A SUBMISSION IN RESPONSE TO OFCOM’S BRIEFING FOR ANALYSTS ON 22 SEPTEMBER 2009 REGARDING THE PAY TV MARKET INVESTIGATION

1 Introduction

1.1 On 22 September 2009 Ofcom held a briefing for analysts (the “Briefing”) which included a presentation on Ofcom’s pay TV market investigation and the proposals set out in Ofcom’s third pay TV consultation document (the “Consultation Document”).

1.2 Sky has raised separately with Ofcom its concerns that the Briefing has resulted in misapprehension on the part of analysts regarding Ofcom’s position on the circumstances in which interim relief may be sought and/or obtained from the Competition Appeal Tribunal (“CAT”).

1.3 Both Ofcom’s prepared presentation and its answers to the questions from analysts that followed revealed information which was not apparent from the Consultation Document or from Sky’s previous discussions with Ofcom.

1.4 This submission therefore supplements Sky’s response to the Consultation Document submitted on 18 September 2009 (“Sky’s Response”). It responds to points made by Ofcom in the Briefing which Sky would have addressed in its Response had they been made prior to the deadline for submission and highlights their relevance to arguments made in Sky’s Response.

2 Ofcom’s approach to its investigation

Timing and process

2.1 Notwithstanding that Ofcom had not yet read (or even received) all responses to the Consultation Document, at the Briefing Ofcom communicated an intention to “put out a final statement just this side of Christmas or just the other”.

2.2 Ofcom has therefore created a public expectation as to when it will take the next step in its investigation, and what that next step will be, at a stage when it cannot know whether that expectation can reasonably be met. Sky has already noted, in Section 2 of its Response, that Ofcom appears determined to push ahead with its preferred remedy in a manner which puts its objectives ahead of evidence, and that Ofcom has not subjected the submissions that it received at earlier stages of its process to adequate scrutiny. Ofcom’s most recent statement on process further supports the view that Ofcom has pre-judged the outcome of its consultation.

2.3 Sky has previously expressed concern that Ofcom’s desire to meet self-imposed deadlines in the market investigation has compromised due process. It is of concern, therefore, that Ofcom has again unnecessarily and inappropriately communicated that its next step will be its final one, as well as a target date for

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1 Emails from James Conyers (Sky) to Steve Unger (Ofcom) between 22 and 28 September 2009.
2 Sky has used Ofcom’s transcript of the Briefing (the “Transcript”) as its source.
that final statement. Ofcom has foreclosed the possibility that it might need to conduct a further consultation, which, for the reasons set out below and in Sky’s Response, is inappropriate. It is also leaving itself open to the possibility that it has allowed insufficient time properly to consider all responses to the Consultation Document, including time for any follow-up clarification and/or meetings.

**Ofcom’s position on re-consulting**

2.4 In the Briefing, Ofcom appeared to express the view that if responses to the Consultation Document led it to conclude that there were errors in its modelling and assumptions, Ofcom would not need to consult again provided that, post correction, the proposed regulated charges for Sky’s premium channels that emerged still fell within the ranges of proposed regulated charges on which it has consulted. If this is Ofcom’s view then it is not tenable.

2.5 Ofcom’s Consultation Document stated that its proposed regulated charges were determined by its view that regulated “charges should be set to allow a larger competitor to compete with Sky’s retail prices”. The charges that Ofcom determined as appropriate given such an objective were specified as point estimates, not as ranges. While Ofcom’s Consultation Document included ranges for potential regulated charges, those ranges were the result of different potential objectives for regulation of charges – such as setting charges based on a cost-plus, rather than a retail-minus, approach or setting charges that a ‘small’ retailer could ‘afford’.

2.6 Accordingly, if Ofcom were to:

(a) continue to take the view that the appropriate objective for the determination of charges is to set charges “to allow a larger competitor to compete with Sky’s retail prices”; and

(b) having corrected the errors in its modelling, find that the results were significantly different to the point estimates on which Ofcom has previously consulted in relation to that objective,

it would not be open to Ofcom to argue that it does not then need to re-consult because it “consulted on a range of prices” – because the basis for the “range of prices” was not based on there being a range of estimates for the charges required to allow a large competitor to compete. It would be incumbent on Ofcom in such a situation to consult on whether there were implications arising from its new, significantly different, estimates that needed to be taken into account in its decision-making.

