construction of Ofcom's case and reduces the risk of Ofcom understating the effects of Sky's mutually reinforcing market positions. Further, subject to Virgin Media's observations in relation to Ofcom's approach to the definition of Core Premium Sports,[10] Virgin Media agrees with Ofcom's approach to defining these retail markets and the market definitions ultimately proposed by Ofcom. In particular, Ofcom was correct to:

(a) focus on the actual packages of channels purchased by consumers as the basis on which to start considering the parameters of the relevant market;

(b) acknowledge that FTA TV broadcasts are unlikely to be a sufficient constraint on retailers of packages containing Core Premium Sports channels and packages containing Core Premium Movies channels; and

(c) conclude that there was a lack of supply-side substitution.

3.7 Virgin Media notes that Ofcom's approach to retail market definition is now consistent with the approach taken by Ofcom in its *Pay TV market investigation Consultation document* of 18 December 2007 (**"First Consultation Document"**) where it assessed Sky's market power in "*retail markets for packages containing premium sports or premium movies channels.*"[11] Virgin Media explicitly agreed with this approach in the *Response of Virgin Media to Ofcom's Consultation Document* of 7 March 2008 (**"Virgin Media Response to First Consultation Document"**).[12]

Sports Market Definition

Introduction

3.8 Section 4 of the Third Consultation Document sets out Ofcom's analysis in relation to the definition of wholesale and retail markets for the sale of Core Premium Sports and Movies channels. This section comments on Ofcom's proposals in relation to Core Premium Sports, and, in particular, Ofcom's definition of relevant wholesale markets.[13]

3.9 Ofcom has broadened its view of the sports that are important in Core Premium Sports channels. This has not, however resulted in a change of view as to the relative importance of the channels themselves. Ofcom is still of the view that the relevant economic market for the wholesale of Core Premium Sports channels comprises Sky Sports 1, Sky Sports 2 and Setanta Sports 1[14] (which is the position it reached in the

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10 See paragraphs 3.8 to 3.48 below.

11 First Consultation Document, paragraph 5.54.

12 Virgin Media Response to First Consultation Document, paragraph 5.2.

13 Retail market definition is considered in paragraphs 3.5 to 3.7 above.

14 Albeit that Setanta has now exited the market.

Second Consultation Document albeit based on a view that live FAPL football represented the most important characteristic of premium sports channels). Virgin Media welcomes the broadening of Ofcom's approach but disagrees with Ofcom's conclusion, in particular the exclusion of Sky Sports 3 and Xtra from the relevant economic market, for the following reasons:

(a) Ofcom's finding reflects its approach to market definition which focuses on the range of sports available on a channel-by-channel basis in order to assess the degree to which retailers could potentially substitute alternative channels and thereby constrain Sky's ability to exercise market power at the wholesale level in relation to these channels. This approach fails to reflect the way subscribers make purchasing choices by choosing between packages of channels (and not between individual channels), and the way in which Sky is able to exercise market power (at both the wholesale and retail level) across all of the Sky Sports channels by assembling attractive packages of sports content which appeal to customers and which must be matched by rival retailers in order to compete;

(b) some of the content which is broadcast on Sky Sports 3 and Xtra is additional coverage of live sporting events which are also broadcast on Sky Sports 1 and Sky Sports 2 (in particular, UEFA Champions League ("**UCL**") matches and FAPL end of season games with simultaneous kick-offs). Very often the decision to include coverage of such events is a means of addressing scheduling issues. Another way in which Sky manages these scheduling issues is to provide some of this content behind the red button. In this context, Ofcom has accepted the importance of rival retailers being offered content available on the red button equivalent to that shown on the main linear stream in order to ensure fair and effective competition; and

(c) lastly, Virgin Media considers that a WMO remedy which is restricted to Sky Sports 1 and Sky Sports 2 will be easily "gamed" by Sky in such a way as to undermine the effectiveness of the remedy. In particular, Sky could move content away from WMO channels to Sky Sports 3 and Xtra. Even if this occurred to a limited extent, it could inflict considerable damage on rival retailers if the content comprised key events (for example, key matches such as Manchester United FAPL games, additional UCL matches and important cricket or rugby matches).

3.10 For these reasons, which are addressed in greater detail in turn below, the scope of the WMO remedy must be extended to cover Sky Sports 3 and Xtra. A failure to do so will undermine the ability of the remedy to promote fair and effective competitive at the retail level in respect of packages containing premium sports channels. In this context, we would emphasise that when considering the "*relevant market…for the retail supply of Sky Sports 1 [and/or] Sky Sports 2*", Ofcom has expressly confirmed that it will assess "*…whether there is a risk that there is not, and will not be, fair and effective competition in* ***the provision of packages*** *containing [Sky Sports 1 or Sky Sports 2*"].[15] (Emphasis added).

Ofcom's approach

3.11 Ofcom has reached the same finding as regards the channels which fall within the relevant economic wholesale market (i.e. Sky Sports 1, Sky Sports 2 and Setanta Sports 1) as it did in the Second Consultation Document. This is based on a different view, however, as to the importance of the underlying sports content. In particular the Second Consultation Document focused on the importance of FAPL by defining the relevant market as follows:

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15 Third Consultation Document, paragraph 4.253.

> "*There is a narrow economic market for the wholesale of certain premium sports channels specifically those premium channels which contain live FAPL matches*".[16]

3.12 Ofcom has now broadened the sports content which it considers to be important to subscribers on the basis of research showing that other sports are important to significant minorities of consumers.[17] Ofcom now considers the relevant economic market to comprise:

> "*channels regularly featuring live sporting events which a significant number of consumers find highly attractive*".[18]

3.13 Ofcom's identification of the relevant Sky Sports channels which fall within this definition is based on an assessment of the characteristics of Sky Sports 1 and potential substitutes based on survey data on subscriber preferences for the sports content on different channels. Ofcom correctly identifies the following issues in this regard:

> "*Although football is highly valued by a significant majority of subscribers, tastes for other sports are heterogeneous. Different consumers will value different elements of the bundle and therefore consider different products as substitutes.*
>
> *Most consumers have preferences for more than one sport. Therefore consumers would switch to the bundle which best reflects their preferences for multiple sports."*[19]

3.14 As discussed further below, Virgin Media agrees entirely with this description of consumer demand, and considers that this necessitates an analysis of Sky's potential market power in relation to bundles of content across channels as opposed to a channel-by-channel assessment. In contrast, Ofcom adopts a channel-by-channel approach assessing whether alternative channels to Sky Sports 1 can offer sufficient quantities of multiple sports, including, but not necessarily limited to football.[20]

3.15 In this regard, Ofcom concludes that Sky Sports 3 and Xtra are not a close substitute for Sky Sports 1, Sky Sports 2 and Setanta Sports 1 because of the relatively low amount and quality (measured by average audience) of football, cricket and rugby union on these channels. More specifically:

(a) Sky Sports 3 – Ofcom notes that very little top flight football is shown on Sky Sports 3. It acknowledges that there is a significant amount of golf coverage on this channel but notes that only 1 per cent of subscribers highly value golf but not football. It concludes that "*given the relatively low amount of top flight football shown on this channel compared with either Sky Sports 1, 2, Setanta Sports 1 or FTA we consider that it would be a relatively weak substitute even at a very low notional price*";[21] and

(b) Sky Sports Xtra – Ofcom notes the significant amount of tennis coverage on Sky Sports Xtra and a small amount of Champions League football. It considers that the channel is likely to only appeal to the small proportion (1 per cent) of

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16 Second Consultation Document, paragraph 4.4.

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

18 Third Consultation Document, paragraph 4.209.

19 Third Consultation Document, paragraph 4.114.

20 Third Consultation Document, paragraph 4.115.

21 Third Consultation Document, paragraph 4.124.

subscribers to Sky Sports 1 who highly value only tennis. Ofcom concludes "*We consider it would be a relatively weak constraint on Sky Sports 1 at the wholesale level (either as a direct wholesale demand side substitute, or as an indirect constraint on Sky Sports 1)*".[22]

Sky has market power at the wholesale level in relation to Sky Sports 3 and Xtra

3.16 Virgin Media agrees with the broader approach which Ofcom has taken in identifying the sports which are of value to subscribers. Virgin Media also agrees with Ofcom's view that because consumers have preferences for more than one sport, they will choose pay TV bundles which best reflect their preferences for multiple sports.[23] Virgin Media considers, however, that when consumers exercise this choice, it is not between bundles of content aggregated into channels, but between bundles of content aggregated into packages of channels – in short, the products which are the focus of retail competition are not individual channels but retail packages of channels. At the wholesale level, therefore, the key issue is not whether Sky is able to exercise market power in relation to individual channels, but whether it is able to exercise market power in relation to a body of content across all of the Sky Sports channels which rival retailers need in order to be able to offer competing retail packages.

<u>A rival retailer would not be able to resist an increase in wholesale price for Sky Sports 3 and/or Xtra</u>

3.17 Ofcom's finding implies that, faced with a small but significant increase in the wholesale price for Sky Sports 3 or Xtra, a downstream firm would be able to resist such an increase because subscribers do not value the content on these channels significantly, and would be prepared to switch to Sky Sports 1, Sky Sports 2 or Setanta Sports 1 in the event that the wholesale price increase was passed on to subscribers.

3.18 This hypothetical scenario is entirely divorced from the way in which consumers actually exercise choice. In the event of a wholesale price increase for Sky Sports 3 and/or Xtra, the real question is what could a downstream firm do to resist such an increase given that subscribers will not be choosing amongst different sports channels but amongst pay TV retail packages including Sky's packages which will offer the full range of Sky Sports channels including Sky Sports 3 and (for the vast majority of subscribers) Sky Sports Xtra at no extra cost.[24]

3.19 In these circumstances, Virgin Media considers that a downstream firm cannot resist a wholesale price increase for Sky Sports 3 and/or Xtra. If the price increase were passed on, subscribers would be likely to choose the better priced Sky package. If the retailer chooses instead to absorb the price increase, this would reduce its retail margin and render it a far less effective competitor to Sky. In particular it would not be able to make investments in improving and advertising its offer comparable to those of Sky because its retail margin would be lower than that of Sky.[25]

3.20 If a retailer decided not to buy the channels and to offer a package without Sky Sports 3 and Xtra content, subscribers would have incomplete coverage of some of the valuable

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[22] Third Consultation Document, paragraph 4.126.

[23] Third Consultation Document, paragraph 4.114.

[24] Sky Sports 3 is not available separately from Sky Sports 1 and 2 at the retail level but is bundled with these channels and offered to consumers at no extra cost. As regards Sky Sports Xtra, Virgin Media understands that there is, notionally, a stand-alone retail price for Sky Sports Xtra but there is negligible demand for this option and, therefore, for the vast majority of subscribers, Sky Sports Xtra is provided as a bonus channel bundled with Sky Sports 1 and 2 at no extra cost. In this regard, over 95 per cent of subscribers to Sky Sports on Virgin Media's service subscribe to all four Sky Sports channels.

[25] See paragraph 7.5(a)(i) for a discussion of the impact on competition of significant discrepancies in the retail margin available to Sky as compared to its rivals.

sporting content which Ofcom has identified as making Sky Sports 1 and Sky Sports 2 particularly attractive (including top flight football). They would also be denied coverage of sports which are mainly broadcast on Sky Sports 3 and Xtra (such as golf, rugby league and tennis). This would be likely to induce switching to Sky's retail package which would offer a greater range and more complete coverage of key live sporting events. For the same reason, the retailer would be unable to substitute alternative wholesale inputs and be able to offer packages which were competitive with those of Sky. The importance of the content on Sky Sports 3 and Xtra as part of a pay TV sports package is examined in the next section.

<u>The absence of Sky Sports 3 and Xtra would make it very difficult for a rival retailer to compete</u>

3.21 In practice, rival retailers would find it very difficult to compete with Sky without access to Sky Sports 3 and Xtra. This is because, as set out in paragraphs 3.22 to 3.31 below, Sky Sports 3 and Xtra broadcast some attractive live football content and a considerable volume of other sports coverage which is highly valued by subscribers. This is important for the following reasons:

(a) in some cases certain matches from an event or competition are broadcast on Sky Sports 3 and Xtra in addition to Sky Sports 1 and 2 (for example, in relation to UCL matches, cricket and rugby union). In that context, subscribers expect to be able to watch all of an event if it is advertised as part of their retail package. A package without Sky Sports 3 and Xtra would offer incomplete coverage of these events which would be likely to cause a much higher degree of dissatisfaction amongst consumers than might be assumed by considering only the proportion of broadcast hours on each channel; and

(b) for other sports, such as golf and tennis, a significant proportion of the events are broadcast on Sky Sports 3 and/or Xtra. The absence of this content from a retail package would make such a package very unattractive to subscribers who highly value such content (whether on its own, or in addition to other sports content).

Live football is not confined to Sky Sports 1 & 2

3.22 Ofcom highlights the lack of top flight football on Sky Sports 3 and on Xtra in explaining why these channels have been excluded from the relevant wholesale market.[26] [**CONFIDENTIAL**].[27]

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3.23 In addition, an analysis of Barb data by Virgin Media indicates that a live FAPL match was broadcast exclusively on Sky Sports 3 or Xtra on the last day of the season in 2009 (on

26 Third Consultation Document, paragraphs 4.123, 4.126 and 4.133.

27 [**CONFIDENTIAL**].

Sky Sports 3), 2007 (on Sky Sports 3), 2006 (on Sky Sports 3) and 2005 (on Sky Sports Xtra). Those broadcasts were billed as "Live Ford Survival Sunday" or "Ford Super Sunday" and attracted sizeable audiences (the matches were amongst the top 20 events measured by audience numbers on Sky Sports 3 and Xtra in each of those years).[28]

3.24 As confirmed by both Ofcom's survey research [**CONFIDENTIAL**], football is the single biggest driver of subscriptions to premium sport TV packages. [**CONFIDENTIAL**].[29] [**CONFIDENTIAL**].[30]

Other sports are important to subscribers

3.25 Virgin Media notes that Figure 7 of the Third Consultation Document lists 27 sports events that are broadcast on Sky Sports 1 and 2 and confirms that 17 of those 27 events are also shown on Sky Sports 3 and Xtra. In particular:

(a) Sky Sports 3 broadcasts a significant proportion (i.e. over 20 per cent measured by hours broadcast) of a number of key live events which are also broadcast on Sky Sports 1 and/or Sky Sports 2 including European Tour Golf, World Golf Championship and Rugby League SuperLeague; and

(b) Sky Sports Xtra broadcasts a significant proportion (i.e. over 20 per cent measured by hours broadcast) of European Tour Golf as well as key tennis events (including Masters Cup Tennis, and US Open Tennis) which are also broadcast on Sky Sports 1 and/or Sky Sports 2.

3.26 Figure 7 of the Third Consultation Document indicates that Sky Sports 3 and Xtra also broadcast a small proportion (i.e. between 2 and 14 per cent measured by hours broadcast) of UCL matches, England Test cricket, non-England ICC Championship cricket, and the County Championship, as well as Heineken Cup and Guinness Premiership rugby union matches. In addition, the channels are the main outlet for a substantial volume of minor sports (for example WWE and motor sports). [**CONFIDENTIAL**].[31]

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3.27 Virgin Media also notes that the data collated in Figure 7 of the Third Consultation Document focuses on events in 2008. Virgin Media considers, however, that in previous years there is additional evidence that highly attractive live sporting events have been broadcast on Sky Sports 3 and/or Sky Sports Xtra. For example, in 2003 all live World Cup cricket matches and the vast majority of the highlights programming were broadcast on Sky Sports 3. In 2007, a smaller proportion of World Cup live cricket matches were broadcast on Sky Sports 3 and Xtra,[32] but a crucial England match against Sri Lanka as

28 Third Consultation Document, figure 7, page 68, indicates that no FAPL content was broadcast on Sky Sports 3 and Xtra in 2008.

29 [**CONFIDENTIAL**].

30 [**CONFIDENTIAL**].

31 [**CONFIDENTIAL**].

32 In 2007, a small proportion of the World Cup live cricket matches were shown on Sky Sports 3 (approximately 5 per cent, measured by proportion of hours broadcast) and on Xtra (approximately 1 per cent), with the remainder broadcast on Sky Sports 1 (approximately 58 per cent) and Sky Sports 2 (approximately 36 per cent).

part of the Super 8 stage of the tournament was broadcast on Sky Sports 3 and resulted in the largest audience for a World Cup broadcast across the entire tournament on any channel.[33]

3.28 In measuring the value of this content, Ofcom refers to low audiences and the fact that only a small proportion of subscribers (1 per cent) value *only* tennis and golf respectively as part of their sports subscription.[34] Whilst this may be relevant in assessing whether subscribers would choose Sky Sports 3 and Xtra as substitutes for Sky Sports 1, it is not relevant in assessing whether subscribers would choose a package including Sky Sports 3 and Xtra (as well as Sky Sports 1 and 2) in preference to a package which did not include these channels. Indeed it is the larger proportions of subscribers who highly value these sports **as well as other sports** which is of relevance in this regard (i.e. 20 per cent of subscribers in the case of both tennis and golf).[35] This survey evidence suggests that the lack of significant amounts of tennis and golf coverage within a sports package (in the event that Sky Sports 3 and Xtra were not included) would affect a significant proportion of subscribers, and may be expected to result in switching to "*the bundle which best reflects their preferences for multiple sports*"[36] – i.e. Sky's bundle.[37]

3.29 [**CONFIDENTIAL**],[38] [**CONFIDENTIAL**].

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[**CONFIDENTIAL**].[39] [**CONFIDENTIAL**].

3.30 [**CONFIDENTIAL**].[40] [**CONFIDENTIAL**].

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33 Virgin Media analysis of Barb data.

34 Third Consultation Document, paragraphs 4.123 to 4.126.

35 Third Consultation Document, paragraph 4.112, states that "*Tennis is considered important by 20% of subscribers who watch sport at least once a week*". Paragraph 4.123 states "*However, although 20% of subscribers highly value golf, only 1% of subscribers highly value golf but do not value football*".

36 Third Consultation Document, paragraph 4.114.

37 The lack of Rugby League, which is considered to be very important by 17 per cent of subscribers who watch sport at least once a week (Third Consultation Document, paragraph 4.110), is also likely to be important in driving subscribers away from a package which did not include Sky Sports 3 because of the significant amount (30 per cent) of Super League coverage on this channel.

38 [**CONFIDENTIAL**].

39 [**CONFIDENTIAL**].

40 [**CONFIDENTIAL**].

Summary

3.31 To summarise, Virgin Media considers that if the terms upon which a rival retailer were to be offered Sky Sports 3 and Xtra were to deteriorate, this would not be constrained by the ability of a rival retailer to either switch to alternative channels or to choose not to purchase the Sky Sports 3 and Xtra. This is because those channels would be necessary in order to compete effectively for consumers making choices between the full range of content available in the channel packages offered by rival retailers. Virgin Media considers, therefore, that Ofcom's approach to market definition, which focuses on Sky Sports 1 and Sky Sports 2, fails to capture the body of content which Sky is able to aggregate, and from which it derives its market power.

The need for consistency with the approach to interactive content

3.32 Ofcom has recognised that there is a risk to effective competition in the retail market if Sky is able to provide an inferior product to rival retailers as compared to the products supplied to its own retail arm. It particular Ofcom states that:

> "***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. …we believe that the restricted supply of HD versions of the channels and primary interactive content does create a risk to fair and effective competition. On this basis our view is that these should be included within the scope of the obligation*."[41] (Emphasis added)

3.33 Accordingly, Ofcom has accepted the importance of rival retailers being offered content which is part of events shown on the linear streams on Sky Sports 1 and 2, but which Sky chooses to show behind the red button, in order to ensure fair and effective competition. It states:

> "*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…*
>
> *The position here is finely balanced; we propose to consult on including within the scope of the remedy any sports matches shown live via the red button which are part of events that appear on Sky Sports 1 and Sky Sports 2, e.g. those shown in Figure 7 such as FAPL, Champions League, Carling Cup, English Test cricket, World Golf Championship, Heineken Cup, Super League.*"[42]

3.34 Ofcom's proposal (which Virgin Media supports) is based on a concern that, without access to content shown behind the red button, subscribers will not gain access to live coverage which are part of events that appear on Sky Sports 1 and Sky Sports 2 and that, without complete coverage of these events, a rival may not be able to compete effectively.

3.35 Virgin Media agrees[43] and considers that corresponding issues arise in respect of Sky Sports 3 and Xtra. In particular, like Sky's interactive sports services, which are not offered independently of Sky's premium channels at the retail level, Sky Sports 3 and (for the vast majority of subscribers) Sky Sports Xtra are offered within a wider Sky Sports

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41 Third Consultation Document, paragraph 8.91.

42 Third Consultation Document, paragraphs 8.106 and 8.109.

43 See paragraphs 8.13 to 8.21 below for Virgin Media's comments on Ofcom's proposals as regards interactive features.

bundle at no extra cost. Consumers access Sky's interactive services by pushing the "*red*" button. Consumers access Sky Sports 3 and Xtra by pushing the "*channel down*" button. In both cases, they are accessing additional video streams which are offered as part of the bundle with Sky Sports 1 and 2. For example, as indicated above, Sky has broadcast important end of season FAPL matches on Sky Sports 3 and Xtra in recent years, and frequently uses these channels to broadcast popular UCL fixtures featuring England clubs when there are simultaneous kick-offs. These fixtures are also broadcast occasionally behind the red button.

3.36 It is of little practical significance to Sky's subscribers whether content which forms part of the events shown on Sky Sports 1 and 2 is shown on Sky Sports 3/Xtra or on Sky's interactive service, provided they have access to both (which is the case for the vast majority of Sky's premium sports subscribers).[44] It is of enormous significance to rivals, however, if the products provided to them by Sky do not include this content because Sky Sports 3 and Xtra do not fall within the scope of the WMO remedy, and Sky chooses, therefore, not to provide them. Sky could also avoid providing to rivals the content which currently forms part of its interactive service simply by choosing to include it within Sky Sports 3 and Xtra rather than within its interactive services. It is critical that Sky is not able to determine whether or not these additional video streams are included within the scope of the WMO obligation simply by choosing to include them within Sky Sports 3 or Xtra rather than within its interactive services.

The risk of gaming is raised if Sky Sports 3 and Xtra are excluded from the remedy

3.37 Virgin Media notes Ofcom's concern that excluding content made available behind the red button from the scope of the remedy could provide a mechanism for the remedy to be gamed. It states:

> "*We are in any case concerned that if premium content could be excluded from the scope of the remedy, by making it available via the red button rather than on the main channel, this would provide a mechanism for the remedy to be gamed.*"[45]

3.38 Ofcom also recognises the risks to the effectiveness of the proposed remedy arising from Sky shifting content away from the WMO channels, both in its analysis of pricing[46] and in respect of its proposal to limit the scope of the remedy to Sky Sports 1 and 2. As regards the latter Ofcom states:

> "*This conclusion is of course based on our current market definitions. The evidence on which these market definitions are based can only relate to existing channels, and the existing distribution of content rights across those channels. We noted in our Second Pay TV Consultation the possibility that* ***Sky might change the way in which it distributes its content rights across its channels****, and we are also mindful of the international study by Value Partners, which shows that WMO remedies in other countries have been limited in their effectiveness where there has been a lack of clarity over what constitutes a "premium channel", allowing the remedy to be gamed. If Sky were to create new channels, containing a significant amount of content currently broadcast on channels within the scope of the proposed remedy, then we would clearly need to consider extending the scope of the remedy to those channels*."[47](Emphasis added)

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44 Over [**CONFIDENTIAL**] of Virgin Media customers who take Sky Sports take all of the Sky Sports channels, and Virgin Media is confident that the proportion will be similar for Sky's customers.

