

**Submission to Ofcom on
the need for a market investigation
into the pay TV industry**

by

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the need for a market investigation into the
UK pay TV industry**

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Executive Summary

Introduction and summary

- 1 Competition in pay TV in the UK is not working effectively. There are a number of features of the pay TV industry which result in competition in the UK being prevented, restricted or distorted. Absent regulatory intervention to address these features, the 'vicious circle' which leads to reduced competition and therefore higher prices, reduced choice and diminished innovation, will continue to prevail.
- 2 Each of the Parties to this Submission – BT, Setanta, TUTV and Virgin Media – has its own concerns about how such market failure manifests itself in practice and its own experiences of the specific adverse effects on competition that arise from the existing market conditions and Sky's ability to exploit those conditions. Examples are described in the Confidential Annexes to this Submission.
- 3 Sky's incentives and ability to leverage the existing market structure mean that any competition or other regulatory remedy aimed at addressing one or other aspect of its conduct will not prevent Sky from exploiting that structure in other ways. Accordingly, this market failure cannot adequately be addressed by piecemeal regulatory intervention (in particular, on the basis of the Competition Act), aimed at addressing individual manifestations of market failure.
- 4 Indeed, previous attempts by competition authorities to address competition problems present in the UK pay TV industry and in particular to regulate individual instances of Sky's conduct have proved inadequate to deal with the structural features which allow such conduct to occur and the industry-wide market failure which results.
- 5 As a consequence, the Parties to this Submission consider that the full investigation of the UK pay TV industry which Ofcom announced on 20 March 2007 is thoroughly warranted. In the event that appropriate undertakings are not offered and accepted to address the market failure, the Parties would urge Ofcom to exercise its discretion under section 131 of the Enterprise Act 2002 to refer the UK pay TV industry to the Competition Commission for a market investigation.

The UK pay TV industry

- 6 As established in previous cases, the pay TV supply chain can be divided into three main tiers: (i) the acquisition of content, (ii) the wholesale supply of channels and (iii) the distribution of those channels by platforms/retailers. Among other things, Sky has leading market positions at each of these three tiers of the supply chain in respect of sports and movie content and channels which are widely acknowledged to be the drivers of pay TV. For example:

- (a) Sky holds approximately 80% (by value) of the sports rights which are broadcast on a pay TV basis in the UK;
- (b) Sky has a 100% share of premium subscription movie rights;
- (c) Sky's share of the wholesale supply of sports channels is approximately 96% (by revenue);
- (d) Sky's share of the wholesale supply of premium subscription movie channels is 100%; and
- (e) Sky accounts for approximately 86% of the retail subscribers to premium sports and movie channels in the UK.

7 These leading market positions have endured over a prolonged period due to the existence of the vicious circle.

Features of pay TV in the UK

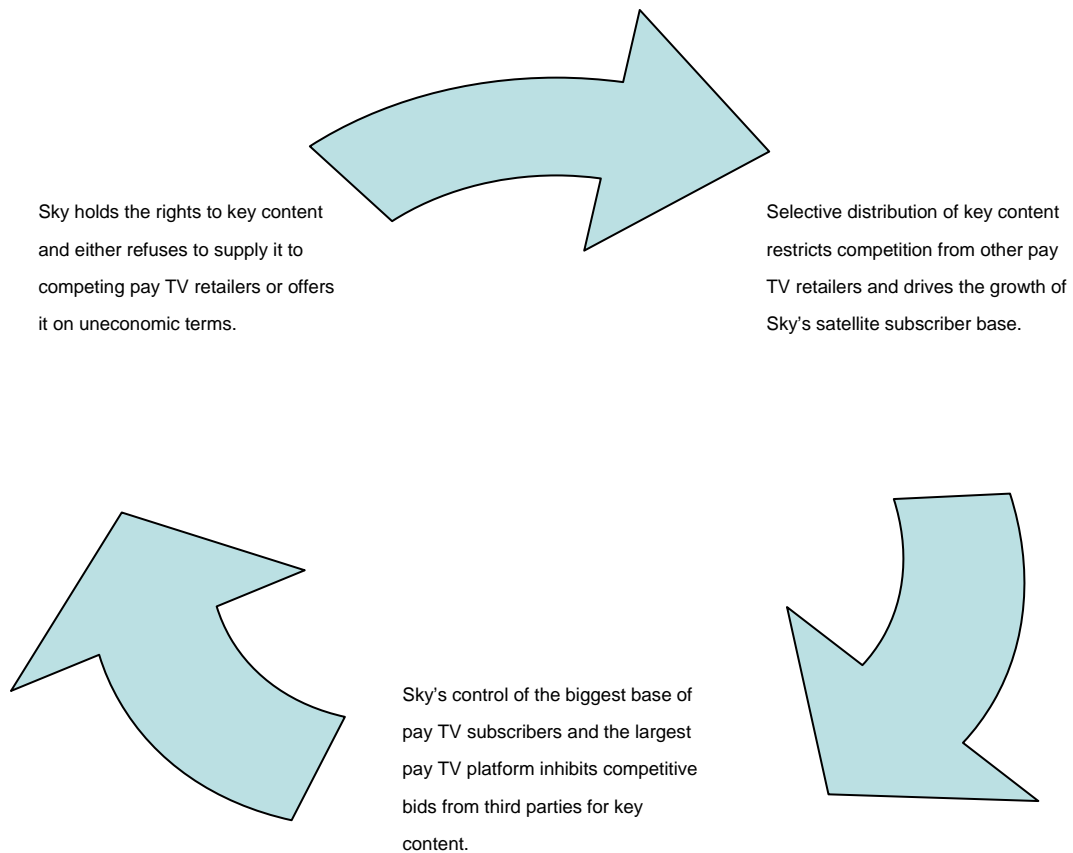
8 At each of its three main tiers, the pay TV industry exhibits significant barriers to successful market entry, which are due in large part to the following distinctive features:

- (a) ***A finite pool of key content.*** in previous investigations, the UK and EU competition authorities have consistently identified high quality sports and movies as being key content for entry into and competition in pay TV and, in particular, the provision of premium pay TV services. The pool of rights for live broadcasting of the most popular sports events and the pool of rights for broadcasting (on a subscription basis) the movies produced by Hollywood studios are, however, necessarily finite.
- (b) ***The limited duration of certain contracts for key content.*** not only is the pool of rights to key content finite but the rights to broadcast certain key content are, themselves, often limited in duration. For example, some of the most valuable rights (such as live rights to the FA Premier League) expire after just three years. This means that (i) an acquiring firm has a strictly limited time period in which to make a return on its content investments and (ii) a firm with an established subscriber base downstream enjoys a competitive advantage when bidding for content as it can monetise its investments in content faster than firms without such a subscriber base. This allows the former to outbid the latter for future key content, thereby perpetuating its leadership downstream.
- (c) ***Staggered availability of key content.*** content rights are also staggered in their availability, which significantly increases the barrier to entry. For example, in order to acquire a material subscriber base, a sports channel will need to offer regular coverage of attractive sporting events. Since contracts for key sports rights are staggered with several years between the sales of those rights, current holders of key content possess an advantage when bidding for additional rights.

- (d) ***The exclusive licensing and selective distribution of key content.*** pay TV broadcasters package content into channels which are then wholesaled to downstream distributors. The exclusive licensing of key content denies that content to competing broadcasters. The selective distribution of that key content (e.g. the refusal to wholesale channels to certain pay TV retailers) inhibits downstream competition.
- (e) ***Economies of scale in the distribution of content.*** pay TV broadcasters and retailers enjoy significant economies of scale. A larger subscriber base enables a broadcaster to reduce its average content acquisition costs and this downstream advantage provides it with an ability to outbid its rivals in the competition for key content.
- (f) ***Feedback effects:*** the pay TV industry is also characterised by significant feedback effects along its vertical supply chain. Pay TV broadcasters and retailers need to be able to offer attractive content to retain existing subscribers and to win new ones. But, as outlined above, the contest for content, especially for exclusive rights to key content, will most likely be won by channel providers with larger downstream subscriber bases. The selective distribution of that exclusive content enables them to enlarge their subscriber bases further, which in turn will bias the contest for content even more.

The core issue: a vicious circle in pay TV in the UK

- 9 The combination of the six features outlined above distinguishes the pay TV industry from other industries with “feedback effects”. Pay TV’s market structure and these distinctive features give rise to two factors which demonstrate a clear cut need for regulatory intervention:
- (a) The pay TV industry exhibits a tendency for concentration and “increasing dominance” (i.e. leading market positions become entrenched). A firm with access to superior content is able to build a customer base advantage which consolidates its ability to monopolise the acquisition of content and, in turn, achieve a leading position downstream.
 - (b) Market forces are unable to offset this tendency. Leading market positions become entrenched because consumers will not subscribe (or switch) to new entrants unless their content offerings are sufficiently attractive. But this is not likely because new entrants will face the handicap of having to compete for subscribers with inferior content and to compete for content with fewer subscribers.
- 10 Applied to pay TV in the UK, these features result in market failure. Sky holds the leading market positions at the key levels of the supply chain and, in particular, controls the most attractive pay TV content, the largest pay TV platform and the largest base of pay TV subscribers. Sky’s control of these mutually reinforcing upstream and downstream bottlenecks results in a vicious circle for its competitors.



- 11 Against this market background, Sky is able to ensure that its leading position in the acquisition of content upstream is perpetuated by preserving its downstream advantage in pay TV distribution. Sky's past conduct vis à vis its competitors confirms that Sky has both the incentive and the ability to foreclose downstream competition. For example, Sky is able to use its leading position in the acquisition of content upstream to deny key content to competing pay TV retailers and thereby restrict downstream competition for its own retail business. By refusing to provide third party pay TV retailers with access to its premium channels on economically viable terms and on a non-discriminatory basis as compared with its own downstream distribution arm, Sky can place its downstream competitors at a significant disadvantage which adversely impacts on the prices and choices available to consumers.
- 12 Sky is also able to ensure that its leading position downstream in pay TV distribution is perpetuated by preserving its upstream advantage in the acquisition of content. Sky's past conduct vis à vis its competitors confirms that Sky has both the incentive and the ability to foreclose upstream competition. For example, Sky is able to use its leading positions downstream in pay TV distribution to inhibit access to the largest pay TV platform and the

largest base of pay TV subscribers in the UK and thereby inhibit competitive bids for the most attractive pay TV content.

- 13 Sky is also now seeking to reinforce the effects of the vicious circle outlined above by extending it into new distribution platforms and technologies. For example, Sky imposes onerous obligations, including most favoured nation clauses, on third party broadcasters in its agreements with them for satellite distribution of their channels. These MFN clauses result in either restricted access to content for competitors seeking to use new platforms and technologies or the imposition upon such competitors of commercial terms which are appropriate for more traditional linear broadcast services. Thus, these MFN clauses inhibit the development of innovative services over new platforms and technologies.
- 14 The vicious circle described above is in no way tempered by the fact that exclusive rights for some key content (such as FAPL rights and premium movies) is awarded on the basis of a competitive bidding or auction process. As described in recent independent economics papers for the Competition Commission and the OFT, the competition problems of bids and auctions are broadly the same as 'ordinary' markets. In other words, the fact that there is a 'competition' for the rights does not mean that there is a level playing field in this 'competition' – firms in Sky's position will have an inherent advantage in the competition for the rights, as a result of the features described above, and Sky's leading market positions will be perpetuated in the bidding or auction process.

Consumer Harm

- 15 Evidence indicates that consumers are harmed by these adverse effects on competition in terms of higher prices, restricted choice and reduced innovation. For example, data published by Ofcom indicates that, on average, pay TV subscribers in the UK pay more than their counterparts in other European countries.
- 16 LECG has undertaken an econometric study which compares the average pay TV prices observed in the UK and fourteen other European countries and investigates whether the differences between these prices can be explained by benign factors such as country-specific differences in demand, such as pay TV being of a higher quality in the UK or the UK having higher income per capita. LECG's econometric study strongly indicates that, even when account is taken of these differences in demand, UK consumers have to endure substantially higher average prices for pay TV - on average 36% higher than the pay TV prices in the other European countries in the sample.
- 17 In light of this conclusion, LECG investigated whether the remaining price differences can be explained by certain observed differences in market structure. LECG's analysis strongly suggests that a significant proportion of the price differences between the UK and the other European countries in the sample can be shown to result from the market structure in the UK. LECG's analysis is, therefore, evidence in support of the proposition that UK consumers are harmed by the current lack of effective competition in pay TV in the UK.

18 Consumers in the UK also suffer as a result of less choice and diminished innovation. For example, Sky is inhibiting the take-up of HD services on competing platforms by refusing to supply its HD channels to those platforms. Sky is also inhibiting the development of competing HD services on the satellite platform by refusing to provide conditional access services for such channels.

19 Further examples of reduced choice and innovation are set out in the Confidential Annexes to this Submission.

Remedies

20 The market investigation is necessary in order to address both the mutually reinforcing upstream and downstream bottlenecks and the conduct which is associated with the structural features of the market (as in the case of the recent referral by the OFT of airport services in the UK by BAA to the Competition Commission). For the reasons explained briefly above and in more detail in the Submission, intervention is needed at all levels of the supply chain in order to facilitate effective competition in pay TV in the UK. This should include fair, reasonable and non-discriminatory access by third party pay TV retailers to Sky's premium channels on economically viable terms and appropriate remedies to address the adverse effects which Sky's downstream advantages have on the contest for content.

21 Whilst such remedies would limit Sky's ability to foreclose (or marginalise) competitors at the various levels of the supply chain, Sky's incentives to do so would remain. Trying to regulate a company against the grain of its incentives will always be both costly and difficult. A solution to this problem could be to complement the remedies above by modifying Sky's vertical structure through operationally separating its channel and distribution businesses.

22 Overall it is clear that remedies are available to the Competition Commission to address the features of the pay TV industry described above. These remedies can be implemented at a proportionate cost, particularly given the increase in consumer welfare which would result from the introduction and consolidation of effective competition in the UK pay TV industry.

Conclusion

23 As Ofcom is aware, it has a discretion under the Enterprise Act to make a market investigation reference to the Competition Commission where it has "reasonable grounds to suspect" that any market feature prevents, restricts or distorts competition in the UK.

24 The Parties submit that the evidence of market failure in pay TV in the UK and the need for remedies to address the structure and distinctive features of pay TV is overwhelming. Accordingly, absent the offering and acceptance of adequate undertakings to address the

market failure in a comprehensive manner, the Parties request Ofcom to refer the pay TV industry to the Competition Commission.

Part 1

Background to the Submission and the Parties

1 Introduction

1.1 This Submission to Ofcom is made by British Telecommunications plc (“BT”), Setanta Sport Holdings Limited (“Setanta”), Top Up TV Europe Limited (“TUTV”) and Virgin Media Limited (“Virgin Media”), together the “Parties”.¹

1.2 As a result of certain structural features of the UK pay TV industry, which are centred on a vicious circle of mutually reinforcing upstream and downstream bottlenecks, competition in pay TV in the UK is prevented, restricted or distorted. As a consequence of these structural features, Sky is able to marginalise and even foreclose upstream and downstream competitors.

1.3 Each of the Parties has its own concerns about how such market failure manifests itself in practice, and the way in which specific adverse effects on competition arise from the existing market structure and Sky’s ability to exploit that structure. Examples are described in the Confidential Annexes to this Submission. These include *inter alia*:

- (a) inhibiting competitive bids for key content (such as sports rights);
- (b) the restricted or selective distribution of Sky’s channels and enhanced, interactive and HD services;
- (c) the level of Sky’s wholesale rates for cable distribution of its channels;
- (d) the nature of Sky’s agreements with content providers, including the effect of its bundled rights acquisition;
- (e) the nature of Sky’s agreements with third party channel providers, including the effect of its most favoured nation clauses;
- (f) inhibiting access to the satellite platform; and
- (g) the proliferation of Sky’s activities into additional and new platforms and technologies.

1.4 It is clear from Sky’s leverage of the existing market structure that any competition or other regulatory remedy aimed at addressing one or other aspect of its conduct will not prevent it from exploiting that structure in other ways. Addressing individual aspects of Sky’s conduct will not break the vicious circle. Indeed, previous attempts by competition authorities to address competition problems present in the UK pay TV industry and in particular to regulate

¹ The arguments in this Submission are made without prejudice to the arguments which the Parties are making elsewhere, and may in future make, on these and other issues.

individual instances of Sky's conduct (for example under the Competition Act) have proved inadequate to deal with the structural features which allow such conduct to occur and the industry wide market failure which results.²

1.5 Accordingly, the Parties consider that the full investigation of the pay TV industry which Ofcom announced on 20 March 2007³ is thoroughly warranted and will confirm the concerns outlined in this Submission. Whilst the investigation will consider the pay TV industry as a whole, it will need, in particular, to address Sky's pivotal position and entrenched gatekeeper roles, both upstream and downstream.

