

**RESPONSE OF VIRGIN MEDIA TO OFCOM'S SECOND CONSULTATION DOCUMENT ON
BSKYB'S PROPOSED DIGITAL TERRESTRIAL TELEVISION SERVICES (PROJECT "PICNIC")
OF 30 SEPTEMBER 2008 ("SECOND PICNIC CONSULTATION")**

18 DECEMBER 2008

1. **Do you agree with our current view that under the Proposal, Sky would be likely to emerge as the sole or main retailer of pay TV services on DTT, given its market power in the wholesale markets for Core Premium channels and its incentives to withhold its Core Premium channels from other retailers of pay TV services?**
 - 1.1 Virgin Media agrees with Ofcom's view that under the Proposal, Sky would be likely to emerge as the sole or main retailer of pay TV services on DTT. This conclusion is entirely consistent with the observations of Virgin Media as set out in its response to Ofcom's consultation of 4 October 2007 (the "**First Picnic Consultation**") of December 2007 (the "**First Picnic Response**").¹ Virgin Media also agrees with Ofcom's reasons (as far as they go), as to why Sky would be likely to emerge as the sole or main retailer of pay TV services on DTT. In particular:
 - (a) Sky controls, and will continue to control, on an exclusive basis, the overwhelming majority of the attractive content that has been shown to drive pay TV subscription in the UK (see paragraph 3.55 of the Second Picnic Consultation and paragraphs 3.9 to 3.11 of Virgin Media's First Picnic Response); and
 - (b) Sky has the incentive to become the sole pay TV provider on DTT (see paragraphs 3.56 to 3.59 of the Second Picnic Consultation and paragraphs 3.29 to 3.32 of Virgin Media's First Picnic Response).
 - 1.2 Nevertheless, notwithstanding the fact that Ofcom has concluded that Sky would be likely to emerge as the sole or main retailer of pay TV services on DTT, Virgin Media considers that Ofcom has failed to have full regard to a range of other factors that would be likely to lead to that outcome. These factors are relevant to the question of whether Sky should be prohibited from launching the proposed pay TV services on DTT and are, therefore, dealt with in response to question 3 below.
2. **Do you agree with our current view that the emergence of Sky as the sole or main retailer of pay TV services on DTT and the consequent adverse effects on competition would be likely to occur in a relatively short timeframe?**
 - 2.1 Virgin Media agrees with Ofcom's view that the emergence of Sky as the sole or main retailer of pay TV services on DTT, and the consequent adverse effects on competition, would be likely to occur in a relatively short timeframe. This conclusion is entirely consistent with the observations made by Virgin Media in its First Picnic Response (see, in particular, paragraphs 3.34 and 3.35).
3. **Do you agree with our current view that Sky should not be prohibited from retailing pay TV services on DTT provided that its Core Premium channels on DTT are made available to its retail competitors on a suitable wholesale basis?**
 - 3.1 Virgin Media does **not** agree with Ofcom's current view that Sky should not be prohibited from retailing pay TV services on DTT. In short, Sky should not be permitted to retail a pay TV service on DTT, even if its Core Premium channels are made available to its retail competitors on a suitable wholesale basis. This is because Virgin Media does not consider that such a wholesale remedy would be sufficient to address satisfactorily the competition concerns arising from the Proposal.
 - 3.2 In the First Picnic Response, Virgin Media drew Ofcom's attention to a number of factors, in addition to control of attractive content, that would operate to distort both competition on the DTT platform (intra-platform competition) and competition between DTT and other digital TV platforms (inter-platform competition) in the event that Sky were to be permitted to retail pay TV services on DTT. These factors include the following:

¹ See, in particular, paragraphs 1.5 to 1.7 and paragraphs 3.3 to 3.35 of the First Picnic Response.

- (a) enormous financial resources;²
- (b) relationships with third party set-top box ("**STB**") manufacturers;³
- (c) relationships with third party content providers;⁴ and
- (d) access to scarce DTT capacity.⁵

3.3 In its Second Consultation Document on Sky's Picnic Proposal of 30 September 2008 (the "**Second Picnic Consultation**"), Ofcom has sought to address these issues and concerns by evaluating them within the context of a number of, in Virgin Media's view, artificial categorisations. These are:

- (a) issues which are not unique to Sky;
- (b) issues which are unique to Sky but addressable; and
- (c) issues which are unique to Sky and in principle may raise competition concerns.⁶

3.4 By adopting this approach Ofcom has in practice assessed each issue on a stand alone basis. In doing so, Ofcom fails to have proper regard to the aggregate effect of all of the relevant features. In other words, by considering each issue or concern in turn, Ofcom has underestimated the aggregate weight and impact of these factors and the ways in which they would operate to Sky's advantage. In consequence, Ofcom has materially underestimated the adverse impact on competition that would arise from the features identified at paragraph 3.2 above.

3.5 Quite apart from Ofcom's failure properly to consider the aggregate effect of the above factors, Virgin Media considers that Ofcom's assessment of the individual potential impact on competition of each of these factors is also unsound. Each of Ofcom's categorisations is considered in turn below.

Issues which are not unique to Sky

3.6 A number of the factors which Ofcom accepts operate to the benefit of Sky, but which Ofcom does not consider to be unique to Sky, are addressed below.

Significant financial resources and brand strength

3.7 Ofcom notes that Sky benefits from significant financial resources and brand strength⁷ but is wary of prohibiting Sky from retailing pay TV services on DTT on this basis, as Sky's existing and potential competitors also have the ability, in principle, to engage in the types of activities that this brand strength and these financial resources would allow.⁸

3.8 Even if it were feasible meaningfully to draw the distinction proposed by Ofcom (i.e. between advantages which are unique to Sky and those which are not), Virgin Media considers that such a distinction has little or no value in assessing the Proposal. This is because such a distinction fails to have regard to the varying incentives of different parties. In short, those entities identified by Ofcom as having significant financial

² See paragraphs 3.12 to 3.13 of the First Picnic Response.