45 Third Consultation Document, paragraph 8.108.

46 Third Consultation Document, paragraph 9.40(i).

47 Third Consultation Document, paragraph 8.35.

3.39 Virgin Media considers that there is a significant risk of gaming by Sky in the event that Sky Sports 3 and Xtra are excluded from the scope of the remedy. This risk, moreover, is not limited to the possible creation of new channels containing a significant amount of content currently broadcast on Sky Sports 1 and 2. Indeed, Virgin Media considers that it is much more likely that Sky would migrate content to Sky Sports 3 and Xtra and choose not to wholesale these channels to rival retailers.

3.40 Sky already broadcasts certain live events on Sky Sports 3 and Xtra which attract sizeable audiences. Even without any significant change to the distribution of content across channels, therefore, there is scope for causing considerable dissatisfaction amongst the subscribers of rival retailers if this content is not made available. Virgin Media research of the top 20 programmes on Sky Sports 3 or Xtra (measured by audience size) indicates that the following highly attractive events have been regularly amongst the top 20 programmes in recent years:

(a) UCL football matches featuring England clubs (from 2004 onwards approximately 4 to 6 matches each season featuring England clubs have been broadcast on Sky Sports Xtra or Sky Sports 3);

(b) the FAPL end of season matches (see paragraph 3.23 above);

(c) live US Open and Masters tennis matches involving Andy Murray (for example Paribas, Miami and Monte Carlo Masters tennis featuring Andy Murray in 2009);

(d) live rugby union matches (for example the Guinness Premiership rugby union semi-final in 2009); and

(e) live Rugby Super League matches.

3.41 In addition, Sky has used these channels more heavily in the past to broadcast highly attractive events such as international football qualifying matches and World Cup cricket, which indicates that Sky is flexible in scheduling content across the Sky Sports channels to accommodate highly attractive but infrequent events.

3.42 Notwithstanding the large body of highly attractive content which is already broadcast on Sky Sports 3 and Xtra, Virgin Media considers that Sky could gain a material competitive advantage at the retail level by migrating further content to these channels. Sky would not need to migrate a large volume of content in order to achieve this objective. It could, for example, broadcast a small number of key events on these channels. Key events could include the occasional FAPL fixture involving Manchester United or an England cricket one-day international. Sky could add incrementally to the existing UCL matches broadcast on Sky Sports 3 and Xtra. With four English clubs taking part in the UCL each year, and these four clubs almost invariably being the "big 4" which generate audience interest, there is ample scope to add to the UCL content on Sky Sports 3 and Xtra. This incremental switching of content could also take place for other sports in the portfolio.

3.43 The vast majority of Sky subscribers would be unaffected as they would still have access to the content within their retail packages. Virgin Media considers, in this regard, that Sky subscribers will not mind which channel offers the content which is of interest to them, provided they can access it within their package. Rivals without access to these channels, on the other hand, could be significantly affected as this would create considerable annoyance and disenchantment amongst subscribers with the result that they would be more inclined to switch to Sky.

3.44 Sky could further exploit its unfair competitive advantage by heavily marketing the fact that rivals are offering inferior premium sports services. More specifically, on the channels which were provided as part of the WMO regime, Sky could cross-promote its own more comprehensive package of channels. As a result the subscribers of rival retailers could be constantly reminded that they have chosen an inferior service and that they are being provided with access to substantially less content than subscribers to Sky's sports package.[48]

3.45 As discussed further in Section 7 on pricing, Virgin Media considers that Ofcom's proposal for addressing this problem is wholly unsatisfactory. Ofcom has indicated that it will reassess its wholesale pricing calculations only in the event of "*very major changes*".[49] Sky could, however, use tactical content switching on an infrequent basis which would cause the maximum dissatisfaction amongst the subscribers of rivals whilst potentially not amounting to a "very major change".

3.46 The content switching would be likely to take the form of one-off events and would vary between the sports involved, such that it would be difficult to conclude that there had been a significant aggregation of valuable sports content on these channels sufficient to give Sky market power (if Ofcom adopts the channel-by-channel approach described above). Even if Ofcom decided that such behaviour did warrant investigation, any analysis of whether the channel did possess market power would take time during which the ability of Virgin Media and other rival retailers to compete would be compromised. If Ofcom reached a finding that the channel did possess market power and should be subject to the WMO regime, Sky could then move content amongst its channels again in order to make the original analysis redundant.

3.47 Virgin Media considers that this problem arises because of Ofcom's decision to restrict the scope of the WMO regime to Sky Sports 1 and Sky Sports 2. It should be addressed, therefore by widening the scope of the WMO regime to include these channels, both to ensure that the scope of the WMO is consistent with the body of content in relation to which Sky has market power, and to prevent the gaming behaviour by Sky outlined above.

3.48 If, however, Ofcom decides not to widen the WMO regime then Virgin Media considers that significantly greater regulatory oversight will be required to prevent the effectiveness of the remedy from being undermined. As discussed further in paragraph 7.95 of the Section on pricing, Virgin Media considers that Sky should be obliged to seek consent from Ofcom for moving key content away from WMO channels such that it is not available to rivals. This would allow Ofcom to assess any objective justification for such a shift as well as the potential damage to rival retailers. However, the burden for Ofcom of being required to adjudicate on such behaviour would be removed if Sky Sports 3 and Xtra were included within the scope of the WMO.

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48 Sky is currently acting in this way by cross-promoting its enhanced and interactive services on the linear streams of its channels which it supplies to Virgin Media.

49 Third Consultation Document, paragraph 9.42.

4. MARKET POWER

4.1 Section 5 of the Third Consultation Document sets out Ofcom's analysis and findings as regards market power in the relevant wholesale and retail markets. This section comments on Ofcom's views on Sky's market power in each of the relevant markets in turn.

Wholesale of Core Premium Sports

4.2 Subject to Virgin Media's observations in relation to the definition of Core Premium Sports, Virgin Media reiterates its support for a finding that Sky has market power in relation to the wholesale supply of Core Premium Sports. In particular, Virgin Media supports Ofcom's findings that:

(a) there are limited competitors in this market (now only ESPN 1) and Sky has a persistently very large share of this market (Ofcom notes that its share for the second half of 2008 was 80-90 per cent)[50] and its share is likely to increase as a result of Sky winning a fifth package of FAPL rights in the most recent auction;

(b) even if out of market constraints are taken into account, Sky would nevertheless enjoy a very high market share;[51]

(c) barriers to entry and expansion are high. In order to materially undermine Sky's position of market power, any new entrant or expansion would depend on acquiring the rights to sufficient highly attractive live rights, including the majority of live FAPL rights and this is extremely unlikely given Sky's bidding advantages;[52] and

(d) Virgin Media is unable to exercise countervailing buyer power over Sky in relation to the wholesale supply of Core Premium Sports channels.[53]

4.3 In this context, widening the definition of Core Premium Sports as suggested by Virgin Media in paragraphs 3.9 to 3.48 would not affect this conclusion. If Sky Sports 3 and Xtra were included in the market for Core Premium Sports, Sky would nevertheless retain market power in that market.[54] Further, while Ofcom observes that "*if the ownership of the Live FAPL Rights were to change significantly in the future we would revisit our assessment of market power*",[55] it is clear from Ofcom's own analysis that this is highly unlikely.[56]

Wholesale of Core Premium Movies

4.4 Virgin Media reiterates its support for the finding that Sky has market power in relation to the wholesale of Core Premium Movies. In particular, Virgin Media supports Ofcom's findings that:

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50 Third Consultation Document, paragraph 5.30.

51 Third Consultation Document, paragraph 5.35.

52 Third Consultation Document, paragraphs 5.38 to 5.61.

53 Third Consultation Document, paragraph 5.72.

54 For detailed submissions on this point, Virgin Media refers to section 3 of the Virgin Media Response to Second Consultation.

55 Third Consultation Document, paragraph 5.61

56 Third Consultation Document, paragraphs 5.54 to 5.60.

(a) there are limited competitors in this market and Sky has a persistently very large share of this market (Ofcom notes that its share for the second half of 2007 and in 2008 was 90-100 per cent[57]);

(b) even if out of market constraints are taken into account Sky would nevertheless enjoy a very high market share;[58]

(c) barriers to entry and expansion are high. In order to materially undermine Sky's position of market power, Sky would need to lose the rights to the movies of two to four major studios and this is extremely unlikely given Sky's bidding advantages;[59] and

(d) Virgin Media is unable to exercise countervailing buyer power over Sky in relation to the wholesale supply of Core Premium Movies channels.[60]

4.5 Virgin Media notes that Sky has argued that putative market shares understate the extent of the competitive constraint on Sky's channels[61] and Ofcom has acknowledged that Sky's market share is decreasing over time.[62] In this connection, Virgin Media refers to Section 4 of the Virgin Media Response to Second Consultation where it sets out in detail why there are no reasons for believing that Sky's market power in relation to the wholesale of Core Premium Movies will change materially in the foreseeable future, even in light of the fact that Sky's market share may be declining. This is because Virgin Media's experience suggests that movie rights from three studios would be required to assemble a viable and attractive package to challenge Sky's dominance[63] but acquiring this critical mass would be very difficult given that contracts for movie rights are only available on a staggered basis[64] and Sky has incredibly strong bidding advantages.[65] As previously submitted to Ofcom, Virgin Media's direct experience supports these market characteristics.[66]

Retail market power as regards Core Premium Sports and Core Premium Movies

4.6 Ofcom is consulting on its view that Sky holds a position of market power for the retailing of packages including Core Premium Sports and Core Premium Movies. Virgin Media supports Ofcom's view that Sky has market power in these markets which is consistent with submissions made by Virgin Media.[67] Specifically, Virgin Media agrees with the following views as expressed by Ofcom:

(a) Sky is not constrained by existing competitors in relation to the retail supply of Core Premium Sports and Core Premium Movies where it has market shares of 70-80 per cent and 90-100 per cent respectively;[68]

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57 Third Consultation Document, paragraph 5.84.

58 Third Consultation Document, paragraphs 5.85 to 5.94.

59 Third Consultation Document , paragraphs 5.96 to 5.107.

60 Third Consultation Document, paragraph 5.109.

61 Third Consultation Document, paragraph 5.91.

62 Third Consultation Document, paragraph 5.92.

63 Virgin Media Response to Second Consultation, paragraph 4.4.

64 Virgin Media Response to Second Consultation, paragraphs 4.12 to 4.16.

65 Virgin Media Response to Second Consultation, paragraphs 4.16 to 4.18.

66 Virgin Media Response to Second Consultation, paragraphs 4.19 to 4.22.

67 Virgin Media Response to Second Consultation, section 5. See also Joint Response to Second Consultation, Section 3.

68 Third Consultation Document, Figure 44 and Figure 46 respectively.

(b) Sky is not constrained by "out of market" suppliers, (even if out of market constraints are taken into account Sky would nevertheless enjoy a very high market share);[69]

(c) customers have no countervailing buyer power;[70] and

(d) there would be insufficient retail competition to constrain Sky even if it did not have market power at the wholesale level of the supply chain.

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[69] Third Consultation Document, Figure 45 and Figure 47.

[70] Third Consultation Document, paragraph 5.133 and 5.169

5. COMPETITION ISSUES

5.1 Section 6 of the Third Consultation Document sets out Ofcom's analysis and findings as regards competition issues in the UK pay TV market. Ofcom has identified three competition concerns arising from Sky's market power, namely:

(a) Sky as a vertically integrated firm, with market power in a key upstream market, distributes its Core Premium channels in a manner that favours its own platform and its own retail business. In addition, the heightened importance of "triple play" bundles increases the risk that this distortion is extended to other services such as broadband and telephony services;[71]

(b) Sky is setting high wholesale prices in order to maximise wholesale profits;[72] and

(c) some services, such as services relying on SVOD rights, are unavailable because Sky favours its own platform and retail business.[73]

5.2 Virgin Media agrees with these three concerns and, indeed, has (along with the Joint Parties) submitted evidence on these competition concerns throughout Ofcom's investigation of the pay TV market. In this regard, Virgin Media and the Joint Parties have submitted evidence on, for example:

(a) the uneconomic terms on which Sky supplies premium channels to cable. Virgin Media has submitted evidence on the high level of the Sky premium channel wholesale prices and how these limit Virgin Media's ability to compete with Sky;[74]

(b) Sky withholding the supply of HD and interactive services to cable;[75]

(c) Sky refusing to offer premium channels to other retailers on a wholesale basis;[76] and

(d) Sky restricting the ability of competitors such as Virgin Media to access SVOD rights for movies and, accordingly, offer innovative SVOD movie services.[77]

5.3 In addition to its broad agreement with Ofcom's findings and analysis of competition concerns, Virgin Media makes the following observations on specific aspects of Section 6 of the Third Consultation Document.

5.4 First, in paragraphs 6.47 to 6.53 Ofcom notes that Setanta reached wholesale carriage agreements in a more platform-neutral manner than Sky and hypothesises that ESPN is likely to be in a similar position as Setanta and accordingly is more likely than Sky to negotiate in a platform-neutral manner. Virgin Media's experience supports this hypothesis. Virgin Media has reached an agreement for the carriage of ESPN under which ESPN is available on Virgin Media in standard definition ("**SD**") and HD as a part of the XL pack. M or L pack customers can subscribe to ESPN and ESPN HD for £8 a month if they already subscribe to any combination of the Sky Sports channels or £10 a month if they

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71 Third Consultation Document, paragraph 6.2.

72 Third Consultation Document, paragraph 6.3.

73 Third Consultation Document, paragraph 6.4.

74 July 2007 Joint Submission, Annex 6, paragraphs 2.7 to 2.15.

75 July 2007 Joint Submission, Annex 6, paragraphs 2.16 to 2.39.

76 July 2007 Joint Submission, Part 4, paragraph 5.3 and Virgin Media Response to First Consultation, paragraph 6.14.

77 *Virgin Media Supplementary Submission to Ofcom* of 15 August 2005 (**"Virgin Media Supplementary Submission"**), section 5.

do not. Both channels were available for free to Virgin Media customers throughout August. ESPN is also available on Sky, Top Up TV BT Vision and Tiscali.

5.5 Second, in paragraphs 6.97 to 6.129 Ofcom analyses the supply of premium channels to Virgin Media. Virgin Media agrees with Ofcom's review of the terms on which Sky wholesales these channels to Virgin Media, namely that:

(a) Sky wholesales the channels to Virgin Media because it considers it may be under an obligation to do so. However, Sky seeks to meet this obligation whilst inhibiting as far as possible the effectiveness of Virgin Media as a competitor in the retailing of those channels (e.g. by charging uneconomic prices and withholding interactive and HD services); and

(b) even if Sky has a short-term incentive to supply premium channels to Virgin Media, it also has long-term strategic incentives to weaken or eliminate Virgin Media as a retail competitor and withholding premium channels (or supplying them on disadvantageous terms) can assist Sky in meeting this long-term strategy.

5.6 Third, in paragraphs 6.130 to 6.140 Ofcom discusses the competition concerns arising in relation to the supply of premium channels to commercial premises. The supply of premium channels to commercial premises is discussed in more detail from paragraph 8.3 below. However, at this stage, Virgin Media notes that the logic of Ofcom's analysis of the competition concerns arising in relation to commercial premises is flawed. Ofcom appears to conclude that the competition concerns arising in relation to commercial premises are less extensive than those arising in relation to retail premises because retailers are less interested in supplying commercial premises and it is more difficult to make a sufficient margin in relation to commercial premises. This analysis ignores the fact that this lack of interest and limited ability to make a margin are a direct result of the difficulties retailers would have in reaching economic terms with Sky for wholesale supply of premium channels (based on their experience in negotiating with Sky as regards residential customers). Indeed, given the near absolute lack of competition in the retail supply of premium channels to commercial premises, the competition concerns as regards commercial premises are arguably even greater that those in relation to retail supply to residential subscribers.

5.7 Fourth, in paragraphs 6.141 to 6.154 Ofcom sets out in more detail the reasons why it concludes that Sky has an incentive to restrict the exploitation of SVOD movie rights to protect its own linear move channels. Virgin Media agrees with Ofcom's analysis (to the extent to which it has not been redacted) and notes that it is consistent with Virgin Media's own extensive submissions on this issue. In this connection, Virgin Media refers specifically to paragraphs 7.9 to 7.18 of the Virgin Media Response to Second Consultation and section 5 of the Virgin Media Supplementary Submission.

5.8 Fifth, in paragraphs 6.155 to 6.207 Ofcom discusses the wholesale pricing of Core Premium channels. Ofcom, with the assistance of Oxera, has undertaken a considerable amount of further analysis of the economic returns for Sky's pay TV business at both aggregate and various disaggregate levels. Ofcom concludes that there is evidence that Sky is earning and will (if the pay TV market is left unchanged) continue to earn aggregate returns in excess of its cost of capital, and that this is likely to be reflected in higher retail prices for consumers.

5.9 In particular, Virgin Media notes the finding that aggregate returns (which have been modelled under a range of different assumptions, time periods and measures of profitability) appear to be above 20 per cent which is significantly in excess of Ofcom's calculation of Sky's cost of capital which stands at 10.3 per cent. The disaggregated analysis undertaken by Oxera leads Ofcom to the view that Sky's wholesale returns are greater than retail returns and they are also above those of appropriate comparators.

Within wholesale, Ofcom also states that it is likely that movie returns are greater than on sports.

5.10 Whilst Virgin Media cannot comment in detail on Oxera's analysis due to a lack of access to the underlying data, the approach used by Oxera to assess Sky's profitability is conceptually appropriate in the context of a competition investigation. In particular:

(a) as regards the aggregate analysis, Oxera has used a profitability metric (namely the truncated internal rate of return (**"IRR"**) approach) which allows profitability to be measured over a specific period, thereby avoiding the distortions which can arise by focusing on "snapshots" of profits earned in any particular year.[78] The approach mirrors an investment appraisal by taking account of inflows and outflows of an activity over time;

(b) Oxera has cross-checked its IRR results by considering alternative approaches, in particular a return on capital employed (**"ROCE"**) measure. In mature, steady-state industries, there is likely to be a close correspondence between the results of these two measures. Oxera has identified such a relationship in estimating returns for Sky over the period 2004-2008 during which these market conditions have been more prevalent as compared to earlier periods. Virgin Media agrees with Ofcom that this provides "*a strong degree of comfort around the IRR estimates*";[79]

(c) Ofcom rightly highlights that the IRR approach requires an estimation of opening and closing assets values and that, in this case, that also requires an estimation of off-balance sheet intangible assets which are likely to represent a relatively high proportion of the economic value of Sky. Oxera uses a reasonable approach based on assessing the replacement costs of such assets. This avoids the problem of circularity which can arise in using value-based measures based on future cash-flows, in particular, the difficulty of separating the value that arises from intangible assets from the value that could be derived from exercising market power. Oxera has also undertaken appropriate sensitivity checks to allow for the inevitable uncertainties in undertaking such a valuation.[80] This allows their impact on the calculation of returns to be explored in a transparent manner, and for Ofcom to reach a view which is robust to these uncertainties;[81] and

(d) As regards the disaggregate analysis, Oxera again uses a variety of metrics to assess Sky's returns but places greater emphasis on the ROCE and return on sales measures. Virgin Media considers this to be a reasonable and conservative approach and one which is consistent with the recommendations contained in Oxera's guidance to the OFT in its report *Assessing profitability in competition policy analysis.*[82] In view of the reliance of these calculations on cost and revenue

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78 Virgin Media notes that in the report prepared for Sky by Professor Paul Grout of Bristol University (dated 11 May 2009) on the use of the truncated IRR methodology to measure profitability, Professor Grout raises a number of issues particularly in the use of this metric to infer the possible presence of monopoly power. He concludes as follows: "*First, in addition to calculating the truncated IRR carefully it is essential that the numbers are interpreted carefully. Simple mechanical procedures are very misleading. Second, any judgement about excessive profitability should not be based on truncated IRR analysis alone but should be considered alongside alternative approaches*." Virgin Media recognises that Oxera has considered alternative approaches and that the results have been interpreted carefully by Ofcom on the basis of a transparent assessment by Oxera of how different assumptions affect the overall results.

79 Third Consultation Document, paragraph 6.188.

80 For example, Oxera creates a "conservative" and "base case" scenario where the former includes an upper end estimate as regards subscriber acquisition costs and the latter attempts to provide a more accurate estimate for this cost category based on a detailed analysis of costs.

81 *Assessing profitability in competition policy analysis*, Economic Discussion Paper 6, July 2003, A report prepared for the Office of Fair Trading by Oxera.

82 *Assessing profitability in competition policy analysis*, Economic Discussion Paper 6, July 2003, A report prepared for the Office of Fair Trading by Oxera.

allocations, Oxera makes appropriate use of sensitivity checks which are vital in assessing the robustness of its estimates to different cost allocation approaches. The result that returns for wholesale activities appear higher than retail activities holds under a number of cost allocation approaches including the same detailed cost allocation which Ofcom uses as part of its calculation of regulated wholesale prices. Virgin Media also notes that the result that movie channels have higher margins than sports channels holds even under the most extreme of revenue allocation approaches.

5.11 In summary, Virgin Media considers that the conclusions drawn by Ofcom from the analysis of Sky's profitability by Oxera are well supported. Oxera has undertaken its analysis carefully and conservatively using the appropriate conceptual framework. The study makes sensible use of scenarios to test the sensitivity of results to key assumptions and thereby allows conclusions to be drawn which are robust to different assumptions. Oxera has also cross-checked the results using alternative measures, in particular the ROCE, as well as carefully considering potential comparator companies against which Sky's returns could be appropriately measured.

6. CONSUMER EFFECTS

6.1 Section 8 of the Third Consultation Document sets out Ofcom's analysis and findings as regards consumer effects. Ofcom starts its analysis with a recognition of the importance of taking a forward-looking approach, which considers important recent and future developments, when considering consumer effects.[83] Virgin Media strongly supports this approach, especially in light of recent technological developments such as the explosion of VOD and the ongoing digital switchover process. Ofcom then considers consumer effects as regards consumer choice, innovation and pricing. Each of these considerations is discussed in turn below.

6.2 First, Virgin Media agrees with Ofcom's finding that choice in the pay TV market is being distorted by the restricted availability of Core Premium channels (including a distortion "*in favour of satellite and away from cable over time*")[84]. This distortion of consumer choice is likely to be exacerbated in the future, especially in a world where there is the potential for more platforms and retailers. In this connection, and in support of Ofcom's finding, Virgin Media notes that it, and the Joint Parties, have submitted evidence on the consumer detriments related to a distortion of consumer choice. The following examples of reduced consumer choice illustrate the consumer detriment suffered:

(a) Sky's refusal to supply premium channels to certain pay TV retailers on the DTT platform means that consumers on those platforms are denied the ability to choose to subscribe to those channels;[85]

(b) Sky's refusal to supply enhanced, interactive or HD services or on-demand content to Virgin Media means that customers on the cable platform are denied access to those features and services;[86]

(c) Sky's stranglehold on premium content prevents third parties from creating attractive channels in competition with Sky's premium channels;[87] and

(d) the bundled acquisition of ancillary rights on an exclusive basis by Sky leads to these rights being exploited on a limited basis, if at all. This means that consumers are often only able to access services associated with these rights via Sky, if at all.[88]

6.3 Second, Virgin Media also agrees with Ofcom's discussion as regards innovation, in particular the finding that innovation in pay TV is skewed towards innovation that suits the digital satellite (**"DSat"**) platform. In this regard, Virgin Media agrees with Ofcom's findings that:

> "*Sky's exclusive right to first-run premium movies, its technical inability to make those movies available on a true SVOD service on DSat, and its non-supply of those movies for SVOD on other platforms, mean that UK consumers do not have access to this content on a full SVOD service on any TV platform.*"[89]

6.4 In support of this view, Virgin Media draws Ofcom's attention to following submissions made by Virgin Media and the Joint Parties as regards the consumer detriments related to less innovation:

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83 Third Consultation Document, paragraphs 7.10 to 7.20.

