



Ofcom's review of television advertising and teleshopping regulation – Stage two

Set out below is Sky's response to Ofcom's consultation of 7 October 2008 on the amount of airtime and teleshopping advertising and on the number and length of advertising breaks.

Before considering the main proposals on which Ofcom is consulting, Sky wishes to raise some important points of principle.

1. *Important points of principle*

- 1.1. In the last meeting on 9 May 2008 it was suggested that Ofcom had various legal duties, but that its duty to Public Service Broadcasting (PSB) was greater than its duty to the market as a whole and/or to consumers and that PSB merited concessions in order to preserve it. That prompted Sky to visit the regime laid out in the Communications Act 2003 (the Act), on which Richard Hawking wrote previously (see paragraph 10 of his letter of 28 May 2008).
- 1.2. This also prompted Sky to revisit Ofcom's formulation of its regulatory objectives in this consultation. In the 7 October condoc (para 2.31 (a), also at 3.28 of the 19 March condoc), Ofcom characterises its "*first regulatory objective*" as that of furthering the interests of citizens and consumers in relation to the "*range, quality and appeal of television services available*" in the UK, "*in particular, public service channels*". The emphasis added with regard "*in particular*" to PSB channels is not, however, in the Act, where Ofcom only has a duty, where "*relevant*" to "*have regard...to...the desirability of promoting the fulfilment of the purposes of public service television broadcasting in the United Kingdom*"¹, which is not the same.
- 1.3. It is not clear why Ofcom has formulated its duties in this way, but it would seem to be elevating the desirability of promoting PSB to the same status as Ofcom's principal duty² and those things it is *required* to secure in carrying out its functions (to further the interests of citizens and consumers in relation to the range, quality and appeal of TV services). Bearing in mind the comments made at the last meeting, and since this formulation is not supported in law, it would appear that Ofcom, as a matter of policy, is pre-disposed towards conferring some benefit on the PSBs.
- 1.4. Sky's argument is not that Ofcom should have no regard to the role of PSB; but rather that Ofcom should not seek to elevate its importance beyond that prescribed in law in order to lend credence to a policy pre-disposition in favour of the Public Service Broadcasters (PSBs). Sky would be concerned at any such pre-determination of policy (determined at least as long ago as the 19 March condoc), in advance of gathering the evidence in the course of this consultation. Such an

¹ S. 3 (4) (a)

² S. 3 (1)



approach would, in Sky's view, be inconsistent with Ofcom's best practice obligations under the Act (section 3 (3), to strive to ensure that its interventions will be evidence-based etc).

- 1.5. Sky would, moreover, question the fairness of any such predetermined policy, were it to lead to a transfer of wealth to those with the most market power (in the sale of TV airtime) and existing benefits, namely the PSBs, from those with the least power and benefits, namely the non-PSBs (as further set out in Richard Hawking's letter of 28 May 2008).
- 1.6. The position in respect of ITV is worthy of distinct consideration from the PSBs more generally, as it has the most market power and would stand to benefit most from any such relaxation:
 - 1.6.1. in Sky's submission to the OFT regarding its review of CRR, Sky explained how the merger of Carlton and Granada continues to enable ITV to exploit the market power derived from the unique attributes of ITV1, which the Competition Commission was anxious to control with the CRR remedy. Sky highlighted, in particular, the unique ability of ITV1 to consistently deliver large audiences, more prized than ever by advertisers in a fragmented multichannel environment (see paragraphs 5.2 to 5.7 of Sky's CRR submission). ITV1's position is yet more pronounced in terms of its peak time SOCI (see paragraph 5.10 and Annex 2 of Sky's CRR submission); and despite difficult trading conditions, there is no evidence of any decline in ITV1's position, relative to its competitors;
 - 1.6.2. many of the changes on which Ofcom is consulting would be of greatest benefit to ITV. Some of those changes (for instance, Options 5 and 6 on amount and 2 on length), if implemented, would further strengthen ITV's market power, precisely in those areas where ITV1 is already strongest (namely in the delivery of peak time mass audiences).
- 1.7. There is, moreover, little justification for any such transfer of wealth, where:
 - 1.7.1. it could undermine the very existence of some non-PSB channels, which rely on airtime income to survive and, in some respects cater for more diversified tastes than the PSB channels, thereby making an important contribution to consumer choice (and indeed, to furthering "*the range, quality and appeal of television services available throughout the UK*").
 - 1.7.2. there would be no guarantee as to how the PSBs would use it, for instance whether they would invest it in programming at all, still less in programming considered to be of a PSB nature (instead, any such benefit could simply flow to the bottom line). At 3.36/8, Ofcom suggests that additional revenue "could be" invested in better quality programming, but that inchoate possibility is not sufficient to justify any change in regulation



