# Ofcom’s consultation on the “Pay TV market investigation”

# Response by
# Setanta Sport Holdings Limited
# and
# Top Up TV Europe limited

**March 2008**

# Ofcom's consultation on the "Pay TV market investigation"

## Response by
## Setanta Sport Holdings Limited
## and
## Top Up TV Europe limited

## Contents

## Ofcom's consultation on the "Pay TV market investigation"

## Response by
## Setanta Sport Holdings Limited
## and
## Top Up TV Europe limited

### Executive summary

1. Setanta and TUTV substantially agree with the analysis undertaken and conclusions reached by Ofcom in its Consultation Document on the pay TV market investigation. Nevertheless, Setanta and TUTV suggest below certain factors to which Ofcom must also have regard. (See section 1)

2. Setanta and TUTV agree with Ofcom's conclusion that there are separate retail and wholesale markets for the supply of premium sports pay TV channels, i.e. pay TV channels that provide live access, often on an exclusive basis, to key sports events. Such premium sports pay TV channels should, however, not be regarded as simply those channels which include live FAPL coverage. Sky spends approximately £½ billion per annum on sports rights other than those for live FAPL coverage. In Q3 2007, Sky provided nearly 14,000 hours of sports coverage other than live FAPL. Consumer research confirms the importance that subscribers attach to this additional sports coverage. Ofcom must, therefore, have due regard to Sky's total sports coverage. (See section 2)

3. Whilst Setanta might be the closest substitute to Sky Sports, the degree to which to which it can be regarded as a substitute is limited. As a consequence, Sky Sports is subject to no effective competitive constraint. This is demonstrated by, among other things, Sky's pricing response following Setanta's entry as a mainstream premium sports broadcaster in the UK. (See section 3)

4. Setanta and TUTV agree with Ofcom's conclusion that there are separate markets (at both the retail and the wholesale level) for free-to-air and basic-tier pay TV channels. (See section 4)

5. In order to assess Sky's market power in respect of basic channels, Ofcom must have regard to its position in respect of the supply of all basic channels and not just packages containing only basic channels. If Ofcom were to do this, it would observe that distribution by Sky on satellite accounts for at least 70% of the retail revenues of basic channels. Hence, Sky's share at the retail level of the relevant basic-tier market is comparable to its share at the retail level of the premium sports channel market. On this basis, Ofcom should conclude that Sky not only has market power in respect of the retailing of basic-tier pay TV channels but also has substantial buyer power when negotiating with providers of such channels. It is this buyer power that enables Sky to impose terms on third party basic channel

providers which limit the availability of their channels to Sky's competitors. (See section 5)

6. Ofcom notes in the Consultation Document that Sky enjoys significant advantages when bidding for content and that there are significant barriers to entry into the market for premium wholesale channels. One of these barriers to which Ofcom must have regard is Sky's first mover advantage upstream when bidding for content due to its existing retail customer base downstream, which enables Sky to monetise rights more quickly than an entrant. (See section 6)

7. Ofcom acknowledges the existence of the dynamic incentive on Sky to withhold its premium channels from competing pay TV retailers downstream in order to restrict their ability to bid for key content upstream. Ofcom must have due regard to this issue when reaching its conclusions on the competition problems that arise due to the structural features of pay TV in the UK. (See section 7)

8. Ofcom notes in the Consultation Document that a new entrant may need to incur initial losses in order to outbid the incumbent which is able to extract more value from rights. A key issue for an entrant, therefore, is the time that it will take to be able to monetise the rights that it acquires (e.g. the time it will take the entrant to build up its own base of subscribers). This is critical given the fact that rights to much key content are only offered for terms of three years. This barrier to entry is not removed through the potential for an entrant to wholesale a new channel to an existing pay TV retailer rather than seek to build its own retail subscriber base. This is because the existing pay TV retailer will still need to acquire subscribers for the new channel – i.e. whilst the existing pay TV retailer has a subscriber base for its existing channels, it will start with no subscribers to the new entrant's channel. (See section 8)

9. Ofcom notes that the bidding advantages which Sky enjoys include its ability to create additional barriers to entry by exploiting its position in downstream markets, such as restricting access to its platform by new entrants. In light of this, Ofcom must investigate Sky's ability to restrict access to its platform (notwithstanding the regulatory regime) in order to be able properly to assess both Sky's bidding advantages and the structural features of pay TV in the UK which lead to the restriction, distortion or prevention of competition. (See section 9)

10. In order to ensure that the objectives of the market investigation are achieved, Ofcom must consider whether, in the absence of particular features of the pay TV market, there would be increased competition which would give rise to consumer benefits. In circumstances in which Sky's premium channels were made available at competitive rates on all platforms, consumer choice of the available combinations of platforms/content would increase (not just in respect of premium channels but also basic channels and other services). Consumers would also benefit in terms of choice over platforms/content if there were greater competition upstream. The ability for Sky's competitors to launch innovative services is

limited due to Sky's control of mutually reinforcing upstream and downstream bottlenecks. In a more competitive market, it is clear that further innovations would result – for example, greater availability of HD services on platforms other than satellite and the development of an increased range of on-demand services by Sky's competitors. In such a more competitive environment, consumers would benefit from reduced prices resulting from increased retail price competition. (See section 10)

11. Ofcom's assessment of Sky's financial strength is somewhat cursory and insufficient for the purpose. TSR is not an appropriate measure for assessing a company's financial strength in the context of a competition inquiry. The assessment of Tobin's q which Ofcom has undertaken employs a volatile measure which is then adjusted in a subjective and unrefined way and compared against non-comparable companies whose Tobin's q have not been similarly adjusted. The OFT advocates the use of IRR as a profitability measure in competition cases. The truncated IRR methodology advocated by the OFT discloses an IRR for Sky of approximately 40% over the financial years from 2003 to 2007. Sky's operating margin, profitability per subscriber, ROCE and ROE are also all substantially higher than those of comparable companies. Furthermore, Sky's ROCE is substantially higher than its cost of capital. These assessments confirm the strength of Sky's current market position. (See section 11)

12. Ofcom has observed the tendency of pay TV platforms to tip towards one retailer. In light of this, Ofcom must adopt a prophylactic approach towards Picnic and must not authorise Sky to become a pay TV retailer on DTT while the competition concerns identified in the market investigation remain unresolved. (See section 12)

13. Ofcom's analysis in its Consultation Document confirms the existence of features of the pay TV market which prevent, restrict and distort competition. The existence of these features results consumer harm through restricted choice, reduced innovation and higher prices. In the event that appropriate undertakings are not offered and accepted to address the market failure in pay TV, Ofcom should exercise its discretion under section 131 of the Enterprise Act to refer the UK pay TV industry to the Competition Commission for a full market investigation. (See section 13)

**Ofcom's consultation on the "Pay TV market investigation"**

**Response by**
**Setanta Sport Holdings Limited**
**and**
**Top Up TV Europe limited**

## 1. Introduction

1.1 Setanta and TUTV substantially agree with the analysis undertaken and conclusions reached by Ofcom in its Consultation Document on the pay TV market investigation.

1.2 In particular, Setanta and TUTV agree with Ofcom's conclusions that:

- Sky has market power at the retail and wholesale levels in respect of premium sports channels;
- there are significant barriers to entry into the market for premium sports channels; and
- Sky has the incentive and ability to foreclose potential new retailers by denying them content.

1.3 Nevertheless, Setanta and TUTV suggest below certain refinements to Ofcom's analysis, for example, in respect of the definition of what constitutes a premium sports channel.

1.4 In addition, Setanta and TUTV highlight certain factors to which Ofcom must have due regard in respect of (i) Sky's bidding advantages, (ii) its dynamic rationale for downstream foreclosure and (iii) the time it would take a new entrant to monetise rights (irrespective of whether it seeks to build its own subscriber base or to wholesale its new channel to an existing pay TV retailer).

1.5 Setanta and TUTV also outline below certain consumer benefits which would result from a more competitive pay TV market.

1.6 Finally, Setanta and TUTV assess Sky's financial strength (and thus its market position) by reference to certain comparative analyses which Ofcom should undertake.

1.7 In light of Ofcom's conclusion in its Consultation Document and the refinements suggested below, Ofcom must, at the very least, not authorise Sky to become a pay TV retailer on DTT until the competition concerns raised in the context of the market investigation have been resolved.[1]

## 2. Market definition – premium sports channels and the FAPL

2.1 In the Consultation Document, Ofcom states that:

> "*Our preliminary conclusions on market definitions for content and channels are that:*
>
> - *It remains likely that* ***there are separate retail and wholesale markets for the supply of premium sport … channels***."[2] (Emphasis added.)

In this context, Ofcom states that:

> "*A 'premium sports' pay TV service is usually defined as one that provides live access, often on an exclusive basis, to a specific set of highly-valued sports events.*" [3]

Setanta and TUTV agree that there are separate retail and wholesale markets for the supply of premium sports pay TV channels, i.e. pay TV channels that provide live access, often on an exclusive basis, to key (attractive) sports events.

2.2 Ofcom does, however, go on to state that:

> *For the purposes of this work [on market definition], we have considered packages of premium sports that* ***include access to live FAPL matches***."[4] (Emphasis added.)
>
> "*In reaching our conclusion on premium sport channels we note firstly that the objective characteristics of these channels are quite distinct from those of either free to air or basic tier pay TV services. A 'premium sports' pay TV service provides live access, often on an exclusive basis, to a specific set of highly-valued key sports events****, most notably live FAPL coverage***."[5] (Emphasis added.)

In light of these comments, it appears that Ofcom may consider that, in order to be regarded as a premium sports pay TV service, a service must include live FAPL coverage.

---

1 These are the competition concerns Ofcom has identified to date (paragraph 6.77 of the Consultation Document) and the competition concerns identified in the Joint Submission of 3 July 2007.

2 Paragraph 5.23 of the Consultation Document.

3 Paragraph 5.25 of the Consultation Document.

4 Paragraph 5.25 of the Consultation Document.

5 Paragraph 5.26 of the Consultation Document.

2.3 In practice, there are only two services in the UK that could be regarded as premium sports pay TV services – i.e. there are only two pay TV services that include "*live access, often on an exclusive basis, to … key sports events*". These are the Sky Sports package of channels and the Setanta Sports package of channels, both of which include live FAPL coverage. It would, nevertheless, be inappropriate for Ofcom to conclude that live FAPL coverage is a pre-requisite to a service being a premium sports pay TV service.

2.4 When highlighting the importance of live FAPL coverage, Ofcom observes that:

> "*The uniqueness of FAPL in particular as compared to other sports events is illustrated most clearly by the commercial valuations which wholesale channel providers attach to the different rights packages. …* ***FAPL is by some distance the most valuable of sports rights****, selling for £669 million per year. This is over six times the revenue generated by the next most valuable set of rights, the FIFA World Cup (£110 million) …. The most significant non-football sports rights are the 2012 Olympics (estimated at £71 million) and English cricket (£52 million). These relative valuations (even when adjusted to take account of the volume of programming related to each event) suggest that wholesale channel providers … do not regard any other sports rights package as being a close substitute for FAPL.*"[6] (Emphasis added.)

2.5 In practice, there is no doubt that, in this respect, the FAPL is unique. The sums earned from the sale of rights to broadcast live FAPL coverage in the UK are significantly higher than the sums earned from the sale of UK rights to any other sports event. Nevertheless, in combination, the sale of UK rights of other sports events does generate significant sums. For example, in the 2006/7 financial year, Sky's expenditure on live FAPL rights was £340 million. Yet in that financial year, Sky also spent £502 million on other sports rights.[7] Thus, approximately 60% of Sky's expenditure on sports rights in 2006/7 was applied to rights other than for live FAPL coverage.[8]

2.6 If Ofcom were to define the market for premium sports pay TV channels as essentially a market for channels which include live FAPL coverage, it would have failed to have due regard to the other sports rights on which Sky spends approximately £½ billion per year. It is clear that Sky must have a very strong rationale for spending such substantial sums on other sports rights. The rationale is that these other sports rights contribute significantly to the creation of a product with unique appeal – i.e. the Sky Sports package of premium sports pay TV channels.

