ANNEX 3

BARRIERS TO ENTRY AT THE CHANNEL PROVIDER LEVEL

1. Introduction

1.1 Ofcom puts forward the proposition there are insurmountable barriers to entry to markets for premium sports and premium film channels that it has defined, principally because other operators cannot compete with Sky for the rights which comprise key inputs in relation to operating in those markets. This argument is central to its conclusion that Sky is likely to be dominant in those "*markets*". Ofcom's arguments on barriers to entry, however: (a) are based on an unreasonable benchmark for entry; (b) are not balanced – they focus only on a set of potential impediments to entry and do not consider a large range of factors that facilitate entry; and (c) are based on theories that are both flawed and contradicted by readily available evidence. Accordingly, Sky considers that it is not possible to rely on the arguments that Ofcom has made in support of a proposition that Sky does not face effective competition for programming rights.

2. Ofcom's argument

2.1 Ofcom argues that there are significant barriers to entry to the wholesale markets for the supply of premium sports and premium film channels.[1] In relation to sports rights, Ofcom argues that these derive from Sky's "*incumbency advantages*",[2] or 'first-mover advantages' as we might also call them, in bidding for rights when they become available. Ofcom argues further that because rights become available periodically, a potential entrant must repeatedly outbid Sky for rights, over a potentially significant period of time, and is likely to incur losses during that period.[3]

2.2 In relation to film rights, Ofcom argues that Sky's contracts with the six major Hollywood studios amount to a significant barrier to entry. Ofcom notes that contracts with more than one studio may be required "*in order to construct a compelling film package*", and that the varying durations and expiry dates of these contracts make it difficult for an entrant to construct such a package.[4]

2.3 This argument is central to its conclusion that Sky "*is likely to be*" dominant in each of those putative markets. For example, in relation to premium sports channels, Ofcom states:

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[1] See Paragraph 5.48 in relation to premium sports channels and Paragraph 5.69 in relation to premium film channels. For the purposes of this Annex we assume that the relevant markets are as narrow as those defined by Ofcom.

[2] Paragraph 5.47 of Annex 13.

[3] Paragraph 1.57

[4] Paragraph 5.67 of Annex 13.

> "*Sky's very high and sustained market shares, together with the existence of high barriers to entry and limited countervailing buyer power, strongly suggest that Sky is likely to be dominant in the wholesaling of premium sports content.*"[5]

3. Ofcom has adopted an unreasonable benchmark for entry

3.1 Ofcom's implicit model of entry sets an unreasonable benchmark for what counts as "*entry*". Implicitly, Ofcom's benchmark is a very strong form of entry, namely the rapid and straightforward replication of Sky's sports or movie channels.[6]

3.2 Such a benchmark lacks perspective. Entry into a sector in which there is an established operator will never be simple, as Sky knows, having done this a number of times. It will involve investment, potentially on a large scale, and the bearing of risk. It is neither sensible nor realistic to argue that "*entry*" is feasible only if another operator can create a Sky Sports or Sky Movies equivalent quickly and easily.

3.3 Instead, the most likely form of entry is relatively gradual entry over time: winning rights periodically and building up the operator's channel offering (along with its subscriber base). It is, for example, also possible for operators first to develop basic channels, and then turn those channels into premium channels once a set of sufficiently attractive programming has been acquired.

3.4 The approach of building up channels gradually over time is the approach that both Sky and Setanta adopted, neither of which reached their current scale of operations overnight:

- Setanta initially launched with inexpensive rights to Irish sports, and gradually grew to handle more substantial rights (such as Scottish Premier League and overseas FAPL). It acquired financial backing and developed experience before bidding for, and winning, several major sports rights.
- Similarly, Sky Sports (originally The Sports Channel) initially aired sports such as rugby, golf, the Football League Trophy and overseas cricket, along with UK rights to overseas football leagues, and later acquired FAPL rights and expanded the number of channels broadcast after gradually increasing the scale of its operations.

3.5 There is no reason for Ofcom to discount this approach to entering the market when considering whether effective entry can take place.

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5 Paragraph 5.52 of Annex 13. A similar conclusion for the wholesale market for premium film channels is reached in Paragraph 5.69.

6 See, for example, Paragraph 1.57.

A. A range of entry strategies is available

3.6 There is also no reason to believe that services need to be as broad as those of Sky to establish themselves in the market. Experience from the US suggests that movie services based primarily on pay TV window rights from one or two 'major' studios can be a viable commercial model: for example, Showtime (which has contracts with Paramount and MGM[7]) and Starz (which has contracts with Walt Disney and Sony).

3.7 A view in which the only form of competition with a premium channel provider consists of the creation of new specialised premium pay TV channels is too narrow a concept of entry. It is evident from looking at pay TV in other countries that there is a wide variety of other methods of exploitation of *"premium content"* which could be imitated in the UK – most notably mixed-genre premium pay TV channels.

3.8 It is notable in this respect that both Showtime and Starz, referred to above, include other programming in their channels, as does HBO, which has contracts for movies with Dreamworks, Twentieth Century Fox, Universal and Warner Bros., and has also offered a variety of sports content, alongside its original drama and comedy series for which it is perhaps best known.

3.9 There is also a range of different consumer groups that could be targeted, particularly within sports. Sky Sports' strategy is to acquire a wide range of sporting content and to attract a large number of subscribers. This leaves an obvious opportunity for channels focusing on a specific sport or category of sports to target a smaller audience – a strategy pursued by the likes of Attheraces, Setanta Golf, MUTV, Chelsea TV and NASN. Indeed, this strategy was also pursued by Setanta prior to the acquisition of FAPL rights: it charged a relatively high price for content targeted at a relatively small audience. When it purchased FAPL rights, it switched towards a broader strategy and cut its price (despite significantly increasing its range of content) in order to reach a wide audience.