1.6 As Ofcom is aware, it has a discretion under section 131 of the Act⁴ to make a market investigation reference to the Competition Commission ("CC") where:

"it has reasonable grounds to suspect that any feature, or combination of features, of a market in the United Kingdom for goods and services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom."

1.7 The threshold for the exercise of Ofcom's discretion is therefore a low one.⁵ The evidence and information provided by the Parties in this Submission clearly demonstrate that there are reasonable grounds to suspect that there are features of the UK pay TV industry which prevent, restrict or distort competition. Accordingly, in the event that Ofcom cannot remedy the market failures identified, and in the absence of appropriate undertakings being offered and accepted, the Parties would urge Ofcom to exercise its discretion under section 131 of the Enterprise Act 2002 (the "Enterprise Act") to refer the UK pay TV industry to the CC for a market investigation.⁶

1.8 Such a reference is entirely consistent with Ofcom's "*principal duty afforded to it under the Communications Act 2003, which is ... to further the interests of consumers in relevant markets, where appropriate by promoting competition*".⁷ Ofcom has frequently referred to this overriding duty to further the interests of consumers as being "*at the core of [its] raison d'être*"⁸ and paramount to its approach to regulation. In light of this duty, the Parties consider that Ofcom should now remedy the market failure in order to generate an environment in which there can be a genuine competitive dynamic and, as a result, enhanced consumer benefits.

1.9 It is necessary for Ofcom to take action at this time because, among other things:

² This is discussed further in Part 6, Section 3 below.

³ See Ofcom's announcement of 20 March 2007 entitled "*Market investigation into the pay TV industry*".

⁴ Section 370 of the Communications Act 2003 (the "Communications Act") grants Ofcom concurrent powers with the OFT to make a market investigation reference under section 131(1) of the Act so far as relating to commercial activities connected with communications matters, which includes broadcasting and related matters. Thus, the issues raised by the Parties fall squarely within Ofcom's competence.

⁵ See Part 6, paragraph 2.1 for further detail in this regard.

⁶ The relevant criteria for assessing whether a market investigation reference is appropriate are dealt with in more detail in Part 6 below.

⁷ The Consumer Experience: Telecoms, Internet and Digital Broadcasting, 16 November 2006, page 1.

⁸ FT World Mobile Communications Conference 'Where Value Matters - Content Drives', speech by Peter Ingram, 11-12 May 2005.

- (a) there is evidence that the vicious circle, and the market structure which fosters it, is already giving rise to significant consumer harm;
- (b) previous measures have failed to address either the structural problems or Sky's conduct; and
- (c) in addition to the competitive harm that is already being caused, there is evidence of Sky leveraging its current position into additional and new platforms and technologies, thereby protecting its leading market positions and further preventing, restricting or distorting competition. This is of particular concern in the run up to digital switchover, during which the more than 5 million households⁹ that have yet to switch to digital must make their choice of digital platform.

2 The Parties

BT

- 2.1 BT is a provider of communications solutions and services in the UK and worldwide. BT's principal activities include networked IT services; local, national and international telecommunications services; broadband and internet products and services; and converged fixed/mobile products and services.
- 2.2 BT Vision is a new service by BT which provides access to DTT and on-demand services. BT Vision, which does not require a regular monthly subscription, is delivered via a new set-top box which contains a personal digital recorder able to store up to 80 hours of content, and pause or rewind live TV.
- 2.3 The on-demand content currently provided by BT Vision includes film, television and children's programming, music and sport.¹⁰ It does not include any channels from Sky.

Setanta

- 2.4 Setanta is an international pay TV broadcaster with subscribers in the UK and the Republic of Ireland. It is the number two pay TV sports broadcaster in the UK after Sky. Setanta broadcasts live sports events primarily on a subscription basis but with some events broadcast on a pay-per-view basis. Setanta's sports coverage includes the Scottish Premier League, the Football Conference and a number of the leading European leagues for football and rugby union.
- 2.5 In the UK, Setanta will broadcast 46 FAPL matches live during the 2007/8 to 2009/10 seasons and will broadcast some FA Cup and England matches live from 2008/9.
- 2.6 Setanta's channels are available in the UK on satellite and cable and a new Setanta channel has been available on DTT since March 2007.

⁹ This figure of more than 5 million excludes those homes which, although able to receive a digital signal on their principal television set, have yet to switch other television sets to digital.

¹⁰ As described in BT's Confidential Annex.

TUTV

- 2.7 TUTV launched a pay TV service on DTT in the UK in April 2004. This service initially comprised a package of basic channels. It now offers content through the Top Up TV Anytime PVR. TUTV's Anytime service downloads programming from a range of channels onto subscribers' PVRs during the night. Subscribers can express preferences in order to determine what content is stored on the PVR's hard drive. TUTV's service does not currently include access to any Sky channels.
- 2.8 TUTV also provides conditional access services on DTT for Setanta's new sports channel.

Virgin Media

- 2.9 NTL Incorporated¹¹ merged with Telewest Global Inc. in March 2006 and subsequently changed its name to Virgin Media Incorporated. Virgin Media provides broadband, fixed line telephone and TV services to customers within the areas covered by its UK cable network.¹² It supplies some services outside its cabled areas using BT lines. Virgin Media provides mobile telephone services over a mobile network operated by T-Mobile. Virgin Media also has a subsidiary, Virgin Media Television Limited, which produces and supplies basic pay TV channels and is a 50% joint venture partner in UKTV.¹³ Virgin Media Television and UKTV both wholesale basic channels to Sky for retail on the satellite platform.
- 2.10 Virgin Media offers a range of basic pay TV packages over its cable network. Subscribers have the ability to add premium sports or movie channels (including Sky's premium channels) to packages. The vast majority of premium package subscriptions are for Sky premium content. Sky does not supply Virgin Media with its entire premium content and withholds interactive and HD services. Sky ceased to supply Virgin Media with its basic channels at the end of February 2007.

¹¹ Virgin Media Incorporated is a publicly traded company listed on NASDAQ. All of its operations are conducted in the UK. Virgin Media Limited is its principal UK operating subsidiary.

¹² The Virgin Media cable network can reach approximately 50% of UK homes.

¹³ UKTV is an independent commercial joint venture formed in 1997 between Virgin Media TV (50%) and BBC Worldwide (50%), the commercial arm of the BBC. UKTV broadcasts 10 channels including UKTV Gold, UKTV Drama and UKTV History.

Part 2

The UK Pay TV Industry

1 Introduction

- 1.1 The UK and EU competition authorities have examined the provision of pay TV services on several occasions. They have concluded that (a) TV markets are national in scope, being delineated by language, culture and local regulation;¹⁴ and (b) pay TV (and, within that, premium pay TV) is a market which exists separately from free-to-air TV.¹⁵ This is because of certain characteristics, including a greater number of channels (with some dedicated to specialist programmes, exclusive coverage of live sporting events and earlier movie windows) and the way in which it is financed (i.e. by subscription revenue).
- 1.2 For example, in its recent Report to the Secretary of State for Trade and Industry on the acquisition by Sky of 17.9% of ITV, the OFT noted that:

“Past decisions at both the UK and EC levels have consistently defined pay TV and premium pay TV as constituting separate markets to free to air TV.”¹⁶

2 The supply chain

- 2.1 The pay TV supply chain can be regarded as being divided into three main tiers: the production and acquisition of content; the wholesale supply of channels; and the distribution of those channels by platforms/retailers.¹⁷ The pay TV supply chain can also be regarded as comprising a fourth tier, as the distribution tier described above can be sub-divided into separate tiers for pay TV retailing and TV platform operation.
- 2.2 The supply chain begins with the rights owners or controllers who sell their content rights to broadcasters (for example, the FA Premier League (“FAPL”) sells rights to Sky, which broadcasts this content on its Sky Sports channels).
- 2.3 Pay TV broadcasters acquire rights to create programming and/or rights to existing programming from content providers and package this programming into channels. The

¹⁴ See for example Paragraph 48 of Commission Decision of 2 April 2003 in Case No COMP/M.2876 Newscorp/Telepiú and Paragraph 28 of Commission Decision of 21 March 2000 in Case No COMP/JV.37 BSKyB /KirchPayTV and the decisions cited and the Director General's 1996 Review of Sky's Position in the Wholesale Pay TV Market (the “1996 Review”).

¹⁵ See for example Paragraphs 18 to 47 of Commission Decision of 2 April 2003 in Case No COMP/M.2876 Newscorp/Telepiú and Paragraph 23 of Commission Decision of 21 March 2000 in Case No COMP/JV.37 BSKyB /KirchPayTV and the decisions cited.

¹⁶ Paragraph 1.19 of the OFT's Report to the Secretary of State for Trade and Industry dated 27 April 2007 entitled “Acquisition by British Sky Broadcasting Group plc of a 17.9 per cent stake in ITV plc”. In this context, the OFT cited the following references: *BSkyB/Manchester United*, 1999, Cm 4305; *ntl/Cable & Wireless Communications Plc* 2000 Cm 4666; *Carlton Communications Plc/Granada Group Plc/United News and Media Plc*, 2000 Cm 4781; *BskyB Chapter II decision*; *Newscorp/Telepiu*, 2003, COMP/M.2876, 2 April 2003.

¹⁷ See e.g. paragraph 23 of The Decision of the Director General of Fair Trading - *BskyB Investigation: Alleged Infringement of the Chapter II Prohibition*, dated 17 December 2002 - case CP 01916-00 (the “2002 Decision”).

channels are then supplied at the wholesale level to retailers, who in turn distribute them to subscribers via various platforms.¹⁸

2.4 There are currently four principal technologies over which pay TV content is delivered in the UK: (a) satellite; (b) digital terrestrial television (“DTT”); (c) cable; and (d) DSL.

2.5 Although there are currently several pay TV retailers on the satellite platform, Sky is by far the largest. TUTV and Setanta currently retail pay TV services on DTT. Virgin Media is the sole pay TV retailer on its cable platform and there are currently several pay TV retailers on DSL (including BT Vision, Tiscali TV - formerly Homechoice - and Sky).

3 Share of supply

3.1 Sky enjoys leading and enduring positions at each of the three levels of the supply chain.

(a) *Sky has a leading position in the acquisition of content.*

(i) *Sports rights*

Sky’s position is especially strong in sports content, which is widely acknowledged as a major driver of pay TV services.¹⁹ Table 1 below illustrates Sky’s position in terms of sports rights owned. The first row of Table 1 sets out the shares of all sports content currently controlled by UK broadcasters. With a share of 49%, Sky owns approximately half of sports rights, followed by the BBC with a share of 22.5%. Events of “national importance” (so called “A-list” events) may not be broadcast exclusively live on a pay TV channel such as Sky Sports without Ofcom’s consent. When these events are excluded, Sky’s position in sports is stronger: as shown in the second row of Table 1, Sky’s share climbs to 56.2%. Sky’s position is even stronger when only those events that are actually broadcast on a pay TV basis are considered. In this context, Sky’s share rises to approximately 80%.²⁰

Table 1: Sports rights acquisition shares based on the value of sports rights owned in December 2006 (adjusted for the March 2007 FA deal)²¹

¹⁸ In the case of a vertically integrated operator such as Sky, there is only a notional sale of Sky’s channels at the wholesale level for distribution by Sky on its own satellite platform.

¹⁹ In this regard, see the decisions discussed at paragraph 2.2 of Part 3 below. In addition, in its Report dated 29 May 2007 entitled “*Blue Sky*”, UBS stated that “*Sport has become more important as a driver ... than was the case in 2005*” and “*Sky’s sports offering ... is at the heart of Sky’s competitive positioning*”. Rupert Murdoch recently stated that “*Sport is the great, number one common denominator. And, of that, football [is number one]*.” Media Guardian 22 June 2007, “Murdoch Warns on Football Rights”.

²⁰ The lack of competition for Sky in the acquisition of sports rights is confirmed not only by its very high and stable market shares but also by anecdotal evidence. For example, in an article in Broadcast on 11 August 2006, Richard Freudenstein, the then Chief Operating Officer of Sky, was described as “*a man who can’t remember a single deal that got away*”. In that article, Richard Freudenstein was quoted as saying: “*Honestly! I can’t think of a time I’ve had to go into the Chief Executive’s office and say: ‘Sorry I’ve missed out on that’. Anything we’ve really wanted, we’ve got.*”

²¹ Source: Parties, including estimates. The data includes rights bought at different dates. To provide a coherent comparison LECG has rebased the sums paid for the rights in 2006 terms. The data also includes sports rights which were sold before December 2006 but relating to later events (e.g. FAPL rights for the 2007/8 to 2009/10)

	Sky	BBC	ITV	Setanta	Virgin Media
All	49%	22.5%	16%	12.2%	0.3%
Excluding A-list events ²²	56.2%	15.8%	13.1%	14.5%	0.4%
Events on pay TV	79.7%	NA	NA	19.9%	0.5%

(ii) *Movie rights*

Movies are another major driver of pay TV subscriptions.²³ Sky has exclusive pay TV subscription contracts with all the major US movie studios (Disney, Columbia, Fox, Sony, Paramount, Universal, Dreamworks and Warner Brothers).²⁴ This means that Sky has a 100% share of premium subscription movie rights.²⁵ Whilst pay-per-view movie rights are sold on a non-exclusive basis, these make up a relatively small proportion of pay TV revenues in the UK.

(b) *Sky has a strong position in the wholesale supply of certain types of channels.*

(i) *Sports channels*

Sky's share of the wholesale market for the provision of sports channels is even greater than its share of the acquisition of sports rights. Table 2 below displays sports channel providers' shares of revenues in the wholesale provision of sports channels: Sky holds a near monopoly with a share of approximately 96%.

Table 2: Wholesale supply of sports channels shares in 2006²⁶

Sky	Setanta	MUTV	Chelsea TV	UK Racing	Eurosport
96.4%	1.0%	0.1%	0.1%	0.4%	2.0%

seasons). LECG has included these future rights in its calculation as they provide a forward looking indication of market position. A static annually based valuation of the rights would value a ten year £10m contract as approximately the same as a one year £1m contract. However, in the ten year contract clearly provides a stronger market position. LECG's use of the total value of rights, both past and future, avoids this problem.

²² A-list events may not be broadcast live on an exclusive basis on a pay TV channel without Ofcom's consent.

²³ In this regard, see the decisions discussed at paragraph 2.2 of Part 3 below.

²⁴ This is the Parties' understanding from their own experience, although little, if any, evidence of Sky's exclusive movie contracts is publicly available. In the event that it requires further evidence in this regard, the Parties consider that Ofcom will be best placed to obtain the relevant information about these contracts.

²⁵ For completeness, the Parties note that TUTV distributes a movie service on DTT, Picturebox, which comprises movies from Universal in a second pay TV window. Sky's premium movie subscription channels comprise movies from all the major US studios in the first pay TV window.

²⁶ Source: Parties, including estimates. Shares are based on wholesale revenues. The latter are calculated upon multiplication of retail subscribers with channel wholesale prices. The calculation includes channels supplied to the channel provider's own retail arm (e.g. Sky Sports in Sky's retail packages) and channels supplied to third party retailers (e.g. Sky Sports in Virgin Media's retail packages).

(ii) *Movie channels*

Due to Sky's control of all the major studios' output on a subscription basis, Sky is the only wholesale provider of premium subscription movie channels in the UK and hence Sky has 100% of this wholesale market.²⁷

(c) *Sky has a leading position in the distribution and retailing of pay TV content.*

Table 3 below describes the position of Sky and its main competitors in the retailing of pay TV services. Sky has a leading position in pay TV retailing with 67.6% of all pay TV subscribers. The second largest platform, cable, accounts for less than half the number of subscribers relative to Sky (28.8%).

Table 3: Pay TV retail shares based on pay TV subscriber numbers, 2006²⁸

Satellite (Sky)	Cable (Virgin Media)	Digital Terrestrial (TUTV)	TV over DSL (BT, Tiscali TV)
67.6%	28.8%	2.9%	0.7%

The level of concentration increases further when the retailing of premium channels is considered. For example, the Parties estimate that Sky's share of the retailing of premium channels is approximately 86%.

Table 4: Share of retailing of premium channels based on pay TV subscriber numbers in 2006²⁹

Sky	Virgin Media	Setanta
86.3%	10.7%	3.0%

Indeed, it is likely that Sky's share of retailing of premium channels has been growing over time as the cable platform has seen consistent declines in recent years in the

²⁷ The 2002 Decision noted that Sky had a share of this market of 95.6% as at June 2001. The remaining 4.4% was held by FilmFour. FilmFour is now broadcast free to air and so is no longer wholesaled to pay TV retailers. There are currently other wholesale providers of channels of "non-premium" movies, including Turner Classic Movies (TCM), Disney (with two channels, Cinemagic +1 and Disney Cinemagic 1) and Movies 24.

