OFCOM PAY TV MARKET INVESTIGATION

RESPONSE OF VIRGIN MEDIA TO OFCOM'S CONSULTATION DOCUMENT

OF 18 DECEMBER 2007

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1. OVERVIEW

1.1 This Memorandum sets out Virgin Media's response to Ofcom's consultation document on the pay TV market investigation of 18 December 2007 ("the **Consultation**").

1.2 This document is structured as follows:

- Section 1 – Overview;
- Section 2 - Observations on the criteria against which Ofcom proposes to assess the functioning of the UK pay TV market;
- Section 3 – Observations on Ofcom's overview of the UK pay TV market;
- Section 4 – Observations on Ofcom's analysis of the consumer experience of pay TV;
- Section 5 – Observations on Ofcom's analysis of characteristics of the pay TV market; and
- Section 6 – Observations on Ofcom's analysis of the operation of the market;

1.3 As set out in the submission to Ofcom on the need for a market investigation into the pay TV industry by British Telecommunications plc, Setanta Sport Holdings Limited, Top Up TV Europe Limited, and Virgin Media Limited (together, the "**Parties**") of 3 July 2007 ("the **Joint Submission**")[1], and recognised by Ofcom[2], Ofcom has the discretion to make a market investigation reference to the Competition Commission ("**CC**") where it has reasonable grounds for suspecting that

> "*Any feature, or combination of features, of any market in the United Kingdom for goods or services prevents, restricts, or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom*"[3]

1.4 In the Joint Submission the Parties argued that the evidence of market failure in the supply of pay TV in the UK and the need for remedies to address that market failure was overwhelming. Accordingly, absent the offering and acceptance of adequate undertakings to address the market failure in a comprehensive manner, the Parties argued that Ofcom should refer the pay TV industry to the CC.[4]

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1 Part 6, paragraph 1.2 of the Submission.

2 Paragraph 6.9 of Annex 7 of the Consultation.

3 Section 131(1) of the Enterprise Act 2002 ("**EAO2**").

4 Paragraph 24 of the Joint Submission.

1.5 For the reasons set out below, on Ofcom's own analysis, there can be no room for doubt that Ofcom has reasonable grounds for concluding that there are a combination of features which are preventing, restricting or distorting competition in connection with the supply of pay TV in the UK. In other words, the threshold for Ofcom to make a market investigation reference to the CC is clearly met.

1.6 In support of their position that Ofcom should refer the pay TV industry to the CC, the Parties made a number of observations, supported by evidence, in relation to conditions of competition in, and features of, the pay TV industry in the UK. These are summarised in brief below:

(a) Sky has leading market positions at all three tiers of the pay TV supply chain in respect of premium sports and movie content;

(b) the pay TV industry exhibits significant barriers to successful market entry and expansion, which are due in a large part to a number of distinctive features;

(i) there is a finite pool of key content;

(ii) certain contracts for key content are for limited duration;

(iii) key content is only available on a staggered basis;

(iv) key content is supplied on an exclusive basis and is selectively distributed;

(v) the distribution of content benefits from economics of scale; and

(vi) the pay TV industry is characterised by significant feed back effects along its vertical supply chain;

(c) these features distinguish the pay TV industry from other industries with feedback effects and have resulted in market failure in the supply of pay TV in the UK, by enabling Sky to develop and entrench its leading market positions at the key levels of the supply chain; and

(d) as a consequence, the evidence indicates that consumers are harmed in terms of higher prices, restricted choice and reduced innovation.

1.7 For the reasons set out below, Virgin Media considers that the analysis set out in the Consultation, and the further evidence produced by the Parties, support all of the above observations made by the Parties in the Joint Submission.

The market position of Sky

1.8 The Parties indicated in the Joint Submission that Sky has leading market positions at all tiers of the pay TV supply chain. That this is the case is strongly supported by Ofcom's findings on market definition and market power as set out in section 5 and Annex 13 of the Consultation. Virgin Media sets out its detailed observations on Ofcom's assessment of market definition and market power in section 5 of this Memorandum. However, in summary Virgin Media agrees:

(a) with Ofcom's approach to market definition, which is in line with the guidance provided by the OFT and the EC Commission on market definition;

(b) that there are separate retail and wholesale markets for the supply of premium sport and movie channels[5];

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5 Paragraph 5.23 of the Consultation.

(c) that basic-tier pay TV and free-to-air TV are also in separate retail markets[6];

(d) that Sky is dominant in the retailing of packages containing premium sports channels[7];

(e) that Sky is dominant in the wholesaling of premium sports channels[8];

(f) that Sky is dominant in the retailing of packages containing premium movie channels[9]; and

(g) that Sky is dominant in the wholesale supply of premium movie channels[10].

1.9 The above conclusions of Ofcom are clear support for the position of the Parties, as set out in the Submission, that Sky has leading market positions at all tiers of the pay TV supply chain.

1.10 Nevertheless, Virgin Media considers that Ofcom has understated the market power of Sky in the pay TV supply chain. In particular, Virgin Media considers that Ofcom's approach to market definition in connection with the retailing of basic channels does not adequately reflect Sky's market position in the retailing of basic channels (whether on a stand alone basis or as part of a package containing premium channels). In particular, Virgin Media disagrees with Ofcom's view that Sky does not have market power in relation to the retailing of basic pay TV. In Virgin Media's view, Sky's market position in the retailing of basic pay TV is best judged by reference to its 70 per cent share of pay TV subscribers who have access to pay TV (all of whom will take a package of basic channels). Finally, Virgin Media considers that Sky has very substantial market power as a purchaser of basic pay TV channels, given the absence of any practical alternatives for basic pay TV channels to achieve significant subscription and advertising revenues.

Features of pay TV in the UK

1.11 The Parties observed in the Joint Submission that the pay TV industry exhibits significant barriers to successful market entry, which are in large part due to a number of distinctive features of the market. Ofcom's analysis of the pay TV industry in the UK, as set out in the Consultation, has explicitly or implicitly, supported each of the observations of the Parties.

Finite pool of key content

1.12 The Parties observed that competition authorities have consistently identified high quality sports and movies as being key content for entry into and competition in pay TV. Ofcom's analysis in the Consultation clearly supports this view:

> "*Sport is by some distance the most important genre to pay TV consumers and one of the most important for free-to-air consumers; pay TV consumers are twice as likely to mention sport as free-to-air consumers. For pay TV consumers, films and children's were the next most mentioned important genres.*"[11]

> "*The importance of such content is also illustrated by the breakdown of Sky's expenditure on different categories of content, …….. Programming costs*

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6 See Paragraph 5.23 of the Consultation.

7 See paragraph 5.38 of Annex 13 to the Consultation.

8 See paragraph 5.52 of Annex 13 to the Consultation.

9 See paragraph 5.63 of Annex 13 to the Consultation.

10 See Paragraph 5.69 of Annex 13 to the Consultation.

11 See paragraph 3.62 of the Consultation.

represented 41 per cent of all operating expenses in 2007. Of that, sport and movies content were the biggest two components at 55 per cent and 19 per cent respectively."[12]

1.13 It goes without saying that the pool of rights for live broadcasting of the most popular sports events, and the pool of rights for broadcasting movies produced by Hollywood Studios, are necessarily finite.

Contracts for key content are for limited duration

1.14 The Parties observed that the rights to broadcast certain key content are often limited in duration and that this confers an advantage on an incumbent by limiting the time in which a new entrant acquiring rights has to make a return on its investment. In essence, this point relates to the difficulty of building a subscriber base sufficiently fast to be able to "monetise" the value of the rights acquired.

1.15 In this context, Ofcom has explicitly recognised that a large retail customer base will confer a bidding advantage in relation to attractive content.[13] Ofcom has also observed that it takes time to build up both a portfolio of content and a large retail customer base:

> "*During the extended period in which a new wholesale channel provider is building up a portfolio of content rights, the vertically integrated incumbent may be able to restrict the new entrant's access to retail markets, and therefore make it more difficult for the new entrant to monetise its rights.*"[14]

1.16 It follows that, in circumstances where it takes time to build a large retail customer base and where a large customer base confers a bidding advantage on the incumbent, content rights of limited duration will further disadvantage new entrants and thereby confer an advantage on the incumbent.

Key content is available only on a staggered basis

1.17 The Parties observed in the Joint Submission that key content is only available on a staggered basis and that this significantly increases the barriers to entry for channel providers (and particularly new providers of sports and movie channels). This has been explicitly recognised by Ofcom in the Consultation:

> "*An important feature of content markets is the fact that content providers tend to sell content via multi-year contracts. As a result, rights become available on a staggered basis rather than all at once. This may create barriers to entry, since a wholesale channel provider wishing to launch a new service will typically need to assemble several rights packages in order to be able to do so, and these rights will not all be available at a particular point in time. Indeed it may take several years to assemble the various rights packages necessary to launch a service.*"[15]

Key content is supplied on an exclusive basis and is selectively distributed

1.18 The Parties observed in the Joint Submission that pay TV broadcasters purchase content on an exclusive basis and package that content into channels which are then made available to downstream distributors. The exclusive licensing of key content denies that content to competing broadcasters, and the selective distribution of that key content (e.g.

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[12] See paragraph 3.64 of the Consultation.

[13] See paragraph 6.18 of the Consultation.

[14] See paragraph 6.67 of the Consultation.

[15] See paragraph 5.70 of the Consultation. See also paragraph 5.47 of Annex 13 to the Consultation in relation to the sale of sports rights and paragraph 5.67 of Annex 13 to the Consultation in relation to movie rights.

the refusal to wholesale channels to certain pay TV retailers) and the imposition of unreasonable prices and terms, inhibits downstream competition.

1.19 Ofcom recognises that key content is typically supplied on an exclusive basis to broadcasters[16]. In addition, Ofcom has recognised that Sky's key premium sports and movie channels are not available on the DTT platform and are only available on the IPTV platform through Sky (i.e. they are not made available on a wholesale basis to other retailers on platforms other than the cable platform)[17]. Further, Ofcom has recognised that the versions of Sky's premium channels which are available on cable do not have the full range of functionality (e.g. interactivity, enhanced features, and related additional content) which is available on the Sky satellite service, and are not available in high definition[18].

1.20 In short, Ofcom has confirmed the observation of the Parties that key content is supplied on an exclusive basis, and is selectively distributed by Sky.

The distribution of content benefits from economies of scale

1.21 The Parties observed that pay TV broadcasters and retailers enjoy significant economies of scale. A larger subscriber base enables a broadcaster to reduce its average content acquisition costs and this downstream advantage provides it with an ability to outbid its rivals in the competition for key content. Again, this is implicitly recognised by Ofcom in the Consultation[19]. It is also expressly accepted by Sky that there are economies of scale at the broadcaster level.[20]

The pay TV industry is characterised by significant feedback effects

1.22 In the Joint Submission, the Parties observed that the pay TV industry is characterised by significant feedback effects along its vertical supply chain. In particular, a firm with access to superior content is able to build a customer base advantage which consolidates its ability to monopolise the acquisition of content which, in turn, achieves and entrenches its leading position downstream.[21]

1.23 As a starting point it is unarguable that Sky has access to superior content. This is demonstrated by the fact that, as indicated above, Ofcom found Sky to be dominant in: the retailing of packages containing premium sports channels, the wholesaling of premium sports channels, the retailing of packages containing premium movie channels, and in the wholesale supply of premium movie channels.

1.24 Ofcom also accepts that superior content drives subscriber acquisition. Ofcom notes in the Consultation that content is the element of a TV service that is most often described as "must have"[22] and that sport and movies are two of the most important content genres[23].

1.25 As regards the observation that a large customer base leads to bidding advantages upstream, this is also accepted by Ofcom. In particular, Ofcom observes that the ability of one retailer to outbid other potential retailers for content is strengthened by the first

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16 See, for example, paragraphs 5.84 to 5.86 of the Consultation.

17 See paragraph 4.14 of the Consultation.

18 See paragraph 4.14 of the Consultation.

19 See in particular paragraphs 6.63 to 6.67 of the Consultation.

20 See paragraph 4.7 of Part C of Sky's Response to the Joint Submission ("**Sky's Response**").

21 See, for example, paragraphs 8(f) and 9(a) of the Executive Summary of the Joint Submission.

22 See paragraph 3.61 of the Consultation.

23 See paragraph 3.62 of the Consultation.

mover advantage conferred on the incumbent by its existing retail customer base. For example, Ofcom observes:

> "S*witching barriers, as discussed in chapter 5, mean that a potential new entrant without that existing base would have to bid for content in the knowledge that a proportion of the incumbent's retail customers would not switch to the new entrant's offer to follow that content. This may restrict the new entrant's ability to match the incumbent's bid for the content*"[24].

1.26 The advantages in bidding for rights conferred on Sky as a consequence of its large customer base are further exacerbated by the fact that there are very significant barriers to entry in acquiring a portfolio of premium sports rights. As observed in the Consultation, this gives Sky two related incumbency advantages:

(a) the first is that the value of premium rights is typically greater to a wholesaler that already holds a portfolio of rights than to one with few or no rights; and

(b) second, a new entrant channel is in a relatively weak bargaining position as against retailers and may, therefore, find it difficult to obtain full value for its rights.[25]

1.27 In short, Ofcom's findings in the Consultation support the proposition that a company with access to superior content is able to build a customer base advantage which consolidates its ability to monopolise the acquisition of content and, in turn, achieves and entrenches its leading position downstream.

Market Failure in the Supply of Pay TV in the UK

1.28 In the Joint Submission, the Parties argued that the relevant features of the market, and its tendency for concentration and increasing dominance, had resulted in market failure. In particular, the Parties argued that:

(a) Sky has been able to use its leading position in the acquisition of content upstream to foreclose downstream competition[26]; and

(b) Sky has used its leading position downstream in pay TV distribution to foreclosure upstream competition[27].

Ability and incentive to engage in downstream foreclosure

1.29 Ofcom specifically considered the question of whether vertically integrated operators have the incentive to foreclose potential new retailers and/or platform operators by denying them content. In this regard, Ofcom concluded:

> "*It might therefore be in the long-term interest of the vertically integrated firm to act in a manner that forecloses market entry by new retailers.*
>
> *Furthermore, the incentive to foreclose market entry by new retailers might be strengthened where this also has the effect of foreclosing market entry by new platforms*[28]".

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24 See paragraph 6.18 of the Consultation.

25 See paragraph 5.47 of Annex 13 to the Consultation.

26 See paragraph 11 of the Executive Summary of the Joint Submission.

27 See paragraph 12 of the Executive Summary of the Joint Submission.

28 See paragraphs 6.72 and 6.73 of the Consultation.

1.30 In other words, Ofcom accepts that Sky might have an incentive to foreclose downstream competition. However, in the present case, given Sky's **actual** conduct, there can be no doubt as to where Sky's incentives lie:

(a) first, Sky supplies its premium channels to cable only on uneconomic terms. For example, Sky's wholesale terms are such that Virgin Media's margins are actually **reduced** if a subscriber to Virgin Media's XL package of basic channels upgrades to a package containing one or more of Sky's premium channels. As a consequence, Sky's conduct removes any incentive on Virgin Media's part to compete with Sky as regards the retailing of premium channels;

(b) second, Sky does not supply its enhanced and interactive services and content to cable and Sky's channels are not available on cable in high definition (as noted by Ofcom in the Consultation[29]).[30]

(c) third, again as noted by Ofcom,[31] Sky does not offer its premium channels on a wholesale basis to other retailers on the DTH, DTT or IPTV platforms.