that is likely to transfer wealth away from those least able to afford it, to the detriment of broadcasters and consumers.

- 1.8. Sky would urge Ofcom to take into account these important points of principle, whilst consulting on the options before it.

2. Sky's position in relation to the main options being considered

Amount of advertising

- 2.1. Sky remains firmly in favour of a status quo in the regulation of advertising minutage overall (i.e. Option 1, at 3.9) and during peak (Option 4 at 3.32), and against Options 2, 3, 5 and 6, for the important reasons of principle explained above (in short, because any relaxation, would skew the playing field still further in favour of the PSBs, at the expense of non-PSBs). Sky notes that the status quo would appear to meet with universal approval in that it is in the interest of most consumers (3.12 of the 7 October condoc), broadcasters and advertisers (3.13). Ofcom's provisional assessment (3.30) that "*the status quo may strike the best balance between maintaining a wide range of high quality television services, and the opinions of consumers*", therefore, has particular force. Ofcom's formulation of its objectives at paragraph 3.30, moreover, conforms to Sky's understanding of the legislative regime (as discussed above), unlike that at 2.31 (a).

Weekly averaging of peak time limits

- 2.2. Sky highlighted above the fact that any relaxation in favour of the PSBs would favour ITV the most (as appears to be recognised by Ofcom). Option 6, ITV's last minute proposal to average daily peak time minutes across the week, is worthy of specific mention in this regard. This option is likely to strengthen ITV1's existing market power precisely where that power is strongest (namely peak time mass audience delivery) and where ITV's competitors are at their weakest and should, therefore, be rejected. Given the magnitude of impact that this proposal would likely entail (according to 3.44, an increase in SOCI of between 6-10%, of which ITV would account for the vast majority), it was perhaps incumbent on ITV to have raised it earlier in the process and not at a time when only ITV would be able to make representations on it, unchallenged. It is hoped that Ofcom is now conducting a thorough assessment of the likely impact of this proposal (without any pre-disposition in favour of it).

Ofcom's impact assessment

- 2.3. Otherwise, Sky's main concern with Ofcom's assessment of the impact of the various potential changes under consideration is that it continues to inadequately reflect the realities of TV advertising.

Observed reality is that an increase in supply has lead to a reduction in NAR in real terms



- 2.4. As mentioned in Sky's last meeting and letter of 28 May, the reality Sky has observed in TV advertising over the last few years is an increase in volume of advertising which has caused price deflation and a reduction in overall investment. During the period 2000 to 2007, total broadcast impacts have increased by some 27%³; price has decreased by some 34% in real terms⁴; and revenue has decreased by some 16% in real terms⁵. Like the PSBs (at 3.21 and A4.4), Sky considers demand to be inelastic and that any increase in advertising would cause both price and industry revenue to fall. Indeed, there has been a decline in investment in real terms as agencies (on behalf of their advertiser clients), observing a steady increase in supply, have anticipated that they can achieve the same weight of impacts/communication for their clients, whilst spending less in real terms (and perhaps more on other advertising media such as online).

