RESPONSE BY BRITISH SKY BROADCASTING GROUP PLC TO OFCOM'S *"PAY TV MARKET INVESTIGATION"* CONSULTATION DOCUMENT OF 18 DECEMBER 2007

INTRODUCTION

1. This document (the "**Response**") is the response of British Sky Broadcasting Group plc ("**Sky**") to Ofcom's *"Pay TV market investigation"* consultation document of 18 December 2007 (the "**Consultation Document**").

2. This Response is structured as follows:

   Part 1: Executive summary/Overview

   Part 2: Key issues

   Part 3: Sky's responses to Ofcom's Consultation Questions

3. This Response incorporates two Annexes prepared by external consultants: **Annex 1**, a report by PricewaterhouseCoopers on the outcomes for consumers in relation to pay TV in Europe;[1] and **Annex 4**, a report prepared by CRA International, Dr Pierre Régibeau and Professor John Van Reenen, on the analysis and arguments in the Consultation Document on the likely consequences of vertical integration, including the potential *"short term"* and *"long term"* issues identified by Ofcom.

4. This Response also incorporates four Annexes prepared by Sky:

   Annex 2: a critique of Ofcom's approach to market definition and market power in the Consultation Document and presentation of Sky's position on these issues

   Annex 3: a critique of Ofcom's analysis of barriers to entry at the channel provider level

   Annex 5: a critique of Ofcom's treatments of the issues surrounding content aggregation

   Annex 6: a non-exhaustive list of errors in the Consultation Document

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1 In accordance with the terms of PwC's engagement, Ofcom is referred to the disclaimer at Page i of **Annex 1** to this Response.

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PART 1: EXECUTIVE SUMMARY/OVERVIEW

1. The UK enjoys a competitive pay TV sector which is functioning well and delivering strong benefits to consumers. Sky has made a significant contribution not only to the development of the pay TV sector, but to the development of a broad and vibrant marketplace: creating choice and plurality; developing a platform that supports hundreds of third-party channels; pioneering innovations including digital TV, personal video recorders ("**PVRs**") and high definition ("**HD**") TV; and helping to raise standards across the board by transforming the way news, sports and the arts are broadcast. Around one in three UK households now chooses to receive pay TV services from Sky. These positive outcomes are the result of the high standards of quality and service that Sky brings to the pay TV sector and our commitment to fair and open competition.

2. Ofcom's Consultation Document provides strong evidence in support of this healthy picture, containing analysis carried out over more than a year. In its *"initial assessment"* of the "*consumer experience of pay TV*", Ofcom reveals a sector with good consumer satisfaction levels, good choice of platforms and channels and continued delivery of innovative services. It finds no reliable evidence of high prices compared to other countries and no evidence of excessive profitability. Ofcom's conclusion is that its assessment *"reveals a market that currently appears to be serving its existing customers reasonably well."*[2]

3. It is all too easy to forget this conclusion in the pages that follow. Yet this is an extremely important conclusion - the most important in the entire Consultation Document. It is based on the current, observed position and is supported by evidence. It is not prone to theorising or reliance on hypothetical scenarios. It is a conclusion that is relatively simple and reliable. For reasons set out in this Response, the same cannot be said for the remainder of the Consultation Document.

4. As a fair and open-minded regulator, Ofcom should have concluded that, on the basis of the evidence in the Consultation Document alone, the sector is functioning effectively and delivering strong consumer benefits. It would have been perfectly reasonable for Ofcom, in light of its commitment to being a "*light touch regulator*", to have made its "*initial assessment*" a firmer conclusion and to have decided that no further action is required.

5. The positive picture painted by Ofcom's assessment of consumer outcomes is confirmed and, indeed, bolstered by evidence that we have previously provided to Ofcom. In our response to the submission (the "**Complaint**") made to Ofcom by BT, Setanta, Top Up TV and Virgin Media (together the "**Complainants**") on the need for a market investigation into the pay TV industry ("**Sky's Response to the Complaint**"), we provided an overview of key

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2 Paragraph 4.76.

recent developments in the sectors in which Sky operates.[3] The picture of rapid and pervasive change that emerges from that overview provides overwhelming evidence of the dynamic and innovative nature of the UK audiovisual sector. It also depicts an environment that offers opportunities for new entry and expansion, and in which even firms with well-established positions must continue to strive to serve customers well and stay ahead of their actual and potential competitors.

6. This Response provides additional evidence to confirm Ofcom's "*initial assessment*" that the sector is serving customers "*reasonably well*". This evidence shows that the UK compares very favourably with other European countries in terms of outcomes for consumers in relation to pay TV.

7. A study commissioned by Sky and conducted by PricewaterhouseCoopers ("**PwC**") demonstrates that the UK performs well against 14 other European countries in terms of digital pay TV penetration, choice and value from pay TV, and innovation in pay TV. It will be clear that the report (contained in **Annex 1** to this Response) has been very thoroughly researched and the evidence very carefully analysed. Accordingly, considerable weight may be placed on the positive outcomes identified for UK consumers in relation to pay TV services. In particular, PwC's report shows that:

- the UK is among the three countries with the highest digital pay TV penetration (a conclusion wholly inconsistent with Ofcom's concern about the pricing of pay TV services and the possibility that some customers are 'excluded' from pay TV);
- the UK is the leading country when take-up of digital pay TV, HD TV and PVRs are all taken into account;
- the UK compares well with the comparator countries in terms of the number of 'genuine' pay TV channels available to consumers; and
- when evaluated properly, charges for pay TV services in the UK cannot be said to be *"high compared to other countries"*.[4]

8. However, despite the evidence in its own Consultation Document, Ofcom has set out - and then expressly sought evidence to bolster - a series of hypothetical concerns. This approach is inconsistent with both Ofcom's regulatory principles and its statement in the Consultation Document that it has not yet reached a view on the existence of competition problems.[5] For reasons that we detail in this Response, Sky believes that Ofcom commenced this investigation with preconceptions both as to the scope of relevant markets and as to market power in the relevant markets. Further, we believe that these preconceptions lead Ofcom to ignore or downplay the significance of any evidence that is inconsistent with these preconceptions or that would

[3] Paragraphs 3.7 to 3.13 of Part B of Sky's Response to the Complaint.

[4] Paragraph 4.76.

[5] Paragraph 7.2.

undermine its theoretical concerns. These preconceptions lead Ofcom to believe that there must be a problem somewhere, which it just needs to uncover.

9. We fundamentally disagree with the markets that Ofcom has defined and with its attribution of market power to Sky. As part of this Response, we provide both a detailed exposition of the material flaws in Ofcom's approach to these areas and our views on the correct approach to identifying relevant markets and assessing whether market power exists. We show that Ofcom cannot legitimately draw any conclusions on possible concerns based on its flawed market definition and market power framework. In particular, we show that Ofcom is wrong to treat Sky as if it competes within a number of hermetically sealed 'pay TV bubbles'. In fact, Sky competes vigorously with free to air broadcasters and with free to air digital TV services such as Freeview. The reality of the strong competition between pay TV and free to air TV was recognised by the Competition Commission in its recent report on Sky's investment in ITV plc.

10. Our analysis of Ofcom's "*possible concerns*" demonstrates that, even if Ofcom were correct in relation to market definition and Sky's market power, no clearly discernible or credible theory emerges from this Consultation Document that competition in pay TV is not effective or will not be effective in the future, whether in the short or the long term. Ofcom's concerns are complex, entirely theoretical and often do not take into account commercial realities. Ofcom cannot demonstrate that any of these "*possible concerns*" are more likely than not to distort competition in the future. Indeed, Ofcom has ignored or downplayed significant evidence referred to or provided by Sky. Proper consideration of this evidence would have resulted in Ofcom being able to take a view that its concerns were not likely to result in competition problems.

11. As the specialist sectoral regulator, Ofcom is of course right to take a forward-looking view of likely market developments. However, Ofcom's duties do not require it to take action simply on the basis of mere possibilities. Indeed this would likely constitute a breach of Ofcom's duty to have regard to the principle under which regulatory activities should be targeted only at cases in which action is needed.

12. Ofcom must also be mindful of the context in which its investigation is taking place. Ofcom acknowledges in the Consultation Document that its investigation was triggered not as a result of any evidence of widespread consumer dissatisfaction or harm, but as a result of a Complaint made by certain of Sky's competitors.[6] The investigation has inevitably become a quasi-adversarial process in which Sky is the Defendant and the Complainants the Claimants. This means that not only must Ofcom be even more vigilant in distinguishing between the protection of consumers and the protection of competitors, but it must also be wary of putting Sky in a position in which the burden of proof is

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[6] Paragraph 1.3.

reversed and in which Sky must comprehensively disprove wide ranging and fanciful allegations by the Complainants.

13. Moreover, the quasi-adversarial nature of the investigation, in which Sky is alleged to be at the centre of wider problems, has resulted in the focus of the investigation, and of Ofcom's Consultation Document, being on Sky's activities, without consideration of the wider context within which Sky operates. As recently as 10 April, in its Public Sector Broadcasting Review, Ofcom emphasised the rapidly changing environment in which all audiovisual service providers are operating, and the difficulties involved in anyone, regulators and market participants alike, predicting how markets will evolve in such an environment.[7] Ofcom's view is that:

> *"It is clear that the regulatory and funding model which supports today's public service broadcasting framework has had its day. It is too fixed in linear media and too inflexible. As a result it is unsustainable."*[8]

It is entirely unrealistic to treat Sky and the pay TV sector as if they were impervious to these profound changes to the audiovisual sector. Still less is it possible, in such a rapidly changing and unpredictable environment, to make sound regulatory judgments on the basis of hypothetical future developments.

14. There is nothing in the Consultation Document that reveals a current problem of a magnitude that merits any form of intervention (let alone anything that would justify the market investigation reference to the Competition Commission that the Complainants seek in relation to Sky). Any intervention based on the "*possible concerns*" set out by Ofcom would amount to 'regulation by hypothesis', which runs serious risks of unintended consequences, market distortions and stifling innovation. Ofcom should heed the warning that it has itself previously highlighted:

> *"Sometimes the fact that a market is working imperfectly is used to justify taking action. But no market ever works perfectly, while the effects... of regulation and its unintended consequences, may be worse than the effects of the imperfect market."*[9]

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7 Paragraph, 1.13, Executive Summary, Public Service Broadcasting Review.

8 Foreword, Public Service Broadcasting Review.

9 *Better Policy Making: Ofcom's Approach to Impact Assessment* (21 July 2005), page 3 and in particular Paragraph 1.1 (quoting the Better Regulation Taskforce, September 2003).

PART 2: KEY ISSUES

1. Introduction

1.1 In this **Part 2**, we set out the key issues arising from the Consultation Document and from the manner in which Ofcom has approached the investigation.

1.2 We demonstrate below that, based on Ofcom's own evidence and analysis, the broadcasting industry is functioning well. This conclusion is bolstered by evidence provided by Sky in the form of PwC's report attached as **Annex 1**, which demonstrates that the outcomes for UK consumers compare very favourably with other European countries.

1.3 We conclude that an open-minded, light touch regulator could reasonably have concluded that there is no fundamental problem in the pay TV industry that requires any further analysis, investigation or indeed intervention. Ofcom, however, chose to develop a series of *"possible concerns"* based on hypotheses about how the market will operate in the future. We examine those concerns and conclude that Ofcom has come nowhere near demonstrating that they are anything more than exercises in hypothesis, let alone that they are more likely than not to result in competition problems in the future.

2. Ofcom's own evidence shows a market working well for consumers

2.1 In the Consultation Document, Ofcom assesses the *"consumer experience of pay TV"*.[10] Ofcom makes the following observations about the "*consumer experience*":

- pay TV has delivered *"significant benefits to consumers"*;[11]
- *"customer satisfaction levels are in the 80-90% range, broadly in line with other communications markets"* which *"suggests at least that consumers are generally happy with the services they take"*;[12]
- *"consumers have a significant level of choice, both of the TV platform which they use, and the content which they can access on this platform"*[13] *and "Consumers tend to have a better choice of platforms than a few years ago. Channel choice is also strong"*[14];

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10 In particular, see Section 4 of the Consultation Document.

11 Paragraph 1.15.

12 Paragraph 4.76.

13 Paragraph 1.17.

14 Paragraph 4.76.

- *"innovation in this market to date appears to offer strong benefits for consumers"*;[15]

- it is "*unable to conclude on the basis of currently available evidence that UK prices are excessive*";[16]

- it *"seems unlikely from an analysis of Sky's profitability that Sky's returns to shareholders could be judged to be excessive*".[17]

2.2 Ofcom concludes:

> *"Our initial assessment of the various criteria..... reveals a market that currently appears to be serving its existing consumers reasonably well".*[18]

2.3 It is all too easy to forget this conclusion in the nearly 700 pages which follow. This is, in fact, an extremely important conclusion – and, we would submit, the most important conclusion in the Consultation Document.

2.4 There are a number of reasons why this is the most important conclusion that Ofcom reaches in the Consultation Document:

- it is based on a detailed consideration of consumer outcomes assessed against a number of criteria that Sky (broadly) agrees are appropriate for their purpose;[19]

- it is based on the **current**, **observed** position and therefore is not prone to great theorising or reliance on hypothetical scenarios;

- it is based on evidence in relation to **current** purchasers of pay TV services rather than speculative, so-called, "*evidence*", based on a vague theory of "*customer exclusion*" (we expand upon this point at Paragraphs 5.3 to 5.4 below); and

- any action proposed or taken which alters a state of affairs in which consumers are currently well served, risks the unintended loss of or diminution in current, observable consumer benefits, with no guarantee of sufficient gains in consumer welfare to offset those losses.

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15 Paragraph 4.28.

16 Paragraph 4.48.

17 Paragraph 4.76.

18 Ibid.

19 See further Sky's response to Consultation Question 1 in **Part 3** of this Response.

3. Ofcom should have concluded that no further action is required

3.1 Ofcom's *"initial assessment"* reveals a market that currently appears to be serving its existing customers reasonably well, with good customer satisfaction levels, good choice of platforms and channels, continued delivery of innovative services and their take-up by consumers, no reliable evidence of high prices compared to other countries and no evidence that profitability is excessive. This assessment is based on evidence gathered and analysis carried out over a period in excess of a year.[20]

3.2 Whilst we have numerous issues with the Consultation Document, and in particular the approaches to market definition, market power, and the hypothetical *"concerns"* which Ofcom identifies,[21] it would have been perfectly reasonable for Ofcom, as a self-declared *"light touch regulator"*, to have made its *"initial assessment"* a firmer conclusion and to have adopted the approach that no further action is required.

3.3 What is remarkable, however, about Ofcom's overall approach to the Consultation Document is that, notwithstanding reliable and important evidence in Section 4 – *"The Consumer Experience of TV"* that the market is working well, which must constitute *prima facie* evidence that there are no appreciable distortions of competition currently operating, Ofcom still appears fundamentally to believe that there is a problem somewhere, which it just needs to uncover. This approach is encapsulated by a long list of bullet points showing that the market is serving customers well, followed by the phrase: "*Having said that…*". "*Having said that*" is then followed by another phrase in the same vein, namely that the evidence "*does not preclude the possibility that…* [there is a problem somewhere]".[22]

3.4 Ofcom itself has recognised that:

> *"Sometimes the fact that a market is working imperfectly is used to justify taking action.* ***But no market ever works perfectly,*** *while the effects… of regulation and its unintended consequences, may be worse than the effects of the imperfect market."*[23] (emphasis added)

3.5 In spite of this recognition that no market ever works perfectly, Ofcom appears to be seeking to measure the operation of the market against a standard in which there is absolutely no possibility of any harm. This is, in effect, a

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20 Some of Ofcom's research clearly pre-dates the Complaint which was submitted in January 2007.

21 See further Section 4 of **Part 2** of this Response.

22 Paragraph 4.76, and especially the last bullet point "***Having said that,*** *the absence of high profits for pay TV operators* ***does not preclude the possibility*** *that consumers are still paying a lot for certain types of content, but that this is being invested back into the firm….Furthermore, there are a number of indicators that there* ***may*** *be an incentive for Sky to invest in market share now, even at the cost of short-term profits, in pursuit of a longer-term market position. This is discussed in chapter 6*" (emphasis added).

23 *Better Policy Making: Ofcom's Approach to Impact Assessment* (21 July 2005), page 3 and in particular Paragraph 1.1 (quoting the Better Regulation Taskforce, September 2003.)

standard that is unreachable, and it is therefore not an appropriate standard against which to judge possible outcomes. As a result, Ofcom appears reluctant to assess properly the balance of evidence that it has before it – which as we show above is perfectly adequate to draw some firm initial conclusions – but rather feels compelled to seek further evidence until it reaches a point where all potential adverse outcomes that might possibly arise – no matter how remote the possibility - are definitively ruled out or are definitively confirmed. This is simply unrealistic. As an experienced and so-called *"evidence-based"* regulator, Ofcom should know that it is very rare to be presented with evidence that is sufficient to rule out or confirm definitively all other possibilities. The role of an experienced and evidence-based regulator is to assess when it is appropriate to rely on the evidence in front of it, rather than investigating all and any *"possibilities"*.

3.6 Moreover, to the extent that Ofcom identifies possible concerns which it suggests cannot be dismissed until evidence is provided to "*preclude*" that concern, Ofcom is effectively reversing the burden of proof.[24] It is not the case that, unless evidence is provided to preclude those concerns, there are grounds for regulatory intervention.

3.7 Although the Consultation Document purports to set out criteria for whether the market in which pay TV services are provided is working well (see Section 2 of the Consultation Document), it appears that Ofcom does not believe that the criteria do their job – to provide a set of standards against which to judge the working of the market. If it were otherwise, then Section 6 of the Consultation Document would not exist.

3.8 It is clear from the Consultation Document that Ofcom's reason for exploring *"possibilities"* lies partly in its interpretation of its principal duty under the Communications Act to further the interests of consumers in relevant markets, where appropriate by promoting competition. Ofcom says that this means that it is *"required, where appropriate, to take a dynamic and forward-looking view of the effectiveness with which competition might deliver benefits to consumers"*.[25] As the specialist sectoral regulator, Ofcom is of course right to take a forward-looking view of likely market developments. But Ofcom misinterprets its duty if it believes that it is required to investigate all and any possibilities and to regulate on the basis that one or more of them might come to pass. Ofcom's duties do not require it to take action simply on the basis of mere possibilities; indeed this would likely constitute a breach of Ofcom's duty to have regard to

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[24] The evidentiary burden that Ofcom needs to meet is all the higher in relation to speculative future concerns.

[25] Paragraph 2.17. In the same paragraph, Ofcom refers to this duty as a *"duty to promote competition"*; it is important to note that Ofcom does not in fact have an absolute duty to promote competition – rather, it has a duty to promote competition only where this is appropriate in order to further the interests of consumers. We note in this context that, as confirmed in Paragraph 1.3 of the Consultation Document, Ofcom's investigation was triggered by a complaint from Sky's competitors, not consumers.

the principle under which regulatory activities should be targeted only at cases in which action is needed.[26]

3.9 Sky's view is that, as a fair and open-minded regulator, Ofcom should have concluded that, on the basis of the evidence in the Consultation Document, the market is functioning effectively and delivering appropriate consumer benefits, and that there are therefore no problems worthy of further action. Ofcom should not have effectively ignored this evidence and proceeded to examine hypothetical future scenarios.

4. The UK compares well to other EU countries

4.1 We submit above that, based on its own criteria and evidence, it would have been reasonable for Ofcom to have made its *"initial assessment"* a firmer conclusion and to have adopted the approach that no further action is required.

4.2 Sky commissioned a report from PwC, included at **Annex 1**, on "*The outcomes for consumers in relation to pay TV in Europe*". PwC was asked to conduct a study of outcomes for consumers in relation to pay TV services, focusing on prices, consumer choice and innovation across 15 European countries including the UK.

4.3 The key findings of PwC's research further bolster Ofcom's initial assessment that the market is serving its existing customers well.

4.4 The key findings of PwC's research are as follows:

- **digital pay TV penetration**: the UK is among the three countries with the highest digital pay TV penetration.[27] This level of penetration clearly constitutes important evidence, given Ofcom's concern about the pricing of pay TV services and the possibility that some customers are 'excluded' from pay TV;

- **choice and value from pay TV**: the UK compares well with the comparator countries in terms of the number of pay TV channels which offer genuine value (over and above what is freely available to consumers) and when evaluated properly, charges for pay TV services in the UK cannot be said to be "*high compared to other countries*".

- **innovation**: the UK is the leading country in terms of both take up of digital pay TV and take up of PVRs and HD.

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26 Section 3(3), Communications Act 2003.

27 Sky also asked PwC to examine the take-up of *premium* pay TV channels in different countries in Europe. Sky believes that the UK is likely to lead Europe in terms of the penetration of premium pay TV channels, which again would be a significant indicator of positive outcomes for consumers. There is, however, little publicly available data on the mix of retailers' pay TV subscribers as between premium and basic services and therefore PwC was unable to complete this aspect of the research.

4.5 As Ofcom will see, PwC's report has been very thoroughly researched and the evidence very carefully analysed. Accordingly, weight may be placed on its conclusions, which demonstrate that the UK is a leader among the comparator countries in terms of digital pay TV penetration, choice and value from pay TV, and innovation in pay TV.

4.6 Ofcom can, therefore, take considerable comfort from PwC's report, that its "*initial assessment*" that the market is serving customers well, is correct. Ofcom can now rest assured that the UK is not out of line with other European countries on any of the most important measures of customer outcomes, and is certainly now in a position to firm up its "*initial assessment*" and draw a positive conclusion that the market is serving consumers well.