1.31 In summary, Sky's actual behaviour (as observed by Ofcom in the Consultation) clearly demonstrates that Sky has the incentive to foreclose, or marginalise, downstream competition. In addition, there can be no doubt as to Sky's ability to foreclose retail competition given its virtual monopoly position in the wholesale supply of premium sports and premium movie channels.

Ability and incentive to engage in upstream foreclosure

1.32 Ofcom also observes that Sky has an incentive to engage in upstream foreclosure:

> "*Another example of longer term incentives might be a desire to eliminate a rival retailer that is also active at the content acquisition level. By weakening or eliminating that rival, this may reduce degree* [sic] *of competition between buyers of content rights. This might allow the vertically integrated firm to acquire content for a lower price in the future.*"[32]

1.33 In practice, the mechanism for engaging in upstream foreclosure is a combination of preserving its downstream advantage (which it can achieve by protecting its large retail customer base through downstream input foreclosure (see above)), and through utilising its gatekeeper access to the satellite platform. As regards the latter point, Ofcom queries the extent to which Sky could foreclose access to the DTH platform due to the existence of the Technical Platform Services ("**TPS**") regime.[33] In this regard, Virgin Media considers that Ofcom has very significantly overstated the efficacy of the TPS regime for, amongst others, the following reasons:

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29 See the third bullet point of paragraph 1.17, and paragraph 6.38 of the Consultation. See, further Sections 3 and 4 of Part II of Virgin Media's Response to Ofcom's questionnaire of 20 December 2007.

30 Ofcom speculates that the failure to supply those services may have an objective justification on technical or reputation/branding grounds, but it should be noted that such justifications are specious. Any such technical issues are eminently addressable – Sky simply has no interest or incentive to supply these factors/services in practice since this would enhance the competitiveness of a competing retail platform. Similarly, reputation/branding arguments simply do not justify Sky forcing rival retail platforms to offer a lower quality version of Sky's premium channels. Indeed, reputation/branding considerations should have the reverse effect and should drive Sky to endeavour to work cooperatively with rival retail platforms to offer the best inactivity and HD experience possible, and thereby enhance the reputation of those channels.

31 See paragraph 6.36 of the Consultation.

32 See paragraph 5.127 of the Consultation.

33 See paragraph 6.67 of the Consultation.

(a) Sky has already shown itself to be quite able to manipulate the regulatory arrangements as regards access to the DTH platform to its advantage (and thereby foreclose access to the DTH subscriber base[34]);

(b) even if this were not the case, rival channels securing access to the DTH platform will still be at a major competitive disadvantage in competing with Sky to acquire premium content. This is because a new entrant would need to acquire a portfolio of rights (with all the difficulties this entails), and it would then still take a new entrant significant time to build up a subscriber base and thus monetise (i.e. recover) its fixed investments in content; and

(c) even a "*temporary*" delay in developing a critical mass of subscribers reduces both the nominal cash value and the net present value (i.e. accounting for the time value of money) of the revenue streams generated by the rival premium channel broadcaster over the duration of the rights contract (assuming optimistically for the moment that the same base of subscribers as that enjoyed by Sky could be attained at the end of the contract period).

1.34 Against this background, there should be no doubt that rival bidders for premium content are substantially weaker bidders due to Sky's retail advantage (which effectively gives Sky the ability to engage in customer foreclosure despite the TPS regime). These advantages will also be increased by the fact that, since consumers value a range of premium content, Sky's existing portfolio of content will enable Sky to bid more to acquire particular incremental content rights when these rights come up for renewal (as they are more valuable in a package with Sky's existing rights than if they were to be retailed separately to consumers). Sky also has an incentive to acquire a range of substitutable content (and thus to pay more for this range of content), so as to give it market power as the monopoly (or leading) supplier of this content.[35]

1.35 That Sky has the **ability** to engage in upstream foreclosure is revealed very clearly in practice by Sky retaining and entrenching over time its dominant position at the wholesale and retail level in the supply of premium channels (as found by Ofcom in the Consultation). As noted in section 6 below, the only entry in premium sports channels has been by Setanta and its impact has been limited (which has been confirmed by Sky in public statements[36]).

1.36 In summary, it is clear from Ofcom's findings in the Consultation that Sky has both the incentive and ability to engage in behaviour which has, as both its object and effect, the foreclosure, or marginalisation, of competitors both downstream and upstream.

Consumer Harm

1.37 Finally, the Parties argued in the Joint Submission that consumers are adversely affected by the identified market failure in the pay TV industry in the UK, in terms of higher prices, restricted choice and reduced innovation.

1.38 Ofcom's assessment of the consumer experience is made against a number of criteria, namely:

(a) choice of platform and content;

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34 See Virgin Media's response to question 7 of Ofcom's request for information of 20 December 2007.

35 Ofcom made this point as follows: "*For example, a wholesale channel provider that is seeking to accumulate exclusive rights to packages of subscription movie rights from all studios is likely to outbid a rival wholesale channel provider that only wishes to acquire rights from one or two studios. This is because a firm which has aggregated substitutable rights in this way is likely to possess a degree of market power and can thus pay more for the underlying rights.*" (second bullet point of paragraph 6.11 of the Consultation.)

36 See, for example, an article in the Financial Times of 7 February 2008 (Andrew Edgecliffe Johnson and Ben Fenton).

(b) innovation in platform services; and

(c) whether pay TV services are priced competitively and efficiently.

1.39 As a preliminary observation, Ofcom has sought to establish whether the market has been serving consumers well by describing consumer experience in relation to the factors outlined above. This does not, however, provide direct evidence as to whether features of the market are preventing, restricting or distorting competition (such as by creating high barriers to entry and expansion), nor whether the experience of consumers would be improved in the absence of these features. For example, surveys of consumer satisfaction levels cannot address whether consumers would be better served if prices were lower or quality or choice greater. Similarly, international comparisons cannot address directly whether competition could be greater in the UK.

1.40 Accordingly, Virgin Media does not consider that the full consumer benefits of effective competition in pay TV wholesale and retail markets can be judged simply by observing prevailing outcomes as regards factors such as choice, innovation and price levels. The focus should be whether, in the absence of the features which Virgin Media considers are distorting competition, there would be better outcomes for consumers.

1.41 Virgin Media has made a number of detailed observations on consumer harm in section 4. Nevertheless, even considering only the experiences of Virgin Media, it is clear that market failure in the pay TV industry has resulted in a range of consumer detriments.

1.42 Detriments arising from downstream (input) foreclosure include the fact that:

(a) against the background that Ofcom has found Sky to be dominant in the wholesale and retail provision of premium channels, Sky's high wholesale prices and restrictive terms of supply for premium channels mean that Virgin Media has neither the ability nor the incentive to compete on price or quality at the retail level;

(b) **[Confidential]**. This has left Sky with a 70 per cent share of basic pay TV subscriptions (with a large proportion of these subscribers also purchasing its premium channels);

(c) due to Sky's decision to refuse to wholesale its premium channels to DSL or DTT operators at all, customers who live outside cable areas have no choice at all of premium channel retailer.

1.43 Detriments arising from upstream (customer) foreclosure include Sky's virtual monopoly of the wholesale supply of premium sports and movie channels and its unique ability to control access to well over 70 per cent of premium sports subscribers and well over 80 per cent of premium movie subscribers[37].

Conclusion

1.44 In conclusion, in the Consultation, Ofcom:

(a) has found that Sky is dominant in the wholesale supply of premium sports channels and premium movie channels;

(b) has found that Sky is dominant in the retailing of packages containing premium sports channels and packages containing premium movie channels;

(c) has found that barriers to entry in each of the above markets are high;

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37 See paragraph 5.54 of the Consultation.

(d) has found that each of the features of the market identified by the Parties in the Joint Submission as giving rise to barriers to entry, and causing market failure, are present;

(e) has found that Sky, as a vertically integrated operator, may have the incentive to engage in behaviour that forecloses, or marginalises, competition both downstream (input foreclosure) and upstream (customer foreclosure);

(f) has identified a range of facts, and behaviour on the part of Sky, which point to Sky engaging in both input and customer foreclosure; and

(g) has identified a range of facts which point to Sky's behaviour having had the effect of foreclosing, or marginalising, other market participants at all levels of the pay TV supply chain.

1.45 Against this background, on Ofcom's own analysis, there can be no room for doubt that Ofcom has reasonable grounds for concluding that there are a combination of features which are preventing, restricting or distorting competition in connection with the supply of pay TV in the UK. In other words, the threshold for Ofcom to make a market investigation reference to the CC is clearly met.

1.46 It goes without saying that if there were greater competition in the pay TV industry in the UK, consumers would benefit from lower retail prices, greater choice and increased innovation. These outcomes would be an inevitable consequence of rectifying the current market failure.

1.47 Accordingly, absent undertakings adequate to address this market failure in a comprehensive manner, Virgin Media again urges Ofcom to refer the pay TV industry to the CC for a full market investigation.

2. OBSERVATIONS ON THE CRITERIA AGAINST WHICH OFCOM PROPOSES TO ASSESS THE FUNCTIONING OF THE UK PAY TV MARKET

2.1 This section sets out Virgin Media's very limited observations on section 2 of the Consultation, which addresses the context of Ofcom's investigation. In this regard, Ofcom raises the following question:

"Do you agree with the criteria against which we propose to assess the functioning of the pay TV sector?"

2.2 Virgin Media is in broad agreement with the criteria against which Ofcom proposes to assess the functioning of the pay TV sector. Virgin Media would, however, make the following limited comments:

(a) as regards choice of platform and content,[38] whilst Virgin Media agrees with Ofcom's objective that a variety of content be made available to consumers on all platforms, Ofcom will recognise that, on certain platforms, capacity limitations will constrain the number of channels and variety of content that can be made available to consumers;

(b) as regard innovation in platform services,[39] Virgin Media considers that innovation in relation to the supply of HD services is an additional issue to which Ofcom should have particular regard; and

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38 See the first bullet point of paragraph 2.24 of the Consultation.

39 See the second bullet point of paragraph 2.24 of the Consultation.

(c) as regards pay TV services being priced competitively and efficiently[40], Ofcom has identified that it will focus on considering whether prices give consumers good value and allow efficient producers to earn a reasonable return on their investments. In this context, Virgin Media would suggest that the concept of "efficient producers" is extended to "efficient market participants". This is to address the concern that producers may be interpreted overly narrowly to refer only to broadcasters.

2.3 As set out above,[41] however, Virgin Media would emphasise that it does not consider that the full customer benefits of effective competition in pay TV wholesale and retail markets can be judged simply by observing prevailing outcomes as regards factors such as choice, innovation and price levels.

2.4 Virgin Media notes that Ofcom has given priority to the market investigation over and above the review of wholesale digital television broadcasting platform markets[42]. Virgin Media agrees with this approach but considers that the market investigation should also take priority over Ofcom's consultation in relation to Sky's proposed digital terrestrial television service.

2.5 In particular, for the reasons set out in the response of Virgin Media to Ofcom's consultation on that matter,[43] Virgin Media considers that Sky's Picnic proposal has the potential to impact both conditions of competition in the pay TV sector generally and, in particular, in relation to the future development of the DTT platform. Given that this is the case, Virgin Media does not consider that it is either practical or sensible for Ofcom to attempt to run the market investigation on a different timetable to its consultation on the proposed Sky digital terrestrial television services. In short, Virgin Media considers that Ofcom should reach a determination in relation to the market investigation before reaching a conclusion on Sky's Picnic proposals.

3. OBSERVATIONS ON OFCOM'S OVERVIEW OF THE UK PAY TV MARKET

3.1 Virgin Media is broadly comfortable with Ofcom's overview of the pay TV market as set out in Section 3 of the Consultation. The only material element of the current structure of the pay TV market which appears to have been omitted from this overview, and which is relevant to Ofcom's analysis of the market, is the degree to which pay TV content is aggregated, and the degree to which pay TV services are bundled with other services. Specifically:

(a) section 3 of the Consultation does not address the manner in which retail bundling is used as a mechanism for retail price discrimination. This is, however, a feature that is addressed later in sections 5 and 6 of the Consultation[44]; and

(b) Ofcom has not addressed the fact that pay TV services are often sold to customers along with other services (such as broadband, fixed line telephony and mobile telephone services). This is important because this characteristic of the market is relevant to the question of whether Sky, as a vertically integrated operator, has the incentive to foreclose market entry by new retailers, or marginalise market entry by existing retailers, where this also has the effect of foreclosing or marginalising market entry by new platforms. This is recognised by Ofcom as being a relevant

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40 See the third bullet point of paragraph 2.24 of the Consultation.

41 See also section 4 below.

42 See paragraph 2.33 of the Consultation.

43 See response of Virgin Media to Ofcom's consultation on Sky's proposal to offer pay TV services on digital terrestrial TV, dated December 2007.

44 See, in particular paragraphs 5.93 to 5.102, and paragraphs 6.7 to 6.26 of the Consultation.

consideration in the Consultation[45] (and is addressed in more detail in Section 6 of this Memorandum[46]).

4. OBSERVATIONS ON OFCOM'S ANALYSIS OF THE CONSUMER EXPERIENCE OF PAY TV

Introduction

4.1 This section sets out Virgin Media's comments on section 4 of the Consultation, which focuses on whether the pay TV market is functioning well for consumers. In this context Ofcom raises the following questions:

(a) "*Do you agree with the views we have expressed as to the level of platform and content choice available?*";

(b) "*Do you agree with our analysis of innovation levels in UK pay TV?*";

(c) "*Do you agree with our analysis of pricing structures in UK pay TV?*";

(d) "*Do current pricing structures act in the aggregate interests* [of] *consumers?*";

(e) "*Do you agree with our initial assessment that we cannot conclude on the basis of currently available evidence that UK prices are excessive?*";

(f) "*Do you agree with our initial assessment that there is not convincing evidence to support the claim that the industry is earning excessive profits?*"; and

(g) "*Are there any other comments or evidence which you wish to provide?*"

4.2 Ofcom's assessment of the consumer experience is made against a number of criteria, namely, (i) choice of platform and content; (ii) innovation in platform services; and (iii) whether pay TV services are priced competitively and efficiently. This structure is adopted for the purpose of commenting on Ofcom's findings and questions in relation to the consumer experience of pay TV. However, before specifically commenting on these matters and responding to the consultation questions, it is appropriate to make some preliminary remarks.

4.3 The focus of Ofcom's investigation is to consider whether there are features of the pay TV market which result in competition being prevented, restricted or distorted to the detriment of consumers. Ofcom has sought to establish whether the market has been serving consumers well by describing consumer experience in relation to the factors outlined above. This does not, however, provide direct evidence as to whether features of the market are preventing, restricting or distorting competition (such as by creating high barriers to entry and expansion), nor whether the experience of consumers would be improved in the absence of these features. For example, surveys of consumer satisfaction levels cannot address whether consumers would be better served if prices were lower or quality or choice greater. Similarly, international comparisons cannot address directly whether competition could be greater in the UK.

4.4 Accordingly, Virgin Media does not consider that the full consumer benefits of effective competition in pay TV wholesale and retail markets can be judged simply by observing prevailing outcomes as regards factors such as choice, innovation and price levels. The focus should be whether, in the absence of the features which Virgin Media considers are distorting competition, there would be better outcomes for consumers. In particular,

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45 See paragraphs 6.73 of the Consultation.

46 See paragraphs 6.40 to 6.42 of this Memorandum.

whether the price and profit mechanisms work effectively in pay TV markets, as they would in a fully competitive market, to ensure that:

(a) competitive forces compel firms to set low prices;

(b) innovative firms which deliver quality, choice and competitive service win market share and profits at the expense of their rivals, and

(c) all firms have incentives to make investments to this end.

