

**Joint Response to Ofcom's Third Pay
TV Consultation**

by

British Telecommunications Plc

Top Up TV Europe Limited

Virgin Media Inc.

September 2009

Joint Response to Ofcom's Third Pay TV Consultation

Contents

Executive summary

- 1. Introduction**
- 2. Consumer benefits from the proposed remedy**
 - More choice*
 - Lower retail prices*
 - Greater innovation*
 - Ladder of investment*
- 3. Market definition**
- 4. Retail markets**
- 5. HD and interactive services**
- 6. Sky Sports 3 and Sky Sports Xtra**
 - Discriminatory supply of inferior products*
 - Retail competition in premium sports packages*
 - Exclusion of sports coverage from the remedy*
 - Anti-gaming measure*
- 7. Non-Sky platform**
- 8. Sky's high wholesale prices and profitability**
- 9. Retail-minus methodology**
 - Overall approach to determining Sky's wholesale prices*
 - Determination of reference retail prices*
 - Calculating the "minus"*
 - Transmission costs*

Appropriate scale of retailer and SAC

Appropriate cost of capital

Level of fixed costs of retailing

Appropriate churn rate

Cost of third party basic channels

Other bundled services

Bespoke wholesale prices

10. Changes to Sky's wholesale prices over time

Annual review

Changes to SAC

Ratchet mechanism

Reasons for wholesale price increases

Margin between Sky's wholesale and retail prices

11. Cost-based cross-check

Assumed rights costs inflation

Excessive retail margins

Wholesale price for Sky Sports 2

12. Commercial market

13. Draft licence condition and resolution of complaints

Qualifying platforms

Advertising on Sky's channels and cross-promotion

Resolution of complaints

14. Reference offer and qualifying criteria

15. Minimum security requirements

16. Picnic

17. FAPL

18. SVoD

19. Conclusion

Annex 1 Highly attractive content on Sky Sports 3 and Xtra

Joint Response to Ofcom's Third Pay TV Consultation

Executive summary

1. The Parties support Ofcom's proposal to deal with its concerns about restricted distribution of Sky's premium channels by imposing a wholesale must-offer obligation together with an *ex ante* pricing mechanism under Ofcom's sectoral powers. The Parties do, however, believe that certain specific details of Ofcom's proposals need to be adjusted in order to achieve Ofcom's goal of promoting fair and effective competition. (See section 1.)
2. Subject to the adjustments described below, Ofcom's proposed wholesale must-offer remedy would promote the emergence of a more balanced mix of pay TV platforms and retailers which will benefit consumers in terms of increased choice, reduced retail prices and greater innovation in pay TV in the UK. The Parties provide some information on these consumer benefits below and are separately providing more specific details of the activities in which they will be able to engage following the implementation of the wholesale must-offer remedy. Furthermore, as the Parties have explained previously, the structural market failure in pay TV currently precludes competitive bidding against Sky for the rights to attractive content. By enabling Sky's competitors to develop their own bases of premium pay TV subscribers, the wholesale must-offer remedy should be seen as facilitating the first step on the ladder to investment in and the creation of competing premium pay TV channels. (See section 2.)
3. In respect of market definition, the Parties support the broader view that Ofcom is now taking over the importance of sports other than FAPL. Yet, for the reasons outlined below, the Parties believe that Sky Sports 3 and Sky Sports Xtra are also within the relevant market for premium pay TV sports channels. (See section 3.)
4. The Parties agree that, at the retail level, the relevant markets are for the supply of packages containing premium pay TV channels and that Sky enjoys dominant positions in these retail markets. (See section 4.)
5. The Parties agree with Ofcom that the restricted supply of HD versions of Sky's premium channels and the associated interactive content creates a risk to fair and effective competition. Thus the Parties support the proposal to include HD and interactive services within the scope of the wholesale must-offer remedy. (See section 5.)
6. The Parties agree with Ofcom that if Sky were to supply competitors with inferior products to the ones it supplies to its own retail arm, it would prevent those other pay TV retailers from being able to compete effectively. This principle applies not only to HD and interactive services but also to the bonus channels that Sky offers with Sky Sports 1 and 2 – namely Sky Sports 3 and

Xtra. Ofcom's own analysis confirms that of the 27 sports events that it has identified as being broadcast on Sky Sports 1 and 2, 17 of those events are also shown on Sky Sports 3 and Xtra. Thus, although Sky Sports 3 and Xtra overall have less attractive schedules than Sky Sports 1 and 2, they do, nevertheless, regularly feature live sporting events which a significant number of consumers find highly attractive. Accordingly, these two bonus sports channels should also be included within the scope of the wholesale must-offer remedy. (See section 6.)

7. Ofcom's proposed remedy applies to a variety of distribution technologies, including cable, satellite, DSL, DTT and mobile TV. It applies to all platforms using those technologies which are not operated by Sky. This proposed approach seems to be clear in respect of platforms which used established cable, DTT or satellite distribution technologies. Ofcom should, however, clarify how the remedy would apply in the event that Canvas (or other DSL-based services) were to be widely deployed. For example, Ofcom must ensure that Sky cannot avoid the wholesale must-offer obligation through remote use of DRM within a third party DSL platform. (See section 7.)
8. Whilst the Parties cannot comment in detail on Oxera's analysis of Sky's profitability due to a lack of access to the underlying data, the Parties do agree with the approach used by Oxera and consider it to be conceptually appropriate in the context of a competition investigation. (See section 9.)
9. The Parties broadly agree with Ofcom's proposed approach to determining the wholesale prices for Sky's premium channels. In particular, the Parties consider that Ofcom is right to determine prices rather than leaving price setting to subsequent negotiations. The Parties also agree that a retail-minus methodology coupled with a cost-based cross-check is a pragmatic approach which is responsive to the key competition concerns identified by Ofcom. Furthermore, the Parties support the use of a retail-minus methodology to derive wholesale prices by determining how much an efficient entrant could afford to pay for the wholesale channels after taking into account all of its other costs and the need to earn a return on its investment. The Parties do, however, believe that the detailed implementation of Ofcom's approach needs to be adjusted in a number of respects in order to reflect the circumstances of new premium pay TV retailers and thereby achieve Ofcom's objective of promoting fair and effective competition. In particular, Ofcom must take due account of DTT transmission costs and the cost of capital, level of fixed costs and churn rate for an entrant. In addition, Ofcom should not determine wholesale prices which will inhibit or preclude entry by smaller scale pay TV retailers. Once adjustments are made to Ofcom's modelling in order properly to address these issues, the Parties believe that Ofcom's modelling should indicate that the appropriate wholesale prices are at the bottom of the retail-minus range on which Ofcom is consulting (i.e. Ofcom's Scenario 5). (See section 9.)
10. There will be a material risk to competition and the effectiveness of Ofcom's proposed wholesale must-offer remedy if the wholesale prices for Sky's

premium channels do not evolve over time in such a way as to address changes in Sky's retail prices and packaging and also increases in Sky's retail costs (for example its SAC). As a consequence, Ofcom must recalculate the reference retail prices at least annually in order to reflect Sky's annual price change. At the same time, Ofcom must also recalculate the "*minus*" in order to address relevant changes in costs and thereby determine appropriate wholesale prices for the next twelve months. (See section 10.)

11. The Parties believe that Ofcom should both adjust its cost-based cross check and make more use of it. In particular, the Parties believe that whilst Ofcom's wholesale remedy and the steps it proposes to take as regards upstream rights should, in due course, enable more companies to bid competitively for attractive rights, this is unlikely in the medium term. For the time being, the current market failure in pay TV will preclude such competitive bidding. Accordingly, it is reasonable to assume that sports and movie rights costs will remain constant in real terms over the period considered by Ofcom rather than increase as Ofcom has assumed in its modelling. Having adjusted the cost-based cross-check to take account of this factor, the Parties believe that Ofcom should have more regard to the cost-based cross-check when determining retail prices. In particular, Ofcom's analysis demonstrates that the weighted average cost-based price is significantly below the bottom of the range of weighted average retail-minus prices included within Ofcom's consultation. This indicates that Ofcom should determine wholesale prices at the bottom of its range of retail-minus prices in order to minimise any discrepancy in the margins available to Sky and its competitors from the retailing of premium pay TV channels. Furthermore, given the very significant discrepancy between the retail-minus price and the cost-based price calculated for Sky Sports 2, Ofcom needs to adjust its retail-minus methodology for that channel in order to establish a more appropriate reference retail price as a basis for the retail-minus methodology. (See section 11.)
12. There is a clear and serious consumer detriment arising from Sky's monopoly over the supply of premium pay TV sports channels to commercial premises. If Ofcom were to extend its wholesale must-offer remedy to the commercial market, rival pay TV retailers would be able to offer choice, innovation and retail price competition to commercial customers. The reasons put forward by Ofcom for not doing this (such as a perceived absence of restricted supply at the retail or wholesale levels in respect of commercial premises) are clearly contradicted by the evidence provided by the Parties. (See section 12.)
13. An effective and timely dispute resolution process will be crucial to the successful implementation and operation of the wholesale must-offer remedy. Whilst the Parties consider that Ofcom is best placed to resolve complaints about Sky's conduct under the wholesale must-offer remedy, they believe that Ofcom's current guidelines may not provide an effective basis for ensuring the efficient implementation and operation of the remedy. It would, therefore, be appropriate for Ofcom to set out specific guidelines relating to the enforcement

of the wholesale must-offer remedy, as Ofcom has done in relation to the enforcement of BT's undertakings. (See section 13.)

14. Ofcom must ensure that Sky promptly produces its reference offer (i.e. within one month of Ofcom's decision to impose the wholesale must-offer remedy). When determining whether that reference offer is fair, reasonable and non-discriminatory, Ofcom must ensure that it is not more onerous than industry norms established worldwide in respect of the wholesale supply of premium channels where there is approximate parity between the bargaining strength of wholesalers and retailers. (See section 14.)
15. The Parties note that, as part of the wholesale must-offer obligation, Sky will be required to specify minimum security requirements for third party platforms to retail its premium channels. Ofcom must specify that these minimum security requirements may not go beyond what is common practice in pay TV markets around the world today. It is vital that Ofcom gives detailed consideration to the issue of minimum security requirements in advance so as to ensure that it is quickly able, following Sky's publication of those requirements, to identify whether there is a likely breach of the newly imposed licence condition. Also, Ofcom must ensure that Sky does not delay over the publication of those requirements and that enforcement proceedings are commenced forthwith in the event that Sky's minimum security requirements are not, or do not appear to be, fair reasonable and non-discriminatory. (See section 15.)
16. If Picnic is authorised, it will result in increased scope for Sky to prevent competition in the retailing of premium pay TV channels. For example, the retail-minus methodology needs to have regard to Sky's retail prices on DSat and, if Picnic is authorised, Sky's retail prices on DTT as well. Furthermore, Sky must be prevented from restricting competition from pay TV retailers by cross-subsidising Picnic, for example through a subsidy of Picnic's SAC. Accordingly, if Ofcom is still minded to authorise Picnic, it must formally consult on the actual conditions which it is intending to impose on Sky in respect of Picnic. (See section 16.)
17. **[Redacted – confidential.]** (See section 17.)
18. The Parties agree with Ofcom's assessment that subscription video on demand ("SVoD") movie rights are of strategic importance and that they can result in increased choice which is highly attractive to consumers. **[Redacted – confidential]** (See section 18.)
19. Ofcom commenced this investigation on 20 March 2007. At this stage, it seems likely that the third anniversary of that date will arrive before the wholesale must-offer remedy is fully implemented. Ofcom must, therefore, not delay in concluding its pay TV investigation and introducing the remedies that are needed in order to enable consumers to benefit from fair and effective competition in pay TV in the UK. (See section 19.)

Joint Response to Ofcom's Third Pay TV Consultation

1. Introduction

- 1.1 The Parties¹ welcome Ofcom's confirmation of its view that (i) Sky is acting on an incentive to restrict the distribution of premium channels; (ii) this has adverse effects on a variety of platforms including cable, DTT and IPTV; (iii) this situation is not consistent with fair and effective competition; and (iv) it has a detrimental effect on consumers.²
- 1.2 The Parties support Ofcom's proposal to deal with its concerns about restricted distribution of Sky's premium channels by imposing a wholesale must-offer obligation under Ofcom's sectoral powers. The Parties also support Ofcom's proposals for determining wholesale prices for Sky's premium channels on the basis of a retail-minus methodology with a cost-based cross-check.
- 1.3 The Parties still have a number of reservations about Ofcom's market definition in respect of premium sports channels. They also believe that Ofcom has made a number of inappropriate assumptions in its application of the retail-minus methodology. These are explained below.
- 1.4 The Parties agree with Ofcom's acknowledgement that some concerns about the pay TV market would not be resolved by the imposition of the wholesale must-offer remedy, in particular the restricted access to certain content rights – namely SVoD movie rights and live FAPL rights.
- 1.5 **[Redacted – confidential].**

2. Consumer benefits from the proposed remedy

- 2.1 The UK is in the midst of a communications revolution. First generation broadband has gone from being unavailable in UK homes just eight years ago to being in 63% of homes today,³ a huge surge of consumer uptake. The market structure has completely changed from a position where almost all broadband services were based on BT wholesale broadband five years ago to a position where there are six million unbundled lines today, which has driven hundreds of millions of pounds of investment and innovation by the six leading providers and resulted in broadband speeds of up to 50Mb/s. Competition is driving another wave of hundreds of millions of pounds of investment in next generation broadband.

¹ **[Redacted – confidential].**

² Paragraph 1.3 of Ofcom's Third Pay TV Consultation Document.

³ National Statistics Omnibus Survey, 28 August 2009.

- 2.2 Regulation has opened up the fixed-line communications market and has resulted in vibrant and dynamic competition in the UK. Across an array of product categories prices have been driven down whilst service propositions have diversified to satisfy different consumer preferences. These are the results of effective competition in action.
- 2.3 Consumers are starting to experience the promise of convergence: any content delivered anywhere, at anytime. The capabilities of broadband, both in the fixed network market and through 3G and wifi in the wireless market, are bringing to consumers truly converged propositions driven by competitive pressure.
- 2.4 There is, however, one glaring omission from this communications revolution: in pay TV the market is essentially structured in the same way it was in the early 1990s with Sky as a near monopolistic supplier of premium pay TV services, its market share well in excess of 80 per cent. The market as currently structured makes it impossible for alternative suppliers to compete effectively with Sky. Choice remains low and prices high. These are the results of a flawed market in action.
- 2.5 This is a critical issue at a time of converging markets. Equal access to BT's access network has put competitors on the same footing as BT Retail in the broadband market. In a world of converging broadband and pay TV, Sky has the only unregulated market power through its near-monopoly of premium pay TV channels which operates to the detriment of customers.
- 2.6 Things do not have to be like this. Ofcom's proposed wholesale must-offer remedy, if implemented properly, will benefit consumers by transforming the pay TV market from being dysfunctional to competitive, like other communications markets from which consumers have benefitted so greatly.
- 2.7 The proposed wholesale must-offer remedy would promote the emergence of a more balanced mix of pay TV platforms and retailers which will benefit consumers in terms of choice, price and innovation. The proposed remedy will enable each platform to compete based on its different strengths, and products to be developed which appeal more closely to the preferences of different groups of customers. Those who do not want or cannot have a satellite dish will not need one. Those that do not wish to commit at the outset to a twelve months subscription but are willing to pay for some TV channels will be more readily able to do so. Those whose preferences are orientated to on-demand viewing rather than linear TV will have more opportunity to have it. New market segments and more innovative and compelling consumer offers will appear.
- 2.8 More choice, lower prices and greater innovation: the following paragraphs look at each in turn.

More choice

- 2.9 The first level of consumer benefit from wholesale access to Sky's premium channels will be the emergence of alternative pay TV platforms as more effective competitors to satellite.
- 2.10 The cable platform will be able to compete more effectively with satellite by obtaining wholesale access on regulated terms to Sky's premium channels including, for the first time, its HD and interactive services. DTT and DSL platforms will also be able to compete for pay TV subscribers who want premium channels. This will allow them to build the scale of their platforms.
- 2.11 DTT and, in due course, DSL both have the potential to be significant pay TV platforms in competition with satellite, to the long term benefit of the consumer. DTT has the advantage that it is already very widely used as a technology for free-to-air TV, by approximately 70% of households,⁴ it is a very familiar technology to consumers and doesn't require the installation of a satellite dish. As such, using DTT to provide a pay TV service is likely to require no installation costs for the consumer.
- 2.12 Similarly DSL has the potential to offer a low cost of entry to a new pay TV platform for the consumer. The consumer will need to be connected to fixed-line broadband services, which is already the case for over two thirds of households. Using their broadband connection to access pay TV will require the consumer to purchase a broadband enabled TV or set top box. These are already widely available and DSL has the potential to deliver very large numbers of linear pay TV channels. DSL and cable also have the potential to provide interactive and on-demand services more effectively than the satellite platform. Both of these present opportunities for benefits to consumers and again, offer considerably more choice.
- 2.13 Wholesale access to premium pay TV channels is essential if these alternative technologies are to develop as pay TV platforms. It is only by achieving significant revenue scale that the fixed costs of developing these technologies as pay TV platforms can be recovered. That can only be achieved if pay TV retailers are able to attract premium pay TV subscribers – it is widely acknowledged that premium sports and movie channels are the “*drivers*” of pay TV. As a result of Sky's competitors gaining wholesale access to premium channels at economically viable rates, consumers will benefit from more choice of pay TV platforms, each with different characteristics and advantages relative to each other, each driven to exploit its own particular strengths by competition from the other platforms and other pay TV retailers.

Lower prices

- 2.14 The second level of consumer benefit from wholesale access to Sky's premium channels will be the emergence of cheaper prices for the consumer.

⁴ Paragraph 3.27 of Ofcom's Communications Market: Digital Progress Report, Q1 2009.

- 2.15 Due to the uncompetitive market structure in the UK today, Sky's retail prices for pay TV are high and rising, as the Parties have set out in previous submissions. If an effective remedy is put into place, retail prices for premium pay TV channels will fall due to the competition which will result from wholesale access to Sky's premium channels at regulated prices as companies look to increase their market share by attracting consumers through offering a range of different retail prices and bundles of channels/services. Whilst it is clearly inappropriate in a Joint Response to include specific retail prices that are being contemplated by the Parties, certain broad pricing projections can be made now. With the wholesale supply of Sky Sports 1 at a price which is consistent with Ofcom's Scenario 5 (i.e. at the bottom of the range on which Ofcom is consulting) it is possible that some providers would plan to retail the leading premium sports channel on a standalone basis at a price under £20, representing a significant saving of more than 20% for consumers in comparison to Sky's offer.
- 2.16 Again, similar levels of consumer savings could be derived from third party retailers of Sky Movies. Even at the mid-point level of the range of prices on which Ofcom is consulting, providers would expect to retail these packages at prices offering a saving of around a third against Sky's current retail tariff. (For the reasons explained in section 9 below, Ofcom should, in practice, determine wholesale prices for Sky's premium channels that are at the bottom of the range on which it is consulting which should lead to even lower retail prices.)
- 2.17 In addition to offering potential subscribers substantial savings over Sky's current retail prices as indicated above, providers would also be able to offer consumers significant benefits by way of much more flexible subscription terms than those offered by Sky for its premium channels. Following the introduction of the wholesale must-offer remedy, it is likely that some providers would not require subscribers to "*buy through*" basic tier packages in order to access the premium channels. Flexibility in packages would also be generated with some providers dispensing with the requirement to commit to a twelve month contract that Sky imposes on new subscribers. This would mean that signing up to Sky Sports 1 and 2 on an alternative platform could be at a cost of one month's subscription versus a current minimum of £426 from Sky. Exactly what the retail prices will be will depend on the wholesale prices that Ofcom determines and on the margin different providers will need to make as part of their own overall pay TV business case.
- 2.18 There will also be benefits to consumers in the variety of bundled packages that will be on offer. It is increasingly common practice in the communications and pay TV markets at present for consumers to purchase bundles of services including pay TV, broadband, telephony and access lines. Wholesale access to Sky's premium content will allow effective competition with Sky in the provision of pay TV and communications bundles. There is a clear preference for buying such bundles. Here again, opening the market through wholesale access to premium pay TV channels will allow more competitors to serve customers on the terms that they prefer.

Greater innovation

- 2.19 The third level of consumer benefit from wholesale access to Sky's premium channels will be the emergence of more innovative consumer offerings.
- 2.20 In terms of the ongoing evolution of the UK's TV platforms it is important to acknowledge that development is likely to be slow and sporadic unless the premium channels, which drive acquisition and subscription, are made available to all pay TV retailers at reasonable prices.
- 2.21 The wholesale must-offer remedy will provide all pay TV operators with much greater incentives to invest and innovate in relation to new services, features and functionality relating to their TV propositions. For the first time, Sky's competitors will be assured of the security of supply of premium channels and for the first time they will be able to make a margin on the supply of Sky's premium channels. The absence of access to Sky's premium channels or, in the case of Virgin Media, the absence of any security in supply or ability to preserve margin currently undermines investment incentives.
- 2.22 When considering the increase in innovation that would result from the wholesale must-offer remedy it is important to emphasise that there is currently limited innovation in relation to the supply of sports channels. Sky, as the major supplier of sports channels, designs its Sky Sports service for satellite distribution and does not design its services to make optimum use of technological capabilities of other platforms, such as cable or DSL, which have return path capability. As a result, there is limited investment and innovation in relation to interactive services, which would work particularly well on other pay TV platforms, especially those with a return path to subscribers.
- 2.23 In a more competitive market, it is clear that further innovations would result. One example is the greater availability of HD services on platforms other than satellite and the development of an increased range of on-demand and interactive services by Sky's competitors (particularly once the barriers to accessing SVoD movie rights are addressed). For the first time consumers will be able to enjoy genuinely interactive services by being able to participate actively in the TV experience, (through voting, gaming, contributing to the content in real time, calling down related video material on demand) in a manner which goes beyond what is possible from one-way broadcast platforms.