84 Third Consultation Document, paragraph 7.81.

85 July 2007 Joint Submission, Part 4, paragraph 5.3(a).

86 July 2007 Joint Submission, Part 4, paragraph 5.3(c).

87 July 2007 Joint Submission, Part 4, paragraph 5.5(a).

88 July 2007 Joint Submission, Part 4, paragraph 5.5(b).

89 Third Consultation Document, paragraph 7.97

(a) by wholesaling its premium channels to Virgin Media at uneconomic rates, Sky effectively forces Virgin Media to follow Sky's pricing model leading to less innovation in how pay TV services are packaged and priced;[90]

(b) the lack of certainty in terms of supply makes it more difficult for Virgin Media to adopt a forward-looking strategy and this reduces the incentives for Virgin Media to make the marketing and other investments necessary to launch innovative pricing mechanisms and new or improved services;[91]

(c) the refusal to supply enhanced and interactive services, and prohibiting Virgin Media from developing its own enhanced and interactive services in connection with Sky's premium channels, means that Virgin Media is deprived of the ability to develop such services;[92]

(d) the uneconomic terms imposed on cable reduces the ability of Virgin Media to invest in research and development of new products and services;[93]

(e) since Sky is able to marginalise its upstream competitors, Sky faces reduced upstream competition and, as a consequence, has a reduced incentive to innovate and develop new products and services.[94]

6.5 Third, in support of Ofcom's view as regards the consumer detriments related to high wholesale prices, Virgin Media refers to evidence of all of the following, which has already been submitted to Ofcom during the course of its investigation:

(a) Sky's market power, high wholesale prices and restrictive terms of supply mean that Virgin Media neither has the incentive nor the ability to compete on price at the retail level. As a result, Virgin Media is unable to exert any real competitive pressure on Sky's prices;[95]

(b) [**CONFIDENTIAL**];[96] and

(c) higher prices in the UK for pay TV compared to other jurisdictions.[97]

6.6 Further, as regards high wholesale prices, Virgin Media agrees that Sky's high wholesale prices tend to result in high retail prices for both Sky's DSat subscribers and also subscribers on other platforms. However, Virgin Media notes that high wholesale prices not only affect retail prices but also affect the ability of competing retailers to invest in research and development and accordingly can reduce innovation in the retailing of such channels.

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90 July 2007 Joint Submission, Part 4, paragraph 5.4(a).

91 July 2007 Joint Submission, Part 4, paragraph 5.4(b).

92 July 2007 Joint Submission, Part 4, paragraph 5.4(c).

93 July 2007 Joint Submission, Part 4, paragraph 5.6(c).

94 July 2007 Joint Submission, Part 4, paragraph 5.6(d).

95 July 2007 Joint Submission, Annex 6, paragraphs 2.10 to 2.11.

96 [**CONFIDENTIAL**].

97 July 2007 Joint Submission, Part 4, Sections 2 to 4 and Annex 1. See also *Joint Response to Sky Submission to Ofcom of October 2007* dated 29 February 2008, paragraphs 5.3 to 5.5 and Annex 2 which responds to Sky's criticism of this evidence.

7. **PRICING TERMS AND PRINCIPLES OF WMO**

Introduction

7.1 Section 9 of the Third Consultation Document sets out Ofcom's analysis to establish the appropriate level for regulated wholesale prices. This section comments on Ofcom's proposals, covering issues of principle and methodology as well as providing Virgin Media's views on the range of prices identified by Ofcom for consultation.

7.2 Virgin Media considers that Ofcom is right to seek to establish prices and other non-price terms rather than imposing a WMO regime but leaving price-setting to subsequent commercial negotiations. A successful implementation of the remedy depends on the explicit determination of these terms in order to avoid protracted future disputes.

7.3 Virgin Media also agrees with the broad approach adopted by Ofcom to derive prices. A retail-minus approach coupled with a cost-plus cross-check is a pragmatic approach which is responsive to the key competition concerns identified by Ofcom. Nevertheless, Virgin Media has a number of observations on the detail of Ofcom's proposed approach which are addressed in turn under the following general categories:

(a) the overall approach to deriving prices adopted by Ofcom;

(b) the calculation methodology, covering:

(i) the appropriate retail prices as the starting point of the calculation;

(ii) the costs to be deducted from the reference retail price;

(iii) the allowance for an appropriate return;

(iv) the appropriate scale of an efficient entrant;

(v) the allowance for transmission costs;

(c) the calculation of cost-plus prices as a cross-check; and

(d) the evolution of prices over time.

7.4 In summary, as a consequence of its observations on the assumptions underlying Ofcom's pricing analysis, Virgin Media considers that prices no higher than the bottom of Ofcom's proposed range are more consistent with the aim of ensuring fair and effective competition than prices mid-way through the range, which Ofcom appears to favour.[98]

Overall approach to deriving prices

7.5 As indicated above, Virgin Media is broadly in agreement with the approach which Ofcom has adopted to derive prices, as discussed further below:

(a) Calculation methodology for deriving price levels. Virgin Media supports the use of a retail-minus approach which focuses on whether the wholesale price is sufficiently low to enable efficient rivals to compete on price and other terms with the retail arm of their wholesale supplier (Sky), and is therefore directly responsive to Ofcom's aim of enabling fair and effective competition. Ofcom has identified that the cost-plus cross-check is required in order to ensure that the wholesale prices which are set by Ofcom permit Sky to recover efficiently incurred costs in the

98 Third Consultation Document, paragraph 9.8.

provision of its Core Premium wholesale channels. Virgin Media considers that the cost-plus cross-check should also be used by Ofcom for the following purposes:

(i) *ensuring comparability of margins* – Virgin Media considers that the cost-plus cross-check should also be used by Ofcom to ensure that there is not a significant discrepancy in margins between Sky and rival retailers. As stated in the Virgin Media Response to Second Consultation, Virgin Media is concerned that a retail-minus approach should not be applied in such a way that it allows Sky to earn a significantly higher retail margin than its rivals. If this were the case, then each premium subscriber attracted or retained by Sky would be significantly more profitable for Sky as compared to rivals. The ability of rival retailers to compete through making comparable investments would be compromised because their gross retail margin per new subscriber won would be lower than that of Sky. Virgin Media considers that this supports the use of wholesale prices no higher than the bottom of Ofcom's retail-minus range (i.e. Scenario 5) in order to minimise any significant discrepancy in margins and allow rival retailers to compete on a non-discriminatory basis (albeit that the cost-plus price should be used for those packages where the retail-minus price is below the cost-plus price); and

(ii) *enabling Ofcom to decide whether to give regulatory approval for increases in wholesale prices in response to increases in retail prices* – as discussed further in paragraphs 7.97 to 7.103 below, Virgin Media considers that there should be no automatic regulatory approval for increases in wholesale prices in response to increases in retail prices (which, for example, may be justified by Sky on the basis of an increase in wholesale costs arising from bidding by Sky in rights auctions). In these circumstances, Virgin Media considers that Ofcom should have regard to the cost-plus cross-check to inform its decision such that wholesale price increases would be permitted if the cost-plus floor exceeds the retail-minus price, but not otherwise;

(b) <u>Appropriate structure for wholesale prices</u>. Virgin Media agrees with the proposal to derive linear per subscriber prices as opposed to alternative non-linear structures, and considers this to be a pragmatic approach which is consistent with current practice; and

(c) <u>Applicable prices for different platforms</u>. Virgin Media agrees with Ofcom's position that there should be one price for retailers across all distribution technologies.[99] As stated in the Virgin Media Response to Second Consultation, Virgin Media considers that this is justified on the grounds of pragmatism and the need to preserve a level playing field amongst rival retailers.[100] The question of which transmission technology should be considered in setting retail-minus prices is considered further below.

7.6 Virgin Media's observations as regards the evolution of prices over time, are addressed below at paragraphs 7.84 to 7.103 (as Virgin Media considers that the issues are linked with the way in which prices are calculated at the outset).

The calculation methodology

Retail prices as the starting point of the calculation

7.7 Ofcom rightly identifies that there are a number of retail prices for each of the 11 Core Premium wholesale products identified by Ofcom. The effectiveness of Ofcom's proposed

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99 Third Consultation Document, paragraph 9.56.

100 Virgin Media Response to Second Consultation, section 6, paragraph 6.17.

remedy in enabling fair and effective competition will depend, among other things, on which retail prices are used as the starting point for the retail-minus price calculation. Virgin Media has a number of concerns in this regard particularly relating to the proposal to use a weighted average of Sky's retail prices for different bundles. As discussed further below, Virgin Media considers that this approach will potentially inhibit the ability of rivals to compete in relation to price points which are critical in attracting new customers and will be vulnerable to gaming by Sky given the lack of transparency in determining the weighted retail reference price.[101]

7.8 In considering the retail prices that should be used as a starting point, this section addresses issues raised by:

(a) retail packages including different basic channels;

(b) retail packages including other Core Premium channels; and

(c) retail packages including additional non-TV services.

<u>Retail packages including different basic channels</u>

7.9 Ofcom has considered how to derive a single retail reference price given that each of the Core Premium wholesale products is offered in six different combinations with basic channels (depending on which basic mixes a customer chooses). It proposes to take a weighted average of Sky's retail prices for different bundles, weighted by the number of Sky's retail customers who take that number of basic channels. In this connection, it is relevant that in June 2009 (just prior to the publication of the Third Consultation Document), Sky announced that, from September 2009, it would offer "premium-only" packages to customers. This raises two questions:

(a) is the use of a weighted average price as the reference price for bundled basic and premium products appropriate?; and

(b) what are the implications for Ofcom's pricing analysis of the availability (from September) of standalone premium prices?

7.10 Ofcom's proposal to use a weighted average price as the reference price is justified by Ofcom as follows:

(a) it provides the most accurate representation of the retail price paid by Sky's customers;[102] and

(b) it will provide rival retailers with a retail cost "allowance" which is comparable to that which is incurred by Sky, and will enable competition by rivals with a differentiated set of services. Ofcom argues that it is not necessary to enable competition by rivals which exactly replicates the bundles offered by Sky at precisely the same price points because, as regards the basic component of the

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101 Virgin Media notes that Ofcom has adjusted headline published prices to take account of the presence of discounts. In particular, it has calculated Sky's average customer discount by deriving Sky's expected pay TV revenues (given headline retail prices) and comparing this with actual pay TV revenues. The discount factor derived on this basis is then applied to all Sky's retail prices (Third Consultation Document, paragraph 9.70). Virgin Media agrees that the calculation of wholesale prices should take into account the presence of discounts. Nevertheless, as the level of discounts is not transparent, Virgin Media considers that Ofcom will need to monitor the use of discounts by Sky going forward in order to establish whether actual prices have changed (without, necessarily, a change in headline retail prices) which might require an adjustment to wholesale prices.

102 Third Consultation Document, paragraph 9.84.

package, rivals should be able to bundle alternative basic channels (which are readily available) and other services to offer differentiated packages.[103]

7.11 Virgin Media considers that the use of a weighted average price as suggested by Ofcom has a number of important drawbacks. Underlying Ofcom's use of a weighted average price is the assumption that, in order to compete, rival retailers should be able to match the bundles which are taken by most existing customers, at Sky's prices for those bundles. Most of Sky's existing customers take larger bundles and therefore, using a weighted average approach, the reference price will be skewed towards the larger bundles. Virgin Media considers, however, that competition for marginal customers (both new customers attracted into the pay TV market and switching customers) is focused on smaller bundles and lower price points.[104]

7.12 Virgin Media is also concerned that, in view of this competitive dynamic, a weighted average approach would give Sky an opportunity to "game" the regime by altering its relative retail prices in order to disadvantage rival retailers whose wholesale price is determined by reference to an average weighted price. It could, for example, drop its retail prices for those smaller bundles which are of key importance in attracting new and switching customers. To the extent that a wholesale price determined by reference to an average weighted price would not enable rival retailers to compete at the lower retail price points, this would inhibit the ability of rival retailers to compete for new customers.

7.13 In this regard Virgin Media notes that, as part of the most recent annual revision of its retail prices, Sky has increased prices for its larger pay TV bundles and decreased prices for its smaller packages. For example, the cost of taking four or more basic mixes as well as dual sports and dual movies has increased by £1.50 per month.[105] In contrast, customers taking either (i) four or more basic mixes and dual movies or (ii) four or more basic mixes and dual sports will pay an additional £1.00 per month. Customers taking one to three basic mixes as well as single sports, however, benefit from a £1.00 price reduction.[106] In these circumstances, the weighted average approach proposed by Ofcom would result in an increase in the weighted average retail price starting point of approximately £1.00 which could, subject to the ratchet mechanism proposed by Ofcom, result in an increase in the wholesale price by the same amount. Sky would be able, therefore, to increase the wholesale price for rivals whilst simultaneously reducing the price for single sports and fewer basic mixes where the market is most competitive, allowing it to compete more aggressively for marginal premium subscribers.

7.14 The problem is exacerbated because of a lack of transparency surrounding the derivation of the weighted average reference price. Virgin Media assumes that the weights which are applied to the different retail prices (based on the proportions of Sky's customers taking different bundles) would be commercially confidential to Sky allowing Sky, but not its rivals, an awareness of how changes to relative retail prices would affect the regulated wholesale prices. In these circumstances, Sky will be in a unique position to game the pricing of packages in order to ensure that rivals are constrained in their ability to compete with Sky on the basis of a wholesale price calculated by reference to an average weighted retail price.

7.15 As a consequence, in order for Ofcom's proposed remedy to enable fair and effective competition, it is critical that regulated wholesale prices are set in a way which assures competition in relation to smaller packages which have become the focal products for

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103 Third Consultation Document, paragraphs 9.83 and 9.88.

104 This is evident in both Sky's marketing strategy, which now focuses on lower price points, as well as its packaging strategy (for example, the lowering of the buy-through threshold allowing customers to take lower amounts of basic mixes before qualifying to buy premium channels, and the recent decision to launch premium-only packages).

105 Customers taking one to three basic mixes as well as dual sports and dual movies face a price increase of 50 pence per month.

106 Source: Sky website: hhttp://packages.sky.com/

attracting marginal customers. Virgin Media considers, therefore, that Ofcom should take each of the Core Premium wholesale products (identified in paragraph 9.22 of the Third Consultation Document) and undertake a retail-minus calculation for each combination of these products with different basic mixes. It should then use the lowest of the resulting wholesale prices as the regulated price. This will guarantee that rival retailers will be able to compete with any current retail package offered by Sky.

7.16 Virgin Media does not see this option as enabling the exact replication of Sky's bundles at precisely the same price points, but rather ensuring that rivals can compete in relation to the bundles and the price points which are critical for successful competition. The weighted average approach, although ensuring competition for the bundles which have been the most popular in the past does not provide the same guarantee in relation to the bundles which are popular now. Although the approach recommended by Virgin Media gives rise to greater complexity, Virgin Media considers that this is justified given that the remedy is intended to promote competition.

7.17 The final issue to be considered is whether Ofcom's pricing analysis should reflect Sky's offer (from September) of standalone premium prices. Although this product will provide the closest available retail product to the focal wholesale products, using the standalone retail prices as the relevant reference prices is highly unlikely to deliver regulated wholesale prices which will enable fair and effective competition.

7.18 In particular, there is a risk that Sky will set relative prices for these standalone products and its bundled products[107] in a way which will make it difficult for rivals to compete. Sky could set standalone prices relatively high as compared to its bundled products. The effect on Sky might not be significant since it may not be anticipating a significant take up of these standalone products by subscribers. Indeed, by setting an inflated price for the standalone products relative to bundled products, Sky can limit the "*spin down*" from bundled products. It would, however, have the effect of increasing the regulated wholesale price for the premium wholesale products to the disadvantage of rivals.

7.19 Ofcom acknowledges the risk of pre-emptive price-setting by Sky ahead of the WMO coming into force in order to manipulate the regulated wholesale prices to the disadvantage of rivals. It states:

> "*…we note there is an incentive for Sky to change its current retail prices ahead of any WMO obligations coming into force. One way to address this concern would be to determine wholesale prices on the basis of retail prices effective at the time of this consultation.*"[108]

7.20 Sky has not yet published prices for its standalone premium products, but it has been suggested in press commentary that the price differential between standalone premium products and bundled products may be small. An article in New Media Markets states the following:

> "*…a single premium sports subscription with one basic package costs £26.50 per month; this would change to £25.50 for a stand-alone premium sports subscription…The pricing for premium films will follow the same pattern*."[109]

7.21 As discussed further below, Ofcom has expressed concern about the efficacy of its remedy if Sky bundles non-TV products, and wholesale prices are not set to allow rivals to assemble competing bundles. Equally, the efficacy of the remedy would be undermined if wholesale prices are set by reference to a standalone premium price in circumstances in which this does not allow rivals to compete in offering comparable basic/premium bundles

107 Bundles including premium and basic channels as well as, potentially, non-TV services (broadband and telephony).

108 Third Consultation Document, paragraphs 9.89 and 9.90.

109 New Media Markets, 26 June 2009, "BSkyB scraps "buy-through" rule."

to those of Sky. Ofcom must continue, therefore, to incorporate bundled prices in its analysis. In line with Virgin Media's proposal that Ofcom should undertake a retail-minus calculation in relation to all combinations of the Core Premium product in question with the various basic mixes, Ofcom should also perform a retail-minus calculation in relation to the stand-alone premium price, and take the lowest resulting price from across the range of prices.

Retail packages including other Core Premium channels

7.22 Virgin Media agrees with Ofcom's proposal to derive the appropriate reference price for each Core Premium product by identifying the closest retail product (i.e. the retail package which includes the Core Premium wholesale product and no other Core Premium channels). Virgin Media considers that this should enable competitors to replicate each of Sky's Core Premium bundles (subject to the point made below in relation to the offer of "free" broadband as part of all pay TV packages).

7.23 Virgin Media acknowledges the point made by Ofcom that this approach potentially acts to the detriment of rival retailers who might seek to differentiate themselves by offering only smaller packages.[110] In order to enable rival retailers competitively to offer smaller packages (for example, by offering Core Premium channels individually), Ofcom would need to apply the retail-minus calculation to all of the larger bundles containing these channels, (making appropriate adjustments to deduct the cost of additional premium channels in the bundle), and then take the lowest resulting wholesale price. Whilst Virgin Media can see merit in this approach, Ofcom's suggestion of undertaking a cross-check to identify any significant discrepancies in the wholesale prices arising from the different approaches might offer a pragmatic alternative.

7.24 Virgin Media notes in this regard that, in undertaking this cross-check, Ofcom has identified that the retail price for Sky Sports 2 does not represent an effective benchmark for the purpose of establishing an appropriate regulated wholesale price for Sky Sports 2. Ofcom does not, however, propose to make any further adjustment because "*our competition concerns are focussed much more on Sky Sports 1 and Sky Sports 1&2*".[111]

7.25 Virgin Media considers that Ofcom's conclusion in relation to Sky Sports 2 is not appropriate or supportable. Ofcom has identified that Sky Sports 2 is a close substitute for Sky Sports 1 on the basis that it broadcasts a portfolio of important sports that broadly reflect the offering on Sky Sports 1.[112] For this reason, it falls within the relevant economic market in relation to which Sky has been identified as having a position of market power. Ofcom has indicated that the WMO remedy should apply to those channels which have been identified as the source of Sky's market power.[113] Since Sky Sports 2 has been identified in this regard, it is important that a regulated wholesale price is set for this channel which is appropriate, and which will allow rival retailers to compete if they wish to offer this channel on a standalone basis.

7.26 The problem arises because Sky sets a relatively high retail price for Sky Sports 2. Indeed the retail price for Sky Sports 2 is set equal to the price for Sky Sports 1 retail packages. This is acknowledged by Ofcom:

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110 Third Consultation Document, paragraph 9.89. The regulated wholesale prices paid by these retailers for smaller premium products may not allow them to effectively compete against retailers offering wider bundles of premium products. This would not be a problem for rivals seeking to offer the same bundles as Sky as regulated wholesale prices will be determined for each of these bundles.

111 Third Consultation Document, paragraph 9.171.

112 Third Consultation Document, paragraph 4.121 and 4.131.

113 Third Consultation Document, paragraph 8.34.

"*The retail price for this Core Premium channel appears particularly high relative to costs, with limited take-up, suggesting that the retail price reflects pricing simplicity….rather than purely a full reflection of cost or value.*"[114]

7.27 This results in an inflated wholesale price when calculated using the retail-minus approach because costs are deducted from a retail price which is too high. In this case, therefore, Virgin Media considers that Ofcom should derive a regulated wholesale price for Sky Sports 2 by applying the retail-minus methodology to a larger Core Premium bundle which includes Sky Sports 2 and then deducting the costs of the other Core Premium product(s). Consistent with Virgin Media's proposal in relation to premium/basic bundles, Virgin Media considers that Ofcom should apply the retail-minus calculation across all premium bundles including Sky Sports 2, and take the lowest price as the regulated wholesale price.

<u>Retail packages including additional non-TV services</u>

7.28 Ofcom has acknowledged the risks to the efficacy of its proposed WMO in the event that Sky sets the incremental price of additional products (in particular its broadband and telephony products)[115] below their incremental cost. Ofcom states:

"*In such circumstances, the wholesale prices that we set out below would enable competition in the provision of pay TV bundles, but may not ensure fair and effective competition in the provision of bundles of wider retail services. Efficient retailers would not be able to replicate Sky's wider bundles*."[116]

7.29 Virgin Media considers that Ofcom has correctly identified bundling of retail products by Sky as a potentially significant risk to the effectiveness of its remedy. Access to premium pay TV content on the basis of reasonable prices will clearly not suffice to promote fair and effective competition if efficient rival retailers are unable to compete with the bundles offered by Sky because of the way in which Sky is pricing the broadband and telephony components of the bundle.

7.30 Virgin Media can also see merit in addressing this problem through an ex post adjustment mechanism as proposed by Ofcom in order to avoid any further delay in the establishment of regulated wholesale prices. Virgin Media considers, however, that offering bundled products including non-TV services has become central to Sky's competitive strategy as evidenced by the focus of its marketing on these bundles, and its pricing - particularly the option to include broadband and certain telephony call packages at no extra cost in all of its pay TV packages. Accordingly, although Ofcom intends to base its analysis on a TV-only retail price, a significant proportion of customers who pay this price will also be receiving broadband from Sky at no extra cost. Rival retailers seeking to compete with Sky will be placed at an immediate disadvantage because the wholesale price will not be set to reflect any broadband costs which the rival would need to incur in order to replicate Sky's bundle.

7.31 In light of this, Virgin Media considers that Ofcom should commence its analysis of the incremental costs and revenues of Sky's additional bundled products as soon as possible. This would allow it to quickly form a view on whether an ex-post adjustment in relation to broadband and telephony is appropriate, and avoid rivals being placed at a significant disadvantage for an extended period.

