1 Introduction

1.1 Since 18 September 2009, when Sky submitted its response (“Sky’s Response”) to Ofcom’s third pay TV consultation document (the “Consultation Document”), new information has been obtained, and new matters have arisen, which are relevant to the submissions made in Sky’s Response.

1.2 This submission, which supplements Sky’s Response, identifies that information and those matters and explains their relevance to the submissions made in Sky’s Response (following the order in which those submissions were made in Sky’s Response).

2 Ofcom’s recourse to sectoral powers is legally unsound (Section 3 of Sky’s Response)

2.1 At paragraph 3.17 of Sky’s Response, Sky noted that, on 20 June 2005, a Senior Ofcom Project Team had recommended to Ofcom’s Policy Executive a “test for action under s.316”, namely that it should be imposed only “on firms which materially affect competition.”

2.2 On 12 October 2009 (after the submission of Sky’s Response), in response to a request under the Freedom of Information Act 2000 (“the FOI”), Ofcom provided to Sky a redacted copy of Policy Executive Note 23(05) headed “Note and Action Points from the Policy Executive Meeting held on Monday, 20 June 2005.” The third bullet point of this Note reads as follows:

“PE agreed that a standard competition based approach was appropriate and noted the circumstances in which the team considered it appropriate to consider using the s.316 powers. It was noted that the team recognised the potential for conflict of the approach with conditions imposed for reasons other than competition (eg public purposes) but that transparency in terms of the approach was key in this. However, the following comments and issues made/raised by PE Members were noted:

- [redacted s.42]

- That there was some concern that s.316 should not be used instead of the Enterprise Act where action under that legislation might be appropriate. PE noted the team’s view that, as the Enterprise Act was such a relatively untried tool, s.316 could be used ex-ante, leaving Ofcom with discretion about whether to take ex-post action under the Enterprise Act. Some PE Members were concerned, nevertheless, that to take action ex-ante, without the checks and balances of the Enterprise Act could be irrational and disproportionate.”
2.3 Thus, consistent with Sky’s submissions in paragraphs 3.12 to 3.33 of Sky’s Response and in contrast to Ofcom’s position as expressed in the Consultation Document, Ofcom’s Policy Executive agreed that (i) a standard competition based approach should be used when considering the use by Ofcom of its s.316 powers, and (ii) (at least in the case of some members of Ofcom’s Policy Executive) to take action ex-ante under s. 316 without checks and balances could be irrational and disproportionate.

2.4 The Note concludes that:

“PE agreed that the proposed approach should be discussed with the Board but that it would be helpful if the Board Paper could: (i) place more emphasis on the evidential threshold point above1; (ii) mention concerns about the relationship with the Enterprise Act; and (iii) include the team’s thinking about where Ofcom might want to invoke s.316 in future. (NB: it has been added as an agenda item for the Board meeting in 12 July).”

2.5 Despite this reference to the “proposed approach” agreed upon by Ofcom’s Policy Executive being raised as an agenda item for Ofcom’s Board meeting on 12 July 2005, it would appear that the matter was not in fact raised at that Board meeting. This is a subject on which Sky has raised further requests under the FOI, and Sky reserves the right to make further submissions in light of any further information becoming available as a result of such requests.

3 Ofcom’s analysis of Sky’s historic aggregate profitability (Section 4 of Sky’s Response)

3.1 At paragraphs 4.53 to 4.56 of Sky’s Response, Sky noted that it is evident from the Consultation Document that, at least in its Pay TV investigation, Ofcom has failed to appreciate the important distinction between excess returns and excessive returns.

3.2 In contrast, Sky notes the following paragraphs from Ofcom’s PPC determination, published on 14 October 2009 (after the submission of Sky’s Response):

“A11.43 The existence of returns in excess of the cost of capital in markets where a charge control is in operation therefore is consistent with the charge control operating correctly, rather than necessarily being symptomatic of a problem...

A11.44 The role of cost orientation in such circumstances is therefore not to deny the incumbent firm any opportunity to earn returns in excess of its cost of capital, but rather to restrict its ability to attempt to stifle competition or otherwise act to the detriment of consumers by setting

1 Sky assumes that the “evidential threshold point above” is included in the part of the Note marked “[redacted s.42]”. There is no reference to an evidential threshold point elsewhere in the Note.
prices at anti-competitive or excessive levels.” (Emphasis added).