²⁸ Source: Ofcom, *The Communications Market: Digital Progress Report Q3 2006, published 20 December 2006 (Satellite, Cable)*, ScreenDigest, *2006 year end estimates (Digital, Terrestrial and TV over DSL)*. Ofcom estimates that, in addition to Sky's 7.8m retail subscribers, there are approximately 755,000 households who are no longer subscribers but use satellite to access free-to-view television. The figure of 7.8m has been used as the basis of the calculations in table 3 above.

²⁹ Source: Dresdner Kleinwort, 11 January 2007, Equity Research: British Sky Broadcasting, page 6 and Parties' estimates at the end of 2006.

proportion of customers taking Sky's premium channels while Sky has maintained or grown its premium base.

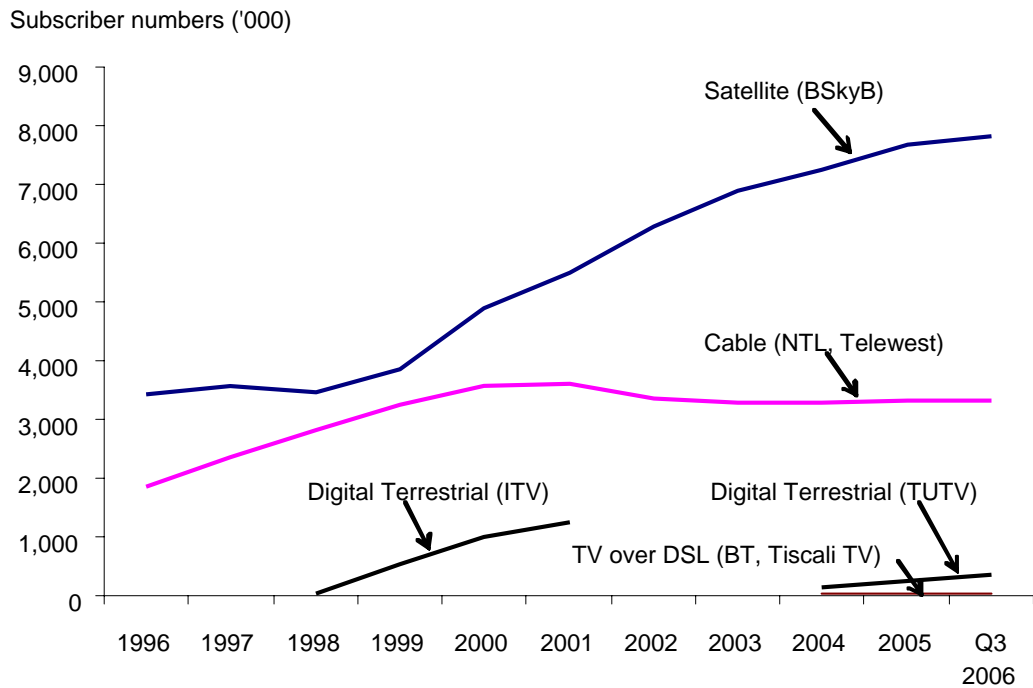
Having investigated the retail supply of premium movie channels, the OFT previously concluded that PPV movies do not exercise sufficient constraint on premium movie channels for them to be in the same markets.³⁰ The parties support the OFT's conclusion and consider that it applies equally to VOD.

Sky's substantial market positions have endured for a significant period. For example, Figure 1 below shows pay TV distributors' subscriber numbers between 1996 and Q3 2006. In 1998/1999, Sky and cable (the two operators NTL and Telewest together) had similar size subscriber bases. From around 2000 onwards, however, Sky's leading position in pay TV retailing has considerably strengthened. Whilst the size of cable's subscriber base has remained largely unchanged since 2002, its position relative to Sky has substantially weakened.

Figure 1: Pay TV subscriber numbers by platform, 1996 - Q3 2006³¹

³⁰ See, in particular, paragraph 223 of the 2002 Decision.

³¹ Source: ScreenDigest. For TUTV Q3 2006 only the year end estimate was available.



3.2 The data above clearly show that each of the key levels of the supply chain is highly concentrated, which is further demonstrated by calculating the Herfindahl-Hirschman Index (HHI) concentration ratio at each level:³²

- (a) Table 1 confirms that the HHI ratio for the market for the acquisition of sports content is extremely high: 3,312 for all sports content; 3,790 when A list sports content is excluded and 6,748 when only rights broadcast on a pay TV basis are considered. The corresponding ratio for the acquisition of subscription pay TV movie rights is 10,000 (the maximum possible);
- (b) Table 2 above confirms that the HHI for the wholesale supply of sports channels is 9,389, which is close to its theoretical upper limit of 10,000; and
- (c) Table 3 confirms that the HHI for pay TV retailing is again very high at 5,408. The HHI for the retailing of premium channels is higher still at 7,571.

3.3 It should be noted that the OFT classifies markets with HHIs over 1,800 as 'highly concentrated'.³³

4 Barriers to Entry

³² HHI is a measure of market concentration used by competition authorities.

³³ See Mergers: Substantive Assessment Guide, May 2003, Office of Fair Trading, <http://www.of.gov.uk/NR/rdonlyres/283E1C2D-78A6-4ECC-8CF5-D37F4E4D7B22/0/oft516.pdf>.

- 4.1 As is explained below, each of the key levels of the pay TV supply chain is also subject to significant barriers to entry (a fact which was acknowledged recently by the OFT³⁴). The barriers to entry are reinforced by Sky's leading position at each level of the supply chain and the resulting distortion of its incentives to deal with upstream and downstream competitors.
- 4.2 In relation to the **acquisition of content**, some of these significant barriers are contractual: (i) premium content is generally sold on an exclusive basis and (ii) the availability of such content is staggered over time. Sky's studio output deals in particular operate to limit the availability of key movie content to entrants - it is understood that some have durations of up to ten years and they expire at different points in time.
- 4.3 Other barriers to the acquisition of content go to the very heart of the economies of scale and scope associated with a pay TV business: even premium content (e.g. sport or movies) may be of little or no value for a potential entrant unless (a) it already possesses other complementary content and (b) it can access subscribers. As a result, entrants are at a disadvantage vis-à-vis established players with existing content portfolios and downstream distribution assets. Finally, and perhaps most importantly, competitive disadvantages downstream create barriers to entry at this (upstream) level, as discussed in Part 3 below. (Again, the OFT has recently noted that downstream barriers to entry adversely affect the potential for Sky's competitors to acquire premium sports rights.³⁵)
- 4.4 At the **wholesale** level of the supply chain, entrants also face significant barriers to entry. To be viable, a broadcaster needs to have access to content/programmes and also to distributors/retailers. As above, broadcasters will face contractual barriers to entry (exclusive contracts for content/programmes and staggered availability), barriers associated with economies of scale and scope (the need for complementary content and access to distribution/retail) and, especially, barriers to entry which relate to the vicious circle of mutually reinforcing upstream and downstream bottlenecks described in Part 3 below.
- 4.5 The significant barriers to entry upstream reinforce the barriers downstream at the **retail** level of the supply chain, where Sky's market position in turn reinforces the upstream barriers. First, platform operators and retailers must gain access to attractive channels to acquire customers. But these channels are sometimes controlled by competitors with no incentive to share them with entrants. The fact that few pay TV subscribers will be attracted by an offering that does not include a range of appealing channels makes it even more difficult for a new entrant to build a customer base in a relatively short period of time. This undermines its ability to pay for the most attractive content. Finally, and again most importantly, significant entry at this (downstream) level of the supply chain is highly unlikely

³⁴ See paragraphs 142 and 182 of the OFT's Report to the Secretary of State for Trade and Industry dated 27 April 2007 entitled "*Acquisition by British Sky Broadcasting Group plc of a 17.9 per cent stake in ITV plc*". UBS recently acknowledged in its Report of 29 May 2007 entitled "*Blue Sky*" that Sky "*has created high barriers to entry*" into pay TV.

³⁵ See paragraph 182 of the OFT's Report to the Secretary of State for Trade and Industry dated 27 April 2007 entitled "*Acquisition by British Sky Broadcasting Group plc of a 17.9 per cent stake in ITV plc*".

when there is a vertically integrated incumbent with a leading position at all levels of the supply chain, as is explained in Part 3 below.

5 Summary

5.1 Sky's very substantial positions at all key levels of the pay TV supply chain make a precise market definition largely unnecessary for the purposes of the market investigation reference advocated in this Submission.

5.2 As is demonstrated in Part 3 below, given the nature of the pay TV industry and Sky's position in it, Sky enjoys mutually reinforcing competitive advantages upstream (content acquisition) and downstream (distribution and retailing). Due to the current structure of the market, these advantages cannot be matched by competitors and thus make Sky the gatekeeper of the UK pay TV industry and allow it to manage competition in pay TV to the ultimate detriment of consumers. In order to enable effective competition, both the upstream and downstream bottlenecks need to be opened (see Parts 3, 4 and 5 below). For this reason, piecemeal intervention, which is aimed at only one level of the supply chain or which seeks to remedy separate instances of Sky's behaviour, will not solve the competition problems facing this industry in an effective and sustainable way. The symbiotic relationship between competition at the different levels of the supply chain and Sky's incumbency at each level enable it to neutralise the effects of any regulatory intervention that does not address the totality of the market failure.

Part 3

The Competition Problem

1 Introduction

- 1.1 Foreclosure of competition in pay TV in the UK results from the combination of: (a) Sky's leading position at each of the key levels of the pay TV supply chain; (b) the distinctive features of the pay TV industry; (c) the effect of Sky's vertical integration; and (d) Sky's incentive and ability to consolidate its leading positions in pay TV. The first of these features has been described in Part 2 above - this Part focuses on the remaining features of pay TV. Together, these features of pay TV markets in the UK prevent, restrict and distort competition and require a market investigation.
- 1.2 Sky's conduct - which derives from the market features described in Parts 2 and 3 - and the effect of such conduct on the operations of the Parties are described in detail in the Confidential Annexes to this Submission and the resulting consumer harm is considered in Part 4 below. Potential remedies are discussed in Part 5.

2 Distinctive features of the pay TV industry

- 2.1 The pay TV industry exhibits the following distinctive features (all of which act as barriers to successful market entry): (i) a finite pool of key content; (ii) the limited duration of certain contracts for key content; (iii) the staggered availability of key content; (iv) the exclusive licensing and selective distribution of key content; (v) economies of scale in the distribution of content; and (vi) feedback effects between the various levels of the supply chain. These distinctive features are considered below.

Finite pool of key content

- 2.2 In previous investigations, the UK and EU competition authorities have identified high quality sports and movies as being key content for entry and competition in pay TV and, in particular, the provision of premium pay TV services.³⁶ For example:
- in its Review of BSkyB's position in the wholesale pay TV market in December 1996, the OFT found that "*premium sports and movie channels were the main drivers of subscription to pay TV*"³⁷ and that without rights to high quality sports and/or movies, there seemed no way that competing broadcasters would be able to enter the market at the premium level;³⁸

³⁶ In addition to sport and movies, there may be other content which is a driver of pay TV services. In this submission, however, the Parties have focussed on the former types of content.

³⁷ See paragraph 1.4 of the 1996 Review.

³⁸ See paragraph 2.18 of the 1996 Review.

- in its Decision on Bertelsmann/Kirch/Premiere in 1998 the European Commission stated that: *“Access to programme rights is even more important in the case of pay TV than it is in the case of free TV since, in order to entice the consumer to subscribe or to take particular productions on a pay per view basis, certain specific types of content are required. Experience of pay TV in Europe so far shows that in order to be sufficiently attractive, a pay TV bouquet must include a combination of premium rights for the first broadcast of films produced at the major Hollywood studios and for popular sporting events”*;³⁹
- in its Decision in respect of TPS in 1999, the European Commission noted that: *“It is universally acknowledged that films and sporting events are the two most popular pay TV products. It is necessary to have the corresponding rights in order to put together programmes that are sufficiently attractive to persuade potential subscribers to pay for receiving television services”*;⁴⁰
- in its Decision in respect of British Interactive Broadcasting in 1999, the European Commission stated that: *“experience has shown that, to be successful as a pay television operator, it is essential to include film and sports channels as part of the service. BSkyB itself identified ‘movies and sports as key sales drivers.’”*⁴¹ The Commission also noted that premium film and sports channels: *“are the basics around which other channels can be offered to subscribers”*;⁴²
- in its Report on NTL/Cable & Wireless Communications, the Competition Commission noted that televised sports, especially football, are a key driver of demand for pay TV services.⁴³ In addition, the Competition Commission recognised that premium movies are a key driver and an important value component of pay TV;⁴⁴ and
- in its Decision on BSkyB/Kirch, the European Commission noted that: *“It is universally accepted that films and sporting events are the two most popular pay TV products. It has been acknowledged by the Commission in a previous decision that it is necessary to have the corresponding rights in order to put together programmes that are sufficiently attractive to persuade potential subscribers to pay for receiving television services. Films and sport are therefore pay TV’s drivers.”*⁴⁵

³⁹ See paragraph 48 of Commission Decision of 27 May 1998 in Case No IV/M.993 Bertelsmann/Kirch/Premiere, [1999] OJ L 53/1.

⁴⁰ See paragraph 34 of Commission Decision of 3 March 1999 in Case No IV/36.237 TPS, [1999] OJ L 90/6.

⁴¹ See paragraph 28 of Commission Decision of 15 September 1999 in case IV/36.539 British Interactive Broadcasting/Open.

⁴² See paragraph 72 of Commission Decision of 15 September 1999 in case IV/36.539 British Interactive Broadcasting/Open.

⁴³ See paragraph 1 of Appendix 4.4 of the Competition Commission’s report on the proposed acquisition by NTL Incorporated of the cable business of Cable and Wireless Communications plc, March 2000

⁴⁴ See paragraph 1 of Appendix 4.5 of the Competition Commission’s report on the proposed acquisition by NTL Incorporated of the cable business of Cable and Wireless Communications plc, March 2000.

⁴⁵ See paragraph 42 of Commission Decision of 21 March 2000 in Case No COMP/JV.37 BSkyB/ KirchPayTV.

2.3 There is, therefore, voluminous precedent on the significance of sports and movie rights. The pool of rights for live broadcasting of the most popular sports events and the pool of rights for broadcasting (on a subscription basis) the movies produced by Hollywood studios are, however, necessarily finite. This factor has been recognised by the competition authorities. For example, the Monopolies and Mergers Commission indicated in its Decision in respect of Sky/Manchester United that it was unlikely that there were enough commercially valuable rights to popular sports to sustain many premium sports channels.⁴⁶

Limited duration of certain contracts for key content

2.4 Not only is the pool of rights to key content finite but the rights to broadcast certain key content are, themselves, often limited in duration. For example, some of the most valuable rights (such as live rights to the FAPL) expire after just three years. This means that (a) acquiring firms have a strictly limited time period in which to make a return on their content investments and (b) firms with an established subscriber base downstream enjoy a competitive advantage when bidding for content. Where there is a period of only three years in which to recoup a content investment, it would not be commercially rational to bid very aggressively (even for valuable exclusive content) without access to a pre-existing subscriber base.⁴⁷

2.5 In contrast, an incumbent vertically-integrated firm with a sizeable established subscriber base is able to monetise its content investment faster, and more efficiently, than a firm without a subscriber base. This allows the former to outbid the latter for future key content, thereby perpetuating its leadership downstream.⁴⁸

Staggering of content contracts

2.6 Content rights are not only limited in duration but are also staggered in their availability. This significantly increases the barrier to entry for new broadcasters and pay TV retailers. In order to create a successful pay TV offering, more than one piece of content is required. For example, to acquire a material subscriber base, a sports channel will have to offer regular coverage of attractive sporting events. Since contracts for the key sports rights are staggered with several years between the sales of those rights, current holders of a critical mass of content possess an advantage relative to new entrants when bidding for additional content. This staggering of content contracts creates inertia upstream and entrenches existing market positions downstream.⁴⁹

⁴⁶ See Paragraph 2.56 of the Monopoly and Mergers Commission's report on the proposed merger between British Sky Broadcasting Group plc and Manchester United PLC, April 1999.

⁴⁷ Paradoxically, as discussed in Part 2, another key driver of pay TV (Hollywood movies) is foreclosed to entrants by the long duration of Sky's output deals – so that new entrants can neither access this content because it is tied up by Sky, nor challenge Sky's advantages in accessing sports content because of the difficulty in making a return.

⁴⁸ Economists have shown time and again that such asymmetries between bidders have a significant impact on auction outcomes. See Bulow, Jeremy, Ming Huang and Paul Klemperer "Toeholds and Takeovers" *Journal of Political Economy*, vol 107(3), pages 427-454, 1999; and Paul Klemperer, "Auction Theory: A Guide to the Literature," *Journal of Economic Surveys*, vol. 13(3), pages 227-86, 1999.