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3 “We did consult on a range of prices as we recognise that this is something that is not certain. We were pretty sure that some of the numbers would change following consultation. Once we have reviewed all the responses, we shall work out where those changes take us but that is why we consult on a range of prices. We weren’t pinning everything at that very first stage on a single right answer, we were giving people the chance to comment on that before we reached some sort of conclusion and hopefully without the need to consult yet again!” (at page 35 of the Transcript).

4 Paragraph 1.65 of the Consultation Document.
Implementation of any wholesale supply obligation

2.7 In the Briefing, Ofcom stated that, if it decided to proceed with its proposals, it “would expect to move swiftly to the implementation of a remedy”.

2.8 Ofcom has apparently ruled out the possibility that, if Ofcom’s decision was the subject of an appeal, Ofcom would itself refrain from implementation until such time as the appeal had been heard; Ofcom has indicated that Sky would need to apply to a Court or Tribunal for a stay in order to prevent implementation.\(^5\) In the situation contemplated, Sky would be contesting a decision on an unquestionably novel and radical (and, Sky would say, extreme) regulatory intervention and arguing that such intervention went beyond the scope of Ofcom’s powers. Moreover, it is accepted by Ofcom that there is no case made against Sky that it has infringed any law. The reasonable position of a regulator in such circumstances would be to hold back from implementation until the matter had been subjected to judicial scrutiny by the appropriate authority. It is particularly troubling for Ofcom to commit itself to pressing ahead with implementation of its proposals irrespective of the circumstances and the representations against them.

2.9 Furthermore, before Ofcom can vary a Broadcasting Act licence, it must (pursuant to section 3(4)(b) of the Broadcasting Act 1990) give the licence holder notice of the proposed variation and a reasonable opportunity to make representations on the proposed changes. Annex 8 of Sky’s Response explains why, contrary to Ofcom’s apparent intention, Ofcom cannot treat its inclusion of the draft licence condition in the Consultation Document as fulfilment of this statutory obligation. The draft condition it is not fit for purpose and does not provide Sky with a reasonable opportunity to make representations. Ofcom’s ‘consultation’ on a licence condition was premature; proper consultation will be possible only after Ofcom has finalised its proposals and developed a proposed licence condition which is properly drafted and which reflects those final proposals. Ofcom therefore needs to factor such further consultation into any timetable for implementation of its proposed new regulation.

2.10 Sky trusts that Ofcom will also take account of comments in Sky’s Response regarding the need for an appropriate transition period in the event that Ofcom

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\(^5\) See pages 37-38 of the Transcript:

“\textit{Ed Richards:} ... There is a way of appealing to try to stop it from ever being implemented at all but that is quite a high threshold. There is another merits-based appeal which could overturn the remedy.

\textit{Matthew Walker:} Your view is basically that, if it is a merits-based appeal, Sky would not be able to get a stay while the appeal took place?

\textit{Ed Richards:} I believe they are different kinds of appeal, but that would be our understanding under Section 316.

\textit{Steve Unger:} There are probably three different questions. One is whether Sky can get into measures which will suspend the decision, and that is not a decision for us but the threshold is high, as Ed says. The second route they have is that they can judicially review the fact that we have used Section 316 and, thirdly, they can take on a merits appeal on the specifics of what we propose to do.”

(Emphasis added).
establishes that it is necessary and proportionate to proceed to implement its proposed new regulatory regime, to enable Sky to take all necessary steps to prepare for implementation of any new licence condition and, similarly, for Sky to be given sufficient time to draw up documentation along the lines envisaged in the draft licence condition.\(^6\)

3. **Ofcom’s recourse to sectoral powers is legally unsound**

**Ofcom’s misapprehension of its principal duty**

3.1 In the Briefing, Ofcom referred no fewer than four times to its “duty to promote competition”. At one point Ed Richards went to some pains to impress the nature of this ‘duty’ upon the audience. He stated:

> “Remember that we have a duty to promote competition, not a passive duty but a duty to promote competition”.\(^7\)

But Ofcom’s principal duty under section 3(1)(b) of the Communications Act 2003 is, in fact, to further the interests of consumers in relevant markets, *where appropriate* by promoting competition – which is crucially different.