5. The underlying theme of concern about pricing of pay TV

5.1 Notwithstanding the overarching positive conclusion on how the market is serving consumers (including the level of consumer satisfaction), Ofcom indicates in several places that it has reservations about the pricing of pay TV services, noting variously that:

- certain types of customers may be "*excluded*" from pay TV by pricing structures;[28] and
- UK prices may be high compared to other countries.[29]

5.2 We suspect that the above reservations stem from Ofcom's belief that there is market power (on Sky's part) at one or more levels of the market, and its presumption that this must give rise to problems, including prices above competitive levels.[30] We explain briefly below why these reservations are not justified, and, therefore, why Ofcom could have reached the conclusion that we suggest above.

5.3 In relation to 'customer exclusion', the first point to note is that a key test for whether a market is currently working well is the outcomes for consumers who are currently experiencing the service in question. The fact that some consumers are not prepared to pay for additional TV services provided at competitive prices does not merit the nomenclature of a theory of *"exclusion"*. For example, one cannot conclude that someone who has compared Freeview and pay TV and has concluded that the former is, for them, better value for money is, therefore, 'excluded' from pay TV. Consumers making the decision not to purchase a particular service are evidence neither of a lack of competition, nor of *"exclusion"*.

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28 Paragraph 4.5.

29 Paragraphs 1.19 – 1.20.

30 Sky sets out in **Annex 2** (Market definition and market power) to this Response the material flaws in Ofcom's analysis of market definition and market power including, in particular, its foundation on a set of ill-founded and/or unsupported preconceptions. Sky's views, as set out in that Annex, are summarised at Paragraphs 6.1 to 6.45 below.

5.4 Moreover, Ofcom is mistaken if it considers that it is its role or duty to ensure that the entire population can afford to take a pay TV service or will perceive pay TV services as offering value for money when compared with free to air services. Even in a highly competitive market, it is inevitable that some consumers will not be able to afford pay TV or will choose to spend their money on other things.

5.5 In this regard, Ofcom should have accorded greater weight in the Consultation Document to the UK's high levels of penetration of relevant services, as evidenced by its own research, which found that *"the UK has the highest take-up of digital terrestrial services, the second highest take-up of digital satellite (after Japan), and the third highest cable take-up (after the US and Ireland)"*.[31] The UK's high penetration levels for digital satellite and cable constitute a clear indication that there can be no valid concern about "*customer exclusion*".

5.6 In relation to the price of UK pay TV services, Ofcom states that "*a headline comparison of revenues per head may be taken to indicate that UK prices are high compared to other countries*".[32] Although Ofcom goes on to refer to a number of caveats that need to be recognised, the fact remains that Ofcom chose to summarise its initial assessment by stating that UK prices appear high compared to other countries. (This then appears to form the basis for Ofcom's statement that there is a "*possibility that consumers are still paying a lot for certain types of content*".[33])

5.7 Given that:

- Sky provided Ofcom with a comprehensive and definitive critique of LECG's work, the overall conclusion of which was that *"LECG's analysis cannot be relied upon to tell us* ***anything*** *about any alleged consumer harm in the UK associated with the competitive state of the pay TV market"*;[34] and

- Ofcom and a well-respected academic, Professor Andrew Chesher, identified "*a number of concerns"*[35] arising from LECG's analysis;

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31 Ofcom, *"The Consumer Experience"* – research report (20 November 2007), pages 29-30 and in particular paragraph 2.2.17, which, we note, is not referred to or cited in the Consultation Document despite preceding it by several weeks.

32 Paragraph 4.76.

33 *Ibid.*

34 Paragraph 17 of the Executive Summary of Sky's Response to the Complaint. PwC's report provides confirmatory evidence in relation to a key flaw in LECG's study – the treatment of cable access packages in a number of European countries as 'pay TV' when in fact they simply comprise essentially free to air services delivered via cable for a monthly utility charge. PwC show the very significant differences that exist between 'genuine pay TV' penetration in countries such as Belgium and Germany, and the data on pay TV penetration relied on by LECG, which play a key role in their conclusion that prices in the UK were above the European average.

35 Sky notes that Ofcom has not made public either its initial assessment of LECG's analysis or the additional data and analysis provided by LECG to Ofcom in response to its concerns. Sky also notes that Ofcom was unwilling to share this data or analysis with Sky.

Ofcom was, at the time of publication of the Consultation Document, in a position robustly to dismiss LECG's analysis (which, as noted in Sky's Response to the Complaint, was the only purported evidence submitted by the Complainants to support their allegations of consumer harm) as being of no evidential value at all.

5.8 Following the receipt of PwC's report, Ofcom now has even less justification for any reliance on LECG's flawed report or indeed for any concerns about prices in the UK being high in relation to those in other countries. Unlike LECG's report – which examined prices paid by no-one for pay TV services that do not exist – PwC examined the services that are *actually provided* to consumers in 15 European countries (including the UK). Such a detailed examination is necessary in order to ensure that proper like-for-like comparisons are made, as far as possible, between pay TV services provided in different countries. It also avoids the need to rely on 'average revenue per user' as a measure of charges, given that such a measure is a poor proxy for charges. PwC's report shows clearly that, when evaluated properly, charges for pay TV services in the UK cannot be said to be "*high compared to other countries*".

5.9 PwC also found that penetration of digital pay TV in the UK is amongst the highest in Europe.[36] This provides further evidence in support of the proposition that UK pricing levels are not unduly high (and, therefore, as we note above, that there is unlikely to be any material 'customer exclusion' as a result of pricing levels). If prices were unduly high, then one would expect to see reduced penetration of pay TV services by reference to comparator countries.

5.10 Despite finding no convincing evidence that "*the industry is earning excessive profits*"[37], Ofcom hints that something is nonetheless amiss by referring to the "*possibility*" that consumers are still "*paying a lot for certain types of content*" but that this is being invested for "*growth rather than short term shareholder returns*" and that *"there are a number of indicators that there may be an incentive for Sky to invest in market share now, even at the cost of short-term profits, in pursuit of a longer-term position*".[38] We address in more detail in Section 8 to Section 11 of this **Part 2** the theories at which Ofcom obliquely hints here, and which it sets out in Section 6 of the Consultation Document.

36 According to **Figure 2** of PwC's report, as at the end of 2006 the UK was one of the top three of the fifteen European countries in PwC's comparison in terms of digital pay TV penetration. As noted at Paragraph 4.2 of PwC's report and for the reasons set out in Paragraph 2.6, the extent of development of digital TV in a country is a supporting indicator of the level of *"genuine"* pay TV penetration (i.e. excluding cable access/mini-pay TV subscribers who pay fees which include only a small or no element related to content – see Section 2.1.3 of PwC's report).

37 Question 9 of the Consultation Document.

38 Paragraph 4.76.

6. Ofcom's preconceptions about market definition and market power drive it to find problems

6.1 We identify above that notwithstanding reliable and important evidence that the market is working well for consumers, Ofcom nonetheless seems to believe that there is a problem somewhere that it needs to uncover. In an approach that appears inconsistent with its regulatory principles and its assertions that it retains an open mind as to whether or not competition problems exist,[39] Ofcom sets out, and then (through questions asked in the Consultation Document) seeks evidence to bolster, its series of hypothetical concerns.

6.2 In Sky's view a key reason behind Ofcom's apparent search to try to uncover a competition problem is a preconception both as to the scope of relevant markets and as to Sky's market power within them. This preconception leads Ofcom to ignore or downplay the significance of any evidence that is inconsistent with it or that would undermine its theoretical concerns.

6.3 Ofcom's Consultation Document seeks to establish Sky's dominance in a number of relevant markets using the normal analytical tools of market definition and assessment of market power. However, these are applied in the context of a presumption that Sky held a dominant position in the past, with the aim of testing whether that continues to be the case – for example by seeking to determine whether markets that were defined in the past are still 'markets' today, or have "*widened*" over time.

6.4 This approach leads Ofcom to conclude that premium pay TV services are supplied in very narrow relevant economic markets, both at the wholesale and retail levels.[40] At the wholesale level, the preliminary relevant markets that Ofcom defines are focused closely on particular types of television channels in which Sky has specialised, namely premium sports and movie channels. As a result, Sky is, naturally, found to have very high market shares in their supply – indeed, to have a 100% of the supply of premium movie channels. In conjunction with Ofcom's view that there are significant barriers to entry to these putative markets, and no countervailing buyer power, Ofcom finds that Sky is likely to hold a dominant position in those putative "*markets*".

6.5 Ofcom's approach is inappropriate for two reasons. First, the starting point is wrong. Second, the analysis of these issues set out in the Consultation

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39 Sky notes, in this regard, the dissonance between Ofcom's statements in the consultation document and its reference to "*warning signs*" in the press release that accompanied its publication.

40 In the following we focus on market definition and market power in relation to premium pay TV services. In relation to basic pay TV services, Ofcom concludes that no operator has significant market power, at either the wholesale or retail levels, in spite of concluding that there is a retail market for the supply of basic-only pay TV packages. Sky considers that Ofcom's preliminary conclusion in relation to the relevant market for basic-only pay TV services defies all available evidence, as well as common sense. Clearly, it is incompatible with the conclusion on the relevant market at the retail level reached by the Competition Commission in the BSkyB/ITV inquiry.

Document is analytically and evidentially deficient and no weight can be placed on it. A proper consideration of relevant evidence instead suggests that Sky does not hold a dominant position in any relevant market. Ofcom's hypothetical competition concerns are, therefore, based on unsound grounds.

6.6 We discuss these points further in the sections below. A more detailed discussion is provided in **Annex 2** (Market definition and market power).

Ofcom's approach is based on preconceptions

6.7 That Ofcom started its analysis with preconceptions is made clear by the comment about market definition and Sky's alleged dominance made by Ed Richards of Ofcom at the first media analysts' briefing on 19 September 2007:

> *"If you look at [the OFT's] conclusions to a very substantial piece of work, they say, in their conclusions, that Sky is dominant in the provision of wholesale premium content,* ***and that is the base from which I am working****. It may be that, in the work that we do, we conclude that that is no longer the case, but that is the last serious competition authority assessment of that position and****, at the moment, I do not see any reason to change that view.*** *In the course of the work we do, we may do, but* ***that is my current view****.* ***I am always happy to receive evidence to refute that from any party, but that is the basis of the current view****"*[41] (emphasis added).

6.8 Similar sentiments are echoed throughout the Consultation Document, where conclusions from past decisions are labelled as "*precedent*".[42] Ofcom's approach can, therefore, be characterised as one of having to be persuaded that there are good reasons for departing from the conclusions reached in past decisions, and in particular by the OFT in 2002.

6.9 Four things are striking about such an approach:

(i) it is entirely at odds with an open-minded, evidence-based approach to the examination of the relevant issues (and appears at odds with Ofcom's usual approach of seeking to examine issues afresh for itself). In particular, it introduces a significant risk of error in the conclusions – if the presumption is wrong (as it is in this case[43]) there is a real risk

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41 This also effectively confirms the point made above about the reversal of the burden of proof. Here, the suggestion is that, rather than looking at the available evidence on market definition in an objective manner, Ofcom prefers to start with an existing decision and to presume that the decision is correct unless evidence is received to refute that.

42 It is erroneous for Ofcom to label past findings as "*precedent*", which refers to binding legal decisions. Market definition in past cases in relation to pay TV may provide some assistance in a new assessment but may equally be of no relevance whatsoever.

43 Ofcom sets out no examination of the OFT's findings in the consultation document and it therefore appears that it has done nothing to assure itself that those findings were correct at the time they were reached. Sky sets out (briefly) at **Appendix 4** to **Annex 2** (Market definition and market power) its reasons for considering that the OFT's findings in 2002 were erroneous. It is particularly important to note that a proper reading of the OFT's Decision indicates that conclusions in relation to relevant markets at the retail level were essentially 'tacked on' to an analysis that was almost entirely focused on Sky's position at the wholesale

that the conclusion reached will be wrong. For example, a preconception that market power is already being exercised leads Ofcom entirely to discount consumer survey evidence that would normally be regarded as strongly supportive of wider markets (which in turn would be supportive of a proposition that Sky did not have significant market power);

(ii) the OFT's decision referred to by Ed Richards dates from December 2002, and covers an even earlier period (from June 1998 to December 2001). There have been vast changes in the sector since then, which have implications for market analysis, as noted by Ofcom elsewhere:

> "*In our regulatory stance, we believe convergence is a good thing – **eroding conventional market boundaries,** offering added choice, range, keener prices and improved quality of service*"[44]

(iii) it is wholly at odds with Ofcom's stated aspiration in the Consultation Document that its analysis is "*forward-looking*"; and

(iv) the statement that the OFT's inquiry comprises the "*last serious competition authority assessment*" of these issues is no longer valid. The last such examination of these issues was the Competition Commission's report on Sky's purchase of a 17.9% stake in ITV, which was published at the end of 2007. In particular, the Competition Commission's report is the only major assessment of relevant markets in this sector to have occurred in the UK since the introduction of Freeview.

6.10 Sky considers that the only proper approach to these matters is for them to be determined de novo. Account should only be taken of those past findings which are sufficiently recent and robust to be relevant to the current investigation. The most recent and relevant finding is the relevant market definition reached by the Competition Commission in its report on Sky's purchase of a 17.9% stake in ITV. Ofcom must therefore accord that finding far greater weight than it does currently.

Ofcom's analysis of market definition and market power is deficient

6.11 Ofcom's analysis of market definition at the retail level is based on three pieces of analysis; (i) consumers' preferences in relation to product characteristics; (ii) the relationship between changes in retail prices, quality and subscriber numbers; and, (iii) the hypothetical monopolist test.

6.12 Much of the analysis undertaken by Ofcom in relation to the first two of these is either cursory in nature, or significantly flawed such that no evidential weight can be placed on it.

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level. Accordingly, no weight should be placed on those findings, let alone using them as a starting point for market definition at this point in time.

[44] Speech by Ed Richards, 30 November 2006.

6.13 For example, part of Ofcom's assessment of the inter-relationship between past changes in charges for Sky's pay TV packages that include premium sports channels and subscriber numbers to those packages involves an assessment of the change in quality of Sky's sports channels since January 2000. That assessment is as follows:

> *"there does not appear to have been a substantial change to the underlying quality of Sky's sports offering…On a simple measure, although there has been some growth in the overall number of hours broadcast, the number of live FAPL games shown by Sky has actually declined following the 2006 auction."*

6.14 That is the full extent of the analysis. Of the factors cited, one is erroneous (the number of live FAPL games shown on Sky's sports channels increased following the 2006 auction), and the other is significantly underplayed – the number of hours of live FAPL football broadcast on Sky's sports channels has increased by 256% since January 2000 (and the total hours coverage of FAPL matches, including 'near live', same day coverage of matches has increased enormously). Clearly, such a cursory analysis is wholly inadequate as a basis for reaching well-supported, evidence-based conclusions. A proper analysis would have demonstrated very material increases in the quality of Sky's sports channels since January 2000 – for example via the addition of new content such as live Champions' League matches, and more England domestic Test Cricket matches, as well as a host of other improvements. Yet, on the basis of its cursory analysis, Ofcom concludes:

> "*On balance we believe the evidence presented here suggests that historical precedent with respect to premium sports in the UK (sic) [that a narrow retail market for pay TV packages that include premium sports channels exists] is likely to remain relevant."*[45]

6.15 The second piece of analysis on which Ofcom places weight in its assessment of relevant retail markets is an assessment of products' characteristics. Much of Ofcom's analysis comes very close to a position that products are in separate markets because they have different characteristics (which is put in the Consultation Document in terms of consumers purchasing them for different reasons, based on an assessment of the "*key drivers*" of demand). Clearly, such a proposition is erroneous in the context of market definition – particularly where product differentiation plays a key role in competition, as it does at both the retail and wholesale levels of this sector. Similarly erroneous is Ofcom's singular focus on the preferences of those consumers who are most attached to (or "*must have*") particular types of pay TV service, as opposed to 'marginal customers' – those who are least attached to them. This is the 'toothless fallacy' in market definition.

6.16 The third piece of analysis relating to market definition is the hypothetical monopolist test which Ofcom seeks to apply by considering consumer research on potential reactions by pay TV subscribers to increases in subscription

45 Paragraph 4.30 of Annex 13.

charges. This evidence is, however, strongly suggestive that relevant markets are wider than those that Ofcom has defined. Ofcom, however, places no weight on this evidence. The reasons given for effectively ignoring this analysis are ill-founded. A key reason for Ofcom ignoring this evidence is that it believes that it is tainted by the 'cellophane fallacy' – a belief that clearly stems from Ofcom's preconception that Sky has market power and therefore that charges for pay TV services are currently above 'competitive levels'. There is a complete disconnect between this belief and the finding in Section 4 of the Consultation Document that Sky does not earn excess profits. It is clear that consideration of profitability provides a useful cross-check on whether prices are above competitive levels – an approach that Ofcom itself has used in previous market definition exercises.

6.17 Ofcom's willingness to ignore or significantly downplay evidence which conflicts with its preliminary conclusions in this respect is notable.

6.18 In summary Ofcom considers three pieces of analysis, two of which are flawed or too cursory to be relied on and the third of which conflicts with its conclusion and so is ignored. Ofcom therefore has no evidence at all on which to base its preliminary conclusions in relation to market definition at the retail level.

Ofcom's approach is narrow and mechanistic and leads to conclusions that run counter to the evidence set out in Section 4 of the Consultation Document

6.19 Given the complexity of applying the standard market definition framework in this sector, Ofcom should have adopted a more pragmatic approach to market definition and market power. This difficulty arises because the sector exhibits characteristics such as: significant differences between the business models of competing operators; competition through product differentiation; the existence of economic rents; and significant ongoing changes in technology and consumer demand.

6.20 Ofcom's approach is instead narrow and mechanistic and as a result fails to have regard to a wide range of evidence that would be highly informative of the issues it has considered. It is evident that application of standard procedures for defining markets and assessing market power in a narrow and mechanistic way will tend to produce conclusions that run counter to both observed market outcomes and common sense.

6.21 That this is the case is clearly demonstrated by the complete disconnect between the evidence on market outcomes presented in Section 4 of the Consultation Document (together with other readily available evidence), and Ofcom's analysis of market power.

6.22 At the retail level, the market outcomes examined in Section 4 of the Consultation Document provides strong corroborative evidence of the absence of market power: Ofcom finds that there are no excess profits; innovation is strong, there is considerable consumer satisfaction with services and, as

Ofcom finds elsewhere[46], take-up of pay TV in the UK is among the highest in Europe. Ofcom's own evidence is strongly corroborated by the findings of PwC's report.

6.23 Although Ofcom does not devote attention to this issue, it is clear that similar results pertain at the wholesale level: there are no excess profits; Sky strives continuously to provide high-quality, innovative television channels, which are valued by its customers; and Sky is not able to hold down (or reduce) the amounts it pays for rights – as would be expected if Sky was a dominant purchaser of such rights.

A proper examination of relevant evidence suggests that Sky does not hold a dominant position

6.24 Sky considers that the relevant market at the retail level is at least as wide as that recently defined by the Competition Commission (a market for "*all TV*"), but should also include ways of viewing audiovisual content such as via non-linear services (whether on a free or paid-for basis) and via pre-recorded media (notably DVDs), whether on a purchase or rental basis.

6.25 At the upstream (channel provider) level, Sky considers that all broadcasters, whether free or pay, are in competition with each other and, therefore, that the relevant market is at least all television channels. In principle, it should also be defined to include the provision to retailers of programming on a stand-alone basis (e.g. a film, television series, or episode of a television series) given the significant and increasing role that such services play at the downstream level.

6.26 The relevant evidence and arguments on which Sky relies in support of these views, in addition to the evidence above, are discussed briefly below. They are set out fully in **Annex 2** (Market definition and market power).

Retail level

6.27 Clearly, the interplay between pay TV and free to air television is central to this assessment. As ITV submitted to the Competition Commission:

> "*the stronger the free-to-air viewing proposition (via analogue and now digital free-to-air platforms), the less likely consumers will be willing to convert to (or maintain their subscription with) a pay TV platform.*"

6.28 It is entirely evident that the "*free-to-air viewing proposition*" in the UK has always been strong. The main terrestrial free to air broadcasters collectively spend over £3 billion a year on programming, which underpins the fact that they continue to dominate television viewing, even in households that subscribe to pay TV services. It is similarly evident that the strength of the free-to-air proposition has grown considerably in the recent past – and will continue to do so in the future. Relaxation of the constraints imposed on the main free to air television broadcasters by reliance on analogue terrestrial

46 Ofcom, *"The Consumer Experience"* – research report (20 November 2007).

broadcasting has enabled them to broaden and deepen their offerings.[47] Together with a large expansion in the range of broadcasters delivering free to air television in the UK, this has resulted in a major shift in the competitive strength of the UK's free to air proposition. It now consists of around 40 channels delivered via DTT, and over 200 channels delivered via DTH. The platform take-up for both DTT and DTH is around 40% of UK households each (42% for DTH and 43% for DTT)[48]; within four years all UK households will only be able to receive digital TV.

6.29 In addition to these past and prospective changes in over the air delivery, the UK is clearly at the early stages of a massive increase in use of online distribution of programming on a free basis – the level of demand for such services indicated by data on usage of the BBC's iPlayer service since its launch at the start of 2008 speaks for itself in this respect.

6.30 Discussion of such trends is conspicuous by its absence in the Consultation Document. Yet, last month, Ed Richards stated in another context:

> "*The future will never be about linear television alone, but a rich mix of linear TV and new and diverse forms of content and delivery.*"[49]

6.31 The increasing strength (from a high starting point) of free to air services has a major impact of the demand for pay TV services. Pay TV subscribers – particularly more marginal subscribers that are less attracted to pay TV than early adopters and 'dedicated fans' of particular programmes carried on pay TV channels – are highly sensitive to the value for money of their subscriptions. This is confirmed by Ofcom's consumer research. Increases in the value of free to air television – whether through the addition of more programming, or improved ways of accessing programming – will therefore have a significant impact on the providers of pay TV services at the retail level.