3.10 Again, there is no reason for Ofcom to entirely rule out the development of services that do not simply mimic Sky's business model as constituting market entry, as Ofcom's approach does.

B. Rapid entry is possible

3.11 Even focusing on rapid, large-scale entry as one of a range of possible forms of entry, in Sky's view Ofcom is wrong to dismiss such entry as a possibility on the basis that rights only become available periodically. In fact, significant groups of rights become available within relatively short periods, providing opportunities for potential entrants quickly to acquire broad sets of programming rights. For example:

- [**CONFIDENTIAL**]; and

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7 MGM is not traditionally viewed as one of the six 'major' studios.

- in relation to sports, in 2006 new contract periods commenced for a range of rights including the Champions League, the Football League, the Football League Cup, Primera Liga, Scottish and Irish home football internationals, international rugby union played in South Africa, Australia and New Zealand, European Rugby Cup, all domestic and international cricket in England and Wales, international cricket played in a range of different countries, and all British Speedway events.

3.12 The significant financial outlay that would be required to acquire large tranches of rights within a relatively short period of time means that potential entrants would themselves have to have access to relatively large amounts of funding (though, as most rights are paid for on an annual basis, the actual outlays should not be exaggerated). Such entities, however, abound – particularly given the rapid convergence between the worlds of broadcasting, telecommunications and the internet. Rapid entry on a large scale could clearly be accomplished by entities such as Disney/ESPN, BT, or Hollywood studios.

C. An entrant need not incur significant losses while it accumulates rights

3.13 There is no obvious reason why entrants should bear significant losses as they develop their businesses, as there is a range of strategies available to them which can be deployed to mitigate such entry costs – notably, as discussed above, by building up their channels incrementally over time.[8] In this respect, Ofcom appears to ignore the fact that the wholesale charge for a channel is likely to reflect the range and quality of the content it carries: a new channel with relatively limited content will achieve a low wholesale charge. Yet its costs will be similarly small.

3.14 Clearly, firms may choose different entry strategies, which may involve them incurring large losses in their start-up phase. However, this is not the only possibility, as Ofcom appears to believe. Moreover, the key issue in relation to barriers to entry is whether or not firms have a realistic expectation of recouping such early losses through profits at a later date. To expect entrants to make profits from day one of a new business is, clearly, entirely unrealistic.

4. Ofcom fails to consider a wide range of factors that facilitate entry

4.1 Ofcom's discussion of barriers to entry in its Consultation Document is one-sided. It considers only the difficulties of entry and not the features of the sector which facilitate entry. Consideration of such factors is needed in order to reach a balanced view on the threat that firms already operating in the putative markets defined by Ofcom face from potential entrants. In particular, Ofcom ignores the following factors:

(A) there is a wide range of potential entry strategies;

(B) challenging for rights is easy;

8 We discuss Ofcom's theory that losses will arise from entrants having to 'overpay' for rights in Section 5 below.

(C) the DTH platform is open;

(D) there are low switching costs for consumers;

(E) the periodic availability of rights lowers barriers to entry; and

(F) there is a wide range of potential entrants.

We discuss each of these in the sections below.

A. There is a wide range of potential entry strategies

4.2 As set out above, Ofcom's focus on the benchmark of full and rapid replication of Sky sports or film channels means that it ignores the wide variety of other forms of entry to the markets that it has defined that are possible. This very variety in ways in which other operators may seek to exploit rights means that potential entry is a significant competitive constraint.

B. Challenging for rights is easy

4.3 The costs associated with participating in tenders or negotiations for programming rights are small. Furthermore, rights are usually awarded some time in advance of the commencement of the relevant contract, giving potential acquirers time to acquire any additional inputs required[9] in order to exploit those rights if they are successful in acquiring them. Rights are often sold in advance of the commencement date of contracts for this very reason.

4.4 The ease of participating and the fact that rights are normally awarded in advance of commencement dates encourages prospective new entrants to compete for rights. For example, the last FAPL auction attracted a range of bidders without existing premium sports channels in the UK. Speculation as to the identity of bidders for live rights includes the BBC, ITV, Channel 4, five, Virgin Media, BT and ESPN/Disney.[10]

C. The DTH platform is open

4.5 The fact that the DTH platform is open[11] means that any entrant has the option to retail its channel directly to an addressable base of over 9 million households. This has two benefits:

(i) it assures the entrant of being able to reach a sizeable proportion of the UK population in the event that it is successful in acquiring rights; and

(ii) it gives the entrant a strong bargaining position if it wishes to negotiate a wholesale deal with Sky, or indeed any other retailer on the DTH platform.

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9 As noted below, in many cases little or no additional inputs are required.

10 Ofcom should also note that even the threat of a credible bidder entering a sale process will impact the price that an incumbent bids.

11 See **Section 5.E** below.

D. There are low switching costs for consumers

4.6 It is straightforward for consumers to 'follow the content' if rights to broadcast particular types of content move between different broadcasters.[12] The strong likelihood is that a broadcaster acquiring a particular set of content rights would seek to distribute the channel based on those rights on as many platforms as possible – whether via wholesale arrangements with existing retailers, or (where possible) by retailing the channel itself.[13] Accordingly consumers would be able to subscribe to a new entrant's channel without switching platforms. Given this, it is likely that the costs to consumers of taking up a subscription to the channel[14] will be negligible.