3.3 In this context, Sky again draws Ofcom’s attention to Ofcom’s statement at paragraph 8.17 of the Consultation Document that it does not consider that the evidence is sufficient for an excessive pricing case under the Competition Act 1998.

4 Analysis of competition at the retail level (Section 5 of Sky’s Response)

The Competition Commission’s Report into the Purchase by Sky of a stake in ITV

4.1 At paragraph 5.56 to 5.60 of Sky’s Response, Sky noted Ofcom’s failure to have due regard to the Competition Commission’s Report into the purchase by Sky of a stake in ITV.

4.2 Sky notes that the transcript of the first day of the Court of Appeal hearing of the appeals by Sky and Virgin Media in relation to the Competition Commission’s Report (29 October 2009) contains the following submission from the Competition Commission’s counsel, John Swift QC, with reference to that Report

“Then at 16 is an absolutely key finding. This is a summary:

“We found that FTA services posed a constraint to BSkyB’s prices and that the BBC and ITV were both key to the strength of the FTA offer. Channel 4 and Five also made a significant contribution. BSkyB’s business model relied on the ability to persuade consumers to pay for the content available in its packages, rather than opt for freely-available services. We concluded that, given the competitive constraint of the FTA offer on BSkyB’s services, and the importance of ITV within the FTA offer, BSkyB would have the incentive to influence ITV’s strategy in such a way as to minimise the constraint it offered to BSkyB. We did not find that entry or expansion would be likely to constrain the parties and hence mitigate BSkyB’s incentive to influence ITV’s strategy.”

So here we have – and this, of course, is a concluding statement – a clear finding that within [the all] TV market Free to Air is head on in competition with Sky. We take that as a fact, a finding by the Commission not challenged at the Tribunal and one of considerable
importance in considering how and why the Commission reached its decision in respect of the finding of SLC and the appropriate remedies.”

(Emphasis added)

4.3 Thus, the Competition Commission submitted to the Court of Appeal that it is a “fact” that free to air services are “head on in competition with Sky”, and that free to air services constrain Sky’s prices. Neither of these propositions is consistent with Ofcom’s analysis and findings in the Consultation Document.

Public Statements

4.4 At paragraph 5.62 of Sky’s Response, Sky noted that Ofcom has, in its analysis of competition in the Consultation Document, made little use of public statements by industry players about matters of direct relevance to their business, which are normally favoured as a source of evidence in analyses of competition among firms.

4.5 In an investor conference on 9 December 2009, the Chief Financial Officer of Virgin Media responded as follows to a question about Virgin Media’s long term content strategy:

“The dynamics in the UK around content versus distribution are very different than the U.S. We have a lot of very different features in our marketplace compared to the U.S. First of all, our regulatory environment is very, very different. Our regulator is very – quite intent to making sure that content is available at economic rates to all consumers in the UK so that’s kind of a good thing. We also have a thing called public service broadcasting in the UK, which to all of you would be better known as the BBC. That is an enterprise that gets somewhere around £120 from every household in Britain per annum, which adds up to about £4 billion, and they produce content and actually distribute it free. That’s a very unique feature compared to for example the U.S. market.

And that plays into the whole content distribution issue in a very, very important way, because at the BBC with its high quality content is intent on giving that content away for free, and not just free to air but actually Over-the-Top. It does kind of undermine somewhat the content orientated pay-TV business model. And that is a significant threat for people that actually are leveraging content in terms of pay subscribers. So there are a number of unique features in the UK that make the content distribution conversation a little bit different than perhaps in the US”.

4.6 Virgin Media’s Chief Financial Officer expanded on these comments as follows in response to a later question:

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2 Sky notes also that, in its judgment, the Court of Appeal described Sky and ITV as “significant competitors”.
“Well, in lots of ways where our business model is, which is gravitating towards the distribution model, which is really where our advantage is because we have a big fat pipe going into half the homes in Britain. And that gives us a big advantage around the distribution piece.