---

6 Paragraph 5.29 of the Consultation Document.

7 BSkyB's Annual Report 2007.

8 Furthermore, the sum of £502 million spent by Sky in 2007 on sports rights other than FAPL represents not far off double what Sky spent in 2007 on movie rights (£285 million). Source Sky's Annual Report 2007.

2.7 In this context, it is noteworthy that Ofcom also observes in the Consultation Document that:

> "***The other key distinction between free to air sports and premium sports relates to the quantity of programming available**. A subscriber of Sky Sports would have access to around 14,000 hours of sport during Q3 2007, while only 3,400 hours of sports programming were available free to air on DTT. Of these 3,400 hours, around 2,100 hours relate to Sky Sports News, one of the channels that Sky is seeking to withdraw from Freeview. If this withdrawal takes place, **a subscriber to Sky Sports will then have access to over ten times the amount of sports programming than is available free to air**.*"[9] (Emphasis added.)

2.8 Thus, Ofcom notes that one of the key differences in the objective characteristics of premium sports channels and other TV channels (e.g. free to air services) is the volume of sports coverage which is offered by the former – around 14,000 hours of sports coverage on Sky Sports during Q3 2007 as compared with 1,300 hours on free to air channels.[10] Of those 14,000 hours of sports coverage on Sky Sports during Q3 2007, Setanta and TUTV estimate that approximately 47 hours involved live FAPL coverage, which represents approximately 0.3% of the total sports coverage on Sky Sports in that period.[11] Thus, if Ofcom were to define the market for premium sports pay TV channels as essentially a market for channels which include live FAPL coverage, it would have failed to have due regard to approximately 99.7% of the sports coverage on Sky Sports – i.e. Ofcom would have failed to have due regard to the substantial volume of sports coverage which differentiates premium sports pay TV channels from other TV channels.

2.9 In practice, the 47 hours of live FAPL coverage during Q3 2007 are the most expensive content per hour on Sky Sports and are likely to be the most important for Sky Sports subscribers in general. Nevertheless, the coverage on Sky Sports of other sports events besides FAPL is clearly also very important.

2.10 The consumer research which is summarised in Annex 14 to Ofcom's Consultation Document confirms not only the importance of live FAPL coverage but also the importance of Sky's extensive portfolio of other sports rights. For example, this research confirms that, in 2005 (i.e. when Sky still enjoyed a monopoly over live FAPL coverage in the UK), 35% of respondents spontaneously gave live FAPL coverage as the main reason for subscribing to Sky Sports. That means, however, that 65% of respondents spontaneously gave

---

9 Paragraph 5.30 of the Consultation Document.

10 The figure of 1,300 hours of free to air sports coverage reflects Sky's proposal to withdraw Sky Sports News from Freeview.

11 Sky broadcasts on average 2.4 live FAPL matches per week during the FAPL season. Thus, the parties estimate that Sky broadcast approximately 31 FAPL matches live during Q3 2007.

another reason for subscribing to Sky Sports, e.g. sports in general (12%), football in general (5%), rugby (3%), other sport (3%), cricket (2%) etc.[12]

2.11 Ofcom's Consultation Document also confirms that, according to its research, many respondents identify sports other than football as being "*must have*" – in particular, 20% cited cricket, 17% cited rugby union, 12% cited tennis, 12% cited rugby league, 9% cited athletics, 9% cited golf and 6% cited motor racing.[13]

2.12 The importance to subscribers of the coverage of sports other than FAPL is also disclosed by the viewing figures which Ofcom includes in Annex 14. In Q3 2007, the total time spent per person watching football on the satellite platform, for example, was 450 minutes. Yet the total time spent per person viewing other sports on the satellite platform in Q3 2007 was 1,465 minutes.[14] Thus, 76.5% of the time spent viewing sports on the satellite platform in Q3 2007 did not involve football coverage. The percentage of time spent viewing sports other than FAPL would clearly be even greater.

2.13 Furthermore, the consumer research commissioned by Ofcom in 2005 in connection with the European Commission's proceedings under Article 81 of the EC Treaty in respect of the FAPL noted that:

> "*… amongst all UK households live Premier League football played a less important role in decisions to take up a pay TV platform. Here the proportion saying they decided to subscribe to Sky or cable because of live Premier League football is less than 5%. Just over a third cite live Premier League football as a reason for subscribing to Sky Sports.*"[15]

In fact, just 28% of respondents cited only live FAPL as the reason for subscribing to Sky Sports. A further 8% of respondents cited FAPL together with other sports as the reason for subscribing to Sky Sports. Thus, only 36% of respondents mentioned FAPL amongst their reasons for subscribing to Sky Sports, whereas 64% of respondents did not mention FAPL amongst their reasons for subscribing to Sky Sports.[16]

2.14 The research commissioned by Ofcom in 2005 also inquired how Sky Sports subscribers would react if Sky lost all its rights to live FAPL coverage but did not reduce the price for its channels (a somewhat absurd proposition as, in those circumstances, Sky would be saving over £400 million per year on FAPL rights costs, based on current payments to the FAPL). Notwithstanding the perverse

---

12 Figure 38 of Annex 14 to the Consultation Document.

13 Figure 16 in paragraph 3.65 of the Consultation Document.

14 Figure 40 of Annex 14 to the Consultation Document.

15 Paragraph 124 of Ofcom/Human Capital's document entitled "*Premier League Football: Research into viewing trends, stadium attendance, fans' preferences and behaviour, and the commercial market*".

16 Figure 37 of Ofcom/Human Capital's document entitled "*Premier League Football: Research into viewing trends, stadium attendance, fans' preferences and behaviour, and the commercial market*".

question, approximately half (46%) of Sky Sports subscribers confirmed that they would continue to subscribe to Sky Sports at the same price even if it included no live FAPL coverage.[17] It is clear, therefore, that at least half of the subscribers to Sky Sports attach a very significant value to its coverage of sports other than the FAPL (as it is reasonable to infer from this research that more than 46% of Sky Sports subscribers would continue to subscribe to Sky Sports if Sky lost all its live FAPL rights but reduced the price of its Sky Sports channels to reflect its saving on rights costs).

2.15 The fact that Sky's rights to broadcast sports other than FAPL are also very important to subscribers should be self-evident (not least because Sky spends approximately £½ billion on these rights each year). As Ofcom notes in the Consultation Document:

> "*…this use of bundling reflects the fact that consumers' preferences for content are highly variable. Content that is highly desirable for one group of consumers may be of less interest to another. In this context, bundling provides a potential mechanism for … allowing content rights holders to recoup the fixed costs of content production whilst still distributing to a large number of subscribers.*"[18]

Ofcom reiterates these principles on several occasions when it states:

> "*There is a tendency to aggregate content because aggregation increases the value of that content to suppliers and, in certain circumstances, to final consumers too*".[19]

> "*Consumers have widely varying preferences for content*".[20]

> "*This process of aggregation reflects, at least in part, the observed fact that consumers have widely different preferences for content"*.[21]

> "*By aggregating content into channels, wholesale channel providers can increase the collective value of the content above its stand alone value*".[22]

> "***Content aggregation may lead to the creation of market power** in relation to categories of premium content, which may lie **in narrow wholesale markets, in particular, premium sports***".[23] (Emphasis added.)

---

17 Paragraph 133 and figure 43 of Ofcom/Human Capital's document entitled "*Premier League Football: Research into viewing trends, stadium attendance, fans' preferences and behaviour, and the commercial market*".

18 Paragraph 5.77 of the Consultation Document.

19 Paragraph 6.2 of the Consultation Document.

20 Paragraph 6.9 of the Consultation Document.

21 Paragraph 5.63 of the Consultation Document

22 Paragraph 6.64 of the Consultation Document.

23 Paragraph 6.10 of the Consultation Document.

2.16 It is clear, therefore, that by bundling into Sky Sports a substantial portfolio of rights to many attractive sporting events, Sky has created a product for which there is no effective substitute.[24]

2.17 Sky itself implicitly acknowledges this fact. On 7 February 2008, the Financial Times reported that:

> "*The fourth-quarter figures include the first season of Sky's new contract to air Premier League games since it was forced to share the rights with Setanta Sports. Mr Darroch [Sky's CEO] said the group had seen no fall-off in its football audience as a result of the regulatory intervention, saying that subscriber numbers for its sports packages had grown.*
>
> "*In terms of interest in the platform and viewership it is as strong as ever*", *Mr Darroch said.*
>
> *He added, however, that Sky had broadened its range of sports programming, getting 4.3 million viewers for a recent darts match. "You wouldn't want to be overly exposed to one individual package [and] sports fans like a breadth of content", he said.*"

2.18 In practice, Ofcom must have regard to Sky's other sports coverage when concluding its definition of the relevant markets for its pay TV market investigation.

2.19 Market definition is, ultimately, a step on the way to identifying and resolving competition problems: it is not an end in itself. Ofcom acknowledges in the Consultation Document that:

> "*The purpose of a market definition exercise is to identify all relevant products that consumers consider substitutable by virtue of a product's characteristics, prices and intended use*".[25]

2.20 When the two key characteristics which Ofcom has highlighted in the Consultation Document (namely expenditure on sports rights and volume of sports coverage) are considered, it is clear that there is a bright line distinction between, on the one hand, the Sky Sports package of channels and the Setanta Sports package of channels and, on the other hand, all other channels.[26]

---

[24] In this regard, Setanta and TUTV note Ofcom's observation that: "…, *supply-side substitution … appears unlikely since the exclusivity, duration and staggered nature of key sports rights contracts make it impossible for an existing wholesale channel provider to switch quickly into premium sports programming.*" Paragraph 5.35 (second bullet).

[25] Paragraph 5.9 of the Consultation Document.

[26] The price and use of these two sports packages also distinguish them from other TV channels.

## 3. Competition between Setanta and Sky Sports

3.1 In the context of its definition of the relevant markets, Ofcom states that:

> "*The market for premium sports channels is likely to include both Sky Sports and Setanta, although we cannot rule out a narrower market for Sky Sports alone.*"[27]
>
> "*Two examples of such a [premium sports pay TV] service in the UK are the sports channels provided by Sky Sports and Setanta, both of which include live FAPL coverage.*"[28]

3.2 On the basis of Ofcom's definition of a premium sports pay TV service as one that "*provides live access, often on an exclusive basis, to … key sports events*",[29] Setanta and TUTV agree that the Sky Sports package of channels and the Setanta Sports package of channels should both be regarded as premium sports pay TV services.

3.3 Ofcom then states that:

> "*We have used our consumer research to apply the hypothetical monopolist test to premium sports services, with Sky Sports channels as the focal product. Our key conclusion is that consumers respond to a SSNIP on Sky Sports either by switching to Setanta, or by dropping an element of their current service.* ***Setanta therefore appears to be the closest substitute to Sky Sports****, and we identify no other close substitutes*".[30] (Emphasis added.)

3.4 Whilst Setanta might be the closest substitute to Sky Sports, the degree to which it can be regarded as a substitute is limited. This is demonstrated by Sky's pricing response to Setanta's entry as a mainstream premium sports broadcaster in the UK. When Setanta started to broadcast live FAPL matches in the UK in August 2007, it reduced the price of its package of channels on the satellite platform from £14.99 per subscriber per month to £9.99 per subscriber per month. Thus, the quality of Setanta's offering improved significantly with the addition of 46 live FAPL matches whilst, at the same time, its retail price was reduced by one third. Shortly after this, on 1 September 2007, Sky responded by increasing certain retail prices for its premium sports channels. For example:

- Sky's retail price for its package of premium sports channels when bought through two mixes of basic channels was increased by £1 per subscriber per month to £35 per subscriber per month;

27 Paragraph 5.23 of the Consultation Document.
28 Paragraph 5.26 of the Consultation Document.
29 Paragraph 5.26 of the Consultation Document
30 Paragraph 5.31 of the Consultation Document.