E. The periodic availability of rights lowers barriers to entry

4.7 Ofcom entirely overlooks the fact that periodic availability of rights in fact lowers barriers to entry in relation to entry strategies of an incremental nature – which is the most likely form of initial entry.[15]

4.8 In Sky's view, the alternative – of large tranches of rights becoming available simultaneously - would in fact considerably raise barriers to entry by raising significantly the minimum scale of entry. Issues of both (a) raising finance; and (b) the level of risk faced by entrants, would increase significantly. For example, potential entrants would have no certainty that they would be able to secure all the rights which they were interested in acquiring. If the would-be entrant found that it has won fewer rights than it had planned for, then it would have no opportunity to rectify the situation until all the rights again become available, at which point it would have no security even in respect of the rights that it had successfully acquired since these would again become available for sale.

4.9 Sky considers that such a situation would significantly diminish competition for rights.

F. There is a wide range of potential entrants

4.10 The breadth of the set of potential entrants to the markets defined by Ofcom also acts as an important competitive discipline on firms already operating in those markets. There are two clear types of potential entrants: firms

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12 The potential advantages (to a broadcaster) from an installed base of customers were examined by CRA in Annex 4 of Sky's Response to the Complaint, Paragraphs 96-100. The analysis concluded that "…*in the absence of detailed analysis there cannot be a presumption that even a significant installed base gives Sky a 'leg up' in bidding for content rights in a way that entirely disables third parties from bidding and winning valuable content*" (Paragraph 100).

13 This is possible where the broadcaster is vertically integrated with the platform, or where the platform is open. Currently, Sky's DTH platform is the only open platform in the UK.

14 Here we refer to any costs over and above any additional subscription charges.

15 Sky notes that several of these points have already been made to Ofcom as part of Sky's Response to the Complaint (see Paragraph 104 of Annex 4) and Ofcom does not appear to have had due regard to them in its Consultation Document.

operating in adjacent market segments and rights owners. We discuss each of these in the following sections.

(1) Other existing broadcasters

4.11 Given the narrowness of the markets which Ofcom has defined, there is a large range of existing television broadcasters, both in the UK and internationally, with the expertise and assets which make them ready potential entrants to those putative markets. For example, one of the key concerns throughout the OFT's and Competition Commission's investigations into Sky's purchase of a stake in ITV was the potential effect of the stake on ITV's incentives to bid for premium sports rights for a new pay TV service. Indeed, the summary of the Competition Commission's hearing with Ofcom states:

> "*ITV entry into pay-TV... was, however, a relevant factor, given the pressure on ITV in the free-to-air advertising market and hence the need to find growth from a new source of commercial activity. One obvious possibility was to enter pay-TV markets in some form.*"[16]

4.12 Again, the list of probable bidders for live FAPL rights in 2006 is instructive in this respect. It is said to have included (in addition to Sky and Setanta): the BBC, ITV, Channel 4, five, Virgin Media, and ESPN/Disney, all of whom are well-established existing broadcasters.

4.13 In relation to film programming, clearly, a wide range of broadcasters already broadcast films on their television channels. The impediments to them extending into broadcasting films in the pay TV window are therefore so small as to be irrelevant.

(2) Rights owners

4.14 In relation to sports rights, many rights owners are large entities with considerable financial resources and a good awareness of the value of their rights, who are accustomed to dealing with broadcasters on an international basis. Furthermore, buying-in broadcasting expertise and assets is relatively straightforward. These factors mean that sports rights owners are potential entrants via downstream integration. Vertical integration by sports rights owners into broadcasting is not yet common in Europe,[17] but there are examples of this occurring in the US and elsewhere. For example, in the US three out of the 'Big Four' (the NFL, NBA and NHL) all operate their own pay TV channels.

4.15 In relation to film rights, the key factor is that most rights owners are themselves already active in the television sector internationally. As a result,

16 http://www.competition-commission.org.uk/inquiries/ref2007/itv/hearing summaries.htm. While the Competition Commission rejected such a theory (see Paragraph 4.35 of its report) it is instructive nonetheless that Ofcom appears to believe that it is correct.

17 In 2002 the Scottish Premier League narrowly decided against setting up its own television channel.

it would be a relatively small step for them to set up their own television channels which broadcast their films. By way of example, it is necessary only to consider the scope of activities of Time Warner which owns Warner Brothers (one of the six major Hollywood movie studios):

- it also owns smaller studios and TV production businesses such as New Line Cinema, Castle Rock Entertainment, Warner Brothers Television and Warner Brothers Animation;

- it is a joint venture partner (with CBS Corporation) in The CW Television Network in the US;

- it owns US TV network Home Box Office (HBO) as well as a suite of other TV channels such as TCM, CNN and Cartoon Network; and

- it owns AOL, a major international broadband provider.

4.16 Ofcom erroneously downplays the possibility of entry, at least with respect to movies by stating:

> "*This problem* [that a wholesale channel provider may require rights packages from more than one studio] *would also be faced by the Hollywood studios themselves should they attempt to 'go downstream' and enter the wholesale channel market. It is not clear that one studio alone would be capable of attracting enough subscribers to construct a sufficiently attractive retail package.*"[18]

4.17 Ofcom's response to this possibility is flawed: it is not the creation of an "*attractive retail package*" to which it is alleged that there are barriers to entry; it is the creation of a new television channel (or expansion of existing television channels).

4.18 Moreover, Ofcom's response again appears to be based on an overly narrow view of how effective entry might occur. Ofcom puts forward no good reasons why a single studio would be unable to develop a new and attractive channel given (a) that such a channel could potentially broadcast a range of different types of programming – including blockbuster films, library films, and other types of programming (there is absolutely no reason why such a new channel would have to be dedicated entirely to broadcasting films, as shown by the examples above[19]); and (b) the wide range of media-related activities in which the parent companies of the studios are involved.

4.19 Alternatively, studios could enter into joint-venture arrangements, which would provide a viable business opportunity even under Ofcom's narrow view. It is unclear why Ofcom does not give this possibility more credibility given that there are already numerous examples of studios working together closely in providing film services. For example:

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18 Footnote 66 to Annex 13.