The PwC study has been a poor predictor of actual industry outcomes

- 2.5. The PwC study was designed for a different purpose, to try to predict overall industry revenue, than for which Ofcom uses it now, namely to try to predict the impact on different broadcasters of different minutage scenarios. Moreover, the dynamics of TV advertising are complex and have changed considerably over time (for example, the proportion of multichannel households has increased by almost 10 percent a year over the last few years according to Ofcom's own estimates), and these dramatic changes are naturally difficult to accommodate within a single model. Ofcom should be cautious, therefore, when relying on the study's results.
- 2.6. The PwC model predicted in 2004 that demand is elastic, and significantly so in the long run, when actual experience (as above at 2.4) suggests that an increase in impacts supplied would lead, at best, to a neutral effect on revenues, and more likely a fall. This disparity appears to have grown with the update commissioned by one stakeholder, showing even higher levels of price elasticity than observed reality supports. Notwithstanding that the model has not been a good predictor of actual industry outcomes, Ofcom continues to rely on it as providing "the most accurate estimates of the price elasticity of demand of the UK TV advertising market for the purposes of this IA" (A5.53). A better use of that stakeholder's resource than the commissioned update of the PwC study might have been to develop a new model focussed on the issues raised in this consultation and capable of delivering more appropriate outputs for Ofcom's modelling.

Ofcom's model builds on the shortcomings of PwC's study

³ from 581,148,074 to 740,096,737

⁴ from an average of £6.73p to £4.45p, taking into account RPI 2000-2007 (down 20%, from an average of £6.73 to £5.37, in absolute terms).

⁵ from £3,328m to £2,797m, though it has remained relatively constant in nominal terms (at £3,328m in 2000 and £3,375m in 2007).



- 2.7. Ofcom's model, however, builds on the shortcomings of the PwC study. Ideally, to adequately model the different minutage scenarios, Ofcom would take a range of inputs on the elasticities of demand faced by different broadcasters (including the individual PSBs, to reflect ITV's market power and the process of negotiation between advertisers and agencies). But the only input Ofcom's model can take from the PwC study is a single predicted elasticity of demand for airtime on PSB channels as a group. As noted above, the overall predicted elasticity has proven to be inconsistent with the inelasticity Sky (and the PSBs) observe, and so the estimate for the PSB channels should be treated with scepticism.
- 2.8. On top of this, the PwC study provides no estimate for the elasticity of demand for airtime on non-PSB channels, which gap Ofcom seeks to bridge with an assumption, that the relative price ratio between PSB and non-PSB remains constant. There is no evidence for this assumption, however; the results of the model are highly sensitive to it; and it is clearly not robust as it produces counter-intuitive results in the levelling down scenario (as Ofcom notes at A5.126).
- 2.9. From here, Ofcom predicts that a reduction in price resulting from an increase in volume would be offset (or exceeded) by an increase in demand such that overall industry NAR would remain constant (or would increase). Hence Ofcom models a lower case consistent with a "*no change in advertising revenue*" (A5.60) and an upper case consistent with an increase in NAR (A5.61), but no case where NAR is in fact reduced, an outcome which accords most directly with industry experience.
- 2.10. If the assumption made as to constant price ratio is wrong (as would appear to be the case from its failure, in Sky's view, due in no small part to the unique attributes of the PSBs, in particular ITV1), and the rate of decline in the price of multichannel airtime is faster than that of the PSBs, a distinct possibility is that the model is underestimating the overall net revenue position and that the prediction should in fact be a net loss to the industry. Sky considers, therefore, that Ofcom should model a lower case, consistent with an overall reduction in revenue, and use constant industry NAR as its central case.
- 2.11. The combined result of these failings is that there is considerable margin for error and so Ofcom should approach its estimates of the impact of all scenarios with extreme caution.
- 2.12. The margin for error is clearly greatest in the most extreme scenario of a full levelling up, where Ofcom loses all faith in the estimates generated (itself highlighting a further complexity, that of audience drop off in the face of increased advertising, not reflected in the model). Ofcom recognises in this scenario that a transfer of wealth to the PSBs would be likely, but without any useful estimate of impact with which to work, appears to somewhat understate its likely magnitude. The language employed at 3.15 and 3.16, which seeks to describe the impact in all levelling up scenarios as likely to be "more limited than