4.5 In addition to these general remarks, Virgin Media has a number of more specific points as regards the various measures of consumer experience on which Ofcom has chosen to focus as set out further below.

Consumer satisfaction levels

4.6 Ofcom cites survey evidence indicating overall satisfaction with communication services (including digital TV) and satisfaction with multi-channel TV services[47]. Virgin Media considers that there are a number of difficulties in interpreting this evidence, several of which are also acknowledged by Ofcom.

4.7 First, as noted above, the key issue for Ofcom is whether features of pay TV markets are acting to prevent, restrict or distort competition to the detriment of consumers. The survey evidence which is cited does not provide any information on customer satisfaction levels which might otherwise prevail under more competitive market conditions (i.e. there is no competitive benchmark against which to measure the observed responses). Ofcom acknowledges this when it states "*evidence on consumer satisfaction levels is often hard to interpret, first, as it is difficult to establish benchmark levels of satisfaction*".[48]

4.8 Indeed, Virgin Media believes that consumers are likely to express satisfaction with their current level of service because their expectations are met, and they cannot necessarily conceive of what improvements might be available to them through innovation, technological advances or more platform and content choice. In short, customers have no clear competitive comparator or frame of reference, and therefore express satisfaction on the basis of their current experience. For example, in a 2003 Oftel survey, consumers indicated very high levels of satisfaction (96 per cent for overall internet service, 92 per cent for quality and reliability, 92 per cent for speed) with their broadband service despite prices being significantly higher and broadband speeds significantly slower than they are today. Paradoxically, satisfaction levels are slightly lower today despite improvements in value for money and broadband speeds.[49] Virgin Media would expect that this is attributable to consumers' expectations being higher in 2007 than in 2003, and that consumers have in fact strongly benefited from competition and choice in broadband markets.

4.9 Second, the results are biased as they only relate to consumers who have voluntarily opted to purchase pay TV services which is bound to reflect their valuation of pay TV. Ofcom observes that "*There may be certain types of consumers who are not well served by pay TV in the sense that the pricing structure may serve to exclude them from the market*"[50] Further, Virgin Media agrees with Ofcom's conclusion that because evidence on

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47 See Paragraphs 4.3 and 4.4 of the Consultation.

48 See paragraph 4.7 of the Consultation.

49 The Oftel residential survey dated 27 October 2003 was undertaken in the context of broadband services offering speeds of 150-600 kbps which were available for £16-£30 per month with higher speed services, offering speeds of 1-2 mbps, also available. Average prices for broadband services were £23 per month. In November 2007, the Ofcom survey of consumer experience indicated the following satisfaction levels: 88 per cent overall, 87 per cent for reliability and 78 per cent for value of money. This survey was undertaken in the context of an average price of £14.73/month and an average blended speed of 4.6 mbps.

50 See paragraph 4.5 of the Consultation.

consumer satisfaction levels "*reflects the fact that those consumers who are able to express a view are those who have voluntarily chosen to pay for the service…it is hard to infer conclusions on the effectiveness of competition within the market from satisfaction measures alone*"[51] [emphasis added].

Platform choice

4.10 Virgin Media concurs with Ofcom's description of platform choice. In particular, whilst a variety of distribution technologies are available in the UK, certain of these, in particular digital cable and IPTV, are only available to 47 per cent and 15 per cent of the population respectively. Again, it is difficult to infer any conclusions on the effectiveness of competition in the market from a simple observation of the prevailing availability and coverage of platform technologies. A more relevant analysis would focus on whether platform choice could be greater under more competitive conditions. In particular, Virgin Media considers that platform coverage is in large part a function of whether platform providers have the necessary investment incentives in order to extend coverage of their distribution technologies. These investment incentives are substantially reduced and compromised by the behaviour of Sky which can affect the profitability of Sky's platform rivals (and thereby their incentives to invest in expansion) through, for example, the terms upon which it will supply Sky channels, particularly its premium channels, on a wholesale basis to these entities.

4.11 Ofcom also notes that the availability of broadcast platforms based on different distribution technologies in the UK compares "*fairly well in terms of the total number of options available*" (paragraph 4.11) with other countries (namely, US, Germany, France, Italy and Spain). Virgin Media does not consider, however, that consumers make choices amongst platforms purely on the basis of distribution technologies but rather on the basis of the platform and content available on that platform. Accordingly, a comparison based purely on the total number of platform options available in each country is not informative as regards customer experience, without understanding the content choice available via these platform options.

4.12 In addition, without a detailed competitive analysis, there is no reason to suppose that the other countries which are cited by Ofcom provide any meaningful benchmark as regards the number of platform options which would be available in a UK pay TV market in which competition is working effectively.

Content choice

4.13 Virgin Media agrees with Ofcom's description of content choice. As discussed above, Virgin Media considers that the relevant issue as regards content choice is whether greater content choice might be achievable under a more competitive market structure. In this regard, Virgin Media considers that a more competitive market structure would be likely to yield greater content choice in that it would address, in part, the distortions which arise in Sky's incentives and actions as regards the supply of its channels to rival retailers. In particular:

(a) the Consultation highlights that, as a result of its dispute with Sky, Virgin Media has been denied three of the most frequently watched basic-tier channels that are owned by Sky (Sky 1, Sky News and Sky Sports News);

(b) the Consultation highlights that Sky's premium channels which are available on cable do not have the full range of functionality and content which is available on Sky's DTH satellite service, and are not available in high definition; and

51 See paragraph 4.7 of the Consultation.

(c) the Consultation highlights that Sky's premium channels are not made available on a wholesale basis to retailers on the IPTV or DTT platforms.

Prices and profitability

Prices

4.14 As noted above at paragraphs 4.1(c) to 4.1(e), Ofcom raises a number of questions as to its analysis of pricing structures, whether these structures serve consumers' interests and its provisional view that it is unable to conclude on the basis of currently available evidence that UK prices are excessive. Virgin Media agrees with Ofcom's factual description of prices, but Virgin Media believes that the fact that the UK has the highest average revenue per subscriber than any other country with the exception of the USA[52] is highly significant. At the very least, there is no evidence to suggest that prices in the UK are competitive, and that effective consumer choice is being delivered as to the range of services which would be available in a competitive market.

4.15 Moreover, high pay TV prices must be judged against the background that Sky accounts for some 70 per cent of pay TV subscribers, has increased prices despite a rising customer base (which should generate cost efficiencies), and sets very high prices for key "must have" premium programming which is packaged together with its basic channels (with its high wholesale prices and pricing structure precluding price competition from Virgin Media). In this regard, Ofcom observes that:

(a) Sky's prices of premium sports packages have risen steadily in real terms since 2003[53];

(b) Sky's prices for premium movies have risen steadily in real terms (while subscriber numbers have also continued to rise)[54];and

(c) that the real price of Sky's full basic package has also increased since 2002[55]. Although Ofcom goes on to observe that prices of Sky's full basic packages have been constant in nominal terms since September 2005,[56] this is a period in which Sky's costs per basic subscriber have been falling as a consequence of economies of scale achieved through the growth in Sky's subscriber base and, in particular, due to its declining expenditure on third parties' basic pay TV channels[57]. In a fully competitive market, Virgin Media would have expected to have seen those reductions in the cost of servicing a basic subscriber reflected in lower prices for packages of basic channels.

4.16 In short, a trend of rising prices in real terms over time is, all else equal, indicative that consumers are paying higher prices than would be expected if competition was effective.

Profitability

4.17 As noted above at paragraph 4.1(f), Ofcom reaches an initial conclusion that there is insufficient evidence to support a claim that Sky is earning excessive profits. Again, Virgin Media would observe that there is no evidence that effective competition in pay TV markets has led to Sky realising a competitive level of profits.

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52 The countries which formed part of the assessment were as follows: France, Germany, Italy, Spain, Sweden, UK and the USA (figure 30, page 60 of the Consultation).

53 See paragraph 5.33 of the Consultation.

54 See paragraph 5.44 of the Consultation.

55 See paragraph 5.51 of the Consultation.

56 See paragraph 5.51 of the Consultation.

57 See in particular paragraphs 5.21 to 5.22 of this Memorandum.

4.18 Virgin Media observes that there is considerable fluctuation in the measures of profitability for Sky over the period from flotation to 2007. Indeed in relation to the measure of total shareholder returns, Ofcom states the following:

> "*There are some periods where investors would have observed very high returns and other periods where investors would have received low or negative returns. Likewise…there are periods during which investors in Sky would have out-performed the market indices*".[58]

4.19 This renders any "snap shot" analysis of the returns to shareholders highly sensitive to the period considered, such that this measure is unlikely to be definitive. Virgin Media considers that this observation is consistent with a situation where Sky has market power but is able to choose whether or not to use that market power to generate super-normal profits, or rather to pursue other strategies such as investment and growth which will depress returns in the short run, but reinforce Sky's dominant position in the long run. Indeed, Ofcom explicitly acknowledges this possibility. It states:

> "*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 this is being invested back into the firm to pursue growth rather than short-term shareholder returns. 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 longer-term market position.*"[59]

4.20 In addition, Ofcom should note that it may also be the case that, rather than enjoying the benefits of market power by way of super-normal profits, Sky may instead have a higher cost base than would be the case under more competitive conditions.

4.21 Lastly, in Virgin Media's view, profitability should also be judged in each of the wholesale and retail pay TV markets identified by Ofcom, not across a broader business.

5. OBSERVATIONS ON OFCOM'S ANALYSIS OF CHARACTERISTICS OF THE PAY TV MARKET

Introduction and Summary

5.1 Ofcom raises a number of questions in section 5 of the Consultation, which are repeated below for ease of reference:

(a) "*What is your view on our approach to defining markets?*";

(b) "*Do you agree with our definitions of premium content markets?*";

(c) "*Do you agree with our preliminary conclusions on basic / free-to-air markets?*";

(d) "*Do you agree with our assessment of market power?*";

(e) "*Have we identified the correct set of intrinsic market characteristics? Are there any that you would add?*"; *and*

(f) "*Have we correctly captured the role of vertical integration?*".

5.2 The issues raised in these questions are addressed below. However, in summary, Virgin Media agrees:

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58 See paragraph 3.9 of Annex 12 of the Consultation.

59 See paragraph 4.76 of the Consultation.

(a) with Ofcom's approach to market definition, which is in line with the guidance provided by the OFT and the EC Commission on market definition;

(b) that there are separate retail and wholesale markets for the supply of premium sport and movie channels;

(c) that basic-tier pay TV and free-to-air TV are also in separate retail markets;

(d) that Sky is dominant in the retailing of packages containing premium sports channels;

(e) that Sky is dominant in the wholesaling of premium sports channels;

(f) that Sky is dominant in the retailing of packages containing premium movie channels; and

(g) that Sky is dominant in the wholesale supply of premium movie channels.

5.3 Nevertheless, Virgin Media considers that Ofcom has understated the market power of Sky in the pay TV supply chain for the following reasons:

(a) Ofcom is overly cautious in its conclusion that basic-tier pay TV and free-to-air TV are in separate retail markets. In Virgin Media's view they are clearly in separate markets;

(b) Virgin Media considers that Ofcom's approach to market definition in connection with the retailing of basic channels does not adequately reflect Sky's market position in the retailing of basic channels (whether on a stand alone basis or as part of a package containing premium channels). In particular, Virgin Media disagrees with Ofcom's conclusion that Sky does not have market power in relation to the retailing of basic pay TV. In Virgin Media's view, Sky's market position in the retailing of basic TV is best judged by reference to its 70 per cent share of pay TV subscribers who have access to pay TV, all of whom take a package of basic channels;

(c) even if Sky is not dominant in relation to the wholesale supply of basic pay TV channels, competition may nevertheless still be restricted or distorted as a consequence of Sky's conduct in relation to the wholesale supply of its basic channels; and

(d) Sky has very substantial market power as a purchaser of basic pay TV channels, given the absence of any practical alternatives for basic pay TV channels to achieve significant subscription and advertising revenues.

Ofcom's approach to market definition

5.4 Before commenting on Ofcom's specific findings as to market definition, it should be noted that Virgin Media agrees with Ofcom's approach to market definition which, in line with the OFT's guidelines and EC Commission's notice on market definition, focuses on the application of the SSNIP test[60] (i.e. whether a hypothetical monopolist would find it profitable to increase prices above the competitive level). Further, Virgin Media considers that it is appropriate for Ofcom to consider the issues associated with the array of evidence available including:

(a) differences in the nature and attributes of different services and consumer surveys as to the basis for consumers' choices;

[60] SSNIP – a small but significant non-transitory increase in price.

(b) the difficulty of interpreting consumers' responses to questions about hypothetical price increases, due to stated preference bias meaning that price sensitivity is overstated and the fact that prices may already exceed the competitive level (such that further price increases may be unprofitable); and

(c) the impact of recent past events and "shocks" as regards the supply of possible alternatives and how this has impacted consumer demand for the various categories of pay TV channels.

Sky's approach to market definition

5.5 In this connection, it is appropriate to contrast Ofcom's approach with that adopted in Sky's response of October 2007 ("**Sky's Response**") (and, in particular, Annex 1). A detailed analysis of the flaws in Sky's approach to market definition are set out in Annex 1 of the Joint Response of the Parties to Sky's Response (and Annex 1 of this Memorandum). However, in summary:

(a) Sky's Response contains no factual economic evidence as to market definition of the type normally considered by competition authorities, and which is considered by Ofcom in the Consultation. While Sky identifies a number of alternatives to pay TV, any assessment of market definition cannot be based on the mere existence of alternatives, as alternatives will not necessarily have any impact on consumers' valuations of the relevant product or service or lead to/require prices to be set at the competitive level. The substantive issue for market definition, and market power, is whether competition from these alternatives is a binding competitive constraint upon pay TV markets, thereby safeguarding consumers' interests by forcing prices down to efficiently incurred costs, ensuring that consumer choice is well served, and promoting competition in innovation and customer service and so on.

(b) Annex 1 of Sky's Response (a paper on "The standard economic model of substitutability between pay TV and free to air television services") contains a number of fundamental flaws. In particular;

(i) it is based on a hypothetical model, which makes a number of unsubstantiated assumptions and relies on fictitious numbers. No hypothetical model can sustain any conclusion as to actual market conditions; and

(ii) the model assumes that the consumer's willingness to pay for pay TV is driven by the difference between their relative financial valuations of free-to-air and pay TV. This unsubstantiated assertion is then used to demonstrate an inter-relationship between free-to-air and pay TV. In other words, the model assumes the relationship that it is trying to demonstrate.

The consistency of Ofcom's findings as to market definition and those reached by the Competition Commission

5.6 In its report on the merger between ITV and Sky, the CC concluded that:

"*Our view, based on the evidence set out in paragraphs 4.9 to 4.29, is that free-to-air and pay services compete with one another within a market for 'all-TV', which includes VoD. The all-TV market is highly differentiated, however, and we conduct our analysis of the impact of the acquisition not only by assessing the impact on the market as a whole under current competitive conditions, but also by looking separately at possible future competition in pay-TV. Despite the dynamic nature of the industry, we conclude* *that, based on our view of likely future trends, the market should not be widened to encompass television-over-the-Internet services or DVD sales and rentals.*"[61]

5.7 Ofcom, however, draws a distinction between the issue being considered by the CC in its provisional findings and the approach adopted by Ofcom on the basis that (as the CC expressly acknowledged), the issue for the CC was whether market power would increase as a result of the Sky/ITV merger, not whether existing prices were already above the competitive level due to the exercise of market power[62].