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114 Third Consultation Document, paragraph 9.171.

115 But potentially also other TV services such as Multiroom, Sky Box Office and standalone premium channels such as MUTV and Chelsea TV, and other TV and non-TV services which Sky may offer in the future.

116 Third Consultation Document, paragraph 9.76.

Costs to be deducted

7.32 Virgin Media agrees with Ofcom's proposal to deduct the incremental costs associated with retailing and basic content as well as a proportion of common costs. As indicated by Ofcom, it is reasonable to assume that potential rival retailers are likely to offer other products and services in relation to which they should be able to recover a proportion of their common costs.

7.33 Virgin Media notes, however, that this means that the methodology used by Ofcom to allocate costs between different parts of Sky's business becomes central to its pricing analysis. In particular, this methodology is likely to be very sensitive to the allocation of costs between Sky's different business functions. Virgin Media has been unable to review this methodology in any detail because of the confidential nature of both the cost information and the drivers which have been used to allocate these costs.[117] Whilst the difficulty of providing greater transparency in these circumstances is recognised, Virgin Media considers that Ofcom's approach to cost allocation should be particularly cautious given that its analysis will not be subject to the normal levels of scrutiny which a consultation aims to achieve. In short, Ofcom should place greater emphasis on an approach which delivers lower wholesale prices given that the only party with full visibility of the analysis will be Sky who can be expected to argue forcefully for higher wholesale prices.[118]

The treatment of risk and the allowance for an appropriate return

7.34 In setting wholesale prices, Ofcom has used a multiple year discounted cash flow analysis with a discount rate set equal to an estimate of Sky's cost of capital, thereby incorporating a return on investment. Ofcom does not propose to make an adjustment for the different risk profiles of new entrants on the grounds that it is "*unclear whether competitors face systematically different risks from Sky*".[119] In particular, Ofcom states that entrant retailers of Core Premium pay TV services may, like Sky, be significant retail operators, providing a range of services to existing customers.[120] Ofcom also states that, "*as convergence and bundling become more important we expect more firms competing in retail communications markets to be fairly diversified, facing a broadly similar risk profile*".[121]

7.35 In view of the aim to set wholesale prices which enable fair and effective competition by rival retailers of Core Premium TV services, Virgin Media considers that it is inconsistent for Ofcom to take into account issues created by differences in scale and distribution technology between Sky and other retailers, whilst not acknowledging potential differences in the risks facing new entrants. In particular, Virgin Media considers that Ofcom's cash flow analysis should take account of differences in specific risks facing new entrants. Moreover, the weighted average cost of capital (**"WACC"**) estimate, should

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117 Whilst Ofcom has provided Virgin Media with a high-level overview of the allocation of certain of Sky's pay TV operating costs to Sky's different business "functions" (see email from William Hayter to Virgin Media dated 9 September 2009), Virgin Media has not been able to undertake a detailed analysis of Ofcom’s approach to cost allocation on the basis of the information provided because it is presented at a high level of aggregation.

118 Virgin Media notes that in setting prices for wholesale bitstream broadband access products using a retail-minus approach, Ofcom’s ability to provide full transparency as regards its approach was similarly limited by the commercially confidential nature of the information on which the margin setting model was based. In that case, Ofcom sought to balance respondents’ wishes for greater transparency with the need to respect commercial confidentiality by contracting an external consultancy, Analysys Consulting Ltd, to review the model. Ofcom made several adjustments to its approach in line with the recommendations of Analysys and respondents were invited to a presentation of Analysys' finding. Virgin Media notes that Ofcom has not opted for such an external review in this case, and therefore the need for a cautious approach is even greater.

119 Third Consultation Document, paragraphs 9.117.

120 Third Consultation Document, paragraphs 9.117.

121 Third Consultation Document, paragraphs 9.116.

reflect differences in systematic risks, as well as differences in the ability of new entrants to raise debt and the cost of this debt.[122]

Treatment of specific risk

7.36 In a statement on its approach to risk in the assessment of the cost of capital, Ofcom states the following:

> "*Cash flows should be calculated in such a way as to ensure that the rewards from successful investments within the portfolio are expected to be sufficient to pay for the losses associated with unsuccessful investments*.[123]

7.37 In other words, Ofcom should ensure that the cash flows used in its multiple year analysis reflect the ex ante expected value of the cash flows from the investment. At the point where a risky investment is undertaken, there are a range of outcomes that may arise each with an associated probability. A probability-weighted approach is required, therefore, in order to ensure that the profile of cash flows is consistent with what an investor would expect, taking into account both the chances of success and of failure.

7.38 Given that Ofcom has based its analysis of cash flows on data provided by Sky (except where there is a compelling reason to do otherwise, as in the case of scale and DTT costs) it is not clear to Virgin Media how Ofcom has taken into account, within its cash flow estimates, the ex ante risks facing a new entrant to premium pay TV retailing.

7.39 In particular, Virgin Media considers that the risks facing such an entrant in the start-up phase of an investment will inevitably be far higher than those facing an established, mature incumbent. In particular, new entrants' start-up costs are certain and front-loaded but margins and revenues, in contrast, are uncertain and weighted to the future. The fixed costs of new entrants will be higher than for the incumbent because they include entry costs. The revenues and margins are more uncertain for new entrants than they are for the incumbent because the entrant's customers have yet to be recruited whereas the incumbent's customers are already in place. Lastly, Virgin Media notes that although prospects for new entrants will undoubtedly be enhanced because of improved terms of access to Sky's content, there will still be a significant risk of failure.

7.40 It is not clear whether or how Ofcom has taken account of these specific risks facing new entrants, and the relative prospects of success and failure in estimating its cash flows. Virgin Media understands, however, that wholesale prices are set within the cash flow model such that the additional costs from the wholesale charges take the net present value of entrant's cash flows to zero. Virgin Media, considers, therefore, that a greater allowance for ex ante specific risks facing new entrants will result in a lower wholesale price, and hence there is a further reason for Ofcom to set prices no higher than those at the bottom end of its proposed range.

WACC: Cost of equity

7.41 Virgin Media considers that the cost of capital figure used by Ofcom (which is based on a forward-looking analysis) does not reflect the ex ante risks which confronted Sky in developing its Core Premium TV services. In this regard, Virgin Media has compared Sky's equity beta for the first three years of available data (December 1994 to December

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122 This is consistent with the approach which Ofcom has previously taken in addressing risk and return in relation to the companies regulated by Ofcom. For example in its consideration of the appropriate return to allow for BT, Ofcom has previously stated the following: "*In the first consultation, Ofcom proposed that it should, in certain circumstances, reflect differences in risk between projects in its financial analysis, with differences in systematic risk modelled via cost of capital estimates, and differences in specific risk reflected in cash flow estimates*". Ofcom, *Ofcom's approach to risk in the assessment of the cost of capital, Final statement*, 18 August 2005, paragraph 1.12.

123 Ofcom, *Ofcom's approach to risk in the assessment of the cost of capital, Final statement*, 18 August 2005, paragraph 1.26.

1997) to the equity beta for the latest three years (September 2006 to September 2009).[124] The equity beta has decreased from 1.12 to 0.84 (a fall of approximately 25 per cent) between these respective time periods which is consistent with the transition of Sky from a moderately risky and growing venture to a more stable, mature and predictable business model.[125] Virgin Media considers that the equity beta for Sky which has been used by Ofcom (i.e. 0.85) reflects the systematic risk of a mature operator. It is not, therefore, appropriate as a proxy for the systematic risks which would face a new entrant which will be at an earlier stage in its risk cycle as compared to Sky.

7.42 Ofcom also appears to suggest that the move towards greater convergence and bundling will mean that firms operating in the retail communications market may be expected to have a similar risk profile. Virgin Media considers that there is no evidence to support such a claim, nor is there any reason to assume that Sky's current WACC represents the best proxy of such a risk profile. The only relevant consideration is whether different firms may be expected to have greater or lesser volatility in their returns as compared to the market as a whole. In this regard, Virgin Media has identified benchmarks in the mobile telephony sector which may be expected to have similar characteristics to potential pay TV retailers, namely significant start-up costs, high marketing requirements and the challenges of attracting customers in a well-established sector. In particular, Virgin Media has identified beta estimates for various mobile operators (who may be considered to be potential entrants to the provision of Core Premium TV services) which were submitted as part of the Competition Commission's 2003 investigation of charges for terminating calls by mobile operators. These are as follows: Vodafone (1.3 to 1.7), T-Mobile (2.1-3.2), Orange (1.45 to 1.55) and O_2 (1.22 to 1.49).[126] The equity betas for these operators are significantly higher than the figure which has been used in estimating Sky's WACC.

7.43 Using an equity beta of 1.00 to 1.15, consistent with the higher volatility of Sky's equity at an earlier stage of its development (but not at start-up), would translate to a pre-tax WACC of between 11.0 per cent and 11.8 per cent (which is higher than the estimate of Sky's WACC which has been used by Ofcom). Virgin Media considers, however, that this would still be a considerable under-estimate of the appropriate pre-tax WACC for a start-up.

<u>WACC: Cost of debt and gearing</u>

7.44 Ofcom has identified an optimal gearing level for Sky of 30 per cent on the basis that "*investors should want a gearing rate that maximises the benefit from cheaper debt financing, but without jeopardising the financial viability of the firm*".[127] Virgin Media considers that Sky will always be able to maintain a higher debt to equity ratio than a new entrant reflecting its financial strength and its high levels of profitability (as demonstrated by Oxera's analysis).[128]

7.45 Virgin Media also considers that the use of Sky's current cost of debt is likely to represent a significant under-estimate of the cost of debt for a new entrant. Ofcom proposes a range for Sky's long-term debt premium of 1 to 2 per cent, and notes that "*the debt premium for a mature, well-established and well-funded operator may well tend towards the lower end of the* range".[129] Virgin Media considers that new entrants to the premium

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124 The equity beta in both cases has been calculated by measuring the correlation between the volatility of Sky's share price with the volatility of the FTSE All Share Index over the relevant periods.

125 Data on Sky's share price is available from flotation onwards. Prior to this, however, Sky's ex ante risks are likely to have been higher still reflecting the nascent pay TV market in the UK, and the significant losses incurred by Sky (in particular prior to 1991).

126 The pre-tax WACC estimates submitted by theses mobile operators were as follows: Vodafone (17.4 per cent), T Mobile (24.3 to 29.3 per cent), Orange (16.6 to 17.4 per cent); O_2 (15.4 per cent to 17.1 per cent).

127 Third Consultation Document, Annex 10, paragraph 2.46.

128 See paragraphs 5.10 to 5.11 above.

129 Third Consultation Document, Annex 10, paragraph 2.74. The upper end of the range would only apply, in Ofcom's

pay TV retailing market are unlikely to be able to secure more favourable terms and that it is not therefore appropriate to use Sky's current cost of debt in setting wholesale prices. It is important to note, moreover, that new entrants seeking debt financing will face an extremely challenging credit market at present. In particular, the covenants and price of debt which are available mean that debt financing is significantly more costly than it has been in previous years, and debt is more difficult to arrange as banking consortia are typically required to put together any material debt financing.

Using Sky's WACC is appropriate for the cost-plus calculation

7.46 Virgin Media considers that a different cost of capital estimate should be used when considering the return required by a new entrant (as part of the retail-minus calculation) as compared to calculating a reasonable return to Sky's wholesale business (as part of the cost-plus cross check). As indicated above, Virgin Media considers that the ex ante systematic risk facing new entrants will be under-estimated by the beta coefficient which has been estimated for Sky, and the gearing and cost of debt assumptions reflect the financial strength and maturity of Sky's business, which are unlikely to be replicated by a new entrant.

7.47 Nevertheless, while it would be more appropriate to use a different cost of capital when considering the return required by a new entrant, it is, for obvious reasons, entirely correct to use the estimated WACC for Sky in the context of applying the cost-plus cross-check. This is because that cross-check is designed to ensure that Sky (and not any other party) is afforded a reasonable return to its wholesale business on the basis of the relevant prices.

The appropriate scale of an efficient entrant

7.48 Virgin Media agrees with the principle that Ofcom should set wholesale prices which allow an efficient entrant to compete with Sky in retail markets, and that this should take account of the fact that an entrant operating at a lower scale will have higher average costs than Sky because of the presence of fixed costs. This approach is entirely consistent with the aim of promoting competition because it will allow rival retailers to recover efficiently incurred retail costs, notwithstanding that they cannot immediately achieve the economies of scale and scope available to Sky. In this regard, Sky, as the incumbent operator, has a significant advantage arising from its large subscriber base and the range of products and services which it has developed over many years and over which common costs can be recovered. It is entirely reasonable that Ofcom should make an allowance to reflect the fact that an efficient entrant cannot immediately achieve the benefits to Sky from its scale and scope which have arisen from its presence and growth in the market over many years.

7.49 Virgin Media has concerns, however, in relation to the assumptions made by Ofcom in relation to (i) the appropriate scale of an efficient entrant and (ii) the fixed costs which would be incurred by an efficient entrant (irrespective of its scale).

Scale assumptions

7.50 In calculating the costs which should be deducted from the reference retail prices, Ofcom has considered the position of an entrant that would be as efficient as Sky at an equivalent scale but is smaller (and therefore incurs higher average costs). Two scenarios are considered by Ofcom:

(a) a "large" entrant which assumes a subscriber base of one million at three years and three million after 10 years; and

view, in periods of relatively high market uncertainty and volatility.

(b) a "small" entrant which assumes a subscriber base of 330,000 at three years and one million after 10 years.[130]

7.51 Ofcom also assumes that the total market for premium subscribers will reach 10 million after 10 years from 7 million at the present day. This implies a market share of 30 per cent and 10 per cent for the large and small entrant respectively by year ten. Ofcom indicates that it has based its projections of subscriber growth for potential new entrants on "*evidence we have reviewed from Sky's Picnic forecasts, and from the scale that existing competitors have achieved to date*."[131]

7.52 Virgin Media notes that Ofcom has identified for consultation a range of prices where the top of this range makes no allowance for scale effects and the bottom assumes the small entrant scenario outlined above. Ofcom proposes, however, that retail-minus prices should be set to allow a larger competitor to compete with Sky's retail prices.[132] Virgin Media notes that, contrary to Ofcom's remark that scale effects are relatively small because fixed costs are a relatively small proportion of a pay TV retailer's overall costs,[133] the difference between wholesale prices based on assumptions of a large and small entrant respectively are fairly significant. Indeed, Ofcom confirms that:

> "*…Scenario 5, which reflects the scale of a "small" entrant on DTT, as opposed to a "large" entrant in Scenario 4, is a more significant difference with retail-minus prices about 10-17% lower using this assumption*".[134]

7.53 Virgin Media considers that Ofcom should not set wholesale prices which discriminate against smaller new entrants and prices should be set which allow competition by both larger and smaller entrants. A smaller entrant facing wholesale prices which are 10 to 17 per cent higher than the level which would allow them to compete effectively with Sky is likely to be deterred from entering, or would be an entirely ineffective competitor even if entry occurred. This is contrary to the key objective of Ofcom's remedy to promote fair and effective competition.

7.54 Ofcom assumes, as part of its calculation of the DTT transmission costs which would be incurred by a new entrant pay TV retailer, that there will be three pay TV retailers on DTT which will share the cost of capacity equally between them.[135] As noted above, Ofcom proposes to set prices to allow a larger competitor to compete with Sky's retail prices. Ofcom has confirmed that it is envisaging that each of these three new entrants will be a larger competitor (i.e. they will attract a subscriber base of one million at three years and three million after 10 years). This implies that the new entrant pay TV retailers on DTT will, in aggregate, acquire nine million premium pay TV subscribers by year ten. This implies a market share of 90 per cent with the remaining 10 per cent being held by Sky, cable and DSL operators. This is clearly an unrealistic proposition, assuming, as it does, that three entrants on DTT will, collectively, eclipse not only Sky but also the retailers of premium pay TV channels on cable and DSL.

7.55 Virgin Media notes that Ofcom has also stated that:

> "*Our view is that unmet demand on DTT-based platforms may lie in the region of two million subscribers over five years (including the one million customers who we*

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130 Third Consultation Document, paragraph 9.163.

131 Third Consultation Document, paragraph 9.164.

132 Third Consultation Document, paragraphs 9.7 and 9.8.

133 Third Consultation Document, paragraph 9.165.

134 Third Consultation Document, paragraph 9.190.

135 Ofcom states: "*For DTT pricing scenarios, we assumed that videostream costs would be shared equally between three retailers, so the quantity of transmission costs in the retail-minus calculation equalled one-third of the assumed videostream cost.*" Letter to Virgin Media from Ofcom dated 23 July 2009.

would expect to switch from DSat, households who currently subscribe to other platforms, and households who do not currently subscribe to pay TV)."[136]

7.56 Virgin Media considers that this is a reasonable and plausible forecast. It also considers that the total number of premium subscribers on DTT over a period of ten years may reach three million (implying a 30 per cent market share). This would be consistent with the entry of three small entrants who will each attract one million subscribers by year ten (and who, in line with Ofcom's assumption, could feasibly share DTT capacity costs).

7.57 In summary, Virgin Media considers that Ofcom should set regulated wholesale prices which allow competition by both large and small entrants. Virgin Media considers, moreover, that entry on a smaller scale on the DTT platform is significantly more plausible. The profile of subscriber growth for a smaller entrant is consistent with Ofcom's view on unmet demand for access to premium content on the DTT platform, in the context of DTT costs being shared between three potential new entrants. For these reasons, Virgin Media considers that Ofcom should set wholesale prices no higher than its Scenario 5 (i.e. at the lower end of the range on which it is consulting).[137]

Fixed costs

7.58 Ofcom has assumed that a pay TV retail business (whether Sky's business or that of a new entrant) would incur £12 million per annum of fixed costs (i.e. costs which are incurred at each and every level of output). Virgin Media understands that Ofcom has identified £15 million per annum of fixed costs in total and has allocated £12 million to retail, platform and basic wholesale activities, and £3 million to premium wholesale activities.[138]

7.59 The figure of £15 million (£3 million of which is attributed to retailing basic channels, and £9 million to retailing premium channels) has been derived as follows:

(a) marketing: Ofcom has estimated marketing costs of £9.6 million based on a simplified bottom-up model. The model provides an estimate of the minimum expenditure on TV advertising, newspapers and outdoor advertising that would be necessary for a pay TV operator providing premium and basic channels. Virgin Media understands that this estimate does not include staff costs; and

(b) other fixed costs: Ofcom has estimated costs of £5.4 million relating to subscriber management (£1.8 million), administration (£1.8 million) and transmission and related functions (£1.3 million).[139] Virgin Media understands that Ofcom has considered data from existing smaller competitors (namely Setanta, BT Vision, Tiscali, Top Up TV and Virgin Media) in estimating the fixed costs of subscriber management and administration. In particular, it has considered the smallest amount incurred in each of the categories amongst the benchmark operators.

7.60 Virgin Media considers that Ofcom's assessment of fixed costs is likely to be a significant under-estimate of the actual fixed costs which a new retailer of premium pay TV channels would incur, for the following reasons (which are discussed in detail below):

(a) Virgin Media considers that the estimate should take into account the fixed costs across the range of output which Ofcom has identified in relation to its entry scenarios;

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136 Third Consultation Document, paragraph 1.40.

137 In addition, the scale assumptions will need to be consistently applied in deriving retail-minus wholesale prices for HD.

138 Ofcom letter to TUTV dated 10 September 2009.

139 Ofcom letter to TUTV dated 10 September 2009. Virgin Media notes that the costs in these categories add to £4.9m and not to £5.4m. No explanation is provided for this difference in Ofcom's letter.

(b) Virgin Media also considers that the comparators used by Ofcom in relation to non-marketing fixed costs are unlikely to provide reliable estimates of the relevant costs;

(c) Virgin Media considers that Ofcom's estimate should take into account fixed staff costs; and

(d) finally, the aim of the retail-minus price calculation is to establish a wholesale price which allows a new entrant to incur a reasonable level of retailing costs and still be able to compete with Sky's retail prices. In this regard, in the event of a material discrepancy between the allowance made for fixed costs which will be incurred by a new entrant and actual expenditure by Sky, there is likely to be a risk that the new entrant will not be able to compete effectively with Sky.

7.61 Firstly, Virgin Media considers that, whilst the cost categories identified by Ofcom may be fixed over a range of output, they are not fixed indefinitely and will increase with volumes, albeit at a slower pace than costs which vary directly with volumes. By way of example, a billing system may be adequate to deal with subscribers of up to 100,000, but beyond that would need to be replaced. Equally there is clearly a relationship between marketing spend and the scale of entry which is envisaged. A campaign with greater reach and frequency is likely to attract larger numbers of subscribers but will be more costly.

7.62 Virgin Media considers, therefore, that the fixed cost estimate should be relevant to the range of output which is envisaged under Ofcom's entry scenarios. For the reasons outlined in paragraphs 7.48 to 7.57, Virgin Media considers that only the small entrant scenario can be supported as a plausible forecast for a new entrant pay TV retailing business. This scenario assumes a premium subscriber base of 330,000 at three years and one million after 10 years. Virgin Media notes that its own premium subscriber base is approximately [**CONFIDENTIAL**] at present (which falls between the subscriber base envisaged for a small entrant in the third and tenth year). Virgin Media suggests therefore, that its own estimate of the fixed costs of retailing pay TV should provide some insights as to the costs which would be incurred by a new entrant operating at the scale envisaged by Ofcom.[140]

7.63 [**CONFIDENTIAL**].

7.64 Secondly, Virgin Media considers that the comparators used by Ofcom in relation to non-marketing fixed costs are unlikely to provide reliable estimates of the relevant fixed costs. Of the five companies mentioned by Ofcom, only Virgin Media retails Sky's premium channels, and Virgin Media has little incentive actively to market those channels. Accordingly, Virgin Media considers that cost information for those companies cannot be used to estimate fixed costs which would be incurred by a new entrant pay TV retailer of combined basic and premium bundles. As regards Setanta, it has since exited the market, which has a number of implications for Ofcom's analysis of its fixed costs. First, given the severe financial difficulties Setanta experienced before its demise, its expenditure is unlikely to be representative of a more financially secure entrant of that scale. Second, it is clear that the investment in retailing undertaken by Setanta was insufficient to enable it to compete with Sky. Accordingly, there can be no assumption that Setanta's expenditure in any of the relevant cost categories was at a level which may be considered to be viable for a successful new entrant.

7.65 Thirdly, Virgin Media considers that staff costs should be included as an element of fixed costs. As suggested above, Ofcom's estimate should reflect the minimum fixed costs achievable by a new entrant (consistent with the scale envisaged for this entrant) and this should include the staff costs which form part of those costs. This would include, for

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[140] Virgin Media estimated its own pay TV retailing fixed costs in order to respond to Ofcom's information request of 18 November 2008 (see Virgin Media's response of 12 December 2008 to questions 3 to 8).

example, the staff required to implement the marketing strategies for a new entrant and to perform the required subscriber management and administrative functions.