19 Showtime, Starz and HBO were discussed in **Section 3.A**.

- Sony and Disney operate the FilmFlex PPV movie service that is part of Virgin Media's VoD system;

- the Hulu online video service is a joint venture between NBC Universal and News Corporation (owner of Fox);

- the United International Pictures (UIP) distribution company is a joint venture between Universal and Paramount; and

- Warner Brothers and Universal have formed a joint venture with Digital Cinema Implementation Partners to develop digital distribution to digital cinemas.

4.20 In Sky's view, the potential for 'disintermediation' is a very important competitive threat to incumbent holders of sports and film rights.

5. Ofcom's theories about factors that give rise to a lack of contestability for rights are flawed

5.1 In essence, Ofcom's argument in relation to barriers to entry is that other operators are unable to compete effectively for programming rights as a result of Sky's incumbency position. Ofcom's theories on barriers to entry to the markets that it has defined are not, however, set out in a clear or straightforward way. Instead, the different elements of Ofcom's views are set out in different places in the Consultation Document.

5.2 Ofcom's arguments appear to include at least the following set of elements:

(i) in order to launch a new premium channel, it is necessary to outbid Sky repeatedly for some of a limited number of rights;

(ii) the fact that Sky already holds programming rights creates an asymmetry between Sky and potential entrants, which means that rights are worth more to Sky than potential entrants (i.e., Sky has a 'first mover advantage');[20] and this makes it extremely hard for potential entrants to outbid Sky at all, let alone repeated); and

(iii) it can take a long time for an entrant to accumulate sufficient rights to build up a new channel business, and it may incur losses while doing so.

5.3 It is important to recognise that these are largely theoretical points; Ofcom offers no evidence in relation to them.

20 Throughout this Section we use Sky to mean an incumbent, i.e., a broadcaster which holds some rights when another right is for sale. The arguments would equally apply to any incumbent.

5.4 Ofcom appears to attribute Sky's putative first-mover advantage, at (ii) above, to the following elements: [21]

(a) a given set of programming rights for sale may be complementary to other rights already held by Sky and thus worth more to Sky than to any other bidder;

(b) a given set of programming rights for sale may be substitutes to rights already held by Sky and so Sky may be willing to pay more for them than the entrant;

(c) an entrant may have a weaker bargaining position with retailers than Sky if it wins rights; and

(d) there are likely to be efficiencies from "*bundling*" content rights and, therefore, given that Sky already holds an existing portfolio of rights, it has an advantage over entrants arising from the ability to exploit such efficiencies. (Ofcom appears to place more weight on this factor than the others, describing it as the "*most important*" reason for an asymmetry between Sky and potential entrants in relation to winning rights when they become available.)

5.5 Finally, Ofcom claims that Sky's vertical integration exacerbates these elements.

5.6 A general point applies to the first three of these elements: even if there is a first-mover advantage, its effect is limited because Sky holds its existing rights for a finite period. If right A is held by Sky and is in some way related to right B, such that joint ownership of both rights is more valuable than separate ownership, then the length of time remaining on the licence for A affects the size of any first-mover advantage for Sky. When Sky's licence for A expires and it comes up for auction again, whoever owns right B at that point would have an advantage in bidding for A. That advantage is effectively 'priced in' to bids for B, but is worth the same to *all bidders*. Therefore the period for which the entrant earns less value from B is limited by the remaining licence period on A, and so any bidding advantage to Sky is also limited.

5.7 A second general point is that one factor in influencing consumer demand, and thus the value of rights, is the quality of the programming that will be produced. Therefore, an entrant would have to be able to match the quality of the incumbent in order to be able to extract the same value from the rights. Sky considers that this encourages innovation and works in the interests of consumers.[22] Matching quality may also require some marketing expenditure on the part of the entrant, in order to signal its ownership of the rights and the quality of its programming; incumbents will typically have had to make a

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21 See Paragraph 5.47 of and Footnote 62 to Annex 13.

22 For example, both Channel 4 and Sky are widely credited with introducing significant innovations in cricket coverage which are now being used by broadcasters in other countries.

similar investment, and will also engage in marketing on an ongoing basis if they win rights.

5.8 However, as long as the quality can be matched, Sky considers that consumers will be willing and able to watch programming on a new or different channel. In the case of rights to content of particular interest to viewers, Sky considers that if rights change hands, viewers are able to respond very quickly. This is because if viewers have a specific desire to watch, for example, the FA Cup, they will not care too much which channel is showing the games, subject to quality of programming considerations. Accordingly, if the underlying right moves from one broadcaster to another then such viewers will subscribe to a new channel if necessary in order to watch the FA Cup on that channel.[23,24]

A. Consumer preferences and bundling

5.9 Given that Ofcom describes bundling as the "*most important*" reason for a lack of contestability in competition for premium programming rights, we address it first.

5.10 Ofcom's theory is that the potential for "*bundling*" programming means that two different programming rights are worth more to a single broadcaster than to two different broadcasters. Ofcom states:

> "*The most important reason* [for asymmetries in valuations of rights] *is the nature of consumer preferences and the resulting efficiencies associated with the bundling of rights.*"[25]

5.11 Ofcom's reasoning behind this theory is opaque and consultees must attempt to work out for themselves what Ofcom means. It appears to have in mind one of two possible mechanisms: either (a) that broadcasters can "*bundle*" programming, i.e., create a channel based on content using more than one set of rights; or (b) that channels can be bundled into packages. In either case, because consumers have heterogeneous preferences, this can lead to more efficient selling.