most might think”, and though “more noticeable on PSB channels...still relatively limited” seems misplaced. It can be contrasted with the rather more emphatic language of the IA (for instance, at A5.68, Ofcom records how the March IA anticipated that the “benefit to PSBs would overwhelm that of the non-PSBs, causing the latter to forfeit SOCI and advertising revenue”). Whatever the degree of reliance to be placed on the estimates, Ofcom should not lose sight of the fact that the transfer in the full levelling up scenario is likely to be the largest and, therefore, that any such change would likely cause the greatest distortion.

- 2.13. This highlights the need for caution in interpreting the results in the most extreme scenario. Sky would submit that in light of the flaws in Ofcom’s model, as discussed above, there is also a need for caution across all scenarios. Given industry experience, there is at least a distinct possibility that the model may be underestimating the likely transfer of wealth from multichannel to PSB across all scenarios, in which case, Ofcom should resist implementing any change in regulation that might lead to such a transfer, no matter how small its predicted impact.

Ofcom’s attempts to reconcile the differences in its results and industry experience do not go far enough

- 2.14. Ofcom recognises the disparity between its predicted results and industry experience and tries to reconcile this in two ways:

2.14.1. by putting the reality of decline in overall NAR down to “*other more general factors*” or macro-economic conditions (A5.65); and

2.14.2. by simply treating the results with caution and resisting placing too much emphasis on them (A5.113, A5.132).

- 2.15. This is a step in the right direction, but does not go far enough to reflect reality. Whilst the acceleration in decline in revenue in recent times (for example) can perhaps be attributed to wider macro-economic conditions (and for this reason 2008 estimates are not included in the analysis at 2.4 above, though needless to say, with these estimates, the decline is even more marked), this is unlikely to explain the structural decline witnessed over the last 8 years. As above, Sky believes the explanation is that demand is inelastic and that both price and investment have fallen. Ofcom should, therefore, seek to reflect this reality in its assessment of the impact of different minutage scenarios.

3. Number and length of advertising breaks

Number of breaks

- 3.1. In the letter of 28 May, Sky expressed concern that, despite recognising the benefit to viewers of allowing broadcasters more flexibility to schedule advertising breaks in support of the proposal to scrap the 20-minute rule (6.27 of



the last condoc), Ofcom is nevertheless still determined to regulate the frequency of advertising breaks. This concern remains. In essence, Sky's view is that there is a natural system of checks and balances, which ensures that consumers' interests are adequately safeguarded, without the need for further regulation.

- 3.2. Sky's major principled objection was Ofcom's starting determination to regulate, in the absence of any evidence as to the need for it. In the last condoc, Ofcom recognised (6.29) that *"the available research...sheds little light on whether viewers would prefer longer, less frequent breaks, or shorter more frequent breaks"*. In the 7 October condoc, Ofcom also recognises that there was at the time, limited evidence available to it (4.5), but it nevertheless *"remained of the view that there should be limits on the number of advertising breaks"* (4.4). At 4.10, and with specific reference back to 4.4 (i.e. to its view at the time of the first condoc), Ofcom states that *"we have already decided that there should be limits on the number of advertising breaks. Accordingly we are not considering the possibility of no regulation."* In doing so, Ofcom reveals that it decided to regulate from the outset, on the basis of only very limited evidence. Whereas Ofcom does not consider it appropriate to foreclose certain options, it considers it appropriate to foreclose the option of no regulation on which it purports to have already consulted (4.9). It is difficult to reconcile this approach with the best practice principle of evidence-based regulation.
- 3.3. It is clear from the deliberative research that there is a large degree of knee-jerk reaction to an unfounded concern that UK advertising patterns will become like those in the US. This is evident in a number of comments from interviewees, but none of them is identified as having any extensive experience of US television viewing beyond taking holidays there. This perceived association between more frequent, shorter breaks and the US system has also made its way into Ofcom's consultation document (in particular at 4.20 which concludes with the assertion that participants' *"spontaneous judgement was towards longer advertising breaks"*). But, changing the rules on distribution alone in the UK will not lead to a US-style situation, because there will continue to be caps on the overall amount of advertising, unlike in the US. These caps provide an important back stop to any perceived excess in advertising.
- 3.4. In Sky's last meeting, Ofcom recognised that it did not have clear evidence of consumer preferences in this area and placed much emphasis on the deliberative research it was planning to conduct. Sky welcomed that research as a potential source of evidence of consumer preferences, provided it was conducted properly.
- 3.5. Even taking the report at face value, it is difficult to understand how it supports the conclusion that *"viewers generally opposed the idea of more frequent breaks"* (at 4.29). For example, for viewers who watched an episode of The Bill with 4 breaks, the average score for *"The level of advertising felt about right overall"* amongst viewers was 5.38 out of 7, and for *"The amount of advertising was acceptable for this type of programme"* was 5.37 out of 7. These scores can only be interpreted as being positive towards 4 breaks. The example of a programme