The other players are having the satellite data in, or they are having to come over the copper wire, which is sort of the established incumbent BT network. So if you think about it that way, the Over-the-Top – the content Over-the-Top kind of plays into our sweet spot a little bit, because if you look at our business – and it is a little bit different to Sky’s – we make a lot of our money on broadband and on fixed telephony and obviously mobile and B2B, and yes, we make a little bit of money on sort of people paying for television.

Sky is kind of the other way; there is a lot of content, and people paying a lot of money for that and that’s where they make all their money, which is on the content side, since their vertical integration. We have to buy the content predominately. And we don’t get into particularly fab rates, one of the participants actually mentioned earlier. So I think Over-the-Top video kind of puts the – the people with the advantaged platform and the advantaged distribution network at a slight advantage versus other players. So it’s not that we’re complacent about that, but we’re certainly in a slightly better place than the people who have content as a big, big part of their business model.”

4.7 These comments, in particular as regards the competitive constraints on pay TV operators imposed by the BBC and Virgin Media’s perceived long term competitive advantage as a distributor, are entirely at odds with Ofcom’s analysis of competitive dynamics in the Consultation Document, and indeed with Virgin Media’s submissions to Ofcom in the course of Ofcom’s Pay TV investigation.

5 Sky has an incentive to distribute its channels widely (Section 6 of Sky’s Response)

5.1 At paragraph 6.107 of Sky’s Response, Sky noted that Ofcom suggests in the Consultation Document that Sky has set its wholesale prices so as to ensure that Virgin Media does not have an incentive to market Sky’s channels, and, as a result, over time customers with an interest in Sky’s channels are more likely to choose DTH satellite.

5.2 At paragraphs 6.108 to 6.116 of Sky’s Response Sky explained why this proposition is not sustainable. Sky would now also draw attention to the following statement by Virgin Media’s Chief Executive in announcing “Strong 3Q results” on 29 October 2009 (after the submission of Sky’s Response):

“Our focus remains on attracting high value customers, who buy more from us and stay with us longer.”

5.3 It is evident, therefore, that Virgin Media does not consider that Sky’s wholesale prices have acted as a deterrent to a strategy focused on attracting “high value
customers, who buy more from us.” Moreover, this statement also indicates that Virgin Media in fact has stronger incentives to market Sky’s premium channels to current or prospective customers than are recognised by Ofcom in the Consultation Document, because it is Virgin Media’s view that “high value customers, who buy more from us...stay with us longer.”

5.4 That is not to say that Virgin Media does not have the incentive opportunistically to lobby Ofcom to reduce its input costs through the unwarranted imposition of wholesale price regulation on Sky. Virgin Media regularly updates investors and analysts of its perceived success in pursuing such a strategy.

5.5 As noted at paragraph 1.65 of Sky’s Response, in a conference call with investors in August 2009, Virgin Media’s Chief Executive stated (with reference to the Consultation Document) that:

“Given our recent success, our decision to focus our attention and resources on the regulatory debate rather than competing head on and acquiring premium content is proving to be the right one.”

5.6 In a similar vein, Virgin Media’s Chief Financial Officer, in response to a question regarding Ofcom’s pay TV investigation at an investor conference on 9 December 2009 stated:

“In terms of regulatory review, we have a particular view on that, which is completely different to Sky. The good news is that the regulator kind of agrees with our view. Other than that, we’re very happy to just let the regulatory process take its course and play out. We expect a favourable outcome, but the timing of that and exactly what it’s going to be – that’s up for speculation.”

6 Ofcom’s allegations regarding high wholesale prices are unfounded (Section 7 of Sky’s Response)

6.1 At paragraphs 7.105 to 7.115 of Sky’s Response, Sky addressed Ofcom’s argument in the Consultation Document 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.

6.2 The statement of Virgin Media’s Chief Executive cited at paragraph 5.2 above is also pertinent to this argument. It is evident that Virgin Media has not been deterred by Sky’s wholesale pricing policy from pursuing what it considers to be a successful competitive retailing strategy.