⁴⁹ A common argument regarding the distribution of content is that, because the content market is a 'bidding market', it will provide an efficient outcome. However this common argument is incorrect as Prof. Paul Klemperer states; "*The competition problems of auctions are broadly the same as those of 'ordinary markets'. [...] If one firm is advantaged, e.g. by lower costs or reputation, it has market power.*" Indeed Klemperer goes on to argue that in auctions, winners

- 2.7 The Competition Commission noted the significance of the staggering of content contracts and the limited duration of content contracts when, in its Decision in Vivendi/Sky, it stated that:

“Sports rights/content are essential for TV sports programmes and channels and a potential barrier to entry to sports channels is the cost and difficulty of acquiring a portfolio of attractive TV broadcasting rights – which are usually specified for a fixed time period of several years and therefore only become available for acquisition on a periodic basis.”⁵⁰

Exclusive licensing and selective distribution of key content

- 2.8 Pay TV broadcasters package content into channels which are then wholesaled to downstream distributors. Key content, such as that described above, is licensed to broadcasters on an exclusive basis. This enables broadcasters and pay TV retailers to differentiate their offerings and thereby retain their existing subscribers and attract new subscribers.⁵¹

- 2.9 The limited pool of key content which is licensed on an exclusive basis does, however, also significantly raise the barrier for new firms to enter downstream. If key content is exclusively controlled, a competing broadcaster will struggle to attract subscribers. If that key content is selectively distributed, competing pay TV retailers who are denied access will struggle to build up a subscriber base. Exclusivity and the selective distribution of key content entrenches existing market positions downstream and thereby contributes to the prevention, restriction or distortion of competition upstream.

- 2.10 In the context of UK pay TV, this problem is significantly increased by Sky's position as both broadcaster and distributor – Sky the broadcaster acquires content on an exclusive basis and, to promote the success of Sky the distributor, it has an incentive to distribute such content on a selective basis at the wholesale level.

Economies of scale

- 2.11 The pay TV industry exhibits important economies of scale in the distribution of content. A larger subscriber base enables a broadcaster to reduce its average content acquisition costs. This downstream advantage provides it with an ability to outbid its rivals in the competition for key content.⁵²

Feedback effects

of past contracts often have information and reputation over new entrants and hence auctions may indeed prolong market power. See Klemperer, Paul. (2005) “Bidding Markets”, UK Competition Commission.

⁵⁰ See Paragraph 4.60 of the Competition Commission's report on the merger situation between Vivendi SA and British Sky Broadcasting Group plc, April 2000.

⁵¹ See the OFT's 2002 Decision.

⁵² Economies of scale in conjunction with network effects may give rise to market leadership for a single product, regardless of whether more efficient products exist. “...[Alfred Marshall] noted that if firms' production costs fall as their market shares increase, a firm that by good fortune gained a high proportion of the market early on would be able to best its rivals; “whichever firm first gets off to a good start” would corner the market.” p.93, Arthur, W., (1990) “Positive feedbacks in the Economy”, *Scientific American*, 262.

- 2.12 The pay TV industry is characterised by significant feedback effects along its vertical supply chain.⁵³ Broadcasters and pay TV retailers need to be able to offer attractive content to retain existing subscribers and to win new ones. But, as outlined above, the contest for content, and in particular for exclusive rights to key content, will most likely be won by broadcasters with larger downstream subscriber bases, especially through a vertically integrated retail business. That content will then allow the broadcaster to enlarge its subscriber base further, which in turn will bias the contest for content even more.
- 2.13 The combination of the features of pay TV outlined above distinguishes the pay TV industry and has clear-cut implications for competition within it:
- (a) The pay TV industry exhibits a tendency for concentration and “increasing dominance”.⁵⁴ A company with access to superior content is able to build a customer base advantage which consolidates its ability to monopolise the acquisition of content and, in turn, to achieve a leading position downstream.
 - (b) Market forces are unable to offset this tendency. Leading market positions become entrenched because consumers will not subscribe to new entrants unless their content offerings are sufficiently attractive and existing subscribers are unlikely to switch to alternative providers unless they can obtain a more attractive price-quality offer. But this is not likely because new entrants will face the handicap of having to compete for subscribers with inferior content and to compete for content with fewer subscribers - the vicious circle discussed below.

3 Sky’s vertical integration and market positions confer competitive advantages

- 3.1 Sky is a vertically integrated company which operates at the three key levels of the supply chain (the acquisition of content, the wholesale supply of channels and the retail distribution of channels). At each of those levels, Sky holds the leading market positions (see Part 2 above).
- 3.2 Given the structural characteristics of the pay TV industry, Sky’s leading market positions are firmly entrenched.

⁵³ These feedback effects are also known as “indirect network effects” in the economics literature and may lead to monopolisation. *“How is dominance achieved and preserved in markets with network externalities? Beyond the classical way of dominance by merger, such markets are prone, as the literature has clearly established since the mid-80s (e.g., Katz and Shapiro 1994), to significant tendencies for monopolization through “positive feedback effects” or snowball effects”* Dewatripont, M. and P., Legros. (2003), Mergers in Emerging Markets with Network Externalities: The Case of Telecoms, Discussion Paper FS IV 00-23, Wissenschaftszentrum Berlin. See also Farrell, J. and Saloner, G. 1992. “Converters, compatibility, and the control of interfaces.” *Journal of Industrial Economics* 40: 9–35; Chou, C. and O. Shy. 1990. “Network effects without network externalities”. *International Journal of Industrial Organization* 8: 259–270; Church, J. and Gandal, N. 1992. “Network effects, software provision, and standardization.” *Journal of Industrial Economics* 40: 85–103. Economides, N., 1996, “The Economics of Networks”, *International Journal of Industrial Organization*, Vol. 14, No.2.

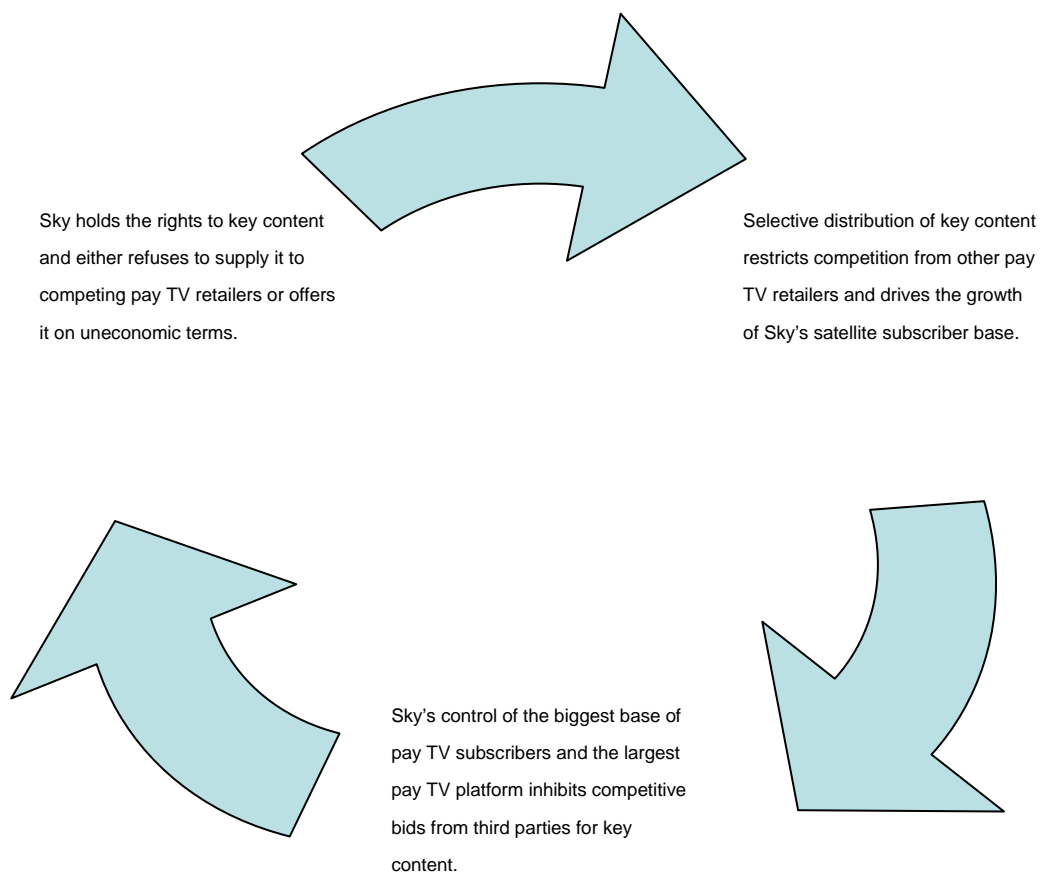
⁵⁴ Increasing dominance refers to a situation in which a “firm that is currently ahead of its rivals in respect of technology, product quality, or goodwill tends to forgo further ahead”, see Budd, C., C. Harris and J. Vickers. 1993. “Duopoly: Does the Asymmetry between Firms Tend to Increase or Decrease?” *Review of Economic Studies*, 60: 543-573.

- 3.3 Sky's downstream leadership confers upon Sky two important competitive upstream advantages. First, it provides Sky with significant economies of scale which reduce its (content and other) costs per subscriber. Second, it provides Sky with access to a large base of subscribers to whom content can be sold immediately upon the rights becoming available.
- 3.4 In other words, Sky has a significant first-mover advantage in acquiring content rights and, in particular, exclusive rights to content for its premium channels. Sky's competitors would need to build a subscriber base for any new premium channels in order to be able to exploit the rights that they acquire which would be a time consuming activity. In contrast, Sky can rely on the immediate demand from its substantial and pre-existing subscriber base. Both these advantages enable Sky to outbid other channel providers in the contest for content.
- 3.5 The ability to secure exclusive rights to the most valuable content creates positive feedbacks for Sky's downstream operations. As explained above, pay TV retailers and platform operators with access to superior content will attract additional subscribers and will also retain and lock in their existing subscriber base. Not surprisingly, therefore, Sky's substantial market positions downstream have remained unchallenged for years.⁵⁵
- 3.6 In addition, Sky's downstream leadership provides Sky with very significant purchasing power when negotiating carriage terms with third party broadcasters of basic channels. This market power stems from the value to such broadcasters (in terms of subscription and advertising revenue) of Sky's very large subscriber base. In practice, Sky is a compulsory trading partner for broadcasters of basic pay TV channels for reasons explained further in the Confidential Annexes to this Submission:
- (a) Freeview does not generate subscription revenue;
 - (b) there is almost no prospect of a third party pay TV retailer being able to viably launch one or more basic channels on the DTH platform; and
 - (c) other TV platforms including cable, DSL and pay services on DTT (such as Top Up TV) have insufficient scale to be an economically viable substitute to the DTH platform for pay TV basic channels.
- 3.7 Lastly, competitors at the wholesale channel supply or retail distribution levels will not provide a competitive constraint on Sky unless they are able to acquire content that is comparable in quality and quantity to Sky's. But they are unlikely to be able to do so because of their disadvantages at the downstream level. Sky's control of these mutually reinforcing upstream and downstream bottlenecks results in a vicious circle for its competitors.⁵⁶

⁵⁵ With about 3.9 and 3.2 million subscribers respectively, BSkyB and Cable (NTL and Telewest) had a similar subscriber base in 1999. BSkyB's subscriber numbers increased sharply up to 6 million subscribers in 2002 and to 7.8 million in 2006. In contrast, Cable's subscriber numbers remained broadly constant to date. See Ofcom, "The Communications Market: Digital Progress Report", (various), and annual reports.

⁵⁶ This fact that this vicious circle within the Pay TV industry can lead to inefficient foreclosure has been articulated by Matteucci (2003): "Thanks to the wide availability of new and cheap transmission capacity, new entrants can easily

Figure 2: The vicious circle in pay TV in the UK



4 Sky's incentive and ability to consolidate its leading positions in the pay TV industry

4.1 This vicious circle would be mitigated if (a) competitors had fair, reasonable and non-discriminatory access to the source of Sky's upstream advantage (i.e. its key content) and (b) appropriate remedies were introduced in respect of Sky's downstream advantages (i.e. its control of the largest pay TV platform in the UK and the largest base of pay TV subscribers). If condition (a) were satisfied, rival pay TV retailers and platforms would be able to compete effectively with Sky at the distribution level. Likewise, if condition (b) were met, other channel providers would be able to compete more effectively with Sky in the acquisition of content.

4.2 However, neither of these two conditions can hold in practice without regulatory intervention. Due to its vertical integration, Sky has an incentive to foreclose, or at least to marginalise, its upstream and downstream rivals and it is able to do so due to its leading market positions at each horizontal level of the supply chain.

Downstream foreclosure

build new hardware platforms, but they may encounter severe difficulties in finding valuable content to subscribers. Since content is proprietary and broadcast under exclusivity regimes, a first mover advantage in (premium) content acquisition is likely to result in vertical market foreclosure and monopoly, even when a duopoly would be socially optimal (high fixed cost regime)." N. Matteucci, (2003) Entry Deterrence and Multidimensional competition in the satellite pay-TV market". Working paper, Universita Politecnica delle Marche.

- 4.3 Were Sky not vertically integrated, its channel broadcasting business would have an incentive to supply its channels on terms that would maximise wholesale revenues across the various retail distribution platforms. However, because Sky is vertically integrated, it has the **incentive** to foreclose, or at least to marginalise, its downstream competitors. In this regard, as argued above, access by competing pay TV retailers on reasonable terms to Sky's premium channels would lead to increased competition downstream (and thus lower prices for consumers). As a result of such downstream competition, Sky's competitive advantage in the acquisition of content would be reduced. While the wholesale revenues from the supply of its channels to competing pay TV retailers could in principle compensate Sky for the loss in its downstream profits, they are highly unlikely to offset the loss of its competitive advantage upstream.⁵⁷ By preserving this competitive advantage, Sky ensures that its leading positions upstream and downstream are perpetuated.
- 4.4 Sky also has the **ability** to foreclose downstream competition. As noted above, Sky controls the most valuable content from the perspective of pay TV retailers in the UK. It can, therefore, be characterised as a content gatekeeper in the UK pay TV industry.
- 4.5 Sky's past conduct vis-à-vis its downstream competitors confirms these allegations about its incentive and ability to foreclose downstream competition. This conduct is explored in detail in the Confidential Annexes to this Submission, but in very broad terms, Sky has, among other things:
- (a) supplied its premium channels to cable at uneconomic rates;⁵⁸
 - (b) withheld its enhanced, interactive and HD services from cable;
 - (c) refused to supply its premium channels to certain other third party pay TV retailers and platforms;
 - (d) acquired exclusive rights to content not only for the satellite platform but also for other distribution platforms which it has then warehoused; and
 - (e) leveraged its position as the primary pay TV retailer on the UK's largest pay TV platform into other platforms and technologies.
- 4.6 For example, by refusing to provide certain third party pay TV retailers with access to its premium channels (including its enhanced, interactive and HD services) on commercially viable terms and on a non-discriminatory basis as compared with its own downstream distribution arm, Sky places its downstream competitors at a material disadvantage.

⁵⁷ See Carlton, D.W. and Waldman, M. 2002. "The strategic use of tying to preserve and create market power in evolving industries". *Rand Journal of Economics*, 33: 194-220. These authors show that a vertically integrated company enjoying a monopoly position upstream may have an incentive to foreclose competition downstream, even if that entails a loss in profits downstream, in order to protect its upstream monopoly. This will be the case when entry downstream makes it more likely that the monopolist will face entry upstream. This is precisely the case in the UK pay TV industry for the reasons explained above (i.e. the existence of mutually reinforcing upstream and downstream bottlenecks).

⁵⁸ It should be noted that Sky has supplied only certain video and audio streams for its premium channels to cable without any enhanced or interactive components and the video and audio streams which can only be accessed via those enhanced or interactive components.

Competition is therefore prevented, restricted or distorted at the downstream level, with consumers being forced to pay higher prices and their choices being restricted.⁵⁹ Sky's platform proliferation strategy further forecloses innovative new entrants. As the sole retailer of its premium channels not only on satellite but also on DSL and DTT, Sky can extend the vicious circle described above into these other platforms.⁶⁰

Upstream foreclosure

- 4.7 Were Sky not vertically integrated, its downstream distribution business would decide the terms on which it would grant access by channel broadcasters to its subscriber base without taking into account any upstream impact on bidding for rights. However, because Sky is vertically integrated, it has the **incentive** to foreclose, or at least to marginalise, its upstream competitors. As discussed above, Sky's competitive advantage in the acquisition of content and channels for retail distribution is related to its downstream advantage - i.e., the number of users of its platform (the platform advantage) as well as the large number of subscribers to its pay TV services (the retail advantage). Enabling competing channel providers and pay TV retailers to benefit from these downstream advantages would lead to stronger competition for the most attractive content.⁶¹ This would, in turn, threaten Sky's leadership both at the wholesale channel supply and retail distribution levels of the supply chain.
- 4.8 The loss in upstream profits resulting from the increase in competition for content could be compensated in full or in part by the revenues raised in the form of downstream platform access charges or retail revenues (if Sky were to distribute the relevant third party channel(s) on satellite). However, those additional revenues would not be enough to offset the loss of its competitive advantage downstream as well as the advantages derived from the operation of the vicious circle of mutually reinforcing upstream and downstream bottlenecks. By allowing competitors effective access to its downstream bottlenecks, Sky risks losing its leading position upstream and, eventually, downstream as well. The costs of losing those pre-eminent positions at key levels of the supply chain (today and in the future) would exceed any additional revenues that Sky could obtain by granting access to its downstream assets at a given point in time.