5.8 In this context, the CC's report observed:

"*In response to our provisional findings, we received submissions from several third parties pointing to previous cases where the relevant market was found to be no wider than pay-TV services despite the existence of a constraint from free-to-air . They suggested that we should look at the possibility of defining a narrow market in this case. We believe that the relatively broad market that we defined in paragraph 4.30 is the appropriate framework for analysing any loss of competition arising from this acquisition. <u>However, we note that this does not imply that the same market definition should necessarily be used to analyse other mergers in the industry or should necessarily apply in other competition cases.</u>*"[63] [Emphasis added]

5.9 The highlighted sentence is a clear statement that the appropriate market definition to adopt depends on the competition issue being assessed – for example, a merger between the leading commercial free-to-air operator (which has made a major contribution to Freeview's success), ITV, and the leading pay TV operator, Sky, may lead to a substantial lessening of competition (as the CC found), but so might a merger between two pay TV operators which are close rivals[64]. Further, while the CC's analysis does not address whether existing prices already exceed the competitive level[65], the CC notes that:

"*It is possible that if BSkyB were to face stronger competition from pay-TV retailers, prices would fall to an extent that free-to-air services no longer presented a constraint. In this situation it would be appropriate to define a separate market for pay-TV.*"[66]

5.10 Accordingly, the different conclusions as to market definition which have been reached by Ofcom and the CC are consistent.

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61 See paragraph 4.30 of the Report of the CC in relation to the Acquisition by British Sky Broadcasting plc of 17.9 per cent of the shares in ITV plc ("the **CC Report**").

62 See paragraph 5.22 of the Consultation. In this regard, paragraph 4.3 of the CC's final report states that: "*In line with our usual practice, we have carried out our analysis at current prices and conditions of competition, regardless of whether these represent competitive price levels.*" Paragraph 4.16 similarly emphasises that the CC considered whether a hypothetical pay TV monopolist would be constrained by free-to-air from increasing prices from current levels.

63 See paragraph 4.31 of the CC Report.

64 In this regard, the CC notes that Virgin Media's and Sky's services are particularly "*close substitutes*". The CC states, at paragraph 4.19 of the CC Report:

> "*We note that all pay-TV packages offer content and services in addition to those which are available free-to-air . Certain pay-TV providers with the most similar offers are likely to be particularly close substitutes, for example BSkyB and Virgin Media, whose packages are most similar, and whose marketing clearly targets one another's services (see paragraph 4.66).*"

65 In this regard, it should be noted that the Cellophane fallacy is simply that a dominant firm can already be expected to have increased prices above the competitive level such that further price increases would not be profitable, so asking how consumers would respond to further price increases may not be informative for the purpose of assessing whether these is pre-existing market power.

66 See footnote 85, on page 39, of the CC Report.

Ofcom's conclusions as to premium content market definition

5.11 As regards premium content, Ofcom reaches the preliminary conclusions that there are narrow wholesale and retail pay TV markets for premium movie and premium sport channels, and "*The market for premium sports channels is likely to include both Sky Sports and Setanta, although we cannot rule out a narrower market for Sky Sports alone*"[67]. Virgin Media concurs with these conclusions and the evidential bases for these conclusions for the reasons set out below.

A market for premium sports channels

5.12 Ofcom identified a range of evidence which supports its provisional conclusion that there is a retail market for packages containing premium sport channels. A narrow wholesale market definition follows. Virgin Media finds Ofcom's analysis compelling, particularly the observation:

> *"We have also considered how prices and consumption levels have changed over time. While there are always challenges in interpreting historic data of this sort – especially where there may have been changes to the underlying quality of the products – evidence provided by stakeholders suggests that subscriber numbers have grown even as the prices of premium sports packages have risen steadily in real terms since 2000."*[68]

5.13 Whilst the level of Sky's prices might well have been higher in the absence of competition from Setanta and Freeview more generally, Sky's real price increases <u>and</u> growing subscription numbers do not suggest that Sky is subject to any binding competitive constraints.

5.14 Virgin Media would add that, whilst Football Association Premier League football ("**FAPL**") is an important driver of demand, the "must stock" status of Sky's sports channels arises due to the strong consumer demand for the range of premium sports programming that they offer including, but not limited to, FAPL content. This is reflected by the following points:

(a) FAPL accounted for 40.5 per cent of Sky's expenditure on sports content in its 2007 financial year, rising to 47.0 per cent in its 2008 financial year[69]. Sky would not spend another approximately £500 million per annum in acquiring sports content other than FAPL (which is more than it spends on FAPL) unless this made a major contribution to the appeal of its sports channels;

(b) whilst football is identified as "must have" by 59 per cent of consumers who value specific sports ahead of a range of sports, other sports also achieve significant rankings (20 per cent of these consumers indicated that cricket was "must have", 17 per cent for rugby union, and 12 per cent for each of tennis and rugby league)[70];

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67 See paragraph 5.23 of the Consultation.

68 See paragraph 5.33 of the Consultation.

69 Sky's 2007 Annual Review (for the year ending 30th June 2007) reports that "*Sports costs increased by £76 million to £842 million, principally behind one-off events such as the Ryder Cup and the Cricket World Cup, together with the first full season of domestic cricket. We continue to expect sports costs for the 2008 financial year to increase by around £90 million following the start of the new FAPL contract.*" Figure 17 of the Consultation indicates that Sky's annual expenditure on FAPL rights amounted to £341 million from 2004 and £438 million from 2007. This indicates that FAPL accounted for 40.5 per cent of Sky's expenditure on sports content in its 2007 financial year, rising to 47.0 per cent in its 2008 financial year.

70 See figure 16, on page 40, of the Consultation.

(c) Sky actively promotes the range of premium sports content its premium sport channels offer (not just FAPL) on the basis that customers purchasing Sky Sports Mix are able "..*to enjoy over 100 sports across 4 dedicated channels - Sky Sports 1,2 and 3 and Sky Sports Xtra*"[71];

(d) Sky itself emphasises the need for a diversified range of sports content, with the Financial Times (Andrew Edgecliffe Johnson and Ben Fenton) reporting, on 7 February 2008, that:

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

5.15 In this context, Ofcom should be cautious in drawing overly strong conclusions in relation to the importance of FAPL content from the evidence on consumer preferences set out in paragraph 3.65 and Figure 16 of the Consultation, as this evidence focused on those viewers that valued specific sports ahead of a range of sports. By definition, such evidence fails to capture the importance to Sky of those viewers that value a range of sports ahead of any particular sport. In practice, the fact that the majority of Sky's expenditure on sport is made in relation to sports content other than FAPL clearly demonstrates the need for a range of high quality sports content in order to able to market a premium sports channel to a large and wide base of subscribers.

A market for premium movies

5.16 Ofcom considers a similar wide range of evidence to support its conclusion that the relevant retail market is premium movies:

(a) "*Since January 2000, sales of premium movie subscription pay TV packages have increased, and prices have increased in real terms, despite the rapid growth of DVD sales, and increased competition from Freeview, pay-per-view and VoD. As quality has not notably increased, this tends to suggest that the competition from these potential substitute products is limited.*"[72]

(b) Ofcom also cites various survey evidence that customers value the convenience of having films available at all times and access to new releases, not having to pay each time and not having to rent a DVD.[73]

5.17 While pay-per-view movies offer perhaps the most convenient alternative to premium movies channels, as Ofcom observes, the inclusion of pay-per-view movies in the market would not appreciably affect any assessment of Sky's market share or, therefore, its dominance at the retail or wholesale level.[74]

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71 See http://mysky.sky.com/portal/site/skycom/skyproducts/skytv/pricesandpackages.

72 See paragraph 4.81 of Annex 13 to the Consultation.

73 See paragraph 4.55 – 4.59 of Annex 13 to the Consultation.

74 See paragraph 5.66 of Annex 13 to the Consultation.

5.18 As Virgin Media agrees with Ofcom's analysis, it has no further observations at this stage.

The retail market for pay basic TV channels

Ofcom's preliminary conclusions

5.19 Ofcom reaches the preliminary conclusion that free-to-air and basic pay TV are in separate retail markets, but this is a less firm conclusion due to the growing constraint from free-to-air.[75] While Virgin Media strongly agrees that free-to-air and basic pay TV are in separate retail markets, it considers that:

(a) Ofcom is overly cautious in caveating this conclusion due to the growing constraint from free-to-air; and

(b) to the extent that Ofcom has concluded that there is a retail market "*for packages containing only basic-tier TV channels*", Virgin Media strongly disagrees with this conclusion.

Each issue is addressed in turn below.

The extent of the competitive constraint provided by Freeview

5.20 Virgin Media considers that the extent of the competitive constraint provided by Freeview should not be overstated for a number of reasons:

(a) the growth of Freeview has had no observable impact on Sky's prices and subscriber numbers;

(b) even if there is some competition from Freeview, effective competition between pay TV operators offers a much more direct constraint given the obvious differentiation between Freeview and basic pay TV; and

(c) the constraint imposed by Freeview on basic pay TV prices will be limited by:

(i) Sky's packaging of its basic and premium channels; and

(ii) the scope for Sky to achieve cost savings if demand were to fall.

<u>Freeview has had no observable impact on Sky's prices and subscriber numbers</u>

5.21 It is difficult to envisage a greater market "shock" than the recent substantial expansion of Freeview, both in terms of its channel offering and penetration. This shock has occurred at broadly the same time as Sky's costs per basic subscriber have been falling (due to the economies of scale achieved through the growth in Sky's subscriber base and its declining expenditure on third parties' basic pay TV channels). For example, Sky's 2007 annual report indicates that:

> "*Sky's expenditure on Third party channel costs decreased by 29% to £228 million in the current year. The cost increase resulting from the 5% increase in the average number of DTH subscribers was more than offset by savings generated from the renewal of some of our channel distribution contracts on improved terms during the current period.*"[76]

5.22 Similarly, Sky's 2006 annual review indicates that:

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[75] See paragraph 5.23 of the Consultation.

[76] Page 28 of Sky's 2007 annual report.

"Third party channel costs fell by 11% on the comparable period to £323 million, a reduction of £39 million. A 5% increase in the average number of DTH subscribers was more than offset by a 15% reduction in the cost per subscriber to £3.37 per month."[77]

5.23 Against that background, if Freeview did impose a material competitive constraint on Sky's basic pay TV packages, it would have been expected to have had a major impact on Sky's prices and subscriber numbers, with Sky having substantial scope to cut price (due to its increased gross profit margins and falling costs per subscriber). No such effects can be observed.

Pay TV operators offer a much more direct constraint than Freeview

5.24 Further, even if Freeview had some impact on Sky and represented some competitive constraint on its basic pay TV services, any such conclusion would not address the facts that:

(a) Virgin Media is a closer pay TV retail competitor to Sky, and this could potentially also be the case as regards other pay TV retailers in the future depending on the barriers to entry and expansion they face; and

(b) Freeview cannot replicate the competition which could exist between pay TV operators, because Freeview offers a narrower range of channels and these channels cannot support greater expenditure on content without access to subscription revenues.

Limitations of the constraint imposed by Freeview

5.25 Sky's bundled pricing structure enhances its ability to set high prices (thereby limiting the competitive constraint imposed by Freeview). Sky's current pricing structure is structured on the basis that:

(a) The cost of one mix of basic channels is £16 per month;

(b) each additional mix of basic channels costs only £1 more per month (up to £21 per month for all six);

(c) it costs £17 more per month to add either Sky Sports or Sky Movies to one or more mixes of basic channels (customers are unable to buy just Sky Sports or Sky Movies); and

(d) it costs only £7 more per month to add either Sky Sports and Sky Movies to a package already containing one of these.

5.26 A 10 per cent increase in the price of Sky Basics only packages would increase these prices by between £1.60-£2.10 per month, depending on the number of basic mixes chosen. For a customer buying Sky Sports and Sky Movies and all of the basic mixes, this additional cost would amount to an increase of only approximately 4.7 per cent in the total price of the combined package[78]. Accordingly, the first observation to make is that

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77 Page 5 of Sky's 2006 annual review.

78 Similarly, increases in the additional cost of the Sky Movies and/or Sports have a proportionately smaller impact on the overall price of Sky's packages including basic and premium channels. A 10 per cent increase in the additional cost of buying just Sky Sports or Sky Movies (on top of basic) is £1.70, which represents approximately 4 per cent of the most expensive TV only package and approximately 5 per cent of the cheapest package including just Sky Sports or Sky Movies (which includes one pay basic tier mix). A 10 per cent increase in the cost of adding Sky Sports or Sky Movies to a package already including one of these (which also includes Sky Basics) would increase the total package price by only 70p, which represents 1.6-1.7 per cent of the total package price (the exact percentage overall percentage price increase depends on whether 1-6 basic mixes are chosen).

bundling moderates the overall percentage price increases in the total cost of the bundle which is associated with increasing the cost of one element of the bundle. It would generally be expected that this would moderate consumers' responses to such a small overall price increase – relatively small overall percentage price increases year on year may thus be profitable, particularly where growing subscriber numbers (despite price increases) should enable fixed costs to be spread over greater volumes.

5.27 Secondly, a 10 per cent increase in the price of basic mixes may have a different impact on consumers depending on the mix considered and how the increase is implemented (e.g. by changing the mix of channels available or increasing some mixes and not others). This gives Sky substantial scope to manipulate its pricing structure so as to maximise its revenues[79]. This pricing matrix is designed to discriminate amongst customers, and thus achieve high prices from less price sensitive customers.

5.28 Thirdly, given the above points, any responses by customers to price increases (hypothetical or real) need to be considered in the light of what mix the customer currently purchases. For example, a 10 per cent increase for each mix combination might predominantly lead to a loss of customers which choose lower value mixes (thus reducing any revenue loss). This dynamic would not be captured by survey responses which do not clearly identify which mix customers were purchasing. In short, it should be expected that Sky would implement any price increase by manipulating its pricing structure in such a way to minimise any loss of revenue from those customers lost. Survey evidence will typically fail to reflect this dynamic and overstate the response of customers, quite apart from any other any biases associated with survey responses[80].

5.29 Fourthly, a further complexity is that a unilateral increase in the price of pay basic packages <u>reduces</u> the additional cost of buying Sky Sports or Sky Movies (or both), with the total prices of the premium and basic bundles remaining unchanged. At present it costs £17 more to buy either Sky Sports or Sky Movies on top of a Sky basics package, or £24 more to buy both. For a customer buying all six basic mixes an increase in the price of this package of 10 per cent would reduce these differentials by £1.70 to £15.30 (a 10 per cent decline) for Sky Sports or Sky Movies separately, and by £1.70 to £22.30 for both Sky Sports and Sky Movies (a 7.1 per cent decline). While the increase in price of pay basic channels may lead to loss of revenue, it may also be expected that by reducing the additional cost of acquiring either Sky Movies or Sky Sports that this would generate some trading up to these bundles. This trading up may offset the loss of revenue from lost basic channel subscribers. This is best demonstrated by the example set out at Annex 1.

5.30 A further complexity is that price increases may be profitable if any fall in Sky's revenues following the price increase is more than offset by a corresponding decline in costs. In the context of assessing whether basic price increases are profitable Ofcom assumes "…*that cost savings from supplying fewer customers are likely to be negligible (as most costs are fixed)*…", which is an incorrect assumption given that wholesale prices for basic channels are based on price per subscriber.[81] There will be variable elements to other costs as well.[82]

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79 For example, on 1 September 2007 Sky changed its pricing structure so that individual mixes of basic pay TV can be purchased (rather than offering a choice between bundles containing 2, 4, and 6 mixes), with cheaper mixes all becoming more expensive (for example, the price of a 2 mix package increased by £2 to £17, an increase of 11.8 per cent). Sky also changed its pricing structure from charging for 1, 2, 3 or 4 premium channels to only three premium packages (just sport, just movies, or both).