- Sky's price for its package of premium sports channels when bought through six mixes of basic channels was increased by £1 per subscriber per month to £38 per subscriber per month;

- Sky's price for the bundle of both its premium sports and movie channels when bought through two mixes of basic channels increased by 50p per subscriber per month to £42.00 per subscriber per month; and

- Sky's price for the bundle of both its premium sports and movie channels when bought through six mixes of basic channels increased by £1.50 per subscriber per month to £45.00 per subscriber per month.

3.5 In practice, it should not be a surprise that Setanta is currently unable to impose an effective pricing constraint on Sky's premium sports channels. As noted in section 2 above, when considering the objective characteristics of premium sports channels (which differentiate them from other channels), Ofcom has highlighted two characteristics: the cost of sports rights[31] and the quantity of sports programming.[32] In respect of both of these characteristics, Setanta's position is dwarfed by that of Sky:

- in the 2007/08 financial year, Sky will spend approximately £940 million on sports rights. In contrast, Setanta will spend approximately £200 million. Thus, Sky's expenditure on sports rights is approximately 4.7 times Setanta's corresponding expenditure; and

- as Ofcom notes in Q3 2007, Sky Sports provided subscribers with approximately 14,000 hours of sports coverage. In contrast, during Q3 2007, Setanta offered subscribers approximately 2,900 hours of sports coverage.[33] Thus, the quantity of sports programming available on Sky Sports is approximately 4.8 times the corresponding quantity that is available on Setanta's premium sports channels.

3.6 Thus, whilst Setanta may be the closest substitute to Sky Sports, it is, nevertheless, abundantly clear that, by reference to the two objective characteristics which Ofcom highlighted in the Consultation Document as being particularly relevant, Setanta is not a very close substitute for Sky Sports.

3.7 In this context, it is worth considering not only the overall differences between Sky's premium sports channels and Setanta's premium sports channels but also their respective live coverage of FAPL matches:

- during the 2007/08 season, Sky will broadcast 92 FAPL matches live whereas Setanta will broadcast 46. Thus, Sky will provide live coverage of twice as many FAPL matches as Setanta; and

---

31 Paragraph 5.29 of the Consultation Document.
32 Paragraph 5.30 of the Consultation Document.
33 Paragraph 4.12 of Annex 13 to the Consultation Document.

- Sky's costs for these live FAPL rights in the 2007/08 season amount to £438 million whereas Setanta's corresponding costs amount to £130 million. Thus, Sky's expenditure on live Premier League rights is approximately 3.3 times Setanta's expenditure.

3.8 There is, therefore, a significant difference between both the number of live Premier League matches broadcast on these channels and the cost of those rights. Yet the comparison of the overall offerings on Sky Sports and Setanta Sports demonstrates that there is a much bigger gulf between the two offerings. In practice, Sky's expenditure on non-FAPL sports rights and the quantity of Sky's programming which covers other sports substantially differentiate Sky's premium sports channels from those of Setanta.

3.9 If it were appropriate, when considering premium sports pay TV services, merely to have regard to the live FAPL coverage on each such service, then Setanta Sports should be a closer substitute for Sky Sports than is in fact the case. In practice, it is clear that when assessing the degree of competition between Sky Sports and Setanta's premium sports channels, Ofcom must have regard not only to their live FAPL coverage but also to the exclusive coverage of other key sports events included on these channels.

3.10 The fact that Setanta is only a limited substitute for Sky Sports is reinforced by Setanta's experience in respect of the satellite platform (which is, of course, the largest pay TV platform). On the satellite platform, premium sports subscribers tend to subscribe either to Sky's premium sports channels or to Sky's premium sports channels and Setanta's premium sports channels. In Setanta's experience, very few, if any, of its subscribers on satellite do not also subscribe to Sky's premium sports channels.

3.11 In light of the above, it is clear that Sky Sports is subject to no effective competitive constraint. As a consequence, Setanta and TUTV agree with Ofcom's conclusions that:

> "*Sky is … likely to have market power in the retail market for packages containing premium sports … channels*";[34] and
>
> "*Sky is … likely to enjoy substantial market power in the sports [market at the wholesale level]*".[35]

---

34 Paragraph 5.54 of the Consultation Document.

35 Paragraph 5.56 of the Consultation Document.

## 4. Market definition – basic pay TV and free-to-air channels

4.1 In the Consultation Document, Ofcom states that:

> "*There is likely to be a particularly close relationship between basic-tier pay TV services and free-to-air services, and we have therefore considered whether these should be regarded as being in the same economic market*".[36]

4.2 Ofcom concludes that:

> *"It seems likely that the basic-tier pay TV and free-to-air TV are also in separate retail markets. However, this conclusion is less firm than our conclusion on premium sport and movie channels, since free-to-air represents a growing constraint on basic*".[37]

Setanta and TUTV agree that there are separate markets (at both the retail and the wholesale level) for free-to-air and basic channels.

4.3 In reaching this conclusion, Ofcom has focussed on a subset of the consumers of basic tier pay TV channels. Specifically Ofcom remarks that:

> "*Our assessment of* ***the constraint imposed on basic-tier pay TV by free-to-air TV focuses on stand-alone basic packages*** *– i.e. those that do not include premium sports or movies. This is because these are the only packages for which consumers' response to a change in price of basic content can be directly observed*".[38] (Emphasis added.)

4.4 It should be emphasised that, in carrying out this exercise, Ofcom is assessing "*the constraint imposed on basic-tier pay TV by free-to-air TV*" – i.e. it is considering whether basic-tier pay TV and free-to-air TV are in the same market. Ofcom ultimately concludes that:

> "*On balance, we believe that the evidence suggests that free-to-air and basic are likely to be in separate markets* ".[39]

4.5 Ofcom does, however, somewhat cloud this view by the conclusion in Annex 13 to its Consultation Document (which considers the issues of market definition and market power in pay TV). In Annex 13, Ofcom states that:

> "*There appears to be a growing constraint from Freeview, but it is not yet clear that, that constraint is sufficient to argue that free-to-air and stand-alone basic-tier pay TV are in the same market.* ***We conclude that stand-***

[36] Paragraph 5.3 of the Consultation Document.
[37] Paragraph 5.23 of the Consultation Document.
[38] Paragraph 5.47 of the Consultation Document.
[39] Paragraph 5.52 of the Consultation Document.

***alone basic-tier pay TV is likely to be in a separate market** …*”.[40] (Emphasis added.)

4.6 Whilst it is sensible for Ofcom to focus on stand-alone basic packages when assessing the constraint imposed on basic-tier pay TV by free-to-air TV, the conclusion in Annex 13 that stand-alone basic-tier pay TV constitutes a separate market seems inappropriate.

4.7 Sky supplies basic channels to over half of its base of approximately 9 million subscribers in packages which also contain premium channels. The supply of basic-tier pay TV channels to these subscribers would fall outside a market for "*stand-alone basic-tier pay TV*".

4.8 In practice, a satellite subscriber to Sky's premium sports channels necessarily obtains certain basic-tier pay TV channels from Sky due to its retail bundling. Consumers are, therefore, unable to obtain Sky's premium sports channels in isolation. Nevertheless, Ofcom has identified a separate market for premium sports channels.[41] Similarly, notwithstanding Sky's retail bundling, it would be correct for Ofcom to conclude that there is also a separate market for basic-tier pay TV channels, as Ofcom apparently does in the main body of the Consultation Document.

## 5. Market power in respect of basic channels

5.1 Having concluded in paragraph 5.52 of the Consultation Document that there is a separate market for basic-tier pay TV channels, Ofcom then considers the question of market power.

5.2 As part of its assessment of market definition, Ofcom had previously stated that:

> "*We have … looked at historic prices and subscriber numbers. If basic and Freeview were economic substitutes, we might expect basic take-up to be reduced as the Freeview product offering and customer base have grown, and/or an inability of retailers of basic packages to increase prices without losing subscribers to Freeview.* ***There has been an increase in the number of basic subscribers since the launch of Freeview. The real price of Sky's full basic package has also increased since 2002, although prices have been constant in nominal terms since September 2005***".[42] (Emphasis added.)

5.3 These factors are also relevant to the assessment of market power. Ofcom should note, however, that not only has Sky's price for its full basic package increased in

[40] Paragraph 4.129 of Annex 13 to the Consultation Document.
[41] Paragraphs 5.23 and 5.34 of the Consultation Document.
[42] Paragraph 5.51.

real terms since the launch of Freeview (and more recently been constant in nominal terms), but Sky has at the same time been able to reduce the sums it pays for third party basic channels. Specifically, in the 2006/07 financial year, Sky reduced its payments for third party (principally basic) channels by 29%[43] and, in the 2005/06 financial year, Sky reduced its payments for such channels by 11%.[44] Thus, Sky has substantially increased the margins it earns from the retailing of basic-tier pay TV channels notwithstanding the launch, growth and success of Freeview - an indication of Sky's market power in respect of the distribution of basic-tier pay TV channels.

5.4 Ofcom's assessment of market power in basic channels (erroneously) focuses on the subset of the relevant market to which it referred when defining that market – i.e. packages containing only basic-tier pay TV channels. It is, as Ofcom acknowledges, appropriate to focus on stand-alone basic packages when considering market definition as those are the only packages for which consumers' responses to a change in price of basic content can be directly observed.[45] Yet when considering market power, Ofcom must have regard to the supply of all basic-tier pay TV channels - i.e. the whole of the basic market that it has identified.

5.5 In this context, Ofcom seeks to rely upon market share information and states:

> "*Our evidence shows that:*
>
> - *Sky and Virgin have roughly equal market shares* ***in the market for packages containing only basic-tier pay TV channels****, alongside a small number of other very minor players … this suggests that* ***neither party is likely to have market power in the market for stand-alone basic-tier pay TV***".[46] (Emphasis added.)

Yet, as noted above, Ofcom has identified a relevant market for basic-tier pay TV channels in general. Therefore, the market shares to which Ofcom should have regard are the relevant parties' shares of the whole of the market for basic-tier pay TV channels, which should include packages containing basic-tier and premium pay TV channels as well as packages containing only basic-tier pay TV channels.

5.6 If Ofcom were to assess the correct market shares in respect of basic-tier pay TV channels, as outlined above, Setanta and TUTV estimate that it would observe that Sky's market share is substantially higher than that of Virgin Media. Ofcom should also observe that distribution on satellite accounts for at least 70% of the retail revenues of basic-tier pay TV channels. Hence, Sky's share at the retail level of the relevant basic-tier market is likely to be comparable to its share at the

---

43 Page 28 of Sky's 2007 Annual Report.
44 Page 41 of Sky's 2006 Annual Report.
45 Paragraph 5.47 of the Consultation Document.
46 Paragraph 5.54 of the Consultation Document.

retail level of the premium sports channel market, which lead Ofcom to conclude that Sky has market power in that market.[47]

5.7 On the question of using market shares as an indicator of market power, Ofcom notes that:

> "*Although high market shares do not of themselves imply dominance, there is little evidence that other competitive constraints are significant, with the possible exception of the constraint which free-to-air services provide on basic-tier pay TV services*".[48]

5.8 Ofcom seems, however, to overemphasise this latter factor. For the reasons explained in paragraphs 5.2 and 5.3 above, it is clear that free-to-air services have, at best, imposed a limited constraint on Sky's pricing of its basic-tier pay TV channels given the significant improvement in Sky's margins from the retailing of basic-tier pay TV channels since the launch of Freeview. Accordingly, in light of Sky's share of the relevant basic-tier market, Ofcom should conclude that Sky has market power in the retailing of basic tier pay TV channels.