6.32 The clear inter-relationship between pay TV and free to air television is borne out by the very considerable changes that Sky has made to its business strategy in the past few years, which have clearly been aimed at addressing the changing environment in which it operates. These initiatives include: a £[**CONFIDENTIAL**] million advertising campaign aimed at raising awareness of the quality of programming carried on basic pay TV channels; increased investment in Sky's own basic channels (in addition to the major investments that Sky has always made in its premium channels); holding down (or foregoing entirely) price increases; major changes to Sky's pricing and packaging for basic channels (which delivered a new set of basic channel

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47 Given the pace of change in the sector it is easy to forget that, other than the BBC, the terrestrial broadcasters have been only recent converts to free to air digital television. For example, ITV only converted ITV2 to a digital free to air channel only in November 2004, and completed the introduction of its current portfolio of free to air channels in November 2005. Channel 4 took Film Four free to air in July 2006, while five launched five Life and five US only in October 2006.

48 http://www.ofcom.org.uk/research/tv/reports/dtv/dtv_2007_q4/dtvq407.pdf

49 http://www.ofcom.org.uk/media/speeches/2008/03/rtspsb

packages offering significant improved value), and a shift to focus on promoting those cheaper packages; large investments in the delivery of broadband services which act to significantly enhance the value for money delivered to Sky subscribers; and driving take-up of Sky+ (for example through reductions in charges for its use or in the cost of a Sky+ box). These types of changes are entirely inconsistent with the view espoused in the Consultation Document of Sky dominating a set of hermetically sealed pay TV bubbles at the retail level.

6.33 Further evidence of the increasing competitive pressure imposed by a strengthening free to air proposition is provided both by Sky's econometric research and the relative difficulty faced by Sky in attracting Freeview homes to pay TV as compared to analogue terrestrial homes (who receive only the five main free to air channels).

6.34 It is, moreover, erroneous simply to regard this as an increase in competition in relation to basic-only pay TV services. Subscribers to basic-plus-premium pay TV packages place value on the basic channels in their packages, so that any diminution in that value, arising from increased attractiveness of free to air services, also diminishes the ability of pay TV providers to attract and retain subscribers to premium packages.

6.35 Over and above this set of factors, it is evident that competition in the provision of films to consumers has also increased dramatically. This increase arises from a range of sources, including: a large expansion in the number of films shown on free to air and basic channels (the number of films broadcast on free to air channels increased threefold between 2001 and 2007); falling prices for DVDs; a wide range of new DVD rental services; and, significantly, the development of new 'on-demand' film services, such as those provided on Virgin Media's cable networks, and by BT Vision and Tiscali TV on their IPTV platforms. A number of such services – such as DVD sales and rental, and on-demand film services - are able to deliver films in earlier windows than the pay TV window, which means that many users of these services will have viewed films already by the time the pay TV window commences.

6.36 It is apparent that this increase in competition is having a major impact on pay TV retailers' ability to attract subscribers to packages that include premium movie channels. In spite of increases in the value provided by such packages, and their charges being broadly flat in inflation-adjusted terms since 2001, the number of DTH subscribers to such services is in decline (the number of cable subscribers to such services has been declining for many years). The difficulty of attracting new subscribers to such services is illustrated by the fact that whereas in mid 2004 [**CONFIDENTIAL**][more than 50]% of new Sky subscribers took movie channels in their packages, in the same period in 2007 this figure had fallen to [**CONFIDENTIAL**][less than 50]%. It defies both actual evidence and common sense to assert that nothing significant has changed in the past five years in relation to such services.

6.37 Charges for pay TV services at the retail level for the most popular premium packages have been constant in inflation-adjusted terms for many years. For example, in inflation-adjusted terms: the charge for Sky's Top Tier package is no higher now than January 2004; the charge for Dual Movies is essentially the same now as in January 2002; and the charge for Dual Sports is no higher than in September 2005. The charge for Sky's 'Big Basic' package is actually lower in inflation-adjusted terms now than in January 2002. At the same time, there have been very material improvements in the value of these packages, which means that when charges are adjusted both for inflation and what is actually provided to consumers, they are likely to have declined considerably over time.

6.38 Sky considers that the weight of this available evidence, assessed in the round, points strongly to the conclusion that the relevant market downstream is wider than the set of narrow pay TV markets defined by Ofcom (to the extent that these can be discerned), and that Sky does not hold a dominant position at this level.

Wholesale level

6.39 The competitiveness of the market at the downstream level plays a key role in determining constraints on the position of broadcasters at the upstream (wholesale) level; demand for pay TV channels on the part of pay TV retailers is a derived demand and therefore retailers' willingness to pay for channels carried in their pay TV packages, both basic and premium, is directly affected by constraints on their ability to attract and retain subscribers to their services.

6.40 The intensely competitive nature of the relevant downstream market therefore means that television channel providers (both free and pay) must strive to make their channels as attractive as possible – both in terms of the programming they carry, and in the case of pay TV channels, in terms of price. Notably, television channels also compete by attempting to differentiate their channels from others in some way.

6.41 The constraint arising from the intensity of downstream competition is reinforced by retailers' switching options, and low barriers to entry to the provision of premium pay TV channels.

6.42 Ofcom's belief that pay TV distributors have little or no bargaining power in relation to pay TV channel providers overlooks the fact that a number of pay TV retailers – notably Virgin Media - also operate closed platforms. This means that channel providers are dependent to a very significant degree on them marketing channels effectively to their subscriber base, which gives them considerable countervailing bargaining power. In essence, they are able to substitute away from a broadcaster's channel simply by focusing their marketing effort elsewhere – in particular on high margin broadband or telephony. The extent to which Virgin Media, for example, emphasises selling broadband and telephony ahead of marketing Sky's channels to its subscribers is demonstrated not only by its public statements to this effect, but also by the significant decline in the number of cable subscribers to Sky's sports and movie channels.

6.43 In relation to barriers to entry, the main barrier identified by Ofcom is the alleged inability for other operators to obtain rights to "*premium content*". As discussed below, and in more detail in **Annex 3** (Barriers to entry at the channel provider level), Ofcom's consideration of this issue, however, is (a) wholly theoretical, (b) one-sided – it considers only impediments to entry and not factors that facilitate entry, and (c) contradicted by available evidence. A proper examination of relevant evidence points to the fact that programming rights are contestable and therefore potential for entry ensures that upstream 'markets' are competitive.

6.44 Clear evidence that Sky faces significant competition at the wholesale level is provided by trends in wholesale charges over time. In inflation-adjusted terms, charges for both Dual Movies and Single Sports have been declining for a considerable period, and the charge for a package of all Sky's premium channels is lower now than it was in September 2004. Given the considerable improvements in the channels in these packages over time, it is clear that such packages provide increasing value for money to pay TV retailers.

6.45 The weight of this available evidence, assessed in the round, points strongly to the conclusion that the relevant market at the wholesale level is wider than the narrow pay TV channel markets defined by Ofcom, and that Sky does not hold a dominant position in any relevant market at this level.

7. Ofcom's *"concerns"* are purely hypothetical and cannot form the basis for regulatory intervention

7.1 Ofcom's flawed findings on market definition and market power underpin its analysis of the characteristics of the market and, ultimately, its hypotheses as to how these might operate to create competition problems. Ofcom states that the presence of market power *"is particularly relevant to the feasibility and profitability of anti-competitive conduct"*.[50]

7.2 We have explained above and in **Annex 2** (Market definition and market power) why Ofcom's conclusions on market definition and market power are incorrect. However, even if Ofcom's market definition and market power analyses were correct, the *"concerns"* that Ofcom sets out in the Consultation Document are purely hypothetical and cannot form the basis for regulatory intervention under any of Ofcom's available powers.

7.3 Sky has commissioned CRA International, Dr Pierre Régibeau and Professor John Van Reenen to review and report on the analysis and arguments contained in the Consultation Document on the likely consequences of vertical integration and in particular on the potential *"short term"* and *"long term"* issues that may arise, especially when combined with other features such as the aggregation of content. CRA's report is contained at **Annex 4** (CRA's report: Vertical integration and short-run/long-run issues) and we refer to it as appropriate below.

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[50] Paragraph 5.129.

7.4 Ofcom sets out, in Paragraphs 1.61 to 1.65 and Paragraphs 6.74 to 6.78, a summary of its "*possible concerns*". We have categorised these "*possible concerns*" and have analysed each in turn in the following Sections of this **Part 2**. The categories are as follows:

- Content aggregation (Section 8);
- "Tipping" of platforms towards one retailer (Section 9);
- Ofcom's short-run and long-run concerns – "*premium content*" (Section 10), which we have split out as follows:

    1) Significant barriers to entry in the "*market for premium wholesale channels*", exacerbated by the presence of a vertically integrated incumbent "*with an incentive to control access to downstream markets*" (long run concern);

    2) Ability and incentive of vertically integrated incumbent to reduce the quality of what it supplies in order to strengthen its retail offering (short run concern);

    3) Ability and incentive of vertically integrated incumbent to foreclose potential new retailers by denying them content (long run concern);

    4) Prevalence of vertical integration may cause foreclosure of new retailers to foreclose the possible development of new platforms (long run concern);

    5) "Dynamic foreclosure";

- Ofcom's short-run concern – "*basic content*": buy-through (Section 11).

8. Content aggregation

8.1 Ofcom discusses content aggregation in the context of it being a "*characteristic of [the] pay TV market*" in Section 5.[51] Content aggregation is also described as the "*starting point*" for all of Ofcom's hypotheses "*for the ways in which these characteristics might lead the market to operate"*, as set out in Section 6.[52]

8.2 **Annex 5** (Content Aggregation) sets out in detail Sky's comments on Ofcom's theories of content aggregation. We summarise our key comments on content aggregation in this Section 8.

No evidence that aggregation leads to reduced choice

8.3 Ofcom's starting point is that a wide variety of content is generated upstream but is ultimately sold to consumers in a "*relatively small selection of retail*

51 Heading above Paragraph 5.60.

52 Paragraph 6.2.

bundles".[53] There is no explanation of what Ofcom means by "*relatively small*" (relative to what?), but Sky does not recognise this description:

- content which is offered as part of a pay TV package is often available without a pay TV subscription, and hence the set of choices open to consumers is much larger than Ofcom acknowledges;
- even focusing on pay TV packages, consumers have a very considerable number of retail bundles available to them – the total number of bundles offered by Sky alone on its DTH platform is 1,764.

Content aggregation at the wholesale level as the basis for competition concerns

8.4 Ofcom states that:

> "*[it] may have competition concerns where aggregation of content by a particular provider leads to the creation of market power*";.[54]

8.5 In relation to competition concerns arising from content aggregation at the wholesale level, Ofcom argues that where a single channel provider is able to aggregate the majority of closely substitutable content, prices are likely to rise above the competitive level. It notes that such aggregation can arise either as a result of a purchaser aggregating a portfolio of rights from different suppliers (i.e., at the wholesale level) or as a result of co-ordination between content suppliers (i.e., at the content production level), and suggests that regardless of the particular mechanism for aggregation of "*closely substitutable content*", any monopoly rents are likely to flow upstream rather than to the retailer. It further alleges that this ability to earn monopoly rents creates an incentive for wholesale channel providers to seek to aggregate closely substitutable content. Ofcom acknowledges, however, that the extent to which any rents earned by aggregating content at the wholesale level might accrue to the channel provider versus the content producer will depend on their relative bargaining strength.[55]

8.6 Ofcom concludes that aggregation of content that is closely substitutable – such as (in Ofcom's view) within Sky's sports channels and within its movie channels - is likely to be bad for consumer welfare.[56] Ofcom does not, however, provide any evidence to support its inference that Sky Movies and Sky Sports do aggregate content that is closely substitutable (or that has not already been aggregated by content producers). Nor does Ofcom set out the alternative outcome against which such aggregation is being judged. The lack of a proper counterfactual makes it very difficult to respond effectively to the

53 Paragraph 5.62.

54 Paragraphs 1.61 and 6.74.

55 Paragraph 1.34 and 1.35 and 6.14 and 6.15.

56 See for example Paragraphs 1.61 and 6.12. Sky notes in this context the tension between Ofcom's apparent view that Sky's sports channels aggregate closely substitutable content and its view that there is no close substitute for live FAPL football.

points that Ofcom makes about the aggregation of closely substitutable content.

8.7 Although Ofcom expressly recognises the benefits associated with the aggregation of content that is not closely substitutable,[57] Ofcom has ignored the benefits of content aggregation in relation to what it classifies as "*closely substitutable content*". As a result, its starting point for assessing the trade-off between efficiency and possible competition problems is too low. The 'benefits' side of the trade-off is set artificially low (in fact, at zero) compared to the 'detriments' side.

8.8 Ofcom does not acknowledge the efficiencies and consumer benefits deriving from content aggregation at the wholesale level in respect of Sky's movies and sports channels as a result of:

- a failure to take account of the fact that the aggregation of content within Sky's sports and movies channels can also result in efficiency gains. This potential bundling efficiency arises because there are a variety of tastes and preferences within the Sky Sports customer base (and the Sky Movies base). The fact that subscribers to Sky Sports are not, as Ofcom appears to believe, all the same but are instead substantially varied is clearly demonstrated by [**CONFIDENTIAL**][58];

- a failure to consider that channels that offer a series of matches and a variety of sports may be more valuable to consumers versus the availability of those events on a disaggregated, pay-per-view basis. A channel can create additional value by placing a single sports event in the context of a tournament or season of which it is a part, and this ability to 'tell a story' adds to the enjoyment that a viewer may gain from watching a particular sports event.;

- giving insufficient weight to the significant information and transaction costs associated with selling content on a very disaggregated basis (for example on a pay-per-view basis). If wholesalers did not aggregate sports content or movie content, then retailers would face the additional cost of billing customers for content, as well as significantly higher marketing costs;[59]

- a failure to recognise that the most appropriate benchmark for the wholesale provision of channels is differentiated competition, a key feature of which is that prices lie above marginal cost, which allows fixed costs to be recovered. Given the necessity for channels to be differentiated, it is not clear that more fragmented sports content (for

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57 For example Paragraph 6.9.

58 [**CONFIDENTIAL**]

59 We note that Ofcom recognises that the efficiencies of <u>retail</u> bundling include "*avoiding transaction costs resulting from multiple consumer purchases*" (Paragraph 5.97). This efficiency also applies at the wholesale level.

example) would lead to lower prices, particularly for the same combinations of sports rights.

8.9 Ofcom goes on to state that "*if any market power which results from content aggregation can then be leveraged into other markets, then this is likely to produce additional competition concerns without any compensating efficiency benefits. Such leverage is likely to be of particular concern from a competition perspective*".[60] Ofcom does not explain in this paragraph what it means by *"leverage"* or *"additional competition concerns"*, nor which *"other markets"* it is referring to. We therefore do not comment on this particular paragraph and assume that it is intended merely to paraphrase what is contained in the paragraphs which follow in Ofcom's Consultation Document, on which we comment in detail below.

9. "Tipping" of platforms towards one retailer

9.1 Ofcom states:

> "*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.*"[61]

9.2 This paragraph encapsulates a number of key issues and theories. Below, Sky comments on its 'unpacked' elements.

(a) "Bundling efficiencies mean that platforms may be prone to "tipping" towards one retailer."

9.3 In the Consultation Document Ofcom hypothesises that there might be a tendency for one retailer to emerge as the primary retailer on each platform because once one retailer has a larger portfolio of channels, bundling efficiencies allow that retailer to outbid any other potential retailers for additional channels or pieces of content.

9.4 We comment in more detail on this hypothesis in **Annex 5** (Content aggregation), but the key points we make in response are as follow:

- whilst there would appear to be a tendency in the UK for a single retailer to emerge on a platform, this does not arise for the reasons suggested by Ofcom. Rather, there is only one retailer on the Virgin Media and BT Vision platforms because these platforms are closed and other retailers are excluded from competing to retail pay TV services over them;

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60 Paragraphs 1.62 and 6.75.

61 Paragraphs 1.63 and 6.76.

- Ofcom singularly fails to recognise that there is no intra-platform competition on these two platforms. Its analysis of the effects of content aggregation on intra-platform competition are therefore unduly focused on the DTH platform, which is particularly ironic given that it is the only open platform, to which third party retailers are assured of access on regulated terms;

- Ofcom's theory that bundling efficiencies lead to the emergence of a single retailer on platforms where there is a possibility of more than one retailer is flawed, overly theoretical and pays scant regard to the reality of retailing pay TV content. In particular, Ofcom's analysis fails to take into account the other various factors, in addition to bundling efficiencies, to which a pay TV retailer has regard in devising its package structure (e.g. the need to simplify packaging so that it can be communicated to actual and potential subscribers and the paucity of information on underlying channel demands). As a result, a pay TV retailer will not be able to exhaust the theoretical potential to generate efficiencies through bundling. Thus, the scale of advantage available to a retailer with a portfolio of channels in terms of obtaining new channels is much smaller than Ofcom suggests. Moreover, neither Sky nor CRA are aware of any valid theory of 'tipping' that is based on bundling efficiencies. [62]

(b) *"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."*

9.5 This statement would appear to derive from a view (not clearly articulated in the Consultation Document) that some TV programmes and/or TV channels (namely, *"premium sports"* and *"premium movies"*) are 'must have' and/or are *"key drivers"* of pay TV subscriptions, and that, as a result, pay TV retailers will be in a position to compete effectively only if such content is wholesaled to them for onward distribution on reasonable terms.

9.6 As Sky notes in Appendix 1 and Appendix 2 to **Annex 2** (Market Definition and market power), it is obvious that Ofcom places a considerable amount of weight in its analysis of market definition and market power on these two concepts of *"must have"* content and *"key drivers"* of subscriptions,[63] but it provides no explanation of what it means by these terms, nor does it have evidence to support the theories in which they implicitly feature in the Consultation Document (insofar as Sky understands them).

9.7 Sky explained in Sky's Response to the Complaint why pay TV retailers who do not have a wholesale relationship with Sky in respect of Sky's movies and sports channels are not foreclosed from retailing pay TV services.[64] Ofcom has

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[62] Any theory of "tipping" requires that an initial advantage be self-reinforcing. No bundling-based mechanism for such reinforcement is proposed, nor are we aware of any that could be.

[63] Paragraph 4.33 of Annex 13.

[64] Paragraphs 5.4 to 5.9 of Part C.

not, however, even considered that explanation in the Consultation Document (even to dismiss it). To summarise Sky's explanation in the Response to the Complaint:

- first, Sky's movies and sports content is not relevant to a very large number of potential subscribers, who therefore comprise a significant target market for a pay TV service that does not include these channels.[65] A pay TV retailer is able to establish a customer base regardless of the availability or otherwise of Sky's content;

- second, a pay TV retailer can build a customer base by retailing other content alongside Sky retailed content. None of the different scenarios set out by Ofcom for content availability and potential outcomes for competition at Paragraph 6.25 and Figure 40 includes a vertically integrated wholesaler/retailer negotiating access to a third party platform and retailing its content directly to customers who are subscribers to the pay TV services of that platform's operator. This is the case where Sky's premium channels are available via 'Sky by Wire'. As Sky set out in its Response to the Complaint,[66] Sky's preference is to retail its premium channels directly to consumers on all platforms, and it has made substantial efforts to engage with the operators of closed platforms so that it can retail its channels directly to customers of those operators. Where Sky is able to secure such access, the platform operator can then include the availability of Sky's premium channels in its marketing messages, and is therefore able to attract customers to its platform based on the combination of services that it retails itself and those that are retailed by Sky. There is no reason why subscribers need to purchase all services delivered over a single platform from one retailer. Tiscali's customers, for example, can take basic TV (including Sky's basic channels), telephony and broadband from Tiscali, and can contract directly with Sky for Sky's premium channels.

9.8 Therefore, even if it were correct that, as Ofcom suggests, "*premium content*" is crucial to attracting pay TV subscribers to a platform, it is not the case that the effectiveness of inter-platform competition depends on *"whether retailers on different platforms are able to gain access to premium content"*[67]. To the extent that the attractiveness of a platform depends on the content available on that platform, it does not matter whether that content is wholesaled or retailed.

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65 For example, some [**CONFIDENTIAL**]% of Sky's UK DTH subscribers and over [**CONFIDENTIAL**]% of cable TV customers do not take any of Sky's premium channels (although note that, from the point of view of a potential retail entrant, the statistic on cable penetration is of general rather than specific interest only, given that the closed nature of cable's platform means that only Virgin Media can retail to those households over that platform).

66 Paragraph 5.7 onwards of Part C.

67 Paragraphs 1.63 and 6.76.

10. Ofcom's short-run and long-run concerns – "*premium content*"

10.1 Ofcom states that it has "*four particular concerns with the prospects for this kind of inter-platform competition*"[68]. It does not expressly spell out what *"this kind"* of inter-platform competition means, but we assume it merely means undistorted competition.

10.2 Ofcom's four concerns for inter-platform competition, and whether they are categorised by Ofcom as *"short-run"* or *"long-run"* concerns, may be summarised as follows (all such concerns relate to "*premium content*" only):

1) significant barriers to entry in the "*market for premium wholesale channels*", exacerbated by the presence of a vertically integrated incumbent "*with an incentive to control access to downstream markets*" (long run concern);

2) ability and incentive of vertically integrated incumbent to reduce the quality of what it supplies in order to strengthen its retail offering (short run concern);

3) ability and incentive of vertically integrated incumbent to foreclose potential new retailers by denying them content (long run concern);

4) prevalence of vertical integration may cause foreclosure of new retailers to foreclose the possible development of new platforms (long run concern).