⁵⁹ One of the earliest economic papers to demonstrate that upstream firms may have the incentive and ability to foreclose downstream competition is Aghion, Philippe and Bolton, Patrick 1987. "Contracts as a barrier to entry." *American Economic Review*, Volume 77, No 3: 388-401.

⁶⁰ See, among others, Schmalensee, Richard. 1982. "Product Differentiation Advantages of Pioneering Brands." *American Economic Review*, 74: 341-352; and Bonanno and Giacomo. 1988. "Location Choice, Product Proliferation and Entry Deterrence." *Review of Economic Studies*, 54: 37-46, for a discussion of the competitive implications of product proliferation strategies. A dominant company may engage in product proliferation in order to deter entry. Entrants seeking to enter the market offering a differentiated product may see how the incumbent matches their offerings and denies them the scale needed to fund the fixed costs of entry. This strategy may not only deter current entry but also chill future entry as the incumbent develops the reputation of fighting entry even in niche segments of the market.

⁶¹ While content is sold using a number of different mechanisms (e.g., informal negotiations for movie rights and formal auctions for Premier League rights), economic theory shows that the outcomes of all those different mechanisms are likely to satisfy the following properties: the expected winner is the bidder with the highest valuation for the content and the price paid for that content increases, or at least does not decrease, if (a) the number of bidders increases and (b) the valuation of the second highest bidder increases. (See Klemperer, Paul, *Auctions: Theory and Practice*, Princeton University Press, 2004.) If Sky shared its platform and retail advantages with rival channel providers on a fair, reasonable and non-discriminatory basis, Sky would face an increased number of credible competitors (bidders) in the contest for content and those competitors would be able to compete (bid) more aggressively as a result of the increased returns they could obtain from the sale of that content.

- 4.9 Sky not only has the incentive, it also has the **ability** to foreclose upstream competitors through its control of the largest pay TV platform and the largest base of pay TV subscribers.⁶² As noted above, Sky has approximately 7.8⁶³ million pay TV subscribers in the UK, of which approximately 5.1⁶⁴ million subscribe to its premium sports channels. The closest downstream competitor, Virgin Media, has only 3.3⁶⁵ million pay TV subscribers in total. Through these strong market positions downstream, Sky is able to inhibit downstream access (to a sufficient customer base) by its rivals in the upstream market and reduce their ability to compete for key content. (This issue is explored in more detail in the Confidential Annexes.) In turn, this also affects the ability of Sky's downstream rivals to compete as they are beholden to Sky for the supply of premium channels.
- 4.10 Both the upstream and downstream foreclosure discussed above result from the features of the pay TV industry already described, in particular the structure of the markets. Combined with Sky's conduct, these features lead to higher prices for consumers and less choice and innovation, as is explained in Part 4 below (and in the Confidential Annexes to this Submission).

⁶² Sky's past conduct vis-à-vis its upstream competitors confirms Sky's incentive and ability to foreclose upstream competitors. By way of example, Sky's conditional access ("CA") charges were a key factor in determining whether new entrants could make competitive bids for live FAPL rights when they were auctioned in 2006. The Methodology for Establishing CA Charges, which Sky had published at the time of the last FAPL auction, stated that Sky would charge £3.20 per subscriber per month for subscription CA services for a package of channels containing live FAPL coverage. This published CA charge was sufficient to deter certain prospective entrants from competing vigorously for the rights.

⁶³ As discussed previously, Ofcom estimates that Sky has 7.8m retail subscribers and that there are 755,000 consumers who no longer subscribe to Sky but use satellite to access free-to-view TV. See Ofcom, The Communications Market: Digital Progress Report Q3 2006, published 20 December 2006.

⁶⁴ Citigroup (April 2006) estimates that 66% of Sky subscribers take Sky's sports package. This translates to approximately 5.1m subscribers. See Citigroup Equity Research Report, BSKYB: Football - Approaching final whistle, 27th April 2006.

⁶⁵ See footnote 30 above.

Part 4

Consumer Harm

1 A vicious circle that distorts competition and requires intervention

- 1.1 The previous sections establish that the combination of the structural characteristics of the pay TV industry and Sky's conduct at each of the key levels of the pay TV supply chain has generated a vicious circle which adversely impacts upon (i) the acquisition of content rights, (ii) the wholesale supply of channels and (iii) the retail distribution of channels.
- 1.2 As a result, the competitive process in the pay TV industry is prevented, restricted or distorted. Effective competition in the wholesale supply of channels and the retail distribution of channels cannot take off because the most valuable content is in the hands of a single player, Sky, and effective competition for content is absent because competing bidders cannot match the platform, retail and other incumbency advantages enjoyed by Sky.
- 1.3 This vicious circle of mutually reinforcing upstream and downstream bottlenecks harms consumers, as a result of less competition, in three ways: (a) they pay higher prices; (b) they are denied choice; and (c) they suffer from less innovation. Furthermore, from a consumer and social perspective, the adverse impact of this vicious circle is not restricted to the pay TV industry but also has negative spillover effects on neighbouring businesses such as free-to-air TV and broadband.
- 1.4 The following sections provide evidence of consumer harm. Further analysis of the industry, which Ofcom is able to undertake, will no doubt confirm this evidence.

2 Higher prices for pay TV

- 2.1 Figure 3 below compares the average subscription revenue per pay TV subscriber in various European countries. Figure 3, which has been derived from data published by Ofcom, shows that the average subscription revenue per subscriber to pay TV in the UK is well above the equivalent sum for other European countries.⁶⁶
- 2.2 It is worth noting that both in Italy and the UK, the satellite pay TV retailer faces limited competition from cable or any other platform.⁶⁷ In contrast, in Germany, which has one of the lowest per subscriber revenues, Premiere (the German satellite pay TV retailer) faces competition from the German cable operators which have significant market penetration.⁶⁸ The lowest revenue per subscriber of the countries shown in Figure 3 below is found in the Netherlands, where the pay TV market features three cable operators with similar customer

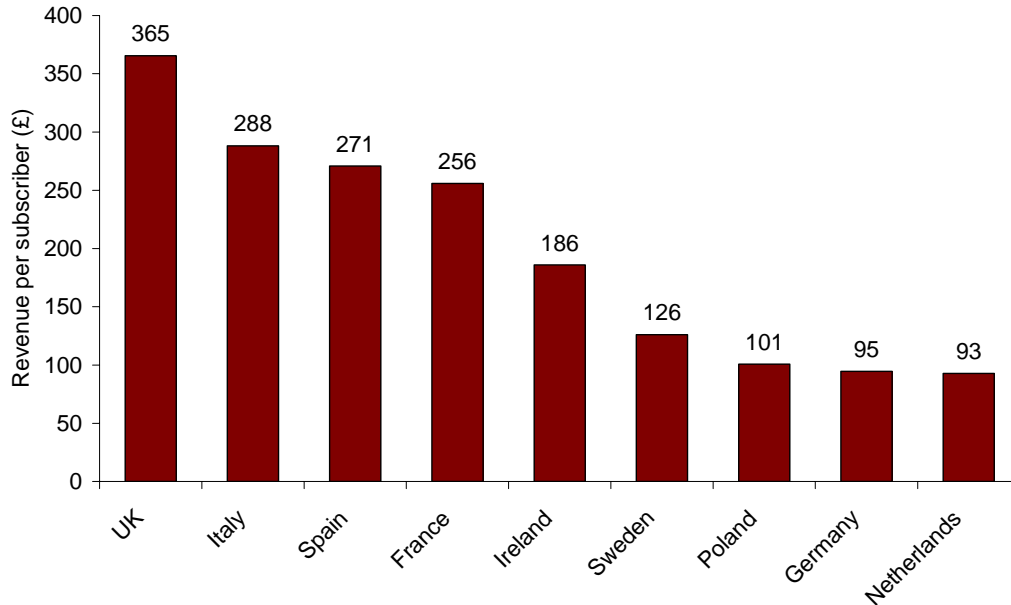
⁶⁶ Source: Subscription revenue per capita and proportion of households using pay television from Ofcom, "Internal Communications Market 2006", November 2006 Figure 3.20 and Figure 3.41; population figures from <http://www.infoplease.com/ipa/A0004379.html> available 22 December 2006; number of households from Dataxis, "Digital Television Data", 2006.

⁶⁷ See Ofcom, "The International Communications Market 2006", November 2006, Figure 3.8.

⁶⁸ See Ofcom, "The International Communications Market 2006", November 2006, Figure 3.8.

bases and additional competition from satellite and DTT pay TV retailers.⁶⁹ The evidence suggests a relationship between concentration and prices and is consistent with the proposition that the vicious circle in the UK pay TV industry is harming consumers.

Figure 3: Yearly subscription revenues per subscriber⁷⁰



3 LECG's econometric analysis

3.1 Figure 3 above shows that, according to data published by Ofcom, the average pay TV price paid per subscriber in the UK is substantially higher than the average prices paid in other European countries. This higher price may, in theory at least, be due to reasons other than features of the market which prevent, restrict or distort competition, such as country-specific differences in demand. The Parties have, therefore, engaged LECG to undertake an econometric study which compares the average pay TV prices observed in the UK and other European countries and investigates whether the differences between these prices can be explained by country-specific differences in demand (e.g. differences in content quality⁷¹ and income per capita). A presentation of LECG's econometric analysis is provided at Annex 1 to this Submission.

3.2 LECG's analysis is based on a database which is compiled and published by ScreenDigest, an independent market research and consulting company.⁷² ScreenDigest's database of pay TV information confirms that, in 2005, the average pay TV price in the UK was 79%

⁶⁹ See Ofcom, "The International Communications Market 2006", November 2006, Figure 3.8.

⁷⁰ Subscription revenue per subscriber calculated by taking subscription revenue per capita, converting into total subscription using populations for each country, then dividing by number of households with pay television (calculated from number of households and proportion of households using pay television.) Per subscriber revenues for Germany and the Netherlands include a large share of non-premium subscribers.

⁷¹ Programming expenditure is used as a proxy for content quality in order to assess this variable in an objective fashion.

⁷² See <http://www.screendigest.com/>. Screen Digest is based in London and has tracked the development the world's media markets for more than 30 years.

higher than the average pay TV price across the fourteen other European countries.⁷³ Using data for each of these countries between 1997 and 2005, LECG has calculated the pay TV prices that would have been observed in each of the countries of the sample if they had the same level of programming expenditure and the same income per capita as the UK.⁷⁴ These prices are called “conditional” prices (i.e., prices which are conditional on these demand factors). In this way, LECG has identified price differences which do not result from cross-country heterogeneity in content quality and ability to pay.

- 3.3 LECG’s study indicates that content quality and income differences explain some of the observed price differences between the UK and other countries. Nevertheless, having adjusted the observed prices so as to take account of these differences in demand, LECG’s study suggests that the average UK pay TV price is still 36% higher than the average conditional pay TV price for the other fourteen European countries in the sample.
- 3.4 Thus, LECG’s econometric study strongly indicates that the substantially higher average prices for pay TV which consumers in the UK have to endure (as compared with their counterparts in other European countries) are not due to pay TV being of a higher quality in the UK or due to the UK having higher income per capita.⁷⁵
- 3.5 In light of this conclusion, LECG investigated whether the remaining price differences (having adjusted for differences in demand) can be explained by certain observed differences in market structure. In order to do this, LECG calculated the pay TV prices that would be observed in each of the countries of the sample if they had the same level of programming expenditure, the same income per capita and also exhibited certain structural features of the UK market. The structural market features for which LECG had data for all fifteen European countries between 1997 and 2005 were the number of platforms in each country and the market share of the largest DTH operator in each country.⁷⁶
- 3.6 LECG’s analysis supports the conclusion that differences in market structure account for a significant proportion of the price difference between the UK and other European countries in the sample. The difference between the average UK pay TV price and the average conditional pay TV price for the other European countries in the sample was significantly reduced when these features of market structure were taken into account.

⁷³ The other 14 European countries included in the database are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, Netherlands, Norway, Portugal, Spain, Sweden and Switzerland. It should be noted that the average pay TV price in the UK which is recorded in this database is somewhat lower than the figure published by Ofcom and referred to above.

⁷⁴ As part of this investigation, which Ofcom announced on 20 March 2007, Ofcom will be able to obtain more extensive data than was available to the Parties in order to validate the analysis undertaken by LECG.

⁷⁵ LECG performed various tests to verify the robustness of its results. LECG estimated two different conditional price models (a fixed effects model and an instrumental variables model). The results obtained for the fixed effects and the instrumental variable models are consistent. In addition, for each of these models, LECG specified four alternative regressions. All those specifications produce similar results. The figure of 36% cited above is arguably conservative, as it is the lower of the results produced by the two methodologies (using the preferred regression).

⁷⁶ The selection of these structural variables was driven exclusively by the availability of data. ScreenDigest does provide subscriber information on a platform by platform basis but the data provided at the company level is not complete and only allowed LECG to calculate market shares for all countries and periods for the DTH operators.

3.7 In summary, therefore, evidence of pay TV prices and other factors from fifteen European countries over a period of eight years:

- confirms that UK consumers pay substantially more on average for pay TV than their counterparts in other European countries;
- strongly indicates that these higher prices are not due to legitimate factors such as the higher cost of content and higher average income in the UK; and
- strongly suggests that a significant proportion of the price difference between the UK and other European countries can be shown to result from the market structure in the UK.

3.8 LECG's analysis is, therefore, robust evidence in support of the proposition that UK consumers are harmed by the current lack of effective competition in pay TV in the UK.

4 Cost of access to coverage of top football

4.1 A further example of UK pay TV consumers paying higher sums on average than their counterparts in other European countries arises in respect of the minimum access price per month for live coverage of the top domestic football league in each European country.

4.2 Table 4 below shows that in 2005, for example, this price is highest in the UK.

Table 4: Cost of access to live coverage of top football leagues⁷⁷

	MATCHES AVAILABLE LIVE	MINIMUM ACCESS PRICE PER MONTH – ALL AVAILABLE MATCHES
UK (FAPL)	138 MATCHES	€58
ITALY (SERIE A)	323 MATCHES (380 MATCHES)	€39 (€54) ⁷⁸
FRANCE (LIGUE 1)	380 MATCHES	€39

⁷⁷ Research undertaken by Oliver and Ohlbaum, which was presented on 31 October 2005 at a seminar entitled "The next FA Premier League Rights Auction – issues and opportunities". Setanta will, from August 2007, offer access to live FAPL coverage at a cheaper price than Sky, but only in respect of 46 games. Indications are that Sky will not reduce the price of the 92 games which it will continue to broadcast live.

⁷⁸ The price of €39 provides access to 17 out of 20 clubs' matches.

SPAIN (LA LIGA)	380 MATCHES	€52
GERMANY (BUNDESLIGA)	306 MATCHES	€35
NETHERLANDS (EREDIVISIE)	306 MATCHES	€40

5 Less choice and diminished innovation

5.1 For the reasons explained above, the vicious circle of mutually reinforcing upstream and downstream bottlenecks places existing and potential competitors at a substantial disadvantage. Entry may not take place at all and, even if it does, entrants have to compete without access to key content and may be marginalised or forced to exit the market.

5.2 The result of this is that consumer choices are restricted, with fewer alternative options and less attractive ones. Sky's ability to manage competition therefore harms consumers. Furthermore, the distortions in the competitive process resulting from the combination of the structural features of the market and Sky's conduct also impact negatively on innovation. Indicative examples of the reduction of choice and diminished innovation resulting from the structural features of the pay TV industry described above are considered below by reference, in turn, to downstream and upstream foreclosure effects.⁷⁹

Downstream foreclosure

5.3 Examples of the **reduction in choice** arising from the ability of Sky to marginalise, or foreclose, downstream competitors include the following:

- (a) Sky's refusal to wholesale its premium channels to certain pay TV retailers on the DTT platform means that consumers on those platforms are denied the ability to choose to subscribe to those channels. The fact that Sky does not wholesale its channels to DSL providers (instead, insisting on retailing direct to customers via 'Sky by Wire') denies those platforms the ability, among other things, to offer bundled or discounted offerings including premium content to their customers.
- (b) In this regard, although Sky recently announced that it has plans to launch its own pay TV services on DTT, Ofcom has previously acknowledged that, if Sky were allowed to launch pay TV services on DTT, it would avoid pricing such services competitively when compared with its pay TV services on satellite.⁸⁰ Thus,

⁷⁹

See also the Confidential Annexes to this Submission.