5.9 When considering market power in respect of basic-tier pay TV channels, Ofcom goes on to note that:

> "*… the basic-tier pay TV service is an entry-level product, which consumers often need to purchase in order to obtain the possibility of purchasing premium pay TV content. This means that the overall demand for basic pay TV services is, in part at least, derived from the demand for premium pay TV content*";[49] and
>
> "*…total demand – and particularly Sky's total demand – for basic-tier pay TV services is considerably larger than the demand for stand-alone basic packages because of the derived demand from consumers purchasing premium sports and movies.* ***This may afford Sky a degree of buyer power when negotiating with third party wholesale channel providers****, even if it does not have market power in relation to the sale of stand-alone basic-tier services.*"[50] (Emphasis added.)

5.10 In practice, the latter comment is a material understatement. As Sky's distribution of third party basic channels accounts for approximately 70% of the revenues of those channels, it is clear that Sky enjoys substantial (and not just "*a degree of*") buyer power when negotiating with the providers of such channels. It is this

47 In respect of premium sports channels, Ofcom notes that Sky has market shares of "*well over 70%*" at the retail level and "*well over 80%*" at the wholesale level. These market shares lead Ofcom to conclude that Sky has market power in the retail market for packages containing premium sports channels and "*substantial*" market power in the corresponding wholesale market. (Paragraphs 5.54 and 5.56 of the Consultation Document.)

48 Paragraph 5.54 of the Consultation Document.

49 Paragraph 5.47 of the Consultation Document.

50 Paragraph 5.55 of the Consultation Document

buyer power that enables Sky to impose terms on third party basic channel providers which limit the availability of their channels to Sky's competitors (as described in the Joint Submission of 3 July 2007).

## 6. Sky's bidding advantages

6.1 When considering the barriers to entry into the upstream market for the provision of, among other things, premium sports pay TV channels, Ofcom notes that:

> **"*…there are significant first-mover advantages in the market for premium wholesale channel provision*.** *These arise because of bundling efficiencies, and the existence of a* ***limited set of key content rights****, which only become* ***contestable on a staggered basis****. A new entrant that wishes to assemble a viable portfolio of rights must gradually accumulate those rights, by repeatedly winning the bidding for different pieces of content, a process which may take months or years. Such* ***a new entrant may need to incur initial losses, in order to outbid the incumbent, which is able to extract more value from those rights***".[51] (Emphasis added.)
>
> "*In addition to those barriers to entry which are intrinsic to content markets at the wholesale level, a vertically integrated incumbent may have an incentive to create additional barriers to entry by exploiting its position in downstream markets. For example, a vertically integrated incumbent such as* ***Sky may have an incentive to restrict access to its platform*** *by a new entrant such as Setanta, thereby making it more difficult for such a new entrant to monetise its rights, particularly during the period within which it is still building its rights portfolio*".[52] (Emphasis added.)

6.2 These observations by Ofcom lead it to conclude that:

> "*There may be significant barriers to entry into the market for premium wholesale channels. These are primarily due to the way in which content rights become contestable only the staggered basis. These barriers to entry may be exacerbated by the presence of a vertically integrated incumbent, which has an incentive to control access to downstream markets …*".[53]

6.3 Thus, Ofcom has acknowledged the following barriers to entry into the upsteam market for the provision of premium sports pay TV channels:

- the limited set of key content rights;

---

51 Paragraph 1.57 of the Consultation Document.
52 Paragraph 1.58 of the Consultation Document.
53 Paragraph 1.64 of the Consultation Document.

- the availability of key content rights only on a staggered basis;

- the need to assemble a viable portfolio of rights gradually over a relatively long period;

- the need to outbid the incumbent which will be able to extract more value from the rights; and

- the incumbent's exploitation of its position in downstream markets in order to inhibit, for example, a competitor's access to a key distribution platform.

6.4 Setanta and TUTV note that all these barriers to entry were expressly highlighted in the Joint Submission of 3 July 2007. Nevertheless, in summarising the barriers to entry in this way, Ofcom may not have had due regard to the substantial bidding advantage which Sky gains from its downstream incumbency (i.e. its existing base of pay TV subscribers.)

6.5 In its summary of the barriers to entry into the upstream market, Ofcom does expressly note that the incumbent (i.e. Sky) will be able to "*extract more value*" from particular rights. This ability to extract more value arises as a result of two discrete factors:

- Sky will be able to bundle any new rights with its existing portfolio of rights and such aggregation increases the value;[54] and

- Sky will be able to monetise the rights more quickly than an entrant because of its existing subscriber base – i.e. a pay TV operator's ability to bid for rights is directly influenced by its scale downstream. Annex 1 provides further details on how Sky can monetise rights more quickly than its competitors.

6.6 Ofcom acknowledges both of these factors in its Consultation Document when it states that:

> "*… there might be a tendency for one retailer to emerge as the primary retailer on [a] platform, simply because* ***once one retailer has a large portfolio of … content, bundling efficiencies allow that retailer to 'outbid' any other potential retailers for additional pieces of content***".[55] (Emphasis added)
>
> "***This tendency may be strengthened by the first-mover advantage conferred on the incumbent by its existing retail customer base****. Switching barriers … mean that a potential new entrant without that existing base would have to bid for content in the knowledge that a*

54 See, for example, paragraph 2.15 above.

55 Paragraph 6.17 of the Consultation Document.

*proportion of the incumbent's retail customers would not switch to the new entrant's offer to follow that content. This may restrict the new entrant's ability to match the incumbent's bid for the content*".[56] (Emphasis added.)

6.7 Thus, even though Ofcom did not expressly refer in its summary to the bidding advantage which results from Sky's downstream incumbency (i.e. its existing subscriber base), Ofcom has acknowledged this material advantage in the Consultation Document. It is important that, in its ongoing market investigation, Ofcom has due regard to this bidding advantage, not least for the reasons set out in section 7 and Annex 1 below.

## 7. Dynamic rationale for downstream foreclosure

7.1 Ofcom has acknowledged that the existence of Sky's bidding advantage due to its downstream incumbency incentivises Sky to withhold its premium channels from competing pay TV operators. This is because such withholding inhibits the ability of Sky's downstream competitors to build up a subscriber base and thus inhibits their ability to bid competitively against Sky for key content such as the rights to broadcast attractive sports events.

7.2 Specifically Ofcom states that:

> "*Vertical integration may also change the incentives on firms which determine how they transact with one another. This is because a vertically integrated firm will also take into account the impact of its actions at one level of the supply chain on other parts of its business*".[57]
>
> "*To illustrate, consider a firm which is vertically integrated between wholesale and retail markets. … that firm may have* ***an incentive to provide wholesale content in a manner which favours its own retail operation*** *… it might refuse to supply other retailers with key content or supply them with key content on less favourable terms:*
>
> - *In the short term, by making rival downstream retailers relatively less attractive, this conduct may encourage some consumers to switch from those rivals to the vertically integrated firm*".[58] (Emphasis added.)
>
> "*Another example of longer term incentives might be* ***a desire to eliminate a rival retailer that is also active at the content acquisition level****. By weakening or eliminating that rival, this may reduce degree of competition*

56 Paragraph 6.18 of the Consultation Document.
57 Paragraph 5.125 of the Consultation Document.
58 Paragraph 5.126 of the Consultation Document.

*between buyers of content rights. This might allow the vertically integrated firm to acquire content for a lower price in the future*".[59] (Emphasis added.)

7.3 This dynamic rationale for Sky withholding content from a downstream competitor (such as Virgin Media, BT Vision and TUTV) is a significant issue for the market investigation. Nevertheless, Ofcom may not have had due regard to it in paragraphs 6.57 to 6.73 of the Consultation Document, when Ofcom considers the "*long-run operation of the market [in respect of] access to premium content*". In the whole of this section, Ofcom does not expressly refer to the dynamic incentive (which Ofcom acknowledges in section 5 of the Consultation Document) for Sky to withhold content from a downstream competitor in order "*to eliminate a rival retailer that is also active at the content acquisition level*". This is a material omission.

7.4 In the Consultation Document, Ofcom has observed that:

- Sky enjoys a first mover advantage upstream when bidding for content due to its existing retail customer base downstream (paragraph 6.18 of the Consultation Document); and

- Sky has an incentive to withhold content from competing pay TV retailers downstream in order to restrict their ability to bid for key content upstream (paragraph 5.127 of the Consultation Document).

Ofcom must have due regard to both of these issues when reaching its conclusions as to the competition problems that arise due to the structural features of pay TV in the UK.

## 8. The time to build a subscriber base

8.1 As noted in section 6 above, Ofcom has recognised that:

"*… a new entrant may need to incur initial losses, in order to outbid the incumbent, which is able to extract more value from … rights*".[60]

8.2 As also noted in section 6 above, one of the key reasons why the incumbent can extract more value from rights is that it is able to monetise the rights more quickly due to its existing subscriber base. Accordingly, a key issue for an entrant is the time that it will take for the entrant to be able to monetise rights that it acquires (e.g. the time it will take the entrant to build up its own base of subscribers). This is critical given the fact that rights to much key content (e.g. FAPL) are only offered for terms of three years. Hence, an entrant will have just three years in

---

[59] Paragraph 5.127 of the Consultation Document.

[60] Paragraph 1.57 of the Consultation Document.

which to build up a sufficient base of subscribers in order to earn a return on its investment in such rights. Yet, in practice, as is demonstrated by Setanta and Sky, it takes a long time (i.e. many years) for a pay TV retailer to build up a substantial base of subscribers

8.3 In addition, Ofcom recognises that:

> "*An important feature of content markets is the fact that content providers tend to sell content via multi-year contracts. As a result, rights become available on a staggered basis rather than all at once. This may create barriers to entry, since* ***a wholesale channel provider wishing to launch a new service will typically need to assemble several rights packages in order to be able to do so****, and these rights will not all be available at a particular point in time. Indeed,* ***it may take several years to assemble the various rights packages*** *necessary to launch a new service.*"[61] (Emphasis added.)

Thus, a new entrant will not only incur losses in order to outbid the incumbent for one set of rights, it will need to do this several times over a period of years in order to establish a viable portfolio of rights.

8.4 The size of this barrier to entry is increased dramatically if the incumbent is unable to make a return on its investment in particular rights during the initial period in which it holds the rights. In such circumstances, in order to rebid for those rights when they are next offered for sale, the investors in the entrant will be asked to continue funding a loss making business in the hope that, over time, it will acquire sufficient subscribers to be able to make a return on not only subsequent investments in rights but also the initial (loss making) investments in rights.

8.5 In practice, the barrier to entry which is presented by the time it takes an entrant to monetise rights is not removed through the potential for an entrant to wholesale a new channel to an existing pay TV retailer rather than seek to build its own retail subscriber base. This is because the existing pay TV retailer will still need to acquire subscribers for the new channel – i.e. whilst the existing pay TV retailer has a subscriber base for its existing channels, it will start with no subscribers to the new entrant's channel.

8.6 Furthermore, in the context of premium channels, it should be noted that Sky is dominant at both the retail and wholesale levels. Hence, if a new entrant were to acquire certain sports rights and wholesale its new channel to Sky, it would be placing its future revenue streams and future viability in the hands of its principal upstream and downstream competitor. In such circumstances, the following issues would arise:

---

61 Paragraph 5.70 of the Consultation Document.

- Sky would be highly unlikely to assist a rival by agreeing wholesale terms that would signal to it and other rivals that Sky could be outbid for content rights.

- Even if wholesale terms were agreed, Sky would not have an incentive to promote the rival channel in competition with its own channels.

- In order to be able to agree wholesale terms with Sky, the third party would have to cede to Sky a portion of the revenues that would be generated from the content in question. This would disadvantage the third party when bidding for rights.

- In its Submission of October 2007, Sky explains why it has a preference for retailing, rather than wholesaling, its content over third party platforms.[62] For example, Sky states that:

  > "*Third party retailers do not have the same incentives as Sky to market Sky's channel. Whereas Sky has very low marginal costs (since many of its rights costs are largely fixed), third party retailers must bear a marginal cost (namely the wholesale price). This is inherent in wholesale distribution, as there is a marginal cost whatever the supply price (unless it is zero).*"[63]

  To the extent that these arguments by Sky have any validity, they also explain certain disadvantages that would be faced by any new entrant wholesaling to Sky.