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23 In circumstances in which all premium channels are distributed to all platforms then the consumer will be easily able to subscribe to the channel to which the content has moved. Of course the situation is more complex if the supplier of an entrant elects not to supply all platforms, or access to particular platforms is denied. However, premium rights holders will typically seek to distribute their channels as widely as possible.

In circumstances in which a sports right that had been exploited on a premium sports channel was acquired for exploitation on a free to air channel, a subscriber to the premium sports channel would also have access to the free to air channel and so would be able to view the sport on the new channel with ease.

24 If consumers are not willing to switch from one channel to another when rights move, then it is difficult to argue that access to the rights is a barrier to entry; the barrier must lie elsewhere.

25 Footnote 62 to Annex 13.

5.12 Sky agrees that bundling plays an important role in the provision of pay TV services, as a result of "*the nature of consumer preferences*".[26] However, this does not necessarily confer an advantage on an incumbent broadcaster in bidding for rights, and may in fact mean that rights are worth more to an entrant or a broadcaster with a small existing set of rights.

(1) Combining content from different rights owners into a channel

5.13 As part of its examination of bidding asymmetries, Ofcom discusses the way that content is aggregated into channels in order to form a valuable product:

> "*By aggregating content into channels, wholesale channel providers can increase the collective value of the content above its stand-alone value. This means that a channel provider that already has the rights to a significant range of content can potentially extract more value from the next set of rights to come available than could a new entrant. It will therefore be able to pay more for those rights.*"[27]

5.14 A broadcaster will usually combine content acquired from a number of different rights owners to form a channel. Ofcom seeks to suggest that a broadcaster with relatively few or no rights may not be able to form a channel in a way that uses those rights most efficiently. However, this suggests that the asymmetry, in terms of the value of rights, actually goes in favour of the *entrant*: if the incumbent has a large mass of rights, losing any one right should not significantly affect its ability to bundle efficiently. By contrast, winning certain combinations of rights will significantly improve the entrant's ability to bundle. Therefore a recent entrant with a small portfolio, or a prospective entrant who plans to bid for several rights, but not the incumbent, would be willing to pay a premium for one or more of those rights.

(2) Bundling of channels by retailers

5.15 Retailers can bundle channels regardless of whether they are supplied by one broadcaster or several. Therefore, much of the potential efficiency from bundling can be generated at the retail level. To deduce whether there is a first-mover advantage, the only question is whether the identity of the broadcaster affects the retailer's willingness to pay for the channel. In fact, it should not.

5.16 Suppose that two channels sold individually are worth £100 each to a retailer (revenue minus retail costs), but by taking advantage of bundling efficiencies (e.g., reaching more subscribers), being able to sell both of them together is worth £250. Then the retailer will be willing to pay up to £250 to the broadcaster(s) of those two channels. Suppose further that Sky holds the

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26 There are two dimensions to heterogeneity in consumer preferences: (a) different people have different preferences in relation to particular television programmes; and (b) particular individuals like some types of programmes more than others.

27 Paragraph 6.64.

rights used to produce the first channel, but the rights used to produce the second channel are for sale.

5.17 If there are two broadcasters, then the division of this £250 between them will depend on their relative bargaining strength, but *the extra value of the second channel is the same to either broadcaster.* To see this, note that Sky could charge a wholesale price of £250 for both channels if it provided both, and consider how much the retailer would pay for the second channel when it is provided by an entrant. If Sky has already agreed to wholesale the first channel for £130, then the entrant can charge £120 for its channel. Sky's potential gain from winning the rights used in the second channel is £250 minus £130, i.e. £120, which is the same amount that the entrant can earn.

5.18 In other words, there is a pie of a fixed size, and however large a piece of that pie the entrant could gain if it won the rights, that is the same piece that Sky loses. What matters to Sky is the difference between the price it can charge for its first channel alone and the price it can charge for both channels, and that difference is equal to the price the entrant could charge for the second channel. It does not matter how Sky would actually price the two channels if it held the rights for both, the extra value from holding the rights for the second channel is still the same. Therefore the right is still worth the same to both broadcasters.[28]

B. Acquisition of complementary rights

5.19 Ofcom argues that a second reason that an additional set of content rights may be worth more to a broadcaster that already has a portfolio of rights, than one that does not is that the additional rights may be complementary to those already held. Ofcom states:

> "*Rights may be complementary, in which case a wholesaler can charge more for (say) two complementary rights, than rights sold on an individual basis.*"[29]

5.20 In order for a right to be worth more to Sky under Ofcom's theory, two conditions must hold:

(a) some rights sold at different times must be complementary for consumers; **and**

(b) this complementarity must permit a broadcaster that controls both rights to charge more than two separate broadcasters could charge in total if they each controlled only one of the rights.

5.21 Close inspection of this theory suggests that there is likely to be little or no such effect on broadcasters. It is important to bear in mind that broadcasters buy rights, and consumers buy channels or packages of channels: therefore

28 Note that even if a retailer does not carry Sky's existing channel, his willingness to pay for the second channel will still not vary according to the broadcaster.

29 Footnote 62 to Annex 13.

when Ofcom discusses rights which are complementary, Sky assumes that it means that channels (or programmes) based on those rights are complementary to consumers.

(1) There are few rights which are sold separately but are complementary

5.22 The term "*complementary*" means[30] that consumption of *x* increases willingness to pay for *y*, and vice versa: in other words, they are worth more together than separately. To simplify the exposition, we assume that content based on right *x* is used to create programme *x*.[31] Below is an example of a customer's willingness to pay for two programmes which are complementary:

- £10 per month for an FAPL programme (Programme A);
- £5 per month for a cricket programme (Programme B);
- £20 per month for both programmes[32] (i.e., a single channel combining the content of both A and B).

