

ANNEX 3

THE CHANGING MARKET CONDITIONS FACING SKY MOVIES

1. Introduction

- 1.1 The movies sector is in a state of flux. The popularity of Sky Movies has been decreasing for a number of years as movie ‘windows’ have changed and a range of alternative movie offerings have become more attractive. Similar effects can be expected in the near future as new services launch and consumers adopt new delivery mechanisms. But Ofcom’s analysis does not properly reflect these changes.
- 1.2 Ofcom has focussed on a very narrow market definition for Sky’s movie channels: “*channels or packages of channels which include the first TV subscription window of film content from the Major Hollywood Studios*”,¹ and concludes that Sky is dominant in this wholesale market.²
- 1.3 In reaching this view Ofcom has failed to have proper regard to changes that have taken place in the availability of films in different windows and via different delivery mechanisms. Ofcom’s conclusions on market definition and market power are instead based primarily on historical data. Because competitive conditions have changed significantly in the recent past, historical data is of limited relevance and hence much of the evidence Ofcom uses in its discussion of market definition and market power is invalid. In particular, Ofcom understates: (a) the competitive constraints provided by a range of competing products; and (b) the cumulative constraint provided by the set of competing products.
- 1.4 Moreover, as Ofcom itself acknowledges, its “*competition analysis must therefore take a forward-looking view, focusing on those characteristics of the market which are most likely to influence its development over the next few years*”.³ This is particularly important given that Ofcom is proposing to implement intrusive and ongoing regulation which would impact Sky’s ability to determine its own distribution strategy for years to come and distort incentives within the industry. Ofcom has, however, failed to take a thorough forward-looking view of market definition and market power.⁴
- 1.5 In recent times, the availability of movies outside the pay TV window has increased, through both new ways of making movies available (e.g. DVD subscription rental services, VoD services offered over TV platforms, and online

¹ Paragraph 3.5 of Annex 7 to the Consultation Document.

² Paragraph 3.43 of Annex 7 to the Consultation Document.

³ Paragraph 3.23 of the Consultation Document.

⁴ To the extent that Ofcom does consider possible future expansion of competing services (for example Annex 7 footnote 73 of the Consultation Document), it is entirely focussed on putative market shares rather than on the way in which the market may be expected to operate and the competitive constraint imposed.

delivery) and increased consumer take-up of the means of receiving and viewing movies (DVD players and broadband connections). Another change is movies being made available to consumers for home viewing closer to the date of theatrical release. All of these trends are likely to continue in the near future which is likely to cause the rights which Sky currently holds to decline in importance and value.

- 1.6 Ofcom describes the key features of Sky Movies for consumers as “*the ability to pay monthly, access to a wide range of films, access to new films and the convenience of not having to rent a DVD*”.⁵ A range of services are being launched and expanded which meet many or all of these criteria – and in some cases meet the criteria better than Sky Movies. For example, VoD services (especially online) typically provide access to a wider range of films, and PPV services (including VoD) and DVDs provide access to films newer than those available on Sky Movies.
- 1.7 At the retail level Sky Movies clearly competes with (at least) providers of movies in different windows, and the greater the availability of movies in other windows (especially those *prior to* the first pay TV window), the greater the competitive constraint on Sky Movies. At the wholesale level, the constraint is twofold. First, there is an indirect constraint imposed by retail level consumer behaviour. Secondly, pay TV retailers are able to offer alternative movie services to their subscribers, as the likes of Virgin Media, Tiscali, BT Vision and Top Up TV already do.
- 1.8 Therefore, a high *retail* market share for Sky Movies does not mean that it is an essential product for pay TV retailers – the range of alternative services that have been created in recent years and the ability of consumers to access recent movies without a subscription to Sky Movies (i.e. a potential Sky Movies subscriber could combine a basic pay TV subscription with movies consumed via a platform-based PPV service, DVDs or online) mean that retailers can attract consumers with an interest in movies without the need to offer Sky Movies.
- 1.9 Sky considers that had Ofcom taken proper account of the recent changes in the market it would not have taken such a narrow view of the market as it stands today and certainly would not have concluded that the market was likely to remain narrow in the future.
- 1.10 This Annex briefly describes some of the recent and likely future changes in the provision of movie services. Part 6 of this Annex illustrates the effects that recent changes have already had on Sky Movies.

⁵ Paragraph 4.187 of the Consultation Document.