10.3 We address each of these four concerns below.

1) Significant barriers to entry at the wholesale level, exacerbated by presence of vertically integrated incumbent which has an incentive to control access to downstream markets (long run concern)

10.4 We comment below on (1a) whether there are significant barriers to entry; (1b) whether they are exacerbated by the presence of a vertically integrated incumbent; and (1c) whether an incumbent has incentives to control access to downstream markets.

(1a) <u>*Significant barriers to entry*</u>

10.5 Ofcom concludes that there are significant barriers to entry to content markets at the wholesale level, which it attributes to a limited amount of relevant rights combined with the staggered availability of those rights giving first mover advantages to certain wholesale channel providers. Ofcom argues that an entrant will have to outbid repeatedly the incumbent for content, hence the entrant will take considerable time to assemble sufficient rights to enter and may incur significant losses in so doing.[69]

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[68] Paragraphs 1.64 and 6.77.

[69] See for example Consultation Document Paragraphs 1.57 and 6.62 to 6.66.

10.6 We address a number of the points made by Ofcom about entry barriers and their significance in more detail in **Annex 3** (Barriers to entry), and summarise our key points below.

10.7 First, it is notable that Ofcom has adopted an unreasonable benchmark of what constitutes 'entry' in this context. Ofcom's benchmark is a very strong form of entry, namely the rapid and direct replication of Sky's sports or movie channels. Ofcom ignores the approach of building up channels gradually over time. There is no reason for Ofcom to rule out entirely the development of services that do not simply mimic Sky's business model as constituting market entry.

10.8 Ofcom's discussion of barriers to entry also lacks balance. It considers only the difficulties of entry and not the features of the sector which facilitate entry. In reality, a wide range of factors make entry possible, including a range of possible types of channel strategy, the low cost of participating in tenders for programming rights, the open nature of the DTH platform, low switching costs for consumers between channels, and the fact that there are a range of potential entrants including existing broadcasters and rights owners.

10.9 Ofcom also entirely overlooks the fact that the "*staggering*" of rights can make entry *easier*, by allowing broadcasters to enter the market incrementally and by avoiding the risks involved for any broadcaster in bidding for many rights simultaneously.

10.10 Ofcom also suggests that rights are in many cases worth more to incumbent broadcasters, but those theories are vague and unparticularised. When examined closely they appear ill-founded. In particular, Ofcom's "*most important*" reason for a lack of contestability in competition for premium programming, bundling efficiencies, overlooks the fact that the gains from bundling may be exhausted fairly quickly. Rights may be worth more to an entrant with a small portfolio of rights than to a broadcaster with a large existing portfolio: 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 benefits of bundling available to the new entrants.

10.11 Most importantly, however, Ofcom's theory is inconsistent with observed facts: if it were correct, and barriers to entry prevented contestability, Sky would hold (for example) all available sports rights and pay relatively low prices for them. This scenario is far removed from a reality in which there are many desirable rights held by other broadcasters, and Sky has had to pay high and rapidly increasing prices for the rights it does hold.

10.12 The conclusion must be that there is a significant degree of contestability in relation to programming rights, and a significant threat of competitive entry.

(1b) Barriers are not exacerbated by the presence of a vertically integrated incumbent

10.13 Ofcom states that entry barriers may be exacerbated by the presence of a vertically integrated incumbent such as Sky.

10.14 Before addressing this specific point, we comment in general terms on Ofcom's approach to vertical integration, which, as noted by CRA, "*is the leitmotif that runs through Ofcom's entire analysis of potential concerns about the operation of the market*".[70] This is particularly apparent when reviewing the summary of Ofcom's concerns in Paragraph 10.2 above. CRA's report concludes that Ofcom's description of the possible effects of vertical integration is too simplistic and too focussed on *Sky's* vertical integration. It suggests that a more careful analysis will show that the effects of vertical integration are likely to be a lot less material than Ofcom appears at this stage to believe, and that taking into account the existing regulatory framework, traditional static upstream and downstream foreclosure arguments are of little relevance to this sector.

10.15 In relation to downstream foreclosure, CRA concludes that Ofcom's approach of making a simple trade-off between upstream revenue foregone and downstream gains is overly narrow. CRA concludes that a vertically integrated firm that can use sufficiently non-linear tariffs would never refuse to sell to an efficient downstream rival.[71]

10.16 In relation to upstream foreclosure, CRA concludes that traditional static arguments are also of little relevance. Ofcom's hypothesis seems to assume that vertical integration is a key advantage in bidding for rights, whereas CRA show that even where a vertically integrated firm is assumed to benefit from some retail advantage, an independent upstream broadcaster would have exactly the same incentives to bid for content.[72]

10.17 In relation specifically to the suggestion that barriers to entry are exacerbated by the presence of a vertically integrated incumbent, both Sky and CRA have already demonstrated that vertical integration is not likely to result in or exacerbate any advantage that may be caused by Sky's incumbency as a broadcaster.

10.18 Ofcom appears to rely on Sky's 'installed base' of customers as a factor in preventing rivals from bidding successfully for content (see para 6.18). However, as already explained in Sky's Response to the Complaint, Sky's installed base is a feature of incumbency and not a function of vertical

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70 Paragraph 40 of **Annex 4** (CRA's report: Vertical integration and short run/long run issues).

71 See Sky's response to Consultation Question 16 of the Consultation Document, at **Part 3** below, for further detail on this.

72 See Sky's response to Consultation Question 16 of the Consultation Document, at **Part 3** below, for further detail on this.

integration.[73] Sky's Response to the Complaint also demonstrated that Sky's retail presence does not enable it to achieve a return on the cost of rights more quickly and efficiently than actual or potential competitors. [74]

10.19 In its Consultation Document Ofcom also suggest that a wholesale channel provider that is vertically integrated may have an informational advantage which allows it to better assess the value of rights (Paragraph 5.124). This argument is addressed by CRA (in Section 2.6 of **Annex 4**). CRA point out that Ofcom has not shown that any such informational advantages are significant and that Ofcom needs to distinguish more carefully between informational advantages that arise due to vertical integration and those that arise in any case because of incumbency.

(1c) Incentives of an incumbent to restrict access to downstream markets

10.20 Ofcom suggests that a vertically integrated incumbent may have incentives to create additional barriers to entry by restricting access to retail markets.[75] As explained above, however, traditional (static) upstream foreclosure arguments are of little relevance to this sector. Sky's Response to the Complaint and CRA's previous report,[76] also demonstrated that Sky has very little ability or incentive to use its presence downstream to hamper third parties' bidding in the market for content.

10.21 Ofcom cites Setanta and Sky as relevant examples of a new wholesale channel provider and a vertically integrated incumbent, and postulates that Sky may have an incentive to restrict Setanta's access to the retail market by restricting access to its DTH platform. Ofcom proceeds to acknowledge, however, that *"Sky's ability to do this will be limited, due to the regulatory obligation which Sky faces to make access available on fair, reasonable and non-discriminatory terms"*.[77] It is unclear why Ofcom even raises this as a possibility in the first place, particularly given that the regulatory regime in question is the responsibility of Ofcom and has only recently been reviewed. Ofcom is in a position to conclude that regulation is effective in securing access to Sky's platform.

10.22 As Sky pointed out in its Response to the Complaint, if any platform operator is able to gain an advantage from the type of foreclosure problem envisaged by Ofcom (and the Complainants), it is Virgin Media, whose closed platform enables it to bid for content with guaranteed access to not only the 9 million DTH households available to Sky and any other broadcaster, but also around

73 The relevant base of customers is the subscribers to Sky's channels across all platforms, not the number of subscribers to Sky's retail packages. See also Part C, Paragraphs 4.2-4.8 of Sky's Response to the Complaint and Annex 4 to Sky's Response to the Complaint: CRA and Prof John van Reenen's paper, Paragraphs 96 – 100.

74 Sky's Response to the Complaint, Part C, Paragraphs 4.9-4.18.

75 Paragraph 6.67.

76 "*Sky's 'incentives' to foreclose competition in the UK pay TV industry*", Annex 4 to Sky's Response to the Complaint.

77 Paragraph 6.67.

3.5 million of its own subscribers.[78] Ofcom continues to choose to disregard this and other consequences of the asymmetry of regulation that currently exists as between Sky's DTH platform and closed platforms.

10.23 Ofcom has suggested that it needs to be "*particularly alert to the risks associated with dynamic foreclosure, i.e. the risk that firms already present in the market might either exploit or benefit from certain dynamic characteristics of the market to foreclose entry by new providers (or – analogously – to drive out firms that have recently entered)*".[79]

10.24 CRA considers the 'dynamic foreclosure' theory that Ofcom has attempted to set out, and concludes that "*Ofcom's preliminary analysis does not amount to anything like a coherent and credible dynamic leveraging story*".[80] We address the so-called dynamic foreclosure theory below at Paragraphs 10.48 to 10.51 and explain why the necessary conditions for the theory to apply are simply not present.

2) Ability and incentive of vertically integrated incumbent to reduce the quality of what it supplies in order to strengthen its retail offering (short run concern)

10.25 In the summary of concerns for inter-platform competition, Ofcom refers only to the ability and incentive of a vertically integrated incumbent to reduce the quality of what it supplies. In the main body of the Consultation Document, however, Ofcom considers first whether vertically integrated operators have the incentive and ability to restrict access to their premium channels by downstream competitors, which we address here before considering Ofcom's concerns about reduced quality.

(2a) Incentive and ability to refuse to supply premium channels

10.26 Ofcom effectively acknowledges that, in the short term, a vertically integrated incumbent **is** likely to have the incentive to supply established retail competitors. However, there are three specific aspects of Ofcom's analysis of the incentive and ability to restrict access to premium channels, that CRA addresses in Section 3 of its Report at **Annex 4** (CRA's report: Vertical integration and short-run/long-run issues), and which we consider are worth drawing specific attention to:

i. Ofcom suggests that incentives *"may"* exist for wholesale channel providers to supply content exclusively. However vertical integration is never a sufficient condition to justify a presumption in favour of incentives to foreclose rival retailers. Without specific evidence on the likelihood of switching in response to a specific withholding strategy, the analysis can only provide a potential framework for outlining the

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78 Paragraphs 4.21 to 4.25 of Part C of Sky's Response to the Complaint and http://www.ofcom.org.uk/research/tv/reports/dtv/dtv_2007_q4/dtvq407.pdf

79 Paragraph 6.57.

80 Paragraph 25 of **Annex 4** (CRA's report: Vertical integration and short-run/long-run issues).

potential issue, and not an indicator of whether an issue is likely to exist;

ii. Ofcom overstates the significance of switching costs. Low switching costs make it less likely that there is licensing to multiple retailers on the same platform (because with low switching costs a single retailer with access to "*premium content*" could access most interested customers), but they also level the playing field when it comes to bidding for content in the first place (because low switching costs mean that companies bidding for rights to "*premium content*" need not worry about having access to their own subscriber base because customers can move easily to find the most attractive content); and

iii. Ofcom notes that there are few examples of content being licensed to multiple retailers on the same platform. It is not the case that this situation is caused by vertical integration, since, unless competing retailers are highly differentiated on the same platform, an <u>independent</u> upstream firm would also choose to licence exclusively. [81]

10.27 As referred to above, CRA show that the economics of (static) downstream foreclosure is considerably more subtle than currently allowed for in the Consultation Document and that Ofcom's approach of making a simple trade-off between upstream revenue foregone and downstream gains is only part of the story.

10.28 We also refer Ofcom to the earlier paper by CRA included in Sky's Response to the Complaint, which demonstrated that, on any reasonable assumptions, foregoing revenues from potential subscribers on other platforms (whether served directly by Sky as retailer or via a wholesale contract with a third party retailer) implies significant costs which do **in fact** provide a strong **dis**incentive for downstream foreclosure by Sky.[82] The lack of any proper examination of CRA's analysis (Ofcom makes only the briefest of references to the analysis at Paragraph 6.60) is particularly striking given Ofcom's statement that *"the important question is whether, in the particular circumstances of the pay TV industry, it is profitable for vertically integrated firms to engage in conduct that adversely affects competition"*.[83]

10.29 Other than noting that Sky wholesales its premium channels to platforms on which it does not itself currently retail those channels (or have plans to do so), Ofcom does not discuss whether specific evidence exists to support or undermine the argument that Sky has an incentive to withhold its premium channels from third party retailers. In Sky's Response to the Complaint, Sky provided Ofcom with evidence that, contrary to allegations made by the Complainants, who claimed it demonstrated Sky's incentive and ability to foreclose downstream competitors, Sky has not refused to make its channels

81 Note also that it is simply not possible to license to more than one retailer on a closed platform operated by a vertically integrated retailer/operator such as cable.

82 Annex 4 of Sky's Response to the Complaint, Paragraphs 42 to 69.

83 Paragraph 5.128.

available on non-DTH platforms and, indeed, has made substantial efforts to engage with the operators of closed platforms so that it can retail its channels directly to customers of those operators.[84]

10.30 CRA's report concludes that Ofcom's short term concerns in relation to "*premium content*" are described in a generic and hypothetical manner without much reference to relevant facts, and that nothing in the discussion put forward by Ofcom is indicative that an issue might indeed be likely to exist. The only observation to which Ofcom refers – that there is no multiple licensing of "*premium content*" on the same platform – has a rational explanation that does not depend on vertical integration or foreclosure.

(2b) <u>Incentive and ability to reduce the quality of content supplied</u>

10.31 Ofcom identifies as a short-run concern "*the ability and incentive [of a vertically integrated incumbent] to reduce the quality of what it supplies, in order to strengthen its retail offering*".[85]

10.32 We note first of all that it is *prima facie* illogical and inconsistent to take the view that there are effectively insufficient incentives to restrict the supply of content to downstream competitors, but that there are sufficient incentives to reduce the quality of that content. The analysis of incentives to restrict access to content, and to supply reduced quality content, should be no different.

10.33 As CRA points out,[86] in order for the outcome of that analysis to be different, Ofcom would need to show that a reduction in quality would <u>not</u> be matched by a reduction in wholesale prices, <u>and</u> that the quality degradation would cause enough retail customers to switch from rival retailers to Sky to make this profitable. Ofcom does not do so and the available evidence (see below) clearly demonstrates that reduced quality would be unlikely to cause retail customers to switch.

10.34 Ofcom observes that interactive services are not available in conjunction with Sky's channels on the cable platform and questions why a vertically integrated wholesaler/retailer might only supply what Ofcom describes as a "*degraded version*" of its channels to third party retailers.[87] Although Ofcom acknowledges that "[t]*here may be legitimate reasons for a vertically integrated firm to refuse to supply its enhanced content to third party retailers*",[88] it fails to acknowledge that Sky has provided it with evidence that there **are** in fact legitimate reasons for the non-availability of Sky's interactive and HD services on Virgin Media's platform.[89] Instead, Ofcom cites the non-availability of

84 Part D of Sky's Response to the Complaint.

85 Paragraphs 1.64 and 6.77.

86 At Paragraph 74 of **Annex 4** (CRA's report: Vertical integration and short-run/long-run issues).

87 Paragraph 6.39.

88 Paragraph 6.40.

89 These were set out in Paragraphs 4.8 to 4.11 of Part D and Annex 5 of Sky's Response to the Complaint.

interactive services as a possible example of the operation of an incentive on vertically integrated firms to supply only a degraded version of its channels to third party retailers.

10.35 Despite carrying out three rounds of market research, Ofcom does not support its theory with any evidence. In fact, the limited evidence that Ofcom has, suggests that these features are not valued by the majority of consumers. It is notable that the following evidence is either not given enough weight or not even referred to within the Consultation Document:

- in Phase 1 of Ofcom's consumer research,[90] it found that interactivity was rated as "*important*" by only 14% of respondents, and of those, only 27% (or 4% of all respondents) rated it as "*must have*". This covered a wide range of interactive services, most of which are related to a platform rather than associated with specific channels. Only 2% of respondents mentioned "*angles/sports/matches*" (i.e., services which are associated with Sky's sports channels) as an important interactive service, and only a third of those (in total, 23 respondents out of 2008) rated it as *"must have"*; and

- in Phase 3 of its consumer research, Ofcom found that only 3% of respondents listed interactive services as a reason for choosing their provider, and this figure was no higher for those taking sports or movies.[91]

10.36 Sky's own data is consistent with that of Ofcom and shows that, [**CONFIDENTIAL**][92] [**CONFIDENTIAL**]. Moreover, Champions' League games broadcast on the linear Sky Sports channels between September and December 2007 received a far greater average audience than the Champions' League games shown interactively via the red button. The average audience for a Champions' League game shown behind the red button was 24,000 compared to an average audience of 339,000 for a Champions' League game broadcast on a linear Sky Sports channel. Over the same period (September to December 2007), FAPL matches shown interactively via 'Football First'[93] gained an average of 16,200 viewers. The FAPL match broadcast on Sky Sports 1 on a Saturday evening (from which 'Football First' is accessible via the red button) gains an average audience of 166,000 viewers.

10.37 Ofcom's theory of a possible longer-term *"market positioning incentive"* would have the strategy *"support*[ing] *the vertically integrated firm's marketing/branding efforts by reinforcing in consumers' minds the perception that the vertically integrated firm is the market leader in pay TV and that the general quality of rival retailer's* [sic] *offering is 'inferior'."* Ofcom recognises that *"the*

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90 Pay TV Phase 1: Preferences for TV services and content. Questions QT1A and QT2B.

91 Pay TV Phase 3: Preferences for specific elements of movies, sports, and general TV content. Question D2.

92 [**CONFIDENTIAL**]

93 Sky broadcasts extended highlights of one match and offers the choice of extended highlights of other matches via the red button.

strength of this market positioning incentive is an empirical question".[94] One would expect that if Sky was pursuing a strategy based on such an incentive, it would seek to capitalise strongly on the non-availability of the relevant services on other platforms in its marketing and advertising. Sky has not done so.

10.38 Ofcom should, on the evidence available to it, conclude that there is no reason to believe that Sky is pursuing a strategy of foreclosure through selective distribution of its enhanced services, or indeed that withholding the content in question is capable of having a material effect on competition.

3) Ability and incentive of a vertically integrated incumbent to foreclose potential new retailers by denying them content (long run concern)

10.39 Ofcom suggests that the incentives of a vertically integrated wholesale channel provider to supply its content may be different for a new entrant compared to an established retailer. It is not entirely clear whether Ofcom is suggesting that there is an incentive to withhold supply from new retailers on the same platform as the vertically integrated channel provider or whether the concern relates to new retailers on platforms on which the vertically integrated channel provider's content is not currently available.

10.40 In relation to new retailers on the same platform we summarise above (at Paragraph 10.26), why, irrespective of whether a firm is vertically integrated, there are unlikely to be multiple licensees of the same content on the same platform.

10.41 In relation to new retailers on platforms on which the channel provider's content is not currently available, this is a question of the incentives to foreclose which are dealt with at length by CRA in its report. The reference to specific concerns in relation to potential *new* retailers reflects Ofcom's hypothesis that incentives to foreclose are stronger when the downstream rival is a recent or potential entrant. CRA explains in Section 2.3 of its report at **Annex 4** (CRA's report: Vertical integration and short-run/long-run issues) why this theory (which it characterises as *"a frequently held folk belief"*) is incorrect.

10.42 In summary:

- Ofcom effectively argues that a vertically integrated firm will have an incentive not to supply a new downstream rival because the cost of such foreclosure is small, since the sales revenues foregone are necessarily small. However, Ofcom fails to consider that, in such circumstances, the benefits of reducing competition downstream would be proportionally small, and there cannot be any presumption, therefore, that foreclosure is more likely to occur in a static framework in relation to potential new or recent entrants than against established competitors;

94 Paragraph 6.42.

- CRA concludes that the concern about foreclosure is no more justified in a forward-looking perspective. Although it might be argued that any loss of revenues from refusing to license content now would be exceeded by the benefits of eliminating a rival for the foreseeable future, that logic would be flawed, since eliminating a small rival today means that the foreclosing firm also forgoes the opportunity to obtain greater revenues from the rival in the future. Again, the potential benefits and losses go hand-in-hand. As CRA succinctly states: "*In essence, the economic arithmetic of foreclosure properly must include all the factors*".[95]

10.43 Since Ofcom also appears to allude to the possibility that dynamic foreclosure may be at play here, we address this theory in more detail below.

4) Prevalence of vertical integration may cause foreclosure of new retailers to foreclose the possible development of new platforms (long run concern)

10.44 Ofcom posits that an incentive to foreclose market entry "*might be strengthened where this also has the effect of foreclosing market entry by new platforms*".[96] Ofcom's hypothesis suffers from the same fundamental flaw as that above in relation to new retailers: that the critical factors affecting incentives to foreclose move hand-in-hand, such that if the potential harm from new platform entry is greater, then so is the potential opportunity cost in terms of foregone future wholesale revenues from retailers on that new platform, or foregone retail revenues if a channel supplier seeks to retail on that new platform.[97]

10.45 We note that Ofcom does not cite any evidence of such a foreclosure approach actually having been pursued by a vertically integrated firm. However, after asserting "*the importance of vertical integration between platform operation and retailing, not just for incumbents, but also new entrants*",[98] Ofcom states that "*the success of the new platform will depend to a significant [(sic) extent] on the success of the related retail business*".[99] Ofcom gives BT Vision, Top Up TV and Tiscali as examples of platform operators which are also the primary retailer on their platform, and goes on to state that "[f]*oreclosure of market entry at the retail level may also in these cases foreclose market entry at platform level*".[100]

10.46 As Ofcom is aware, Sky has entered into 'Sky by Wire' arrangements with smaller platform operators such as Tiscali in both the UK and Republic of Ireland, pursuant to which its premium channels are made available to the platform operators' customers. Sky has also provided Ofcom with evidence that, contrary to cynical allegations by the Complainants, Sky has sought to

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95 Paragraph 52 of **Annex 4** (CRA's report: Vertical integration and short run/long run issues).