5.23 If Ofcom wishes to rely on this theory, it must demonstrate that this is a plausible relationship between *sets of rights which are sold separately and at separate times*.[33] If two complementary rights are sold at the same time, then any gains from that complementarity are equally available to either an incumbent or an entrant, because either party can buy both rights and take that into account in their bidding. There can only be a first-mover advantage if a right being sold is complementary to one that is mid-way through its licence period, i.e., the holder of the latter right is the 'first-mover'.

5.24 It is possible to construct specific hypothetical examples where content may be complementary for most consumers: as an extreme case, if two halves of a film or two halves of a football match were sold separately, which of course is highly unlikely. There are other examples where rights are likely to be complementary for some consumers: for example, individual football matches in the World Cup may be more attractive to consumers when placed in the context of the whole competition, but again these rights are very likely to be sold together, or at least at the same time.

5.25 In summary, it is possible to identify rights which could plausibly be complementary for significant numbers of consumers, but these rights are generally sold *simultaneously* (whether or not they are part of a single package), and hence there is *no first mover*: every bidder could buy all the

30 In the economic sense on which Ofcom's argument relies.

31 It would be more realistic to consider that content based on right x is combined with other content on channel z, and assess the additional value consumers place on channel z as a result. However, this simplification does not affect the results of the analysis.

32 Assuming, of course, that a consumer cannot buy the two programmes separately for a lower total price.

33 In other words, between a right that is already held by one broadcaster and another right that is available for sale.

rights, and so every bidder could reap the same benefits from complementarity. Sky considers that there are relatively few rights sold at different times which display strong complementarities across a large number of consumers.

(2) Complementary rights do not confer a first-mover advantage

5.26 Even if rights A and B are complementary to consumers and right B is sold after right A, this is nevertheless unlikely to generate an advantage in bidding for right B for the broadcaster that has already acquired right A. This is because, as with bundling, discussed above, the retailer can sell two channels or programmes in an efficient way regardless of whether they are supplied by one broadcaster or two.

5.27 This can be illustrated using a simple example. If a consumer is already paying a retailer £10 for programme A (broadcast by Sky),[34] he would be willing to pay the retailer a further £10 for programme B, irrespective of which broadcaster actually provided programme B. So the amount that the retailer can charge consumers is the same irrespective of the provider of programme B. As with the case of bundling discussed in the previous section, this means that the size of the 'pie' is fixed; it does not matter how two broadcasters would divide that pie, the right is worth the same to Sky as to an entrant.

C. Acquisition of substitutable rights and the "*strategic premium*"

5.28 Ofcom's third reason why rights may be worth more to Sky than entrants is that certain rights are substitutes, and Sky gains some advantage from securing substitutable rights:

> "*Where rights are substitutes, there may be a strategic advantage to the incumbent in securing rights by reducing the threat of wholesale competition.*"[35]

5.29 Again, Ofcom's reasoning behind this theory is opaque and consultees must attempt to work out for themselves what Ofcom means. The most plausible theory relating to "*wholesale competition*", and one similar to arguments that Sky has heard before, is that Sky has an incentive to overbid for rights in order to prevent or limit the existence of channels which compete with it for carriage from retailers.

5.30 In order to rely on this argument, Ofcom must first identify rights which are substitutable in this sense, i.e., if those rights are exploited on different channels, then those channels are substitutes for retailers. They must be "*premium rights*" under Ofcom's definition, and they must be sold *separately and at different times* – otherwise *there is no incumbent*, as explained for

[34] As noted above, consumers buy channels rather than programmes; but the simplification here does not affect the results of the analysis.

[35] Footnote 62 to Annex 13.

complementary rights above, and so by definition there can be no first-mover advantage.

5.31 Even if an incumbent that has already acquired some rights had an incentive to overbid for certain further rights, the effects would be small and of limited duration:

- any short-term gain from overbidding would be small. This is because the incumbent would have to pay a premium to acquire rights, and its benefit from that premium comes in the form of a higher carriage fee than it would otherwise receive. But the size of that benefit depends on the degree of substitutability of the channels,[36] and the nature of competition and negotiation that would take place with each retailer. It may not outweigh the premium that the incumbent would need to pay (particularly for any competition in which FTA broadcasters also bid; their bids will not be affected by any such retail concerns);
- for any given right, if there is only one substitutable "*premium*" right, then the effect will be small: there will still be many other rights that can be used to set up a channel;
- if there is more than one substitute for a right, i.e. any one would make a rival channel into a substitute, then the incumbent would have to repeatedly overpay to prevent entry each time a relevant right becomes available. This makes it even less likely that doing so would be a profitable strategy; and
- in any case, as discussed above in the introduction to this **Section 5**, any first-mover advantage persists only until the expiry of the related substitutable right, and it can relate only to substitute rights which are sold separately and at different times.

D. Potential hold-up problems

5.32 A further argument introduced by Ofcom is that the process of contracting with retailers will give an advantage to an incumbent:

> "*The second* [first-mover advantage] *is that it puts a new entrant in a relatively weak bargaining position against retailers, as whilst Sky Sports is likely to be a 'must have' product, it may well be credible for a retailer not to contract with a new entrant who owns a very limited portfolio of rights. This potentially makes it difficult for a new entrant to obtain full value for its rights.*"[37]

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36 Note that retailers will typically want to carry all channels containing 'premium content', as long as they can agree commercially attractive terms. So although one channel may be a substitute for another in terms of affecting a retailer's valuations for that channel, it will be rare for one channel to replace another in a retailer's packages.

37 Paragraph 5.47 of Annex 13.

5.33 This argument is not explicitly linked to the amount an entrant is willing to bid (and indeed is listed as a second advantage, rather than in support of the first) but it seems to be saying that there is a risk of 'hold-up' problems, and that this risk – which only applies to the entrant – causes an asymmetry.

