AN EXAMINATION OF LECG’S ARGUMENTS IN RELATION TO PAY TV OPERATORS’ ABILITY TO MONETISE THE ACQUISITION OF NEW CONTENT

A. Introduction

1. At page 14 of their paper entitled “Revisiting Sky’s incentives to foreclose competition in the UK pay-TV industry”¹, LECG raise a number of arguments that are intended to relate to the alleged advantages held by a vertically integrated pay TV broadcaster/retailer, compared to a non-vertically integrated broadcaster, in bidding for content rights. The purpose of this note is to examine those arguments.

2. In doing so, however, Sky is, once again, hampered significantly by the lack of clarity in their exposition.² In this note, we have therefore done as best we can to address the arguments that LECG appear to be making. We note, however, that these arguments appear to cover issues that were addressed in Sky’s October 2007 response to the complaint made to Ofcom by BT, Setanta, Top Up TV and Virgin Media (“the Complaint”), and it is therefore somewhat surprising that LECG’s arguments (a) do not take into account the points made by Sky in that response, and (b) remain so unfocused.

3. Our examination of LECG’s arguments on these issues in their latest paper shows that they continue to be ill-founded and cannot be relied upon.

B. The comparative speed at which vertically integrated pay TV broadcaster/retailers and non-vertically integrated broadcasters can monetise new content rights

4. In their paper, LECG argue that:

   “[a] vertically disintegrated broadcaster may not be able to monetise new rights as quickly as a vertically integrated broadcaster/retailer as it may not be able to bundle new content into existing packages which are accompanied by price increases.”³

5. At the outset, the following points are notable about this proposition:

¹ “Revisiting Sky’s incentives to foreclose competition in the UK pay-TV industry, A report for British Telecommunications plc, Setanta Sport Holdings Ltd, Top Up TV Europe Ltd and Virgin Media Ltd.”, 19 March 2008.

² See paragraph 2.2 of Part C of Sky’s October 2007 response to the Complaint.

³ First bullet point of first paragraph on page 14, ibid.
(i) LECG do not appear sure of this point - they state only that a vertically integrated operator may have an advantage stemming from its control over retail pricing and packaging of channels carrying the new content;

(ii) LECG make no claims as to the magnitude of the claimed advantage – they claim only that there is one. This appears to be linked to their erroneous point that any advantage, however small, creates large problems for other operators in competing for programming rights against an operator with such putative advantages;4

(iii) LECG focus on retail price increases to existing subscribers as the way in which a vertically integrated pay TV broadcaster/retailer would monetise programming rights. This, however, is a partial perspective for two reasons.

First, increasing revenues through subscriber acquisition and retention at unchanged prices may be a better option for a pay TV operator than raising prices to existing (and potential) customers – indeed, it may even be optimal to reduce prices in order to grow subscriber numbers following the acquisition of new programming. The fact that LECG ignore this point entirely is surprising given that the strategy of reducing prices in order to grow subscriber numbers was followed by Setanta – one of LECG’s clients – after winning FAPL rights.5

Indeed, once it is recognised that increasing subscriber numbers is also a means by which a pay TV operator can monetise new content rights it becomes clear that newer entrants such as Setanta may be at an advantage relative to more established operators such as Sky. This is clearly illustrated by the substantial increase in the number of Setanta Sports subscribers - from around 200,000 subscribers to around 2.5 million UK subscribers - in the four months following the commencement of its broadcasting live FAPL matches.6 Sky Sports, however, already has over [CONFIDENTIAL] subscribers and its ability to grow this base substantially by acquiring new content is more limited. The value to Sky from acquiring new programming lies to a greater extent in retaining existing subscribers.

4 As explained at paragraph 59 of CRA’s July 2008 paper on Sky’s incentives to foreclose, such an argument is ill-founded.