- Most importantly, as noted above, even if a new entrant were to wholesale its rival channel to Sky for Sky to retail on DTH, the rival channel would still have no DTH subscribers at the outset. Such wholesale arrangements almost always involve variable charges – i.e. wholesale charges calculated on a per subscriber basis. Thus, such wholesale arrangements would not overcome the barrier to entry presented by the time needed to build a subscriber base for the new channel.[64]

8.7 Further issues in respect of access to satellite subscribers are described in Annex 2.

8.8 For all the reasons outlined above, the time that it takes to build a subscriber base is a substantial barrier to entry for wholesale channel providers. This barrier

---

62 Paragraph 4.16 et seq of Part D of Sky's Submission of October 2007.

63 Paragraph 4.17(b) of Part D of Sky's Submission of October 2007.

64 Even if Sky (or any other existing pay TV retailer) were to bundle a new channel with one of its existing packages (as Virgin Media has done by including Setanta's channels in its XL package) that would not generate as much revenue per subscriber for the new entrant as selling the new channel as a stand-alone premium channel. This is because the latter would retail for say £10 per subscriber per month whereas the existing pay TV retailer would most likely not be able to introduce pure bundling of the new channel and impose a £10 retail price rise on the existing price of its package.

exists whether or not the wholesale channel provider seeks to build its own retail subscriber base or to wholesale its new channel to an existing pay TV retailer.

## 9. Technical platform services

9.1 As noted in section 6 above, the bidding advantages which Sky enjoys include its ability to create additional barriers to entry by exploiting its position in downstream markets, such as restricting access to its platform by new entrants.[65]

9.2 Yet Ofcom also states that:

> "*We do not expect to reach any formal conclusions within this market investigation on either market definitions of wholesale platforms or the market power of specific platform operators. The appropriate vehicle for taking forward any concerns which we might identify in relation to platform market power is the TV platform market review.*"[66]

9.3 Even if Ofcom does not reach any formal conclusions within the market investigation on market definitions of wholesale platforms or the market power of specific platform operators, it must investigate Sky's ability to restrict access to its platform by new entrants (notwithstanding the regulatory regime) in order to be able properly to assess both Sky's bidding advantages and the structural features of pay TV in the UK which lead to the restriction, distortion and prevention of competition.

## 10. Consumer benefits/harm

10.1 In its Consultation Document, Ofcom states that, when assessing whether the pay TV market "*is functioning effectively - i.e. whether it is delivering benefits to consumers now, and likely to deliver benefits in the future*", it has sought to use the following criteria:

- choice of platform and content;
- innovation in platform services; and
- pay TV services priced competitively and efficiently.[67]

Each of these criterion is considered in turn below.

---

65 See paragraph 6.1 and 6.2 above and paragraphs 1.58 and 1.64 of the Consultation Document.
66 Paragraph 5.59 of the Consultation Document.
67 Paragraphs 2.24 and 4.1 of the Consultation Document.

10.2 At the outset, however, it should be noted that, due to their static nature, there is a risk that Ofcom's use of these criteria will not achieve the objectives of the market investigation, which are to identify and remedy any features of the pay TV market which prevent, restrict or distort competition. In order to ensure that these objectives are achieved, Ofcom must consider whether, in the absence of particular features of the pay TV market, there would be increased competition which would give rise to consumer benefits. Hence, Ofcom must take a dynamic view of the consumer experience of pay TV.

***Choice of platform and content***

10.3 Ofcom's assessment of the consumer experience of pay TV starts with a survey of consumer satisfaction levels. This survey is, however, necessarily of limited utility for the following two reasons, among others:

- the results of the survey are biased as they only relate to consumers who have chosen to subscribe to pay TV services at current prices. As Ofcom itself notes: "*there may be certain types of consumers who are not well served by pay TV in the sense that the pricing structure may serve to exclude them from the market*". In light of this, Ofcom concludes that evidence on consumer satisfaction levels "*obviously reflects the fact that those consumers who are able to express a view are those that have voluntarily chosen to pay for the service. For [this] reason, it is hard to infer conclusions on the effectiveness of competition within the market from satisfaction measures alone*";[68] and

- current consumers of pay TV services may express relative satisfaction with their service because they cannot conceive of the alternatives which would be available in a more competitive market. As Ofcom observes: "*Evidence on consumer satisfaction levels is often hard to interpret … as it is difficult to establish benchmark levels of satisfaction*".[69]

10.4 The magnitude of the first issue highlighted above is very significant. Ofcom's Digital Progress Report for Q4 2007 confirms that only 46% of UK households subscribe to a pay TV service.[70] Thus, 54% of (i.e. 13.8 million) households do not subscribe to a pay TV service and thus are not satisfied with current pay TV offerings.

10.5 In light of these material deficiencies with the survey of consumer satisfaction levels, Ofcom must ensure that it does not have undue regard to it. Ofcom should also seek to conduct a corresponding survey of consumer satisfaction levels in respect of pay TV churners. Over the last 5 years, Sky's average number of

68 Paragraph 4.7 of the Consultation Document.
69 Paragraph 4.7 of the Consultation Document.
70 The Communications Market: Digital Progress Report, dated 27 March 2008. It should be noted that pay TV penetration of 46% in the UK is substantially below the pay TV penetration of 80% in the US, which is a much more competitive market.

satellite pay TV subscribers has been approximately 7 million. Over this period, its average churn rate has been approximately 12% (i.e. approximately 840,000 churned subscribers per annum). If this annual churn rate were cumulative (i.e. if there were no subscribers who churned, re-subscribed and then churned again), then over 4 million subscribers would have churned from Sky's satellite service in the last 5 years. This is a very significant number of dissatisfied customers to whom Ofcom has apparently had no regard.

10.6 In this context, a key question is whether consumers' choices of platforms and content could be greater in a more competitive market. Ofcom has observed that Sky's premium channels, which represent very attractive content for pay TV services and subscribers, are only fully available on the satellite platform and partially available on cable. Accordingly, in circumstances in which Sky's premium channels were made available at competitive rates on all platforms, consumer choice of the available combinations of platform/content would increase (not just in respect of premium channels but also basic channels and other services).

10.7 If Sky were to wholesale its premium channels to competing pay TV retailers on these other platforms, consumers would also gain substantial benefits as a result of the ensuing retail price competition. (This issue is considered further in paragraphs 10.17 *et seq* below.) In circumstances in which competing pay TV retailers on other platforms had access to this key pay TV content at economically viable prices, they would be incentivised to develop their platforms and pay TV offerings further. (This issue is considered further in paragraph 10.10 *et seq* below.)

10.8 Consumers would also benefit in terms of platform/content choice if there were greater competition upstream. Setanta is the only broadcaster of premium pay TV services other than Sky. Yet, for the reasons explained in sections 2 and 3 above, the competitive pressure which Setanta is able to exert on Sky is limited. In addition, for the reasons explained in sections 6, 7 and 8 above, there are significant barriers to entry upstream. Hence, there are limited opportunities for Setanta to obtain additional content and thereby increase the competitive pressure which it exerts on Sky. If these upstream barriers were to be reduced (or indeed eliminated), consumers would benefit from increased choice and competition.

10.9 It is clear, therefore, that with regard to the criterion of choice of platforms and content, consumers could be much better served in a more competitive pay TV market.

***Innovation in platform services***

10.10 In the context of innovation in platform services, Ofcom observes that TV viewers have been able to take advantage of a number of innovations including DVRs, HD services, increasing availability of VOD and increasing levels of interactivity. Ofcom concludes that:

"*On this basis, innovation in this market to date appears to offer strong benefits for consumers*".[71]

10.11 This assessment appears to be rather superficial. For example, for the reasons explained in the Joint Submission of 3 July 2007, Sky has been able to inhibit the launch of HD services by competing pay TV platforms and competing broadcasters. Similarly, Sky has been able to inhibit the supply of content which competing pay TV retailers could offer on a VOD basis. Consumers would undoubtedly benefit more if HD and VOD services were more widely available.

10.12 In practice, the "*innovations*" which Ofcom cites in the Consultation Document have been imported from other territories. DVRs, for example, were introduced in the US several years before their introduction in the UK, as were HD services.

10.13 One innovation in the UK, which is a world first, has not been expressly mentioned by Ofcom. TUTV's launch of a DVR based SVOD service makes very efficient use of the scarce resource of DTT capacity. By downloading this SVOD service to its customers' DVRs using overnight DTT capacity, TUTV employs spectrum which previously had a limited utility and thereby substantially increases consumer choice.

10.14 The ability for Sky's competitors to engage in such innovation is, however, limited due to Sky's control of mutually reinforcing upstream and downstream bottlenecks. Sky's control of these bottlenecks limits its competitors' access to key content which could form the basis of further innovative services.

10.15 Section 11 below considers Sky's financial strength and specifies a number of comparative analyses which Ofcom should undertake. These demonstrate that, on many measures, Sky is substantially more profitable than comparator companies. In practice, Sky's profitability exceeds the aggregate profitability from pay TV activities in the UK of all its competitors. This exceptional imbalance (there is no other industry in the UK which is dominated by one company to such a degree) ensures that Sky's competitors have limited capability to innovate in respect of pay TV in the UK.

10.16 In a more competitive market, it is clear that further innovations would result – for example, greater availability of HD services on platforms other than satellite and the development of an increased range of on-demand services by Sky's competitors.

***Pay TV services prices competitively and efficiently***

10.17 With regard to the pricing of pay TV services, Ofcom notes that the average revenue per pay TV subscriber in the UK is higher than in other European

---

[71] Paragraph 4.28 of the Consultation Document.

countries. Nevertheless, Ofcom proposes a cautious approach to this issue due to perceived difficulties with cross-country comparisons.[72]

10.18 The Joint Submission by BT, Setanta, TUTV and Virgin Media of 3 July 2007 included econometric analysis by LECG which sought to address these difficulties. Ofcom put certain concerns to LECG in respect of this analysis. Ofcom also put this analysis to Sky which argued, in its Submission of October 2007, that the analysis could not be relied upon to draw any conclusions about consumer detriment.[73]

10.19 In the Joint Response to Sky's Submission, which was made by BT, Setanta, TUTV and Virgin Media on 29 February 2008, the Parties included a further paper by LECG which responded to Sky's criticisms of its econometric analysis. This further paper shows that Sky's criticisms have no material impact on the conclusions of the econometric analysis. LECG has, therefore, been able to demonstrate that average pay TV prices in the UK are significantly above average pay TV prices in 14 other European countries even when differences in content quality and income per capita are taken into account. LECG has also demonstrated that these price differentials can be substantially explained by differences in market structure.

10.20 Notwithstanding Ofcom's cautious approach to cross-country comparisons, it is clear that UK consumers are paying relatively high prices for pay TV services. If there were to be greater competition in pay TV in the UK, consumers would benefit not only from greater choice and increased innovation as described above but also from lower retail prices.

10.21 For example, Setanta's entry as a mainstream premium pay TV sports broadcaster was as a result of the European Commission's intervention in respect of the FAPL. That intervention has enabled Setanta to offer a premium sports pay TV service (including live coverage of FAPL matches) in the UK at the price of £10 per subscriber per month, which is far lower than Sky's prevailing price prior to Setanta's entry. Following Setanta's entry, Sky has started to market the availability on satellite of a package containing Sky Sports 1 together with one mix of basic channels at a price of £26 per subscriber per month whereas, prior to Setanta's entry, the cheapest price which Sky actively marketed for a package containing its premium sports pay TV channels was £35 per subscriber per month (for a package containing all the Sky Sports channels and two mixes of basic channels).