5.34 This is implausible on the open DTH platform. Retailers generally have an incentive to pay up to the value of content in attracting and retaining subscribers.[38] Ofcom itself notes that "*to the extent that there are any monopoly rents associated with the aggregation of premium content, these will flow upstream*".[39] If a problem can arise, it is only on closed platforms, but there Sky Sports is itself prey to the same potential hold-up problems. If Sky Sports is "*must-have*" for a retailer, that is only because of its content. If an entrant wins rights for some of that content, then its bargaining position becomes stronger while Sky's becomes weaker.

5.35 If the rights are not very valuable, then it is true that an entrant's bargaining position is relatively weaker; but it will only be seeking a small fee, and would not have been willing to pay a large sum for the rights, so there can be no presumption that there is an issue with smaller or less valuable rights.

E. Sky's vertical integration does not create or enhance barriers to entry

5.36 Ofcom notes in several places in the Consultation Document that it believes a lack of contestability for programming rights caused by Sky's incumbency is increased as a result of its vertical integration. For example:

> "*There are likely to be substantial challenges facing a firm wishing to enter the wholesale channel market and bid for premium content rights,* ***particularly if it is in competition with a vertically integrated incumbent.***"[40]

5.37 Ofcom acknowledges that Sky cannot restrict access to the DTH platform or its DTH subscriber base,[41] and, as noted above,[42] like any retailer, Sky generally has an incentive to pay up to the value of content in attracting and retaining subscribers and so it is implausible that Sky would not wish to retail any *"premium channel"* on appropriate commercial terms. Of course, this is a potential issue with regard to closed platforms, which benefit the operators of

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38 The question of Sky's strategic incentives due to vertical integration is discussed in **Section 5.E** below.

39 Paragraph 1.35.

40 Paragraph 6.62, emphasis added.

41 "*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. We acknowledge however that Sky's ability to do this will be limited, due to the regulatory obligations which it faces in relation to platform access*" (Paragraph 1.58). Sky notes that this is not a "*limited*" ability, but a complete inability under current regulation, and by investing to create the largest pay platform in the UK, Sky has facilitated access to over 9 million households.

42 See Paragraph 5.34 above.

those platforms should they choose to bid for rights: they have guaranteed access to both their own platform and the DTH platform. But this does not apply to Sky: the only platform it is guaranteed access to is the DTH platform, and that is also open to all other broadcasters and retailers.

5.38 Once again, Ofcom's arguments are not spelled out beyond a brief assertion, but Sky has previously addressed these types of vertical arguments. In its Response to the Complaint, Sky demonstrated that:

(a) Sky's retail presence does not increase its ability to make a return on the cost of rights more quickly and efficiently than actual or potential competitors (see Paragraphs 4.9 to 4.18 of Part C of Sky's Response to the Complaint). Sky's position as a retailer does not allow it to monetise new content any more quickly than an entrant, regardless of whether that content is shown on an existing Sky channel or a new Sky channel; and

(b) the size of Sky's retail subscriber base does not disadvantage competitors in bidding for content (see Paragraphs 4.19 to 4.25 of Part C of Sky's Response to the Complaint). Sky provides access to the DTH platform on transparent terms.

5.39 These issues were discussed further in Annex 4 of Sky's Response to the Complaint: CRA and Professor John van Reenen's paper on "*Sky's 'Incentives' to Foreclose Competition in the UK Pay TV Industry*", October 2007, Paragraphs 84-93. A useful summary is at Paragraph 86:

> "*A logical distinction must therefore be drawn between two different types of mechanisms. Vertical integration of Sky's broadcasting function with its retail function could be argued to create "upstream foreclosure" concerns (i.e. inhibit competition for rights acquisition) only if Sky's actions made it somewhat difficult for third-party channel providers to reach Sky's customer base – or meant they could only reach it on comparatively unfavourable terms. Only in this case could there be a vertical "upstream foreclosure" issue arising from Sky's "installed base advantage". Distinct from this are pure "incumbency/size" effects which matter for channel production, but have very little to do with vertical integration between Sky's broadcasting function and its retail operations:* ***they would arise even if Sky's broadcasting function was not vertically integrated with its retailing function***" (emphasis in original).[43]

5.40 Once again, Ofcom's analysis makes no attempt to address or even mention the point made in Sky's previous submission.

F. There are no other incumbency advantages

5.41 Ofcom also mentions or alludes to other theories of incumbency advantage. These are addressed below.

[43] See also **Section 4.4** of **Annex 4** (CRA's report: Vertical integration and short-run/long-run issues) to this Response.

(1) Holding a right is not a barrier to an entrant winning that same right in the future

5.42 The mere fact that Sky currently holds certain rights is not a barrier to other broadcasters winning those rights in the future. Rights holders will typically be concerned with several factors including the price paid for rights, the breadth of audience available and the quality of programming to be produced. If an entrant is able to make an offer to a rights owner that, based on the totality of these factors, matches (or exceeds) the offer made by the Sky then it should be at no disadvantage.[44]

5.43 As one example, Ofcom claims that:

> "*Sky's contracts with the six major Hollywood studios cover the large majority of the most popular films distributed on UK television. These contracts, which are exclusive to Sky*[[45]], *amount to a significant barrier to entry to the wholesale market.*"[46]

5.44 The existing contracts constitute a barrier to entry only in the most literal sense, in that they prevent anyone else using those rights until the point at which they expire; but from a dynamic point of view, a potential entrant simply has to win a right when the existing contract expires.