with 5 breaks was less positive but, as explained below, this is due to flaws in the research. Even in this instance, the score for *"The amount of advertising was acceptable for this type of programme"* was 4.08 out of 7, which is broadly neutral.

- 3.6. More fundamentally, the deliberative research is deeply flawed, in three key ways (as examined in more detail below), and this undermines any conclusions that might be drawn from it:
 - 3.6.1. it uses different programmes, so no direct comparison is possible between the two scenarios tested;
 - 3.6.2. the choice of programmes is likely to bias the results; and
 - 3.6.3. it was badly executed in a way which is also likely to bias the results
- 3.7. If the object of the exercise was to see what pattern of breaks viewers preferred, the research should have used different patterns of breaks within the same programme. If one group saw an episode of *The Bill* with 4 breaks, another group should have seen the same episode with 5 breaks. Instead the second group was shown a completely different programme, *Pushing Daisies*, with 5 breaks. This means that the 4-break and 5-break scenarios cannot be compared.⁶
- 3.8. This effect could have been mitigated if the two programmes were similar, but it is clear from the report that they were not, and that the type of programme affected subjects' opinions. A widely watched British staple such as *The Bill* and a "quirky" US comedy-drama as *Pushing Daisies* are not meaningful comparisons and to test attitudes towards advertising patterns in this way would likely have distorted the results. As the report says of the reaction to 5 breaks in *Pushing Daisies*, *"Some of this negativity was generated from the programme itself, which did not appeal to many participants"* (p27 of deliberative research findings).
- 3.9. The report also makes clear that the adverts in *Pushing Daisies* were not inserted at sensible or sympathetic points in the programme. It is clearly not in the interests of a broadcaster to insert advertising breaks in such a disruptive way. Ofcom itself reports that *"The advertising breaks were said to be placed in 'unnatural' and 'unusual' places within the programme (i.e. there appeared to be no relevance or logic to where they were placed)"* (p27 of deliberative research findings).
- 3.10. It is unfortunate that the deliberative research has been conducted in this flawed manner, which ultimately provides little evidence of consumer preferences as to

⁶ Although Sky understands the potential value in testing different types of programme, the appropriate way to do so would have been to use 4 groups, one watching *The Bill* with 4 breaks, the second watching *The Bill* with 5 breaks, and the other two watching *Pushing Daisies* with 4 and 5 breaks respectively.



the frequency of breaks. One interesting observation that does emerge, however, is that for both The Bill and Pushing Daisies, the group that actually saw it found the advertising more acceptable than those who simply discussed the concept – as Ofcom notes, *“viewer perceptions of the revised break pattern were more negative than the actual viewed experience”*. Again, the description here belies a preconception about consumer preferences, as responses to the Bill (as described above) were clearly positive, not *“less negative”*.