³ See, in particular, paragraphs 3.14 to 3.17 of the First Picnic Response.

⁴ See paragraphs 3.18 and 3.19 of the First Picnic Response.

⁵ See paragraphs 3.20 to 3.26 of the First Picnic Response.

⁶ See paragraph 3.84 of the Second Picnic Consultation.

⁷ See paragraph 3.85 of the Second Picnic Consultation.

⁸ See paragraphs 3.88 to 3.90 of the Second Picnic Consultation.

resources and brand strength will not have the same incentive to devote those resources and brand strength to developing a pay TV proposition on the DTT platform. In summary, this is because:

- (a) as the operator of the largest pay TV platform in the UK, Sky has a greater incentive than other retailers to become the sole pay TV provider on the DTT platform to minimise the future potential threat of the DTT platform to Sky's retail pay TV proposition on the DSat platform;⁹
- (b) as the dominant provider of premium sports and movie content in the UK, Sky has an ongoing incentive to maximise its ability to acquire attractive content, whilst minimising the ability of third parties to compete for that content, and thereby preserve its dominant position. Becoming the sole provider of pay TV services on the DTT platform will increase Sky's retail pay TV subscriber base thereby increasing the prospect of it successfully bidding for content in the future.¹⁰ In this context, Ofcom has recognised in its second consultation document in relation to the pay TV market investigation (the "**Second Market Investigation Consultation**") that Sky's established subscriber base is one of the factors associated with high barriers to entry in the markets for the acquisition of key content rights, and that this creates a feedback mechanism by which reduced resale competition reinforces upstream market power.¹¹ In this regard the greater Sky's retail subscriber base, the greater the feedback effect;
- (c) once Sky is the sole provider of pay TV on DTT it will be able to "manage" competition between the DSat and DTT platform.¹² Although other platform operators (such as Virgin Media) might be said to have a similar incentive, given that they operate much smaller pay TV platforms than Sky, they will be less able to engage in action which manages competition between their platforms and the DTT platform. This is because such action would almost inevitably be unsuccessful given the enormous constraint imposed on their platforms by the DSat platform. Conversely, were Sky to become the sole provider of pay TV on DTT it would control the pay TV operations of the two largest platforms in the UK. There would, therefore be a much greater prospect of Sky being able successfully to manage competition between those two platforms (as competition from services on other platforms would be ineffective to constrain such behaviour).

3.9 In summary, no other potential entrants, whether broadcasters or otherwise, have the same strong incentives as Sky to become the sole provider of pay TV services on the DTT platform. This is either because the DTT platform does not offer the same threat to them as to Sky (and launching a service on DTT would have no defensive benefit) or because they are not vertically integrated and will not benefit from the positive feedback effect Sky would enjoy as a consequence of growing its retail subscriber base. In addition, even where a potential entrant would derive some defensive or other benefit from launching a pay TV service on the DTT platform, the benefits will be of a considerably lower order of magnitude than would accrue to Sky.

3.10 Accordingly, Virgin Media considers that Ofcom has very materially understated the degree to which the financial and brand strength from which Sky benefits will, if Sky is permitted to retail pay TV services on the DTT platform, inevitably cause Sky to become the sole retailer of pay TV services on the DTT platform.

⁹ See, for example, paragraph 3.29 of the First Picnic Response.

¹⁰ See, for example, paragraph 3.30 of the First Picnic Response.

¹¹ See, for example, paragraph 131 of the Second Market Investigation Consultation.

¹² See, for example, paragraph 3.31 of the First Picnic Response.

- 3.11 Against this background, Ofcom has suggested that securing wholesale access to Sky's Core Premium channels may increase the incentives of retailers other than Sky to seek to launch a pay TV proposition on the DTT platform and to use their financial resources and brand strength to engage in the types of activities summarised by Ofcom at paragraph 3.89 of the Second Picnic Consultation.
- 3.12 As a preliminary observation the incentive of third party retailers to launch a pay TV service on the DTT platform will, of course, be highly dependent on the structure and form of any such wholesale must-offer regime. However, even assuming that such a wholesale must-offer regime would increase the incentives on the part of rival retailers to launch and promote a DTT pay TV service, Virgin Media still considers that the incentives for any potential retailer other than Sky will be very considerably lower than those of Sky for the reasons set out above (and in paragraphs 3.27 to 3.33 of the First Picnic Response).
- 3.13 Finally, it should be emphasised that not all of Sky's existing and potential competitors can be considered to enjoy significant financial resources. By way of example, neither Top Up TV (which already offers pay TV services on the DTT platform) nor Setanta (which is the only entity of note other than Sky to offer a premium sports channel) have access to anything like the financial resources enjoyed by Sky. Given their existing business models, each of these entities must be considered to be obvious candidates for offering pay TV services on the DTT platform. There is, however, no prospect of them being able to do so in a way which enables them to make the same magnitude of investment as would be available to Sky.

Access to scarce DTT capacity

- 3.14 As regards the advantage conferred on Sky due to its privileged access to scarce DTT capacity, Ofcom observes that it is not convinced that this should lead it to prohibit Sky from retailing pay TV services on DTT for three reasons:
- (a) first, Sky has access to less than 10 per cent of total DTT capacity;
 - (b) second, other competitors may benefit from similar advantages to Sky; and
 - (c) third, Ofcom observes that this advantage can be considered a reward for risk taking in committing to DTT at the time of the launch of Freeview.¹³
- 3.15 Even considering access to scarce DTT capacity on a stand alone basis (i.e. ignoring other factors operating to Sky's advantage) Virgin Media does not agree with Ofcom's assessment for the following reasons:
- (a) 10 per cent of total DTT capacity is likely to be more than sufficient to launch an initial pay TV offering on the DTT platform that could then form the basis for a more developed offering in the event that additional capacity became available. In other words, 10 per cent of total DTT capacity provides a very valuable foothold on the DTT platform;
 - (b) 10 per cent of DTT capacity is a material advantage when such capacity is extremely scarce (or even unobtainable). Furthermore, when it is available, capacity on the DTT platform has such a high value that any pay TV retailer acquiring capacity will place itself at an enormous cost disadvantage relative to Sky. **[CONFIDENTIAL]**;¹⁴

¹³ See paragraph 3.92 of the Second Picnic Consultation.