5.45 Ofcom may be making a similar point when it says that:

> "*As with the retailing of premium sports packages, obtaining access to a significant portfolio of premium content is the most significant entry barrier. The difficulties faced by a potential new entrant are arguably higher for premium movies than premium sports, as all the premium content is controlled by one wholesaler (Sky).*"[47]

5.46 This argument is a *non sequitur*. Content is not controlled by Sky; Sky merely holds current rights and, subject to genuine quality issues, an entrant's chances of buying them in the future are unaffected by the fact that Sky currently holds them.[48]

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44 To the extent that an incumbent has an advantage from having demonstrated that it can produce quality output, this merely reflects the risks and investments made by that broadcaster in the past. Ofcom should note that many companies other than Sky also have existing relationships with rights owners and experience in producing high quality programming based on rights. For example, in the case of Hollywood studios, several UK companies hold contracts for films in the PPV and FTA windows.

45 Sky notes that its various contracts give it exclusive rights only in the pay TV window. For example, Sky also has contracts in the PPV window, but they are not exclusive across all platforms: operators such as Virgin Media have similar contracts.

46 Paragraph 5.67 of Annex 13.

47 Paragraph 5.61 of Annex 13.

48 In other words, Ofcom needs to consider the relevant counterfactual: an entrant would not have a greater chance of winning if rights were currently held by several different broadcasters.

(2) There is no "tipping"

5.47 Ofcom makes a reference to "*tipping*" in relation to incumbency advantages. This does not, however, appear to be a standard use of the term. Ofcom argues that:

> "*Indeed, that potential new entrant may need to incur initial losses (in order to outbid the incumbent which is able to extract more value from those rights), in the hope that it ultimately acquires sufficient content for the market to begin to 'tip' in its favour.*"[49]

5.48 The meaning of this statement is opaque. Sky does not consider that Ofcom intends to suggest that a market may "*tip*" from one firm to another in the standard sense of the term, i.e. that there is only room for one channel supplier within a particular type of content. There is no suggestion of network externalities, which are usually associated with tipping.

5.49 The most plausible interpretation is that Ofcom is referring to a point at which an entrant has acquired sufficient rights that it is no longer at a 'disadvantage' when bidding against an incumbent and so rights are worth the same to the entrant as the incumbent. If so, this is a further illustration of Ofcom's fixation on channels which are *as similar as possible* to Sky's. As well as being predicated on arguments which have been shown above to have little if any force, it overlooks the wide range of methods of different business models, as discussed in Section 3 above: there is no reason to assume that a channel needs to have a certain range of rights in order to enter and compete effectively in the market.

6. The observed facts are inconsistent with Ofcom's hypothesis that rights are not contestable

6.1 Ofcom's view that there are significant barriers to entry to the markets that it has defined arising from a lack of contestability in relation to programming rights is not consistent with observed facts. In particular:

- if Ofcom's theory was correct, Sky would have won five FAPL packages in the 2006 auction, and would own every other available pay TV sports right (which it does not);
- if the "*staggering*" of availability of rights reduced their contestability, as Ofcom believes, rights owners would have strong incentives to move towards a degree of co-ordination in the dates at which rights become available. For example, the Hollywood studios are sophisticated sellers with considerable international experience in negotiating rights. It is implausible that they would allow their contracts to expire at different times if doing so reduced the revenue they expect to receive;

[49] Paragraph 6.65.

- evidence indicates that other firms who do not operate sports or film channels seek to acquire pay TV sports and film rights. If Ofcom's theory about the contestability of rights was correct, it would be expected that it would be pointless for such operators to consider purchasing such rights, and they would have dropped out of contending for them a long time ago;

- if rights were not contestable, as Ofcom believes, such that Sky held a dominant position in purchasing those rights, auction theory indicates that prices paid for rights would be depressed.[50] Such a proposition is inconsistent with observed increases in and absolute levels of prices paid for sports rights over time. There are numerous examples of this in Annex 10 of Ofcom's Consultation Document:

  - the annual value of FAPL rights has risen from £186 million in 1997-2001 to £669 million in 2007-2010 (a 260% increase);

  - the annual value of Champions League rights has risen from £36 million in 1996-9 to £85 million in 2006-9 (a 136% increase), and has risen still further in the recent auction;[51]

  - FA rights for the FA Cup and England internationals have risen in price from £31 million per year in 1997-2001 to £106 million per year for 2008-12 (a 241% increase);

  - Football League rights have risen in price from £25 million per year in 1995-2001 to £88 million per year for 2009-2012 (a 250% increase);

  - English domestic cricket rights have risen in price from £26 million per year in 1999-2002 to £52 million per year for 2006-9 (a 100% increase).

6.2 These observed increases in prices paid for sports rights are wholly incompatible with a hypothesis that Sky is a dominant purchaser of such rights.

7. Conclusion

7.1 Ofcom puts forward the proposition there are insurmountable barriers to entry to the markets that it has defined principally because other operators cannot compete with Sky for the rights which comprise key inputs in relation to operating in Ofcom's putative markets. Ofcom, however, has adopted an unreasonable benchmark of what constitutes 'entry' in this context, and its assessment of barriers to entry is not balanced. It focuses entirely on impediments to entry and does not consider a wide range of factors that give rise to a significant degree of contestability in relation to programming rights, and a significant threat of competitive entry.

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50 See, for example, Paul Klemperer, "*Auction Theory: A Guide to the Literature*", *Journal of Economic Surveys*, July 1999.

51 Sky's estimate of the total value of the winning bids in the most recent auction is [**CONFIDENTIAL**].

7.2 Ofcom's theories about why rights are not contestable are vague and unparticularised. When examined closely they appear ill-founded. Most importantly, however, they are inconsistent with observed facts.

7.3 Sky concludes, therefore, that Ofcom's proposition that there are insurmountable barriers to entry to the markets that it has defined cannot be relied on, and both actual evidence and arguments instead support the contrary view, that programming rights are contestable and that potential for entry ensures that the market is competitive.