Ladder of investment

- 2.24 For the reasons that the Parties have explained at length in their previous submissions to Ofcom, as a result of the current vicious circle in pay TV, it is not commercially viable for competitors to attempt to outbid Sky for the rights to attractive content. Setanta's demise reinforces this point. Having outbid Sky for the rights to certain attractive content, Setanta was unable to build a sufficient subscriber base to recoup its investment in those rights. The key issue here is that Sky is able to monetise rights immediately because of its very large

base of installed subscribers. As a result, Sky is able to bid more than its competitors for the rights to attractive content. The wholesale must-offer remedy will enable competing pay TV retailers to build up their own bases of premium pay TV subscribers. As a consequence, in due course, their ability to bid effectively for the rights to attractive content will increase. Indeed, over time, it is to be hoped that the aggregate number of subscribers to Sky's premium pay TV competitors will match Sky's subscriber base. This will mean that, together, these competitors should be able to compete with Sky for rights to key content.

- 2.25 Thus, the structural market failure in pay TV currently precludes competitive bidding against Sky for the rights to attractive content. By enabling Sky's competitors to develop their own bases of premium pay TV subscribers, the wholesale must-offer remedy should be seen as facilitating the first step on the ladder to investment in and the creation of competing premium pay TV channels.
- 2.26 In conclusion, unlike other parts of the media and technology industry, the pay TV industry has suffered for too long from a lack of effective competition and consumers have lost out. If there were to be greater competition in pay TV in the UK, consumers would enjoy increased choice of platforms and content, pay TV prices would fall as a result of retail competition and third party pay TV operators would be able to engage in more innovation. Ofcom has accurately identified the problem and the means to rectify it. The implementation of its proposed wholesale must-offer remedy will herald a new dawn of more choice, lower prices and greater innovation for pay TV consumers in the UK.
- 2.27 The Parties will, individually, provide further details to Ofcom on the specific activities in which they will be able to engage following the implementation of the wholesale must-offer remedy and the ways in which this will benefit consumers.

3. Market definition

- 3.1 In its Second Pay TV Consultation Document, Ofcom concluded that:

*“There is a narrow economic market for the wholesale of certain premium sports channels, specifically those premium channels which contain live FAPL matches”.*⁵

- 3.2 For the reasons set out in the Parties Joint Response of 12 December 2008 to Ofcom's Second Pay TV Consultation and the additional Submission on market definition of March 2009, the Parties believe that (i) Ofcom's approach to defining the relevant wholesale market for premium sports channels in its

⁵ Paragraph 4.4 of Ofcom's Second Pay TV Consultation Document.

Second Pay TV Consultation Document resulted in an overly narrow focus on channels containing live FAPL matches and (ii) Sky's market power at the retail and wholesale levels results from Sky's control of a portfolio of sports rights.⁶

3.3 The Parties note that, after further consideration, in its Third Pay TV Consultation Document Ofcom has:

*“... identified a relevant economic market for the wholesale supply of channels regularly featuring live sporting events which a significant number of consumers find highly attractive (“Core Premium Sports Channels”). This market includes the wholesale supply of Sky Sports 1 [and] Sky Sports 2 ...”*⁷

3.4 A key issue when defining the relevant market in this context is to identify which channels and packages of channels (if any) are substitutes for premium sports channels and packages of premium sports channels. In light of the detailed analysis set out in Ofcom's Third Pay TV Consultation Document, and the various submissions by the Parties, the Parties support the broader view that Ofcom is now taking in respect of the importance of sports other than FAPL. Yet, for the reasons outlined in section 6 below, the Parties believe that Sky Sports 3 and Sky Sports Xtra are also within the relevant market for premium pay TV sports channels.⁸

3.5 In their Joint Response to Ofcom's Second Pay TV Consultation, the Parties confirmed that they broadly agree with Ofcom's approach to market definition and the assessment of market power in respect of premium movie channels.⁹ That view continues to hold.

4. Retail markets

4.1 In their Joint Response to Ofcom's Second Pay TV Consultation Document, the Parties observed that:

*“In its Second Pay TV Consultation Document, Ofcom has not explicitly addressed the question of market definition and market power in relation to the supply of premium channels at the retail level. This is a material omission ...”*¹⁰

“... in its final decision on the investigation into the pay TV industry, Ofcom must include an assessment of relevant markets at the retail level

⁶ See paragraph 4.87 of Ofcom's Third Pay TV Consultation Document.

⁷ Paragraph 4.209 of Ofcom's Third Pay TV Consultation Document.

⁸ For completeness, the Parties acknowledge that Setanta Sports 1 was in this relevant market and that since ESPN has acquired some of the most attractive rights previously held by Setanta (e.g. FAPL and SPL), its channel is now within this market.

⁹ Paragraph 4.6 of the Joint Response to Ofcom's Second Pay TV Consultation Document.

¹⁰ Paragraph 3.3 of the Joint Response to Ofcom's Second Pay TV Consultation Document.

*and the degree to which Sky possesses market power in those retail markets”.*¹¹

- 4.2 In the circumstances, the Parties agree with Ofcom’s confirmation in its Third Pay TV Consultation Document that:

*“... an assessment of the relevant downstream markets can be helpful to assess the impact of concerns about upstream markets on downstream markets”.*¹²

- 4.3 The Parties note Ofcom’s statements that:

*“... the relevant market is for retail supply of Sky Sports 1 [and/or] Sky Sports 2 ... as well as HD versions of these channels or TV packages that contain these channels”;*¹³ and

*“... the relevant retail market is for retail supply of television bundles containing Core Premium Movie channels”.*¹⁴

The Parties certainly agree that a key concern at the retail level is the supply of packages containing premium pay TV channels.

- 4.4 The Parties also agree with Ofcom’s conclusions that “*Sky enjoys a dominant position*” in retail markets for the supply of packages containing premium pay TV sports channels¹⁵ and the supply of packages containing premium pay TV movie channels.¹⁶

5. HD and interactive services

- 5.1 The Parties note Ofcom’s confirmations that:

*“... The markets for Core Premium channels are defined by reference to the content contained within these channels, not the resolution at which this content is viewed, or whether the content is delivered via the main channel or the red button”;*¹⁷ and

“... we believe that the restricted supply of HD versions of the channels and primary interactive content does create a risk to fair and effective competition. On this basis our view is that these should be included within the scope of the obligation”.

¹¹ Paragraph 3.9 of the Joint Response to Ofcom’s Second Pay TV Consultation Document.

¹² Paragraph 4.15 of Ofcom’s Third Pay TV Consultation Document.

¹³ Paragraph 4.252 of Ofcom’s Third Pay TV Consultation Document.

¹⁴ Paragraph 4.410 of Ofcom’s Third Pay TV Consultation Document.

¹⁵ Paragraph 5.134 of Ofcom’s Third Pay TV Consultation Document.

¹⁶ Paragraph 5.170 of Ofcom’s Third Pay TV Consultation Document.

¹⁷ Paragraph 8.90 of Ofcom’s Third Pay TV Consultation Document.

The Parties agree with this proposal subject to the reservations noted below about the limitation of the remedy to “*primary*” interactive content.

5.2 In this context, Ofcom states that:

“The possibility that content could be shown via the red button suggests that there could be a risk to fair and effective competition if video and audio streams containing content of types otherwise shown on the main linear stream were not offered as part of the remedy”.¹⁸

The assumption underpinning this statement seems to be that “*content of types otherwise shown on the main linear stream*” is non-replicable. Yet, whilst third party pay TV retailers may be able to replicate other content included in Sky’s interactive services, Sky will not currently permit such third parties to offer that interactive content via a red button on its premium channels.

5.3 Ofcom concludes that:

*“We propose to consult on including within the scope of the remedy any sports matches shown live via the red button which are part of events that appear on Sky Sports 1 and 2 ... ”*¹⁹

5.4 Yet, Sky’s interactive services comprise more than this. In order to ensure that viewers on third party platforms are not discriminated against or otherwise provided with inferior products/services, Ofcom must ensure that either:

- (i) Sky provides a comprehensive version of its interactive services to third party pay TV retailers for them to supply to their customers; or
- (ii) Sky provides just the “*primary*” interactive content noted by Ofcom and allows third party pay TV retailers to provide their viewers with links from Sky’s premium channels to their own interactive services or those of other parties.

6. Sky Sports 3 and Sky Sports Xtra

6.1 Ofcom states that the wholesale must-offer obligation:

“... should apply to those channels which are the source of Sky’s market power, and where Sky’s approach to wholesale supply does and will lead to a situation in which there is not, and will not be, fair and effective competition”.²⁰

¹⁸ Paragraph 8.106 of Ofcom’s Third Pay TV Consultation Document.

¹⁹ Paragraph 8.109 of Ofcom’s Third Pay TV Consultation Document.

²⁰ Paragraphs 8.31 and 8.89 of Ofcom’s Third Pay TV Consultation Document.

6.2 Whilst the Parties are broadly supportive of this principle, it is nevertheless very important that Ofcom's remedy also includes Sky Sports 3 and Sky Sports Xtra. In this context, the Parties note Ofcom's apparently contradictory statements that:

*“... including both Sky Sports 1 and 2 in the remedy, but not 3 and Xtra, is appropriate in order to ensure fair and effective competition. Similarly, we believe it is appropriate to include all the Core Premium Movie channels in the remedy. Our views on market definition and market power indicate that only including some of the channels would be likely to result in a continued risk to fair and effective competition”.*²¹
(Emphasis added.)

In practice, Ofcom's proposal to include Sky Sports 1 and 2 in the remedy but not Sky Sports 3 and Xtra will “*be likely to result in a continued risk to fair and effective competition*”.

Discriminatory supply of inferior products

6.3 Ofcom itself notes that it would be:

*“... potentially discriminatory for Sky to supply others with inferior products to the ones it supplies its own retail arm – this could prevent other retailers from being able to compete effectively in the retail market. Our level of concern would depend on whether there is a risk to fair and effective competition. As the paragraphs below indicate, we believe that the restricted supply of HD versions of the channels and primary interactive content does create a risk to fair and effective competition. On this basis our view is that these should be included within the scope of the obligation”.*²² (Emphasis added.)

6.4 Corresponding issues arise in respect of Sky Sports 3 and Xtra. In this context, it is important to note that Sky does not offer interactive sports services independently of its premium channels at the retail level. Instead, they are bundled with Sky's premium sports channels and offered to consumers at no incremental retail price. Similarly, Sky Sports 3 is not available separately from Sky Sports 1 and 2 at the retail level. Instead, it is bundled with Sky Sports 1 and 2 and offered to consumers at no incremental retail price. Whilst the Parties understand that there is, notionally at least, a stand-alone retail price for Sky Sports Xtra, in practice no (or virtually no) consumers purchase Sky Sports Xtra on its own.²³ Instead, consumers gain access to Sky Sports Xtra in the same manner as Sky Sports 3, i.e. as a bonus channel which is bundled with Sky Sports 1 and 2 at no incremental retail price – indeed, the name of this bonus channel is particularly apposite in this regard.

²¹ Paragraph 8.36 of Ofcom's Third Pay TV Consultation Document.

²² Paragraph 8.91 of Ofcom's Third Pay TV Consultation Document.

²³ Sky does not actively market this stand-alone price for Sky Sports Xtra.

- 6.5 Consumers access Sky’s interactive services by pushing the “red” button. Consumers access Sky Sports 3 and Xtra by pushing the “channel down” button. In both cases, they are accessing additional video streams which are offered as part of a bundle with Sky Sports 1 and 2. There is, therefore, little or no practical difference from a consumers’ perspective - whether a particular sports event is shown on Sky Sports 3/Xtra or on Sky’s interactive services will not be a concern for viewers provided they have access to both. It is critical that Sky is not able to determine whether or not these additional video streams are included within the scope of the wholesale must-offer obligation simply by choosing to include them within Sky Sports 3 or Xtra rather than within its interactive services.
- 6.6 As Ofcom notes, it would be “*discriminatory for Sky to supply others with inferior products to the ones it supplies its own retail arm*”. Discrimination would arise if Sky were to refuse to wholesale Sky Sports 3 and Sky Sports Xtra to competing pay TV retailers. Such a refusal “*could prevent other retailers from being able to compete effectively in the retail market*”.²⁴

Retail competition in premium sports packages

- 6.7 As Ofcom has noted, consumers purchase (and Sky has market power at the retail level in respect of) “*packages*” containing premium sports channels.²⁵ When considering, in its Third Pay TV Consultation Document, the “*relevant market ... for the retail supply of Sky Sports 1 [and/or] Sky Sports 2*”, Ofcom expressly confirms that it will assess:

“... whether there is a risk that there is not, and will not be, fair and effective competition in **the provision of packages** containing [Sky Sports 1 or Sky Sports 2]”.²⁶ (Emphasis added.)

- 6.8 In this context, it is particularly important to note that competition at the retail level takes place in respect of **packages** containing such channels. By virtue of Sky’s bundling as described above, those packages also include Sky Sports 3 and Xtra for the vast majority of Sky’s premium sports subscribers. It is, therefore, clear that the omission of Sky Sports 3 and Xtra from the scope of the remedy “*could prevent other retailers from being able to compete effectively in the retail market*” in the supply of such “*packages*” of premium sports channels if, as a result, Sky is able to prevent them including Sky Sports 3 and Xtra in their premium sports packages.²⁷

²⁴ In this context, it is important to recognise that such prevention of competition could result if content that is withheld from Sky’s competitors is highly attractive even if the volume of content that is withheld is relatively small (e.g. one decisive FAPL match).

²⁵ Paragraphs 1.21 and 5.134 of Ofcom’s Third Pay TV Consultation Document.

²⁶ Paragraph 4.253 of Ofcom’s Third Pay TV Consultation Document.

²⁷ In practice, Ofcom must ensure that the wholesale must-offer remedy enables retail competitors to replicate the packages of Sky Sports channels which Sky offers to consumers.

Exclusion of sports coverage from the remedy

6.9 With regard to Sky’s interactive services, Ofcom again acknowledges that:

*“The possibility that content could be shown via the red button suggests that **there could be a risk to fair and effective competition if video and audio streams containing content of types otherwise shown on the main linear stream were not offered as part of the remedy**”.*²⁸ (Emphasis added.)

Corresponding issues arise in respect of Sky Sports 3 and Xtra. To date, the content shown on Sky Sports 3 and Xtra has tended overall to be less attractive than the content shown on Sky Sports 1 and 2 and hence has attracted smaller audiences. Nevertheless, Figure 7 in Ofcom’s Third Pay TV Consultation Document confirms that Sky Sports 3 and Xtra do contain content of the types otherwise shown on Sky Sports 1 and 2.²⁹ For example, Sky Sports 3 and Xtra do show very attractive sports events including Champions League, England Test Match Cricket, European PGA Golf, Heineken Cup Rugby, Super League Rugby and US Open Tennis. As is shown by the data in Annex 1, Sky Sports 3 and Xtra regularly show highly attractive content. Accordingly, there would clearly be a risk to fair and effective competition if Sky Sports 3 and Xtra were not included within the scope of the remedy.

6.10 Ofcom is proposing that it should include:

*“... within the scope of the remedy any sports matches shown live via the red button which are part of events that appear on Sky Sports 1 and Sky Sports 2, e.g. those shown in Figure 7 such as FAPL, Champions League, Carling Cup, English Test Cricket, World Golf Championship, Heineken Cup, Super League”.*³⁰

6.11 Although Ofcom has, here, specifically named as examples just seven sports events, Figure 7 actually lists 27 sports events that are broadcast on Sky Sports 1 and 2 and confirms that 17 of those 27 events are also shown on Sky Sports 3 and Xtra. Thus, although Sky Sports 3 and Xtra overall have less attractive schedules than Sky Sports 1 and 2, they do, nevertheless, *“regularly feature live sporting events which a significant number of consumers find highly attractive”*. Hence they fall within Ofcom’s proposed market definition in their own right.

6.12 More importantly, for the reasons outlined above, Sky Sports 3 and Xtra should properly be regarded as part of Sky Sports 1 and 2 as they are bundled by Sky with those channels at the retail level at no incremental charge to consumers. Hence, Sky Sports 3 and Xtra fall within Ofcom’s proposed market definition as they are part of the Sky Sports 1 and 2 offering. In this context, what matters is the retail offer to consumers. Even though Sky Sports 3 and Xtra are separately

²⁸ Paragraph 8.106 of Ofcom’s Third Pay TV Consultation Document.

²⁹ Paragraph 4.72 of Ofcom’s Third Pay TV Consultation Document.

³⁰ Paragraph 8.109 of Ofcom’s Third Pay TV Consultation Document.

licensed by Ofcom, they are properly regarded as being part of the offer of Sky Sports 1 and 2 to consumers.

- 6.13 In the circumstances, the Parties believe that, in order to be consistent with its approach to Sky Sports 1 and 2 and its approach to interactive services, Ofcom must include Sky Sports 3 and Sky Sports Xtra in the wholesale must-offer remedy.

Anti-gaming measure

- 6.14 Ofcom also acknowledges that:

*“We are in any case concerned that **if premium content could be excluded from the scope of the remedy**, by making it available via the red button rather than on the main channel, **this would provide a mechanism for the remedy to be gamed**”.*³¹ (Emphasis added.)

- 6.15 A corresponding concern also arises in respect of “*premium content*” being excluded from the scope of the remedy by Sky scheduling it on Sky Sports 3 or Xtra (if those channels are not included within the scope of the remedy). Sky has, in the past, migrated and/or scheduled sports events in such a way as to deny the coverage of those events to its retail competitors. For example, in 2000 Sky scheduled its coverage of the Ryder Cup on Sky Sports 2 rather than on its flagship channel, Sky Sports 1, despite the fact that this is one of the three major golf tournaments broadcast by Sky. At that time, Sky supplied Sky Sports 1 but not Sky Sports 2 to ONdigital. Accordingly, by scheduling this prestigious golf tournament on its second sports channel, Sky was able to gain a substantial marketing advantage and thereby inhibit ONdigital’s ability to compete effectively in the retail market. Whilst this example of programme migration is some years old, it remains valid as it demonstrates Sky’s conduct at a time when it only wholesaled some of its premium sports channels to a competing pay TV retailer

- 6.16 Sky would not have to migrate a large volume of content to Sky Sports 3/Xtra in order to gain a material competitive advantage at the retail level. By migrating, for example, one key FAPL match (e.g. a match between the two top teams which effectively determines the winner of the Premier League) or a small number of key matches in the Champions League to Sky Sports 3/Xtra and marketing the fact that those channels were only available to its satellite subscribers, it could persuade viewers that third parties were retailing inferior premium sports services.³²

³¹ Paragraph 8.108 of Ofcom’s Third Pay TV Consultation Document.

³² In this context, the Parties note Ofcom’s observation in paragraph 8.107 that: “... *Sky can show 15 live Champions League matches per week from the start of the 2009/10 season, of which many will be shown via the red button. Our view is that this amount of content via the red button is likely to be material*”. It should be noted that the Champions League matches that will be shown on Sky’s interactive services will, in most cases, be the least appealing for a UK audience (i.e. those matches featuring no English or Scottish teams). Nevertheless, an attempt by Sky to withhold

- 6.17 In respect of its proposal to limit the scope of the wholesale must-offer remedy for premium sports channels to Sky Sports 1 and 2, Ofcom notes that:

*“This conclusion is of course based on our current market definitions. The evidence on which these market definitions are based can only relate to existing channels, and the existing distribution of content rights across those channels. We noted in our Second Pay TV Consultation the possibility that **Sky might change the way in which it distributes its content rights across its channels**, and we are also mindful of the international study by Value Partners, which shows that wholesale must-offer remedies in other countries have been limited in their effectiveness where there has been a lack of clarity over what constitutes a “premium channel”, allowing the remedy to be gamed. **If Sky were to create new channels, containing a significant amount of content currently broadcast on channels within the scope of the proposed remedy, then we would clearly need to consider extending the scope of the remedy to those channels**”.*³³ (Emphasis added.)

- 6.18 Clearly this concern over Sky gaming the remedy is not limited to the possible creation by Sky of new channels containing a significant amount of content currently broadcast on Sky Sports 1 and 2. As noted above, the same concern would arise if Sky Sports 3 and Xtra were to be omitted from the scope of the wholesale must-offer remedy and Sky were to migrate content from Sky Sports 1 and 2 to Sky Sports 3 and Xtra. In practice, this would be an easier and more probable means for Sky to game the wholesale must-offer remedy than the creation of new channels.

- 6.19 This is yet another compelling reason why Ofcom must ensure that Sky Sports 3 and Sky Sports Xtra are included within the scope of the remedy. Anti-gaming provisions need to be included in the wholesale must-offer remedy from the outset, given the length of time it will take to modify the remedy once it is in place and the damage to the competitive process that will ensue if Sky is able to game the remedy in the meantime.

- 6.20 In the event that Ofcom does not apply the wholesale must-offer remedy to Sky Sports 3 and Xtra, it must put in place clear rules that prevent Sky migrating content from Sky Sports 1 and 2 to Sky Sports 3 and Xtra.

7. Non-Sky platform

- 7.1 In its Third Pay TV Consultation Document, Ofcom states that:

those matches from other pay TV retailers could prevent them from being able to compete effectively.
³³ Paragraph 8.35 of Ofcom’s Third Pay TV Consultation Document.