10.22 In a market in which Sky's retail competitors could obtain wholesale supply of Sky's premium channels at economically viable rates and in a market in which the barriers to entry upstream for broadcasters such as Setanta were to be reduced (or

72 Paragraph 4.41 of the Consultation Document.
73 Paragraph 4.47 of the Consultation Document.

indeed eliminated), consumers would undoubtedly benefit from increased retail price competition.

***Conclusion on consumer benefits/harm***

10.23 For the reasons outlined above, Ofcom must take a dynamic view of the consumer experience of pay TV. If there were to be greater competition in pay TV in the UK, consumers would enjoy increased choice of platforms and content, third party pay TV operators would be able to undertake more innovation and pay TV prices would come down as a result of retail price competition.

10.24 In the circumstances, it is clear that consumers are suffering as a result of the lack of effective competition in pay TV in the UK.

## 11. Sky's financial position

11.1 In the Consultation Document Ofcom undertakes a somewhat cursory assessment of profitability and investment returns in respect of Sky.[74] In this context, Ofcom states that:

> "*… our initial analysis has not found conclusive evidence of excessive profits being earned by Sky*".[75]

11.2 In undertaking this initial analysis, Ofcom apparently rejected accounting based measures of profitability commonly used in competition cases such as IRR.[76] Instead, Ofcom employed two market-based indicators (i.e. indicators which reflect the company's publicly listed share price) in a bid to assess whether Sky is earning excessive profits. The indicators used by Ofcom are:

- Sky's total shareholder return;[77] and
- a comparison of the enterprise value implied by the market for Sky (being market capitalisation plus debt financing) with the value of Sky's assets (i.e. "Tobin's q").[78]

11.3 Setanta and TUTV briefly comment below on Ofcom's two assessments of Sky's financial position and then consider the more standard assessment of IRR and other measures of profitability to which Ofcom should have regard.

---

74 Paragraphs 4.49 to 4.75 and Annex 12 to the Consultation Document.
75 Paragraph 4.74 of the Consultation Document.
76 See paragraph 1.25 of Oxera's paper entitled "*Assessing profitability in competition policy analysis*", published by the OFT in July 2003.
77 Paragraph 4.53 of the Consultation Document.
78 Paragraph 4.54 of the Consultation Document.

***Total shareholder return ("TSR")***

11.4 Ofcom's TSR assessment for Sky represents the ratio between, on the one hand, the appreciation in Sky's share price since its flotation together with its dividend payments (the "*numerator*") and, on the other hand, Sky's share price on flotation (the "*denominator*").[79] In practice, both the "*numerator"* and the "*denominator"* of this ratio are affected by factors which are external to the performance of Sky's business.

11.5 The "*denominator*" in this ratio is contingent upon market perceptions at the time of that flotation, which will have been based on expectations of how the company would perform in the future. Following the merger between Sky and British Satellite Broadcasting in 1990 and the consolidation of the merged pay TV businesses, expectations at the time of the flotation in 1994 would have been high. Indeed, Ofcom observes that:

> "*… Sky's implied market value upon flotation was higher than the sum of investment required to fund the business up to that point*".[80]

11.6 This high market value upon flotation reflected the strength of Sky's market position at that time. During a previous investigation the OFT assessed Sky's financial strength as at June 1995 (i.e. shortly after the flotation date) and noted that it:

> "*… was possible to conclude with reasonable degree of confidence that there was evidence of supra-normal profitability consistent with the existence of barriers to entry to the UK pay TV market*".[81]

11.7 Ofcom's TSR assessment does not, therefore, measure Sky's financial strength or market position but rather how the company has performed against the expectations for the company and the assessment of its market position at the time of its flotation. As those expectations were high at the time of Sky's flotation, by definition this TSR assessment will most likely understate both Sky's current financial strength and its market position. [82]

11.8 Turning to the "*numerator*" of the TSR ratio, changes in Sky's share price since its flotation are a function of not only the performance of the business but also the assessment of any likely bidders and the approach which the company adopts

---

79 Thus, this seems to be an assessment of the IRR earned by Sky's shareholders rather than the IRR earned by Sky. Clearly the former is dependent on the price at which shareholders invest.

80 Paragraph 4.62 of the Consultation Document. In fact, Ofcom notes that such a high implied market value "*is not in and of itself evidence that shareholders were anticipating future super-normal returns*". Nevertheless, it is clear that there was a high implied market value upon flotation.

81 Paragraph 7.13 of the OFT's Review of Sky, December 1996.

82 Thus, the use of TSR to assess whether excess returns are being made will not address the fact that supra-normal returns expected in 1994 as a result of Sky's market position will have been capitalised in Sky's share price at flotation.

towards its own strategy and hence share price. Both of these latter points are substantially affected by the fact that Sky is controlled by News Corp. through its near 40% shareholding.

11.9 This control by News Corp. removes the potential for any bid premium. It also means that, in practice, Sky's management should be less concerned with its share price and short term profits and more concerned with its long term market position and its position within the News Corp. group.[83] Accordingly, given Sky's particular circumstances, the numerator in this ratio, and hence Sky's TSR, will be depressed and will not, therefore, reflect its true financial strength and market position.

11.10 In addition, TSR does not allow for the disaggregation of Sky's various business elements (such as telephony and broadband) and therefore the returns and market valuation calculations are not good measures of Sky's pay TV business.[84]

11.11 In summary, TSR is not a credible measure of Sky's financial strength and market position in the context of Ofcom's current pay TV investigation. Indeed, the Competition Commission has previously indicated that:

> "*… measures of total shareholder return which incorporate movements in stock market values are unlikely to be sufficiently robust for our purposes*".[85]

***Tobin's q***

11.12 Ofcom's initial assessment of the ratio of Sky's enterprise value to its asset value discloses a very highly profitable company (i.e. a ratio of 7:1), whereas in a competitive market it would be expected that enterprise value would be in line with asset value (i.e. the ratio would be 1:1).[86]

11.13 The enterprise value in such a ratio will, however, depend upon both the stage at which the business is in the investment cycle and the market outlook at the time. As a consequence, this measure can be volatile. Indeed, Ofcom acknowledges as much.[87]

11.14 Ofcom also notes that the book value of Sky's assets may tend to understate their economic value when expenses are written off in a single period for accounting

---

83 For example, Sky has in the past invested in the growth of its subscriber base at the expense of dividend payments. It is certainly arguable that Sky's dividend payments are influenced by the cash needs of the News Corp group and the tax impact of such dividend payments.

84 This is, of course, an inherent shortcoming of any approach based on Sky's overall market value (which would include Tobin's q as well as TSR).

85 Paragraph 2.418(c) of volume 1 (Conclusions) of the Competition Commission's report of 2002 on "*The supply of banking services by clearing banks to small and medium-sized enterprises*".

86 Paragraph 4.63 of the Consultation Document.

87 Paragraph 4.64 and figure 31 of the Consultation Document. More generally, disequilibrium effects can be significant, with Tobin originally envisaging q as an economy-wide measure.

purposes whilst the economic value of such expenditure may extend beyond that period.[88] As a consequence, Ofcom observes that the unadjusted book value of Sky's assets may understate the enduring value of its marketing expenditure and the value of its subscriber base.

11.15 Ofcom then states that:

> "*An attempt to capture some estimate of this value can be made by **capitalising all marketing expenditure** undertaken by Sky during the period*".[89] (Emphasis added.)

11.16 This is, however, a rather unrefined and sweeping response to this issue and will substantially overstate the modern equivalent value (or depreciated replacement cost) of Sky's asset base. Sky's marketing expenditure can be viewed as, among other things, having several broad objectives including (i) brand building, (ii) maintaining the existing subscriber base (i.e. replacing churn) and (iii) investing in growth. It is not clear why Ofcom should treat all these components in the same way and capitalise all such expenditure. In practice, when valuing the business at a particular point in time, the SAC of maintaining the subscriber base (e.g. replacing churned subscribers) should be regarded as a cost of the business operations whereas the SAC of growing the subscriber base could be regarded as a capital cost or investment which will produce increased returns in the future.[90] Similarly, whilst marketing expenditure on brand building may involve an element that can be capitalised, the benefits of brand building may be short lived. Furthermore, there is a relatively sophisticated calculation which should be undertaken in order to establish brand value – this does not simply entail the assumption that £100 million spent on brand marketing adds £100 million to the balance sheet.

11.17 In addition, Ofcom adds that

> "*In an attempt to bring the value of this expenditure into current terms, the value of this spend is inflated by 3% for each year between the year of account in which the expense was recorded and 2007. This assumption appears relatively generous given that the replacement cost of set top boxes has fallen significantly over this period, notwithstanding that the cost of other forms of marketing may have risen*".[91]

11.18 This is another questionable assumption which also inflates Sky's asset base. Equipment costs have fallen and all assets should be valued on the basis of their depreciated replacement cost.

---

88 Paragraph 4.65 of the Consultation Document.

89 Paragraph 4.67 of the Consultation Document.

90 An analogy is a manufacturer which might capitalise a new piece of machinery that improves its output whereas expenditure on maintaining existing machinery (e.g. replacing worn out parts) would certainly not be capitalised.

91 Paragraph 4.10 of Appendix 12 to the Consultation Document.

11.19 Furthermore, Ofcom adds that:

> "*In principle, Ofcom believes that such capitalised expenditures should be amortised over time, reflecting the likelihood that such investments are unlikely to provide benefits into perpetuity. However, for the purposes of this analysis, Ofcom has not amortised the value of these expenditures and as such considers that the results presented represent an upper bound estimate of the significance of these intangibles in relation to the comparison between asset value and enterprise value*".[92]

11.20 Consumer recollection of advertising expenditure depreciates rapidly over time, and indeed the nature of what is being marketed changes (e.g. due to changes in channel and service offerings). In addition, a proportion of new subscribers will also be progressively lost over time. Accordingly, any capitalised marketing expenditures should be depreciated over relatively short time periods, which would reduce the impact of capitalising such expenditures on estimates of the modern equivalent value of Sky's asset base.

11.21 Having made these subjective and unrefined adjustments to the book value of Sky's assets, Ofcom concludes that:

> "*Although with a ratio of 1.7:1, Sky's market valuation still exceeds the asset valuation by a significant amount, this also appears to be true for a significant number of other companies*".[93]

11.22 Yet, from Annex 12 to the Consultation Document, it appears that, when undertaking a comparison with other companies in the FTSE 100, Ofcom has not sought to adjust its assessment of Tobin's q for the other companies in the same way that it has adjusted its assessment for Sky, even though Ofcom acknowledges it is likely that the unadjusted market to book value ratio will be overstated for the majority of FTSE 100 companies.[94]

11.23 Furthermore, where market indicators are used to assess the financial strength and/or market position of a company, they should be benchmarked against comparable companies. It is not clear, however, why Ofcom seeks to compare Sky to other FTSE 100 companies.[95] It would be more appropriate for Ofcom to seek to compare Sky to other major pay TV companies, as Setanta and TUTV have done in the assessments below.

11.24 In summary, therefore, Ofcom's assessment of Tobin's q for Sky employs a volatile measure which is then adjusted in a subjective and unrefined way and compared against non-comparable companies whose Tobin's q have not been

---

92 Paragraph 4.11 of Annex 12 to the Consultation Document.

93 Paragraph 4.14 of the Consultation Document.

94 Paragraph 4.6 of Annex 12.

95 Paragraph 7.36 of Oxera's paper. As Oxera's paper for the OFT notes, the benchmark companies should have considerable similarity with the company under investigation.

similarly adjusted. Despite all this, Ofcom concludes that Sky's market valuation still exceeds its asset valuation by a significant amount.