3.2 Ofcom’s description of its duty cannot be dismissed as a (misleading) abbreviation; it follows a pattern which runs through Ofcom’s pay TV consultation documents as Ofcom has persistently emphasised the promotion of competition rather than, as ultimately matters, the interests of consumers. This is symptomatic of Ofcom’s skewed and insufficiently holistic focus, which, as Sky argues in its Response, risks underminding consumer benefits and thus harming the very consumer interests that Ofcom is tasked with furthering, in breach of Ofcom’s principal duty.

4. **Sky has an incentive to distribute its channels widely**

4.1 In the Consultation Document Ofcom alleged that Sky has a strategic incentive to restrict the wholesale supply of its premium channels to other retailers.

4.2 The Briefing has provided further support for Sky’s argument, set out in Section 6 of its Response, that Ofcom has mischaracterised Sky’s ‘approach’ to the distribution of its premium channels.

*Strategic incentives to withhold supply*

4.3 Section 6 of Sky’s Response shows that Sky is not acting on alleged incentives to restrict supply of its premium channels. In particular, Sky has made considerable efforts to make its premium channels available on DTT, including via Picnic.

4.4 In the Briefing presentation, Ofcom referred to the discussions which took place between Sky and Ofcom between December 2007 and April 2008 during which

\(^6\) Annex 8 to Sky’s response to the Consultation Document.

\(^7\) Page 28 of the Transcript.
Sky offered commitments to Ofcom in relation to wholesale supply of its premium channels to secure platforms. Ofcom confirmed in the Briefing that those discussions were serious and that, had they had a positive outcome and resulted in approval of Picnic, this would have been “in the consumer interest”. All of this is inconsistent with the Consultation Document’s proposition that Sky has been acting on an incentive to restrict supply of its premium channels via DTT.

4.5 Sky’s Response also rebuts Ofcom’s view that Sky has an incentive to insulate its downstream arm from retail competition with evidence that Sky has offered wholesale deals to new entrants. The wholesaling commitments offered by Sky would also have covered supply to new entrants (and existing retailers expanding their operations).

4.6 Ofcom has now acknowledged, in the Briefing, that the wholesale pricing structure offered by Sky in discussions was designed to incentivise retailers to re-sell Sky channels. This undermines Ofcom’s argument that Sky has (and is acting on) incentives to restrict supply in order somehow to protect the position of its DTH platform and prevent rival retailers from establishing a strong retail presence.

4.7 It is now even clearer than before that Ofcom’s rejection of a constructive offer from Sky has been a significant barrier to availability of Sky’s premium channels via DTT.

**Ofcom’s account of discussions between Sky and Ofcom**

4.8 As set out in Sky’s Response, between December 2007 and April 2008, Sky and Ofcom discussed proposals aimed at ending the stasis caused by Ofcom’s various reviews and investigations. In the Briefing Ofcom misrepresented the position that Sky adopted on pricing in those discussions in relation to wholesale charges for its premium channels. In Ofcom’s words:

“Sky came to us with a pricing proposal but they made it clear to us that the pricing proposal was not for negotiation... pricing... was excluded from the scope of our discussions.”

4.9 [CONFIDENTIAL].

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8 Paragraphs 6.62 et seq. of Sky’s Response.
9 At page 20 of the Transcript:

“[Sky] were willing to consider a set of discounts to that cable rate card relating to platform penetration. That does have the effect for some companies of bringing the price down. There is, however, a potential concern that it would incentivise platform operators to focus on reselling Sky’s content rather than innovating around it.”

Sky notes that the meaning of ‘innovating around Sky’s content’ is wholly unclear. Ofcom has not explained what it means by this phrase, either in the Consultation Document or its Briefing.

10 See paragraph 1.14 of Sky’s Response.
11 Page 20 of the Transcript.
12 [CONFIDENTIAL]
4.10 The discussions ultimately foundered because it became apparent that Ofcom was determined to secure wholesale price cuts which went beyond the significant discounts that Sky had already offered. [CONFIDENTIAL].

4.11 As noted above, Ofcom has acknowledged that it would have been in the consumer interest for Sky’s Picnic proposition to have launched. [CONFIDENTIAL].

