On August 6, BT, Setanta Sport, Top Up TV and Virgin Media (“the Complainants”) filed a “Joint Response to Sky’s submission to Ofcom of April 2008” (“the Complainants’ Response”). At Section 3, the document mentions a number of alleged “deficiencies” in Sky’s arguments on “refusal to supply downstream competitors”. Here, the document focuses mainly on a critique of the analysis of Sky’s incentives to foreclose in a CRA paper of April 2008 (attached to Sky’s Response). At Section 5, the document also criticises our references to the Microsoft case as disclosing a “wilful blindness” to a number of factors.\(^1\) In a further report dated 2 July 2008 (“the July CRA Report”), we have addressed all criticisms of our analysis put forward separately by LECG and NERA. We stand by the July CRA report, where we believe we carefully considered the observations made by the Complainants’ economists and explained why they are flawed, and in any event do not change our conclusions. Our comments below will therefore be brief, and address only the major points where the Complainants’ Response systematically fails to engage with our arguments and egregiously misrepresents our position.

1. Harbord and Ottaviani

1. We certainly do not regard the paper by Harbord and Ottaviani – or any paper for that matter – as a bearer of “universal truth” as charged by the Complainants (para. 3.7). However, we believe models have an important role as simplified views of reality that nonetheless highlight useful and important economic mechanisms at play. For example we do not take Harbord and Ottaviani’s conclusion that there would always be resale of content literally. In fact we argue that, in practice, firms are unlikely to “neutralise” downstream competition perfectly. An upstream content holder might then be expected not to license to all downstream firms if downstream competition is particularly “fierce” (or “strong” if this term accords better with the Complainants’ sensitivities). This is why one should not necessarily expect to observe resale/non-exclusive licensing within platform. In a similar vein, we have explained that in practice very small advantages

\(^1\) We note in this context that in its separate submission of August 6, BT criticises Sky’s response to the consultation document for making “tangential arguments about dynamic foreclosure and the Microsoft case”. It is therefore unclear whether the Complainants consider dynamic foreclosure arguments to be relevant or irrelevant to their case.
downstream (especially those that are not of the toe-hold sort investigated in the *Manchester United* case) are unlikely to translate into large advantages in bidding upstream. In that case, it is in fact the Complainants who seem to take economic models a little bit too literally.

2. The Complainants’ claim that we attach much weight to the analysis of Harbord and Ottaviani (para. 3.16) is another example of their peculiar attitude towards modelling. As we made abundantly clear, our reference to Harbord and Ottaviani was simply to illustrate the well-known point that, with flexible enough downstream contracts, *static* downstream foreclosure (in the sense of refusing to sell) is unlikely to occur. We chose to refer to Harbord and Ottaviani because it is one of the more recent papers (re)stating this point and because it has the added attraction of couching the discussion in terms of the TV market. As mentioned by Harbord and Ottaviani themselves (Section 6, “Relation to the Licensing Literature”), the basic point has been made many times before. In other words, it is not the Harbord and Ottaviani paper – or the precise model that it contains – that we “attach weight” to. What we care about is the long-established and well-understood underlying economic mechanism that the first part of the paper (re)explains. To us at least, this seems like a completely proper use of the existing literature.

3. The Complainants claim we are effectively arguing “that it is acceptable for Sky to charge as high a wholesale per-scriber (sic) fee as it sees fit so as to reduce, if not eliminate, effective retail competition when licensing its content to a competing retailer.” (Para 3.8) This is a caricature. We are not arguing that this is “acceptable” and we are not saying that this is what Sky *does*. What we are saying is that this is what a vertically integrated firm having a monopoly over content upstream would rationally do. Moreover – and this is the crucial aspect – this is also exactly what a *non-integrated* firm with monopoly over content would do. So it is not vertical integration that matters: if there is monopoly power over content upstream then – absent regulation – this monopoly power will get exploited. If one does not like this then one could consider restraining the monopoly power upstream – but (as discussed further below) this will decrease the rewards to content creator.

4. Overall, it is hard to see what the Complainants’ comments at paragraphs 3.7 and 3.8 are based on. First, we have explained very clearly that the incentive to sell to multiple downstream firms in Harbord and Ottaviani is rooted in the ability to soften downstream competition. Secondly, we have never said or implied that such an outcome enhances consumer welfare. That is a separate question to the one on which we focused. The whole point of our argument has always been that such an outcome is not the result of vertical integration. Whether desirable or not, the same outcome would arise if the firm in control of the rights was not vertically integrated. Thirdly, it is misleading of the Complainants to attribute to us some nefarious intent by using phrases such as “softening” competition, or that competition is “fierce” or “harsh”. These are all standard terms in the economics profession.