80 See, for example, paragraph 3.10 of Annex 13 to the Consultation.

81 Similarly, it would also be an incorrect assumption as regards movie channels as Ofcom observes that "*Payments are primarily made to studios on a per-subscriber basis*" see paragraph 5.86 of the Consultation.

82 Moreover, in growing markets and markets subject to customer "churn", the profitability of pricing decisions also needs to be assessed in relation to the profitability of price changes which impact on winning new customers as well as retaining existing customers. In this regard, Sky's gross margins on winning new customers will be lower than in

5.31 All of the above factors have the effect of limiting the competitive constraint imposed on packages of basic channels by free-to-air television channels.

The retail market for basic pay TV should not be limited to "packages containing only basic-tier TV channels"

5.32 Virgin Media notes that in considering market power, Ofcom observes that:

> "*Sky and Virgin have roughly equal market shares in the market for packages containing only basic-tier TV channels….. This suggest that neither firm is likely to have market power in the market for stand-alone basic-tier pay TV"*[83] (emphasis added)

> *"We conclude that stand-alone basic-tier pay TV is likely to be in a separate market,* …"[84]

5.33 While Virgin Media agrees with Ofcom's conclusion that free-to-air basic channels are in a separate market from basic-tier pay TV channels, it appears from the above statements (and related analysis in the Consultation) that Ofcom may also have concluded that there is a market for stand-alone packages of basic-tier TV channels (i.e. that basic-tier TV channels sold in a stand-alone package are in a separate market from basic channels sold in a package with premium channels). This view is supported by Ofcom's approach to market power in relation to the supply of basic channel (which is addressed below). If this is Ofcom's view, Virgin Media strongly disagrees with Ofcom.

5.34 Ofcom offers no justification as to why, in circumstances in which the majority of basic packages sold by Sky are sold as a bundle with premium channels, it is appropriate to identify a retail market for the packages containing only basic tier TV channels. If it has done so, Ofcom has adopted an approach to market definition that fails entirely to reflect Sky's market power as a retailer of basic channels. Indeed, as Ofcom defines separate retail and wholesale markets for premium sports and premium movies, the logical (but absurd) consequences of this approach are that Ofcom would be effectively assuming that:

(a) each retail package offered by Sky should be a separate economic market (i.e. basic, basic plus sport, basic plus movies, basic plus sport and movies), and these markets would be redefined each time Sky changes its bundles;

(b) Sky's bundling of basic with premium channels *weakens* its competitive position by reducing its market share in the retail supply of basic channels. Ofcom's approach would result in Sky's share of the basic retail market reducing each time a basic subscriber upgrades to a bundle containing premium channels. However, the more consumers who chose to buy Sky's higher priced premium bundles in preference to its basic packages or Virgin Media's basic only packages, then:

(i) the higher Sky's overall retail revenues and retail profits would be, given the higher price of these premium bundles and its near monopoly position in premium retail bundles; and

(ii) the fewer basic TV packages would be sold by Sky's retail competitors, the less competitive they will be (e.g. rival retailers' abilities to recover their fixed costs from retail investments, advertising and channel/content procurement will be reduced if their subscriber base is smaller).

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supplying existing customers due to the additional costs of winning new customers (such as new equipment and installation costs).

83 See paragraph 5.54, second bullet of the Consultation.

84 See paragraph 4.129 of Annex 13 to the Consultation.

5.35 Accordingly, in Virgin Media's view, the retail market should be defined as the retailing of pay basic TV channels, regardless of whether they are sold on a standalone basis or part of a package including premium channels.

Market power

An overview of Ofcom's conclusions

5.36 Ofcom concludes that:

(a) Sky has market power at the wholesale and retail level as regards premium movies and sports channels. Virgin Media concurs with Ofcom's views;

(b) Ofcom does not find any supplier to be dominant as regards the wholesale supply of basic pay TV channels. Even if this is the case, Virgin Media nevertheless considers that Sky's conduct as regards the supply of its pay basic channels restricts and distorts competition (which is the relevant question for a market investigation under the Enterprise Act);

(c) Ofcom does not find any supplier to have market power as regards the retail supply of basic pay TV channels. Virgin Media strongly disagrees with that view; and

(d) Ofcom suggests that Sky may have a degree of buyer power over wholesale channel suppliers. Virgin Media considers that there can be no doubt that Sky possesses very material buyer power over wholesale channel suppliers.

These points are considered in further detail below.

Premium channels

5.37 Considering first retail markets, Ofcom states that:

> "*Sky has revenue market shares of [Q] (well over 70%) in the premium sports retail market and [Q] (well over 80%) in the premium movies retail market, and its market share has increased every year in each of the last five years in both markets. With such a high market share there would normally be a presumption of market power unless there was strong evidence to the contrary, which there does not appear to be. Sky is therefore likely to have market power in the retail market for packages containing premium sports or premium movies channels.*" [85]

5.38 Turning to wholesale market power in the supply of premium sport and movies, Ofcom concludes that:

> *"Sky has a share of [Q] (well over 80%) in the premium sports content market – Setanta being its only rival – and 100% of the premium movies market. Access to content in both markets represents a very significant barrier to entry, so that there are very limited direct constraints imposed upon Sky. The limited competition in the retail market and the dependence of retailers on Sky for content also suggests that there are very limited indirect constraints on Sky's pricing. Sky is therefore likely to enjoy substantial market power in both the sports and movies markets.*"[86]

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[85] See paragraph 5.54 of the Consultation.

[86] See paragraph 5.56 of the Consultation.

5.39 A narrow wholesale market definition follows, with Ofcom identifying barriers to entry at the channel level and concluding that any indirect constraint at the retail level would be "*insufficient*"[87].

5.40 As regards barriers to entry and expansion at the wholesale level in premium sports and premium movies, Ofcom identifies staggered exclusive contracts as a key barrier to entry in obtaining access to a portfolio of premium sport and movie content.[88]

5.41 While there has been new entry by Setanta Ofcom concludes that "*very significant*" barriers to entry and expansion remain[89]. As regards Setanta's successful acquisition of FAPL rights, this was only achieved through regulatory intervention forcing FAPL to split its rights packages and preventing complete exclusivity. In practice, consumers (and thus retailers) are likely to view Setanta channels (and its FAPL coverage in particular) as complementary to the sports coverage offered by Sky rather than as a substitute[90].

5.42 Ofcom concludes that Virgin Media has some countervailing buyer power over Sky as regards the wholesale supply of premium movies and premium sports channels as it provides the only means of accessing customers on the cable platform. However, Ofcom concludes that this buyer power is insufficient as if no agreement were reached with Virgin Media some of its customers would switch to Sky whilst Virgin Media does not have any alternative but to buy from Sky.[91]

5.43 Virgin Media considers that Ofcom has erred in concluding that Virgin Media has some countervailing buyer power over Sky. Virgin Media does not consider that it has any buyer power in its dealings with Sky. In particular, these dealings cannot be reasonably described as negotiations as revealed by the wholesale prices and the terms and conditions imposed by Sky (including refusing to supply high definition programming, interactivity and related content).[92]

5.44 More generally, in considering the respective bargaining positions of Sky and Virgin Media, there are two trade-offs which need to be considered – the trade-off from Sky's perspective of supplying or not supplying Virgin Media, and Virgin Media's trade-off from buying or not buying Sky's channels, i.e. their respective "walk away" positions. It should be noted that Sky has a major influence over both trade-offs since Sky's retail and wholesale margins from premium packages are determined by Sky. As a result, Sky can choose to set its retail and wholesale prices such that Virgin Media makes a very low retail margin or a loss on selling Sky's premium channels. Such a strategy has a number of consequences:

(a) Virgin Media finds it marginally worthwhile to continue to buy Sky's premium channels, thereby generating very high wholesale margins for Sky from Virgin Media's smaller subscriber base;

(b) very low retail margins on premium pay TV bundles prevent Virgin Media from competing on price as regards these bundles or having sufficient profits for it to be

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87 See paragraph 5.46 of the Consultation.

88 See paragraph 5.71 of the Consultation and paragraph 5.47 of Annex 13 to the Consultation as regards premium sport content, and paragraphs 5.71 of the Consultation and paragraph 5.67 of Annex 13 of the Consultation as regards premium movie content.

89 See paragraph 5.48 of Annex 13 to the Consultation.

90 See paragraphs 5.45 and 5.46 of Annex 13 to the Consultation.

91 See paragraphs 5.49-51 and 5.68 of Annex 13 to the Consultation.

92 In the context of considering the adverse effects from Virgin Media's perspective of losing wholesale access to Sky's premium channels, it should also be borne in mind that those subscribers lost would be purchasing a bundle including basic and premium channels – so the totality of these retail revenues would be lost by Virgin Media and gained by Sky (not just the additional revenues from premium channels). Revenues from other telecommunications services which consumers purchase with their pay TV packages might well also be affected.

viable for Virgin Media to fund investments in its pay TV offering to attract new subscribers (e.g. in marketing, product innovation etc). Accordingly, Sky thus faces limited competition from Virgin Media as regards new premium subscribers, particularly since Sky prevents Virgin Media from offering equivalent high definition or interactive programming and content to that offered by Sky as regards its channels.

5.45 Finally, while the existence of some switching costs between platforms may reduce the gain in customers which Sky would enjoy following a refusal to supply, the effect of such costs should not be overstated. In practice, they are not out of line with the costs/hassle of consumers switching various other services, such as their broadband provider, particularly since they do not apply as regards new consumers of basic or premium pay TV, with Sky adding 4.7 million subscribers between Q1 1999 and Q3 2007 (an increase in its subscriber base of 57 per cent)[93].

5.46 In summary, Virgin Media strongly concurs with Ofcom's assessment that Sky is dominant in the wholesale and retail supply of premium sports and movie channels. Virgin Media considers, however, that Ofcom is incorrect in concluding that Virgin Media possesses any degree of countervailing buyer power as regards Sky.

Basic channels

5.47 Virgin Media considers that Sky's market position in the retailing of basic pay TV is best judged by reference to its 70 per cent share of pay TV subscribers with access to pay TV. Virgin Media considers that whilst there is a competitive dynamic between free-to-air and pay TV, this does not prevent Sky from exercising market power.

5.48 As regard the wholesale supply of basic pay TV channels, Ofcom concludes that:

> "*The market for the wholesaling of basic TV channels is fragmented, with no supplier having a subscriber market share in excess of 10%; consequently there are likely to be no market power issues.*"[94]

5.49 It is not clear on what basis Ofcom has calculated this market share. However, even if Sky is not dominant in the wholesale supply of pay basic TV channels, competition may nevertheless still be restricted or distorted by any constructive refusal to supply its channels, particularly given **[Confidential]**. In particular, market share by viewing of pay TV channels may be a poor measure **[Confidential]** because:

(a) Sky has an ownership interest in 7 of the top 20 most viewed basic tier pay TV channels[95];

(b) at both the wholesale and retail level, operators also need to offer a range of content due to consumers' diverse preferences and thus various channels may be more complementary rather than substitutable. Ofcom expresses this point in the following terms:

> "*We observe a limited amount of content which is highly valued by large groups of consumers, plus a long tail of content that is attractive to some individual*

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93 Para 3.9 of the Consultation reports that: "...*In Q1 1999 the number of pay TV subscribers on Sky and on cable were broadly similar (3.5 million and 3.0 million respectively). By Q3 2007 there were many more subscribers on Sky (8.2 million as compared to 3.4 million for cable – i.e. Sky has approximately 70% of all subscribers). Recent growth has therefore been driven predominantly by Sky's satellite service….*"

94 See paragraph 5.56 of the Consultation.

95 See Figure 34, and page 87 of the Consultation.

consumers, but not to others. In such circumstances content aggregation is likely to be necessary in order to assemble a credible pay TV proposition."[96]

(c) Ofcom also cites various survey evidence that pay customers value access to a range of channels, as well as valuing specific channels (including Sky 1).[97]

5.50 In other words, a lack of access to Sky's channels restricts competition **[Confidential]**.

Purchasing power in relation to basic channels

5.51 Ofcom suggests that Sky may have a degree of buyer power over wholesale channel suppliers:

> "*We note in this context that total demand – and particularly Sky's total demand – for basic-tier pay TV services is considerably larger than the demand for stand-alone basic packages because of the derived demand from consumers purchasing premium sports and movies. <u>This may afford Sky a degree of buyer power when negotiating with third party wholesale channel providers, even if it does not have market power in relation to the sale of stand-alone basic-tier services.</u>*" [98] [Emphasis added]

5.52 Virgin Media considers that Sky has very substantial market power as a purchaser of basic-tier pay TV services, given the absence of any practical alternatives for basic tier channels to achieve significant subscription and advertising revenues.

5.53 Due to Sky's access to 70% of pay TV households, it is in a uniquely powerful position with regard to the purchase of basic pay TV channels. This is because basic pay TV channels cannot operate viably unless they are distributed on the DTH platform under a carriage agreement with Sky. Whilst there are theoretically alternatives to entering into a carriage agreement with Sky, there are no alternatives that are economically viable:

(a) first Sky's access to 70% of basic subscribers in the UK cannot be replicated by any other platform or combination of platforms;

(b) second, Freeview does not provide a viable alternative for, inter alia, the following reasons:

(i) Freeview is predominantly a free-to-air platform and does not provide for subscription revenues to be generated by basic channels;

(ii) there is very limited capacity available on Freeview, and such capacity as has recently become available has attracted prices so high as to be uneconomic for channel providers that invest in significant content, and that do not have the substantial advantages of a terrestrial presence;

(iii) as Freeview is predominantly a free-to-air platform, basic pay TV channels would have to acquire additional costly free-to-air rights from content providers;

(c) third, for basic pay TV channels that require significant investment in programming, unencrypted free-to-air distribution via the DTH platform would not be a viable alternative for, inter alia, the following reasons;

(i) there would be no subscription revenue;

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96 See paragraph 1.23 of the Consultation.

97 See paragraph 5.49 of the Consultation.

98 See paragraph 5.55 of the Consultation.

(ii) the channels would have to acquire additional costly free-to-air rights from content providers; and

(iii) the channels would be obliged to pay significant conditional access and related service charges to Sky.

(d) fourth, no third party channel (or even group of channels) could viably market their basic channels direct to Sky's retail subscribers because:

(i) consumers' valuations of yet more basic channels will be low (on top of the large number of basic channels retailed by Sky), which will limit the number of Sky's subscribers which can be attracted directly;

(ii) Sky offers additional mixes of basic channels for a relatively low incremental cost of £1 per month, with the result that the revenues which could be expected to be derived by a broadcaster retailing its basic channels to Sky's subscribers would be correspondingly low;

(iii) Sky has exclusive DTH distribution agreements with the majority of providers of basic pay TV channels (which are staggered over time). This makes it effectively impossible to obtain and launch a combined package of basic pay TV channels of sufficient scale, scope and quality to attract subscribers; and

(iv) any retailer of basic pay TV channels on the DTH platform would be required to pay significant fees to Sky for conditional access and related services;

5.54 For all of these reasons, Sky is effectively a compulsory trading partner for providers of basic pay TV channels. This status confers on Sky very considerable purchasing power.

Market characteristics and the role of vertical integration

5.55 As regards the questions relating to the correct intrinsic market characteristics and the potentially pro and anti-competitive effects of vertical integration, Virgin Media's substantive comments are set out in its comments on section 6 below. However, Virgin Media would briefly observe at the outset that the likely effects of vertical integration depend heavily on whether the firm in question enjoys appreciable market power.