*“We ... make a distinction between a ‘platform’ and a ‘distribution technology’. Our proposed remedy applies to a variety of distribution technologies: cable, satellite, IPTV, DTT, mobile TV. There may then be several different ‘platforms’ on each distribution technology, each platform being defined by the set of conditional access technology and reception equipment that is particular to it”*³⁴

*“We do not propose to extend our proposed remedy to Sky’s platform(s), but we do propose that it should extend to other platforms using the same distribution technologies as Sky. For example, both Sky and Freesat operate satellite platforms, and our proposed remedy would apply to an alternative retailer on Freesat (obviously subject to that being part of Freesat’s strategy, and a suitable conditional access system being put in place)”*³⁵

7.2 **[Redacted – confidential].**

7.3 It is proposed that, subject to relevant regulatory approval, Canvas will establish a set of standards and elements of a TV platform based on a combination of distribution technologies (for example, DTT and DSL). Among other things, Canvas should enable content/service providers to offer a combination of broadcast linear TV via DTT, DSL, DSat or cable and a range of content applications provided on demand to the TV via DSL. It is also proposed that Canvas will embrace open standards for its distribution technology, so that multiple service providers can effectively operate their own Canvas-compliant TV platforms, and so that consumer electronics manufacturers can supply Canvas-compliant reception equipment. To offer Canvas-based TV services, service providers will need to build their own TV platforms, which will comply with Canvas standards and interface with the Canvas platform, or secure access to a Canvas-compliant TV platform.

7.4 **[Redacted – confidential].**

7.5 The Parties note that under the proposed licence condition, Sky is obliged to offer the relevant channels to third party pay TV retailers in respect of “*Qualifying Platforms*” which are defined as:

*“... any platform used for the distribution of programmes to residential consumers in the United Kingdom, other than a platform operated by the Licensee”*³⁶

7.6 In the body of its Third Pay TV Consultation Document, Ofcom has stated that each platform is:

³⁴ Paragraph 8.51 of Ofcom’s Third Pay TV Consultation Document.

³⁵ Paragraph 8.52 of Ofcom’s Third Pay TV Consultation Document.

³⁶ See paragraph 11.10 of Ofcom’s Third Pay TV Consultation Document.

“... defined by the set of conditional access technology and reception equipment that is particular to it”.³⁷

- 7.7 [Redacted – confidential].
- 7.8 [Redacted – confidential].
- 7.9 [Redacted – confidential].
- 7.10 [Redacted – confidential].

8. Sky’s high wholesale prices and profitability

- 8.1 Ofcom, with the assistance of Oxera, has undertaken a considerable amount of further analysis of the economic returns for Sky’s pay TV business at both aggregate and various disaggregate levels. Ofcom concludes that there is evidence that Sky is earning and will (if the pay TV market is left unchanged) continue to earn aggregate returns significantly in excess of its cost of capital, and that this is likely to be reflected in higher retail prices for consumers.
- 8.2 In particular, the Parties note the finding that aggregate returns appear to be above 20 per cent,³⁸ which is significantly in excess of Ofcom’s calculation of Sky’s cost of capital which stands at 10.3 per cent. The disaggregated analysis undertaken by Oxera leads Ofcom to the view that Sky’s wholesale returns are greater than retail returns and they are also above those of appropriate comparators.
- 8.3 Whilst the Parties cannot comment in detail on Oxera’s analysis due to a lack of access to the underlying data, the approach used by Oxera to assess Sky’s profitability is conceptually appropriate in the context of a competition investigation. In particular:
 - (a) Oxera has (unsurprisingly) followed the approach set out in the OFT’s discussion paper on profitability analysis, which was adopted by the Parties in previous submissions on Sky’s probability.³⁹
 - (b) as regards the aggregate analysis, Oxera has used a profitability metric (namely the truncated internal rate of return (“*IRR*”) approach) which allows profitability to be measured over a specific period, thereby avoiding the distortions which can arise by focusing on “*snapshots*” of profits earned in

³⁷ Paragraph 8.51 of Ofcom’s Third Pay TV Consultation Document.

³⁸ Paragraph 6.186 of Ofcom’s Third Pay TV Consultation Document.

³⁹ OFT Economic Discussion Paper 6 “*Assessing profitability in competition policy analysis*” Oxera, July 2003.

any particular year.⁴⁰ The approach mirrors an investment appraisal by taking account of inflows and outflows of an activity over time.

- (c) Oxera has cross-checked its IRR results by considering alternative approaches, in particular a return on capital employed (“ROCE”) measure. In mature, steady-state industries, there is likely to be a close correspondence between the results of these two measures. Oxera has identified such a relationship in estimating returns for Sky over the period 2004-2008 during which these market conditions have been more prevalent as compared to earlier periods. The Parties agree with Ofcom that this provides “a strong degree of comfort around the IRR estimates”.⁴¹
- (d) Ofcom rightly highlights that the IRR approach requires an estimation of opening and closing assets values and that, in this case, that also requires an estimation of off-balance sheet intangible assets which are likely to represent a relatively high proportion of the economic value of Sky. Oxera uses a reasonable approach based on assessing the replacement costs of such assets. This avoids the problem of circularity which can arise in using value-based measures based on future cash-flows, in particular, the difficulty of separating the value that arises from intangible assets from the value that could be derived from exercising market power. Oxera has also undertaken appropriate sensitivity checks to allow for the inevitable uncertainties in undertaking such a valuation.⁴² This allows their impact on the calculation of returns to be explored in a transparent manner, and for Ofcom to reach a view which is robust to these uncertainties.⁴³
- (e) As regards the disaggregated analysis, Oxera again uses a variety of metrics to assess Sky’s returns but places greater emphasis on the ROCE and return on sales (“ROS”) measures. The Parties consider this to be a reasonable and conservative approach and one which is consistent with the recommendations contained in Oxera’s guidance to the OFT in its report “Assessing profitability in competition policy analysis”.⁴⁴ In view of the

⁴⁰ The Parties note that in the report prepared for Sky by Professor Paul Grout of Bristol University (dated 11 May 2009) on the use of the truncated IRR methodology to measure profitability, professor Grout raises a number of issues particularly in the use of this metric to infer the possible presence of monopoly power. He concludes as follows: “First, in addition to calculating the truncated IRR carefully it is essential that the numbers are interpreted carefully. Simple mechanical procedures are very misleading. Second, any judgement about excessive profitability should not be based on truncated IRR analysis alone but should be considered alongside alternative approaches.” The Parties consider that Oxera has considered alternative approaches and that the results have been interpreted carefully by Ofcom on the basis of a transparent assessment by Oxera of how different assumptions affect the overall results.

⁴¹ Paragraph 6.188 of Ofcom’s Third Pay TV Consultation Document.

⁴² For example, Oxera creates a “conservative” and “base case” scenario where the former includes an upper end estimate as regards subscriber acquisition costs and the latter attempts to provide a more accurate estimate for this cost category based on a detailed analysis of costs.

⁴³ “Assessing profitability in competition policy analysis”, Economic Discussion Paper 6, July 2003, A report prepared for the Office of fair Trading by Oxera.

⁴⁴ “Assessing profitability in competition policy analysis”, Economic Discussion Paper 6, July 2003, A report prepared for the Office of fair Trading by Oxera.

reliance of these calculations on cost and revenue allocations, Oxera makes appropriate use of sensitivity checks which are vital in assessing the robustness of its estimates to different cost allocation approaches. The result that returns for wholesale activities appear higher than retail activities holds under a number of cost allocation approaches including the same detailed cost allocation which Ofcom uses as part of its calculation of regulated wholesale prices.

- 8.4 In summary, the Parties consider that the conclusions drawn by Ofcom from the analysis of Sky's profitability by Oxera are well supported. Oxera has undertaken its analysis carefully and conservatively using the appropriate conceptual framework. The study makes sensible use of scenarios to test the sensitivity of results to key assumptions and thereby allows conclusions to be drawn which are robust to different assumptions. Oxera has also cross-checked the results using alternative measures, in particular the Return on Capital Employed as well as carefully considering potential comparator companies against which Sky's returns could be appropriately measured.

9. Retail-minus methodology

Overall approach to determining Sky's wholesale prices

- 9.1 The Parties broadly agree with the approach to determining the wholesale prices for Sky's premium channels which is set out in Ofcom's Third Pay TV Consultation Document. In particular:
- the Parties consider that Ofcom is right to seek to establish prices and other non-price terms rather than imposing the wholesale must-offer regime but leaving price-setting to subsequent commercial negotiations - successful implementation of the remedy will depend on the explicit determination of these terms in order to avoid protracted future disputes;
 - the Parties agree that a retail-minus methodology coupled with a cost-plus cross-check is a pragmatic approach which is responsive to the key competition concerns identified by Ofcom;
 - the Parties support the use of a retail-minus methodology "*to derive wholesale prices by asking: how much could an efficient entrant afford to pay for the wholesale channels after taking into account all of its other costs and the need to earn a return on its investment?*".⁴⁵ The Parties agree that "*the resulting wholesale prices should be at a level*

⁴⁵ Paragraph 9.64 of Ofcom's Third Pay TV Consultation Document.

*which allows the efficient entrant to compete with Sky in retail markets, providing similar products at similar prices”;*⁴⁶

- the Parties agree with the proposal to derive linear per subscriber prices as opposed to alternative non-linear structures and consider this to be a pragmatic approach which is consistent with current practice;⁴⁷ and
- the Parties agree with Ofcom’s position that there should be one wholesale price for pay TV retailers across all distribution technologies.⁴⁸

9.2 Although the parties broadly agree with Ofcom’s proposed approach to determining the wholesale prices for Sky’s premium channels, they believe that this approach should be refined in a number of respects. For example:

- the Parties consider that wholesale prices at the bottom of Ofcom’s range will be needed to ensure fair and effective competition (as opposed to prices mid-way through the range which Ofcom appears to favour);⁴⁹
- if Ofcom is to sanction some flexibility for bespoke wholesale prices to be negotiated (subject to regulated wholesale prices providing a fall back option), it is vital that any bespoke terms offered by Sky are subject to the requirement that they are fair, reasonable and, in particular, non-discriminatory; and
- the role of the cost-plus cross-check should not be limited to ensuring that the wholesale prices which are set by Ofcom permit Sky to recover efficiently incurred costs in the provision of its premium channels.⁵⁰ Ofcom should have greater regard to the prices derived via the cost-plus methodology (i) when they are noticeably lower than the retail-minus prices and (ii) when considering requests by Sky to raise its wholesale prices.

The Parties elaborate on these (and other) issues below.

Determination of reference retail prices

9.3 When considering which retail prices should form the basis of the retail-minus calculation, Ofcom states that:

“Given the presence of discounts, which means that consumers may not pay the headline published price for a package, we have derived reference

⁴⁶ Paragraph 9.64 of Ofcom’s Third Pay TV Consultation Document
⁴⁷ Paragraph 9.30 of Ofcom’s Third Pay TV Consultation Document.
⁴⁸ Paragraph 9.56 of Ofcom’s Third Pay TV Consultation Document.
⁴⁹ Paragraph 9.8 of Ofcom’s Third Pay TV Consultation Document.
⁵⁰ Paragraph 9.65 of Ofcom’s Third Pay TV Consultation Document.

retail prices by assessing the average revenue per user (ARPU) for different retail packages. We have calculated Sky's average customer discounts by deriving Sky's expected pay TV revenues (given headline retail prices) and comparing this with actual retail revenues. We have then applied the discount factor to all Sky's retail prices as a first step in our calculation".⁵¹ (Emphasis added.)

The Parties broadly agree with this approach. They note, however, that on each occasion when Ofcom recalculates the reference retail prices (see Section 10 below) it will also need to recalculate this discount.

9.4 Ofcom rightly notes that there is a multitude of retail prices for each of the eleven premium wholesale products it has identified.⁵² The effectiveness of Ofcom's proposed remedy in enabling fair and effective competition will, among other things, depend directly on which retail prices are used as the starting point (i.e. the "reference retail prices") for the retail-minus price calculation.

9.5 The Parties note Ofcom's comment that:

"There are no stand-alone premium retail packages – all of Sky's Core Premium channels are currently subject to a compulsory buy-through, meaning that consumers have to buy a basic package before they can buy a premium package".⁵³

9.6 As Ofcom will now be aware, New Media Markets reported on 26 June that Sky is apparently going to end this buy-through requirement.⁵⁴ The article in New Media Markets stated that:

"Under this system, a single premium sports subscription with one basic package costs £26.50 per month; this would change to £25.50 for a stand-alone premium sports subscription. That is on the basis of today's prices – the actual prices that would apply from September ... have still to be announced".

9.7 Despite searching Sky's website, the Parties have not been able to identify prices for stand-alone premium channels which would apply from September. Nevertheless, assuming that Sky adopts the same structure as is described above (i.e. stand-alone prices being set at £1 below the prices for the relevant premium channel(s) together with one basic package) then these stand-alone prices do not represent an appropriate starting point for the retail-minus calculation as they are clearly inflated and have been set at a high level to limit "spin down" from Sky's premium packages which also include basic channels.

⁵¹ Paragraph 9.70 of Ofcom's Third Pay TV Consultation Document.

⁵² Paragraph 9.72 of Ofcom's Third Pay TV Consultation Document.

⁵³ Paragraph 9.80 of Ofcom's Third Pay TV Consultation Document.

⁵⁴ New Media Markets, 26 June 2009 "BSkyB scaps 'buy-through' rule".

9.8 In its assessment of “*retail prices as the starting point of the calculation*”, Ofcom states that:

*“There are a number of different approaches we could take. For example, we could simply take the smallest retail package (with the lowest retail price) – i.e. the retail bundle with only one basic channel mix. This approach would minimise the retail costs to be deducted from this retail price, arguably leading to the simplest calculation. However, in reality most consumers purchase significantly more than one basic channel mix and so this approach may not be very representative of the retail price actually paid by Sky’s customers”.*⁵⁵ (Emphasis added.)

9.9 Assuming that Sky does proceed with the stand-alone retail prices described in New Media Markets, then in future Sky’s “*smallest retail [premium] packages*” will be for stand-alone premium channels. Nevertheless, with such a small incremental retail price (£1) for packages containing basic channels it is unlikely that many customers will subscribe to stand-alone premium channels at the stand-alone retail prices reported in New Media Markets.⁵⁶ Thus, these stand-alone prices will not represent the prices actually paid by Sky’s customers. If Ofcom were to use these inflated stand-alone retail prices as the starting point for its retail-minus calculation, it would merely determine inflated wholesale prices which would not fulfil its objective of promoting fair and effective competition.⁵⁷

9.10 An alternative approach, which Ofcom proposes to take, involves:

“... a weighted average of Sky’s retail prices for different bundles, weighted by the number of Sky’s retail customers who take that number of basic channels”.

9.11 The Parties consider that the use of a weighted average price as suggested by Ofcom has a number of drawbacks. For example, as “*most consumers purchase significantly more than one basic channel mix*”,⁵⁸ it can be inferred that the packages with more basic channels have been given greater weight in Ofcom’s calculation. This may result in wholesale prices which do not support fair and effective competition in the current market.

9.12 Ofcom states that:

⁵⁵ Paragraph 9.82 of Ofcom’s Third Pay TV Consultation Document.

⁵⁶ It should be noted that this incremental retail price of £1 will be below Sky’s incremental cost for supplying basic channels.

⁵⁷ This is the key risk with the approach outlined in paragraph 9.8 above of simply taking the smallest retail package (with the lowest retail price) as the starting point for the retail-minus calculation. Given that most Sky subscribers take bigger packages, Sky could game a remedy based upon the prices of its smallest retail packages by inflating the prices for those small retail packages without suffering much consequential churn.

⁵⁸ Paragraph 9.82 of Ofcom’s Third Pay TV Consultation Document.

*“... our aim is to derive a set of wholesale prices which allow other retailers a comparable retail cost ‘allowance’ to compete in retail markets with a differentiated set of bundles, rather than to ensure that it can compete by offering precisely the same bundles as Sky, at exactly the same price points”.*⁵⁹

9.13 Yet, underlying Ofcom’s use of a weighted average price seems to be the assumption that, in order to compete, rival retailers should be able to match Sky’s prices for its larger bundles which are taken by most of its existing customers. The Parties consider, however, that competition for marginal customers (both new customers attracted into the pay TV market and switching customers) will focus on smaller bundles and lower price points.⁶⁰

9.14 Furthermore, in view of this competitive dynamic, a weighted average approach could give Sky an opportunity to “game” the regime by altering its relative retail prices in order to disadvantage rival retailers whose wholesale price is determined by reference to an average weighted retail price. If Ofcom were to use this weighted average approach, Sky could reduce its own retail prices for those smaller bundles which the Parties believe are of key importance in attracting new and switching customers without having much effect on its existing retail pay TV revenues or the derived wholesale prices. If this resulted in wholesale prices (as determined by reference to an average weighted retail price) which did not enable rival retailers to compete at the lower retail price points, it would inhibit the ability of rival retailers to compete for new customers.

9.15 The problem is exacerbated because of a lack of transparency in the derivation of the weighted average reference price. The weights which are applied to the different retail prices (based on the proportions of Sky’s customers taking different bundles) are apparently commercially confidential to Sky allowing Sky, but not its rivals, an awareness of how changes to relative retail prices would affect the regulated wholesale prices. Sky may, therefore, be able to game the pricing of its retail packages so that rivals are constrained in their ability to compete with Sky on the basis of a wholesale price calculated by reference to an average weighted retail price.

9.16 In the circumstances, the Parties believe that a better approach to deriving wholesale prices would be:

*“... to calculate the ... wholesale prices derived from a retail-minus calculation applied to all [relevant] retail prices and then to take the lowest of the resulting wholesale prices”.*⁶¹

⁵⁹ Paragraph 9.93 of Ofcom’s Third Pay TV Consultation Document.

⁶⁰ The Parties note, in this context, that J P Morgan’s report on B Sky B of 22 July 2009 stated that “At 9M 09 results, Sky noted that new customers are tending to join on slightly cheaper packages than the existing sub base”.

⁶¹ Paragraph 9.83 of Ofcom’s Third Pay TV Consultation Document.

9.17 In this context, “*relevant*” retail prices would be all the retail prices for the reference premium product. For example, for a package of Sky Sports 1 and 2, the “*relevant*” retail prices would currently be Sky’s standalone retail price for Sky Sports 1 and 2 (if there is one) and the retail prices for Sky Sports 1 and 2 when bought through 1 to 6 basic packs.

9.18 This is broadly the approach proposed by the Parties in their Joint Response to Ofcom’s Second Pay TV Consultation Document.⁶² This approach will ensure that rivals can compete in relation to the bundles (and the retail price points) which are critical for successfully building a base of premium pay TV subscribers. As Ofcom notes:

*“This approach would ensure that other retailers are able to compete with all Sky’s retail price points”.*⁶³

9.19 As the weighted average approach focuses on the bundles which have been the most popular in the past, it will not necessarily enable competition in relation to the bundles which will now be bought by new and switching subscribers. Although the approach advocated by the Parties may give rise to slightly greater complexity, the Parties consider that this is justified given that the remedy is intended to promote competition.⁶⁴

Calculating the “minus”

9.20 The Parties agree with Ofcom’s assessment that the categories of costs to be deducted from the retail price in order to establish an appropriate wholesale price include the following:

- programming costs;
- marketing costs;
- subscriber management costs (including TPS charges);
- subscriber acquisition costs;
- transmission costs; and

⁶² Paragraph 5.14 of the Joint Response to Ofcom’s Second Pay TV Consultation Document.

⁶³ Paragraph 9.83 of Ofcom’s Third Pay TV Consultation Document.

⁶⁴ As noted above, the approach to deriving wholesale prices described in paragraph 9.17 above could accommodate any new Sky retail prices for stand-alone premium channels. Those stand-alone retail prices could be included within the group of retail prices to which the retail-minus calculation is applied and from which the lowest wholesale price would be determined. Similarly, if Ofcom were to persist with its proposal to use a weighted average approach, then any new Sky retail prices for stand-alone premium channels should also be included in that weighted average calculation, together with the other retail prices identified by Ofcom in its Third Pay TV Consultation Document. Such stand-alone retail prices should certainly not replace the weighted average calculation for the reasons noted above.

- administration costs.⁶⁵

9.21 In the Parties' Joint Response to Ofcom's Second Pay TV Consultation Document, they highlighted that, before deducting such costs, VAT should be deducted from the retail price which Ofcom has established as the starting point for its calculation.⁶⁶ It is not clear from Ofcom's Third Pay TV Consultation Document whether Ofcom has done this.

9.22 Furthermore, in their Joint Response to Ofcom's Second Pay TV Consultation Document, the Parties identified "*general overheads*" as a category of costs to be deducted. In its Third Pay TV Consultation Document, Ofcom has used the category of "*administration*" costs. The Parties assume that Ofcom is treating these two categories as synonymous. If not, it is important that Ofcom does not omit general overheads from the calculation of the "*minus*". In practice, administration costs could be seen as being just one component of general overheads, which would include the costs of running premises, salaries etc. which Ofcom has not mentioned when elaborating on the category of administration costs.

9.23 Having identified the relevant categories of costs to be deducted, the next step is to establish a reasonable cost benchmark for an efficient retail entrant.⁶⁷ Ofcom confirms that:

*"... we start with Sky's costs, as the best available proxy for an efficient scale retailer. We address the notable exception of scale issues and transmission costs ..."*⁶⁸

9.24 In the context of the wholesale must-offer remedy, the Parties consider that Ofcom's proposal to use Sky's costs as the basis for calculating the minus, subject only to adjustments for transmission costs and scale will not result in wholesale prices that promote fair and effective competition. In particular, in order to reflect the position of new entrants, Ofcom also needs to make adjustments to the cost of capital, fixed costs, churn, SAC and the cost of third party basic channels.