¹⁴ See paragraph 3.21 of the First Picnic Response.

- (c) it is not obvious to Virgin Media that any other organisations likely to launch a pay service on DTT currently benefit from a similar advantage to Sky in terms of access to valuable DTT capacity;
- (d) Virgin Media does not consider that Sky's advantage in having access to scarce DTT capacity can be legitimately considered to be a reward for risk taking in committing to DTT at the time of the launch of Freeview. In practice, the Freeview proposition to which Sky signed up did not envisage Sky offering a range of pay TV channels. Instead, it envisaged the offer of a free-to-air service incorporating a number of Sky's basic channels. That service has been successful and Sky has derived considerable benefits from participating in Freeview. It was not suggested at the time Freeview was launched that Sky may in the future be permitted to launch a range of pay TV services using the relevant capacity. Indeed, quite the opposite, there were serious concerns at the time in relation to Sky's involvement and, as a consequence the channels which it was permitted to launch on the Freeview platform were both limited and clearly identified. Specifically, the Independent Television Commission ("**ITC**") stated that, in order to address competition concerns relating to the award of the DTT licences in 2002, it had made the awards subject to inter alia the condition that:

"BSkyB may supply the three channels named in the application on Multiplex C, but may not manage a multiplex."

The three Sky channels named in relation to Multiplex C were Sky News, Sky Sports News and Sky Travel.¹⁵

- 3.16 In summary, even considered individually, Ofcom's assessment of the issues which it has categorised as not being unique to Sky is unsound. In practice, Ofcom has failed entirely to recognise the advantages conferred on Sky by the relevant factors and the material adverse effect on competition those factors would facilitate in the event that Ofcom consented to the Proposal and permitted Sky to retail its pay TV channels on the DTT platform.

Issues which are addressable through a wholesale must-offer regime

- 3.17 Ofcom observes that concerns regarding Sky's exclusive access to Core Premium channels could, in principle, be addressed through making the channels available to Sky's retail competitors on a suitable wholesale basis.¹⁶
- 3.18 As Ofcom observes,¹⁷ the effectiveness of any intervention to make Sky's Core Premium channels available to retail competitors is likely to depend on the technical and commercial terms on which Sky's Premium content is made available, in particular, the wholesale pricing arrangements for that Premium content. Virgin Media will address the form and structure of an appropriate wholesale must-offer regime in detail in its response to the Second Market Investigation Consultation.

¹⁵ See press release "ITC announces decision on digital terrestrial television", 4 July 2002. This concern over Sky's involvement in DTT was also raised when the ITC was considering the grant of DTT licences in 1996/7 when it required BSkyB to cease to be a shareholder in British Digital Broadcasting plc ("BDB") prior to permitting BDB's acquisition of multiplexes B, C and D. In this connection, the ITC commented that it: *"had fundamental concerns stemming from the role of BSkyB as both a shareholder in BDB, thereby having an influence over BDB's choice of programmes, and a supplier of programmes to BDB, having regard to BSkyB's strength in the UK pay-television market, particularly in relation to premium film and sports channels."* (see press release "ITC announces its decision to award multiplex service licences for Digital Terrestrial Television", 24 June 1997).

¹⁶ See paragraph 3.94 of the Second Picnic Consultation.

¹⁷ See paragraph 3.95 of the Second Picnic Consultation.

Issues which are unique to Sky and, in principle, may raise competition concerns

- 3.19 Ofcom recognises that in addition to issues identified above, there are a number of other issues raised by stakeholders which are unique to Sky and which, in principle at least, could raise competition concerns in relation to the retailing of pay TV services on DTT.¹⁸ In particular:
- (a) Ofcom accepts that Sky would have a unique incentive and ability to influence manufacturers of STBs;¹⁹ and
 - (b) Sky's retailing of DSat services affords it a unique ability to influence retailers and thereby promote Picnic STBs by influencing high street retailers in different ways to restrict the take-up of competing pay TV services on DTT. Specifically, Ofcom recognises that Sky's ability and incentive to engage in these activities is derived from its position as a leading buyer of DSat STBs.²⁰
- 3.20 Notwithstanding these observations, however, Ofcom considers that such activities, to the extent that they amounted to anti-competitive conduct, would be more appropriately addressed through reliance on Ofcom's ex-post powers under the Competition Act 1998.²¹ In this context, Virgin Media continues to consider that the use of ex-post powers would be wholly insufficient to address these concerns for the reasons set out in paragraphs 4.29 to 4.36 of the First Picnic Response. In summary this is because ex-post regulation:
- (a) has, to date, failed to ensure a competitive pay TV industry;
 - (b) takes a long time to reach a conclusion;
 - (c) is costly for all parties; and
 - (d) has not afforded any real degree of certainty for all players in the market.
- 3.21 In addition to the above points, Virgin Media considers that it would be extremely difficult for parties other than Sky to obtain evidence to show that Sky had been using its market power to influence both STB manufacturers and STB retailers in a way which operates to the detriment of competing pay TV retailers on the DTT platform. There would, therefore, be a very heavy burden on Ofcom to ensure that it monitors Sky's behaviour very closely in this regard. Even in those circumstances, Virgin Media considers that Sky will have significant latitude to exert its influence without this being apparent to either third party retailers or to Ofcom.
- 3.22 In addition, whilst Ofcom recognises that the cumulative effect of Sky's advantages that derive from its position of a leading buyer of DSat STBs may well be material, Ofcom entirely fails to have regard to the cumulative effect of (i) issues which are not unique to Sky, (ii) issues which are addressable through a wholesale must-offer regime, and (iii) issues which are unique to Sky but which may raise competition concerns. In other words, Ofcom's conclusion that it is appropriate to use its ex-post competition powers to address issues which are unique to Sky (in particular Sky's ability to influence STB manufacturers and retailers) is taken in isolation of the other factors which will lead to Sky being likely to become the sole retailer of pay TV services on the DTT platform (i.e. access to the most attractive content and to the enormous financial resources and brand strength of Sky).