6. OBSERVATIONS ON OFCOM'S ANALYSIS OF THE OPERATION OF THE MARKET

Introduction

6.1 Ofcom raises four questions in section 6 of the Consultation regarding the operation of the market, which are repeated below for ease of reference:

(a) "*Do you agree with our assessment of the effects of content aggregation on retail competition?*";

(b) "*Do you agree with our summary of the possible issues relating to the short-run operation of the market?*";

(c) "*Do you share our possible concerns over the long-run operation of the market?*"; and

(d) "*What do you see as the impact of these considerations on consumers?*"[99]

[99] See page 118 of the Consultation.

6.2 This broad structure is adopted in this section, albeit that the issue of content aggregation is addressed in the context of its implications on competition. However, as a preliminary point, Virgin Media notes that Ofcom considers separately "*the short-run operation of the market, in which established firms compete with each other*", and the "*longer-term dynamic effects, associated with new market entry*"[100]. Whilst this approach is adopted in this section, it is important that Ofcom does not consider in isolation any particular aspect of the operation of the market, or Sky's conduct and incentives, but instead has regard to the totality of effects on both new entrants and existing competitors at all levels of the pay TV supply chain.

6.3 In addition, there should be no suggestion that "*longer-term dynamic effects"* are not currently having an adverse effect on competition, and thus consumers, by creating and enhancing Sky's market power across a number of related pay TV markets. Moreover, in normally competitive markets even future competitive threats constrain leading firm's behaviour, since a failure to deliver low prices, innovate and offer consumers choice will lead to them losing market share to smaller existing rivals (who are not subject to artificial barriers to expansion) and encouraging new entry (from potential entrants who are not subject to artificial barriers to entry or expansion).

6.4 In assessing impacts on consumers, this section also considers whether there are offsetting efficiency advantages from vertical integration (with the final question raised in section 5 of the Consultation being whether Ofcom has "*correctly captured the role of vertical integration*").

6.5 Finally, this section also comments on various points raised in the paper prepared for Sky by CRA and Prof. John Van Reenen (the "**CRA Paper**") entitled "*Sky's "Incentives" to Foreclose Competition in the UK Pay TV Industry*".

The short run operation of the market

6.6 In considering the short-run operation of the market Ofcom focuses on the risk of downstream input foreclosure and the competitive implications of Sky's "buy through" (or bundling) of its premium and basic channels.

The risk of downstream foreclosure - the importance of considering actual conduct and carrying out a complete assessment of competitive effects

6.7 The starting point of Ofcom's analysis of risk of downstream foreclosure is to consider, with the aid of an illustrative example, Sky's incentives to supply its premium channels to downstream competitors "*which are already present in the market*".[101]

6.8 Before commenting on this model, it should be noted that CRA has carried out a related exercise (albeit that the details are excised) with the aim of demonstrating that Sky has *incentives* to supply its premium channels to downstream competitors[102], because Sky derives high profits at the wholesale level and given the low incremental costs of supplying additional customers (albeit that this point does not apply for movies which are priced on a pence per subscriber basis). In brief, given Sky's prevailing high wholesale margins, it is asserted by CRA that it would not be profitable for Sky to cease wholesale supply of its premium channels as allegedly too few cable customers would switch to Sky's retail platform due to the switching costs they would incur[103].

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100 See paragraph 6.26 of the Consultation.

101 See paragraphs 6.28 to 6.37 of the Consultation.

102 Section 4 of the CRA Paper is entitled "*Does Sky have incentives for downstream foreclosure*"?

103 See paragraphs 50, 63 and 64 of the CRA paper.

6.9 Before commenting on this arithmetical exercise (Virgin Media considers that CRA's modelling of even the direct gains to Sky's retail platform is fatally flawed), Virgin Media would emphasise two headline points about Sky's incentives and ability to foreclose competition:

(a) Sky's **actual** behaviour is the best indicator of its true incentives and its ability to foreclose competition; and

(b) the CRA Paper is based heavily on the Chicago School which denies that foreclosure is ever profitable, and it simply does not fit the facts. In particular, it is important to carry out a complete assessment of the competitive effects of Sky's actual behaviour.

Sky's incentives and hard facts as to its actual behaviour

6.10 Virgin Media considers that CRA's theoretical arguments as to Sky's incentives to supply premium content are a "red herring". Considering the incentives for foreclosure may be sensible in the context of the assessment of a proposed vertical merger (e.g. between a supplier and a retailer), where the likelihood of future anti-competitive conduct needs to be judged. However, in the present case, there can be no uncertainty as where Sky's incentives lie given its **actual** conduct.

6.11 First, Sky supplies its premium channels to cable on uneconomic terms. Ofcom does not comment on this point[104], but it cannot be at issue (see Annex 6 of the Joint Submission which sets out an "Outline of Problems Encountered by Virgin Media"). Virgin Media's margins are, for example, reduced if a subscriber to Virgin Media's XL package of basic channels upgrades to a package containing one or more of Sky's premium channels.

6.12 As a consequence, Sky's conduct removes any incentive on Virgin Media's part to compete with Sky as regards the retailing of premium channels. Given Ofcom's provisional findings that Sky is dominant in the wholesale and retail supply of premium sports and movie channels, this is self-evidently a very serious competition issue.

6.13 Second, Sky does not supply its enhanced and interactive services (and related content) to cable, and Sky's channels are not available on cable in high definition (as noted by Ofcom in the Consultation[105]). Ofcom speculates that the failure to supply those services may have an objective justification on technical or reputation/branding grounds[106], but it should be noted that such justifications are specious. Any such technical issues are eminently addressable – Sky simply has no interest or incentive to supply these factors/services in practice since this would enhance the competitiveness of a competing retail platform. Similarly, reputation/branding arguments simply do not justify Sky forcing rival retail platforms to offer a lower quality version of Sky's premium channels. Indeed, reputation/branding considerations should have the reverse effect and should drive Sky to endeavour to work cooperatively with rival retail platforms to offer the best inactivity and HD experience possible, and thereby enhance the reputation of those channels.

6.14 Third, Sky does not offer its premium channels to other retailers on a wholesale basis. Ofcom observes that:

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104 Ofcom does observe that "*Sky does make its premium content available to other platforms, especially those such as cable where it is not itself present as a retailer.*" See paragraph 6.36 of the Consultation.

105 See the third bullet point of paragraph 1.17 and paragraph 6.38 of the Consultation. See further Sections 3 and 4 of Part II of Virgin Media's Response to Ofcom's questionnaire of 20 December 2007.

106 Paragraph 6.40 of the Consultation.

"*Sky does not appear to make its premium content available to other retailers on its own satellite platform. Nor is premium content currently made available on DTT, where Sky has announced its desire to launch its own retail operation.*"[107]

6.15 This behaviour is not consistent with a claim that Sky does not have the incentive to engage in input foreclosure.

6.16 Nor can there be any doubt as to Sky's ability to foreclose retail competition given its virtual monopoly position in the wholesale supply of premium sports and premium movie channels.

<u>Foreclosure is highly profitable, and these profits are not based solely on the additional premium retail subscribers won by Sky's retail platform</u>

6.17 CRA's theory as to Sky's lack of incentives to engage in input or output/customer foreclosure are based on the Chicago School argument that monopoly power cannot be leveraged from one market to another, with CRA stating that "*this intuition is powerful and holds in a broad set of circumstances*"[108]. The key point behind the Chicago School argument is that a monopoly supplier would set a high wholesale price based on final consumers' maximum willingness to pay a high retail price, with this high wholesale price effectively being the retail price paid by consumers less retailers' gross profit margins. In this framework, the monopoly supplier's interest is in maximising retail sales (at this high wholesale price) and maximising its share of the revenues from those sales. This can best be achieved by the margin of the retailer being kept as small as possible. This is because, assuming the monopoly supplier's wholesale price is set at a level close to the final consumers' maximum willingness to pay, a large retail margin on top of that wholesale price will lead to the manufacturer losing sales and profits (as the retail price will then exceed the price some consumers are prepared to pay). In these circumstances, vigorous retail competition is actually in the interests of the monopoly wholesale supplier as it depresses retail margins which will, all else equal, lead to increased sales and profits for the wholesale supplier. For this reason, the Chicago School argues that monopoly suppliers have no anti-competitive incentives to reduce retail competition (e.g. by refusing to supply inputs to other retailers or supplying them on discriminatory terms).

6.18 However, it is well recognised that Chicago School theory is based on an array of assumptions which do not generally apply. As a preliminary observation, the Chicago School would suggest that vertical integration will rarely, if ever, give rise to competition concerns. However, downstream and upstream foreclosure is a legitimate competition concern which is well covered in academic literature, specific cases, and competition authorities' guidelines/discussion papers (such as the EC Commission's guidelines on non-horizontal mergers and the Article 82 discussion paper).

6.19 Indeed, while post-Chicago School economic theory accepts that vertically integrated suppliers with market power *may* have incentives to supply competing retailers, it also recognises that such suppliers may have anti-competitive incentives to engage in input foreclosure, with these incentives being completely separate from the direct benefits to that supplier's downstream retail platform arising from it gaining customers from other retail platforms. These anti-competitive incentives may be categorised under two main headings, and they have the common theme of violating the key Chicago School finding that a monopoly supplier cannot increase its profits by reducing retail competition:

(a) the monopoly supplier's conduct would enable it to reap additional profits from consumers in other markets. A key Chicago School assumption, in this case, is that the only customers affected by a refusal to wholesale Sky's premium channels (or supplying them on discriminatory terms), are those who would have purchased

[107] See paragraph 6.36 of the Consultation.

[108] See footnote 11 of CRA Paper.

Sky's premium programming, whether from Sky or another retailer. It is only as regards these customers, in relation to whom Sky would make wholesale sales in any event, that the one monopoly profit argument may apply under the Chicago School theory. In practice, however, rival retailers' entire pay TV businesses are impacted by Sky's wholesale terms for its premium channels, because the resulting inability of these rivals to compete effectively at the retail level as regards the retailing of premium pay TV channels also compromises their ability to compete as regards basic channels. Reducing rival retailers' total subscriber base also reduces the overall profitability and viability of their basic channels offering and platform investments, because of the economies of scale and scope which their retail platforms fail to achieve as a consequence (e.g. in relation to the fixed costs of the platform, subscriber management, and advertising). This leads to:

(i) basic only customers switching to Sky and, more importantly in the context of a growing market, new subscribers joining Sky instead of rivals' retail platforms. This is also important because such customers may take additional services from Sky, such as broadband or telephony, which would generate an additional source of revenue and profit for Sky (see paragraph 6.24 below);

(ii) rivals' retail platforms being forced to set higher basic only prices, which in turn will permit Sky to set high basic only prices and higher prices for its premium/basic bundles. This point is made by Ofcom, with "X" in the text below being a reference to the vertically integrated incumbent supplier of content and "Y" being a competing retail platform:

> "*Suppose that the retail price of Y's basic content constrains the retail price of X's basic content. This constraint might be weakened if X refuses to supply premium content to Y. For example, by refusing to supply Y this reduces the number of Y subscribers. If there are significant economies of scale at the platform or retail level, then this will drive up Y's average costs. If this increases the retail price of Y's basic content then it this may allow X to increase its retail margin on that content.*"[109]; and

(iii) Sky possessing very significant *purchasing power* when negotiating carriage terms with third party broadcasters of basic channels, given the value to such broadcasters (in terms of subscription and advertising revenue) of accessing Sky's very large subscriber base. In practice, as explained by the Parties in the Confidential Annexes to their Joint Submission, Sky is a compulsory trading partner for broadcasters of basic pay TV channels. This is a further source of competitive advantage for Sky;

(b) the monopoly supplier's conduct would enable it to increase barriers to expansion and entry at the wholesale supply level. Sky's foreclosure of competition downstream enables it to engage in upstream foreclosure by denying rival channel providers access to Sky's subscriber base (or only providing access on terms which place them at a competitive disadvantage). The issue of upstream foreclosure is addressed further below.

6.20 Accordingly, CRA's modelling of its incentives to supply rival retail platforms substantially understates the profitability of input foreclosure by Sky. Ofcom acknowledges "*that a vertically integrated firm may also weigh up other, longer-term, factors when deciding whether to supply its retail competitors*"[110]. However, Virgin Media does not consider that these effects outlined at (a) and (b) above are "*long-term*" in that they are a source of

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[109] See the final bullet of paragraph 6.71 of the Consultation.

[110] Paragraph 6.37 of the Consultation.

Sky's existing market power and have a major, on-going anti-competitive impact on existing firms (as well as impacting on new and potential entrants).

CRA's modelling of even the direct gains to Sky's retail platform is fatally flawed

6.21 Quite apart from its failure to take account of the anti-competitive benefits outlined above, CRA's one-sided modelling of the direct benefits to its retail platform of supplying premium channels to other retail platforms, is fundamentally flawed because:

(a) it treats Sky's wholesale margins and its total margins where it retails its own channels as both being exogenously determined. In fact, Sky's total margins and its wholesale margins from premium packages are determined by Sky. Indeed, on the basis of CRA's incentives methodology, the more excessive Sky's wholesale channel prices are to Virgin Media, the greater incentive Sky has to maintain these sales – but this is not a competitively neutral outcome. This is akin to the Cellophane fallacy, which warns that the market power of a monopolist which has already increased prices above the competitive level cannot be judged with reference to whether further additional price increases would be profitable;

(b) it assumes that Sky faces a binary choice of supplying or not supplying Virgin Media, or other retail platforms. However, this is not the case:

(i) Sky has deliberately chosen to set its retail and wholesale prices such that Virgin Media makes a very low retail margin or a loss on selling Sky's premium channels. Such a strategy may be more profitable to Sky than an outright refusal to supply and has a number of consequences:

(A) on the one hand, Virgin Media finds it marginally worthwhile to continue to buy Sky's premium channels, thereby generating very high wholesale margins for Sky from Virgin Media's smaller subscriber base;

(B) on the other hand, very low retail margins on premium pay TV bundles prevent Virgin Media from competing on price as regards these bundles (see further below) and reduces the viability and profitability of Virgin Media investing in its pay TV offering (e.g. in marketing, product innovation etc) to attract new premium and basic subscribers.

(ii) quality and quantity degradation is another complementary strategy for Sky (see paragraph 6.13 above), which damages rival retailers' quality and brand image and enhances Sky's ability to charge higher retail prices and increases the prospect of new subscribers choosing its platform.

6.22 CRA refers to the existence of some switching costs between platforms, or even impossibility of switching, which may reduce the gain in cable customers which Sky would enjoy following a refusal to supply[111].

6.23 Whilst such switching costs are a relevant factor to be considered, they should not be overstated (even as regards existing customers they are not out of line with the costs/hassle of consumers switching various other services, such as their broadband provider), particularly since they do not apply as regards new consumers of basic or premium pay TV, with Sky adding 4.7 million net new subscribers between Q1 1999 and Q3 2007 (an increase in its subscriber base of 57 per cent)[112]. Indeed, allowing for

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[111] See paragraphs 63-64 of CRA Paper.

[112] Paragraph 3.9 of the Ofcom document reports that: "...*In Q1 1999 the number of pay TV subscribers on Sky and on cable were broadly similar (3.5 million and 3.0 million respectively). By Q3 2007 there were many more subscribers on Sky (8.2 million as compared to 3.4 million for cable – i.e. Sky has approximately 70% of all subscribers).*

"churn", an even higher proportion of Sky's current subscribers will be new subscribers over this period. **[Confidential]**. In this context, Ofcom observes that new customers do not incur switching costs, and that Sky may wish to trade any short term losses (which may be small in absolute terms given Sky's very high market share in the retailing of its premium channels) with the gain from winning future customers[113].