5. Further, Harbord and Ottaviani’s own conclusion as to the welfare effect of allowing resale with unit fees is more nuanced than one would gather from the Complainants’ own presentation of the material:
“...some consumers are worse off than in the case of no resale, when some of them are deprived of premium programming. In aggregate, consumers would prefer a ban on resale contracts, even though this would typically reduce social welfare” (Harbord- Ottaviani, July 2001, p. 3, emphasis added)

6. The Complainants also imply that if we believe Harbord and Ottaviani’s analysis, then we must also agree with their policy recommendation. In particular, we are asked to agree with the conclusion that a bar on exclusive sales of content would be desirable. Even ignoring the fact that one can very well agree with part of an economic paper and disagree with the rest (as shown by a large proportion of academic referee reports), there is a profound misunderstanding of what the Harbord and Ottaviani paper “is about” and hence of what lessons one should legitimately take away from it.

7. Harbord and Ottaviani make essentially two contributions to the literature. Armstrong (1999) previously showed that, if resale can only be made for a fixed fee, then resale is not profitable. The first contribution of Harbord and Ottaviani is to show that this result no longer holds once per unit fees are allowed. As discussed below, this contribution just “imports” into the “media” literature something that had been known for a long time in the licensing literature. The second contribution of Harbord and Ottaviani is to show that vertical integration between broadcasting and retail is not actually the source of any potential inefficiencies. What transpires from Harbord and Ottaviani’s analysis is that, as recognised in Ofcom’s own report, the issue is the monopoly power of the upstream producers of content. We agree with this assessment. If one actually wants to reduce any adverse consequences of any such monopoly power, one might consider putting restrictions on how the rights are sold in the first place.

8. This, however, is very dangerous territory. As Harbord and Ottaviani show, any restriction that would lead to greater consumer surplus downstream means lower revenues for the original producers of content. A large portion of important content is protected by intellectual property rights. The economic logic of intellectual property right protection is that it imparts temporary rights of exclusivity as a “reward” for the development of the innovation or content. This reward is thought to be necessary to ensure socially sufficient incentives to invest in innovation/content. Because of this, competition policy has been very reluctant to constrain ex post the exercise of exclusive rights promised ex ante. In practice, such limits have only been imposed in specific cases in three broad categories. First, when there were significant issues of interoperability (e.g. Microsoft, which we have discussed extensively and return to below); second, when the intellectual property was seen as an essential facility and the IP holder was also involved downstream; or third, when the IP was seen as an essential facility and the IP holder’s refusal to sell prevented the emergence of a new product for which there was clearly identified pent up consumer demand (e.g. Magill). At first sight, it is not clear to us that the existing situation in the UK TV market would fit well into any of these three categories.

2. Weeds

9. The Complainants’ discussion of the paper by Weeds is flawed in three main respects. First, they engage in selective quotation. Secondly, they simply fail to understand the role of vertical integration in Weeds’ argument. Thirdly, the fact that it is possible to
build a coherent theory of foreclosure can hardly be used to bolster the Complainants’ own vicious circle “theory” as the economic mechanism on which Weeds relies has nothing to do with the Complainants’ story line.

10. At paragraph 3.9, the Complainants provide the following citation from Weeds:

“Although non-exclusivity is socially optimal, consumers are worse off than under exclusive distribution: the softening of downstream competition results in higher prices that outweigh the benefit to them to viewing the content. However, this should not be seen as an argument in favour of exclusivity: rather, regulation to reduce per-subscriber fees might be considered ...”.

It is instructive to finish the last sentence of this quotation. It reads:

“...depending on the implications for content production”.

So, like Harbord and Ottaviani, Weeds recognises that the main issue is the monopoly power of content producers…and acknowledges that the issue requires a careful analysis of the effect of any regulation on the producers’ incentives to invest.