⁸⁰

See paragraph 3.2 of Ofcom's consultation document of 27 October 2005 in respect of the provision of pay TV service on DTT multiplexes B, C and D in which Ofcom noted that "Given Sky's position in supply of pay TV services on the digital satellite platform, there was a potential concern that [Sky's] participation in an alternative digital TV or

consumers would not benefit from retail price competition or a choice of pay TV retailer of key content if Sky were to launch pay TV services on DTT.

- (c) The refusal by Sky to supply enhanced, interactive or HD services or on-demand content to Virgin Media means that customers on the cable platform are denied access to those features and services. For example, Virgin Media customers are unable to view sports content in HD or to benefit from the on-demand capabilities of the Virgin Media platform in connection with Sky's premium content. In consequence, those customers wishing to benefit from these features in association with premium content are either denied them entirely (e.g. video on-demand) or have no option but to choose the DTH platform (e.g. HD).⁸¹
- (d) Sky's constructive refusal to supply its basic channels to Virgin Media has deprived customers on the cable platform of access to those channels, thereby reducing their choice of channels on the cable platform.

5.4 Examples of **diminished innovation** arising from the ability of Sky to marginalise, or foreclose, downstream competitors include the following:

- (a) By wholesaling its premium channels to Virgin Media at uneconomic rates, Sky effectively forces Virgin Media to follow the pricing model of Sky and deprives Virgin Media the flexibility necessary to innovate in the pricing of its retail packages.
- (b) Virgin Media's incentive to innovate in pricing is further diminished as a consequence of the failure of Sky to offer any security of contract in relation to the terms of supply of premium channels. This lack of certainty makes it difficult for Virgin Media to adopt a forward looking strategy and reduces the incentive for Virgin Media to make the marketing and other investments necessary to launch innovative pricing mechanisms. Virgin Media is acutely aware that Sky could almost immediately react to such pricing innovations by changing the terms on which it supplies its premium channels to Virgin Media.
- (c) By refusing to supply Virgin Media with enhanced and interactive services, and prohibiting Virgin Media from developing its own enhanced and interactive services in connection with Sky's premium channels, Virgin Media is deprived of the ability to develop services that utilise the inherent advantages of the cable platform.
- (d) Much of the content (particularly the US sports content) broadcast by Setanta is filmed in high definition ("HD"). When Setanta starts broadcasting live FAPL matches in the UK from August this year, it would like to provide viewers with the

pay TV platform could reduce the degree of future competition between the two platforms." Ofcom also noted, in paragraph 2.28 of the consultation document that, if Sky were to be allowed to change its DTT channels to pay TV, it would *"have an incentive to make them complementary rather than substitutable for Sky's satellite services"*.

⁸¹ Sky exploits this position by heavily cross-promoting its enhanced and interactive services on the linear streams of its premium channels which it does supply to the cable platform.

option of watching that coverage in HD. As outlined in Part 2 above, the satellite platform is by far the biggest pay TV platform in the UK. In order for a Setanta HD sports channel to be viable, it needs access to the satellite platform. That platform is, however, controlled by Setanta's principal competitor, Sky. Whilst Sky currently provides conditional access services to Setanta to enable it to distribute its standard definition channels on satellite, Sky has refused to provide conditional access services to Setanta for a new HD channel. It has, however, indicated that it may be willing to retail a Setanta HD sports channel on the satellite platform to its subscribers – an arrangement which would eliminate retail price competition between such a channel and Sky's own channels (including its existing HD sports channels). Sky is, therefore, inhibiting Setanta's ability to introduce better quality broadcasts for its viewers.

- (e) As is well understood, and as Ofcom has recently acknowledged,⁸² DTT is a scarce national resource. As a consequence, the number of channels that can be broadcast on DTT is necessarily limited. This scarcity has constrained TUTV's ability to expand the content it provides in response to consumer demand. TUTV's solution has been to develop a DTT overnight download service to digital TV recorders. This service not only significantly increases the choice of programmes that can be watched at any point in time by DTT viewers, it achieves this through the use of overnight DTT capacity which has previously had a relatively low utility. Further expansion of the content available via this innovative service has been (and is being) impeded by Sky's selective distribution policy in respect of its channels and the way in which Sky influences the distribution decisions of third party channels.
- (f) Sky is also now seeking to reinforce the effects of the vicious circle outlined above by extending it into new distribution platforms and technologies. For example, Sky imposes onerous obligations, including most favoured nation clauses, on third party broadcasters in its agreements with them for satellite distribution of their channels. These MFN clauses result in either restricted access to content for competitors seeking to use new platforms and technologies or the imposition upon such competitors of commercial terms which are appropriate for more traditional linear broadcast services. Thus, these MFN clauses inhibit the development of innovative services over new platforms and technologies.
- (g) By virtue of the ability of Sky to marginalise its downstream competitors, Sky faces reduced downstream competition and, as a consequence, itself has a reduced incentive to innovate and develop new products and services.

Upstream foreclosure

⁸² Ofcom's statement of 19 June 2007 entitled "*Future pricing of spectrum used for terrestrial broadcasting*".

5.5 Examples of the reduction in choice arising from the ability of Sky to marginalise, or foreclose, upstream competitors include the following:

- (a) By inhibiting the ability of third parties to win premium content, Sky is able to prevent third parties from creating attractive channels and sports programming that would provide an alternative choice to Sky's premium sports and movie channels.
- (b) Through the bundled acquisition of ancillary rights (including rights such as DSL) on an exclusive basis, Sky denies such rights to innovative new entrants such as BT Vision whilst not fully exploiting these ancillary rights itself. Because of the exclusivity provisions, these rights are not available directly from content owners.⁸³
- (c) A reduction in the choice of sports and movie channels may also have the direct effect of reducing the choice for some consumers of available TV platforms. This is because, if consumers have a demand for a particular type of content (whether it be premium sports or premium movie content) and the only channels that show that content are not available on all relevant digital platforms, this will reduce the choice of digital platforms for those consumers.

5.6 Examples of **diminished innovation** arising from the ability of Sky to marginalise, or foreclose, upstream competitors include the following:

- (a) By hindering access to attractive content by third parties, Sky prevents those third parties from developing products and channels which contain innovations and features that are not currently available on Sky's premium channels. By way of example Virgin Media is unable to develop new sports programming that allow it to maximise the advantages of the bandwidth provided by the cable platform.
- (b) Sky's ability to use its very significant downstream purchasing power to impose an enormous reduction on the carriage fees paid by Sky to Virgin Media TV will reduce the financial ability of Virgin Media TV to invest in attractive content, in experienced human resources and in the development and innovation of novel and new programming. This will reduce both choice and innovation for viewers. To the extent that Sky exploits its downstream purchasing power in a similar way in negotiations with other channel providers, this effect will be exacerbated.
- (c) The very significant purchasing power conferred on Sky as a consequence of its large subscriber base, and the ability to impose restrictive terms in relation to the supply by channel providers of programmes to the DTH platform (and, in particular, the imposition of restrictions as to the availability of such content on other

⁸³ The European Commission has noted that: "*Bundling of rights across platforms may represent a restriction which, due to the strong asymmetry of value between the TV rights and the [new media] rights, prevents operators that offer [new media] services from purchasing meaningful rights. The purchasers of bundled rights are most frequently TV operators.*" Paragraph 32 of the European Commission's Concluding Report on the Sector Inquiry into the Provision of Sports Content over Third Generation Mobile Networks (21 September 2005). Whilst this comment of the Commission expressly referred to mobile rights, the principle applies equally to DSL rights.

platforms) again reduces the ability of affected broadcasters to innovate in terms of the use of content and in overall strategy.

- (d) By virtue of the ability of Sky to marginalise its upstream competitors, Sky faces reduced upstream competition and, as a consequence, itself has a reduced incentive to innovate and develop new products and services.

6 Spillover effects

- 6.1 This Submission focuses on the competitive implications of the vicious circle for the UK pay TV industry. The adverse effects of this vicious circle do, however, extend beyond the pay TV industry. For example, Sky's unrivalled ability to acquire key content denies such drivers to the Freeview offering on the DTT platform. Given the importance of DTT to digital switchover, it is imperative that Ofcom address the vicious circle so as to ensure not only that progress towards digital switchover is not impeded but also that the structural problems in the pay TV industry are not simply perpetuated into the post-analogue era.
- 6.2 In addition, the competitive advantages stemming from the vicious circle of mutually reinforcing upstream and downstream bottlenecks can be and are being leveraged by Sky to extend its leading position into related markets and services as described in the Confidential Annexes.

Part 5

Potential Remedies

1 Introduction

- 1.1 Before making a market reference to the CC, Ofcom must satisfy itself that there is a reasonable chance that appropriate remedies will be available to address its concerns.⁸⁴ In this context, it is worth noting that the CC has extremely broad powers to impose the wide-ranging remedies necessary to address the structural and associated behavioural problems identified above and in the Confidential Annexes. These include remedies designed to modify the structure of a market (for example requiring separation or divestment of a business or assets) and remedies relating to conduct (for example directing a firm to discontinue or to adopt certain behaviour, restraining the way in which it would otherwise behave or requiring it to provide Ofcom with information so that Ofcom may monitor its behaviour). If acceptable undertakings are not offered to Ofcom, the structural and associated behavioural problems identified would best be remedied by recourse to these far-reaching powers.⁸⁵
- 1.2 When considering how the vicious circle of mutually reinforcing upstream and downstream bottlenecks can be remedied, several decades of economic regulation in network industries⁸⁶ and the experience of the pay TV industry suggest that:
- (a) intervention is needed at all horizontal levels of the supply chain. Downstream regulation without upstream intervention will not lead to effective competition in retail distribution. Likewise, measures aimed at generating a level playing field for content acquisition will fail in the absence of effective regulation downstream; and
 - (b) the design of the remedies should address Sky's vertical integration and the resulting incentives to foreclose, or at least to marginalise, its upstream and downstream competitors. Remedies that are intended to ensure access on a non-discriminatory basis will require the adoption of measures designed to increase transparency and hence to facilitate monitoring and enforcement. Alternatively, structural remedies could be considered.
- 1.3 A wide, but not exhaustive, range of remedies appropriate to address issues arising from both horizontal and vertical features of the market is described below.⁸⁷ These remedies

⁸⁴ See also Part 6 below.

⁸⁵ In practice, the necessary remedies can be made to take effect by the CC accepting undertakings, by it exercising its order making powers (see Schedule 8 of the Act) or by a recommendation that action be taken by a third party (for example the government, a regulator or a public authority).

⁸⁶ See for example M. Cave and Peter Crowther, Co-ordinating regulation and competition law: ex ante and ex post in *The Pros and Cons of Antitrust in Deregulated Markets*, Konkurrensverket (Swedish Competition Authority), 11-28 (2004).

⁸⁷ The proposals on remedies in this Submission are at an early stage of development. The Parties intend to supplement these proposals in due course.

take into account the two prerequisites discussed above and are implementable at a proportionate cost. Further investigation may reveal that these remedy proposals have to be supplemented in order to deal effectively with the problems identified in this Submission.

2 Remedies to address horizontal features of the market

2.1 Remedies designed to enable effective competition at all levels of the pay TV supply chain might include:

- (a) fair reasonable and non-discriminatory (“FRND”) access by third party pay TV retailers to Sky’s premium channels;
- (b) FRND access by third party broadcasters and pay TV retailers to Sky’s downstream distribution platform (i.e. Sky’s technical platform services);
- (c) appropriate remedies to address the fact that Sky has the largest base of pay TV subscribers;
- (d) a prohibition on the forced buy through of premium channels through a basic channel;
- (e) modifications to the next FAPL auction in order to increase competition for live rights, including the establishment of more balanced content packages, permitting contingent bidding by non-dominant bidders and limiting to four the number of live packages any bidder can win;
- (f) a constraint on the overall amount of sports and movies content any one broadcaster can acquire;
- (g) a limit on the duration of Sky’s exclusive rights to sports and movies;
- (h) an obligation on Sky to unbundle its bids for ancillary rights; and
- (i) a “use it or lose it” provision in respect of rights acquired by Sky.

These components are explained below.

Access to Sky’s premium channels

2.2 An express obligation on the market leader in the provision of premium sports and movies channels to provide FRND access to third party retailers has already been imposed in a number of instances; for example, on Canal+ and Sky Italia. Whilst these access obligations were imposed on Canal+ and Sky Italia as remedies in merger cases, it should be noted that the underlying rationale for the imposition of remedies in both merger cases and market investigations is broadly the same. Remedies are imposed in merger cases in order to prevent a situation arising in which competition in a market is lessened. Remedies in market investigations are intended to redress existing market failure. Moreover, as Ofcom is aware, the CC has the power to impose wide ranging remedies by seeking undertakings or making

orders in both merger cases and market investigations.⁸⁸ In both cases, any order made by the CC may include the types of provisions set out in Schedule 8 of the Enterprise Act.⁸⁹ In imposing remedies as a result of adverse findings in a market investigation, the CC would therefore be exercising exactly the same menu of powers as it would exercise as a result of adverse findings in a merger inquiry, in order to achieve the same end (i.e. to bring about market conditions that allow for effective competition).

- 2.3 FRND access to Sky's premium channels would need to encompass commercially viable wholesale charges, among other things. As part of its investigation of Sky between 2000 and 2002, the OFT applied (i) a margin squeeze test in an attempt to ensure that Sky's overall **retail** distribution business is profitable and (ii) a mixed bundling test in an attempt to ensure that the incremental costs incurred by Sky in supplying an additional premium channel to a subscriber would be covered by the **wholesale** revenues earned by Sky's broadcasting business (either actually from a third party distributor or notionally from Sky's own distribution business). Thus, whilst the margin squeeze test was applied at the retail level, the mixed bundling test was only applied at the wholesale level.
- 2.4 As a consequence, in several cases, Sky has been able to set the wholesale charge for a premium channel so that it is higher than the incremental retail revenue that Sky earns as a result of supplying that premium channel to an additional subscriber.⁹⁰ As Virgin Media has to pay those wholesale prices but still compete with the retail price points, this results in Virgin Media (the only current third party distributor of Sky's premium channels) having little or no incentive actively to compete with Sky in the retailing of these channels.
- 2.5 In order to be commercially viable, therefore, the wholesale charges for Sky's premium channels must not only satisfy the OFT's (retail) margin squeeze test and the OFT's (wholesale) mixed bundling test but also a mixed bundling test which is applied at the retail level. This should ensure that Sky's wholesale charges are set at a level which is lower than the incremental retail revenues earned by Sky from the sale of those channels (thereby enabling third party retailers of these channels to compete more effectively with Sky). In this context, it is noteworthy that Sky Italia's incremental wholesale charges for its premium channels are expressly subject to a "*retail minus*" test. The "*minus*" in that case comprises, among other things, the retail distribution costs (including marketing, transmission and box costs) which Sky Italia avoids when supplying premium channels to third party distributors.⁹¹
- 2.6 FRND access to Sky's premium channels should, subject only to reasonable and demonstrable technical constraints, include access to the same product as that retailed to DTH subscribers (i.e. including associated enhanced, interactive and HD services) on

⁸⁸ In merger cases, the CC's power to accept final undertakings is contained in section 82 of the Enterprise Act and its power to make final orders is contained in section 84 of the Act. In market investigations, the CC's power to accept final undertakings is contained in section 159 of the Enterprise Act and its power to make final orders is contained in section 161 of the Act.

⁸⁹ As Ofcom is aware, whilst the content of any orders made by the CC is limited by the Act, the subject matter of an undertaking is not similarly limited (section 164(1) of the Act).

⁹⁰ Sky's distribution business, therefore, often earns a negative gross margin on the incremental sale of an additional premium channel.

⁹¹ Paragraph 10.5 of the Commitments given by News Corp to the European Commission on 13 March 2003.

commercially viable wholesale terms. This would allow efficient rival pay TV retailers and platforms to compete more effectively with Sky, thereby benefiting consumers by offering greater choice and retail price competition.

Access to Sky's platform and subscribers

- 2.7 One of the principal reasons for the introduction of regulation of technical platform services ("TPS"), and the requirement on platform operators such as Sky to provide FRND access to TPS including conditional access and EPG services, was the desire to facilitate intra platform competition – i.e. to enable competing pay TV retailers to build up their own base of satellite subscribers, for example, and thereby increase the choice available to satellite viewers. To date, there has been limited competitive entry on to the satellite platform in the UK, for reasons outlined in the Confidential Annexes. The pay TV channels which are retailed on satellite by third parties independently of Sky's pay TV packages are largely confined to adult services, ethnic channels and Setanta's package of sports channels.
- 2.8 For reasons which are (again) explained in the Confidential Annexes, the current TPS regulatory regime is insufficient and needs to be strengthened. In particular, whilst effective FRND access to Sky's TPS should assist third party broadcasters to compete upstream for rights, it will not address the material bidding advantage which Sky enjoys as a result of having by far the largest base of pay TV subscribers in the UK. Accordingly, appropriate remedies should be considered in respect of Sky's downstream bottlenecks.
- 2.9 Furthermore, for reasons set out above, and in the Confidential Annexes, the TPS regime will never be sufficient to provide viable access to the DTH platform for pay basic channels. Accordingly, pay basic channels will always be reliant on being included in Sky's retail distribution pack thereby conferring enormous purchasing power on Sky.