6.24 Further, Ofcom makes a number of sensible points about the type of arithmetic calculations (utilised by CRA's similar methodology), which emphasise that CRA's results depend on:

(a) Sky's wholesale margins from supplying Virgin Media. However, as emphasised above, there is an inherent fallacy in any assessments of Sky's incentives to supply which are based on its excessively high wholesale prices that effectively marginalise competing retail platforms;

(b) Sky's total margins where it retails its own channels, which will be increased by the additional profits from other services which are sold to the premium subscribers who switch to Sky's platform. In this regard, it should be noted that Sky's retail revenues from additional subscribers include its revenues from its premium packages which include basic channels, as well as its revenues from HD, multi-room, broadband and telephony; and

(c) switching rates, which will be influenced by consumers' perception of the benefits of switching (i.e. the value they place on the content and whether it is available on other platforms) as well as switching costs. The importance of premium sport and premium movie channels to some of Virgin Media's customers is clear cut, as is their ability and willingness to switch to Sky (hence the low retail prices which Virgin Media sets for Sky's premium channels, despite their very high wholesale price – see further above).

Sky's ability and incentives to foreclose competition from new retail platforms is considered in the sub-section below on the longer-term dynamic effects of Sky's conduct.

Content aggregation and buy through

6.25 Sky engages in content aggregation in that it offers consumers packages of a large number of channels, and "buy through" in that those consumers wishing to acquire premium channels must also acquire one of its packages of basic channels. Retail prices are also set by Sky so that the incremental cost of increasing the number and range of basic channels purchased is low. For example:

(a) the cost of buying all six of Sky's basic mixes is £21 per month, but buying just one mix costs £16 per month, with each additional mix costing only £1 more per month; and

(b) on top of the cost of 1-6 basic channel mixes, it costs £17 more per month to buy just Sky Movies Mix or Sky Sports and a further £7 per month to buy both Sky Movies Mix and Sky Sports. This additional expenditure offers a substantial volume and range of premium content. In this regard, Sky Movies Mix is promoted by Sky as offering: "...*12 separate movie channels, each dedicated to a specific film genre. Add Sky Movies Mix for your choice of over 850 different films per month, including 5 brand new premieres a week*"[114]. Similarly, Sky Sports Mix is promoted by Sky as

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Recent growth has therefore been driven predominantly by Sky's satellite service…."

113 See the second bullet point of paragraph 6.71 of the Consultation.

114 See http://mysky.sky.com/portal/site/skycom/skyproducts/skytv/pricesandpackages.

offering: "*Sky Sports Mix to enjoy over 100 sports across 4 dedicated channels - Sky Sports 1,2 and 3 and Sky Sports Xtra*"[115].

6.26 Virgin Media has two main indirect concerns with these pricing arrangements. The first relates to their impact on the TPS regime, particularly as regards basic channels. Quite apart from any other issues associated with this regime, given the degree of content aggregation and Sky's retail pricing, **[Confidential]**:

(a) **[Confidential]** which will limit the number of Sky's subscribers which can be attracted directly; and

(b) Sky offers an entire mix of basic channels for a relatively low incremental cost of £1 per month, with the result that the revenues which could be expected to be derived by a broadcaster basic channel retailing its channels to Sky's subscribers would be correspondingly low. (These limited revenues would also need to cover the costs of Sky's charges, fixed advertising costs, billing costs and so on.)

6.27 This is a further reason why third party access regulation in relation to the DTH platform is a very poor substitute for addressing directly Sky's market power and the issues raised by its vertical integration.

6.28 Virgin Media's second main concern is that Sky's bundling of basic and premium packages means that if it wishes to compete with Sky in relation to basic channels as regards those subscribers which want access to Sky's premium channels, Virgin Media must offer packages including these premium channels. **[Confidential]**.

6.29 Again, Virgin Media considers that the substantive competition issue in this regard is not Sky's bundling of basic and premium channels, but Sky's unreasonable prices and wholesale terms of supply for its premium channels.

The long-run operation of the market

Introduction

6.30 In considering the long-run operation of the market, Ofcom identifies three separate issues:

(a) barriers to entry into the wholesale premium channel market and the risk of customer foreclosure;

(b) whether vertical integrated operators have an incentive to foreclose potential new retailers and/or platform operators; and

(c) the vicious circle.

Barriers to entry into the wholesale premium channel market and the risk of customer foreclosure

6.31 As noted in section 5, Virgin Media concurs with Ofcom's views that access to a range of premium content represents a major barrier to entry in wholesale premium channel markets. This arises because it is important to offer consumers a range of attractive premium content, but it is inherently difficult to secure such a portfolio due to staggered rights contracts which come up for renewal at different times.

6.32 However, Ofcom questions the risk of customer foreclosure due to the existence of the TPS regime which a rival wholesale premium channel broadcaster could ostensibly use to access Sky's retail platform:

[115] See http://mysky.sky.com/portal/site/skycom/skyproducts/skytv/pricesandpackages.

"*During the extended period in which a new wholesale channel provider is building up a portfolio of content rights, the vertically integrated incumbent may be able to restrict the new entrant's access to retail markets, and therefore make it more difficult for the new entrant to monetise its rights. In the case of Setanta and Sky, for example, Sky may have an incentive to restrict Setanta's access to the retail market by restricting access to its satellite platform. We 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.*"[116]

6.33 In this regard, the CRA Paper claims that Sky's competitors would only be inhibited from bidding for content if they were "*materially disadvantaged in reaching Sky's existing retail subscribers*"[117], but that given the regulatory regime for access to the DSat platform, a third party channel provider "*has the very real option of retailing itself directly to DSat viewers*"[118]. The CRA paper alleges that the option to retail directly is especially easy for premium channels which are marketed as add-ons and thus do not require customers to switch their pay TV subscription[119]. CRA also claims that "*As the transaction costs seem small, we see little reason to suppose that a competing channel provider with attractive content could not gain a substantial body of subscribers to its channel(s). Installed base advantages would thus be temporary.*"[120]

6.34 However, quite apart from Sky's ability to manipulate the regulatory arrangements as regards access to the DTH platform to its advantage (and thereby foreclose access to the DTH subscriber base[121]), rival channels securing access to the DTH platform will still be at a major competitive disadvantage in competing with Sky to acquire premium content. This is because a new entrant will need to acquire a portfolio of rights (the difficulties of which Ofcom recognises), and it would also take time for the new entrant to build up a subscriber base and thus monetise (i.e. recover) its fixed investments in content. Sky, on that other hand, already has a pre-existing portfolio of rights and can realise its investments in content without delay from its large pre-existing subscriber base. Accordingly, the installed base advantages would not be as temporary as claimed by CRA.

6.35 Further, even a "*temporary*" delay in developing a critical mass of subscribers reduces both the nominal cash value and the net present value (i.e. accounting for the time value of money) of the revenue streams generated by the rival premium channel broadcaster over the duration of the rights contract (assuming optimistically for the moment that the same base of subscribers as that enjoyed by Sky could be attained at the end of the contract period).

6.36 In this regard, it should be emphasised that wholesaling its channel to Sky would not be a solution for a new entrant seeking to address the difficulties arising from the time needed to build a subscriber base. This is because:

(a) even if a new entrant were to wholesale its rival channel to Sky, the rival channel would still have no DTH subscribers at the outset. In other words, as such wholesale arrangements invariably involve payments by the retailer to the wholesaler on the basis of subscriber numbers (i.e. per subscriber fees), Sky would still need to persuade customers to purchase the new channel (on top of their existing channel package) before the wholesaler generated any revenues;

116 Paragraph 6.67 of the Consultation.

117 See paragraph 89 of the CRA Paper.

118 See paragraph 91 of the CRA Paper.

119 See paragraph 92 of the CRA Paper.

120 See paragraph 98 of the CRA Paper.

121 See Virgin Media's response to question 7 of Ofcom's request for information of 20 December 2007.

(b) Sky would have a major advantage in the process of bargaining for wholesale terms, in that the third party would clearly be dependent on it to monetise its content rights. The likely result of this is that the third party would have to cede to Sky a significant portion of the revenues that would be generated from the content in question. This inherent negotiating advantage would, of course, materially disadvantage the third party in its bidding for the rights in the first place;

(c) it is unlikely that Sky would assist its rivals by agreeing wholesale terms that might cause Sky to be outbid for content rights; and

(d) even if satisfactory wholesale terms could be agreed, Sky would have no incentive to promote the rival channel ahead of its own channels. In short, it is very unlikely that Sky would actively market a new entrant's channel in a way that might allow a timely return to be made on content acquisition costs.

6.37 Further, notwithstanding the competitive advantages that Sky enjoys by virtue of its large installed base of premium subscribers and the portfolio of premium content rights it holds, it should also be noted that there may be significant risks to owners of premium content in selling their content to a new wholesale channel or retail platform. These risks are well illustrated by the Football League's experience of selling its rights to ONdigital (later rebranded ITV Digital) in 2000 for £315m. As a consequence of ITV Digital failing to achieve its subscriber targets, it ceased broadcasting during the contract term, leaving £178 million unpaid to the Football League. This shortfall contributed to 17 clubs being forced into administration and other clubs also being forced to make players and staff redundant, and cut wages. Sky then subsequently acquired the rights for less than 25 per cent of the amount paid by ITV Digital.[122]

6.38 Against this background, there should be no doubt that rival bidders for premium content are substantially weaker bidders due to Sky's retail advantage (i.e. which effectively gives Sky the ability to engage in customer foreclosure despite the TPS regime). These advantages will also be increased by the fact that, since consumers value a range of premium content, Sky's existing portfolio of content will enable Sky to bid more to acquire particular incremental content rights when these rights come up for renewal (as they are more valuable in a package with Sky's existing rights than if they were to be retailed separately to consumers). Sky also has an incentive to acquire a range of substitutable content (and thus to pay more for this range of content), so as to give it market power as the monopoly (or leading) supplier of this content. Ofcom makes this point as follows:

> "*For example, a wholesale channel provider that is seeking to accumulate exclusive rights to packages of subscription movie rights from all studios is likely to outbid a rival wholesale channel provider that only wishes to acquire rights from one or two studios. This is because a firm which has aggregated substitutable rights in this way is likely to possess a degree of market power and can thus pay more for the underlying rights.*"[123]

6.39 The magnitude of barriers to entry and expansion in the wholesale supply of premium channels is revealed very clearly in practice by Sky retaining and entrenching over time its dominant position at the wholesale and retail level in the supply of premium channels (as found by Ofcom in the Consultation). As noted above, the only entry in premium sports has been by Setanta and its impact has been limited. In this regard, Sky itself emphasises the limited impact of Setanta and Sky's advantages in offering a range of content, with a Financial Times article of 7 February 2008 (Andrew Edgecliffe Johnson and Ben Fenton) reporting that:

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122 This is well documented at pages 49-51 of Annex 10 to the Consultation.

123 The second bullet point of paragraph 6.11 of the Consultation.

"The fourth-quarter figures included the first season of Sky's new contract to air Premier League games since it was forced to share the rights with Setanta Sports. Mr Darroch said the group had seen no fall-off in its football audience as a result of the regulatory intervention, saying that subscriber numbers for its sports packages had grown.

"In terms of interest in the platform and viewership it is as strong as ever," Mr Darroch said.

He added, however, that BSkyB had broadened its range of sports programming, getting 4.3m viewers for a recent darts match. "You wouldn't want to be overly exposed to one individual package [and] sports fans like a breadth of content," he said."

Whether vertical integrated operators have an incentive to foreclose potential new retailers and/or platform operators

6.40 Ofcom observes that a vertically integrated operators' incentives to supply new retail platforms may be different from those associated with supplying established platforms[124]. This is because, on the one hand, only limited initial wholesale revenues would be foregone by Sky if it were not to supply a new platform, and any decline in Sky's overall profitability (from its combined wholesale channel supply and retail platform business) may be offset by longer term (or dynamic) competitive effects.

6.41 In particular, Ofcom argues that these longer term effects might be important where:

(a) the new rival retail platform is a significant competitive threat to Sky's retail platform as consumer switching costs to this rival are likely to be low in the future. By refusing to wholesale its premium channels to this platform on reasonable terms, Sky can eliminate this competitive threat[125];

(b) there are significant number of potential new pay TV consumers who, by definition, would not incur any retail platform switching costs, and would choose Sky's retail platform if other retail platforms cannot offer Sky's premium channels[126];

(c) rival platforms' loss of premium subscribers would reduce these rivals' ability to achieve retail platform economies of scale across their pay TV businesses as a whole, thereby driving up their average costs for basic channels as well. This could enable Sky to increase its retail prices for basic content as well[127].

6.42 Virgin Media strongly concurs with these concerns but would add that:

(a) all of these issues also arise as regards established platforms, since Sky has every incentive to marginalise Virgin Media as a future competitive threat;

(b) as noted above at paragraphs 6.7 to 6.21, Sky also has a strong incentive to protect its downstream retail advantage by engaging in input foreclosure, since its large installed base of premium subscribers gives it an unparalleled advantage in competing for premium content. Such a strategy therefore safeguards Sky's dominance in premium channel supply.

(c) Virgin Media also agrees with Ofcom's observation that weakening or eliminating competition from rival retail platforms at the retail level "may" reduce degree of

124 See Paragraphs 6.70-6.72 of the Consultation.

125 See the first bullet point of paragraph 6.71 of the Consultation.

126 See the second sub-bullet point of the second bullet point of paragraph 6.71 of the Consultation.

127 See the third bullet point of paragraph 6.71 of the Consultation.

competition between buyers of content rights, and "might" therefore depress content rights' prices.[128] The only point of difference is that such outcomes are not possibilities (as reflected by Ofcom's use of words such as "may" and "might") but are commercial realities;[129]

(d) where Sky's incentives lie is not a matter of conjecture – this can be observed from its behaviour, namely to impose wholesale prices and terms and conditions which marginalise Virgin Media as a competitor (whilst enabling Sky to achieve very high wholesale prices) and to refuse to wholesale its premium channels to new retail platforms at all.

CRA's response to the vicious circle

6.43 In the Joint Submission, the Parties expressed their concerns about a number of features of the UK pay TV industry and, in particular, about the existence of mutually reinforcing upstream and downstream bottlenecks that give rise to a vicious circle for competitors and harm consumers.

6.44 The CRA Paper criticises what it calls the vicious circle "*theory*" in a few paragraphs at the end of their lengthy paper.[130]

6.45 The key point of the vicious circle is simply that downstream and upstream foreclosure are mutually reinforcing strategies.

6.46 First, Sky has an incentive to foreclose its downstream competitors in order to protect its future stream of profits *both* upstream and downstream. If Sky were to wholesale its channels to competing distributors on economically viable terms it would lose its downstream advantage and, consequently, its advantage in securing key content in the future. Second, by securing a bidding advantage over its upstream rivals, it reduces the likelihood that those rivals will bid high prices for that premium content or even bid at all, which can be expected to reduce the price that Sky has to pay, and reinforce its downstream advantage.

6.47 For these reasons, the increase in the stream of future profits resulting from the refusal to supply key content is likely to exceed any short-term sacrifice associated with such a strategy. These dynamic factors have been neglected by CRA.

The impact on consumers

Does the operation of the pay TV market serve consumers' interests?