7.66 Finally, whilst Virgin Media understands that it would not be appropriate to base the estimate of fixed costs on the actual fixed costs currently incurred by Sky, it notes that the discrepancy between the figure proposed by Ofcom and the scale of operating costs incurred by Sky's pay TV business is enormous.[141] An under-estimate of the fixed costs associated with pay TV retailing will result in insufficient costs being deducted from the reference retail price, and therefore wholesale prices will be too high to allow an efficient entrant to compete with Sky providing similar products at Sky's prices. Virgin Media considers that a new entrant incurring fixed costs of £12 million will be at a significant competitive disadvantage to Sky in circumstances in which Sky is incurring costs of many multiples of that sum. Ofcom should therefore increase the allowance for fixed costs in its pricing calculation to allow a better reflection of the magnitude of costs likely to be incurred by a retailer at the scale envisaged by its small entry scenario, and to give a more reasonable cost allowance providing the entrant with a better chance of competing against Sky (given the scale of Sky's expenditure).

The allowance for transmission costs

7.67 Virgin Media agrees with Ofcom's approach of adjusting Sky's costs to take account of differences in distribution technology. In particular, consistent with the position outlined above in relation to scale, Virgin Media considers that Ofcom should make an allowance for transmission costs based on the most likely technology to be used by new entrants within the next 10 years. Control of the existing major pay TV platforms resides with companies who already have established retail sports offerings, and the option to use Freesat and IPTV is limited by their low penetration and the likelihood that these will remain minority platforms in terms of households and share of viewing within the relevant period. Virgin Media agrees, therefore, that DTT transmission is the most likely technology to be used by a new entrant based on its high reach and penetration and the lack of existing pay TV competition. It is appropriate that wholesale prices should be set to allow effective competition by small and large entrants on this platform.

7.68 Virgin Media is concerned, however, that the observations of market rates for DTT capacity which have been used to inform Ofcom's view of the cost of transmitting premium channels have been under-estimated. In particular, Virgin Media understands that Ofcom has assumed a DTT transmission cost of £8 million per videostream per annum (within a range of £6 million to £10 million).[142] Virgin Media considers, however, that a more reasonable range for this cost would be £10 million to £12 million per videostream because of the likelihood that demand for DTT capacity will exceed supply over the relevant period driving prices to levels which have been seen in previous auctions for DTT capacity when demand has exceeded supply.

7.69 Virgin Media observes that auction values for DTT channel slots have in the past been quite considerably higher than the £8 million proposed by Ofcom. For example in November 2005, Channel 4 won a slot on the SDN multiplex for £12 million after a very competitive auction and in October 2007, Discovery secured a slot for £10 million on the same multiplex[143]. Virgin Media considers that the high values for DTT capacity seen in the November 2005 and October 2007 auctions reflect both supply and demand side factors which are likely to continue in the foreseeable future and, therefore, that market

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141 This is confirmed by a cursory review of Sky's own costs. For example, amongst the categories which Ofcom has reviewed in order to inform its fixed cost number are the following: marketing, subscriber management and administration. [**CONFIDENTIAL**]

142 Letter to Virgin Media from Ofcom dated 23 July 2009.

143 This compares to a price of £1 million per channel per annum at the launch of Freeview, and £5 million estimated to be paid by ITV and Channel 4 in April 2005 for slots on the Crown Castle multiplexes.

rates going forward may be expected to be similar to those in recent auctions, in particular:

(a) demand factors - in order to compete effectively with existing pay TV services, it is likely that new entrants will need to offer a package of premium content as well as non-premium content. Ofcom has indicated that it anticipates that the transmission of Sky Sports 1 and 2 and three movies videostreams on DTT will entail the use of five videostreams in total.[144] A package including non-premium content would require further capacity. To the best of its knowledge, Virgin Media considers that the total number of DTT videostreams that are currently available is less than five. Demand will, therefore, outstrip supply which will push up prices for capacity; and

(b) supply factors – the introduction of HD services will increase the scarcity of channel slots on the DTT platform. The decision by Ofcom to reserve some of the DTT capacity which will be released at digital switch-over in 2012 for HD broadcasts will reduce significantly the availability of SD slots from that which was previously anticipated. Under the terms of Ofcom's "HD settlement" the additional capacity will be re-organised to provide 4 HD channels and only 3 further SD channels (reducing the availability of SD slots by 66 per cent compared to the 9 slots originally identified).[145] This can be expected to apply upward pressure on the value of these slots. The HD slots, moreover, will be auctioned and so potential pay TV retailers on DTT that wish to provide an HD version of Sky Sports would need to outbid other prospective users of that capacity; and

7.70 As noted above, Virgin Media also understands that Ofcom has assumed that video stream costs would be shared between three retailers such that the market rates for DTT capacity discussed above are divided by three in order to derive the transmission cost which is used in the retail-minus calculations.[146] This is based on the assumption that these costs can be shared through the use of simulcrypt arrangements.

7.71 As indicated in paragraphs 7.47 to 7.57 above, Virgin Media considers that this is assumption is only supportable if made in conjunction with Ofcom's small entrant scenario (i.e. a subscriber base of 330,000 at three years and one million after 10 years). If, alternatively, Ofcom sets prices based on the large entrant scenario, then entry by three such entities would imply a market share for the new entrants of 90 per cent by year ten, which is clearly unrealistic.

7.72 Virgin Media also notes that Ofcom has assumed that a DTT Sky Movies service would comprise three Sky Movies channels (namely, Screen 1, Screen 2 and Premiere) as opposed to the full suite of movies channels offered by Sky. This is justified by Ofcom on the basis that Screen 1 and 2 contain films across the movie genres and all major studios, and Premiere is used by Sky to showcase films as they enter the subscription pay TV window. Ofcom considers, therefore, that "*the difference between the three DTT channels and Sky's larger satellite offering is not substantial*".[147]

7.73 Virgin Media considers that Ofcom has provided no substantive evidence to support this claim. The wholesale price, moreover, is to be set for the full set of Sky Movies channels (albeit with a lower DTT transmission cost than would be required to broadcast the full set of channels). It seems to Virgin Media, therefore, that the new entrant will be paying a

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144 Letter to Virgin Media from Ofcom dated 23 July 2009.

145 Oliver and Ohlbaum consideration of potential outcomes from the move to 64 QAM and the proposed reallocation of slots based on information provided in Ofcom's consultation document, *The Future of Digital Terrestrial Television: Enabling New Services for Viewers*, 21 November 2007.

146 Letter to Virgin Media from Ofcom dated 23 July 2009.

147 Letter to TUTV from Ofcom dated 10 September 2009.

wholesale price for Sky Movies but the retail margin assumed by Ofcom will only allow it to retail three channels. Indeed a new entrant on DTT will be seeking to compete with an offering of Sky Sports 1 and 2 and three video streams of Sky Movies against Sky's premium offering on satellite which will include the full suite of Sky Sports channels (including Sky Sports 3 and Xtra) and a total of 12 movie channels. As a consequence, even though the WMO regime will result in more effective competition in the retailing of premium channels than has ever existed in the UK, Sky's satellite offering will nevertheless be more comprehensive and hence better able to attract and retain subscribers than the offerings of new entrants on DTT.

7.74 In summary, Virgin Media considers that Ofcom is right to use DTT transmission costs in setting regulated wholesale prices in order to reflect the technology which is most likely to be used by new entrants. It considers, however, that the assumed DTT transmission cost of £8 million per video stream per annum under-estimates the likely DTT capacity costs going forward. Virgin Media considers that a more appropriate range for this cost is £10 million to £12 million because the factors which have driven market rates to these levels in previous auctions are likely to remain a key feature of the market for the period being considered by Ofcom. Virgin Media also agrees that simulcrypt arrangements could be used to share such costs but an assumption that the costs may be shared between three retailers is only supportable in conjunction with Ofcom's small entrant scenario. Ofcom must, therefore, set wholesale prices no higher than its Scenario 5 (i.e. at the lower end of the range on which it is consulting).

The cost-plus cross-check

7.75 Virgin Media notes the critical importance of Ofcom's assumptions regarding the evolution of the costs of rights in determining cost-plus prices. Ofcom has assumed that sports and movie rights fees increase with inflation and subscriber numbers (i.e. they are constant per subscriber in real terms). Ofcom has tested the sensitivity of this assumption against an alternative assumption that total premium rights costs will remain constant over time in real terms (i.e. they will not rise in line with subscriber numbers). The weighted average cost-plus price is 20 per cent lower using this alternative assumption.

7.76 Virgin Media does not agree that Ofcom's assumption that rights fees will increase with inflation and subscriber numbers is "*appropriate given inherent uncertainties and the role of cost-plus in our overall approach*".[148] Indeed, in view of these uncertainties Virgin Media considers that a careful appraisal of trends and the dynamics affecting content rights fees is important. Virgin Media also considers that the role of cost-plus prices is potentially more significant than has been recognised by Ofcom as outlined in paragraph 7.5(a) above, and therefore it is important that the calculation of these prices is based on robust assumptions.

7.77 As regards movie rights, Virgin Media notes that Sky's costs have steadily been reducing in recent years, and may be expected to continue declining in the foreseeable future. Sports rights tend to be sold for a fixed sum over a specific period by means of an auction process. The costs of these rights, therefore, will reflect the level of competition and the bidding strategies of competitors for those rights. Virgin Media considers that there are reasons to expect competition for key sports rights to remain muted in the relevant period. Virgin Media considers, therefore, that an assumption that total premium rights costs will remain constant over time in real terms is more reasonable than an assumption that the costs will increase in line with subscriber numbers.

Movies

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148 Third Consultation Document, paragraph 9.156.

7.78 As indicated above, Virgin Media notes that the cost of movie rights has been declining in recent years as shown in the table below and Virgin Media considers that this is a continuing and consistent trend.

Table 4: Sky movies programming costs 2006-2009

	2006 £m	2007 £m	2008 £m	2009 £m
Sky Movies programming cost	310	285	281	278

Source: 2006 - 2009 BSkyB Annual Reports

7.79 In practice, the Sky Movies programming cost has fallen by approximately 30 per cent over the period from 2003 to 2009. Ofcom is, however, apparently anticipating that the wholesale must-offer remedy will result in wider distribution of Sky Movies and hence more subscribers to those channels in respect of which Sky will need to pay incremental per subscriber fees. Nevertheless, the amounts payable to the studios are steadily being reduced by Sky upon each renegotiation. Hence it appears reasonable to assume that any increase in subscriber numbers will at least be offset by reductions in the levels of payments due to the studios over the period.

Sports

7.80 Sports rights tend to be sold for a specified period (for example, three years) at a fixed price. The costs are not, therefore, linked directly to subscriber numbers and so increased subscriber numbers *per se* will not drive up sports rights costs.

7.81 The auction based nature of sports rights sales means that the realised value for the rights is a function of the intensity of competition. The FAPL live rights value over the past decade illustrates how the realised value has varied depending on the degree of competition which Sky has faced:

(a) auction in 2000 (for the period 2001/02 to 2003/04) – the live rights increased by 154 per cent (from £168 million per year for the previous three year period to £427 million per year for the forthcoming three years). Much of this rise was attributable to increased competition as both ntl and ITV Digital were active participants in this auction;[149]

(b) auction in 2003 (for the period 2004/05 to 2006/07) – the competitive threat lessened following the insolvency of ITV Digital and the financial difficulties facing ntl. Neither provided a bid as part of this auction. As a result there was a decrease of 20 per cent in the value of the rights (from £427 million per year for the previous three year period to £341 million per year for the forthcoming three years);

(c) auction in 2006 (for the period 2007/08 to 2009/10) – this auction was vigorously contested when a greater number of live packages prompted increased interest from Sky, ESPN, Setanta and Virgin Media (with Setanta winning two packs of rights). Although the European Commission agreed undertakings with FAPL that no single bidder could win all of the packages, the top packages remained disproportionately attractive to broadcasters which also stimulated competition. As

149 The rights for 2001/2 to 2003/04 included a £60m per annum valuation of pay per view rights. At that time, FAPL broke the rights into a subscription package and a pay per view package and would not allow a broadcaster to win both packages. Sky won the subscription package and ntl initially won the pay per view package. It subsequently failed to conclude an agreement with FAPL and hence FAPL split the pay per view rights by platform and sold them separately to Sky, ntl and ITV Digital. Whilst Sky continued to sell PPV matches from 2004 to 2007, these were not sold by the Premier League as a separate rights package.

a result, the live rights value increased by 67 per cent (from £341 million for the previous three year period to £569 million for the forthcoming three years);

(d) auction in 2009 (for the period 2010/11 to 2012/13) – the number of bidders in the 2009 auction was broadly the same as in 2006. ESPN and Five are believed to have placed unsuccessful bids while Sky and Setanta were awarded live rights packages. No other platform, however, posed a strategic threat (Virgin Media, for example did not bid for the rights) and the rights value increased by just 4 per cent between 2006 and 2009 (from £569 million for the previous three year period to £594 million for the forthcoming three years).[150]

7.82 Virgin Media considers that recent inflation in FAPL (and other non-FAPL) sports rights has been driven by competition, in particular the involvement of Setanta in the various auctions. Following the recent exit of Setanta, however, such competition for rights is very unlikely to occur in future auctions, reflecting the status quo whereby breaking Sky's stranglehold over upstream rights is extremely difficult given its significant bidding advantages. Indeed, the demise of Setanta has demonstrated that, in order to outbid Sky, an entrant must bid a sum which it is not subsequently able to recover over the period in which it holds the particular rights.

7.83 Whilst Ofcom's remedy and the steps it proposes to take as regards upstream rights may eventually result in more companies being able to bid competitively for attractive rights, this is unlikely in the medium term. Accordingly, it is reasonable to assume that sports rights costs will remain constant in real terms over the period considered by Ofcom, reflecting the continuation of factors which mitigate against successful rival challenges for upstream rights (at least until the WMO has assisted rivals in building a sufficient subscriber base which is unlikely in the medium term).

The evolution of prices over time

7.84 Ofcom highlights the need for regulated wholesale prices to be responsive to changes in the market, whether in terms of prices or costs. Virgin Media considers this to be essential to the successful implementation of Ofcom's proposed remedy. A number of other principles are also identified by Ofcom as being important in determining how wholesale prices should evolve over time namely: predictability and transparency, practicality, incentives to bid for rights and the potential for Sky to manipulate pricing rules to its own advantage.[151] Ofcom considers separately how it proposes to deal with minor changes in retail pricing from more significant changes to wholesale costs, retail costs or retail prices. Whilst Virgin Media considers that Ofcom has made some helpful suggestions as regards the treatment of minor changes in retail pricing, it regards the proposal relating to significant changes as being wholly unsatisfactory.

Significant changes to wholesale costs, retail costs or retail prices

7.85 Ofcom has correctly identified that Sky will have an incentive to implement changes to wholesale costs, retail costs or retail prices in a manner which will place its rivals at a significant disadvantage. Indeed Ofcom sets out a number of specific examples which include shifting content away from a WMO channel, increasing marketing expenditure and increasing certain retail prices but not others.[152] Ofcom's conclusion on how best to address this problem is, however, entirely insufficient. It states:

"…*we acknowledge that significant changes…would require us to reassess the full set of pricing calculations. The calculations are complex and we believe it would be impracticable to do this on a regular basis. Our expectation is therefore that the*

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150 Data for 2000 auction published by Sky. Data for auctions in 2003, 2006 and 2009 from TV Sports Markets.

151 Third Consultation Document, paragraph 9.37.

152 Third Consultation Document, paragraph 9.40.

threshold for this type of intervention will be high – in other words, we propose only to reassess the full set of pricing calculations if there are very major changes to wholesale costs, retail costs or retail prices. We therefore do not propose to impose accounting separation obligations, which we believe would be disproportionate in these circumstances. We also anticipate reviewing the effectiveness of this approach after a reasonable period…".[153]

7.86 Virgin Media considers that the proposal to reassess wholesale prices only in the event of "*very major changes*" is wholly unsatisfactory. Sky can be expected to capitalise on the uncertainty surrounding what would constitute such a major change in order to undermine the competitiveness of its rivals. Moreover, Virgin Media considers that Sky can achieve this objective without necessarily resorting to significant changes to wholesale costs, retail costs or retail prices.

7.87 As regards marketing expenditure, for example, Ofcom has identified that the retail margins of Sky's competitors could be squeezed if they are forced to increase their marketing expenditure in response to increased expenditure by Sky, but this additional retail cost is not reflected in the determination of regulated wholesale prices.[154] Without greater clarity as to what would constitute a "*very major change*", Sky may be expected to increase its marketing expenditure to a level which potentially imposes a significant disadvantage on its rivals, but which is likely to avoid regulatory scrutiny. Virgin Media considers, therefore, that a more prescriptive approach is required to provide greater transparency and predictability as to the circumstances in which a change to wholesale prices would be considered appropriate and, in particular, the circumstances in which increased marketing expenditure by Sky would prompt such a review. In this regard, Virgin Media would propose the following (which are discussed in more detail below):

(a) an annual review coinciding with the re-setting of wholesale prices to reflect annual changes in Sky's retail prices; and/or

(b) an obligation on Sky to notify Ofcom when its expenditure on subscriber acquisition exceeds a certain level, resulting in either:

(i) a reassessment of wholesale prices; or

(ii) a decision by Ofcom to re-set wholesale prices in line with the cost-plus prices established as part of the initial price setting exercise.

7.88 Virgin Media has proposed that Ofcom should establish wholesale prices by applying the retail-minus calculation to each combination of the Core Premium wholesale products with the different basic mixes (as well as any standalone premium price offered by Sky). Ofcom should then use the lowest of the resulting wholesale prices as the regulated price.[155] Under this proposal Ofcom would need to repeat the pricing analysis each time Sky alters its retail prices (which currently occurs on an annual basis), because the bundle which previously delivered the lowest regulated price may no longer do so. As this analysis will need to be undertaken on the basis of updated information on Sky's costs, this provides an opportunity to establish lower regulated wholesale prices consistent with any significant increase in Sky's subscriber acquisition costs.

7.89 If Sky were to continue with annual price revisions, the review would occur annually. But if revisions did not occur annually going forward, Virgin Media considers that an annual review should occur in any event in order to take account of relevant changes within the year (for example the creation of new retail packages, and changes in costs which would effect both the "minus" in the retail-minus calculation and the calculation of the cost-plus

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153 Third Consultation Document, paragraph 9.42.

154 Third Consultation Document, paragraph 9.40 (ii).

155 See paragraphs 7.15 to 7.16 above.

cross check). Virgin Media considers that this would be a reasonable and practical time period for a review of this kind which would address any competitive disadvantage facing rivals within a reasonable timeframe.

7.90 Sky should also be required to notify Ofcom in the event that its subscriber acquisition costs exceed the costs assumed at the time of the initial determination of wholesale prices by a certain percentage. Virgin Media considers that 10 per cent would represent a reasonable threshold as an increase of this magnitude or greater would be likely to place rivals at a competitive disadvantage. This would be calculated in relation to Sky's expenditure over the most recent quarter as compared to the same quarter in the previous year (to reflect the fact that marketing expenditure has seasonal variations). In the event that Sky notified Ofcom of expenditure above the threshold, Ofcom could decide to reassess its pricing calculations in order to determine a new set of wholesale prices which would allow rivals to compete by allowing for an increased level of marketing expenditure.

7.91 Alternatively, Ofcom could act on any such notification from Sky by deciding to re-set wholesale prices in line with the cost-plus prices established as part of the initial determination of prices. The benefit of this option would be that Ofcom would not have to undertake a re-determination of prices. It also has the advantage of directly addressing the problem of margin squeeze caused by a significant increase in Sky's subscriber acquisition expenditure by ensuring equivalence of retail margins between Sky and its rivals.

7.92 As regards, the shifting of valuable content away from a WMO channel, Virgin Media considers the "*very major change*" threshold for regulatory intervention proposed by Ofcom to be particularly inappropriate. Virgin Media considers that there is ample scope for Sky to shift a small quantity of highly valued content to channels not covered by the WMO regime (for example, the occasional FAPL match). This would be unlikely to harm Sky since its subscribers would be able to access the relevant content on one of the channels in their retail package. For rivals, however, the inability to provide key content is likely to provoke a significant degree of dissatisfaction and annoyance amongst subscribers, even if it happens infrequently. Indeed, over a period of time, tactical shifting of content by Sky in this way may be expected to erode the confidence of subscribers and increase switching away from rivals in favour of Sky. Paragraphs 3.37 to 3.48 highlight the risk of content switching to Sky Sports 3 and Xtra in the event that these do not fall within the scope of the WMO, and Sky chooses not to retail these channels to rivals. These channels already broadcast certain live sports events which attract sizeable audiences such that their withdrawal from a rival's retail package would be likely to cause considerable dissatisfaction. Sky could also gain a material competitive advantage at the retail level by migrating further content to these channels.

7.93 This problem cannot be adequately addressed through an ex post review by Ofcom. The content shifts in question are likely to be infrequent and varied as regards the sport or movie content involved. In other words, they would not necessarily be sufficient to result in a reassessment of which channels have market power and should be subject to the WMO remedy. The cumulative effect on rivals, however, of a small number of tactical content shifts could be very significant.

7.94 Virgin Media considers that this problem arises primarily because of Ofcom's decision to restrict the scope of the WMO regime to Sky Sports 1 and Sky Sports 2. This provides Sky with the opportunity to move key content to Sky Sports 3 and Xtra and not to wholesale these channels to rival retailers. Virgin Media considers, therefore, that this should be addressed by widening the scope of the WMO regime to include these channels (and it discusses in Section 3 why this is justified by the need to ensure that the scope of the WMO is consistent with the body of content in relation to which Sky is able to exercise market power.)

7.95 If, however, Ofcom decides not to widen the WMO regime, then significantly greater regulatory oversight is required to prevent the effectiveness of the remedy from being undermined. As discussed further below, Ofcom is considering a "ratchet" approach which would require Sky to seek consent from Ofcom in order to increase wholesale prices in the event of an increase in Sky's retail prices. Virgin Media considers that the shifting of content away from WMO channels is akin to a wholesale price increase (albeit involving a deterioration of the quality of the product at the same price). Accordingly, Virgin Media considers that Sky should also be obliged to seek consent from Ofcom for moving key content away from WMO channels such that it is not available to rivals. This would allow Ofcom to assess any objective justification for such a shift as well as the potential damage to rival retailers.

7.96 Virgin Media agrees with Ofcom that there is considerable scope for the proposed WMO regime to be "gamed" by Sky. Ofcom's proposal, however, to reassess wholesale prices only in the event of "*very major changes*" to wholesale costs, retail costs or retail prices is insufficiently precise, and will enable Sky to inhibit the ability of rivals to compete without necessarily prompting regulatory scrutiny. Virgin Media considers that a considerably more prescriptive approach is required from Ofcom in relation to this issue.

Minor changes in retail pricing

7.97 As outlined above, Virgin Media proposes that retail-minus prices should be calculated by considering all of the bundles of Core Premium product with different basic mixes and taking the lowest price. As regards the adjustment of wholesale prices on an ongoing basis, this implies that Ofcom would need to repeat the pricing analysis each time Sky alters its retail prices (which currently occurs on an annual basis), because the bundle which previously delivered the lowest regulated price may no longer do so. Virgin Media considers that such a review should be undertaken every time Sky changes its retail prices and otherwise at least annually in order to take account of relevant changes within the year.

7.98 If, however, Ofcom decides to proceed with the weighted average approach which it has proposed, then Virgin Media considers that Ofcom should still undertake an annual review for the reasons outlined in the paragraph above. Between these annual reviews, however, Ofcom could apply an automatic adjustment mechanism as suggested in the Third Consultation Document. In this regard, Virgin Media agrees with Ofcom that wholesale prices should evolve over time in a manner which maintains the margin between retail and wholesale prices.[156] Ofcom raises the following issues:

(a) should the margin be maintained as an absolute margin in pounds per subscriber, or as a fixed percentage of the retail price?; and

(b) should a "ratchet" be applied whereby Sky would be required to seek consent for an increase in wholesale prices in the event of an increase in its retail prices, but with no such procedure in the event of a retail price decrease. In this regard, Ofcom raises the issue of the notice period to be given to purchasers of the WMO products prior to any changes in wholesale prices.