- 3.11. In short, there is little evidence still of the need for regulation of the number of advertising breaks and in Sky's view it is unnecessary. The decision to regulate seemingly having been made at the outset, however, Sky would generally urge the greatest flexibility within it, and therefore would be in favour of regulation permitting more breaks in longer programmes (whilst Sky accepts that there are likely to be some limits to viewers' acceptance of the number of breaks, as suggested in 4.21, its view is simply that Ofcom does not need to prescribe this, because if advertising patterns alienate viewers, they will switch away).

Length of advertising breaks on PSBs

- 3.12. For the same reasons that Sky is against any relaxation in the rules on minutage, Sky does not consider it appropriate to transfer wealth to the PSBs by allowing them to increase break lengths.
- 3.13. The scale of impact would clearly vary according to the exact combination of relaxations under consideration, but even a relaxation on break length in isolation would likely strengthen the ability of the PSBs, and in particular ITV, to deliver more “centre”, “first” and “last-in” breaks, which are more valuable to advertisers and would likely attract increased revenue, at the expense of non-PSBs.
- 3.14. Any relaxation of the limits on length of PSB breaks combined with an increase in the amount of advertising would clearly have a far greater quantitative impact, arguably greatest in a levelling up scenario, though still significant in any scenario allowing greater flexibility in peak time. The benefit to ITV would be particularly significant in such a scenario, given ITV1's command of peak time mass audience delivery. Sky can see no justifiable basis to add further to ITV's existing position of significant strength and would agree with Ofcom (at 4.42) that retention of the rule on number of breaks is an opportunity cost of PSB status.

4. Teleshopping minutage

- 4.1. Sky has previously said that it would be in favour of full flexibility in teleshopping for non-PSB channels, because this was thought to be of particular benefit to some of the smaller non-PSB channels, who might rely on this income to fund programming, or indeed for survival (Sky is not particularly concerned for itself as it does not use its teleshopping allowances on its channels). Indeed, it is



precisely here where the gap between the PSBs and the smaller multichannels is widest, which gap the latter try to bridge as best they can with teleshopping.

- 4.2. Having seen the evidence in Ofcom's consultation, however, and in particular the chart at p.37, it would appear that of the main commercial broadcasters, ITV and five would be the main beneficiaries of any such change as only they currently use their full teleshopping allowances (ITV on ITV2 and five on fiver and five US). This would evidently transfer wealth to those who need it the least, and who already benefit from gifted DTT capacity for their sister channels.
- 4.3. Moreover, Sky would not be in favour of any relaxation of the current teleshopping limits for the PSB channels themselves, as this is likely to benefit ITV, already with significant market power, the most. It should be recognised that in this scenario, only ITV could capitalise on the reclassification of gambling services as teleshopping, because only ITV1 has a Northern Irish variant of its channel, where gambling services can be removed in order to comply with the ban (no other channel or broadcaster has a Northern Irish variant and so would be committing a criminal offence in Northern Ireland were it to transmit such programming). In any event, Sky would question the contribution of teleshopping services to the PSB remit (and notes that Ofcom itself questioned the contribution of such services to the range, quality and appeal of TV services, at paragraph 7.25 of the 19 March condoc), particularly without any suggestion as to how any such additional revenue might be committed.
- 4.4. On reflection, and in light of the estimates of the transfer of wealth from non-PSBs to PSB (of between £44m and £46m), Sky would no longer support deregulation for PSB or non-PSB channels and considers that the status quo should be maintained.

5. Cumulative effect of any possible changes

- 5.1. Finally, Sky would also urge Ofcom, were it minded to make any changes, to consider their cumulative effect on the TV airtime market, rather than looking at the effect of single changes in isolation. In doing so, there may be a case for postponing the implementation of possible changes, which when viewed in isolation might appear suitable candidates for immediate implementation, but when viewed collectively might in fact be better suited to implementation in time for the deal season 2010, to give stakeholders as much time as possible to adjust.
- 5.2. A specific example would be the possible combination of relaxations discussed in 3.13 above. Ofcom would propose to implement any changes in regulation of the length of PSB breaks shortly after publication of Ofcom's conclusions. In combination with any changes to minutage or peak time limits, that would clearly be premature.

Sky 11 December 2008