96 Paragraph 6.73.

97 See also Section 2.3 of **Annex 4** (CRA's report: Vertical integration and short run/long run issues).

98 Paragraph 6.73.

99 *Ibid.*

100 *Ibid.*

enter into arrangements to make its premium channels available to customers of Top Up TV and BT Vision.[101] Such conduct is clearly at odds with any claim that Sky has the incentive and ability to withhold its content from new and emerging platforms. Ofcom has sufficient evidence available to it already to reach the view that this theoretical concern is not borne out by reality, and that no further action is required.

10.47 Again, to the extent that Ofcom considers that a dynamic foreclosure theory is applicable in this hypothesis, we address the elements of this theory in more detail below.

5) "Dynamic foreclosure"

10.48 Section 4 of CRA's report addresses Ofcom's thesis that it needs to take account of risks associated with dynamic foreclosure, concluding "*We believe the Consultation Document does not make even a* prima facie *case for concerns about dynamic leveraging. ...Ofcom would need to properly recognise the preconditions that would be required for such a theory to apply, it would need to identify those conditions explicitly, and in particular it would need to outline the empirical evidence necessary to ensure the conditions are met*".[102]

10.49 We outline CRA's main points below:

- if Ofcom has in mind a dynamic foreclosure theory similar to that advanced in the Microsoft case, it should be aware that a number of conditions were central to that case. It would be critical for Ofcom to show that a credible mechanism existed which linked a particular commercial practice in one period to rivals' loss of share in another, and further linking this loss of share to rivals' lack of ability to invest, and therefore to exit from, or be marginalised in, the market. Yet there is no equivalent in the pay TV sector to the 'applications networks effect' mechanism which was at the core of the Microsoft dynamic leveraging theory: 'Porting' software applications to different systems is costly and therefore application developers tend to write for the dominant platform, marginalising others, but in the pay TV sector, content can be transported across many platforms without difficulty;

- Ofcom would also need to demonstrate that the characteristics of both the upstream and downstream markets are likely to lead to those markets 'tipping' in favour of the vertically integrated player who gains an advantage, without real prospects for others to remain in the markets. Yet no theory is specified in the Consultation Document as to why and how such tipping would occur, nor is there evidence of this occurring.

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101 It is notable that Ofcom has omitted to refer to the facts that significant impediments to such arrangements are (a) the need to obtain Ofcom's consent to the substitution of Sky's existing FTA DTT services with premium pay TV services (which consent Ofcom has withheld to date), and (b) the lack of clarity in relation to Ofcom's position regarding the extent of Top Up TV and BT's obligations to make available access to their respective platforms on FRND terms.

102 Paragraph 87 of **Annex 4** (CRA's report: Vertical integration and short run/long run issues).

CRA notes that it does not see this industry as one where "*the winner takes all*"[103] and Ofcom does not explain why this should be so;

10.50 CRA also notes that Ofcom appears to believe that Sky's installed base of customers and its control over a library of content are key factors in preventing rivals from bidding successfully for access to content, and explains why Ofcom would be wrong to attach too much significance to these two factors when considering the credibility of dynamic foreclosure theories. We summarise CRA's reasons below:

- *Access to an installed base of customers*: Installed bases can only confer a competitive advantage if they cannot be accessed by rivals, and since access to the DTH platform is regulated by Ofcom it would be reasonable to assume that access to retail customers on the DTH platform cannot be a factor (and if there is real concern about access to installed bases of customers then the first place to look would be at the closed cable platform). CRA (at Section 4.4.1 of **Annex 4** (CRA's report: Vertical integration and short-run/long-run issues)) explores whether, even if access to the DTH platform is not an issue, installed bases of customers at the retail level might nonetheless be important, but concludes that this is not the case for two reasons. First, the importance of existing bases of retail customers is lessened by being able to sign channel supply agreements with third party retailers, and since this would be anticipated at the time of bidding for content, this will tend to reduce differences in the value of content to channel providers with small and large retail bases. Second, customers are able to switch retailers relatively easily, especially to another retailer operating on the same platform, in order to 'follow' attractive content. In addition, high levels of switching also increase the incentives of a channel provider to license content to all, which makes it hard to believe that retail switching costs would be a factor when bidding for content;

- *Access to an 'installed base' of content*: The relevant point is not simply whether a firm with established existing content can extract more value from additional content. It is rather whether another channel provider without much established content could put together a viable channel. Ofcom seems to believe that this would not be possible, for reasons which CRA finds unconvincing.[104] First, in relation to Ofcom's argument that it is difficult to accumulate sufficient rights due to staggering of rights at the upstream level, CRA states that Ofcom's emphasis on assembling a portfolio of rights quickly is not justified, and nor is it the case that a channel could only be viable if it has large amounts of "*premium content*". Second, in relation to the assumption that an incumbent can extract more value from the same rights than a new entrant, CRA argues that there are diminishing marginal returns to similar content, and so conversely, at the margin, a right adds more value to a channel provider with fewer rights

103 Paragraph 12 of **Annex 4** (CRA's report: Vertical integration and short run/long run issues).

104 See Section 4.4.2 of **Annex 4** (CRA's report: Vertical integration and short-run/long-run issues).

than to one who already has a large number of rights. CRA also dismisses the theory that an incumbent has an additional incentive to bid hard in the hope that the upstream market begins to tip. We also address these points in detail in **Annex 3** (Barriers to entry).

10.51 In short, Ofcom has not made out a credible theory of dynamic foreclosure in the Consultation Document.

11. Ofcom's short-run concern – "*basic content*": buy-through

11.1 We turn now to the final concern summarised by Ofcom, which is categorised as a short run concern:

11.2 *"It is unlikely that owners of premium content will make this content available to multiple retailers on the same platform. Despite this, it is still possible that competition might emerge between different providers of basic content on the same platform. However, the prospects for this type of competition may be restricted by the existence of buy-through, which requires consumers wishing to purchase premium content to purchase basic content from the same provider."*[105]

11.3 Ofcom's key short-term concern about access to "*basic content*" relates to buy-through. It beggars belief that Ofcom can express concern that the existence of buy-through may restrict potential competition between providers of basic channels, yet does not appear to be concerned that such competition is not even possible on closed platforms. The latter surely falls squarely into the category of *"strategic issues"* in relation to access to digital TV platforms that Ofcom anticipated would overlap with issues raised in the market investigation and for which the market investigation would be a better vehicle for consideration.[106]

11.4 Ofcom must recognise that closed platforms act as absolute barriers to intra-platform competition and that any proper consideration of factors that may affect intra-platform competition must include the impact of platform operators' ability to control access to customers, particularly where such platform operators are also retailers. Virgin Media has an installed base of nearly 3.5 million cable TV customers[107] which is inaccessible to competing retailers (of basic or premium channels); whereas the provision by Sky of access to the DTH platform on transparent terms, together with its success at developing a large subscriber base, facilitates rather than forecloses retail competition.

11.5 Ofcom can draw comfort from the fact that, as is evident from information included in the Consultation Document and in PwC's report,[108] buy-through is prevalent in most countries.

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105 Paragraphs 1.65 and 6.78.

106 Paragraph 2.32.

107 http://www.ofcom.org.uk/research/tv/reports/dtv/dtv_2007_q4/dtvq407.pdf

108 Paragraph 3.2.1 of PwC's report.

11.6 Ofcom should note that it is now possible for Sky subscribers to take one 'mix' or package of basic channels at £16 and the content which must be 'bought through' to premium is in fact relatively limited. Similarly, on cable, customers can buy premium channels through the 'M' pack, which largely comprises channels which are free to air on other platforms. This demonstrates that the practical effect of buy-through obligations placed on retailers by channel wholesalers is minimal and that if such buy-through obligations were removed by channel wholesalers, this would be very unlikely to have any material effect on the buy-through structure adopted by retailers.

11.7 Ofcom should not presume that, in order for a market to be working well, consumers should have completely free choice – this is unrealistic and does not reflect the important trade-offs that benefit consumers. The key questions are whether consumers have sufficient choice, not unlimited choice. Where choice is limited (e.g., as a result of the operation of buy-through) Ofcom needs to question whether the removal of those limitations on choice might result in the disappearance of other benefits to consumers (such as a greater range of channels than might be available if customers had the choice of subscribing to premium channels on a stand-alone basis, i.e., independently of basic channels). The fact that the overwhelming majority of consumers are happy with the service they receive from the pay TV sector suggests that the pay TV sector has got the balance of trade-offs right, and that the pricing and packaging structures that the pay TV sector adopts in order to sell its products are meeting the needs of consumers.

11.8 Ofcom does not yet have a view on whether, in the absence of buy-through, the type of self-assembly of bundles that it hypothesises might facilitate entry of retailers of basic channels is, in fact, plausible. Nor does Ofcom appear properly to have considered whether the abolition of buy-through might operate to the detriment of consumers - for example, by leading to a reduction in the range of basic channels available. As with all its hypotheses, Ofcom must be wary of the possibility that intervention in the absence of clear need risks having unforeseen consequences, which could be detrimental to consumers.

12. Conclusion: no basis for further action by Ofcom

12.1 We recap the discussions above as follows:

- Ofcom finds that the market in which pay TV services are provided "*currently appears to be serving its existing consumers reasonably well*"[109];
- "*Having said that*", Ofcom persists in believing in and searching for a competition problem involving Sky;
- Ofcom's approach to market definition and market power is entirely at odds with an open-minded evidence-based approach. In particular, it

[109] Paragraph 4.76.

introduces a significant risk of error in its (provisional) conclusions because it starts from preconceptions;

- it spends an inordinate amount of effort theorising about "*possible concerns*", which are complex, hypothetical, and often do not take into account commercial realities;

- notwithstanding the considerable amount of work that Ofcom has already done, it is not able to demonstrate any evidence of likelihood that these concerns will adversely affect competition in pay TV. Certainly Ofcom is not in a position to demonstrate that its concerns are more likely than not to lead to competition problems in the future.

12.2 Sky has a number of concerns about the Consultation Document and the way in which Ofcom has conducted the market investigation process.

12.3 First, Sky has concerns in relation to the inappropriate focus of the Consultation Document on Sky. Ofcom's analysis of the role of vertical integration is mostly conducted in terms of Sky's alleged incentives and behaviour, with very few references to other vertically integrated players such as Virgin Media. Indeed, such is the focus on Sky that Ofcom fails to consider other types of integration, such as between TV, telephony and internet services. BT (which, through its BT Vision service) is presumably one of the new entrants for whose future Ofcom expresses potential concerns, enjoys a huge installed customer base and incumbent position (in relation to fixed line telephony and broadband internet access); yet Ofcom does not consider how this might impact the dynamics of the market within which pay TV services are provided.

12.4 Ofcom may argue that its failure to analyse other vertically integrated players is just that: a failure, and an innocent one at that. However, the overt (and inappropriate) nature of its focus on Sky is clearly exposed in the list of consultation questions.[110] The second question at Question 9 of Annex 4 to the Consultation Document asks "*Is there evidence to support the suggestion that Sky is pursuing objectives other than short term profitability?*" Both the nature of the question and its direct reference to Sky are entirely inappropriate. Its inclusion exposes the fact that Ofcom clearly intended to focus the market investigation on Sky.

12.5 Sky wrote to Ofcom in early February to ask whether this question was included in error. Ofcom has not yet provided any sort of explanation as to why this question was included and we are still awaiting Ofcom's justification for the question's inclusion.

12.6 Second, Sky has concerns in relation to the way in which Ofcom has conducted its market investigation. In particular, Ofcom's procedure has been seriously defective to the detriment of Sky. Sky's main concerns relate to:

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110 Annex 4 of the Consultation Document.

- Ofcom's failure to consider Sky's previous submissions and evidence:
  - during the course of the market investigation, Sky has provided Ofcom with a considerable amount of evidence. The Consultation Document makes little reference to the evidence provided by Sky. In particular, we refer Ofcom to Sky's detailed submission as to why the Complainants' 'vicious circle' theory is fundamentally flawed in its Response to the Complaint. It is highly unsatisfactory that Sky's detailed submission on these issues, which included a paper prepared by CRA, is not addressed in the Consultation Document;
  - Ofcom allowed only seven weeks from receipt of Sky's Response to the Complaint before deciding to publish the Consultation Document. The Consultation Document is clearly the product of many months' work, and it is evident that it had already been well developed before Sky's Response to the Complaint was considered by Ofcom. A seven week period was manifestly insufficient to allow for proper and fair consideration to be given to the evidence submitted in Sky's Response to the Complaint;
  - Ofcom's failure to refer to evidence provided by Sky suggests that Ofcom either considered and decided to ignore this evidence or that it failed to consider the evidence entirely;
- the manner in which Ofcom seeks evidence from third parties through questions included in the Consultation Document to bolster its theoretical concerns;
- the manifest imbalance, in what has been permitted to become a quasi-adversarial process in which Sky is the Defendant and the Complainants the Claimants[111], in the ability of each party to put its case and in the treatment afforded by Ofcom to each party's submissions. The Complainants, for example, were afforded a period of more than five months in which they could rework their original complaint, while Sky's requests during that period to see full details of that complaint were denied[112]. Conversely, as noted above, Ofcom allowed only seven weeks for its consideration of Sky's Response to the Complaint before deciding to publish a Consultation Document which had evidently already been well developed over the preceding months;
- the inappropriately short period of time that was allowed for responses to Ofcom's Consultation Document. As the (effective) Defendant, a period of

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111 It is notable that Virgin Media has publicly referred to the Complaint as forming part of its litigation strategy against Sky.

112 The Complainants' use of this period selectively to leak elements of its original complaint to the press while Sky was not in a position effectively to defend itself is a matter of public record.

ten weeks which encompassed a significant public holiday was not adequate to allow Sky – given its position - properly to respond;

- the opacity of the Consultation Document, the lack of proper counterfactuals and the poorly explained theories, all of which have made it a very difficult document to respond to;

- the way in which, through its drafting of the Consultation Document, the burden of proof has effectively been placed on Sky to demonstrate that the *"possible concerns"* are not likely to arise in practice.

12.7 Despite over a year's work by Ofcom prior to issuing its Consultation Document, the considerable concerted efforts of the Complainants and a Consultation Document that runs to almost 700 pages, Ofcom has not found any evidence of competition problems. The analysis above of Ofcom's "*possible concerns*" demonstrates that, even if Ofcom were correct in relation to market definition and Sky's alleged market power, there is *no clearly discernible or credible theory that competition in pay TV is not effective or will not be effective in the future, whether in the short or the long term.* On the contrary, the evidence on consumer outcomes depicts a market which is functioning effectively and delivering significant benefits to consumers.

This is not a market meriting a market investigation reference

12.8 Ofcom's initial assessment is that the market in which pay TV services are provided is serving its current customers reasonably well. We explain above why Ofcom can accord its initial assessment the status of a firm conclusion. Ofcom's assessment and analysis have revealed ***no reasonable grounds*** for suspecting that there are ***currently*** both single firm conduct and structural market features which prevent, restrict or distort competition. There are no grounds that would justify the market investigation reference to the Competition Commission that the Complainants seek in relation to Sky. In essence the Complainants' objection is to the success of Sky as a broadcaster and it is very clear that the purpose of the market investigation regime is not to address the market position of a single firm.

No grounds for any other form of regulatory intervention by Ofcom

12.9 Ofcom states that it is entitled to collect evidence and undertake analysis to inform itself as to the operation of the pay TV sector with the aim of determining whether there are competition problems, in pursuit of duty to further the interests of consumers, where appropriate by promoting competition. We have explained above why, based on the work that Ofcom has already done, it was in a position to have drawn a firm conclusion from its *initial assessment*" of consumer outcomes to the effect that UK consumers are well served by the pay TV sector and that no further analysis or evidence is required.

12.10 Clearly Ofcom has not chosen to go down this route but has, inappropriately, through questions in the Consultation Document sought further evidence that would bolster its hypothetical concerns. Sky fails to see what further evidence

Ofcom believes it might gather that would give credence to these particular theories (particularly given the amount of time and effort that Ofcom has already devoted to its investigation and the evidence provided by stakeholders and Ofcom's own market research). Furthermore, as Sky has demonstrated in this Response, it is evident from the Consultation Document that Ofcom's understanding and analysis of the relevant market and how it operates is flawed, and therefore forms a thoroughly unsound basis for developing hypotheses.

12.11 As we note above, it is not realistic to expect evidence to be provided that will either confirm definitively, or rule out, any possible future competition concerns. It is Ofcom's role to sift and once and for all evaluate such evidence that it does have and to take a realistic view, having due regard to both the impossibility of achieving a market that works perfectly, and to its duty to have regard to the principle that regulatory activities should be, *inter alia*, *"proportionate"* and *"targeted only at cases in which action is needed"*.[113]

12.12 There is nothing in Ofcom's Consultation Document that reveals a current problem of a magnitude that merits any form of intervention. Any intervention based on the *"possible concerns"* set out by Ofcom would amount to *"regulation by hypothesis"*. An attempt to regulate on the basis of hypotheses alone runs serious risks of unintended consequences, market distortions and stifling innovation.

113 Section 3(3) of the Communications Act.

PART 3: SKY'S RESPONSES TO THE CONSULTATION QUESTIONS

SECTION 2: CONTEXT

1. Question 1: Do you agree with the criteria against which we propose to assess the functioning of the pay TV sector?

1.1 Ofcom states that its criteria (choice of platform and content, innovation in platform services, and the competitive and efficient pricing of pay TV services) reflect its statutory duties to "*further the interests of consumers*" both now and in the future, with particular reference to "*choice, price, quality of service and value for money*".[114]

1.2 Sky considers that these are important factors against which Ofcom should consider the functioning of the pay TV sector.[115]

1.3 Sky notes that *"consumer satisfaction"* is not a stand-alone criterion against which Ofcom proposes to assess the functioning of the pay TV sector. Consumer satisfaction is, however, a means of judging the functioning of a sector and we would expect Ofcom to consider consumer satisfaction in relation to each of the criteria. We have, therefore, discussed Ofcom's evidence on consumer satisfaction below, in the section immediately preceding Sky's response to Consultation Question 5.

1.4 Levels of penetration of pay TV (in the UK and elsewhere) is also an important factor on which Ofcom has not placed sufficient emphasis. Again, relevant evidence is set out below, in the section immediately preceding Sky's response to Consultation Question 5.

1.5 Sky sets out immediately below more specific points in relation to each of Ofcom's criteria.

Choice of platform and content

1.6 Ofcom refers to "*switching between retailers and platforms*".[116] Ease of switching is an important measure of choice. However, switching should not be limited to switching between retailers and between platforms. Ofcom should also consider the range of packages that are available to consumers and the ease of switching between channel packages provided by the chosen retailer, which gives consumers the ability quickly and easily to vary their choice of content.

1.7 Part of this criterion refers to "*the availability of a broad range of high-quality content... made available to consumers on all platforms*".[117] All broadcasters

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114 Paragraphs 2.17, 2.19 and 2.23 to 2.24.

115 This does not mean that any concern arising under any of these criteria would, of itself, be sufficient to justify intervention under any of Ofcom's powers.

116 Paragraph 2.24.

117 *Ibid.*

strive to broadcast content that meets their viewers' preferences. Whether this content is considered "*high-quality*" may, in part, be a subjective matter for each particular viewer (although Sky considers that a wide range of packages showing a variety of high-quality content is made available to consumers on a number of platforms). If, in fact, Ofcom means by this criterion that 'all content should be made available on all platforms', then this is not an appropriate criterion unless proper account is taken of the effects of closed platforms, the availability of capacity on platforms and the regulatory barriers to launching new services on platforms.

1.8 It is also important to recognise that choice is inevitably constrained by administrative practicality. 'A la carte' availability of channels would give consumers ultimate choice but would be impossible to administer. Furthermore, Ofcom should not proceed on the basis that completely free choice is the optimum outcome for consumers; to do so would ignore benefits that may accrue to consumers from more limited choice (e.g., a greater range of channels than might otherwise be available).[118] The relevant criterion should be whether consumers have sufficient choice and whether the packaging structures that participants in the pay TV sector adopt in order to sell their products are meeting the needs of consumers. Sky's packages, for example, are designed to provide consumers with a manageable menu of options which can be effectively communicated and understood by customers whilst still providing sufficient choice such that customers can tailor a package that most closely matches their own preferences. Accordingly, with reference to Sky's premium channels and the six basic mixes alone, the number of total bundles from which a customer is able to choose is 1,764.

1.9 Despite the express reference to "*quality of service*" in Ofcom's duty under Section 3(5) of the Communications Act 2003, Ofcom refers only to "*high quality* ***content***" (emphasis added) in its first criterion. Quality of service is clearly an important consideration when assessing the functioning of the TV sector, and Ofcom should take account of other measures of quality, such as picture and sound quality, set top box reliability and the quality of customer service.

Innovation in platform services

1.10 The second of Ofcom's three criteria relates to innovation but, for reasons which are not explained, Ofcom's consideration of innovation is limited to innovations in platform services (which are not defined and the meaning of which is unclear). Ofcom should look broadly at innovation in the sector, without either limiting itself to platform services (which risks ignoring significant innovations at the content level) or seeking to draw some distinction between 'platform' services and other services. HD, interactivity and VOD, all of which are listed by Ofcom, are all clearly relevant to a consideration of outcomes in the TV industry, but we would not categorise

118 Ofcom is referred to Sky's comments on Ofcom's possible concern about the possible effects of buy-through at Section 11 of **Part 2** of this Response for further discussion of these types of issues.

them as 'platform services' and nor would many consumers. The timing of the introduction of innovation is also important and, as can be seen in Table 12 of PwC's report at **Annex 1** to this Response,[119] the UK has been a pioneer of innovation in relation to pay TV.