Prohibition on the forced buy through

- 2.10 As described above, and in the Confidential Annexes, one of the reasons that the TPS regime is not effective in providing viable access to the DTH platform for a retailer of basic channels (other than Sky) is Sky's strategy of requiring customers to buy a basic package of channels before they can buy a premium channel. This strategy means that all Sky's premium channel subscribers will already have access to a large number of basic channels and are, therefore, very much less likely to be inclined to purchase further basic channels. It also means that subscribers are already paying a significant monthly sum for TV services which will make potential customers less inclined to purchase further channels. If this forced "buy through" were to be addressed, this could lead to much more innovative offering and pricing on the DTH platform and may make it easier for rival pay TV retailers to attract subscribers on the DTH platform.

Monitoring and enforcement

- 2.11 Experience shows that monitoring and enforcing FRND conditions (such as those described above) can be inherently difficult. On the one hand, there may be some vagueness in the

meaning of FRND in particular circumstances; on the other, the information required to implement those conditions effectively can be open to manipulation.

2.12 The first problem can be dealt with by publishing detailed guidelines on how to approach the calculation of FRND charges. Ofcom has recently made an attempt at this in connection with Sky's provision of TPS.⁹² As the Confidential Annexes demonstrate, however, the TPS charges which Sky published in December 2006, following Ofcom's new TPS guidelines, exhibit a number of deficiencies. Thus, even prescriptive guidelines tend to leave room for manipulation and abuse.

2.13 The second issue outlined in paragraph 2.11 will require Sky to maintain separate accounts for each of its different businesses. Accounting separation is not a remedy in itself, it is a tool designed to increase transparency and thus facilitate the enforcement of an access remedy.⁹³

Content acquisition

2.14 Whilst the first three components outlined in paragraphs 2.1(a), (b) and (c) above (and explained in more detail in paragraphs 2.2 to 2.10 above) contribute to breaking the vicious circle of mutually reinforcing upstream and downstream bottlenecks, they will not be sufficient to resolve the competition problem described in Part 3 above. This is because Sky's downstream advantages, among other things, will continue to ensure that it wins the contest for key content.

2.15 For this reason, it will be necessary to address Sky's first-mover advantage in the contest for content.⁹⁴ This could be done in various different ways, which are to some extent complementary.

(a) The most significant rights in the UK from the point of view of pay TV channels are the live rights to FAPL coverage. As is explained in Annex 2, competition for these rights could be increased in the next auction by (i) balancing the attractiveness of the various live packages being sold, (ii) allowing non-dominant bidders to submit contingent bids and (iii) limiting to four the number of live packages any bidder can win.

(b) Competing broadcasters would gain further opportunities to acquire sports and movie rights if an overall constraint were imposed on the content share (by value) in each genre which could be acquired by any given broadcaster. This constraint

⁹² Provision of technical platform services: Guidelines and Explanatory Statement, Ofcom, 21 September 2006. <http://www.ofcom.org.uk/consult/condocs/tpsguidelines/statement/statement.pdf>

⁹³ Accounting separation was applied in respect of Sky's broadcasting and distribution business between 1995 and 2002, following Sky's undertakings to the OFT to prepare separate accounts for its broadcasting entity ("BroadCo") and its distribution entity ("DiscCo"). Accounting separation is currently only applied in respect of Sky's TPS activities.

⁹⁴ Klemperer shows that when contracts are large and specialised, the winner of the past contract is likely to have a substantial advantage in the future auction. This makes new entry particularly hard, especially when there are sunk costs of participating in the auction. See Klemperer, Paul. "Bidding Markets", UK Competition Commission, 2005.

could, for example, be defined on the basis of a broad genre such as sports content, or on a narrower basis such as all live football rights.

- (c) A limitation could be imposed on the duration of Sky's agreements for sports and movie rights, some of which extend to ten years. Agreements of such a long duration clearly preclude the possibility of competitors acquiring these rights and establishing channels which could compete more effectively downstream with Sky's pay TV channels.
- (d) Sky could be required to unbundle its bids for ancillary rights. Thus, when bidding for sports rights, for example, Sky should specify stand-alone sums for the live rights and any other rights which may be offered by the rights owner, such as delayed and/or clip rights. This would enable competitors to bid for the ancillary rights in isolation should they wish to do so.
- (e) Sky could be subject to a "use it or lose it" provision in respect of the sports and movie rights it acquires. If it acquires particular rights and does not exploit them within a reasonable period, it should either sub-license those rights to third parties on an FRND basis or the rights should revert to the rights owner so that they may be re-auctioned.

2.16 The above remedies would all be practicable to implement and would help address the fact that the features of the pay TV industry have enabled Sky to acquire a position of market power at each horizontal level of the supply chain. The wider dissemination of content rights would increase the degree of competition between pay TV retailers and platforms and, therefore, reduce the price that consumers pay for content. Over time, the downstream markets would be expected to become more symmetric which would then, closing the loop, lead to more symmetric competition upstream. This new virtuous circle of competition upstream and downstream may ultimately cause competition downstream to be sufficiently symmetrical that the constraint on content share (and other content remedies) would no longer be binding or necessary.

3 Remedies to address vertical features of the market

3.1 Whilst the remedies outlined above would limit Sky's ability to foreclose, or marginalise, competitors at the various levels of the supply chain, Sky's **incentive** to do so would remain. This incentive will remain intact for as long as Sky is fully integrated along the different tiers of the pay TV supply chain. Sky would, therefore, continue to have a strong incentive to limit the quality of access available to its rivals and to attempt to find ways around the regulation. Trying explicitly to regulate a company against the grain of its economic incentives will always be both costly and difficult. The only way to address Sky's incentive effectively is to modify its vertical structure.

- 3.2 Given that the combination of (a) the economic features of the market (outlined in Part 3 above), (b) Sky's vertical integration and (c) its leading market positions results in the prevention, restriction or distortion of competition, an option is to ensure that Sky's upstream and downstream businesses, though vertically-related, are operationally separated.⁹⁵ This type of separation would address directly the vicious circle of mutually reinforcing upstream and downstream bottlenecks by cutting *de facto* the links between Sky's upstream and downstream businesses.
- 3.3 The remedy would require Sky's channel business (including content acquisition) and its distribution business (including its retail activities) to be operationally separated. For want of better names at this stage, the content acquisition and channel supply business is referred to as "ChannelCo" and the pay TV retailing and satellite platform operation business is referred to as "SatCo".⁹⁶
- 3.4 It should be noted that the separation described above will result in SatCo controlling two downstream bottlenecks: the largest pay TV platform in the UK and the largest base of pay TV subscribers in the UK. Further investigation may indicate that Sky's platform and retail distribution businesses should themselves be subject to similar remedies. Nevertheless, for the purposes of this Submission, the Parties have merely focused on the separation of ChannelCo from SatCo.
- 3.5 Such a remedy would have as its objective the removal of Sky's incentive to foreclose or marginalise its competitors at the various levels of the supply chain and to reduce Sky's incentive to undermine remedies designed to address its market power at each horizontal level of the distribution chain. By separating the content acquisition and wholesale channel supply division from the retail distribution and platform operation division, Sky's incentives and ability to foreclose or marginalise competitors should be greatly reduced as:
- (a) SatCo should have an incentive to carry rival upstream channels to increase the attractiveness of its offerings and increase the profitability of the downstream platform, even if this may be at the expense of ChannelCo's competitive positions and profits. ChannelCo will, therefore, have a reduced competitive advantage (which should be eliminated over time) in respect of future contests for content; and
 - (b) ChannelCo should no longer discriminate against rival downstream distribution platforms. As shown by Rey and Tirole (1997),⁹⁷ an upstream monopolist that is not vertically integrated downstream and cannot sign exclusive contracts will proceed to sell to all downstream competitors. This is precisely what ChannelCo

⁹⁵ This is within the power of the CC. The CC's power to accept final undertakings is contained in section 159 of the Enterprise Act and its power to make final orders is contained in section 161 of the Enterprise Act. The provisions that may be contained in an order under section 161 are described in Schedule 8 to the Enterprise Act.

⁹⁶ The fact that accounting separation of a content/channel business (called "Broadco") and a satellite distribution/platform operation business (called "Disco") business has been tried before for Sky should not detract from this proposal. The previous attempt at accounting separation was not part of a separation remedy.

⁹⁷ Rey, Patrick and Jean Tirole, "A Primer on Foreclosure", in Mark Amstrong and Robert Porter (eds.), *Handbook of Industrial Organisation*, vol 3, 1997.

should be expected to do. *First*, ChannelCo's managers will not take into consideration SatCo's profits when negotiating with SatCo's competitors. That is, ChannelCo will act as a non-integrated company. *Second*, ChannelCo cannot sign exclusive contracts (and if it did they would not be enforceable) with one or more downstream competitors due to the imposition of FRND obligations. As a result, there should be more effective competition downstream.

- 3.6 If the remedy worked as intended, then there may be less need for any further content regulation, such as the imposition of content share caps. Under such remedy, SatCo, when deciding what channels to take and commercialise, will consider the offerings of all channel suppliers and not just ChannelCo's. Both ChannelCo and its competitors will bid for content with the knowledge that whoever wins the content will have its channel distributed by SatCo. ChannelCo will no longer enjoy quite the same first-mover advantage. A remedy to separate operationally the two businesses could, therefore, over time, address the leveraging of the downstream platform and retail advantages into the acquisition of content.

4 Conclusion on remedies

- 4.1 In order to address the vicious circle of mutually reinforcing upstream and downstream bottlenecks, it is clear that more extensive remedies are required than have been applied in respect of pay TV in the UK to date.
- 4.2 Nevertheless, as is demonstrated above, there is undoubtedly more than a reasonable chance that appropriate remedies will be available to the CC to address the concerns identified.

Part 6

Legal assessment of the market reference test in section 131 of the Enterprise Act 2002

1 Introduction

1.1 In its announcement of 20 March 2007, Ofcom indicated that following its initial investigation and having obtained information from market participants, it will determine whether a market reference to the Competition Commission is required. It will also consider whether any of the concerns raised would be better addressed using sectoral powers or the Competition Act 1998. Against a background of the relevant legislative criteria for assessing whether a market investigation reference to the CC should be made, this Part demonstrates that this is now the appropriate course of action for Ofcom to take.

1.2 As Ofcom is aware, it has a discretion under section 131 of the Act⁹⁸ to make a market investigation reference to the CC where:

“it has reasonable grounds to suspect that any feature, or combination of features, of a market in the United Kingdom for goods and services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom.”

1.3 The evidence and information provided by the Parties in this Submission clearly demonstrate that there are reasonable grounds to suspect that there are features of the UK pay TV industry which prevent, restrict or distort competition. In the absence of appropriate undertakings being offered and accepted, the Parties would therefore urge Ofcom to exercise its discretion to make a market investigation reference to the CC.⁹⁹

2 Reasonable grounds to suspect that features of the market prevent, restrict or distort competition

2.1 As explained above, in order to make a reference, Ofcom only needs to establish “reasonable grounds to suspect” that a feature, or combination of features, prevents, restricts or distorts competition in a market in the UK for goods and services. Where this threshold is met, Ofcom has a discretion whether to make a reference. The reasonable grounds threshold is recognised as a very low one,¹⁰⁰ reflecting Ofcom’s role as first phase

⁹⁸ Section 370 of the Communications Act 2003 (the “Communications Act”) grants Ofcom concurrent powers with the OFT to make a market investigation reference under section 131(1) of the Act so far as relating to commercial activities connected with communications matters, which includes broadcasting and related matters. Thus, the issues raised by the Parties fall squarely within Ofcom’s competence.

⁹⁹ None of the situations under section 131(4) of the Act, which might otherwise prevent a reference under section 131(1), are applicable to an investigation of the UK pay TV industry.

¹⁰⁰ See Peter Freeman’s speech “Regulation and Competition - Chalk and Cheese? The Role of the Competition Commission”, CRI Frontiers of Regulation Conference Keynote Speech, 7 September 2006.

investigator.¹⁰¹ Indeed, the OFT rejected a claim by BAA that the OFT had not made a ‘compelling case for reference founded on a robust analysis of the market’ on the basis that a ‘compelling case’ implied a higher standard of proof than the legal test requires.

2.2 Accordingly, Ofcom need not reach a definitive view on the concerns identified by the Parties (although it may of course choose to do so in light of the information provided in this Submission). A full CC investigation would establish whether there are in fact adverse effects on competition and consumers, the extent to which the features identified are inherent to the industry and how competition can be improved (in other words, the determination of appropriate remedies to address the harm identified).

2.3 A full investigation by the CC would also reveal the extent to which Sky is taking advantage of existing market features to its benefit and to the detriment of competition and consumers. As Ofcom is aware, for the purposes of section 131 of the Act, the feature (or features) of the market that gives rise to the adverse effect on competition may relate to:¹⁰²

- (a) the structure of the market concerned or any aspect of that structure;
- (b) any conduct of one or more than one person who supplies or acquires goods or services in the market concerned; or
- (c) any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.

2.4 The OFT recognises in its guidance that it may not always be clear whether a feature of a market that affects competition is best described as a structural feature or as an aspect of conduct, but that provided the relevant feature is clearly identified, categorising it will be a semantic exercise.¹⁰³

2.5 Whilst an argument can no doubt be constructed that it is not the purpose of the market investigation provisions of the Act to deal solely with single firm conduct, these provisions can clearly be used in circumstances where, as is the case here, the combination of single firm conduct and other structural features of a market results in adverse effects on competition¹⁰⁴. This is supported by paragraphs 2.7 and 2.8 of the OFT guidance¹⁰⁵ and by the OFT’s decision of April 2007 to refer the supply of airport services in the UK by BAA to the CC. The OFT recognised in its decision that whilst the reference focused on a single firm, it was nonetheless appropriate (and equally the use of Chapter II prohibition was inappropriate) because the underlying issues were structural in that case.

¹⁰¹ See paragraph 8.2 of the OFT’s reference to the CC of BAA, dated April 2007.

¹⁰² Section 131(2).

¹⁰³ Paragraph 1.9.

¹⁰⁴ It is worth noting in this regard that the relevant provisions of the Enterprise Act have effectively replaced the Fair Trading Act’s monopoly reference provisions, including not only complex monopoly references, but also references of “scale” monopolies where distortions of competition were identified as a result of the conduct of a firm or firms with over 25 percent of the market.

¹⁰⁵ References to the OFT’s guidance in this Submission refer to “Market Investigation References: Guidance about the making of references under Part 4 of the Enterprise Act”, dated March 2006.

- 2.6 In Part 3 above, the Parties have identified specific structural defects affecting the UK pay TV supply chain which lead to competition being prevented, restricted or distorted.¹⁰⁶ The specific anti-competitive practices identified are a direct consequence of, amongst others, the following:
- (a) the industry is characterised by a high degree of vertical integration across its various levels, namely the acquisition of content, the wholesale supply of channels and the distribution and retailing of pay TV content;¹⁰⁷
 - (b) each level of the supply chain exhibits substantial horizontal concentration, significant barriers to entry and a persistent first mover advantage, which lead to serious impediments to effective competition and result in market failure;¹⁰⁸ and
 - (c) the piecemeal regulation of individual symptoms of market failure has proved to be deficient. For example, current TPS regulation has not resulted in the creation of effective competition between pay TV retailers on the satellite platform.¹⁰⁹
- 2.7 These structural features, among other things, give rise to the mutually reinforcing upstream and downstream bottlenecks and the resulting vicious circle which makes it impossible for other operators to compete effectively with Sky (as described at length in this Submission).¹¹⁰
- 2.8 It is the particular features of the pay TV industry which ensure that Sky is not subject to normal competitive constraints from rivals and which therefore allow it to behave in a way which forecloses, or at least marginalises, its competitors. Its stranglehold on the industry gives particular cause for concern at a time when advances in technology offer the potential for new entry, for example, PVR based services on DTT and DSL delivered on-demand services.
- 2.9 The approach to an assessment of the adverse effects on competition, which result from the structural features and conduct identified in this Submission, is equivalent to the analysis of foreclosure effects which may be expected to result from non-horizontal mergers. In this case, as in the case of non-horizontal mergers, for structural reasons actual or potential rivals' access to supplies or markets may be hampered or eliminated, thereby reducing these companies' ability and/or incentive to compete. The European Commission's approach to analysing non-horizontal mergers is described in its recently published draft notice.¹¹¹ Notwithstanding that the foreclosure effects in the present case do not arise as a result of a merger, the analysis in the Commission's draft notice is directly relevant, because of the

¹⁰⁶ It is worth noting that the OFT guidance on market investigation references specifically envisages that market investigation references may embrace several levels of a supply chain (paragraph 4.3).