9.25 The Parties note that the methodology used by Ofcom to allocate costs between different parts of Sky's business is central to its pricing analysis. The Parties have been unable to review this methodology in any detail because of the confidential nature of both the cost information and the drivers which have been used to allocate these costs. Whilst the difficulty of providing greater transparency in these circumstances is recognised, the Parties consider that Ofcom's approach to cost allocation should be particularly cautious given that its analysis will not be subject to the normal levels of scrutiny which a consultation aims to achieve. In short, Ofcom should place greater emphasis on

⁶⁵ Paragraph 9.100 of Ofcom's Third Pay TV Consultation Document.

⁶⁶ Paragraph 5.21 of The Parties Joint Response to Ofcom's Second Pay TV Consultation Document.

⁶⁷ Paragraph 9.93 of Ofcom's Third Pay TV Consultation Document.

⁶⁸ Paragraph 9.97 of Ofcom's Third Pay TV Consultation Document.

an approach which delivers lower wholesale prices given that the only party with full visibility of the analysis will be Sky who can be expected to argue forcefully for higher wholesale prices.⁶⁹

Transmission costs

9.26 Ofcom states that:

*“... we ... propose to adopt an approach which sets a single price, applicable to all competing retailers, for a given factory gate product which excludes onwards transmission to retail customers”;*⁷⁰

*“... there are good reasons to consider deviating from Sky’s own costs when it comes to transmission costs”;*⁷¹ and

*“Our assessment is that competitors are particularly likely to adopt DTT as a distribution technology in the short to medium term and therefore it is necessary for us to consider what wholesale prices would enable a DTT-based retailer to operate a viable business”.*⁷²

The Parties agree with these principles.

9.27 Ofcom has, however, also confirmed that it has assumed:

“... a DTT transmission cost of £8 million per video stream per annum; and

*“... that video stream costs would be shared equally between three retailers, so the quantity of transmission costs in the retail-minus calculation equalled one-third of the assumed videostream cost”.*⁷³

9.28 **[Redacted – confidential].**

9.29 **[Redacted – confidential]**⁷⁴.

9.30 **[Redacted – confidential].**

⁶⁹ The Parties note that in setting prices for wholesale bitstream broadband access products using a retail-minus approach, Ofcom’s ability to provide full transparency as regards its approach was similarly limited by the commercially confidential nature of the information on which the margin setting model was based. In that case, Ofcom sought to balance respondents’ wishes for greater transparency with the need to respect commercial confidentiality by contracting an external consultancy, Analysys Consulting Ltd, to review the model. Ofcom made several adjustments to its approach in line with the recommendations of Analysis and respondents were invited to a presentation of Analysys’ findings. The Parties note that Ofcom has not opted for such an external review in this case, and therefore the need for a cautious approach is even greater.

⁷⁰ Paragraph 9.130 of Ofcom’s Third Pay TV Consultation Document.

⁷¹ Paragraph 9.131 of Ofcom’s Third Pay TV Consultation Document.

⁷² Paragraph 9.135 of Ofcom’s Third Pay TV Consultation Document.

⁷³ Ofcom’s letter to Virgin Media dated 23 July 2009.

⁷⁴ **[Redacted – confidential.]**

Appropriate scale of retailer and SAC

9.31 Ofcom confirms that it has:

“... considered two types of entrant in addition to a business operating at Sky’s scale:

- A ‘large’ entrant: total fixed cost of retailing of about £12 million per year, subscriber numbers of 1 million at 3 years and 3 million after 10 years. In addition, there are fixed costs associated with the transmission of premium channels.*
- A ‘small’ entrant: total fixed costs of retailing about £12 million per year, subscriber numbers of 330,000 at 3 years and 1 million after ten years. As above, there are fixed costs associated with the transmission of premium channels”⁷⁵.*

“We believe that these subscriber bases are plausible based on evidence we have reviewed from Sky’s Picnic forecast and from the scale that existing competitors have achieved to date. These scale assumptions need to be placed in the context of the overall market. Our base case assumes a total addressable market of premium subscribers of 10 million subscribers in year 10 from 7 million at the present day”⁷⁶.

9.32 Thus, Ofcom has modelled a “large” scale entrant which it anticipates will achieve a 30% market share after ten years and a “small” scale entrant which it anticipates will achieve a 10% market share after 10 years.

9.33 The Parties agree with the principle that Ofcom should set wholesale prices which allow an efficient entrant to compete with Sky in retail markets and that this should take account of the fact that an entrant operating at lower scale will have higher average costs than Sky because of the presence of fixed costs. This approach is consistent with the aim of promoting fair and effective competition because it will allow rival retailers to recover efficiently incurred retail costs, notwithstanding the fact that they cannot immediately achieve the economies of scale available to Sky.⁷⁷

9.34 The Parties note that Ofcom has identified for consultation a range of prices where the top of this range makes no allowance for DTT transmission costs or scale effects (Ofcom’s Scenario 2) and the bottom of the range assumes DTT transmission costs for a “small” scale entrant (Ofcom’s Scenario 5). Ofcom

⁷⁵ Paragraph 9.163 of Ofcom’s Third Pay TV Consultation Document.

⁷⁶ Paragraph 9.164 of Ofcom’s Third Pay TV Consultation Document.

⁷⁷ In this regard, the Parties consider that Sky, as the incumbent operator, has a significant advantage arising from its large subscriber base and range of products and services which it has developed over many years and over which common costs can be recovered. It is entirely reasonable that Ofcom should make an allowance to reflect the fact that an efficient entrant cannot immediately achieve the benefits to Sky from its scale and scope which have arisen from its presence and growth in the market over many years.

proposes, however, that wholesale prices for Sky's premium channels should be set to allow a larger competitor on DTT to compete with Sky's retail prices (Ofcom's Scenario 4).⁷⁸ The Parties note that, contrary to Ofcom's remark that scale effects are relatively small because fixed costs are a relatively small proportion of a pay TV retailer's overall costs,⁷⁹ the differences between wholesale prices based on assumptions of a "large" and "small" entrant respectively (i.e. the differences in prices between Scenarios 4 and 5) are significant. Indeed, Ofcom confirms that:

*"... Scenario 5, which reflects the scale of a "small" entrant on DTT as opposed to a "large" entrant in Scenario 4, is a more significant difference with retail-minus prices about 10-17% lower using this assumption".*⁸⁰

9.35 The Parties consider that Ofcom should not set wholesale prices which discriminate against smaller new entrants or represent a substantial barrier to new entrants, all of which are small at the outset. Prices should be set which allow competition by both larger and smaller entrants. A smaller entrant facing wholesale prices which are 10 to 17% higher than the level which would allow them to compete effectively with Sky is likely to be deterred from entering, or would be a far less effective competitor even if entry occurred. This is contrary to the key objective of Ofcom's remedy to promote fair and effective competition.

9.36 With regard to the issues of scale and DTT transmission costs it should be noted that Ofcom not only anticipates that there will be three pay TV retailers on DTT which will share the cost of capacity equally between them but also that:

*"... retail-minus prices should be set to allow a larger competitor (for example, 3 million subscribers after ten years) to compete with Sky's retail prices, incorporating an allowance for DTT transmission costs and a reasonable return on investment. This would suggest prices roughly mid-way through [Ofcom's] range for consultation [i.e. Scenario 4]."*⁸¹

9.37 Ofcom then goes on to observe that:

*"Scenario 4 shows the impact of making an allowance for DTT distribution costs compared to DSat transmission costs as incurred by Sky (Scenario 3). As the figures show, **the use of DTT distribution costs does not make a significant difference** when compared with DSat costs – a difference of between about 0% and 3%".* (Emphasis added.)

9.38 This outcome is merely due to the fact that Ofcom has proposed that the DTT distribution costs will be shared equally between three pay TV retailers and thus

⁷⁸ Paragraphs 9.7 and 9.8 of Ofcom's Third Pay TV Consultation Document.

⁷⁹ Paragraph 9.165 of Ofcom's Third Pay TV Consultation Document.

⁸⁰ Paragraph 9.190 of Ofcom's Third Pay TV Consultation Document.

⁸¹ Paragraph 9.8 of Ofcom's Third Pay TV Consultation Document. See also Paragraph 9.167 of Ofcom's Third Pay TV Consultation Document.

in Scenario 4 Ofcom is assuming that the pay TV retailers on DTT will, in aggregate, acquire nine million premium pay TV subscribers by year ten (out of a total market of 10 million premium pay TV subscribers⁸²). Hence, in Scenario 4 Ofcom is assuming that the entrants on DTT will between them achieve a 90% market share of premium pay TV subscribers within ten years – with the remaining 10% of the market being held by Sky, cable and DSL operators. This is clearly an unrealistic assumption.

9.39 As Ofcom itself notes:

“...it is unlikely to be reasonable to expect an efficient entrant to achieve Sky’s scale”.⁸³

9.40 It is equally unreasonable to assume that three entrants on DTT will between them eclipse not only Sky but also the retailers of premium pay TV channels on cable and DSL.

9.41 The Parties note that Ofcom has also stated that:

“Our view is that unmet demand on DTT-based platforms may lie in the region of 2 million subscribers over five years (including the 1 million customers who we would expect to switch from DSat, households who currently subscribe to other platforms, and households who do not currently subscribe to pay TV)”.⁸⁴

9.42 The Parties agree with this projection. They also consider that the total number of premium subscribers on DTT over a period of ten years may reach three million (and a 30% market share). This would be consistent with the three entrants on DTT which Ofcom has assumed all achieving subscriber growth in accordance with Scenario 5. Thus, the Parties consider that entry on a smaller scale on the DTT platform (Scenario 5) is significantly more plausible over the 10 year period identified by Ofcom than the larger scale scenario (Scenario 4).

9.43 Furthermore, the Parties understand that Ofcom uses Sky’s 2008 SAC of around £250 as a benchmark for the SAC of a new DTT retailer of Sky’s premium channels. For Sky, such a high SAC is sustainable because Sky enjoys the benefit of both retail and wholesale pay TV margins and other revenue streams. In contrast, a new premium pay TV retail business on DTT will only generate a retail pay TV margin and so necessarily will only be able to bear a lower SAC on the basis of the wholesale prices proposed by Ofcom. A reduced SAC will naturally result in fewer subscribers for a new entrant than Ofcom is anticipating on the basis of a £250 SAC. Such an entrant would only be able viably to bear a higher SAC at wholesale prices which are below the bottom of the range on which Ofcom is consulting.

⁸² Paragraph 9.164 of Ofcom’s Third Pay TV Consultation Document.

⁸³ Paragraph 9.194 of Ofcom’s Third Pay TV Consultation Document.

⁸⁴ Paragraph 1.40 of Ofcom’s Third Pay TV Consultation Document.

- 9.44 For all the reasons outlined above, the Parties believe that, to achieve its goal of promoting fair and effective competition, Ofcom must set wholesale prices in accordance with Scenario 5 (i.e. at the lower end of the range on which it is consulting).
- 9.45 Ofcom is, however, apparently concerned that market entry by sub-scale firms may lead to higher costs being passed onto consumers. Underlying this concern seems to be a belief that with each entrant requiring a certain level of fixed costs, if there are many entrants each with a low level of subscribers over which to amortise their fixed costs, the subsequent high unit costs can only be recovered by higher prices to the consumer. The Parties believe that this takes a static view of the market and that such a “*big is beautiful approach*” will only serve to stifle innovation and reduce competition.
- 9.46 Applying this type of static thinking to the airline industry would result in airport slots only being given to one airline for each route to maximise plane loading efficiency. Allowing other airlines to enter would theoretically increase cost which would be passed onto the passenger. Such a static view could dictate that only BA should be able to fly from London’s airports. Yet when other airlines were allowed to enter the opposite happened. For example, Easyjet and RyanAir innovated. They cut-out the frills, reduced costs and reduced prices. Consumers benefitted and airline travel grew massively. A dynamic market was created.
- 9.47 The Parties believe that the parallels with the pay TV market are clear. New entrants will innovate. Some will cut-out the frills, unbundle the packages and allow customers to buy what they really want. This will cut the cost to the consumer and grow the market. In turn this will reduce unit costs further (despite the potential for multiple fixed costs) and create a virtuous circle. More consumers paying lower prices will result, as per the airline industry.
- 9.48 Therefore the parties believe that Ofcom should take a dynamic view of the market in this respect rather than the current static approach. Prices should be objectively calculated in a way that is “*new entrant neutral*” rather than set at a level which allows only larger scale entrants.

Appropriate cost of capital

- 9.49 Ofcom confirms that:

*“In our analysis of an efficient entrant’s cash flows, the discount rate should be set to the appropriate cost of capital. We have derived a forward looking **cost of capital figure of 10.3%**. This figure is based upon our view of Sky’s cost of capital, derived from the capital asset pricing model (CAPM) approach”*.⁸⁵ (Emphasis added.)

⁸⁵ Paragraph 9.116 of Ofcom’s Third Pay TV Consultation Document.

“Our general approach to setting wholesale prices is to base our analysis on Sky’s costs as an efficient retailer of pay TV services, except where there is a particularly compelling reason to do otherwise. With respect of the appropriate cost of capital we recognise that Sky is an established operator. However, we note the potential for entrant retailers of Core Premium pay TV services to also be significant retail operators, providing a range of services to existing customers. Furthermore, it is unclear whether competitors face systematically different risks from Sky, assuming access to Sky’s content. We therefore do not propose to make an adjustment for the different risk profiles of entrants”.⁸⁶ (Emphasis added.)

- 9.50 The Parties note that Ofcom has not presented any evidence to support its assumption that the systematic risk of new entrants will be similar to that of Sky. In practice, competing pay TV retailers clearly do face substantially higher risks than Sky not least because they have to compete against Sky, a dominant incumbent which, among other things, has a current annual marketing budget in excess of £900 million.⁸⁷
- 9.51 Sky’s market power and past aggressive responses to all attempts at competitive entry significantly increase the risks for rival pay TV retailers. Ofcom suggests that third party retailers of premium pay TV services have the “*potential*” to be significant operators. That potential does not mitigate the risks of entry or reduce the cost of capital for such entrants. New entrants’ fixed costs are certain and front-loaded; in contrast, new entrants’ margins and revenues are uncertain and weighted to the future. The fixed costs of new entrants will be higher than for the incumbent because they include entry costs. The revenues and margins are more uncertain for new entrants than they are for the incumbent, because the entrant’s customers have yet to be recruited whereas the incumbent’s customers are already in place.⁸⁸
- 9.52 In view of the aim to set wholesale prices which enable fair and effective competition by rival retailers of premium channels, the Parties consider that the allowance which is made for a reasonable return on investment should reflect the *ex ante* risks faced by a new entrant at the outset of its investment. The forward-looking estimate of the cost of capital for Sky, which is a very well established and diversified operator, does not represent an appropriate proxy of this return. Indeed, the cost of capital figure used by Ofcom (which is based on

⁸⁶ Paragraph 9.117 of Ofcom’s Third Pay TV Consultation Document.

⁸⁷ These firm-specific risks are very substantial and, if they are not taken into account in the cost of capital, then they ought otherwise to be taken into account in the wholesale charges for Sky’s premium channels in order to fulfil Ofcom’s objective to promote effective competition.

⁸⁸ In addition to these risks, new entrants will experience higher systematic risks than the incumbent, in respect of their pay TV businesses. (Where the pay TV business is part of a wider group, the cost of capital for pay TV could be considered as pooled with the other investments of the Group. However, in its analysis, Ofcom should consider the cost of capital for the pay TV business separately, consistent with its approach to separate costs of capital in parts of the BT Group business.)

a forward-looking analysis) does not even reflect the *ex ante* risks which confronted Sky in developing its premium pay TV services.

9.53 The Parties agree with Ofcom that the CAPM is the appropriate way of calculating the WACC for a new entrant to retailing premium pay TV channels on DTT. As noted above, however, the Parties believe that the use of Sky as a benchmark for a new entrant's WACC is inappropriate. The CAPM calculates WACC on the basis of:

- (a) the level of debt of the company versus equity;
- (b) the cost of financing the proportion of debt; and
- (c) the cost of equity.

On every component of the calculation of WACC, Sky is at an advantage to a new entrant and so will have a lower WACC.

9.54 In any company, the shareholder equity always ranks below debt in the list of creditors. By definition this makes equity riskier than debt as there is always a greater chance that the debt will be repaid.⁸⁹

9.55 Therefore debt financing, with lower risk and lower returns, typically costs less than equity financing. As such an efficient company should always try to finance itself through debt rather than equity. The level that a company is able to fund itself through debt rather than equity is a function of the financial strength of the company and the risk associated with its business. Sky, as the dominant pay TV operator with high levels of profitability and a mature business (as is demonstrated by Oxera's analysis), will always be able to maintain a higher debt to equity ratio than a new entrant.⁹⁰ Therefore in the first part of the WACC calculation Sky will always be at an advantage.

9.56 This superior debt position will also result in an advantageous cost of debt financing versus a new entrant (part (b) above). This is due to the lower risk of a mature incumbent, such as Sky, defaulting and is demonstrated by the fact that the cost of Sky's debt is only 6% whereas the Parties understand that the cost of Setanta's debt was 20%. Ofcom has recognised the different costs of capital for a mature incumbent with a high market share in other markets including telecoms, where it applies a lower cost of capital to the access business Openreach than to competitive businesses elsewhere in BT Group. The Parties assess that, due to higher risk, there will be a premium for debt of at least 2 to 3% over the cost to Sky for a new entrant which is a division of blue chip company and a premium of around 14% over the cost to Sky for a private equity backed entrant such as Setanta.

⁸⁹ The flip side to this is that once the debt is repaid, all returns accrue to the shareholders, enabling the equity to achieve higher returns.

⁹⁰ This is particularly true in the current economic climate.

- 9.57 Sky also has an advantage over a new entrant in part (c), the cost of equity. This cost is measured according to the volatility of the equity versus the rest of the market, the equity beta. A low risk stock will show a lack of volatility due to a stable and predictable profit stream. As a result of Sky's dominant position in pay TV, it has very high and stable levels of profit, making it less risky and so less volatile than the rest of the market. As a consequence, Ofcom has used an equity beta of 0.85 for Sky. As the market average is 1.0, Sky's cost of equity is approximately 15% less than the market average.
- 9.58 Any new entrant will by definition be a riskier venture than a dominant incumbent and so its equity will be more volatile and more costly. This is particularly true given that Ofcom's modelling (as replicated by TUTV) discloses a £400 million peak cash requirement for a "large" scale DTT entrant and a £200 million peak cash requirement for a "small" scale DTT entrant and a period in either case of over 10 years to pay back that investment. This is a far riskier profit profile than Sky and is made riskier by the fact that the entrant will need to compete against Sky which is the dominant incumbent.
- 9.59 Furthermore, the equity beta for a pay TV entrant will be substantially higher than Sky because the two key variables driving the revenues and margins, the rate of recruitment of subscribers and the generation of average revenue per subscriber, are more dependent upon the general state of the economy for a new entrant than for the incumbent. This is not surprising because pay TV is an experiential product: new customers do not know what value they will derive from a service until they have experienced it and consequently in periods of economic uncertainty they tend to discount the expected benefits relative to the certain prices they are being offered. For the installed subscriber base of the incumbent, the customers know what value they get out of service already. So while there may be an increase in attrition reflecting the general economic climate, which the new entrants also face, the incumbent's customers are not likely to discount the unknown value in the way that new entrant's potential customers are. Furthermore, scale itself is a factor in the lower beta of the incumbent than new entrants, as scale allows the incumbent to diversify its economic risks.
- 9.60 Therefore each component of the WACC calculation is higher for a new entrant:
- (a) it will have a lower proportion of "cheaper" debt finance versus equity as there will be less financial security than Sky's debt;
 - (b) the cost of the new entrant's debt will be higher due to the increased risk;
and
 - (c) the cost of the equity will be higher due to the increased volatility.

9.61 The Parties estimate in the table below that the likely WACC of a new entrant will be around 15% (for a low to medium debt-backed company or division of a blue chip company), which is consistent with Ofcom’s sensitivity calculation.⁹¹

	Sky as per Ofcom	Low debt entrant	Medium debt entrant	Private equity entrant
Equity risk Premium	5.00%	5.00%	5.00%	5.00%
Equity Beta ⁹²	0.85	1.25	1.50	3.50
Nominal risk free rate	4.50%	4.50%	4.50%	4.50%
Cost of Equity (post tax)	8.75%	10.75%	12.00%	22.0%
Senior debt Premium ⁹³	1.50%	3.5%	4.5%	15.05%
Cost of Debt pre tax	6.00%	8.00%	9.00%	19.50%
Senior debt Gearing ⁹⁴	30%	5%	20%	20%
WACC pre tax	10.3%	14.6%	15.1%	28.3%

9.62 Furthermore, Ofcom has itself recently confirmed that even a very well established business such as BT (excluding Openreach) has a cost of capital of 11%.⁹⁵ In addition, the Competition Commission’s 2003 investigation of charges for terminating calls by mobile operators identified the following costs of capital:

	Pre-tax WACC (low)	Pre-tax WACC (high)
Vodafone (2003)	17.4% (mid-point)	
T Mobile (2003)	24.3%	29.3%
Orange (2003)	16.6%	17.4%

⁹¹ Paragraphs 9.117 and 9.174 of Ofcom’s Third Pay TV Consultation Document.

⁹² The equity beta figure for Sky is sourced from Ofcom. The other figures have been estimated by BT and TUTV.

⁹³ The figure for senior debt premium for Sky is sourced from Ofcom. The other figures have been estimated by BT and TUTV.