4.12 In Ofcom’s account in the Briefing presentation of the discussions between Sky and Ofcom, it adduces a new reason why those discussions ultimately failed, in addition to Ofcom’s desire that Sky reduce wholesale charges for its premium channels. This reason has not previously been communicated to Sky.

4.13 Ofcom now states that a penetration discount scheme of the kind proposed by Sky in its discussions with Ofcom was of potential concern to Ofcom because it “would incentivise platform operators to focus on reselling Sky’s content rather than innovating around it”.13

4.14 The scheme proposed by Sky was intended to address the issue that cable has weaker incentives than Sky to market Sky’s premium channels to its basic subscribers - a principal/agent problem that Ofcom has acknowledged is inherent in a wholesale supply arrangement.14 Ofcom’s ex post reasoning for rejecting the scheme relies on an ill-articulated concern that operators (including cable) would be so incentivised to retail Sky’s channels that ‘innovation around content’ would be compromised. Given Ofcom’s view that Sky is acting on an incentive to protect its retail business from competition from retailers on other platforms, it is surprising that Ofcom would reject a pricing scheme on the basis that it would increase the competitive constraint on Sky’s retail business.

4.15 In particular, in the case of Virgin Media, Ofcom’s reasoning is inconsistent with the proposition put forward in the Consultation Document that Sky is acting on an incentive to inhibit Virgin Media’s effectiveness as a retailer of Sky’s premium channels. Ofcom cannot credibly allege that Sky sets its prices so that Virgin Media does not have an incentive to market Sky’s channels, but then cite a concern that retailers would be over-incentivised to resell Sky’s channels as grounds for rejecting the wholesale pricing structure proposed by Sky.

4.16 Ofcom’s characterisation of the effect of the discount scheme that Sky proposed also adds further weight to Sky’s arguments that:

(a) wholesale prices charged to Virgin Media are not evidence of an incentive to withhold, and that Sky has sought to conclude agreements

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13 Page 20 of the Transcript. Sky notes that this also contradicts the statement on Slide 29 of the Briefing presentation that Ofcom and Sky “disagreed on price, not on the principle of this type of supply arrangement”.

14 Paragraph 3.54 of the Consultation Document.
the effect of which would in fact be to increase cable’s incentives to sell Sky’s channels; and

(b) Sky’s preference for self-retailing its premium channels via third party platforms is legitimate and derives from Sky’s motivation to maximise revenues from its premium channels and does not support Ofcom’s views concerning Sky’s alleged strategic incentive to restrict wholesale supply to other retailers.

4.17 Ofcom’s objection to the penetration discount scheme also supports the argument made by Sky in its Response that the problem of how to incentivise third party retailers of Sky’s premium channels requires a more complex solution than simple wholesale price cuts.

5 Ofcom’s allegations regarding high wholesale prices are unfounded

5.1 When setting out its concerns in relation to Sky’s prices in the Briefing presentation, Ofcom was considerably more measured than in the Consultation Document.

5.2 In the Consultation Document, for example, Ofcom stated:

“our analysis indicates that Sky earns high margins in its pay TV business... and these high margins are particularly concentrated at the wholesale level of the business”;

“we do not consider that ongoing high prices can be justified by Sky’s history of investment”.

5.3 In the Briefing presentation, however, Ofcom referred to only a “potential risk that Sky could set high wholesale prices, and that would feed through into high retail prices for consumers” (emphasis added). Ofcom then described this as “a very complex question” and the evidence as “quite difficult to interpret”. This more tempered position is clearly significant given Ofcom’s reliance in the Consultation Document on its strong conclusions that wholesale prices are ‘high’ to justify its proposals for intrusive price regulation at sharply reduced rates.

6 Ofcom’s proposed price control regime is neither necessary nor proportionate, and does not reflect best regulatory practice

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15 Sky’s past attempts to conclude discount schemes with cable in order to increase the number of premium cable subscribers are described in paragraphs 6.21 to 6.25 of Sky’s Response.