2. Windows prior to the pay TV window are moving closer to theatrical release dates

- 2.1 Films in the UK are typically exploited through a series of distribution ‘windows’ resulting from negotiations with distributors. The theatrical window is followed by the home video window, which is generally open-ended and includes both DVDs for retail and rental, and ‘download to own’ services. The pay per view/VoD window (which includes VoD and ‘download to rent’ services) generally begins later, runs for a finite period, and is followed by the pay TV window (which includes ‘first run’ films on Sky Movies). Finally, films pass into the library window in which films can be acquired for exploitation by terrestrial channels, subscription and VoD services. The exact periods vary according to distributor and have changed over time.
- 2.2 It is axiomatic that consumers value a given film more the closer it is to theatrical release (hence Ofcom’s assertion that “*channels containing older films... are likely to be a weak substitute*” for Sky Movies⁶ – the natural corollary of which is that films in a window prior to the pay TV window are considered superior substitutes to Sky Movies). In Sky’s experience, and consistent with this theory, Sky considers that earlier availability of movies in windows prior to that used by Sky Movies will reduce the value of and demand for Sky’s movie channels.
- 2.3 There is a variety of evidence to demonstrate that early availability of films is an important selling point for consumers. For example, a recent Olswang survey⁷ reported that:
- “The second most highly rated factor encouraging take up of online movies and TV... was the ability to see movies just after they come out at the cinema – 44% of respondents would be encouraged a lot by this and a further 24% encouraged a bit. Obtaining movies online ‘day and date’ with DVD release is also attractive, with 36% being encouraged a lot by this factor and 29% encouraged a bit.”*
- 2.4 Windows have changed substantially over the last few years, and this change can be expected to continue. Between 2000 and 2008, the typical period between a film’s theatrical release and its home video release has halved from around 6 months to around 3 months, making DVDs more attractive to consumers.
- 2.5 The period between home video and PPV release has fallen even more dramatically: the typical period is now 45 days (ranging from 1 to 60 days amongst the major Studios),⁸ whereas in 2000 it was 160 to 180 days. In the

⁶ Fifth bullet, paragraph 4.234 of the Consultation Document.

⁷ *Converging Media - Olswang Convergence Consumer Survey 2008*, page 91. Available at <http://www.olswang.com/convergence08/default.asp>.

⁸ Note that this is significantly shorter than the 4 months quoted in Figure 2 of Annex 11 to the First Consultation Document a year ago, reflecting the changes that have taken place even in this short time period.

US, it is increasingly common for titles to be released simultaneously on DVD and various forms of PPV. Warner Bros. in particular has experimented extensively with simultaneous release dates. If these experiments are successful, they may become common practice, with the UK likely to follow.

- 2.6 Although the major Studios have so far been more cautious in experimenting with windows in the UK, Warner Bros and Lionsgate have tested bringing a film's PPV/VoD release date close to, or simultaneous with, its DVD / home video release date, using high-profile titles such as *Beowulf*, *The Assassination of Jesse James by the Coward Robert Ford* and *3:10 to Yuma* on various services including Sky Box Office, Virgin Media and BT Vision. Sky Box Office has also conducted experiments with independent studios to make available the films *Edge of Heaven* and *Mum and Dad* on a PPV basis on the same day as their theatrical release. Similar trials have also taken place in other European countries.⁹
- 2.7 More generally, Sky's knowledge of the industry suggests that the PPV window (which applies to most of the on demand services available on TV platforms and 'download to rent') is likely to move closer to theatrical and home video release dates, making such services even more attractive relative to Sky Movies.

3. The penetration of DVD hardware has increased and new DVD rental services have been introduced

- 3.1 It is widely acknowledged that the availability of films on DVD is likely to provide some constraint on Sky Movies at the retail level (although the extent of that constraint is the subject of debate). Key recent trends include the increased penetration of DVD hardware, the launch of subscription DVD rental services which share many characteristics with Sky Movies, and the launch and adoption of the Blu-ray standard providing high definition movies. Sky considers that all of these factors have contributed to an increased constraint on Sky Movies imposed by DVDs.
- 3.2 Since the launch of the DVD format in 1998, over 1 billion DVDs have been sold in the UK and penetration of DVD hardware was estimated as 86.1% of homes at the end of 2007, compared to 61.2% in 2004 and 71.7% in 2005.¹⁰ Therefore the addressable base for DVD retail and rental has increased by 41% over three years and 20% over two.
- 3.3 General evidence of the importance of the DVD format to consumers can be found in a recent Olswang survey which reported that:
- *“Indeed, the DVD format continues to defy industry expectations, with over 160 million DVDs sold in the UK over the first three quarters of 2008 (a record) and the total for the year expected to top 250 million, following the*

⁹ See footnote 30 and page 33 of the PwC Report at **Annex 1**.