<u>Preserving the margin between wholesale and retail prices</u>

7.99 If Ofcom decides to proceed with the weighted average approach which it has proposed then the margin between wholesale and retail prices should be maintained as a percentage of the retail price. If the weighted average approach is used by Ofcom, Sky could change the relativity of its retail prices in order to raise the weighted average price (in relation to which the regulated wholesale price is determined) whilst maintaining its

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156 Third Consultation Document, paragraphs 9.38 and 9.43.

competitiveness in relation to smaller bundles. In these circumstances, Virgin Media would prefer a mechanism which provides a higher margin as retail prices are increased.

7.100 Virgin Media is aware however, that this approach creates a downside risk. As noted by Ofcom, some retail costs will be incurred as an absolute cost per subscriber and will be incurred irrespective of the revenue earned per subscriber.[157] As retail prices decrease, the margin must be sufficient to allow retailers at a minimum to cover these costs and still earn a reasonable return – i.e. the presence of these costs creates a "floor" for the margin reduction. Virgin Media proposes, therefore, that, when prices decrease, Ofcom will need to undertake a cross-check to ensure that the percentage approach does not give rise to a margin which goes beneath this "floor".

<u>Ratchet proposal</u>

7.101 Virgin Media agrees with the ratchet approach proposed by Ofcom and considers that this provides a useful opportunity for a regulatory review of whether retail price increases by Sky can be objectively justified, and whether corresponding wholesale price increases should therefore be permitted. As regards possible reasons for allowing retail price increases to be reflected in increases in wholesale prices, Ofcom states the following:

> "*To improve transparency, a pragmatic addition would be to identify generic types of reasons for legitimate increases in wholesale prices in response to increases in retail prices (in addition to inflation)*."[158]

7.102 Virgin Media considers that a key issue in this regard for Ofcom will be whether increases in Sky's wholesale costs should be accepted by Ofcom as a generic type of reason for legitimate increases in wholesale prices in response to increases in retail prices. Virgin Media considers that there should be no automatic regulatory approval for increases in wholesale prices in response to increases in retail prices which are justified by Sky on the basis of an increase in wholesale costs, due, for example, to its increased rights costs. In these circumstances, Virgin Media considers that Ofcom should have regard to the cost-plus cross-check to inform its decision. In particular, if, as a result of the increase in wholesale costs the cost-plus floor now exceeds the regulated wholesale price based on the retail-minus approach, then an increase in the wholesale price in response to an increase in the retail price should be permitted. If however, the retail-minus price exceeds the cost-plus price then the proposed wholesale price rise should not be permitted.

7.103 An important principle for Ofcom's proposed remedy is that new entrants need to be able to operate with certainty as to the costs of their inputs and the security of their supply. As regards the notice period to be given to purchasers of the WMO products in advance of any changes in wholesale prices, Virgin Media considers that competing retailers should have a period of not less than 90 days in respect of any price increases. As stated in the Virgin Media Response to Second Consultation, Virgin Media considers that this notice period is required because rival retailers will set their own retail prices partly on the basis of their wholesale costs, and will therefore need a reasonable period within which to consider their pricing strategy, and effect any changes that might be required. Virgin Media also indicated in the Virgin Media Response to Second Consultation that a notice period of 12 months should be provided in relation to non-price terms in order to provide sufficient security of supply.[159]

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157 Third Consultation Document, paragraph 9.44.

158 Third Consultation Document, paragraph 9.50.

159 Virgin Media Response to Second Consultation, Section 6, paragraph 6.38(b).

8. OTHER (NON-PRICING) TERMS AND PRINCIPLES OF WMO

8.1 This section sets out in detail Virgin Media's observations on the non-pricing terms and principles of the WMO, including observations on:

(a) the application of the WMO to commercial premises;

(b) the application of the WMO to enhanced services;

(c) the approach to minimum qualifying criteria;

(d) complaint handling;

(e) technical delivery;

(f) cross-promotion/clean feed issues; and

(g) the use of a reference offer.

8.2 These issues were considered in sections 8 and 9 of the Third Consultation Document. Each of these issues is considered below in turn. Virgin Media notes that paragraphs 3.9 to 3.48 above discuss in detail why it is essential for the scope of the WMO to extend to Sky Sports 1, Sky Sports 2, Sky Sports 3 and Sky Sports Xtra.

Commercial premises

8.3 In paragraphs 8.53 to 8.67 of the Third Consultation Document, Ofcom sets out its reasoning for its continued view that the WMO should not extend to the retail to commercial premises,[160] despite the fact that it received numerous submissions on why the WMO should apply to the retail to both residential and commercial premises. Indeed, it appears that the majority of submissions to Ofcom on this point argued that it was also necessary for Ofcom to take action in relation to the supply of Core Premium channels to commercial premises.

8.4 Ofcom states that it does not intend to apply the WMO as regards the retail to commercial premises because:

(a) there is no evidence of restricted supply of Core Premium channels at either the wholesale or retail level, rather the main concern appears to be high retail prices;[161]

(b) the WMO is not an appropriate mechanism for achieving a specific reduction in price;[162]

(c) in any event, there are no distribution networks to take advantage of any WMO;[163] and

(d) it is not necessary to extend the WMO to commercial premises in order to address issues as regards the upstream bidding for content rights.[164]

8.5 As a preliminary observation, Virgin Media notes that Ofcom's consideration of whether to impose a WMO in relation to commercial premises is coloured by its view in paragraphs 6.130 to 6.140, i.e. that it does "*not consider that arguments of a competition concern*

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160 Ofcom also held this view in the Second Consultation Document, see paragraphs 9.14 to 9.16.

161 Third Consultation Document, paragraph 8.63.

162 Third Consultation Document, paragraph 8.64.

163 Third Consultation Document, paragraph 8.63

164 Third Consultation Document, paragraph 8.66.

arising from lack of wholesale access to be strong on the commercial side – and they are certainly less strong than on the residential side."[165] The evidence does not support this view. In practice, Sky is the monopoly retail supplier to commercial premises and accordingly commercial premises and rights owners **must** contract with Sky. In other words, commercial premises do not benefit from any competition in relation to the supply of premium sports channels. As the most obvious manifestation of a lack of competition is high prices, it is unsurprising that there have been repeated complaints made to both the OFT and Ofcom about high retail prices to commercial premises. The competition concerns arising in relation to commercial premises are, therefore, at least as great as those arising in relation to the residential sector (if not greater).

8.6 In response to Ofcom's specific arguments as to why the imposition of a WMO is inappropriate in relation to the retail to commercial premises, Virgin Media notes:

(a) first, it is clear that there is restricted supply of Sky's Core Premium Sports channels. Virgin Media understands that only cable is able to purchase Sky's Core Premium Sports channels on a wholesale basis. This is exactly the same situation as regards the supply of such channels to residential customers;

(b) second, Ofcom's arguments that the WMO is not an appropriate mechanism to address high retail prices is entirely without merit. At the heart of competition policy is the principle that effective retail competition will drive down retail prices. The object of the WMO in relation to residential subscribers is to facilitate and enable retail competition. In other words, if extended to commercial premises, the WMO proposed by Ofcom should be expected to incentivise entry, thereby leading to greater competition, and ultimately lower prices and more innovation.

(c) third, the lack of existing distribution networks is not a valid reason for not imposing a WMO in relation to commercial premises. The lack of existing distribution networks is related to the restricted supply of Core Premium Sports channels. Without access to Sky's Core Premium Channels (on sustainable terms), there would be no incentive to create such distribution networks. In short, if the WMO is not extended to commercial premises, there is very little prospect of distribution networks being set up to compete with Sky. In this regard, Virgin Media considers that the reason that Setanta chose Sky to retail its channels to commercial subscribers is that, without access to Sky's channels, it would have had too limited a product offering to support the building of a distribution network. This is particularly the case given that, like residential customers, commercial premises would also have a strong preference to acquire all their pay TV services from a single retailer; and

(d) fourth, Ofcom has not provided any evidence to support its view in paragraph 8.66 that rights owners could either supply their content directly to commercial premises or via wholesale arrangements with Sky. In this connection, Setanta's approach of supplying its channels by way of a wholesale arrangement with Sky ultimately failed with the collapse of Setanta and accordingly Ofcom should be wary about using this as an example of a sustainable model for rights owners to retail to commercial premises. This is particularly the case as such an approach (in which Sky is the retailer) will not lead to competition between rival suppliers at the retail level. Further, as indicated above, it is unlikely to be feasible for a rights owner with a limited product offering to establish its own distribution network.

8.7 Virgin Media notes that many of these points have already been raised in the Virgin Media Response to Second Consultation (paragraphs 7.66 up 7.74) and the Joint Response to Second Consultation (Section 7).

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[165] Third Consultation Document, paragraph 6.140.

8.8 Against this background, it is very surprising that Ofcom does not propose to address the commercial premises competition issues in the context of this investigation process. Ofcom does, however, acknowledge that "*it might be appropriate to consider a specific remedy in relation to commercial customers, potentially as part of any further action we may pursue relating to the sale of FAPL sports rights*".[166] Virgin Media is of the strong view that the most efficient, practical and effective means by which to address these concerns is, in fact, as part of Ofcom's pay TV investigation and not a separate, further, action that Ofcom may pursue. This is because the concerns that Ofcom would be addressing are very much the same as those arising in relation to the retail to residential customers. Further the imposition of a WMO would address many of the concerns.

Enhanced services

8.9 In paragraphs 8.88 to 8.111 of the Third Consultation Document, Ofcom sets out why it considers that the WMO should extend to enhanced services such as primary interactive services (i.e. access via the red button to footage which is directly dependent on the licensing of rights from content owners and not editorial content which could be generated by any TV retailer) and HD versions of channels.

8.10 Virgin Media strongly supports Ofcom's finding that the WMO should apply to HD versions of channels subject to the WMO. In this regard, Virgin Media agrees with Ofcom's findings that:

> "*HD capability sits at the heart of next generation TV platforms …".*[167]
>
> "*HD is becoming increasingly important to consumers, and consumer adoption is accelerating.*"[168]
>
> "*HD appears no longer to be a brand new innovation, and more an integral part of the pay TV landscape. We therefore consider we need to include HD versions of the channels within the scope of the remedy in order to ensure fair and effective competition.*"[169]

8.11 Virgin Media refers to paragraphs 7.39 to 7.42 of the Virgin Media Response to Second Consultation which sets out in detail why there are no technical or other issues which would prevent the inclusion of HD services in the WMO.

8.12 Virgin Media also observes that Ofcom appears to base its reasoning of why HD channels should be included in the WMO on the fact that HD services are increasingly important, key to next generation technology and an integral part of the pay TV landscape. In this connection, any future service which becomes as popular and integral to the TV landscape should also be subject to the WMO. This is particularly the case for 3D TV which is likely to be the next generation of technological innovation after HD.[170] Accordingly, the WMO should be structured in such a way as to enable it to be extended to new services such as 3D TV.

8.13 As regards interactive services, it is clear to Virgin Media that Ofcom's definition of primary interactive services would capture, in addition to live matches not scheduled on the linear service, video streams that broadcast, for example, an alternative camera angle for, or an additional match to, that which is broadcast on the relevant linear channel.

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166 Third Consultation Document, paragraph 8.67.

167 Third Consultation Document, paragraph 8.95.

168 Third Consultation Document, paragraph 8.96.

169 Third Consultation Document, paragraph 8.99.

170 Indeed, the potential widening of the scope of the WMO is envisaged by Ofcom. See Third Consultation Document, paragraph 9.231 to 9.233.

8.14 Virgin Media agrees that it is important that the WMO extends to primary interactive services.[171] This is because:

(a) Virgin Media's customers, and the competitive process, suffer from the lack of access to Sky's primary interactive content, especially in relation to live sports content behind the red button on Sky Sports channels.[172] [**CONFIDENTIAL**];

(b) as acknowledged by Ofcom, the amount of highly attractive live sporting events on the red button on Sky Sports is likely to increase as a result of Sky winning the rights to televise even more live Champions League matches from the 2009-2010 season (some of which will inevitably be placed behind the red button).[173] This will compound Virgin Media's competitive disadvantage and the harm suffered by consumers;

(c) given the increasing importance of interactive services (and the fact that developments are increasingly blurring the distinction between interactive services and platform functionality)[174] it is essential that such services are included within the WMO so that the WMO can be, as far as possible, future-proofed; and

(d) if the WMO did not extend to primary interactive services, Sky would be able to move content from linear transmission to interactive services in order to undermine the effectiveness of the WMO.[175] Paragraphs 3.32 to 3.48 of this Submission discuss Sky's incentives and ability to engage in such gaming behaviour.

8.15 Although agreeing with Ofcom's general position as regards interactive services, Virgin Media nevertheless has some important observations in relation to Ofcom's proposed remedy. First, Virgin Media does not consider the position as regards the inclusion of primary interactive services as part of the WMO to be "*finely balanced*".[176] For the reasons set out in paragraph 8.14 above, it is clear that the WMO must extend to primary interactive services.

8.16 Second, as acknowledged by Ofcom, Sky must provide information to retailers on the design and technical specifications of the primary interactive content subject to the WMO.[177] Ofcom needs to be more specific about how this obligation would work in practice. In this regard there is a real risk that Sky would game the WMO by withholding the information such that it is very difficult for competing TV retailers to deliver to their subscribers features/services using the same content as is available to Sky subscribers. Also, such gaming strategies would undermine the efficacy of any requirement to make primary interactive services available under the WMO.[178] In order to prevent such gaming strategies, Ofcom will need to impose a number of related conditions on Sky, such as obligations requiring Sky to:

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171 Virgin Media refers to the Virgin Media Response to Second Consultation, paragraphs 7.43 to 7.65 where it sets out in detail why the WMO should extend to interactive services and why there are no insurmountable technical concerns which should prevent this.

172 In this connection Virgin Media refers to the July 2007 Joint Submission, Annex 6, paragraphs 2.16 to 2.25 which discuss Sky's refusal to supply interactive content to Virgin Media.

173 Third Consultation Document, paragraph 8.107.

174 See Third Consultation Document, paragraph 8.105.

175 Third Consultation Document, paragraph 8.108.

176 Third Consultation Document, paragraph 8.109.

177 See Third Consultation Document, paragraph 8.111 where 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 (at their own expense)*".

178 In this connection, many of the concerns Virgin Media has expressed about the imposition of a minimum qualifying criteria also apply in relation to primary interactive services (see, for example, paragraphs 8.22 to 8.25 of this Submission).

(a) inform retailers of new primary interactive services (or indeed changes to existing services);

(b) work with retailers when developing new primary interactive services to facilitate cooperation on technical standard;

(c) provide advance notification of scheduling information where this impacts on elements that a retailer will need to configure;

(d) cooperate on the use of proprietary technical interfaces; and

(e) supply the necessary images, logos etc required for the primary interactive service.

8.17 Third, although Virgin Media appreciates the requirement for some form of minimum functionality, Virgin Media is concerned that Sky would set design and minimum functionality at a level that would be very difficult for other TV service providers to meet. Sky could do this, for example, by using unnecessarily complex technology so that it is very difficult for competing TV retailers to deliver similar features to its subscribers in sufficient time or by requiring retailers to use identical fonts or colour palettes to that used on the Sky service (in full knowledge that replicating colours and fonts exactly can be very difficult to achieve and of no material consequence to the consumer).

8.18 In this regard, any minimum functionality requirement set by Sky must be fair, reasonable and non-discriminatory. Further, such requirements should not be unilaterally imposed by Sky – TV retailers should have the opportunity to shape these requirements in order to ensure that they are workable. TV retailers must also have a degree of flexibility as to how, from a technical perspective, primary interactive content is accessed via their services. This would ensure that TV retailers are able to use the most appropriate technology for their own service and platform.

8.19 In any event, the minimum functionality requirements set by Sky should be relatively basic. This is because primary interactive content is not a true interactive service but it is merely a means by which viewers can access a hidden broadcast stream via the red button. This type of interactive service is relatively easy to replicate. Accordingly Virgin Media considers that there are no insurmountable technical issues and that Sky should be able to make interactive services available to TV retailers under the WMO quickly and without undue delay.

8.20 Fourth, Virgin Media notes that Ofcom's decision to focus on primary interactive services appears to be based on the assumption that editorial interactive content can be generated by any other retailers (and primary interactive content cannot because it depends on having access to the underlying content rights). However, this general proposition does not take into account the fact that, although TV retailers availing themselves of the WMO may be able to generate equivalent editorial content to that available on the Sky platform, in order to be able to compete with Sky it would be necessary for those retailers to be able to link this content to Sky's Core Premium Sports channels in the same way as Sky. [**CONFIDENTIAL**].[179] [**CONFIDENTIAL**].

8.21 Lastly, albeit related to the above point, the ability successfully to develop editorial interactive applications requires active cooperation between TV service providers and content providers. Usually this is not a problem because content providers have an incentive to deliver applications that will enhance their content to be developed.[180] [**CONFIDENTIAL**][181] [**CONFIDENTIAL**]. Accordingly, in order for there to be any prospect of retailers other than Sky developing interactive features to complement Sky's

179 [**CONFIDENTIAL**].

180 Virgin Media Response to Second Consultation, paragraphs 7.62 to 7.64.

181 [**CONFIDENTIAL**].

Core Premium channels, Ofcom will need to impose on Sky an obligation to co-operate with other retailers in the development of such services and, in particular, to provide access to any necessary information to allow interoperability.

Minimum qualifying criteria

Introduction

8.22 At paragraphs 9.212 to 9.227 of the Third Consultation Document, Ofcom specifies that Sky has a legitimate concern that wholesaling its channels to any particular retailer should not have a damaging effect on its business and/or brand. Under the proposed WMO regime Sky will, therefore, be permitted to devise reasonable minimum qualifying criteria (the "**Minimum Qualifying Criteria**") which could specify minimum standards with regard to quality and security to ensure that a prospective retailer's platform is sufficiently secure and is able to deliver the channel to the viewer at a reasonable quality to avoid deteriorating Sky's brand. The Minimum Qualifying Criteria includes both general minimum qualifying requirements (paragraphs 9.212 to 9.217) and specific minimum security requirements (**"MSRs"**) (paragraphs 9.218 to 9.227).

8.23 In principle, Virgin Media agrees that Minimum Qualifying Criteria will provide some certainty for retailers in relation to the requirements that must be met in order to receive the channels subject to the WMO regime. [**CONFIDENTIAL**].[182] In this connection, a requirement that, for example, HD and interactive services must be identical to the equivalent services on Sky's DSat service ignores the technical nuances of individual TV platforms and results in cable customers being foreclosed access to such services. [**CONFIDENTIAL**].

8.24 However, Virgin Media considers that Ofcom's approach in permitting Sky to specify "reasonable" requirements without any input from industry participants or Ofcom into these requirements will inevitably lead to Sky proposing Minimum Qualifying Criteria that will be extremely difficult to meet and which, potentially, could be designed specifically to exclude specific retailers who are perceived as a competitive threat. There would be no purpose in Ofcom mandating a WMO regime if Sky could avoid or materially undermine the regime simply through specifying unduly onerous Minimum Qualifying Criteria.

8.25 To avoid this possibility, at the very minimum, industry participants should be given the opportunity to comment on the Minimum Qualifying Criteria in advance of implementation to ensure that the requirements are fair, reasonable and non-discriminatory. This will identify in advance of any final publication the possibility of qualifying criteria being inserted which are not technically feasible or only feasible for certain retailers.

8.26 Given that Virgin Media already carries the SD versions of Sky's wholesale channels, it would be perverse if Sky were to be entitled to specify Minimum Qualifying Criteria (including specific MSRs) in relation to SD channels with which Virgin Media does not currently comply. In other words, the basis on which Virgin Media currently broadcasts Sky's channels must be the maximum benchmark for any Minimum Qualifying Criteria set by Sky.

8.27 In relation to the HD versions of the relevant channels, Virgin Media has recently started to carry a number of new HD channels including National Geographic HD, FX HD, Channel 4 HD, MTVN HD and ESPN HD. Virgin Media takes these channels via DSat and transcodes the feed from MPEG 4 to MPEG 2 with no viewer discernible degradation in picture quality. [**CONFIDENTIAL**].

8.28 Set out below are Virgin Media's comments on Ofcom's proposed approaches as regards general minimum qualifying requirements and MSRs.

182 [**CONFIDENTIAL**].

General Minimum Qualifying Requirements

8.29 At paragraph 9.216 Ofcom cites examples of general minimum qualifying criteria that Sky would be able to specify. The minimum requirements would relate to: (i) picture quality; (ii) support for access services; and (iii) parental control. Virgin Media has given some preliminary thought to how each of these criteria could be developed into a reasonable set of requirements.

(a) Picture quality: Virgin Media acknowledges that requirements in relation to HD picture quality may be more onerous than in relation to SD. However, if there is a case for more stringent obligations regarding particular rights then it falls upon Sky to be transparent about what these requirements are and which rights holders are stipulating the requirement. However, Virgin Media considers that any requirements relating to picture quality must be assessed by whether, from the viewer's perspective, the picture quality gives a "reasonable" viewing experience, rather than any assessment of whether the picture quality is identical to Sky. If the requirements require a retailer to mirror Sky's picture quality, this could lead to Sky claiming that minor aesthetic differences between a third party's service and the Sky channels justify refusal to supply. To avoid this problem comparison objective picture quality metrics could be used to evaluate the picture quality of a service. For example, "BT500 Picture Quality" analysis is more or less standard throughout Europe. Therefore any requirements could be standardised such that picture quality degradation can be measured by way of a scale as depicted in BT500 (for example, [5] Excellent (no difference), [4] Good (no notable difference), [3] Fair (good), [2] Poor (notable differences) and [1] poor. A picture will be deemed as reasonable quality if the measurement is equal to or greater than 4 (good) in most instances.

(b) Parental controls: Virgin Media currently has pin protection controls in place in relation to the linear Sky movie channels to comply with the Ofcom Broadcasting Code. Rule 1.22 of the Broadcasting Code allows BBFC 15-rated films to be shown at any time of the day provided a mandatory pin is in place between the hours of 0530 and 2000 and that the security systems that are in place to protect children are clearly explained to all subscribers. [**CONFIDENTIAL**]. Virgin Media considers that Sky should not be entitled to insist on parental controls going beyond those required of Sky by Ofcom. However, even such a requirement should not be used as a pretext to restrict supply. For example, no technical solution is infallible and occasional human error or technical failure relating to the efficacy of a pin protection system should not automatically trigger a withdrawal of the channels. Only in cases where Ofcom threatens to withdraw the broadcast licence from Sky should this trigger an equivalent threat to withdraw the channel from the retailer.

(c) Support for access services: Virgin Media currently supports audio-description and subtitles on the Sky channels as mandated by Ofcom's Code on Television Access Services, which currently requires platforms to have the technical capability to carry access services such as sign language and audio description provided as part of the channel. Virgin Media considers that the minimum requirements to support access services should go no further than is currently required under the existing Ofcom Code.