16 Section 6 of Sky’s response to the Consultation Document.

17 Paragraphs 6.115 and 8.41 of Sky’s Response.

18 Paragraph 7.104 of the Consultation Document.

19 Paragraph 7.112 of the Consultation Document.

20 Page 18 of the Transcript.

21 Ibid.
Ofcom’s ‘extended retail-minus’ approach amounts to industrial planning

6.1 In the Briefing presentation, Ofcom set out its reasoning for proposing to set regulated charges on a ‘retail-minus’ basis, rather than a cost-plus basis. Ofcom cited as an advantage of a cost-plus approach that “it does not require a regulator to take a view as to what downstream models of competition it wants to encourage”. Ofcom’s implication was that setting charges on a retail-minus basis requires Ofcom to take such a view (and, by extension, that it has done so).

6.2 Ofcom has demonstrated that, as Sky suggested in its Response was the case, Ofcom does not appreciate the vital distinction between:

(a) the well-established competition-law based approach to retail-minus price control, under which the ‘minus’ is determined according to a vertically integrated operator’s own retail costs, and

(b) Ofcom’s proposed approach (which Sky terms ‘extended retail-minus’ price control), under which the ‘minus’ is instead to be determined using a novel methodology based on Ofcom’s forecasts of the costs and revenues of developing and operating hypothetical new DTT-based pay TV retail businesses.

6.3 If Ofcom was, in fact, proposing a ‘retail-minus’ approach as normally implemented, Ofcom would not need to concern itself with the business models of downstream competitors. It is only because Ofcom proposes to adopt its radical and unprecedented ‘extended retail-minus’ price control that the nature of (actual or potential) downstream operators is an issue at all.

6.4 In its Response, Sky noted that it is impossible to reconcile Ofcom’s claim in the Consultation Document that its objective is that the market should determine which platforms are successful, not the regulator, with Ofcom’s proposals to introduce a profoundly interventionist new regulatory regime with the explicit aim of supporting the development of services deemed desirable by Ofcom. The fact that Ofcom considers it appropriate for it to seek to “encourage” particular “models of competition” (in fact, to seek to support particular types of business) reinforces Sky’s argument that Ofcom is engaged in industrial planning, the many and serious inherent risks of which are set out by both Sky and an independent expert, Professor Cave, in Sky’s Response.

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22 Page 21 of the Transcript.
23 Ofcom also stated, during the Q&A session, that “[w]hen you do a retail-minus model, you inevitably are taking a range of judgments about the types of retail model that you are trying to support” (at page 31 of the Transcript).
24 Paragraph 9.6 of the Response.
25 Paragraph 10.77 et seq.
26 Paragraph 9.56 of the Consultation Document.
Ofcom’s proposal that Sky must reduce wholesale charges to Virgin Media

6.5 The Consultation Document argued that Sky’s wholesale pricing policy has the intention and likely effect of inhibiting the effectiveness of Virgin Media as a competitor to Sky’s DTH service. It is notable, therefore, that when Ofcom outlined its concerns regarding the “restricted distribution” of Sky’s channels in the Briefing presentation, it focussed solely on new platforms and did not mention Virgin Media.

6.6 As Sky has highlighted in Part III of Section 10 of its Response, in the Consultation Document Ofcom failed entirely to demonstrate that its proposal to compel Sky to reduce wholesale charges paid by Virgin Media is legitimate.

6.7 It is significant, therefore, that when specifically asked at the Briefing why Virgin Media should benefit from lower wholesale prices, Ofcom said only that it did not believe that its proposal would give Virgin Media “a sudden massive advantage given where they are at the moment in terms of the incremental profitability that they currently have from Sky’s content”. This is clearly not an answer to the important question that was posed. Ofcom’s evasion exemplifies Sky’s point that Ofcom has provided no cogent justification for Virgin Media gaining the windfall benefit of substantial price cuts.

The effects of Ofcom’s proposals on rights owners

6.8 Sky has argued in the Response that Ofcom has failed to acknowledge or to take seriously the very material adverse effects on incentives to invest in content that would flow from any implementation of its proposed regulatory regime. In particular, Sections 10 and 11 of Sky’s Response set out its view that Ofcom’s consideration of the potential for its proposals to result in reduced payments for programming rights has been inadequate and does not provide a sound basis for Ofcom’s conclusion that its proposed regulatory regime is unlikely to lead to a significant decrease in rights values. In the Briefing presentation, Ofcom demonstrated that its analysis of this issue remains unsound, despite recent public confirmation that the bidding incentives of at least one important potential bidder have been affected even by Ofcom’s investigation (see below).