¹⁰ British Video Association Yearbook 2008, page 106. The figure excludes homes which have no dedicated DVD player but do have devices such as PCs and games consoles which can also play DVDs.

*usual Q4 peak. This popularity is borne out both by the quantitative survey results and also by the focus group discussions. Across the survey base as a whole... 53% of respondents spending at least one hour per week watching movies on DVD (a higher percentage than any other medium - even live TV)."*¹¹ and

- *"For most of our respondents, in the absence of a cinema trip, the next best thing is a DVD. Our analysis of those who watch movies for at least one hour per week, indicates that pre-recorded DVD is the most frequently used playback medium for movies (used by 53% of respondents), appearing to eclipse even live TV viewing (at 51%)."*¹²

3.4 Of particular interest is the significant recent growth of online DVD rental, which shares most (if not all) of the characteristics of Sky Movies identified by Ofcom, as Ofcom acknowledges:

*"Over-the-counter DVD rental services may be closer substitutes to Sky Movies packages than DVD sales... Services which allow consumers to rent DVDs by ordering over the internet may be an even closer substitute to Sky Movies packages, since they provide the same certainty of a fixed monthly subscription, as well as a convenient means of choosing films."*¹³

3.5 There are now over 20 online DVD rental sites in the UK, offering up to 50,000 different titles. This is becoming an increasingly popular model for consumers: by 2007, 29.5% of DVD rentals (by volume, and 26% by value) were via online subscription.¹⁴ It is also notable that the average online renter hires nearly twice as many DVDs as the average over-the-counter renter,¹⁵ suggesting that online rental may be more suitable as a substitute for a service such as Sky Movies rather than being used in conjunction with it.

3.6 The recent adoption of the Blu-ray standard has ended uncertainty over the future path of high definition DVD and is likely to lead to increased sales. Take-up has been relatively rapid: in its first three years, Blu-ray hardware (including PS3) has outsold DVD hardware by about five times over the equivalent period, despite format uncertainty until last year.¹⁶ British consumers bought 462,500 Blu-ray discs in November 2008 alone.¹⁷ Its take-

¹¹ Page 25 of Olswang's 'Converging Media - Convergence Consumer Survey 2008'. Available at <http://www.olswang.com/convergence08/default.asp>

¹² Ibid., at page 46.

¹³ Paragraphs 4.207 to 4.208 of the Consultation Document.

¹⁴ British Video Association Yearbook 2008, page 89.

¹⁵ British Video Association Yearbook 2008, page 103.

¹⁶ Source: Futuresource. See <http://www.prweb.com/releases/2008/12/prweb1776184.htm>.

¹⁷ Source: GFK. See <http://www.prweb.com/releases/2008/12/prweb1776184.htm>.

up may also further depress the price of standard definition DVDs for both rental and retail.¹⁸

3.7 As set out in Sky's Response to the First Consultation Document, there is some evidence of the effect that online DVD rental has had on the decline in Sky Movies subscribers. Ofcom itself refers¹⁹ to a survey conducted for Sky in 2007. One of the questions in that survey was: "*Which of the following have occurred since you started renting DVDs online?*". The responses included:

- [CONFIDENTIAL];
- [CONFIDENTIAL];
- [CONFIDENTIAL]; and
- [CONFIDENTIAL].

4. More PPV and VoD services are being offered via television platforms

4.1 Retailers on a number of television platforms in the UK have in recent years launched and expanded 'on demand' movie services featuring films available on both pay per view and subscription terms. See **Annex 2** for more details of the services offered to customers of Virgin Media, Tiscali TV, Top Up TV and BT Vision.

4.2 For a subscriber to Virgin Media (for example) the availability of a large range of films²⁰ in a window prior to the pay TV window, which can be viewed at a time of the subscriber's choosing, must reduce the attractiveness of Sky Movies. If the size of the range increases, the effect on take-up of Sky Movies by Virgin Media subscribers will be amplified.