⁹⁴ The figure for senior debt gearing for Sky is sourced from Ofcom. The other figures have been estimated by BT and TUTV.

⁹⁵ Ofcom’s document entitled “A New Pricing Framework for Open Reach” dated 22 May 2009.

O ₂ (2003)	15.4%	17.1%
-----------------------	-------	-------

9.63 As a consequence, it is clear that the cost of capital of a new retailer of premium pay TV channels on DTT would certainly be above the figure of 10.3% which Ofcom is proposing to use.

9.64 As is noted above, Ofcom confirms that:

*“... a competitor that is as efficient as Sky at equivalent scale may nevertheless at lower scale have average total costs which exceed Sky’s ...”*⁹⁶

9.65 Similarly, a competitor that is as efficient as Sky at equivalent scale will, nevertheless, at lower scale (i.e. upon entry) have a higher cost of capital than Sky, as noted above. It is inconsistent for Ofcom to take account the higher average total costs of an entrant which result from the presence of fixed costs of retailing but to ignore the higher cost of capital of efficient entrants.

9.66 Furthermore, Ofcom proposes to have regard to DTT transmission costs, even though Sky does not incur them, because:

*“... competitors are particularly likely to adopt DTT as a distribution technology in the short to medium term and **therefore it is necessary for us to consider** what wholesale prices would enable a DTT based retailer to operate a viable business”.*⁹⁷ (Emphasis added.)

9.67 Similarly, new entrant pay TV retailers will have a cost of capital of around 15% and will not enjoy the benefits of Sky’s low cost of capital of 10.3%. Accordingly, it is inconsistent for Ofcom to have regard to the higher cost of DTT transmission technology which is likely to be used by pay TV entrants but not to have regard to their higher cost of capital.

9.68 In the circumstances, the Parties believe that it would be far more appropriate for Ofcom to adopt a cost of capital of around 15% for third party pay TV retailers and use this cost of capital when calculating the “*minus*” within its retail-minus methodology. It would, however, not be appropriate to use this cost of capital when calculating wholesale prices via the cost-based methodology as the cost-based methodology must have regard just to Sky’s wholesale costs, including its cost of capital and not the higher costs of capital of its pay TV competitors.

⁹⁶ Paragraph 9.125 of Ofcom’s Third Pay TV Consultation Document.

⁹⁷ Paragraph 9.135 of Ofcom’s Third Pay TV Consultation Document.

Level of fixed costs of retailing

9.69 Ofcom explains in its approach to the adjustment for scale in the following statements:

“Given economies of scale, a competitor that is as efficient as Sky at equivalent scale may nevertheless, at lower scale, have average total costs which exceeds Sky’s due to the presence of fixed costs”.⁹⁸

“We assume that the efficient entrant will incur a set level of fixed costs, which is incurred at each and every level of output. Over and above these fixed costs, the entrant incurs variable costs, primarily driven by its number of subscribers”.⁹⁹

“We have generated this fixed cost number by reviewing a range of data relating to certain cost categories in Sky’s business. These are third party programming, news and entertainment channels, marketing, subscriber management, administration and transmission not directly related to channels. ... The majority of fixed costs arise from marketing expenditure where we have estimated the minimum required expenditure to allow a competitor to run marketing campaigns each year”.¹⁰⁰

9.70 In practice, these statements are rather opaque. Having sought clarification from Ofcom, the Parties understand that Ofcom has identified £15 million of fixed costs (i.e. costs which are incurred at each and every level of output and so do not vary with subscriber numbers). Of the total pool of £15 million of fixed costs for both the wholesale and the retail businesses, the Parties understand that Ofcom believes that approximately £9.5 million relates to fixed costs of marketing. Rather than look at benchmarks (including Sky’s fixed marketing costs – which would run into hundreds of millions of pounds), Ofcom has established a “*simplified bottom-up model*” for marketing costs. This does not include staff costs. It does, however, include Ofcom’s estimate of “*the minimum expenditure necessary to mount a marketing campaign*”,¹⁰¹ that is, Ofcom’s estimate of the minimum annual expenditure on TV advertising, newspapers and outdoor advertising that would be necessary for a pay TV operator providing premium and basic channels.

9.71 The Parties also understand that the balance of the total pool of £15 million of fixed costs (approximately £5.5 million) is divided roughly equally between SMS, administration and transmission (not relating to channels). In respect of this pool of £5.5 million of fixed costs, the Parties understand that Ofcom has looked at benchmarks from other operators (specifically BT Vision, Setanta, Tiscali, TUTV and Virgin Media). Ofcom has used the smallest amount for

⁹⁸ Paragraph 9.125 of Ofcom’s Third Pay TV Consultation Document.

⁹⁹ Paragraph 9.127 of Ofcom’s Third Pay TV Consultation Document.

¹⁰⁰ Second bullet of paragraph 9.127 of Ofcom’s Third Pay TV Consultation Document.

¹⁰¹ Paragraph 9.165 of Ofcom’s Third Pay TV Consultation Document.

these costs that he has identified for any of these parties.¹⁰² **[Redacted – confidential]**.¹⁰³

9.72 Ofcom then allocates this pool of £15 million of fixed costs between wholesale channel provision and pay TV retailing. Ofcom confirms in its Third Pay TV Consultation Document that it has used a figure for “total fixed costs of retailing of about £12 million per year”.¹⁰⁴ In a footnote, Ofcom states that:

*“This is consistent with our single cost curve and an assumption that £15 million of Sky’s costs are fixed across the whole of Sky’s business. Given the allocation of these fixed costs to different functions, around £3 million are allocated to Sky’s premium wholesale function, leaving approximately £12 million of fixed costs to be incurred by a retail business – whether Sky’s retail business or that of an entrant”.*¹⁰⁵

9.73 The Parties consider Ofcom’s estimate of £12 million to be a significant understatement of the annual fixed costs which are likely to be incurred by an efficient retailer of premium pay TV channels. The Parties note that the categories that Ofcom included within this pool of fixed costs include marketing, SMS, administration and transmission (not relating to channels).

9.74 As regards Ofcom’s assumption that approximately two thirds of the fixed costs relates to marketing, this suggest an annual fixed cost for retail marketing of approximately £8 million.¹⁰⁶ The Parties note in this regard that total marketing expenditure for Sky in the financial year ending 30 June 2009 was £907 million.¹⁰⁷ The Parties consider that an allocation of less than 1% of this figure as a fixed cost to new entrants who will compete against Sky is a significant under-estimate of the actual costs of marketing campaigns which the new entrant will need to undertake to promote its pay TV retail packages.¹⁰⁸ The Parties will clarify individually with Ofcom their fixed costs of retail marketing. They are, however, aware that Setanta’s fixed retail marketing expenditure in 2008 was approximately £22 million. With a total direct subscriber base of 1.2 million (of which 1 million were on satellite and 200,000 were on DTT), Setanta is similar to the ‘small’ entrant contemplated by Ofcom’s Scenario 5. Even an entrant at this scale will need to incur over two and half times the fixed level of marketing expenditure that Ofcom is contemplating. In practice, it

¹⁰² Ofcom has not disclosed which party had the lowest fixed costs in these categories as that is confidential. Nevertheless, it seems likely that a small company which has strenuously sought to avoid incurring fixed costs such as TUTV will have had more impact on this number in Ofcom’s modelling than a much larger scale operator such as Virgin Media.

¹⁰³ **[Redacted – confidential]**.

¹⁰⁴ Paragraph 9.163 of Ofcom’s Third Pay TV Consultation Document.

¹⁰⁵ Footnote 546 of Ofcom’s Third Pay TV Consultation Document.

¹⁰⁶ This figure can also be derived by taking approximately four fifths of Ofcom’s total marketing cost of £9.5 million.

¹⁰⁷ British Sky Broadcasting Group PLC “Results for the twelve months ended 30 June 2009”.

¹⁰⁸ **[Redacted – confidential]**. Hence, this is further evidence that Ofcom’s identification of a total fixed marketing budget for a new retailer of premium pay TV channels of £8 million is clearly too low.

should also be noted that Setanta's business failed. Hence in order to promote fair and effective competition, Ofcom should be seeking to establish wholesale prices which will permit a level of marketing expenditure in excess of that incurred by Setanta.

9.75 As regards the other components of fixed costs, the Parties note that Ofcom has reviewed benchmarks from BT Vision, Setanta, Tiscali, TUTV and Virgin Media and has used the smallest amount that it has identified for any of these parties. (It is quite possible that these smallest amounts reflect a deliberate attempt to avoid fixed costs on the part of the relevant company, which has been the case for TUTV.) Yet, in practice, it should be noted that of those five parties, only Virgin Media currently retails Sky's premium channels and, due to Sky's current wholesale pricing, Virgin Media has little or no incentive actively to promote those channels. Once the other companies, such as TUTV have access to Sky's premium channels via the wholesale must-offer remedy, they will incur significantly higher levels of fixed costs in relation to, for example, subscriber management services. Hence the lowest figures, to which Ofcom has had regard, will not be representative of these companies' fixed costs of pay TV retailing once the wholesale must-offer remedy is in place.

9.76 An under-estimate of the fixed costs associated with pay TV retailing will result in insufficient costs being deducted from the reference retail price, and the resulting wholesale prices will be too high to allow an efficient entrant to compete effectively with Sky. In practice, the fixed costs of pay TV retailing are certainly higher than the figure of £12 million which Ofcom has assumed. The Parties will separately provide further information to Ofcom on their own fixed costs.

Appropriate churn rate

9.77 The Parties understand that Ofcom has used Sky's current churn rate of 10.4% in its modelling in order to generate wholesale prices for new entrants on DTT. This figure of 10.4% is unrealistically low for such a new entrant for three reasons:

- (i) a new entrant will be acquiring new subscribers who in general will be less loyal than Sky's long term base of customers;
- (ii) Sky's current level of churn is a result of the lack of effective competition in the retailing of premium pay TV channels; and
- (iii) it is likely that DTT premium products will be "*less sticky*" than DSat premium products as they will comprise fewer channels and no premium pay TV HD services, at least in the medium term.

9.78 In practice, the first people to subscribe to any service tend to be the keenest and most loyal. As with any other product, attracting pay TV customers becomes progressively harder as the "*low hanging fruit*" is picked and the "*law of*

diminishing returns” sets in for the more marginal customers. This is observed by the level of Sky’s SAC which has increased from approximately £200 per subscriber in 2003 to approximately £300 per subscriber in 2009. Similarly Sky’s marketing has increased from approximately £400 million to more than £900 million over the same period as it has become progressively harder and hence more expensive to attract new customers.

- 9.79 A natural extension of having to pay more to induce these newer, more marginal customers to subscribe is that they are less loyal than customers who came to the service early on with lower inducement to subscribe. An example of this is with Setanta. The Parties understand that, while the churn rate for early adopters of Setanta on DTT was approximately **[Redacted – confidential]**, the churn rate for the later subscribers to Setanta was approximately **[Redacted – confidential]**.
- 9.80 All of a new entrant’s customers will by definition be new. If they are completely new (i.e. have not previously subscribed elsewhere) then having resisted premium subscriptions for up to 17 years they will be the opposite of the “*low hanging fruit*” and so more likely to churn. If they did previously subscribe to Sky’s premium channels and hence have churned from Sky or cable then they are likely to have switched as a result of a better offer. Given their willingness to switch, they are clearly open to offers and so have a higher propensity to churn than the majority of Sky’s established subscriber base.
- 9.81 A higher level of churn is often a feature of a healthy competitive market. In the UK broadband market, BT estimates the churn rate has been **[Redacted – confidential]** in the last 12 months, again because of the availability of substitutes in a highly competitive market.
- 9.82 Similarly, US pay TV retailers such as DirectTV have 17% churn, DISH Network 22%. With access to all the premium channels (due to the Program Access Rules – i.e. the established US version of a wholesale must-offer remedy) these pay TV retailers provide competitive alternatives to each other, resulting in customer switching and hence higher churn.
- 9.83 With the acknowledged lack of competition in the retailing of premium pay TV channels in the UK, it should not be surprising therefore that Sky currently has much lower levels of churn. Clearly this will change following the implementation of wholesale must-offer remedy which, by promoting competition and hence switching, will lead to increased churn for Sky as well as for new entrants. In practice, therefore, it is clear that Ofcom is not correct to assume that the churn rate for new entrants in a more competitive market in future will be the same as the churn rate for a dominant incumbent which is currently not subject to effective competition.
- 9.84 Finally, the Parties note that Ofcom has assumed that the largest offer of Sky’s premium channels on DTT will comprise five video streams (Sky Sports 1 and 2 and three video streams of Sky Movies). On satellite, Sky’s premium offerings

comprise many more channels including Sky Sports 3 and Xtra and a total of 12 movie channels. In addition, Sky offers HD services which are highly likely to have a lower churn rate than SD services. As a consequence, even though the wholesale must-offer remedy will result in more effective competition in the retailing of premium channels than has ever existed in the UK, Sky's satellite offering will nevertheless be more comprehensive and hence better able to attract and retain subscribers than the offerings of new entrants on DTT.

- 9.85 For these reasons, the Parties believe that a churn rate of around 18% is a more realistic level to use which is comparable to the levels of US pay TV retailers. Ofcom should note that, for a given level of SAC, a higher churn rate is likely to lead to a lower number of total subscribers for an entrant – yet another reason why Ofcom should not be seeking to determine the wholesale prices is the basis of “*large*” scale entrants.

Costs of third party basic channels

- 9.86 As is noted above, Ofcom confirms that:

*“... we start with Sky's cost as the best available proxy for an efficient scale retailer. We address the notable exception of scale issues and transmission costs ...”*¹⁰⁹

- 9.87 When Ofcom addresses the exception of “*scale issues*” it appears that it is contemplating a smaller scale entrant which will have higher unit costs than Sky due to the fixed costs of pay TV retailing. It does not appear that Ofcom has had regard to the cost of third party basic pay TV channels in this context. The costs of third party basic channels tend to be established on a per subscriber basis and hence vary with subscriber numbers.

- 9.88 Due to its scale and its standard practice of including Most Favoured Nation clauses (“*MFNs*”) in its distribution agreements with third party basic channel providers, Sky will almost certainly be able to distribute basic pay TV channels on more favourable terms than its competitors. As a consequence, by including Sky's lower costs for third party basic channels in its calculation of the “*minus*”, Ofcom will not be furthering its objective of promotion fair and effective competition.

- 9.89 Ofcom should, therefore, have regard to the higher costs which third party retailers pay for basic pay TV channels when calculating the “*minus*”.

Other bundled services

- 9.90 Ofcom has acknowledged the risks to the efficacy of its proposed must-offer obligation in the event that Sky sets the incremental price of additional products

¹⁰⁹ Paragraph 9.97 of Ofcom's Third Pay TV Consultation Document.

(in particular its broadband and telephony products¹¹⁰) below their incremental cost. Ofcom states:

*“In such circumstances, the wholesale prices that we set out below would enable competition in the provision of pay TV bundles, but may not ensure fair and effective competition in the provision of bundles of wider retail services. Efficient retailers would not be able to replicate Sky’s wider bundles”.*¹¹¹

- 9.91 The Parties consider that Ofcom has correctly identified bundling of retail products by Sky as a potentially significant risk to the effectiveness of its remedy. Access to premium pay TV content on the basis of reasonable wholesale prices will clearly not suffice to promote fair and effective competition if efficient rival retailers are unable to compete with the bundles offered by Sky because of the way in which Sky is pricing the broadband component of the bundle.
- 9.92 The Parties can also see merit in addressing this problem through an *ex post* adjustment mechanism as proposed by Ofcom in order to avoid any further delay in the establishment of regulated wholesale prices. The Parties consider, however, that offering bundled products including non-TV services has become central to Sky’s competitive strategy as evidenced by the focus of its marketing on these bundles, and its pricing - particularly the option to include broadband at no extra cost in its pay TV packages. Rival retailers seeking to compete with Sky will be placed at an immediate disadvantage because the wholesale price determined by the retail-minus methodology will not be set to reflect any broadband costs which the rival would need to incur in order to replicate Sky’s bundle.
- 9.93 In light of this, the Parties consider that Ofcom should commence its analysis of the incremental costs and revenues of Sky’s additional bundled products as soon as possible. This would allow it quickly to form a view on an appropriate *ex-post* adjustment in relation to broadband is appropriate, and avoid rivals being placed at a significant disadvantage for an extended period.

Bespoke wholesale prices

- 9.94 Ofcom states that:

“Although the principle we intend to follow is that of a simple linear per subscriber price, this is not intended to prohibit alternative structures being negotiated as part of commercial discussions between Sky and its wholesale customers. We see advantages in there being flexibility in

¹¹⁰ But potentially also other TV services such as Multiroom, Sky Box Office and standalone premium channels such as MUTV and Chelsea TV, and other TV and non-TV services which Sky may offer in the future.

¹¹¹ Paragraph 9.76 of Ofcom’s Third Pay TV Consultation Document

*pricing structures, which may have more desirable efficiency properties, to allow greater innovation in retail packaging”.*¹¹²

*“We recognise that **there would be flexibility for bespoke prices to be negotiated between Sky and its wholesale customers.** This would be in addition to wholesale customers having the fallback option of access to Core Premium channels at simple linear prices per subscriber, as set by the remedy. We are keen to receive comments on whether our approach would be likely to raise any concerns, and to understand the nature of any such concerns”.*¹¹³ (Emphasis added.)

- 9.95 If Ofcom is to sanction some flexibility for bespoke wholesale prices to be negotiated (subject to regulated wholesale prices providing a fall back option), such bespoke negotiated prices must not be allowed to result in a distortion of competition.
- 9.96 The Parties note that the draft licence conditions set out in Ofcom’s Third Pay TV Consultation Document refers to “*Maximum Prices*” which would be established in accordance with the methodology described in section 9 of that document. Draft licence condition 14A(2) states that Sky’s charges for the channels which are subject to the WMO obligation “*shall not exceed the maximum prices*”. This implies that Sky could offer lower wholesale prices than those established via the retail-minus methodology.
- 9.97 Nevertheless, the draft licence condition also states that Sky must offer the channels which are subject to the WMO obligation “*on fair and reasonable terms*” and “*without any undue discrimination*”. The requirement to offer its premium channels on fair, reasonable and non-discriminatory (“FRND”) terms must govern any flexibility for bespoke wholesale prices to be negotiated in order to ensure that such bespoke prices do not distort competition.

10. Changes in Sky’s wholesale prices over time

Annual review

- 10.1 In their Joint Response to Ofcom’s Second Pay TV Consultation, the Parties highlighted the risks to fair and effective competition if the wholesale prices for Sky’s premium channels do not evolve over time in such a way as to address not only changes in Sky’s retail prices but also increases in Sky’s retail costs (for example its SAC).
- 10.2 Ofcom has acknowledged these concerns. For example, Ofcom has noted:

¹¹² Paragraph 9.34 of Ofcom’s Third Pay TV Consultation Document.

¹¹³ Paragraph 9.35 of Ofcom’s Third Pay TV Consultation Document.

*“If the efficient costs of retailing increased unexpectedly and this level of expenditure was not reflected in the initial retail-minus calculation, then it would be appropriate for wholesale prices to be adjusted downwards in response to the higher retailing costs. ... If these types of changes were sufficiently material, ... **the only plausible option is likely to be to reassess the full set of pricing calculations**”.*¹¹⁴ (Emphasis added.)

10.3 Ofcom confirms that:

“We recognise that Sky would have the incentive to implement changes to ..., retail costs ... because of the possible adverse impact these changes might have on its competitors. Specific examples ... are:

*“(ii) Increases in marketing expenditure: a significant increase in Sky’s marketing expenditure would be expected to require a similar increase in marketing expenditure for other retailers in order to remain competitive. However, if this level of expenditure was not reflected in the initial allowance of retailing costs used to derive retail-minus wholesale prices, and wholesale prices remained unchanged as a result of no change in retail prices, this would reduce competitors’ retail margins which might cause them to be unprofitable”.*¹¹⁵

10.4 Despite acknowledging these very real concerns, Ofcom does not then address them. It concludes that:

*“...We acknowledge that significant changes which fall into [among other things category (ii) above] would require us to reassess the full set of pricing calculations. The calculations are complex and we believe it would be impracticable to do this on a regular basis. Our expectation is therefore that the threshold for this type of intervention would be high – in other words we propose only to reassess the full set of pricing calculations if there are very major changes to wholesale costs, retail costs or retail prices”.*¹¹⁶

10.5 For the reasons outlined in paragraphs 10.2 and 10.3 above, Ofcom’s proposed approach will not be sufficient to ensure that the wholesale must-offer obligation promotes fair and effective competition. In practice, Ofcom must recalculate the reference retail prices at least annually in order to reflect Sky’s annual price change which has, in the past, taken effect from 1 September each year.¹¹⁷ This recalculation will also need to take account of the creation of new retail packages by Sky. At the same time, when Ofcom undertakes this annual

¹¹⁴ Paragraph 9.39(ii) of Ofcom’s Third Pay TV Consultation Document.

¹¹⁵ Paragraph 9.40 of Ofcom’s Third Pay TV Consultation Document.

¹¹⁶ Paragraph 9.42 of Ofcom’s Third Pay TV Consultation Document.

¹¹⁷ Thus, when Sky announces its new retail prices, Ofcom must recalculate the wholesale prices as described in paragraphs 9.16 to 9.18 above.

recalculation of the reference retail prices, Ofcom must also recalculate the “*minus*” in order to determine appropriate wholesale prices for the next twelve months.

- 10.6 In addition to this annual recalculation, Ofcom must recalculate both the reference retail prices and the “*minus*” in the event that Sky changes its retail prices (and/or introduces new retail packages) at any point in between its normal annual pricing review which takes effect from 1 September each year. This will be necessary to ensure that Sky does not use its ability to modify its retail prices in order to undermine the wholesale must-offer regime.