Minimum Security Requirements

8.30 Ofcom proposed in its Second Consultation Document, that Sky would be able to impose a set of MSRs on third party platforms to ensure that its content is secure and protected against piracy. Ofcom set out a number of options as to how these MSRs could be defined.[183]

8.31 In response, Virgin Media set out its support for Ofcom's third option, which proposed that Sky could define a set of MSRs that would be both technology and platform agnostic.[184] However, Virgin Media's support for this approach was subject to a number of important caveats:

(a) first, contrary to Ofcom's suggestion, Sky should not be able unilaterally to decide which MSRs it considered necessary but rather that the MSRs should be defined by Sky, relevant retailers and Ofcom together such that the MSRs are objectively justified, reasonable and proportionate;

(b) second, as a starting point, the MSRs should not go beyond the current security arrangements used by Virgin Media. In this regard, Virgin Media is continuously working to improve and enhance security features;

(c) third, the MSRs should be capable of being met by Sky's own platform;

(d) fourth, platforms should be able to adopt technologies best suited to their platform so long as the end-result is an equivalently secure environment as that stipulated under the WMO; and

(e) fifth, Ofcom should be involved in formulating a robust dispute resolution mechanism to avoid Sky using the MSRs as a pretext to withhold supply.

8.32 Ofcom's view in the Third Consultation Document is that Sky should be able to set MSRs which are both platform and technology agnostic, but that it is not necessary for prospective retailers to participate in the development of the MSRs. However, Ofcom considers that these MSRs should be objectively justifiable.

8.33 As stated above, Virgin Media considers that Ofcom's approach in permitting Sky to specify "objectively justifiable" requirements without any input from industry participants or Ofcom will inevitably lead to Sky proposing MSRs that will, either deliberately or inadvertently, be difficult or impossible to meet for some or all potential retailers. In circumstances in which Sky does not wish to supply its channels on a regulated wholesale basis, it will have an incentive to design a set of MSRs which, although appearing to be technology and platform agnostic, are intended to exclude, or unreasonably increase the costs of, retailers on competing platforms. Even if this were not the case, without input from rival retailers (who will understand the technological capabilities of their platform better than Sky), it is very possible that Sky will inadvertently propose MSRs that are technologically incompatible with the relevant platform but which, with the input of the retailer, could be modified to deliver the desired objective.

8.34 For these reasons, Virgin Media considers that it is imperative that, at a minimum, relevant retailers are consulted in advance on any MSRs proposed by Sky being implemented. Failure to mandate this form of consultation will lead to the very high risk that Sky will be able to use MSRs to undermine the efficacy of the WMO by delaying or inhibits the acquisition of Sky's Core Premium Sports and Movies channels by both existing retailers and potential new entrants.

8.35 [**CONFIDENTIAL**].

8.36 [**CONFIDENTIAL**]. However, again, Virgin Media does not consider that Sky should be able to mandate MSRs in relation to the supply of HD versions of the channels subject to

[183] Second Consultation Document, paragraph 9.82.

[184] Virgin Media Response to Second Consultation, section 8.

the WMO regime that go beyond what has been required by other HD channels launching on the cable platform. [**CONFIDENTIAL**].

8.37 At paragraph 9.227 of the Third Consultation Document, Ofcom specifies that the MSRs may include requirements associated with subscriber audits and operational processes to establish levels of theft. These audits could be carried out by third parties if the parties cannot agree on how they should be performed. Virgin Media is comfortable that some form of audit may be necessary; however any audit requirements must not be overly intrusive and broad-ranging such that it becomes a fishing expedition.

8.38 [**CONFIDENTIAL**]. Any audit under the WMO must be reasonable and objectively justifiable. For example, the audits should not allow Sky to gain information on Virgin Media's conditional access system [**CONFIDENTIAL**], which Sky could then potentially use to gain a competitive advantage. Also, the robustness of a conditional access system relies on the very limited distribution of information on that conditional access system. As a result, users of conditional access systems are often contractually prohibited from sharing certain information on the conditional access system. This prohibition may well apply to the type of information Sky may seek under MSRs.

Complaint handling

8.39 Virgin Media has previously stressed the need for Ofcom to consider in more detail the requirement for some form of complaint handling and resolution process in relation to any disagreements arising from the implementation and operation of the WMO.[185] In this connection, Virgin Media's strong preference was for a WMO-specific process to be established.

8.40 In the Third Consultation Document Ofcom has stated "*[*w*]hilst our preference is for prospective retailers and Sky to reach commercial agreement in relation to supply of the relevant channels and content, in the event that a complaint is brought to us, we would normally follow [*our published general guidelines on handling complaints*] (or any subsequently published guidelines) in handling the complaint unless there is good reason not to do so.*"[186] In this connection Virgin Media assumes that Ofcom is referring to its *Guidelines for the handling of competition complaints, and complaints and disputes about breaches of conditions imposed under the EU Directives* July 2004 (**"Complaints and Disputes Guidelines"**); and its *Draft Enforcement Guidelines* of 6 July 2006 ("**Draft Guidelines"**) (together referred to as **"the Guidelines"**).

8.41 In response to Ofcom's proposed approach as regards complaint handling, this sub-section of the Submission:

(a) first explains why it would be inadequate in the context of the WMO for Ofcom to rely on the Guidelines; and

(b) second proposes an alternative approach for Ofcom which would provide more clarity and assist in the efficient resolution of disagreements between parties, namely the publication of specific guidelines for resolving complaints about the implementation and operation of the WMO (**"WMO Enforcement Guidelines"**).

8.42 As a preliminary point, Virgin Media would emphasise that an effective and timely complaints handling process will be crucial to the successful implementation and operation of the WMO. This is because the WMO addresses only Sky's ability to **act** on its incentive not to wholesale it Core Premium channels to third parties (or only do so on uneconomic terms) and will not change Sky's incentives. Accordingly, Sky must be expected to utilise every opportunity available to it to limit or frustrate the objectives of the WMO. This will

185 Virgin Media Response to Second Consultation, section 10.

186 Third Consultation Document, paragraph 9.240.

result in Sky aggressively testing every aspect of the requirements of the WMO which will, in turn, inevitably lead to disagreements between Sky and rival retailers in relation to the implementation and operation of the WMO.

8.43 In this context an effective complaints handling process will provide a means to resolve those disagreements between parties and, perhaps more importantly, provide an incentive for Sky to act reasonably in relation to the obligations imposed by the WMO. Without an effective complaints handling process Sky can be expected to take every opportunity to obstruct the implementation of the WMO and thereby undermine its effectiveness in facilitating fair and effective competition.

Inadequacy of Ofcom's existing dispute resolution process

8.44 Whilst Virgin Media considers that Ofcom is best placed to resolve complaints under the WMO, for the reasons set out below it does not believe that the Guidelines will prove to be an effective means of resolving those complaints and ensuring the efficient implementation and operation of the WMO.

8.45 First, there is a very material lack of clarity as to how Ofcom's current complaint handling process, set out in the Guidelines, would be applied in the context of conditions imposed under section 316 of the Communications Act 2003. Specifically:

(a) it is not clear which of the Complaints and Disputes Guidelines and Draft Guidelines will actually apply. The Complaints and Disputes Guidelines, although relatively old (they are from 2004 which was Ofcom's first year of operation), are still formally in place as they have never been revoked nor replaced with finalised revised guidelines. However, in 2006 (after only two years of operation) inadequacies in the Complaints and Disputes Guidelines led to the acknowledgement that they need to be revised and Ofcom consulted on the Draft Guidelines. However, three years after the closing date for the consultation, the Draft Guidelines have yet to be finalised. This is important because it is not clear which of the Guidelines will be applied by Ofcom in circumstances in which there are considerable differences between them;

(b) although the Guidelines both state that they apply to conditions imposed to ensure fair and effective competition in broadcasting,[187] there is very little further reference to the approach that will be adopted in relation to such conditions. Indeed section 9 of the Draft Guidelines, which deals with enforcing ex ante conditions and rules, does not mention conditions imposed under section 316 and makes reference only to enforcement action that would apply in relation to conditions imposed under section 45 of the Communications Act.

(c) in practice, the Guidelines are each drafted very much from the perspective of new complaints or disputes being brought to Ofcom and do not obviously contemplate complaints being raised in respect of conditions imposed by Ofcom after a long running detailed investigation. In consequence, the vast majority of the content of the Guidelines does not appear appropriate for dealing with issues relating to the implementation and operation of the WMO. A number of the implications of this are addressed below;

(d) the specific guidance relating to resolving disputes will not apply to disputes arising under the WMO (as they are not one of the types of dispute which Ofcom is permitted to handle using those powers);[188] and

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187 Complaints and Disputes Guidelines, paragraph 20 and Draft Guidelines, paragraph 3.11.

188 Complaints and Disputes Guidelines, paragraph 21 and Draft Guidelines, paragraph 3.12.

(e) as far as Virgin Media is aware, Ofcom has never enforced a fair and effective competition provision in a licence so there is no precedent to inform interested parties in relation to the processes that will be adopted.

8.46 Second, as indicated in 8.45(b) above, the Guidelines do not specifically address the process to be adopted in dealing with complaints being raised in respect of a condition imposed by Ofcom under section 316. In consequence, the processes set out in the Guidelines would not be an effective means of resolving complaints arising in the context of the WMO. A number of illustrative examples are set out below:

(a) under the Guidelines Ofcom has considerable discretion as to whether to open an investigation.[189] Notwithstanding the fact that most of the factors which Ofcom states it will take into account in deciding whether to open an investigation should be irrelevant in the context of the WMO, there is no certainty that Ofcom will open investigations into complaints about the implementation and operation of the WMO. This lack of certainty would be very likely to be gamed by Sky. Accordingly, greater certainty is required in relation to the circumstances in which Ofcom would be prepared to resolve complaints and disagreements in relation to the WMO;

(b) under the Guidelines, Ofcom requires a significant level of information before accepting a complaint.[190] In cases in which an urgent decision is required, this will place an unacceptable burden on the parties given that Ofcom would already have considerable information relating to the markets and the WMO;

(c) Ofcom has a target timetable of four months for a closure statement or notification that Ofcom has reasonable grounds for believing that an *ex ante* condition has been breached.[191] However, this four month period is merely a "target" and there is no guarantee that complaints will be resolved within this period. Further, this four month period only starts once Ofcom has decided to open an investigation and accordingly the period for resolving a dispute is likely to be longer than four months because there will be a delay (of up to 15 working days)[192] between the receipt of any complaint and Ofcom taking a decision whether to open an investigation. This period would be far too long in circumstances in which Sky has refused to wholesale Core Premium channels (or, even worse, has withdrawn those channels from a retailer). This is particularly the case as Ofcom has no power to impose orders for interim relief in respect of breach of a condition imposed under section 316.[193] It is therefore necessary for Ofcom to be able to take action much more quickly in relation to complaints arising in the context of the WMO. This is particularly the case given:

(i) Ofcom has extensive knowledge on the operation of the pay TV market which it has acquired during the course of the pay TV market investigation. Ofcom will be well-placed to take advantage of this learning when faced with a complaint;

(ii) Ofcom has already been made aware of ways in which Sky may attempt to game the WMO (Virgin Media and the Joint Parties have made various

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189 See, for example, Draft Guidelines, paragraph 4.42.

190 See, for example, Complaints and Disputes Guidelines, paragraphs 33 to 43 and Draft Guidelines paragraphs 4.9 to 4.18.

191 Complaints and Disputes Guidelines, Table 4, page 15 and Draft Guidelines, Table 1, page 28.

192 Draft Guidelines, paragraph 4.5.

193 Draft Guidelines, paragraph 5.16.

submissions on this)[194] and has considered, at least to some extent, the likelihood of Sky behaving in these ways; and

(iii) Ofcom has designed the WMO and accordingly knows intimately how the WMO operates and how variables will impact on the effectiveness of the WMO;

(d) the Guidelines indicate that investigation teams will be established on an ad hoc basis to deal with complaints as and when they are received and investigations are opened.[195] There is, therefore, no guarantee that an inquiry team established to investigate a complaint about the operation of the WMO will be made up of Ofcom staff that were involved in the pay TV market investigation, which would be the most sensible approach in order to ensure consistency and promote the efficient and speedy resolution of complaints.

8.47 Against the above background there is a real risk that if Ofcom relies on the processes set out in its Guidelines for resolving complaints arising in the context of the WMO, this will give rise to a very slow, inefficient, process. Quite apart for providing very little legal and commercial certainty for rival retailers, this outcome would provide Sky with a clear ability and incentive to game the WMO regime at every opportunity. This is because there will be no guarantee that Ofcom will take any action to prevent such behaviour and, even if it does, it is likely to take a considerable time to reach a conclusion. In the meantime, Sky will be able to inhibit the ability of rival retailers to provide effective competition to Sky. This would be to the ultimate detriment of consumers. In circumstances in which Ofcom has spent almost three years investigating and consulting on the pay TV market it would be absurd for the efficacy of the WMO regime to undermined by an ineffective enforcement regime.

Alternative approach

8.48 Given Virgin Media's serious misgivings about Ofcom relying on the Guidelines to enforce the WMO regime, Virgin Media believes that it would be more appropriate for Ofcom to set out specific guidelines relating to the enforcement of the WMO (i.e. WMO Enforcement Guidelines). This would be similar to the way in which Ofcom has consulted on specific guidelines relating to the enforcement of BT's undertakings.[196] By publishing WMO Enforcement Guidelines, Ofcom will be able to address many of the concerns Virgin Media has raised above. For example, WMO Enforcement Guidelines would address the uncertainty arising from having two sets of guidelines, namely the Complaints and Disputes Guidelines and the Draft Guidelines. WMO Enforcement Guidelines would also address concerns relating to the lack of precedent for enforcing fair and effective competition provisions and would also reduce the scope for Sky to game the WMO regime by taking advantage of the uncertainty arising from the Guidelines and lack of precedent.

8.49 The WMO Enforcement Guidelines would need to cover the entire complaints handling and investigation process relating to complaints and disagreements arising from the WMO, including:

(a) confirmation of the form and detail required in any complaint about the WMO. In this connection, the WMO Enforcement Guidelines must take into account the fact that Ofcom has extensive background knowledge on the pay TV market and the operation of the WMO, and therefore should not require complainants to reproduce this information;

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[194] See, for example, this Submission, paragraphs 3.37 to 3.48 and paragraph 8.33.

[195] See, for example, Draft Guidelines, paragraph 4.32.

[196] Draft Guidelines, section 8.

(b) the threshold for opening an investigation. The threshold should be low, and there should be a presumption that an investigation will be opened when a complaint is brought to Ofcom having regard, in particular to the following:

(i) the fact that Sky has the incentive and ability to game and undermine the WMO;

(ii) Sky is highly likely to attempt to game the WMO by undertaking a series of what may seem inconsequential measures but would, in aggregate, impact the effectiveness of the WMO; and

(iii) Sky has considerable market power and accordingly benefits from a very strong bargaining position when negotiating with pay TV retailers in relation to the supply of premium pay TV channels. In this connection, it cannot be assumed that the parties will be able to reach a commercially-negotiated solution;

(c) timing of the handling of a complaint and any subsequent investigation. For reasons set out in paragraph 8.46(c) above, Virgin Media considers that investigations should be completed considerably faster than the four months period suggested by the Guidelines. In relation to certain issues, it may be appropriate for decisions to be taken by Ofcom within a very short period of time; and

(d) as regards the make-up of any investigation team Ofcom should establish a pool of personnel who would deal with incoming complaints about the WMO. These people should have been heavily involved in Ofcom's three year pay TV market investigation and accordingly have extensive background knowledge on the pay TV market and the WMO imposed by Ofcom.

Technical delivery

8.50 At paragraph 9.57 of the Third Consultation Document, Ofcom proposes to derive the wholesale price of the channels subject to the WMO remedy based on a "factory gate" price which would exclude any cost of onward transmission. The channels will be made available for retailers to pick up via a leased line at Sky's premises for onward transmission to end users. Ofcom has not, however, included any provision within the remedy for those retailers who, due to technical practicalities and efficiency reasons, would prefer to pick the feed up via DSat rather than at the factory gates (this is how Virgin Media currently picks up Sky's channels). At footnote 530 of the Third Consultation Document Ofcom states, however, that retailers would be able to commercially negotiate alternative arrangements for an incremental charge to the factory gate price.

8.51 As a general position, Virgin Media considers it perverse that the WMO may result in Virgin Media receiving Sky channels on terms that are worse than the current terms on which it receives those channels. Indeed, this overarching concern is reflected in Virgin Media's observations as regards sports market definition (and correlating scope of the WMO) and the imposition of Minimum Qualifying Criteria. As regards technical delivery, Virgin Media is concerned that, as a result of the WMO, it may be forced to accept technical delivery of Sky's channels on a less efficient basis (i.e. via the leased line) than it currently does (via DSat).

8.52 [**CONFIDENTIAL**].

8.53 [**CONFIDENTIAL**].

8.54 In light of these concerns, Virgin Media therefore proposes an amendment to the provisions on technical delivery to include that transmission over DSat should also be accommodated within WMO and that the terms associated with DSat delivery should be subject to review by Ofcom.

Cross-promotion

8.55 In paragraph 9.29 to 9.33 of the Second Consultation Document, Ofcom identified a concern that Sky could make use of excessive cross-promotion and advertising to promote channels which are not included within other retail bundles, such as those channels which are retailed by Sky as premium channels but which may not be caught by the proposed obligation. Likewise, although Ofcom acknowledged it is reasonable for Sky to use its brand to promote its channels it should do so in a manner that is appropriate for a channel which is being distributed to a variety of different retailers.

8.56 To address these concerns, Ofcom sets out its proposal to require Sky to make available a "clean feed" of the channels to other retailers.[197] This clean feed could be the same channel which Sky provides to itself or a different feed. Ofcom suggested that there should be:

> "*[n]o cross-promotion of specific channels which are not included within the supply obligation....*"
>
> "*No cross-promotion of specific retail propositions*."
>
> "*To the extent that advertising minutage is used to promote other channels or other retail offerings, this advertising minutage must be available to all retailers on a non-discriminatory basis or the retailer must be able to insert its own advertising into pre-defined ad breaks with the clean feed prior to onward transmission to their own subscribers*".

8.57 Ofcom has moved significantly from its position in the Second Consultation Document that specific conditions are required to mitigate against the concern that Sky will use its cross-promotion muscle to undermine the wholesale regime. Ofcom now considers that reliance on existing codes will be sufficient. Ofcom states that "*compliance with the existing codes will address many of the concerns we might have on how Sky may cross promote its channels and services. We therefore do not intend to introduce specific conditions relating to these activities*".[198]

8.58 Ofcom does not explain why it is not necessary to address its previous concern in relation to cross promotion or why, contrary to its previous position, it now considers that the existing codes are sufficient to mitigate the concerns identified above. As stated in the Virgin Media Response to Second Consultation, Virgin Media considers that it would be wholly insufficient to rely on Ofcom's cross-promotional code as a mechanism to curtail Sky's incentive and ability to run harmful cross-promotions on the Sky channels which are wholesaled to competing platforms.[199] In this regard, the following points should be noted:

(a) first, Sky has previously ignored and breached the cross-promotion code in an aggressive attempt to undermine the Virgin Media platform; and

(b) secondly, even if Sky complied with the existing codes (which Virgin Media considers extremely unlikely) it would not address the concerns identified in the Second Consultation Document and set out in paragraphs 8.60 to 8.65 of this Submission.

Each of these points is discussed below in turn.

Sky has previously ignored the rules on cross-promotion

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197 Second Consultation Document, paragraph 9.32.

198 Third Consultation Document, paragraph 9.236.

199 Virgin Media Response to Second Consultation, paragraph 9.5.

8.59 The Virgin Media Response to Second Consultation described the harm caused when Sky ran a series of cross promotions aimed at damaging the Virgin Media platform following the breakdown of negotiations with regard to the carriage by Virgin Media of Sky's basic channels. Although Ofcom found Sky in breach of the cross-promotion code it took, after an appeal by Sky, 18 months to reach a decision during which Virgin Media suffered significant harm. Given that, following the finding of breach, no financial penalties were imposed and Sky had in the interim period benefited from [**CONFIDENTIAL**] Virgin Media customers who turned to Sky, Virgin Media considers it extremely unlikely that the rules on cross-promotion will in future provide a sufficiently meaningful constraint on Sky's incentive and ability to weaken a third party platform.

Insufficient to rely on Ofcom's Cross-promotion Code

8.60 The current regulations on cross-promotion are contained in the Ofcom Broadcasting Code 2008. Section 10 of the Broadcasting Code contains rules about "undue prominence" but those rules only apply to promotions within programmes. The rules governing cross-promotion in airtime outside of programmes are set out in the Cross-Promotion Code (**"the Code"**). A key principle of the Code is to ensure that promotions on television outside of programmes do not prejudice fair and effective competition. However, the specific rules in the Code in this respect are limited to controls over the terrestrial broadcasters.

8.61 Virgin Media's analysis of the rules on cross-promotion and undue prominence indicates that the rules would place no restriction on Sky in relation to the harm set out in the Second Consultation Document and summarised in paragraph 8.55 of this Submission. In particular the rules would not prohibit:

(a) Sky failing to indicate, during promotions of the channels that are subject to the WMO regime, that the channels are available on platforms other than the DSat platform:

(i) under Rule 2.2 of the Code, promotions on ITV, Channel 4 and Five to analogue households that mention a digital retail or platform service must treat all other major services in a fair and equal manner. This rule is designed to ensure that those PSB channels who naturally favour free-to-air platforms do not use their cross-promotional muscle to distort competition. However, Sky is not subject to this requirement and therefore would be free, absent contractual agreement otherwise, to promote its own retail platform over those of competing providers. For example, Sky would be able to run a promotion which only informed viewers that Sky Sports 1 is available on the DSat platform (i.e. did not make it clear that Sky Sports 1 is available on other platforms).

(b) The cross-promotion of specific channels not included in the WMO regime:

(i) the Code allows broadcasters to promote programmes, channels and other broadcasting-related services in promotional airtime. There is no restriction regarding promotion of channels not available on a third party's service. In other words, Sky would be able to promote, on channels subject to the WMO regime and broadcast by rival retailers, other Sky channels that are not available from that rival retailer.

(c) The cross promotion of specific retail propositions:

(i) although under the Code a retail service is not considered to be a broadcast related service capable of being cross promoted, it can be mentioned to inform viewers of how to access the broadcast related service. In Ofcom's finding of breach against Sky in relation to the promotions it ran on the

Virgin Media platform following the carriage dispute, it states: "[t]*elevision platforms and television retail services are not themselves broadcasting-related services capable of being cross-promoted under the Cross-promotion Code. However, they may be mentioned in a promotion for the purpose of informing viewers how to access the broadcasting-related service, e.g. a television channel. However, as the guidance on undue prominence explains, any reference to the platform or retail service on which the broadcasting-related service is provided should not be unduly prominent in the context of the promotion.*"[200] It is clear therefore that the Code does not actually prohibit the promotion of specific retail propositions provided the promotions are not unduly prominent.

(d) The use of advertising minutage to run promotions similar in nature to those described in paragraphs 1.11 (a), (b), (c):

(i) the Code does not apply to advertising minutes and, therefore, any such promotional commercials may still be run using advertising airtime.

8.62 Notwithstanding Ofcom's suggestion that existing codes will address its concerns, Ofcom appears implicitly to accept the limitations of the cross promotion code, as it observes:

> "*However, we would expect Sky to ensure that the feeds provided to third party retailers did not include excessive promotions of services and features which were not available to consumers on non-Sky platforms which could lead to consumer confusion or that might degrade the consumers' perception of the quality of the service provided by their pay TV retailer*."[201]

8.63 This observation makes it clear that Ofcom considers that Sky will be able promote, on the channels subject to the WMO regime, services and features that are not available on non-Sky platforms and that this may lead to consumer confusion and degradation of the consumer perception of other platforms. Given this is the case, it is not sufficient for Ofcom to simply express an expectation that Sky should not engage in excessive promotions of this type. A mere expectation will carry no weight with Sky and Ofcom will have no means of taking any enforcement action in the event that Sky engages in such activity (which must be considered a virtual certainty).