The competitive and efficient pricing of pay TV services

1.11 The final criterion referred to by Ofcom is competitive and efficient pricing of pay TV services. Sky agrees that this is an important factor against which Ofcom should consider the functioning of the pay TV sector. As part of Ofcom's analysis of this criterion, the following factors should be considered, which go to the question of whether pricing is competitive and efficient:

- levels of consumer satisfaction (see the analysis immediately preceding Sky's response to Consultation Question 5 below);
- levels of penetration: penetration is a key indicator of quality/value for money. If penetration of pay TV (and, in particular, premium content) is high, this is *prima facie* evidence that the sector is working well for consumers and that pricing is both competitive and efficient (see the analysis immediately preceding Sky's response to Consultation Question 5 and Sky's response to Consultation Question 7 below);
- the quality and nature of the content and the quality of the service provided by different pay TV providers; and
- the fact that excessive profits are not being made. There is no evidence that profitability is excessive, as discussed in Sky's response to Consultation Question 9.

1.12 Ofcom is also referred to Section 5 of **Part 2** of this Response, which addresses Ofcom reservations about the pricing of pay TV services, and in particular its statements that certain types of customers may be "*excluded*" from pay TV by pricing structures[120] and that UK prices may be high compared to other countries.[121]

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119 **Annex 1** (PwC's report: The outcomes for consumers in relation to pay TV in Europe).

120 Paragraph 4.5.

121 Paragraphs 1.19 to 1.20.

SECTION 3: OVERVIEW OF THE UK PAY TV MARKET

2. Question 2: Does our overview of the pay TV market fairly reflect the key developments within this market?[122]

2.1 Although described as an "*Overview of the UK pay TV market*", this section, as rightly it should, looks more broadly at the TV sector and describes some of the key developments within it. However, Ofcom is very broad-brush in its approach, providing insufficient detail in some areas and not addressing, or not addressing adequately, developments that are key to the sector.

2.2 Sky recently provided Ofcom with an overview of the key developments in the TV sector in Section 3 of Part B of Sky's Response to the Complaint. Key developments that are notably absent from Ofcom's overview include the following:

- the continued proliferation in the number of channels and amount of content available to UK households on both a free and pay basis and, in particular, the very significantly increased range of high quality, well-funded and heavily-promoted free to air channels provided by PSBs;
- significant changes to the distribution and consumption of movies (e.g., the expansion in the number of movies available free to air;[123] the expansion of DVD sales and DVD rental most notably via online services; increasing availability of VOD services; and the growth of services offering download-to-own/rent);
- changes in products offered to consumers (e.g., changes in pay TV packages, introduction of 'catch-up TV' services and TV services offered as part of a package of (notably communications) services); and
- changing consumer demands, with increasing demands for control, flexibility and mobility with respect to consumption of audiovisual services.

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122 The relevance of, and reasons for, the inclusion of the data at pages 37 to 43 of the Consultation Document is unclear. Sky questions the need for recourse to market research to reach such obvious conclusions as at paragraph 3.61 and Figure 12 that "*content is the element of consumers' TV service that is by far most often described as 'must have'*."

123 We note Ofcom's statement that the *"number of film transmissions on the five major terrestrial channels has declined significantly in the last decade"* (Paragraph 39 of Annex 11). Whilst this may be the case, the inclusion of this statement is misleading – the relevant consideration is whether the number of films shown by the five major terrestrial **broadcasters** (on the terrestrial channels and digital sister channels) has declined or increased. In fact, according to BARB data, whereas in 2001 those broadcasters showed 2,954 different films in a total of 3,041 transmissions including repeats, in 2007 the terrestrial channels and digital sister channels (BBC3, BBC4, ITV2, ITV3, ITV4, E4, More 4, Film 4, Five US, Five Life) combined showed 4,524 different films in a total of 9,947 transmissions – an average of 27 films screened per day. Furthermore, the top ten films shown in 2007 had an average audience of 6.9 million viewers and an average audience share of 33%. These top 10 films in terms of viewing were all shown on terrestrial channels.

2.3 Moreover, the Consultation Document omits:

- any consideration of the importance of the quality of channels as a measure of content choice;

- any significant reference to services that deliver content over the internet, such as the BBC iPlayer, 4OD and the soon-to-be launched Kangaroo. In particular, it is notable that, despite the popularity of the iPlayer, there is only limited and indirect reference to it. In addition, there is no reference to digital media adaptors, such as the PS3, Xbox 360 or Apple TV, which enable video downloaded from the internet to be viewed on TV sets.[124]

2.4 Ofcom asserts that it is important for it to take a *"forward-looking view"*[125] in making its assessment of the pay TV sector. It is disappointing that the significant developments outlined above are not properly considered by Ofcom in its analyses of the sector. However, we note, with cautious optimism, that Ed Richards identified the rapid pace of change in the TV sector and the importance of new and different forms of content distribution in a recent speech on PSB:

> *"The future will never be about linear television alone, but a rich mix of linear TV and new and diverse forms of content and delivery;*
>
> *Content, but also technology and distribution have to be at the core of our challenge;*
>
> *Personal control, mobility and interaction will be central to audience demands; and*
>
> *Managing change, uncertainty and the ability to adapt will be crucial to success – not only for commercial companies but also to public service broadcasters and to our system of public service broadcasting."*[126]

2.5 Subsequent analyses by Ofcom should give due consideration to the developments that we have identified.

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124 See the **Appendix** to **Annex 6** (Commentary on the Consultation Document), which addresses Ofcom's failure in the Consultation Document to appreciate the current and future importance of programming delivered via the internet.

125 Press Release, dated 18 December 2007, Ofcom (http://www.ofcom.org.uk/media/news/2007/12/nr 20071218)

126 Ed Richards speech on "The Future of Public Service Broadcasting", 11 March 2008, published at http://www.ofcom.org.uk/media/speeches/2008/03/rtspsb.

3. Question 3: Do you agree with our analytic framework for the pay TV value chain? If not, why not?

3.1 No, we do not. The key problem with Ofcom's "*analytic framework*" is that it fails adequately to address the complexity of the audiovisual sector. Unlike other, more straightforward, sectors, the audiovisual sector simply does not have a tidy "*value chain*", and any attempt to squeeze it within such a framework will inevitably come at the price of accuracy and clarity.

3.2 We cite four examples of the inaccuracy of Ofcom's "*framework*" as indicative of its flaws, rather than as an exhaustive list:

- one of the stages in Ofcom's "*value chain*" is labelled "*content and production*". Leaving aside that this appears to conflate an activity ("*production*") with output ("*content*"), it is evident that "*production*" in the context of the media sector is a diverse category in its own right. For example, it would include the (TV) content production activities of the BBC, ITV, Sky and the myriad of independent TV production companies operating in the UK – not to mention overseas producers of TV content- as well as the production of films by Hollywood movies studios and independent film producers. Ofcom also appears to intend this category to include the sale of rights that are used by content producers to produce content that may be broadcast on TV. Again, this spans an enormous diversity of inputs – from film scripts and ideas for TV series, through to rights to enter sports grounds to record and broadcast sports events. Accordingly, this is a clear example of the problem of trying to apply a broad label to a diversity of highly differentiated activities;

- the framework does not accurately reflect the very significant differences between the many ways in which audiovisual programming is delivered to consumers – for example, via analogue TV, DTH, cable, DTT, IPTV, the internet, and DVDs. All these methods of delivery have unique features (for example, in terms of who provides what to whom) that are lost entirely in an attempt to fit them all within a simple categorisation; and

- this framework does not include the provision of content on an a la carte (e.g. PPV) basis.

3.3 We set out below a number of more specific comments on Ofcom's "*analytical framework*".

3.4 We also note that this is the third different version of the *"value chain"* produced by Ofcom in the space of three months (the others are contained in the Proposed BSkyB digital terrestrial TV services consultation and the Market Impact Assessment of the BBC's High Definition Television proposals), yet no explanation is provided of why different versions are needed, which is unhelpful.

Ofcom makes inappropriate use of the term "wholesale"

3.5 Ofcom liberally applies the term *"wholesale"* to a range of different activities in the sector in contexts where, in most cases, this makes little or no sense. The term wholesale is normally understood to mean the provision of a product or service to another party for resale. This is clearly different to the provision (and acquisition) of inputs which are used in the production of the outputs of a firm.

3.6 In the context of the provision of services relating to the TV sector, use of the term *"wholesale"* makes no sense in relation to the provision of services such as conditional access, for example, as those procuring such services (in the case of services provided by Sky) have no right to resell them to anyone else; they simply comprise inputs into firms' businesses (normally pay TV retailers in the case of CA services). It is, however, a commonly understood and used term in relation to the production of pay TV channels as these are often provided by their producers to other parties for resale. Similarly, the term has relevance in relation to the supply of transponder capacity, as it is possible to lease transponder capacity from resellers such as Arqiva and Globecast.

"Wholesale channel provision"

3.7 The concept of *"wholesale supply"* of TV channels is only applicable in the context of pay TV channels; there is no commonly understood 'retailer' activity in relation to free to air channels. "Wholesale" supply of pay TV channels refers to the licensing by a broadcaster of the right to distribute the broadcaster's channels to a third party. The amounts paid by third party distributors for these rights are known as 'carriage fees' (as the retailer/distributor is said to 'carry' the broadcaster's channel(s)). In the case of free to air channels, there is no such intermediary function – the broadcaster simply broadcasts its channels; none of the activities carried out by a pay TV retailer are necessary. In this context, the figure is erroneous. The BBC and ITV, for example, do not as the figure indicates, provide their channels to *"Retail service providers"* nor any other kind of providers.[127] In common with all other broadcasters of free to air channels (including Sky), they broadcast them directly to viewers.

3.8 Whilst it mentions the sale of advertising airtime, Ofcom's description omits other important activities from the range undertaken by channel providers in relation to their channels, notably broadcasting and marketing:

- broadcasting – channel providers are more commonly known as broadcasters; they are the entities licensed by Ofcom under the Broadcasting Acts and are responsible for, *inter alia*, compliance with broadcasting laws and regulation. Having assembled and scheduled a TV channel, broadcasters then deliver (or arrange delivery) of their channels to end users. In the case of all channels this involves playing out the

127 Nevertheless, we note that these broadcasters do provide their channels to closed platforms such as BT Vision and Virgin Media.

channel from the broadcaster's premises. This also generally involves the procurement of broadcasting services in order to deliver the channel to end users;

- channel marketing - this involves the activity of encouraging consumers to watch the programmes carried on broadcasters' TV channels which, in a world of hundreds of competing TV channels, is an essential part of any broadcaster's activities. Broadcasters undertake a wide range of such activities including advertising (both general channel brand marketing and advertising of particular programmes on channels), provision of programmes to reviewers, inclusion of their channel schedules in electronic and hard-copy listings guides and developing and maintaining websites relating to their channels.

"Wholesale platform service provision"

3.9 This category does not correspond to any commonly recognised industry function. From the description it appears to include a disparate set of activities that might be best described as 'provision of services related to TV broadcasting'. In particular, the use of the term *"wholesale"* is entirely redundant in the title of this category.

3.10 There appears to be considerable confusion in relation to this category about who provides what services to whom. For example, transponder capacity from Astra and Eutelsat (or intermediaries) in relation to satellite broadcasting, and DTT multiplex capacity in relation to digital terrestrial broadcasting is generally procured by broadcasters, not platforms. On the other hand, platform services such as conditional access in relation to Sky's digital satellite platform *are* provided to pay TV retailers.

"Retail service provision"

3.11 Again, we find this category highly confusing. We do not understand what Ofcom means by *"retail platform access services"*. In the Market Impact Assessment of the BBC's High Definition Television Proposals, which includes a (slightly different version of) the *"value chain"*, Ofcom has stated that "*Retail supply involves the sale to end consumers of access to a platform*".[128] This does not correspond to any retail service provided by operators in the UK of which Sky is aware, and no adequate explanation is provided by Ofcom of what it means by this concept.

4. Question 4: Are there any additional comments or evidence which you wish to provide?

4.1 In Section 2 of the Consultation Document (Context), Ofcom sets out the legal framework for this investigation and lists the various duties that it considers applicable. Ofcom does not, however, acknowledge its overarching obligation (which applies when performing its core general duties) to have regard to the

128 http://www.ofcom.org.uk/research/tv/bbcmias/bbc_hdtv/bbc_hdtv.pdf

principles under which "*regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed*".[129] Given, amongst other things, the weight of consumer research, which proves that the overwhelming majority of consumers are happy with the pay TV services that they receive (and that pay TV fares well in terms of customer satisfaction in comparison to other communications sectors regulated by Ofcom), Sky considers that no regulatory action should be taken in relation to the pay TV sector.[130]

4.2 Whilst Ofcom briefly describes certain relevant existing regulation at Paragraphs 2.25 to 2.34, it fails to analyse or give due weight to the impact of this regulation on the TV sector. In particular, there is little (or no) analysis of the following recent regulatory interventions:

- the FAPL commitments, which were adopted in 2006 and apply until 2013;
- the regulation of Sky's technical platform services, the most recent guidelines for which were put in place in 2006; and
- Ofcom's proposal to apply access-related conditions to Top Up TV (though it is noted that these conditions still have not been applied by Ofcom).

4.3 In addition, given the potential impact of Ofcom's review of wholesale digital TV broadcasting platform markets, started in July 2006, the Consultation Document should, at the least, contain some analysis of the impact of this work on the pay TV sector.

SECTION 4: THE CONSUMER EXPERIENCE OF PAY TV

(a) Whilst Section 4 of the Consultation Document starts with a description of evidence of high levels of consumer satisfaction, we note that Ofcom does not ask any Consultation Questions about consumer satisfaction levels, nor does it place any weight on this evidence in the remainder of the Consultation Document. However, as noted in response to Consultation Question 1 above, consumer satisfaction levels are a relevant factor in relation to all the criteria suggested by Ofcom. We therefore set out below Sky's view on the evidence on consumer satisfaction in the Consultation Document. In summary, Sky's view is that there are high levels of customer satisfaction which constitute *prima facie* evidence that the sector is working well for consumers.

Consumer satisfaction levels

(b) According to Ofcom's own consumer research, 84% of pay TV consumers are either very satisfied or fairly satisfied with their service (48% of Sky's pay TV customers are very satisfied with their pay TV service and 37% are fairly satisfied; the satisfaction levels of Virgin Media's customers are lower: 32%

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129 Section 3(3)(a) Communications Act 2003.

130 See further Section 12 of **Part 2** of this Response.

very satisfied, 46% fairly satisfied).[131] As a comparison, the level of satisfaction in fixed line is 92%, for mobile it is 93%, for internet (both narrowband and broadband) it is 88% and for digital TV subscribers it is 86%.[132] This evidence leads Ofcom to conclude that consumer satisfaction levels for pay TV are *"broadly in line with other communications markets"*[133]. Ofcom goes on to characterise the level of satisfaction with pay TV as *"reasonable"*;[134] Sky would argue that this begrudging assessment underplays matters.

(c) Ofcom argues that *"evidence on consumer satisfaction levels is often hard to interpret"*.[135] Sky disagrees. Ofcom itself compares consumers' satisfaction levels with digital pay TV to satisfaction levels with other communications services (at paragraph 4.3 and Figure 19), which tends to contradict the view that benchmarking is difficult. The high levels of consumer satisfaction constitute *prima facie* evidence that the market is functioning effectively and that consumers are well-served. In any event, in summing up the evidence on consumer satisfaction levels, Ofcom expresses the view that it *"suggests at least that consumers are generally happy with the services they take."*[136] Ofcom fails to acknowledge that, to the extent that anything <u>might</u> be inferred from it, such evidence tends to support a positive conclusion and would certainly undermine any suggestion that the market is functioning to the detriment of consumers.

(d) Further analysis of Ofcom's research shows that consumers believe that they can easily compare the cost and quality of multi-channel TV providers (which would include pay TV). This research also shows the ease with which consumers can make cost and quality comparisons across fixed line providers, mobile providers and internet providers.[137] For Q2 2007, the proportion of consumers of multi-channel TV who considered that it was *"very easy"* or *"fairly easy"* to make cost comparisons was higher than the proportion who answered the same in respect of mobile and fixed line, and only slightly lower than the proportion in respect of internet. Multi-channel TV performed similarly against the other communications services in respect of consumers' opinions on the ease of making quality of service comparisons.

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131 Figure 20 and Paragraph 1.15.

132 Figure 19.

133 Paragraph 4.76.

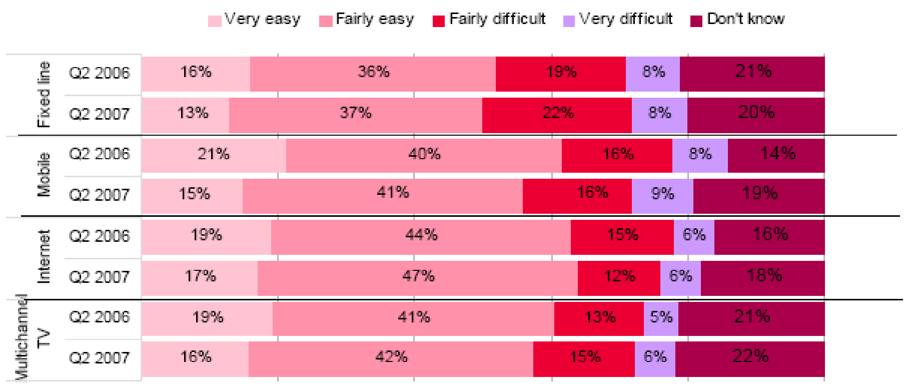
134 Paragraphs 3.22 to 3.23.

135 Paragraph 4.7.

136 Paragraph 4.76.

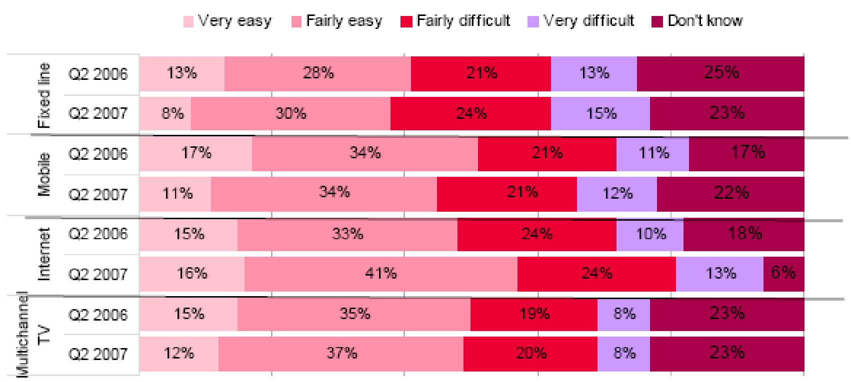
137 *"The Consumer Experience"*, Figures 128 and 132, 20 November 2007

Figure 128: Consumer opinions on ease of making cost comparisons



Base: All Adults with fixed-line (2006, 2234) (2007, 1350) mobile (2006, 1883) (2007, 1273) internet (2006, 1479), multichannel TV (2006, 1784) (2007, 1211)
Source: Ofcom communications tracking survey Q2 2007

Figure 132: Consumer opinion on ease of making quality of service comparisons



Base: All Adults with fixed-line (2006, 2234) (2007, 1350) mobile (2006, 1883) (2007, 1273) internet (2006, 1479) (2007, 917), multichannel TV (2006, 1784) (2007, 1226)
Source: Ofcom communications tracking survey Q2 2007

(e) These facts again support the view that the sector is functioning well for consumers.

Penetration levels

(f) A further factor against which Ofcom should assess whether the pay TV sector is functioning well for consumers (and, in particular, the pricing of pay TV services), proposed by Sky in its response to Consultation Question 1 above, is penetration levels of pay TV.

(g) Ofcom's own research has found that *"the UK has the highest take-up of digital terrestrial services, the second highest take-up of digital satellite (after Japan), and the third highest cable take-up (after the US and Ireland)"*).[138]

(h) PwC's report at **Annex 1** (PwC's report: The outcomes for consumers in relation to pay TV in Europe) provides further evidence on penetration levels.

138 *"The Consumer Experience"*, pages 29-30 (20 November 2007), and in particular paragraph 2.2.17.

PwC found that the penetration of digital pay TV in the UK is amongst the highest in Europe.[139]

(i) Sky considers that these findings are strongly indicative of a market that is working well for consumers.

5. Question 5: Do you agree with the views we have expressed as to the level of platform and content choice available?

5.1 Ofcom considers "*platform choice*" before "*content choice*". As a preliminary point, Sky considers that content choice is what matters most to consumers. TV is about delivering content to customers; consumers' central concern being the ability to watch **what** they want to watch, not **how** they watch it.

5.2 With regard to ***platform choice***, we note Ofcom's view that the *"[a]vailability of broadcast platforms [in the UK] compares fairly well in terms of the total number of options available"*,[140] and their *"initial assessment"* which *"reveals a market that currently appears to be serving its existing consumers reasonably well"*.[141]

5.3 We note, however, that despite Ofcom's earlier emphasis on the need for it to "*take a dynamic and forward looking view*",[142] it gives little consideration to significant future platform developments. Ofcom makes no mention of (for example) the impact on future platform choice of the growth in IPTV networks, the emergence of internet to the TV,[143] the upcoming launch of BBC Freesat, and most notably, of the effect of digital switchover itself, which will result in DTT coverage being extended from around 75% to 98.5% of the population.

5.4 With regard to ***content choice***, Ofcom states that "*the UK compares **fairly well** to other countries in terms of content choice*" (emphasis added).[144] Given Ofcom's evidence that "*the number of channels available across the UK is… second only to the US*"[145] (a richer and vastly more populous country), Sky considers "*fairly well*" to be at best an understatement and, at worst, a misrepresentation.