4.3 Subscribers to pay TV services on all platforms²¹ now have access to a range of movies on demand via their set top boxes, and in most cases this includes a substantial offering of movies in earlier windows than Sky Movies. The availability of these competing services reduces the importance of Sky Movies for a pay TV retailer that wishes to offer a movie service, and demonstrates that Sky Movies cannot be regarded as essential to a retailer (if it ever was).

¹⁸ It is well-established that DVD prices have steadily fallen in recent years as the format has become ubiquitous, displacing videotapes, and fierce price competition has been driven by supermarkets and online retailers.

¹⁹ Paragraph 4.197 of the Consultation Document.

²⁰ Virgin Media claims that its FilmFlex movies on demand service, operated and managed by FilmFlex, experienced a 15% month-on-month growth in August 2008, following a 9% rise in July, that the service has totalled over 30 million buys since its launch in January 2005, and that it offers more first run on demand movies than any other service in Europe. See <http://pressoffice.virginmedia.com/phoenix.zhtml?c=205406&p=irol-newsArticle&ID=1202541&highlight=>.

²¹ Customers of Virgin Media, BT Vision and Tiscali all have access to pull-VoD film offerings. Top Up TV and Sky offer a more limited range of movies using a push-VoD service.

5. New forms of electronic delivery are being introduced in both the home video and PPV windows

5.1 Electronic Sell Through (EST) movies are available in the home video window (for 'download to own') and the PPV window (for 'download to rent').²² In addition, thousands of library titles are available for download. EST can provide instant access to a large range of movies on an 'on demand' basis, given a sufficiently fast broadband connection, or slightly delayed viewing over slower connections. This type of service is clearly in principle a potent direct competitor to Sky Movies, since it offers both convenience and greater flexibility combined with a larger range of movies available at any point in time.

5.2 Although this is a relatively new sector, the UK has already seen the launch of various download to own and download to rent movie services by existing suppliers of DVDs, major international retailers and entirely new entrants. Companies currently offering digital delivery of movies in the UK include Apple, Lovefilm, Blinkbox and Tesco.²³

5.3 Experience abroad, notably in the US, suggests that further services will launch in the near future. For example, Amazon has launched an online service in the US offering movies from all the major studios except Disney that can be watched instantly without download, and firms such as Sony and Disney also offer download services. Paramount, MGM and Lionsgate have formed a joint venture, 'epix', to offer new releases and library movies from their own studios both on TV and online.

5.4 In the past there have been some barriers to take-up of online services, and hence the volumes involved are relatively small at the moment, but there is evidence to suggest that online delivery will become increasingly important in the near future. For example, a recent Olswang survey²⁴ reported that between 50% and 70% of consumers would be encouraged to start accessing TV programmes and movies online, or to do so more frequently, if they:

- had a faster internet connection;
- could watch content on their main television set;
- could find legal online content with good technical quality; or
- could get the latest movie releases online just after they are released in the cinema or at the same time as they are released on DVD.

5.5 All of these barriers are being addressed by recent and ongoing technological and commercial developments, and so Sky expects to see demand for online access to movies to increase rapidly:

²² In the US there have been some experiments with windows which have led download to rent to be available earlier. As with other US developments this may lead to future changes in the UK.

²³ For more details of their EST products, see **Annex 2**.

²⁴ Olswang's 'Converging Media - Convergence Consumer Survey 2008', (see footnote 6 above).

- first, there are numerous innovations which provide for content delivered over the internet to be viewed on a TV set. For example, the current generation of games consoles include the facility to watch content that has been downloaded from the web,²⁵ and televisions (such as the Sony Bravia) and Blu-Ray players (from companies including Samsung and LG) are being manufactured with built-in internet connections and connections to online movie services. A range of purpose-built devices such as Apple TV (and, in the US, set top boxes from Vudu and Netflix) are also available and likely to fall in price;
- second, the widespread availability of high-speed broadband to the home is facilitating the introduction and take-up of new methods for digitally distributing movies to consumers. Enders reported in November 2008 that there would be 16.0 million broadband households in the UK at the end of 2008 and projects that this will have increased to 18.9 million by 2013;²⁶ and
- third, the range of operators who have already launched and can be expected to launch services will make movies easier to find and may be expected to add momentum to the trend for windows to move forwards.