5 See paragraph 3.4 of the response by Setanta and Top Up TV to Ofcom’s consultation document.

Second, vertically integrated operators are likely also to wholesale their channels to third party retailers. In this context the options available to them are exactly the same as those available to non-vertically integrated broadcasters; and

(iv) it appears to fail to recognise that both Virgin Media and Setanta are themselves vertically integrated pay TV broadcaster/retailers. Accordingly, if LECG’s proposition were well founded (which it is not), it would imply that these operators are at no disadvantage in competing with Sky for content rights.7

6. More generally, it is evident that LECG’s proposition is one-sided. LECG allege that one type of pay TV operator is able to monetise rights more quickly than another type of pay TV operator. In order to establish such a proposition, it is clearly necessary to consider the ways in which each type of operator would monetise new content rights and then determine the rate at which additional revenues would flow to each type of operator under the options available to them. LECG’s argument, however, is devoid of any consideration of how a non-vertically integrated broadcaster monetises new content rights. Accordingly, its proposition that a vertically integrated pay TV broadcaster/retailer is able to monetise new content rights more quickly than a non-vertically integrated broadcaster is without foundation and cannot be relied on.

7. In fact, it is clearly the case that a non-vertically integrated broadcaster may also be able to monetise new rights by similar means to a vertically integrated pay TV broadcaster/retailer – by changing the wholesale pricing and packaging of its channels, and attracting and retaining subscribers to its channels. In such circumstances, the subscribers in question will be customers of the retailers of the broadcaster’s channels, but, given that carriage fees are normally determined on a per-subscriber basis, additional subscribers to packages that include the broadcaster’s channels mean higher revenues for the non-vertically integrated broadcaster. Indeed, as noted above, this is exactly the means by which Sky and Setanta would expect to monetise new content in relation to distribution to cable subscribers.8

8. LECG’s proposition also overstates significantly a vertically integrated pay TV operator’s ability to earn a return on new content rights by raising retail prices. LECG’s approach is overly simplistic and does not bear close scrutiny. We discuss this issue further in the next section. Given the context of LECG’s

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7 Clearly, it also overlooks the fact that Virgin Media has an advantage in bidding for rights arising from its vertical integration that is not available to Sky or Setanta – guaranteed access to all households connected to its closed platform. (See paragraphs 4.22-4.23 of Part C of Sky’s October 2007 response to the Complaint.)

8 It may be the case that LECG’s argument is that pay TV retailers cannot be incentivised via contract to market third party broadcasters’ channels to their subscribers as effectively as a vertically integrated pay TV broadcaster/retailer markets its own channels (i.e. that vertical integration helps overcome a principal-agent problem). If this is the argument, it is evident that it relates entirely to closed platforms – where a broadcaster has no option to self-retail – and that the solution would be to permit self-retail by broadcasters on all platforms.
argument, we have assumed in that section that the “new content” in question is carried on a premium pay TV channel.

C. The ability of a vertically integrated pay TV broadcaster/retailer to monetise new content rights via its own retail pay TV services

9. LECG argue that a vertically integrated pay TV broadcaster/retailer which wins new content rights is able to monetise such rights by bundling new content into “existing packages” and increasing their prices. The strong implication of LECG’s argument is that this is straightforward and enables such an operator quickly to monetise new content rights. In reality, however, this is not the case.9

10. In examining the merits of this proposition it is important first to clearly specify the options available to a vertically integrated pay TV broadcaster/retailer in relation to the exploitation of new content rights via its own retail pay TV services. If such an operator wins new content rights, it can:

(a) include the programming that is produced as a result of acquiring those rights in an existing television channel; or

(b) include the programming in a new television channel and either:

(b)(i) offer that channel as a ‘bonus channel’ to an existing premium channel package;10 or

(b)(ii) include the channel in new premium channel packages (including new single premium channel packages and channel packages that also include pre-existing premium channels).11, 12

11. In relation to LECG’s argument, the issue then is the extent to which a vertically integrated pay TV broadcaster/retailer is able to either:

(i) raise prices for existing premium packages that include the new content (either on an existing channel or because the premium package has been enhanced by the inclusion of a new bonus channel – i.e. in cases (a) and (b)(i) above); or

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9 This issue was discussed at paragraphs 4.9-4.18 of Part C of Sky’s October 2007 response to the Complaint. LECG do not appear to have had regard to that response.

10 A bonus channel is defined in the ITC’s Minimum Carriage Requirements (“MCR”) Direction as “a Channel that is available free of charge when a particular Channel with which it is connected is subscribed to.”