¹⁸ See paragraph 3.98 of the Second Picnic Consultation.

¹⁹ See, for example, paragraphs 3.99 to 3.104 of the Second Picnic Consultation.

²⁰ See, for example, paragraphs 3.105, 3.106 and 3.112 of the Second Picnic Consultation.

²¹ See paragraph 3.113 of the Second Picnic Consultation.

- 3.23 In summary, Virgin Media continues to be strongly of the view that a combination of a suitable wholesale must-offer regime (if one can be devised) and Ofcom's use of its ex-post competition powers will be insufficient to prevent Sky utilising its existing market power to ensure that it becomes the sole retailer of pay TV services on the DTT platform within a very short space of time.
4. **If we were to consent to the Proposal, subject to a condition that Sky must make its Core Premium channels available to competing retailers on a suitable wholesale basis, do you agree that it would not be necessary to impose additional conditions addressing the provision of TPS by Sky?**
- 4.1 As indicated in response to question 3 above, Virgin Media does not consider that Ofcom should consent to the Proposal, even subject to a condition that Sky should make its Core Premium channels available to competing retailers on a suitable wholesale basis. This is because notwithstanding that remedy, the other advantages enjoyed by Sky (and its very strong incentives as regards the provision of a pay TV service on DTT) would inevitably cause Sky to become the sole provider of pay TV services on the DTT platform within a short space of time.
- 4.2 The very likely consequence of this would be that Sky would gain effective control over the provision of TPS on the DTT platform, not because of the merits of its TPS but as a result of its other advantages in the retailing of pay TV services (including its position in the supply chain for STBs). This risk is specifically identified by Ofcom in paragraph 3.125 of the Second Picnic Consultation.
- 4.3 Ofcom's current view is that it is not clear that Sky would necessarily become the sole provider of TPS on DTT as a result of its influence over the supply chain of DTT STBs²² and that, even if it did, it would be subject to existing regulations regarding the provision of TPS.
- 4.4 Virgin Media does not consider that it would be appropriate for Ofcom to rely on existing regulations regarding the provision of TPS in those circumstances. This is because it would first be necessary for Ofcom to carry out a review to determine whether Sky had market power in relation to the provision of TPS on DTT. This would be a time consuming exercise and by the time Ofcom had reached a determination, it would be effectively too late to prevent Sky becoming the sole provider of TPS on DTT. This would in turn strengthen the ability of Sky to become the sole supplier of pay TV services on the DTT platform.
- 4.5 In addition, Virgin Media has material reservations about how effective the existing TPS regime has been in practice. In this context, it is instructive that despite the existence of the existing TPS regime in relation to the DSat platform, no rival retailer of pay TV services has had any success in making inroads into Sky's market position.
- 4.6 As a final point, Ofcom's market review of wholesale digital television broadcasting platforms (currently on hold) would not be the appropriate vehicle for deciding whether Sky has market power in the wholesale provision of TPS on the DTT platform. This is on the assumption that the current market review is likely to be completed prior to Sky developing a position of market power in relation to the provision of TPS on DTT.
- 4.7 In conclusion, if, notwithstanding Virgin Media's concerns, Ofcom were to consent to Sky being permitted to retail its pay TV channels on the DTT platform, it would be essential, as a condition to that consent, for Ofcom to impose additional conditions addressing the provision of TPS on DTT by Sky.

²² See paragraph 3.126 of the Second Picnic Consultation.

5. **Do you agree with our current view that the Proposal is unlikely to have a significant adverse effect on the DSO process or the appeal of Freeview to consumers?**
- 5.1 Virgin Media observed, in its First Picnic Response²³ that the starting point for an analysis of the proposal is that Freeview subscribers would definitely lose access to the three existing Sky channels if Ofcom were to consent to the Proposal. In this context, Virgin Media would observe that:
- (a) Freeview itself appears to consider that the Proposal is likely to have a significant impact on the appeal of Freeview;²⁴
 - (b) 75 per cent of the individuals that responded to Ofcom's First Consultation indicated that removal of Sky's existing free-to-air channels under the Proposal would result in significant harm to Freeview;²⁵ and
 - (c) Ofcom's own consumer survey provides support for the proposition that the Proposal will have a negative effect on Freeview, including the provision of news content.²⁶
- 5.2 In light of the above, Virgin Media does not consider it would be appropriate for Ofcom to conclude that the proposal is unlikely to have a significant adverse effect on the appeal of Freeview until it has considered the applicable statutory test relating to the variety of tastes and interests served by programmes broadcast (see paragraph 3.148 of the Second Picnic Consultation).
- 5.3 Virgin Media currently has no clear view as to whether the Proposal would be likely to have a significant adverse effect on the DSO process.
6. **Do you agree with our current view that the extent to which the Proposal may increase complexity in the decision-making process for consumers wishing to buy DTT reception equipment, this issue can be managed effectively without the need for imposing relevant conditions on Sky?**
- 6.1 If, contrary to Virgin Media's view, Ofcom considers it appropriate to permit the Proposal to proceed subject to some form of wholesale must-offer regime, it will be necessary to impose additional conditions on Sky to address the increased complexity in the decision-making process for consumers wishing to buy DTT reception equipment.
- 6.2 The reason for this is that the greater the complexity of the decision making process, the more important will be the advisory role of retailers. In other words, the more complex the options, the more consumers will rely on the advice of retailers. In this regard, Ofcom has already recognised that (i) Sky has a unique ability to influence retailers (in particular, to provide additional support to retailers if Picnic is stocked or to engage in punishment mechanisms if Picnic is not stocked or rival DTT retailers are promoted),²⁷ (ii) Sky will have an incentive to act in such ways, and (iii) if Sky were to influence retailers in such ways, this would act to the detriment of consumers.²⁸
- 6.3 In consequence, the additional complexity to the decision making process for consumers that would arise as a consequence of the launch of Picnic would make it more likely that

²³ See paragraph 1.12 of the First Picnic Response.