Changes to SAC

- 10.7 When recalculating the “*minus*”, as described in paragraphs 10.5 and 10.6 above. Ofcom should have regard to increases in Sky’s SAC since it last determined the wholesale prices. This will ensure that, on at least an annual basis, Ofcom adjusts the wholesale prices in order to take account of increases in Sky’s SAC.
- 10.8 Furthermore, with regard to Ofcom’s proposal that it will reassess the full set of pricing calculations “*if there are very major changes to ... retail costs*”, Ofcom should, for example, (i) inform Sky of the quantum of its SAC to which Ofcom has had regard when determining the wholesale prices and (ii) ensure that the licence condition which will implement the wholesale must-offer remedy obliges Sky to notify Ofcom if its SAC exceed that figure by more than 10% when pro-rated over a relevant period such as a quarter. Such an increase in Sky’s SAC should constitute a “*major change*” (as described in paragraph 10.4 above) and thus prompt a recalculation of the “*minus*” and thus Sky’s wholesale prices.
- 10.9 If Ofcom were to authorise Picnic, the need to have regard to changes in Sky’s retail costs would be even more acute. Sky’s SAC is currently in excess of £250. Such a SAC is only sustainable because Sky enjoys the benefit of both retail and wholesale margins. In contrast, Picnic, if it were to be authorised, would only benefit from retail margins. As a consequence, the SAC that Picnic could, itself, incur without a cross-subsidy from Sky, would be substantially lower than £250. Based on Ofcom’s assessment of viable entry for a premium pay TV retailer on DTT, TUTV believes that the maximum SAC that Picnic, as a standalone premium pay TV retailer on DTT, could incur without a cross-subsidy from other parts of Sky’s business would be approximately £80. Accordingly, if Ofcom were to authorise Picnic it should ensure that Picnic informs Ofcom if its current level of SAC exceeds that figure by more than 10%. In the event of such an increase, Ofcom should again recalculate the “*minus*” and thus reduce the wholesale prices for Sky’s premium channels.

Ratchet mechanism

- 10.10 Ofcom notes that:

“Sky routinely revises its retail prices In this case, we would want, as far as possible, for wholesale prices to respond appropriately, without the need to reopen the full set of pricing calculations”.¹¹⁸

10.11 Ofcom is, therefore, consulting on a ratchet mechanism:

“... which would have the following properties:

- *if retail prices decrease then wholesale prices should also decrease;*
- *if retail prices increase then, while there is a presumption that wholesale prices should increase in a corresponding manner, we would first require Sky to seek consent for any increase in wholesale prices”*.¹¹⁹

10.12 This proposed ratchet mechanism could, in theory, be applied as a short cut to establishing new wholesale prices if Sky changes the reference retail prices. The Parties note, however, that if Ofcom calculates Sky’s wholesale prices in the manner proposed by the Parties in paragraphs 9.16 to 9.18 above, the reference retail prices are only identified once the wholesale prices have actually been determined (as they are the retail prices from which the lowest wholesale prices are derived). Thus, with the approach proposed by the Parties in paragraphs 9.16 to 9.18 above, the ratchet mechanism would not be appropriate.

10.13 If, contrary to the Parties’ arguments in paragraphs 9.11 to 9.19 above, Ofcom persists with its proposed approach of calculating wholesale prices on the basis of weighted average retail prices (as described in paragraph 9.10 above) it would be possible to apply Ofcom’s ratchet mechanism to the relevant reference retail prices (i.e. the weighted average retail prices). Such a ratchet mechanism should, however, supplement and not replace the full annual review described in paragraph 10.5 above.

10.14 This is because it would not be sufficient for Ofcom (as it currently proposes) merely to go through a full exercise of determining wholesale prices by calculating reference retail prices and the “*minus*” once in a three year period and relying on the ratchet mechanism in between. For the reasons outlined in paragraphs 10.1 to 10.5 above, the Parties believe that Ofcom should determine the wholesale prices at least annually through a full application of the retail-minus methodology in order to reflect Sky’s annual retail pricing changes and at the same time take account of, among other things, any increases in Sky’s SAC.

10.15 Such annual reviews would, however, not entirely obviate the need to adjust the wholesale prices if Sky seeks to introduce new retail prices and/or packages in between its annual retail pricing reviews. Thus, if Ofcom does calculate

¹¹⁸ Paragraph 9.39(iv) of Ofcom’s Third Pay TV Consultation Document.

¹¹⁹ Paragraph 9.47 of Ofcom’s Third Pay TV Consultation Document.

wholesale prices on the basis of weighted average retail prices, it could apply its proposed ratchet mechanism in the event of a (non-major) change to Sky's retail prices between Ofcom's annual pricing reviews (described in section 10.5 above).¹²⁰

- 10.16 In the circumstances described in paragraph 10.15, the Parties would broadly support the proposed ratchet mechanism in respect of retail price changes implemented by Sky between Ofcom's annual price reviews. The remaining paragraphs of this section to consider the application of the ratchet mechanism in these circumstances.
- 10.17 The Parties note that to apply the ratchet mechanism, Ofcom would, following changes to Sky's retail prices, need to recalculate the reference retail prices to determine whether they have decreased. If they have, Ofcom would need then to apply the ratchet mechanism to reduce the wholesale prices. In order to ensure the efficacy of the remedy, it is important to minimise the time lag between Sky reducing its retail prices and the reduction of its wholesale prices, otherwise Sky will be able to squeeze the retail margin by reducing retail prices before wholesale prices.
- 10.18 The Parties do not believe that there should automatically be a presumption when applying the ratchet mechanism that wholesale prices should increase in a corresponding manner to retail prices as this issue will depend upon the rationale for the increase in retail prices. With regard to retail price increases, Ofcom states that:

“There are a number of examples where we would expect increases in retail prices to be reflected in increases in wholesale prices. For example we would expect both retail prices and costs to increase with inflation – and this is the assumption that we have incorporated into our calculations”.¹²¹

“However we can anticipate situations where an increase in retail prices is not primarily a response to consumer demand and preferences, but is prompted by an incentive to increase the wholesale prices that Sky's competitors face. For example ... we would be more cautious if the relativities in the prices of Core Premium retail packages were revised significantly”.¹²²

- 10.19 In the circumstances, Ofcom must carefully scrutinise the rationale put forward by Sky for raising wholesale prices following an increase in the reference retail prices and relevant evidence which either supports or contradicts that rationale.

¹²⁰ The benefit to Ofcom of applying the ratchet to such interim pricing reviews is that it would not at that point need to recalculate the “minus”. In the event of a major change to Sky's retail prices between Ofcom's annual pricing reviews, Ofcom must recalculate the “minus” in order to determine new wholesale prices in accordance with the full retail-minus methodology.

¹²¹ Paragraph 9.49 of Ofcom's Third Pay TV Consultation Document.

¹²² Paragraph 9.50 of Ofcom's Third Pay TV Consultation Document.

If Ofcom were to start from a “*presumption*” that wholesale prices should increase under the ratchet mechanism in a corresponding manner to retail prices, that would entail an apparent prejudice of the competition concerns.

Reasons for wholesale price increases

- 10.20 In respect of the application of the ratchet mechanism, Ofcom states that:
- “To improve transparency, a pragmatic addition would be to identify generic types of reasons for legitimate increases in wholesale prices in response to increases in retail prices (in addition to inflation)”*.¹²³
- 10.21 Other than inflation, the Parties believe that Sky should only be entitled to increase its wholesale charges if its wholesale costs were to increase and, following such increase, the cost-based cross-check were to generate a wholesale price which is higher than the wholesale price being charged by Sky at that time.
- 10.22 There should be no automatic regulatory approval for increases in wholesale prices in response to increases in retail prices which Sky seeks to justify on the basis of an increase in wholesale costs arising from bidding by Sky for rights. In these circumstances, the Parties consider that Ofcom should have regard to the cost-plus cross-check to inform its decision such that wholesale price increases would be permitted on the basis of “*increased rights costs*” if the inclusion of additional rights costs resulting from successful bids by Sky causes the cost-plus floor to exceed the current retail-minus price, but not otherwise. In circumstances in which Sky’s current wholesale prices are still above the cost-based cross-check even when that increased bid is included, then Sky’s wholesale business should absorb such increased rights costs.
- 10.23 The Parties also consider that Sky should not be entitled to increase its wholesale charges if it increases its retail prices due to an increase in its discretionary expenditure on retailing, for example, by spending more on retail marketing. For the reasons outlined in paragraphs 10.7 to 10.9 above, increases in Sky’s SAC should result in reductions in Sky’s wholesale prices so as to allow competitors to increase their SAC.
- 10.24 Finally, an important principle for Ofcom’s proposed remedy is that new entrants need to be able to operate with certainty as to the costs of their inputs and the security of their supply. Hence, even where Ofcom determines that it is appropriate for wholesale prices to increase, Sky’s wholesale customers must be given reasonable notice (of not less than 90 days) in respect of such wholesale price increase.¹²⁴

¹²³ Paragraph 9.50 of Ofcom’s Third Pay TV Consultation Document.

¹²⁴ Where BT is deemed to have market power (e.g. in the wholesale provision of partial private circuits) it is required to give 90 days notice of price rises.

Margin between Sky's wholesale and retail prices

10.25 In the context of Ofcom's proposed ratchet mechanism, Ofcom states that:

"... consistent with our retail-minus approach to setting initial prices, it is appropriate for wholesale prices to maintain the margin between retail and wholesale prices over time. A further question under this approach is whether wholesale prices should:

- *track retail prices preserving an absolute margin in pounds per subscriber; or*
- *track retail prices preserving the margin as a fixed percentage of the retail price".*¹²⁵

*"In practice, we ... note that each of these approaches has different effects on incentives to engage in regulatory gaming. If there is a greater concern of margin squeeze through reducing retail prices, preserving an absolute margin may be preferable. If, however, there is a concern of increasing retail prices in order to raise the competitors' costs, tracking a percentage of the retail price is likely to dampen this incentive, and might help to address this concern".*¹²⁶

10.26 The Parties believe that Sky would have the incentive to engage in either approach to gaming, depending upon the way in which Ofcom seeks to ensure that wholesale prices track retail prices (i.e. as an absolute margin or as a fixed percentage).

10.27 As Ofcom notes, some retail costs will be incurred as an absolute cost per subscriber and thus will be incurred irrespective of the revenue earned per subscriber.¹²⁷ As retail prices decrease, the margin between retail prices and wholesale prices must be sufficient to allow competing pay TV retailers at a minimum to cover these costs together with other fixed costs and still earn a reasonable return. The Parties believe that the retail margin that Ofcom has calculated will be an absolute minimum retail margin which is necessary for competing pay TV retailers to cover those costs. In practice, such a margin will only enable new retailers of premium pay TV channels to engage in the minimum amount of fixed and variable marketing expenditure in order to try to compete effectively with Sky and build up a base of premium pay TV subscribers.

10.28 Accordingly, if Sky's retail prices fall in between the annual reviews contemplated in paragraph 10.5 above, the ratchet mechanism must ensure that the wholesale prices preserve this absolute margin in pounds per subscriber.

¹²⁵ Paragraph 9.43 of Ofcom's Third Pay TV Consultation Document.

¹²⁶ Paragraph 9.45 of Ofcom's Third Pay TV Consultation Document.

¹²⁷ Paragraph 9.44 of Ofcom's Third Pay TV Consultation Document.

Otherwise, competing premium pay TV retailers will not be able to bear this minimum level of retailing costs and therefore will not be able to compete effectively with Sky.

- 10.29 Conversely, if Sky's retail prices rise in between the annual reviews and Ofcom permits a corresponding rise in wholesale prices, then competing premium pay TV retailers will need to raise their retail prices in order to bear the increased wholesale prices. They will also need to engage in more marketing in order to attract subscribers at the higher retail prices; yet the minimum margin that Ofcom establishes at the outset of the remedy will not cover the costs of such increased marketing. Thus, if Sky's retail prices rise and Ofcom determines, under the ratchet mechanism considered above, that it is appropriate for Sky's wholesale prices also to rise then they should track retail prices whilst preserving the margin as a fixed percentage of the retail price.

11. Cost-based cross-check

Assumed rights cost inflation

- 11.1 With regard to Ofcom's cost-based cross-check, Ofcom states that:

*“A critical aspect of the modelling is our assumption about the costs of rights in future years. We have assumed that sports and movie rights fees will increase over time with both inflation and subscriber numbers. In other words, we have assumed that these fees remain constant per subscriber in real terms”.*¹²⁸

- 11.2 The Parties note the critical importance of Ofcom's assumptions that sports and movie rights fees will increase with inflation and subscriber numbers (i.e. they are constant per subscriber in real terms). Ofcom has tested the sensitivity of this assumption against an alternative assumption that total premium rights costs will remain constant over time in real terms (i.e. they will not rise in line with subscriber numbers). The weighted average cost-plus price is 20% lower using this alternative assumption.
- 11.3 The Parties do not agree with Ofcom that its assumption is “*appropriate given inherent uncertainties and the role of cost-plus in our overall approach*”.¹²⁹ Indeed, in view of these alleged uncertainties the Parties consider that a careful appraisal of trends and the dynamics affecting content rights fees is important. The Parties also consider that the role of cost-plus prices should be more significant than has been recognised by Ofcom and hence the calculation of cost-based prices must be based on robust assumptions.

¹²⁸ Paragraph 9.156 of Ofcom's Third Pay TV Consultation Document

¹²⁹ Paragraph 9.156 of Ofcom's Third Pay TV Consultation Document.

11.4 As regards movie rights, the Parties note that Sky’s costs have steadily been reducing in recent years, and may be expected to continue declining in the foreseeable future. Sports rights tend to be sold for a fixed sum over a specific period by means of an auction process. The costs of these rights, therefore, will reflect the level of competition and the bidding strategies of competitors for those rights. The Parties consider that there are reasons to expect competition for key sports rights to remain muted in the relevant period. The Parties consider, therefore, that an assumption that total sports and movie costs will remain constant over time in real terms is more reasonable than an assumption that the costs will increase in line with subscriber numbers.

11.5 As indicated above, the Parties note that the cost of movie rights has been declining in recent years as shown in the table below and the Parties consider that this is a continuing and consistent trend.

	2006 £m	2007 £m	2008 £m	2009 £m
Sky Movies programming cost ¹³⁰	310	285	281	278

11.6 In practice, the Sky Movies programming cost has fallen by approximately 30% over the period from 2003 to 2009. Ofcom is, however, apparently anticipating that the wholesale must-offer remedy will result in wider distribution of Sky Movies and hence more subscribers to those channels in respect of which Sky will need to pay incremental per subscriber fees. Nevertheless, the amounts payable to the studios are steadily being reduced by Sky upon each renegotiation. Hence it appears reasonable to assume that any increase in subscriber numbers will at least be offset by reductions in the levels of payments due to the studios over the period.

11.7 Sports rights tend to be sold for a specified period (for example, three years) at a fixed price. The costs are not, therefore, linked directly to subscriber numbers (as they are for movie rights) and so increased subscriber numbers *per se* will not drive up sports rights costs.

11.8 The auction based nature of sports rights sales means that the realised value for the rights is a function of the intensity of competition. The FAPL live rights value over the past decade illustrates how the realised value has varied depending on the degree of competition which Sky has faced:

- (a) auction in 2000 (for the period 2001/02 to 2003/04) – the value of live rights increased by 154 per cent (from £168 million per year for the previous three year period to £427 million per year for the forthcoming

¹³⁰ Source: 2006 - 2009 BSkyB Annual Reports.

three years). Much of this rise was attributable to increased competition as both ntl and ITV Digital were active participants in this auction;¹³¹

- (b) auction in 2003 (for the period 2004/05 to 2006/07) – the competitive threat lessened following the insolvency of ITV Digital and the financial difficulties facing ntl. Neither provided a bid as part of this auction. As a result there was a decrease of 20 per cent in the value of the rights (from £427 million per year for the previous three year period to £341 million per year for the forthcoming three years);
- (c) auction in 2006 (for the period 2007/08 to 2009/10) – this auction was vigorously contested when a greater number of live packages prompted increased interest from Sky, ESPN, Setanta and Virgin Media (with Setanta winning two packs of rights). Although the European Commission agreed undertakings with FAPL that no single bidder could win all of the packages, the top packages remained disproportionately attractive to broadcasters which also stimulated competition. As a result, the live rights value increased by 67 per cent (from £341 million for the previous three year period to £569 million for the forthcoming three years);
- (d) auction in 2009 (for the period 2010/11 to 2012/13) – although the number of bidders in the 2009 auction was broadly the same as in 2006, the auction was informed by Setanta’s struggle to build a sufficient subscriber base having won FAPL rights in the 2006 auction. ESPN and Five are believed to have placed unsuccessful bids while Sky and Setanta were awarded live rights packages. No other platform, however, posed a strategic threat (Virgin Media, for example did not bid for the rights) and the rights value increased by just 4 per cent between 2006 and 2009 (from £569 million for the previous three year period to £594 million for the forthcoming three years).¹³²

11.9 The Parties consider that recent inflation in FAPL (and other non-FAPL) sports rights has been driven by competition, in particular the involvement of Setanta in the various auctions. Following the recent exit of Setanta, however, such competition for rights is very unlikely to occur in future auctions, reflecting the status quo whereby breaking Sky’s stranglehold over upstream rights is not possible given its significant bidding advantages. Indeed, the demise of Setanta has demonstrated that, in order to outbid Sky, an entrant must bid a sum which it is not subsequently able to recover over the period in which it holds the particular rights. In the circumstances, ESPN which has taken over the Setanta’s FAPL rights, can be expected not to bid against Sky for rights in

¹³¹ At that time, FAPL broke the rights into a subscription package and a pay per view package and would not allow a broadcaster to win both packages. Sky won the subscription package and ntl initially won the pay per view package. It subsequently failed to conclude an agreement with FAPL and hence FAPL split the pay per view rights by platform and sold them separately to Sky, ntl and ITV Digital.

¹³² FAPL sports rights values provided by O&O.

future auctions but rather it will acquire the rights which Sky is not interested in holding or will jointly acquire rights with Sky where Sky only wishes to broadcast part of an event. This view is confirmed by the recent joint acquisition of SPL rights by ESPN with Sky.

- 11.10 Whilst Ofcom's remedy and the steps it proposes to take as regards upstream rights may eventually result in more companies being able to bid competitively for attractive rights, this is unlikely in the medium term. Accordingly, it is reasonable to assume that sports rights costs will remain constant in real terms over the period considered by Ofcom, reflecting the continuation of factors which mitigate against successful rival challenges for upstream rights (at least until the wholesale must-offer remedy has assisted rivals in building a sufficient subscriber base which is unlikely in the medium term).
- 11.11 Accordingly, the Parties believe that Ofcom's cost-based cross-check overstates Sky's wholesale prices as a result of Ofcom's assumption that sports and movies rights will increase over time with subscriber numbers.

Excessive retail margins

- 11.12 The Parties consider that the cost-plus cross-check should not only be used by Ofcom to ensure that the determined wholesale prices for Sky's premium channels enable it to recover its wholesale costs. The Parties believe that the cost-plus cross-check should also be used to ensure that there isn't a significant discrepancy in retail margins between Sky and third party pay TV retailers of Sky's premium channels.
- 11.13 Thus, the retail-minus methodology should not be applied in such a way that it allows Sky to earn a significantly higher retail margin than its rivals. If this were the case, then each premium subscriber attracted or retained by Sky would be significantly more profitable for Sky as compared to rivals. The ability of rival retailers to compete through making comparable investments would be compromised because their gross retail margin per new subscriber won would be lower than that of Sky.
- 11.14 As is shown by Figure 69 in Ofcom's Third Pay TV Consultation Document, several of the retail-minus price ranges determined by Ofcom are significantly above the cost-based prices which Ofcom has calculated.¹³³ Furthermore, Figure 64 confirms that the weighted average (by Sky's volumes) of Sky's wholesale prices for Scenario 5 (i.e. the bottom of Ofcom's retail-minus range) is £14.55, whereas the weighted average (by Sky's volumes) of cost-plus wholesale prices is £13.57.¹³⁴ These Figures indicate that the wholesale prices on which Ofcom is consulting can be regarded as high.
- 11.15 As a consequence, Ofcom should, at the very least, determine wholesale prices at the bottom of its retail-minus range (i.e. Scenario 5) in order to minimise any

¹³³ Paragraph 9.197 of Ofcom's Third Pay TV Consultation Document.

¹³⁴ Paragraph 9.168 of Ofcom's Third Pay TV Consultation Document.

discrepancy in margins and allow rival retailers to compete on a non-discriminatory basis (albeit that the cost-based price should be used for those packages where the bottom of the retail-minus range is below the cost-plus price).

Wholesale price for Sky Sports 2

11.16 The Parties note that, in undertaking the cost-based cross-check, Ofcom has identified that the retail price for Sky Sports 2 does not represent an effective benchmark for the purpose of establishing an appropriate regulated wholesale price for Sky Sports 2. Ofcom does not, however, propose to make any further adjustment because “*our competition concerns are focussed much more on Sky Sports 1 and Sky Sports 1&2*”.¹³⁵

11.17 The Parties consider that Ofcom’s conclusion in relation to Sky Sports 2 is not appropriate or supportable. Ofcom has identified that Sky Sports 2 is a close substitute for Sky Sports 1 on the basis that it broadcasts a portfolio of important sports that broadly reflect the offering on Sky Sports 1.¹³⁶ For this reason, it falls within the relevant economic market in relation to which Sky has been identified as having a position of market power. Ofcom has indicated that the wholesale must-offer remedy should apply to those channels which have been identified as the source of Sky’s market power.¹³⁷ Since Sky Sports 2 has been identified in this regard, it is important that a regulated wholesale price is set for this channel which is appropriate, and which will allow rival retailers to compete effectively if they wish to offer this channel on a standalone basis.