11 Under the ITC’s MCR Direction, any such new channel would have to be able to be bought on an individual basis in conjunction with any basic package offered by the retailer, although it could also be included in existing channel packages.

12 As an illustration, if Sky were to create a new channel, Sky Sports 4, it would offer this as a new single premium channel package (basic plus Sky Sports 4) and in combination with other existing premium channels (e.g. basic plus combinations of Sky Sports 1, 2, 3, 4 and Xtra).
(ii) set higher prices for new channel packages (compared to pre-existing packages without the new channel) and attract subscribers (both new subscribers, and existing subscribers currently on other packages) to the new packages (i.e. in case (b)(ii) above).

(i) Ability to monetise rights through price rises for existing packages

12. In relation to the first of these options – raising prices for existing premium packages – it is erroneous to regard any pay TV retailer’s ability in this respect as unfettered. In addition to the purely logistical issues involved, and administrative costs associated with, changing prices (which should not be underestimated for pay TV retailers with large subscriber bases), there are several costs that need to be balanced against the additional revenues gained from raising prices:

- **churn and spin-down:** price increases will cause some existing subscribers to cancel their subscriptions, or spin-down to a less-inclusive package. It must be borne in mind that not all subscribers to a given package will place value on the additional content (or bonus channel) included in the package, or attribute sufficient value to the new content to pay the higher price for the package. Accordingly, a price increase to them represents a value-adjusted price increase, which may cause some of them to cancel their subscriptions or switch to other packages. The risk of spin-down is likely to be higher the larger the number of subscribers taking the premium package the price of which is increased. This is because, as the number of subscribers to that package increases, the preferences of those subscribers are likely to become more heterogeneous and the reasons for subscribing to the package more diverse;

- **reduction in acquisition of new subscribers:** price increases are likely to deter some potential subscribers from taking up a pay TV subscription. Given that this results in the loss of an entire future revenue stream in relation to such potential customers, this element of the equation can be very significant;

- **customer (and potential customer) ill-will:** consumers’ perceptions of a company’s attitude to its customers play an important role in their propensity to become or remain its customers. A reputation for imposing frequent price increases is likely to be very harmful to those perceptions.

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13 Implementation of price changes (taking into account notice periods and logistical issues such as ensuring that all customers get the notice of price change relevant to them) is currently a [CONFIDENTIAL] process for Sky.

14 Against this, the pay TV retailer avoids any acquisition costs associated with taking on new subscribers. The loss from increasing prices in relation to such lost subscribers is determined by the net present value of the returns that such subscribers would otherwise have generated.
13. Accordingly, it is mistaken to believe that pay TV retailers are able to raise prices as and when they wish in order to monetise new content, without regard to anything other than the additional revenue they might earn.

(ii) Inclusion of the new programming in new pay TV packages offered at higher prices

14. The second case involves the creation of new premium pay TV packages, with higher prices than pre-existing premium packages, which contain a newly-formed channel. In this case, the vertically integrated operator would initially have no subscribers to the new packages. In order to build a base of subscribers to the new package(s) a pay TV retailer would have to persuade existing subscribers to choose to upgrade by marketing the new content that they would be able to view if they were to do so.\textsuperscript{15, 16} It is therefore evident that this route to monetising new content rights also is not straightforward.

D. LECG’s additional proposition(s)

15. LECG then put forward a further proposition (which, as discussed below, appears to be at least two further propositions) as follows:

“In addition, the relevant third party retailer would be better able to migrate its subscribers to new entrant channels if they were to win relevant rights. The time a third party broadcaster would need to build a sizeable subscriber base under vertical separation would therefore be shorter than the time it would have needed under vertical integration – i.e. without access to the contact details of the incumbent’s customers. Consequently, the gap between the incumbent broadcaster’s willingness to pay for content and that of its rivals would narrow and upstream competition would become more balanced under vertical separation.”\textsuperscript{17}

16. The principal problem with this proposition is that it is unintelligible. We have examined it thoroughly, and have been defeated as to what it is intended to mean. In the circumstances, the best we are able to do with LECG’s ‘additional’ proposition is to comment on a number of points that it appears to be making.

\textsuperscript{15} This was discussed at paragraph 4.17 of Part C of Sky’s October 2007 response to the Complaint. LECG do not appear to have had regard to that response.