6.3 Moreover, further statements made by Virgin Media also demonstrate that Virgin Media considers that it offers a compelling differentiated consumer proposition whose success does not depend in any way on Sky’s wholesale pricing policy.

6.4 For example, in announcing “Strong 3Q results” on 29 October 2009, Virgin Media’s Chief Executive stated that:
“I am pleased to report that this quarter’s results delivered a strong OCF performance. I believe this demonstrates the success we have had in significantly differentiating and monetizing our compelling consumer proposition.”

6.5 In a similar vein, in announcing Virgin Media’s agreement with TiVo on 25 November 2009, Virgin Media’s Chief Executive stated that:

“The superiority of our fibre optic network combined with TiVo’s capabilities, will allow us to offer consumers the most significantly advanced and compelling TV service available in the UK, and we believe will do to the TV market\(^3\) what Virgin Media has done to the high speed broadband market.”

6.6 Finally, Sky refers again to the comments of Virgin Media’s Chief Financial Officer cited at paragraph 4.6 above. Despite describing Sky’s wholesale charges as not “particularly fab”, he confirmed that Virgin Media in fact makes “a little bit of money on sort of people paying for television” (albeit less than the amount Virgin Media makes from broadband, fixed telephony, mobile and B2B), and cites this revenue split as a source of long-term competitive advantage over Sky.

6.7 Each of these statements entirely contradicts the proposition that material distortions to the competitive process arise from Sky’s wholesale pricing policy, justifying the introduction of intrusive regulation of that policy.

7 Consumer effects do not justify Ofcom’s intervention (Section 8 of Sky’s Response)

7.1 At paragraphs 8.22 to 8.66 of Sky’s Response, Sky addressed Ofcom’s argument in the Consultation Document that lack of access to Sky’s premium channels will make it much less likely that there will be substantial innovation on new platforms.

7.2 On 22 December 2009, the BBC Trust published its provisional conclusions in relation to “Project Canvas”. In its “Public Value Assessment” the BBC Trust found that:

“The PVA identifies clear value accruing from BBC involvement, both to individual licence fee payers and society more broadly. Canvas responds to consumer demand for greater choice and brings with it the benefits of industry collaboration. The proposals fit with the further delivery of the public purposes and wider BBC strategy. They represent a logical and necessary step in the evolution of DTT, underpinned by a commitment to preserve the principles of universal, free to air access to BBC content\(^4\)...
Canvas helps to sustain the DTT platform by enriching the range of content and services available on the platform without recourse to a pay television package... By evolving the capabilities of DTT, Canvas will enhance the free-to-air offer, helping to ensure parity with alternative platforms and delivering the benefits of greater choice.

7.3 None of these stated benefits in any way depend upon access to Sky’s premium channels via Canvas being secured, let alone such access being on a mandatory wholesale basis on regulated terms. On the contrary, the BBC Trust is proposing to make it a condition of the BBC’s participation in Canvas that there should always be an ability to access the Canvas platform on a subscription-free basis.

7.4 In a similar vein, the BBC Trust’s Market Impact Assessment in relation to Canvas makes no finding that the prospects of Canvas depend upon access to Sky’s premium channels. On the contrary, it is a “key finding” that:

“Although Canvas, like Freeview, will be mainly complementary to the offerings of pay-TV platform operators using delivery methods other than DTT, Value Partners’ modelling suggests that the competitive pressure of Canvas may have a specific negative impact on those platform operators, including Sky and Virgin. For Sky and Virgin the base case impact has been estimated at a combined £127 million - £470 million loss in revenue for the period to 2015. However, this does not take account of the potential response to Canvas of Sky and Virgin which may engage in more aggressive marketing of their products. In addition, the net impact on Sky is unclear: Sky should be able to profitably distribute its content over the DTT platform via Canvas if it wishes to do so.”

7.5 This analysis – that the competitive pressure imposed by Canvas has the potential negatively to impact pay TV retailers, which would require them to respond competitively – is entirely inconsistent both with Ofcom’s analysis of retail competition in the Consultation Document and with Ofcom’s argument in the Consultation Document that the development of new platforms depends upon regulated wholesale access to Sky’s premium channels.