6.48 From the above analysis, even considering only the position of Virgin Media, an array of consumer detriments can be identified:

(a) Downstream (input) foreclosure:

(i) against the background that Ofcom has found Sky to be dominant in the wholesale and retail provision of premium channels, Sky's high wholesale prices and restrictive terms of supply for premium channels mean that Virgin Media has neither the ability nor the incentive to compete on price or quality

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128 See paragraph 5.127 of the Consultation.

129 See, in particular, sections 1 and 2 of Part I of Virgin Media's response to Ofcom's request for information of 20 December 2007.

130 Only paragraphs 120 to 124 of the CRA Paper deal directly with the vicious circle – a key component of the Joint Submission.

(cable is supplied with an incomplete product, lacking interactivity and HD) as regards the retail supply of premium channels[131];

(ii) **[Confidential]**. This has left Sky with a 70 per cent share of basic pay TV subscriptions (with a large proportion of these subscribers also purchasing its premium channels); and

(iii) due to Sky's decision to refuse to wholesale its premium channels to DSL or DTT operators at all, customers who live outside cable areas have no choice at all of premium channel retailer.

(b) Upstream (customer) foreclosure:

(i) Detriments arising from upstream (customer) foreclosure include Sky's practical monopoly in the wholesale supply of premium sports and movie channels and Sky's unique ability to control access to well over 70 per cent of premium sports subscribers and well over 80 per cent of premium movie subscribers[132].

Efficiency justifications do not apply, and certainly do not justify Sky's anti-competitive behaviour

6.49 Virgin Media does not consider that the scale of the restriction of competition and Sky's dominance across the pay TV supply chain (as outlined above) can be justified by any generic hypothetical efficiency advantages from vertical integration – certainly Sky exclusionary conduct cannot be justified with reference to any hypothetical advantages it enjoys by virtue of its vertical integration.

6.50 Turning to the hypothetical possible efficiencies of vertical integration, Ofcom identifies various efficiency advantages with vertical integration between a retail platform and wholesale channel supply relating to:

(a) a vertical integrated operator avoiding the so called "double marginalisation" problem (see further below);

(b) a vertical integrated operator exploiting various retail platform/channel cooperation opportunities relating to more tailored offerings which better meet consumers' preferences in terms of technical platform offerings, content purchasing, and/or having regard to consumers' willing to pay for content; and

(c) a vertical integrated operator avoiding the "transaction costs" associated with negotiations between retail platforms and wholesale channels[133].

6.51 In this regard, it is uncontroversial that efficiencies can be claimed for vertical integration, but these must be balanced against anti-competitive effects with the overall balance depending on the market power of the vertically integrated undertakings. Moreover, any efficiencies enjoyed by Sky must also be judged against any inefficiencies Sky imposes on its competitors, and taking account of how Sky treats its upstream and downstream competitors in practice.

6.52 CRA relies on the so called "double marginalisation" problem to argue that Sky would prefer to retail its channels directly to consumers on other platforms rather than wholesaling its channels (thereby eliminating all retail competition), on the basis that

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131 See Annex 6 of the Joint Submission, and section 2 of Part II of Virgin Media's response to Ofcom's request for information of 20 December 2007

132 See paragraph 5.54 of the Consultation.

133 See Paragraph 5.124 of the Consultation.

other platforms set excessive prices for Sky's channels and do not invest sufficiently in attracting new subscribers. This allegedly arises because when Sky wins a new subscriber it gains the totality of the wholesale and retail margin, whereas when an independent retail platform wins a new subscriber that platform only gains the retail margin (i.e. the gap between its retail price and Sky's wholesale margin and any other variable costs it incurs). CRA also asserts that competition between platforms is an insufficient constraint on its retail competitors' retail profit margins and promotional activities due to the differentiated nature of pay TV platforms.

6.53 This is an extraordinary line of argument for a number of reasons:

(a) it is uncontroversial that, at a theoretical level, it would be better to have an integrated supplier-retailer monopoly than to have a successive monopoly supplier and an independent monopoly retailer, since an independent monopoly retailer would add an excessive retail margin on top of the supplier's excessive wholesale margin (hence this phenomena being referred to as "double marginalisation"). Indeed, the greater the market power of the supplier and thus the higher its wholesale margin, the less desirable it is for there also to be a separate retail monopoly. However, the appropriate solution to this issue is not for all competition to be eliminated at both the supplier and retailer level (with this being Sky's preference according to CRA), but to promote competition at the wholesale and retail levels; and

(b) in any event, there is no evidence that other parties have any appreciable market power as regards their retailing of premium channels – indeed Ofcom has found that Sky is a dominant retailer of such channels.

6.54 As regards the other efficiencies identified, these can be realised without vertical integration by close working arrangements, cooperation and contracts between wholesale channel suppliers and retailers. In this case, Sky's conduct precludes any such cooperation with third party retail platforms - Sky has made it abundantly clear that it has no interest in developing existing and new retail platforms so as to maximise the availability and quality of its premium channels, or to enable rival retail platforms to offer low retail prices. Similarly, absent Sky's dominance as a supplier of premium wholesale channels, Virgin Media (and other retail platforms and new premium channel suppliers) could expect to have normal commercial negotiations as to prices and terms of supply, with normal associated transaction costs.

6.55 Sky's transaction costs in relation to its dealings between its own wholesale channel supply activity and its own retail platform activity may well be low, but they are self-evidently highly excessive for Sky's upstream and downstream competitors. Virgin Media's need for recourse to litigation, the Parties complaints to regulators, and Sky's refusal to supply (in whole or part), and its unreasonable terms, are all symptomatic of the excessive costs to Sky's competitors of needing to deal with Sky as a compulsory trading partner.

ANNEX 1

FLAWS IN BSKYB'S APPROACH TO MARKET DEFINITION

1. This Annex sets out a detailed analysis of the flaws in Sky's approach to market definition.

2. Perhaps the first point to note is that Sky's submission contains no economic evidence as to market definition of the type considered by Ofcom. Instead, Sky simply asserts that customers' willingness to pay for pay TV depends on the appeal of substitutes, that the appeal of substitutes is increasing (many households have access to Freeview, there is scope for competition from the internet, DVDs etc), and various statements which have been made by Ofcom and various other observers about future competition increasing.

3. However, any assessment of market definition cannot be based on the mere existence of alternatives (particularly where these alternatives have different prices and attributes), even if many consumers choose the alternatives and there is speculation as to future competition increasing. For example, adopting Sky's approach, it would be appropriate to define a market for all soft drinks (whereas in the Competition Commission's ("**CC**") Cott/Macaw report a separate market was defined for own label carbonated soft drinks[1]) or all eggs (whereas in the CC's Stonegate/Deans report the CC defined a number of separate markets relating to the supply to retailers of each of the three categories of: cage and barn eggs, non-organic free range eggs, and organic eggs; and the supply of all shell eggs to catering and wholesale customers[2]).

4. Similarly, the existence of alternatives does not necessarily have any impact on consumers' valuations of the product or service at issue unless the goods or services are reasonably close substitutes. Moreover, even if the existence of alternatives influences consumers' willingness to pay this is far from determinative - the market definition issue is whether prices and all other dimensions of a hypothetical monopolist's competitive offering are constrained to the competitive (cost) level. To put the point another way, the substantive market definition and market power issue is whether competition from these alternatives is a binding competitive constraint upon pay TV markets, thereby safeguarding consumers' interests by forcing prices down to efficiently incurred costs, ensuring that consumer choice is well served, and promoting competition in innovation and customer service and so on.

5. To support its views as to market definition Sky sets out at Annex 1 of Sky's Response a paper on "The standard economic model of substitutability between pay TV and free to air television services". There are a number of fundamental problems with this Annex, which are most appropriately discussed by describing the model and the conclusions which Sky seeks to derive.

6. Perhaps the first point to note is that Annex 1 of Sky's Response provides no factual evidence as to whether Sky faces binding competitive constraints. Indeed, it contains no facts whatsoever, but is based on a number of unsubstantiated assumptions which are considered below.

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1 See paragraph of 4.51 of Macaw (Holdings) Ltd / Cott Beverages Ltd., CC (2006).

2 See paragraph of 5.15 of Clifford Kent Holdings Limited and Deans Food Group Limited, CC (2007).

7. In brief, Annex 1 simply sets out a very stylised economic model in which a consumer with made up valuations for channels chooses to watch three hours of television a day, and chooses between free-to-air channels and pay TV channels each hour according to whether in each hour the valuation of pay TV is higher or lower than the valuation of the corresponding hour of free-to-air TV. In the first hypothetical example (Table 1) consumers choose to watch two hours of pay TV and one hour of free-to-air TV, based on two of the three hours of pay TV having a higher valuation than the corresponding hours of free-to-air TV. The maximum price the consumer is willing to pay for these two hours of pay TV is the difference between the consumer's valuations of free-to-air TV and pay TV in these hours (which in the made up example amounts to only £7). On the basis of the made up valuations, if free-to-air TV did not exist the consumer would have been prepared to pay for all three hours of pay TV which amounts to £26. On the basis of this made up example, Sky concludes that:

> "*It is clear, therefore, that the existence of free to air channels represents a competitive constraint on the prices that can be charged for pay TV services.*"[3]

8. This hypothetical model and example simply cannot sustain any conclusion as to facts – no hypothetical example can.

9. More generally, this model assumes that the consumer's willingness to pay for pay TV is simply driven by the difference between their relative financial valuations of free-to-air and pay TV. This is an unsubstantiated assertion – consumers' valuation of pay TV may well be largely or entirely unconnected from free-to-air offerings, even if consumers chose to watch one type of channel in preference to another. For example, consumers may choose to drink free tap water or mineral water (and indeed may only drink a certain amount of water during the day), but consumers' willingness to pay for mineral water may well be completely unconstrained by the existence or availability of tap water. (Certainly, the EC Commission had no difficulty in concluding that mineral water was a separate product market from tap water or other non-alcoholic drinks in its Nestlé/Perrier decision[4].) This is an important assumption because the model effectively assumes that free-to-air and pay TV are reasonable substitutes – so that a better free-to-air channel reduces the consumer's willingness to pay for pay TV – but mere assumptions cannot support conclusions.

10. Sky also seeks to argue that the constraint imposed by free-to-air is wholly unconnected to the type of programming actually offered:

> "*Programming on the free to air channel need not be a "close substitute", in the sense of being the same type (or genre) of programming, to that carried on channels in the pay TV service for the free to air channel to be a very effective constraint on the prices that may be charged for the pay TV service. The programming shown in a particular hour on each channel in the examples above might be completely different.*"[5]

11. This outcome is, again, "hardwired" into the model – the model assumes that consumers have no preferences for any type of programming, and their willingness to pay for any hour of pay TV simply depends on a comparison of the made up valuations of pay TV and free-to-air TV in that hour. Conclusions cannot be derived from mere assumptions.

12. In the second hypothetical example (Table 2) there is a second free-to-air channel which offers more appealing programming than the first free-to-air channel during the first hour which is also more appealing than the pay TV channel which the consumer would

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3 See paragraph 2 of Annex 1 to Sky's Response.

4 Official Journal L 356 , 05/12/1992 P. 0001 – 0031, at paragraphs 8-20.

5 See the second bullet point of paragraph 5 of Annex 1 to Sky's Response.

otherwise have watched at this time. On the basis of this model and the made up valuations, the additional channel reduces pay TV viewing by 50 per cent (from two hours to one) and the incremental valuation of pay TV over free-to-air for the hour of pay TV watched is reduced from £7 to £5. On this basis, Sky asserts that:

> "*An improvement in the quality of free to air television services will diminish consumers' willingness to pay for pay TV services. Again, an improvement in the quality of free to air services increases the likelihood that consumers will be able to satisfy an increasing amount of their desired viewing with programming that is free at the point of delivery.*"[6]

13. All this hypothetical example effectively does is change the relative valuation numbers and has exactly the same outcome as changing the made up valuation numbers for one free-to-air channel. If this second free-to-air channel had the same or lower valuations than the first free-to-air channel, it would have no impact at all on the model's results.

14. Finally, Sky seeks to leap from an assumption that consumers' valuation of pay TV channels is directly linked to their additional valuations above free-to-air services to the conclusion "..*that the existence of free to air channels represents a competitive constraint on the prices that can be charged for pay TV services.*"[7] The substantive market definition issue is whether all basic pay TV and premium pay TV services face a <u>binding</u> competitive constraint from free-to-air services, such that there is no scope for a hypothetical monopoly supplier of such pay TV services to exercise any market power. For example, any model making assumptions as to consumers' valuations cannot address whether competition between pay TV operators would lead to significantly lower prices (or other improvements in the quality, range or choice of pay TV services) than the maximum prices consumers would be prepared to pay.

15. The above point may be illustrated by returning briefly to Sky's model. This assumed that the maximum price which consumers were prepared to pay for pay TV was £7 or £5, depending on whether the one or two free-to-air channels were available and based on the made up valuations. However, effective competition between pay TV operators could have delivered the outcome that pay TV prices would have only been £1, such that there would be very substantial scope for a hypothetical monopoly provider of pay TV services to increase prices above the competitive level before being constrained by consumers' willingness to pay. In other words, a possible constraint arising from the maximum which consumers would be willing to pay given the existence of free-to-air, does not imply that pay TV prices are constrained to the efficient competitive level assuming effective competition between pay TV operators. Free-to-air TV may act as some form of constraint on the exercise of further market power by a dominant pay TV operator, but not necessarily to the competitive level – in such circumstances, it would be appropriate to consider free-to-air to be outside the relevant market for the purpose of assessing pre-existing market power.

16. More generally, if a pay TV operator were in fact facing a real competitive constraint from alternatives, it would be expected that any substantive improvements in the quality or prices of these alternatives (or other market shocks) would have a major impact on either the competitive offering of pay TV operators (e.g. forcing price cuts) and/or a major decline in their sales volumes/customer numbers. This is precisely the sort of evidence considered by Ofcom, and it finds no evidence of Freeview having a major impact on Sky.

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[6] See the fourth bullet point of paragraph 5 of Annex 1 to Sky's Response.

[7] See paragraph 2 of Annex 1 to Sky's Response.

ANNEX 2

Example of the potential impact on take up of premium channel packages of an unilateral increase in the price of packages of pay basic channels

The potential impact on take up of premium channel packages of an unilateral increase in the price of packages of pay basic channels is perhaps best illustrated by way of a hypothetical example. Suppose that a 10 per cent price increase for the £21 Sky basics bundle (Sky's most popular basic bundle) leads to a 15 per cent loss of subscribers to this bundle[1], this will reduce Sky's revenues from customers purchasing this bundle by 6.5 per cent (£19.64/£21.00). However, it might be expected that by reducing the additional cost of acquiring either Sky Movies or Sky Sports separately by 10 per cent, and both Sky Sports and Sky Movies by 7.1 per cent, that this would generate some trading up to these bundles. If the amount of the trading up were to equal half of the decline in the additional cost (a low degree of upgrading), then Sky's total revenues would increase as shown below.

	Price	% of customers	Revenue
Revenues from basic before price increase	£21.00	100.0%	**£21.00**
Revenues from basic after price increase			
Revenues from customers purchasing same basic mix	£23.10	85.0%	**£19.64**
Extra revenues from new customers buying movies or sport	£38.00	5.0%	£0.85
Extra revenues from new customers buying movies and sport	£45.00	3.5%	£0.85
			£1.70
Total revenues after price increase			**£21.34**
Change in revenues			£0.34

1 Ofcom's own survey reported that 17 per cent of the consumers surveyed would switch to free to air (a further 10 per cent don't know or would not say), but another stakeholder's analysis indicated "*somewhat lower*" switching rates (see paragraphs 4.104 and 4.107 of Annex 13 of the Consultation).