\textsuperscript{16} It is notable that exactly the same task faces any pay TV retailer – whether new entrant or incumbent – which begins offering a new premium package. Part of LECG’s argument appears to be that this task is easier for an established operator because it has an existing subscriber base to which it is able to send direct marketing (as it has its subscribers’ details) whereas an operator seeking to build a subscriber base to new packages de novo must – in LECG’s formulation – rely on other types of marketing. As set out in Part D below, we consider that this argument is exaggerated as (a) it overstates the importance of direct marketing compared to other forms of marketing in attracting subscribers to a new pay TV service, and (b) it underplays the new operator’s ability to use direct marketing (e.g. via the purchase of third party marketing databases).

\textsuperscript{17} First bullet point of first paragraph on page 14, \textit{op. cit.}
17. What is evident, however, is that this proposition does not appear to relate to the comparative ability of vertically integrated pay TV broadcaster/retailers and non-vertically integrated broadcasters to monetise new content rights. It appears to raise entirely different issues that are not related to vertical integration, but are instead about competition against an established operator. As we have indicated numerous times previously, issues of advantages that stem from incumbency (which are horizontal in nature) cannot be considered to form part of an argument in support of LECG’s theoretical “vicious circle”.

(a) Incentives facing a vertically integrated pay TV retailer to market third party channels carried in its packages

18. The first part of LECG’s ‘additional’ proposition is the statement that:

“In addition, the relevant third party retailer would be better able to migrate its subscribers to new entrant channels if they were to win relevant rights.”

19. It is wholly unclear what the terms “relevant third party retailer” and “new entrant channels” mean in this sentence; in particular, the reference to new entry arrives out of the blue. (We suspect that LECG simply mean “new channels”, or channels carrying new content.) The most plausible explanation we can come up with is that this is intended to indicate a belief that a vertically separate pay TV retailer (which we presume is what is meant by the “relevant third party retailer”) would have better incentives to market all broadcasters’ pay TV channels to its subscribers than a vertically integrated pay TV broadcaster/retailer (although, confusingly, this interpretation is contradicted by LECG’s reference to the retailer’s ability, rather than its incentives.)

20. If this is the point that LECG are making, then it is again overly simplistic. The incentives facing retailers (whether vertically integrated or otherwise) to market third parties’ channels depend on the terms of supply that can be negotiated – which often involve obligations on, or financial incentives for, a pay TV retailer to market third party channels effectively. Two key factors that have an obvious bearing on such terms are (a) whether the broadcaster has the opportunity to self-retail if a pay TV retailer does not do a good job of marketing a broadcaster’s channels (i.e. whether the platform on which the retailer in question operates is open or closed), and (b) whether the broadcaster is permitted by regulation to negotiate terms that incentivise third party retailers to market their channels effectively.

21. We note also that the way in which LECG put this proposition suggests an erroneous belief that pay TV retailers, whether vertically integrated or otherwise, have the ability to “migrate” existing subscribers in the sense of

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18 Such an approach is also suggested by the fact that there would be no difference in ability among a vertically integrated pay TV broadcaster/retailer and non-vertically integrated pay TV retailer to “migrate” subscribers among packages (to the extent that they have any such ability). Accordingly, if this were what was meant the use of the term “better able” would be erroneous.
switching existing subscribers to new more expensive pay TV packages that contain a new premium channel. If this is the case, such an argument is fundamentally flawed.

22. First, upgrading a customer from the package they have elected to subscribe to into a new, more expensive, premium tier without their consent would be very likely to contravene the rules on inertia selling under the Consumer Protection (Distance Selling) Regulations 2000.

23. Second, even ignoring such legal risks, such a move would be likely to generate substantial ill-will on the part of existing subscribers which would risk substantially undermining the significant amounts which pay TV retailers invest in customer loyalty and retention.

24. Third, even ignoring both these issues, there would be nothing to stop subscribers rapidly moving back to their preferred package; subscribers cannot be forced to subscribe to packages against their will.