8 Ofcom’s proposed price control regime is neither necessary nor proportionate, and does not reflect best regulatory practice (Section 10 of Sky’s Response)

Requirement of proportionality

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5 Paragraph 4.6, ibid.
6 Paragraph 4.8 ibid.
7 Paragraph 7.6, ibid.
8 It is noteworthy that this sentence assumes that Sky is able to retail its services direct to consumers via Canvas under proposed conditions ensuring platform access for all content providers, without discrimination. In the Consultation Document, Ofcom has expressed concerns with situations where Sky is the retailer of its premium channels on third party platforms (Sky refers to paragraphs 6.122 to 6.142 of Sky’s Response in this regard).
9 Paragraph 2.36 “BBC Trust- Canvas Market Impact Assessment”
At paragraph 9.7 of Sky’s Response, Sky noted Ofcom’s obligation under Section 3(3)(a) Communications Act 2003 to have regard to the principles under which its regulatory activities should be, among other things, proportionate. Sky also noted at paragraph 9.10 of Sky’s Response the CAT’s judgment in Tesco v. Competition Commission, in which the CAT summarised the principles underlying the concept of proportionality.

The CAT’s subsequent judgment (handed down on 16 October 2009) in Barclays Bank PLC v. Competition Commission is also pertinent to Ofcom’s obligation to act proportionately in its consideration of proposed “remedies” in its pay TV investigation. In the Barclays Bank PLC case, the CAT concluded that the Competition Commission had failed to take into account a relevant consideration (detriments flowing from loss of convenience) in assessing whether it was proportionate to include a point of sale prohibition in its proposed remedies package. The relevant part of the Competition Commission’s report was therefore quashed.

Sky would draw particular attention to paragraph 128 of the CAT’s judgment in the Barclays Bank PLC case:

“In our view, the starting point is that the POSP is (as is common ground) a remedy without precedent, designed to bring about a radical re-structuring of the PPI market, by prohibiting the method by which, to date, most PPI sales have been made. The potential for such a radical remedy to cause disadvantageous side effects called for rigorous investigation and analysis of its potentially adverse consequences.”

Sky submits that Ofcom’s proposed “wholesale must-offer remedy” is also a remedy without precedent designed to bring about a radical re-structuring of pay TV retailing. As in the Barclays Bank PLC case, the potential for such a radical remedy to cause disadvantageous side effects call for rigorous investigation and analysis of its potentially adverse consequences. For the reasons detailed in Sections 9, 10 and 11 of Sky’s Response, as well as in the independent expert report of Professor Martin Cave submitted with Sky’s Response, Ofcom has failed, in the Consultation Document, to investigate and analyse the potentially adverse consequences of its proposed “wholesale must-offer remedy” to this standard.

Ofcom’s argument that extended retail-minus price control is needed to support the development of pay TV retailers of a type that it judges to be appropriate

At paragraphs 10.8 to 10.23 of Sky’s Response, Sky addressed Ofcom’s argument in the Consultation Document that a reduction to Sky’s current wholesale charges is necessary in order to facilitate the development of new DTT based TV services. As set out at paragraph 9.8 of the Consultation Document, Ofcom proposed that:

“retail-minus prices should be set to allow a larger competitor (for example, reaching three million subscribers after 10 years) to compete with Sky’s retail prices, incorporating an allowance for DTT transmission costs and a reasonable return on investment.”
8.6 Ofcom’s objective, as set out in the Consultation Document, was:

“to consider what wholesale prices would enable a DTT-based retailer to operate a viable business.”\textsuperscript{10}

8.7 The apparent rationale for Ofcom’s position was that, if a new retailer of Sky’s premium channels charged the same retail price for Sky’s premium channels as that charged by Sky, the margin between that price and the wholesale prices currently charged by Sky to Virgin Media would be insufficient for that new retailer to be viable over the long term. Accordingly, Sky’s wholesale prices needed to be reduced to a level which would ensure such viability.

8.8 Underpinning this analysis was the assumption that, at least in the short term, new retailers of Sky’s premium channels would charge retail prices which would be “closely linked to Sky’s current prices.”\textsuperscript{11}

8.9 On this basis, Ofcom consulted on a range of wholesale prices for Sky Sports 1 representing a reduction of between £2.24 and £4.07 (ex VAT) to the then prevailing wholesale price for Sky Sports 1.