¹⁰⁷ See Part 3, section 3 above. The OFT recognises, at paragraph 5.8 of its guidance on market investigation references, that vertical integration is an example of a structural feature which may have an effect on competition.

¹⁰⁸ See Part 2 above.

¹⁰⁹ In any event, the TPS regulation cannot address the significant first mover advantage that Sky has when bidding for content rights.

¹¹⁰ See Part 5, paragraphs 2.7 to 2.10 above.

¹¹¹ See Draft Commission Notice - Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings, published on 13 February 2007.

particular vertical and horizontal features prevalent in the UK pay TV industry as described in this Submission and, in particular, relating to:

- Input foreclosure where a vertically integrated firm has market power in an upstream market.¹¹² As explained in Part 2 above, with regard to the UK pay TV industry, Sky clearly holds such a position upstream and also in the context of the other levels of the supply chain.
- Anticompetitive foreclosure when vertical integration enables an operator to increase the costs of a downstream rival, thereby leading to an upward pressure on prices.¹¹³
- Raising barriers to entry to potential competitors. A vertically integrated operator can foreclose potential competition on the downstream market when the operator would be likely not to supply potential downstream entrants. The mere likelihood that a vertically integrated entity would carry out a foreclosure strategy may also create a strong deterrent to potential entrants.¹¹⁴ These types of downstream foreclosure effects are directly on point in the UK pay TV industry, as explained at paragraph 4.3 onwards of Part 3 above.
- Likewise, effective competition on the upstream market may also be significantly impeded by raising barriers to entry to potential competitors. This may be so, in particular, if foreclosure of access to customers would require potential competitors to enter at both the downstream and the upstream levels in order to compete effectively on either market.¹¹⁵ As explained at paragraph 4.7 onwards of Part 3 above, Sky has both the incentive and the ability to foreclose or at least marginalise its upstream competitors.

2.10 The various examples of market failure identified in the Submission are a direct consequence of and are inextricably linked to the structural features at each level of the pay TV industry. If changes are not made to these underlying structural defects, then new entry and competition will be stifled or foreclosed. It is only if the pay TV supply chain becomes contestable both upstream and downstream that the vicious circle will collapse and with it Sky's ability to exclude or marginalise its competitors. In other words, it is clear that co-ordinated intervention is needed at all levels of the supply chain. In such circumstances, the market investigation provisions under the Act provide a clear route for redress.

2.11 This Submission therefore demonstrates **at the very least** that there are reasonable grounds for suspecting that a feature, or combination of features, prevents, restricts or distorts competition in the UK pay TV industry.

¹¹² See paragraph 34.
¹¹³ See paragraph 46.
¹¹⁴ See paragraph 47.
¹¹⁵ See paragraph 74.

3 A market investigation is the most appropriate way of proceeding

3.1 In determining whether the relevant thresholds for a reference are satisfied, the OFT's guidance indicates that the following criteria must be met:

- (a) it would not be more appropriate to deal with the competition issues identified by applying the provisions of the Competition Act 1998 or using other available sectoral powers;
- (b) it would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference;
- (c) the scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it; and
- (d) there is a reasonable chance that appropriate remedies will be available.

Availability of other powers and previous and existing attempts at regulation

3.2 The prohibitions contained in Chapter I and Chapter II of the Competition Act 1998 (and Articles 81 and 82 of the EC Treaty) do not provide appropriate tools to deal with a situation where, as here, the process of competition is not working effectively at the different levels of the supply chain and the entire structure of a given industry needs to be reviewed to identify remedies which will secure the future contestability at each such level.

3.3 The behavioural remedies available under the Competition Act are inadequate to deal with the industry-wide market failure and structural features identified in this Submission, as Competition Act remedies by their very nature are intended to address individual instances of anti-competitive behaviour and redress past or current infringements rather than introduce prospective contestability at every level of the supply chain. They are also ineffective to deal with the breadth and extent of the adverse effects on competition identified at every level of the industry.¹¹⁶ The OFT's guidance notes that in such circumstances, where the effectiveness of competition at various levels of the supply chain is questioned, the market investigation route allows sufficient flexibility to investigate.¹¹⁷

3.4 As explained above, the features of the UK pay TV industry that prevent, restrict or distort competition arise inherently and persistently as a result of the existing industry structure. Even if a breach of one or more of the relevant Competition Act prohibitions were established, the Parties consider that this would not be effective either in resolving *all* of the adverse effects on competition arising from Sky's behaviour or in addressing the failures in the market which enable Sky to engage in that conduct.

3.5 Accordingly, piecemeal intervention under the Competition Act attempting to address individual symptoms of the underlying structural failure would not be sufficient to redress the

¹¹⁶ The OFT specifically referred to the number and diversity of issues in its decision to make a reference of the supply of liquefied petroleum gas in July 2004 (see, for example, paragraphs 20 and 27 of the OFT's report). See also the OFT's report on its market reference of store cards, dated March 2004, paragraphs 6.16 and 6.23.

¹¹⁷ See paragraph 2.2.

vicious circle of mutually reinforcing upstream and downstream bottlenecks in the UK pay TV industry. The wide range of distortive conduct is such that even if one aspect is remedied, the existing market structures will enable Sky to undertake alternative behaviour, which will have a similar foreclosing effect. Therefore, to resolve the adverse effects on competition identified and to enable the pay TV industry to work better for consumers, it is not enough to endeavour to analyse each aspect of conduct in terms of separate instances of abuse by a dominant operator. In this regard, the OFT notes at paragraph 2.8 of its guidance that it may make a market investigation reference even where there has been an infringement of Article 82 EC or Chapter II, but it is clear that nothing short of a structural remedy going beyond what is appropriate under the Competition Act would be effective in dealing with the consequential adverse effect on competition.

3.6 It is useful briefly to refer to two previous investigations into Sky's conduct to illustrate the inadequacy of other competition legislation to address the Parties' concerns.¹¹⁸

3.7 In 1996, the Director General of Fair Trading (the "Director") undertook a review (under the Fair Trading Act 1973) of Sky's position in the wholesale pay TV market (the "1996 Review")¹¹⁹. The review followed complaints from cable operators, who requested that the Secretary of State for Trade and Industry refer the market to the then Monopolies and Mergers Commission. Whilst the 1996 Review identified a number of serious competition issues,¹²⁰ the remedies resulting from it were unsatisfactory, with Sky entering into non-statutory undertakings concerning the terms it offered to cable operators for supplying its channels (the "Undertakings"). The Undertakings were subsequently waived following a review of Sky's activities beginning in March 2000. This led to an investigation into Sky under Chapter II of the Competition Act 1998 (the "2000 Investigation")¹²¹, as a result of which the Director found that Sky was dominant on the markets for the wholesale and retail supply of packages containing content unique to premium pay TV sports channels (identified at the time as live FAPL football) and packages containing premium pay TV film channels (defined as those including "category A and B films" as defined).¹²²

3.8 Again, however, the 2000 Investigation was inadequate to address the Parties' concerns. Firstly, the subject matter of the investigation was insufficiently wide. The 2000 Investigation considered allegations of abuse of dominance on the market for the *wholesale* supply of premium sports and film channels. Accordingly, the 2000 Investigation did not cover competition issues at the other levels of the supply chain as identified in this Submission.

¹¹⁸ It is worth reiterating that both of these investigations took place at a time when Sky's market position was not as strong as it is currently.

¹¹⁹ The 1996 Review.

¹²⁰ The Director concluded in paragraphs 1.2 and 2.7 that "*in the supply of premium programming at the wholesale level to cable operators, BSkyB had a very high market share. This was of particular concern because the review identified barriers to entry to the market for premium programming at the wholesale level which served to reinforce BSkyB's position.*"

¹²¹ BSkyB investigation: alleged infringement of the Chapter II prohibition, 17 December 2002, decision CA98/20/2000, case CP 01916-00).

¹²² Paragraph 321 of the 2002 Decision.

- 3.9 Secondly, the investigation relied upon the prohibitions in the Competition Act, which, as stated, in the Parties' view do not provide appropriate tools to deal with the all the issues raised in this Submission. Indeed, one result of the investigation was that the Director notified Sky that it no longer need observe the Undertakings, although "*it must of course observe the prohibitions contained in the [Competition] Act*".¹²³ Reminding Sky of its obligation to comply with competition law is in no way sufficient to prevent Sky acting in a way that negatively affects competitors and consumers and does not in any event deal with underlying structural features of the industry.
- 3.10 It is also worth considering certain relevant aspects of the existing relevant regulatory framework in order to demonstrate that it will not address the concerns raised by the Parties.
- (a) In March 2006, the Commission adopted a decision under Article 9 of Regulation 1/2003 making the commitments offered by the FA Premier League (FAPL) concerning the sale of media rights legally binding.¹²⁴ These commitments specify *inter alia* that the FAPL's live television rights from 2007 onwards will have to be sold in six balanced packages and no one buyer will be allowed to buy more than five. These commitments are binding upon the FAPL until 30 June 2013. The Commission's decision is stated expressly to have as its sole subject matter the *horizontal* joint selling arrangements and did not concern vertical agreements to license the rights concluded pursuant to that joint selling agreement¹²⁵. Accordingly, the Commission's review was limited in scope and did not seek to address all the potential competition issues relating to sports rights at the different levels of the supply chain as identified in this Submission.
- (b) Broadcasters who wish to gain access to viewers using Sky's digital set top boxes can purchase technical platform services (TPS) from Sky, and Sky is required to provide these services on fair, reasonable and non-discriminatory (FRND) terms.¹²⁶ Ofcom has published new detailed guidelines setting out "Ofcom's approach to considering in the event of a dispute or complaint whether Sky has complied with the conditions requiring it to provide access to TPS on fair, reasonable and non-discriminatory (FRND) terms".¹²⁷ The new guidelines apply as from 1 January 2007. On 20 December 2006, Sky published revised charges to adapt its policy to the new guidelines.
- 3.11 The logic behind these measures is appealing. On the one hand, the rules of the contest for FAPL rights - the most valuable content rights from a downstream perspective - are changed so as to limit Sky's upstream advantage and, therefore, promote effective competition at the

¹²³ See paragraph 648 of the 2002 Decision.

¹²⁴ See European Commission IP/06/356, "Competition: Commission makes commitments from FA Premier League legally binding": <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/06/356&format=HTML&aged=1&language=EN&quiLanguage=en>.

¹²⁵ Paragraph 1.1 of the Commission's Decision.

¹²⁶ Ofcom, "Provision of Technical Platform Services – Guidelines and Explanatory Statement", 21 September 2006, <http://www.ofcom.org.uk/consult/condocs/tpsguidelines/statement/>.

¹²⁷ See footnote 142 above.

channel supply and pay TV distribution levels of the supply chain. On the other, Sky is required to grant access to its platform on non-discriminatory terms, which, as a matter of theory, should encourage competition upstream.

- 3.12 Unfortunately, these regulations will not solve the problem generated by the vicious circle of mutually reinforcing upstream and downstream bottlenecks. The evidence so far supports this gloomy prediction.
- 3.13 Notwithstanding the Commission's efforts, the auction of the FAPL rights did not significantly reduce Sky's content or upstream advantage. While it is true that Setanta broke Sky's monopoly of rights to live FAPL coverage, winning the live rights to show 46 matches per season from 2007 for a period of three seasons, Sky won the live rights to 92 matches (including all the "first picks" and both the "A" and "E" packages which include 38 matches at 4.00pm on Sunday afternoons - the most advantageous time slot).¹²⁸ The TV rights auction generated £1.7 billion for the FAPL, with Sky paying £1.3 billion and Setanta £392 million. Thus, Sky will pay an average of £4.7 million per match and Setanta will pay an average of £2.84 million per match, i.e. Sky will pay approximately 70% more per match than Setanta - a clear indication that Sky will be broadcasting more attractive matches than Setanta.
- 3.14 The outcome of this auction was unsurprising. Sky could bank on its 7.8 million customers (its platform advantage) and the 5.1 million subscribers to Sky Sports (its retail advantage) to outbid any other competitor. Although it had to provide access to its platform on regulated terms, access terms were both too high and too uncertain to offset its platform advantage. As regards the first mover advantage gained from its existing retail subscriber base, Setanta (or any other competitor) will need to build a subscriber base within three years, before the rights are auctioned again.
- 3.15 Ofcom's new guidelines and the new TPS charges will not help to address Sky's retail advantage nor its incentive to obstruct access. This is because the TPS regime only requires Sky to provide platform access and it does not address Sky's retail advantage. Meanwhile, and given that Sky will still have the most attractive content, the vicious circle will continue to operate. Its leadership in channel supply and pay TV distribution will be consolidated, if not extended, and the next contest for content will be as biased as the past ones.

For the sake of completeness, the Parties have also considered whether Ofcom could consider using its powers to issue directions under section 316 of the Communications Act. However, as Ofcom is aware, these powers are expressly directed at addressing fair and effective competition in the provision of licensed services or connected services and are inadequate to deal with the structural concerns identified in this case.

Undertakings in lieu

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Annex 5 outlines certain specific shortcomings with the FAPL's commitments of 22 March 2006.

3.16 In the absence of appropriate undertakings being offered and accepted, the Parties would urge Ofcom to exercise its discretion to make a market investigation reference to the CC.

Proportionality

3.17 The OFT guidance states that it will only make a market investigation reference when it has reasonable grounds to suspect that the adverse effects on competition of features of a market are 'significant'.¹²⁹ As part of its assessment, the OFT states that it will consider whether such suspected adverse effects are likely to have a significant detrimental effect on customers through higher prices, lower quality, less choice or less innovation.¹³⁰ As noted in Part 4 above, UK consumers pay substantially more on average for pay TV than their counterparts in other territories, even having adjusted prices to take into account differences in content quality (i.e. programming expenditure) and income. Further, there is a strong indication that a significant proportion of the price differential arises from the market structure in the UK.

3.18 The OFT guidance further states that the following relevant factors will be taken into account when assessing whether adverse effects on competition are 'significant':¹³¹

- (a) the size of the market to be investigated;
- (b) whether a significant proportion of that market is affected by the issues identified;
- (c) whether it is likely that the issues identified are expected to be present in that market in the foreseeable future; and
- (d) whether the adverse effects identified are likely to be offset by consumer benefits.

3.19 The pay TV industry in the UK is important both socially and in economic terms and the adverse effects on competition identified in this Submission have a detrimental effect on a significant proportion of that industry. The vicious circle operates to ensure that neither incumbent operators, (such as Virgin Media) nor relatively new entrants (such as Setanta, TUTV and BT Vision) are able to penetrate any level of the supply chain to an extent that threatens Sky's position. Given that Sky's behaviour is fostered by a market structure which will not change without regulatory intervention, it is likely that its conduct, as well as the structural features which promote it, will remain in the market for the foreseeable future. Finally, as described in Part 4 above, the econometric analysis demonstrates that UK consumers pay more for pay TV services than their European counterparts, there is less choice available for subscribers and Sky's competitors have limited ability to innovate because the opportunity is foreclosed to them. Accordingly, the Parties do not consider that the adverse effects identified are offset by consumer benefits.

Remedies

¹²⁹ Paragraph 2.27.
¹³⁰ Paragraph 2.27.
¹³¹ Paragraph 2.28.

3.20 There is certainly a more than reasonable chance that appropriate remedies are available in this case and these are discussed in Part 5 above. As is demonstrated above, a range of appropriate remedies are available to the CC to address both horizontal and vertical features of the pay TV industry (albeit on a non-exhaustive basis), including: extending the existing access regulation and introducing constraints on the sale of content to ensure that competitors can compete effectively at all levels of the supply chain; and operational separation of Sky's upstream and downstream businesses. In the Parties' view, this wide range of potential remedies would be unlikely to result from isolated investigations of Sky's conduct under the general competition prohibitions. Indeed, in view of the interrelationship between the structural features of the pay TV industry, dealing with each individual feature in isolation would be insufficient to remedy the concerns identified. The Parties consider that the remedies outlined in this Submission are more than sufficient to address the industry-wide market failure described in Part 3 above. Conversely, Competition Act prohibitions will not provide effective forward looking remedies to structural issues which are necessary to address the market failures identified.

4 Conclusion

4.1 A market investigation reference of the pay TV industry to the CC would be entirely consistent with Ofcom's principal duty afforded to it under the Communications Act 2003, which is to further the interests of consumers in relevant markets where appropriate by promoting competition. Ofcom has frequently referred to this overriding duty as being "at the core of its *raison d'être*" and paramount to its approach to regulation.

4.2 In light of this duty, the Parties consider that Ofcom should exercise its powers under section 131 of the Act and refer the pay TV industry to the CC as a first step towards remedying the market failures identified and to generate an environment in which there can be effective competition leading to enhanced consumer benefits from a market that is properly contested.