(b) The impact of Sky’s vertical integration and ownership of its subscriber data on the ability of other operators to build their own subscriber bases

25. A further aspect of LECG’s argument appears to be as follows:

If Sky was not vertically integrated then rival “new entrant” “third party broadcaster[s]” would have access to the contact details of Sky’s subscribers, which would enable them to build “a sizeable subscriber base” more quickly than they are able to under the current situation in which Sky is vertically integrated. In turn, this would lead to stronger competition upstream (i.e. for content rights).

26. It is clear that the rival “third party broadcasters” referred to by LECG in this argument are vertically integrated pay TV broadcaster/retailers like Virgin Media and Setanta - non-vertically integrated broadcasters do not need access to subscriber details and therefore such an argument cannot relate to

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19 We can conceive of no other reasonable meaning being ascribed by LECG to this term. If, instead, LECG mean the activity described at paragraph 13 above – i.e. of marketing new packages to subscribers to encourage them to switch to the new packages – then the relevance of LECG’s point becomes entirely unclear. Similarly, if LECG are simply referring to the inclusion by a pay TV retailer of additional channels within subscribers’ packages at no extra charge, then again the relevance of their point is entirely unclear.

20 If, in order to attempt to get around this, a pay TV retailer sought to introduce into its consumer contracts a right to enable such ‘migration’ without first obtaining subscribers’ consent, there is a high probability that such a term would be found to be unfair and therefore unenforceable under the Unfair Terms in Consumer Contracts Regulations (1999).

21 LECG refer to “the incumbent”. It is evident, however, that they are referring to Sky.

22 LECG refer to “new entrant channels”. It is not possible to say whether they mean channels provided by a new entrant broadcaster, or new channels. As noted at paragraph 19, we suspect the latter. The analysis set out above does not depend on which formulation is correct.
such operators. Accordingly, it is evident that the ‘sizeable subscriber bases’ referred to are retail subscriber bases.

27. It would appear, therefore, that what LECG envisage is a situation in which “upstream competition would become more balanced” by denying Sky the ability to be vertically integrated, while its rivals are permitted to operate in this way. While we do not find such an obviously self-serving proposition surprising as an argument put forward by the Complainants, we do find it surprising that it is put forward by LECG in the guise of economic analysis.

28. Furthermore, it is surprising that LECG appear to believe that, if Sky's DTH satellite retail business was vertically separate, then that business would be willing to provide the details of its subscribers to rival pay TV retailers (whether existing rivals or new entrant rivals, and whether vertically separate pay TV retailers or vertically integrated pay TV broadcaster/retailers). It would have no more incentive to do so than, for example, Orange would have to provide contact details for its mobile phone subscribers to Vodafone. This is purely a horizontal competition issue and has nothing at all to do with issues related to vertical integration.

29. It is also evident from the above that LECG place a significant amount of weight on Sky's ownership of its retail subscriber details as conferring a competitive advantage on Sky in terms of bidding for content. In Sky's view, this emphasis is wholly exaggerated.23

30. First, access to Sky’s subscriber details in order to market to potential subscribers is most relevant in relation to what is known as ‘direct mail’ – i.e. mailing a flyer to customers’ homes. There are, however, many other ways in which a rival pay TV retailer is able to market to potential subscribers. For example, a rival retailer of a premium sports package could:

- use click-through advertising on the internet;
- advertise in the sports pages of national newspapers;
- advertise on mass audience television channels like ITV1 around sports programming;
- include flyers in sports publications; and
- advertise on billboards and on the radio.

31. Indeed, it is arguable that these types of marketing are likely to be more effective ways of attracting subscribers to a new service than direct mail. [CONFIDENTIAL].24

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23 In addition to the reference to “access to the contact details of the incumbent’s customers” cited at paragraph 15, above, there are two further references to such access in the relevant bullet point.

24 [CONFIDENTIAL].
32. Even in the case of direct mail, however, it is not correct that this form of marketing is completely precluded without access to the addresses of Sky subscribers. Many marketing databases are available to purchase from third parties which would allowing targeting of potential subscribers based on demographic and other factors. Whilst the use of such databases may mean that direct mail is sent to some non-DTH homes, such mailings are unlikely to be wholly wasted as the pool of potential subscribers to a rival service is unlikely to be entirely coterminous with the existing Sky DTH subscriber base, especially in circumstances where the pay TV retailer also offers services on other platforms (e.g. Setanta’s DTT service).