8.10 An article in the \textit{Sunday Telegraph} on 17 January 2010, reporting on an interview with the Chief Executive of BT Retail, Gavin Patterson, included the following paragraphs:

“In September [sic], Ofcom said the average wholesale price of Sky’s premium content could fall to between £14.55 and £18.55 a month, compared with £20.72 at present.

Patterson says that if the decision goes BT’s way it will offer Sky Sports packages to its customers “somewhere in the mid teens”, a massive discount compared to the minimum £25.50 Sky charges its customers for Sky Sports 1 and the £34.50 it charges for Sky Sports 1, 2, 3 and 4...

Patterson denies that making Sky Sports available on BT Vision for as little as £15 would be a “loss leader”. “We need to make a fair return for our shareholders as well,” he says. “But I do want to make it available for a very good price.”

8.11 These clear statements of intent have two very important implications for Ofcom’s proposals as set out in the Consultation Document.

8.12 First, if it is the case that BT Vision can make a “fair return” by offering Sky Sports 1 to customers for £10.50 (£8.94 ex VAT) less than Sky in circumstances in which the wholesale price for Sky Sports 1 is reduced by a maximum of £4.07, then it must also be the case that BT Vision could viably pay Sky’s prevailing wholesale price for Sky Sports 1 and still have the ability to offer retail prices either “closely linked to” or significantly lower than Sky’s. Thus, Ofcom’s stated objective in the Consultation Document could be achieved without any reduction to Sky’s prevailing wholesale prices.

\textsuperscript{10} Paragraph 9.135 of the Consultation Document.

\textsuperscript{11} Paragraph 10.55 of the Consultation Document.
8.13 Second, Ofcom’s quantitative analysis of the impact of its proposals in its Third Consultation Document was explicitly carried out on the assumption that the retail prices offered by new retailers of Sky’s premium channels would be “closely linked to” Sky’s. It is now clear that, at least in the case of BT Vision, this assumption was incorrect. Ofcom has relied on its quantitative analysis in support of the proposition that its proposals are unlikely to have a detrimental impact on Sky. On the basis of Ofcom’s incorrect assumption alone, Ofcom cannot now continue to do so.

Ofcom’s proposal that Sky must reduce wholesale charges to Virgin Media

8.14 As Sky has highlighted in Part III of Section 10 of Sky’s 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.12

8.15 Sky’s submissions at sections 5 and 6 of this submission reinforce the point that there is no legitimate basis upon which Ofcom could seek to require Sky to reduce wholesale charges paid by Virgin Media.

8.16 Sky notes also the following response by Virgin Media’s Chief Financial Officer to a question at an investor conference on 9 December 2009 regarding how Virgin Media would respond if, through its lobbying of Ofcom, it secured a reduction to the wholesale prices charged by Sky:

“Well, I’m not going to sit here and speculate exactly what our commercial strategy is going to be. I think if Ofcom does actually move Sky’s premium content ratecard down by 10, 20, 30% that’s only going to be good news for Virgin Media subscribers.”

8.17 While this response is notably circumspect (itself telling as to the necessity of a wholesale price cut for Virgin Media), it is perhaps indicative of an inclination on Virgin Media’s part to pass any wholesale price cuts on to its customers. As noted by Sky at paragraph 7.114 of Sky’s Response, were Virgin Media to respond to Ofcom’s proposed remedy in this way, the remedy would be likely to distort competition by handing to Virgin Media a unique ability to pass on its existing lower retail costs or any future savings in retail costs on to consumers.

8.18 As also noted at paragraph 7.115 of Sky’s Response, if Virgin Media instead uses any wholesale price cut to increase its margins, Ofcom’s own analysis indicates that the principal effect of that price cut would (under Ofcom’s “scenario 4” pricing) be simply a transfer of value from Sky to Virgin Media of £110 million over four years, without any commensurate increase in consumer welfare.

Sky

January 2010

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12 Sky also refers Ofcom to paragraphs 6.5 to 6.7 of its November 2009 submission on this subject.