***IRR***

11.25 As noted above, in the Consultation Document Ofcom apparently rejected the more standard assessment of IRR as a profitability measure for use in competition cases. Ofcom's reasoning seems to have been that:

> "*Accounting based profitability measures can be a poor estimator of economic profit due to accounting distortions and, in the case of comparator analysis, differing accounting treatments*".[96]

11.26 Yet, in contrast with this view, the OFT has published an economic discussion paper prepared by Oxera entitled "*Assessing profitability in competition policy analysis*".[97] This paper confirms that:

> "*… the truncated IRR methodology is particularly suitable for competition investigations where the objective is to assess past performance, and for which reliable data on cash flows and asset values is available over a sufficiently long time period*".[98]

11.27 As a consequence, Setanta and TUTV have attempted to use Oxera's truncated methodology to assess Sky's IRR. The period taken for this IRR assessment is for the financial years from 2003 to 2007 – i.e. the period following the demise of ITV Digital and cable's well publicised financial difficulties. This is a particularly pertinent period in the context of Ofcom's market investigation which is seeking to assess, among other things, the existence of features of the market which prevent, restrict and distort competition and Sky's current market position.

11.28 This IRR assessment involves the following components:

- The initial investment in Sky at the start of this period has been calculated by reference to its balance sheet in 2003 plus the cost of acquiring Sky's then current subscriber base; i.e. the number of subscribers at the beginning of 2003 multiplied by the SAC in 2003, (which is calculated as marketing cost/gross subscriber additions and alternatively is derived from figures quoted in Sky's Annual Report).

- The value at the end of this period is calculated in a similar fashion by reference to Sky's balance sheet for 2007 plus the cost of replacing the 2007 subscriber base (i.e. 2007 subscriber numbers multiplied by the 2007 SAC – calculated in the two ways described above).

---

96 Paragraph 4.52 of the Consultation Document.

97 Economic Discussion Paper 6, dated July 2003 (OFT 657).

98 Paragraph 1.8 of Oxera's paper.

- The returns over the intervening period are taken as the operating cash flow less any elements which are clearly not relevant to the analysis of Sky's UK pay TV business (i.e. Sky's minority stake in KirchPay TV, 100% of Sports Internet Group and 100% of Easynet Group Plc have not been taken into account in this analysis since they are non-core acquisitions from the perspective of assessing the degree of investment in Sky's UK pay TV services and the returns generated from that investment.) In addition, the costs of servicing the finance required to fund the investment programme have been excluded as the objective has been to assess the underlying returns profile irrespective of capital structure.

11.29 In practice, calculating the cost of acquiring Sky's subscriber base by multiplying subscriber numbers by SAC effectively adds the relevant year's marketing costs to Sky's asset base and assumes no depreciation, contrary to the comments made above. Nevertheless, it is consistent with Ofcom's comments in the Consultation Document that:

> "*… Sky's subscriber base might be thought of as an "asset" which is not reflected on its balance sheet but which is likely to be seen as a key source of value by its shareholders. … in a competitive market, it would be expected that the value of such an asset should be approximate [to] its cost*".[99]

11.30 When tax is imputed at 30% (i.e. tax losses carried forward from previous years are not used as these arise in respect of years outside the 2003/07 period), it can be seen that Sky has achieved an IRR of approximately 40%, (with either SAC figure – see paragraph 11.28 above). Such a high IRR is substantially in excess of Sky's cost of capital and is a clear indication of the strength of Sky's current market position.

[99] Paragraph 4.8 of Annex 12 to the Consultation Document.

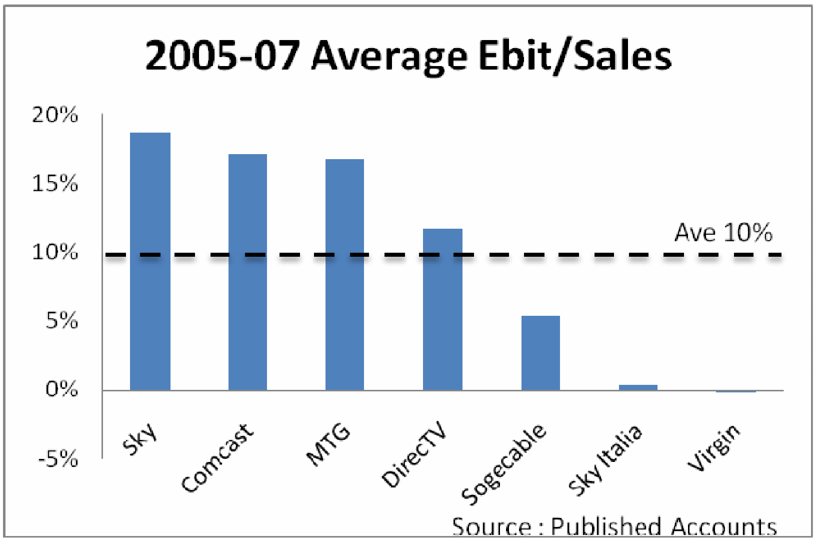
| Sky's IRR from 2003 to 2007<br>Subscriber Replacement cost = Marketing costs / Gross sub ads | | | | | | |
|---|---|---|---|---|---|---|
| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
| Opening/closing balance sheet £m | | -564 | | | | 173 |
| Replacement costs of opening subscriber base £m | | -1803 | | | | 4356 |
| Operating cashflow £m | | 369 | 570 | 765 | 859 | 905 |
| Less : Tax Payable @ 30% | | -111 | -171 | -230 | -258 | -272 |
| Cashflow for IRR calculation | | -2109 | 399 | 536 | 601 | 5163 |
| IRR post tax 2003-07 | | | | | | 40.2% |
| Marketing costs £m | | 401 | | | | 734 |
| Gross sub additions 000s | | 1355 | | | | 1446 |
| Subscriber Acquisition Cost (SAC) £ | | 296 | | | | 508 |
| Total no. subs 000s - EOP | 6101 | 6845 | 7355 | 7787 | 8176 | 8582 |

| Sky's IRR from 2003 to 2007<br>Subscriber Replacement cost = Subscriber Acquisition Cost (as per Annual Report) | | | | | | |
|---|---|---|---|---|---|---|
| | | 2003 | 2004 | 2005 | 2006 | 2007 |
| Opening/closing balance sheet £m | | -564 | | | | 173 |
| Replacement costs of opening subscriber base £m | | -1263 | | | | 2154 |
| Operating cashflow £m | | 368.7 | 570 | 765 | 859 | 905 |
| Less : Tax Payable @ 30% | | -111 | -171 | -230 | -258 | -272 |
| Cashflow for IRR calculation | | -1569 | 399 | 536 | 601 | 2961 |
| IRR post tax 2003-07 | | | | | | 39.4% |
| Subscriber Acquisition Cost (SAC) £ (as per annual report) | | 207 | | | | 251 |
| Total no. subs 000s - EOP | 6101 | 6845 | 7355 | 7787 | 8176 | 8582 |

11.31 Oxera recommends not only the use of a truncated IRR methodology but also reference to other measures such as return on sales and gross margin, with these being benchmarked against suitable comparable companies. In order, therefore, to supplement the above assessment of Sky's IRR, Setanta and TUTV have referred to four additional measures of profitability which are commonly employed. Whilst there may be strengths and weaknesses to each of these measures, the overall conclusion is compelling: Sky is extremely profitable as a result of its exceptionally strong market position. Each of these additional measures of profitability is considered in turn below.

*Operating margin*

11.32 Operating margin (i.e. average Ebit/sale) is a widespread measure of profitability. Setanta and TUTV have assessed this for Sky and six comparable pay TV companies for the financial years 2005 to 2007. The results are as follows:

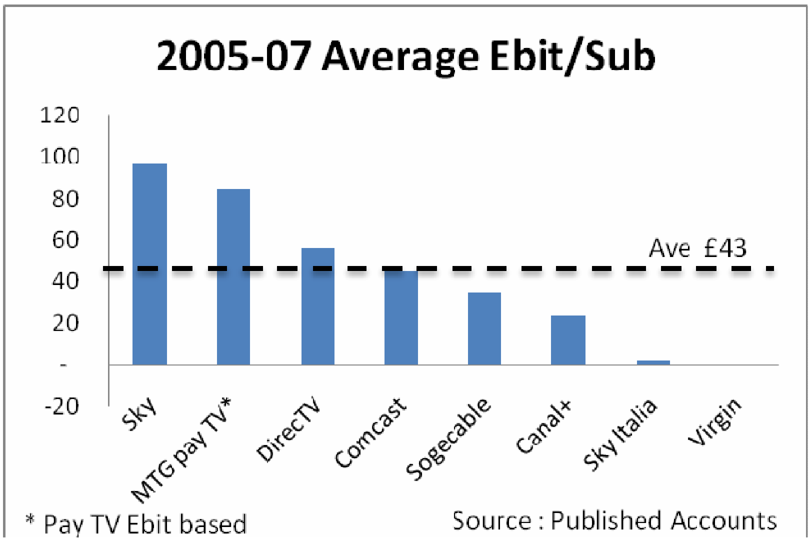



11.33 As can be seen, Sky's operating margin is the highest of this group and double that of the average. Furthermore, Setanta and TUTV understand that Sky has given guidance to the City that this operating margin will increase to between 25% and 30%.

*Profitability per subscriber*

11.34 Profitability per subscriber (i.e. average Ebit/sub) is another common measure of profitability. Setanta and TUTV have, again, assessed this measure for Sky and seven comparable companies for the financial years from 2005 to 2007. [100]

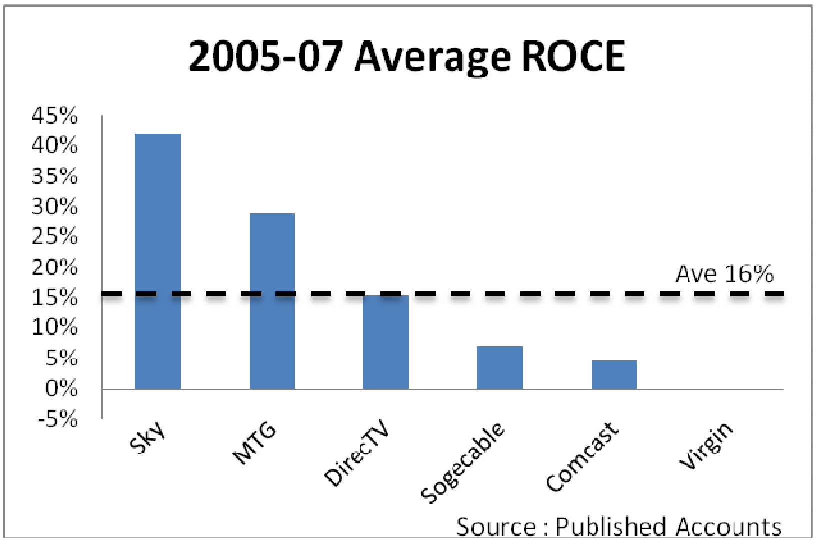
100 Canal + has been included in the assessment of profitability per subscriber but not operating margin due to a lack of availability of certain data in respect of Canal +.




11.35 As can be seen, Sky's profitability per subscriber is more than double the average of the group.

***Return on capital employed ("ROCE")***

11.36 Setanta and TUTV have assessed the return on capital employed for Sky and five comparable companies for the financial years from 2005 to 2007. In this context, ROCE is defined as pre-tax Ebit as a percentage of total capital employed.[101]

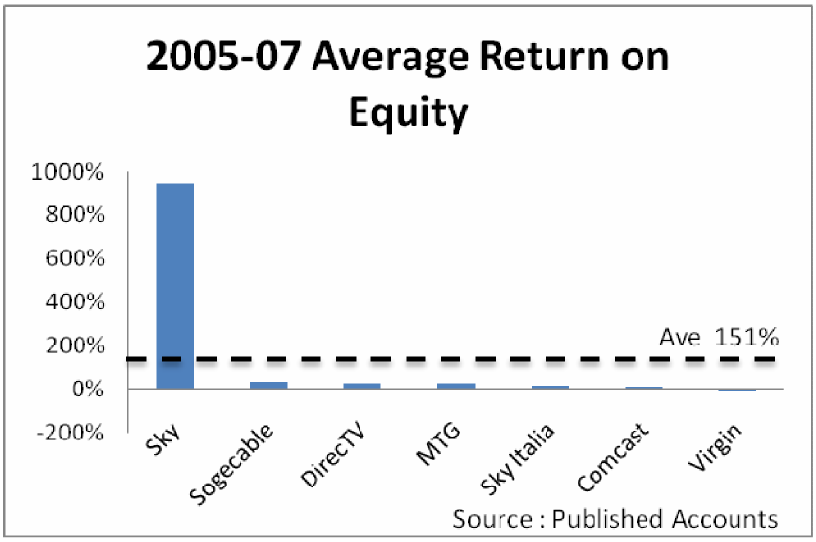



101 Sky Italia and Canal + have not been included in this assessment of ROCE due to the lack of availability of certain data for each of them.