²⁴ See paragraph 3.135 of the Second Picnic Consultation.

²⁵ See paragraph 3.139 of the Second Picnic Consultation.

²⁶ See paragraphs 3.142 and 3.146 of the Second Picnic Consultation.

²⁷ See paragraphs 3.106 (and 3.79) of the Second Picnic Consultation.

²⁸ See paragraph 3.112 of the Second Picnic Consultation.

Sky will be able to use its very strong relationships with retailers, and its considerable financial strength, to ensure that Picnic is promoted over rival DTT offerings. The use of ex post regulatory powers will be insufficient to address this for the reasons set out in paragraphs 4.29 to 4.36 of the First Picnic Response and summarised in paragraph 3.20 above.

- 6.4 This is a further reason for Ofcom not to consent to the Proposal. If, however, Ofcom does consent to the Proposal, it will be essential for this issue to be addressed through the imposition of regulatory conditions on Sky. Some potential conditions that might be imposed are set out in response to question 11 below.
7. **Do you consider that to the extent the Proposal may lead to a (greater) conflict of interests between Sky and the other members of DTVSL (the company which operates Freeview), this is a matter which in the first instance should be resolved by the relevant parties through commercial negotiation?**
- 7.1 If, contrary to the views of Virgin Media, Ofcom considers it appropriate to consent to the Proposal subject to some form of wholesale must-offer regime, Virgin Media has no strong views as to whether a potential conflict of interest between Sky and the other members of DTVSL should be resolved by the relevant parties through commercial negotiation.

Provisional conclusions and recommendations

8. **Do you agree with our current view that a wholesale must-offer arrangement, under which Sky must provide wholesale access to its Core Premium channels on DTT, is the most appropriate solution for us to pursue to address the competition concerns we have identified?**
- 8.1 As indicated in the response to question 3 above, Virgin Media does not consider that it would be appropriate for Ofcom to consent to the Proposal on any terms. In other words, Virgin Media does not consider that Ofcom should consent to Sky being permitted to retail its pay TV channels on the DTT platform. If, however, Ofcom were to consider it appropriate to consent to the Proposal it must, as an absolute minimum, impose on Sky a wholesale must-offer obligation whereby rival retailers on the DTT platform have wholesale access to Sky's premium sports and movie channels (Virgin Media will address the appropriate scope and form of the wholesale must-offer regime in its response to the Second Market Investigation Consultation).
- 8.2 Virgin Media would, however, again emphasise that any wholesale must-offer regime that is put in place in relation to the DTT platform must not distort competition between other platforms (in particular the cable platform) and the DTT platform.²⁹
9. **Do you agree that simulcrypt is the most appropriate means of allowing multiple retailers to have access to Sky's Core Premium channels on DTT?**
- 9.1 If, contrary to the views of Virgin Media, Ofcom were to consider it appropriate to permit Sky to retail its pay TV channels on the DTT platform subject to an appropriate wholesale must-offer regime, Virgin Media agrees that simulcrypt would appear to be the most appropriate means of allowing multiple retailers to have access to Sky's Core Premium channels on DTT.
- 9.2 There is, however, a material caveat arising from the use of simulcrypt in these circumstances. In the Second Market Investigation Consultation, Ofcom specifically acknowledged the importance of any channels supplied by Sky under a wholesale must-offer obligation being made available on a "clean feed" basis.³⁰ Virgin Media strongly

²⁹ See paragraph 4.27 of the First Picnic Response.

³⁰ Second Market Investigation Consultation, paragraphs 9.30 to 9.33.

agrees with this requirement and it should apply in relation to channels supplied in relation to all platforms, including the DTT platform.

9.3 This means that in order to ensure that customers of rival retailers on the DTT platform receive a clean feed of the relevant Sky channels, the versions of Sky's premium channels that are retailed on the DTT platform (and the versions subject to the simulcrypt broadcast) must be provided on a "clean feed" basis. In other words, the relevant channels must not include marketing or promotional material of the type referred to by Ofcom in paragraph 9.32 of the Second Market Investigation Consultation.

10. **Do you consider that Sky or relevant third party retailers on DTT would be provided with an incentive to reduce the effectiveness of a wholesale must-offer arrangement? If so, in what ways might they seek to achieve this?**

10.1 As set out in the First Picnic Response³¹ Sky has every incentive to become the sole pay TV provider on the DTT platform. This being the case, Sky has every incentive to take whatever steps are available to it to reduce the effectiveness of a wholesale must-offer arrangement and thereby minimise the risk of a rival retailer of pay TV services gaining traction on the DTT platform to the detriment of Sky. Virgin Media's experience as the sole retailer of Sky's premium channels other than Sky is that, even where Sky feels obliged to supply its channels on a wholesale basis due to regulatory constraints, it has:

- (a) done so only on the basis of uneconomic terms with the result that Virgin Media has no incentive to market those channels. This is expressly recognised by Ofcom in the Second Market Investigation Consultation;³²
- (b) refused to provide Virgin Media with interactive features available on the version of the channels available on Sky's DSat platform;
- (c) refused to provide a high definition version of its premium channels;
- (d) provided channels which heavily cross-promote Sky's DSat services, including highlighting the deficiencies in receiving the Sky premium channels via competing platforms; and
- (e) established ancillary services which are only available, often at no additional cost, to Sky's DSat subscribers, e.g. access to movies on the internet-based SkyPlayer service at no additional cost.