8.64 The promotional opportunities described above and the potential anti-competitive effects are akin to the provision of a channel with interactive icons where the interactive service is not available on the relevant platform. This was expressly addressed in the prior ITC Code on cross-promotion where digital channels with market power were obliged to provide a feed clean of interactive icons where the interactive service was not available on the relevant platform and was only dropped from the new Code as the provision was already duplicated by the then existing BSkyB undertaking to the OFT.[202]

8.65 To avoid the harms identified above, Virgin Media suggests that Ofcom requires Sky to be:

(a) obliged to give "equal prominence" in any promotions to other platforms which offer its channels. For example, if Sky were to advertise a sporting event on Sky Sports 1 it should notify the viewer that the channel is available on Sky, Virgin Media and any other platforms. This would avoid the harm of Sky distorting competition and using the rules on cross-promotion to promote the availability of the wholesale channels on its platform only; and

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200 See case "*Sky One and other Sky channels, 11 February to 25 March 2007, various times*", Broadcast Bulletin Issue number 120, 27 October 2008 at http://www.ofcom.org.uk/tv/obb/prog_cb/obb120/

201 Third Consultation Document, paragraph 9.237.

202 See footnote 16 to Section 6 of Ofcom's Review of the Cross Promotion Rules published on 6 December 2005.

(b) obliged to permit Virgin Media to replace any damaging cross-promotions or adverts with Virgin Media promotions and adverts.

Reference offer

8.66 In paragraphs 9.228 to 9.230 of the Third Consultation Document, Ofcom suggests that Sky be required to publish a "reference offer" in which it would set out the general terms that apply to all pay TV retailers being supplied Care Premium Channels pursuant to the WMO. Ofcom notes that the terms of this reference offer would be set by Sky and would be expected to be fair, reasonable and non-discriminatory.

8.67 Although Virgin Media agrees that a reference offer may be helpful in that it will increase the transparency for pay TV retailers, Virgin Media has serious concerns about Sky being able unilaterally to set the terms of the reference offer (see, for example, the concerns set out in paragraphs 8.30 to 8.38 as regards MSRs). Ofcom should not assume that Sky, left to its own initiative will set terms that are fair, reasonable and non-discriminatory. Against this background, it is essential that relevant retailers are consulted in advance in relation to the terms of any reference offer before they are finalised. Without input from industry participants, and given Sky's ongoing incentives, it is highly likely that the reference offer will be formulated in such a way that it undermines the efficiency of the WMO.

8.68 Related to the above point, Ofcom should not assume that the terms of the current cable ratecard would form a reasonable basis for any future reference offer. The cable ratecard has been unilaterally imposed on Virgin Media by Sky and has not been the subject of negotiation. In consequence, the terms of the current cable ratecard reflect the very significant bargaining power historically enjoyed by Sky in its dealing with Virgin Media. The cable ratecard cannot therefore be considered to be a viable benchmark for the terms that should be expected in circumstances in which Sky is acting in a fair, reasonable and non discriminatory fashion.

9. PROPORTIONALITY OF A WMO

9.1 Section 10 of the Third Consultation Document considers whether the imposition of the WMO is proportionate by reference to the impact of the WMO on consumers, Sky, retailers other than Sky and rights-holders. In this connection, Ofcom poses two consultation questions, namely:

(a) Do you agree that a WMO remedy is unlikely to contribute significantly to the administrative costs currently incurred by Sky?

(b) Do you consider that Ofcom's impact assessment supports its view that it would be appropriate to impose a WMO in the form proposed in order to ensure fair and effective competition?

9.2 Virgin Media sets out, in reverse order below, its responses to each of these questions.

Consumer benefits arising from the WMO

9.3 Virgin Media agrees that Ofcom's impact assessment supports its view that it would be appropriate to impose a WMO in order to ensure fair and effective competition. Specifically Virgin Media agrees that the benefits (in particular the consumer benefits) of the WMO outweigh any associated costs. In this connection, and as a preliminary observation, Virgin Media has identified very significant consumer detriments resulting from the current market conditions (these are set out in more detail in Section 6 of this Submission). Clearly, the removal, or substantial reduction, of these significant consumer detriments (as would be achieved by the WMO) will deliver benefits to consumers (relative to the current position).

9.4 Turning to the specific benefits to consumers that will result from Sky's Core Premium channels being supplied under the WMO, Virgin Media believes that the WMO will:

(a) allow Virgin Media to lower prices for Sky's premium sports and movie channels, incentivise Virgin Media to market Sky's Core Premium channels and increase consumer awareness of their availability on Virgin Media's platform, thereby leading to more intense head-to-head competition with Sky;

(b) allow Virgin Media to roll-out interactive and HD content related to Sky's Core Premium channels on the Virgin Media platform;

(c) increase the choice of provider for consumers who are not in cable active areas and want Sky's premium sports and movies channels;

(d) facilitate more flexible bundling of Sky's premium sports and movie channels; and

(e) provide much greater incentives to innovate in relation to the delivery of Core Premium channels, especially in relation to services which are particularly suited to platforms other that Sky's DSat platform (e.g. interactive services).[203]

9.5 Below Virgin Media sets out below further information on each of these consumer benefits in turn.

[203] Virgin Media Supplementary Submission, sections 4 and 5.

Lower prices

9.6 Reduced wholesale prices for Core Premium channels resulting from the WMO would enable Virgin Media to reduce retail prices and increase investment in sales and marketing, leading to more intense head-to-head competition with Sky.

9.7 [**CONFIDENTIAL**]:

(a) [**CONFIDENTIAL**];

(b) [**CONFIDENTIAL**];

(c) [**CONFIDENTIAL**].

9.8 [**CONFIDENTIAL**]. This is because the degree of the retail price reductions that would be possible would depend on:

(a) the actual price imposed under the WMO;

(b) whether Sky Sports 3 and Sky Sports Xtra are included in the WMO; and

(c) if Sky Sports 3 and Sky Sports Xtra are not included in the WMO, the price at which Sky will supply these channels to Virgin Media (this is particularly important as consumers have a strong preference to purchase a bundle of channels including a variety of sports content).

9.9 [**CONFIDENTIAL**]:

(a) [**CONFIDENTIAL**];

(b) [**CONFIDENTIAL**];

(c) [**CONFIDENTIAL**];

(d) [**CONFIDENTIAL**];

(e) [**CONFIDENTIAL**].[204]

9.10 Lower prices are likely to lead to material annual savings for customers. [**CONFIDENTIAL**].

9.11 [**CONFIDENTIAL**]. This will provide an incentive for Virgin Media to market those channels to consumers. This would lead to greater consumer awareness of the availability of those channels on the Virgin Media platform and the lower prices at which they are offered. Virgin Media would be able to compete more effectively with Sky with resulting consumer benefit.

Roll-out of interactive and HD content on Virgin Media's platform

9.12 Subscribers to the Virgin Media platform cannot currently receive HD versions of the Sky Sports and Sky Movies channels. Further, the interactive content associated with Sky Sports channels is also unavailable on the Virgin Media platform.

9.13 In its current form, the WMO will extend to the HD versions of Sky's Core Premium Sports and Movies channels and to primary interactive content related to Sky's Core Premium

[204] The Sky comparison prices are based on Sky's published prices in September 2009 for the above packages when taken with one Entertainment Pack.

Sports channels. [**CONFIDENTIAL**][205] [**CONFIDENTIAL**] existing Virgin Media subscribers to Sky Sports will enjoy a richer Sky Sports experience as they will have access to primary interactive content that is currently only available to Sky's DSat subscribers via the red button.

9.14 Virgin Media's customers will also have the opportunity to subscribe to HD versions of Sky's Core Premium channels which will, again, result in a higher quality service. This will introduce competition in relation to the retail supply of HD Core Premium channels, and will facilitate greater platform competition between Sky and Virgin Media (as currently, subscribers that want access to HD versions of Sky's channels have no choice of provider other than Sky).

Off-net proposition

9.15 As a result of the WMO, Virgin Media would be able to secure access to the Sky Core Premium channels for delivery by IPTV [**CONFIDENTIAL**].[206]

9.16 The launch of an off-net IPTV service will enable Virgin Media to compete with Sky in non-cabled areas and provide a more seamless service to customers, especially to subscribers who move in and out of cable areas. This will remove Sky's current monopoly as a retail supplier of Sky's Core Premium Channels in non-cable active areas and will also increase platform competition for pay TV services as a whole.

More flexible package bundling

9.17 The fact that the WMO will enable Virgin Media to make a return on selling Sky's Core Premium channels (in contrast to the current position) will provide an opportunity for Virgin Media to introduce more flexible bundles, thereby increasing consumer choice [**CONFIDENTIAL**]:

(a) [**CONFIDENTIAL**];

(b) [**CONFIDENTIAL**].

[**CONFIDENTIAL**].

9.18 [**CONFIDENTIAL**].

Greater innovation

9.19 The WMO will provide Virgin Media with much greater incentives to invest and innovate in relation to new services, features and functionality in connection with its TV proposition [**CONFIDENTIAL**]:

(a) [**CONFIDENTIAL**];

(b) [**CONFIDENTIAL**]:

(i) [**CONFIDENTIAL**];

(ii) [**CONFIDENTIAL**];

(iii) [**CONFIDENTIAL**];

(iv) [**CONFIDENTIAL**]

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205 [**CONFIDENTIAL**].

206 *Virgin Media Limited Consolidated Response to the Request for Further Information of 20 December 2007,* 21 February 2008, Part I, paragraph 3.3.

(v) [**CONFIDENTIAL**].

(c) [**CONFIDENTIAL**];

(d) [**CONFIDENTIAL**].

9.20 Further, in section 12 of the Third Consultation Document Ofcom proposes liaising directly with the Hollywood Movie Studios in order to address concerns about the restricted availability of SVOD movie rights in the UK.[207] If Ofcom's approach led to the wider availability of such SVOD movie rights, Virgin Media would no longer be denied the opportunity to develop an SVOD movie service which would compete effectively with Sky's linear subscription movie offering. [**CONFIDENTIAL**]:

(a) [**CONFIDENTIAL**];

(b) [**CONFIDENTIAL**];

(c) [**CONFIDENTIAL**];

(d) [**CONFIDENTIAL**];

(e) [**CONFIDENTIAL**];

(f) [**CONFIDENTIAL**].

9.21 More detail on the SVOD opportunities that would be available to Virgin Media in the event that Ofcom's proposal leads to the greater availability of SVOD rights, is set out in the Virgin Media Supplementary Submission, at paragraphs 5.45 to 5.51.

9.22 [**CONFIDENTIAL**].[208]

Sky's costs will not increase significantly

9.23 Virgin Media agrees that a WMO remedy is unlikely to contribute significantly to the administrative costs currently incurred by Sky. Although there will be some additional administrative (including reporting costs) for Sky associated with the WMO, Virgin Media does not consider these to be significant. In this regard, Virgin Media also notes that:

(a) absent the WMO Sky nevertheless incurs administration costs in relation to the wholesale of its premium channels (including management time in negotiating with Virgin Media and potential retailers). These costs may actually reduce as a result of the WMO; and

(b) Sky currently incurs administration and sales costs in relation to the sale of its Sky By Wire retail service to Tiscali customers. If Tiscali were to avail itself of the WMO, Sky would no longer incur these costs.

9.24 Nevertheless, even if Sky were to incur materially larger administration costs as a consequence of the WMO, Virgin Media cannot envisage circumstances in which such cost would be of an order of magnitude that they would not be outweighed many times over by the consumer benefits that would arise from the increased competition that would be generated from the WMO. In short, the benefits to consumers over time of a WMO will be so great that any increase in Sky's costs will be entirely de minimis in comparison.

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207 In this connection Virgin Media refers to section 11 of this Submission which discusses this proposal in more detail.

208 For more detail see the Virgin Media Supplementary Submission, paragraphs 4.17 to 4.20.

10. LICENCE CONDITIONS

10.1 Section 11 of the Third Consultation Document sets out the draft licence conditions which Ofcom proposes to insert into the licences of the channels subject to the WMO.

10.2 At this stage Virgin Media has not reviewed Ofcom's draft licence condition in detail. However it notes that the condition will need to be amended to reflect the various issues raised in this Submission.

11. CONTENT RIGHTS REMEDIES

11.1 In Section 12 of the Third Consultation Document, Ofcom acknowledges that some concerns about the pay TV market would not be resolved by the imposition of the WMO, in particular the restricted exploitation of certain content rights. In this regard, Ofcom has considered in more detail the extent to which separate remedies are required in relation to two types of content rights: SVOD movie rights and FAPL rights. This section of the Submission sets out Virgin Media's views as regards these two types of content rights.

SVOD movie rights

11.2 In paragraph 9.46 to 9.50 of the Second Consultation Document, Ofcom identified that even where it has the relevant movie rights, Sky may have a limited incentive to develop an extensive SVOD movie service because the technical constraints of the DSat platform mean that Sky cannot offer an extensive TV SVOD service. In order to prevent the resulting detriment to consumers Ofcom therefore proposed that it "*would at the very least expect that, where Sky has the appropriate movie rights, and where it uses those as the basis of a subscription VoD service to its own retail customers, it should make a wholesale version of this SVOD service available to other platforms*".[209]

11.3 In the Virgin Media Response to Second Consultation, Virgin Media highlighted that Ofcom's concerns regarding Sky's incentives were well founded and that Sky was acting on those incentives to restrict the availability of SVOD rights in the market. Virgin Media considered that Ofcom's proposed intervention would be justified and Virgin Media provided Ofcom with precedent examples of where Ofcom has previously mandated the offer of wholesale products in the past to justify Ofcom imposing a requirement on Sky to wholesale its SVOD movie service.

11.4 In relation to SVOD rights, Ofcom identifies that:

(a) SVOD rights are of particular strategic importance since they offer a payment mechanism that is likely to be particularly attractive to consumers;[210]

(b) Sky holds the exclusive SVOD rights for all six Major Hollywood Studios;[211]

(c) Sky has an incentive to restrict exploitation of these SVOD rights to protect its own linear movie channels and that it appears to be acting on this incentive;[212]

(d) as a result this is damaging the competitive functioning of the market as "*there appears to be a risk that innovation in the development of VOD services may be stifled by the manner in which the VoD rights to premium movies are currently being exploited*";[213]

(e) the evidence of high margins is stronger for Sky's premium movie channels than it is for its premium sports channels;[214] and

(f) that reduced innovation and high prices could both be addressed by making SVOD rights available transparently and separately from linear rights.[215]

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209 Second Consultation Document, paragraph 9.49.

210 Third Consultation Document, paragraph 12.17.

211 Third Consultation Document, paragraph 12.18. The six Major Hollywood Studios are: Disney; Paramount; Sony; 20th Century Fox; Universal; and Warner Bros.

212 Third Consultation Document, paragraph 12.19 .

213 Third Consultation Document, paragraphs 12.21 and 12.28.

214 Third Consultation Document, paragraphs 12.22 and 12.28.

11.5 Virgin Media entirely supports the above findings, although notes that Ofcom has focussed on Sky warehousing SVOD rights and does not appear to have fully appreciated Sky's holdbacks in respect of such rights. In Section 5 of the Virgin Media Supplementary Submission and paragraphs 7.9 to 7.29 of the Virgin Media Response to Second Consultation, Virgin Media set out:

(a) [**CONFIDENTIAL**]:

(i) [**CONFIDENTIAL**];

(ii) [**CONFIDENTIAL**];

(iii) [**CONFIDENTIAL**].

(b) Virgin Media also highlighted how Sky is acting on its incentive to withhold SVOD movie rights. The Virgin Media Supplementary Submission set out the difficulties of trying to secure SVOD rights from the Major Hollywood Studios in the first pay TV window. Virgin Media described that Sky employs a deliberate strategy of denying its competitors content through either warehousing those rights or by negotiating holdbacks in respect of such rights. These strategies prevent the Major Hollywood Studios from licensing SVOD rights to third parties;[216] and

(c) this lack of access to SVOD rights stifles innovation and makes it impossible for Virgin Media to provide consumers with a full SVOD movie service that would be capable of offering an effective competitive alternative to Sky's linear movie channels.

11.6 As a remedy to address the concerns identified in the Third Consultation Document, Ofcom proposes that the Hollywood Movie Studios should make SVOD rights available separately from linear channel rights. This would be supplemented by a further rule that the same firm cannot buy both sets of rights, which would guarantee that linear and SVOD rights could be exploited independently.[217] Virgin Media considers that such a remedy would be more practicable, and easier to implement, than requiring Sky to wholesale a channel containing SVOD rights.

11.7 Ofcom does not, however, consider that a remedy of this type is well suited to being addressed under either its section 316 power or its general competition powers. Further, while Ofcom states that this form of remedy could be investigated by the Competition Commission following a market investigation reference, Ofcom considers it may be more constructive first to engage further with the Major Hollywood Studios to establish whether it is possible to avoid such an intervention by changing the commercial strategies of the studios.

11.8 Whilst Virgin Media has consistently argued that Ofcom should refer issues relating to the upstream purchasing of key rights to the Competition Commission, and considers that a reference to the Competition Commission may be the only way to resolve the harms identified, it supports Ofcom's proposal to approach the Major Hollywood Studios. However, this support is conditional on the following:

(a) Ofcom commencing its discussions as soon as possible. In particular, this process could commence immediately and need not await the final outcome of Ofcom's investigation; and

215 Third Consultation Document, paragraph 12.24.

216 Virgin Media Supplementary Submission, paragraph 5.36.

217 Third Consultation Document, paragraph 12.29.

(b) Ofcom should be open-minded about considering alternative solutions to those set out in the Third Consultation Document to facilitate the availability of SVOD rights. Virgin Media considers that a potentially more effective remedy, rather than prohibiting one entity acquiring both linear and SVOD rights, may be to open up the market and create more competition. This could be achieved by providing that SVOD rights cannot be sold on an territory exclusive basis but may be sold on a platform exclusive basis within a territory so long as no retailer can purchase the SVOD rights for a platform on which it does not retail. This approach is similar to that adopted in relation to pay per view movie rights and would facilitate competition between SVOD services on competing platforms.

11.9 In any event, if a timely resolution cannot be reached with the Major Hollywood Studios, Ofcom should waste no further time and refer this issue to the Competition Commission for a market investigation.

FAPL rights

11.10 In paragraphs 8.25 to 8.29 of the Second Consultation Document, Ofcom concluded that it was not appropriate to address Sky's market power at source by intervening to change the way in which FAPL rights were bought and sold. Ofcom argued that "*in order for such an intervention to significantly reduce or eliminate the existing market power, it would be necessary to place severe restrictions on the ability of Sky and other firms to aggregate content. Such intervention would go well beyond the previous intervention by the European Commission into the way FAPL rights are sold.*"[218]

11.11 In response Virgin Media noted that the remedies proposed by Ofcom in the Second Consultation Document did not address concerns in relation to the upstream content.[219] Virgin Media observed that "*after such a lengthy review by Ofcom the relevant features and behaviour…will remain unaddressed*" and submitted that a market investigation reference to the Competition Commission under the Enterprise Act 2002 may be necessary to address such concern.[220]

11.12 Against this background, Virgin Media welcomes Ofcom's acknowledgment in the Third Consultation Document of potential competition concerns in relation to the upstream provision of FAPL content rights. In the Third Consultation Document, Ofcom acknowledges that the commitments given by the FAPL to the Commission, which in any event do not apply to the next FAPL live rights auction, have not resulted in sustainable increased competition or consumer benefits (as demonstrated first by Setanta only retaining rights to one package of live FAPL rights in the most recent auction and second by Setanta's ultimate failure and market exit).[221] Against this background, Ofcom observes that there may be a case for more targeted intervention, although it is opposed to a remedy which will place major restrictions on the ability of firms to aggregate content.[222] In this connection, Ofcom appears to be focussed on considering appropriate rules for the 2012 FAPL auction. Ofcom has not, however, specified the form of its proposed more targeted intervention. In this context, Virgin Media makes a number observations.

11.13 First, given that the previous commitments provided by the FAPL to the EC Commission were so unsuccessful, any new intervention would need to go further than those commitments. Ofcom's analysis supports this view. For example, Ofcom finds that more extensive remedies than the original FAPL commitments would be required in order to

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218 Second Consultation Document, paragraph 8.1.

219 Virgin Media Response to Second Consultation, paragraph 2.5.

220 Virgin Media Response to Second Consultation, paragraph 2.6.

221 Third Consultation Document, paragraph 12.41.

222 Third Consultation Document, paragraph 12.14.

generate competition to threaten Sky's market power. In particular, "*as a minimum, rival wholesalers [*to Sky*] would have to win either two packages of live FAPL rights including package A or any three packages of Live FAPL rights*".[223] In this connection, Virgin Media refers to Annex 2 of the July 2007 Joint Submission where the Joint Parties set out ways in which the auction for live FAPL rights could be made more competitive, including:

(a) requiring the packages of FAPL rights to be more evenly balanced in terms of the number and quality of matches;

(b) allowing conditional bids by non-dominant bidders; and

(c) decreasing the maximum number of packages which any one broadcaster can win from five out of six to four out of six.

11.14 Virgin Media remains of the view that Ofcom should consider all of the above options. Virgin Media considers, however, that an intervention that only implements, for example, one of the above recommendations is likely to be wholly insufficient. For example, decreasing the maximum number of packages which any one broadcaster can win to four out of six is unlikely to achieve a sustainable competitive market. In this connection, Setanta originally won the rights to two packages of live FAPL rights, which ultimately proved to be too little on which to base an attractive and sustainable premium sports offering.

11.15 Further, the recent failure of Setanta has caused Virgin Media to doubt whether even the recommendations set out in Annex 2 of the July 2007 Joint Submission would be sufficient to bring about sustainable competition to Sky in relation to the purchase of FAPL rights. Accordingly, Virgin Media is of the view that Ofcom should, in addition to the recommendations set out above, also consider more extensive intervention, such as:

(a) decreasing the maximum number of packages which any one broadcaster can win from five out of six to three out of six;

(b) prohibiting any one bidder from acquiring the two most attractive packages of FAPL rights; and

(c) increased transparency as regards any minimum reserve for bids.

11.16 Second, if, contrary to the submissions made by Virgin Media and the Joint Parties,[224] commercial premises are excluded from the WMO, the protection of commercial customers must be explicitly considered and addressed in any intervention relating to the sale of FAPL rights.

11.17 Third, given that the next FAPL auction will take place in 2012, it is imperative that Ofcom seeks a resolution to this issue immediately. Failure to address the concerns identified by Virgin Media, the Parties and Ofcom prior to this auction would create significant uncertainty and would detrimentally affect the likelihood of the auction resulting in long-term, sustainable competition in the market to the benefit of consumers.

11.18 Lastly, Virgin Media considers that if Ofcom has been unable to reach an accommodation with the FAPL which satisfactorily addresses it concerns by mid-2010, it should make an expedited market reference to the Competition Commission on this point under the Enterprise Act 2002.

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223 Third Consultation Document, Annex 8, paragraph 2.114.

224 See, for example, paragraphs 8.3 to 8.8 of this Submission.