11.37 Yet again, Sky is by far the highest performer on this measure. Indeed, Sky's ROCE over this period is in excess of 40% and is substantially higher than its cost of capital.

***Return on equity ("ROE")***

11.38 Setanta and TUTV have assessed the average return on equity for Sky and six competitors for the financial years from 2005 to 2007. In this context, ROE is defined as pre-tax Ebit as a percentage of invested equity capital.




11.39 As Sky has a comparatively small equity base, its return on equity is many multiples of the return of each of the other comparator companies.

***Conclusion on Sky's financial strength***

11.40 From this brief review, it is clear that Ofcom's assessment in its Consultation Document of Sky's financial strength is somewhat cursory and insufficient for the purpose.

11.41 TSR is not an appropriate measure for assessing a company's financial strength and/or market position in the context of a competition inquiry.

11.42 The assessment of Tobin's q which Ofcom has undertaken employs a volatile measure which is then adjusted in a subjective and unrefined way and compared against non-comparable companies whose Tobin's q have not been similarly adjusted.

11.43 The OFT advocates the use of IRR as a profitability measure in competition cases. The OFT's own discussion paper outlines the method to be adopted for a truncated IRR. Adopting this method identifies an IRR for Sky of approximately 40% in the period from 2003 to 2007 which confirms the strength of Sky's current market position.

11.44 Sky's operating margin, profitabiltiy per subscriber, ROCE and ROE are also all substantially higher than those of comparable companies. Furthermore, Sky's ROCE is substantially higher than its cost of capital.

11.45 Thus, a more appropriate assessment of Sky's financial positon (than Ofcom has conducted to date) confirms that Sky is extremely profitable as a result of its exceptionally strong market position.

## 12. Picnic

12.1 In its summary of possible concerns in the Consultation Document, Ofcom states that:

> "*Bundling efficiencies mean that platforms may be prone to "tipping" towards one retailer, particularly where one retailer on a platform has exclusive control over a core of premium content. In such circumstances consumers are likely to be particularly dependent on the existence of effective competition between vertically integrated platform operators/retailers. This is likely in turn to depend on whether retailers on different platforms are able to gain access to premium content*".[102]

12.2 This is particularly pertinent in light of Sky's proposal to launch pay TV services on DTT which include the premium channels that it has denied to competing pay TV retailers on that platform. Through the launch of Picnic, Sky would be able to eliminate competing pay TV retailers on DTT and thus eliminate the inter-platform pay TV competition between DTT and satellite on which, as Ofcom acknowledges, consumers are particularly dependent.

12.3 Ofcom should, however, note that, for the reasons set out in Setanta and TUTV's Joint Submission of December 2007, a mere requirement on Sky to wholesale its premium channels to competing distributors on DTT will not prevent the elimination of these competitors if Sky is, itself, authorised to retail pay TV services on DTT.

12.4 Furthermore, the elimination of such competitors will entrench Sky's bidding advantages, which are described in section 6 above and increase the barriers to entry in pay TV which are described in section 8 above.

12.5 In the circumstances, and particularly in light of its statutory duty to further the interests of consumers where appropriate by promoting competition, Ofcom must adopt a prophylactic approach to Picnic. At the very least, Ofcom must not authorise Sky to become a pay TV retailer on DTT while the market investigation, and in particular Ofcom's investigation of the issues described above, remains

---

102 Paragraph 6.76 of the Consultation Document.

ongoing and while the competition concerns identified in the market investigation remain unresolved.[103]

## 13. Conclusion

13.1 In conclusion, Setanta and TUTV reiterate that they substantially agree with the analysis undertaken and conclusions reached by Ofcom in its Consultation Document on the pay TV market investigation.

13.2 Ofcom's analysis confirms that:

- there are separate markets for premium sports channels at both the wholesale and retail levels and Sky is dominant in both of them;
- pay TV in the UK exhibits distinctive features which contribute to the lack of effective competition;
- there are significant barriers to entry into the market for premium sports channels;
- Sky has bidding advantages due to, among other things, its leading position in pay TV retailing; and
- having acquired key content, Sky has both the incentive and the ability to withhold it from competing pay TV retailers.

13.3 These features give rise to the vicious circle in pay TV which is at the heart of Ofcom's current investigation and Ofcom has acknowledged the existence of all of these features in its Consultation Document. The existence of these features results in consumer harm through restricted choice, reduced innovation and higher prices.

13.4 In the event that appropriate undertakings are not offered and accepted to address the market failure in pay TV, Ofcom should exercise its discretion under section 131 of the Enterprise Act to refer the UK pay TV industry to the Competition Commission for a full market investigation.

---

103 These are the competition concerns Ofcom has identified to date (paragraph 6.77 of the Consultation Document) and the competition concerns identified in the Joint Submission of 3 July 2007.

# Annex 1

**Bidding advantages from immediate monetisation of rights**

1. In its submission to Ofcom of October 2007, Sky asserts that:

> "*An argument that Sky's retail presence increases its ability to make a return on the cost of rights more quickly and efficiently than actual or potential competitors is … defective*".[104]

2. Sky considers two possible means of exploitation of additional content:

   (a) the inclusion of that content on existing channels; and

   (b) the creation of new channels containing that content.

3. With regard to (a), Sky concedes that such an activity can take place but asserts that:

> "*The subscribers who receive that programming are subscribers to that channel across all retailers not just the subscribers to the channel via an integrated downstream business.*"[105]

Sky then concludes that:

> "*… this argument has nothing to do with vertical integration and therefore contributes nothing to the vicious circle allegation*".[106]

4. Sky does not, however, attempt to deny that it has such a bidding advantage – i.e. Sky does not deny that it can include the content immediately on existing pay TV channels and thereby monetise the content more quickly than a new entrant. In this context, Ofcom should note that the inclusion of the content in an existing channel does not mean that Sky is earning no incremental revenue from existing subscribers who receive that content. In the case of the FAPL, for example, Sky was awarded live rights in May 2006 for the 2007/08 and subsequent seasons. Having won these rights, Sky implemented retail price increases for its channels on 1 September 2007 (approximately two weeks after it started to exploit these rights), thereby earning incremental revenue from its existing subscribers in respect of channels on which it exploited these rights.

5. With regard to (b) above, Sky states that the inclusion of content on new channels does not enable Sky immediately to monetise the investment in additional content.[107] In this context, it gives an example in which:

---

104 Paragraph 4.9 of Part C of Sky's Response.
105 Paragraph 4.11 of Part C of Sky's Response.
106 Paragraph 4.14 of Part C of Sky's Response.
107 See paragraph 4.15 of Part C of Sky's Response.

> "*Sky purchases a set of cricket rights with the objective of starting a dedicated cricket channel which it intends to offer to subscribers for an incremental charge. In these circumstances, Sky would not be able automatically to recover the incremental charge from all of its existing sports subscribers by adding the service to their subscription entitlement*".[108]

6. As a vertically integrated broadcaster/pay TV retailer, however, Sky could seek to include this content on a new channel which it bundled with existing channels and increase the price of those bundles. This would enable Sky immediately to monetise the investment in the additional content from its existing subscriber base.

7. It is clear, therefore, that contrary to Sky's claim,[109] Sky is immediately able to realise additional subscription revenue by packaging and pricing its channels in the manner described above. Thus, Sky's retail presence does increase its ability to make a return on its acquisition of rights more quickly than actual or potential competitors for those rights.

8. Whilst it is true that, were Sky's retail business to be separated from its broadcasting business, the broadcasting business would still benefit from bidding advantages, Sky's incentives are changed as a consequence of the fact that it is vertically integrated. When Sky is considering whether to retail a third party channel to its own subscriber base and/or the terms on which to grant such a third party channel access to its platform, it will take into account the effect of doing so on upstream competition in bidding for rights. Thus, Sky will avoid taking action downstream which undermines the bidding advantages enjoyed by its broadcasting business. There would be no such incentive for a non-vertically integrated retail distribution business or platform operation business to seek to protect the upstream bidding advantage of the broadcasting business from which it sources content.

---

[108] Paragraph 4.16 of Part C of Sky's Response.
[109] See paragraph 4.18 of Part C of Sky's Response.

# Annex 2

**Access to satellite subscribers by third party broadcasters**

1. With regard to the issue of access by third party broadcasters to Sky's existing satellite subscriber base, in its submission to Ofcom of October 2007, Sky puts forward two ways in which a new entrant would be able to reach existing satellite subscribers (allegedly reflecting the "*open nature of the satellite platform*" [110]):

   (a) by entering into a wholesale arrangement with Sky;[111] and

   (b) by directly retailing that content to satellite households.[112]

2. In respect of (a) above, Sky asserts that it:

   > "*… has* ***every incentive*** *to enter into wholesale arrangements to supplement its retail offering by adding attractive content*".[113] (Emphasis added.)

   Yet, Sky subsequently claims that:

   > "*…third party retailers do not have the same incentives as Sky to market Sky's channels*".[114]

3. Thus it appears that, by its own admission, Sky has overstated its incentives to distribute third party channels. In practice, an entrant that acquires key content, such as attractive sports rights, would not wish to rely upon its principal competitor to retail its content on a pay TV basis over the largest pay TV platform in the UK. This is because its competitor would clearly have a greater incentive to promote and sell its own channels rather than those of the new entrant.

4. With regard to paragraph (b) above, Sky takes no account of the time it would take for a third party to build up a base of satellite subscribers by encouraging existing satellite subscribers to take their new channel either in addition to or in substitution for their existing pay TV channels.

5. Sky asserts that its:

   > "*…success at the retail level in developing a large scale subscriber base, together with open access regulation, facilitates rather than forecloses entry upstream*".[115]

---

110 Paragraph 4.20 of Part C of Sky's Response.

111 Paragraph 4.20(a) of Part C of Sky's Response. A wholesale arrangement with Sky clearly has nothing to do with the "*open nature of the satellite platform*".

112 Paragraph 4.20(b) of Part C of Sky's Response.

113 Paragraph 4.20(a) of Part C of Sky's Response.

114 Paragraph 4.17(b) of Part D of Sky's Response.

6. Again, this assertion overlooks the time it would take for a new entrant to persuade some of Sky's "*large scale subscriber base*" to subscribe to the new entrant's channels. This factor is particularly significant given that rights to key content, such as the live rights for the FAPL, are often sold for short terms of no more than three years. Sky faces no such delay in acquiring these subscribers and thereby monetising the content that it acquires.

7. In the circumstances, it is clear that Sky has mischaracterised the Joint Submission and has, in practice, not denied the fact that, even though a new entrant may be able to gain access to Sky's satellite subscribers, the time it would take to build up its own subscriber base on satellite places such a new entrant at a significant disadvantage when bidding against Sky for content.

8. In conclusion, as Ofcom noted in its Consultation Document, there is a:

> "*… first-mover advantage conferred on the incumbent by its existing subscriber base. Switching barriers … mean that a potential new entrant without that existing base would have to bid for content in the knowledge that a proportion of the incumbent's retail customers would not switch to the new entrant's offer to follow that content. This may restrict the new entrant's ability to match the incumbent's bid for the content*". [116]

---

[115] Paragraph 4.21 of Part C of Sky's Response.

[116] Paragraph 6.18 of Ofcom's Consultation Document.