11.18 The problem arises because Sky sets a relatively high retail price for Sky Sports 2. Indeed the retail price for Sky Sports 2 is set equal to the price for Sky Sports 1 retail packages. This is acknowledged by Ofcom:

“The retail price for this Core Premium channel appears particularly high relative to costs, with limited take-up, suggesting that the retail price reflects pricing simplicity....rather than purely a full reflection of cost or value”.¹³⁸

11.19 This results in an inflated wholesale price when calculated using the retail-minus methodology because costs are deducted from a reference retail price for Sky Sports 2 which is too high. In this case, therefore, the Parties consider that Ofcom should derive a regulated wholesale price for Sky Sports 2 by applying the retail-minus methodology to larger premium bundles which include Sky Sports 2 and other premium channels and then deducting the costs of the other premium channels. The Parties consider that Ofcom should apply this slightly modified retail-minus calculation across all bundles including Sky Sports 2 and, in a similar vein to the Parties’ proposal in relation to calculating wholesale

¹³⁵ Paragraph 9.171 of Ofcom’s Third Pay TV Consultation Document.

¹³⁶ Paragraphs 4.121 and 4.131 of Ofcom’s Third Pay TV Consultation Document.

¹³⁷ Paragraph 8.34 of Ofcom’s Third Pay TV Consultation Document.

¹³⁸ Third Consultation Document, paragraph 9.171.

prices in paragraphs 9.16 to 9.18 above, take the lowest price as the regulated wholesale price.

12. Commercial market

- 12.1 As a preliminary observation, the Parties note that Ofcom’s consideration of whether to impose a wholesale must-offer remedy in relation to commercial premises is coloured by its view that it does:

“... not consider that arguments of a competition concern arising from the lack of wholesale access to be strong on the commercial side – and they are certainly less strong than on the residential side”.¹³⁹

- 12.2 The evidence does not support this view. In practice, Sky is the monopoly retail pay TV supplier to commercial premises and accordingly commercial premises must contract with Sky to be able to show premium pay TV sports channels. In other words, commercial premises do not benefit from any competition in relation to the retail supply of premium sports channels. As the most obvious manifestation of a lack of competition is high prices, it is unsurprising that there have been repeated complaints made to both the OFT and Ofcom about high retail pay TV prices to commercial premises (which are thousands of pounds per month for larger premises). The competition concerns arising in relation to commercial premises are, therefore, at least as great as those arising in relation to the residential market (if not greater).

- 12.3 There is a clear and serious consumer detriment arising from Sky’s monopoly. Although consumers do not pay for the service directly, they do pay for it out of the price of the drinks and food they buy in pubs and clubs. Furthermore, consumers are harmed by the fact that some pubs and clubs cannot afford to pay Sky’s subscriptions and so the retail supply is in fact restricted to only certain venues.

- 12.4 Ofcom states that application of the wholesale must-offer remedy to the commercial market (rather than confining it to the residential market):

“... could only be justified if it was appropriate in order to ensure fair and effective competition”.¹⁴⁰

Given the total absence of fair and effective pay TV competition within the commercial market, the extension of the wholesale must-offer remedy to that market is clearly appropriate in order to ensure such fair and effective competition.

¹³⁹ Third Consultation Document, paragraph 6.140.

¹⁴⁰ Paragraph 8.62 of Ofcom’s Third Pay TV Consultation Document.

12.5 Ofcom bases its proposal not to apply the wholesale must-offer remedy to the commercial market on the following claims:

“We do not see evidence of restricted supply either at the retail level or the wholesale level.

*... even if our proposed remedy was extended to retailers to commercial customers, there is currently no other distribution network than that controlled by Sky”.*¹⁴¹

12.6 In the circumstances, it appears that Ofcom has not had due regard to the evidence that has been provided to it by the Parties and the ALMR. At the retail level, supply is restricted by the imposition of high subscription prices. At the wholesale level, Sky has refused to wholesale its channels (either at all or at economically viable rates) for distribution to commercial premises by other pay TV retailers. Furthermore, the Parties have explained that, whilst Sky consistently refused to wholesale its premium channels to them at economically viable rates for retail distribution to the residential market, it would have been a futile exercise to initiate separate negotiations over the wholesale supply of those channels for retail distribution to the commercial market.

12.7 The absence of retail competitors in relation to the commercial market is largely a consequence of Sky’s refusal to supply its premium channels to third party pay TV retailers at economically viable wholesale rates for them to retail to commercial premises. The Parties have previously explained that other barriers to entry at the retail level, such as the need to establish a dedicated sales force for commercial premises, would be surmountable with access to Sky’s premium channels at economically viable rates. Potential pay TV competitors with other lines of business, such as broadband, already have sales forces which address the commercial market and could also sell pay TV services

12.8 In practice, if rival pay TV retailers were able to gain wholesale access to Sky’s premium channels at economically viable rates for distribution to the commercial market, they would be able to offer choice, innovation and retail price competition to commercial customers such as the pubs and clubs.¹⁴² Many pubs and clubs already have broadband and DTT services, so there are readily available distribution technologies which could be used for pay TV in competition with Sky’s satellite service. It would not be difficult to provide cable connections within the cable footprint if they are not currently available in pubs or clubs.

¹⁴¹ Paragraph 8.63 of Ofcom’s Third Pay TV Consultation Document.

¹⁴² For example, rival pay TV retailers would be able to offer choice and innovation in terms of packaging, including the offer of bundles of services including premium pay TV channels and broadband and telephony which could facilitate the use of broadband in pubs and clubs and other commercial premises such as hotels. Openzone hot spots and multiple VoIP telephony lines over a broadband connection would be developments which could suit the commercial sector as they are services that consumers increasingly expect.

- 12.9 In its three Pay TV Consultation Documents, Ofcom has observed that Sky's market power in the wholesale supply of premium channels has led to a reduction of competition in the residential market in which there exists some (albeit very limited) retail competition. Even greater adverse effects on competition must be expected in the commercial retail market in which Sky faces no retail competition. There is no reason why there is not at least an equal need to address the adverse effects on competition in relation to the supply of Sky's premium channels to commercial premises as there is to remedy the effects in the residential market.
- 12.10 It would be an extraordinary outcome if Ofcom made no effort to engender some competition in the commercial market.¹⁴³ The complete absence of any retail competition in this market does not reduce, but instead increases, the imperative for regulatory intervention. As noted previously by the Parties, the extension of the wholesale must-offer obligation to this market (together with an *ex ante* pricing rule such as a retail-minus methodology which ensures a viable gross retail margin for third party pay TV retailers) would be a necessary and proportionate regulatory response which should be pursued by Ofcom.
- 12.11 Furthermore, Sky's revenues from the commercial market (of approximately £300 million per annum¹⁴⁴) represent nearly one third of its total expenditure on sports rights/programming. Thus, a failure on Ofcom's part to address competition concerns in the commercial market will perpetuate one of the most significant barriers to entry downstream and upstream.
- 12.12 In the absence of a remedy applying to the commercial market, Sky would have access to a very large stream of revenue and profit that would be denied to rival pay TV retailers. As a result, Sky would have the ability to subsidise its activities in the downstream residential market, or conduct its business so as to minimise profitability in the residential market for itself and as a consequence for its competitors, while still deriving substantial profit from the commercial market beyond the reach of competition. There is, therefore, a high likelihood that the application of a wholesale must-offer remedy just to the residential market will be undermined by Sky's exclusive access to the commercial market. Upstream, exclusive access to commercial revenues would continue to give Sky the ability to outbid rivals even if there were parity in the residential market, thereby undermining the ladder of investment objectives in Ofcom's proposed remedy.
- 12.13 Against this background, Ofcom acknowledges that:

¹⁴³ In addition, the forbearance by Ofcom from addressing this issue would not be consistent with its principal statutory duty under section 3(1)(b) of the Communications Act to further the interests of consumers in relevant markets, where appropriate by promoting competition.

¹⁴⁴ The Parties believe that Sky's incremental costs for distribution to commercial premises are relatively modest. Hence, the vast majority of this additional £300 million of revenue contributes to Sky's profitability.

“... it might be appropriate to consider a specific remedy in relation to commercial customers, potentially as part of any further action we may pursue relating to the sale of FAPL sports rights”.¹⁴⁵

12.14 Ofcom elaborates on this when it states:

“We would wish to explore mechanisms by which commercial as well as residential customers were protected from the detrimental effects of collective selling [by the FAPL]. For example, we might want to establish separate sets of [FAPL] rights for residential and commercial subscribers. This ... could potentially offer a viable entry strategy for retailers targeting commercial consumers ...”.¹⁴⁶

12.15 The Parties believe that the most efficient practical and effective means by which to address the lack of retail pay TV competition in the commercial market is likely to be as part of Ofcom’s current pay TV investigation and not through a separate further action that Ofcom may pursue. This is because the concerns that Ofcom would be addressing are broadly the same as those arising in relation to the retail market for residential customers. Furthermore, whilst the imposition of a wholesale must-offer remedy would address many of the concerns, it is not clear that establishing a separate commercial FAPL right will have a positive effect on competition as, due to Sky’s installed base of commercial customers, it will always be able to outbid competitors for this commercial FAPL right.

13. Draft licence condition and resolution of complaints

13.1 Ofcom is proposing to introduce a new licence condition into several of Sky’s broadcasting licences pursuant to its powers under section 316 of the Communications Act. The proposed condition is relatively straightforward and, at this stage, most of the Parties’ comments on this issue relate to the way in which complaints about breaches of this new condition will be resolved by Ofcom.

Qualifying platforms

13.2 For the reasons explained in section 7 above, Ofcom needs to have regard to the Canvas proposals and the way in which DRM is operated in respect of DSL platforms. Specifically, Ofcom needs to ensure that the development of these platforms does not have an adverse impact on the application of the wholesale must-offer remedy. As suggested above, such developments should be addressed within the definition of “*Qualifying Platform*” in the draft licence condition,

¹⁴⁵ Paragraph 8.68 of Ofcom’s Third Pay TV Consultation Document.

¹⁴⁶ Paragraph 12.42 of Ofcom’s Third Pay TV Consultation Document.

Advertising on Sky’s channels and cross-promotion

13.3 Ofcom states that:

*“In our Second Pay TV Consultation, we proposed that Sky could be required to offer a “clean feed” of the wholesale must-offer channels which did not contain cross-promotion of Sky’s channels ... which were not included in the wholesale must-offer obligation or promotion of specific retail pay TV offerings. We also suggested all advertising minutes on the channels should be sold on a non-discriminatory basis, thereby providing all retailers the option of advertising their services on the channels”*¹⁴⁷.

*“We note that Ofcom’s existing Broadcasting Code and Cross-Promotions Code, amongst others, set out rules on promotion of channels and services with which Sky must comply”*¹⁴⁸.

*“We consider that compliance with the existing Codes will address many of the concerns we might have on how Sky may cross-promote the channels and services. We therefore do not intend to introduce specific conditions relating to these activities”*¹⁴⁹.

13.4 Thus, whilst Ofcom does consider the issue of cross-promotion in its Third Pay TV Consultation Document, it does not consider further the issue of third party pay TV retailers advertising their new premium pay TV services on Sky’s channels.

13.5 As Ofcom will be aware, Sky has in the past refused to accept advertisements on its channels for competing pay TV services. This will undoubtedly inhibit the development of fair and effective competition and entry by new retailers of premium pay TV channels. In the circumstances, Ofcom should include a provision in its new licence condition which requires Sky to offer all companies which take up the wholesale must-offer obligation the opportunity to advertise their pay TV services on Sky’s channels.

13.6 On cross-promotion, Ofcom concludes that:

*“... we would expect Sky to ensure that the feeds provided to third party retailers did not include excessive promotions of services and features which were not available to consumers on non-Sky platforms which could lead to consumer confusion or that might degrade the consumers’ perception of the quality of the service provided by their pay TV retailer”*¹⁵⁰.

¹⁴⁷ Paragraph 9.234 of Ofcom’s Third Pay TV Consultation Document.

¹⁴⁸ Paragraph 9.235 of Ofcom’s Third Pay TV Consultation Document.

¹⁴⁹ Paragraph 9.236 of Ofcom’s Third Pay TV Consultation Document.

¹⁵⁰ Paragraph 9.237 of Ofcom’s Third Pay TV Consultation Document.

- 13.7 Ofcom does not indicate how this expectation will be fulfilled. In practice, it should include within the licence condition a requirement for Sky to make available the channels which are the subject of the wholesale must-offer obligation in a form which does not include excessive promotions as described above.

Resolution of complaints

- 13.8 In its Third Pay TV Consultation Document, Ofcom has stated that:

*“Whilst our preference is for prospective retailers and Sky to reach commercial agreement in relation to supply of the relevant channels and content, in the event that a complaint is brought to us, we would normally follow [our published general guidelines on handling complaints] (or any subsequently published guidelines) in handling the complaint unless there is a good reason to do so”.*¹⁵¹

- 13.9 The Parties would emphasise that an effective and timely dispute resolution process will be crucial to the successful implementation and operation of the wholesale must-offer remedy. This is because the wholesale must-offer remedy addresses only Sky’s ability to act on its incentive not to wholesale its premium channels to third parties (or only to do so on uneconomic terms) and will not change Sky’s incentives. Accordingly, Sky can be expected to utilise every opportunity available to it to limit or frustrate the objectives of the wholesale must-offer remedy.
- 13.10 At present, there is only one licence for each of Sky’s premium channels which is, in each case, a TLCS licence. Once the wholesale must-offer remedy is implemented in respect of pay TV retailers on the DTT platform, Sky’s DTSPS and the relevant Mux licence will need to be amended in order to include the relevant Sky premium channels within the licensed service that is broadcast on that DTT Mux. As a consequence, once that happens, it may well be appropriate for the new condition (which Ofcom is proposing in order to implement the wholesale must-offer remedy) also to be inserted in Sky’s DTSPS licence.
- 13.11 In the event that Sky breaches the new licence condition, Ofcom should ensure that (despite the insertion of the new condition in Sky’s DTSPS licence) Ofcom can take enforcement action under the TLCS (even in respect of third party pay TV retailers on DTT) as it appears that the maximum amount that Ofcom can fine Sky for a licence breach relates to the qualifying revenue in respect of the relevant licensed service. In that context, it seems highly likely that the qualifying revenue that Sky earns under its TLCS will be greater than the corresponding figure under the DTT licences. Ofcom also needs to be willing to issue directions to Sky in order to ensure compliance with the new licence

¹⁵¹ Paragraph 9.240 of Ofcom’s Third Pay TV Consultation Document.

condition (for example, in respect of a failure by Sky to produce the requisite minimum security requirements – see Section 15 below).

- 13.12 Whilst the Parties consider that Ofcom is best placed to resolve complaints about Sky’s conduct under the wholesale must-offer remedy, for the reasons set out below they believe that Ofcom’s current Guidelines¹⁵² may not provide an effective basis for resolving those complaints and ensuring the efficient implementation and operation of the wholesale must-offer remedy.
- 13.13 There is, for example, a lack of clarity as to how Ofcom’s current complaint handling process, as set out in the Guidelines, would be applied in the context of conditions imposed under section 316 of the Communications Act. Specifically:
- (a) although the Guidelines state that they apply to conditions imposed to ensure fair and effective competition in broadcasting,¹⁵³ there is very little further reference to the approach that will be adopted in relation to such conditions. Indeed section 9 of the Draft Guidelines, which deals with enforcing *ex ante* conditions and rules, does not mention conditions imposed under section 316 and makes reference only to enforcement action that would apply in relation to conditions imposed under section 45 of the Communications Act;
 - (b) in practice, the Guidelines are each drafted very much from the perspective of new complaints being brought to Ofcom and do not obviously contemplate complaints being raised in respect of conditions imposed by Ofcom after a long running detailed investigation. In consequence, the majority of the content of the Guidelines does not appear appropriate for dealing with issues relating to the implementation and operation of the wholesale must-offer remedy; and
 - (c) as far as the Parties are aware, Ofcom has not yet enforced a specific fair and effective competition provision in a licence so there is no precedent to inform interested parties in relation to the processes that will be adopted.
- 13.14 As the Guidelines do not specifically address the process to be adopted in dealing with complaints being raised in respect of a condition imposed by Ofcom under section 316, the processes set out in the Guidelines may well not be an effective means of resolving disputes arising in the context of the

¹⁵² Ofcom’s Guidelines for the handling of competition complaints, and complaints and disputes about breaches of conditions imposed under the EU Directives, July 2004 (“*Complaints and Disputes Guidelines*”) and its Draft Enforcement Guidelines of 6 July 2006 (“*Draft Guidelines*”) (together referred to as the “*Guidelines*”).

¹⁵³ Paragraph 20 of the Complaints and Disputes Guidelines and paragraph 3.11 of the Draft Guidelines.

wholesale must-offer remedy. A number of illustrative examples are set out below:

- (a) under the Guidelines Ofcom has considerable discretion as to whether to open an investigation.¹⁵⁴ Notwithstanding the fact that most of the factors which Ofcom states it will take into account in deciding whether to open an investigation should be irrelevant in the context of the wholesale must-offer remedy, there is no certainty that Ofcom will open investigations into complaints about the implementation and operation of the remedy. This lack of certainty would be very likely to be gamed by Sky. Accordingly, greater certainty is required in relation to the circumstances in which Ofcom would be prepared to resolve complaints in relation to the wholesale must-offer remedy;
- (b) under the Guidelines, Ofcom requires a significant level of information before accepting a complaint.¹⁵⁵ In cases in which an urgent decision is required, this will place an unacceptable burden on the Parties given that Ofcom would already have considerable information relating to the pay TV market and the wholesale must-offer remedy;
- (c) Ofcom has a target timetable of four months for a closure statement or notification that Ofcom has reasonable grounds for believing that an *ex ante* condition has been breached.¹⁵⁶ However, this four month period is merely a “*target*” and there is no guarantee that complaints will be resolved within this period. Further, this four month period only starts once Ofcom has decided to open an investigation and accordingly the period for resolve a complaint may be longer than four months because there will be a delay (of up to 15 working days¹⁵⁷) between the receipt of any complaint and Ofcom taking a decision whether to open an investigation. This period would be far too long in circumstances in which Sky has breached the wholesale must-offer remedy.¹⁵⁸ It is therefore necessary for Ofcom to be able to take action more quickly in relation to complaints arising in the context of the wholesale must-offer remedy. This is particularly the case given:
 - (i) Ofcom has extensive knowledge on the operation of the pay TV market which it has acquired during the course of the pay TV market investigation. Ofcom will be well-placed to take advantage of this learning when faced with a complaint; and

¹⁵⁴ See, for example paragraphs 4.42 of the Draft Guidelines.

¹⁵⁵ See, for example, paragraphs 33 to 43 of the Complaints and Disputes Guidelines and paragraphs 4.9 to 4.18 of the Draft Guidelines .

¹⁵⁶ Table 4 of the Complaints and Disputes Guidelines and Table 1, page 28 of the Draft Guidelines.

¹⁵⁷ Draft Enforcement Guidelines, paragraph 4.5.

¹⁵⁸ See paragraph 5.16 of the Draft Guidelines.

- (ii) Ofcom has already been made aware of ways in which Sky may attempt to game the wholesale must-offer (the Parties have made various submissions on this) and has considered, at least to some extent, the likelihood of Sky behaving in these ways; and
 - (d) the Guidelines indicate that investigation teams will be established on an *ad hoc* basis to deal with complaints as and when they are received and investigations are opened.¹⁵⁹ There is, therefore, no guarantee that a team which is established to investigate a complaint about the operation of the wholesale must-offer remedy will be made up of Ofcom staff that were involved in the pay TV market investigation, which would be the most sensible approach in order to ensure consistency and promote the efficient and speedy resolution of complaints.
- 13.15 Against the above background there is a real risk that if Ofcom relies on the procedures set out in its Guidelines for resolving complaints arising in the context of the wholesale must-offer, this will give rise to a slow and inefficient process. Quite apart from providing little legal and commercial certainty for rival retailers, this outcome would provide Sky with the ability to game the wholesale must-offer regime at every opportunity.¹⁶⁰ In the meantime Sky will be able to inhibit the ability of rival retailers to provide effective competition to Sky. This would be to the ultimate detriment of consumers. In circumstances in which Ofcom has spent almost three years investigating and consulting on the pay TV market it would be absurd for the efficacy of the wholesale must-offer regime to undermine for the want of an effective enforcement regime.
- 13.16 Given the Parties' misgivings about Ofcom relying on the Guidelines to enforce the wholesale must-offer regime, the Parties believe that it would be appropriate for Ofcom to set out specific guidelines relating to the enforcement of the wholesale must-offer remedy (i.e. Wholesale Must-offer Enforcement Guidelines). This would be similar to the way in which Ofcom has consulted on specific guidelines relating to the enforcement of BT's undertakings.¹⁶¹ By publishing Wholesale Must-offer Enforcement Guidelines, Ofcom will be able to address many of the concerns the Parties have raised above.
- 13.17 The Wholesale Must-Offer Enforcement Guidelines would need to cover the entire complaints handling and investigation process relating to complaints arising from the wholesale must-offer remedy, including:
 - (a) confirmation of the form and detail required in any complaint about the remedy. In this connection, the Wholesale Must-offer Enforcement Guidelines must take into account the fact the Ofcom

¹⁵⁹ See, for example, paragraph 4.32 of the Draft Guidelines

¹⁶⁰ This is because there will be no guarantee that Ofcom will take any action to prevent such behaviour and that even if it does, it is likely to take a considerable time to reach a conclusion.