6.9 Ofcom was keen to emphasise, in its presentation, that it was important that its proposals should not be disruptive for rights owners and the continued generation of content. It expressed the same sentiments in the Consultation Document.

6.10 When discussing a cost-plus approach to setting wholesale prices in its presentation, Ofcom correctly recognised that there is a clear link between the price at which a potential bidder is able to acquire channels at a wholesale level and its incentives to bid for rights to programming that is included in those channels. Yet Ofcom fails to appreciate that setting prices on a retail-minus basis also affects bidding incentives, instead suggesting that the adoption of a

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27 Page 31 of the Transcript.
28 Page 19 of the Transcript.
retail-minus approach avoids “a major change in the incentives faced by bidders”. 29

6.11 As in the Consultation Document, Ofcom included a cursory assessment in its presentation of the risk that its proposals would significantly affect the bidding incentives of firms such as BT and Virgin Media. Whilst acknowledging that having “an alternative means of accessing premium content” 30 might mean that such firms would be less interested in bidding for rights themselves, Ofcom discounted this risk for the same flimsy reasons that it gave in the Consultation Document.

6.12 Sky has argued in its Response that the mere fact that, going forward, current potential bidders will benefit from compulsory supply of Sky’s channels, risk free at low prices, cannot but have a significant impact on incentives to bid for content rights. Ofcom’s proposals would reduce the returns sporting bodies earn from the licensing of rights to televise their sports, with profoundly damaging consequences for investment in British sport, for example. Ofcom’s position continues not only to fly in the face of logic but also ignores representations made to it by a significant rights owner: in stark contrast to Ofcom’s confidence that rights revenues would not be affected, the Premier League has voiced serious concerns that Ofcom’s proposals would distort the upstream content rights market, resulting in a diminution in the value of its rights which would have an adverse effect on football as a whole. 31

6.13 The argument that the bidding incentives of firms such as BT and Virgin Media would be fundamentally affected cannot be dismissed as simply as a theoretical proposition. Since publication of the Consultation Document the reality of this view has been confirmed by Virgin Media’s CEO when discussing with investors the implications of the Consultation Document (as Sky has pointed out in its Response 32).

6.14 Ofcom’s dogged adherence to its position in the face of such evidence and representations is symptomatic of Ofcom’s skewed approach. It is another example of Ofcom reaching a perverse view, apparently because it is set on a particular end point.

7 Ofcom’s impact assessment is wholly inadequate

7.1 In the Briefing, Ofcom made the following remark on the subject of the impact assessment in relation to its proposed regulation in the Consultation Document:

“those of you who have actually read the document will know that there is a very thorough impact assessment indeed”. 33

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29 Ibid.
30 Ibid.
31 In the Premier League’s response to Ofcom’s second pay TV consultation document.
32 Paragraphs 1.65 and 11.68 of Sky’s Response.
33 Page 30 of the Transcript.
In fact, nothing could be further from reality. As set out in some detail in Section 11 of Sky's Response, Ofcom's impact assessment is not "thorough"; it is cursory to such an extent that it fails to meet Ofcom's legal duty to undertake an impact assessment.

To the limited extent that Ofcom has undertaken analysis of the impact of its proposals, that analysis is (among other things):

(a) based on a fundamentally flawed counterfactual that Sky's premium channels would never become available via DTT absent the introduction of Ofcom's intrusive new regulatory regime. In fact, it is clear that, absent Ofcom's current intervention, Sky's premium channels would be likely already to be available via DTT; and

(b) not supported by adequate evidence in relation to key input values and assumptions.

Ofcom's remark is all the more surprising in view of the fact that the standards which its impact assessments must meet were considered in an appeal to the CAT only last year. The CAT's judgment in that case - the Vodafone case - set out clear criteria which Ofcom's impact assessments must meet, and found that the impact assessment undertaken by Ofcom in that case was inadequate. Ofcom's impact assessment in the present case manifestly fails to meet those criteria.

Vodafone Ltd v Office of Communications [2008].