11. Weeds never claims that her results depend on the existence of a vertically integrated firm. Quoting from Weeds (2007), p. 18:

“We assume that the content supplier is vertically integrated with one of the two distributors.... This overcomes any commitment problem:.... Vertical integration also simplifies the analysis of the contracting stage, which is more complicated with two-part tariffs. However, it should be noted that vertical integration is not essential for the findings: with sufficient instruments an unintegrated seller can extract the industry surplus and make similar choices”

Hence vertical integration is just a simplifying assumption on two fronts. It makes the computation of the equilibrium easier, and it avoids the typical “commitment problem” found in the literature on foreclosure. However, as pointed out in our July response, this second aspect is not so important in an industry where firms can legally commit to exclusive deals.

12. If vertical integration is just a simplifying assumption, then vertical integration itself cannot be the issue – which has been our argument. It is therefore unjustified for the Complainants to use Weeds (2007) in support of the claim that the vertically integrated structure is the main issue that a review of the industry would have to deal with.

13. Overall, Weeds’ paper is an example of a coherent theory of dynamic foreclosure identifying conditions under which content would not be made available to all downstream firms. As such it satisfies the usual professional standards of internal consistency, which is much more than can be said of the Complainants’ “vicious circle”
story. Still, even Weeds’ analysis does not offer strong grounds on which to order a review of the industry. While the paper shows that dynamic foreclosure might arise if the underlying mechanism is strong enough, the author does not claim to offer any evidence suggesting that such dynamic foreclosure actually is an issue in the UK market. Moreover, how one would find such evidence is far from obvious. Finally, the possible nefarious effects of dynamic foreclosure discussed by Weeds do not have any systematic link to the degree of vertical integration in the market. Since vertical integration has been at the core of the Complainants’ argument, it is difficult to see how Weeds’ paper can be claimed to support their case.

3. “One Monopoly Profit”

14. At paragraph 3.2 the Complainants claim that:

“In seeking to deny that Sky has the incentive to engage in downstream foreclosure, CRA relies on the Chicago school’s “one monopoly profit” theory…”

This is incorrect. We only used the “one monopoly profit” theory as a useful benchmark, and we never asserted that the one monopoly profit theory always holds. Instead, we carefully examined all static and dynamic arguments that could cause it to break down and be overwhelmed by foreclosure incentives. The fact is that the arguments made for foreclosure turned out to be weak when closely examined.

15. The Complainants further quote (paragraph 3.3.) a paper by Kai-Uwe Kühn and John Van Reenen on Microsoft and foreclosure, in particular a sentence that reads:

“There are many reasons why the Chicago critique of leveraging theory breaks down…..”.

This is juxtaposed at paragraph 3.2 with the CRA April report, which stated “In order to be able to argue that a vertically integrated retail/broadcaster would do better by adopting a downstream foreclosure strategy, Ofcom would need to examine carefully the traditional “one monopoly profit” critique, and explain why it does not apply”. The Complainants imply there is some contradiction between the two positions. There is none. The position of Kühn and Van Reenen (and CRA) is that the incentives underlying the “one monopoly profit” theory always exist: there is a short-run cost to a monopolist in market A seeking to drive out rivals from complementary/downstream market B. The Chicago critique does break down, however, in some markets where there are other incentives that may be strong enough to give the monopolist a reason to foreclose. Nevertheless, these countervailing incentives to foreclose need to be spelled out explicitly and in a theoretically coherent manner which fits the empirical facts of the market in question. This is what was done in the Microsoft case. This clearly has not been done in the case against Sky by the Complainants. There are vague allusions to vicious circles and hand waving arguments that, as we showed in the previous two reports, break down when subject to any degree of economic scrutiny. As we say many times in our reports, there has to be a clear and powerful mechanism linking shifting market share today to some long-term advantage.
16. It should also be emphasised that the statement made in the Kühn and Van Reenen paper was in the context of the Microsoft case, and the statement was about the Chicago critique breaking down in that case, not in every other possible case. The standards for making a credible foreclosure case are exacting, which is one reason that the Microsoft case was protracted. Our position is that each market has to be judged on its facts, and there is no reason why the “one monopoly profit” theory breaking down in the Microsoft case must imply it would break down in all cases.

4. Microsoft

17. In Section 5 of their Joint Response, the Complainants return to their alleged “dynamic foreclosure theory”, where they put forward again the same points we have already repeatedly analysed – and found lacking – in our previous reports. We do not return to those here. They also criticise our “wilful blindness” (paragraph 5.4) to a number of factors that in their view undermine the references we have made to the Microsoft case.