10.2 In light of the above, Sky can be expected to utilise whatever means are available to it to provide degraded versions of channels to third party retailers or to undermine the ability of any third party retailer to successfully market those channels on the DTT platforms. By way of example, Sky can be expected to use its financial resources, brand strength, influence over manufacturers of STBs and influence over retailers of STBs to hamper third party retailers. A summary of these potential actions are set out in paragraphs 3.78 and 3.79 of the Second Picnic Consultation. Virgin Media considers it would be extremely difficult, if not impossible, for either Ofcom or third party retailers to effectively detect, and prevent, these types of behaviour.

10.3 In summary, Virgin Media considers that it will be extremely difficult, if not impossible to regulate Sky against its commercial incentives and Sky can be expected to take whatever steps it feels it can get away with to reduce the effectiveness of a wholesale must-offer arrangement.

³¹ See, for example, paragraphs 3.27 to 3.33 of the First Picnic Response.

³² See, for example, paragraph 1.29 of the Second Market Investigation Consultation.

11. **If we were to consent to the Proposal subject to a suitable wholesale must-offer arrangement being put in place, do you consider that any ancillary conditions would be required to ensure that it was workable from a commercial and technical perspective? If so, please explain: (i) the ancillary conditions that would be required and the specific concern(s) they would seek to address and (ii) why there would be no other practicable and less restrictive means of addressing the concern(s) in question.**

11.1 As indicated repeatedly above, Virgin Media does not consider that Ofcom should consent to Sky being permitted to retail pay TV channels on the DTT platform even subject to a suitable wholesale must-offer arrangement being put in place. This is for the reasons set out above and in the First Picnic Response. In this context, Virgin Media agrees with Ofcom's observation that the Proposal may provide Sky with an incentive to act in such a way as to reduce the effectiveness of any wholesale must-offer arrangement and that this is because a less effective wholesale must-offer arrangement would limit increased competition from other retailers of pay TV services on the DTT platform.³³

11.2 In practice, Virgin Media considers that it is extremely difficult to regulate a commercial entity to act contrary to its commercial incentives and that, accordingly, Sky would almost certainly be able to find a way to "work around" any condition put in place to limit its ability to reduce the effectiveness of any wholesale must-offer arrangements. Accordingly, Virgin Media considers that if, notwithstanding Virgin Media's observations, Ofcom were to consent to the Proposal subject to the imposition of ancillary conditions, those conditions should be on the strictest terms possible.

11.3 In this context, Ofcom has identified four potential pre-conditions to Sky being permitted to retail pay TV services on the DTT platform.³⁴ These are:

- (a) a local simulcrypting trial involving Sky, Arqiva and one or more prospective third party retailers having been carried out to the satisfaction of Ofcom, Sky and Arqiva;
- (b) at least one other third party retailer is in a position to start retailing the wholesale must-offer channels;
- (c) a defined time period has elapsed following (i) the launch of a competing pay DTT service that includes at least one of the wholesale must-offer channels or (ii) the satisfactory completion of a local simulcrypting trial (referred to in the first bullet point above); and
- (d) Sky has achieved a specific number of wholesale DTT subscribers, defined to be subscribers of retail competitors on DTT who include at least one wholesale must-offer channel as part of their subscription.

Each of these is addressed below.

A local simulcrypting trial

11.4 Such a condition would be necessary, but not sufficient, to prevent Sky reducing the effectiveness of any wholesale must-offer arrangement and/or Sky becoming within a short period of time the only effective supplier of pay TV channels on the DTT platform. This is because, on its own, a successful simulcrypting trial would do nothing to prevent Sky trying to undermine a wholesale must-offer regime in the ways contemplated by Ofcom³⁵. All such a trial would demonstrate is that, if a third party were to obtain access

³³ Paragraph 4.44 of the Second Picnic Consultation.

³⁴ Paragraph 4.50 of the Second Picnic Consultation.

³⁵ Paragraphs 4.45 to 4.47 of the Second Picnic Consultation.

to Sky's channels, and were to overcome the other significant barriers to supplying pay TV channels on the DTT platform, the technology would allow those channels to be distributed.

11.5 Moreover, such a trial would provide no guarantee that a third party retailer would be able to compete effectively with Sky on the DTT platform. Such a condition would not, for example, address:

- (a) Sky's significant financial resources and brand strength; and
- (b) Sky's ability to use its unique position with manufacturers of STBs and retailers to ensure that Sky's DTT service is promoted ahead of any rival service.

At least one third party retailer is in a position to start retailing Sky's channels

11.6 Again, this condition is necessary, but not sufficient, to prevent Sky from taking steps to reduce the effectiveness of any wholesale must-offer arrangements. Whilst it addresses factors over which Sky may be said to have limited control, it would do nothing to prevent Sky trying to undermine a wholesale must-offer regime in the ways contemplated by Ofcom. In particular, ensuring that at least one third party retailer is in a position to start retailing Sky's channels would do nothing to address the advantages conferred on Sky through its financial resources, brand strength and relationship with STB manufacturers and retailers.

The elapse of time following launch of a competing service or simulcrypting trial

11.7 As regards the elapse of a period of time following completion of a local simulcrypting trial, this would (for the reasons set out at paragraph 11.4 to 11.5 above) be wholly insufficient on its own to prevent Sky reducing the effectiveness of any wholesale must-offer arrangement and/or Sky becoming within a short period of time the only effective supplier of pay TV channels on the DTT platform.