5.5 The discussion of content choice (such as it exists) seems to place emphasis on the availability of content on all platforms (see, for example, the summary at Paragraph 4.25). As mentioned in response to Consultation Question 1 above, any assessment of the availability of content on different platforms should give

139 **Figure 2** of **Annex 1** (PwC's report: The outcomes for consumers in relation to pay TV in Europe).

140 Paragraph 4.11.

141 Paragraph 4.76.

142 Paragraph 2.17.

143 See further the **Appendix** to **Annex 6** (Commentary on the Consultation Document).

144 Paragraph 4.12.

145 *Ibid.*

due consideration to the effects of closed platforms, capacity constraints, the impact of regulatory restrictions, etc.[146]

5.6 Sky's view is that consumers in the UK are very well served in terms of content choice both in terms of range of channels and range and quality of programming carried on those channels. Sky also considers that Ofcom fails to give due weight in its analysis to the importance of content to consumers (notwithstanding the inclusion of Figure 12, which, as Ofcom notes, reflects the fact that content is *"the element of consumers' TV service that is by far the most often described as 'must have', both for pay TV and free-to-air consumers"*[147]).

6. Question 6: Do you agree with our analysis of innovation levels in UK pay TV? Do you agree with our assessment of what has driven innovation in the past, and what will drive it in the future?

6.1 Sky does not disagree with Ofcom's conclusion that innovation in pay TV offers strong benefits for consumers. However, Ofcom's analysis of innovation is extremely sparse. It fails to conduct any analysis of either the benefit of innovations to consumers or the impact of innovations on the development of pay TV.

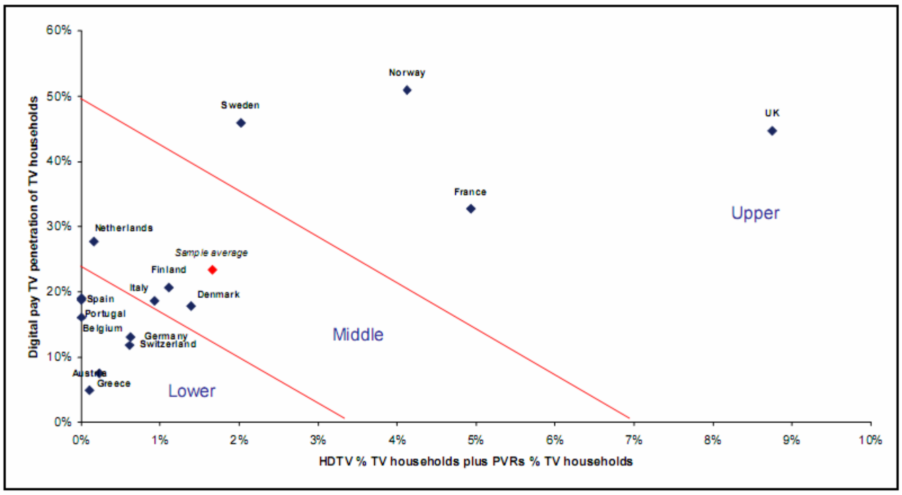
6.2 The UK (and Sky in particular) is a leader of innovation. Sky+ has delivered considerable benefits to consumers who are given greater control and flexibility over what they watch, when.

6.3 PwC's report at **Annex 1** (The outcomes for consumers in relation to pay TV in Europe) contains further information on, and assessment of, innovations within the TV sector in the UK, relative to 14 other European countries, which support the conclusion that UK innovation levels are high and, therefore, delivering significant benefits to consumers. It finds that the UK is one of the leading European countries in terms of the development and penetration of innovative products and services. The figure below, extracted from PwC's report, shows this by setting out the level of innovation in terms of penetration of digital pay TV in households and the percentage of households with HDTV and/or PVRs:

[146] In relation to the impact of regulatory restrictions, it is striking how Ofcom repeatedly refers to the fact that "*two Sky channels that are not available on DTT*" (Paragraphs 1.17 and 4.25), whilst failing entirely to mention that this is because of restrictions for which Ofcom is responsible.

[147] Paragraph 3.61.

Figure 11: Innovation penetration assessment



Source: *Screen Digest and PwC analysis*

6.4 The UK is also shown to be a leader in innovation in TV services when this is assessed in terms of launch dates of key innovations:

Table 12: Indicator of innovation based on launch dates of all innovations

Country	Number of years since introduction of digital pay TV	Number of years since introduction of PVRs	Number of years since introduction of HDTV	Innovation introduction indicator = sum of preceding columns
France	12	5	2	19
UK	10	7	2	19
Germany	12	4	2	18
Finland	11	3	3	17
Norway	11	3	3	17
Sweden	11	3	3	17
Austria	11	3	2	16
Italy	12	2	2	16
Netherlands	12	2	2	16
Denmark	10	3	1	14
Belgium	10	2	1	13
Switzerland	9	3	1	13
Portugal	10	1	1	12
Spain	11	1	0	12
Greece	9	2	0	11
Sample average	*11*	*3*	*2*	*15.3*

6.5 PwC's overall conclusion on innovation can be seen in the table below, which combines the two innovation assessments above:

Table 13: Overall innovation assessment

Country	Innovation introduction index	Innovation penetration assessment	Overall innovation assessment
France	19	Upper	Upper
Norway	17	Upper	Upper
Sweden	17	Upper	Upper
UK	19	Upper	Upper
Austria	16	Lower	Middle
Denmark	14	Middle	Middle
Finland	17	Middle	Middle
Germany	18	Lower	Middle
Italy	16	Middle	Middle
Netherlands	16	Middle	Middle
Switzerland	13	Lower	Lower
Belgium	13	Lower	Lower
Greece	11	Lower	Lower
Portugal	12	Lower	Lower
Spain	12	Lower	Lower

7. Question 7: Do you agree with our analysis of pricing structures in UK pay TV?

7.1 In Paragraphs 4.30 to 4.38 of the Consultation Document, Ofcom purports to "*summarise the typical price structures for pay TV in the UK*". However, both the range of services available in the UK and the structure of prices for such services are very poorly described.

7.2 Under the heading "*Initial Assessment*", Ofcom observes that the "*current pricing structure of pay TV in the UK obliges many consumers to purchase other packages in order to gain access to premium content. They have to buy some form of basic TV package, or a TV package combined with other services.*"[148] Ofcom recognises[149] that buy-though is not uncommon in other markets[150] but fails to make a distinction between buy-though and pure bundling of different communications products by operators such as Virgin Media, BT and Tiscali.

Do current pricing structures act in the aggregate interests if (sic) consumers?

7.3 Ofcom does not explain what the "*aggregate interests of consumers*" means or how that would be measured. Sky can only emphasise again Ofcom's finding of high levels of consumer satisfaction. It must be assumed that these satisfaction levels are a reflection of suppliers' continuing ability to attract and retain (and hence meet the interests of) consumers through their pricing and packaging.

148 Paragraph 4.36.

149 Paragraph 4.35.

150 PwC observes, in Section 3.2.1 of **Annex 1** (PwC's report: The outcomes for consumers in relation to pay TV in Europe), that *"buy-through is a common feature of pay TV retailing"* in the countries that it surveyed and exists to some extent in all 15 countries.

7.4 In considering whether *"pricing structures"* meet the needs of consumers, it is important for Ofcom to take account of the range of different retailers from whom (and platforms on which) pay TV services are available. Alternative packaging and pricing strategies comprise a dimension of competition between retailers; those with better pricing structures, from the point of view of consumers, will do better in attracting subscribers to their services. The existence of a range of retailers means that pricing structures that have a detrimental impact on consumers are unlikely to be adopted.

7.5 In addition to considering the range of retailers, it is also important for Ofcom to consider the number of options available to consumers, which is in fact, at least in respect of Sky's DTH pay TV service, very considerable. For example, Sky bundles basic pay TV channels into six mutually exclusive genre "mixes" which customers can then purchase in any combination. Just taking into account Sky's premium channels and the six basic mixes, the number of total bundles from which a customer is able to choose is 1,764. There are therefore a large number of bundles that a consumer can choose at varying prices according to the content of each bundle.

7.6 It is worth noting again here, as we do in Section 11 of **Part 2**, that Sky does not require a customer to purchase a large basic TV package in order to access the premium channels that it retails. Rather, a customer needs to subscribe to just one of the six available genre-based basic packs in order to purchase a premium channel. Sky notes that Virgin Media customers can buy premium channels through the M pack, which is made up largely of channels available free to air on DTT. This demonstrates that the practical effect of buy-through obligations placed on retailers by channel wholesalers is minimal.

7.7 There should be a presumption that, absent clear market failures, competition between retailers will result in approaches to pricing and packaging that as far as possible meet consumer demands. Whilst this is clearly not a simple task for retailers nor a static one (due to heterogeneity of demands, evolution of demands over time and imperfect information), suppliers are continually seeking to attract and satisfy subscribers through pricing and packaging changes.[151] The fact that the overwhelming majority of customers are happy with the service they receive from the pay TV sector is evidence that they are successful in this endeavour, as is the high level of digital pay TV penetration.

151 For example, on 1 September 2005, after a significant programme of consumer research, negotiations with the providers of basic channels in Sky's pay TV packages, and a very considerable amount of development in its customer management systems, Sky developed and introduced a set of six new genre-based packages or mixes, which allowed customers to select 2, 4 or 6 mixes. Sky has now changed this approach to give customers even more choice. Sky customers can now choose to have between 1 to 6 mixes. Also, from 1 July 2007, Sky dropped the £10 per month fee to basic-only customers for Sky+, resulting in a very significant reduction in charges to such customers. Further details of Sky's pricing and packaging changes may be found in **Appendix 8** (Examples of changes to Sky's basic packages in September 2005) to **Annex 2** (Market definition and market power).

8. Question 8: Do you agree with our assessment that there is currently insufficient evidence to support a conclusion that prices in the UK are excessive?

8.1 Yes. There is no evidence that prices in the UK are excessive.

8.2 Any assessment of pricing should take into account:

- profitability (see Sky's response to Consultation Question 9 below); and
- the high level of consumer satisfaction and the high level of penetration of pay TV in the UK (discussed above), which are *prima facie* evidence that the sector is working well for consumers and that prices are not excessive.

8.3 Sky notes the inconsistency between Ofcom's assessment that there is no evidence of excessive pricing in the UK, on the one hand, and its numerous references to the possibility that prices may be above competitive levels, on the other.[152] It is telling that Ofcom does not even identify this inconsistency, let alone seek to understand the reason for it (which, Sky submits, is that prices are **not** above competitive levels).

8.4 In relation to the price of UK pay TV services, despite going on to refer to a number of caveats that need to be recognised, Ofcom states that "*a headline comparison of revenues per head may be taken to indicate that UK prices are high compared to other countries*".[153]

8.5 We do not consider that Ofcom has properly taken into account the detailed criticisms of the LECG report commissioned by the Complainants that we submitted at Section 6 of Part B and Annex 3 of Sky's Response to the Complaint. Moreover, although Ofcom notes a number of "*concerns*" with the report, as noted in **Part 2**, Sky considers that the assessment commissioned by Ofcom from Professor Chesher and the critique submitted by Sky should have led to the LECG report being robustly discredited by Ofcom in the Consultation Document. The fact is that this work is fundamentally flawed and has no evidential value at all.[154]

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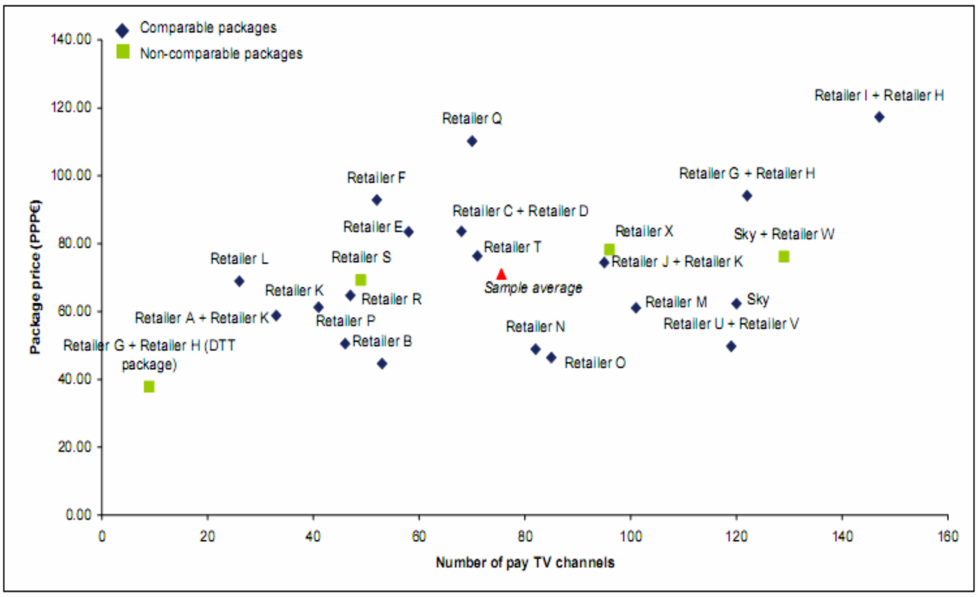
152 See, for example, Paragraph 4.72 ("*A headline comparison of average revenues per subscriber could at first sight be taken to indicate that UK consumers are paying too much for their services*") and Paragraph 5.11 ("*How to account for the possibility that current prices may be above competitive levels – the "cellophane fallacy"*"), Paragraph 5.22 ("*One implication of this is that the CC conducted its market power assessment on the basis of current prices, which, as it acknowledges, are not necessarily at competitive levels*"), Paragraph 5.32 ("*results… could also indicate that prices are already set at a level which extracts the maximum willingness to pay from consumers*"), Paragraph 5.42 ("*the evidence is also consistent with a narrowly defined market for the retailing of Sky Movies packages, where the high level of switching results from prices having been raised above competitive level*") and Paragraph 5.45 ("*Our overall conclusion is… the likelihood that prices are above competitive levels*").

153 Paragraph 4.76.

154 PwC's report provides confirmatory evidence in relation to a key flaw in LECG's study – the treatment of cable access packages in a number of European countries as 'pay TV' when in fact they simply comprise essentially free to air services delivered via cable for a monthly

8.6 Following the receipt of PwC's report at **Annex 1**, Ofcom now has even less justification for any reliance on LECG's flawed report or indeed for any concerns about prices in the UK being high in relation to those in other countries. Unlike LECG's report – which examined prices paid by no-one for pay TV services that do not exist – PwC's report examined the services that are *actually provided* to consumers in 15 European countries. Such a detailed examination is necessary in order to ensure that proper like-for-like comparisons are made, as far as possible, between pay TV services provided in different countries. It also avoids the need to rely on 'average revenue per user' as a measure of charges, given that such a measure is a poor proxy for charges. PwC's report shows clearly that **charges for pay TV services in the UK cannot be said to be "*high compared to other countries*"** (see Section 3 of PwC's report and, in particular, the figure below).

Figure 5: PPP€ price and number of channels for most inclusive packages



Source: PwC analysis

8.7 As a final comment, we note the non-neutral manner in which this Consultation Question is posed, which suggests that Ofcom has an underlying belief that prices are in fact excessive but that it does not (yet) have the evidence to show this (which evidence Ofcom seems to be seeking via the request in the final sentence of Paragraph 4.48). We also note that the way in which Ofcom summarises its initial assessment reflects this apparent prior view - "*unable to conclude on the basis of currently available evidence that prices are excessive*", rather than some more positive expression such as "*currently available evidence does not show that UK prices are excessive*".

utility charge. PwC shows the very significant differences that exist between 'genuine pay TV' penetration in countries such as Belgium and Germany, and the data on pay TV penetration relied on by LECG, which play a key role in their conclusion that prices in the UK were above the European average.

9. Question 9: Do you agree with our initial assessment that there is not convincing evidence to support the claim that the industry is earning excessive profits?

9.1 Although this Question asks about "*the industry*", Ofcom's analysis looks only at Sky's profitability and concludes that there is no "*conclusive evidence of* excessive *profits being earned* ***by Sky***" (emphasis added).[155] Sky agrees that there is no evidence that it is earning excessive profits (at either the wholesale or retail level) and we refer Ofcom to the discussion of the 'cellophane fallacy' in Part One of **Annex 2** (Market definition and market power).

9.2 Although Sky has numerous issues with Ofcom's approach to analysing profitability, Ofcom's conclusion would not be affected by conducting the analysis differently.

9.3 Ofcom's conclusion that there is no evidence of excess profits provides further evidence that pricing at both the wholesale and retail level is broadly reflective of underlying input cost.

Is there evidence to support the suggestion that Sky is pursuing objectives other than short term profitability?

9.4 Sky finds this Question (which appears to have been removed from the main body of the Consultation Document, but appears in the list of questions), entirely inappropriate. It is unclear why Ofcom has included, in what is purportedly an industry wide consultation, a question that (a) refers specifically to Sky; and (b) specifically seeks evidence from third parties that Sky is pursuing objectives that (it is inferred) are nefarious.[156]

9.5 It is extremely difficult to work out exactly what Ofcom is suggesting may be occurring. In Paragraph 4.75 there is a reference to "*pursuing growth*", which clearly is a legitimate objective for any business. Sky's objectives are publicly available and, like all appropriately managed companies are not purely short-term in nature. It is legitimate for Sky to invest in growth by, for example, incurring acquisition costs which it may take some months to recover.

9.6 In the final bullet of Paragraph 4.76, however, the suggestion is put somewhat differently as "*invest[ing] in market share now, even at the cost of short-term profits, in pursuit of a longer-term market position*". Ofcom's second argument (or indeed allegation) is so inchoate that it is impossible to respond. Ofcom appears to suggest a more strategic objective on the part of Sky. In particular, it would appear that Ofcom is implying that Sky is sacrificing short term profits in order to secure longer term benefits through foreclosure. If this is what Ofcom has in mind, we refer it to CRA's report at **Annex 4** (CRA Report: Vertical integration and short-run/long-run issues). Sky has commissioned CRA to

155 Paragraph 4.74; see also 4.71.

156 Sky wrote to Ofcom on 11 February 2008 to clarify why Ofcom had included this question in its consultation. In subsequent correspondence between Sky and Ofcom, Ofcom failed to enlighten Sky as to the reason for this question's inclusion.

consider whether theories of dynamic foreclosure have any relevance to the pay TV sector. CRA concludes that the crucial components for a dynamic foreclosure theory are not present and that there is no basis for a dynamic foreclosure concern in relation to pay TV. Sky has summarised CRA's analysis of this issue in Section 10 of **Part 2** of this Response.

10. Question 10: Are there any other comments or evidence which you wish to provide?

10.1 Sky reiterates the fact that consumers are satisfied with the services they receive from pay TV, that the UK has a high level of digital pay TV penetration, is a leader in terms of innovation, and, as PwC's report shows, the UK compares well with the comparator countries in terms of the number of 'genuine' pay TV channels (see Sky's response to the Consultation Questions relating to Section 4 of the Consultation Document above and also PwC's report).

10.2 Sky has set out, in **Annex 6** (Commentary on the Consultation Document), the inaccuracies in Ofcom's Consultation Document, flaws in Ofcom's analysis and shortcomings in its assessment that are not discussed in detail elsewhere in this Response.

SECTION 5: CHARACTERISTICS OF THE PAY TV MARKET

11. Question 11: What is your view on our approach to defining markets?

11.1 Ofcom's approach to market definition is technically, analytically and evidentially deficient. Ofcom is referred to **Part 2** and **Annex 2** (Market definition and market power) to this Response, which sets out in detail the material flaws in Ofcom's analysis of market definition and market power in the Consultation Document.

12. Question 12: Do you agree with our definitions of premium content markets?

12.1 We assume here that Ofcom intended to refer to its "*preliminary conclusions*" in relation to its definition of "*premium content markets*". This is again indicative that Ofcom has a pre-determined view in relation to market definition.

12.2 As is set out in **Part 2** and **Annex 2** (Market definition and market power), Sky does not agree with Ofcom's "*preliminary conclusions*", nor does it consider that Ofcom's analysis and evidence support its preliminary conclusions.

13. Question 13: Do you agree with our preliminary conclusions on basic / free-to-air markets?

13.1 Ofcom's preliminary conclusions are beyond credibility and seriously lacking in evidence and analysis. It is clear that Ofcom has ignored high quality and relevant evidence, as well as the Competition Commission's clear finding in relation to the BSkyB/ITV inquiry of a market for all TV, which were based on a consideration of a substantial body of evidence. This evidence contradicts entirely Ofcom's implausible view that multi-channel free to air TV comprises a separate relevant product market to basic pay TV packages. Our only explanation for Ofcom's preliminary conclusions is a preconception on Ofcom's part with regard to market definition and the existence of market power, as discussed in **Part 2** and **Annex 2** (Market definition and market power).

14. Question 14: Do you agree with our assessment of market power?

14.1 No. Sky does not agree with the assessment of market power in the Consultation Document. It is technically, analytically and evidentially deficient. Notably, Ofcom fails to address the basic conundrum of why, if Sky has the market power attributed to it by Ofcom, Ofcom has found no evidence of excessive pricing or of Sky earning excess profits, and Sky behaves as it does (for example, consistently driving key innovations in the sector).

14.2 Ofcom's assessment of market power is, in essence, entirely and simplistically determined by its artificially narrow market definitions and the presumption of dominance attached to the resulting high market shares. Ofcom also fails to have regard to any evidence which would suggest that Sky does not have market power.

14.3 Sky sets out its views on Ofcom's assessment of market power in detail in **Annex 2** (Market definition and market power).

15. Question 15: Have we identified the correct set of intrinsic market characteristics? Are there any that you would add?