5.6 With the rate of technological progress and the range of online services that are being launched or expanded, it is clear that there is an appetite for increased use of online movies services, which will add to the competitive pressure on Sky Movies. Consumers will be able to source recent movies from a variety of providers and not just from a pay TV provider. When most households can choose to watch any title from a vast selection, at a time that suits them, Sky Movies' main selling points are undermined and the obvious expectation is that a broadcast service such as Sky Movies will become less attractive and less important for retailers to include as part of their service.

5.7 At the same time, there has also been a rise in the volume of piracy, which is more difficult to quantify but clearly makes a service such as Sky Movies less attractive (if not entirely redundant) for those willing to break the law. Piracy offers a tempting combination of zero price and the availability of films without the constraints of windows.

6. Effects of recent changes on Sky Movies

6.1 Part 6 of this **Annex 3** illustrates the effects that recent changes have already had on Sky Movies. Clearly the effects of recent innovations will not be fully reflected in Sky Movies' current position, and there are more changes still to come. Sky considers that the scale of these historical effects illustrates the potential for recent and future changes to alter further the way movies are packaged, purchased and consumed.

²⁵ Sony and Microsoft have also negotiated deals which will enable the delivery of movies directly to PS3 and Xbox consoles.

²⁶ 'UK Residential Broadband Market: maturity rapidly approaching', November 2008.

6)(a) Subscribers

6.2 [CONFIDENTIAL]

Figure 1

[CONFIDENTIAL]²⁷

[CONFIDENTIAL]

6.3 [CONFIDENTIAL]²⁸

Figure 2

[CONFIDENTIAL]

6.4 [CONFIDENTIAL]

6.5 [CONFIDENTIAL]

Figure 3

[CONFIDENTIAL]

6.6 [CONFIDENTIAL]²⁹ [CONFIDENTIAL]

6.7 [CONFIDENTIAL]

6.8 [CONFIDENTIAL].³⁰ [CONFIDENTIAL].^{31,32} [CONFIDENTIAL].³³

Figure 4

[CONFIDENTIAL]³⁴

6.9 [CONFIDENTIAL]³⁵ [CONFIDENTIAL]

²⁷ [CONFIDENTIAL]

²⁸ [CONFIDENTIAL]

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³³ [CONFIDENTIAL]

³⁴ [CONFIDENTIAL]

³⁵ [CONFIDENTIAL]

6(b) Viewing

6.10 It is readily apparent that Sky Movies' viewing figures have fallen significantly over the last few years, over a period in which, based on available metrics, the quality of the service has actually improved.³⁶

6.11 The UK Film Council reported that the total audience for films on subscription movie channels in the UK declined between 1997 and 2006. By contrast multichannel free to air channels saw nearly a ten fold increase in audience between 2002 and 2006.³⁷

6.12 **[CONFIDENTIAL]**

Figure 5

[CONFIDENTIAL]

6.13 Ofcom's own Communications Market Report 2008 demonstrates the even larger continuous decline in Sky Movies' share of viewing in multichannel homes, from 3.9% in 2002 to 1.6% in 2007, in comparison to greater and relatively constant share of viewing to Sky Sports channels over the same period.³⁸ In addition, three Sky Movies channels feature among the ten channels that lost the most viewing share between 2006 and 2007.³⁹

6.14 Part of this reduction in viewing is likely to be driven by the launch and improvement of other pay and FTA channels, but it seems likely that some of it is also driven by subscribers consuming movies from other sources. It is surprising that viewing amongst Sky Movies subscribers has fallen in a period when subscriptions were also falling, since the usual expectation would be that those households dropping Sky Movies are 'marginal' because they watch the channels less than the average Sky Movies subscribers, and so average viewing amongst subscribers would *increase*. A scenario where viewing has stayed flat or fallen indicates that remaining subscribers are also reducing their viewing and so Sky Movies' ability to compete has reduced further. This is one more indication that the future may hold further change for Sky Movies.

³⁶ See Sky's July 2008 submission 'Changes in the quantity and quality of services delivered to subscribers to Sky's packages that include Sky's sports channels, 2001/02 - 2006/07'.

³⁷ UK Film Council Statistical Yearbook 2006-07, figure 12.6.

³⁸ Figure 3.85 of Ofcom's Communications Market Report 2008.

³⁹ Page 151 of Ofcom's Communications Market Report 2008.