11.8 As regards the elapse of a period of time following launch of a competing service, this would, again, be necessary but insufficient to prevent Sky reducing the effectiveness of any wholesale must-offer arrangement and/or Sky becoming within a short period of time the only effective supplier of pay TV channels on the DTT platform. Such a condition would have the advantage of:

- (a) ensuring that a third party retailer would have been able to overcome the barriers to launching a service (including obtaining access to Sky's channels) before Picnic is launched;
- (b) allowing such a service to establish itself prior to the launch of Picnic;
- (c) preventing Sky from preventing, before launch, the emergence of a potential competitor.

11.9 However, the presence of an existing pay TV service on the DTT platform would do nothing to remove Sky's incentive, once it has been permitted to launch Picnic, to do all it could do to undermine that third party service and ensure that it did not succeed. Further, Sky's enormous financial resources and brand strength would allow it to achieve this objective. Sky could, for example, make the necessary investments in subscriber acquisition (including offering incentives to STB manufacturers and retailers), and in retail pricing (absent the wholesale must-offer regime preventing Sky engaging in a margin squeeze), to ensure that Picnic is successful in eliminating its rivals. This would be the case even if such investments caused Picnic (as a stand alone entity) to be loss making in the short or medium term. In simple terms, the prize of being the sole or dominant retailer of pay TV services on the two largest digital platforms in the UK would make such action on the part of Sky inevitable.

- 11.10 In this context, any wholesale revenue obtained by Sky from supplying its channels to that third party retailer would not operate as a disincentive to such a strategy as Sky would be able to compete for and win access to the customers of those retailers (and would expect to win all such customers if rival retailers were forced to withdraw from supplying pay TV channels on the DTT platform).
- 11.11 In this regard, it should be emphasised that it cannot be assumed that Sky would not almost immediately be able to supply a service to customers that own a STB provided by a rival retailer (and which includes a different conditional access system). In other words, Sky may not even be required to persuade subscribers to purchase a Picnic STB in order to supply the Picnic service. This is because, in the event that the relevant channels are being broadcast on a simulcrypt basis, Sky would need only to enter into contractual arrangements with the conditional access provider for the rival STB in question (e.g. Nagra), to enable Sky to provide the necessary smart card to a subscriber wishing to use his/her existing STB to view Sky's Picnic service.³⁶

Sky has achieved a specific number of wholesale DTT subscribers

- 11.12 This suggestion on the part of Ofcom is simply a variation on the former element of the above suggested condition. This suggestion assumes that a rival third party retailer has both launched a competing service on DTT (offering one or more of Sky's channels) and has achieved a certain level of subscribers to those channels. Again, this proposal would be necessary, but insufficient, to prevent Sky reducing the effectiveness of any wholesale must-offer arrangement and/or Sky becoming within a short period of time the only effective supplier of pay TV channels on the DTT platform. This is for the reasons set out in paragraphs 11.8 to 11.11 above.
- 11.13 In summary, if, notwithstanding Virgin Media's observations, Ofcom were to consent to the Proposal subject to the imposition of ancillary conditions, those conditions should only be on the strictest terms possible. The options set out at paragraph 4.50 of the Second Picnic Consultation would all be necessary but wholly insufficient (both individually and in aggregate) to prevent Sky reducing the effectiveness of any wholesale must-offer arrangement and/or Sky becoming within a short period of time the only effective supplier of pay TV channels on the DTT platform.

Additional ancillary conditions

- 11.14 As indicated above, none of the ancillary conditions proposed by Ofcom address Sky's ability to use its enormous financial resources and brand to engage in whatever investment in subscriber acquisition and/or retail pricing strategy it sees fit to either prevent the emergence of a rival retailer of pay TV channels on the DTT platform, or drive out of business any rival retailer that is able (through regulation or otherwise) to launch a rival service on the DTT platform. In practice, if Ofcom consents to the Proposal, and Sky is allowed to retail its pay TV channels on the DTT platform, Virgin Media does not consider that there are any ancillary conditions that would be capable (either individually or in aggregate) of effectively preventing Sky from undermining the effectiveness of any wholesale must-offer arrangement. It is for this reason that Virgin Media continues to urge Ofcom not to consent to the Proposal.
- 11.15 Nevertheless if, notwithstanding Virgin Media's observations, Ofcom were to consent to the Proposal subject to the imposition of ancillary conditions, Ofcom would need to devise and implement ancillary conditions to deal with the ability of Sky to use its financial resources, brand, and its relationships with retailers and STB manufacturers to stifle

³⁶ Virgin Media recognises that whether Sky is able to do this may depend on the STB ownership model used by the relevant DTT retailer. If, however, the customer owns the relevant STB box such an arrangement between Sky and, for example, Nagra would be perfectly possible.

competition from rival DTT retailers. Such ancillary conditions must include, at a minimum, the following:

- (a) a requirement to retail only a "clean feed" version of its premium channels;
- (b) the implementation of legal or operational separation between Sky and Picnic;
- (c) restrictions on subscriber acquisition funding made available to retailers or STB manufacturers, or general marketing, in relation to Sky's DSat retail business being linked or contingent on behaviour relating to Picnic;
- (d) a requirement that any costs relating to the simulcrypt broadcast of Sky's channels are recovered from rival retailers only on audited fair, reasonable and non-discriminatory terms.

Each of these proposed ancillary conditions is addressed in outline below.

Requirement for a clean feed

11.16 For the reasons set out in response to question 9 above, if Ofcom were to consider it appropriate to permit Sky to retail its pay TV channels on the DTT platform subject to an appropriate wholesale must-offer regime using simulcrypt, it will be necessary to impose a condition that Sky only retail a "clean feed" version of its premium channels. This is because, otherwise, the channels broadcast by Sky (in simulcrypt) will contain the type of Sky promotional material that Ofcom has indicated it would consider inappropriate in the context of the wholesale supply obligation.³⁷

11.17 In consequence, any versions of Sky's premium channels that are retailed by Sky on the DTT platform should not contain:

- (c) cross promotion of any other Sky channels (unless those channels are also subject to a wholesale must-offer obligation in respect of the DTT platform); or
- (d) cross promotion of specific Sky retail proposition; or
- (e) any other promotion which directly or indirectly promotes Sky's retail services, Sky's channels or the Sky brand in general.