15.1 Both the purpose of identifying "*intrinsic market characteristics*" and the intrinsic market characteristics themselves are unclear and misplaced. It is also unclear what Ofcom means by the word "*intrinsic*". If it is trying to set out a number of inherent characteristics that are relevant to most or all industry players, then this approach is inappropriate (given the diversity and complexity of the sector). Instead, Ofcom should have set out a proper description of the pay TV sector and TV services generally.

15.2 It is apparent that Ofcom is either confused or contradictory about whether it is seeking to examine pay TV within the broader context of TV services generally, or to focus on specific characteristics that relate only to pay TV services. Sky's view is that it is imperative for Ofcom to analyse the pay TV sector within the broader context of TV services generally (and the comments below are based on that approach).

Important characteristics which Ofcom failed to consider

15.3 We set out characteristics that Ofcom failed to consider below in italics.

Content production

15.4 *The* direct *or indirect state funding of a considerable amount of content intended for free to air distribution in the UK.* In particular, the influence and impact of the BBC as a result of its state funding.

15.5 *The high degree of product differentiation.* Whilst it is possible to classify content into 'genres' or other categories, it is important to note that each programme is different and the appeal of each programme will differ according to the tastes of particular viewers.

Channel production

15.6 *There is a large variety of business models available to broadcasters.* In choosing a business model, a broadcaster may be highly influenced by the content it owns (or the content that the broadcaster envisages purchasing). The business model adopted by a broadcaster may depend upon a number of factors including the appeal of the content broadcast and consumers' willingness to pay for that content. In addition to considering whether the content appeals to viewers, if a broadcaster derives revenue from advertising, it will also need to consider whether the content appeals to the type of viewers to whom advertisers would also like to appeal.

15.7 *PSB channels have long-standing privileged access to key inputs, particularly high quality sports rights and terrestrial spectrum.* The legacy of this is that these channels have been able to build up significant reputational and brand advantages over other broadcasters. In addition, these channels can cross promote to retain audiences within their digital portfolios. Non-PSB channels do not have the same access to large audiences in order to establish audiences for new series and programmes.

15.8 *Within the UK it is a reasonably simple process for a broadcaster to bring a channel to market.* This is evidenced by the proliferation of channels in the UK, especially on the DTH platform. Indeed, in this respect, the Competition Commission concluded *"that there are relatively low barriers to entry for a television channel provider aiming to reach a small number of subscribers."*[157]

15.9 *Competition occurs through product differentiation.* Given the substantial fixed cost of programming creation, the programming of channels needs to be sufficiently differentiated for broadcasters to charge prices above marginal cost or attract audiences in order to generate advertising revenues.

Content acquisition (as a specific element of channel production)

15.10 *There is already a significant amount of regulatory intervention that applies to the acquisition of content.* For example, the Code on Listed Events restricts the acquisition of certain sports rights by TV broadcasters. The FAPL commitments and the UEFA Champions League commitments have also

[157] Competition Commission report on the Acquisition by BSkyB of 17.9% of the shares in ITV plc, 14 December 2007, paragraph 4.98.

operated to restrict the acquisition of sports rights by TV broadcasters. Ofcom, in part, refers to certain of the Listed Events at paragraph 5.29 and then seemingly dismisses their importance/uniqueness because of the commercial valuation of these rights in comparison with FAPL rights. We consider this to be flawed as Ofcom has failed to take into account the fact that these rights are subject to regulation, which effectively limits the number of broadcasters who can win the rights and thus reduces the competition for these rights.

15.11 *When considering bids for their rights, certain sports rights owners may weigh up both the bid amount and the exposure for their events offered by each channel, such that they may favour a lower bid from a channel with a higher reach over a higher bid from a channel with a lower reach.* For example, we understand that, in relation to the recent bidding for Champions' League rights, UEFA's clear preference was for a free to air broadcaster to win the final live rights package and that Sky's bid for that package was therefore rejected in favour of a bid from ITV.

15.12 *The processes for the sale and acquisition of rights can differ quite considerably.* Ofcom does not consider in any detail sales processes other than the FAPL auction process (which is the subject of regulation) and the sale of movie rights.

Provision of programming to end-users

15.13 In data previously submitted to Ofcom[158], we showed that *total viewing of television is fairly fixed whether a household has analogue terrestrial television or multi-channel television.* This would indicate that overall the amount of TV viewing is broadly fixed and that the different types of content on analogue terrestrial TV and multi-channel TV, as a whole, are reasonably substitutable.

15.14 In addition, pay TV retailers like Sky need to invest a significant amount of money in *marketing their product to educate consumers* about a product and service that they cannot experience or sample without first purchasing the equipment and service. Indeed, consumers may not have seen many of the channels available on, for example, the Sky DTH platform, before they become a Sky subscriber.

Platforms

15.15 *There is a significant difference in the technical capabilities of the different platforms used to carry channels* (different platforms use spectrum differently, have different return paths and different functionality).

15.16 The PSBs have been gifted the control of the majority of available DTT capacity (and ITV also now owns SDN), which clearly places them at a competitive advantage compared to non-PSBs.

15.17 *Different regulation applies to the different platforms* (e.g., cable and IPTV are closed platforms whereas DTH is not. The position in relation to DTT is less

158 Annex 2 of Sky's Response to the Complaint.

clear, given that Ofcom has proposed to apply access related conditions to Top Up TV, but has not, in fact, done so.)

15.18 As set out in our response to Consultation Question 1 above and in PwC's report, there is *continuous and rapid technological innovation in the TV sector.*

Characteristics that are either not significant or are over-stressed by Ofcom

Channel production - Content acquisition (as a specific element of channel production)

15.19 *Staggered availability of rights.* The periodic availability of rights is to be expected given the wide range of content available from multiple sources and the fixed duration terms for TV rights. As Sky explains in **Annex 3** (Barriers to entry at the channel provider level), this staggered availability facilitates entry at the channel provider level.

15.20 *Collective selling of sports rights.* The collective sale of sports rights is not an intrinsic characteristic of pay TV, rather it is a function of the particular sporting body that is selling the rights.

15.21 *Sale of rights on a cross-platform basis.* It is unsurprising that rights owners sell their rights to broadcasters on a cross-platform basis, as this reflects the demands of broadcasters who tend to want to distribute/supply the rights via as many different technologies as possible.

Provision of programming to end-users

15.22 *Switching costs for consumers are low.* Switching costs are overstressed by Ofcom. As discussed in Part Three of **Annex 2** (Market definition and market power), the costs to consumers of switching between pay TV and free to air TV services, between different pay TV products provided by the same retailer and between different retailers operating on the same platform are negligible. While the costs of switching between pay TV retailers operating on different platforms are higher, they are still modest.

15.23 With regard to switching between different retailers operating on the same platform, it should be noted that, currently, the only platforms in the UK that support multiple pay TV retailers are the DTH platform and Tiscali's IPTV network. In relation to the DTH platform, switching between different pay TV services provided is entirely straightforward.

15.24 The costs of reverting to viewing free to air TV services are those of cancelling a pay TV subscription, which normally simply involves a telephone call. In the case of Sky's DTH subscribers, churners can continue to use their set top box to receive over 200 digital free to air TV channels – including the most popular digital free to air channels, such as ITV2 etc.

15.25 In addition, it is bizarre to describe "*consumer inertia*" as a fundamental characteristic of the UK TV sector. This flies in the face of all available evidence, and a myriad of Ofcom publications to the contrary. For example, in recent Ofcom research,[159] multi-channel consumers were asked for their reasons for not switching suppliers. 69% of multi-channel consumers said that they were "*happy with [their] current supplier*". No consumers gave "*inertia*" as a reason for not switching suppliers. The relatively low levels of actual switching are unsurprising in an industry with high customer satisfaction levels, as shown by Ofcom's own survey evidence (which is discussed above – see Sky's comments directly preceding its response to Consultation Question 5 above).

16. Question 16: Have we correctly captured the role of vertical integration?

16.1 In general, Ofcom's analysis is too simplistic, generic and imprecise, and too focused on Sky's vertical integration. Sky has commissioned CRA to address Ofcom's analysis of the role of vertical integration in its report at **Annex 4** (CRA's report: Vertical integration and short-run/long-run issues). CRA identifies a number of specific concerns, which are set out in Section 2 of its report.

16.2 In its discussion of the effects of vertical integration at Paragraphs 5.120 to 5.129, Ofcom raises two potential concerns:

- that a vertically integrated operator may be able to foreclose downstream competition by favouring its own retail operation;[160] and
- that by weakening a rival retailer a vertically integrated firm may also be able to reduce competition for rights thereby potentially leading to upstream foreclosure.[161]

16.3 In its report, CRA notes that the economics of (static) **downstream foreclosure** is considerably more subtle than currently allowed for in the Consultation Document.[162] CRA believes that Ofcom's approach of making a simple trade-off between upstream revenue lost (as a result of not selling, or selling less, to rivals) and downstream gains fails to tell the full story. Contrary to the hypothesis set out by Ofcom, CRA concludes that a vertically integrated firm that can use sufficiently non-linear tariffs would <u>never</u> refuse to sell to an efficient downstream rival. CRA also shows that (under a broad set of assumptions) the same result also holds where premium channels are offered to retailers in exchange for a per-subscriber fee.

16.4 As to **upstream foreclosure**, CRA concludes that traditional static arguments are of little relevance in the present case. [163] Ofcom's hypothesis seems to rest on the assumption that a firm's ability to bid for content would be weakened if it were not also active at the retail level (i.e. that vertically

159 The Consumer Experience, 20 November 2007.

160 Paragraph 5.126.

161 Paragraph 5.127.

162 Section 2.4 of **Annex 4** (CRA's report: Vertical integration and short-run/long-run issues).

163 Sections 2.5 and 2.6, *ibid.*

integration is a key advantage in bidding for rights). CRA points out that, given the possibility of resale, as shown by Harbord and Ottaviani,[164] even where a vertically integrated firm is assumed to benefit from some retail advantage, an independent upstream broadcaster (or a broadcaster with smaller retail operations) would have exactly the same incentives to bid for content. The upstream broadcaster's ability to monetise any rights acquired would not be adversely affected by the fact that it was not itself a retailer. The broadcaster would be able to extract the value of the rights that it had acquired by wholesaling the content to the vertically integrated operator's downstream arm. Moreover, in the case of Sky, the broadcaster would also have guaranteed access to Sky's subscriber base (and other viewers on the DTH platform) on regulated terms and would therefore also be able to monetise any rights that it acquired by retailing the content directly to consumers.

SECTION 6: OPERATION OF THE MARKET

17. Question 17: Do you agree with our assessment of the effects of content aggregation on retail competition?

17.1 Ofcom's discussion of the impact of aggregation/bundling of content on competition at the retail level is inconclusive. Whilst Ofcom outlines a number of *potential* effects that *may* flow from aggregation/bundling of content, nothing in the discussion put forward by Ofcom is indicative that an issue might indeed be *likely* to exist.

17.2 Ofcom's key observation relates to the hypothesis that there is a *"tendency for one retailer to emerge as the primary retailer"*[165] on any given platform. Sky makes a number of observations on this point, which are set out more fully in Section 9 of **Part 2** and **Annex 5** (Content aggregation).

17.3 First, there is only one retailer on cable and BT Vision because these platforms are closed and other retailers are excluded from retailing pay TV services over them. Ofcom's analysis of the effects of content aggregation on intra-platform competition is therefore entirely focused on DTH. DTH is the only significant platform in the UK on which there is any degree of intra-platform competition and on which a number of different retailers already operate, with platform services provided to them on regulated terms. If Ofcom has concerns about the strength of intra-platform competition then it is incumbent on Ofcom to focus first on closed platforms.

17.4 Second, Ofcom assumes that a retailer's pricing and packaging structure is totally dictated by the economics of bundling and has no regard to any other factor. In reality the extent to which a pay TV retailer is able to exploit the theoretical benefits of bundling will be limited by (i) the need to simplify packaging so that it can be communicated to actual and potential subscribers;

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164 Harbord D. and Ottaviani, M., *"Contracts and Competition in the Pay-TV Market"*, Working Paper, London Business School, July 2001.

165 Paragraph 6.22.

and (ii) the paucity of information on underlying consumer demand for channels. The efficiency benefit that a pay TV retailer can generate by continuing to add additional channels will become exhausted long before the theoretical limit. Hence the scale of the advantage available to a retailer with a portfolio of channels, in terms of obtaining new channels, is much less significant than Ofcom suggests.

17.5 Ofcom also suggests that *"platforms may be prone to tipping"*[166]. This specific concern is addressed by CRA in Section 4.3 of its report. CRA notes that there is no network effect that is likely to cause the pay TV market to 'tip' towards one particular retailer. It observes that Ofcom has not put forward, and CRA itself is not aware of, any credible theory of market tipping based around bundling efficiency.

18. Question 18: Do you agree with our summary of the possible issues relating to the short-run operation of the market?

18.1 The issues raised by Ofcom concerning the short-run operation of the market are extremely hypothetical in nature. Ofcom observes that premium content tends not to be licensed to multiple retailers on the same platform and suggests that this reflects the incentive and ability of vertically integrated firms to tie up content in exclusive contracts in order to strengthen their position in retail markets.

18.2 CRA believes that Ofcom is wrong to adopt licensing to multiple retailers as the 'competitive' default benchmark in the absence of vertical integration.[167] The fact that premium content does not tend to be licensed to multiple retailers on a single platform has a rational explanation which does not depend on vertical integration or foreclosure.

18.3 On the contrary, licensing of identical content to retailers operating on the same platform should be regarded as unlikely to occur, whether or not there is vertical integration between the programming and retailing stages. This is because such broad licensing would lead to a significant reduction in the commercial value of content. Moreover, such intra-platform licensing is unlikely to be desirable as it would ultimately lead to a drastic reduction in the returns to the original producers of content.

18.4 Ofcom also observes that cable customers who subscribe to Sky Sports are unable to obtain interactive services. Although Ofcom acknowledges that *"[t]here may be legitimate reasons for a vertically integrated firm to refuse to supply its enhanced content to third party retailers"*,[168] it fails to acknowledge that Sky has provided it with evidence that there **are** in fact legitimate reasons for the non-availability of Sky's interactive and HD services on Virgin Media's

166 Paragraph 6.22.

167 See Section 2.4 of **Annex 4** (CRA's report: Vertical integration and short-run/long-run issues).

168 Paragraph 6.40.

platform.[169] Instead, Ofcom suggests that this might also reflect an incentive of vertically integrated firms to supply reduced quality of content to downstream competitors.

18.5 CRA notes that it is unclear why this is analysed as a distinct concern from refusing to supply content, as the analytical framework is the same. CRA further notes that, in order to identify this as a *"concern"*, Ofcom would need to produce evidence that (i) the quality *"degradation"* in question would not be matched by a reduction in wholesale prices; and (ii) moreover, that it would matter enough to retail customers that they would switch in significant numbers to Sky from rival retailers.

18.6 In fact Sky's own evidence (discussed in Section 10 of **Part 2**) shows that the fact that customers who subscribe to Sky Sports via Virgin Media do not currently have access to certain interactive content is highly unlikely to lead to any switching.

18.7 Ofcom's final short run concern relates to access to basic content - specifically, buy-through and its potential to restrict competition between providers of basic content on the same platform.[170] Sky discusses this concern in more detail in Section 11 of **Part 2**.

18.8 It beggars belief that Ofcom can express concern that the existence of buy-through may restrict potential competition between providers of basic content, yet does not appear to be concerned that such competition is not even possible on closed platforms. Ofcom must recognise that closed platforms act as absolute barriers to intra-platform competition and *that any proper consideration of factors that may affect intra-platform* competition must include the impact of platform operators' ability to control access to customers, particularly where such platform operators are also retailers.[171]

18.9 Ofcom can draw comfort from the fact that, as is evident from information included in the Consultation Document and in PwC's report,[172] buy-through is prevalent in most countries; and also that it is practised by UK pay TV retailers of both basic and premium content, irrespective of size or platform.[173] The amount of basic content that subscribers are required to purchase in order to

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169 These were set out in Paragraphs 4.8 to 4.11 of Part D and Annex 5 of Sky's Response to the Complaint.

170 Paragraphs 1.65 and 6.78.

171 Virgin Media has an installed base of nearly 3.5 million cable TV customers which is inaccessible to competing retailers (of basic or premium content); whereas the provision by Sky of access to the DTH platform on transparent terms, together with its success at developing a large subscriber base, facilitates rather than forecloses retail competition.

172 Paragraph 3.2.1 of **Annex 1** (The outcomes for consumers in relation to pay TV in Europe).

173 Note that buy-through is not limited to premium channels. A similar effect can arise where a pay TV retailer structures its basic packages in tiers. For example, Virgin Media offers three basic tiers - M, L and XL- where M is a sub-set of L, and L is a sub-set of XL. The effect of this is that the channels that are included in XL only (such as MTV) are only available to a customer who also purchases all the channels in the L pack.

access premium content in the UK is low (e.g., in the case of Sky, one mix); this also demonstrates that the practical effect of buy-through obligations placed on retailers by channel wholesalers is minimal and that if such buy-through obligations were removed by channel wholesalers, this would be very unlikely to have any material effect on the buy-through structure adopted by retailers.

18.10 Ofcom should not presume that, in order for a market to be working well, consumers should have completely free choice – this is unrealistic and does not reflect the important trade-offs that benefit consumers (e.g. a greater range of channels than might be available if customers had the choice of subscribing to premium content on a stand-alone basis). The fact that the overwhelming majority of consumers are happy with the service they receive from the pay TV sector suggests that the pay TV sector has got the balance of trade-offs right, and that the pricing and packaging structures that the pay TV sector adopts in order to sell its products are meeting the needs of consumers and giving them sufficient choice.

18.11 Ofcom does not yet have a view on whether the type of self-assembly of bundles that it considers might facilitate entry of retailers of basic content is, in fact, plausible. Nor does Ofcom appear to have properly considered whether the abolition of buy-through might operate to the detriment of consumers - for example, by leading to a reduction in the range of basic channels available.

19. Question 19: Do you share our possible concerns over the long-run operation of the market?

19.1 Ofcom raises a number of potential concerns in relation to the long run operation of the market:

(i) that there are significant barriers to entry into the wholesale provision of channels that are intrinsic to content markets;

(ii) that a vertically integrated operator may have an incentive to foreclose potential new retailers/or platforms; and

(iii) that a vertically integrated operator may have an incentive to create additional barriers in relation to the wholesaling of premium channels by exploiting its position in downstream markets.

Sky does not "*share*" any of these possible concerns or indeed consider that they are likely to arise in practice.

19.2 There are no significant barriers to entry into the provision of premium sports and movie channels, for the reasons summarised in Section 10 of **Part 2** and set out in more detail in **Annex 3** (Barriers to entry at the channel provider level). Moreover, to the extent that potential asymmetries in terms of bidding for content may arise, these are likely to result from incumbency advantages and are unlikely to be systematically exacerbated by vertical integration.

19.3 Ofcom's claim that the incentive to foreclose a downstream competitor is especially strong when this competitor is a recent or potential entrant is also no more than a *"folk belief"*.[174] In the case of downstream rivals with a small presence in the market, the cost of foreclosure is small (as current sale revenues foregone are small), but the benefits of reducing competition downstream are also small. There can therefore be no presumption that there are greater incentives to foreclose recent entrants than more established rivals in a static framework. The assessment holds also in a 'forward-looking' perspective, whereby the small players of today could be larger rivals tomorrow. Again the two sides of the foreclosure trade-off move hand-in-hand: the benefits of foreclosure (reducing competition downstream) may be greater if one expects the current small rivals to get bigger, but the future sales foregone by refusing to license the rival will also be larger.

19.4 To the extent that Ofcom's long term concerns (both in terms of incentives to foreclose new retailers/platforms and to create additional barriers to entry) stem from economic theories of 'dynamic foreclosure', CRA also demonstrates that there is no basis for a 'dynamic foreclosure' concern here.[175] 'Dynamic foreclosure' is not a term that can be liberally applied to all circumstances where new competitors may be emerging, using the same or new technologies. It has a precise meaning, and very strict conditions must hold for the theory to be even *prima facie* credible. Ofcom does not, however, articulate such conditions, nor does it show that they hold in this case. There is no *prima facie* case to support such theories and CRA concludes that, in fact, the crucial components of a dynamic foreclosure theory are not present in this case.

20. Question 20: What do you see as the impact of these considerations on consumers?

20.1 It is unclear what Ofcom means by "*these considerations*". It would appear that Ofcom is referring to the matters set out in the preceding three Consultation Questions, namely (i) the effects of content aggregation on retail competition; (ii) possible issues relating to the short-run operation of the market; and (iii) possible concerns over the long-run operation of the market. As discussed at length in **Part 2** of this Response, there is no evidence that the concerns that Ofcom has developed are any more than exercises in hypotheses, which, in any event, are based on unsound grounds (including its flawed analysis of market definition and market power).

20.2 Sky's overriding comment is that, as discussed in **Parts 1 and 2** of this Response, the available evidence demonstrates that UK consumers are well served by the pay TV sector and, therefore, that there is no reason to believe that these matters (or any others) are having an adverse impact on consumers - the evidence on consumer satisfaction levels with regard to pay TV services is particularly strong in this regard - nor is there any evidence that the

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174 See Section 10 of **Part 2** and Section 2.3 of **Annex 4** (CRA's report: Vertical integration and short-run/long-run issues).

175 *Ibid.*

theoretical concerns that Ofcom has raised are likely to have such an impact in the future.

20.3 Any intervention based on the *"possible concerns"* set out by Ofcom, in the absence of clear need, would amount to 'regulation by hypothesis'. It would run serious risks of unintended consequences, market distortions and stifling innovation – all likely to be detrimental to consumers.

Sky **April 2008**