¹⁶¹ See section 8 of the Draft Guidelines.

has extensive background knowledge on the pay TV market and the operation of the wholesale must-offer remedy, and therefore should not require complainants to reproduce this information;

- (b) the threshold for opening an investigation. The threshold should be low, and there should be a presumption that an investigation will be opened when a complaint is brought to Ofcom having regard, in particular to the following:
 - (i) the fact that Sky has the incentive and ability to game and undermine the wholesale must-offer remedy;
 - (ii) Sky is highly likely to attempt to game the wholesale must-offer remedy by undertaking a series of what may seem inconsequential measures but would, in aggregate, impact the effectiveness of the wholesale must-offer; and
 - (iii) Sky has considerable market power and accordingly benefits from a very strong bargaining position when negotiating with pay TV retailers in relation to the supply of premium pay TV channels. In this connection, it certainly should not be assumed that the parties will be able to reach a commercially-negotiated solution; and
- (c) timing of the handling of a complaint and any subsequent investigation. For reasons set out above, the Parties consider that investigations should be completed considerably faster than the four months period suggested by the Guidelines. In relation to certain issues, for example a failure to commence supply on time at the outset of the remedy or refusal to supply on the grounds of unreasonable security requirements or the discontinuation of supply for any reason, it may be appropriate for interim decisions (at least) to be taken by Ofcom within a matter of days.

14. Reference offer and qualifying criteria

14.1 In its Third Pay TV Consultation Document, Ofcom states that:

*“We would expect that the terms offered by Sky to prospective retailers to be fair reasonable and non-discriminatory”*¹⁶² and

*“We continue to believe that it would be appropriate for Sky to produce a reference offer which would form the basis of its commercial arrangements with third party retailers”*¹⁶³.

¹⁶² Paragraph 9.229 of Ofcom’s Third Pay TV Consultation Document.

- 14.2 When determining whether that reference offer is fair, reasonable and non-discriminatory (“FRND”), Ofcom must ensure that it is not more onerous than industry norms established world wide in respect of the wholesale supply of premium channels where there is approximate parity between the bargaining strength of wholesalers and retailers.
- 14.3 Given the need for the Parties to be able promptly to start retailing Sky’s premium channels on the basis of economically viable wholesale rates, Ofcom must ensure that Sky makes available its reference offer to the Parties within one month of a decision by Ofcom to impose the wholesale must-offer remedy.
- 14.4 Ofcom acknowledges that a key issue:
- “... when considering which third parties could exercise the wholesale must-offer remedy [is] ... to determine whether retailers ... meet certain qualifying criteria”*¹⁶⁴
- 14.5 Ofcom elaborates by stating:
- “Sky could identify a number of objectively justifiable reasons why it would not wish to wholesale its channels to a prospective retailer ahead of individual negotiations. For example, Sky would legitimately want to ensure that a prospective retailer’s platform was sufficiently secure to avoid compromising the value of Sky’s own retail proposition, and that the prospective retailer could deliver the wholesale channels to a reasonable quality to avoid deteriorating Sky’s wholesale channel brands. Documenting these criteria and making them available to prospective retailers would provide increased clarity of the criteria that retailers are expected to meet and could reduce concerns over discrimination by providing increased transparency”*.¹⁶⁵
- 14.6 With regard to the minimum qualifying criteria, Ofcom only specifically identifies “*picture quality, support for access services and parental control*”.¹⁶⁶ When taking its final decision in respect of the wholesale must-offer remedy, Ofcom must ensure that these objectively justifiable and reasonable minimum qualifying criteria are not more onerous than industry norms established world wide in respect of the wholesale supply of premium channels where there is approximate parity between the bargaining strength of wholesalers and retailers.
- 14.7 For example, ESPN is currently broadcast on cable, DTT and DSat in the UK. This channel and brand are part of the Disney corporate group which has a significant presence and reputation worldwide in respect of sports broadcasting. ESPN will be no less concerned than Sky about possible deterioration to its channel brand if picture quality for its channels on certain platforms is

¹⁶³ Paragraph 9.230 of Ofcom’s Third Pay TV Consultation Document.

¹⁶⁴ Paragraph 9.213 of Ofcom’s Third Pay TV Consultation Document.

¹⁶⁵ Paragraph 9.215 of Ofcom’s Third Pay TV Consultation Document.

¹⁶⁶ Paragraph 9.216 of Ofcom’s Third Pay TV Consultation Document.

inadequate. As a result, the acceptable video bit rate for ESPN is clearly a relevant benchmark to which Ofcom must have regard when assessing the reasonableness and objectivity of Sky's minimum qualifying criteria. In this context, the Parties understand that ESPN is currently broadcast on DTT with an average total bit rate of approximately 2.5 Mb/s.

- 14.8 With regard to the reference to "*parental control*", such functionality has no relevance to Sky Sports. It is, however, relevant to Sky Movies as Sky is entitled to include movies in its encrypted movie channels which have a more restricted viewing rating (e.g. 12 and PG) before the watershed provided they are subject to a mandatory PIN. As in relation to other non-price terms, Sky should not be able to impose any standards for parental controls beyond those that are required in regulations (for example Ofcom's Broadcasting Code) and/or are common practice in the UK.
- 14.9 Finally, in addition to the enforcement of the wholesale must-offer obligation through administrative proceedings in respect of breach of a licence condition, as described in section 13 above, it would be desirable if third party pay TV retailers of Sky's premium channels also had a contractual remedy to pursue (provided that such contractual remedy did not result in Ofcom forbearing from enforcing the licence condition itself). Accordingly, the reference offer should include a commitment by Sky (which would be incorporated into the resulting contractual relationships between Sky and each third party pay TV retailer) to comply with the terms of the wholesale must-offer remedy. This contractual commitment could then be directly enforced by third party pay TV retailers of Sky's premium channels

15. Minimum security requirements

- 15.1 In its Third Pay TV Consultation Document, Ofcom has reiterated its previously stated position that:

*"... perceived concerns over the quality of security arrangements on a particular platform should **not be used by Sky as a reason for withholding wholesale must-offer channels** from that platform unless those reasons can be objectively justified".¹⁶⁷ (Emphasis added.)*

The Parties agree with this view.

- 15.2 Ofcom then states that:

*"We continue to hold the view that it is possible for Sky to set out a set of minimum security requirements which are both platform and CA technology agnostic. Whilst we do not think it is necessary for prospective retailers to participate in the development of the MSRs, **we do expect the***

¹⁶⁷ Paragraph 9.225 of Ofcom's Third Pay TV Consultation Document.

*MSRs set out by Sky to be objectively justifiable. These generic requirements would be made available to prospective wholesale customers to form the basis of more detailed technical, operational and commercial arrangements between specific retailers and Sky, which seek to minimise security breaches and assign liabilities”.*¹⁶⁸ (Emphasis added.)

- 15.3 The draft licence condition on which Ofcom is consulting confirms that Sky must offer to wholesale its premium channels on fair, reasonable and non-discriminatory (“FRND”) terms.¹⁶⁹ Hence, any minimum security requirements proposed by Sky must satisfy this requirement and be FRND (which the Parties understand subsumes the concept of “*objective justification*”).
- 15.4 In the circumstances, it is vital that Ofcom gives detailed consideration to the issue of minimum security requirements ahead of Sky publishing those requirements, so as to ensure that Ofcom is quickly able, following Sky’s publication, to determine whether there is a likely breach of the new licence condition. Thus, Ofcom should identify in advance the security requirements that are applied currently in the UK in respect of the distribution of Sky’s premium channels and in other territories in respect of the distribution of similar channels. The Parties are very willing to assist Ofcom in this regard.
- 15.5 Furthermore, a decision by Ofcom to implement the wholesale must-offer obligation should be accompanied by a clear *ex ante* indication by Ofcom of what would constitute FRND minimum security requirements. Ofcom should also confirm that Sky would not be complying with its obligation to wholesale its premium channels on FRND terms if it sought to impose minimum security requirements that go beyond what is common practice in pay TV markets around the world today.
- 15.6 In order to ensure that the wholesale must-offer obligation is implemented in a timely fashion and that consumers are able to benefit from fair and effective competition as early as possible next year, Ofcom must ensure that Sky does not delay over the production of minimum security requirements. Accordingly, Ofcom must mandate that Sky produces the minimum security requirements (as part of the reference offer) within one month from a decision to impose the wholesale must-offer obligation. Once they are published, Ofcom must quickly determine whether or not they are (or appear to be) FRND. In the event that Sky’s minimum security requirements are not (or do not appear to be) consistent with the new licence condition, Ofcom must forthwith commence enforcement proceedings.
- 15.7 In the context of enforcement proceedings, it is also vital that Ofcom not only contemplates a substantial fine in the event that Sky does not produce minimum security requirements on time which are FRND but also contemplates issuing directions in order to bring this breach of the new licence condition to an end –

¹⁶⁸ Paragraph 9.226 of Ofcom’s Third Pay TV Consultation Document.

¹⁶⁹ Paragraph 11.10 of Ofcom’s Third Pay TV Consultation Document.

i.e., Ofcom must in those circumstances consider directing Sky specifically as to what minimum security requirements it may impose on third party pay TV retailers of its premium channels.

- 15.8 Finally, as Ofcom notes “no CA system is 100% secure”.¹⁷⁰ The Parties agree that the minimum security requirements should include FRND operational procedures in respect of remedial action to be taken in response to a security breach. As is demonstrated by the established wholesale supply terms in respect of premium channels both in the UK and abroad, it would not be FRND for Sky to attempt to supplement these operational procedures with a financial indemnity.

16. Picnic

- 16.1 With regard to Picnic, Ofcom notes in its Third Pay TV Consultation Document, that it has previously:

“...consulted on our view that we should consent to the [Picnic] proposal subject to the following conditions:

- *A wholesale must-offer arrangement ...;*
- *The use of simulcrypt ...;*
- *Ancillary conditions which would focus on our intended outcome for competition and consumers by ensuring that a wholesale must offer arrangement is not easily manipulated to be ineffective, but commercially and technically workable”.*¹⁷¹

- 16.2 In this context, Ofcom must recognise that Picnic will result in increased scope for Sky to prevent competition in the retailing of premium pay TV channels. Two examples are considered below of ways in which the wholesale must-offer remedy must be adjusted in order to ensure that Sky does not, through Picnic, engage practices which are prejudicial to fair and effective competition.

- 16.3 Sky could, through Picnic, unfairly seek to undercut the retail prices of competing pay TV retailers if Ofcom were only to have regard to Sky’s retail prices on DSat when establishing the reference retail prices for the retail-minus methodology. Ofcom must, therefore, ensure that the determination of the reference retail prices (as described in paragraphs 9.3 to 9.19 above) also takes account of any Sky/Picnic retail prices on DTT.

- 16.4 As is noted in section 10 above, TUTV has calculated that, based on the retail margin that will be available to retailers of Sky’s premium pay TV channels on

¹⁷⁰ Paragraph 9.227 of Ofcom’s Third Pay TV Consultation Document.

¹⁷¹ Paragraph 2.59 of Ofcom’s Third Pay TV Consultation Document.

DTT, the maximum SAC that Picnic will be able to afford is £80. If Picnic were, for example, to incur a higher SAC through Sky cross-subsidising Picnic from its other businesses (e.g. its dominant positions in pay TV retailing in general and in wholesaling premium channels) a distortion of competition would result as competing pay TV retailers on DTT would not be able to match Sky/Picnic's increased SAC. As a result, the adjustments that are made to Sky's wholesale prices in order to address changes in its SAC (which are described in section 10 above) must have specific regard to any increases in Picnic's SAC.

- 16.5 Whilst Ofcom outlined certain possible ancillary conditions in its previous consultation on Picnic in September 2008, it has not consulted on actual remedies specifically for Picnic. Accordingly, if Ofcom is still minded to authorise Picnic, it must formally consult on the actual conditions which Ofcom is intending to impose on Sky in respect of Picnic.

17. FAPL

- 17.1 In Section 12 of its Third Pay TV Consultation Document, Ofcom acknowledges that some concerns about the pay TV market would not be resolved by the imposition of the wholesale must-offer remedy, in particular the restricted exploitation of certain content rights. In this regard, Ofcom has considered in more detail the extent to which separate remedies are required in relation to two types of content rights: SVoD movie rights and FAPL rights. This section sets out the Parties' preliminary views as regards FAPL rights. Section 18 below, sets out the Parties preliminary views on Ofcom's proposals in respect of SVoD movie rights.

- 17.2 **[Redacted – confidential]**.¹⁷²

- 17.3 **[Redacted – confidential]**. For example, Ofcom notes that more extensive remedies than the original FAPL commitments would be required in order to generate more effective competition in pay TV. In particular Ofcom notes that:

*“... as a minimum, rival wholesalers [to Sky] would have to win either two packages of live FAPL rights including package A or any three packages of Live FAPL rights”*¹⁷³

- 17.4 **[Redacted – confidential]**.¹⁷⁴

- 17.5 **[Redacted – confidential]**.¹⁷⁵

- 17.6 **[Redacted – confidential]**.

¹⁷² **[Redacted – confidential]**.

¹⁷³ Paragraph 2.114 of Annex 8 to Ofcom's Third Pay TV Consultation Document.

¹⁷⁴ **[Redacted – confidential]**.

¹⁷⁵ **[Redacted – confidential]**.

17.7 [Redacted – confidential].

18. SVoD

18.1 [Redacted – confidential].¹⁷⁶

18.2 In its Second Pay TV Consultation Document, Ofcom identified that where Sky has relevant movie rights, it may have a limited incentive to develop an extensive SVoD movie service because the technical constraints of the DSat platform mean that Sky cannot offer an extensive TV SVoD service. In order to prevent the resulting detriment to consumers Ofcom therefore proposed that it:

*“... would at the very least expect that, where Sky has the appropriate movie rights, and where it uses those as the basis of a subscription VoD service to its own retail customers, it should make a wholesale version of this SVOD service available to other platforms”.*¹⁷⁷

18.3 [Redacted – confidential].

18.4 In its Third Pay TV Consultation Document, Ofcom not only identifies that SVoD rights are of particular strategic importance¹⁷⁸ but also identifies the following market features in respect of SVoD which highlight the existing prevention, restriction or distortion of competition:

- (a) Sky holds exclusive SVoD rights for all six Major Hollywood Studios;¹⁷⁹
- (b) Sky has an incentive to restrict exploitation of these SVoD rights to protect its own linear movie channels and that it appears to be acting on this incentive;¹⁸⁰
- (c) as a result this is damaging the competitive functioning of the market as *“there appears to be a risk that innovation in the development of VoD services may be stifled by the manner in which the VoD rights to premium movies are currently being exploited”*;¹⁸¹
- (d) the evidence of high margins is stronger for Sky’s premium movie channels than it is for its premium sports channels;¹⁸² and

¹⁷⁶ [Redacted – confidential].

¹⁷⁷ Paragraph 9.49 of Ofcom’s Second Pay TV Consultation Document.

¹⁷⁸ Paragraph 12.17 of Ofcom’s Third Pay TV Consultation Document.

¹⁷⁹ Paragraph 12.18 of Ofcom’s Third Pay TV Consultation Document,. The six Major Hollywood Studios are: Disney; Paramount; Sony; 20th Century Fox; Universal; and Warner Bros.

¹⁸⁰ Paragraph 12.19 of Ofcom’s Third Pay TV Consultation Document.

¹⁸¹ Paragraphs 12.21 and 12.28 of Ofcom’s Third Pay TV Consultation Document.

¹⁸² Paragraphs 12.22 and 12.28 of Ofcom’s Third Pay TV Consultation Document.

- (e) reduced innovation and high prices could both be addressed by making SVoD rights available transparently and separately from linear rights.¹⁸³

18.5 **[Redacted – confidential]**.

18.6 As a practicable remedy to address the concerns identified in its Third Pay TV Consultation Document, Ofcom proposes that the Hollywood movie studios should make SVoD rights available separately from linear channel rights. This would be supplemented by a further rule that the same firm cannot buy both sets of rights, which would guarantee that linear and SVoD rights could be exploited independently.¹⁸⁴ **[Redacted – confidential]**.

18.7 Ofcom notes that this form of remedy could be implemented by the Competition Commission following a market investigation reference but considers it may be more constructive first to engage further with the major Hollywood studios to establish whether it is possible to avoid such an intervention by changing the commercial strategies of the studios.

18.8 **[Redacted – confidential]**.

18.9 **[Redacted – confidential]**.

19. Conclusion

19.1 For the reasons set out above, the Parties are broadly supportive of Ofcom’s proposal to deal with its concerns about restricted distribution of Sky’s premium channels by imposing a wholesale must-offer obligation together with an *ex ante* pricing mechanism under Ofcom’s sectoral powers.

19.2 For the reasons set out above, the Parties believe that Ofcom should, however, revise its proposed wholesale must-offer obligation in order to ensure that:

- (i) Sky Sports 3 and Xtra are included within the scope of that obligation; and
- (ii) the retail minus methodology which Ofcom uses to determine Sky’s wholesale prices takes adequate account of the business parameters for a new premium pay TV retailer on DTT – in particular, its likely subscriber numbers, cost of capital, level of fixed costs, churn rate and cost of third party basic channels. Once proper account taken of these parameters, Ofcom should determine wholesale prices for Sky’s premium channels at the bottom of the range on which it is consulting (i.e. Scenario 5).

19.3 **[Redacted – confidential]**.

¹⁸³ Paragraph 12.24 of Ofcom’s Third Pay TV Consultation Document.

¹⁸⁴ Paragraph 12.29 of Ofcom’s Third Pay TV Consultation Document.

- 19.4 As a result of the implementation of the remedies proposed by Ofcom, as modified in accordance with the arguments set out above, consumers will benefit from increased choice, reduced retail prices and greater innovation in pay TV in the UK.
- 19.5 Finally, the Parties note that Ofcom commenced this investigation on 20 March 2007. At this stage, it seems likely that the third anniversary of that date will arrive before the wholesale must-offer remedy is fully implemented. Ofcom must, therefore, not delay in concluding its pay TV investigation and introducing the remedies that are needed in order to enable consumers to benefit from fair and effective competition in pay TV.

Annex 1

Highly attractive content on Sky Sports 3 and Xtra

1. There is a considerable amount of top-flight UK football broadcast on Sky Sports 3 and Xtra. **[Redacted – confidential]**.¹⁸⁵

[Redacted – confidential].

2. In addition, an analysis of Barb data indicates that a live FAPL match was broadcast exclusively on Sky Sports 3 or Xtra on the last day of the season in 2009 (on Sky Sports 3), 2007 (on Sky Sports 3), 2006 (on Sky Sports 3) and 2005 (on Sky Sports Xtra). The broadcast is billed as “*Live Ford Survival Sunday*” or “*Ford Super Sunday*” and attracts sizeable audiences (the matches are amongst the top 20 events measured by audience numbers on Sky Sports 3 and Xtra in each of those years).¹⁸⁶

3. Figure 7 of the Third Consultation Document lists 27 sports events that are broadcast on Sky Sports 1 and 2 and confirms that 17 of those 27 events are also shown on Sky Sports 3 and Xtra. In particular:

- (a) Sky Sports 3 broadcasts a significant proportion (i.e. over 20 per cent measured by hours broadcast) of a number of key live events which are also broadcast on Sky Sports 1 and/or Sky Sports 2 including European Tour Golf, World Golf Championship and Rugby League SuperLeague; and

- (b) Sky Sports Xtra broadcasts a significant proportion (i.e. over 20 per cent measured by hours broadcast) of European Tour Golf as well key tennis events (including Masters Cup Tennis, and US Open Tennis) which are also broadcast on Sky Sports 1 and/or Sky Sports 2.

4. Figure 7 of the Third Consultation Document also indicates that the channels also broadcast a small proportion (i.e. between 2 and 14 per cent measured by hours broadcast) of Champions League matches, England Test matches, non-England ICC Championship, and the County Championship, as well as Rugby Union Heineken Cup and Guinness Premiership matches. In addition, the channels are the main outlet for a substantial volume of minor sports (for example WWE and motor sports). **[Redacted – confidential]**.¹⁸⁷

[Redacted – confidential].

¹⁸⁵ **[Redacted – confidential]**

¹⁸⁶ Figure 7, page 68 of Ofcom’s Third Pay TV Consultation Document indicates that no FAPL content was broadcast on Sky Sports 3 and Xtra in 2008.

¹⁸⁷ **[Redacted- confidential]**

5. The Parties note that the data collated in Figure 7 of the Third Consultation Document focuses on events in 2008. Virgin Media considers, however, that in previous years there is additional evidence that highly attractive live sporting events have been broadcast on Sky Sports 3 and/or Sky Sports Xtra. For example, in 2003 all live World Cup cricket matches and the vast majority of the highlights programming were broadcast on Sky Sports 3. In 2007, a smaller proportion of World Cup live cricket matches were broadcast on Sky Sports 3 and Xtra,¹⁸⁸ but a crucial England match against Sri Lanka as part of the Super 8 stage of the tournament was broadcast on Sky Sports 3 and resulted in the largest audience for a World Cup broadcast across the entire tournament on any channel.¹⁸⁹

¹⁸⁸ In 2007, a small proportion of the World Cup live cricket matches were shown on Sky Sports 3 (approximately 5 per cent, measured by proportion of hours broadcast) and on Xtra (approximately 1 per cent), with the remainder broadcast on Sky Sports 1 (approximately 58 per cent) and Sky Sports 2 (approximately 36 per cent).

¹⁸⁹ Virgin Media analysis of Barb data.