Requirement for legal or operational separation

11.18 As indicated above, and in Virgin Media's previous submissions on the Picnic Proposal, Sky benefits from enormous financial resources. Virgin Media has no doubt that Sky will utilise those financial resources in any way it can to ensure that Picnic becomes the sole retailer of pay TV services on the DTT platform within a short period of time.

11.19 Virgin Media considers that the only way in which Sky might possibly be prevented from using cross subsidisation from its existing DSat business to distort effective competition on the DTT platform would be to ensure legal (or at least operational) separation between Picnic and the remainder of Sky's businesses. This is to ensure that Picnic is required to operate on a stand alone basis (equivalent to other retailers on the DTT platform) and that investment decisions in relation to subscriber acquisition (and other matters) are taken on the basis of the objectives of the Picnic business only rather than being taken in relation to the overall strategic objectives of Sky as a whole.

11.20 Any such regime should be subject to independent audit to ensure that Picnic was operating on a viable independent basis. This may require Ofcom to prescribe the degree to which Sky could make investments in Picnic, the degree to which Picnic would be

³⁷ Second Market Investigation Consultation, paragraphs 9.30 to 9.33.

entitled to incur start-up investment cost, and the period within which Picnic should be profitable.

Separate marketing for Picnic

- 11.21 Formal legal/operational separation of the type described above, will not, however, prevent Sky from using marketing and subscriber acquisition initiatives in relation to its retail DSat business to the advantage of Picnic. By way of example, Sky might make funding or promotional activity available to retailers in connection with its DSat retail business only on the basis that retailers promote Picnic, or on the basis that retailers do not promote rival DTT services.
- 11.22 Ofcom should, therefore, impose restrictions in order to prevent the linking, in any way, of the promotion/marketing of Sky's retail DSat business (whether above the line or below the line) with Picnic. At the very least this will require that marketing and subscriber acquisition expenditure made in relation Picnic is clearly identified, and distinct from, that relating to the DSat platform and vice versa. In this regard, it would be necessary for Ofcom to require Sky/Picnic to disclose to Ofcom, on a regular basis, its contractual arrangements with STB manufacturers, retailers and other participants in the supply chain in respect of the supply of DTT reception equipment.
- 11.23 Similarly, it will be necessary to regulate the way in which any enquiries in response to Sky's retail DSat business are addressed to ensure that Picnic does not benefit from any promotion in relation to Sky's DSat business. By way of example, a potential subscriber who responds to Sky's marketing for the DSat retail service but is unable to receive that service (e.g. because they cannot have a satellite dish installed), should not be referred to Picnic as an alternative means by which to receive Sky's premium channels. If, for example, a reference is made to the fact that Sky's premium channels can be obtained on the DTT, any referral should be retailer neutral and should not be limited to Picnic.

Restrictions on transmission charges

- 11.24 In its Second Market Investigation Consultation, Ofcom has confirmed that it is considering establishing "factory gates" wholesale prices for Sky's premium channels.³⁸ Ofcom is proposing to do this:

"...on the basis that distribution is in general not a bottleneck, so where Sky does provide distribution beyond the factory gates, it should do so on commercial terms, and be able to negotiate recovery of any additional costs which it incurs on a commercial basis".

- 11.25 The above observation is not correct in the context of DTT transmission (on the assumption that Sky's premium channels will be broadcast on the DTT platform on a simulcrypt basis) because the relevant channels will, for capacity reasons, almost certainly be broadcast only once. In other words, due to capacity constraints, it is very unlikely that retailers on the DTT platform will choose separately to broadcast Sky's premium channels (i.e. in addition to Sky broadcasting those channels). In this context, if Sky were permitted to impose whatever distribution/charges it saw fit in relation to the simulcrypt broadcast of its channels on the DTT platform, this could operate to undermine entirely any wholesale must-offer obligation in relation to the DTT platform. Accordingly, Ofcom should, in those circumstances, impose an ancillary condition on Sky which ensures that Sky is able to recover only its actual DTT transmission costs on a fair, reasonable and non-discriminatory basis. Whether Sky's charges for such transmission costs are fair, reasonable and non-discriminatory should be subject to independent audit.

³⁸ Second Market Investigation Consultation, paragraph 9.35.

11.26 In conclusion, the above additional ancillary conditions are (together with those identified by Ofcom at paragraph 4.50 of the Second Picnic Consultation) the bare minimum that would be required for there to be any prospect that Sky will not be able to find ways to undermine entirely the effectiveness of any wholesale must-offer arrangements in relation to the DTT platform. Nevertheless, in practice, Virgin Media considers that it is impossible to anticipate in advance, and address, the full range of actions that might be taken by Sky to achieve such an outcome. The above ancillary conditions, and those identified by Ofcom will, therefore, almost certainly be insufficient to prevent Sky from undermining any wholesale must-offer regime and thereby distort competition on the DTT platform. Accordingly, Virgin Media continues to urge Ofcom not to consent to the Proposal.

12. **Do you consider that our indicative analysis, summarised at paragraphs 4.7 to 4.12 and set out more fully in Annex 6, supports our current view of whether we should opt for Option 1, Option 2 or Option 3?**

12.1 No. For the reasons set out above, and having regard to Ofcom's own observations in the Second Picnic Consultation, Virgin Media continues to consider that the only viable and rational option available to Ofcom is to opt for Option 3 and refuse to consent to the Proposal.