18. The Complainants do not seem to have really understood the economics behind the recent Microsoft decision. This is disappointing since, unlike the “vicious circle” story, the economics argument made in the Microsoft case have been spelled out formally and have been tested empirically, precisely in the paper by Kühn and Van Reenen the Complainants refer to. We will not re-explain the Microsoft logic and why it does not apply here in detail. This was done quite clearly in our previous reports and we trust that the reader has now understood the main differences between the two cases. Still a few statements cannot go unchallenged.

19. We have pointed out a large number of flaws in the Complainants’ “vicious circle” fable. As presented by the Complainants, the vicious circle falls significantly short of being what professional economists would consider a credible mechanism for dynamic foreclosure. Rather than answer our direct criticisms of their story with valid economic arguments they simply repeat their claims. This is again true in this Joint Response where we are told that “…this “credible mechanism” to which Sky refers does exist: it is the vicious circle described by the Parties” (para 5.2). Apparently repeating is believing and the “vicious circle” slogan is so self-evident it is enough to refer to it as such, for its existence to be clearly recognised.

20. In paragraph 5.6., the Complainants suggest that Sky’s alleged refusal to supply is the equivalent of the “applications network effect” in the Microsoft case. This is simply wrong. In any analogy between the two cases, the refusal to supply content would surely be analogous to Microsoft’s alleged refusal to supply timely interface information. The fact that applications are written to a specific operating system is at the root of the applications effect in Microsoft. This feature has no equivalent in the industry under review.

21. In its comparison between the current case and Microsoft, the Complainants further state that “Sky has a monopoly position in respect of the broadcasting of premium movie channels…” (paragraph 5.4) What matters in terms of the “monopoly” for Microsoft was not so much current market share upstream, but the strength of the entry barrier. For a PC Operating System monopolist there is a high applications barrier to entry arising from the desire of developers to write to a single platform (the “indirect
network effect” discussed extensively in our reports). In Pay TV the alleged “monopoly” arises because of successful bidding for premium content. There is an open bidding process for this premium content and it is not obvious what would make an unassailable barrier to entrants bidding for attractive content (as we argued before, see also below). The two situations cannot therefore be meaningfully compared as they involved markedly different economic mechanisms.

5. Switching Costs

22. The Complainants’ discussion of the importance and relevance of switching cost is hopelessly confused. Again, having discussed these issues thoroughly before, we will limit ourselves to a few points.

23. The Complainants claim that switching costs to alternative pay TV services are low (para 5.11), but then say that switching is not taking place – apparently based on quotations from the Financial Times.

24. They further repeat the argument that “building up” a channel is not possible because you need a wide portfolio of rights (para. 5.13). We discussed this issue extensively at paragraph 132 of our April report. The Complainants simply do not engage with the arguments that we presented then. Again it seems that repeating is believing.

25. The Complainants’ view seems to be that “because Sky normally win bids, they must have an unfair advantage in bidding” (para 5.17). This is not an economic argument. In such a world any successful performer would immediately come under suspicion. This would give a new meaning to the “winner’s curse”.

6. Miscellaneous

26. In paragraph 3.13., the Complainants claim that we ignore dynamic foreclosure arguments. This is rather surprising as our previous reports contain a large number of pages dealing explicitly with dynamic foreclosure arguments. What LECG has done is take a quote from the part of our report where we explicitly look only at static incentives…and use this to claim that we ignore the whole dynamic dimension of the problem. This must be a clerical mistake.

27. It is important to keep the whole consultation process in perspective. Months spent with parties filing reports disputing each others’ arguments tend to impart some legitimacy to both sides. It is therefore worth remembering what the Complainants should be required to show. First and importantly, they should provide convincing evidence that there is a problem with the industry to start with. So far, no such evidence has been provided. As we – and the independent expert appointed by Ofcom – have shown it is LECG’s empirical analysis purporting to show that the UK market performed more poorly than other similar markets that is completely unreliable. Secondly, the Complainants would have to present a coherent analysis, meeting accepted
professional standards, showing that there are indeed reasons to believe that some features of the UK market can be the source of significant inefficiencies. The Complainants have failed on that point as well. Their own “vicious circle” is not a well developed theory of harm. Moreover the aspect of the industry that the Complainants emphasise (vertical integration) is not an essential component of the one coherent theory of harm available in the literature (e.g. Weeds (2007, 2008)). Finally, one would have to present some empirical evidence that the theory of harm advanced is actually applicable. No such evidence is provided.